Affinius Capital

Unlocking opportunities in European logistics

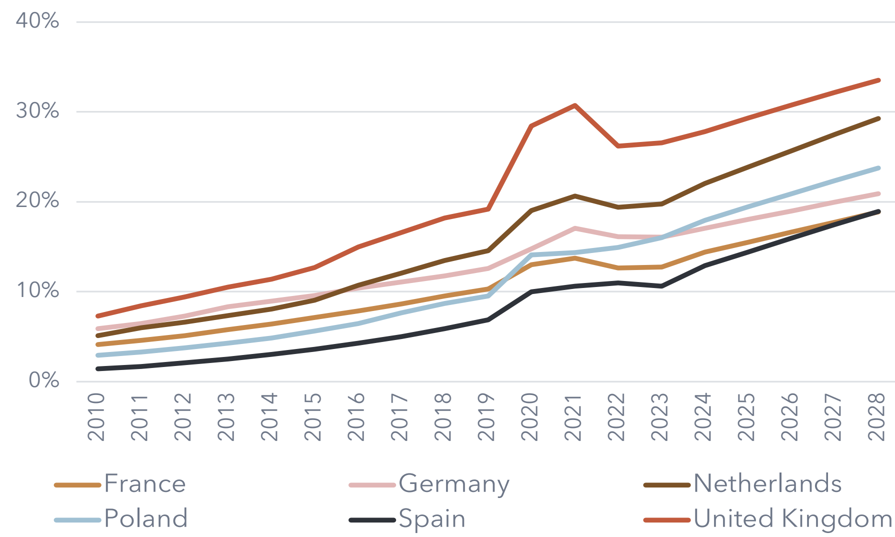
The European economy continues to expand at a steady pace, and although market volatility persists, the environment remains supportive of logistics real estate investment. The sector is supported by strong fundamentals and continued rental growth and, therefore, remains a natural preference for investors. Despite this, new logistics supply is struggling to keep up with the pace of occupier demand. With positive demand-side dynamics and less supply coming online, now is an opportune time to enter the logistics development market in Europe.

Although the economy is still in recovery mode, three key secular themes are expected to underpin demand for modern logistics space: (1) The continuation of ecommerce tailwinds; (2) the reconfiguration of supply chains and nearshoring; and (3) the need for operational efficiency and sustainability. These themes hold significant potential for driving demand for modern-quality logistics stock, which strongly favours a development-led strategy.

Ecommerce: We anticipate future growth in ecommerce to drive demand for logistics space **(Exhibit 1).** It is estimated that for each incremental $1 billion in growth in ecommerce sales, there needs to be an additional 1.25 million square feet of distribution space to support the channel growth. On this basis, we estimate demand for more than 460 million square feet of additional logistics space in Europe during the next five years.[1]

Supply-chain reconfiguration: The movement from just-in-time to just-in-case strategies, centred around holding more inventory to protect against supply-chain disruptions, continues to drive logistics demand. We expect logistics occupiers to continue to look for more space and redundant space to insulate their positions against supply-chain disruption. Related to this trend is a move amongst some logistics users to nearshore activities in Europe. The rising costs of labour, cost of transport, geopolitical factors and social impact, amongst other factors, are driving businesses to examine their sourcing and supply-chain strategies. As a result, European businesses are increasingly considering nearshoring of production and supply.

Exhibit 1: Internet share of all retail (ecommerce penetration)



Source: CBRE, June 2024

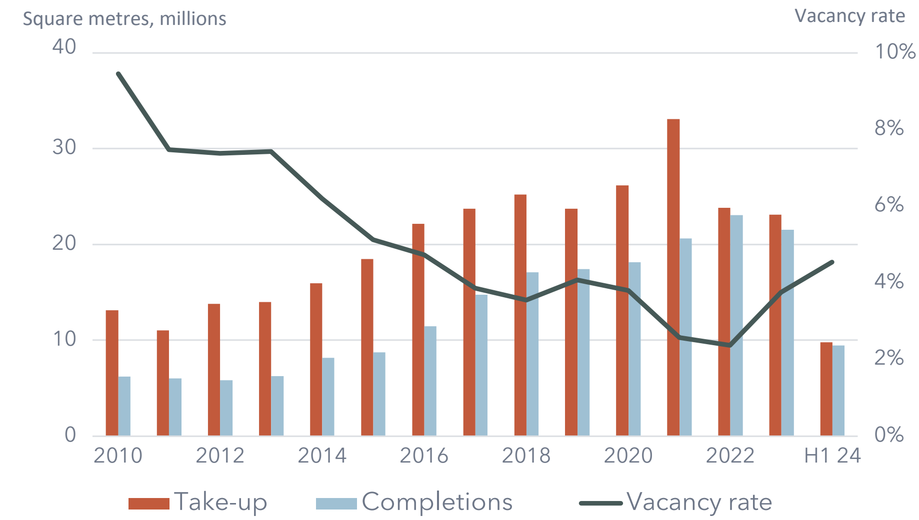
Operational efficiency and sustainability: We continue to see a strong preference amongst occupiers for modern purpose-built logistics facilities. Modern, often larger facilities are better equipped to integrate automation and robotics, resulting in superior operational efficiency. Tenant expectations and environmental regulations also necessitate a focus on modern logistics space.

Resilient market fundamentals

European logistics take-up totalled 22 million square metres (237 million square feet) during the 12 months through second quarter 2024. While this was below the 2021 peak figure of 33.1 million square metres (256.3 million square feet), it is still above the previous decade average, despite an uncertain economic environment in 2023.[2] The moderation in leasing activity has only had a minor impact on the vacancy rate, which increased to 4.5 percent in second quarter 2024 **(Exhibit 2),** although the growth rate is slowing. Delivery of new supply continued to fall, and completions during the first three months of 2024 marked the lowest quarterly figure seen in more than 13 quarters. Low vacancy is continuing to fuel rent growth, which increased by 4.7 percent on average during the 12 months to second quarter 2024.[3]

With less supply coming online in 2024, this could be an opportune time to enter the market, particularly as we see construction costs softening, rents continuing to grow, steady occupier demand, tenant incentives waning and yields stabilising. We see limited risk of oversupply in the coming years due to high barriers to entry. Notably, we expect the lack of suitable land for development, as well as planning and environmental restrictions, to control new development, with an increasing requirement for the redevelopment of brownfield sites. We believe these barriers to entry will continue to support rental growth and investment values in the sector. In addition, elevated borrowing costs have made it challenging for deals to pencil. As a result, we anticipate new supply will be absorbed more quickly than in the past due to increased focus on new facilities and the fact that many developers have put the brakes on new construction projects.

Exhibit 2: European logistics fundamentals



Source: CBRE, June 2024

Growth in investment market

Logistics as an asset class has grown markedly in popularity among institutional investors, due to dependable cashflow, minimal capex requirements and the ability to access locations that can improve over time, as cities grow and expand. In second quarter 2024, European industrial and logistics investment was broadly in line with the same period in 2023. With total European commercial real estate volumes reaching €45 billion ($50 billion) – an increase of 16 percent year-over-year – European industrial and logistics comprised 17 percent of this total.[4]

Logistics has seen the quickest repricing and is now one of the first sectors to see sentiment improve. We think the majority of the valuation adjustment in logistics has occurred, given interest rates are considered to have peaked. The expectation of further rate cuts this year will heighten real estate's investment appeal and should gradually bring investors back into the market. During the next 12 months, the majority of European logistics locations are forecasting yields to remain broadly stable, expecting little movement after continued decompression in 2023. In countries where we have seen strong repricing, such as in the United Kingdom, we can expect to see some inward yield movement during the year.

We see an opportunity to develop logistics assets in Europe with a broad appeal to occupiers and eventual institutional buyers. Healthy occupancy levels and a compelling spread between the cost of new development and the market value of stabilised assets provide a compelling investment opportunity. Although the market has matured during the past decade, there is further to go, with Europe providing one-third as much warehouse space per capita as North America. Development provides an opportunity to mitigate the risks of both physical obsolescence and low tenant renewal probability. New state-of-the-art logistics facilities that meet occupier requirements, including higher clear heights, deeper truck courts, better site manoeuvrability, and a greater focus on sustainability and worker welfare, will have characteristics that improve second-generation renewal and reletting probability.

We believe pricing still adequately reflects a premium for development risk, and with rent growth, will become increasingly accretive. As ever, site selection is critical, but we believe now is a good time for development, and the next wave will be a good vintage. The land market appears to be recovering faster than in past cycles, given the scarcity of consented land; however, we are well positioned to benefit from the current opportunity in the logistics sector. The combination of having a significant consented land bank available for development, well-capitalised development partnerships and long-term relationships with occupiers allows us to deliver best-in-class buildings that will remain resilient as we progress through the real estate cycle.

Notes:

1 Affinius Capital Research and Statista, Ecommerce Europe, accessed 24 June 2024

2 CBRE, first quarter 2024. "Europe" is defined as Belgium, Czech Republic, France, Germany, Italy, Netherlands, Poland, Spain, United Kingdom

3 Ibid

4 Ibid

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