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Modern Logistics: Driving the New Industrial Cycle in Europe

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INVESTORS NEED A MODERN LOGISTICS STRATEGY TO TAKE ADVANTAGE OF THE NEW CYCLE

The European logistics sector has navigated a period of significant adjustment over the past few years. Looking ahead, we see signs that the sector is at an inflection point – be it economic growth, stabilizing occupiers and the demand for modern stock.

The most notable shift is in the demand for modern product with higher specifications which are increasingly required by tenants and their changing distribution requirements. We believe modern product will be the cornerstone of a successful logistics real estate strategy, particularly in the context of rapid technological advancements and evolving ESG standards.

Whilst it is near impossible to time market cycles, we believe there is compelling data to suggest that meaningful opportunities are beginning to present themselves to investors looking to add or build logistics exposure in Europe.

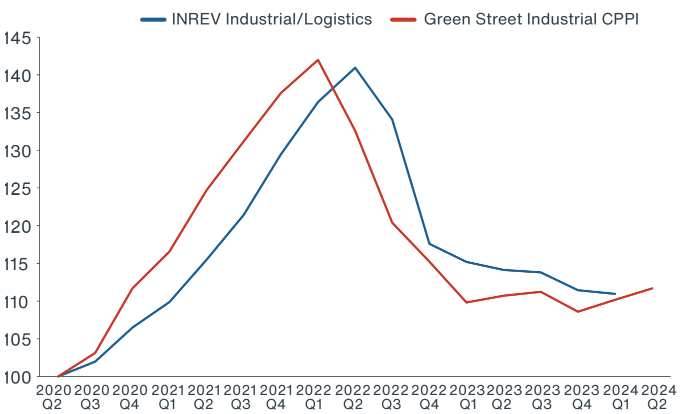
LOGISTICS MARKET REPRICING MOSTLY COMPLETE

We believe that the asset value correction driven by rising interest rates is largely complete and that investors need to look forward to what may be a favourable entry point. The gap between spot prices and valuations has narrowed substantially, and Green Street's Pan-European Industrial CPPI has increased by 2.8% since the start of the year, with a recovery in values underway as highlighted by *(Figure 1)*.

REPRICING HAS PUSHED YIELDS HIGHER MAKING LOGISTICS COMPELLING

From an income perspective, logistics assets remain competitive compared to other sectors, with a 5.8% cap rate—comparable to offices but with better net operating income growth prospects—and meaningfully above the 4.3% cap rate for residential properties[1]. Reversion potential and future income growth set logistics apart and support tighter spreads with the cost of debt in our view.

FIGURE 1: LOGISTICS CAPITAL VALUES HAVE TURNED A CORNER



Source: INREV, Green Street, Clarion Partners Investment Research, Q2 2024.

TIDE MAY BE TURNING FOR OCCUPIER MARKET

Vacancy Rates Return to Pre-Pandemic Levels, But Remain Low

As Covid-19 has subsided, the normalization of e-commerce from pandemic highs has normalized occupier demand. In some markets, especially the UK, this downturn coincided with a surge in new deliveries. Consequently, vacancy rates have been rising (but still low) compared to long-term averages. The pan-European vacancy rates stood at 4.3% in Q2 2024[2].

As demand has cooled, so has development activity. Value declines, financing challenges, and high (though stabilizing) construction costs have hindered new projects. European logistics stock grew at an annualized rate of 5% in the first half of 2024—the slowest pace since 2015 and significantly lower than the 7.4% peak in 2021. By the end of Q2, only 3.8% of European stock was under active construction[3]. Countries like France (-62%) and the UK (-56%) have seen sharp declines in speculative development, which should help limit future vacancy[4]. Most of the supply deliveries are now built in and investors should start sharpening their pencils in anticipation of hardening demand particularly for modern stock.

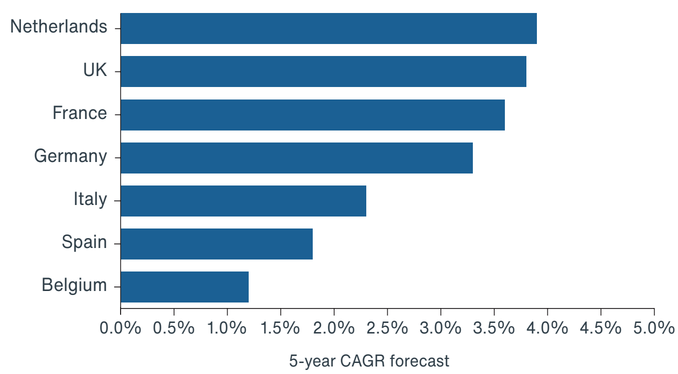
The Economic Environment is Shifting From a Headwind to Tailwind

Economic sentiment has improved in Europe with the shock of the Ukraine conflict wearing off. Economic activity should become a tailwind not a headwind, a shift from six months ago that should positively impact rebounding demand. According to Bloomberg's latest consensus, Eurozone growth is projected to reach 0.7% in 2024 and 1.4% in 2025. Additionally, there are indications that e-commerce activity is picking up and that some of the "grey" space is being reabsorbed. In the UK, sublet space as a proportion of total supply has decreased to 9.9%, down from a peak of approximately 21% in 2023[5].

However, some near-term caution is warranted in the occupier market due to recent softening in PMI indicators[6] and ongoing weaknesses in the manufacturing sector. On a brighter note, there are signs of recovery in European take-up for Q2 2024, which increased by 16% from the previous quarter and 5% compared to the same quarter last year[7].

Short-term slowdown notwithstanding, we expect rental growth to continue and to be stronger in core Western European markets, as depicted in *(Figure 2)*.

FIGURE 2: RENTAL GROWTH EXPECTED TO CONTINUE



Source: Clarion Partners Investment Research, Q2 2024.

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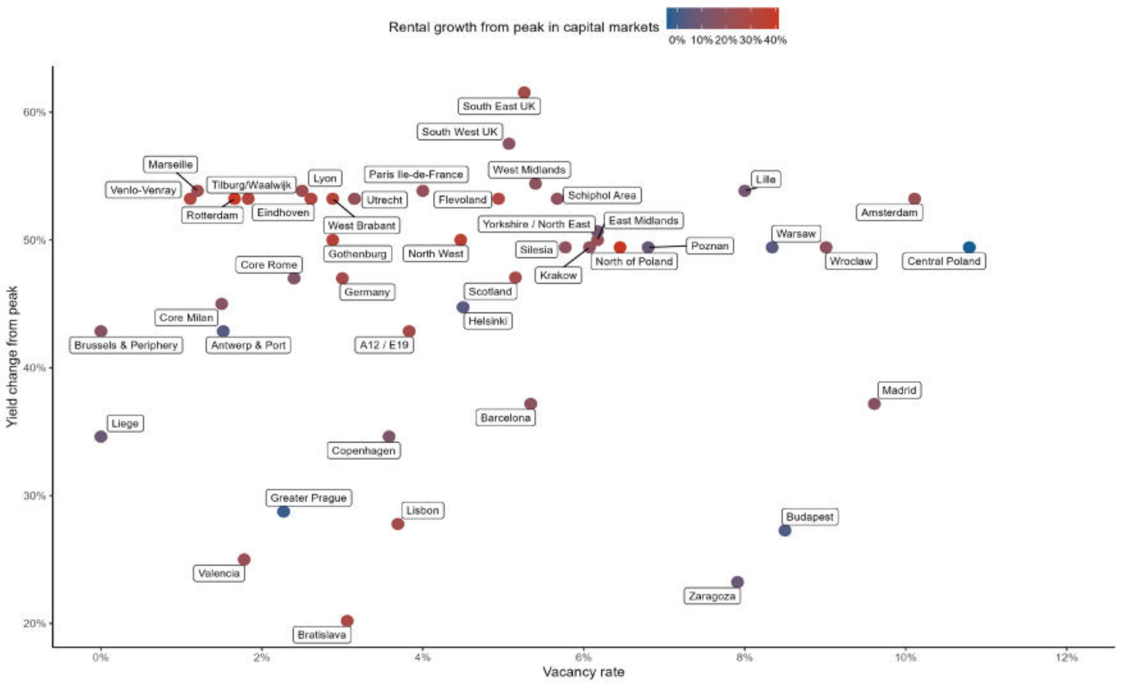
Positioning Portfolios for Growth

We believe that market selection is always important in identifying long-term outperformers especially in the context of logistics and the shifts towards more modern product. In our analysis, we identify European logistics markets which have seen the largest drawdown in values but have maintained relatively low vacancy as potential outperformers (top left quadrant in *Figure 3* below). These markets, in our view, offer greater upside potential within the context of continued rental growth. Key markets include most of the Netherlands, Germany, certain UK regions like the North West, and Lyon/Marseille in France. With vacancy rates expected to remain low, growing obsolescence in existing stock and construction costs decreasing, development in these areas is likely to become an increasingly attractive risk-adjusted strategy for gaining exposure.

Conversely, markets in the bottom left quadrant appear less attractively priced at this stage of the cycle, despite relatively strong fundamentals as yields may have to widen further. This includes parts of Belgium, Spain, and the Czech Republic. In the top right quadrant, while there may be varying degrees of leasing risk due to higher vacancy rates, opportunities exist—particularly in areas where recent rent growth provides some downside protection, such as regional UK markets and parts of Poland.

FIGURE 3: MARKET POSITIONING IN THE CAPITAL MARKETS AND LEASING CYCLE



Source: CBRE, Clarion Partners Investment Research, Q2 2024.

Modern Logistics: The Cornerstone Of a Successful Logistics Strategy

Asset selection is crucial too. We believe that modern logistics facilities have the potential to outperform older stock for a number of reasons, including:

Modern Logistics Offer Cost-Efficient Solutions

To take advantage of the burgeoning cycle, investors should tailor their logistics portfolio to the future, which is increasingly modern, new build assets that offer high specifications, are more efficient and therefore potentially allowing for a reduction in operating costs.

Modern buildings often come equipped with cost-efficient features such as improved insulation, more efficient heating systems, motion-activated LED lighting, building management systems, and smart metering, among others.

Modern warehouses are better suited for automation and the integration of new supply chain technologies like Radio-Frequency-Optimization (RFID), which enhances their flexibility and makes them more future-ready. These facilities typically offer higher clear heights, allowing for more efficient use of vertical space, and are often equipped with multiple cross docks to streamline the flow of goods. Such features are crucial for tenants aiming to meet newer delivery standards and maintain a competitive edge in a rapidly changing market.

By helping occupiers being more efficient and reducing operating costs, modern warehouse can command high rents. Rents and service charges continue to account for a relatively low share of logistics costs (less than 10% for most of occupiers[8]) as other expenses have risen more sharply. Furthermore, occupier revenues, particularly in e-commerce, have outpaced rent increases[9].

ESG Targets Drive Demand for Modern Facilities

Efficiency and sustainability considerations are highly intertwined, with occupiers' ESG goals shifting demand toward more modern buildings. For example, 64% of occupiers plan to achieve net-zero emissions before or during 2030[10], with companies like DHL Supply Chain committed to 100% net zero-carbon warehousing by 2025[11]. Third-party logistics providers (3PLs) are under pressure to enhance their ESG credentials to secure customer contracts.

Solar panel installations, energy storage systems, heat pumps, and EV charging stations are some of the key features that can help occupiers meet their ESG objectives. With transportation often responsible for a significant portion of logistics occupiers' carbon emissions—83% or more for a well-known 3PL[12]—fleet electrification is becoming a top priority. Consequently, having on-site infrastructure to support this transition is increasingly essential. While the economics of solar installations can be complex, with various operating models available, owners can typically expect a payback period of 5 to 8 years and an IRR of 6% to 10% over a 20 to 25-year period.[13]

Despite ongoing efforts, 40% of occupiers recognize that 25% to 45% of their current footprint will become obsolete by 2030 without substantial investment[14]. It's no surprise, then, that around 60% of logistics stock in Western Europe is over 10 years old[15]. Modernizing this stock has therefore become a critical necessity.

Older Buildings Will Struggle for Occupancy

The recent increase in new supply has rebalanced the market, allowing occupiers to be more selective in their building choices - an option that was limited in the tighter post-pandemic market. Occupier preference for modern facilities is not new, but the proportion of new builds in total take-up has reached new heights in some markets (e.g., 80%+ in Italy and the UK[16]), as new developments satisfy pent-up demand.

Modern logistics facilities are also benefiting from consolidation in certain sectors. For instance, e-commerce operators like Amazon are moving out of first-generation buildings and into more modern, functional spaces. As a result, most of the vacant space is now second-hand: 80%+ in the Netherlands, 70%+ in Spain and 60%+ in France[17]. The UK is a notable outlier due to recent strong inflows of new deliveries.

CONCLUSIONS

We believe that the European logistics market is at a critical turning point, with key indicators pointing to a new investment cycle. Asset values have reset significantly, occupier markets remain tight by historical standards, and there is cautious optimism about Europe's economic outlook. Investors need to position themselves to take advantage by focusing on the future – which are new build, modern facilities that offer tenants state of the art distribution options.

Supply chain is increasingly a technology-driven business, and we believe that to capitalize on the recovery and achieve superior long-term returns, investors need to focus on building a modern logistics portfolio designed to meet the evolving demands of tenants today and tomorrow. We are at a turning point in the logistics cycle; investors need to position themselves by orienting to the future.

[1]Green Street economic cap rate, Q2 2024.
[2]Clarion Partners Investment Research calculations based on CBRE data, Q2 2024.
[3]Clarion Partners Investment Research calculations based on CBRE data, Q2 2024.
[4]Clarion Partners Investment Research calculations based on CBRE data, Q2 2024.
[5]Savills, August 2024.
[6]HCOB Eurozone Composite PMI, August 2024.
[7]Clarion Partners Investment Research calculations based on CBRE data, Q2 2024.
[8]European Logistics Occupiers Survey, CBRE, July 2024.
[9]Prime European Logistics Performance, CBRE, December 2023.
[10]European Logistics Occupier Survey 2024, CBRE, July 2024.
[11]Planning Future-Ready Logistics Real Estate, DHL Supply Chain.
[12]Is the Logistics sector delivering on ESG?, Knight Frank, 2023.
[13]Clarion Partners Investment Research based on conversations with market participants.
[14]European Logistics Occupier Survey 2024, CBRE, July 2024.
[15]Clarion Partners Investment Research calculations based on CBRE data, Q2 2024.
[16]Clarion Partners Investment Research calculations based on CBRE data, Q2 2024.
[17]Clarion Partners Investment Research calculations based on CBRE data, Q2 2024