

# PERE

## Logistics

February 2022 • perenews.com

# Supply change

How logistics is racing to meet demand



# KEYNOTE INTERVIEW

## Balancing pricing and rental growth in European logistics



*Core industrial property prices have never been as elevated as they are now, so selecting assets for which occupiers will pay higher rents is increasingly crucial to investment performance, argues UBS Asset Management's **Brice Hoffer***

Rental growth for logistics space has remained strong in key European markets over recent quarters. However, increases cannot be relied upon to outstrip inflation across the whole sector, even in the near term, cautions Brice Hoffer, head of real estate research and strategy for the DACH (Germany, Austria and Switzerland) region at UBS Asset Management. And with pricing reaching hitherto unheard-of levels, he argues that to underwrite industrial transactions successfully, investors need to understand the asset-level factors that will drive performance.

**Q** Has high pricing in European logistics markets deterred investors

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#### from committing capital to the sector?

Definitely not. According to Real Capital Analytics, the first three quarters of 2021 saw record transaction volumes for logistics of more than €40 billion in total, despite yields of less than 4 percent in many prime markets. Demand is not being driven by investors looking at entry yields, but by the structural trends that are lifting the market. In that respect, it is similar to the private rented residential market, where demographic trends are expected to support demand over the coming decade.

Logistics is very strongly supported by an occupier market that has been propelled by e-commerce demand, which has been accelerated by the pandemic. For a while, the pandemic caused intense disruption to supply chains. That is now fading, but in the meantime, stock was depleted massively, and so many businesses are now restocking, which is an additional cyclical driver of demand for logistics.

Whether a manager is investing for their own funds or for a specific mandate, they have the comfort of knowing that in residential, and particularly in logistics, the demand is unquestionable, so the asset will probably remain fully occupied. Those sectors also benefit by comparison with retail, which

is suffering the flipside of the e-commerce effect, and also with offices.

Even if we do not buy the office apocalypse story, and we think for good offices demand will remain strong in the occupational and investment markets, there are still a lot of questions over which assets will be resilient. That uncertainty in other asset classes continues to support demand for logistics assets in Europe.

**Given the low cap-rate environment, what can logistics investors do to drive performance?**

At the pricing levels we see now, it is essential for investors to drill down into the details of the individual market, sub-market and of the asset itself to know if they are being paid appropriately for risk. In the following core markets of continental Europe – France, the Netherlands and Germany – sub-4 percent yields are the new normal.

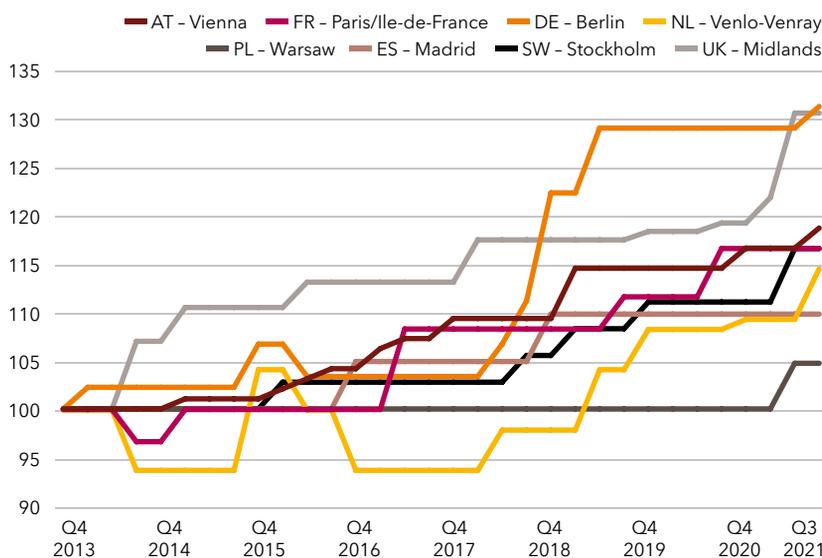
In secondary markets like Central and Eastern Europe, and in Southern Europe, entry yields are higher, but the demand drivers are still strong, so an increasing volume of capital is flowing into those locations. The UK also offers something of a yield gap compared with prime continental markets, although that gap is shrinking as Brexit-related uncertainty gradually fades.

Meanwhile, rental growth is becoming an increasingly important component of investment performance. As many logistics businesses operate on relatively tight margins, it is too optimistic to underwrite across-the-board rental growth that will outstrip inflation. Research consultancy PMA forecasts that in several markets, rental growth will run only just ahead of inflation in the period to 2025.

However, if an investor can identify a location where the tenant can make the highest possible savings on their operating costs, which for logistics firms means transportation, then the occupier will be willing to accept a higher level of rental growth.

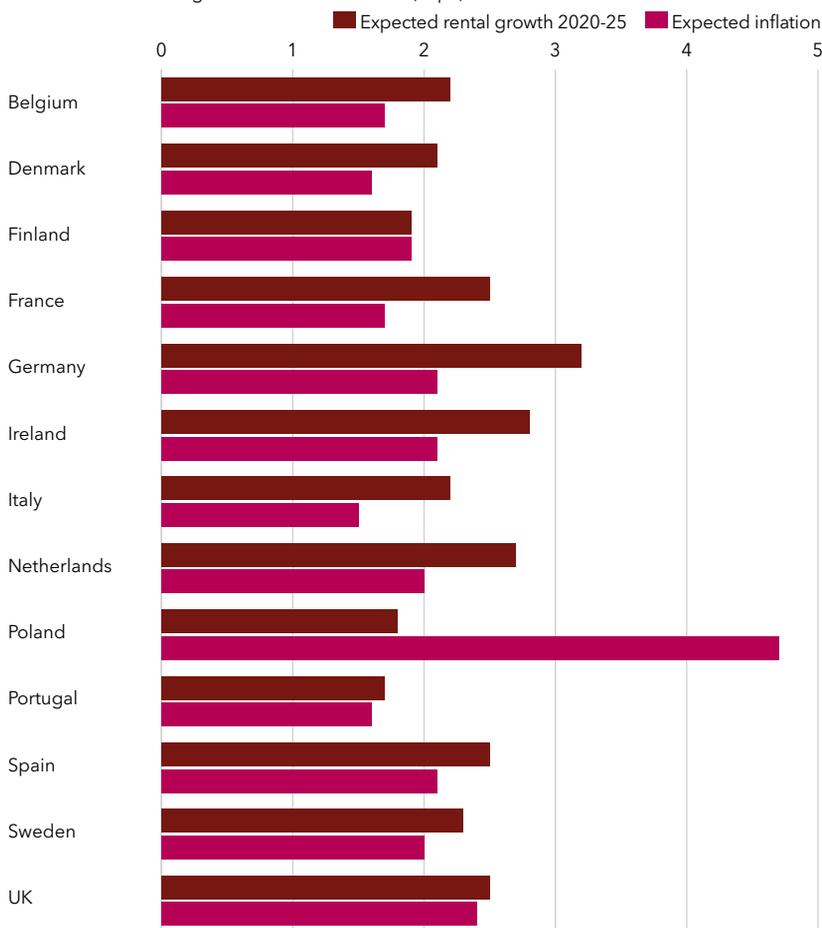
**Positive momentum continued in 2021 for European rental growth...**

Prime industrial rent indices (100 = Q4 2013 level)



**... but mid-term outlook should run just ahead of inflation in several markets**

Prime industrial rental growth forecast from PMA (% pa)



Source: PMA October 2021; UBS Asset Management, Real Estate & Private Markets

### **Q Do other sub-asset classes within the industrial sector represent good value?**

Yields for manufacturing and light industrial space have not compressed to the same extent as those for logistics assets serving e-commerce. But there are trends at play in those sectors that will potentially support demand there too.

The consequence of the pandemic is likely to drive the reshoring of certain activities to Europe. Whether yields for that space will compress as sharply is another question, but it is likely to be strong from a demand-driver perspective. There is also potential to modernize and convert light industrial space to serve distribution users. Investors doing that need to be very selective about the location, ensuring it is one where occupiers can save on transport costs, so that it will generate the higher rental growth that offsets the capital expenditure needed for repositioning.

As with all value-add strategies, success depends heavily on the price paid and the strength of the demand driver, which enable the investor to let the finished product at a higher rent.

Locations within urban agglomerations may also see higher rental growth. Competition with other uses like retail, office and even residential drives up land prices. A tenant who wants to secure that site for urban logistics use is likely to accept a higher-than-average rent.

Prime locations have seen higher rental growth over recent years than was the case in the past, but prime is not the average of the market, and the cost of investing in those locations is that you enter at a lower yield than the market average. At the entry yields we currently see in those locations, investors need to make sure the location of the asset and the nature of the tenant support a rental growth story for their underwriting to work.

### **Q What other factors will determine the rental growth potential?**

*“Demand is not being driven by investors looking at entry yields, but by the structural trends lifting the market”*

The modernity of the asset is important in generating rental growth. The ESG theme will undoubtedly continue to grow in importance within the industrial sector. Historically, logistics facilities have been poor performers in environmental terms. More efficient modern assets, and those that have been improved to bring them up to current standards, will soon show a competitive advantage, both in terms of demand from tenants and from investors.

Investing in a building that is not very modern or energy-efficient may work fine now, there may even be some cap-rate compression. However, investors, occupiers and regulators are starting to look much more closely at these issues, and that risk is not yet priced in for many older logistics assets in Europe. It may be more of a problem for industrial than for other commercial real estate sectors because substantial capex will be needed to make older industrial buildings energy efficient.

### **Q Is there any danger that increasing supply will undermine values?**

There has certainly been an increase in development activity over recent years. According to current data from PMA, we saw record delivery of new space in 2021, with 215 million square meters constructed in continental Europe and the UK. We see that as a positive sign because it creates more opportunity for strategic buyers. There is little threat that construction will upset the

demand-supply balance. The end-user appetite for modern logistics facilities is huge, so development will not derail the strong market fundamentals that we see now. Even in locations with relatively good land availability like Poland, oversupply is not a concern because the pent-up demand for modern logistics assets there is huge. The structural change in the market still has a long way to run, so we actually need more supply. Eventually it may reach a level where it becomes a problem, but that is unlikely to be the case for the next two years, at least.

### **Q Is the outperformance of the European industrial sector at an end?**

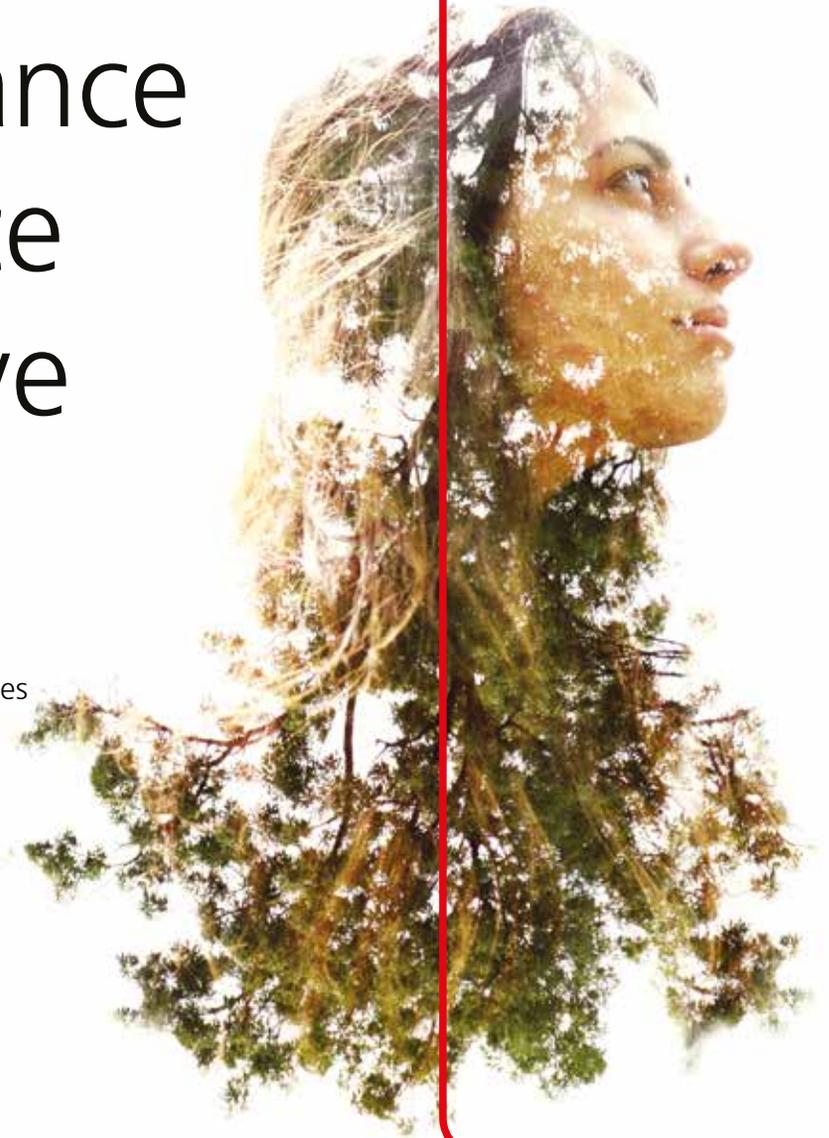
Over the short to medium term, two or three years, we do not think there will be major changes in the performance of any of the commercial real estate sectors. Logistics will still be the top outperformer, ahead of residential. More cap-rate compression will help. While yields are already low, we expect that there is further to go, and in some locations there will also be strong rental growth, especially when compared to other sectors like offices and retail.

Beyond three years, it is difficult to forecast. It could be that the bottom is in sight for the correction taking place in retail property markets. If that is the case, as the logistics market becomes even more expensive and investors seek higher-yielding assets, capital may begin to shift toward retail four or five years from now. At that point we will call the end of the outperformance of logistics, and investors will start to migrate to other property sectors, and perhaps to other niches within the industrial sector like manufacturing and light industrial.

In the meantime, however, in a competitive market like logistics, it will remain crucial to drill down into the detail of each investment. When you take a high-level view, a transaction may look like a good idea, but a great deal still depends upon buying at the right price. ■

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