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Logistics

February 2021 • perenews.com

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KEYNOTE INTERVIEW

Logistics demonstrates resilience amid uncertainty

Ares' David Roth and Wilson Lamont explain how disruptors like the covid-19 pandemic and the so-called 'Amazon effect' are shaping a buoyant logistics market in the US and Europe

A growing appetite for e-commerce globally has increased the need for logistics space – pushing up rents in the process – which is attracting investors' interest in industrial real estate. In turn, asset prices are rising, but supportive supply versus demand is set to keep markets healthy, argue David Roth, head of US real estate equity, and Wilson Lamont, co-head of European real estate equity, at global alternative investment manager Ares Management Corporation.

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Q The pandemic has accelerated e-commerce sales. How is this affecting demand for logistics space and rents in the markets in which you operate?

David Roth: If you go back 10 or 15 years, the industrial business was really about business-to-business – it was suppliers who were delivering product mostly to other businesses. Over time, this has evolved to the point where the fastest growing parts of the business are the ones that service direct to consumer.

We saw total e-commerce sales increase by 32 percent in the second quarter of 2020 and the percent of e-commerce sales of total retail sales jumped to 16 percent from 12 percent in the first quarter. Looking forward, the percent of total sales through e-commerce could exceed 30 percent by 2030.

However, there has been, and should continue to be, a strong acceleration in e-commerce sales with the onset of covid-19. A lot of people who never would have relied upon buying online are now living by that method.

If you combine this trend with slower growth or weakness, depending on the market and tenant, in the traditional model that involved more of a business-to-business approach to distribution, demand for certain parts of the industrial sector – particularly the parts of the distribution channel that are used in e-commerce – is incredibly high. We are seeing that demand, and vacancies are at very low levels.

Wilson Lamont: In terms of industrial property vacancies, Europe is similar to the US at 5 percent vacancy or below in most markets. Where land supply is tight, we have seen rents jump from anywhere between 10 and 20 percent, particularly for those locations close to large metropolitan areas, especially for smaller facilities that are servicing last-mile demand and able to deliver parcels in under two hours. That is having a powerful impact on demand and, therefore, rents.

Q What is the outlook for new supply in key logistics markets?

DR: We feel a lot of comfort from the fact that we are starting at very low levels of vacancy today. Logistics is a product that is relatively easy to build and also fairly easy to stop if it gets over-built.

We believe that we are at national high levels of supply, but also with high levels of demand. In many markets we are starting to see a little bit of excess supply relative to demand, which is driving a slight uptick in vacancy.

But, at least in the near-to-intermediate term, we think that is going to be a modest outpacing of demand nationally, just driven by large pipelines that groups like Ares and others have. Longer term, we think there will always be some need for new product to address obsolescence of older product that doesn't have the specifications that tenants need, like ceiling heights, dock door penetration and trailer parking ratios for bulk distribution. Considering demand in those markets, current rent growth and low vacancy levels, our view is that they should remain healthy for some time.

WL: In Europe we have seen take-up for logistics space tracking significantly ahead of new supply for the last six or seven years. Today, the large balance-sheet developers remain very disciplined with regard to new speculative development, where they are typically focused on build-to-suit type situations. From a traditional European banking perspective, there are very few banks prepared to lend on a pure speculative logistics development.

We see new supply coming in certain markets, particularly in continental Europe, where there is more

Q A key disruptor has been the so-called 'Amazon effect'. How is logistics adapting to changes brought about by this global phenomenon?

WL: We certainly see an 'Amazon effect', where major players are having a significant impact across the markets in which we operate. As an example, in the UK today, Amazon has 60 live leasing requirements, representing about 30 million square feet. To put that in context, we think this year there is going to be a little under 50 million square feet of take-up in the UK.

When you look at Germany, Amazon's requirements are double their needs in the UK. When you have this amount of demand in the market, the impact is significant, considering the tight supply. And of course, rents in these locations are growing quite significantly.

DR: The implications of the 'Amazon effect' clearly have to do with certain locations in the US. For instance, we believe Cincinnati is going to benefit from being an Amazon Air hub. Additionally, Amazon Prime Air, which will use drones to deliver packages, has the potential to be a major disrupter. The development of this technology hasn't been seen before and, over the long term, that may have implications for tenants needing to upgrade their facilities.

In our view, demand for newer space is going to be significant, because of the pressure that Amazon is going to put on every retailer to step up their game as it relates to how their product reaches consumers.

We believe this is going to drive the need for more state-of-the-art facilities across the board.

land available to develop, like Poland as an example. But, overall, we think the supply outlook in Europe remains supportive versus demand, certainly supportive to rents continuing to be on a strong upward trajectory in most of the metropolitan markets that we are operating.

Q How is strong institutional demand affecting asset prices?

WL: There's no doubt that logistics and industrial is strongly in favor, attracting investors from around the world. This is due to the sector's strong fundamentals, but it's also one of the few sectors where investors are seeking to invest their capital in the real estate market today.

With hospitality impacted by covid-19, the structural decline of retail and questions around certain formats of office occupation, we're seeing larger volumes of capital concentrating on a narrower set of property types, namely logistics, industrial and residential. That trend is adding to huge demand for a more limited product set.

So, in the last 12 months we would estimate in several European markets there has been 100 basis points of downward yield compression for the best quality well-let assets – and that goes for whether you are in the primary markets of the UK and Germany or, to a lesser extent, France and the Netherlands.

DR: There has been approximately 8 percent annual capital appreciation for US industrial properties over the last seven to eight years, and that has been incredible. If you look at the product type relative to others, exit cap rates compressed by 200-300 basis points in some US markets.

Looking at that, you could say that provides a risk, but we believe the demand for this product will continue. Rates aren't likely to go through the roof and the supply/demand picture should remain favorable. Overall, our belief is that capital is going to continue to flow into this sector and that is going to support robust values on an ongoing basis.

"In Europe we have seen take-up for logistics space tracking significantly ahead of new supply"

WILSON LAMONT

Q In which pockets of the market do you see overinflated values?

DR: There is some risk around older products because the desire for state-of-the-art product becomes greater as Amazon becomes more impactful on the markets. And retail bankruptcies, which we haven't really seen much of yet, are likely to come for those retailers that traditionally have been focused more in the business-to-business logistics property type. Those retailers are currently occupying a lot of the older product, and I get concerned when I see that.

WL: Over the last four or five years we have been operating intensively on what I have described as core-plus or value-add assets, which are often older generation assets that we felt still had a role to play, but they were certainly not premier assets. As the market has evolved and matured, our point of entry is focused on brand new assets. This is especially important in a post-covid market environment where worker wellbeing and ESG considerations are substantially more important to both occupier and investor.

Q To what extent is the impact of potential retail bankruptcies on tenants affecting the logistics sector?

DR: If a retailer is being liquidated, obviously the industrial box that they are sitting in will go vacant. But if you have decent industrial assets and a retailer goes bankrupt and is being restructured, it is going to come out and likely still need that industrial space. As I said earlier, those retailers tend to occupy some of the older product. The good news for the product that is well-located and could be repurposed for third-party logistics (3PLs) for activities such as processing returns. Since the return process generally does not need the same state-of-the art asset that an Amazon or other e-commerce retailer needs for a fulfilment center, these locations could offer selective opportunities for older product.

WL: In continental Europe, retailer bankruptcies have been more limited, but I do think they are coming. In the UK, on the contrary, we have seen significant retailer bankruptcies in the last five or six years, even before covid-19, but interestingly, the traditional brick-and-mortar retailers that are failing typically have underinvested, less sophisticated, smaller supply chains and distribution networks versus, for example, Amazon or some of the 3PLs; so, they are using more space in stores rather than in distribution warehousing.

We monitored a watchlist of 30 retailers in the UK that we thought were at risk of bankruptcy over the course of 2020, and their total amount of logistics space was around 5 million square feet. Compared to an annual take-up of close to 50 million square feet, this is a manageable amount to come back on to the market. We see it as a low risk in the current market conditions. ■

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Coronavirus and Public Health Emergency Risks

As of March 17, 2020, there is an outbreak of a novel and highly contagious form of coronavirus ("COVID-19"), which the World Health Organization has declared to constitute a pandemic. The outbreak of COVID-19 has resulted in numerous deaths, adversely impacted global commercial activity, and contributed to significant volatility in certain equity and debt markets. The global impact of the outbreak is rapidly evolving, and many countries have reacted by instituting quarantines, prohibitions on travel and the closure of offices, businesses, schools, retail stores, and other public venues. Businesses are also implementing similar precautionary measures. Such measures, as well as the general uncertainty surrounding the dangers and impact of COVID-19, are creating significant disruption in supply chains and economic activity and are having a particularly adverse impact on transportation, hospitality, tourism, entertainment and other industries. The impact of COVID-19 has led to significant volatility and declines in the global public equity markets and it is uncertain how long this volatility will continue. As COVID-19 continues to spread, the potential impacts, including a global, regional or other economic recession, are increasingly uncertain and difficult to assess.