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International

Global research and insights from Frontier Advisors

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Property European Research Trip Part 2

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Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high-level assessment on the key areas and observations unearthed during this recent Real Assets' trip. We would be pleased to meet with you in person to provide further detail on these observations.

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Introduction

The growth of e-commerce has been a primary driver of demand for industrial and logistics (I&L) assets. Consumer demand for speedy service is forcing the retail supply chain to adapt.

In November 2018 Frontier undertook an international research trip focused on the European logistics market. This paper (the third in the series focused on Logistics globally) is written in two parts: **Part 1 Logistics 101** provided an introduction to the sector, asset characteristics, locational attributes and its participants across the most significant European cities, as well as observations from our trip and considerations for client portfolios.

In this paper, **Part 2: European Logistics**, we focus on the investment market for European logistics including drivers, market demand, the e-commerce shift fuelling that demand, rental growth forecasts, investment risks and opportunities, and implementation considerations for client portfolios.

During the research trip, Frontier met with a number of managers active in the sector including Prologis, CBRE, TH Real Estate (a Nuveen Company), Invesco, La Salle and Aberdeen Standard Life.

In Europe, undersupply of modern, large-scale warehouse space remains significant, fuelling rental growth in excess of forecasts across most European logistics hubs. While there is undoubtedly evidence of overheating in some European cities, Frontier sees pockets of opportunities for investors seeking longer term exposure to the European logistics sector.

We have identified a group of specialised managers with the requisite skills and track record to deliver attractive risk-adjusted returns. In the paper that follows, we take a closer look at European I&L and explore key considerations for institutional investment into these markets.

“While there is undoubtedly evidence of overheating in some European cities, Frontier sees pockets of strong opportunities for investors seeking longer term exposure to the European logistics sector.”

European logistics

Too hot, too cold, or just right?

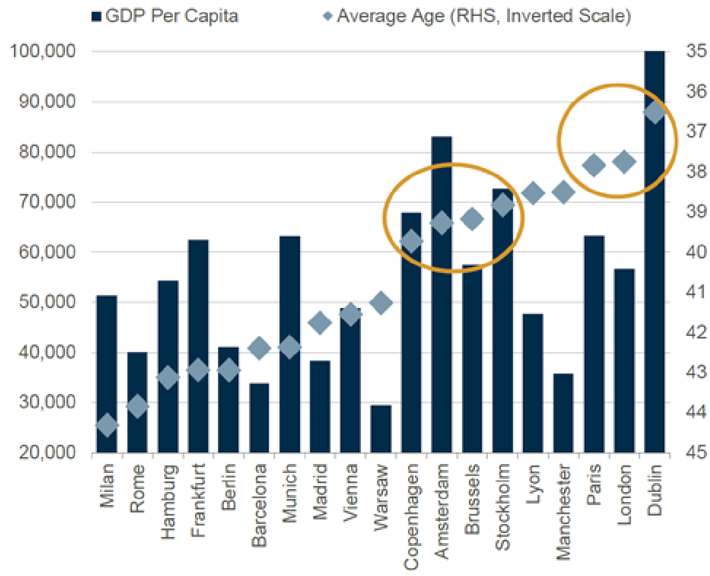
A Goldilocks economy is an economy that is not too hot or cold, in other words sustains moderate economic growth, has low inflation, and which allows a market-friendly monetary policy[1]. Most of this currently holds true for the key Industrial/Logistics (I&L) European markets of Germany, France, the Netherlands and, to a lesser extent, Italy. Gateway cities of Amsterdam, Berlin, Frankfurt, Milan, Munich, Prague and Warsaw are having their 'moment in the sun.' We have deliberately excluded the United Kingdom (UK) from our study as it has been the global I&L leader, surpassing the United States (US) in total returns by several hundred basis points over the past two years, primarily led by London.

European GDP growth will continue to be underpinned by a number of drivers. They include urbanisation across the region, expansion of the middle class, household formation, rapid adoption of technology and changing consumer spending patterns. This is especially pronounced in the 35 to 45-year age group as shown in the Chart 1. Smart cities, a bellwether for structurally advanced demographic change, are experiencing a pronounced e-commerce driven boost.

The growth of e-commerce has been the primary driver of the I&L sector demand during the current cycle. Consumer demand for rapid service has forced everyone in the retail supply chain – manufacturers, suppliers, distributors and retailers – to carry more inventory in more locations.

Demographic drivers

Chart 1: City GDP per capital ($) vs average age



Source: Eurostat, Oxford Economics, PGIM Real Estate.
As of November 2018. PGIM Real Estate | Global Outlook

[1]Wikipedia

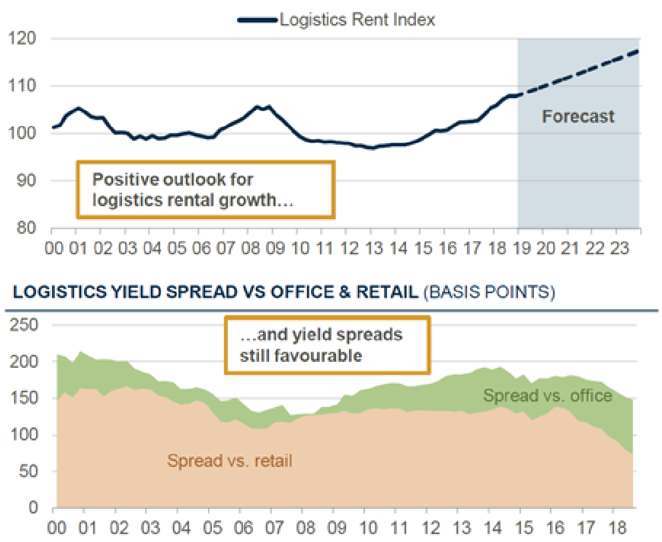
An Overview of the I&L cector

- Online retail sales are forecast to increase by 10% to over 20% over the three years.
- Rental forecasts for the sector show a positive outlook to at least 2023.
- The yield spread of I&L compared to office and retail is circa 100bps. According to CBRE, prime logistics yields in Europe fell to 5.3% in the first quarter of 2018, compressing significantly from the 7.91% figure recorded in the fourth quarter of 2009.
- European investment volumes in 2017 were up 80% to €41.3 billion compared to 2016, suggesting valuations could be stretched in pockets of the market.
- The region's logistics vacancy rate was below 5% in the fourth quarter of 2018, down from 6% in the previous year (CBRE) with some gateway cities dropping below 4%.
- Speculative development accounted for only 24% of the 12.3 million square metres under construction in 2017, down by 1% compared with 2016. In 2018, new speculative supply delivered to the market was expected to slow, due in part to a scarcity of development land in many markets. In Milan we noted a number of abandoned factories and warehouses believed to be in the distressed portfolios of local bank balance sheets.
- While there is a large development pipeline, the undersupply of modern, large-scale warehouse space is still significant, fuelling rental growth in excess of conservative forecasts of 2% to 3% per annum across most European logistics hubs at this point in time.

Chart 2: Online retail as share of retail sales (1%)

Source: Eurostat, Oxford Economics, PGIM Real Estate.

Chart 3: Prime rent index: European logistics



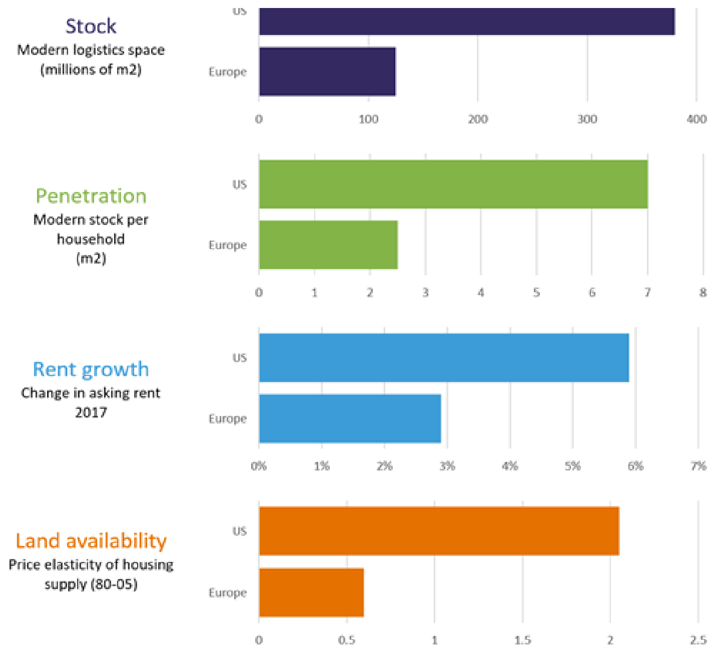
Source: Eurostat, Oxford Economics, PGIM Real Estate.

The case for emerging European logistics is strong based on a number of metrics shown in Chart 4, which highlights the development lag of the sector behind the US.

Furthermore, the gap between prime property yields (I&L, Retail and Office) and local government bonds clearly demonstrates an attractive spread differential, with I&L being the beneficiary of the retail sector's stress.

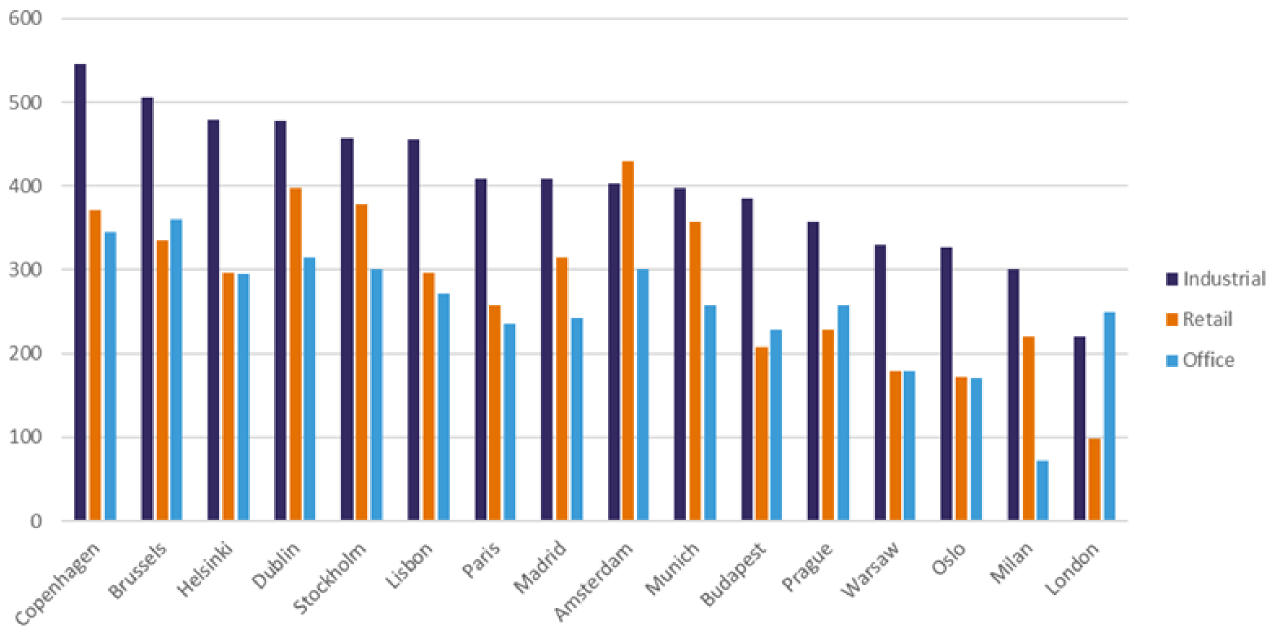
European logistics have a longer tailwind than US markets, as the US I&L market has already benefited from demand arising from the FAANG (Facebook, Apple, Amazon, Netflix and Google) phenomenon. Investors would do well to position themselves to take advantage of the European opportunity set in the near term.

Chart 4: European logistics metrics



Source: Heitman

Chart 5: Gap between property yield and 10 year sovereign



Source: CBRE Research, Global Investors

Markets/demand for logistics investments

Well-established metros and port cities tend to offer last-mile/last-touch opportunities, due to their proximity to end consumers. Hamburg, Rotterdam and Orleans are examples of such cities.

Developing markets should demonstrate strong transportation hubs and spokes to underlying demand, close to large population centres and cheap labour. Greenfield sites are less likely to fit these requirements unless there is strong government commitment to master planning. The Polish border is considered by a number of fund managers active in this space as 'uber strong', with strong cross border trade links to its west and south. Prague equally meets this criterion although its labour pool is increasingly educated and affluent.

East and West Midlands (UK), Budapest, Prague, Warsaw and Munich are cited as cities offering expected upside for build-to-core opportunities due to availability of land zoned by municipalities for specific I&L uses.

Prologis, the largest logistics company globally, expects the rent gradient to steepen, with higher growth for closer-in submarkets, as urbanisation and technology trends coalesce[2]. Already, the combination of retailer priorities, supply chain capabilities and urbanization/congestion has caused increased competition for properties closest to population centres, reportedly pushing rental growth beyond 10% per annum.

International managers and developers (Prologis, CBRE, AXA, Goodman, to name a few) can access deal flow as nimble and reliable capital providers. Such internationals also bring a bevy of global tenants who can execute longer leases. They are also backed by investors who take a long-term view of the sector.

The infill markets in France and the Netherlands have not yet developed as rapidly as the industrial areas in Southern California, London or the East and West Midlands of the UK. Limited land availability in European CBD and periphery areas, plus competing uses for this land, means opportunities to enhance existing industrial buildings are limited. The exception to this may be opportunities underpinned by e-commerce demand.

E-commerce drives demand in infill markets due to the desire to shorten delivery times. In Part 1 of our logistics paper we noted that transportation costs are substantially higher than rent and have been growing faster than rent. So, there is demand from users to lower transportation costs and locate facilities closer to their population catchment. This dynamic is creating real rental growth exceeding managers' underwriting assumptions.

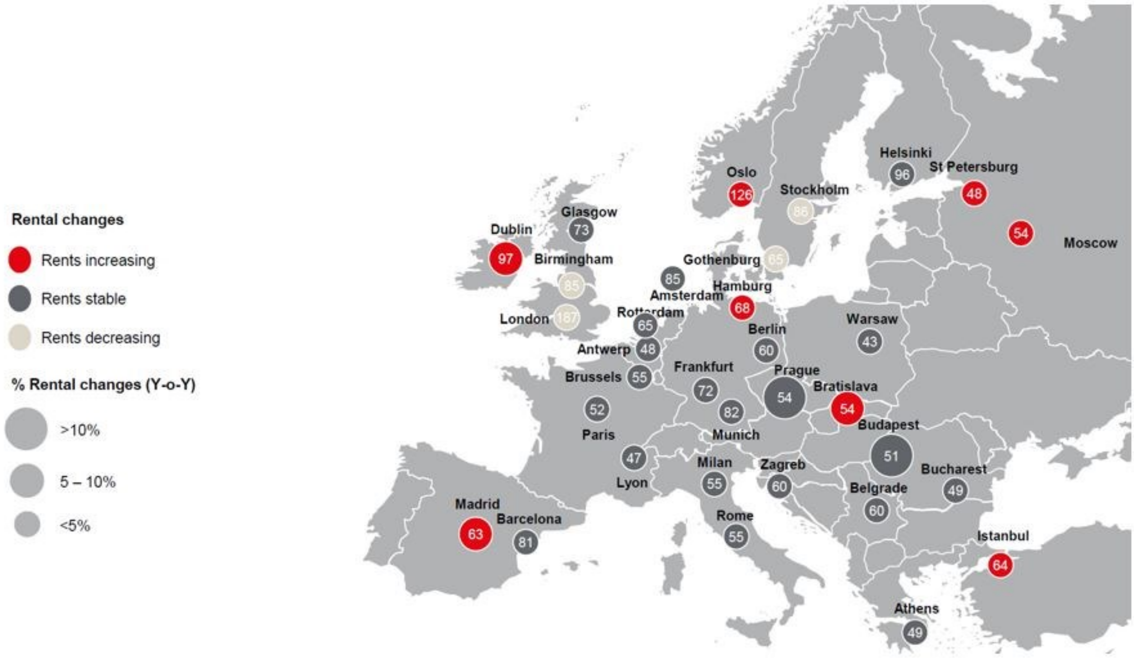
[2]Prologis: Supply Chain and Logistics Real Estate, September 2018

Investment risks and opportunities

Heated market?

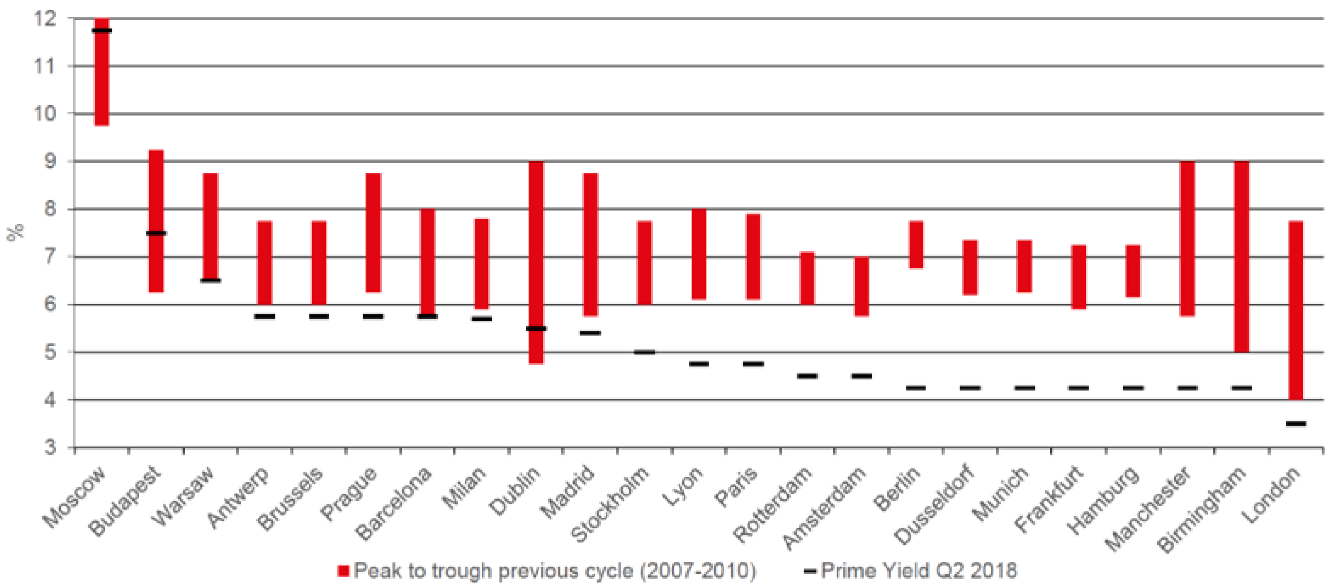
These charts depict a stabilisation of both rents and yields, underlining a market that is in a state of flux.

Chart 6: European Logistics Rents Q2, 2018



Source: JLL

Chart 7: Yield compression Q2, 2018



Source: JLL

Geo-political and cross-border risks

Impacts from Brexit and trade wars present implications for certain segments of the sector that would be vulnerable to any trade disruption. An example is the manufacturing sector making goods and components for the American consumer market.

Facilities such as distribution centres and last-mile delivery facilities, with a variety of tenants and driven by domestic demand, are expected to be more immune to international trade wars. To the extent the Eurozone is able to capitalise on China's rapid growth (over 34% of goods exported globally come from China and growing at circa 22% per World Data Atlas), it would likely cushion the impact from trade conflict.

Technological change—a new eco-system?

Some managers are predicting a shift in warehousing from the traditional linear model to a new 'Supply Chain Ecosystem' comprising robots, next-generation supply chain smart warehouses, greener facilities and a scenario where retail and industrial become one. This is already apparent in the US where well known brands such as WalMart, Trader Joes, Amazon Books and Bonobos have all established physical distribution warehouses across the US. In Germany, online platforms such as Otto, Zalando and Notesbooksbilliger account for circa €9 billion in annual sales whereas Amazon grabs in excess of €6 billion.

The increasing use of robots and automation in I&L is likely to result in markedly different warehouse design. An example is Amazon's almost fully automated distribution centres where robots operate on three floors. Taller structures may replace on-grade sprawling facilities negating the need for staff amenities and parking facilities. The pace and cost of change relative to expected returns should be closely monitored.

ESG for sheds

A key area of focus for Frontier on its research trip was understanding ESG strategies for a sector that appears to largely consist of vanilla sheds of varying sizes.

We found that managers were pleasingly attuned to the ESG expectations of institutional investors. Specific case studies were provided demonstrating implementation of environmental and sustainability initiatives at the firm and asset level. A cross section of examples is discussed below:

- Distribution centre, Venlo, Netherlands. The asset met BREEAM (Building Research Establishment Environment Assessment Method) 'excellent' requirements, providing charging stations for electric vehicles and solar systems on the roof of the asset. Frontier noted that the Netherlands is particularly ahead of other European counterparts in some areas with electric charging stations widely provided by employers and in public places.
- UK Asset B&Q Farnborough. Circa GBP250,000 was invested in ecologically-friendly energy supply resulting in the tenant receiving a 10% discount on electricity costs and reportedly 430 tonnes of CO_2 savings. Direct savings to the tenant in outgoings and investor ROI improvement was measurable (circa 12%).
- Asset in Steenberg, Germany incorporated 'compensation concepts', for example, trading offsets via Greenlease clauses for provision of areas for butterflies and birds.
- Asset in Waiblingen, Germany, included a Green roof photovoltaic system and LED lighting, a common and low-cost efficiency approach resulting in lower tenant outgoings.
- A common theme with large logistics assets was putting solar panels on rooftops and capturing water run-off. France, a nuclear energy country, is an exception where solar power is not a big focus.

Frontier was pleased to see most managers pre-screening developers for BREEAM capabilities and certification.

We observed that monitoring ESG is best implemented when tenants are large corporates with an ESG agenda. In multi-tenanted facilities, where most leases are 'triple net' structures, tenants protect their right to privacy which leaves landlords with limited access to information. Annual inspections are required to mitigate risk of breaches of permits, which are typically outsourced to third party advisors.

Client portfolio considerations

Logistics was considered the more volatile and less attractive segment of the traditional commercial real estate sectors.

In recent years, this view has changed to the extent that allocations are on par with residential, office and retail allocations. There is reportedly a circa €1.0 billion queue for European I&L from institutional investors around the globe. While ordinarily this quantum may not seem high, transactions sizes are significantly smaller than those of the office or retail sector, leading managers to manufacture core in select markets. This is a structural change from an Investor perspective.

Investment structures

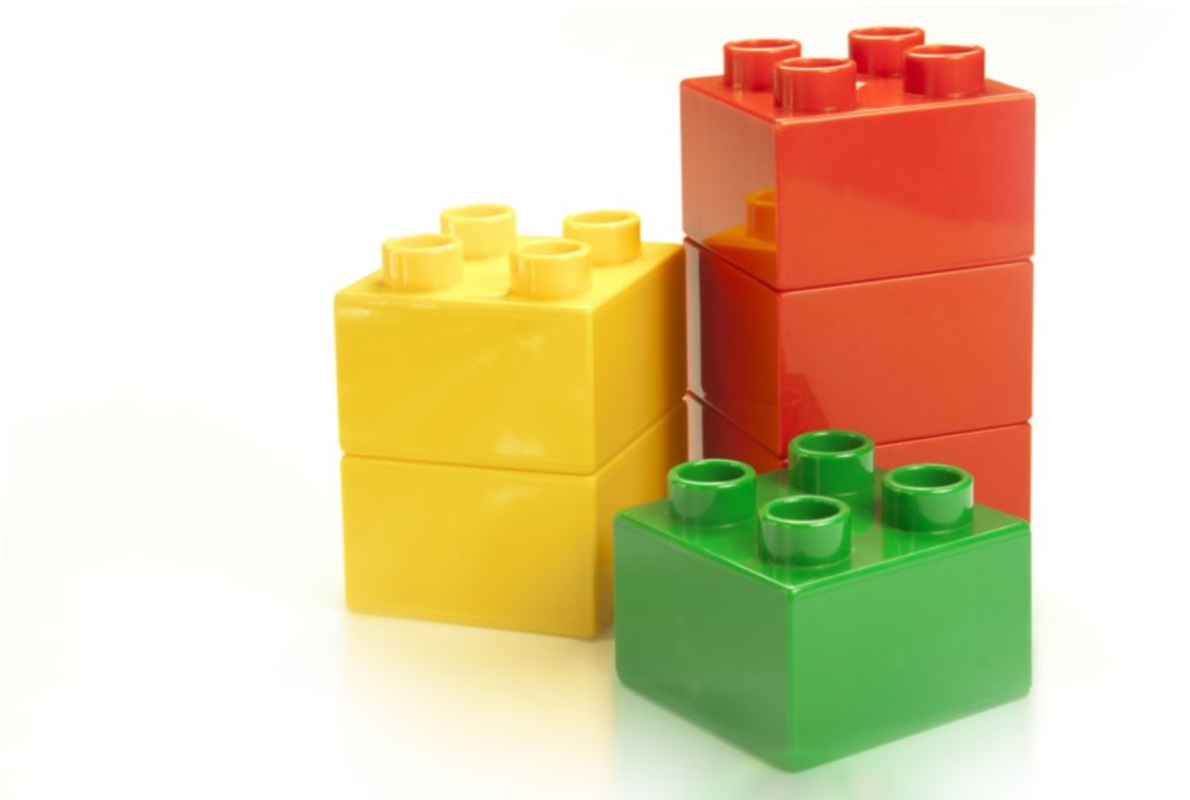
The most appropriate method for accessing the I&L thematic will depend on investors' objectives and the size of the allocation. Fund structures for investing in I&L are typically open-ended funds. Some managers, such as Nuveen (formerly TH Real Estate), Invesco, LaSalle and CBRE, can also run separately managed accounts (SMAs). A notable manager in the sector is Prologis, the largest global logistics company, which runs regional open-ended funds. Frontier inspected several Prologis-managed assets across Europe.

Typically, logistics asset investment sizes are small relative to commercial buildings, which could slow the pace of deployment. Frontier expects an allocation to a build-to-core strategy with a sector specialist with access to land banks, is likely to enable quicker deployment. Such a strategy can create conflicts of interest (notably where assets are transferred from the manager's balance sheet to a fund) and require careful due diligence.

For those investors wanting an exposure to the sector, we would suggest taking a long term view to making investments.

Fees

Management fees are typically greater than 0.7% p.a. dropping down to 0.5% p.a. for commitments in excess of €400m. Typically, performance fees will also apply. Frontier expects an investor of scale to be able to negotiate better fee outcomes, particularly for mandates.



Implementation

Industrial and logistics facilities are no longer simply "warehouses or sheds". Newer assets are often high-tech elements of complicated supply chains and, as such, are high-value properties.

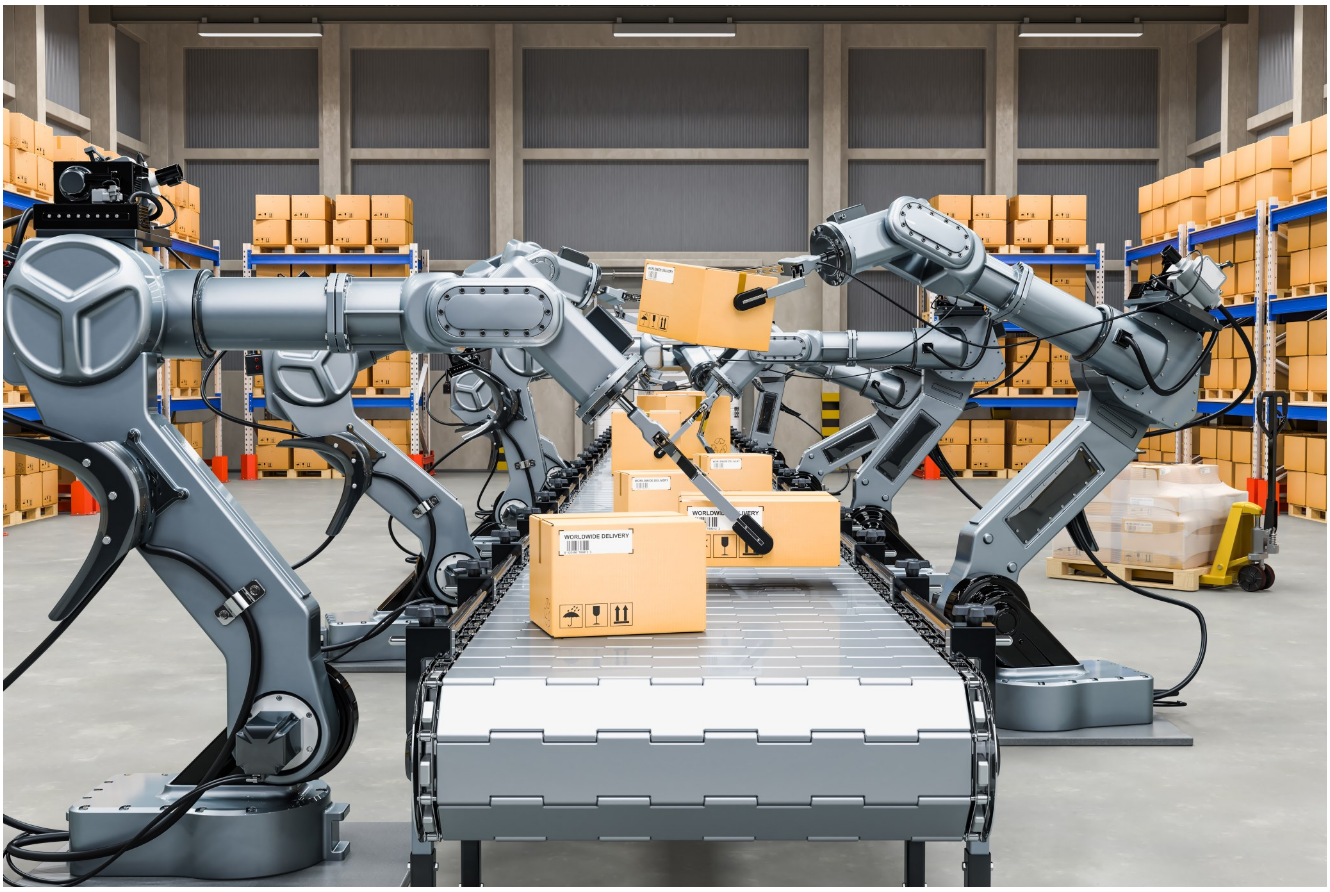
The penetration of e-commerce varies substantially by country, as does the changing nature of assets that enables its growth. For example, the UK imports a large share of goods from overseas and has a well-developed retail and e-commerce market, whereas the Netherlands and Germany are entry points for distributing goods across much of continental Europe. Such differences imply very different demands for industrial real estate and reflect a myriad of underlying property demand and characteristics.

Key European logistics markets are benefiting from economic growth, supply chain restructuring and rapid evolution of e-commerce. Occupier demand is strong and construction is increasing to meet the growing need.

While there is a large development pipeline, the undersupply of modern, large-scale warehouse space is significant, fuelling rental growth far in excess of conservative forecasts of 2 to 3% per annum across most European logistics hubs.

Specialist and diversified strategies may include:
i) buy and own functional warehouses with long-dated leases;
ii) build-to-core new warehouses targeting metro markets close to large population bases, good transportation infrastructure and large labour pools.

Frontier favours sector specialists or diversified managers with strong capabilities and well-articulated forwarding-looking strategies.

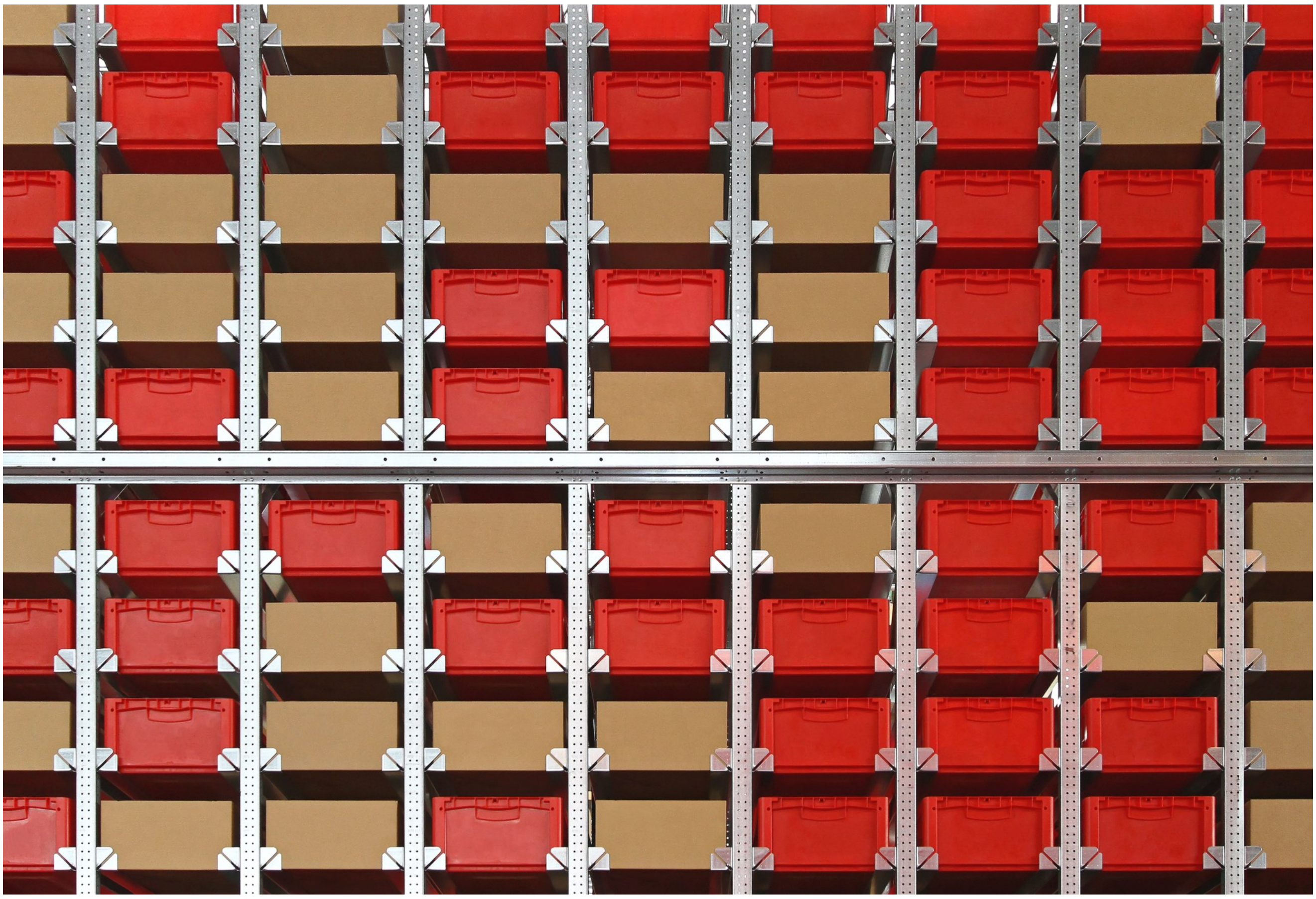


In summary

Warehouse preferences have changed over time and will continue to change into the future. This will impact the value of assets including increasing demand for larger and more technologically sophisticated facilities.

The growth of e-commerce has been the primary driver of demand during this current cycle. Consumer demand for speedy service has forced everyone in the retail supply chain – manufacturers, suppliers, distributors and retailers – to carry more inventory in more locations to meet consumers' heightened delivery expectations.

While there is evidence of overheating in some European cities, Frontier sees pockets of opportunities for investors seeking longer term exposure to European real estate and, in particular, to the logistics sector. We have identified a group of specialised managers with the requisite skills and track record to deliver attractive risk-adjusted returns. We encourage clients to contact Frontier Advisors for more information.



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