

When compared with the office towers that scoop architectural awards, the glitzy shopping malls and six-star hotels, it might seem as if the industrial and logistics sector has had a bit of a glamour bypass.

Indeed, analysts use the nickname 'sheds' to describe the simple, big boxes that cluster around key transport nodes, and which are used to warehouse goods along complex supply chains.

Whatever their image, sheds hold a strong appeal for investors looking to balance their portfolios, accounting for 10% of the European investment market in the first half of 2009, and they offer investors some interesting possibilities during these difficult times.

The logistics industry is intimately linked to patterns of production and consumption – both of which took a hammering during the recession. And Eurostat research shows that the total volume of road freight in continental Europe has fallen by almost a quarter since the middle of 2008, and air freight shows a parallel decline.

The drop in demand has increased vacancies, pushed rents downwards as negotiation levels have risen, and stamped out speculative development everywhere, but especially in Spain and Eastern Europe.

Now that the Eurozone has come out of recession and some of its key economies are taking firmer steps to recovery, the overall picture for the logistics sector is one of stabilisation and weak optimism, although differences between markets can be great.

Guy Jaquier, A.MB president of Europe & Asia, says: "Absorption of distribution space continues to be limited across most markets but customer sentiment appears to be slowly improving, as both interest rates and cap rates

seem to be stabilising. In Europe, we see values bottoming out in core markets coming into the end of 2009 and the beginning of 2010.

"Customers are engaging industrial real estate owners in conversation again, an encouraging sign.

Having said that, until our customers start to expand and absorb existing supply, we don't expect to see pressure on rents in prime locations; rents will remain flat until then.

With consolidation activity shifting demand toward prime locations, we do expect to see continued downward pressure on rents in secondary locations."

And Buddy Roes, head of logistics fund management at Schroders, adds:

"We will see rents continue to fall for the foreseeable future despite the economy recovery. This is an area

that tries very hard to find efficiencies, particularly with all the outsourcing. The growth trend will come back, but people are shifting back and reviewing their business models. It's a pretty good time to review the market if you know what you are doing."

The greatest focus for international investors is the core markets of western Europe, namely the UK, France, Germany and the Netherlands, where rents have been declining but yields have been rising, albeit by small increments. Occupiers are keen to drive overheads downwards, and to make the most efficient use of space, which has led to downsizing and occupiers extracting good concessions.

James Markby, associate director of cross-border industrial and logistics at CBRE, explains the importance and attraction of the core markets: "They are the most liquid real estate markets in which to operate, demonstrated by the higher levels of investment transaction volumes. This is in part due to better transparency of information, and the regulatory, legal, and cultural frameworks of these property markets, making them a relatively more attractive target to a wider pool of investment capital. At a more fundamental macroeconomic level, these countries also form the financial heart of Europe. The ports of Holland and Germany in particular are also the prime global trade hubs for Continental Europe."

Markby says of the outlook for core markets: "There is generally a positive sentiment. In certain markets there is an increasing perception that we have reached the bottom in terms of capital value decline for prime or good-quality assets. However, there is also an expectation that the occupational market will continue to weaken over the short to medium term, although it remains to be seen whether this will be as dramatic as forecast at the start of this year. We've seen the UK acting as a leading indicator through this cycle, and although the specific dynamics clearly differ, in broad terms other core markets are likely to see a similar pattern emerge, but perhaps not to the same extent."

The UK is an interesting case. Although the country is still in recession, its logistics real estate sector was very active over 2009, drawing 46% of all European investment in the first half. Kim Politzer, director of European research at Invesco Real Estate, says: "In the UK people who did deals at the beginning of the year are flipping transactions and putting them back on the market. The market repriced too far out, and people saw opportunities in January and February at prices that looked very cheap. The UK's leasing structure has also helped – insurance and repair costs fall on the tenant and there are upward-only rent reviews." Looking ahead, JLL expects limited new warehousing supply in the UK, and relatively low activity levels over the next 12 months, although activity will be sustained by the alignment of strategic networks and the recession abating.

Interest in core markets is especially focused at present, and there is a split between prime and secondary opportunities. Kim Politzer says: "People are interested in a very specific product. It has to be a long lease, usually to a retailer rather than a logistics operator, and preferably on a strong motorway location. Investors are not expecting rental growth but are expecting yields to harden. It's a straightforward investment and it's easy to understand how it functions in a portfolio."

Lease lengths can appear quite polarised within this sector. A lot of logistics development is purpose built, where a large supermarket or manufacturer asks for a unit to be built to spec, often using long-standing relationships with specialist developers. These buildings may often involve quite high levels of automation and specialist equipment, which also increases the initial investment outlay. Consequently, leases here can be 10-15 years in length, a period of time the credit-crunched and risk-averse banks are more comfortable with. Such buildings are rarely built speculatively in Europe, unlike in the US.



A modern port in Hamburg

At the other end of the scale, logistics firms want to lease warehousing to match their contracts, which may be as short as one year, but more typically are three to five years. The downside for investors and landlords of this drive for flexibility is the risk of vacancy gaps between leases. Clearly, the stability of a long lease with a big tenant is particularly attractive during uncertain times.

Logistics developments tend to be centred on major centres or industrial areas, and on the major seaports, airports and motorways. Transport and market access is paramount, but low labour costs are also a factor.

Alexandra Tornow, head of EMEA industrial & logistics research at Jones Lang LaSalle, highlights another location trend. "In the last couple of years there's been a movement to rural areas where there's very cheap land, which has reduced occupancy costs. At the moment it's reverting as occupiers have discovered they are facing higher transport costs and more and more countries are introducing road tolls. The current trend is back to prime locations with better infrastructure – namely motorways, rail links and the big container seaports."

Guy Frampton, executive director, industrial & logistics Europe, at CBRE says: "Warehouses are getting larger and therefore need more finance and land. The standard specification is getting higher



Frampton: 'the big logistics companies have had their challenges'



Politzer: 'people are interested in a very specific product'



Delivering Opportunity

Consolidation among logistics suppliers and the reorganisation of company supply chains post recession means it's time to take a new look at logistics in 2010. **Paul Benjamin** reports

and the green agenda has a greater influence. Those international developers who are at the forefront of these trends will tend to capture the majority of the multi-market business."

Roes says that, more so than other real estate sectors, the logistics game is about global interconnections and supply chains, so the bigger picture lies beyond individual country conditions. He adds: "A shed isn't just a shed, it's quite a specific type of prod-

uct. It's primarily about the location and how accessible it is. But staffing is key – 7% of logistics costs are in housing, and 60-65% is in staff. So look for areas where you will see unemployment growing. We know of one global logistics player who is considering Madrid over Barcelona for that reason."

Of the southern European markets, JLL says that during 2009 Spain saw a severe decline in take-up, further falls in new completions. CBRE says rents

are down 20% in the biggest Spanish cities over the past year. Greece and Portugal have experienced a slowing in demand. Italy is the region's most active occupier market and further rental declines there will be limited.

Tornow says: "Spain also saw strong speculative development and vacancies are probably the highest in southern Europe. Demand has really declined this year and remains slow. Prices are coming down." As regards eastern Europe, particularly Poland, Hungary and the Czech Republic and Slovak Republics, she adds: "They've been growing over the last 10 years. A lot of production has moved there and wages are lower. The logistics sector then followed, and was further encouraged by the development of organised retail. This caused a lot of speculative development. Vacancies are high and there are units that have never been let. We don't expect any further speculative development in the next two years, though vacancies will come down in mid to end 2010."

Richard Holberton, director of EMEA Research at CBRE, thinks eastern Europe will "remain subdued in the short term, with yield spread against core western European markets needing to expand further. Occupier markets will improve towards the end of the year as economies revive and vacancy levels fall due to almost complete dearth of spec development starts in recent quarters.

"It is dangerous to generalise; clear distinction needs to be made between the core markets of Poland, the Czech Republic, Hungary and Slovakia, where prospects are relatively good, and more peripheral markets such as Russia, Ukraine and the Baltics, where recovery may take longer. In the longer term, growth in shopping centre stock and the presence of international retailers will boost all logistics markets, assisted by big infrastructure improvements."

The recession has caused a shake-out in logistics real estate, especially in terms of speculative development, but a trend that will last beyond the recovery is a consolidation of the logistics companies themselves. Frampton explains: "While the big logistics companies have had their challenges, generally the consolidation in the logistics industry itself has seen a smaller number of companies able to fulfil the logistics requirements of the larger companies. This means that those third-party logistics providers who compete globally are getting stronger and their requirements of developers and investors more exacting. Investors and developers need to keep pace with these changes."

Turning to 2010, recoveries in European consumer spending and world trade are likely to be tentative. A question mark remains over how far recent moves to rebuild industrial stock levels will last into 2010, particularly once government support schemes have evaporated. Some European countries remain worryingly burdened with debt, and for them any recovery might come to a halt in the year ahead.

Against this backdrop, Tornow flags that one additional driver of demand could be corporate reorganisation. She explains: "There are a lot of companies that, even before the recession, had started to look at long-term strategies and to review their global supply chains. Many are drawing back from really big spaces to smaller ones. Sustainability is also playing a role. Companies are realising they can get good space at favourable conditions and next year we will see a more dynamic market bring forward reorganisation."

While activity levels should increase in 2010, the sector can hold downsides for the unwary. Politzer cautions: "Although rents are holding up reasonably well on the quality offerings, there are significant risks if you hold these things too long. Secondary markets are taking a big hit. It's very difficult to find occupiers at the moment. Landlords are having to offer significant incentives. People think it's a straightforward asset class but you do need to think about exit strategies."