EUROPEAN INDUSTRIAL PROPERTY MARKETS

by Mo Barzegar and David Twist

On the Rebound

Rents in Prime European Industrial Markets Are Down, But Growth Is Set to Come Back Strongly

Rents for industrial real estate are generally down by 10 to 20 percent on an effective basis from their 2008 peak and are well below levels that support new construction. In some markets, effective rents are at levels not seen in more than a decade. The good news, however, is that rents are very likely to increase in many hub and gateway markets in 2011 and more broadly in 2012.

RECOVERY IN SIGHT

Although demand for industrial real estate has been very soft in most European markets, our analysis indicates not only that demand will recover, but that it has already begun to do so in some submarkets.

As we look to a recovery in rental rates, we see it taking shape in two phases. First will be the psychological effect between landlords and customers as they anticipate improving fundamentals; landlords will subsequently hold firm on rents while customers try to lock in longer terms at today's unsustainably low rates.

The second phase will be driven by actual improving fundamentals; as demand gains momentum and vacancy rates fall, rents will resume their climb. At some point in the not-too-distant future, rents will achieve levels consistent with new construction. In many markets, this will mean significant near- to medium-term rental growth.

ON THE RISE

New construction of industrial facilities will resume when rents are at or near replacement-cost-justified levels — the amount required to pay for profitable construction. Replacement-cost-justified rents provide a useful gauge for judging rental levels when the market is more normalised and serve as the benchmark for the growth trajectory of today's rents.

Executive Summary

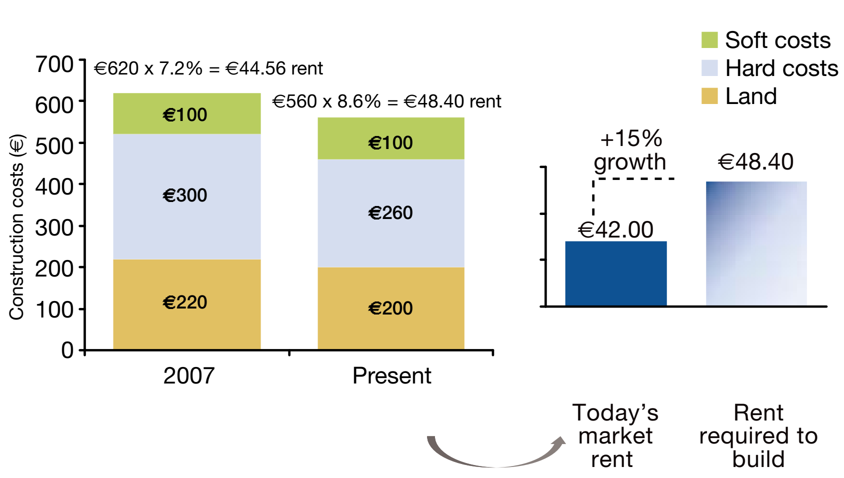
- **The global recession has had an adverse impact on industrial real estate markets across the world.**
- **Vacancy rates have increased, rents have fallen by up to 20 percent and development has slowed.**
- **Economic recovery in western Europe will bring a resumption of rental growth in industrial markets, beginning in 2011.**

Replacement costs can generally be broken into four components: land, hard costs (building materials, labour), soft costs (permitting, design, financing) and the developer's profit. When market rents are too low (or yields too high) relative to these costs, developers will not pursue new construction projects as they would result in economic losses.

The "Market Rents Well Below Replacement-Cost-Justified Rents" chart below depicts the costs of constructing a new building in 2007 relative to today, with the primary difference being reflected in higher expected yields and lower land and development costs. While land sales comps have been relatively scarce in recent quarters, for ease of illustration we have assumed that land prices have fallen about 10 percent from the peak in 2007. In actuality, this assumption varies from 0 percent to more than 20 percent across European distribution markets. We assume that hard costs are down by 13 percent, reflecting lower material and labour costs. While construction costs are down, yields have risen by 125–150 basis points.

In this example, we assume that yields have gone from 6.25 percent in 2007 to 7.5 percent today. With a yield of 6.25 percent, developers could have built to 7.2 percent in 2007, generating a 15 percent

Market Rents Well Below Replacement-Cost-Justified Rents



Source: AMB Property Corp

profit margin. In order to generate the same profit with today's yields, developers would need to build to more than 8.5 percent.

Not surprisingly, the *required* rent today is about 10 percent higher than it was nearly three years ago, given the declining costs and increasing yields (a construction cost of €620 per square metre at 7.2 percent gives a required rent in 2007 of €44.56 per square metre per year, relative to the €48.40 per square metre per year required rent of today from a construction cost of €560 per square metre at 8.6 percent). Furthermore, market rents are down over this same period. In this example, market rents for this product today are down by about 12.5 percent to €42.00 per square metre per year and would need to rise by more than 15 percent to justify construction at today's yields.

This means that most developers won't build until rents, costs and yields make economic sense. It's important to note that today's replacement costs will likely begin to grow again over the coming years, thereby increasing further the rents required to build.

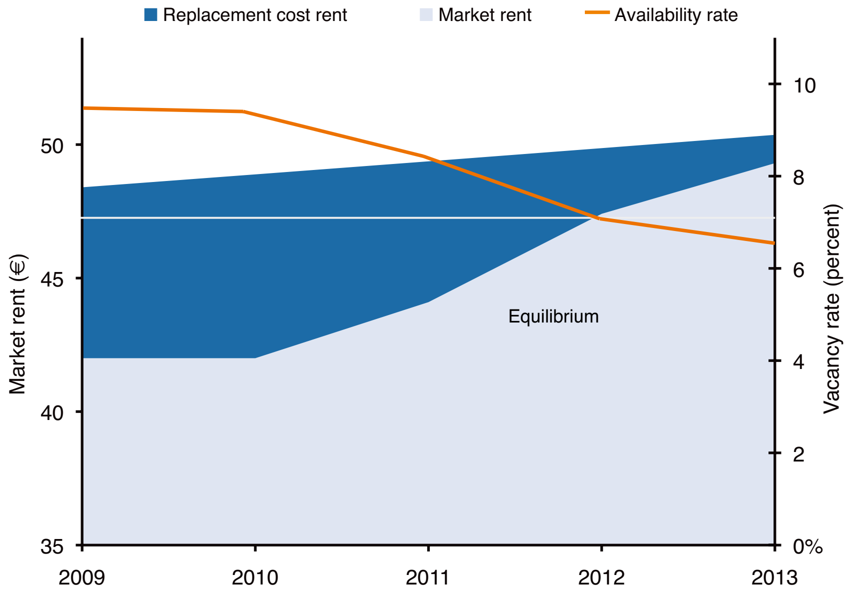
EQUILIBRIUM DISTURBED

Deviations from equilibrium through variations in supply or demand generally result in a "disconnect" between prices, which eventually reconverge to equilibrium. As we apply this relationship to industrial real estate, the key metric is the vacancy rate. There is a strong negative correlation between the variables, indicating that when supply (vacancy) is high, rental growth is muted, and when supply is low, rents grow smartly.

An interesting point to note is that at a vacancy rate of approximately 7 percent, rental growth is close to zero; this is also defined as the equilibrium availability rate, where supply and demand are in relative balance. However, the average industrial lease term is five to six years, and in any given year about 15 percent of the rental market will come up for renewal.

Of this 15 percent, 60–70 percent will typically renew with existing landlords, as their current buildings are deemed sufficient and to avoid the disruption and cost associated with moving. This leaves about 35 percent of those tenants up for renewal who will need to relocate. This 35 percent every five years (at 15 percent) is the equivalent of the 6–7 percent vacancy rate that is needed as the absolute minimum (frictional vacancy rate) to serve the ebbs and flows of the industrial market.

Market Rent Relative to Replacement Costs



Source: AMB Property Corp

On top of a minimum vacancy rate, we must account for the marketing of vacant but obsolete space. For example, very old, multistorey brick factories have been marketed as vacant and available even though most of these facilities would never lease because they are functionally obsolete for industrial users today. The inclusion of this non-leasable product in the pool of vacant space leads to a minimum required vacancy of 7–8 percent. Below this rate the market will not have enough space to function properly, and rents will grow to levels that would generate new construction to satisfy this unmet demand.

In addition to this minimum amount of available space required, the market must also expand to accommodate growth in the economy and demand for new industrial space. Historically, each 3 percent of annual growth in GDP creates an additional space requirement of approximately 2 percent. While the frictional vacancy rate is relatively constant across markets, the levels of obsolescence and expected new supply and demand vary dramatically by market. For example, demand has already begun to stabilise in several markets, and we would expect the more global trade-oriented markets to lead the recovery.

However, most of these markets are supply-constrained due to a combination of geographic, political and economic factors. In fact, these markets are actually shrinking, as there is virtually no new construction and obsolescence continues to shrink the pool of functional space by 1–2 percent per year. As demand continues to recover, these markets should see a more extended rental growth trajectory because there will likely be very little new supply coming on line to temper rental growth. Lower-growth, less-dynamic markets take longer to recover, and those that are less supply-constrained see a more competitive pricing environment as soon as new space is warranted by rental growth.

PRINCIPAL DEMAND DRIVERS

As AMB's model illustrates, production, trade and inventories are the drivers of demand for industrial real estate, together explaining more than 80 percent of the variation in historical demand. As such, forecasts for these leading indicators can be used to estimate the future magnitude and timing of demand.

When we analyse these variables in conjunction with the pipeline of new construction and estimates of new supply, we can forecast the availability rate for Europe overall as well as for individual markets and submarkets. We are able to estimate various scenarios for the timing of their returns to equilibrium, and with the strong linkage between vacancy and rental growth we can predict various scenarios for the size and timing of potential rental rate changes.

The "Market Rent Relative to Replacement Costs" chart on page 27 demonstrates how the vacancy projection from current levels toward equilibrium is likely to move rents. We know that the vacancy rate and rental growth are closely correlated. As prime European markets move toward 7 percent over the next two years, rents can be expected to reach levels necessary to support new construction. In the data depicted in the two charts, rents will grow by more than 15 percent over the next three to four years. Accounting for the estimated obsolescence flow of 1–2 percent per year would bring equilibrium sooner than implied by our model.

With 2009 experiencing the first contraction in global GDP and the steepest decline in global trade, demand for industrial space hit a record low. However, as of this writing, consensus outlooks for trade and production growth in the euro zone are expected to measure 2.7 percent and 4.5 percent, respectively, in 2010. When factored into our trade and production model, these factors imply that western Europe and the world should realise more than 5 million square metres and 45 million square metres of net take-up in 2010, respectively, and even more in 2011.

RENTAL GROWTH COMING

If the current consensus estimates and forecasts for production and trade are realised, our model implies that the overall prime western European logistics market would likely see rental rate growth as early as 2011, with equilibrium reached by 2012.

AMB has developed replacement cost, forecast, equilibrium and rental growth models for markets and submarkets globally. The rental growth trajectory varies by market and submarket, affected by the spread of current rent to replacement-cost-justified rent, the level of vacancy relative to equilibrium and the forecast of demand and supply. A few prime European markets have likely hit an inflection point in terms of demand, and there is virtually no new supply being built.

The leading indicators of demand for industrial real estate are rebounding, and the outlook for these indicators for 2010 and beyond is even stronger. We expect that improving economic conditions will fuel a recovery in demand, starting in the prime western European markets. The consensus forecast for global trade and production suggests that more than 40 million square metres of demand could be realised globally in the next few years, driving the availability rate to equilibrium levels in 2012.

All of this should drive market rent increases to levels necessary to support new construction requiring several double-digit spikes in the coming years. Our analysis of replacement-cost-justified rents and market fundamentals implies a projected return to more sustainable rental growth rates in 2012 and beyond. ❖

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A Prime Focus

Recent research from CB Richard Ellis confirms that 2009 saw a sharp rise in investment activity in the European industrial and logistics market, bringing a return of investor confidence in the sector. The firm's latest *EMEA Industrial & Logistics MarketView* shows that investment levels in the second half of 2009 increased by 52 percent, compared to the first half, taking the full-year 2009 turnover to €6.5 billion. The industrial sector was able to maintain its 9–10 percent share of the overall European market.

James Markby, director of industrial investment at CB Richard Ellis EMEA, comments that "in an environment where investors are particularly focused on quality and length of income as well as liquidity, the UK market ticks these boxes. Investors' focus is also reflected in Germany, France and the Netherlands; combined with the United Kingdom, these markets accounted for nearly 80 percent of second-half turnover in 2009. We are also seeing clear signs that 2009's year-end momentum has carried into 2010.

"Prime values are now showing signs of rising, and non-distressed owners have less incentive to sell stable assets. Investment demand is focused on high-quality buildings, so shortages of prime stock may begin to inhibit turnover growth, forcing buyers to widen their search criteria and turn their attention back to build-to-suit solutions," says Markby. "This will shift some of the demand focus towards value-add opportunities with higher void risk and asset management challenges."

Food retailers are proving to be a key source of demand for space across the European industrial and logistics sector at present, CB Richard Ellis says. This trend is most prevalent in the United Kingdom and other western European markets are likely to follow suit. Demand from manufacturers of finished goods and components is less robust, though, reflecting low levels of capital investment and weaknesses in new orders and exports.

Guy Frampton, executive director of industrial agency at CB Richard Ellis EMEA, points out that the nature of demand is changing. "Third-party logistics operators are increasingly favouring campus-style developments — large, multi-customer buildings clustered together that allow the sharing of services and thereby reduce costs.

"A two-tier occupational market is continuing to emerge, as tenants favour better quality space in strategic locations as long-term solutions, despite incurring higher costs in the short term. This is leaving a residue of poor quality space on which rents are still falling," Frampton adds.

—Richard Fleming