Press Cutting

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A perfect storm

E-commerce is forcing many retailers to develop logistics assets, and a glaring lack of supply is keeping yields low and investors interested. *Claire Robson* reports on an asset class that is emerging from the lower leagues as a top investment prospect

Formerly minor picks in the investment arena, industrial assets are now some of the most sought after in the market. UK distribution warehouse investment volumes hit £2.9bn in 2015, against a long-term average of just £1.7bn, according to research from Savills, while IPD figures show that over the past 35 years, the annualised total return of 10.5% is higher than that of any other asset class.

"Many investors viewed industrial as a slightly grubby, undesirable sector, but logistics has changed all that," says Savills UK investment director James Williams. "It's cleaner and much more appealing. A number of factors have come together around logistics to create a perfect storm."

From big-box distribution to last-mile delivery, assets offer investors a compelling combination of attractive income yields, long leases, strong covenants and low rates of obsolescence.

As the structural shift towards e-commerce transforms space requirements, demand for modern logistics stock is at unprecedented levels. By the end of September this year, more warehouse space had been transacted than by the year end of 2015.

Much of this take-up is accounted for by a small number of active occupiers. Yet, as e-tailing takes hold, businesses are being forced to restructure their supply chains and invest in the most efficient logistics stock.

The implications for the logistics sector are immense. JLL research director Jon Sleeman says: "It is driving demand for large fulfilment centres, through to sorting centres and edge-of-town local parcel delivery centres. The impact of e-commerce has changed perceptions of the logistics asset class and given it real impetus."

Investors are paying close attention to how this pans out. Griffen Capital, for instance, has invested around £200m in UK distribution and logistics assets. Its chief executive, Rui Nobre, moved to the UK from South Africa in 2013 to exploit the market's growth potential.

He says: "Just over 10% of retail sales are online and the ONS foresees that percentage rising to 26% by 2025. Research by Prologis predicts that for every £1bn spent online there is a requirement for 775,000 sq ft of logistics space. If you apply that ratio to the 26% figures, you can extrapolate that and it could lead to requirements for 160m sq ft of logistics space."

The investment case becomes even more compelling when you factor in the supply and demand imbalance. According to Savills, rising take-up, coupled with a fall in speculative development, has shrunk the total supply of logistics and distribution space by 22% year on year.

George Underwood, partner at Gerald Eve, says: "There will be around 10m sq ft of speculative space delivered this year compared with an annual average of around 14m sq ft between 2005 and 2009. A lot of that is let during construction or within six months of practical completion, so it is doing very little to address the supply and demand imbalance."

Even when developers are prepared to deliver more speculative space, forces such as limited land supply, planning restrictions and competition from higher-value uses will keep supply in check.

Hugo White, head of national investment at BNP Paribas Real Estate, says: "Three years ago, institutions held some assets, but the pool of players was dominated by the likes of Prologis and SEGRO. We have since seen the emergence of names such as Blackstone, LondonMetric and Tritax Big Box REIT and a range of overseas investors."

Local authorities have also now entered the arena, buying industrial stock to secure future revenue streams.

As a consequence, yields have sharpened considerably, with prime yields for distribution and logistics space now standing at around 5%.

With logistics moving up the asset class hierarchy, investors have sought to reposition their portfolios.

At the end of 2011, SEGRO announced a portfolio-reshaping exercise in which the investor focused solely on prime European industrial and logistics. It sold

M&G Real Estate's Imperial Park

BIG-BOX BUYER

With a portfolio valued at more than £1.8bn, Tritax Big Box REIT is set to exploit the irreversible shift in the way we shop.

Since the REIT was set up in December 2013, it has made some major acquisitions. Recent deals include the purchase in October of the £80m Euro Car Parts unit at Birch Coppice Tamworth. It bought the asset from M&G Real Estate at a net initial yield of 5.1%.

Tritax Big Box fund manager Colin Godfrey says: "Megasheds did not exist before the 1990s and have become increasingly sophisticated facilities that are hard to replicate. Occupiers recognise how integral these facilities are to their supply chains. And for the right building in the right location, they are keen to sign long leases."

Like many other investors, Tritax is building to own. Seven out of its portfolio of 34 assets involve forward-funding prelet agreements.

Godfrey is confident that occupier demand will remain robust. He says: "Demand is being driven by structural change rather than an anticipated increase in consumer spending. For retailers, these facilities are about improving efficiencies, and that's even more relevant post Brexit."

FTI CONSULTING

RENTAL GROWTH

Rental growth has not traditionally played a major role in driving returns from industrial investment, but times are changing.

Given the supply and demand imbalance within UK logistics, agents are predicting a 3% to 5% annual rental uplift.

Griffen Capital's Rui Nobre says: "Where we see growth over the next 10 years is in rents, not yields, and for the right asset we don't mind paying 20 bits more than the competition in order to secure it."

Yet Gerald Eve's George Underwood warns: "That growth depends on how headstrong landlords are prepared to be. They can't afford to be too nervous. With rising land values, they need the confidence to set new rental benchmarks."

£2.2bn of non-core assets and reinvested £1.2bn in new stock across the distribution supply chain.

"Given the supply and demand imbalance, logistics is enjoying its moment in the sun," says SEGRO's chief investment officer, Phil Redding.

"Its returns comprise a strong income component. The occupier base is diverse and it is likely to outperform other sectors in the short to medium term."

The shift to online retailing has also led to a change in focus for LondonMetric. The investor has spent £750m on acquisitions and developments in the distribution and logistics space since 2013.

LondonMetric strategy director Andrew Smith says: "Historically, our management expertise was focused on retail assets, but it was quite an easy decision to move out of traditional retail space and into the logistics market."

Yet as competition for stock intensifies, it is becoming tougher for investors to source prime logistics assets. As yields continue to compress and supply is more limited, many investors are building to own.

M&G Real Estate has a £2.2bn exposure to the UK logistics sector and around 1.5m sq ft of logistics schemes set to complete in the next nine months. Forward-funding projects include 480,800 sq ft at Wilson Bowden's Optimus Park in Leicestershire and 575,00 sq ft at Imperial Park, Coventry. SEGRO has also committed to major logistics development, including new space at Park Royal in west London.

LondonMetric has decided it will no longer bid for prime big-box assets given current yields. It will instead concentrate on acquiring last-mile delivery units from which it forecasts greater returns.

Meanwhile, it has opted to build its own big-box units and in September completed 524,000 sq ft of distribution space in Wakefield, which it let to Poundland.

Since the Brexit referendum, the appetite for speculative development among investors may be waning. Yet the supply and demand dynamic within logistics remains an attractive investment proposition.

Colliers International's head of industrial and logistics Len Rosso, says: "There is only three or four months' supply of speculative development remaining. If I was a fund manager, I would be looking to develop and secure myself a greater return."

Griffen Capital is one investor determined to forge ahead with speculative development. It has just completed a 132,000 sq ft building at Wellesbourne Distribution Park, Warwickshire, and plans to be on site for more in the coming months.

Griffen's Nobre says: "As far as we are concerned, Brexit presents a real opportunity to take advantage of others shelving their development plans at a time when the supply shortage is becoming ever more acute."

Indeed, for logistics investors, the EU referendum presents as many opportunities as challenges, and the asset class is likely to be viewed as a safe haven in an uncertain climate.

Recent headline deals include Legal & General's £150m commitment to forward fund Amazon's 2.2m sq ft distribution centre at London Distribution Park in Essex and Tritax Big Box REIT's forward funding of Bericote to construct a 540,000 sq ft unit at Four Ashes near Wolverhampton.

The falling pound means that UK assets now offer much greater value to overseas investors and a shortage of supply is likely to lead to decent rental growth and perhaps further tightening of yields.

STANDING OUT FROM THE CROWD

During 2015, a record £24bn was invested in European logistics. In the search for secure income in a stable market, UK assets are standing out from the crowd.

"Across Europe we are seeing a huge response to e-commerce with new buildings created and existing ones repurposed for real-time delivery," says Jack Cox, director at CBRE.

In the European context, the UK logistics market is well positioned to exploit increasing investor interest. "Compared with other European countries, it has the advantage of transparency, longer leases and limited land supply leading to rental growth," says Cox.

"The cheap pound means that the UK has suddenly become 20% cheaper for overseas investors. The UK will come through the coming months with flying colours."

SEGRO's Origin development, Park Royal