EUROPEAN LOGISTICS: RISKS & OPPORTUNITIES

Second Quarter 2022

IN A NUTSHELL

_ The European logistics sector has gone from strength to strength. Recent performance has been exceptional with both rental growth and total returns well-exceeding other property sectors.
_ Our latest research view indicates a more selective and cautious view towards logistics given record-low yields and potential challenges to occupier fundamentals. After a run of yield compression and rental growth, we are aware of growing risks that could dampen future performance in some markets.
_ We continue to favour the supply-constrained urban logistics sector and see the best opportunities in core+ and value-add strategies. Niche logistics segments such as cold storage, appear more insulated to supply and demand risks.

Logistics performance has been nothing short of exceptional

European logistics take-up reached its highest ever level over 2021, eroding vacancy rates to record lows and placing upward pressure on rental levels. Rental growth has been strongest in urban locations, averaging close to 4% per annum over the last decade, compared to 3.1% and 2.3% for residential and office, respectively.[1]

Investor demand for European logistics has never been greater. Investment volumes reached a new high in 2021 and the sector accounted for circa 20% of total European real estate investment, a proportion typically closer to 12%.[2] With liquidity at an all-time high, logistics yields have fallen sharply, sitting just 25 basis points above offices at the end of 2021.[3]

Our outlook for European logistics remains solid, particularly in the short-term, but at current pricing parts of the logistics sector now look fully valued. In addition, we see growing risks to future performance and are therefore increasingly cautious around certain parts of the sector. This report will highlight three key risks that influence our investment strategies.

1.1 Supply Risk: Short and longer-term considerations

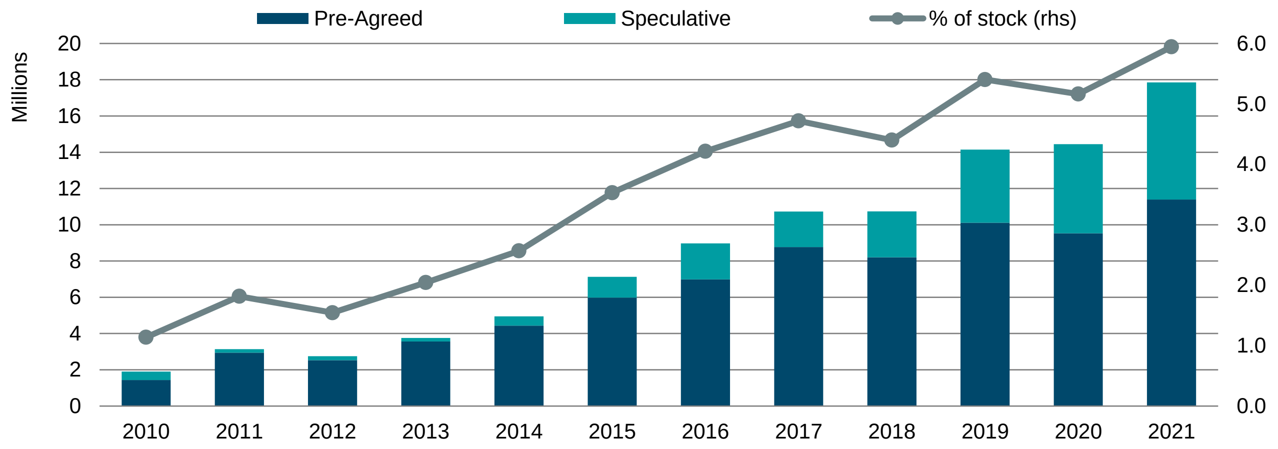
Short-term supply risks

With prime values in Europe doubling since the start of 2015 and low market vacancy, there is clear development incentive. As a result, logistics construction has soared in recent years. Ten years ago, logistics construction was running at about 2% of stock, by 2021 this figure had trebled at roughly 6% of total stock (see exhibit 1).[4]

[1] DWS, January 2022. Past performance is not a reliable indicator of future returns.
[2] RCA, March 2022
[3] DWS, January 2022
[4] PMA, CBRE, March 2022

Much of this supply has been built on a pre-agreed basis, but the volume of speculative development has risen sharply, equating to 36% of all delivered space over 2021, compared to roughly 20% between 2015 and 2019.[4] Despite low vacancy, significant levels of development elevate short-term supply risks, particularly in corridor locations in the CEE countries, particularly Poland, parts of Spain (Madrid) and the UK (Midlands).

EXHIBIT 1: EUROPEAN LOGISTICS COMPLETIONS (MILLIONS SQM)



Source: PMA, CBRE, April 2022
Includes Belgium, Czech Republic, France, Germany, Italy, Netherlands, Poland, Spain & UK

Long-term supply risks: Limited barriers to development in certain locations

In logistics, a supply picture can be very volatile and factors such as land availability and planning process influence a market's supply risk. Lille, for example, has seen significant spikes in vacancy in recent years, peaking at 11% in 2020.[5] Whilst much of this new supply has since been absorbed, land availability remains high and limited barriers to development imply future vacancy remain a threat.

There are barriers to development such as rising building costs driven by inflationary pressures, alongside growing ESG considerations, such as biodiversity. However, given the level of occupier and investor appetite, speculative development is expected to remain elevated in the short to medium term, particularly in those locations with fewer barriers to supply.

In recent years, exceptionally strong levels of demand have more than absorbed the higher levels of speculative supply. However, should supply continue to increase or demand moderate over the coming years, we could see a risk of higher vacancy rates.

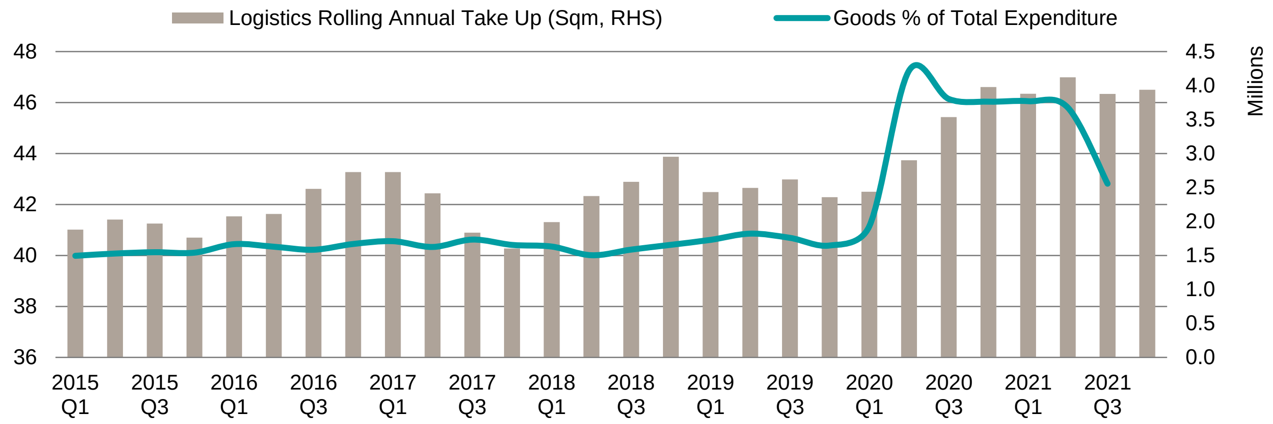
1.2 Demand: Is it sustainable at current levels?

Over the pandemic, logistics demand was exacerbated by the strong growth in goods consumption as consumers replaced spending on services, such as eating out and holidays, with the purchase of physical items. As restrictions have loosened, a rebound in service-based consumption has been evident and the proportion of expenditure on goods has dropped back (see exhibit 2).[6] As this rebalancing continues, logistics demand could revert to more average levels of take up.

[5] CBRE, March 2022
[6] Eurostat, March 2022

In addition, growing concerns around inflation and the cost of living is placing further pressure on consumer spending as household incomes are squeezed. The retail sector accounts for almost half of logistics take up, hence a decline in consumer spending would likely impact logistics demand.

EXHIBIT 2: UK PERSONAL CONSUMPTION OF GOODS AND LOGISTICS DEMAND

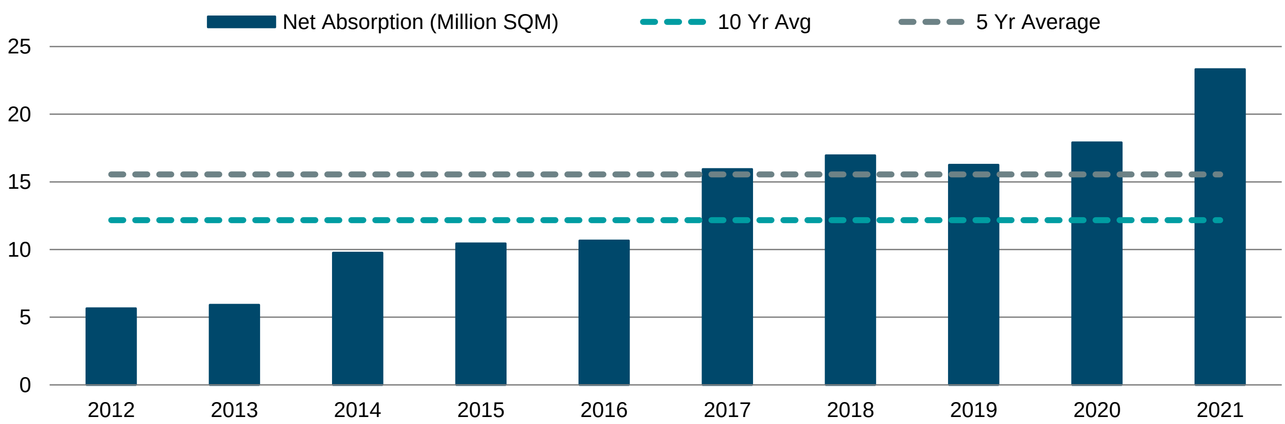


Source: CBRE, ONS February 2022

E-commerce firms have aggressively expanded their European logistics footprint in recent years. In markets such as Spain and Italy, this will likely continue as e-commerce continues to grow from a relatively low base. However, in more mature markets, this heightened level of new demand is unlikely to prove sustainable longer-term. Indeed, in the United Kingdom, Amazon now plan to moderate the level of future logistics floorspace. In addition, we could see the release of older, legacy units back onto the market, thereby increasing the supply of secondary logistics units.[7]

In 2021, we believe that logistics net absorption could have been artificially elevated due to a temporary shift in consumer spending on goods. If net absorption would revert back to the 5-year average, the much higher levels of (speculative) supply could pose a risk and create upward pressure on vacancy rates.

EXHIBIT 3: EUROPEAN LOGISTICS NET ABSORPTION



Source: CBRE, February 2022

[7] CoStar, January 2022

1.3 Tenant Risk: Thin profit margins and increasing costs

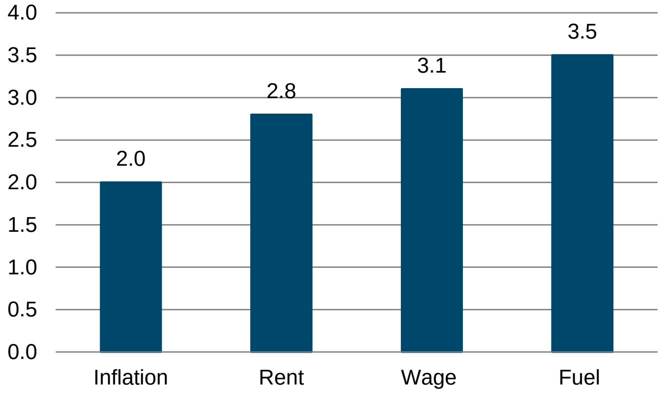
The third-party logistics (3PL) sector is an extremely important component of the European logistics market, typically accounting for over a third of total logistics take up. However, the market is highly fragmented and extremely competitive, with smaller local and regional 3PLs consistently accounting for more than 70% of total 3PL take up.[8]

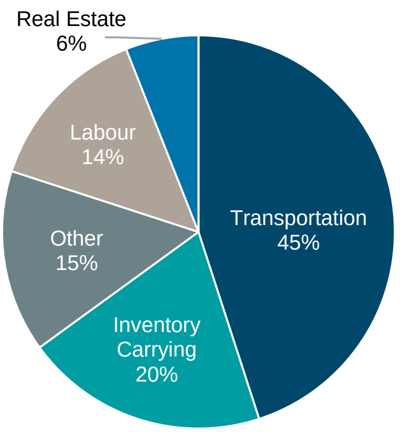
The largest 3PL occupiers in Europe, typically international in nature, recorded an average net profit margin of 6% over 2020. Comparatively, average net profit margins for more regional distribution firms were below 4%.[9] Smaller 3PLs tend to have lower credit ratings and are judged to be more prone to corporate failure and pose higher tenant risk.

Costs associated with logistics operations have risen significantly over recent years. Looking forward, wage, rent and fuel increases are expected to outstrip inflation over the coming five years, squeezing logistics operating margins further.[9] However, real estate typically accounts for only 6% of total logistics costs, a very small proportion compared to both labour (14%) and transport (45%).[10]

Considering notable growth in fuel costs, location selection for 3PL tenants will likely increase in importance and we expect firms will look to locate closer to end consumer to save on transport costs. This is an important factor when considering our logistics strategy around urban and Last Hour / Last Mile logistics.

EXHIBIT 4 & 5: COST GROWTH 2020-2025 (GERMANY, %) & TYPICAL LOGISITICS COSTS





Source: DWS, Oxford Economics, February 2022

Source: Savills, ISG Supply Chain Practice, February 2022

What does this mean for our investment decisions?

Logistics yields are now so low that at current pricing we find that some investors are having to underwrite exceptionally strong future rental growth to meet return targets. Whilst we expect continued elevated rates of rental growth over the next five years, it is unlikely very high level of growth can be sustained over the longer term, particularly in corridor logistics where we see short and long-term risks to supply. However, urban logistics in supply-constrained markets will likely continue to outperform and we also see opportunities for outperformance in niche segments such as cold storage.

[8] PMA, February 2022
[9] Income Analytics, February 2022
[10] Savills, ISG Supply Chain Practice, February 2022

Urban Logistics

Urban logistics concerns warehouse stock within close proximity to a city's main ring road, used to service 'Last Mile' deliveries straight to the consumer. The sector is not new to our strategic calls given the typically supply-constrained nature of urban locations and competing, often higher value, land uses. Our most recent Research house view assumes average rental growth of 3.2% p.a. over the 10-year forecast, compared to 2.0% in corridor locations.[11]

The structural drivers and additional rental growth in this segment mean lower yields could be more justifiable. However, accessing core standing assets is often challenging and it is difficult to build scale. With that in mind, we see the best opportunities in a value add or active asset management approach, such as the repositioning of older light industrial stock, or in some cases the conversion of redundant retail space to last mile or last hour logistics.

In Europe's largest cities such as London, Paris and Berlin, we see solid opportunities for Last Hour logistics, given exceptionally constrained supply and large population catchments within the wider metropolitan areas. In smaller markets, such as Birmingham or Cologne, Last Mile' or 'urban' stock will likely offer greater opportunity for outperformance over Last Hour given the relatively higher availability of development land outside of these city's main ring roads and lower competition from other asset classes. In both cases, tenant covenant is of importance and we should look to target larger 3PLs with solid profit margins.

Cold Storage

Another part of the logistics market that we think looks attractive is the cold storage sector, supported by solid demand and supply fundamentals. Fueled by consumer preferences for convenience, growth in online grocery in Core Europe is supporting demand for cold storage, particularly in markets such as UK, Belgium and the Netherlands. More recently, the storage of medical products has been a driving force behind temperature-controlled storage. We would expect the strongest demand for this type of product in Europe's largest manufacturers of pharmaceuticals, namely France, Italy and Germany.

Given the nature of the cold storage sector and the relatively high build costs, the segment is more insulated to the risks of over-supply that we see for regular dry storage in corridor markets. In addition, given often extensive tenant-borne investment in the fit-out of the building, cold storage tenants tend to be "Stickier" and typically commit to longer leases at higher rental levels.

Given the supply constrained nature of the market, we anticipate rental growth to be at least in line with prime corridor logistics over the forecast period, with the potential to outperform given the supply constrained nature of the market. While the previous yield premium over traditional corridor logistics has narrowed in recent years, yield convergence is anticipated to continue as institutional capital recognises the long-term potential of this part of the market.

Summary

The logistics sector has enjoyed an exceptionally strong run and at present fundamentals behind the sector remain solid. However, there are risks facing the sector, most notably around supply, the sustainability of demand and the credit worthiness of 3PL tenants. With that in mind, we now view the European logistics market with more caution. We still have a positive view on urban logistics, although this is now more of a tactical play and we see greater opportunities in moving toward active strategies, taking on development and (re)letting risk. In addition, niche logistics, in particular cold storage, offers the potential for outperformance vs. dry storage in corridor markets over the coming years.

[11] DWS, December 2021

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