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Logistics

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KEYNOTE INTERVIEW

Investors should keep faith in logistics fundamentals



Thematic drivers of demand and operating income remain healthy despite macro turbulence, argue Partners Group's Peter Holden, AJ Jager and Audrey Symes

Real estate markets have been impacted in recent months by rising interest rates and faltering economic growth. Investment activity in the industrial sector in the US and Europe has reduced in consequence.

Peter Holden, co-head of asset management, private real estate; Audrey Symes, lead investment researcher for private real estate; and AJ Jager, managing director, private real estate Europe, at global private markets firm Partners Group, assess the underlying health of the logistics market on both sides of the Atlantic, finding evidence of continued robust occupier demand supported by supply chain restructuring, and an increasing emphasis on sustainability.

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Q What has been the effect of the current macro-economic headwinds?

Peter Holden: As interest rates have increased, the availability and cost of finance has been impacted and, as a result, we are seeing asset values being repriced. That said, we have a strong conviction towards the logistics sector and there remains an appetite among investor clients for us to deploy capital on their behalf.

We are continuing to look for opportunities, although we are increasingly selective, and we are expecting more return for the investment risk that we take.

However, rents have not increased sufficiently in some cases to cover the increased costs of debt and construction, so viability is more challenging.

While occupier demand remains strong, there will be less supply across all markets. Transaction volumes are reducing because the bid-ask spread between buyers and sellers has widened. Some schemes will remain on the architect's drawing board a little bit longer, and increasing supply-demand imbalance could see existing stock accruing additional value while those challenges for delivery remain.

Audrey Symes: In terms of investment opportunities, when cap rates for logistics assets are already really low compared with other property types, opportunity for further compression is very limited in a rising interest rate environment, despite strong demand fundamentals.

The qualities of the individual industrial asset will start to matter more than they did before, when the momentum of the sector propelled everything along, to a certain degree. Transaction volume in the US logistics sector fell in Q3 2022, just as it did for other asset classes, as rising interest rates led to repricing.

However, industrial overall still offers lower capex than other sectors, as well as inflation protection, because short leases enable the regular repricing of rents. Also, fundamentals in the sector offer a lot of support for positive net operating income growth (NOI). In the US, we will see a reduced number of construction starts because the higher cost of capital will make development difficult. That will help to boost NOI for existing assets.

Q Do the drivers of demand in the logistics sector remain robust?

AS: Logistics real estate has offered an incredible growth story for investors over the past decade, driven by strong thematic tailwinds, and there is more to come. The growth in the stay-home economy has persisted in the aftermath of the pandemic, which has given e-commerce even greater impetus. While Amazon may be dialing down its expansion program, that is in the context of growth that already saw the business front-load its portfolio.

Meanwhile, we are seeing the market diversify, with more mid-sized retailers looking for space to support the expansion of their own e-commerce offerings. The market is still in its infancy in terms of penetration. In the US, about 15 percent of retail goods were sold online in 2019, and that is expected to reach 25 percent in the next three to four years, so there is significant growth potential.

Since the pandemic, the 'just in time' distribution model that became prevalent in the past 20 years has increasingly reverted to 'just in case.' Inventory levels plummeted as a result of pandemic-era shortages, but they are now re-approaching their 10-year average.

As a result of the war in Ukraine and covid-related disruption in China, occupiers are increasingly reluctant to rely on long supply chains, so their inventory-to-sales ratio is creeping up and they need bigger facilities to store more goods. In the US, industry experts expect inventories to increase by 5-10 percent compared with pre-covid, which would translate to a need for around 800 million square feet of additional warehousing.

Partners Group bought a stake in Oslo logistics platform LogCap in March 2022

Nordics shows growth characteristics

Regional fundamentals support a thematic approach to investing

The Nordics is a prime example of a region where demand for last mile logistics buildings is high, while supply has failed to keep up, creating attractive investment opportunities, observes AJ Jager, managing director, private real estate Europe, at Partners Group. The firm has amassed a €750 million Scandinavian portfolio over the past year, closing three transactions.

In March 2022, the firm bought a 50 percent stake in Oslo logistics platform LogCap. Partners Group aims to work with the operator to expand the €442 million seed portfolio of last mile facilities to €1 billion. Two further investments followed in the summer: the off-market acquisition of a 140,000 square meter portfolio in Finland, and 50,000 square meters in Sweden operated by Vencom Property Partners.

"During the first nine months of ownership, we have signed over 74,000 square meters (750,000 square feet) of new leases in the Nordic last mile portfolio, with average mark to market rent reviews exceeding 50 percent versus rents in-place," says Jager. "With the export-oriented Nordic market relying on logistics to support its continued economic growth, we will continue that thematic approach and have reserved growth equity for our Nordic last mile platform, with an intent to increase the allocation further."

PH: The cost-of-living crisis is causing consumers to tighten their belts, which you would think might lead to a contraction. But in most of the markets in which we are active, we are still seeing growth in demand, particularly for 'first mile' facilities, large national and regional distribution centers, as the need for more storage space counterbalances the slowdown in the general economy.

Q How is sustainability playing an increasingly important role in attracting logistics occupiers?

PH: We have already seen how large corporations' global commitments to sustainability, many of them aligned to the Paris agreement and the commitment to achieving net zero by 2050, has driven demand for sustainable office buildings. Global logistics operators such as Kuehne + Nagel, FedEx, DHL and UPS have made similar commitments to decarbonize their operations – we can see this influencing how they lease new space.

When we provide best-in-class energy, water and natural resource-efficient logistics space with a high LEED or BREEAM certification, occupiers have shown that they are willing to pay a rental premium for that high-quality product. With occupiers facing escalating energy costs, a commitment to energy efficiency has never been more valuable. Meanwhile, when it comes to an exit, investors are also willing to pay a premium price for assets that can demonstrate high environmental standards because they know those assets will provide resilient income streams in the long term.

Assets that cannot demonstrate a commitment to achieving net-zero carbon by 2050 will be more difficult to sell, and their valuations will be impacted accordingly. At Partners Group, ESG and sustainability is integrated throughout our investment processes and value creation plans.

> *"In the US, industry experts expect inventories to increase by 5-10 percent compared with pre-covid"*
>
> **AUDREY SYMES**

AS: More emphasis on sustainability will boost the demand for last mile space because adding an urban logistics hub at the end of a supply chain has been shown to provide a significant efficiency gain in terms of emissions. Distributors can reach more households, more quickly and with a higher energy efficiency, which potentially offers huge savings in the context of rising labor and delivery costs.

Online shopping also generates around one-third less emissions than shopping in-store. As consciousness grows on points like those, ESG will be pushed up the agenda for logistics tenants. Meanwhile, consumers are becoming increasingly aware of the carbon footprint of the goods that they buy as more products list their carbon footprint, and that will slowly start to trickle through into buying preferences.

Improving ESG offers some easy wins for investors, too. If you buy an older building in a good last-mile distribution location, it is relatively straightforward to add value by refitting to make it more energy efficient. And by employing advanced data analytics and the internet of things, occupiers can help to meet emissions reduction targets through measures such as load pooling and dynamic rerouting.

Q How important is asset management in generating returns in current market conditions?

PH: When there are headwinds, that is asset management's time to shine. Economic turbulence makes it more challenging for occupiers, so we need to be attuned to that and work collaboratively with them to ensure that they continue to operate successfully from our buildings.

Managers need to really focus on what occupiers are seeking, work hard to reduce voids across their portfolios and reposition assets to pivot towards changing demand. Sometimes that might mean converting a large single-tenant asset to a multi-tenant one, being flexible on leasing, or working with occupiers to help procure low-cost and low-carbon energy.

Sustainability has become part of the definition of what quality means, and you need the best building in the market to attract the best tenants. A 20- or 30-year-old building is completely different to one you would construct today.

However, if you can target the right legacy assets then it is possible to create value through light capex measures such as fitting LED lighting, replacing gas-fired heating systems, sourcing energy from renewable power generators and generating power on site. You can also create improvements that make the building better suited to modern tenants' needs, for example adding sprinkler systems or new dock levelers. These updates extend the lifespan of such assets while reducing the carbon footprint by reusing components to avoid wasting embodied carbon. ■