The Changing Face of the Industrial Investment Market in Europe

By Guy Frampton, SIOR

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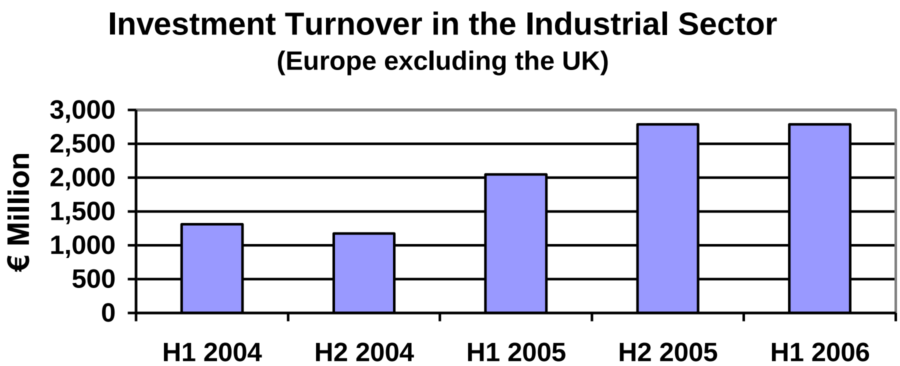
The level of interest in investment in the industrial sector is growing rapidly across Europe as investors realize that the sector generates consistent, stable returns. It is therefore becoming more important to understand the structure of the sector and its drivers going forward. Infrastructure remains the key driver of location in the sector, but the impact of infrastructure needs to be understood in the context of political, economic, and technological changes that are also affecting choice of property and location.

Growth in the Investment Market
While it is still dwarfed by the office and retail sectors as an investment market, industrial property has been attracting growing interest from investors in continental Europe. The total value of investment deals in the sector more than doubled from 2004 to 2005 and the level of activity has been maintained into 2006. This growth is partly due to the growing interest in commercial property generally, but it also reflects a number of attractive characteristics that the sector offers.



Source: CB Richard Ellis

Stability of Income Returns
One of the key attractions of the sector is the stability of income returns. Unlike the office sector, where annual rental growth can swing from plus 20 to minus 20 percent in the space of a couple of years, the history of rental growth in the industrial sector is much more stable. In the past, year-on-year rental growth has tended to range between plus five and minus five percent per year in much more stable returns. Industrial property is never likely to generate

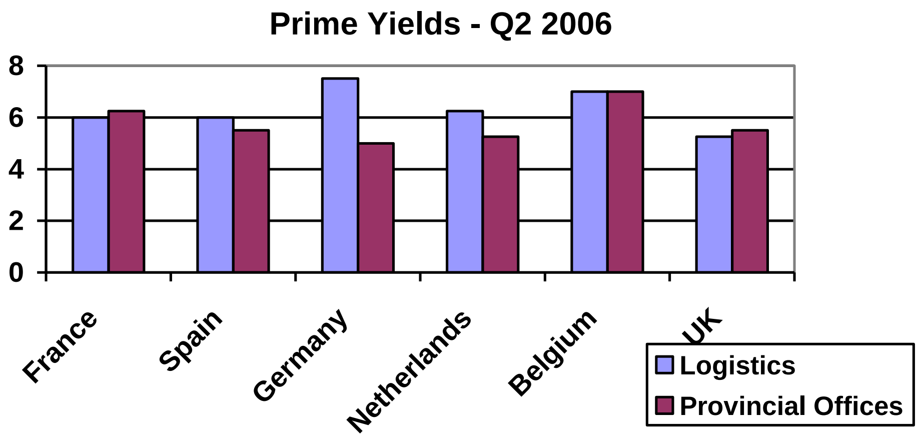
very high rates of rental growth, but it is unlikely to see dramatic falls in rental value either. In fact, industrial rents have kept quite closely in line with inflation over the long term.

The stability of returns is further enhanced by the covenant profile of industrial property. In the case of the large logistics properties that are most sought after as investments at the moment, tenants tend to be large multinationals. This contrasts sharply with the high number of generally small companies that form the occupier profile of a multi-let industrial estate. Each of the occupiers in those properties represents only a small proportion of the entire income flow from the property, so although there will always be some vacancy, there is less risk of a significant level of rental default.

In a low interest rate investment market, where the ability to preserve capital value is a key motivation for many of the most active investors, this stability is a very attractive characteristic of industrial property. Investors have also been attracted by the capital value growth that has resulted from the re-pricing of industrial property.

Over the last 10 years, the gap between prime office yields and prime industrial yields has slowly narrowed from 291 basis points in June 1996 to 222 basis points in June 2006, and further convergence is generally expected. In fact, it is probable that in many cases the “yield premium” for industrial property is not as big as it would appear. Despite the increase in turnover of the industrial market, there are still locations where the market is so thin that only a small number of transactions are recorded each year. As a result, it is difficult to accurately assess the prime yield and in fast-moving conditions—such as those that are currently being seen—the yield at which it is possible to buy can be significantly below what it would appear from the limited evidence available.

For certain types of industrial property the convergence has been more rapid. In the logistics sector, for example, prime yields are now virtually in line with those for provincial offices across most of Europe, and some recent transactions imply even lower yields. The scope for yields to fall too much more in the logistics sector is therefore quite limited. As a result, investment in logistics property is essentially an investment in the current income. The potential for rental growth over and above the indexation normally applied to rents in Europe is limited. Finance rates for real estate investors therefore seem to represent a floor below which it is difficult to see yields falling.

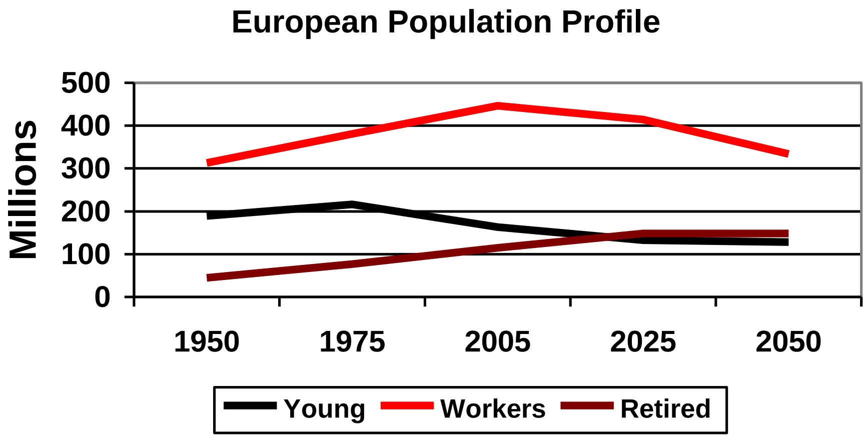


Source: CB Richard Ellis

Demographic Trends
The final characteristic that is attracting investors to the logistics sector is demographic trends. It is well known that the average age of the European population is rising rapidly, as a result of both increasing longevity and a falling birth rate. Overall, the European population is

still rising slowly, but the profile of that population is changing significantly. It is estimated that the peak in terms of the working age population in Europe was 2005, with a steady decline thereafter.

This shift in population has significant implications for investment trends in the major property sectors. In Western European countries, the combination of population growth and the shift from manufacturing to the service sector has supported a significant growth in office stock. The service sector now represents more than 70 percent of total employment in Western Europe, limiting the potential for further growth. As both these trends slow, the impact on the office sector will be to move from the expansion to the replacement phase. This change will affect not only the rental growth that the sector will be able to generate, but also the possible residual value of poorer quality office buildings in the longer term. The change in the age profile of the population will also affect the retail sector, with some retail formats benefiting and others being adversely affected. The implications for the industrial and logistics sector look to be much more neutral.



Source: Erasmus University, Rotterdam

The changing age profile of the population has a more subtle impact on industrial property than on the other sectors. Manufacturing property is generally outside the scope of the investment market, with most factories being owner-occupied. It is logistics properties and smaller multipurpose production and storage properties that are of concern to investors. While demand for office space is very directly related to the number of people employed in office-based occupations, this is not the case for industrial and warehouse space. The trend away from the manufacturing sector has little impact on this type of property and, in fact, the shift in manufacturing to Eastern Europe and the Far East increases the demand for logistics property.

The growth in investor interest in industrial and logistics property is well established and likely to continue. What premium currently exists in the sector between comparable office and retail investments is likely to be completely eroded over time. As the trend away from owner-occupancy grows and the sector becomes more conventional, it will be a core part of any national or international portfolio.

Therefore, it is crucial to understand the dynamics of the market and where the best opportunities lie in the short and long term. While demand for smaller multi-purpose production and storage properties tends to be very closely tied to population centers, the demand for larger logistics facilities will be determined by a range of broader factors operating at a Pan-European level.

The Drivers of Logistics Location Decisions

Infrastructure is by far the most important driver of logistics locations, but it is important to remember that political, economic, and technological changes alter the way the industry interacts with an infrastructure network—a network that is itself changing.

Political Context

The EU is by far the biggest political influence. It would be easy to dismiss the convoluted nature of European politics as largely irrelevant to industrial property. However, the perennial conflict is between a centralizing, essentially protectionist group of politicians and others intent upon liberalization. Which of these groups is able to exert the most influence on the policies of the EU has an impact upon the flow of goods and thereby on demand for logistics facilities.

Geographically, the new central European members are important in that they provide a gateway to markets in the east and south east. Although they only increase the population by 75 million, these new members, particularly Poland, offers much better access to the 200 million-strong markets of Russia, Ukraine, and Belarus. Moreover the process of expansion has accelerated the move of manufacturing eastwards.

The EU transport and labor policies should increase the importance of multi-modal logistics. One goal of the EU's transport policy is to return modal shares back to the 1998 levels; the policy requires rail market share of freight traffic to grow from eight to 15 percent. Labor policy will have the effect of increasing the relative cost of road transport by reducing the number of hours drivers are allowed to operate.

Environmental policies coming from the EU and other global agreements are also influencing the logistics market. The Waste Electrical and Electronic Equipment directive, for example, requires that reverse logistics networks be established, with an emphasis on flexibility. Policies to reduce pollution and global warming will aim to move goods off the road.

Economic Context

The biggest global economic trend in recent years has been the shift in production to take advantage of lower labor costs. In a European context this has primarily been to Eastern Europe where wages are 10 to 20 percent of those in Western Europe. Most notably, most European car producers have now established factories in the Czech Republic, Poland, and Slovakia and are running down production in the West. The growth of China, the Far East, and India, as centers of production has also affected Europe (most notably in the textile industry). The result of both trends has been to increase the transport of goods (and therefore the need for logistics facilities) and to increase the volume of goods passing through European ports. More than 50 percent of European container traffic comes through the ports between Hamburg and Le Havre and this area will therefore see further growth in its logistics industry as world trade expands.

Main European Container Ports

		Million TEUs*
Rotterdam	Netherlands	8.3
Hamburg	Germany	7.0
Antwerp	Belgium	6.5
Bremen	Germany	3.5
Gioia Tauro	Italy	3.3
Algeciras	Spain	2.9
Felixstowe	UK	2.7
Marseille	France	2.2
Le Havre	France	2.1
Valencia	Spain	2.1

Source: Eurostat

*20-foot equivalent units

At a business level, the structure of the logistics industry is changing. In the UK, roughly 80 percent of transportation is outsourced, along with 70 percent of warehousing and some 22 percent of inventory management. In France, by comparison, the rate of outsourcing for transport is estimated at more than 70 percent, but is still less than 50 percent for warehousing and only 10 percent for inventory management. As the level of outsourcing grows, the occupier market for logistics property will become increasingly dominated by a small number of very large operators. Such consolidation of operations will inevitably lead to changes in both the type and location of facilities demanded.

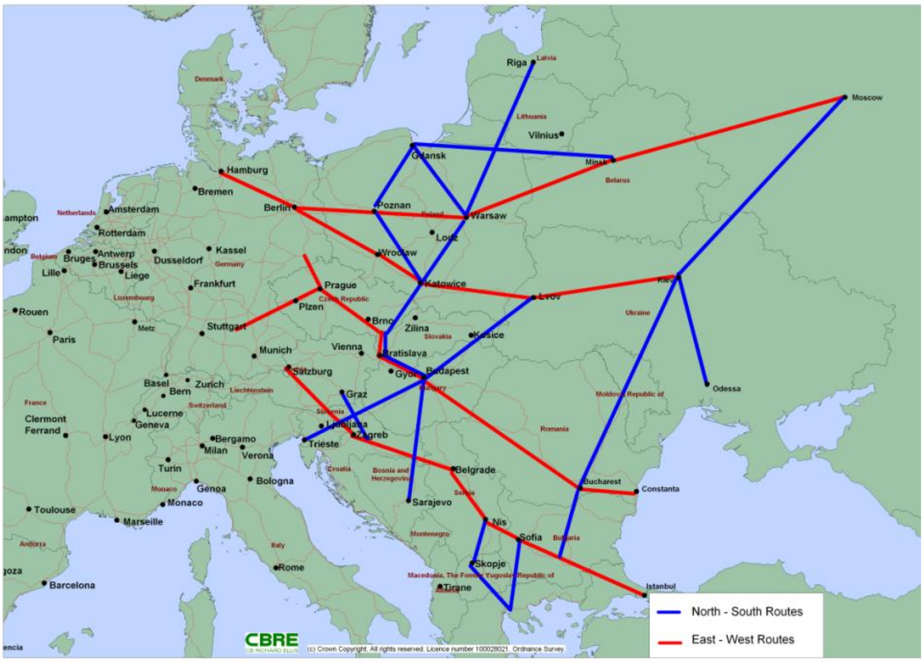
Technological Context

Generally, the path of technology over the next decade is for processes to become faster and more responsive. Over the same timeframe, hardware will become smaller, faster, and cheaper. The next decade will see a revolution in control aspects of the global supply chain leading to greater integration, more responsiveness and—tellingly for industrial real estate—less storage. The technology that will bring this about is the Radio Frequency Identification (RFID) tag. RFID means that products can be tracked from the point of manufacture to the point of sale. It holds the potential to create a genuinely flexible supply chain where the flow of goods is optimized to meet sales in particular places at particular times. On-vehicle inventory can be identified and made deliverable without ever being stored.

Integrated supply chains require better bandwidth. It follows that issues of access to bandwidth infrastructure, hitherto largely confined to office property, are of crucial importance to industrial property in the future.

Infrastructure

Infrastructure remains the most important driver of location for logistics, albeit against the changing political, economic and technological context where it takes place. Moreover, as around 75 percent of all goods in Europe are moved by road, it is the road infrastructure that has the greatest influence. Looking forward, therefore, the Helsinki corridors (the EU’s proposal for Europe’s transport network in the future) are key to understanding how the shape of Europe’s distribution network will evolve over the next 10 years. The network, while actually multi-modal, is dominated by roads and incorporates a high degree of road investment, which is expected to be largely in place by 2016.



This evolving East-West infrastructure is made more important by the growth in the consumer markets in the new entrants to the EU. Currently, the standards of living in these countries are generally well below that in Western Europe. However, rapid economic growth in these countries is narrowing this gap, and the higher standard of living is bringing a growth in consumer spending that is attracting many Western European retailers to expand into the area. So, on the one hand, economic growth is creating movement from west to east. On the other hand, the shift in production to the East results in transport of manufactured goods and components from Eastern Europe to the West.

The expectation is, therefore, that the logistics "center" of Europe will move eastward. Based on the known infrastructure improvements over the next five to 10 years and the expected impact of policy and economic changes, it is possible to predict the locations that are likely to grow in importance over this period. These new hubs of activity are generally, although not exclusively, located in the east because new infrastructure developments are concentrated in this part of Europe.

The European logistics sector is therefore likely to see considerable change over the next 10 years. Fortunately, however, much of this change is predictable. The major infrastructure, economic and social changes anticipated over the next 10 years point to two major trends: the growing importance of ports within the transport infrastructure and a shift eastwards in the logistics ‘center’ of Europe. These fundamental trends will dominate the strategic thinking for the potential investor in European industrial property.