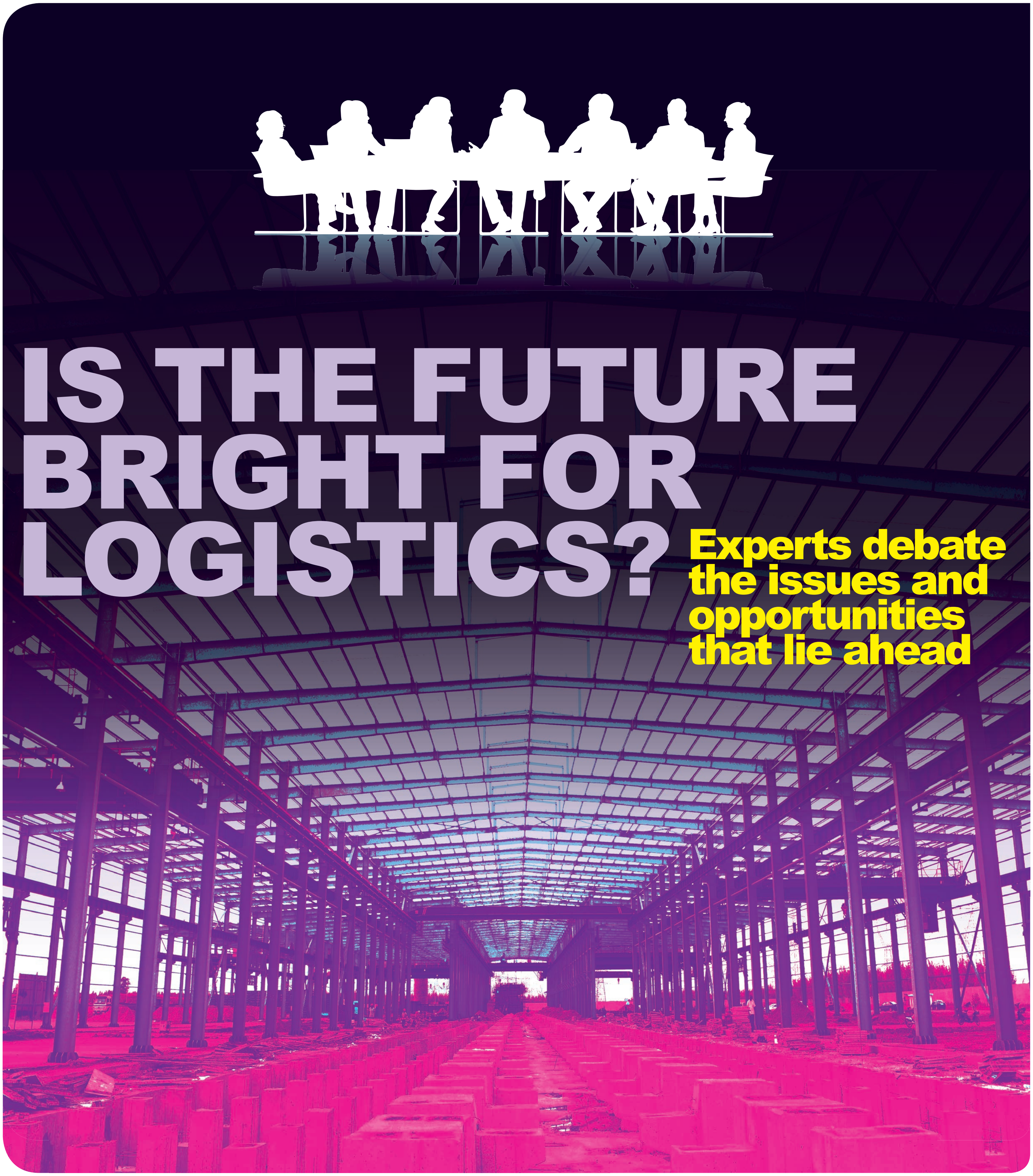
IS THE FUTURE BRIGHT FOR LOGISTICS?

Experts debate the issues and opportunities that lie ahead



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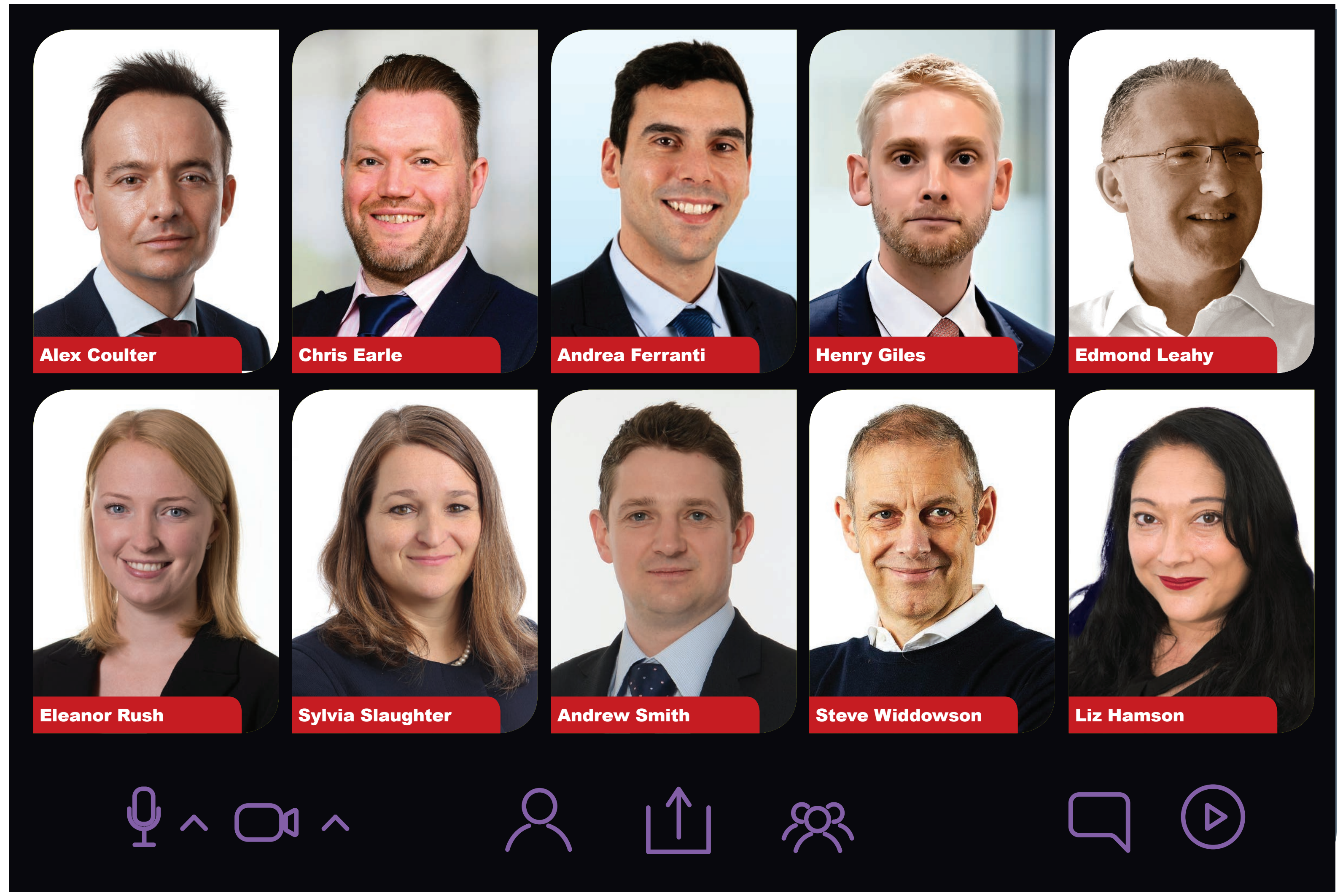
WHAT LIES AHEAD FOR THE SECTOR POST PANDEMIC?

Unlike other areas of the property industry, the industrial and logistics sector has only been boosted by the likes of Covid-19 and Brexit. However, a number of issues are on the horizon. *Property Week*, in partnership with Dentons, recently brought together a virtual panel of experts to ask what the future holds for the sector



OUR ROUNDTABLE PANEL MET TO DISCUSS TOPICS INCLUDING:

>> Whether last-mile logistics is really worth the trouble for investors

>> Opportunities afforded by multi-storey developments

>> Redressing the substantial supply-demand imbalance that now exists

>> How the sector can become more committed to the ESG agenda

Alex Coulter, partner, Dentons

Chris Earle, director of industrial and logistics occupier advisory, Savills

Andrea Ferranti, associate director for industrial client engagement and research and forecasting, Colliers International

Henry Giles, fund manager for IULIF, portfolio director, real estate, InfraRed Capital Partners

Edmond Leahy, senior estates manager, Hermes Parcelnet

Eleanor Rush, associate director, group investment, SEGRO

Sylvia Slaughter, senior director – fund management, GLP Europe

Andrew Smith, strategy director, LondonMetric

Steve Widdowson, North West director, Caddick Developments

Liz Hamson, editor, *Property Week* (chair)

The industrial and logistics sector is booming at the moment. Occupier take-up is hitting new heights and investors are clambering to snap up stock. Rather than dent the sector's progress, Brexit and Covid-19 have turbocharged it.

However, there are a number of issues looming large on the horizon. There is currently a significant supply-demand imbalance, which is causing rents to soar. Could multi-storey developments provide the answer? How about converting redundant retail space to logistics hubs?

These issues and more were covered at *Property Week*'s recent industrial and logistics virtual roundtable debate in partnership with Dentons.

What does the post-Covid future hold for the industrial and logistics sector?

AF: We believe we're going to see a little dip in terms of online sales. This is natural because, of course, people are going to go back to the high street as much as they can. However, the dye is set and structural change has happened.

According to our research, we are going to see the online share of total retail sales in the UK reach 29% as a stable share in 2024-25 on an annual basis, which is pretty much in line with what we've seen over the past few months. It's going to require an extra 15m sq ft of space to fulfil these extra orders so we don't see occupiers slowing down in terms of requiring extra space.

However, next year when most of the requirements will have been partially filled, we can see take up going back to normal rates, but those normal rates won't look like 20m sq ft to 25m sq ft-plus. It will be more around 35m sq ft to 38m sq ft, so we're going to continue to be very busy.

> **We're expecting growth to continue and we're seeing customers place a particular focus on supply chain**
> **Edmond Leahy**

CE: We expect to see the same sort of figures. We often quote some Prologis figures, which are quite interesting, and they say that for every additional £1bn of online sales it results in an average of an additional 775,000 sq ft of demand in warehouse space. Their projections are showing £83bn of additional online retail and that will create demand for 63.9m sq ft of logistics space by 2025.

> **I think what's not going to change is people wanting things more quickly, and that plays very much into online**
> **Andrew Smith**

ER: We're also expecting growth to continue and we're seeing customers place a particular focus on supply chain. So we're looking at working with our customers and seeing how we can help them to repurpose that supply chain, which is really interesting. Also from the investment standpoint, we're seeing investors looking to reposition their portfolios. So we're seeing a huge wealth of money chasing the industrial and logistics sector at the moment and looking to move away from perhaps the more uncertain sectors such as retail and offices.

AS: I quite like [Amazon boss] Jeff Bezos's comments on this kind of stuff, which is: "I don't worry about what's going to change because I can't forecast out. I worry about what's not going to change." And I think what's not going to change is people wanting things more quickly and wanting a wider choice, and that plays very much into online. I think every demographic age group during the pandemic has had their eyes wide open and I think the biggest uptake in online shopping has been among the older age groups, which has been very interesting.

The youngsters were doing it anyway – they've just been doing it a little bit more. In terms of the pricing question, it is all about rental trajectory and where's the cashflow going because, actually, I'm willing to pay a very sharp yield at the front end if I know and have confidence that rents are going to grow.

Many deals today are being done on index-linked leases, so you've got certainty of that cashflow, which means my cap rate can come in. And that's great, up until a point, because at the end of the day, the Bank of England have got a job to do and that's to put inflation rates at a certain level.

Do I think ERV growth will continue at the current rate it has been? For the right asset in the right location, yes I do, but it's not uniform and it's not across the entire country and you have got to be a bit careful. That's why you often hear LondonMetric talking about buying the right asset, in the right location, with the right tenant and the right lease structure.

SS: What I find so interesting about this Covid shock is that it's very clear that logistics has had a massive boost. We're so lucky to be in logistics and it's done well through such an economic shock. But I think there's quite a few research papers out there – and I think we see it too – that this is not a one-year event. Everything that happened in terms of demand in the last 12

months, we're going to see for the next four or five years and I think it's so interesting that one event can make such an impact going forward.

SW: I've been through several cycles in my career and this is probably the easiest one to understand. There's a massive broadening out and thickening of demand across the sector for all the reasons we've talked about, but equally, the supply side is massively challenged as well by the planning system and other issues that are baked in. So I think that's going to sustain the sector and probably smooth out any capital cycle you might normally expect to see, because supply is challenged and will remain challenged. I think there's enough headroom in there for the sector to cool off a little bit, but to still continue to be very attractive for investors.

> **Brexit made everyone pause for a little bit and not really make any new leasing decisions for a while**
>
> **Sylvia Slaughter**

What impact has Brexit had on the sector?
CE: I think what Brexit and Covid have done is caused a lot of people to really look at their supply chains in a bit more detail. Obviously, we all saw what happened with the panic buying at the beginning of Covid and that was obviously slightly different to what happened with Brexit, but I think what's happening now is people are looking at their supply chains and instead of going from this 'just-in-time' piece, people are now looking at 'just in case'.

And I think what's happening is where people have been taking on additional space for Brexit stockpiling reasons or for Covid reasons, that short-term space has now become long-term to medium-term space, because once you've got it, you want to hold on to it on the basis that actually it's probably going to help you in the medium to long term as opposed to just the short term.

AC: It's back to that issue about supply and demand. Perhaps supply chains will need to look at other areas, like a Liverpool for instance, or areas of Kent or maybe some parts of the east coast. In the UK, I'm seeing investors look to do more of a newer model and not to just buy something that's passive and they get four cheques a year. People are looking to do more work now so they're buying things to repurpose, and I'm also seeing a lot more forward funding, forward commitments and also speculative developments across the country in areas to meet demand.

SS: For me, I would say the biggest impact was that Brexit made everyone pause for a little bit and not really make any new leasing decisions for a while. Then Covid happened and it also put a bit of a pause on leasing. And then as we turn a corner, and vaccinations roll out, it feels like now we're catching up on the pent-up leasing demand.

So in the last six months, it's been going gangbusters in terms of leasing demand on both sides of the Channel and that is I think related to people figuring out what to do with Brexit and people figuring out what's happening with Covid now.

Last-mile logistics has really taken off over the last 12 months for all the reasons already stated and everybody wants a piece of the action there, but given the nature of these units, the planning challenges and the intense competition for sites, is it more trouble than it's worth?
SS: Can I float a quick question first? What is last-mile logistics to people because it seems to be a catch-all for anything that's geographically close to people, but is there a standard on what you think is the last-mile building?

EL: From a parcel delivery perspective, if you send a parcel it ends up in a hub and it goes around a sortation machine. It then gets sent to a depot, which is more, I suppose, city based, and it goes through a less sophisticated sortation process. Then it gets sent down to a smaller building and they can be anything from 3,000 sq ft on a multi-let industrial estate through to maybe 15,000 sq ft. It was always modelled on the basis that in order for a courier to make the business model work, it should only really have to travel up to three and five miles because any more than that and it doesn't make it viable in terms of cost. So that's what we would call last-mile logistics. It's actually kind of perhaps 'last five miles' if you like, but it's much more localised.

> **There's a bit of a split definition between the very inner urban city logistics and the more last-mile kind**
>
> **Eleanor Rush**

ER: The way that we look at it is we almost divide last-mile logistics into what we class to be last-mile logistics and then our city logistics piece, which is more zone one, zone two, and that might be properties that are using bicycle deliveries and things like that. As an example, last year, we acquired an electric park in Canning Town, which we consider to be a city logistics hub. It is very close to Canary Wharf and predominantly serving that area. So I think there's also a bit of a split definition there between the very inner urban city logistics and the more last-mile kind, which is serving areas a little bit further out.

HG: I think what the last couple of minutes of conversation has shown is that it's not just every different investor has got different interpretations of that term but also different occupiers, and that creates a diversity of demand in the right locations. We define the strategy based on drive times. So we focus on industrial assets within 20 minutes' drive time of the top 10 UK cities and that's different in London to where it is in Birmingham, for example, or Bristol.

The occupational performance that we're seeing in the portfolio, combined with the residual land value of holdings in these city fringe locations, means we think it is a sensible long-term play for our investors, but coming back to what Andrew was saying earlier, you've got to be highly selective and focus on the right assets.

And so you think it is worth all the trouble for investors?
AC: Legally they can be tricky sites and in terms of asset management, they can be hard work. You aren't buying a lovely, shiny big shed somewhere off the M1, but it is worth it.

However, as I know from Henry, you've got to build up size and scale – whether you do that with portfolio purchases or by rolling your sleeves up and buying different lots around the country. It is worth the hard work and it is necessary to the supply chain that we've been hearing about.

What is it about these edge-of-town locations that logistics occupiers increasingly seem attracted to? Does this offer a solution to the wealth of redundant retail space on retail parks, for instance?
HG: We buy into the idea of these retail schemes playing a more dynamic role, which incorporates some industrial functionality. Construction of the units is not dissimilar [to industrial and logistics units] and the large car parks can be partially reconfigured as yards. The key challenges surround change of use and local authority support for retail-to-industrial change of use, which is often driven by the lower expected number of jobs associated with industrial sites in these areas. I think our expectation is that the best located of these units may form part of the solution in terms of 'last-touch' delivery and maybe the return of goods from consumers back up the supply chain, but it's still pretty early days.

AS: The way we've looked at this is: do the commercial numbers make sense? It's only a very finite number of locations and you're starting with a rent equation where even on some of these redundant retail schemes, they can still attract mid-teens rents against the £6/sq ft to £7/sq ft sort of rent for an urban logistics unit outside core geographies. And so the numbers don't stack.

We think you've got to be buying these things at about £120 capital value per square foot in order for it all to stack and that then assumes the yield compression that you will see once you've dealt with it all comes out the other side and works. So it's a hard equation. I'm not saying it's impossible, because I think there are examples, particularly in and around London, where it's happening, but I think the number of opportunities are very finite.

Are there opportunities where multi-storey developments might work?
AS: Yes, but show me in the UK where multi-storey is a real success story. Edmond, would you take the multi-storey unit? Would you be happy to share access with a whole host of other parcel operators? I've never heard anybody say "yes, this will be our preferred model".

EL: In a word, no. Andrew is absolutely right. I think it would be a bit of a paradigm shift

operationally to start considering shared access and then multi-storey buildings as well. It only takes one vehicle to break down on a ramp and that causes chaos.

ER: Our X2 development at Heathrow is a multi-level warehouse and is what we would consider to be sort of a third-generation multi-level, and actually we've kind of moved designs on since then. In 2019, we developed a multi-level building in Paris, which we consider to be our blueprint for multi-level development going forward. What was great about that is it's fully let, it works very well and customers were very keen and open to look at an innovative solution. It's a great asset of ours that we really want to try and roll out further if we can. We're always on the lookout for sites – we just haven't yet managed to find the right thing [in the UK] at the moment.

We've talked about the different types of scheme coming through, but what about the volume of supply? There is this terrible imbalance in many ways between supply and demand, but is this also a protective imbalance in some ways? What do we need to do to redress that balance?
CE: If you look at 2020, speculative take-up reached 10.8m sq ft, which is its highest ever. You've also got an increasing average building size as well. So average existing units are north of 200,000 sq ft now and build-to-suit units are well over 600,000 sq ft. So there is absolutely that race for space.

It's very easy for us to sit here and just say "build more sheds", but I don't think that is the answer. There's going to be innovation in there as well and there's going to be better utilisation of existing space. I don't think there's a silver bullet for this, but ultimately we've got a supply imbalance, which obviously is creating issues in the marketplace.

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>
> **Chris Earle**

AF: This year, we're looking at 11.5m sq ft of spec space that would have been delivered by the end by December – this is for units of 100,000 sq ft-plus. Last year, there was around 8.5m sq ft and on average we've seen around 8m sq ft to 9m sq ft over the last three to five years and supply actually hasn't really changed much. We now have around 30m sq ft. So all of these spaces that have been specced have been absorbed quickly.

What I'm seeing in the market at the moment is quite a healthy balance for investors and developers, of course, and occupiers are struggling because rents are rising. And I don't really see that changing unless there are issues around the financial markets or corporate debt. Developers and investors have been fairly savvy and we haven't seen what happened prior to the financial crisis. They've been speccing in the right locations where possible and they have been building the right sizes and so we don't see an oversupply anywhere in the country.

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>
> **Andrea Ferranti**

SW: The latest planning white paper was totally focused on residential. It didn't have any understanding or recognition or even mention of any of employment land. You could argue that given the sheer size of the units that we're now seeing demand in the market for, with 500,000 sq ft fairly standard now and even 1m sq ft units with more and more circulation space and then throw into the equation biodiversity net gain, and the absorption rate of allocated land is halved.

A local authority could allocate 100 acres of land [for industrial and logistics development] and they might think that they've done what they need to do, but that could be just one deal. There's a real lack of understanding at local authority level and planning level as to what's happening in the market and the challenges we face.

There's also this other complication or challenge, I guess, of trying to make some of these schemes coming through more sustainable. There's been lots of talk about sustainability in relation to offices and other parts of the property industry, but not so much focus on industrial. What do you think the industry needs to do to become more committed to the ESG agenda?
SW: We're very focused on this as a business and I'm sure every other developer and investor is as well. The biggest challenge for us as developers is embodied carbon in building buildings and how we deal with that embodied carbon. We're only just really beginning to start that journey as an industry and to understand it and how it affects supply chain, how we procure and how we build the thing out, so that's a big challenge – and what we do about the balance of the carbon that we need to offset in some way, shape or form.

ER: Earlier this year, we relaunched our Responsible SEGRO framework, which focuses on three key areas that we think will make the biggest environmental business social impact. They include targeting low-carbon growth, so we will be net zero carbon by 2030. We will also look to invest more in our local communities. So that builds upon last year, when we launched a £10m SEGRO Centenary fund, and we'll look to continue that going forward.

And we're also looking to nurture talent and increasing diversity in our own workforce, which I think is really important.

> ■ There's a lack of understanding at local authority and planning level as to what's happening in the market
>
> **Steve Widdowson**

How important is ESG from a fund management perspective?
SS: It's super important and investors are all over it. But the fresh regulation SFDR [Sustainable Finance Disclosure Regulation] makes it extremely difficult to talk about it to investors and I think as a fund manager, my biggest challenge is I have my existing funds and they get classified under whatever article in the regulation, and that dictates what I can say. But then there's marketing for our new funds, where we want to talk about us as a platform – this is what we do, this is our strategy.

GLP bought Gazeley so we have a 30-year history of developing sustainably. And being quite honest, we're one of the market leaders in it, but that new regulation restricts us in terms of how we disclose this information to investors.

HG: InfraRed became carbon neutral last year and it's a very important thing for the business. But putting in place meaningful initiatives within our portfolio of standing investments is quite

challenging. The key challenge we've found is that most of the demised area of our portfolio is controlled by tenants so we don't actually have a huge amount of control over the carbon generation within the portfolio. Something we've been working on doing with Alex and the Dentons team is introducing green leases across the portfolio that allow you to get that data and then start mitigating against that.

AC: I think for it to work, it needs to be top down and bottom up. Top down, it's been in corporate boardrooms for some time now and it really is important and a real game changer. But bottom up, we need to start seeing it with occupiers.

There needs to be an engagement in leasing with sustainability provisions, data sharing and then some on-site generation – perhaps solar panels. The whole industry needs to look at the benefit that the occupier is going to be getting from having a green lease or a greener building and then there has to be a conversation about who actually pays for the implementation of that. But I think that's a longer- to medium-term goal.

> **We need to look at the benefit that the occupier is going to be getting from having a green lease**
>
> **Alex Coulter**

I want us to cast our minds forward to two years from now. Where do we think the sector is going to be at that point? Are we going to be in a boom or bust scenario? What new hot sectors are likely to come through?

CE: In terms of where we see the market going, we've obviously talked about the fact that there is continual growth. I think some people have made predictions around levelling off and so forth, but I think ultimately there is still going to be that drive to logistics space.

We've talked about the supply and demand piece and while that imbalance is still there rents are going to continue to rise and I think incentives are going to continue to soften.

Looking a bit further ahead, if supply doesn't meet demand, which obviously it's not doing at this moment in time, we might see things moving much more towards an always D&B [design and build]-type scenario and that will affect delivery from an occupier point of view, because you have those RFPs [requests for proposals] that come in and say "we need this space next month" and that just might not be feasible.

EL: I think, the cost of space will go up; I think the commitment and liabilities will go up. I think, therefore, there will be a greater demand for additional power and the need to automate to make space more efficient. Unfortunately, the more parcels you deliver from a box, ultimately you need more land – ie yard – to get vehicles in.

We've obviously had to realign our business in terms of our pricing model and the agreements we have with customers and so on because traditionally we've had very short-term-type agreements and obviously property is becoming a greater and longer-term liability commitment. So we've had to realign that to try and match the two. It's very hard to predict and crystal-ball-gaze, but I really can't see it slowing down. It's very hard to see how it might plateau off even to be honest.

AS: I'd sum it up as the sector has never moved this quickly before, but actually looking forward I don't think the sector will ever move this slowly again. I think it's about having the right asset in the right location and you'll continue to benefit.

But my last sentence is that not all logistics and industrial space is good. You do have to be highly selective and it's only those who are selective that will truly benefit, immaterial of everything else.

ABOUT THIS FORUM...

This event was chaired by ***Property Week's***
Liz Hamson

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