Real Estate
Research

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Pursuing Higher Returns in European Logistics

Pursuing higher returns, environmental benefits, and greater European self-sufficiency through a development-led logistics strategy.

IN A NUTSHELL

— European logistics remains a key investment strategy, supported by robust market fundamentals and healthy rent growth prospects. Development-led strategies have attractive return potential and we believe the risks are well-mitigated.
— Logistics real estate can play an important role in achieving net zero through the upgrade of older logistics stock as opposed to building new warehouses.
— We see the best opportunities in brownfield redevelopment in Last Hour and urban locations in Western European markets.

Why invest in European Logistics?

Fundamentals remain robust

The European logistics sector continues to be supported by solid fundamentals. Despite a slight upward trend in recent months, having reached a record low at the end of 2022, vacancy currently remains well below the long-term average.[1] High-quality space remains particularly scarce in many markets, and with speculative starts falling back sharply across Europe, this picture is unlikely to change over the medium term.[2] Demand drivers remain supportive, with e-commerce set to continue growing, particularly in the lower penetration markets of Southern Europe.[3]

Logistics has an important role to play in European Transformation

Over recent years, the European economy has been confronted by a number of severe shocks. From Covid to the Russia-Ukraine War and extreme weather events, all have impacted a strained European economy and highlighted the need for European transformation. We believe logistics plays a key role in enabling greater European resilience by reducing supply chain distances and dependencies. In our view, this can be achieved through further developing industrial capacity in both existing logistics hubs, as well as within strategic locations across emerging European trade routes, such as Romania and Hungary. In more established logistics locations, given increased backlash and regulation towards greenfield development, we see a growing opportunity in the redevelopment of poor-quality but well-located logistics stock, into high-quality, energy-efficient assets.

Given solid fundamentals and the importance of the logistics sector going forward, we anticipate further healthy rental growth over both a 5-year and 10-year hold period. In addition, the significant price correction in logistics over the last 18 months supports our strong call on logistics. More information can be read here: Flash Report: Return to European Logistics.

How to access higher returns in logistics?

Development-led strategies could offer greater return potential

We estimate that investment into core logistics assets can currently achieve a net IRR of 7-8%, a 250-350 basis point spread over 10-year BBB-rated corporate bond yields. However, we see the opportunity to achieve higher returns through development-led strategies. For example, value-add strategies – including potential planning risk – could deliver double-digit returns in the mid-to-high teens. At the lower end of the risk spectrum, higher risk-adjusted returns vs. core returns can be achieved by partnering with developers and only taking leasing risk.

[1] CBRE, December 2023
[2] PMA, December 2023
[3] DWS, November 2023
There can be no assurance that investment objectives will be achieved. Past performance is not a guarantee of future results.

Development-Led Return Strategies:

	Greenfield Ground-Up Development	Brownfield Demolition and Redevelopment	Comprehensive Refurbishment of Existing Stock
How?	Forward fund: Purchase land, partner with developer to speculatively deliver logistics	Forward commit: Partner with developer to demolish existing stock and replace.	Active asset management: Acquire secondary logistics asset and undertake a large-scale refurbishment.
Risk	High: planning, construction and leasing risk	Medium: moderate construction risk, leasing risk	Medium-Lower: leasing risk
ESG	Seek to deliver best-in-class, highly sustainable product with highest ESG features.	Use of brownfield land limits biodiversity impact. Seek to provide highly sustainable product.	Use of brownfield land limits biodiversity impact. Retain embodied carbon through redevelopment. Seek to incorporate sustainability enhancing measures.
Net Return Expectations*	>15%	~ 13%	~ 10%

*Net Return Expectations were calculated using estimates based on qualitative assessments of current market opportunities based on conversations with market participants.

Source: DWS, November 2023

In the pursuit of potential value-add net returns in excess of 15%, a greenfield development strategy would likely be necessary. This would involve purchasing a plot of land, most likely in a corridor logistics location, and if necessary, partnering with a developer to speculatively deliver new logistics stock. Of course, with this approach comes more elevated risk, including planning, construction and leasing risk.

In addition, there is increasing public resistance towards developing on greenfield land due to the environmental implications, including harm to local biodiversity, loss of green, open space and increased air pollution both during and after completion. Changing regulation and sustainability targets are also making it increasingly difficult to obtain permission for greenfield development. In France, for example, the 2021 Climate and Resilience Law requires that the amount of greenfield development is reduced by 50% by 2031, and completely by 2050[4].

As such, logistics investors and developers are increasingly turning attentions towards brownfield sites. A comprehensive refurbishment of older logistics stock, for example, would represent a far more sustainable strategy for delivering much needed logistics stock. Major improvements to existing logistics stock can include a variety of sustainability-enhancing measures such as the provision of solar panel technology enabling on-site energy production. In addition, simple solutions such as LED lighting and the provision of electric vehicle charging points are effective ways of improving sustainability within a warehouse. Furthermore, this strategy would retain embodied carbon, an important element in achieving Net Zero targets.

However, upgrading an existing shell also comes with risks. Logistics occupiers are increasingly seeking best-in-class product, with the highest specifications and aspects such as dock-to-door ratios, floor loading capacity and clear internal height are often imperative. With that in mind, a comprehensive refurbishment may not deliver the most in-demand product, limiting potential occupier demand.

In our view, therefore, we see the best opportunity for risk-adjusted returns in the demolition of existing, secondary logistics stock and replacement with new build, highly sustainable product that meets modern-day logistics requirements. If necessary,

[4] European Commission, December 2023

this approach could be executed through partnering with a specialist logistics developer with an existing landbank and planning permission.

The recycling of construction materials, if possible, would also allow for a more limited carbon impact. In taking on construction and leasing risk, this strategy involves moving slightly higher up the risk curve but has potential for higher returns than could be expected when purchasing a core, leased-up asset.

Importantly, given low vacancy and robust demand for high-quality space, we believe in the right locations leasing risk would be well-mitigated. Furthermore, through partnering with an existing developer we would seek to access the best land plots, alongside benefitting from their expertise and existing occupier relations.

Why logistics redevelopment?

Rising demand for sustainable warehouses

The robust fundamentals behind the logistics sector have already been covered at the start of this paper. In addition, like other real estate sectors, the European logistics sector increasingly has to comply with stricter energy efficiency standards and landlords need to upgrade existing stock in order to meet these targets. In addition, an increasing number of logistics occupiers now have in-place sustainability goals and net-zero targets, which also have to be met by their suppliers. As a result, third-party operators are equally looking to improve their environmental credentials in order to secure new contracts.

As such, demand for sustainable and high-quality warehouses is certainly growing, further supporting the delivery of modern logistics stock through redevelopment. According to CBRE's 2023 European Logistics Occupier Survey, environmental quality and sustainability ratings are becoming increasingly important, with building features such as electric vehicle charging points and photovoltaic panels desired attributes for occupiers.[4]

Logistics tenants are not only seeking sustainable assets to achieve ESG goals, but many of these features can enhance operational facilities and reduce running costs significantly. For example, on-site energy production through the use of solar photovoltaic systems (PV panels) can greatly reduce more expensive energy consumption. This movement is driving demand for energy-efficient, sustainable, modern, high-quality logistics facilities.

From an investor perspective, environmentally sustainable and modern-day, high quality logistics assets will likely achieve both rental and sales premiums and prove more liquid at exit. According to CBRE, there is a 4.2% uplift in the value of logistics property after the introduction of on-site solar production.[5]

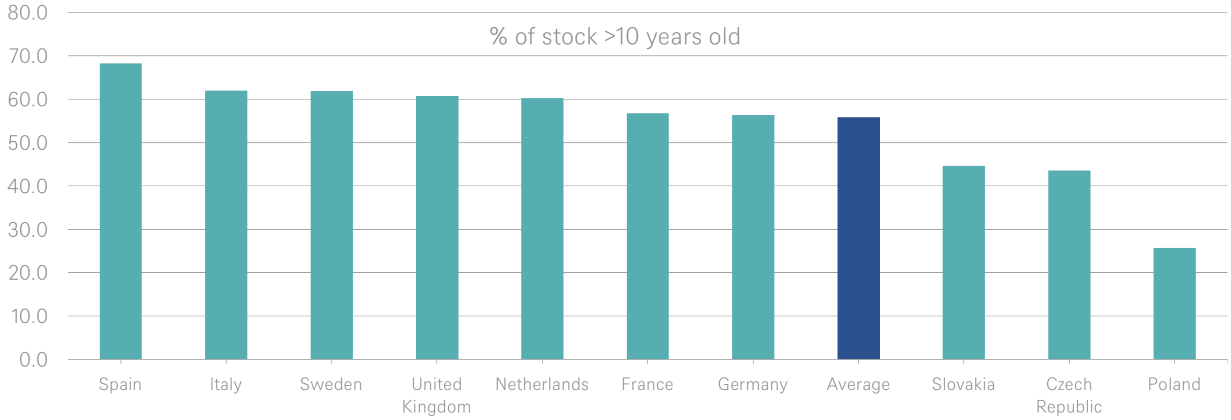
Where could a logistics redevelopment strategy work?

Target urban and Last Hour locations in Western European markets

We see the best opportunity for a logistics redevelopment strategy in Western European markets such as the UK, Spain and the Netherlands, where existing logistics stock is typically of a much older nature compared to Central and Eastern Europe and therefore more suitable for upgrading.

[5] CBRE, July 2023

Logistics Stock by Age



Source: CBRE, November 2023

In addition, a brownfield redevelopment strategy would need to be executed in a liquid investment market, where upon exit there was a large buyer pool for the refurbished unit, alongside a location that is highly sought after by strong covenant logistics tenants. With that in mind, we particularly favour the redevelopment of warehouse stock in last hour and urban locations. In such locations, given the strong demand, scarcity of supply and typically high barriers to new development we would anticipate a rental growth premium over corridor locations of around 70 basis points per annum over a five-year hold.[6] In addition, urban locations typically shorten delivery distances to the end consumer, and journeys can often be taken by electric vehicle, thereby reducing greenhouse gas emissions.

Micro-location is also key and good existing infrastructure, access to power and a large labour pool are exceptionally important for successful implementation. For example, traditional light industrial areas such as West London's Park Royal, typically have a notable level of exceptionally well-located but unsuitable logistics stock in need of redevelopment. Alongside London, other cities include Barcelona, Amsterdam and Berlin.

Conclusion

We continue to view European logistics favourably, supported by strong fundamentals the sector is expected to continue benefitting from healthy rental growth, well out-performing the likes of office and retail. However, given the notable change in the interest rate environment, returns for existing core logistics stock no longer look as attractive when compared to other non-real estate asset classes.

We see the opportunity for excess returns through a redevelopment-led approach. We believe the demolition and redevelopment of well-located but poor-quality urban logistics stock would likely improve return potential, without taking on significantly more risk, alongside delivering much-needed sustainable and high-quality product into a market that is highly demanded and short supplied.

[6] DWS, December 2023

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