Real Estate Insight

Logistics – the cutting edge of retail growth

Standard Life Investments

August 2017

Executive summary

- New technology and changing consumer behaviours are having a major impact on retailers, particularly the move to online shopping.
- Many retailers are adapting their supply chains and, as a result, logistics have undergone a major transformation in recent years.
- Demand for logistics space from retailers has helped drive the performance of the industrial sector. In 2016, Amazon’s UK logistics floor space exceeded its sales by a large margin as it looked to build capacity.
- In terms of supply, industrial developments remain lower than the historic average as build costs continue to outweigh the economic value of industrial space. Multi-storey development could be on the horizon, particularly in land-constrained areas like London.
- For investors, interest in the industrial sector should continue given the security of long-lease income. However, pricing on prime industrial assets will remain competitive, making location and asset selection key to success.

Introduction

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Consumer spending has largely driven UK economic growth in recent years, with many other developed countries in similar positions. The retail sector has benefited from this trend but the rise of e-commerce, fuelled by new technology and changing consumer behaviours, is having a profound impact. While this makes shopping more convenient for consumers, it is a competitive and fast-moving battleground for retailers, who are under increasing pressure to deliver more variety, more quickly.

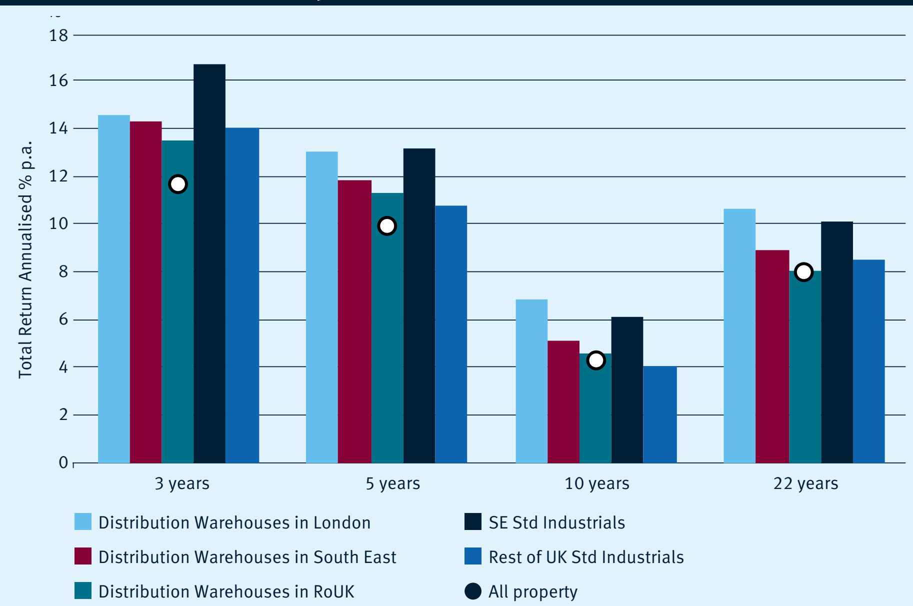
What does this mean for the property market? So far, logistics has been the main beneficiary of retail's dilemma. As a sub-set of the industrial sector, it has undergone structural changes since the Global Financial Crisis in 2007-08. The years that followed were characterised by robust occupier demand driven by e-commerce operators and traditional retailers reshaping their supply chains, third-party logistics companies and muted development. As a result, the industrial sector has delivered strong performance.

In this paper, we analyse historic performance at a regional and sector level, and consider the balance between supply and demand. We also look to the future, examining the key drivers for logistics to ascertain how retailers are adapting their supply chains to accommodate growing online sales.

Outperformance of the industrial sector

The pace of urbanisation has increased globally. Cities are a major driver of logistics demand, as they are the places where active and trend-setting consumers settle. As a result, demand has surged at, or close to, metropolitan hubs in most regions. In the UK, the areas surrounding London and the South East, where land shortage is most acute, are where demand is particularly pronounced. We are seeing this feed through to the numbers (see Chart 1): the MSCI/IPD Quarterly Index recorded total returns of 7.8% and 6.0% respectively for distribution properties in London and the South East in 2016. This compared with the all property market average of 3.5%. Rents in the sector also performed well, rising by 4.1% in London and 3% in the South East, again significantly outperforming the 2.1% market average.

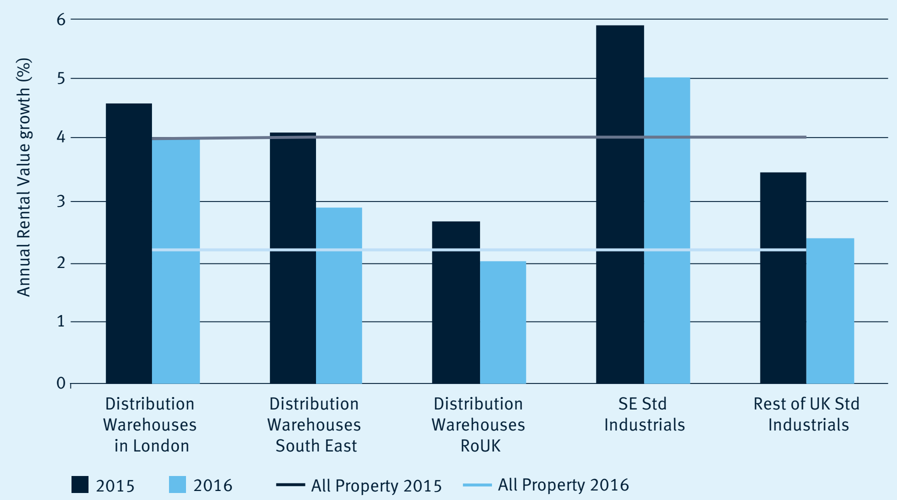
Chart 1: South East industrials outperformed



Source: MSCI/IPD and Standard Life Investments, as at 31 December 2016

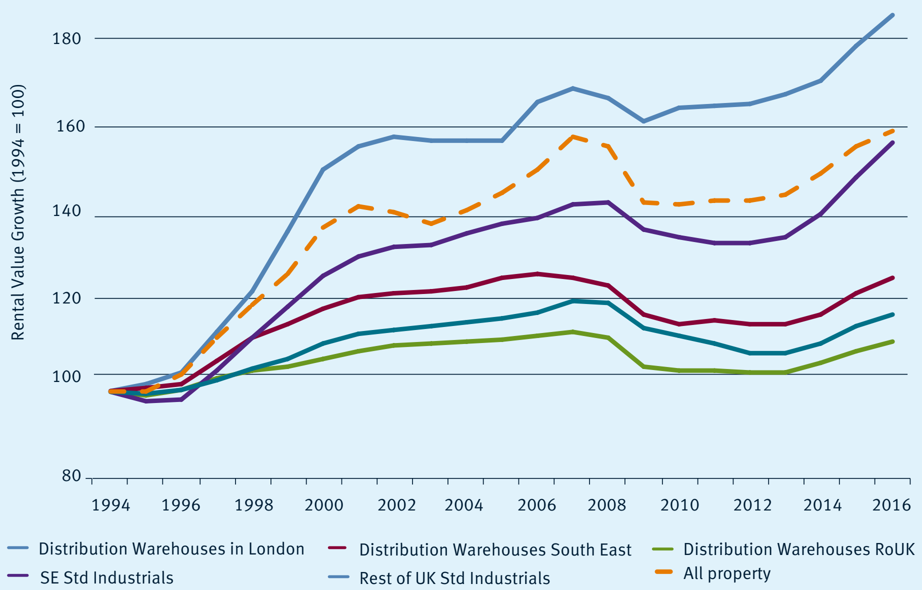
The industrial sector has also performed well over the longer term. In particular, distribution warehouses in London and the South East outperformed all property on all fronts. A similar pattern emerges when looking at capital growth, whereby industrial assets located in London and the South East, both standard industrial and distribution warehouses, delivered stronger growth than their Rest of the UK counterparts and the market as a whole. In terms of rental growth, South East industrials returned over 5% per annum (p.a.) over the three years to end-2016, again significantly higher than the All Property return of 3.2% p.a. (see Charts 2 and 3). If we set an index from 1994, which is the earliest the data is available, the differential is profound between the sub-sectors. South East industrials experienced the strongest growth at 86%, compared with 11.5% for distribution warehouses in the Rest of the UK.

Chart 2: Industrial sector rental growth



Source: MSCI/IPD and Standard Life Investments, as at 31 December 2016

Chart 3: Rental growth in London distribution warehouses



Source: MSCI/IPD and Standard Life Investments, as at 31 December 2016

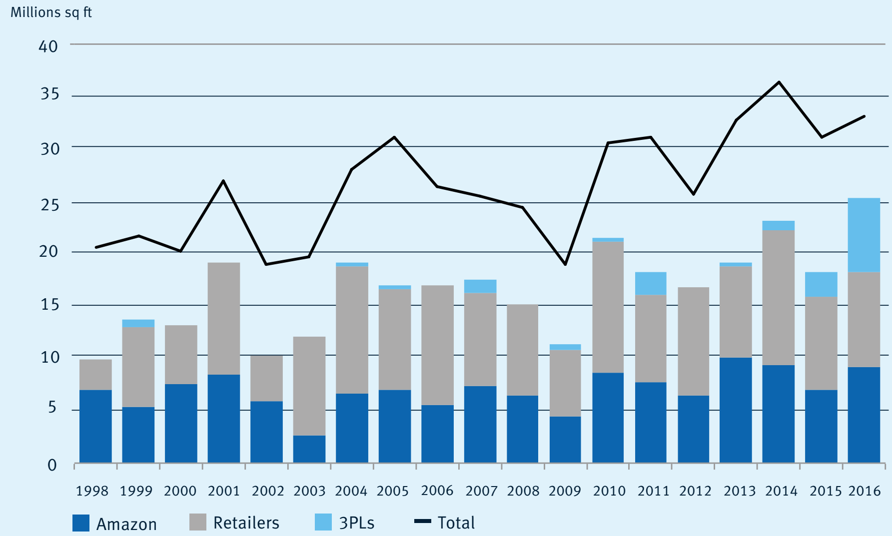
Online sales drives demand

So, what is driving the industrial sector's strong performance? Analysis of logistics take-up shows that the total amount of floor space leased has increased at 8.5% p.a. since 2008, significantly higher than retail sales of 2.7% p.a. However, this still lags online sales growth of 17% p.a. over the same timeframe. This is not surprising, given that retailers have been adjusting their supply chains to meet the changing retail landscape, i.e. not all retailers are expanding their supply chains.

It is therefore important to find out how much space retailers have adapted to the e-commence business model and to provide a realistic estimate of future growth. As retailers, either pure online players or bricks and mortar, adapt to new formats, competition will likely be more intense in an environment characterised by constrained consumer spending. As witnessed in the traditional retail sector, it will be crucial for investors to select the retailers that provide a secure income stream from the logistics aspect of their businesses.

A recent study by Property Market Analysis (PMA) showed that not all retailers have expanded at the same rate. For example, high-end department store chain John Lewis has been very active in recent years with the growth in its logistics space exceeding its sales growth. The 'Click and Collect' format has proven popular, now accounting for over half of its sales. Customers that place an online order before 8pm can collect from a John Lewis store or from a shop of its food retail division Waitrose after 2pm the next day.

Chart 4: Logistics take up – the growing importance of retailer demand



Source: PMA, Standard Life Investments, as at 31 December 2016

Meanwhile, budget/discount retailers, namely Aldi, the Range, Lidl and Primark, have been key drivers of demand since 2014. A number of the more established retailers have been less active. The amount of floor space required directly by supermarkets, such as Asda, Tesco, Sainsbury's and Marks & Spencer, reduced as sales slowed. In 2016, the non-food sector, and Amazon in particular, dominated logistics take-up (see Chart 4). The growth in Amazon's UK logistics floor space exceeded its sales by a large margin, as the online retailing giant built capacity into its supply chain. Looking forward, logistics take-up should remain healthy, assuming sales growth is a good indicator of logistics demand. However, it would seem likely that take-up from the retail sector overall will not exceed current levels in the coming years.

Limited supply of standard space

In terms of supply, an increase in available space has concentrated on large units (i.e. those between 100,000 sq ft and 250,000 sq ft). However, demand for smaller, standard industrials continues to dominate the market. This helps to explain the recent move towards markets where land supply is limited, and costs are high. Furthermore, pre-let demand has continued to increase even though there has been speculative supply. It is also worth noting that design to build on a pre-let agreement remains in favour as occupiers, either retailers or logistics operators, have particular requirements when it comes to their national or regional centres. For example, investment in automation and robotic technologies is playing a more important role.

Regarding standard industrial space, development remains lower than the historic average as build costs continue to outweigh the economic value of industrial space, or they compete with alternative land uses. As a result, availability in London and the South East will continue to fall in coming years, supporting the view that these regions will outperform the Rest of the UK on both a rental and capital growth basis.

What does the future hold?

The evolution of industrial and distribution space will remain a focus as retailers deploy innovative strategies to improve efficiency – such as advanced machinery and multi-storey design. Currently, there is weak demand in the UK for multi-storey logistics space but this could be set to change.

For example, an area of interest is increasing density – integrating industrial activities with other land uses and finding new locations and formats for industrial purposes. The X2 Scheme at Heathrow, developed by Segro in 2008, was the first large multi-storey industrial facility in the UK. It struggled initially, but this was mainly due to poor timing of the development, as occupier demand fell. Furthermore, the concept of multi-storey development was not widely accepted by the market at the time.

However, technology and the surging demand for logistics space have made the concept of high density more viable, with pressure on scarce land from competing uses. As a result, industrial rents and values are increasing rapidly, particularly in the South East.

Increasing density is also not just about multi-storey industrial buildings. It can mean horizontal expansion and multi-functional use, as industrial space combines with emerging sectors and activities such as bioscience, digital media and fashion design. Flexibility would also be at the heart of new design, providing diversity of premises and facilities with the business support they require. Viability will be justifiable in areas with sufficient demand for high rents and where the value of the land released for other uses allow cross-subsidy.

Finally, how companies deliver the ‘last mile’ fulfilment will be a key factor in their success. With more people receiving deliveries close to their work, and living in densely populated areas near cities, the concept of the sharing economy may result in Urban Consolidation Centres (logistics facilities situated close to the areas they serve). How this will change logistics for delivering from regional hubs clearly needs further consideration.

Conclusion

The industrial sector has never been so interesting, as online sales continue to grow and innovative solutions in both architecture and technology combine. In this paper, we examined the impact of these changes on performance in the industrial sector and found that London and the South East have outperformed the rest of UK over the last 20 years or so. Importantly, we expect this trend to continue given the current and projected supply and demand dynamics. Budget and online retailers have been the driving force for logistics demand, taking both large and small industrial space near regional centres. However, it will be crucial to select those retailers that can ensure an ongoing secure income stream.

As landlords, we have to contend with shorter lease lengths, changing regulations, and ‘disruption’ from technology and innovative business models. For developers, finding suitable space in dense urban areas is a challenge, so selective development activity in the right locations could provide attractive returns.

From an investment perspective, we anticipate continued investor interest in the industrial sector given the security of long-lease income, relatively secure covenants and the potential for alternative land use. However, the sector’s market cycle is relatively well advanced, characterised by unusually high demand and low levels of development. The pricing on prime industrial assets is likely to remain competitive, and location and asset selection therefore remain key to success.

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