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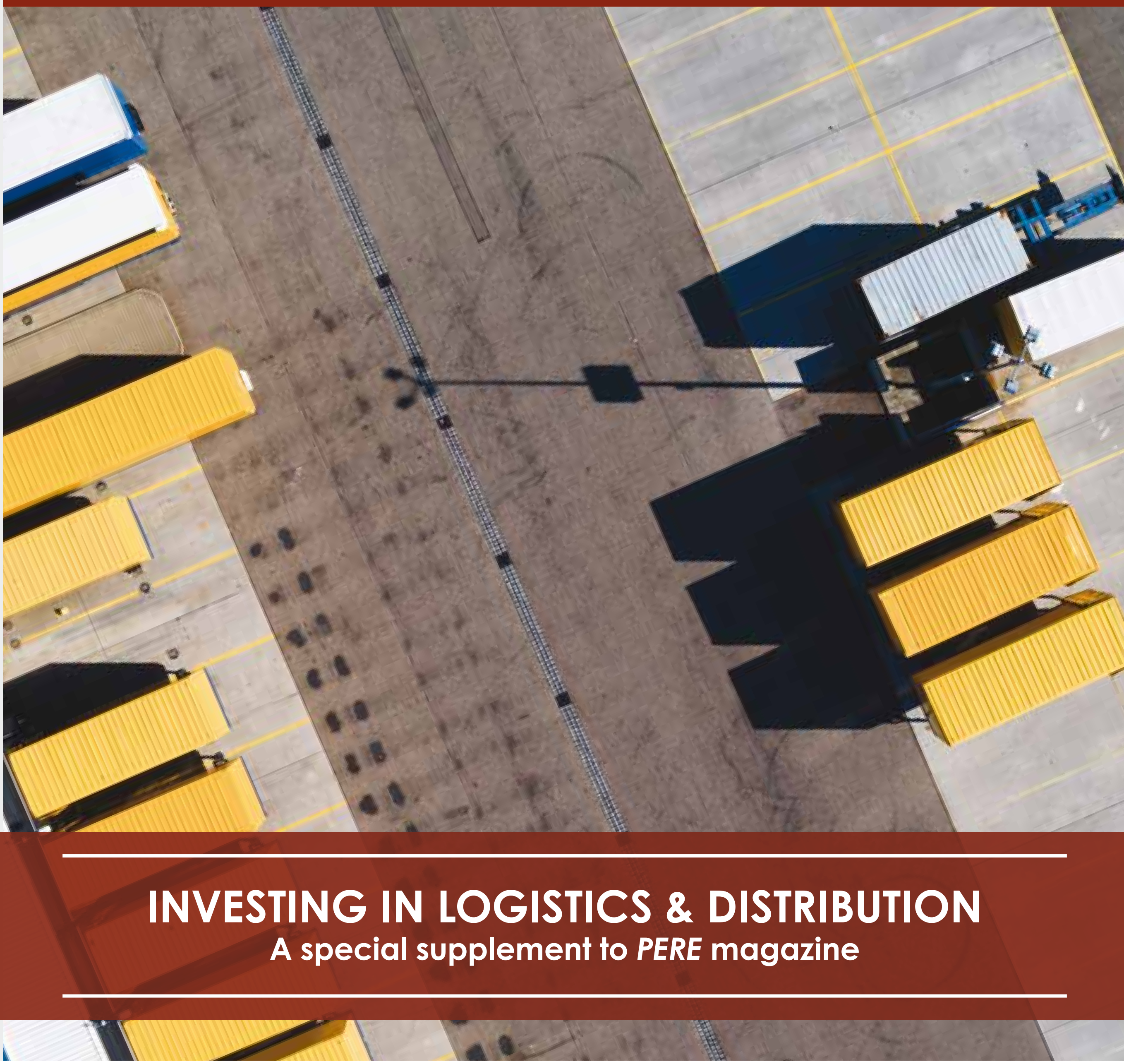
FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS



INVESTING IN LOGISTICS & DISTRIBUTION

A special supplement to *PERE* magazine

Quantum leap

E-commerce has brought about a rapid transformation in the European logistics sector, swelling investor and occupier demand to unheard-of volumes, says Robert Dobrzycki, CEO of Panattoni Europe.
By Stuart Watson

European logistics is high on many investors' wish lists, not least because the online shopping revolution seems to provide a strong structural rationale for backing the sector. The sheer weight of capital and fast-changing nature of distribution networks can make it a challenging space in which to operate, however. Robert Dobrzycki, chief executive officer of developer Panattoni Europe, offers his tips for navigating the rapidly evolving market landscape of Europe's hottest asset class.

***PERE**: What are the critical factors influencing the European logistics market?*

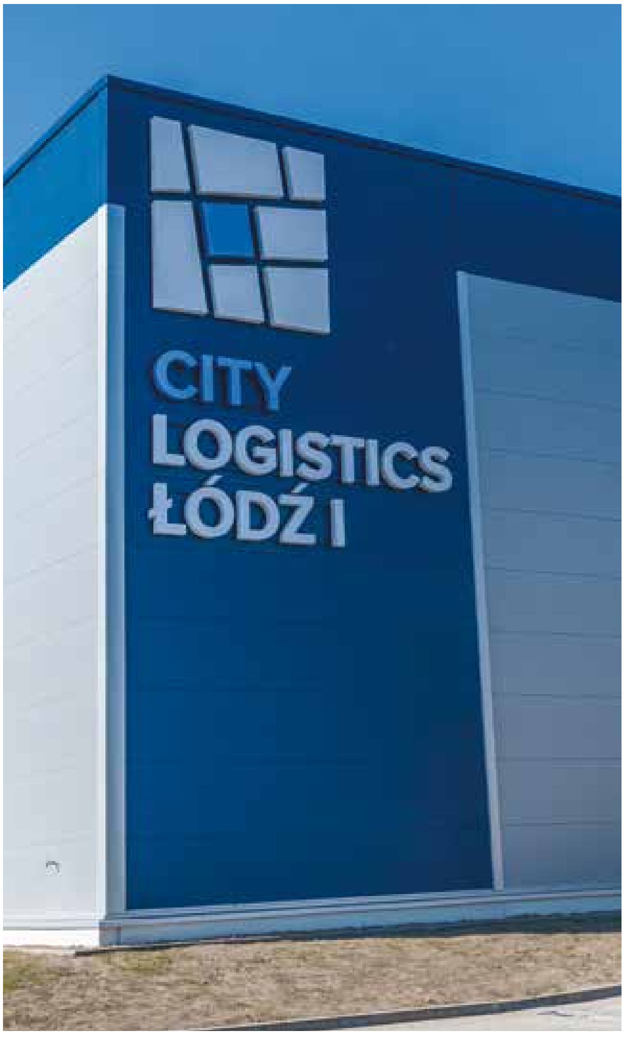
Robert Dobrzycki: Two or three years ago, we all knew e-commerce would have a big effect on logistics, but it has been even more of a driving force and a dominant theme than we expected. Traditional retail is losing out in a big way. No one anticipated the trend would come on so quickly and with so much force. Over the past 12 months many investors have begun to perceive logistics as the best asset class going forward and started to acquire properties in the sector to hedge against the weaker performance of the retail assets they hold.

Meanwhile, we have also seen strong demand from occupiers for huge buildings. Take up has reached a historic high for our business, much higher than the late stages of the last cycle. Deal volumes, occupancy rates and the strength of sentiment in favor of the asset class all exceed anything we have seen in the past.

Dobrzycki: one of the best ways to access the asset class this late in the cycle is through development

***PERE**: How is the surge in e-commerce-related activity reshaping the market?*

RD: E-commerce buildings are more labor-intensive than regular warehouses, so while proximity to the customer is still very important, labor is an even higher priority. We are being asked by e-commerce operators to find sites for big distribution centers close to large labor pools as well as a wave of smaller last-mile facilities located much closer to the customer. The increased use of robotics and automation by some e-commerce companies is having a significant effect on the layout of buildings. They need higher, multi-level facilities, which present difficulties in terms of the construction process and costs, but is even more challenging from an investment standpoint. Investors are asking: what will happen when the lease expires and the existing tenant leaves? That question leads to a discussion over how many potential occupiers there are likely to be for that type of space going forward, as well as around the lease length, and about how much it will cost to make that building reusable when the tenant vacates.



Bigger the better: there is ever greater occupier demand for huge logistics buildings

In spite of the challenges, e-commerce's growing share of the market is a very positive trend for the sector because it uses three times as much distribution space as regular retail. It accounts for around 30 percent of our business today compared with less than 5 percent five years ago. Traditional retail as a share of the market is declining and being replaced by ecommerce. You can see the physical evidence of that in buildings that our retailer clients are using for both traditional distribution to stores and e-commerce: the latter is gradually swallowing up the space that was allocated for the former.

"In central Europe tenant demand is booming and vacancy is very low. That market is underinvested so there must surely be some scope for cap rate compression in the short run"
Robert Dobrzycki

***PERE**: Panattoni operates in both Europe and the US. How do the two markets compare?*

RD: Europe is behind the US in the cycle and European yields are still higher. We are still in a low interest rate environment in Europe whereas in the US borrowing costs have started to go up. As a result, yields are now stabilizing in the US, but there is still potential for compression in Europe, more so the further east you go.

As the logistics market Europe is more fragmented than the US, with lots of different jurisdictions. Because of the variation in labor availability and cost occupiers are moving east. However, while the occupier market is moving in that direction, risk-averse investors are more focused on western Europe, which creates a yield gap that is still bigger than it should be. For example, there can be a 150 basis point yield spread between identical buildings that are only two kilometers apart, but which sit on opposite sides of the Polish-German border.

~30%
E-commerce's share of Panattoni Europe's business

<5%
That share, five years ago

***PERE**: What are the key opportunities and challenges facing investors in European logistics markets right now?*

RD: The uncertainty surrounding Brexit has deterred some investors from the UK market, but we feel that is a short-term trend because there is a continuing need for more logistics real estate there. The e-commerce story is helping the sector in the UK as it is in other countries. Germany is very expensive and very liquid, but there are still opportunities to be had in the value-add space by amalgamating a number of smaller projects into portfolios. Meanwhile, in central Europe tenant demand is booming and vacancy is very low. We feel that market is underinvested, so there must surely be some scope for cap rate compression in the short run.

Over the past year, rental growth across Europe has been driven by an increase in land and construction costs. Building costs alone went up in some places by 25-30 percent. Part of that is due to a lack of capacity, which can have consequences for the amount of time projects take to deliver, but commodity pricing and increased transport costs have also had an effect. Rents have gone up by around 10 percent across Europe on average, so in the short run developers' margins are under pressure. Liquidity and investment appetite are increasing in the meantime though, so higher costs are partly offset by yield compression.

***PERE**: What strategies are currently favored by institutions looking to invest in the sector?*

RD: One of the best ways to access the asset class this late in the cycle is through development. Across Europe we have seen investors looking to get into the market at a lower price level while taking a slice of the development profit by forming joint ventures with developers. The pricing of completed and let assets is very high, so by doing that it provides a bit of a cushion against the potential downside.

Investors often like to partner with a developer that can give them exposure across a number of countries in both western and central Europe because that provides them with diversification across national boundaries. Very few of the investors we deal with today focus on individual countries. They also want sufficient volume to make the joint venture worthwhile. They expect the developer to perform in areas including land assembly, the development process, debt origination, asset management and sometimes even in devising an exit strategy.

From the developer point of view, entering a large-scale arrangement with an investor saves them the hassle of capitalizing deal by deal. Also, to be competitive in the current market, efficiency of execution is the key. Decision-making processes need to be smooth and efficient. Allying with a large investor gives the developer the firepower to execute deals quickly in highly competitive conditions. It also provides a degree of stability, because having an ongoing relationship with a strong capital partner gives the developer confidence to proceed.

For those relationships to work at their best, they have to be a long, steady association so that the partners can concentrate on the platform play. You have to compromise, be flexible on individual transactions and look to the future, and we think that despite the obvious geopolitical turbulence, very strong demand, limited supply and the e-commerce story will all still support the European logistics sector in 2019. □