Logistics real estate: safe-haven status grows Nordic sector reveals lure, risks for investors

Commercial real estate faces some uncertainty as Europe's economies recover from the Covid-19 pandemic, but one segment has proved its resilience and growth potential – logistics. The Nordic region is a good case study of how strongly the logistics segment has developed into a separate asset class.

The lockdowns and physical distancing protocols imposed to curb the spread of coronavirus have had a significant adverse impact on some commercial property subsectors. Denmark, Finland, Norway and Sweden have not been spared, despite contrasting approaches to containing the pandemic.

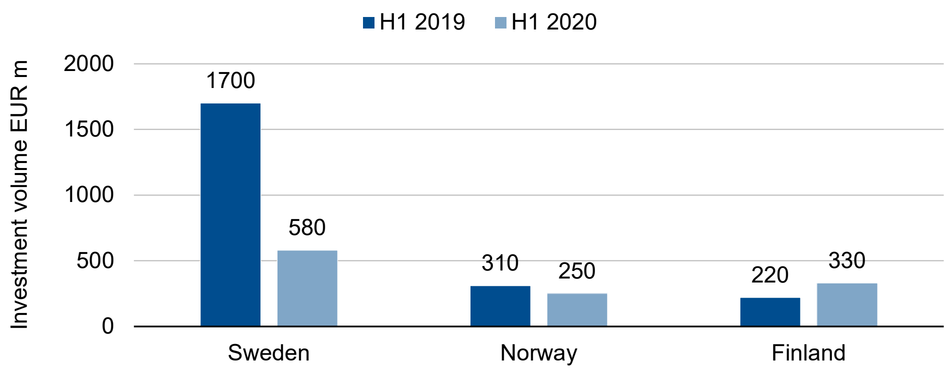
The shift toward to online commerce from physical shops has accelerated. Employers are encouraging remote rather than office working. The pandemic has forced the closure of hospitality, entertainment and sporting venues.

This is partly a consequence of trends that have roiled other parts of the real-estate sector, albeit less for owners of top-tier assets than secondary ones. Prices for prime office property with high-quality tenants and long remaining lease terms remained stable and have even risen in many of Europe's biggest cities. However, there are growing concerns among investors over non-essential retail and second/third tier office locations. Demand for retail and office space may shrink permanently through changes in shopping and working habits. In this context, logistics properties offer a natural hedge against the pandemic-induced risks with which the segment's growth is at least partly correlated. The Nordic logistics sector is currently characterised by higher yields and lower vacancies than elsewhere in Europe.

Online retail business volumes, already on the rise before the pandemic, have hit new records, triggering investment by companies throughout the retailing supply chain in more IT and distribution infrastructure – and the buildings to house it. Such properties tend to have long leases, providing greater cash-flow visibility, valuable for debt and equity investors. A study among European debt investors found that more than 40% expect an increase in senior debt supply to fund sub asset classes like logistics – in 2020, more than for any other category in real estate.[1]

The immediate impact of the pandemic on transaction volumes in logistics and industrial real estate was severe in the first half of 2020, as the Nordic region's experience shows (**Figure 1**) though the crisis has followed three years of record volumes of transactions.

Figure 1: Transaction volumes logistics and industrial real estate[2]



[1] PwC Emerging Trends Survey 2020
[2] BNP Logistics Real Estate Report August 2020

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Nordic logistics segment shows start of potentially robust recovery

Yields held steady in Q3

Latest data, however, show a clear recovery in the third quarter.[3] Unchanged yields, may indicate that the slump in transaction volumes reflected interrupted deal making rather than weaker demand.

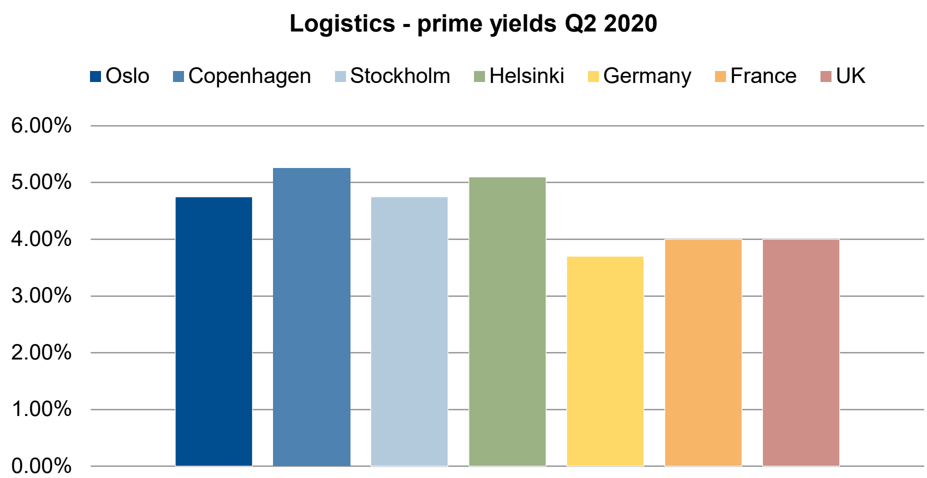
We expect transaction volumes to gradually pick up again, not least because of the favourable financing climate of low interest rates, ample liquidity and the strong underlying industrial trend in which most logistics tenants are benefitting from the shift to e-commerce. This view is also supported by a recent survey by Pangea, finding that 82% of investors are willing to invest now, with logistics properties favoured by 24% of surveyed investors with an increasing trend.

Nordic logistic yields typically above rest of Europe's

Average property yields in main Nordic logistics markets are higher than other large Western European markets. Investors can still achieve relatively attractive asset yields in the Nordics at roughly 100bps higher cap rates (**Figure 2**) when properties have high-quality tenants.

The arrival in the Nordic market of leading logistics companies such as Amazon.com bodes well for future demand and low yields. Low vacancy rates among Nordic logistics assets compared to other European regions further support the picture. (**Figure 3**)

Figure 2. Logistics yields: Nordic cities compared with other European markets



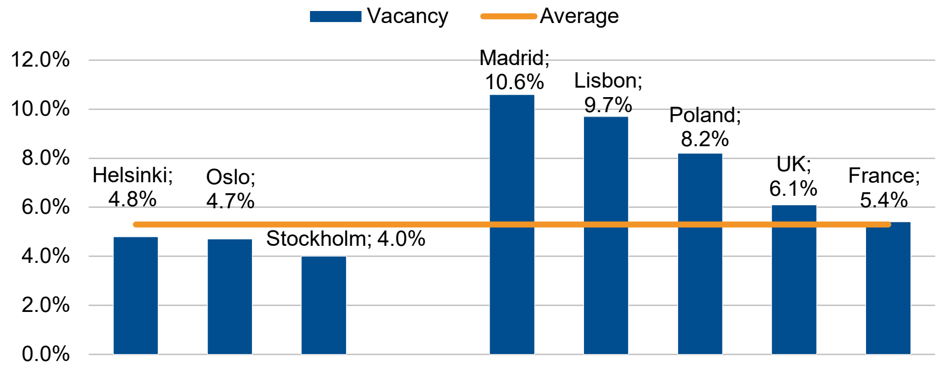
Source: BNP Paribas Real Estate research 2020

Amazon, which recently launched the Swedish version of its website (amazon.se), has set up a 15,000 sqm logistics hub in Kjula, with its logistics partner Kuehne + Nagel. Deutsche Post DHL will take up 10,000 sqm within the same property.[4]

European developers have recently tended to increase the share of develop-to-hold projects across sub-asset classes in the search for more recurring cash flows and attractive financing conditions. This trend is likely to further decrease investment supply of new logistics properties in the coming years in Europe, the Nordics included.

[3] Pangea Report 2020
[4] https://dagenslogistik.se/kuehne-nagel-bekraftar-amazonlagret-blir-15-000-kvm-stort/

Figure 3. Logistics vacancies: Nordic cities vs other European markets – Q3 2020[5]



Risk of bifurcated market in Nordic region

Positive credit outlook; risks for second-tier players

Our outlook is favourable for prime logistics properties in the Nordics, from a credit risk perspective, but there are potential dangers.

The arrival of leading global logistics players in the Nordic region, might accelerate the division of logistics tenants into two camps: deep-pocketed players such as Amazon as well as established international and national postal and parcel services companies; and smaller companies lacking economies of scale whose profitability is worsening in their portfolios of second-tier properties - hence deteriorating credit quality.

Outdated assets without feasible options of retrofitting or changes of use also bear risks of falling of valuation cliffs once significant vacancy shows.[6] This is in addition to the specific logistics challenges of the Nordics like having large distances between population hubs and vast scarcely populated areas to cover.

Surge in property sector bond issues; mispricing risk rises

Real estate dominates corporate bond issuance in Sweden

High investor demand for new real estate debt issued in the Nordics – fuelled by both private and central bank buying – does raise the prospect of risk mispricing. In Sweden, about 40% of all non-financial corporate debt issued in SEK in 2019 was from the real estate sector, illustrating the recent boom in sector debt placement volumes.[7]

Central bank purchases have contributed to yield compression on real estate debt. Another factor is growing investor demand for sustainable investments, with increasing number of companies issuing green bonds.

In this context, we see some credit risks for real estate issuers, even those exposed to the logistics segment. Any repricing of risk – if economic growth proves slow and uneven (see Scope's 2021 sovereign outlook) or inflation picks up and interest rates rise – would put pressure on asset managers with second-tier locations and/or exposure to tenants with challenged business models in the commercial areas of office, retail and hospitality.

Nordic real estate companies diversify funding

More encouragingly, Nordic real estate companies are diversifying their sources of funding. Preferred share issuance and D shares have become important parts of the sector's funding structure. Some companies have also issued hybrid bonds. (see Scope's research on hybrid funding in the Nordics)

One positive development in the Nordic real estate debt markets is the trend that issuers are increasingly seeking external credit ratings for existing debt and new issuance, providing debt investors independent, third-party assessments of credit quality. In addition, comparability and overall transparency levels among issuers are improving.

[5] Savills – European Logistics Outlook 2021
[6] Scope: European Logistics CRE: outdated assets won't ride growth momentum (2020)
[7] Bloomberg

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