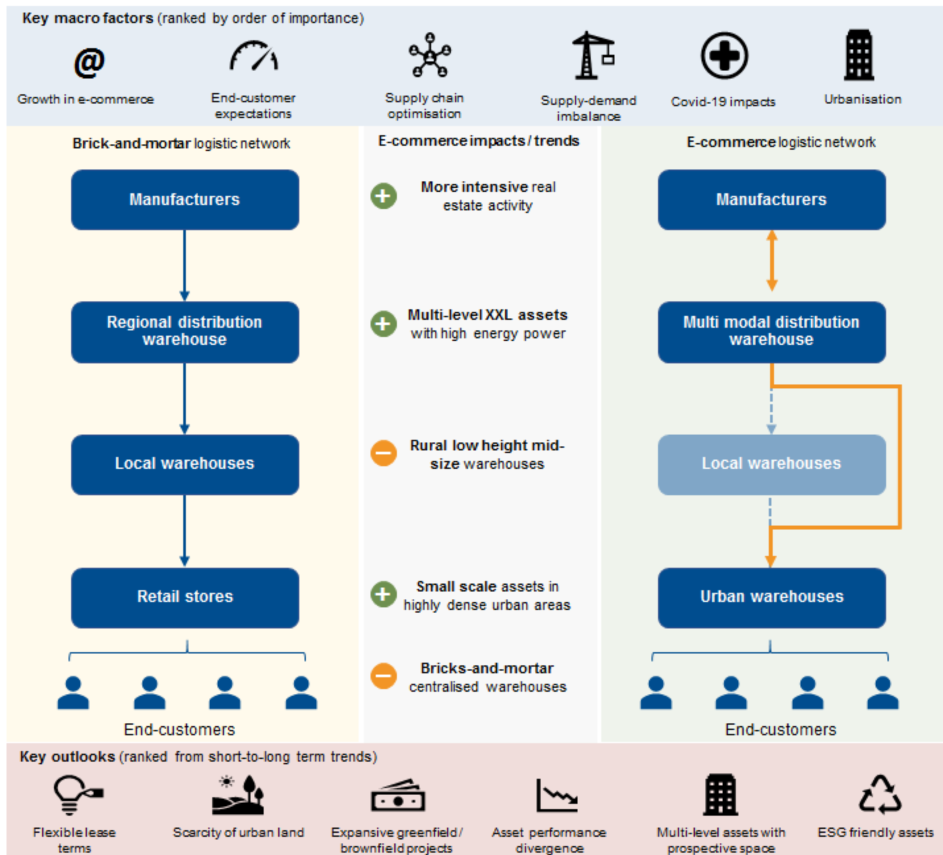
European logistics CRE: outdated assets unlikely to ride the momentum
Asset performance dispersion: a French market study

Structural changes to supply chains are reshaping Europe's logistics real-estate sector, representing a high-conviction opportunity for investors. But asset performance can diverge widely so fit-for-purpose assets are more relevant than ever. This report reviews the main drivers supporting the growth of the European logistics sector and, using results of a survey on French logistics assets, illustrates why players will need to rethink their business models to adjust to the sector's rapid development. Logistics could become the big winner of the Covid-19 crisis among real estate sectors.

There are six fundamental drivers behind the momentum of European logistics (see Figure 1): growth in e-commerce, end-customer demands, supply-chain optimisation, a supply-demand/supply imbalance, new urban developments and Covid-19 impacts. Aside from the deeply uncertain macro-economic outlook as a result of coronavirus effects, these forces are strongly supportive of the mid to long-term growth picture. These momentum drivers also illustrate the disruptive impacts of e-commerce, supporting our key outlook for the asset class, namely: the growing availability of flexible lease terms, the scarcity of urban land, more expansive brownfield and greenfield projects, divergence of performance between newly-built and outdated assets, market appetite for multi-level assets with available space for development, as well as growth of ESG friendly assets.

Figure 1: European logistics real estate overview



Source: Scope Ratings

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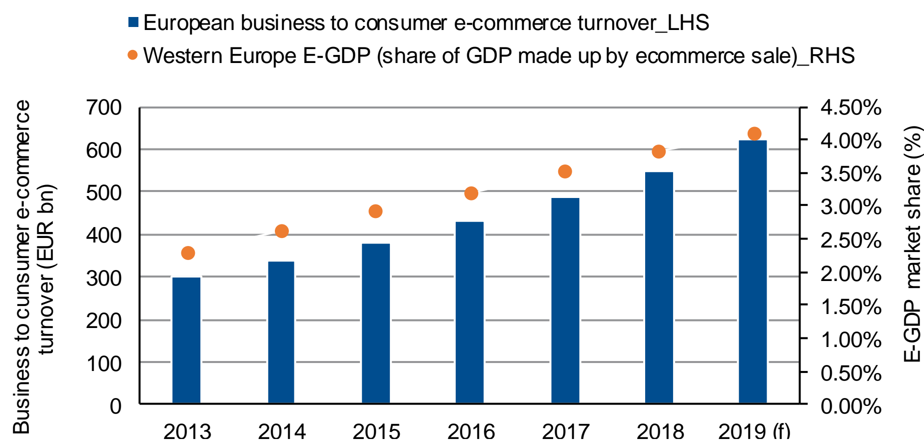
1. Six fundamental drivers behind growth momentum

1.1. e-commerce growth: no sign of a slowdown

Online business-to-consumer supports the growth of e-GDP market share

Changes in consumer patterns are driving rapid growth in e-commerce, which is showing no signs of a slowdown. Western Europe has almost doubled in recent years to 4.1% in 2019 from 2.3% in 2013 and is increasing at a 10.2% seven-year CAGR. Business-to-consumer e-commerce is driving this growth, with 13% year-on-year growth to reach an estimated EUR 621bn turnover in 2019 (see Figure 2).

Figure 2: e-commerce turnover and market share in Europe



Sources: Ecommerce, Scope Ratings

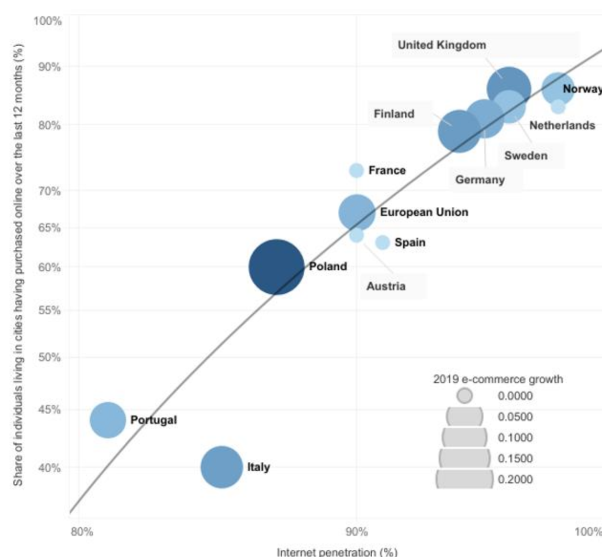
1.2. More stringent consumer demands: faster, cheaper, more convenient

End-consumers now expect next or same-day delivery and flexible solutions to pick up and return purchased goods.

Correlation between internet penetration and e-commerce business penetration

High internet penetration, particularly in northern European countries, is supporting a change in consumer behaviour (see Figure 3). Today, 90% of Europeans have access to the internet, up from 70% in 2010. And 67% of Europeans citizens have purchased online over the last 12 months, up from 33% in 2017.

Figure 3: European e-commerce: growth despite discrepancies



Sum of Internet penetration (%) vs. sum of Last online purchase: in the 12 months_Individuals living in cities (%). Color shows sum of 2019 e-commerce growth. Size shows sum of 2019 e-commerce growth. The marks are labeled by Jurisdiction.

Sources: Eurostat, Scope Ratings

1.3. Supply chain optimisation and real estate: competitive advantage opportunity at marginal cost

Logistics rentals have strong upside potential

E-commerce and end-consumer service awareness are reshaping the entire supply-chain model. E-logistics constitutes a strategic opportunity to improve service levels without a significant impact on costs. Consequently, logistics operators are willing to pay high rents for real-estate assets that can improve their service levels by gaining access to highly populated areas.

Cost-management factors need to be taken into consideration here. Firstly, logistics rental costs are marginal compared to other cost factors, such as labour, transportation and retail operations. In particular, they are estimated to represent less than 5% of total supply-chain spending. Secondly, e-logistics can contribute to reducing more significant cost items such as transportation or energy costs.

While these factors are driving e-logistics demand, giant e-retailers like Amazon[1] and logistics providers are increasingly developing and owning their own logistics properties to control and manage their entire supply chain. The dual phenomenon is putting pressure on available and prospective assets and pushing up rental values.

Available dry powder for logistics demonstrates investor appetite for the asset class

Asset managers and private equity firms were quick to understand this market driver, illustrated by the recent megadeals in the sector like the sale of Logicor for €12.5bn in 2017 or the dry powder recently raised (e.g. Blackstone €8bn Mileway company launch, AXA IM €1.6bn logistics fund).

Existing assets are not fit for purpose and upgrading to current needs is challenging

1.4. Demand/supply imbalance: available logistics parcs not fit for e-retailer business

Available logistic parcs meeting e-retailers' expectations – both in term of asset characteristics and location – are scarce, reflected in decade-low vacancy rates.

Expansive structural refurbishments can upgrade assets to expected quality levels but will not address the issue of location. Existing real estate assets like rural distribution warehouses or centralised bricks-and-mortar real estate assets will struggle to maintain their attractiveness even after refurbishment.

Many assets built before the e-commerce boom no longer fit the needs of e-commerce retailers and are not suitable for retro-refurbishment. They are likely to be too small and too low, while they are too large to meet the reduced needs from high-street retailers downsizing their operations.

1.5. Covid-19 impacts: logistics the big winner?

The Covid-19 crisis will likely catalyse e-commerce penetration in the food and beverage sector and among seniors

Logistics is likely to become the big winner of the Covid-19 crisis among real estate sectors. In the short term, it will exhibit resilience supported by i) extra demand from food retailers and the pharmaceutical industry and ii) all-time low vacancy rates, offsetting reduced industrial activity and overall supply-chain disruption.

When economic activity restarts, companies will rebuild their stocks, and may rethink just-in-time production, benefiting the logistics sector in term of demand for delivery and storage. In the longer term, the world's biggest-ever quarantine experiment will be a tremendous opportunity for the sector to reach two large distinct parts of the economy that have been unreachable so far: senior customers and the food and beverage industry. Most of Europe is confined now, which is forcing Europeans to adapt quickly to the new environment and changing their habits. Online food and beverage delivery, which represent only 3% the European sector, is growing; households are ordering non-

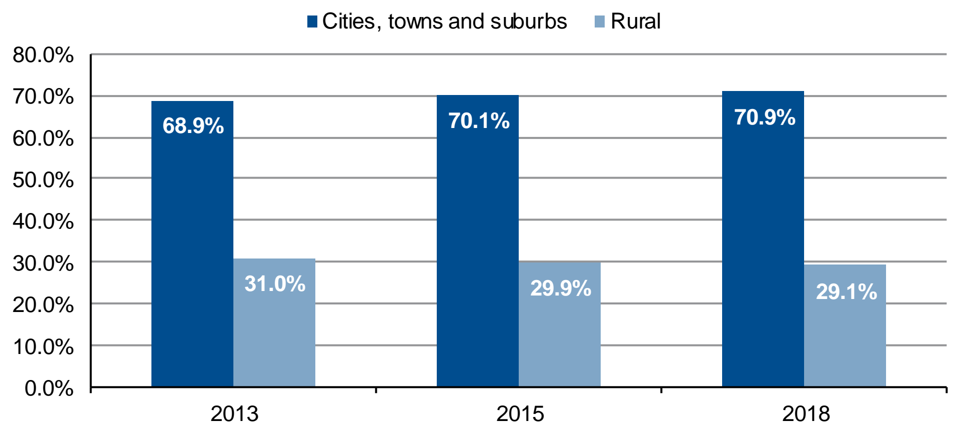
[1] Amazon international owned square footage grew by 311% from 2016 to 2108 while its lease square footage space grew by 23% only.

essential goods online, while seniors are discovering how convenient e-commerce can be. This crisis will likely be a catalyst for new consumer behaviour and trends supporting the logistics sector.

1.6. Continuous urbanisation: mid-to long term favourable trend for urban warehouses

Urbanisation is showing no loss of impetus: the European urban and semi-urban population continues to increase – to 70.9% in 2018 from 68.9% in 2013 representing 10 million additional citizens (see Figure 4). This long-term trend is boosting the development of "last mile" urban warehouses.

Figure 4: Distribution of population by degree or urbanization



Sources: Eurostat, Scope Ratings

2. Sector outlook

2.1 Asset selection: location is no longer paramount: fit-for-purpose assets are more relevant than ever

E-commerce: 3x more real estate intensive than retail

While they are benefiting from the e-commerce growth, companies need to understand the impact of selecting the right real-estate assets. Online retail is a real estate -intensive activity, requiring roughly three times more logistics space than traditional retail[2] owing to larger product ranges, higher inventory turnover, higher handling and shipping requirements and higher reverse logistics. This requires significant logistics support, including higher transport capacity and use of more distribution warehouses and storage space. While location remains key as for any real estate asset, logistics real estate features are more important than ever to address fast-changing customer and retailer demands.

Online retailer needs reshape logistics real estate assets

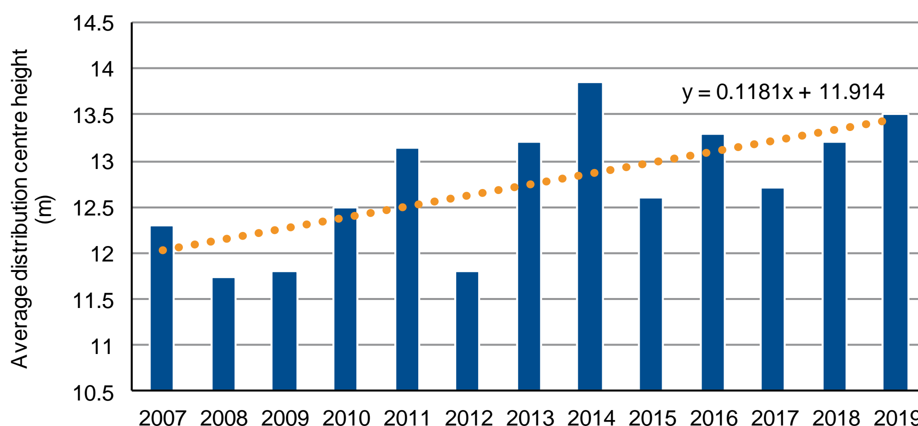
Available warehouses mostly do not possess the specific features the online retailers demand:

- Multi-level assets with high ceilings and robust floors. Tenants are seeking to increase storage capacity by constructing mezzanines while limiting their footprint. New warehouses are more likely to have heights of 12 metres, where six-metres was previously the norm (see Figure 5)
- Agile and prospective sites. Logistic companies need to be flexible to be able to react quickly to new trends and more versatile-than-ever e-customers. Attractive real estate assets will have capacity for expansion and will be designed to allow sub-letting or co-letting.

[2] according to an analysis from Prologis

- Real estate assets with facilities in the surroundings. Logistic companies will need to attract ever more qualified staff and retain them due to sector automation. Assets located near public transport and with employee facilities around will be attractive.
- High levels of power and internet bandwidth to respond to the seemingly unstoppable growth of automated warehouses and the influence of data science.
- Green facilities to respond to global ESG awareness, tenant focus on utility expenses and likely more stringent future legislations.

Figure 5: New built logistics assets in the EU: growing height of distribution centres



Sources: Global Data, AEW, Scope Ratings

2.2. New business models and rapidly changing conditions: adapt or disappear

Flexibility, convenience and time/cost efficiency is the new motto

The entire logistics real-estate chain has to adjust to new online customer and tenant needs: flexibility, convenience and time/cost efficiencies.

Greenfield project sponsors will face skyrocketing land prices – notably for urban hubs where available land is becoming scarce – while competing with other asset-type sponsors. Brownfield project sponsors should not over-estimate marginal gains given the heavy structural costs to upgrade existing assets while exposing them to assets unsuitable for retrofitting. All sponsors will have to rethink their business plans to embed tenants' appetite for agile and vertical real-estate solutions allowing multi-tenanted space and mezzanine expansion.

Tenants incentivised to seek flexible and shorter leases due to market trends and IFRS 16

Sponsors will also have to adapt their lease strategies to offer flexible leases to cope with sudden demand spikes or with the current trend for co-letting. On one hand, tenants of large distribution warehouses will look to secure long-term leases to amortise the sunk costs of unprecedented growth in automation, with flexible options to co-let or sub-let some units. On the other hand, tenants of urban hubs will seek short lease terms to adjust rapidly to customer demographics and preference changes. They will also have to consider the shortage of qualified staff triggered by the automation of the logistics sector combined with the fall in unemployment rate in Europe.

The terms of logistic leases are also likely to change, due to the implementation of IFRS 16, which came into force on January 2019. The rule is aimed at providing a better understanding of what cashflow issues could arise from lease commitments by forcing lessees to account for the entire tenor of their leases on their balance sheet.

The lessee will now show an "obligation to make rental payments" as a liability and a corresponding "right-of-use" on the assets side. Consequently, tenants exposed to long leases will have a significant liability. To improve their balance sheets, tenants will likely

seek shorter leases with variable lease payment conditions (e.g. turnover-linked rents) and de-linked service leases from hard-asset rent leases.

Liquidity risk and residual value risk will likely grow for outdated assets

Lenders will need to remain cautious given the relatively large size of logistics assets, their single-tenant nature, and lower tenant quality that may expose them to cashflow disruption. Additionally, the high level of sophistication reached by some assets increases their fit-for-current tenant features while linking their credit quality to tenants' increasing reletting risks, liquidity risks and residual value in case of enforcement.

ESG the next logistics real estate game changer?

Finally, ESG will be the next game changer for a sector increasingly under focus for its negative environmental footprint. All players will have to factor into their investment decisions the likely rise of utility costs and energy taxes for non-green energies as well as the lower tenant appetite for non ESG-friendly assets. Otherwise they will expose themselves to re-letting and liquidity risks.

3. Asset-performance dispersion: a French market study

Scope analysed the current performance of several logistics real-estate assets along France's north-south logistics axis near the eastern border. The study assessed the performance of approximately 20 assets comprising roughly 70 units. It provides a good illustration of asset-performance discrepancies between recently-built real estate assets[3] fitting tenants' needs, and outdated assets that are not fit for purpose.

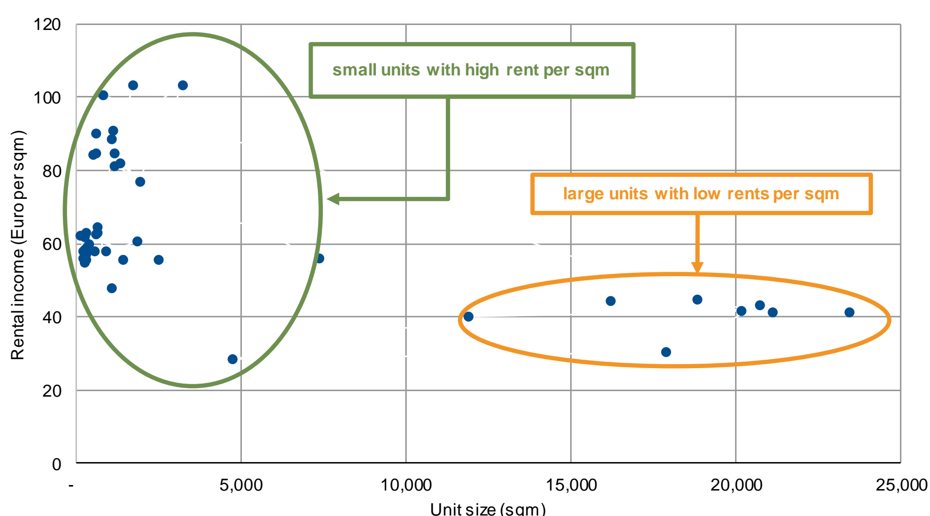
3.1. Rental performance: small units out-perform large units

Small units out-perform larger units in rental performance

Naturally, recently-built real-estate assets out-perform older assets in term of rental performance per square metre. However, leaving aside asset ageing, small units out-perform larger units. Giant e-retailers have gained significant bargaining power in France to push rents down, given their large lease footprints and their credit quality.

Small logistic companies are willing to pay comparatively higher rental prices for small assets if it provides them with the competitive advantages they are looking for considering the relative low cost of real estate compared to their overall cost base (see Figure 6).

Figure 6: Higher rent for smaller units



Source: Scope Ratings

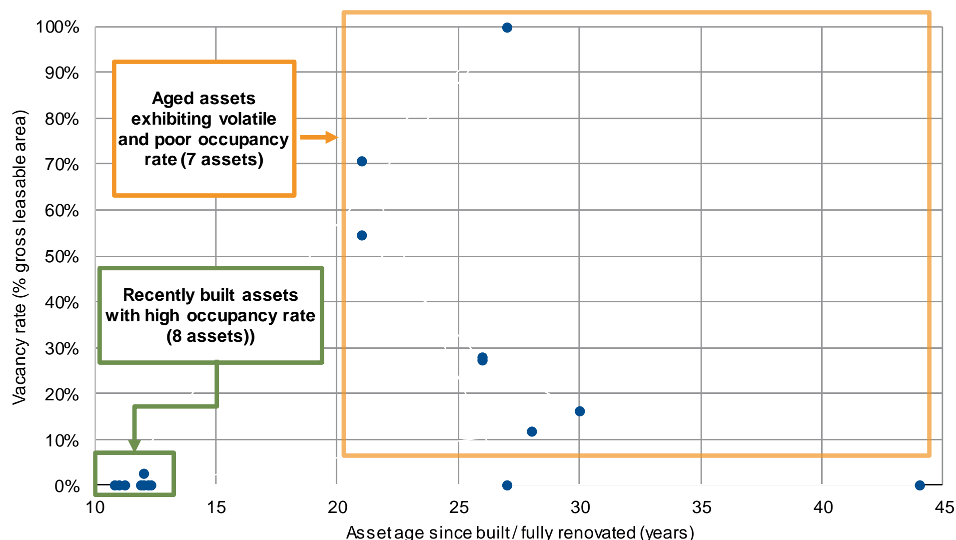
[3] Recently built assets are defined as assets built or fully renovated since 2007.

3.2. Occupancy rate: volatile and poor performance for outdated assets

Volatile and poor occupancy performance for outdated assets

The discrepancy in vacancy performance is even more striking between recently built assets and older ones. Newer assets are fully or almost fully occupied, reflecting the market imbalance between supply and demand for e-commerce-friendly assets. Older assets exhibit a wide performance range, from full occupancy to full vacancy with a high average vacancy rate (see Figure 7).

Figure 7: Volatile and poor occupancy rate for outdated assets



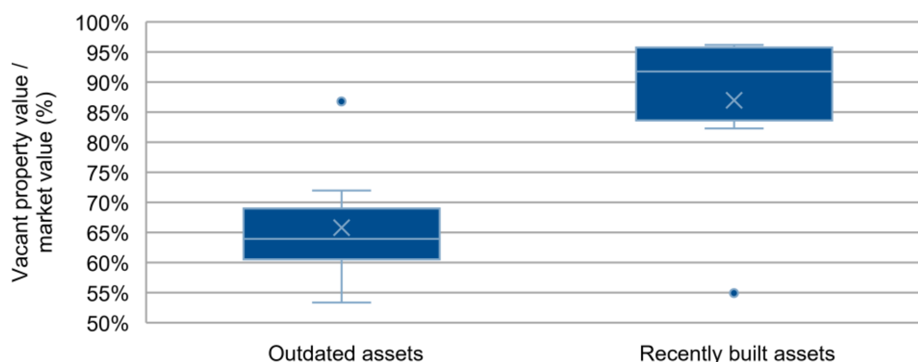
Source: Scope Ratings

3.3. Vacant property value: significant discounted value for outdated assets

Outdated vacant property values exhibit a significant discount to market values

Outdated assets exhibit a significantly higher residual value discount comparing their current market values to their vacant property value[4]. It shows that valuers are embedding a couple of elements into vacant property values: i) a rental value depreciation reflecting in-tenancy lessees paying more than what players will expect to pay, ii) re-letting risk with longer void periods for assets unfit for e-commerce purposes. Vacant outdated asset values exhibit a 36% median discount to market value, while their third quartile is at 31% (92% and 96% respectively for recently built assets).

Figure 8: Vacant property value analysis[5]



Source: Scope Ratings

[4] Vacant property value is the estimated asset value considering the asset fully vacated
[5] The lowest point is the minimum value of the data set, and the highest point is the maximum value of the data set. The box is drawn from first quartile to third quartile with the horizontal line expressing the median value.

4. Scope's insights

4.1. Scope's approach to rating commercial real estate

Scope's CRE expected-loss approach combines term default risk and refinancing default risk analysis

Scope's ratings reflect an expected loss associated with payments contractually promised by a rated instrument until its legal maturity.

Credit analysis of commercial real estate loan is a bottom-up process that focuses on four steps: i) sponsor and business plan analysis, ii) tenancy analysis, iii) property analysis and iv) loan analysis.

The likelihood of default of CRE securities is two-fold:

i) Term default risk: borrower's failure to service interest and principal obligations during the term of the loan;

ii) Refinancing default risk: borrower's failure to refinance at the maturity of the loan. A loan is assumed to be in refinancing-default if the portfolio exit debt yield is below the rating-conditional all-in refinancing rate.

The core of the analysis focuses on the cashflow-generating capacity of the assets and the key financial metrics which drive term default risk (debt service coverage ratio), refinancing default risk (exit debt yield) and the loss severity upon default (loan-to-value)

We underwrite secured assets via an income valuation approach by discounting future estimated net operating income.

Our approach does not apply mechanistic caps on sovereign rating, counterparty rating or minimum liquidity level, while our assumptions are transaction specific and rely on more than a decade of recognised valuer data.

4.2. Scope's commercial real estate snapshot

Figure 9: Asset type coverage

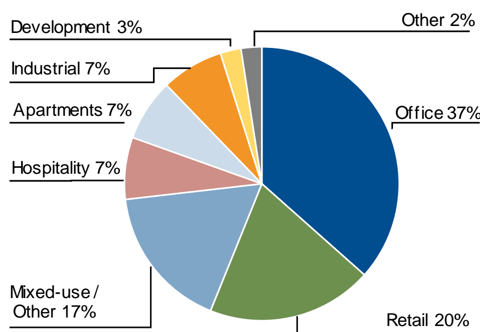


Figure 10: Financing type coverage

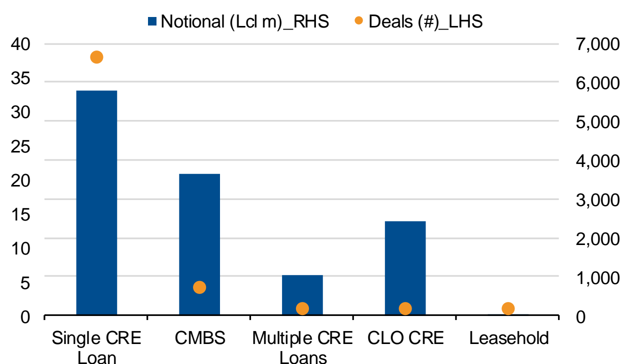


Figure 11: CRE rating evolution

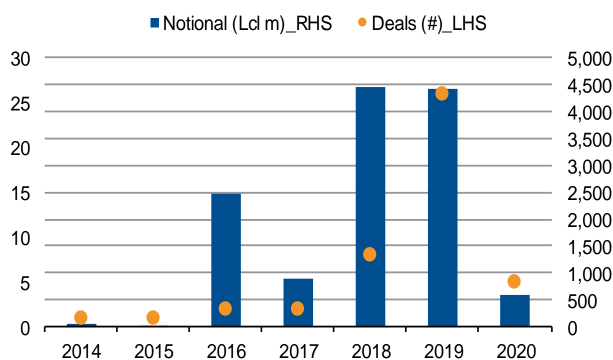


Figure 12: Geographic coverage (USA excl.)

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