

Logistics – A New Hope?

How the Rise of E-commerce Impacts Real Estate



Scope
Ratings

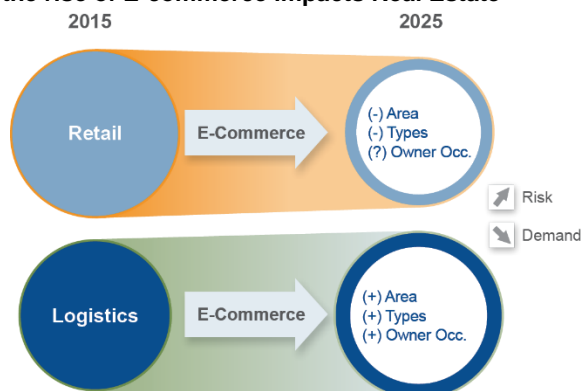
Weaker demand for retail space is meeting a boom in logistics. However, the logistics real estate market is increasingly associated with new hurdles and specific risks for investors.

E-commerce will continue to grow at the expense of classic brick-and-mortar retail concepts. Scope Ratings (Scope) forecasts a CAGR of 10% until 2025, compared with the expected zero growth for stationary retail in the same period.

As e-commerce needs significantly less retail space, Scope expects a decline in demand for retail space. Logistics real estate could become an alternative for investors, supported by a two-fold increase of demand expected by 2025. This development will be driven foremost by the steady growth expected for e-commerce, from a current 9% share of the retail industry to above 20% in 2025. Another driver is the larger space consumed by online retailers, which require three times the logistics space as physical retailers.

The demand for inner-city logistics, or those adjacent to urban areas, is expected to be particularly strong as e-commerce increases its attention on the 'last mile'. Delivery can only be optimised when fulfilment and distribution centres are closer to the customer, meaning logistics have to further enter the urban area.

Figure 1: How the rise of E-commerce impacts Real Estate



Source: Scope

Boom in logistics – a new hope for investors?

The boom in logistics is, of course, also of interest to investors. However, access to the logistics real estate market comes with new hurdles, as a rising share of logistics service providers and online retailers are developing and managing the required space on their own, thus kicking out intermediaries. As of 2016, more than 50% of newly developed logistics space in Germany and France were owner-occupied – an increase of 20 percentage points compared with 2011. This has narrowed choices for investors.

Furthermore, the tremendous change in the logistics industry has led to a greater range of concepts; notably the 'internet of things', 3D printing, automation, robotics, autonomous vehicles and drones. How these innovations will alter demand for logistics space is still difficult to ascertain, however, leaving investors with increasing uncertainty over tenants' future needs. As a result, the attractive logistics properties of today might no longer meet market requirements in just a few years.

The expectation of weakening credit quality for tenants will be a further challenge for investors, according to Scope. Both retailers and e-tailers are operating in an increasingly dynamic and competitive environment – see Scope study for market consolidation ([click here](#)).

As such, logistics could represent a new hope that can offset the anticipated decline in demand for retail properties; investors and developers, however, may have to navigate a minefield to take part.

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Related Research

Adapt or Disappear:
E-commerce Transforms
European Retail
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What drives demand for retail space?

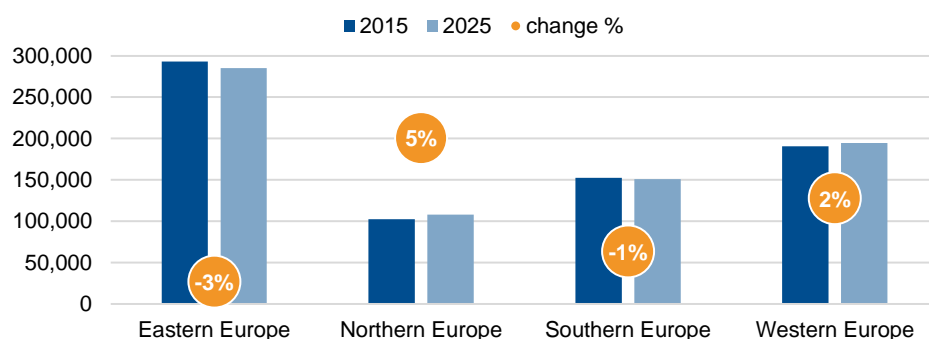
Prospects of increasing demand for retail space in Europe are slightly positive, driven by i) stagnating populations, ii) modest economic growth and iii) expectations that sales area productivity will improve slower than already-meagre industry growth.

Effects from changing demographics

We expect changing demographics to have a neutral effect on retail space, given the high correlation between population growth and sales-area growth. The UN forecasts that Europe's population will stagnate until 2025 ($\pm 0\%$), but will shift slightly towards northern Europe (+5%), western Europe (+2%), and urban areas (+3%). The move towards urban locations is expected to benefit e-commerce, as more customers will be living within the 'last mile'¹, thereby reducing the time and cost of shipping.

Stagnating populations

Figure 2: Europe population forecasts – medium fertility variant (thousands)



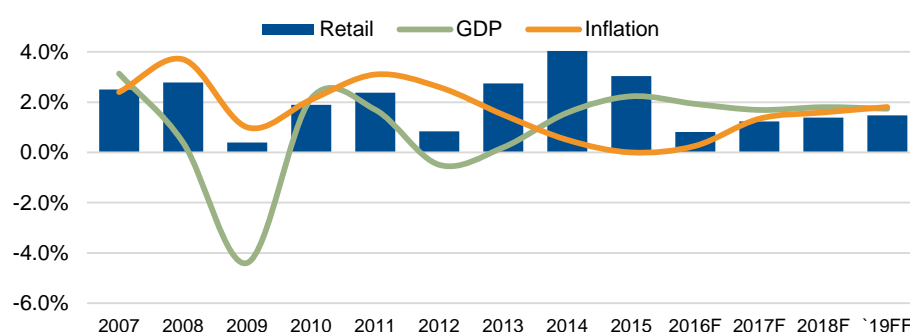
Source: United Nations, Scope Ratings

Economy

Scope identifies retail to be a generally robust industry with medium cyclicity. However, cyclicity depends strongly on a company's product exposures.

Subdued GDP growth

Figure 3: Annual growth rates (European Union incl. UK)



Source: IMF (Forecasts GDP + Inflation), EUROSTAT, Scope Ratings

The economic environment is only marginally supporting demand for additional retail space. We forecast the European retail industry to grow by around 1.5% p.a. Two factors will influence this: i) subdued GDP growth and ii) a slight rise in inflation, with both expected at around 2% p.a. until 2025.

¹ 'Last mile' refers to the movement of people and goods, specifically the distance between a transportation hub and the final destination.

E-commerce reshaping retail landscape

E-commerce key driver of retail growth

Sales area productivity

At best, we expect sales area productivity to increase in line with retail industry growth until 2025, as experienced in the past (2013-2015: +4% sales area productivity vs 10% industry growth / Source: GfK). This assumption is based on:

- Muted growth of sales area productivity, despite the support provided by the meagre growth of sales area in the past (2015: 0.3% | 2014: 0.5% | 2013: 1.9% / Source GfK);
- Retailers' limited ability to reduce rented space if sales decline, as lease contracts can run up to 20 years; and
- The rising share of sales generated without the need for physical locations (e-commerce).

Threat to retail-space demand, but is the future bright for logistics?

Growth in retail will be predominantly driven by the growth expected for e-commerce. As such the inherent positive effects from both industry growth and lower productivity growth are negated by this new business model, which makes much less use of retail space. Yet, e-commerce is expected to generate demand for logistics space.

E-commerce impacts demand for retail space

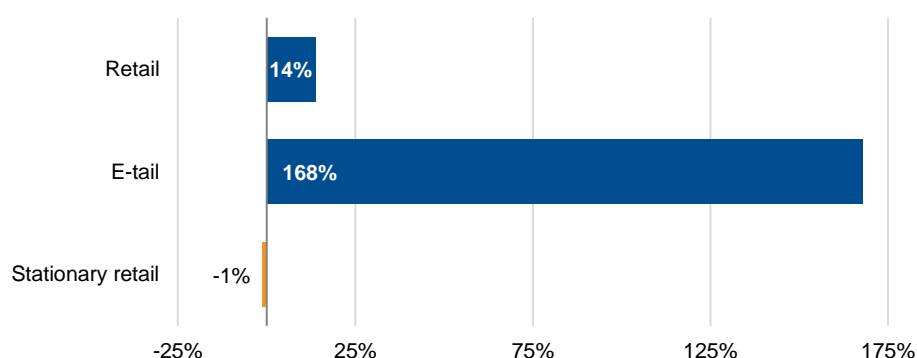
E-commerce is one of the fastest-growing sectors in Europe, averaging an annual growth of 13% against 2% for retail. And it is far from having reached its full potential.

Scope believes there is still room for the sub-sector's growth, based on three factors:

1. The penetration rate of currently 9% is still relatively low;
2. Demographics continue to move towards a more-connected population, backed by increasing internet penetration; and
3. Mentalities have changed to 'IWWIWWIWI' ("I want what I want when I want it", from Dr. Kit Yarrow, 2014).

As a result, Scope forecasts sales volume to exceed EUR 800bn by 2020 and EUR 1,300bn by 2025, increasing the penetration rate to 13% and 21% respectively.

Figure 4: Growth of European retail and sub-industries, 2016-2025



Source: Ecommerce Europe, TNS Infratest, EUROSTAT, Scope Ratings

As seen in Figure 4, Scope believes the strong net growth of e-tail sales in Europe will be the key driver of a steady increase of sales in the overall retail industry. Thus the potential benefits for demand for retail space (see section: 'What drives demand for retail space?'), will be eaten up by the marginal demand for retail space stemming from e-commerce, which dominates industry growth.

High growth potential for logistics real estate

In contrast to retail space, demand for logistics properties in Europe is expected to thrive. The tectonic shift in the European retail landscape towards a higher share of e-commerce is expected to boost the number of new warehouses, fulfilment centres and other types of logistics real estate. This is due to:

- The expected re-location of logistics operations to optimise last-mile delivery; and
- The greater need for logistics space among e-commerce providers.

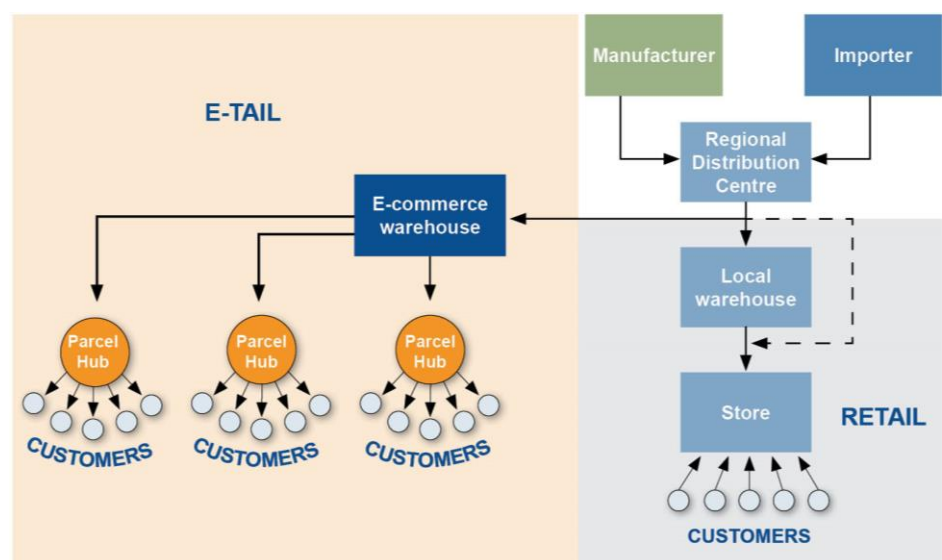
Relocation within and adjacent to larger urban areas

As we state in our study 'Adapt or Disappear: How E-commerce Transforms European Retail' ([click here](#)), efficient logistics processes (i.e. minimal delays, good geographic coverage, and reliable service) are necessary for an e-tailer's brand strength. We expect e-tailers will enlarge and re-locate logistics networks to improve last-mile delivery; balancing this with service levels, transportation costs and network diffusion (logistics networks are becoming more granular).

According to Fraunhofer Institute and Logix, this development (which is predominantly driven by the success of e-commerce) is expected to lead to the integration of small-scale, mechanised delivery bases in city centres (parcel hubs). Amplified by ongoing urbanisation, Scope forecasts increased demand for logistics space in and around large urban areas, as well as for new types of properties. As a consequence, competition for land in urban areas is anticipated to increase, even despite the general shortage of space and sky-rocketing property prices.

These trends will change decades-old logistics concepts, i.e. low-cost labour and a focus on real estate in rural and central locations. As a result we believe existing logistics space in rural areas will see declining demand.

Figure 5: Relocation of logistic space – supply chain



Sources: CBRE, Scope

Consumption of space

According to Prologis, e-tailers require three times the logistics space as 'bricks and mortar' retailers, owing to: i) a high inventory turnover, ii) broader product range, iii) individual product pickings, iv) a larger need for outbound shipping space, and v) an increase in reverse logistics (returned packages).

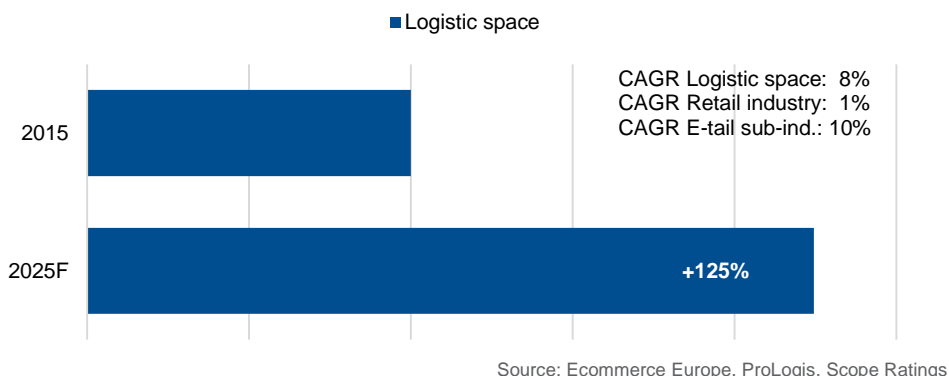
Last-mile needs: small-scale, inner-city, mechanised distribution facilities

Declining demand for rural, centralised locations

E-commerce requires three times the logistics space as traditional retailers

As a result of the higher space consumption and the anticipated relocation of logistics, we expect demand for logistics properties to accelerate, with growth rates to average 8.0% for the next decade (Figure 5). This will double the demand from the whole retail industry for logistics space.

Figure 6: Growth of logistics properties in Europe occupied by retail industry



Outlook – implications for the real estate industry

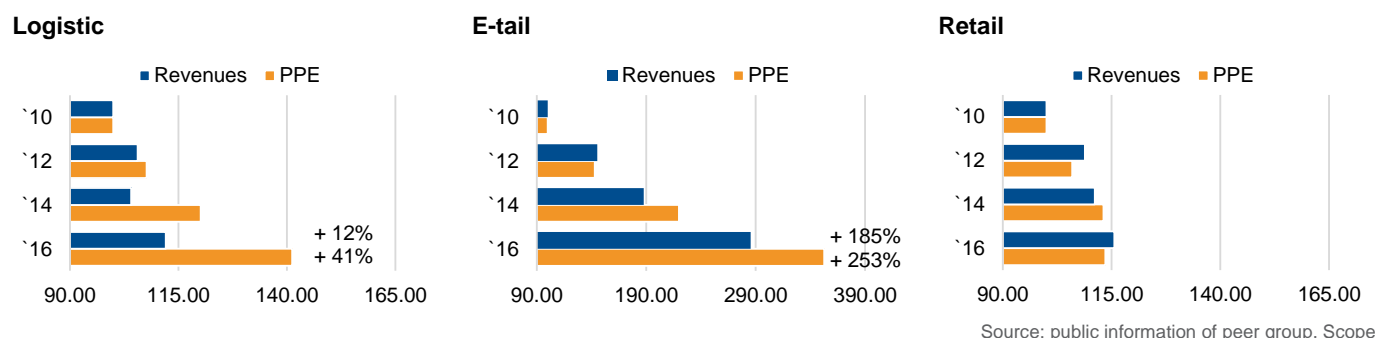
In our view, growing demand for logistics space in the real estate industry will partly counterbalance the decreasing demand for retail space in the short to medium term. However, according to JLL, the increase in property developments on a build-to-suit basis will narrow room for growth in the logistics segment. This is expected to cause: i) fewer available assets for investors, as larger e-tailers and logistics providers are increasingly developing and owning logistics properties; and ii) higher risks in developing or investing in these properties, as their decreasing uniformity escalates reliance on the occupier. In the retail industry particularly, these occupiers could be wiped out in the transformation process expected in the next decade.

Kicking out the real estate intermediary

Third-party logistics providers and e-tailers owned or rented approximately 50% of the logistics space in 2016 (source: JLL), thus being the most active occupier group. But, large e-tailers (such as Amazon, Zalando or Cdiscount) and large logistics providers (like UPS, Kuehne & Nagel and Hermes Logistics) are now increasingly tailoring properties to their needs and keeping them on their balance sheets.

Increasing share of logistics properties held by e-tailers and logistics providers

Figure 7: Growth of revenues compared to property plant & equipment (PPE) (2010=100)



As of 2016, more than 50% of newly developed logistics space in Germany and France were owner-occupied – an increase of 20 percentage points compared with 2011². This

² BNP Paribas Real Estate: European Logistics Market - Property Report Q4 2016 and JLL: Logistics Property – Owner-occupiers at record level September 2014

Increasing emphasis on occupiers' credit strength

Shorter lease contracts increase risk further

has narrowed choices for investors. Figure 7 shows that property, plant and equipment (PPE) has grown faster than revenue among e-tailers and logistics providers. In future we expect these two industries to absorb a high share of demand for logistics space, cutting out real estate intermediaries and investors in the process.

Real estate industry to face more risk

There is tremendous change in the logistics industry, driven, among other things, by the 'internet of things', 3D printing, automation and robotics, autonomous vehicles, and drone deliveries. We believe this will lead to an increasing variety of concepts for logistics properties, heavily influenced by the needs of the tenant or occupier. The market is undergoing a phase of trial and error, and there has so far been no linear response to the various online delivery models. Properties are increasingly being personalised and becoming less uniform, which links their credit quality even more to the occupiers', thereby threatening third-party usability and increasing liquidity risk.

In addition we expect commercial lease contracts to alter with "IFRS 16: Leases", coming into effect 1 January 2019, which states that operating-lease obligations must be brought onto the balance sheet. As companies try to avoid the higher indebtedness, they might develop a preference for shorter lease contracts. As a consequence investors have to deal with a shorter horizon of certainty for future cash flows.

Logistics a new hope, but investors need to do their homework

With demand for retail spaces expected to decline in the next decade, logistics properties could become an alternative for developers, as well as for credit and equity investors in real estate. However, such a strategy will need more attention from management, as logistics properties are expected to become more specialised, creating more uncertainty as a result. Thus developers and investors have to evaluate how global mega-trends will affect tenants' needs around building types and locations. But above all higher emphasis has to be placed on tenants' business models and credit quality – especially for retail tenants, for which competition has increased tremendously, with not all expected to survive.



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