



## UNCERTAINTY AND CHANGE: THE NEW CONSTANTS FOR INDUSTRIAL AND LOGISTICS OCCUPIERS

By Richard Holberton, Director, EMEA Research & Consulting  
and Guy Frampton, Executive Director, Industrial and Logistics Europe

### OVERVIEW

This paper summarises the key issues raised at a recent panel of major industrial and logistics occupiers.

- An uncertain economic environment is presenting industrial and logistics occupiers with a range of significant challenges. In particular, the twin aims of flexibility and future-proofing are paramount.
- There is growing awareness of the need to tailor occupational terms closely to specific situations, not least in order to manage future cost escalation. Occupiers' aspirations towards customer service and landlord relations are also becoming more important, with many looking for increased innovation from landlords.
- With the scope to source good buildings from built stock expected to remain limited, new approaches to development are gaining prominence particularly in high-growth - but unfamiliar - emerging markets.
- Sustainability remains high on the agenda, with many companies seeing it as a form of operational risk management, a means of value enhancement and a buffer against future legislation.

### INTRODUCTION

With the economic environment still challenging, but expansion opportunities available in a range of emerging markets, occupiers of industrial and logistics buildings are juggling a number of pressing issues. Increased agility will be required around portfolio planning, lease structures and different ways of sourcing stock. Above all, finding appropriate and flexible approaches to risk management are regarded as key differentiators.

To explore these themes further, CBRE convened a panel of major occupiers to debate the key challenges they face and how they might deal with them. This paper is a summary of the main issues raised at this event.

### THE LOST ART OF CUSTOMER SERVICE

Landlord-tenant relations still generate strong feelings. While there is acceptance that many landlords own a relatively small number of industrial properties, and hence have limited expertise in the sector, the landlord still has a vested interest in protecting the structural

integrity of the asset. Lease lengths are always shorter than the life of the building, so landlords ought to want to protect the value of the building.

In this context, the frequent onus on the tenant to pay the full-life cost of something they only use for five years appears unreasonable.

**"It's very like the feudal system. We pay our tithes, and every so often the lords of the manor show up to collect their rent. These old habits and the lack of landlord innovation have had their day."**

More broadly, customer service is not generally viewed as a defining characteristic of this sector. A high proportion of the occupiers of institutional-grade buildings are in highly dynamic consumer-responsive sectors and must deliver excellence and value consistently – and this certainly influences their expectations. A reasonable expectation for building provision would encompass a building that works, realistic pricing, an open and

honest transaction and some after-sales care: that is, the landlord fixes any early problems that either shouldn't have happened in the first place or should have been identified earlier. Beyond this, occupiers expect to be treated as they would treat a customer: that is, not just an income stream. Some positive experiences were reported, but set against frustration at landlords' lack of innovation and an attitude of "we've always done it this way".

**"In my industry as in any other, good customer service leads to more repeat business. But I'm not sure that the funds get this, or even that they are really listening."**

#### PLANNING FOR PERMANENT UNCERTAINTY

This economic cycle has defied normal expectations. Periods of economic contraction and falling demand are far from unknown, but it has generally been the case that boom followed by bust gives way to steady recovery. Not this time.

The possibility that the economic crisis – which has persisted on and off since 2008 – will be very prolonged, introduces an unprecedented degree of uncertainty into corporate decision-making. European stagnation may even last for another decade.

The clouded outlook is a major factor governing corporate thinking and behaviour: firms are building more downside into operating assumptions at the moment, and are often reluctant to sign long lease commitments. In any case, restricted access to capital because of continued risk-aversion by investors hinders corporate expansion of any kind, not just real estate. Above all, straight cost reduction is no longer an easy option as most of these mechanisms have already been exhausted, so occupiers need to find other ways to protect margins.

**"At the moment we can't see the short-term very clearly, never mind 15-20 years ahead. It is pretty hard to accept long leases in these circumstances."**

Retailers are the one occupier group taking a longer-term perspective at present. Those retailers with strategic expansion plans are able to sign up for longer periods in the best locations. By buying land and taking early development profit, these retailers are forcing other occupiers to consider more innovative approaches to sourcing space, or accept low-reward positions further up the supply chain.

#### THE CHALLENGES OF GLOBALISATION

The challenge of globalisation is a key theme for corporates in the industrial and logistics market. In addition to the prospect of slow growth in the mature economies of Western Europe and North America, many are saturated in these markets and focussing their expansion efforts on the emerging markets of the Middle East, Far East and Latin America. Since some of these markets have limited transparency and business infrastructure, a key issue is the management of risk in complex situations and markets or, put another way, growing "smartly" and protecting the value of investments in new markets.

Deal execution comes under close scrutiny in these types of market. For Third Party Logistics operators (3PLs), acting on behalf of a contract customer, sourcing product in immature markets for companies with western governance standards is a big challenge. One lesson is to act early so as to exploit "first mover" pricing and implement western standards.

With this in mind, many multinational retailers are acquiring development land early and taking development options in long-lease situations where yield compression is likely. In some instances, retailers who are in expansion mode will look to take up-front benefits in the first five years; then outsource and expect a 3PL to take the remainder of the lease. Some retailers are identifying advantage (in terms of both cost and planning acceptability) in locating logistics functions slightly "off-pitch". This mirrors the long-established process of moving production to emerging markets, which has the effect of splitting the points of production and delivery regionally or even globally. This opportunity is supported by the growth of multi-channel retailing, and e-tailing in particular. If all e-retailers behave the same way, locations that are currently

regarded as “secondary” may become more active. Or to put it another way: what is off-pitch for a retailer-driven scheme ?

**“Emerging markets are not all the same. Contract customers might expect the same standards in all markets but they don’t always price these or understand the challenges”.**

#### **TENURE CHOICE AND LEASE STRUCTURES: HORSES FOR COURSES**

Far from indicating a single “one size fits all” approach, there is a growing awareness of the need to adapt and customise occupational terms to specific situations. There is still a preference for leasing over freehold ownership because of lower capital commitments, but it is no longer the default position.

Driven by the twin goals of “smart growth” and future-proofing portfolios, modelling of different options and the components of a particular business case are now more rigorous. There is interest in managing future cost escalation - for instance by removing mid-lease indexation - and balancing flexibility against value: is five years with a break at three a better choice than 10 years with a break at seven? As ever, it depends – nobody wishes to pay for flexibility they don’t need and won’t use. Across a large portfolio, it’s not prudent to pay for across-the-board flexibility, when it’s only likely to be needed in isolated cases.

Equally, local practices and norms – as well as internal considerations – have a major bearing on outcomes. Many US corporates don’t understand why internal repairing leases - where landlords bear responsibility for repairs and maintenance - aren’t universal, and most tolerate other lease variations only in the context of a full repairing arrangement. In other words, local customs and practices can be honoured but they are conditional.

**“Internal repairing leases are becoming more popular even in the UK – this change is coming and landlords need to respond quickly.”**

But its not always straightforward. UK landlords are the least familiar with this type of lease, but across continental Europe industrial and logistics is a minority asset, and many landlords lack specialist skills in the sector simply because they don’t own much of it. Indeed, some occupiers - even those who regard tenant repairing obligations as unfair - may prefer to retain responsibility for repairs and, particularly in manufacturing, have on-site capability to do them better and more quickly than most landlords could.

In any case, the niceties of analysed rent-buy decisions can sometimes be trumped by large cash reserves. Cash-rich, locationally-footloose corporates with a low cost of capital may be in the strongest position of all. Google’s cash acquisition of its New York HQ for over \$1bn, while partly a reflection of the strength of the technology sector, highlights the point. The threat (real or otherwise) or partial relocation can go a long way to securing the sweeteners that make for an advantageous deal.

**“It’s not our core business to be fixing roofs. It costs £10 per sq ft to fit out a standard building and the benefits last well beyond 10 years”**

#### **PROCUREMENT AND DEVELOPMENT: GO YOUR OWN WAY**

Two key aspects of the development cycle have a bearing on occupiers’ approach to securing new space: many major markets around Europe offer almost no completed Grade A space, and speculative development has virtually ceased. With developers facing restricted liquidity and a high cost of capital, this shows no immediate signs of reviving, and some developers appear to be operating at or near a zero margin, just to keep business “ticking over.” Saddled with high historic land costs, some are still expecting a return on assets that were overpriced initially.

**“The ability to source stock from built space will be impaired for some time, but internal customers don’t thank the corporate real estate department for saying nothing’s available – the pressure is now on to go find and build.”**

Page 3

Occupiers are now more aware of the need for innovation in securing new space. This realisation comes with an increasing need for agility and lateral thinking, an understanding of the imperatives and accountabilities of the developer and their funders, and an ability to understand and price their own risks. Responses vary and are very situation-specific: only the larger occupiers can do this but, for some, a cost of capital of less than 5% compared with significantly over 10% for many developers certainly changes the equation.

Given the difficulty of sourcing stock even in mature markets, some 3PLs and manufacturers are establishing, and building on, their own land banks to satisfy both their own needs and those of strategic customers – and sometimes because there simply isn't an alternative. Whether this is viable depends partly on the length of multi-country logistics contracts. For low margin business that's single contract led, this is usually three to five years, but for global network business (i.e., 3PLs establishing strategic network capacity) that is not dependent on a single customer, it can be as much as 10 to 15 years – which better supports the capital cost of developing. It also depends partly on planning policies and the flexibility of planning officers in different jurisdictions. Some are extremely welcoming of applications for employment-generating uses; others bureaucratic, complex and time-consuming. So while it may be a good time to secure planning consents, some developers still allow around £250,000 per scheme in the UK to navigate the planning process.

In new or immature markets, where most occupiers' expansion efforts are focussed, sourcing land and buildings is an even bigger challenge, particularly where its on behalf of mature customers with western governance standards. One key is to act early and be able to implement western standards but this isn't always possible. Getting the inside-track on new infrastructure schemes and land zoning policies ahead of the locals can be extremely challenging.

**“We need to re-assess our attitudes to the risks of different ways of sourcing stock. Creating the right product at the right time in emerging markets requires a shift in mindset by both 3PLs and contract customers and higher appetite for risk.”**

## **SUSTAINABILITY AND ENVIRONMENTAL REGULATION**

The desire to future-proof operational real estate is keeping sustainability high on the corporate agenda. The growing interest in building for owner-occupation accentuates this since there are operational benefits at stake as well as value gains. As a result, there are now clear differences: cost-effective, environmentally-responsible, smart, sustainable buildings will retain value and non-sustainable buildings will be worth less. This is a direct consequence of occupiers' desire to future-proof their operational portfolios. The larger developers are also contributing: not only are they willingly accepting and developing sustainability initiatives, but their ability to buy construction materials in volume will also reduce the additional cost of developing sustainable space.

The occupier rationale is clear enough – corporate image, cost reduction and carbon emissions reduction – but attitudes still range from the messianic to the sceptical. In part the range of opinion reflects fragmented legislation and significant knowledge gaps, but there is a widespread belief that the regulatory framework will tighten - with more countries coming to resemble France where regulations are already stringent - and that energy costs will rise.

There is less consensus on the shape and focus of future legislation, so concerns linger about backing the wrong technology or pursuing CSR policies that are marginalised by future regulation. These concerns run deepest in those already sceptical of the real estate's industry's commitment to this agenda. There is still a strand of opinion that green buildings cost more to build with no proof that this is rewarded in either higher rents or lower yields.

Against this, the evidence base is growing and aspirations remain high. Most companies see sustainability as a form of risk management – a way of hedging against future legislation that could impact within the lifetime of a new lease. Some have identified substantial cost savings from a relatively modest investment, for instance a two-year payback on retro-fitting intelligent lighting, and a desire to halve electricity bills. A build-to-suit route to new development also lends itself well to the incorporation of sustainable features.

**“We now know that some key features have an attractively short payback period – but this still requires the finance director to take a full-life view of project costs.”**

### **RISK MANAGEMENT: THE HIGHEST COMMON DENOMINATOR**

From an occupier perspective, the linking theme across all these issues is risk management. Difficult economic conditions breed risk-aversion and it is especially hard for low margin businesses to justify risk-taking at present.

Some are concerned that widespread risk aversion - whether the risk be geographic, economic, political, planning, or customer - is a recipe for inertia, and that the challenges faced by occupiers today actually require greater appetite for risk and new approaches to its management. This applies particularly to expansion in new and emerging markets and new land development routes, but also to the adoption of new technologies. The ability to tolerate such risks varies enormously across

different types of business and different situations, but most accept the need to take a new approach to risk in this market. Those who can understand and manage key risks in challenging markets will be secure lasting competitive advantage.

**“If you don’t take risks, you won’t make money. Or perhaps if you don’t take risks, you won’t lose money.”**

### **ACKNOWLEDGEMENTS**

CBRE acknowledges the contributions of:

Sally Duggleby, Amazon

Nigel Glover, BMW AG

Paul Graham, DHL Real Estate

Jean-Marie Graux, Dole Fresh UK Limited

Martin Holub, Kuehne+Nagel

David Mills, Associated British Foods Plc

Jean Poujol, FM Logistics

Andrew Purcell, Honeywell Control Systems

Frank Rietz, APL Logistics

Kevin Thompson, Kuehne+Nagel

Giles Williams, UPS Limited

Matthew Wright, DHL Real Estate

### CBRE GLOBAL RESEARCH AND CONSULTING

This report was prepared by CBRE EMEA Research Team which forms part of CBRE Global Research and Consulting – a network of preeminent researchers and consultants who collaborate to provide real estate market research, econometric forecasting and consulting solutions to real estate investors and occupiers around the globe

For more information regarding this ViewPoint, please visit [www.cbre.eu/industrial](http://www.cbre.eu/industrial) or contact:

#### Richard Holberton

EMEA Research, Director  
 CBRE  
 St Martin's Court  
 10 Paternoster Row  
 London EC4M 7HP  
 t: +44 20 7182 3348  
 e: richard.holberton@cbre.com

#### James Markby

Industrial & Logistics Europe, Director  
 CBRE  
 Henrietta House  
 Henrietta Place  
 London W1G 0NB  
 t: +44 20 7182 2746  
 e: james.markby@cbre.com

#### Guy Frampton

Industrial & Logistics Europe, Executive Director  
 CBRE  
 Henrietta House  
 Henrietta Place  
 London W1G 0NB  
 t: +44 20 7182 2150  
 e: guy.frampton@cbre.com

#### Garrett McClean

Industrial & Logistics Europe, Director  
 CBRE  
 3rd Floor, Connaught House  
 1 Burlington Road  
 Dublin 4  
 t: +353 1 618 5557  
 e: garrett.mcclean@cbre.com

### DISCLAIMER:

CBRE Limited confirms that information contained herein, including projections, has been obtained from sources believed to be reliable. While we do not doubt their accuracy, we have not verified them and make no guarantee, warranty or representation about them. It is your responsibility to confirm independently their accuracy and completeness. This information is presented exclusively for use by CBRE clients and professionals and all rights to the material are reserved and cannot be reproduced without prior written permission of the CBRE Global Chief Economist.