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EMEA ViewPoint

www.cbre.eu/research

February 2010

EMERGING CHALLENGES FOR INDUSTRIAL AND LOGISTICS OCCUPIERS

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OVERVIEW

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

Faced with recessionary conditions in most geographies, occupiers of industrial and logistics buildings have had to take steps to reduce their cost base. This doesn't automatically skew demand towards cheaper space, mainly because the quality gradient is unacceptably steep. More often the issue is how to acquire modern, flexible large-volume space on acceptable terms, either by altering existing leases or securing new ones that are sufficiently short and occupier-friendly. This increased desire for flexibility is mainly the result of shorter business planning horizons, creating the need to be able to review or reverse strategic decisions more quickly. Even where an investor/developer is prepared to grant a short lease there is usually a cost in the form of a higher initial rent. Assessing how much space-flexibility is needed, and how much to pay for it, is difficult but essential. Sustainability remains a live agenda, but weak economic conditions have produced a more discriminating approach to the issue, and a sharper focus on those building features than can be shown to generate cost savings.

INTRODUCTION

Property occupiers in all sectors have been under pressure to cut their cost base in response to weakening demand for their products and services. The consequences of this for real estate markets are numerous and subject to a range of sector, local and building-specific influences.

These pressures are just as evident in the industrial and logistics markets as others. Leasing activity is down and rents fell by around 5% across Western Europe last year. Equally, some of the characteristics of the industrial and logistics sector - including the nature of the stock, high levels of owner-occupation and contractual agreements between landlords, third-party contract logistics firms (3PLs)* and end customers - lead us to think that there may be some particular, perhaps unique, issues faced by occupiers in this sector. In order to explore this theme further, CB Richard Ellis convened a panel of 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 that event.

*3PLs operate outsourced logistics and distribution functions on behalf of a range of contract customers including manufacturers, distributors and retailers.

A TWO-TIER MARKET...

It is increasingly evident that rising levels of vacant space, on which rents are declining, co-exist with growing demand for more modern, flexible space which is in short supply and can often only be satisfied on a build-to-suit basis.

The fact that much of the space currently vacant can be ignored as unsuitable for modern occupiers, despite becoming increasingly cheap to occupy, challenges the notion that falling rents have created a "buyer's market". The fact that current needs are not capable of being satisfied by low-grade legacy space indicates that occupiers' requirements in terms of building specification and flexibility are becoming more demanding. This is particularly true for 3PLs. Some manufacturers are more willing to acquire older or smaller buildings in sub-optimal locations at reduced rents, and they may be the biggest beneficiaries of current conditions. But even manufacturers are becoming less tolerant of poor quality space.

...DESPITE COST-REDUCTION IMPERATIVE

Demand being focussed on better quality modern space doesn't mean that organisations are under no pressure to reduce costs. What it does indicate is recognition that paying more for the right kind of building in the right location can produce more cost savings and efficiency gains across the business.

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The main areas of cost-cutting are headcount reduction and cancellation of property maintenance spending. The second of these, while superficially attractive in the short term, merely defers expenditure – it comes back to bite in the end!

FLEXIBLE LANDLORDS: SOME ARE, SOME AREN'T

It is sometimes possible to renegotiate leases within two to three years of a break or expiry, and many landlords are keen to co-operate. In return for lease extensions of around five years, occupiers can achieve immediate rent reductions of at least 10% and sometimes up to 30%. Landlords vary in their willingness to accommodate such approaches: generally local investors and distressed owners are viewed as most open to such deals. Major institutional investors can often be more resistant.

"Most people recognise the pain has to be shared around, but some of the big institutions still believe they can press ahead with business as usual."

BETTER THE DEVIL YOU KNOW

Landlords need to appreciate that the cost of getting in new business is generally far higher than that of retaining existing business, even on softer terms. The same may be true for 3PLs. Some landlords have perhaps been too willing in the past to tolerate high occupier turnover. In weak economic conditions this can be expensive or even unworkable, and the more enlightened landlords are increasingly aware of this. Some are incorporating the "price of loyalty" into their returns calculations.

"Funds should realise the cost of disloyalty to us is not just a couple of months without any rent being paid. It's also the fees to agents and lawyers of setting up arrangements with a new party."

BUSINESS PLANNING HORIZONS ARE GETTING SHORTER...

Businesses and business units are unable to plan as far into the future as they did two or three years ago, simply because the economic environment is so uncertain. Thresholds for capital investment have been raised, to the point where sponsors are sometimes required to show a payback within one year to secure approval. The need to be able to review and, if necessary, reverse strategic decisions within a shorter timeframe is producing a reluctance among businesses to take unchangeable long-term decisions.

"We have no idea where we'll be in two or three years. It's as simple as that."

... SO FLEXIBILITY IS KING...

As a result, flexibility in the terms of property occupation is increasingly highly-sought. Firms are keen to avoid becoming tied in to lease obligations that their operations may be unable to justify. One response is to seek more frequent lease breaks: even if they are not exercised, the relieved landlord often ends up making further concessions. There are pitfalls here though: there is usually a rental cost attached to greater flexibility and, for some longer contract operations like parcel sorting, it may not be necessary. Gauging the required level of flexibility – and its price – is crucial, to avoid paying for a degree of flexibility that isn't actually needed.

...BUT EVEN THIS HAS ITS LIMITS...

Third-party contract logistics firms may struggle to meet the property needs of customers who, in uncertain times, cannot forecast their activity levels: even the most flexible buildings are not infinitely flexible. Many firms are looking for short, flexible terms and a bespoke solution. Some 3PLs may be prepared to meet this need in the interests of boosting volumes but this can impose extreme pressure on margins. Equally where a corporate wants a shorter term than the landlord is prepared to grant, it can be the 3PL that ends up taking on the remaining leasing risk.

"They say volumes might be plus or minus 25%. But we can't flex the building plus or minus 25% - we don't have rubber walls."

...AND MAY LIMIT SCOPE TO STRIKE THE BEST TERMS...

In situations where there is a need to be in occupation quickly this imperative often trumps the need to strike a favourable property deal – simply because there isn't time to negotiate one.

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...AS WELL AS HIGHLIGHTING THE INFLEXIBILITY OF UK LEASES

The longer and less tenant-friendly leases typical in the UK are regarded as a particular hindrance in an environment where flexibility is so highly-prized. Whether or not it is formally specified in lease terms, the experience in continental Europe is that investors are significantly more involved in issues such as maintenance, rather than offloading the responsibility to tenants. Despite there being a lease code in the UK, the ability of strong covenants to secure favourable terms for themselves is often less than in most other parts of Europe, even though the cost and time burden of negotiation are considered higher.

"We should push for a standardised approach to tenant-friendly leases. Our business is making things, not fixing sprinklers."

OCCUPIERS ALSO NEED MORE REALISM....

Occupiers' recent experience of being able to manage real estate assets successfully in a rising market has raised internal expectations that are slow to subside in a falling one. In particular, operational managers who are not engaged in real estate can be reluctant to accept, when considering disposal of a freehold property, that it is no longer worth as much as its previous valuation. This "unchanging world" position is inhibiting sale and leaseback activity in the sector and, in turn, forcing firms to look again at other capital-raising or cost-cutting measures.

"Memories of great deals stay around for longer than I'd like. Six months later, if real estate managers can't show the same results throughout the portfolio, they ask if we're losing our touch."

...BUT ALSO MORE AGILITY

Equally the logical reverse of this view – that falling property markets can create acquisition opportunities on more favourable terms – has been slow to gain acceptance. Some occupiers struggle to evaluate (or even consider) opportunistic situations that rely on playing the property market, rather than focussing on parts of the core business. As a result there is little or no interest in buybacks from distressed landlords, even at heavily discounted prices, and only partly because the quality of space on offer is inferior.

THE GREEN AGENDA: NOT DEAD, JUST SLEEPING

Sustainability hasn't been forgotten and there is more lasting momentum behind it than was the case in previous recessions. Equally there is a much tighter and more discriminating focus on features that deliver a measurable commercial benefit in the form of cost savings. There is some emerging scepticism around the "anything green is good" view in relation to corporate property, and an impatience with consultants who continue to promote this view. Corporates continue to compete to show the best green credentials, but in property terms, the key issue will be an ability to distinguish and incorporate those building features that deliver the highest cost-benefit trade-off.

"There is momentum behind the green agenda but it has become more discerning: we're not prepared to waste a fortune on consultants designing windmills in the sky."

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ACKNOWLEDGEMENTS

CB Richard Ellis would like to acknowledge the contributions of:

- Paul Graham, DHL Real Estate
- Martin Hime, Heineken (UK) Ltd
- Martin Holub, Kuehne & Nagel
- Derek Kay, DHL Real Estate
- Alan Long, APL Logistics
- Ruairi McCafferty, Federal Mogul
- John Toogood, Iron Mountain
- Giles Williams, UPS

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