



YIELD AND PRICING PATTERNS IN THE EUROPEAN LOGISTICS MARKET

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OVERVIEW

While downward yield movements and investment turnover growth have been relatively modest in the European logistics market over the past year, longer-term changes in the sector’s investment characteristics have established a different, and lower, yield regime over the past ten years than was observed previously. At local market level, varying degrees of yield movement since the market peaked in 2007 have shaped the relationship between current prime yields and historic averages. This relationship is also influenced by differences in levels of market liquidity and investor base, as well as demand-side issues linked to national economic structures and outlooks. This analysis shows that it is not always self-evident that the pattern of prime logistics yields fully reflects these differences. This suggests that the market offers out performance opportunities for informed pan-European investors. In addition to micro-locational and asset-specific issues, an understanding of these trends will be important in informing investors’ market selection decisions.

INTRODUCTION

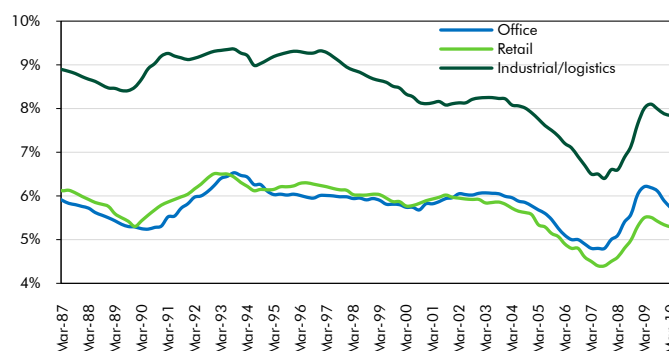
The key features of the European investment market over the past year have included some significant downward shifts in prime yields and a strengthening in investment demand. In some respects, these trends have been less prominent in the industrial and logistics sector than in others: prime yields in the sector across the EU-15 group have fallen by 16 bps over the past year compared with 48 bps in the office sector. In terms of investment activity, the sector accounted for around 8% of European turnover in Q1 2010 – slightly down on recent experience – while the contribution of the retail sector rose to a record high 42%.

Nevertheless, with the investment and production sides of the economy showing some signs of recovery and the sector offering inherent defensive characteristics, recent pricing movements are worth examining. This paper briefly reviews the current position, and recent history, of yields in the sector and comments on these in a long-term context. Changes in its occupational and investment characteristics have clearly affected pricing and these factors should influence investors’ views on future yield levels. It then focuses on local pricing patterns in the major European markets in the context of market liquidity characteristics and economic prospects.

YIELD TRENDS

In common with other sectors of the commercial market, prime logistics yields have been falling since mid-2009, having risen by 160 bps over the previous two years. The period since 2005 has clearly been one of exaggerated changes in pricing – with a sharp period of debt-driven value growth followed by one of restrained liquidity and increased risk aversion – but viewed in a long-term context yields in the sector have been on a downward trend since the late 1990s.

Prime yield indices, EU-15



Source: CB Richard Ellis

Prime yields in the logistics sector across the EU-15 averaged 7.85% in the period 1998-2010 compared with 9.0% in the period 1986-1997, a difference of 115 basis points. For comparison, the differences in the office and retail sectors across these two time periods are 18 bps and 56 bps respectively. As a result the spread between prime office and prime logistics yields is now around 210 bps compared with over 300 bps in the mid 1990s. What has changed ?

Logistics-offices yield spread (bps), EU-15



Source: CB Richard Ellis

A MATURING SECTOR

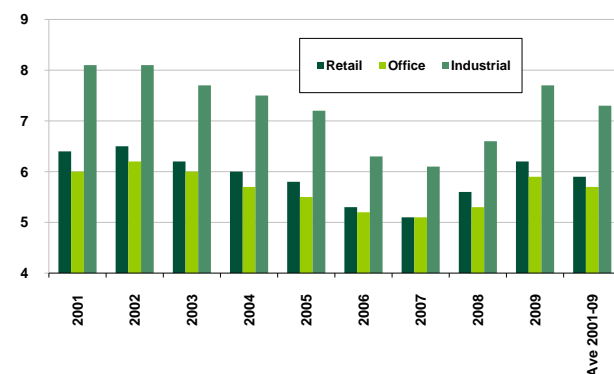
A number of overlapping factors has contributed to changes in the European logistics sector's investment characteristics and its growth as an institutionally-acceptable investment medium:

- Growth in the scale and quality of investable stock. In line with expansion in the number and size of specialist funds targeting the sector, the ownership structure of the sector has been changing: nearly 20% of the transactions in the industrial/logistics market over the past five years have been disposals by former owner-occupiers, compared with 13% for the real estate market as a whole. The absolute scale of the market has also expanded: the stock of new developer-led logistics space in CEE, for instance, rose more than ten-fold between 2000-08.
- Growth in sector liquidity and investor base. Largely through the increased involvement of institutional investors and collective vehicles, the sector now accounts for around 10% of the European property investment market compared with only 6% in 2006 (see Investment Patterns section below for further detail).

- Improvements in the occupier base, via the expansion of outsourcing to third party logistics specialists (3PLs). Growth in world trade and the growing importance of Far East producers such as China and India have caused a reconfiguration in global and European logistics networks. Increasingly these are being serviced by 3PLs active in multiple markets and often globally, supported by the growth of strategic European infrastructure. This reinforces the role of existing strategic logistics hubs such as Hamburg, Milan and Rotterdam, but also expands the network eastwards to include key locations in Central Europe and the Balkans, such as Kiev, Sofia and Central Poland. Despite recent growth in logistics outsourcing, the industry remains fragmented - the combined market share of the top ten contract logistics providers is less than 20% - and further consolidation and growth are expected.

- Acceptance of the sector's "defensive" investment characteristics. Growth in institutional activity in the sector is increasingly focusing attention on its performance record. A particular attraction is the fact that the sector's income return has been over 1.5 percentage points higher than the all-property average over the period from 2001. This would offer some future protection in a low growth or deflationary environment.

Income returns (%), Europe, 2001-09



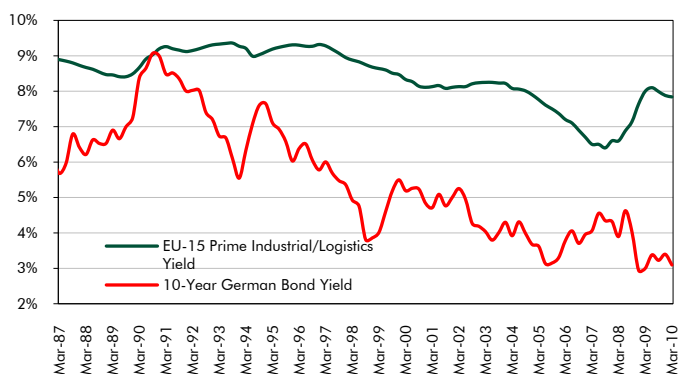
Source: CB Richard Ellis

- The sector generally delivers less rental growth than others over the long term (3.2% per annum over the period from 1986 compared with 5.7% for retail and 3.8% for offices¹), but its potential in an inflationary environment is supported by the "buffer" of a historically high premium between logistics yields and government bond yields, currently over 450 basis points. In total return terms the sector has delivered returns of 7.5% per annum over the past nine years, well ahead of offices and within half a percentage point of retail property².

Notes:

1. Source: CB Richard Ellis rent index EU-15
2. Source: IPD Pan-European index

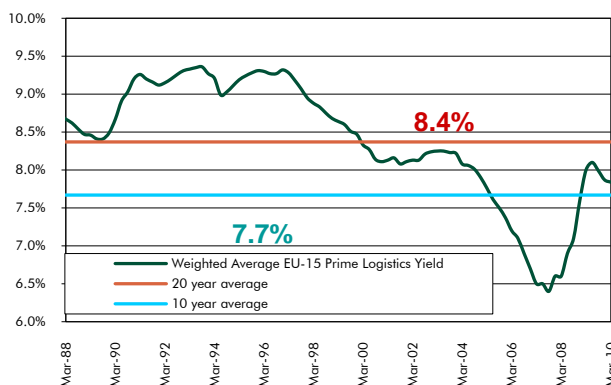
Logistics yields vs bond yields, 1987 - 2010



Source: CB Richard Ellis / Ecwin

In summary, therefore, the market now offers different characteristics to investors in terms of liquidity, asset quality, maturity and covenant base. An important implication of this is that the level of yields that has been typical over the past ten years is likely to be a better general guide to future pricing than a 20-year history. This is reinforced by the fact that the peak level of yields in this cycle barely exceeded 8% (June 2009).

Long-term average logistics yields, 1988-2010



Source: CB Richard Ellis

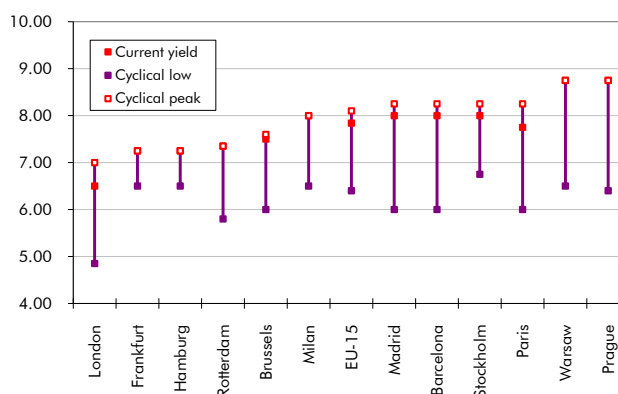
At local level across some of the main European industrial locations, recent shifts and the resulting relationship between current yield and the ten-year average highlight a number of notable points:

- The timings of local market cycles are not precisely synchronized, and yields did not reach their minimum levels in this cycle at exactly the same point. Nevertheless for most markets, mid to late-2007 marks the point at which yields began rising. The scale of yield movement since then to recent cyclical peaks ranged from 75 basis points (Germany) to about 200 basis points (London, Paris, Madrid, Barcelona and CEE), with most other markets recording shifts of around 150 basis points.

- Several markets (notably London, Paris, Madrid and Barcelona but also Stockholm and Brussels) have seen yields fall from their most recent peak. Rotterdam, Milan, Germany and the CEE markets have so far not seen any evidence of downward movement, although there is clearly pressure in this direction.

- With the exception of the London market centred on Heathrow, prime yields in the key Western European markets are now grouped in 7.25-8% range, with the main CEE markets offering yield premia of at least 75 basis points.

Prime logistics yields: from low point of this cycle to Q1 2010

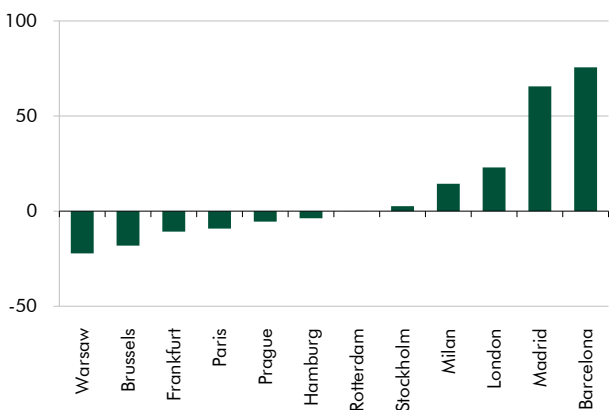


Source: CB Richard Ellis

- In terms of the position of the major markets relative to their ten-year averages, we would expect short-term income growth prospects (which are mostly relatively weak but not uniform) to exert some influence in keeping yields above historic average levels. However, notwithstanding short-term influences, the comparison is useful in informing strategic asset selection.

- There are five markets (Paris, Prague, Hamburg, Rotterdam and Stockholm) where current yields are within ten basis points of their averages; three where they are lower (Warsaw, Brussels and Frankfurt) and four where they are above (Milan, London, Madrid and Barcelona). With the exception of the two Spanish markets, the differences in either direction are all of 40 basis points or less.

Current yields relative to ten-year average (bps)



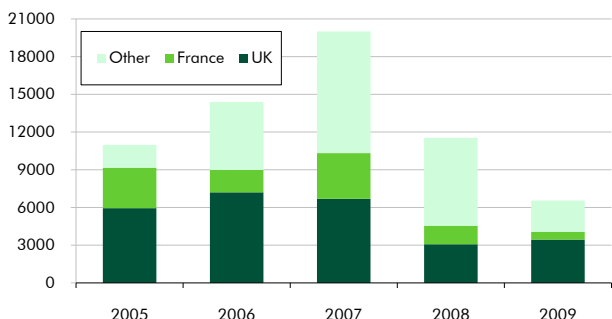
Source: CB Richard Ellis

Apparent pricing anomalies may be explicable by relative liquidity and/or variations in short-term economic and market prospects. In looking to put these relativities into some kind of broader context, therefore, it is worth analyzing firstly the pattern of investment demand across the sector, and also the economic outlook for each of the markets.

INVESTMENT PATTERNS

The pattern of investment in the industrial/logistics sector has been concentrated in a small number of key markets, to a greater extent than is the case for the market as a whole. Over the past five years France and the UK have accounted for nearly 60% of investment in the sector compared with an all-sector figure of 45%. The UK in particular has been the focus of the recent strengthening in investment volumes, and accounted for over half of last year's total. Only 10% of industrial/logistics investment over the past five years has taken place in Germany, compared with 19% for the broader market.

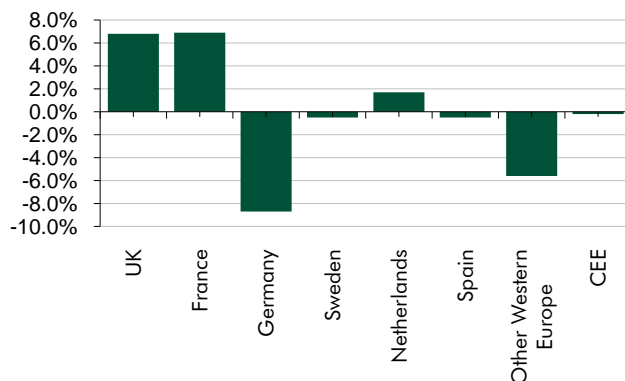
Investment turnover in industrial and logistics (€m)



Source: CB Richard Ellis

Conversely, a group of smaller Western European markets including Italy, Belgium, Southern Europe, Austria, Switzerland and the Nordics has seen relatively little industrial/logistics investment: 11% over the past five years compared with a corresponding figure of 17% across the whole investment market. CEE markets account for around 5.5% in both cases.

Relative investment concentrations, 2005-09



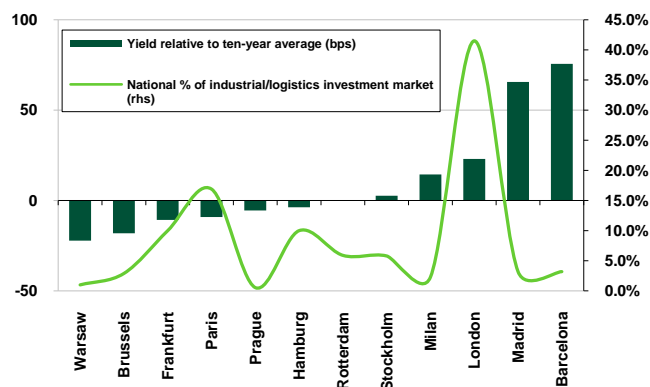
Source: CB Richard Ellis

Note: Balance of industrial/logistics investment % over total investment %

There are clearly some parts of the European market - notably Germany but also Italy and parts of the Nordics - where investment activity is relatively undeveloped in the industrial/logistics sector compared with the broader market. This reflects a range of factors including historic ownership patterns (for example, high levels of owner-occupation or public sector ownership), a limited domestic institutional market, quality of available stock and strength of covenant base.

In general high relative liquidity would be considered an advantage, and should command lower yields, other things being equal. Currently, however, the most liquid markets - France and the UK - have divergent positions in terms of their yield relativities. Of the less liquid markets, only Spain offers a clear yield advantage relative to its ten-year average.

Yield relativities and liquidity



Source: CB Richard Ellis

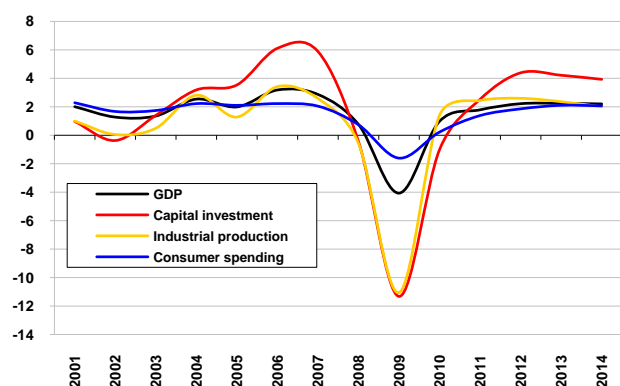
The extent to which less mature low-liquidity markets represent areas of opportunity therefore depends on their medium-term demand prospects and hence economic outlook.

ECONOMIC OUTLOOK

Nearly all European economies contracted in 2009. The peak-to-trough decline in output in this recession across the EU-27 as a whole has been over 5%, with some of the major economies seeing even larger declines, including Germany, Italy and the UK.

The initial phase of the recession was associated with very aggressive destocking by producers, and capital investment across Europe slumped by over 11% last year. At European level, expectations are currently for a slow recovery in economic growth this year, picking up towards a trend rate of growth of 2-2.25%. As the productive sectors recover ahead of consumer spending, industrial production and particularly capital investment (both significant indicators for the logistics market) are expected to see above-GDP growth rates for at least part of the next five years.

Key economic variables (% p.a.), EU-27, 2001-14



Source: Experian Business Strategies, March 2010

Clearly there are downside risks to this view as a number of European economies, in looking to restore their public finances, seek to implement spending cuts and tax increases - both of which have the potential to delay recovery.

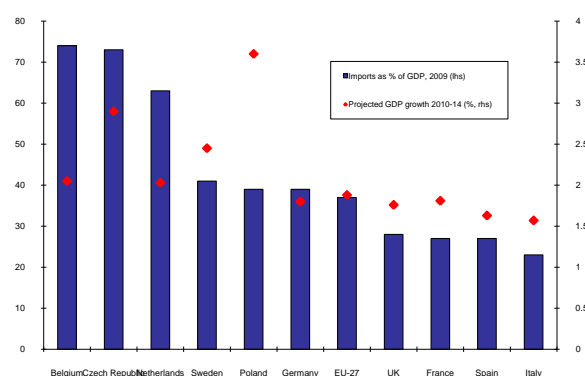
For individual countries, it is possible to identify both import dependency (as an indicator of the need to transport goods to multiple destinations) and GDP growth as helpful proxies for likely demand growth.

- At European level imports equate to around 35-40% of GDP, and aggregate economic growth is expected to run at around 1.9% per annum over the next five years.

- A group of markets comprising Belgium, the Netherlands and the Czech Republic have a significantly higher propensity to import, while Sweden, Poland and the Czech Republic are expected to see above-average economic growth.

- Conversely the UK, France, Spain and Italy import proportionally less, while the latter two are also expected to see below-average growth.

Import dependence and GDP growth



Source: Experian Business Strategies, March 2010

CONCLUSIONS

A key issue for investors in making market selection decisions will be an assessment of current investment pricing alongside indicators of prospective occupier demand and relative liquidity: in other words whether markets offer "good value".

While there is a high degree of commonality in the general pattern of pricing movements over the past three years (yields rose in most of the key markets and have recently begun falling in some), there are also wide differences in the resulting relationship between current and long-term average yields. Equally, it is not self-evident that recent yield movements fully reflect local differences in the liquidity or demand and growth prospects.

The table below summarises the key metrics for the major country markets covered in this report. In interpreting the results of the analysis, it is important to bear in mind that the dimensions analysed - liquidity and growth prospects - are not uniformly important to all types of investor or for every asset decision. Portfolio balance or other motives may be equally or more important in certain situations.

Moreover in market conditions such as those prevailing at present - thin trading levels, some distressed or semi-distressed vendors in the market, irregular value movements driven by economic uncertainty - all markets may offer specific opportunities depending on key decision criteria. Since regional and micro-locational differences will also exist within national markets, it should not be automatically assumed that a "good" market offers only opportunities, or that a "bad" market should be avoided completely.

Across the full set of criteria considered here, the Czech Republic, Sweden, the Netherlands and the UK appear to offer the most favourable prospects. All are at least neutral in terms of yield relativity, liquidity and expected GDP growth. Import dependence is low in the UK and neutral in Sweden, but positive in the other two countries in this group.

The next group of France, Belgium and Poland are no better than neutral in terms of yield position and only France offers significantly positive liquidity characteristics. Belgium and Poland are more favourably positioned as regards, respectively, import dependence and expected GDP growth, while France is neutral to negative on the economic variables.

Finally, the group consisting of Spain, Germany and Italy is neutral to negative on liquidity and economic variables. Spain and, to a lesser extent, Italy offer yields that are some way above their respective ten-year averages while in Germany the reverse is true.

Clearly, in common with the other sectors of the market, the logistics sector is facing the challenges of constrained investment turnover and short-term economic uncertainty. On the basis of the analysis presented here, these issues are more acute in some areas than others.

Equally, macro-locational factors are only one part of the decision framework and, over the medium to long-term as the sector continues to mature and gain wider acceptance, prospects may be driven as much by the existing defensive characteristics of the sector and further structural yield compression.

An understanding of these trends in a pan-European context will help to inform investment selection and, more broadly, will further support the role and liquidity of the logistics sector in the European investment market.

Summary table: pricing, liquidity and economic characteristics

	Yield Relativity ¹	Relative liquidity ²	Import dependence ³	GDP growth ⁴	Summary
Czech Republic	Neutral	Neutral	+ve	+ve	
Netherlands	Neutral	+ve	+ve	Neutral	
Sweden	Neutral	Neutral	Neutral	+ve	
UK	+ve	+ve	-ve	Neutral	
France	Neutral	+ve	-ve	Neutral	
Belgium	-ve	Neutral	+ve	Neutral	
Poland	-ve	Neutral	Neutral	+ve	
Spain	+ve	Neutral	-ve	-ve	
Germany	-ve	-ve	Neutral	Neutral	
Italy	+ve	-ve	-ve	-ve	

Source: CB Richard Ellis

Notes:

1. Based on current prime yield relative to ten-year average
2. Based on balance of industrial/logistics investment % over total investment %, 2005-09
3. Based on imports as % of GDP relative to EU average
4. Based on forecast GDP growth 2010-14 relative to EU average

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