THE NEW LANDSCAPE 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.

The recession of 2009 forced industrial and logistics occupiers to scrutinise all elements of their cost base - including real estate - more closely, and consider new ways of shifting occupational terms in their own favour. While economic conditions have since eased, these strands of thinking are still prominent and look set to feature for some time to come. Examples include the adoption of continental-style leases in the UK; more critical analysis of how much flexibility is actually required in the terms of building occupation (and how much to pay for it); the merits of owning rather than leasing properties; and a more rigorous approach to assessing the cost and benefits of new sustainability features. Occupiers' needs and aspirations in this sector are changing rapidly; and the need to build mutual understanding between landlords and tenants in order to future-proof new buildings has arguably never been greater.

INTRODUCTION

In common with other sectors of the commercial real estate market, rents and values in the industrial sector have begun to show some signs of stabilising recently. This is also starting to be reflected in less adversarial negotiations between different parties relative to those that characterised the early part of the recession.

Leasing activity remains generally slow but in many key markets take-up has climbed well above the levels seen in the trough of early 2009. The degree of downward pressure on rents has eased substantially, and prime rents in most major markets are now stable.

While these are encouraging signs, there is still a high degree of uncertainty around the short-term economic outlook. Moreover, underneath the headline numbers, the recession has forced some important shifts in the thinking and behaviour of occupiers of industrial and logistics buildings. Some of these could be profound enough to survive well beyond any reversal of the balance of power back towards landlords - and possibly permanently.

In order to explore these themes further, CB Richard Ellis 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 that event.

EUROPEAN-STYLE LEASES IN THE UK: HAS THE TIME ARRIVED?

It has long been a view among occupiers that the longer and less "tenant-friendly" leases typical in the UK are a particular hindrance to businesses. Some evidence has begun to emerge over the past year that European-style leases, or at least some of their most distinctive characteristics, are starting to make their way across the channel.

A large manufacturers' new UK regional distribution facility was secured in a deal with a major landlord that, for the first time, explicitly incorporated best practices from the UK, US and continental buildings and leases. The Internal Repairing terms - similar to continental practice - involved clauses around fit-out, and future replacement of plant and equipment that would not be recognisable in traditional UK leases. In particular, a significant amount of the fit-out was included as part of the developer's base specification, the maintenance of which was the obligation of the landlord, leaving the occupier responsible primarily for the most portable items such as racking, signage and IT.

The ten-year lease commitment without break clauses reflected the occupier's view of the robustness of its UK operation at that location, and clearly satisfied the landlord's income and risk criteria as well.

Clearly the perceived absence of any need for the flexibility of a short lease or break clauses was helpful in encouraging the landlord to accept that they had an interest in protecting the long-term value and appeal of the building – as reflected in their taking responsibility for maintenance and upgrades.

This highlights the broader point as to how widespread, and how lasting, this kind of Internal Repairing lease might become in the UK. On the one hand, a natural shift in the balance of power back towards landlords may reduce their willingness to grant this type of lease. Equally, the fact that there is now a prominent example in the market may lead to further similar demands from tenants, and encourage more landlords to treat this as an effective marketing opportunity for their key schemes.

"It's true that an unusual set of circumstances made this style of lease a win-win for both of us."

FLEXIBILITY: STRATEGIC REQUIREMENT OR BARGAINING CHIP ?

The economics of flexibility was a significant area for debate. Many participants were surprised at how little science, or even information, tends to be involved in such negotiations, observing that in the past they had acquired businesses with little or no knowledge of their key lease liabilities.

Previously many occupiers have suggested that the economic downturn has reduced the certainty attaching to forward business plans – and, therefore, that the more flexibility they can secure in their occupational terms the better.

Perhaps the reality is more complex. It became clear in discussion that there is no universal solution to the optimal level of lease flexibility, perhaps not surprisingly as each situation is unique. Equally, there did emerge a clear consensus among occupiers that companies should take a far more informed and strategic approach to the subject, as opposed to the naïve and ad hoc approach that many have taken in the past. This would involve asking such questions as:

- how predictable are our business volumes at this site over the next decade?

- will our customer base or supplier base undergo dramatic change?

- is there new emerging technology that may render current space unsuitable?

- what skills will we require in our workforce and where will we be best able to attract the most productive people?

Answers to issues such as these can provide useful insights into whether paying a rental premium for the flexibility of a shorter lease or a break clause is a prudent investment or an expensive luxury.

These are not trivial points. Several occupiers spoke of the substantial sums they had lost paying for flexibility they didn't need and had not exercised. Others countered that, even when break clauses were not exercised, their presence in contracts represented a crucial bargaining chip when renewals were being negotiated with landlords. All agreed that flexibility has a price, but that organisations should be aware of what they are paying, and make conscious and informed decisions as to whether it is necessary or justified.

THE PENDULUM WILL SWING BACK TOWARDS LANDLORDS AT SOME POINT

Over the past two years or so, many tenants have successfully extracted concessions and more favourable lease terms from landlords who had already seen losses in asset value. With economies now growing again and development limited, the next phase in the cycle will see a shift back in favour of landlords. While vacancy levels are high in some markets, some of this stock is unable to deliver the performance standards required by modern occupiers. Product delivery will therefore increasingly be spurred by tenants starting to sign new pre-lets and build-to-suits to secure the buildings they need.

The ways in which the next generation of buildings is occupied will be interesting to monitor. Occupiers, particularly 3PLs, recognise that properties dedicated to multiple customers may have increasing advantages over those with single customers. In other words, they need more than one underlying contract to be able to establish any long-term commitment to a building, and perhaps to generate its development in the first place. This will have implications for potential investors, who will have to assess the impacts on cash flow patterns and income security.

"Tenants can't bash landlords forever. We are moving into next stage of the cycle."

CBRE
CB RICHARD ELLIS

EVOLVING THINKING ON SECONDARY SPACE

We have noted previously the emergence of a "two tier" market: a growing demand for modern, flexible space at variance with high levels of vacancy for unsuitable lower grade real estate. The logic of this is that the higher cost of occupying the best space would be outweighed by the wider business efficiency benefits of doing so.

Although this trend persists, some manufacturers in particular are starting to modify their perspective. Premium space in the best locations can be difficult to justify when margins are squeezed, and profits under pressure. Secondary space, which may have been dismissed or overlooked in stronger economic conditions, seems to be attracting more serious consideration.

Several companies see little practical difference between a site offering reasonable accessibility, and another one right next to a major transport node especially when the former carries a substantial cost advantage. There is a view that the owners of Grade A industrial space may have over-reached themselves when demand was booming, and that acceptable space a few miles away can be a legitimate alternative.

"We are watching budgets closely. Saving a few Euros missing out on a prime location can mean that other projects get the go-ahead."

GREAT RETURNS FROM ACQUIRING FREEHOLDS – FOR THOSE WHO HAVE THE CASH

Although occupiers acknowledge they are not in the business of property investment or development, a number are attracted by a rare window of opportunity to acquire freeholds, and retain them for a few years until values recover. Some occupiers have been evaluating the merits of owning rather than leasing for the first time in a generation, and a few had recently concluded that the argument was persuasive.

Even the most enthusiastic acknowledged this was not a lasting change in their outlook or business model, but simply a short-term opportunistic move. They anticipate retaining the freehold until values bounce back, and then disposing of the asset through a sale-and-leaseback.

Other occupiers accepted the rationale but regretted they did not have access to the liquid funds, or lines of credit, to pursue such tactics at present. Freehold acquisition is only open to certain parties, but those able to execute see it as the closest thing to a one-way bet they have come across for some time.

"It's not our core business. But it's the devil of a temptation to resist."

PAY ATTENTION WHEN THE ACCOUNTANTS COME CALLING

Perhaps inevitably, accountants found their way into the discussion. Some participants indicated that budget restrictions had started to relax of late.

Having exercised stringent cost control for two years or more, many departments were coming in ahead of budget, offering a glimmer of hope that some stalled projects might be reactivated. While too early to rule out any prospect of a double-dip, the mood on short-term prospects had become notably more upbeat.

There was a further area where accountants were becoming more vocal - one that could potentially carry more ominous side-effects than their comments on budgets. New accounting standards requiring auditors to evaluate the risks associated with options in contracts were causing some agitation within the profession. Occupiers were concerned lest they found themselves making decisions for their accounting treatment rather than exercising proper commercial judgement. Nobody yet had any specific examples of unwelcome consequences from such discussions, but a number felt difficult cases may be in the pipeline.

"Auditing used to be about checking numbers. Now they seem to want to second guess our intentions"

BEWARE THE UNINTENDED CONSEQUENCES OF GREEN

We noted last year that the green agenda was "not dead, just sleeping." And many of the observations still hold true: firms are becoming much more discriminating, and looking to understand better which environmental features could actually save them money and which are merely gimmicks.

While these views persist, there is a new nuance around the unintended consequences that going green indiscriminately can carry. One firm felt caught between CEOs who spoke in general terms about pursuing carbon-neutrality, and an endless procession of environmental technicians arriving to market the latest green equipment.

Occupiers are no less keen than the top developers to incorporate the best standards, but untried new technology carries unknown risks. When it comes to deal delivery, they want "tried and tested", or at least a believable cost-benefit analysis.

Some questioned some of the basic assumptions made by the carbon-reduction enthusiasts. It was pointed out that one of the biggest determinants of emissions is the use of diesel in transportation. So a badly-located building, which might comply with green best practice in a narrow sense, could indirectly cause more pollution than a poorly-specified but more accessible building. The group concluded that, while it was clearly irresponsible to waste resources needlessly, the calculation was more multi-dimensional than simplistic analysis often allowed.

It was also suggested that occupiers' growing and lasting preference for buildings with sustainable features is inadequately reflected in values. The view expressed was that such buildings will retain value and hence make money for landlords in the long term, and that this should therefore be reflected in investment yields. The fact that this isn't (or isn't always) the case, results in occupiers being penalised by excessive rental premia.

"When are valuers going to value the long term positives of sustainable features correctly?"

Underlying this point was the view that there is still a mismatch between customer (occupier) requirements and actual product delivery. Since occupiers' needs are clearly changing rapidly, the need to build mutual understanding between landlords and occupiers in order to future-proof new buildings has arguably never been greater.

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