KEYNOTE INTERVIEW

Granularity is the trend in fast-changing cities



Logistics and light industrial investments are playing a role in evolving urban cityscapes, says Edmond de Rothschild's Theo Soeters

Edmond de Rothschild, a family-owned investment house, focuses on Western Europe – particularly France, Germany, the Netherlands, the UK and Switzerland – and adopts a pragmatic approach to portfolios to foster value creation.

"When it comes to real estate, this translates through to an emphasis on three things: specialization, local presence and impact," says Theo Soeters, head of fund management at Edmond de Rothschild and fund manager of the Euro Industrial Real Estate Fund. "The real estate investment landscape is fundamentally changing and we're living through a major trend. Cities are undergoing major changes [and] this is creating significant opportunities in the light industrial space."

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Q Cities are changing. What does this mean for the logistics and industrial sectors?

There are several structural tailwinds. The first and most important is the continued growth in cities generally. This provides significant downside protection over the longer run, as investments in urban areas are likely to have a fallback alternative use – for example, residential. Most importantly, the focus on sustainability is changing the cityscape. Companies are under intense pressure to decarbonize. When it comes to logistics, this drives a quest to ensure each product travels fewer kilometers. This is exacerbated by the high level of product returns, which ends up doubling the kilometers traveled for products affected.

Central to the dynamics of cities in general, we are seeing a flight to quality, away from secondary locations to prime locations. This is feeding demand for urban industrial and logistics assets closer to where populations are congregating.



Q Which European cities do you think are particularly appealing for investment?

In Germany, we favor cities that tick our three boxes: large concentrations of population, good hinterlands and fast growth. Those are Berlin, Hamburg and Munich, though the latter tends to be more expensive.

However, two projects that really stand out for us are both around Paris. France is a highly centralized economy with something like 50 percent of all French industry located in the city and surrounding areas.

In Île-de-France, we have engaged with developers on two major projects, one in Grigny and one close to the Charles de Gaulle airport. A crucial element there is the ability to attract labor as well as the access to the main highways, the A1 from Paris to Lille and the A6 from Paris to Lyon. We are also engaging in development projects in the Lyon region, at an excellent crossroads for European traffic.

However, we certainly do not like logistics or industrial locations where the only advantage is proximity to a major highway. There are such locations in the east of the Netherlands that provide excellent access to main highways, though in the long run might suffer from a lack of proximity to the end-consumer.

We are not investing in London at present, not because we dislike its fundamentals but simply because our investors wish to stick to euro-denominated investments. This may change at some point, and London is on the radar.

Q What is behind the trend back towards inner cities?

Urbanization has been a major worldwide trend for decades, with a strong gravitation to inner city, amenity-rich locations where people can combine living, working, shopping and leisure activities. The pandemic has accelerated this trend, especially in the office sector as companies search for talent and try to get people back to the office. That can only succeed if the office is a high-quality space in a prime location with desirable amenities.

We are observing the same trend in the light industrial and logistics sector, and we are seeing city centers changing as more space is dedicated to light industrial and logistics properties.

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Building portfolios with these kinds of properties takes time, as it concerns smaller buildings that tend to be difficult to find in a landscape of mostly private ownership. So this is an endeavor where you must have firm convictions. In our case, we made the decision to specialize in urban logistics and industrial properties over five years ago, and it has taken all that time to build the offering that we wanted. Now we are benefiting from what is happening.

Q What trends are driving growth in the light industrial and logistics space in urban settings?

The demand for industrial and logistics warehouse space has been driven

by tailwinds such as the rise of e-commerce and the trend of bringing products closer to the end consumer, leading to a rise in demand for last-mile logistics space. That has been accelerated by the covid pandemic and the respective lock downs, which also led to supply-chain disruptions that are leading companies to produce, assemble and distribute their products from locations with proximity to the end consumer.

The war in Ukraine and the increase in energy prices have further accelerated these trends, forcing companies to locate the production, assembly and distribution of their products closer to where they are consumed. As a result, the demand for warehouse space in and around the major cities has grown substantially.

Q What type of buildings and tenants do you typically find in this landscape?

The big boxes that previously dominated logistics tend to have just one or a few major tenants. As the trend to light industrial takes off, we are seeing more and more small- and medium-sized enterprises with good profitability and a dedication to a particular location.

These tenants need space to grow, which allows us as a landlord to assist them, for instance, by buying adjacent land and exploring possibilities to expand an existing building. We have seen many examples of this in our portfolio as we scramble to satisfy tenants' particular needs to grow in specific locations where supply of land is very constrained.

Therefore, rather than the more-than 50,000 square meters (500,000 square feet) that tended to previously be popular, we focus on smaller and medium-sized buildings between 5,000 and 15,000 square meters. There is increasing demand from companies for high-quality smaller space, whereas there is little available in the market. That is an opportunity to tailor to those needs by offering quality space with good ESG credentials to a growing group of tenants.

"There is no question that reshoring is a trend that is structural and will be here for many years to come. The same is true of decarbonization"

In terms of the number of buildings, the number of tenants and the many different types of businesses, that means a high level of granularity and therefore diversification.

That granularity requires us to be well organized and structured. You need to have a more sophisticated approach to managing your tenants' rent roll and their many different demands.

Given its embedded granularity, this subsector requires a landlord to have a strong local presence with experts that know the local market and are able to dedicate time and energy to active management.

Q Where are you seeing opportunities in the urban light industrial sector?

There is a large market segment that consists of smaller to medium-sized warehouses with a tenant base that consists predominantly of SMEs. Ownership in this sector is historically dominated by private investors and owner-occupiers, and as a result is less transparent and more difficult to explore. Therefore, it provides ample opportunities to identify historical undermanagement of good quality buildings with a potential to drive rents.

This rental growth potential is buoyed because tenants generally have solid profit margins and are bound to a specific urban location – because of proximity to work force – where there is less availability of land to develop. They also appreciate advice on how they can improve the efficiency of the building, offering opportunities to drive rents and explore value potential.

Our development in Grigny, France, is a good example of buildings that tailor to the need of SMEs for quality warehouse space in a densely populated urban area like Île-de-France. SME-type occupiers are increasingly looking to upgrade their warehouse space, at the same time making sure they can attract qualified labor and be as close as possible to the end consumer. We are actively developing this type of product in other areas around Paris and cities such as Lyon, Amsterdam and Munich.

Q How do you see these trends shaping cities going forward?

There is no question that reshoring is a trend that is structural and will be here for many years to come.

The same is true of decarbonization, especially as development of new buildings becomes more difficult and we start to see supply constraints. I think what is most important is that real estate investments must not just comply with ESG regulations but must embrace sustainability as an opportunity; indeed, turn that into part of their business case. For example, in our sector, solar panels and EV charging points are increasingly on-site and are profit centers in themselves. We invest heavily in this approach.

In the future, I believe this will be the big differentiator in urban logistics and industrial property valuations, just as it is increasingly in city-center offices. There is going to be the same flight to quality in this sector, and the same risk of stranded assets. ■