pi roundtable

INDUSTRIAL REAL ESTATE

LGIM

portfolio institutional
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DISCUSSION: OPPORTUNITIES WITHIN INDUSTRIAL REAL ESTATE

Britain's once thriving manufacturing industry meant a thriving industrial property market. But what are such properties used for today and where is the market heading? *portfolio institutional* sat down with a group of professionals from across the investment chain to find out.

My childhood was far from peaceful. Growing up in the West Midlands I found it hard to escape the hum of conveyor belts or the sound of drilling or of something large and metal falling onto a concrete floor.

It was a town which had industrial processes at the heart of its economy. Indeed, if a piece of land became available on the other side of my garden gate, someone would build a big metal box with a door and rent it to a manufacturer or light assembly operator.

But these days it is a lot quieter as most of those metal boxes have been replaced by houses. So what has happened to Britain's industrial real estate market?

"They aren't all used for 'metal bashing' or basic engineering processes anymore," said Bill Page, head of real estate research at Legal & General Investment Management (LGIM). "Of course, there is still a bit of that going on, there has to be, but there are many other uses and significant gentrification has occurred among industrial occupiers."

Warehousing and logistics are the more visible options given the 500,000-square foot sheds we see around the country, usually with Amazon, Tesco or M&S written on the front. However, this is not the full story.

"People looking at the sector from the outside might think it is just big warehouses by the side of motorways, but there is a lot more going on," Page added.

The sector can be segmented as urban logistics, cold storage, trade parks, self-storage, as well as "big box" regional logistics. Then there are multi-let industrial estates, which house many small businesses operating across a range of sectors.

"Lots of different use classes are creeping into the industrial landscape, all doing different things in different locations with different drivers, which means within one umbrella of industrial there are lots of income diversification opportunities," Page said.

His colleague, senior fund manager Jon Holland, added that logistics warehousing appeals to many types of investor, including annuity funds as they tend to be longer let with rental growth and are low maintenance.

However, LGIM favours the multi-let properties at the smaller end the market, where it believes the returns are more exciting.

The firm has also had a big push into urban logistics, which has evolved to take account of how consumers shop and the need for industrial units to be close to the people companies deliver their goods to.

"There is little supply, because there has been limited development of urban logistics-style accommodation for the last 20 years, so we are having to create that product. But ultimately, the returns are quite exciting," Holland said.

The three Ds of self-storage

LGIM's industrial strategy is also exposed to self-storage, making it one of the first institutional investors to move into that space. The firm has 12 outlets trading as SureStore, where it not only owns the business but the bricks and mortar too. "We are trying to get into something new to enhance returns for investors," Holland said.

> **Tenants have higher expectations or requirements in terms of the quality of the space that they occupy.**
>
> Elise Evans, Lambert Smith Hampton

The growth in self-storage is in part connected to the decline in home ownership. "People are living in rental accommodation for longer, which in turn generates a need to store goods for short periods of time," Holland said.

For Page there are three issues driving this market: "Divorce, death and downsizing are the three Ds of self-storage," he said.

Build it yourself

It appears that one factor drawing institutional capital to industrial real estate is the sector's supply-demand imbalance.

LGIM is not the only investor having to create the product the industrial market wants. Royal London Asset Management finished the construction of a 200,000-square foot property housing three units in Southampton earlier in the year.

"We buy a site and build it out because there is little product coming through, so you tend to get quite good returns," said James Orr, the firm's head of industrial and logistics.

"We have some bigger boxes, but it is multi-let where we see growth because not much is being built but there is a lot of demand," he added.

Liquidity issues

From a pension scheme's perspective, the main consideration when building a real estate portfolio is liquidity, said Mike Weston, an independent trustee at PI Partnership. "Our overriding objective is to pay pensions when they fall due. We don't

THE PANEL

Elise Evans
Director, industrial logistics
Lambert Smith Hampton

Jon Holland
Senior fund manager, industrial property
LGIM Real Assets

James Orr
Head of industrial and logistics
Royal London Asset Management

Bill Page
Head of real estate research
Legal & General Investment Management

Mike Weston
Independent trustee
PI Partnership

Claire Williams
Partner, head of UK and European
industrial research
Knight Frank

want to be in a position where we are a forced seller of our assets so we are continually looking at our liquidity.

"Real estate by its nature is an illiquid asset class, so how much of that do I want in my portfolio and how do I manage the cash-flows?" he added.

But most pension schemes do not own property directly, so what should they look for when selecting a fund? For Weston it is important to understand the fund's mandate, its financial characteristics, who the other investors are and how comfortable he would be as a pension scheme investing in that particular fund.

In the defined contribution space the issue is how do these assets fit into a long-term asset fund. "So how do I get exposure without compromising my ability to pay pensions when they fall due?" Weston said.

Time for an upgrade

Supply was a theme picked up by Elise Evans, director of industrial logistics for Lambert Smith Hampton on the South Coast. She explained that a lack of new assets has left the sector in need of modernisation.

"Not much has come through since the banking crisis, which means there is pent-up demand with occupiers sitting in premises that do not necessarily work for them that well," she said.

However, some new developments have hit the market in the past five years or so, which is good news for occupiers wanting an upgrade to match their changing values. But it is not just about what the person signing the lease wants.

"The ESG credentials of an asset are not necessarily just important for the occupier," Evans said. "For example, companies often require that their suppliers are working out of premises which are energy efficient."

Such demands are driving a trend for landlords to refurbish older properties when leases expire to make them kinder to the climate. "There are various parameters that they can work within to improve the efficiency of a building, and we are finding that is becoming more and more important," Evans said.

New trends

Demand for industrial assets is largely driven by online retail, said Claire Williams, a partner and head of UK and European industrial research at Knight Frank.

Enquiries from such companies understandably spiked during Covid but have since returned to pre-pandemic levels. But this is not the only occupier trend she is witnessing.

Manufacturers have taken more space in the past year or so, highlighting that it is not only an industry serving digital shopping. "The occupier base is broad, particularly in urban areas where you have such a diverse mix of occupiers," Williams said.

The high demand for industrial premises could be due to the sector playing a key role in many of the trends driving the global economy, Page said. "If we take a big step back and look at the global megatrends, industrial is at the intersection of many of them."

One of these trends is de-globalisation, which is bringing more manufacturing, processing or distribution nearer to home. This is also a result of the protectionist policies adopted by some governments.

"Friction in supply chains or the movement of goods is generally good for industrial, in that it increases the requirement for the storage to de-risk supply chains," Page said.

"We saw it through Covid, we saw it through the Suez crisis, we saw it through the Panama Canal crisis: if you can't move goods as freely as you used to, they tend to stay put for longer, inventories grow, and therefore you need to store that stuff somewhere. So it is ironically a net benefit to industrial demand," he added.

However, rising wage demands in the Far East are also factor in the re-balancing of supply chains. "Twenty years ago a manufacturer would use cheaper labour which would make what they need and then ship it to Europe.

"That wage differential is not there anymore, so it does not make as much sense to do it that way," Page said.

ESG is also a factor that could shorten corporate supply chains. Shipping is carbon intensive and those with net-zero targets do not want to be associated with that.

Under pressure

It is clear that the fashion for industrial usage moves fast, but it is difficult for property developers to react quickly to those changes. Planning is a process that takes time. "You cannot just switch on a tap and build it," Orr said.

Another difficulty is the rise in labour and steel costs. Historically, they may have been £30 or £40, but now you are looking at £70 or £80 depending on the size of the building, according to Orr.

With higher costs leading to a correction in capital values of 30% in 2022, it could be harder to justify building such properties.

Then there is finding places to build them. Lack of supply is due to their being pressure on land, particularly in urban areas.

"There has been some pushback from local government in terms of trying to protect industrial usage, but housing normally wins when there is competition for land, and that is keeping the pressure on industrial," Page said.

Royal London Asset Management is one company that has not found it easy to add new products to the market. "Within the M25 we have lost so much land to housing and infrastructure," Orr said. "Sometimes you just think that there isn't the land available to build the buildings."

Page confirmed that industrial floor space has fallen by almost a third in London during the past 25 years. "It is significant," he said.

One solution to creating more space could be multi-storey units, but, according to Page, in the UK "we are not seeing a great trend for that".

Rental outlook

However, despite the rise in online shopping, de-globalisation and a lack of space, the pace of rental growth is falling, but is still positive.

Williams predicts industrial rents will grow by 4.7% this year, which would be a fall from the 6.7% recorded in 2023 and less than half of the around 11% collected the year before.

> **"Buildings with higher ESG credentials are letting faster.**
>
> Jon Holland, LGIM Real Assets

"It is coming down off a strong trajectory, but still offers robust growth levels compared with other sectors," she said, but warned: "That UK picture masks the variations, which are quite significant."

Rental growth varies and depends on where the unit is, its size and the quality of the asset. Another issue to highlight is that in some areas vacancy rates have increased in recent quarters. Evans agrees that there are regional fluctuations. "The South

Coast has been one of those areas that institutional landlords quite like," she said. "It has been quite a robust market, quite resilient to external crisis.

"Because of the lack of supply and the geographical layout of the region, we see rents continuing to climb," she added.

Holland said that despite a slight decrease in occupational demand, the asset class still offers attractive growth. "We have been spoilt in the last few years. We have had an almost perfect storm of low void rates, high demand and no real replacement through re-development.

> **Within the M25 we have lost so much land to housing and infrastructure.**
>
> James Orr, Royal London Asset Management

"If you compare that to other commercial sectors, there is no rental growth," he added. "[Industrial] is a sector where we have resilient demand and is one of the preferred institutional asset classes because of that rental tension."

But Page warns that he is seeing a "fundamental reset" in industrial's rental growth, which will be structural rather than cyclical. "Institutional investors need to look through the next cycle to see how long term the rental growth is likely to be," he said.

"E-commerce and the supply side has justified a higher natural rate of rental growth in the sector."

But before Covid, yields were low and expensive, yet rental growth was healthy. But the re-set in yields during 2022 on rising costs added more value to the sector. "So you have a higher starting yield, but undimmed long-term rental growth potential," Page said.

"So when you are deciding between industrial, retail or office, those two things added together, simplistically, put industrial in a good place long term," he added.

What occupiers want

Property is typically viewed as a long-term investment, but are technological advancements and the impact they are having on the sector, making industrial property a shorter-term investment?

"Change is getting quicker," Weston said, who believes that a particular trend is to blame if investors feel uncertain about the long-term investment case of the sector. "We are not making anything," he said.

"There is less manufacturing in industrial property. Arguably, it is just a shed with something in it, and that something is a bit different. They just need a roof, four walls and access.

"In industrial property, your occupiers might change, but they still need a building," he added. "I would be interested in how specific your buildings are. If they are multi-let sheds, or single-occupier sheds, does it matter who is the occupier, whether they are a logistics firm, a storage firm or a service firm. I don't sense that it does, does it?"

Page confirmed that smaller units and big shed logistics can facilitate different occupiers. "But when you get into urban logistics, there is not enough product in the market that allows

for HGVs coming in and maybe electric vehicles going out to deliver to people's front doors. So it needs to be created.

"The one big thing it requires is power," he said. "That is one of the risks to the sector, that there might not be power available in the future."

Evans added that more power is not the issue; how it is generated is. The growing appetite for cleaner energy is the issue. "When you are moving away from gas, that is one of the key elements of a development. At the moment, the move is definitely away from gas, but where's the power?" she added.

Orr added that he has a scheme in West London that he let five years ago for around £12 a foot. A few of those units have come back and rents are now around £25. Putting ground-source heat pumps into those units improved their cleaner energy performance, which has helped boost rental growth.

But back to the issue of whether available space can be used for different purposes: Royal London Asset Management has a 60-acre site in Birmingham which has 120 tenants all doing different things. "Often when a unit becomes available, you get different people looking at it and it is fascinating to hear what they do and what they need. It is just so wide," Orr said.

Page then brought in the occupier's perspective to the discussion. "The other side of this coin is that in some units there will be occupiers who spend so much money on their fit-out and their own processes that it is risky for them to take a short lease," he said. "They prefer a longer term over which they can amortise that cost.

"The likes of Amazon or Ocado spend a fortune on their processes, and they don't want a short-term real estate solution. So it encourages a longer stay of 10 or 15 years, for example."

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>
> Bill Page, Legal & General Investment Management

The office element of industrial is also a selling point. "Tenants have higher expectations or requirements in terms of the quality of the space that they occupy," Evans said. "Traditionally, in an industrial building the quality of the office is not going to be grade A, but nowadays it has to be."

More industrial space is being let to research and development and life sciences companies, Williams added. "They are often looking for dual-purpose space, so they need quality office space and space for manufacturing, which are quite bespoke requirements," she said.

Don't forget the capex

The conversation then moved to what could threaten that long-term rental growth. "Greater regulation and higher taxation are probably what landlords will be looking out for from the new government," Williams said.

Evans pointed out that affordability is becoming increasingly more important for occupiers. "We have seen quite aggressive rental growth in the last few years [in some regions], so the affordability of small multi-let sites, including the overheads, is becoming more important in terms of what it looks like on the balance sheet," she added.

Page then urged the room not to forget about depreciation and obsolescence. "Compared to offices, it is small beer in industrial but with evolving occupier requirements, particularly around energy and other ESG issues, older warehouses are looking increasingly dated.

"For some that is an opportunity because new developments have a premium, but for holders of older stock in need of modernisation there is a risk that values fall faster," Page said.

It is an issue Orr is aware of. "You might get a slightly stranded asset for some of the older kit," he said.

Regulation is also driving upgrades with the government prohibiting lettings of non-domestic properties from 2028 unless they are within a certain energy category – band C.

Another issue is that pension schemes have to know what their carbon footprint is for their Task Force on Climate Related Financial Disclosures (TCFD) reporting. Private markets are famously difficult to get accurate and consistent data on, but Weston said all you need to know is: what's in your property portfolio and what their energy ratings are.

"So it is one of the easier private markets to include in TCFD reporting. And that is not going away. It is probably going to get stricter," he said.

Holland is receiving inquiries from LGIM's tenants for the carbon footprint of buildings. "Buildings with higher ESG credentials are letting faster," he added. "Ultimately, it might not be reflected fully in market pricing yet, but it will at some point."

LGIM are not waiting for that day to come. They have a substantial programme aimed at upgrading existing assets and consider the issue when investing in new stock. "We factor in significant capex when looking at potential properties to buy to reflect what sustainable upgrade that needs to be done," he added.

"The market is evolving. And clearly there is a risk of illiquidity for some assets unless sustainability is addressed."

To buyout or not to buyout

While the right industrial real estate could provide a boost to an institutional portfolio, it may not fit with the endgame strategy of many defined benefit (DB) schemes.

"We have seen over the last three years an acceleration of DB schemes going to buyout," Holland said. "A number of them were in deficit for years but now find themselves solvent."

Indeed, the expectation is that in the next 10 years the number of open defined benefit schemes will fall to low single digits. All of the others will either be closed or have achieved buyout.

"Property assets might be perfectly good assets, but insurers focus on secure, well defined and predictable cashflows. Typically, real estate does not match that because the income is just not secure enough," Weston said.

> **"DB pension scheme ownership of real estate assets is probably not going to be a major growth area going forward.**
>
> Mike Weston, PI Partnership

So to attract an insurer, a scheme will have to get rid of their real estate assets, which probably means taking a haircut.

Property could be applicable for a run-on strategy, but if the scheme wants to retain the option to buyout, they are unlikely to increase their illiquid exposures. "DB pension scheme ownership of real estate assets is probably not going to be a major growth area going forward," Weston said.

However, Page believes that there could be some nuance. "Within logistics there is the ability to have long-term inflation-linked income streams to major global corporates.

"That would be more appealing for the insurer than a shorter-let alternative" he added.

Location, location, location

The industrial property market in the UK is more advanced than its peers in Europe, in terms of e-commerce penetration rates, Williams said.

She added that around a quarter of retail sales here take place online, compared to 20% in the Netherlands, 18% in Germany and around 11% in Italy and Spain.

"We are much further along in terms of that growth but that is not to say there isn't more growth coming from that sector," she added.

Strong population growth forecasts are another factor supporting the investment case for the UK. As does the 30% pricing correction for UK industrials in 2022, which was far greater than in Europe and the US, while sterling has since weakened. This has resulted in greater investment in UK industrial.

"So there has been an influx of investors coming into this country, particularly North American capital, targeting UK industrials for that rental growth story," Holland said.

> **There are three reasons to be an optimist about industrial property: population growth, urbanisation and a diverse occupier base.**
>
> Claire Williams, Knight Frank

"That has been positive for this sector and we are forecasting that yields will tighten over the next few years, particularly as interest rates start to decrease."

Orr said that the UK is "pretty unique" compared to the rest of Europe. "The supply chain has matured more, certainly in that urban logistics or last mile product. There are no funds which just deal in multi-let products across the continent who have that scale.

"What that presents is an opportunity in Europe, if you believe that e-commerce penetration is going to increase," Orr added. "And right now there are quite a lot of people looking into that."

Evans pointed out that lease term commitments are, at typically 10 to 15 years, longer here than in many other countries. "We find with American occupiers that it is sometimes a battle to make them understand that landlords require a longer lease commitment than five years to guarantee the income.

"This is why the industrial market in the UK is more sophisticated than in other parts of the world," she added.

Holland finds that companies are willing to commit to leases of longer than five years, especially if they have made a large investment in the property. "If you have a large distribution centre, the amount of money you need to invest into your facility can be twice the bricks and mortar cost," Holland said.

The example he used was that it could take £30m to build a unit but the occupier could install £60m worth of operational infrastructure and IT kit "which they can't write off over a five-year lease".

Williams added that the stringent planning and regulation in the UK is another benefit for investors as supply, particularly in Eastern Europe, is less restricted.

Outlook

Looking to the future, urban logistic hubs delivering goods to big cities, such as London, Manchester and Birmingham, are likely to continue offering rental growth.

"It is those big conurbations where there is a lot of demand," Orr said. "Those assets are rarer and the lack of new units will drive rents forward."

Holland agrees that strong income growth will come off the back of landlords having to "create the space" in the face of no real supply in that market.

Then there are multi-let estates, the resilience of which, Page believes, will endure for the long term. He is also seeing interesting growth in self-storage. "It has different drivers and often different income streams," Page said. "It can be in partnership with an operator where the income rises and falls with the leasing of the units.

"If you partner with the right operator in the right locations, then it doesn't have to be more risky than traditional leases."

On the future of industrial real estate, Williams had the final word and concluded our discussion. "There are three reasons to be an optimist about industrial property: population growth, urbanisation and a diverse occupier base. They will drive demand for industrial space," she said.

Bill Page is head of real estate research at Legal & General Investment Management.

BEYOND BEDS AND SHEDS: INDUSTRIAL REAL ESTATE IN A 4D WORLD

We expect industrials to outperform in the coming years, but could investors overlook new and growing segments?

'Beds and sheds' has been an investment mantra for some time and with good reason, given established tailwinds and expected performance. Investment volumes from industrial remain above long-term averages despite a weak overall investment market[1].

Meanwhile, following the sector's repricing from the summer of 2022[2], LGIM Real Assets forecast outperformance from the sector.

Being overweight industrial has worked; UK funds that outperformed over 2023 had an overweight allocation to 'beds and sheds' in common. Meanwhile, the sector has given investors an additional 6.4% p.a. over all property over five years, and 6.1% p.a. over 10[3].

Also, average allocations have grown. Using the MSCI Quarterly Digest as a proxy, institutional weights generally showed a 35% allocation to all industrials at the end of 2023 compared to 15% 20 years ago[4].

Segments within a popular sector

We think there are at least seven segments within industrial that are differentiated by specification as well as function: multi-let estates, urban logistics, regional logistics, trade parks, self-storage, and cold and open storage.

This list could be expanded to include factories (whether traditional or hi-tech labs or giga factories) and specific industrial processes such as waste to energy, but we restrict it to more investible segments. We have also chosen to exclude things like dark kitchens or dark stores as we feel this is more a description of a function within a conventional industrial unit than a dedicated specification.

It is worth pausing to consider data centres. These are a rapidly growing part of the investible universe for real asset investors with compelling structural tailwinds. However, in operation they are dissimilar to conventional industrial and are better regarded as digital infrastructure, in our view.

Furthermore, lot sizes can be large, creating concentration risk for most conventional real estate funds.

Having said that, we also recognise that the skills in site selection, assembly, development and power provision are similar to those required for modern regional logistics. We therefore see data centres as an important strategy for industrial investors in

Centric in Stevenage

providing exit opportunities from existing industrial holdings, with transferable skills in site selection and development, but do not see data centres as an 'in use' industrial segment.

Evaluating risks

Investment performance has been supported by low vacancy and supply tension fuelled by net stock loss over the long term as estates were converted into housing (or the Olympic Park).

Development-led supply risk remains low due to complexities in delivery compared to a 'single box' regional logistics, while planning policy tends to favour residential. Business creation across all sectors has been strong over the medium term, especially in London and the South East, supporting the stock of small-and-medium-sized enterprises (SMEs), which could offer some income diversification benefits[5].

Although there are cyclical risks from rising occupier costs, we think that will most likely result in slowing rates of rental growth – compared to the 8.7% p.a. seen over the last three years[6].

Structurally, government support for innovation may offer support for 'makers' within expanded and targeted supply chains. Cyclically, we see potential opportunities for selective equity-led development within existing estates and capitalising on market pricing to re-enter the market, particularly where asset management can aim to drive performance from relatively complex holdings.

This was an extract from LGIM's Industrial Real Estate in a 4D World report, which considers the prospects for the sector in the context of four key megatrends shaping the global economy.

1) RCA, part of MSCI, year-end 2023 data.
2) Figures from MSCI Monthly Digest suggest current values are >25% lower than 2022 peaks.
3) Data from MSCI to Q4 2023 and our own analysis.
4) MSCI Quarterly Digest Q4 2023, standing investments capital value.
5) It should be noted that diversification is no guarantee against a loss in a declining market.
6) MSCI Quarterly Digest, Q4 2023

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