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Logistics

February 2021 • perenews.com

Time to shine

Warehouses take center stage

KEYNOTE INTERVIEW

Logistics 'one of modern cities' vital organs'

Fueled by technology and the pandemic, Hines' Logan Smith and Palmer Letzerich witness remarkable changes to industrial assets and supply chains in the urban environment

The first building Gerald D Hines, the founder of his namesake real estate investment management firm, developed back in 1957 was a small office warehouse in Houston, Texas. Since then, in addition to building landmark office buildings in cities around the world, the firm has developed, acquired or has in development more than 92 million square feet of industrial and logistics space globally. Logan Smith, head of European logistics, and Palmer Letzerich, senior managing director and head of the industrial and logistics platform at the US south-west region, discuss why the future of logistics continues to look promising.

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Q Are we on the cusp of a tech revolution in warehouses? How much will it change the logistics market?

Logan Smith: Warehousing has always been on the cusp of a tech revolution, and now is no different. For example, advances in electronic data interchange in the 1990s enabled the first wave of 'big-box' warehousing in the US. The e-commerce and automation-led growth we are seeing now is in many ways simply an extension of this same trend. E-commerce providers such as Amazon and others are fond of highlighting the importance of speed of delivery, or 'last mile.' While this is of course important, it's not the whole story. The principal underlying theme in all cases is the continued march in the direction of increased inventory and order visibility throughout the supply chain.

For example, being able to understand the contents and location of a container that has not yet cleared customs or knowing how a particular parcel is moving through the city can impact the type and location of warehouse required.

So, how will it change the logistics real estate markets? Paradoxically, it is likely to lead to bigger and smaller warehouses at the same time. Bigger in the form of XXL and multi-story – smaller in the form of smaller fulfillment centers and urban logistics. Considering that warehouse space is relatively cheap to rent compared to traditional retail space, more space is therefore affordable and typically required. It will also lead to more automation and sophisticated materials handling equipment. And there will be an increasing blurriness between product types.

Palmer Letzerich: I would characterize it as the fact that tenants and landlords are asking these buildings to perform more activities and to be more flexible today than ever before and I see this trend continuing over the coming three to five years. Ten years ago, the traditional distribution center was located on the periphery of a city.

The user inbounded on one side of the building, conducted some bulk break and racking activities and then outbounded on the other side. DCs were located to fit within the occupiers' existing network and where the lowest occupancy cost was achievable.

The previous construct has changed dramatically in today's warehouses. Today, tenants are still performing the same distribution activities, but they are also shipping directly to the end customer, which is the big change.

These same tenants are servicing will-call and pick-up applications; storing by destination and frequency of throughput in addition to category of product; and using the buildings as training centers for their employees and increasing their office and showroom features. This increased utilization and variety of applications means that tenants are prioritizing a different menu of requirements in today's logistics facilities, which in turn require new locations, new technologies, new building features and an incredible level of flexibility.

Q At this point of the cycle, does it make more sense to focus on logistics developments rather than buying core products?

LS: There is of course more investor interest in logistics than there used to be. However, given that we are still seeing increasing tenant demand being driven by continued e-commerce growth, it is not necessarily clear where we are in the cycle in the first place.

Rather than trying to time the cycle, we are more comfortable simply sticking to our business plan – working with our deep local teams to invest in good real estate, in good locations, at fair prices. If we continue to do this well, where we are in the cycle will become less important. We continue to see interesting opportunities in both the acquisition as well as the development side.

PL: The fundamental shift with increased demand within the industrial landscape is going to break the traditional cyclicality in an interesting way going forward. The question of whether to build versus buy depends on our investors' investment objectives. We have investors who see value in development and are looking for opportunistic returns, and others who are interested in stability of the returns and potential for rent growth, so they are looking more toward acquisitions. We believe Hines is uniquely capable of sourcing and executing both.

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LOGAN SMITH

Q How has covid-19 affected the supply chain and how are logistics players adjusting to these changes?

LS: Covid-19 has led to three years of e-commerce growth in a period of about three months. This has created additional demand from occupiers and also investors. In most markets, absorption and leasing in 2020 has been higher than it was in 2019, which is really remarkable if you consider that most of the planet was in lockdown for about 10 months in 2020.

During the first few months of covid-19, a lot of investors and developers were understandably cautious – postponing speculative developments, for example. They are now back, and Hines leaned into this trend from the beginning, investing through both acquisitions and developments in Europe, Asia, North and South America. We are seeing an increase in inventory levels because the coronavirus highlighted the stress in the supply chain, so building additional capacity within warehouses is something we have taken seriously.

PL: Covid-19 has had a big effect on e-commerce, which ended 2020 with an 80 percent increase in space absorbed over 2019 levels, with a penetration rate of 20 percent of retail sales in the US. As tenants all increased their e-commerce sales, I have also seen a variety of product segments that have benefited during the pandemic, specifically building materials, wellness, grocery and home furnishing.

Similarly, the lowest e-commerce percentage retail segments have now moved online, specifically grocery, beauty and cosmetics and household goods. To exemplify this, Kroger, which is a US grocery store chain, has now replaced Macy's in the top-10 online sellers in the country.

At the same time, we are seeing not only the large e-commerce users taking more space, but the smaller users – under 100,000 square feet – also began ramping up mid-2020. By number of leases signed – these smaller users in most markets will end 2020 at a higher number than 2019.

It is remarkable to think that while most markets I cover were locked down for three to six months, these markets are going to post higher absorption numbers for year-end 2020 than 2019 totals. As a result of covid-19, occupiers are thinking about increased inventory levels and redundancy in the supply chain, which points to increased square footage to be required post covid-19 and into 2021.

Q Why do you see an opportunity to invest in urban logistics?

LS: Firstly, 'urban logistics' can mean different things to different investors, and many types of logistics assets can fairly be classified as 'urban logistics.' The industry has yet to arrive at a consensus definition.

For example, a new multi-level fulfillment building with a LEED certification a few kilometers outside of the city might be accurately considered urban logistics. But so might be an older, low-clear height building servicing 'trade space' type users such as building materials suppliers.

The critical factor, whether from an acquisition standpoint or a development standpoint, is to have a thoughtful, well-researched view as to the long-term value of its location, within the context of the surrounding community, its functionality for tenants (both current and future tenants) and, of course, cost basis. Proximity to population and good access to transportation links will continue to be as important as they always have.

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>
> **PALMER LETZERICH**

Q What are the right locations and products to invest in these urban developments?

PL: Every market is different. In every market that I cover, there are sub-markets where the large, modern format 500,000-square-foot to one-million-square-foot spec building makes sense, and others where multi-building, multi-format parks make more sense, and yet others where urban infill buildings are the most appropriate.

In each submarket and each specific product, we focus on providing a location with access to major transportation arteries and ample interior circulation. Today, more than ever, we are also targeting locations that offer ample labor supply and urban density, but also aspects that enhance the employee experience for our tenants. We are creating covered landscaped areas for outside dining, as well as offering sport courts and employee wellness options, in addition to food and dining options.

We are implementing the highest standards in these urban locations. This type of quality and innovation have been in the Hines DNA since our firm's inception, and our goal is to offer our tenants the most efficient location and building so their business is more profitable in our asset.

Q How do you see the future of logistics as an industry and asset class post-pandemic?

LS: This past year has certainly been one of acceleration when it comes to logistics. 2020 was the year that communities and societies around the world – along with many real estate investors – realized something about logistics real estate. In some ways, it is not really a 'real estate asset class' at all. Rather, logistics real estate is one of the vital organs within the living organism that is the modern city; just as is the case with, say, a power grid or a metro system.

PL: Industrial absorption used to be a leading indicator of economic growth and was generally tied to growth in GDP. With 2020 absorption in most markets exceeding 2019 levels, we have seen this paradigm turned upside down in 2020. On top of that, today there is higher investor interest. Those two factors create the opportunity for rent growth and cap rate compression, which of course set the table for compelling returns.

When the world emerges from the pandemic and GDP, employment and consumer confidence begin to ramp up, the growth in our markets will be notable. Given the shifts during the pandemic which I see as permanent, that means more growth and a higher percentage of that growth will be moving through our warehouses. For that reason, I see the potential for our investments in logistics to continue to outperform. ■