Retail logistics
– the omni-channel revolution

Real estate investment opportunities
in a changing world

Retail Property Analyst:
European futures series, number 7

By Mark Faithfull
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Foreword

Jasper Gilbey, Director, TIAA Henderson Real Estate

“With ultra-low bond yields driving down real estate income returns across the board and the weak economic environment limiting the opportunities for rental growth, the relatively high income returns offered by logistics are hard to ignore. Logistics has never been an asset class delivering strong capital growth over the long term though with higher yields the current low financing costs have a disproportionately positive impact on returns.

So even if investors have to pay above the odds to get exposure to the sector, logistics return expectations remain above those of the office and retail sector. Due to even more attractive yields the highest returns are available in Europe’s recovering markets of Italy, Spain and to some extent also in the Netherlands, Poland and France. However, these markets are arguably more risky in terms of their liquidity and economic risk. The UK, Sweden and Germany are in our view already fully priced, but logistics still outperform other sectors and on a risk adjusted basis these core markets remain the best choice for conservative investors.

Investors should look beyond short term performance and consider that the sector is very well placed to benefit from the online revolution currently unfolding in the retail sector; in particular, they might be wise to focus on countries where online shopping is still in its infancy, across Southern and Eastern Europe. As e-commerce transforms logistics, including tenant requirements, it opens up new investment types for institutional investors such as fulfilment centres and parcel distributions centres.

These were considered too specialized in the past, until e-commerce led to a sharp rise in tenant demand. Amid all the excitement about e-commerce, investors should not forget that the vast majority of logistics still takes place in the traditional 3PL, industrial and retail sector. This is concentrated along the so called European back bone, running from South East England through Northern France, the Benelux region, Western Germany to Northern Italy.

Assets located in this region should form the bulk of any European logistics portfolio for it is where Europe is most densely populated making it harder for developers to build more space. Only in this core region would we recommend considering a move up the risk curve, as secondary stock is significantly discounted while occupier market risk remains manageable.”
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Executive summary

An omni-channel environment has created huge opportunities for some retailers and has signalled the demise or downsizing of others. In changing how they source, distribute and deliver the retail sector has created a broadening retail real estate logistics market.

Retail Property Analyst has previously produced three reports on the dominant retail and real estate topic of recent times, omni-channel retailing. In doing this, Retail Property Analyst continues to be unique as a publication positioned to consider purely the impact of omni-channel developments on property requirements. In each year of publication, these impacts have changed and the focus on retailing and property has altered, often quite dramatically. This illustrates the fast-paced nature of the sector and also the fact that even those at the cutting-edge continue to find their way against an ever-changing backdrop.

The mainstream retail property industry had still been guilty of largely ignoring the issue until early 2012 – with some commendable exceptions among developers and investors – and a pervasive view has taken hold that somehow retail units and requirements would be left unchanged by the revolution of e-commerce, the proliferation of mobile-technology and the explosion in the power and ubiquity of social media. This view no longer holds sway, although it is notable that even now the conversations had by retailers on the subject and those had at property networking events differ markedly, with some within the real estate sector still behind the curve. Issues seen as key by many retailers are being overlooked by too many landlords. A disconnect remains, which we hope our reports play their own small part in narrowing.

While the impact of omni-channel and pure play retail on mainstream bricks and mortar retailers has been profound and often negative, this is not the case for the logistics real estate sector. Logistics is agnostic: it matters not whether the need for distribution comes from a pure play online-only retailer or from an omni-channel retailer operating across a variety of channels, or a hybrid of any channel mix. The net result of the internet revolution is that more distribution space is required and also, crucially, different space. That may mean mega-shed or hub and spoke systems, it may mean a system for home delivery or for click & collect, it may mean distributing from traditional geographies or moving the distribution closer to the key buying catchment (in a similar mode to shopping centres). Most likely, it means a mix of all those factors.

The drive is clear: consumers are now interacting with the multiple channels in an ad hoc manner. An increasing number of consumers are researching products in bricks-and-mortar retail stores before purchasing online, using click-and-collect or showrooming. How the consumer touches the retailer or the brand differs by person, time of day, location and mood. It is why multi has become omni – the channels can no longer be treated as a series of silos, they are integrated, blended and potentially revenue capturing for those who can bring each of their channels under a clear, consistent and relevant banner.

This report considers both the technological and cultural trends but also then briefly examines how these translate across 100 top European active retailers. The analysis considers what the retailers are doing, how they are doing it and how it is impacting their real estate strategies.

A number of clear trends have emerged compared, notably the ongoing rise in mobile-based retailing, the surge in international delivery, the strengthening of the third party delivery relationships and the downscaling in store numbers among a number of retailers, notably in the fashion sector. Click and collect has also become a vital component of location planning,
Executive summary continued

Some indicative data
European online retail sales will reach €191 billion by 2017, up from €112 billion in 2012 – reflecting an 11% compound annual growth rate (CAGR) over the next five years (Forrester)

US online retail sales will hit $370 billion by 2017, up from $231 billion in 2012 (Forrester)

Online sales growth, Europe (2012): UK (14%), Germany (13%), Poland (24%), France (22%), Sweden and Italy (18%).

Highest single day sales, 2012: UK 26 December (national holiday), 113 million website visits (Experian)

Highest internet penetration: Singapore 99.9% (IMRG)

Global broadband subscribers, end of 2011: 597 million (+12.3% y-o-y) (Point Topic)

Access to internet shopping: Laptop 55%, smartphone 19%, tablet 11% (WorldPay)

Increase in mobile-internet use (2010-2012): 2,000% (IMRG CapGemini)

Global broadband use: 2016: 1.3 zettabytes (approximately 4x current use) (Cisco)

Cost of Europe-wide broadband: €80bn (Point Topic)

Top 100 retailers in Europe, key findings
1. The UK retail market remains the most advanced in Europe in terms of omni-channel retail, with home delivery services among grocers particularly strong but with a strong shift towards click-and-collect, especially from convenience stores. Click-and-collect remains in its infancy and a huge number of options are growing, from the proliferation of grocery c-stores through to the expansion of offers such as Amazon lockers and Collect+.

2. France continues to pioneer a Drive format for grocery retail, with click-and-collect dedicated services at an increasing number of stores. France operates the only dedicated Drive format, using a warehouse-style dark store. Drive is likely to have universal appeal across mature European markets.

3. Many German retailers have come to online quite late but are investing heavily in a bid to catch up. Germany is Europe’s second biggest e-commerce market.

4. Department stores have pioneered the development of e-commerce and a number of department store retailers have changed or are considering changing their store formats, while reducing full-line store requirements.

5. Penetration of e-commerce remains low in southern Europe, notably the major retail markets of Spain, Italy and Portugal. This could put retailers in these locations at significant disadvantage as cross-border retailers are increasing their international delivery capabilities.

6. Central and Eastern European e-commerce remains in its infancy and store networks will need to mature before online sales can grow. Poland and the Czech Republic are bucking this regional trend, with online retail services increasing and a growing logistics market to support this.

7. Attempts to commercialise social networking have been largely unsuccessful but the weight of new sites suggests that a new model will emerge. This remains an ongoing issue, with legacy social networking sites being rivalled by a series of start-up operations.
Executive summary continued

8. The consumer electronics, entertainment and gaming sectors have been hardest hit by e-commerce but Europe’s and America’s market leaders have both adopted tactics designed to combat ‘showrooming’, with strategies which may indicate the way for the broader market. Online sales adoption may slow as gains in ‘transactional and ‘downloadable’ product categories have largely been realised.

9. Fashion retailers have adopted significantly different international strategies. There has been a proliferation of multiple-country delivery retailers, increasingly supported by local language websites. Third party click-and-collect partnerships are being discussed.

10. Mobile retail has exploded and continues to be the major focus of retail innovation, driven by smart phones and tablets. This provides some significant opportunities around place and destination.

**Fundamental drivers which can be identified include:**

Global retail supply chains are becoming more complicated and retailers are reliant upon a more complex web of hubs, spokes and urban distribution points both internationally and domestically.

The growth of online sales – whether from pure play operators or bricks and mortar retailers – is increasing the space requirements for distribution real estate.

The combination of the above factors means that not only more but different property requirements are emerging. These include huge mega-sheds, distribution centres located closer to online catchment areas, smaller urban postal nodes, parcel hubs and delivery centres, returns processing centres and dark stores and/or highly automated distribution centres.

In addition, while stores and shopping centres are largely in competition with online selling – although there is increasing convergence between digital and physical – for distribution and logistics it is largely additional space which is required.

Expansion is largely notable in Western Europe and Poland, with port cities becoming increasingly important within this new model.

Ostensibly part of what is known as the ‘industrial sector’, e-commerce distribution is a small but growing component of a not well understood sector (by comparison with offices, residential, retail, etc).

Speculative development largely ceased as a result of the economic downturn and has largely failed to reignite, meaning that there is pressure on supply.

The changing nature of real estate requirements in this sector means there is an inevitable level of redundancy within existing stock.

Lack of investment in speculative development will continue to focus the above influences, making this an increasingly attractive area for investment. The presumed redundancy of buildings after a certain period largely means this is not a capital play but an income opportunity.
Executive summary continued

Mega fulfilment centres

Mega fulfilment centres or XXL warehouses (typically above 50,000 sq m – 100,000 sq m), typically operate 24/7 and operate with individual picking. A range of factors is driving the remodelling of logistics networks, such as a growth in the number of product lines and order complexity, customer demand for quicker delivery times, and the need for flexibility to cope with demand volatility. These are particularly relevant for supply chains that support growth in online retailing. Occupier demand for larger schemes also reflects a growing realisation that supply chains, when efficiently managed, are a strategic asset that can boost profitability for retailers and others.

According to CBRE, these drivers have pushed take-up of XXL warehouses in Europe above 4 million sq m in the 18 months from the beginning of 2012. This represents around 14% of the total industrial market compared with 5-6% in the two years from 2010-2011.

In the major European markets, take-up of XXL warehouses rose to over 2.5 million sq m in 2012 and ran at a similar level in the first half of 2013. Take-up had previously been running at 1-1.5 million sq m per year throughout 2010-11. While the UK, France and Germany dominate, XXL warehouses are accounting for a growing proportion of total leasing activity throughout Europe.

Amaury Gariel, head of EMEA industrial & logistics, CBRE, said: “We are undoubtedly seeing growth in demand for XXL warehouses arising from supply chain reconfiguration and the consolidation of operations into fewer, larger centralized hubs. These hubs supply a large hinterland area more cost-effectively than might be possible from traditional networks.”

The retail sector – including online retail – accounted for more than two-thirds of take-up in XXL warehouses from 2010-2013. Third party logistics operators (3PLs) also accounted for a significant amount of take-up in XXL warehouses (22%) over this time period. As 3PLs will usually be operating on behalf of one or more contract customers, this figure probably understates the contribution of retailers to overall demand.

The sector is also attracting interest from investors. XXL warehouses have accounted for nearly 20% of the European industrial property investment market since the beginning of 2012, with the UK, France and Germany again to the fore. Investor demand for larger schemes is also growing strongly in Asia Pacific and the Americas where there are strong indications that large pension funds, sovereign wealth funds and other institutional investors regard this type of asset as an opportunity to deploy capital on a scale that would otherwise involve multiple acquisitions.

Parcel hubs/sortation centres

These sort orders by postal/geographical code so that items can be delivered to the appropriate parcel delivery centre for final delivery to the home or to a designated collection point (eg store, locker, etc).

Global property advisor Jones Lang LaSalle points out: As a result, this will encourage some retailers to set up their own networks of local depots – either to cross-dock items shipped from larger e-fulfilment centres or to ship certain ‘fast moving’ products direct to customers. In this emerging model, e-fulfilment blends with urban logistics, as these facilities will be mainly based around the major population centres where online sales densities are highest.

For example, in the US, Amazon has started to open smaller scale distribution facilities to offer same-day delivery services. In the UK, Amazon has a current requirement for some 20 smaller distribution facilities around major urban areas. By contrast, in France Amazon’s demand remains focused on very large units, with the last kilometre delivery being operated by third party providers.
Executive summary continued

**Parcel delivery centres**
These handle the ‘final mile’ delivery to the customer.

While pure-play retailers have set up dedicated distribution facilities to fulfil orders, multi-channel retailers have a variety of fulfilment options, including picking from their stores, using existing distribution centres, opening dedicated e-fulfilment centres or using a combination of these depending on the density of customer orders.

Although online food sales are currently a low proportion of total grocery spending in developed markets, its share is predicted to increase. As this happens, we believe the next shift in online food retail will see an expansion of dedicated multi-temperature e-fulfilment centres from both pure-play and multi-channel retailers, focused around major population centres. Jones Lang LaSalle speculated: “In our opinion, multi-channel retailers will switch from picking orders from stores to picking from e-fulfilment centres (sometimes referred to as dot.com centres) in areas where sales densities justify this. However, stores will remain important in areas where ‘drop’ densities are relatively low.

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Source: JLL
Executive summary continued

**Game changer: Drive/Click & collect**

Earlier this year, German retailer Real became the latest European supermarket chain to push ahead with a click-and-collect service called Drive, a system that could well overtake home delivery for groceries. While the Drive concept was first established across a number of pioneering retail chains in the USA, it has become especially popular in France, and as consumers respond positively to the offer, Drive has emerged as a surprise hit with limited tests heading towards rollout going on in other major European markets such as Germany, through Real, and the UK, via Tesco.

Drive is a specific version of click & collect, which we will also examine.

The rise of Drive has come about for cultural as much as technological reasons. In France home delivery is, by comparison with some other European countries, quite expensive and delivery hours predominate around typical business working hours – this inflexibility has meant home delivery is not especially popular. Consequently, the cheaper and more convenient Drive formats have thrived, with French grocery chain Auchan in particular pushing forward with not only its own service but also taking a majority stake in pure player Chronodrive, which provides a click-and-collect only service from a so-called ‘dark store’ format. Consumers can either pre-order online and collect from the full product offering or turn up and order on-site at a terminal from a more limited assortment of 500 basics and popular sellers.

Orders can be ready two hours after purchase online and packing the car is guaranteed within five minutes of pulling up at the warehouse. Missed orders are held for 24 hours. Chronodrive has expanded its selection to a minimum of 5,000 items in each store from 3,500 initially, and many stores now offer 7,000 products. The company has replaced freezer units for frozen food with freezer rooms, which makes it possible to fulfil orders more quickly.

Auchan opened a new hybrid Drive store concept in Villeparisis, Seine-et-Marne on 28 February and called it Arcimbo, referring to the Italian painter Arcimboldo, who composed his human portraits from fruits and vegetables. The concept is a new iteration of Auchan’s successful ‘drive’ stores, but with an additional food space with what Auchan called a “predominance of fresh food”, including fruit, vegetables and a bakery.

In taking this route, Auchan is attempting to address what is seen as the major weak point of this format, the low share of fresh products in the average basket.

Drive purchases are currently primarily devoted to products such as canned goods, or heavy items and drinks, while fresh cuts of meat, fish, fruits and vegetables sell far more poorly, with French consumers preferring to touch and select these categories directly in-store. Auchan is trialling the new fresh elements, which will require the customers to get out of their cars to shop in a c-store sized unit dedicated to fresh food and including a baker, butcher and fishmonger in a market-style proposition. The Arcimbo store is for now a one-off, while Auchan assesses its performance and customer perception.

For inspiration, Auchan has apparently looked at the success a number of UK supermarket groups have had in persuading customers to buy fresh produce online. In France this has proven far more difficult, not least because of the knowledgeable consumer base in the country.

The size of the prize is clear, however. In 2012, fresh products (fruits, vegetables, bakery, deli, cheese, fish, meat) represented €23 billion of sales in food supermarkets, according to Symphony IRI Institute. Auchan would like a bigger bite of the pie with its Drive formats. Auchan has not been afraid to experiment and in recent years has launched several concepts devoted to fresh products (such as Les Halles of Auchan, or more recently, ‘premium’ stores) and the latest innovation, The Heart of Nature, is a specialist in organic products and opened in May 2012 in Brétigny-sur-Orge (Essonne).

The desire to improve the customer offer is laudable and the Auchan experiment does make sense, but major misgivings remain about whether consumers who love the convenience of Drive will then want to get out of their cars to complete in effect a second shop. However, UK and German grocery groups, which have been nowhere near as bullish in rolling out Drive stores as have the French, will also be looking on with interest.

There is also plenty of activity among Auchan’s rivals. E.Leclerc opened its first Express Drive in 2007 in Roques sur Garonne near Toulouse and has extended this service to 65 Leclerc stores, opening stores at the rate of two or three a month. Groupe Casino has opened 42 Drive stores after trialling the service just before the summer of 2009 at its supermarket in Ratarieux Etienne. In December 2009 it tested out the concept at Géant Casino. Casino also operates in the Paris region through coursengo.com, where currently 29 Franprix and Leader Price stores provide home delivery or collection from their warehouses.
Executive summary continued

Intermarche was a little slower to the online world and in October last year ramped up its offer through Cybermarche, which provides either home delivery or click-and-collect from over 20 stores. Intermarché intends to have 1,000 stores accommodating e-commerce by the end of 2013 against 500 today, including pick-up locations in stores. A third of Intermarché’s drive outlets are located near its stores, but it will pilot 13 standalone drives, in the south-east of France and in the north. Intermarché is also thinking about a non-food e-commerce portal with a possible 2014 launch featuring in-store pick-up points.

Meanwhile, Systeme-U has gradually been building its Drive service and is forecasting that the turnover of its drive format will double in 2013 and again in 2014. The format, which turned over €250m in 2012, excluding Telemarket, is expected to generate €500m in 2013 and €1bn in 2014. Shoppers currently have the option of collecting goods ordered online at some 500 stores. This number is expected to increase to 1,000 within the next two years. Reportedly, more than 50% of sales volume with the drive format are generated by the retailer’s private label products.

The notable exception has been France’s biggest grocer, Carrefour, which had been far more sceptical than its rivals about the value of multi-channel retailing and has opened just two Drive stores so far, although it is now ramping up the offer. The failure to bolster its omni-channel strategy has resulted in a number of board directors being unseated and Carrefour has at last started to pledge to a significant increase in Drive stores.

The concept is now spreading. In Germany, Metro Group-owned Real has tested a drive-in at Altwarmbüchen, Isernhagen near Hannover, at which shoppers order online through real-drive.de then collect from the store as quickly as two hours after ordering. The 800 sq m trial store opened on 29 October 2011 with a soft opening before Real began promoting the offer in mid-November. Reports from the Group suggest that it has performed well and will form the basis for a further roll-out.

The UK’s first drive-through supermarket was launched by Tesco in August 2011 at Baldock, Hertfordshire. Online customers choose the ‘click and collect’ option and book a two-hour collection slot for flat £2 charge. Ian Crook, online marketing director at Tesco, said the company has set up offices in London’s Shoreditch in a bid to bring more innovation into the business and has recruited people from Amazon, eBay, O2 and Expedia as part of a move to “capture the thinking and technology for the next decade”. Tesco is also developing its Drive format, which now operates at 150 of its stores, has introduced F&F virtual fitting rooms and launched digital film service Blinkbox.

Where UK retailers have focused so far is in using their stores estates as a platform for the collection of non-food items. In late May 2011 Sainsbury’s began to expand its click-and-collect service to 800 stores by Christmas of that year, leveraging its recent estate growth through convenience-stores in urban locations, close to where most people live and therefore within easy pick-up distance. Similarly, Tesco doubled its click-and-collect stores to 600 last year and intends to double it again this year. Department store John Lewis is also using an increasing number of stores from its grocery sister chain Waitrose as click-and-collect locations.

John Lewis has created “flexi-format” branches in Exeter and York that has used technology such as iPads and touch-screens to enable it to offer the same in-store assortment within its 6,000 sq m space as is available in the full-line 25,000 sq m John Lewis stores.

Real estate implications for investors

For investors there would appear to be an opportunity around the changing nature of the retail logistics model. A lack of speculative development has mean that in most mature market there is a potential under-supply of good quality logistics stock. The market does have a legacy of redundant stock and over-supply, which will make some investors remain cautious about the market.

In addition, logistics has traditionally been an income rather than a capital play and the risk of full-life redundancy remains, although this is less of a risk than previously given the growing nature of this property sector.

Henderson notes: “An opportunity appears to be around click & collect facilities off-site, perhaps at an out-of-town or warehouse location to complement a shopping centre in the town centre. This is not dissimilar to the e-drive concept that is popular with grocery retailers in France. The idea being that you do not need retail planning consent and are unconstrained by trading hours because the transaction does not happen on-site. The effective sales densities generated by a click & collect facility could be higher than on the high street, but where rents are considerably lower.”
Executive summary continued

Distribution has become a huge issue for retailers, with consumers expecting increasingly fast response times, plus the ability to return goods. A later chapter deals with ‘final mile’ delivery which has become a huge battleground because: 1. It is a very expensive element of the supply chain for retailers; 2. Super-fast delivery strategies are being developed both for retailers and for pure plays, with eBay recently buying Shutl, for example.

The strongest structural growth in demand from retailers is likely to be for customer fulfilment centres, distribution hubs and dark stores. The changing shape, size and locational requirements is transforming the investment appeal of the logistics and warehousing market. Industrials have always accounted for a small proportion of institutional property investment, offering investors high income returns, but very little scope for rental growth or potential for asset management. Recent transaction activity, however, has shown significant increases in investment volumes for industrials globally, with investors recognising the space demand that online shopping is generating.

Henderson describes the market thus: “Many retailers are now looking for dedicated e-commerce warehouses, as opposed to trying to service both stores and home delivery from one location. Some retailers will look to despatch all their home deliveries from one customer fulfilment centre, located somewhere centrally, and this might be something in the region of 100,000 sq m – there are few warehouses of this size available in most markets. Most retailers will look to support this central facility with smaller distribution hubs located close to major conurbations. As expectations of speed of delivery rise, there will certainly be more demand for satellite hubs. The larger the country (geographically), and the less densely populated it is, the greater the network of hubs is likely to be.”

What appears clear is that space demand will increase, whether that demand is fuelled by pure players or omni-channel retailers. From a real estate perspective, the source of this demand actually does not matter, which is where the drivers divert dramatically from store-based property considerations. Logistics is effectively agnostic.

It is estimated that retailers in Europe will need as much as 25 million sq m of additional logistics space in the coming five years, significantly surpassing previous requirements. Demand in emerging markets, where the supply chain network is less established, could be greater still.

Unsurprisingly, property investment flows into the sector have risen, especially in the most developed online markets and the core real estate economies. However, it should be noted that while transaction volumes are up, industrials still account for a modest proportion of overall investment and the continued lack of prime product will continue to hold this back to some extent. Nevertheless, this sector should grow in importance. Industrials, in most markets, should offer investors better value in terms of yield than the other core sectors, plus lower volatility of capital values and high income returns. Logistics real estate performance matched commercial property as a whole across Europe in 2012, with a total return of 4.3%, according to the IPD Pan-European Logistics Performance Report.

Investors in European logistics properties have benefited from a strong income return through recent economic difficulties, standing at 7.1% in 2012 compared with 5.5% for all commercial real estate.

Henderson notes: “The yield discount available does not reflect inherent risk and smart investment in this sector should mean occupational risk is modest. Traditionally industrials have delivered very little rental growth, but this could be set to change. With rapidly growing demand and limited supply that meets modern requirements, there could be a structural uplift in rent levels for the right product. And over time, as the sector becomes more liquid and attractive as an investment market, we could see a lowering of equilibrium yields.”

One final implication for landlords and investors is the significance of the investment in technology that major retailers and logistics providers are adding to their centres. Huge investments in automation and carefully selected catchment areas mean those retailers are unlikely to be going anywhere soon. This is a phenomenon which is actually becoming increasingly reinforced, with greater levels of automation being applied to their new generation facilities. This provides the landlord with a strong, committed covenant for their properties.