LIGHT INDUSTRIAL AS A REAL ESTATE ASSET CLASS

THOUGHT LEADERSHIP PAPER

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During the last 10-15 years, there have been a number of macro trends driving the growth in the logistics and industrial markets from both a capital and occupier markets perspective. The first big tailwind for the sector was the rise of E-commerce, which was boosted further by the recent COVID pandemic and respective lock downs that reinforced the online shopping trend. COVID 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 ("re-shoring"). The outbreak of the war in the Ukraine and the increase of energy prices, as well as the desire from companies to de-carbonise their business, has further accelerated this trend. The rise in interest rates has led to a slowdown and decreasing valuations, but Edmond de Rothschild Real Estate Investment Management has recently observed a stabilisation of valuation yields in its core markets. Given the structural tailwinds, leading to strong underlying occupier demand and low vacancy rates, the next few years in our opinion will prove to be an interesting vintage for further investments in the logistics and particularly the light industrial sector.

In this brief paper, we describe the characteristics of the logistics and (light) industrial space, its key growth drivers and specifically our investment conviction for the light industrial sector considering the ongoing structural changes, as well as the current market opportunity in Europe.

MARKET SEGMENTS: SETTING THE STAGE

FROM LARGE BOX, TO LIGHT INDUSTRIAL AND LAST MILE LOGISTICS

The logistics and industrial sector can be grouped into different sub-sectors. Traditionally, institutional investors have preferred to invest in larger warehouses (>15,000 sqm), often close to transportation hubs and corridors. This type of buildings offers relatively good liquidity and an underlying tenant base consisting of well-known large multinationals and 3rd-party logistics ("3PL") providers. Banks also have had a preference to finance larger buildings with creditworthy tenants, further driving demand from investors for these type of assets. Although occupier demand has been strong, driven by the sectoral tailwinds, larger warehouses represent a more bulky reletting risk, in particular if it goes with a substantial component of office space. Because of the out of town locations, there is often ample availability of land with development potential, so these assets carry a risk that tenants leave at the end of the lease term to a newly developed property next door. Furthermore, large multi-national companies and 3PL providers tend to work at low profit margins and often have internal real estate professionals that limit the pricing power of the landlord when (re-)negotiating leases.

On the other hand, there is also a large market segment that consists of smaller to medium sized warehouses (5,000-15,000 sqm) with a tenant base that consists predominantly of small and medium sized enterprises (SME's). Often, these assets will have elements of production/assembly as well as warehouse use. In addition, there is a small component of office space (5-15%) typically through mezzanine floors. Ownership in this sector is historically dominated by private investors and owner-occupiers. As a result of the ownership structure and the diversity of buildings in terms of quality, size and lay-out, this light industrial market segment is less transparent and more difficult to explore. Nevertheless, it provides ample opportunities to exploit historical under-management of very good quality buildings with a potential to drive rents. This rental growth potential (aside from contractual inflation linkage) is buoyed because tenants generally have solid profit margins and they are bound to a specific urban location (proximity to work force) where there is less to no availability of land to develop. They also have a need for professional advise as how they can improve the efficiency of their building, offering opportunities for the landlord to drive rents and explore value potential. Given its embedded granularity, this sub-sector 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.

Next to the large warehouses and smaller (light) industrial sector, there are ample niche segments such as last mile (inner-city) logistics, cold storage facilities or micro-unit (50-250 sqm) facilities. All require dedicated expertise management and are often best pursued through specialised operating platforms.

Big Box – Seacon Logistics Venlo (c. 50,0000 sqm)

Light Industrial - Theuma Nijkerk (c. 11,500 sqm)

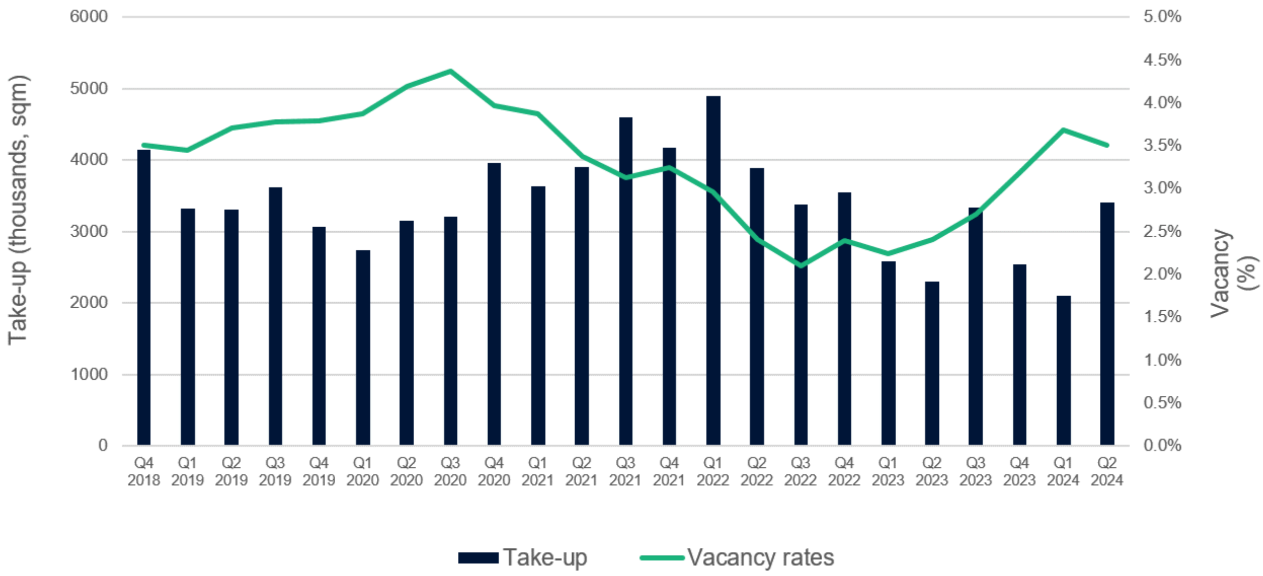
MACRO TAILWINDS FOR LOGISTICS / INDUSTRIAL

The first big tailwind for the sector has been the rise of E-commerce, in particular boosting demand for larger logistics and distribution facilities and attracting ample (institutional) investor capital. Whereas the logistics sector for long only was marginally represented in institutional investors' portfolios, the growth of E-commerce and connected demise of the retail sector has driven investors to re-allocate their traditionally large retail exposure to the logistics sector. The COVID pandemic and respective lock downs of economies have reinforced this trend as online shopping was boosted further.

The COVID pandemic also exposed weaknesses in supply chains, as lockdowns and restricted transportation abilities disrupted many industries. This has led companies to redesign their supply chains and to produce, assemble and distribute their products from locations with proximity to the end-consumer ("re-shoring"). The outbreak of the war in the Ukraine and the increase of energy prices has further accelerated this trend, which in particular can be seen in the light industrial sub-sector.

Figure 1. Historical take-up volume and vacancy rate in key markets[1]

(Based on data for the period Q4 2018 - Q2 2024 across the Netherlands, Germany and France)



THE CASE FOR LIGHT INDUSTRIAL

From 2018, Edmond de Rothschild REIM have developed a strong conviction on the small logistics and light industrial sub-sector. This is driven by three key beliefs:

1. **Yield differential:** Edmond de Rothschild REIM ("EdR REIM") believes there are two main reasons for a consistent yield differential between large logistics assets and small light industrial properties. First, there is more investor appetite for larger logistics properties as it is easier to deploy significant amounts of equity and debt capital into this sub-segment and it is less labour intense to manage these assets. In addition, the perceived increased credit risk on the SME tenants in smaller assets warrants investors to demand a return or yield premium for this type of properties. However, this last risk can be mitigated by building a portfolio and creating a diversified pool of tenants from different (sub-) industries. EdR REIM estimates the yield premium to consistently range between 100-250 basis points in favour of light industrial.

2. **Pricing power:** as outlined above, the pricing power of the landlord for light industrial assets is far greater given that tenants are less likely

1. Source: CBRE, Q2 2024.

to move (see also point #3 below) and tenants appreciate the added value of the professional expertise of the landlord that helps drive efficiencies for the tenants. This offers the ability for specialised landlords to drive income beyond the contractual inflation linkage embedded in the rental contracts.

3 **Downside protection:** given the urbanized locations of light industrial properties, there is embedded downside protection of land value which constitutes a bigger proportion of the total capital value of a property compared to an out of town logistics warehouse. Land constraints in urban areas and the potential of alternative use in the long term (for instance residential) limit the risk of new supply of space.

It is important to note, that the potential of light industrial assets is more difficult to exploit given its embedded granularity. Sourcing properties requires an extensive network across a very disperse landscape of mostly private owners. In addition, on the ground specialists are needed to understand the local occupier demand and to manage tenant relationships. Nevertheless, investors have increasingly discovered the potential of this sector and as a result of that, investment volumes are growing as this sub-sector is maturing.

SUSTAINABILITY: A TOOL TO FURTHER DRIVE INCOME

Depending on the use of the building, energy consumption can vary substantially across buildings. Dry storage requires little cooling and heating while production and assembling activities often require more energy. But generally, tenants have become increasingly sensitive to the energy consumption of the building from a cost perspective as well as the aim to reduce the carbon footprint of their business. Investments from the landlord therefore have a real impact on the attractivity of the building and the net rent received by the landlord.

Furthermore, investments in sustainability start to be a business model and a driver of additional income in itself. Solar panels, which fit well on the generally large roof surface of light industrial properties, can generate total returns well above 10% dependent on the energy usage of the tenant, grid congestion and the need for electricity in the direct environment of the building. But also, logistics and industrial buildings are often located at strategic locations with good road connection with ample room around the building. While the electrification of the cars has strongly taken off, it is expected that the same will (and has to) happen in the (light) truck market. EV chargers therefore are becoming a real asset for an industrial building, beneficial for the tenant and generating additional income for the landlord. Companies such as BP and Shell are looking to facilitate the underlying investments in the infrastructure as part of their strategy to transform their businesses and are eager to partner up with investors. EV charging companies have a natural advantage to do so but overall, it means that investments in the production and use of sustainable energy are becoming a new driver of income on industrial and logistics real estate.

RECENT MARKET DEVELOPMENTS AND OUTLOOK

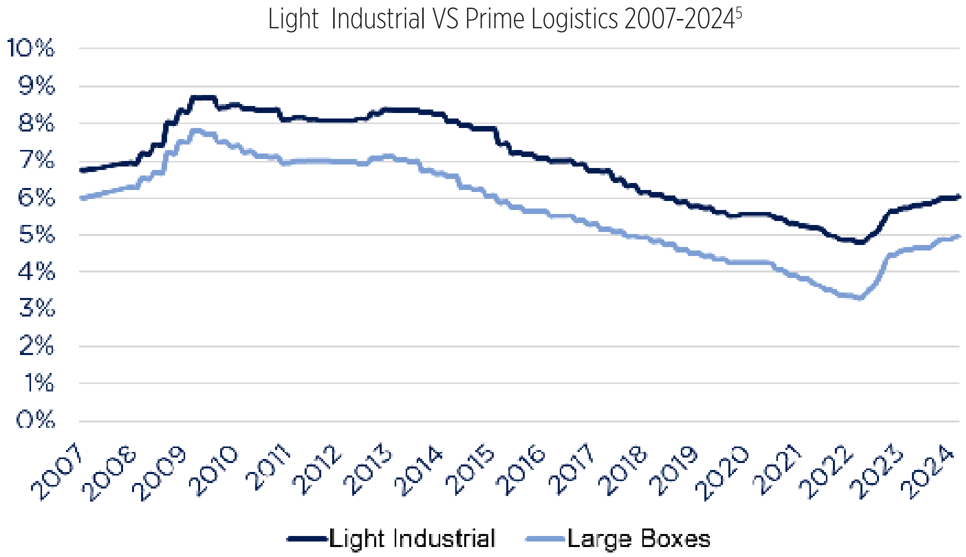
Driven by the macro tailwinds, investor appetite and the low interest rate environment, capital markets have driven down yields in the logistics sector to record low levels in 2022. At the peak of the market, prime large logistic assets were trading at 3% net initial yields (i.e. 33x the net operating income of the properties)[2]. In contrast, EdR REIM has continued to acquire light industrial properties during 2022 on yields of 5+%[3]. Given the changes in central banks' policies over recent quarters, leading to increasing interest rates and a great re-pricing across asset classes, also the logistics and industrial have been affected, albeit to a different degree. This difference stems from the yield basis (a 50bps increase in yield has a different valuation impact on a 3% yield compared to a 5% yield), as well as from the leverage across key European markets that was still accretive for light industrial assets (all-in debt costs was below the acquisition yield). Since the beginning of the third quarter of 2023, EdR REIM invested EUR 120 mln in assets and observes a stabilization of valuation yields in its core markets at around 4.5-5% while the average yield on EdR REIM's industrial portfolio is at 6.2%[4].

While capital markets have led to a repricing of properties, occupational markets are still showing significant resilience. Driven by the macro tailwinds, the small logistics and light industrial space has seen very strong growth in occupier demand. Combined with vacancy rates at very low levels (see also figure 1), this has led to a strong increase of market rents of 6.6% (annualized) in Q1 2024

2. Source: JLL, March 2022.
3. Source: Edmond de Rothschild; represents the average gross initial yield on acquisitions made by EdR REIM's industrial strategy in 2022.
4. Sources: Cushman & Wakefield, CBRE, Edmond de Rothschild 30 June 2024.
Past performance may not be indicative of future results.

Figure 2. Yield evolution for Light Industrial and Larges Boxes

(Based on data for the period 2007-2024 across the Netherlands, Germany, France, Sweden, Spain and United Kingdom)



following increases of 8.1% in 2023 and 16.8% in 2022[6]. The lack of available land as well as environmental considerations lead to a substantial slowdown of construction activity. New supply is further restricted by rising construction costs and higher costs of financing of developers as a result of the rise of interest rates. More recently, E-commerce growth has slowed down, still demand from occupiers is increasing, in particular in urban areas. Nearshoring and the need to de-carbonize their business has caused tenants to look for warehouse space closer to the end-consumer. So even if occupier demand is affected by lower economic growth, vacancy rates are expected to remain at record low levels driving rental levels up strongly in particular in urban areas in the key north western European markets.

All in all, EdR REIM believes the recent stabilisation in valuation yields, coupled with the continuously strong occupier market will likely lead to a new upward cycle for the light industrial sector and thus the coming quarters are expected to be a great vintage for deploying new capital into the space.

CASE STUDY: GRIGNY

In January 2022, EdR REIM launched a speculative development with K Promotion consisting of three multi let buildings located in Grigny with a total lettable area of 7,600 sqm. Grigny is located just south of Paris with the buildings having direct access to the highway A6 to Lyon. The local occupier market is tight and characterized by the lack of availability of land with strong demand for smaller units. The buildings are designed to accommodate occupiers for sizes from 200 sqm up to 1,800 sqm and tailor to the search of occupiers for high quality space. The construction of all three buildings has been completed and demand from occupiers has been very strong, leading to achieve 85% occupancy rate of the surface by Q2 2024. There has been a large variety of interest from small and medium sized local production and distribution companies to one of the leading companies in the aviation industry (maintenance and repairs) having signed a long lease for one entire building. Across these various tenants, rents are consistently higher than expected early 2022. Because the buildings offer good environmental performance, a perfect location (close to Paris and public transport) and the use of new modes of transport (bicycles and electric vehicles), tenants can reduce their energy bills as well as their carbon footprint. The landlord also benefits from these savings because tenants can afford higher net rents. Last but not least, by offering qualitative buildings in a city (Grigny) with a high unemployment rate, we can significantly improve the overall environment by attracting businesses to the area, thereby enhancing the city's attractiveness.

Asset in Grigny, France

5. Source: CBRE, April 2024.
6. Source: JLL, May 2024.

EDMOND DE ROTHSCHILD REIM AS A CREDIBLE SOLUTION TO ADDRESS THE PAN-EUROPEAN LIGHT INDUSTRIAL MARKET

With a long history of managing alternative investments, such as Real Estate, Infrastructure and Private Equity, Edmond de Rothschild has a dedicated real estate investment management platform with 140+ real estate professionals spread across 9 offices in the largest markets in Europe. The platform manages over 670 assets with an aggregate value of over EUR 12.1bn. Of this amount, over EUR 2bn represents logistics / light industrial properties giving the team real-time data on the latest capital and occupier markets.

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