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Outside the box

Rebounding demand prompts a shift in thinking

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KEYNOTE INTERVIEW

European industrial offers buying opportunity

Relatively attractive pricing of assets returns as investors start to compete again for limited stock in 2025, says Edmond de Rothschild's Theo Soeters

The past 18 months have presented investors with a buying window to deploy capital in the European industrial and logistics space.

Theo Soeters, head of fund management at Edmond de Rothschild Real Estate Investment Management, explains that price levels have fallen and returns have become much more attractive compared with the peak of the market.

Since Q3 2023, the pan-European asset manager has deployed almost €250 million in industrial and logistics property, representing around a quarter of its total real estate exposure in the sector.

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Q How much longer will the buying opportunity in European industrial and logistics property persist?

The chance to buy at attractive prices is expected to be there for a while. Funds deploying at the yields of today will probably prove a very good vintage going forward. Since many investors have allocated capital to the sector, it can be expected that markets will become active and liquid again very quickly and yields are expected to fall again in the course of 2025.

We consider that valuations have stabilized since Q3 2023, so that was already 18 months ago. The bid-ask spread has also closed since, which is another sign that prices have stabilized. Supply will probably not increase proportionally with demand, and interest rates have been on a downward trajectory more recently, which might lead to yields compressing and prices increasing again soon.

All in all, the negative price adjustment seems complete, and we saw indications that prime yields were beginning to fall again in Q4 2024.

Investors are still relatively cautious

Q What capital market trends have you observed in the commercial real estate sector?

Alongside residential, industrial and logistics is probably the favorite sector for a lot of investors. Over the last 12-18 months, many of the investors looking to deploy money in the space were looking for value-add or opportunistic strategies, typically targeting returns of 15 percent or more.

Some market participants expected distress to create a buyer's market, which never really materialized because industrial markets have proven resilient. Some investors were willing to take on speculative development risk in the hope of achieving higher returns. Lately, as interest rates have reduced, we have seen core and core-plus capital with lower return requirements coming back into the market.

after the instability of the last two years, but capital has been allocated to the sector and is looking to be deployed. All the signs now point to a market that is recovering, and which will continue to do so unless unforeseen geopolitical events occur to spoil the picture.

Q How do occupier market conditions look going forward?

The underlying occupier fundamentals are strong. Supply and demand have become more balanced compared with recent years when supply chain disruptions caused by the pandemic and the war in Ukraine created soaring demand for logistics space. That boom period has ended because of weaker economic growth, but demand is still sufficient for a healthy market. In urban areas in particular, occupier demand will be supported by the trend of moving the distribution of goods closer to where consumers live.

Meanwhile, it has become more expensive to build. Construction and financing costs have gone up. Environmental and planning restrictions have made development more difficult, especially in urban areas where a lot of demand is concentrated. Therefore, new supply has been rather restricted, so vacancy rates remain at a level which is still low by historic standards; they are averaging just over 4 percent across Europe from what we can see. Meanwhile, we expect rental growth to be slightly above inflation at 2.5-3 percent over the next five years.

Q Which strategy offers investors the most attractive risk-adjusted return?

For those investors seeking higher returns, strategies involving taking on permitting, development and construction risk do not always pay off. Development risk is binary in nature; it either produces a return within your investment period or it doesn't, which can really hurt investment performance, particularly in a market where occupier demand is weaker than it was previously.

Like many of our investor clients, we prefer to target realistic returns and a more conservative risk profile. Selectively taking on leasing risk on newly constructed buildings in established markets like the Randstad in the Netherlands, greater Paris and the Lyon region, and combining that with buying standing investments offers, in our view, more solid returns and it is also easier to access financing. We only invest in countries where we have a local presence because we believe this is a sector where a manager needs to have an impact on the asset, and that requires proximity to the asset and to the tenant.

Value creation starts with acquisition. The first step is to buy under-managed buildings, in an off-market process if possible. There is more non-institutional private ownership in the industrial space than in many other sectors, which helps when looking for those opportunities. Then you engage with the tenant and add value by making investments that the former landlord has not made – for example, identifying sustainability improvements – which create the potential to increase rental income.

Building quality and ESG performance are increasingly important to occupiers. While small to medium-sized enterprises have less public exposure and are under less scrutiny than big corporates, they have begun to appreciate ESG credentials. They are becoming a more meaningful factor in the ability to attract employees, particularly younger people, as well as being more cost efficient. We will see rents for prime industrial buildings diverge from old, lower-quality stock, just as we have already seen in the office market.

Q What industrial asset types offer the greatest potential?

We are more inclined to look at light industrial and small to medium-sized warehouses, slightly smaller buildings of 5,000-20,000 square meters (50,000-200,000 square feet), located close to cities, where the tenant base is typically composed of small and medium-sized enterprises.

Tenants of those buildings tend to appreciate the advice of a professional landlord more than the large, third-party logistics operators or e-commerce firms, so there is more room to interact with them to drive income. They are less inclined to move than large occupiers because they are often more tightly bound to the location and to the building. That means better tenant retention and willingness to invest in their building.

Pricing in that segment of the market has been more stable than in the big-box logistics sector. Prices didn't increase that much and have not fallen as far, while rental growth has been more substantial. There is a clear historic price differential of around 100-150 basis points between those buildings and modern, big-box logistics. That is partly because of a perceived higher risk of default where tenants are not big multinational firms. But our rent collection rates in that segment of the market have been just as strong, which suggests that there may be a difference in credit rating without a differential in overall credibility.

There are higher management costs associated with that segment of the market because of its granularity. Nonetheless, more and more investors are discovering its advantages, and the price gap could close over time. This could bring the yield differential between light industrial and big boxes in Europe closer to the more narrow gap we observe in certain other geographies.

Another important advantage of investing in smaller buildings is that your investment is intrinsically more diversified, not only in terms of the number of assets, but also the number and type of tenants.

The European industrial strategy that we launched six years ago has around 150 different tenants across almost 60 different buildings. Rent collection rates are close to 100 percent and remained at that level even during the pandemic, so the credit risk that some might expect on such a portfolio has not materialized.

Q How do you expect market conditions to evolve in 2025?

The market is already slowly becoming more liquid. Capital will find its way. The number of properties for sale is not going to increase substantially, so more money will be chasing a relatively limited supply of assets, and that will trigger price increases.

How quickly that will happen depends on a number of factors. I do not believe that in three months we will be in a bull market again – things will evolve relatively slowly because there is still a feeling of insecurity, and investors will therefore remain disciplined for a while. However, over the course of 2025, we will probably see yields tightening again.

Then if rental growth continues to be positive, and we see income returns at 5-6 percent, that could well lead in the next 12-18 months to double-digit unlevered returns being achieved on industrial and logistics assets. Thereafter, we expect more normalized returns, but also for the sector to continue to do well given the structural tailwinds.

In our strategies, we are unlikely to start taking on speculative development risk. We will continue to focus on slightly smaller buildings in urban areas. We trust that this approach will still pay strong returns going forward, so we will stay disciplined and stick to our business plan. ■

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