The impact of rising inflation on European logistics real estate

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Record high inflation in the Eurozone

Europe, much like other parts of the world, is grappling with inflation levels not seen since the oil shocks in the 70s. In August 2022, inflation in the Eurozone reached 9.1%, up from 8.9% in July 2022 and 3.0% in August 2021.[1] Core inflation, a closely watched indicator for price stability, edged higher to 4.3% in August 2022, up from 4.0% in July 2022. The closest total inflation reached these levels in recent times is during the commodity boom in 2008, when inflation was running at 4% year-over-year.

The causes of this surge in inflation have been well documented. Part of the record savings amassed by consumers during lockdowns (~ €1 trillion in Eurozone according to the IMF) have found their way quickly back into the economy as restrictions have been lifted, while the supply side of the equation has taken much longer to respond, causing bottlenecks and a spike in prices along the supply chain. The conflict in Ukraine and fresh Covid lockdowns in China have exacerbated these inflationary pressures by disrupting further supply lines and the energy market. In particular, the energy component of the Eurozone HICP increased by 38.3% year-over-year in August 2022, partially driven by sanctions against Russian energy.

GDP growth, inflation, and logistics real estate

From a property perspective, inflation could be a positive to the extent that it is associated with economic growth and positive levels of occupier sentiment (the so-called "demand-pull" inflation): rising economic activity leads to an increase in demand for goods and services which in turn bolsters consumption, sales, and wages in a virtuous cycle. In such conditions, businesses typically require more space and landlords are generally able to pass on higher costs in the form of higher rents to tenants.

Historically, logistics capital values have tended to correlate relatively strongly with GDP growth (much less so with inflation), although since the mid 2010's this correlation appears to have weakened (Figure 1). This partial decoupling could be explained by the rise of e-commerce across Europe, which has contributed to insulate the European logistics market from macro-economic fluctuations, as seen during the pandemic. As a result, going forward GDP might be a less reliable predictor for activity levels and returns in European logistics real estate because of the secular e-commerce demand driver.

Despite this decoupling, if current high levels of inflation were to significantly depress economic activity and business profitability (and turn into "stagflation"), landlords would presumably find their ability to recoup higher costs through rents diminished – all other things being equal. In other words, inflation can negatively impact demand for logistics space to the extent that it increases expenses and hurts business profitability and consumer sentiment ("cost-pull" inflation).

At the time of writing, most economic forecasters still expect the European economy to expand in 2022 even though the likelihood of a recession has increased substantially. A protracted recession would hurt consumer spending and likely weaken demand for logistics space in the near term.

European logistics real estate as an effective hedge against inflation

The common wisdom is that as a real asset, property, and logistics property within it, ought to provide a good hedge against inflation, i.e., its income stream/value should keep up with the nominal rate of inflation. This is largely predicated on the basis that most industrial leases in Europe contain rent indexation/escalation mechanisms, typically pegged to Consumer Price Index (CPI). These mechanisms vary by country and can sometimes include structures (e.g., caps and collars, limitations on transmission of CPI to rent, hurdle rates, indexation holidays) which can limit the landlord's ability to unconditionally capture CPI growth. Even accounting for these structures, European logistics leases are likely to provide a better inflation hedge than U.S. logistics leases, which most often have fixed annual rent bumps (typically 3.0-3.5%).

While indexation ensures that gross rental income grows roughly in tandem with inflation, the relationship between logistics market rental values and inflation has historically been less clear cut. One argument is that inflation – specifically construction cost inflation – drives building values up, and with them, market rents. In reality, inflation is only likely to generate upward pressure on market rents when low vacancies give landlords increased pricing power (Figure 2).

Data for the Eurozone shows that average prime rental growth has comfortably outpaced inflation over the last 5 and 10 years[2] and it is expected to continue to do so over the 5-year forecasting horizon (2022-2026) despite the current spike in inflation in 2022.

Because most logistics leases are largely tied to CPIs, inflation and rental growth dynamics have implications for investment and asset management decisions, as described in the following two scenarios:

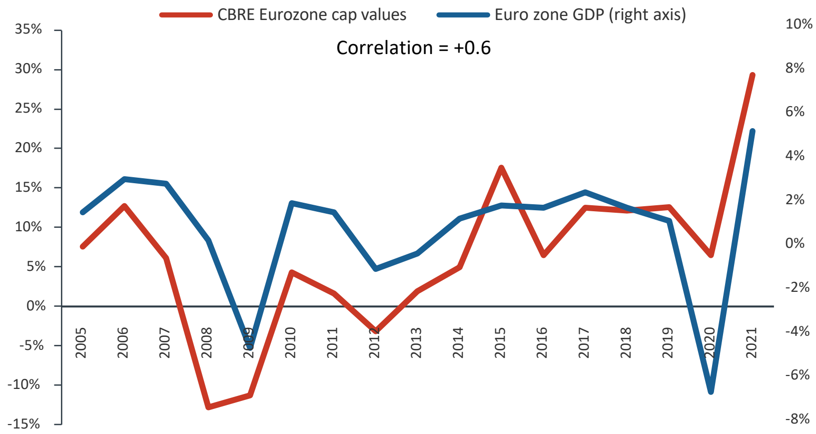
- Inflation > market rental growth: (over the life of a lease): investors may have an interest in keeping the tenant and taking advantage of CPI uplifts. In this scenario, however, there is a risk of over-renting (i.e., the passing rent paid by the tenant exceeding the market rent), which can impact the profile of exit yields and property values.
- Inflation < market rental growth: (current situation): investors may increasingly be tempted by short-term leases and/or have an interest in getting existing tenants to leave and securing a new occupier at a higher rent. However, this may not be always practically possible due to lease regulations preventing landlords from evicting occupiers at the end of the lease in some jurisdictions.

In general, occupiers' motivations will be symmetrically opposite to the landlords'. That said, transaction and relocation costs, plus other factors (e.g., local availability of labour, how much a tenant has invested in the building, etc.), may make tenants more "sticky" and less sensitive to rental/ CPI inflation dynamics than this scenario-analysis suggests.

Implications of inflation for replacement costs and new supply

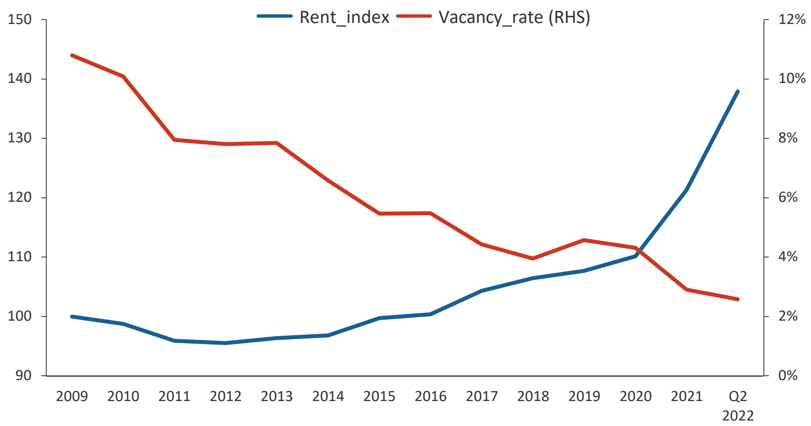
The recent spike in inflation also resulted in an unprecedented surge in construction materials costs (and land prices) that was already well underway as economies began reopening in 2021.

Figure 1: Eurozone GDP growth vs. Prime logistics capital values growth



Source: CBRE Research, Moody's, Clarion Partners Investment Research.

Figure 2: Vacancy rate and prime logistics rental index for selected European countries* (2009=100)



* Belgium, Czech Republic, France, Germany, Italy, Netherlands, Poland, Spain, United Kingdom
Source: CBRE Research, Clarion Partners Investment Research.

The following data for Germany, which is representative of other Western European logistics markets, gives a sense of the magnitude of these cost pressures (2021 data):

Selected construction materials[3]:
- Solid construction timber: +77.3%
- Rebar steel: +53.2%
- Concrete reinforcing steel mesh: +52.8%
- Industrial/logistics land[4]: +60.0%

Soaring energy costs and continuing supply disruptions have sent the prices of some materials even higher since the beginning of 2022. The price of corrugated steel as monitored by the Chamber of Commerce of Spain, a reliable gauge for construction cost inflation in the country, has risen by over 55% in the first four months of the year, although prices appear to have cooled off since. This could be partly attributable to buyers delaying/postponing orders of certain construction materials in response to supply chain disruptions associated with the conflict in Ukraine and the weaker economic outlook. These cost increases have boosted logistics replacement costs that until recently had largely lagged valuations and may squeeze logistics development margins, discouraging some new development projects.

As a result, the sustainability/desirability of development will increasingly depend on the market delivering consistently higher rental growth. According to CBRE Research, prime rents in the Eurozone grew at their fastest annual rate since the early 2000's (+15%) in Q2 2022, supported by strengthening fundamentals.

High inflation should deter new development in markets where supply is more plentiful, thereby preventing developers from passing through the extra development costs to end-users. This in turn should contribute to rebalancing the market. In low-vacancy markets, development should remain an attractive proposition even though extra rental growth will be required to mitigate rising construction costs. For example, modelling done by Clarion Partners Europe for logistics speculative developments in Spain suggests that 10% of hard cost inflation requires approximately 4.5% market rental value growth to practical completion to deliver the same levered IRR.[5]

In a rapidly-escalating cost environment, legacy landowners and early movers that can lock in the most favorable terms (either within an open book or fixed price contract – with the latter increasingly in demand) should be able to market their assets more competitively while taking advantage of rental growth. This might prove to be more challenging for late entrants as they deal with escalating costs as well as possible delays in construction materials, potentially squeezing development margins.

Nonetheless, while development appraisals may still stack up, delivery timescales are certainly likely to be challenged due to persisting supply chain bottlenecks that are not expected to clear until at least 2023. This could cause slippages in planned vs. actual delivery dates in addition to potential cost overruns. As such, new supply growth is likely to slow going forward as developers wait for the storm to pass.

Higher financing costs

Elevated inflation has substantial (mostly indirect) implications for the cost of capital and levered investors as the inflation outlook influences monetary policy decisions and the cost of debt financing. This is true for all sectors, although logistics is arguably in a stronger position due its perceived lower risk profile and stronger fundamentals.

Since the beginning of 2022, higher inflation and interest rates expectations have pushed hedging costs (as measured by 5-year fixed rate swap rates) higher – by over 200 bps at its recent peak in June. As a result, the spread between prime average Eurozone logistics yields and borrowing costs is at levels comparable to pre-GFC (approximately 170 bps).

Overall, the all-in 5-year fixed-rate mortgage rate for core assets in Western Europe is estimated to have increased to 300-325 bps, from 75-100 bps over the past 2 years. For reference, the average prime yield in the Eurozone stood at 3.93% at Q2 2022 according to CBRE.

The rising cost of debt has forced many levered investors to the sidelines, restricting the pool of active buyers. Nonetheless, most sellers are not in a hurry to sell. Some have withdrawn their assets from the market, waiting for uncertainty to abate and more evidence on values to emerge. This price discovery period may potentially result in a market repricing in the short term.

That said, record capital inflows combined with continued projected rental growth and CPI indexation should cushion, at least partially, the impact of rising rates on values/returns. Investors' interest in European logistics property is well documented and continues unabated. Logistics came out as investors' preferred asset class in Europe in INREV's latest Investment Intentions Survey (71% of respondents).[6]

Concluding remarks

European logistics real estate is positioned well to navigate the current high-inflation environment thanks to the inflation hedge offered by CPI indexation and the sector's robust market fundamentals. Under the impulse of rising replacement costs and record-low vacancies, rental growth is expected to accelerate in most European logistics hotspots.

While lingering economic, political, and financial markets uncertainties may cloud investment decisions in the short-term, investors should take a longer-term view towards a sector that continues to benefit from secular trends, such as the recent e-commerce boom and supply chain reconfiguration, that are far from being exhausted. We therefore remain optimistic that European logistics real estate should continue to perform well on a relative basis going forward.

FOOTNOTE
1 Source: Eurostat, Clarion Partners Investment Research, September 2022.
2 Source: CBRE Research, Green Street Advisors, Moody's, Clarion Partners Investment Research, July 2022.
3 Source: Destatis, April 2022.
4 Source: CBRE Research, March 2022.
5 Assuming achieved rent at PC is then indexed annually for the remaining 4 years of hold at assumed CPI of 3.25%, all other things being equal.
6 Source: INREV Investment Intentions Survey 2022 (carried out before war in Ukraine).