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# Where bricks are beating clicks— implications for last-mile real estate

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## Executive summary

The explosive growth of e-commerce disruptors like Alibaba, MercadoLibre and Amazon has sent shockwaves across retail markets worldwide, and of course, retail sector stocks. The effects of these shockwaves have extended to alternative investments as well. In commercial real estate, for example, the e-commerce paradigm has created a new demand for logistics infrastructure.

Many observe the impacts of e-commerce growth as decimating commercial retail properties, leaving empty big-box warehouses and strip malls in its wake. While this may be true to a certain extent, it ignores the tremendous opportunity this new trend is creating in the industrial property sector. It seems that for every mall that closes, a distribution warehouse—or so called last-mile logistics space—opens.

### Key takeaways

- As e-commerce continues to penetrate global markets, we believe the shift from physical retail real estate to industrial logistics space will persist as well. We view this as an attractive investment opportunity.
- Some analysis suggests that e-commerce retailers require three times the logistics space of a traditional retail business.
- Investments in last-mile delivery facilities like urban logistics spaces and parcel hubs can serve as a proxy for investors seeking to capture additional exposure to e-commerce growth, outside of equities.

### From clicks to bricks

Undeniably, the digitization of the retail industry over the last 10 years has dramatically changed traditional commerce. Keystrokes and mouse clicks have increasingly supplanted physical visits to corner stores and strip malls. Shoppers worldwide now have instant access to virtually unlimited selections of goods and services, from toothbrushes and razors to esoteric and bulky items like mattresses and televisions, delivered to their doorsteps often in 24 hours or less.

This new e-economy has had a ripple effect impact on commercial real estate, particularly commercial retail and industrial properties, felt across the

United States, Europe, Latin America and Asia. This is the so-called “Amazon effect,” or “clicks versus bricks,” referring to the economic pressures put on traditional retail properties due to declining on-site traffic. While this impact on retail real estate is significant, the narrative associated with it often tends to emphasize the negative aspects—the closures of malls and big-box retailers. What we think is overlooked is a vast redevelopment opportunity, particularly as it pertains to the space required to support “e-tail” business logistics.

As consumers of all ages embrace the convenience of online shopping, they have come to expect near-instant

### E-commerce: a global trend

Online shopping is truly a global phenomenon. In South Korea, for example, the e-commerce penetration rate is currently the highest in the world at 18%—and is forecast to rise above 30% by 2021.<sup>1</sup> The South Korean e-commerce market stands at over \$55.7 billion per year.<sup>2</sup>

According to a 2016 report co-authored by Google, the Southeast Asian online market is expanding at a rate of roughly four million users per month, making it the fastest growing in the world.

gratification in terms of product delivery. Goods of all sizes and types are delivered within 24 hours, and in some cases, less.

Consumers in Europe cited “best price,” “speed,” and “the ability to order anywhere and anytime” as the top three most-important factors driving their online shopping habits, according to Euromonitor’s syndicated Lifestyles Survey.<sup>3</sup> E-retailers aim to meet this demand by securing warehouse and distribution space to house the inventory in as close proximity to their customer base as possible. If inventory is no longer on store shelves at stores like Edeka and Best Buy, or on garment racks at Macy’s, for example, it must be kept somewhere. It’s certainly not at the Alibaba’s headquarters in Hangzhou—or at Amazon’s in Seattle, or MercadoLibre’s in Buenos Aires, either.

To accommodate this growth, investors and developers around the globe are snapping up industrial-use land and buildings, as well as repurposing shuttered big-box stores and other old retail spaces into distribution hubs. These are so-called “last-mile” logistics spaces, and they present a tremendous opportunity for investors possessing the resources and expertise to navigate this burgeoning real estate market. Alibaba and MercadoLibre are investing heavily in logistics infrastructure, and we expect this trend will continue.

### When a mall closes a warehouse opens

Alibaba’s Chief Executive, Jack Ma, predicts that China’s courier sector will be delivering 1 billion internet parcels per day by 2025.<sup>4</sup> By contrast in the United States, it is estimated the city of Chicago alone currently

““ These are so-called “last-mile” logistics spaces, and we see a significant opportunity for investors possessing the resources and expertise to navigate this burgeoning real estate market.”

generates 270,000 e-commerce package deliveries daily, according to analysis by the National Real Estate Investor magazine.<sup>5</sup> Some analysis suggests that e-commerce retailers require three times the logistics space of a traditional retail business, as noted in Exhibit 1 below.

Assuming an online company generated sales of US\$1 billion, for example, it would need more than 1 million square feet of warehouse space to support its fulfillment and distribution operations.<sup>6</sup> A 2018 Industrial Labor report by CBRE predicts demand of 184 million square feet of e-commerce logistics demand by 2020.<sup>7</sup>

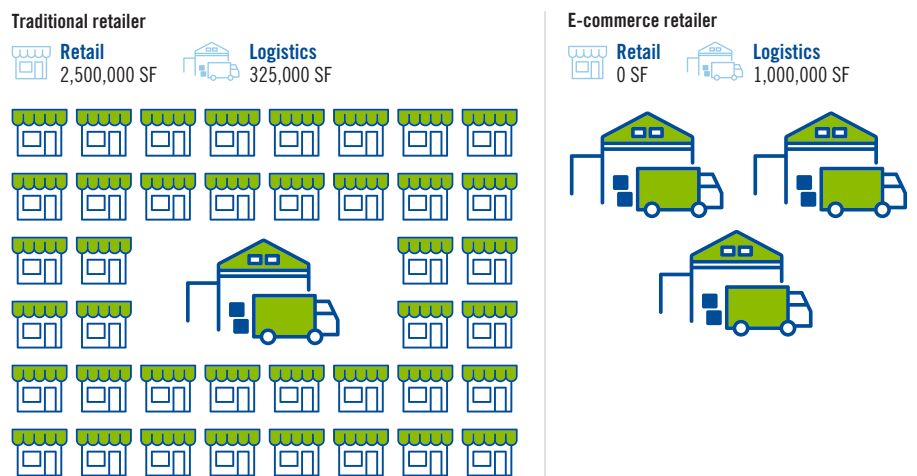
### Where is the last-mile?

While not a literal measured distance (naturally), the objective of “last-mile” logistics facilities is to situate them as close to the end consumer as possible—the closer the better in terms of rapid and efficient delivery of goods ordered online. Unlike sprawling fulfillment centers typically built in regional distribution hubs, newer last-mile logistics sites are usually situated in densely populated areas.

Intuitively, last-mile facilities should be close to highly urbanized and dense population centers. Demand for this coveted space is highest in those areas as well. For example, in an analysis of

### HOW MUCH REAL ESTATE DOES A \$1BN RETAILER NEED?

Exhibit 1: Traditional vs e-commerce retailers typical space needs



For illustrative purposes only. Note: SF = square feet.

Source: Prologis Research as of July 2014. Assumptions are based on an average \$400 annual retail sales per square foot (PSF) implying a retail space requirement of around 2.5 million SF. Distribution centers for traditional retailers are assumed to support \$2,500–3,500 annual sales PSF implying around 325,000 SF logistics space requirement. Logistics facilities used by pure play e-commerce retailers are assumed to support \$1,000 annual sales PSF implying around 1 million SF logistics space requirement.

the location of last-mile facilities in 15 largest metropolitan areas in the United States, sites ranged from six miles from the city center in the San Francisco Bay Area to nine miles from the city center in the Inland Empire of Los Angeles.<sup>8</sup> In Asia, logistics rental growth is highest in Melbourne, Shanghai, Beijing and Hong Kong. Demographic trends—such as baby boomers retiring in cities and the growth of tech-savvy millennials—have resulted in a concentration of buying power in metropolitan areas.

In some parts of the world, last-mile logistics presents an even greater challenge for companies. Consider Indonesia, for example, where the distance from Aceh to Papua, is roughly the same nautical distance as between Rio de Janeiro and Cape Town.

For a company like Lazada, which serves the Southeast Asia region, expanding its logistics footprint to cut costs and improve service is imperative. Smaller local hubs located closer to customers on various islands in Indonesia are needed, as well as major warehouses it can use in places like Kuala Lumpur for goods that move less often. Today, Lazada has 130,000 merchants on its platform, 14 warehouses, over two million square feet of space, and 130 distribution centers. The company plans to open another five to six warehouses next year.<sup>9</sup>

## Finding new use for old spaces

As we observed earlier, the growing demand for last-mile logistics space has opened a new frontier in terms of investment and redevelopment opportunities for previously vacant or under-utilized properties—such as empty big-box retail lots, old government facilities,

abandoned industrial sites in various stages of remediation and underused office space. More often than not, last-mile deals involve buying existing buildings and converting them. This offers an opportunity to acquire assets from pressured retailers and create value through adapting the use and tenant mix in response to logistics demands.

In one unique case, an underutilized parking garage in Chicago was converted into a last-mile hub. Millennium Parking Garage, one of the largest underground parking systems in the world with 3.8 million square feet over two floors,<sup>10</sup> was recently partially transformed into a shipping/warehouse location. And in Bayonne, New Jersey, owners converted a 90-acre former Naval base abandoned since its closure in 1999 into a warehouse. Repurposing the site created millions of dollars of tax revenue for Bayonne, brought jobs to the city, and revitalized a waterfront that had fallen into decay.

## Enabling the movement of goods

Interestingly, factors that once dictated the viability of a site for industrial use at the turn of the 20th century are again deemed to be important when considering warehouses for last-mile logistics.

Things like easy access to transportation, for example, proximity to urban areas filled with potential customers

and employees, access to waterways, appropriate zoning, rail service, etc. Consider the converted Bayonne site as an example. It is across the river from New York City, possesses a private rail line, is zoned for commercial/industrial use, and is adjacent to Route 440—a major shipping route into New York City.

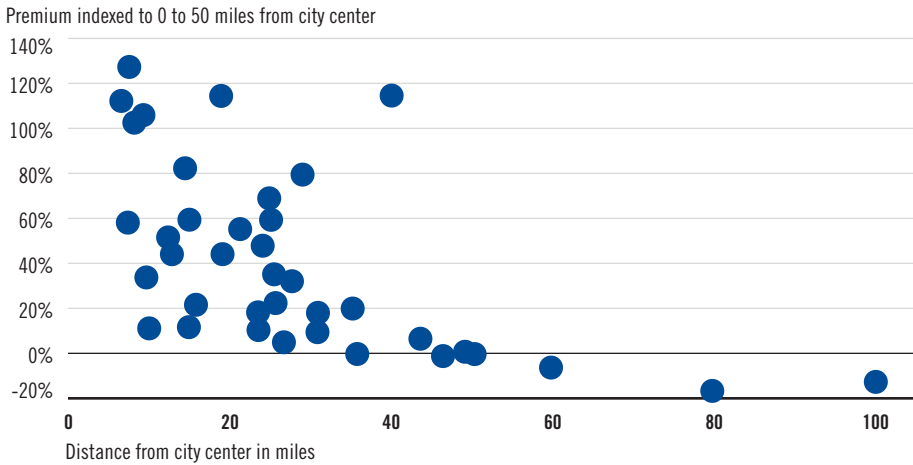
In order to meet the growing e-commerce demand, particularly during regional holidays such as the Chinese New Year and Diwali in India, companies have implemented unconventional solutions. According to an article in the Wall Street Journal, during the holiday rush in the United States in 2018, e-commerce giant Amazon pitched tents on vacant lots in three metropolitan areas to help support last-mile logistics requirements.<sup>11</sup>

In addition, to capture a share of the e-commerce market, some big-box stores still in operation are adapting their business models to use current real estate to serve as last-mile sites. For example, 70% of the US population lives within five miles of a Walmart. The company is using its traditional stores as e-commerce hubs by incentivizing customers to buy online and pick up merchandise at their neighborhood store without paying shipping charges. The bottom line is that creativity in operations has been key to enable companies to maintain efficiency in last-mile warehousing.

“Interestingly, factors that once dictated the viability of a site for industrial use at the beginning of the 20th century are again deemed to be important when considering warehouses for last-mile logistics.”

## LOCATION, LOCATION, LOCATION...IS IN THE CITY

**Exhibit 2: Rental rate premium based upon intra-city differences**



Source: Prologis Research, September 2018. For illustrative purposes only. This is not intended to be a complete analysis of every major market.

Note: Includes the market rents at the submarket level of seven major consumption markets.

### The real estate opportunity

Demand for last-mile real estate, particularly in densely populated suburbs and metropolitan centers, has spiked in recent years. Investors and tenants are now competing for small previously obsolete class-B, -C and -D industrial buildings in urban locations. Globally, industrial funds—which include

logistics spaces—raised US\$54.7 billion in capital between 2012 and 2017. Asia Pacific accounted for the majority of this (US\$20.8 billion), followed by North America and Europe.<sup>12</sup>

Revenue from logistics infrastructure in the Asia Pacific region is predicted to grow by a compound annual growth

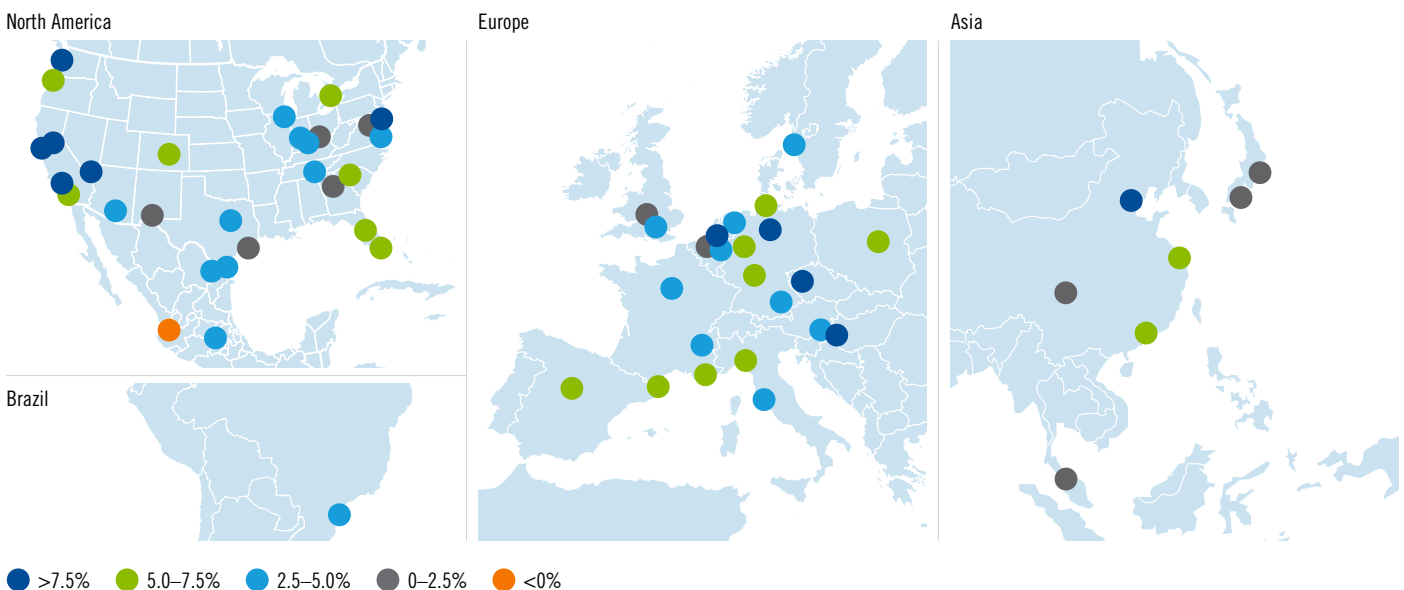
rate (CAGR) of 7.6% between 2018 and 2025.<sup>13</sup> This is more than double the rate of expected growth in North America and Europe over the same period.<sup>14</sup> In addition, in the coming years we anticipate a steady increase in investments in warehouses, industrial parks and ports in countries associated with China's Belt & Road initiative. Furthermore, the capitalization rate ("cap rate")<sup>15</sup> for logistics assets in the region has continued to compress in 2018, especially in Japan and Hong Kong where the cap rates were approximately 4.5% and 3.0%, respectively, by year end.<sup>16, 17</sup>

In the United States, the supply/demand imbalance is especially acute in the West, where light-industrial rents (a good proxy for last-mile) have grown by more than 10% annually in 2016 and 2017.<sup>18</sup>

In 2018, the US rental growth rate for logistical real estate consistent with the prior years grew at 8% with the top three highest rental growth markets all being West-San Francisco Bay Area, Seattle and Southern California.<sup>19</sup>

## GROWTH IN LOGISTICS RENTAL IS GLOBAL

**Exhibit 3: 2018 rent growth by market, by 60 logistics clusters globally**



Source: The Prologis Logistics Rent Index, January 2019. For illustrative purposes only.

Additionally, the overall cap rate for last-mile assets in the United States has dropped to 6% as a result of the growing demand.<sup>20</sup>

In the European market, e-commerce logistics demand continues to be a key driver of real estate performance as well. BNP Paribas estimates that 13% of all commercial real estate investment in the region is logistics related.<sup>21</sup> Three out of the top 10 performing cities in global rental growth for logistics markets are in Europe: Rotterdam, Budapest and Prague.<sup>22</sup> Cap rates have compressed across the European continent, with prime yields in the more mature markets of the United Kingdom and Germany now at 4% and 4.05%, respectively.<sup>23</sup>

Cap rate compression indicates the current market prices are increasing. The bottom line is that warehouse values for last-mile sites will likely continue to increase, as the scarcity of suitable property, especially in urban areas, is like high-demand beach-front property.

## Investment considerations

Sourcing and selecting suitable industrial sites for use as last-mile logistics distribution centers presents a specific set of challenges. We think proper due diligence can go a long way towards selecting investments.

In our view, last-mile capability sites should have the following characteristics: be close to end-users and employee bases, be adequate in size, have good parking and access, have appropriate ceiling heights, loading areas, enough heating, ventilation and

air-conditioning and electrical systems, and the capability to sustain heavy floor loads.

It is important to note that industrial properties, especially sites formerly utilized for manufacturing purposes, can pose a wide range of environmental concerns. Hazardous waste generation, underground and above ground storage tanks, oil/water separators, fueling operations, vehicle maintenance activities and waste disposal are also factors to be considered.

Specialists can help identify building deficiencies and evaluate suitability of building sub-systems, as well as quantify potential risks posed by former property usage.

Converting big-box sites and retail sites to warehouse space can also be challenging due to zoning laws and restrictions. Vacant department stores and grocery stores, or retail spaces large enough to accommodate last-mile sites, are likely located in town centers or along busy corridors. These areas are typically not zoned for industrial use. Variances can be obtained, but cities will likely consider the impact on the community before issuing. Distribution centers present the possibility of noise and heavy freight traffic—several reasons why variances are often denied.

Another often overlooked consideration in the United States is distribution centers are considered “commercial facilities” under the Americans with Disabilities Act, and as such subject to accessibility standards. This can be tricky, affecting parking ratios, building entry points, doorways and hallways, curb heights, etc. Specialists can

help identify these barriers before they become a liability—saving time and money.

Ultimately, however, we believe these “last-mile” properties can offer a compelling opportunity to those who can manage and navigate these challenges.

## Conclusion

As e-commerce continues to penetrate global markets, we believe the shift from physical retail real estate to industrial logistics space will persist as well. We view this as a quality investment opportunity for those well positioned globally to negotiate the varied and complex landscape.

Logistics real estate offers investors various long-term opportunities, as demand for new space is expected to continue, particularly in urban regions. The digitalization and increased outsourcing of retail business toward online and multichannel commerce is likely to have a long-term impact on supply chains. Businesses are therefore showing an increased willingness to invest in last-mile logistics real estate, using rapid service as a means of differentiating themselves from competition.

In our view, investments in these type assets can make a significant contribution to risk diversification in a well-balanced real estate portfolio. In addition, investments in last-mile delivery facilities like urban logistics spaces and parcel hubs can serve as a proxy for investors seeking to capture additional exposure to e-commerce growth outside of equities.

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## Endnotes

1. E-commerce penetration rate is the percentage of a target market a product, service or brand has reached in a period of time. It is calculated by dividing the number of customers by the size of a target market.
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23. Source: BNP Paribas Real Estate, Property Report, *European Logistics Market*, February 2019.

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**All investments involve risks, including possible loss of principal.** The risks associated with a real estate strategy include, but are not limited to various risks inherent in the ownership of real estate property, such as fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by general and local economic conditions, the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, environmental laws, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.

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