The Future of Digitalisation – looking beyond Covid-19

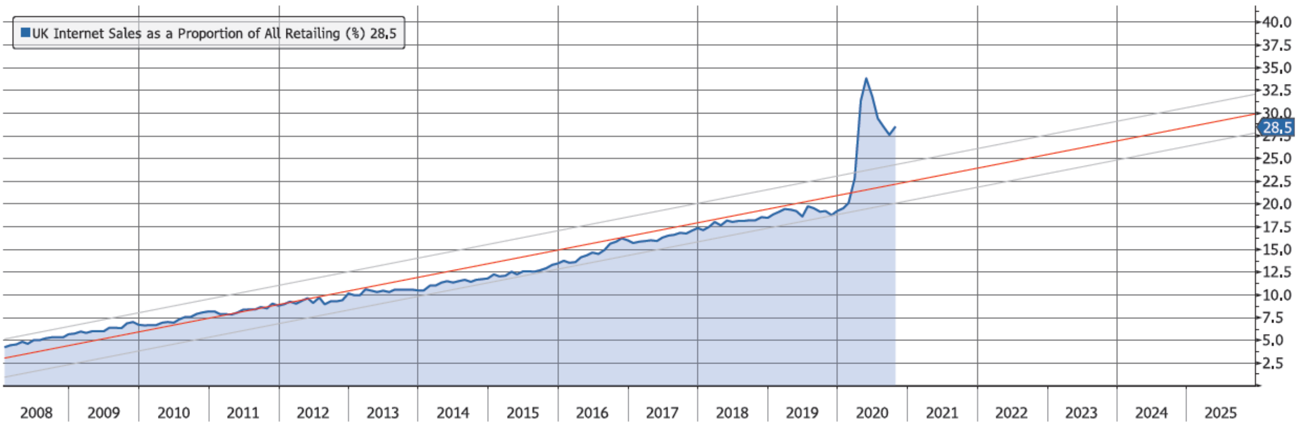
"Don't wait to buy real estate, buy real estate and wait" – Will Rogers

The rise of the 'cobot' is set to transform the way we work and shop, yet they are far from a futuristic ambition. In advanced warehouses acting as the storage and supply function for the UK's biggest online 'e-tailers', 'cobots' are already flying around vast warrens of shelving, picking stock and supplying the boxes to their human counterparts ready for packing.

These 'collaborative robot solutions' are just one part of the increasingly sophisticated generation of logistics real estate that has developed in the UK in recent years. Bolstered by the growth of the digital world and the surge in use of internet shopping, demand for logistics centres is increasing as businesses battle to provide online shoppers with a greater variety of goods and ever-faster delivery times. Logistics spaces are no longer simply storage; Colliers International recently described them as "part of a complex supply chain solution", marked by the likes of 'cobots' and increasing rates of automation. Tritax Big Box, one of the largest UK listed logistics REITs, states that 54% of the assets in its portfolio are automated.

Digitalisation of commerce is a fast-moving mega trend that is defining the opportunity in logistics real estate, all while continuing to chip away at the survival of the beleaguered bricks-and-mortar retail sector. It has been evident for some time that as online shopping gains in popularity the demand for warehouses and storage facilities would likely increase, and Covid-19 has had a well-publicised accelerative effect on the figures. Year-on-year growth in online retail sales was 60% in October 2020, with online sales making up 29% of total retail spend, according to the Office of National Statistics. The Covid-19 spike in the pace of online shopping has accelerated a trend that was well underway prior to the outbreak and which is set to gain ground over time.

The graph below shows UK internet sales as a proportion of all retailing. The proportion of UK internet sales has reached 28.5%, the level expected in 2024/2025 based on the trendline shown in red. Covid-19 has acted as the catalyst, accelerating the adoption of online retailing by four to five years.



Source: Bloomberg

This has had a clear impact on demand for an old, but refreshed, form of real estate – warehouses. Physical stores have their wares on the shelves for consumers to browse, a stock room at the back of the store serving as a mini depot, and product held in reserve elsewhere. For online retailers, all stock must be stored in a warehouse, resulting in a greater need for space. It is estimated that online retailers require 3x more warehouse space than traditional high street retailers. The larger quantity and variety of products, coupled with the need to pack orders and process returns, means they have a much greater requirement for warehouse space.

The continued and growing demand for logistics real estate has two main impacts. Firstly, in the 'big box' warehouse sector, e-tailers require large distribution hubs which enable them to store and transport vast amounts of stock around the country quickly and efficiently. These large distribution hubs – often more than 300,000 sq. ft in size and with a footprint similar to Wembley Stadium – need to be located near to centralised transport infrastructure; demand for these facilities continues to increase as we change our shopping habits. The second key area benefitting from demand led by the growth of the digital economy is in smaller, urban warehouses. Often located within or near towns and cities, these centres are increasingly needed as mini-hubs for 'last mile' distribution as the nation's appetite for next day – or even same-day – delivery proliferates. These smaller hubs enable e-tailers to be far nimbler and provide products quickly to nearby homes.

Both sub-sectors complement each other, yet it is the latter where architectural innovation is moving at the fastest pace. The supply of land for new urban hubs is increasingly restricted due to population growth in cities and the associated demand for residential development land. The solution is the evolution of multi-storey warehouses which solve the limitations of a building's footprint. Still a nascent concept in the UK – with possibly the first such centre built by SEGRO near Heathrow several years ago – these logistics facilities are built vertically, with vehicle ramps and vehicle docking bays on multiple floors, and are already common in parts of Asia Pacific such as Japan, South Korea, Hong Kong and Singapore.

Example: Prologis rendering of a multi-storey warehouse. Multi-storey warehouses are built vertically, with truck ramps and docks located on multiple floors. Small trucks can navigate the ramps to the upper floors, whilst larger lorries are accommodated by the main loading dock. By building vertically, plot sizes do not need to be as large, helping to resolve the issues of competing demand for space in urban centres.

Source: Prologis

REITs such as SEGRO, Tritax Big Box, Urban Logistics, Warehouse and LondonMetric are benefitting from growing demand from current and potential occupiers – and may offer a rewarding opportunity for investors seeking exposure to the future of the traditional industrials property sub-sector.

With a traditional 'landlord-occupier' model, the REITs are focused on the ownership of space and their ability to fill it with good quality, rent-paying tenants. Many of the REITs report a shortage of supply of newly constructed buildings which adds to the continued upward pressure on rental values. Clearly this limited supply of new stock benefits the owners of existing assets and throughout the pandemic, levels of rent collection have remained high. For many occupiers such as Amazon, and third-party logistics firms such as FedEx and Hermes, warehouse space has been classed as 'business critical' during the pandemic. Additionally, although often incorporating fixed uplift or index-linkage, rents are largely affordable for tenants, meaning the tenant is more likely to be able to pay their rent. In the case of Warehouse REIT, rent averages £5.49 per square foot and 98% of rent was collected in Q2 and Q3. Likewise, Urban Logistics REIT has collected at least 99% of its rent in 2020 so far.

This 'stickiness' of tenants is also evident in the lease lengths. 41% of leases in the Urban Logistics portfolio are at least five years in length, whilst the average remaining life of the leases in the Tritax Big Box portfolio is currently 14.1 years. The meaningful amount of money involved in moving warehouses makes selecting the right site and planning for future growth a critical consideration for businesses. Urban Logistics estimates that it costs c.£4m to relocate 100,000 sq ft of warehouse space. Equally, the level of investment required to automate systems and improve efficiency – such as the arrival of the 'cobot' – means many tenants are less likely to move and abandon the investment in the improvements they have put in place. Ocado is estimated to have invested c.£200m in bespoke technology within its customer fulfilment centre in Erith, a building leased from Trixtax Big Box who acquired it for £102m. The 'stickiness' of tenants and the long-term nature of their leases makes specialist logistics REITs potentially attractive for investors.

If you would like to see these robots in action, please click the image.

Source: Ocado

Long lease lengths and rental growth have resulted in strong support for asset values. According to SEGRO's valuers, prime logistics yields in London are valued at 4.4%, whilst 10-year Gilts yield less than 0.3%. This marks a significant opportunity for asset owners in this sub-sector to capture an attractive yield spread.

This wide yield spread has worked well for many different types of investors, from pension funds and institutional investors to private equity houses. The attractions of the sector to these investors underpins the valuation of the assets owned by the REITs. For a fund such as the **VT Gravis UK Listed Property (PAIF) Fund**, the growing demand from both tenants and institutional buyers indicates a prime investment opportunity. The long-term investment case is well supported by the digitalisation trend, which continues to grow at pace and behind the scenes is rapidly changing the world as we know it.

Matthew Norris, CFA
Director of Real Estate Securities
Fund Adviser, VT Gravis UK Listed Property (PAIF) Fund
2nd December 2020

To find out more about the Fund, please click here.