Research & Strategy

Secular trends in Asia favouring logistics – a strong buy opportunity

- **As governments around the world seek to reopen economies and exit lockdowns, expect changes in how we work, live and consume. Not everything will be the same and, in this context, the evolutionary trends in e-commerce are only going to accelerate. The logistic sector will be a key beneficiary, post COVID-19.**
- Heightened risks around deglobalisation, rising global trade war tensions and the growing need for diversification of the global supply chain will result in the requirement for more onshoring of logistics real estate in Asia Pacific.
- Ongoing trends in door-to-door delivery are only likely to strengthen, bringing the various types of logistics even more into focus for investment.
- **COVID-19 will push the real estate industry closer to a future where digitalisation and technology is highly integrated with real estate. The logistics sector in Asia Pacific is expected to benefit significantly from digitalisation and modernisation supported by changing consumer behaviours and demographics.** Businesses should take into consideration the new norm, which would hasten structural changes and investment convictions.
- **We remain a strong buyer of logistics formats and would recommend investors to embrace various risk profiles that lead to buying opportunities.**

Secular themes and implications

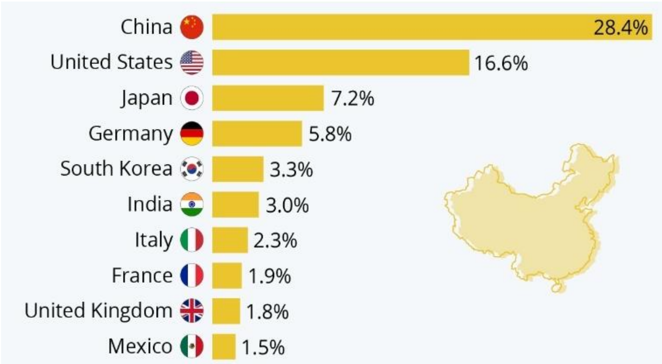
Themes	Implications (real estate impact/ opportunities)	Recommendations
Deglobalisation of trade and onshoring	• **Greater diversification of global manufacturing supply chains** away from China (**potential increased demand for onshore modern logistics facilities**; enhances the case for real estate diversification as markets/sectors become increasingly polarised) • Automation of supply chains (revamp of obsolete logistics facilities with technology/ robotics) • **Government intervention and control of key strategic commodities such as medical supplies/food (potential increased demand for cold-storage facilities)**	• Buy-and-hold in land-constrained markets (core/core-plus). Examples: sale and leaseback of logistics assets by owners who need to secure liquidity/ cashflow • Refurbishing and repurposing existing assets in land-constrained markets (value-add). Examples: conversion of obsolete warehouses into niche cold-storage facilities as part of national long-term strategic initiatives to future proof domestic supply chains of food and pharmaceutical goods • Development and lease-up (build-to-core) to access modern stock and higher yield in lesser land-constrained markets (opportunistic)
E-commerce acceleration	• **Retailers look to consolidate their outlet store network while incorporating more digital strategies to market products** (pricing dislocation for assets while landlords look to double efforts of an omnichannel retail strategy) • **Digitalisation of supply chains to limit disruptions (implementation of smart solutions and systems in logistics facilities)** • Urbanisation, rising incomes and millennial consumption behaviours support online shopping (convenience highly valued, which drives demand for cold-storage facilities)	

Structural shifts in a new norm spell opportunities

Greater geographic diversification of global supply chains and reshoring efforts drive logistics space demand and investments

- Most countries are now in the midst of exiting lockdowns and restarting economies after the unprecedented impact of the coronavirus outbreak. We believe the crisis is likely to underpin major structural and cyclical changes globally that would reshape future business models, particularly in the logistics sector, which has remained more resilient than other sectors
- **In the wake of the pandemic, we expect trade tensions to flare up between the US and China again.** The COVID-19 crisis has deepened strategic competition between the two powerhouses, and with anti-Chinese sentiment at a record high, according to China's Ministry of State Security, we do believe that there would be an accelerated exodus of foreign manufacturing firms out of China. **Besides the US, Japan has earmarked USD 2.2 billion to bring companies that have their production centres in China home as part of its economic stimulus package.**
- Historically, many companies have chosen the lowest-cost option for their manufacturing needs – namely, China, which accounts for a major share of global manufacturing output (figure 1). **But the pandemic has exposed vulnerabilities in the global supply chain, meaning companies will need to fundamentally rethink their sourcing strategies.** This includes increasing resilience by diversifying geographically across multiple locations or **seeking to enhance reshoring efforts through implementing automation in their home markets.**

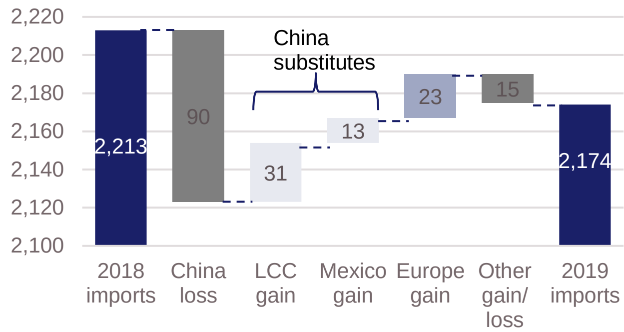
Figure 1: Top 10 countries by share of global manufacturing output, 2018



*output measured on a value-add basis in current USD
Sources: Statista, United Nations Statistics Division

- In addition, the rising labour costs in China, and China's pursuit of a consumption-led economic model, further support diversification of manufacturing supply chains away from China. Alternative affordable destinations include Vietnam or other South East Asian low-cost markets where the manufacturing capability and a skilled workforce is available.
- Changing trade dynamics resulted in an annual decline in US manufacturing imports from China by 17%, a total drop of roughly USD 90 billion in 2019. At the same time, imports from other Asian low-cost countries (LCCs) increased by USD 31 billion in 2019, according to Kearney (figure 2).

Figure 2: Change in US manufacturing import mix (real USD billion, 2018-19)



Source: Kearney analysis
Note: LCC refers to other Asian low-cost countries, including the bulk of South East Asia and India. Losses are denoted by grey while gains are denoted by shades of blue.

- At the same time, China is moving up the manufacturing value chain and focusing on high-tech industries while moving low-cost manufacturing production lines to other countries. **The exodus of foreign firms out of China would mean a more inward-looking domestic market opportunity across the region.**
- Other companies caught unprepared to handle the effects of the pandemic may also **consider diversifying inbound logistics options**, ensuring they have alternative ways to bring in supplies in the event of port disruptions, decreases in air freight capacity or truck driver shortages during the next pandemic event.

Offline to online: continued polarisation in the logistics and retail sectors

Digitisation and automation are technological enablers to the logistics sector

- **The pandemic has strengthened the case for logistics assets**, highlighting the importance of global supply chains. This is supported by the shift towards online retail sales as physical retail will almost certainly record further losses.
- Forrester predicts that retail sales in 2020 will decline by 9.6% globally, a loss of USD 2.1 trillion (figure 3). It will take four years for retailers to recover to pre-pandemic levels, Forrester predicts, although to varying levels worldwide given the regional differences and considering that each country is at a different stage of the pandemic.
- **Asia is set to record the largest retail sales losses in retail sales, according to Forrester: USD 767 billion in 2020, a decline of 10% from 2019.** In Europe, this will reach EUR 260 billion across the EU-5 (UK, France, Germany, Spain and Italy) in 2020, a decline

of 10.4% from 2019, while US retail sales will fall by USD 320 billion in 2020, a decline of 9.1% over the same period.

Figure 3: Decline in global retail sales value post–COVID-19 (USD tn)

Source: Forrester

- As investor interest in the logistics sector gathers strength, it is important to understand the heterogeneous nature of the logistics industry. Requirements vary widely and are dependent on the product and services offered. As such, different types of logistics formats cater to varying needs, with table 1 showing the definitions of different types of logistics facilities.

Table 1: Types of logistics facilities

Urban logistics facilities	Warehouse facilities close enough to their final delivery points while avoiding as much traffic congestion as possible.
Private warehouse	A warehouse or network of warehouses owned by one organisation, used in support of its supply chain.
Public warehouse/non-bonded warehouse	Public warehouses are typically subleased to retailers in need of extra inventory space.
Automated/smart warehouse	An automated warehouse utilises technology, robotics and even some forms of artificial intelligence to automate processes and minimise the number of required full-time employees.
Climate-controlled warehouse/cold-storage warehouse	A climate-controlled warehouse is designed to house refrigerated, frozen and temperature-sensitive inventory.
Fulfillment centre	Fulfillment and distribution centres are, in essence, specialised buildings that house different products from different sellers, and services such as product finishing. Third-party logistics (3PL) providers are in charge of them, responsible for customer engagement.
Distribution centre	Distribution centers handle everything from shipping to selling, but are more business-to-business focused, versus fulfillment centers, which are business-to-consumer and more location dependent. They are like retailers on their own.
Bonded warehouse	A bonded warehouse is a building or other secured area in which dutiable goods may be stored, manipulated or undergo manufacturing operations without payment of duty.
Ramp-up logistics facilities	Ramp-up warehouses provide direct vehicular access to all levels and offer greater efficiency in the movement of cargo as well as lower operating and maintenance costs. They are typically found in land-scarce markets.
On-demand warehouse	The function of on-demand warehousing is to provide short-term storage, transportation and inventory management for retailers on a month-to-month basis.

Source: Indospace, Mapletree, Knowthis.com, Stets Group, Fulfilltopia

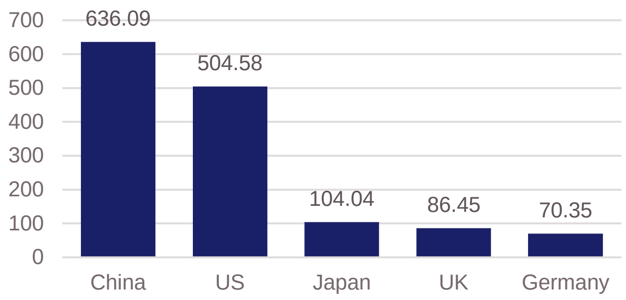
- Logistics as a sector is highly localised, requiring licensing for land zoning and a deep understanding of local market conditions. Such market complexities and regulatory regimes mean that most single-country industrial funds are established by domestic managers or pure-play industrial operators who have extensive experience and a large footprint in the targeted market.
- Logistics investments are usually done either through single-country vehicles or an allocation to industrial as part of a pan-regional multisector strategy. There is limited investment opportunity to create a sizeable pan-regional industrial fund, given the shortage of supply in a number of tightly held markets across Asia-Pacific. Thus, low-risk offshore investors who are new to Asia would typically invest in pan-Asia core funds that acquire modern institutional-grade industrial facilities in prime locations.
- A strategy further up the risk spectrum would see fund managers source assets in secondary locations, seeking assets that require value-add works, acquiring niche logistics formats or engaging in development projects such as build-to-core or build-to-suit.

Wave of capital heading to China

Rise of middle class and accelerating online retail sales underpin opportunity in China

- As e-commerce continues to gain traction globally, the competition for speedy delivery and lower costs is driving many companies to turn to 3PLs to distribute their products directly to customers. China's logistics property market is at the forefront of such growth opportunities.
- China remains a key target market for the bulk of logistics funds in the Asia-Pacific region, where fundamentals are favourable and where scale can be achieved. Thanks to ongoing urbanisation that has facilitated the rise of the middle class and rising Internet penetration rate, this has helped the world's largest consumer market (1.4 billion people) dominate the global e-commerce revenue market share (figure 4).

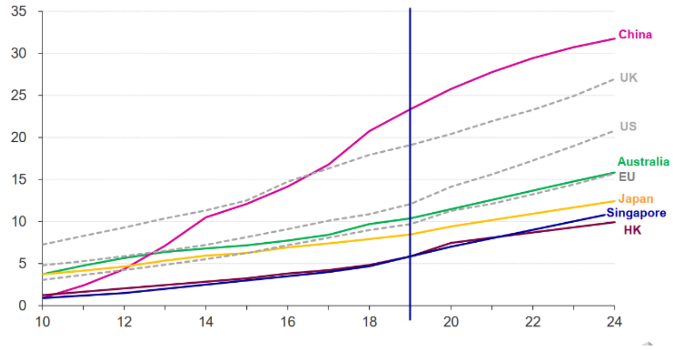
Figure 4: Top five e-commerce markets by revenue in 2018 (USD bn)



Source: World Retail Congress

- **Indeed, e-commerce retail sales in China are set to grow further, outperforming other global markets as the middle-income population continues to grow thanks to ongoing urbanisation (figure 5).**

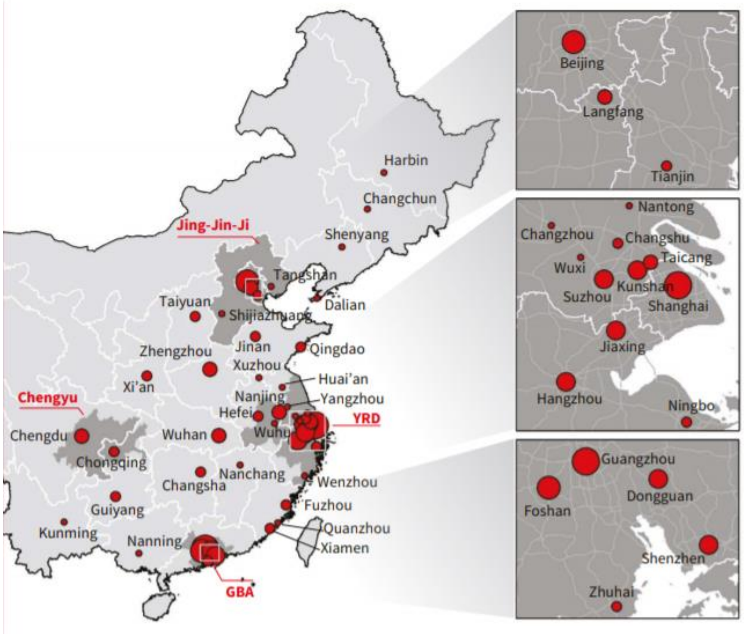
Figure 5: Online retail sales as a % of total retail sales over time



Source: PMA

- China's robust retail performance has supported the growth of consumer markets far beyond tier 1 cities, with the strongest city-level retail sales growth concentrated in a select number of city clusters. Regional economic development initiatives will increasingly determine where consumers concentrate and, hence, where there are key opportunities for warehouse developers and investors.
- City clusters such as the Yangtze River Delta, Greater Bay Area, Beijing-Tianjin-Hebei and Chengdu-Chongqing have done well over the past decade, and the government's ambitious plans to foster the growth of city clusters will also bolster incomes and living standards in these regions while potentially supporting the emergence of new ones, fuelling an acceleration in logistics demand.
- One of the biggest beneficiaries of these trends will be satellite markets – i.e., warehouse markets that are growing in small cities just outside of major urban centres. The most competitive satellite markets occupy advantageous locations with quick access to both their clusters' biggest cities and other major markets, making them ideal locations for regional distribution. Such satellite markets are located inland where land costs are lower, hence investors have higher capitalisation rate expectations (5.5–6.0% in satellite markets versus 5.0–5.5% in tier 1 markets, based on a 2020 JLL survey).
- According to the JLL survey, investors identified the greatest investment potential in the three most mature clusters of the Yangtze River Delta, Greater Bay Area and Beijing-Tianjin-Hebei (figure 6). In the longer term, investors are likely to expand to other markets as China's regional integration plans foster new opportunities for regional distribution.

Figure 6: Investor survey: locations with most potential for warehousing over the next 5-10 years



Source: JLL Research

- **The same survey also points out that most investors expect a 12–15% IRR to invest in Grade A Chinese warehouses, followed by the next group of respondents expecting a 15–18% IRR range.**
- The opening of domestic listed markets for Chinese real estate through the development of REITs will further accommodate core vehicles by introducing liquidity and direct capital, facilitating market transparency. Over the longer term, investor interest in China's logistics sector is likely to remain strong as the sector benefits from economic and demographic changes that extend across business cycles.

Developed markets opportunities

Addressing inefficacies in the logistics sector across developed markets

- Opportunities do not reside only in the developing markets. Beyond China, South Korea, Japan, Singapore and Australia, for example, are also on investors' radar. These markets have good infrastructure in place (e.g., established ports, wide expressways and roads) – an important criterion when it comes to logistics transportation – and are all ranked higher than China in the World Bank's 2018 Logistics Performance Index.

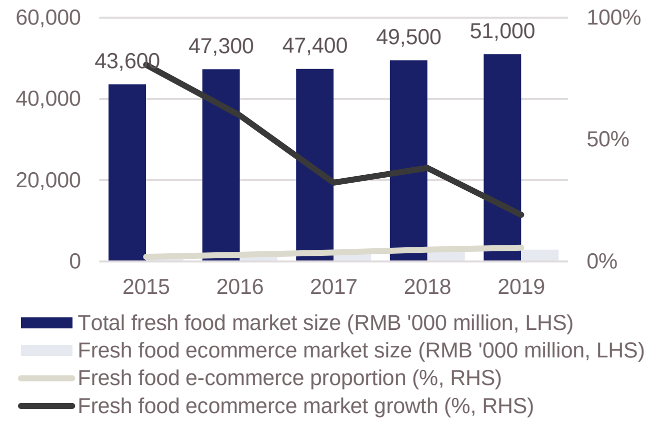
- A common theme across most of these markets as well as globally is the lack of modern logistics stock that is driving strong occupier upgrades and relocation demands for more modern, higher specification industrial space. For instance, modern logistics facilities account for only 4.9% and 11.0% of total stock in Japan and the US, respectively according to CBRE.
- **The future of supply chains requires a focus on greater efficiency driven by technology, including alternative fuels, autonomous vehicles, robotics/automation and predictive analytics.** Reducing transport costs, a key component in logistics cost, is crucial for occupiers. Other means of improving logistics efficiencies include investments in ramp-up/multi-storey logistics facilities or those with higher eave heights.
- **As retailers rebuild and expand their online presence, fulfilment and last-mile delivery capabilities will involve more space utilisation and development of industrial properties, which offers increased investment opportunities**. Moreover, while increased reshoring may shift the concentration risk to domestic markets, many firms will find it easier to monitor and rely on supply chains closer to home, hence underpinning further demand for modern logistics facilities.
- Robotic and other automated outfitting of warehouses, such as the ability to coordinate with delivery drones or smart stock-take systems, may be more common in the future for both the benefit of employee and customer safety, health considerations as well as fulfilment efficiencies.
- Maintaining higher stock levels in-country is set to generate more warehousing demand and will transform how companies store goods, plan infrastructure and serve local customers.
- Integration of smart technology, however, incurs higher capital expenditure. An upside to the high capital expenditures and operating expenses is that occupiers tend to stay in the same facility for longer periods of time, according to CBRE. This means that modern or niche logistics facilities can command higher rental premiums than traditional warehouses, and occupiers are more willing to commit to longer lease terms as the capital expenditure is amortised over a longer lease.

Alterative investment focus on forward-thinking niche logistics

Long-term trends and COVID-19 impact to hasten investments in modernisation and new types of logistics

- **The pandemic has likely also caused new attitudes towards medical supplies and foodstuff as key strategic commodities and requiring a certain level of stockpile**. This could further strengthen logistics facilities or, in particular**,** cold-storage facilities needed to store pharmaceutical supplies and perishable goods. Onshoring and an increase reliance on domestic goods should also boost occupier demand for food-processing facilities as well as vertical farms, according to CBRE.
- Despite the current economic downswing, incomes continue to grow across the region, with consumers becoming more selective regarding goods, products and services. Such products include fresh produce and medical supplies, which are proving to be a boon for the cold-storage logistics market.
- Taking the largest consumer market as a case study, China's fresh food e-commerce industry has been developing rapidly. According to Euromonitor and the Qianzhan Industry Research Institute, in 2019 the country's fresh food e-commerce market size was about RMB 288.8 billion, an increase of 19.1% y/y, and accounted for more than 5.6% of the total fresh food industry market in China. This has been growing consistently over the past five years (figure 7).

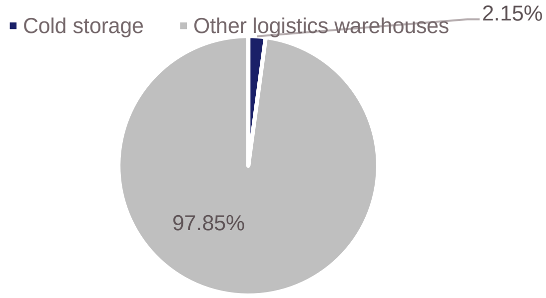
Figure 7: China's fresh food and e-commerce market size



Source: Cushman & Wakefield

- The cold-storage market is also highly underserved. According to Warehouse in Cloud (WIC), total cold-storage logistics warehouse stock in the country exceeded 6.65 million sq m in 2019, accounting for 2.15% of the total logistics warehouse market (figure 8). It is also worthwhile considering that vacancy rates in the tier 1 cities were around 5% or less as of 2019, according to Cushman & Wakefield, where household incomes are higher.

Figure 8: China's proportion of cold storage warehousing (2019)

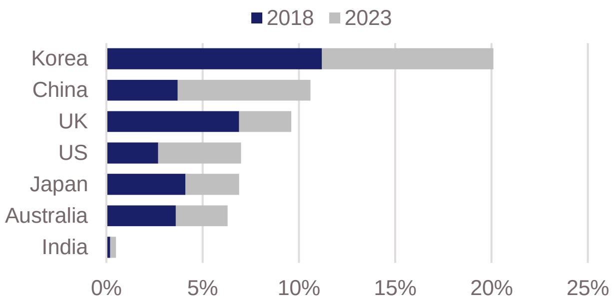


Sources: Cushman & Wakefield, Warehouse in Cloud

- **The limited availability of stock and low vacancies also mean that leasing risk is fairly modest and this also applies to other Asian markets. Since specific** infrastructure is needed for storage, tenants are usually willing to commit to long lease terms.** According to CBRE, the typical term for cold storage averages 10 to 25 years and includes a fixed rental escalation every year or CPI-linked rental increase. This is double the tenure of a typical warehouse lease, which usually lasts five years at most.

- Even before the COVID-19 outbreak, the cold-storage market was predicted to experience healthy growth. Of course, lockdowns have spurred even more of a surge in online shopping for fresh food items and home-delivered meals, with Forrester predicting stronger growth across the region (figure 9).

Figure 9: Online grocery sales proportion of total grocery sales



Sources: Forrester, CBRE Research

- **In the future, there will be even greater emphasis on food safety, security and convenience as consumers become more wary of the sourcing and distribution of their meat products and other food supplies. With cold-storage warehouse facilities being in a favourable position to assist in this alongside surging pharmaceutical usage, we will likely see a surge in construction or conversion of obsolete warehouses into modern cold-storage facilities.**
- Build-to-suit or forming partnerships with cold-storage developers and operators is the preferred investment channel to mitigate investment risk in this sector. Investors may also consider building a mixed-use cold-storage logistics facility (i.e., lower levels for cold storage and higher levels for normal warehousing purposes) to minimise leasing risks.

Conclusion: key investment themes and implications

The pandemic serves as a short-term economic disruptor but a catalyst for long-term transformation

- The extent of the effects of the ongoing coronavirus outbreak remain unclear, although the general consensus prediction is for global recession.
- **As the global economy emerges from the so-called Great Lockdown, it is important that long-term investors look past the immense disruption of today to consider how the aftermath of the COVID-19 crisis will transform the investments in their future portfolios.**
- **The growth in logistics in Asia is set to accelerate due to the following three key fundamentals:**
    - **Robust sustainable growth in e-commerce**
    - **Onshoring/diversification of supply chains**
    - **Secular trends towards technological integration and changing consumer lifestyles due to rising affluence**
- Investment strategies differ based on risk-return profile:
    - Buy-and-hold in land-constrained markets (core/core-plus). Examples: sale-and-leaseback of logistics assets by owners who need to secure liquidity/cashflow
    - Refurbishing and repurposing existing assets in land-constrained markets (value-add). Examples: conversion of obsolete warehouses into niche cold-storage facilities as part of national long-term strategic initiatives to future proof domestic supply chains of food and pharmaceutical goods
    - Development and lease-up (build-to-core) to access modern stock and higher yield in lesser land-constrained markets (opportunistic)
- Possible market entry strategies are:
    - Portfolio acquisition of a (technically homogenous) logistics portfolio (standalone strategy)
    - Build up a portfolio by selecting (technically homogenous) single assets in different markets for diversification
    - Acquire individual logistics assets for existing portfolios
- **In conclusion, we firmly believe the logistics sector offers attractive risk-adjusted returns supported by robust underlying secular trends that support rental income growth and capital value protection in the long term.**

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