SIXTH EDITION

IS IT TIME TO RECAST GLOBAL SUPPLY CHAINS?

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EXECUTIVE SUMMARY

- The pandemic has exposed the vulnerabilities in global supply chains and is challenging existing practices.
- A desire for more resilient and flexible supply chains has become a lasting legacy.
- The lessons learned from the pandemic are already generating substantial new demand for logistics facilities.
- E-commerce growth will further drive positive momentum for the logistics market.
- A reassessment of ideal inventory levels and diversification of supply chains is expected to generate additional logistics demand in Europe.
- Dependency on an ever-tightening labour market coupled with the need for business continuity will accelerate warehouse automation.

INTRODUCTION

THE PANDEMIC HAS EXPOSED POINTS OF WEAKNESS AND FRAGILITY IN GLOBAL SUPPLY CHAINS. HOWEVER, IT HAS BEEN STRIKING HOW THE LOGISTICS SECTOR HAS COME TO BE RELIED UPON AS AN ESSENTIAL SERVICE.

Whether delivering critical goods around the world or supporting businesses as they adapt their operations, the logistics sector has helped ensure the continuation of commerce and has provided a crucial service for society during this unique time.

As lockdown restrictions continue to impact across the world, it is worth reflecting on the future implications for supply chains. Many companies had already begun to reassess their approach to sourcing and distribution long before the pandemic, while others will see it as a necessity to re-evaluate operating models. In the wake of the still ongoing pandemic, we already see a desire for more resilience and flexibility.

We expect the pandemic will generate substantial new demand for logistics facilities across Europe. New sources of demand are being driven by i) the recasting of supply chains for increased e-fulfilment ii) increased inventory levels to assure resilience iii) advocacy of new sourcing practices and iv) more widespread adoption of technology. In this article, we ask ourselves what this part of the 'new normal' will look like and reflect on the growing demand for logistics real estate.

SURGE IN E-COMMERCE

THE CLOSURE OF NON-ESSENTIAL RETAIL STORES DUE TO THE PANDEMIC RESULTED IN A SHARP UPTICK IN ONLINE SALES AND WITH IT, AN INCREASE IN THE DEMAND FOR LOGISTICS SPACE.

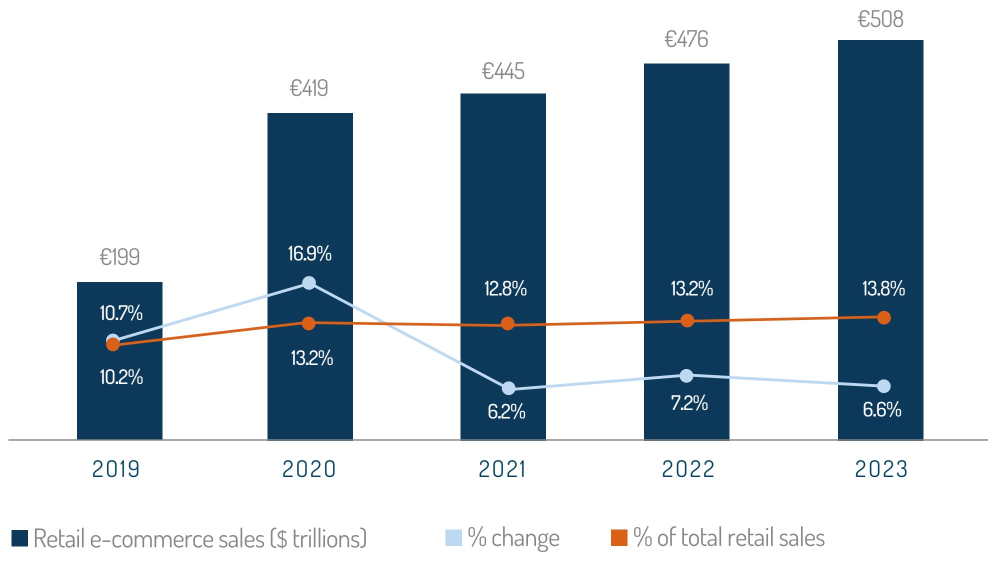
Following the first set of national lockdown measures in 2020, e-commerce sales across the EU increased by 30%, compared with the previous year, while total retail sales diminished by 17.9%.[1] Although not all this growth may endure, there has likely been a permanent upward shift in the trajectory of e-commerce growth, as new online adopters are now familiar with e-commerce and the convenience it provides and those that were already accustomed to shopping online are doing even more.

The UK, Europe's largest e-commerce market, saw the proportion of online sales reach a new record level in February 2021 reaching 36.1%, up from 35.2% in January 2021. This was far higher than the 20.0% in February 2020, reflecting the impact the pandemic has had on consumer behaviours for online retailing.[2]

Logistics is one of the few real estate sectors that has seen demand for space increase in the short term. Take-up across Europe in 2020 hit a record high of 25.7 million square meters, increasing 9% compared with the previous year.[3]

Some markets have proved particularly robust. UK leasing activity surpassed 35 million square feet, the highest total on record. E-commerce was a significant driver of demand, accounting for 42% of Grade A take-up in the UK last year.[4] E-commerce sales predictions have been reworked to reflect the surge in online activity. E-commerce sales across Western Europe were approximately $426 billion in 2019 and are projected to reach over $604 billion by 2023.[5]

Retail E-commerce Sales in Western Europe, 2019-2023



Source: eMarketer, May 2020. Conversion rate $1 = €0.84, Mar 2021

Using a conservative industry-standard approach of 1 million square feet of logistics space required for every $1 billion spent online, indicates a need for an additional 178 million square feet (16.5 million square meters) of space in Western Europe over the next three years. This compares with 10-year average annual take-up of 152 million square feet (14.1 million square meters) across Western Europe.[6] E-commerce growth will require substantial logistics development. Even if over time, efficiencies improve space utilisation rates, the robust forecast for online retail and competition, particularly for well-located assets, is likely to drive positive momentum for the logistics market.

Sources: [1] OECD [2] Office for National Statistics [3] CBRE [4] JLL [5] EMarketer [6] CBRE, includes: UK, France, Germany, Spain, Italy & the Netherlands

REASSESSMENT OF INVENTORY LEVELS

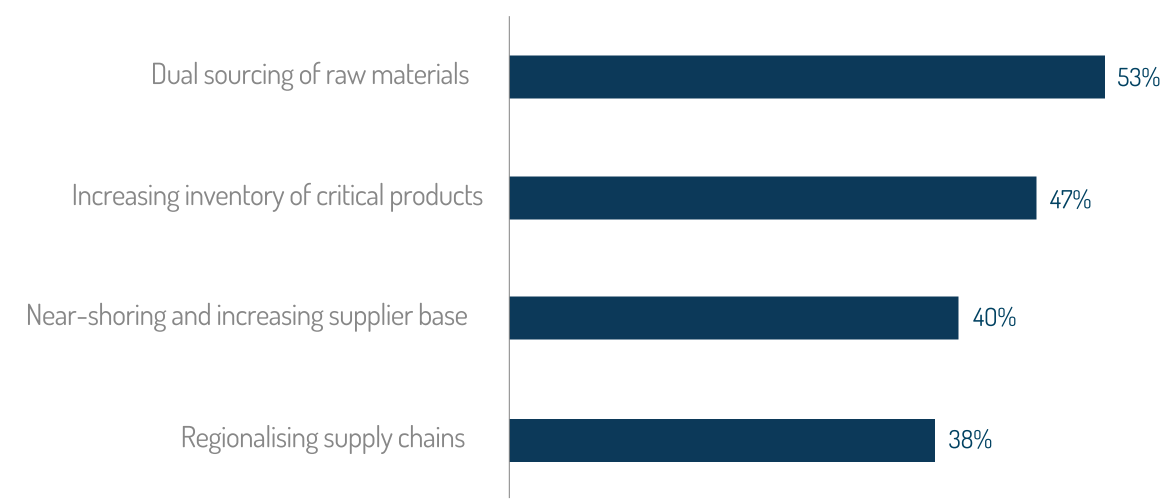
IN THE SHORT-TERM MANY BUSINESSES ARE INVESTING IN FAR HIGHER INVENTORY BUFFERS TO PROVIDE THEM WITH LONG-TERM SECURITY. IN A RECENT SURVEY OF BUSINESS LEADERS, 47% PLANNED TO INCREASE INVENTORY OF CRITICAL PRODUCTS TO BUILD SUPPLY CHAIN RESILIENCE.[7]

One of the most immediate impacts of the pandemic was the rapid depletion of inventory levels. Consumers panic bought large quantities of necessities in anticipation of quarantine measures. Immediately before the first lockdowns, sales of hand sanitizer in British supermarkets more than tripled, while liquid soap sales grew 7%.[8] In Germany, the Health Ministry even published a food survival list suggesting consumers keep a staple of supplies for 10 days on hand.

Meanwhile, automotive manufacturing plants were forced to halt or scale back production due to a lack of intermediate parts and materials. Health concerns and the anticipated drop-off in consumer demand also forced closures. The European Automobile Manufacturers Association reported that EU-wide production losses due to Covid-19 amounted to over 4 million vehicles in Europe, during 2020. That is equivalent to almost a quarter of total EU production in 2019.[9]

Disruption to production and bottlenecks in the logistics chain hampered automotive manufacturing in Europe. During the first half of 2020, shipping lines cancelled hundreds of trips as coronavirus lockdowns caused a sudden slowdown in global trade. Aftershocks are still being felt, with the average cost of container shipping from Shanghai to other parts of the world surging to new records in January.[10]

Planned actions to build resilience in supply chains among business leaders



Source: Mckinsey July 2020

Sources: [7] McKinsey, Resetting supply chains for the next normal [8] Kantar [9] European Automobile Manufacturers Association [10] Freightos Baltic Index, Financial Times

Many businesses are likely to build higher inventory levels and keep stock closer to consumption points and service locations to ensure resilience. Holding additional inventory is relatively easy to implement, however companies are expected to weigh the practicalities and costs. Carmakers, for example, may find it difficult to hold higher inventories due to the bulky nature of parts and costs involved. Likewise, in the fashion industry clothing has a limited shelf life, meaning that little resilience is gained by holding larger inventories.

Maintaining higher stock levels in country is expected to generate more logistics demand. However, this is likely to be concentrated in consumer-focused industries, especially those engaged in the production of necessities that held limited stocks before the pandemic. Elevated demand for cold-storage facilities are also expected to grow now that the roll-out of vaccine production and distribution is underway. Real estate company Knight Frank reported that it had fielded inquiries for excess stock for over 6 million square feet of short-term let warehouse space in the UK since the pandemic took hold. Although the majority of requirements have been absorbed into existing 3PL networks, this has meant that 3PLs have re-entered the market with new requirements.[11]

Source: [11] Knight Frank, Covid-19 June 2020

NEW SOURCING PRACTICES

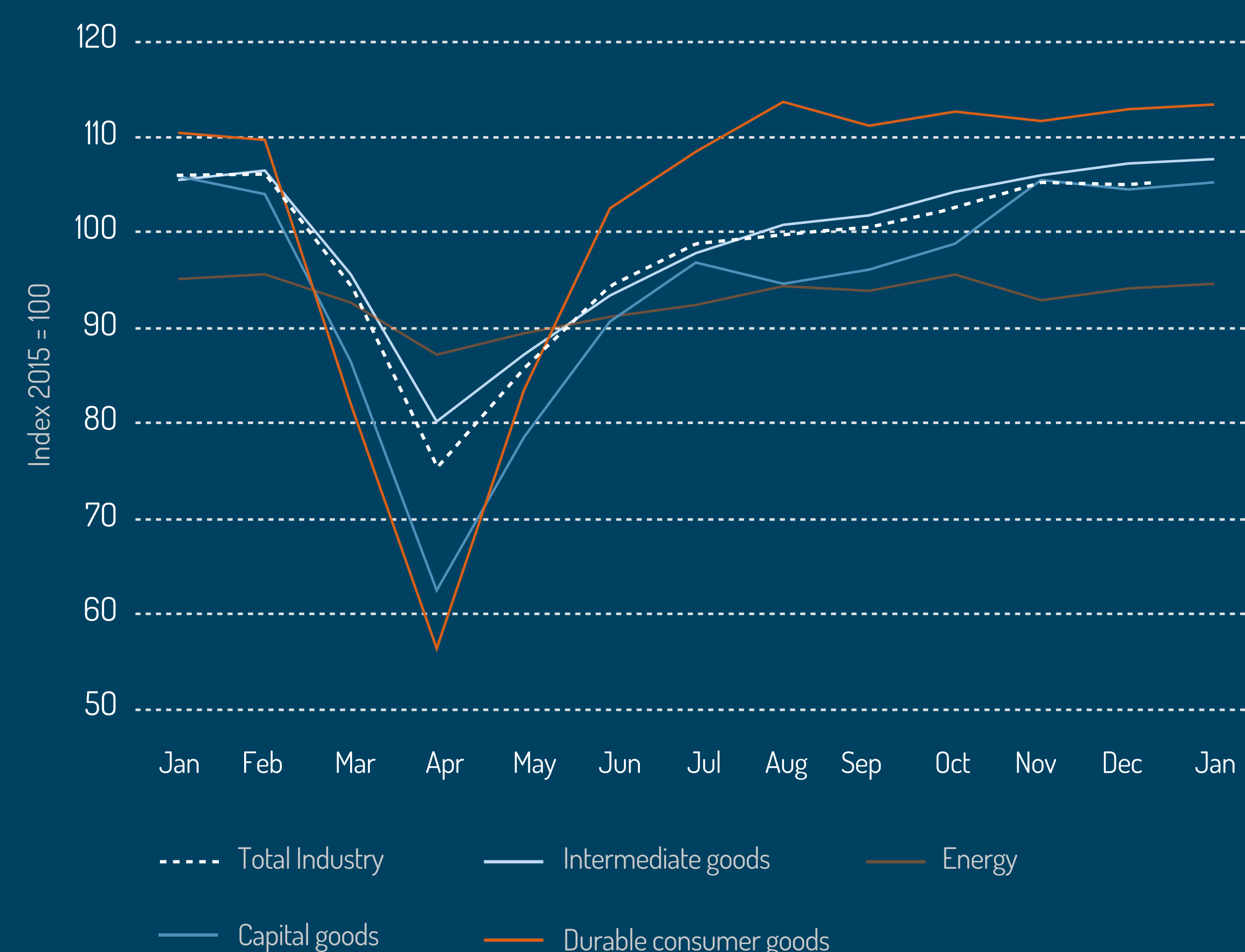
THE PANDEMIC HAS BROUGHT TO LIGHT THE RISK OF CLUSTERING SUPPLIERS IN SINGLE LOCATIONS. COMPANIES HAVE FELT THE PAIN OF FACTORY CLOSURES AND DISRUPTION WHERE OVERDEPENDENCE ON OTHER COUNTRIES REVEALED VULNERABILITIES.

The lessons learned from the pandemic could gradually encourage greater diversity of manufacturing locations, including on- and near-shoring. Whether it be a move back to Europe or diversification within Asia, the pandemic is expected to add impetus to plans to diversify supply chains.

Governments of major European economies have reflected on how to reorganise supply chains in the wake of disruption. French President Macron said the coronavirus pandemic had exposed the "flaws and fragility" of France's, and more broadly Europe's, over-reliance on global supply chains. The French President went further during a visit to French pharmaceutical manufacturer Sanofi in July 2020 observing that, everyone saw during this crisis that certain drugs were no longer manufactured in France or even in Europe. We must draw lessons from that...and the state is ready to invest in such reshoring projects.[12]

Even before the pandemic, several factors had the potential to accelerate the creation of localised supply chains within Europe. From global trade tensions to rising wage costs in parts of Asia, shifts in public policy, automation or sustainability concerns. However, evidence of significant on-shoring activity has been limited. This underlines the costs and complications involved in shifting sourcing or production, particularly for industries as complex as car manufacturing.

EU-27, development of industrial production, January 2020 to January 2021



Source: [12] Financial Times

Source: Eurostat

Advocacy of on- and near-shoring preceded the pandemic, but the outbreak has thrown these issues into sharper focus. Companies are beginning to value being closer to the market and end consumers and making sure they can have confidence in their distribution networks. UK-EU supply chains are also being tested by the new Brexit trade deal. Some businesses have suspended services saying that they would face higher costs, increased bureaucracy and delays to exports. The requirement for Covid-19 vaccinations is at least as responsible for any delays, but it will take time before a clearer picture emerges of Brexit's impact on trade.

The recent surge in shipping costs from Asia to Europe could add further impetus to on- and near-shoring. The cost of shipping goods from Asia to Europe more than quadrupled in January, hitting record highs due to a shortage of empty containers stemming from the pandemic.[13] While this will not lead to a wholescale reindustrialisation of Europe, some companies are likely to try to mitigate future risks by placing production closer to consumers and end-users. Over the long-term, this could drive increased demand for logistics space, particularly in low-cost production centres, such as Central and Eastern Europe. There may also be a trend towards placing additional warehousing capacity near demand centres to shorten the time to get goods to market.

Source: [13] Financial Times

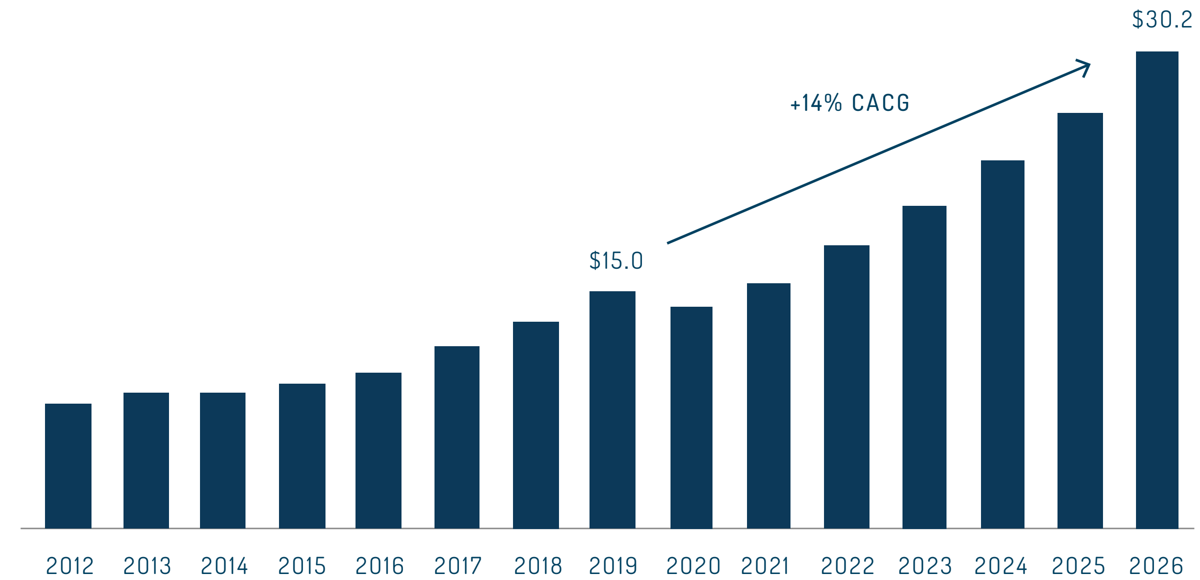
ADOPTION OF TECHNOLOGY

THE PANDEMIC HAS HEIGHTENED MANUFACTURERS' AND LOGISTICS PROVIDERS' CONCERNS AROUND LABOUR SUPPLY.

The possibility that people working in logistics facilities fall ill or call in sick for fear of infection has emerged as a new risk. This may mean that labour intensive processes are viewed as an area of potential vulnerability. As such, an acceleration toward greater reliance on robotics and automation may be a lasting consequence. The Warehouse Automation Market was valued at $15 billion in 2019 and is expected to be worth over $30 billion by 2026, growing at 14% (CAGR) during the forecast period.[14] Automation can help companies maintain operations in the event of a severe labour shortage and allows companies to more easily adhere to social distancing and hygiene practices. It can also help to drive efficiencies and scale capabilities which is especially important for labour intensive operations such as e-commerce.

Increased automation could open up new locations for logistics. If dependence on a large pool of labour is reduced, then alternative locations could become more attractive. The need to maintain distance to consumers will prevent remote locations benefitting from this trend. However, automation could help bridge the gap in locations where the cost or availability of labour has been prohibitive.

Global Warehouse Automation Market ($ billions)



Sources: Statista

Source: [14] Statista

CONCLUSION

THE PANDEMIC HAS EXPOSED THE VULNERABILITIES IN GLOBAL SUPPLY CHAINS AND IS CHALLENGING EXISTING PRACTICES. THE LESSONS LEARNED FROM THE PANDEMIC WILL GENERATE SUBSTANTIAL NEW DEMAND FOR LOGISTICS FACILITIES ACROSS EUROPE.

We expect businesses to re-assess manufacturing, transportation, and warehouse networks in the wake of these events. Short-and long-term it seems inevitable that supply chains will be different.

A desire for more resilient and flexible supply chains has become essential. The pandemic has highlighted the risks of over-reliance upon a single market while challenging the conventional wisdom of maintaining lean inventory. Dependency on an ever-tightening labour market coupled with the need for business continuity means that people-only-based solutions are unlikely to remain viable in the long-term. Ultimately, we are still quite early in understanding how this situation will unfold. But, if as expected, companies look to bolster supply chains, this should bode well for industrial real estate markets in Europe.

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Mountpark Logistics EU Sarl is a Luxembourg domiciled joint venture between Mountpark Finco and Affinius Capital Europe Holdco B.V.

The venture was established to undertake logistics development across Europe, with particular emphasis on the UK, Western and Central European markets.

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