



Obsolescence in Continental Europe's Logistics Property Sector

By Lisa Graham*

Europe's prime distribution warehouse markets are becoming increasingly cluttered with obsolescent properties, many of which are situated in strategic locations near ports, airports and motorway intersections. Structural trends combined with evolving logistics requirements and standards, changes in building codes, and softening market conditions have all accelerated the pace of obsolescence in many of Continental Europe's markets.

Continental Europe's distribution warehouse sector emerged as a viable property investment sector during the mid-1990s, following the creation of the European Union (EU) in 1992. Additionally, companies were then transitioning from owning to leasing their warehouse premises, with some of them also opting to outsource their logistics functions. In the wake of these structural trends, which have fueled demand for leased modern warehouse space during the past 15 years, a growing number of properties built prior to 1995 have become obsolete. These properties are easy to identify because they generally lack the requisite features of modern distribution facilities.

Moreover, in recent years, even the first generation of leased, modern warehouses (i.e., those built after 1995) has begun to experience functional obsolescence. In particular, those facilities built prior to 2002 generally fail to comply with the new building code that France adopted in 2002. Also, these older facilities are less conducive to the latest supply chain practices — i.e., they are smaller, have fewer dock doors, lower ceiling clearances, or unduly narrow truck-turning areas. In recent years, as property market conditions across Continental Europe have weakened, these first-generation facilities have had to compete against the newer, more up-to-date facilities for a shrinking pool of prospective tenants. Eventually, many of these older facilities will either be converted to alternative uses or knocked down, yet they are often located in modern

logistics zones and included in market inventory-stock counts. Consequently, in many markets, the reported vacancy levels will not reflect true competitive market conditions inasmuch as the corresponding stocks include those obsolescent properties.

This report examines the growing stock of obsolete first-generation leased properties in Continental Europe. Our focus is on mature property markets, not those that are emerging. Indeed, because the logistics property markets in Central Europe are younger and smaller, obsolescence is much less of a concern there. The big challenge is to identify which properties within the mature markets have become obsolete — an impossible task without detailed market-wide and building-specific data. Toward this end, we will focus on the logistics property markets in Lyon, France, as a proxy for conditions across Continental Europe. Over the past 20 years, DTZ has created a detailed database on the Lyon market, making this study possible.

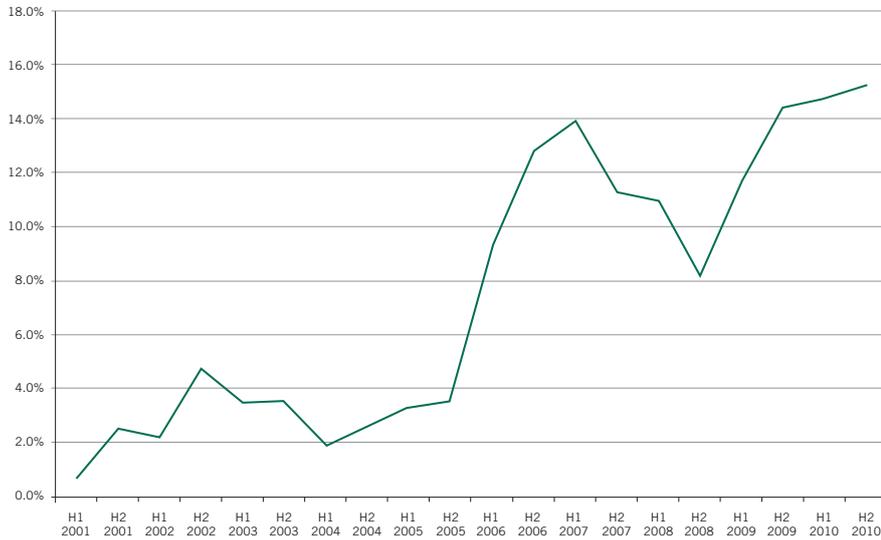
Structural Trends Contributing to Obsolescence

Few warehouses built in Continental Europe before 1995 are still in use today, and those that are have usually been retrofitted to alternative uses. Most of these pre-1995 warehouses were built to suit the needs of specific owner-occupants. These older facilities were ill-suited to the new competitive environment that materialized after the EU was created in 1992. With the disappearance of country borders, companies operating in Europe have sought to re-design their distribution networks. Formerly, those companies customarily operated one or more facilities in every country where they marketed their goods. Today, they rely on fewer but bigger so-called regional distribution centers, each one servicing a large geographic region that often cuts across country borders.

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Exhibit 1: Overall Vacancy Rate — Logistics Properties in Lyon, France



Sources: DTZ and ProLogis.

Modern distribution facilities are designed to facilitate the rapid throughput of goods from suppliers to final users. Hence, the new facilities tend to be bigger with higher ceilings, more dock doors, and more parking space for trailers waiting to be unloaded or picked up. France's prototypical modern distribution facility spans at least 10,000 square metres (sqm) of floorspace, with ceiling heights of at least 9 metres, load-bearing floors able to support at least 5 tons per sqm, one loading dock for every 1,000 sqm, and truck-turning areas of at least 35 metres. In response to ongoing supply chain reconfigurations to find further economies of scale, the size of warehouses continues to increase so that today the average modern warehouse is closer to 20,000 sqm.

Both location and accessibility contribute importantly to a property's competitive position. Location can refer to either a market or a submarket. Lyon's industrial submarkets have evolved over the past 40 years, even as the city itself has expanded necessitating changes in land uses and zoning. The older industrial submarkets provide proximity to the city, and the local authorities have expanded the zoning rules governing them to allow for a wide range of possible building uses. Indeed, many of the warehouses built prior to 1995 and situated in these submarkets have been converted to alternative uses. The newer submarkets are located along Lyon's periphery where land parcels are larger and can be developed to conform to modern distribution requirements.

Existing zoning rules permit only modern logistics use for properties that are constructed in these newer submarkets.

Lyon — Overbuilding Leads to Trouble

Lyon's logistics property markets are strategically located, accommodating both domestic and pan-European logistics companies. Lyon itself is France's second largest city with a population of 1.1 million people and is nestled in the Rhone-Alps region with a population of three million inhabitants. Benefitting from France's superb land transport infrastructure, Lyon is centrally located both in France and also along Western Europe's major North-South distribution corridor that connects Northern European ports and population centres

in The Netherlands and Belgium with those of Italy and Spain in Southern Europe. Lyon's population fuels a steady stream of demand for distribution warehouse space while its strategic central location has made it one of Europe's fastest growing logistics hubs.

Since 2001, the Lyon logistics property market has expanded more than threefold. According to DTZ, the current total stock of warehouse space in Lyon is 3.95 million sqm. It has attracted a significant amount of speculative construction especially during the boom years of 2004-06, with new deliveries totaling 740,000 sqm in those three years and accounting for almost one-fifth of the entire stock. As a result, Lyon's distribution warehouse market quickly became overheated as speculative construction outpaced demand. When market conditions weakened in 2007 and worsened further in 2008 and 2009 during the recession, the overheated Lyon market crashed. Today, Lyon is burdened with a vacancy rate of 15.4%, the highest in France. (See Exhibit 1.)

France's "New" 1510 Building Code

When France adopted its new so-called 1510 building code in 2002, one of the unintended effects was to hasten the obsolescence of the first generation of modern distribution facilities built prior to 2002. (See text box.) The new code required enhanced fire proofing with additional

Exhibit 2: Vacancy Rate for Logistics Properties in Lyon, France
Across Different Quality Classes of Floorspace



Sources: DTZ and ProLogis.

sprinklers, firewalls between units with a maximum size of 3,000 sqm in multitenant facilities, and a 20 metre-wide border between the exterior walls of the warehouse and the property line. Moreover, property owners were required to refurbish their pre-2002 facilities to meet these new standards whenever there was a change in occupancy. Otherwise, the authorities would deny an occupancy certificate for logistic use.

Initially, property owners readily adapted their pre-2002 modern warehouses to the new building code. The additional costs of site and building reconfigurations were then passed onto tenants who were eager to lease one of the limited stock of modern facilities in Lyon. And because the 1510 code only required compliance in the event of a change of tenancy, these reconstruction costs could be postponed and anticipated (or so it was thought).

However, once market conditions weakened and tenants became scarcer, owners of any pre-2002 facilities not yet in compliance with the 1510 building code found themselves in a difficult predicament when their pre-2002 tenants departed. With ample vacant space now available in the Lyon market, tenants no longer were willing to shoulder the costs of reconfiguring the pre-2002 facilities to bring them up to code. In fact, many tenants opted for space in the newer generation of modern warehouse space which was now available at lower rents. Over the past four years, an increasing number of vacated pre-2002 facilities

have remained vacant in Lyon's prime logistics submarkets with landlords unable to justify the cost of reconfiguration. Some experts are doubtful that these pre-2002 facilities will ever be upgraded, and if not, they will cease to be tenatable. Analysts at DTZ, we note, have relegated these noncompliant, pre-2002 facilities to the class C category, along with pre-1995 properties and other less attractive properties.

Flight to Quality When Quality is More Affordable

Logistics property owners faced additional regulatory problems in 2006. Contract rents that were indexed to the cost of construction ended up rising faster than market rents. This gap opened up just when a record number of speculative deliveries hit the mar-

ket. As Lyon's vacancy rate soared from 3.6% at year-end 2005 to 14% at mid-year 2007, many tenants in pre-2002 facilities exercised their break clauses in 2006 and moved from class B and C space into new class A premises at a lower rent.

While some of the vacant space situated in these class B and C facilities was later absorbed, the overall vacancy rate has remained between 8% and 16% following this event. A detailed analysis of vacancy data at a building level shows that the combination of the 1510 building code, high contract rents, overbuilding and poor market conditions has contributed to the obsolescence of a growing number of first generation modern warehouse facilities.

First Generation Modern Distribution Facilities

For France, this property classification encompasses those distribution facilities built for lease after 1995 but before the 1510 change in building code in 2002. In general, these properties are standard modern warehouses in terms of building height, depth, dock heights, number of doors and indoor lighting, though may not include environmental and technological features introduced since 2002. To comply with the 1510 code, these warehouses must be reconfigured when there is a change in tenancy in order to obtain a new occupancy certificate. DTZ categorizes this space as class C.

Exhibit 3: L'Isle d'Abeau Market Statistics, Q4-2010

	Class A	Class B	Class C	Total
Zone Ancienne				
Total Stock (sqm)	33,454	403,037	66,392	502,883
Vacant Space (sqm)	9,954	76,900	31,320	118,174
Vacancy Rate (%)	29.8%	19.1%	47.2%	23.5%
Zone Logistique				
Total Stock (sqm)	1,237,003	410,906	41,679	1,689,588
Vacant Space (sqm)	218,814	10,903	35,333	265,050
Vacancy Rate (%)	17.7%	2.7%	84.8%	15.7%
Total L'Isle d'Abeau				
Total Stock (sqm)	1,270,457	813,943	108,071	2,192,471
Vacant Space (sqm)	228,768	87,803	66,653	383,224
Vacancy Rate (%)	18.0%	10.8%	61.7%	17.5%

Sources: DTZ and ProLogis.

In recent years, the vacancy rates in Lyon for distribution facilities of different quality have sometimes moved in lockstep — but more often have not. For example, the vacancy rates of classes A, B, and C space all surged in 2006, for the reasons outlined above. (See Exhibit 2.) Subsequently, class A and B properties managed to recover some of the lost ground by 2008; but when leasing market conditions worsened in late 2008 and 2009, vacancy rates rose again — particularly for class B properties. Sub-prime properties tend to be harder-hit during cyclical downturns, because the attendant declines in rents trigger a “flight to quality” response among those tenants occupying class B and C properties.

The impact of the 2006 “flight-to-quality” on the vacancy rate for class C properties was even more dramatic. As tenants sought to upgrade their warehouse premises, they moved from class C to class A facilities, thus boosting the vacancy rate for the former and lowering it for the latter. Indeed, the vacancy rate for class C space surged to 34%, partly because the stock of class C space is so small relative to the stocks of classes A and B space.

During the next four years, however, the vacancy rate for class C properties (including non-compliant, pre-2002 facilities) has declined steadily as some of these pre-2002 properties were re-leased and occupied. Many of these class C properties are located in Lyon’s older submarkets where zoning permits a broader range of uses. This added flexibility has made it possible to find tenants for uses other than modern logistics, which explains why the vacancy rate for class C properties is lower at 10% in these

submarkets as compared to 18% in the exclusively modern logistics submarkets. Since most of these properties were built prior to 1995 and therefore would not be considered part of the competitive supply of modern distribution warehouses, they are functionally obsolete and, as such, should be eliminated from the estimated competitive base.

Analysis: Peeling the Onion

The DTZ analysts divide the Lyon market into five submarkets plus a catch-all category for everything else: L'Isle d'Abeau — Zone Ancienne, L'Isle d'Abeau — Zone Logistique, Rocade Est, Plaine de l'Ain, Logipark de la Cotiere, and Autres Lyon. With the Lyon market having evolved over time, each of these submarkets differs in terms of stock quality, age, zoning and accessibility.

We have limited our analysis to the two L'Isle d'Abeau submarkets, where the growth in Lyon’s logistics property sector has been concentrated since 1995. In contrast, with its total stock of 700,000 sqm, the Rocade Est submarket consists predominately of pre-1995 properties and is zoned for a broader range of uses than modern logistics. Meanwhile, Lyon’s other submarkets were developed more recently and therefore do not contain any first-generation modern distribution warehouses.

The combined total stock of modern distribution facilities in the two L'Isle d'Abeau submarkets amounted to 2.2 million sqm at year-end 2010, or slightly more than half of the reported total stock for Lyon. The year-end vacancy rate in the L'Isle d'Abeau submarkets was 17.5% — equal to 383,000 sqm, of which 57% was in class A buildings. (See Exhibit 3.) Year-end vacancy rates varied widely, however, among the different quality categories — from 61.7% for this submarket’s class C space to 10.8% for class B space.

The class C properties in the two L'Isle d'Abeau submarkets consist entirely of first-generation modern distribution facilities that have not been upgraded to comply with the 1510 code. Pre-1995 warehouses are totally absent from these two submarkets because, as noted above, they have been developed since then. Furthermore, upon close inspection, it turns out that 100% (i.e., all 66,653 sqm) of the class C vacant space situated in the L'Isle d'Abeau submarkets has been empty for over two years, whereas the average market vacancy period in Lyon is currently twelve months. (See Exhibit 4.)



Exhibit 4: Duration of Vacancy — L'Isle d'Abeau, Q4-2010 (Square Metres)

Quality	< 6 Months	6-12 Months	1-2 Years	> 2 Years	Total
Class A	80,402	31,732	97,553	19,081	228,768
Class B	---	13,495	36,316	37,992	87,803
Class C	---	---	---	66,653	66,653
Total	80,402	45,227	133,869	123,726	383,224

Source: DTZ and ProLogis.

modern distribution warehouses built since 1995. By removing obsolete class C properties from the stock and vacancy count, the submarket's vacancy rate decreases from 17.5% to 14.7%. In the case of L'Isle d'Abeau, the impact of obsolete first generation modern distribution properties on the market data is minimal because the stock of class C properties is small relative to the total competitive stock. However

For all intents and purposes, those 66,653 sqm of vacant class C space in L'Isle d'Abeau are functionally obsolescent. By law, if these warehouses do not comply with the new 1510 code, their owners cannot obtain new occupancy certificates. Moreover, the remaining 41,418 sqm of class C space that are currently occupied will also become obsolescent once their current tenants elect not to renew their current leases, because these buildings also fail to meet the new 1510 standards. Of course, if market conditions were to tighten substantially, the owners of these class C properties could invest in upgrading them to comply with the 1510 code. But most observers doubt that the Lyon logistics property markets will tighten any time soon and that, when they finally do so, these older buildings will likely be deemed unsuitable for contemporary supply chain practices.

Whether and to what extent any of the vacant class A or B facilities within L'Isle d'Abeau may also be obsolescent is an open question. All of these properties are in compliance with the 1510 code, including a few properties built before 2002 but reconfigured subsequently to conform to the new code. In principle, each and every one of these buildings should be potentially leasable as market conditions improve. Yet some of these buildings have been vacant for more than two years, which suggests that they may suffer from inherent defects in their configurations, accessibility, or locations — i.e., flaws that render them less desirable and thus less competitive in the marketplace. However, determining the leasing potential of all vacant Class A or B warehouses can only be done on a property-by-property basis, and such a detailed analysis lies outside the scope of this study.

Hence, by our reckoning, the total volume of obsolete first-generation space amounts to 110,000 sqm in L'Isle d'Abeau — or about 5% of DTZ's estimated stock of

in other markets in Europe, there is potentially a more significant impact of obsolescence when obsolete properties account for a larger portion of total stock counts.

Conclusion

The specific conditions that have led to the obsolescence of first-generation modern distribution facilities in Lyon may or may not be replicated in other markets in France or Europe. However, the Lyon example clearly demonstrates how flexibility is critical to a property's competitive position. As properties lose their adaptability whether through a change in building code, rent indexation, oversupply, weak market conditions or all four as in the example of Lyon, they risk dropping out of the stock of competitive supply and becoming functionally obsolescent.

As a rule, as market vacancy rates climb higher, so does the incidence of obsolescence among the less competitive (and thus more vulnerable) properties. Indeed, many European markets today are coping with overbuilding that worsened during the recession. Other markets are experiencing a shift in market boundaries making traditional locations no longer optimal. With the expansion of the EU and the attendant rapid growth of Continental Europe's logistics property sector, many older properties — even some built since 1995 — have failed to keep up with the new requirements and codes and have thus become functionally obsolescent. Additionally, Energy Performance Certificates (EPCs) have set a new standard of construction and building features making many of Europe's first generation modern distribution warehouses that lacked these elements less competitive.¹ The combination of oversupply and weak demand has provided tenants with the opportunity to choose. And it is this choice that distinguishes competitive properties from non-competitive properties.

¹ For details on Energy Performance Certificates, see the report by Simon Cox and Lisa Graham entitled, "Sustainability Measured: Gauging the Energy Efficiency of European Warehouses," *ProLogis Research Insight, Spring 2010*.



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