OBSOLETE, DEPRECIATION AND CONSEQUENCES FOR LOGISTICS INVESTMENT
EXECUTIVE SUMMARY

There are three primary types of obsolescence that may affect the value of a commercial property. They are: economic, functional and locational obsolescence, the latter possibly the most important one. However, asset management skills and knowledge of the territory can help a great deal with the aim to minimise the impact of depreciation.

The most respected literature on inter-sector comparisons shows that offices have witnessed more rental depreciation and higher levels of capex than logistics assets. This is likely to be the result of offices having a more volatile building cycle and office investors needing to inject more capex to stay competitive. Moreover, with rising land prices, the construction costs for sheds are relatively low, therefore the impact on capital values is smaller.

While age and local market conditions affect depreciation rates, building quality and asset management skills are at least equally important. As a result, acquiring buildings that show flexible features and comply with latest regulation should be conducive to better performances.
INTRODUCTION

Within the real estate sector, depreciation and obsolescence are related to asset quality. It follows that higher quality represents a barrier to depreciation and obsolescence. As a result, these factors affect property returns. Clearly, physical assets deteriorate and become obsolete as they age. However, the depreciation rate is not only a function of age but also of the quality of the asset.

WHAT IS OBSOLESCENCE

Over time a commercial property may acquire or lose value. Some assets are well-maintained, in a great location, and, as a result, they develop defensive features that contribute to maintain their value. However other property owners are not so fortunate. The value of their commercial real estate decreases due to some form of obsolescence.

Depreciation is a loss in the value of use of the asset. This consists of a decline in utility unrelated to usage or age. This matter is somewhat confusing as obsolete properties can still witness rising capital values in an upturn. Of course, this means that the obsolete asset is underperforming better-quality assets.

There are three primary types of obsolescence that may affect the value of a commercial property. They are:

a) Economic obsolescence: this type represents factors external to an asset that reduce the value of the asset itself, and is most often present in downturns or when external factors have caused a change in market demand, or mostly, supply. Within the logistics market, the cost opportunity for alternative uses, i.e. residential within increasingly urbanised areas, can be quite important. Moreover, an asset can become economically unviable when the asset cannot deliver an acceptable return any longer. In several cases, the investor can react to economic obsolescence via changing use of the asset.

b) Functional obsolescence: this occurs when the building loses utility, as a result of poor design, changing size specifications and, increasingly, varying technological requirements. Again, within the logistics sector, tenants need to be in phase with a rapidly-evolving supply chain. Typical examples include factors such as ceiling heights and dock doors counts. The rise of e-commerce has made this aspect even more important as modern facilities need to accommodate individual picking, packing, shipping and reverse logistics.

The best way for an investor to protect against changing specs and requirements is to focus on buildings that cater for generic occupiers. In this sense, e-retailing is generally not an exception to the rule. Generally, new properties will meet prevailing basic customer requirements. Aside general specifications, the kit that goes inside the buildings is what ultimately makes it suited to the specific needs of the occupier. As a result, we advise to avoid assets featuring complicated specs. Ultimately, the more flexible the features of the building, the less likely to depreciate the asset.

c) Locational obsolescence: this final type is related to tenants’ target locations. As a result of globalisation, current’s supply chains are increasingly trans-national. In general, consumer preferences are driving the choice of the location for modern warehouses. As a result, operators need to conciliate between the choice of centralised hubs, characterised by developed transport networks, and other facilities adjacent to or within major population centres, driven by trends like faster delivery times and retailer scale.

Changes and improvements in transport infrastructure can alter trade flows and, therefore, generate obsolescence. This is potentially the most dangerous type of obsolescence as the investor cannot simply relocate the asset. A poorly located warehouse will find it challenging to attract tenants over its economic life. On the other hand, locational obsolescence can reverse though. For example, a few disused 1970s edge-of-town industrial units are now perfect for last-mile delivery. As a result, a thorough monitoring of trade flows along with a perfect knowledge of future infrastructure plans is vital for the financial health of the asset.

As a general rule, warehouses that are well connected to ports, airports, intermodal hubs, major highways and other nodes are to be favoured, even in a context of changing technology. Moreover, highly densely populated areas support strong logistics activity. Indeed, it is estimated that around three-quarters of European leases are in urban conurbations with more than 1 million inhabitants.
MEASURING DEPRECIATION

Real estate investors recognise the importance of obsolescence and the effects of depreciation on performance. Most academic literature has focused on assessing the impact of depreciation on rental and capital values. Indeed, rental values and the rental growth outlook for quickly-depreciating assets are expected to decline, with subsequent effects on capital values and total returns. Depreciation may also result into higher capex.

Depreciation in the real use value of a property asset also varies according to sector. While literature on inter-sector comparisons is not vast, the Investment Property Forum (IPF) has defined sector-average rates for rental depreciation and capex using MSCI data on individual institutionally-owned assets in the UK1. One of the main results of the study is that, over a 20-year span, it is notable that offices have witnessed more rental depreciation and higher levels of capex than logistics assets2. This is likely to be the result of offices having a more volatile building cycle and office investors needing to inject more capex to stay competitive. Moreover, with rising land prices, the construction costs for sheds are relatively low, therefore the impact on capital values is smaller. The same study shows that there exist large disparities in rental depreciation across assets, which might mean that older assets are more likely to be affected by changes in tenant preferences, regulation and technology. Moreover, local market conditions have also an impact on depreciation.

However, age and market conditions are not sufficient to explain different performances. Equally important are building quality and asset management. For example, even buildings of the same vintage differ in terms of quality attributes and the amount of capex received.

In summary, the debate about obsolescence is complex and equally difficult is to develop a precise analysis about how much each factor contributes to asset depreciation. Nowadays, the increasing use of technology and the increasing attention to sustainability could easily translate to a further source of depreciation. As a result, we advise investors in logistics to focus on modern buildings that are a) sufficiently flexible in terms of spec so that they are easier to re-let and b) comply with the most recent regulatory standards.

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1- IPF: “Depreciation of Commercial Investment Property in the UK” (2011). The results are compatible with previous studies in the same country.
2- The MSCI definition also includes industrial assets in general.
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