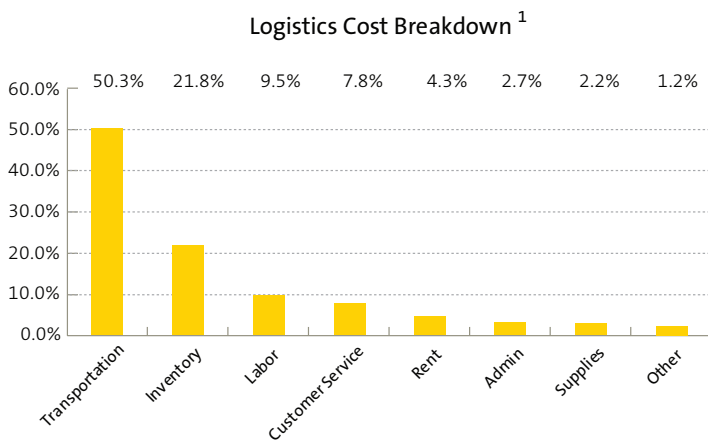


Preparing Portfolios for Global Logistics Challenges

Logistics real estate is a unique subset of industrial real estate with specific locational, physical and operational attributes. As supply chains continue to grow in length and complexity, companies seek to align their real estate portfolios with basic logistics principles. CoreNet Global and Grubb & Ellis recently joined to survey association members to better understand the perspectives of real estate managers and users of logistics real estate. The results identified both commonalities and disconnects between logistics industry experts and real estate managers, especially in addressing current economic challenges. This paper compares the survey responses to logistics best practices and calls upon logistics experts to weigh in on development of a logistics network capable of adapting to changes taking place in the global supply chain.



Logistics has become a key topic for any business involved in shipping and receiving goods. Today's distribution network has been driven by years of supply chain optimization in the environment of low labor costs overseas and inexpensive oil prices. The flow of manufactured goods through America's ports has affected the size and layout of industrial real estate, caused a resurgence in rail usage, and created new strategic planning methods in designing an optimal shipping network. This expanded supply chain has noticeably increased the ratio of transportation cost to the total cost of operations for logistics companies. Currently, transportation makes up 50% of total cost, followed by inventory (21.8%) and labor (9.5%).¹

With such a heavy emphasis on the movement of goods, it is not surprising that supply chains and logistics buildings have become the focus for manufacturers intent on squeezing cost savings from their operations.² Recent shocks to the system like last year's skyrocketing oil prices have drawn attention to the weaknesses and risks associated with some companies' distribution networks.

About Logistics Real Estate

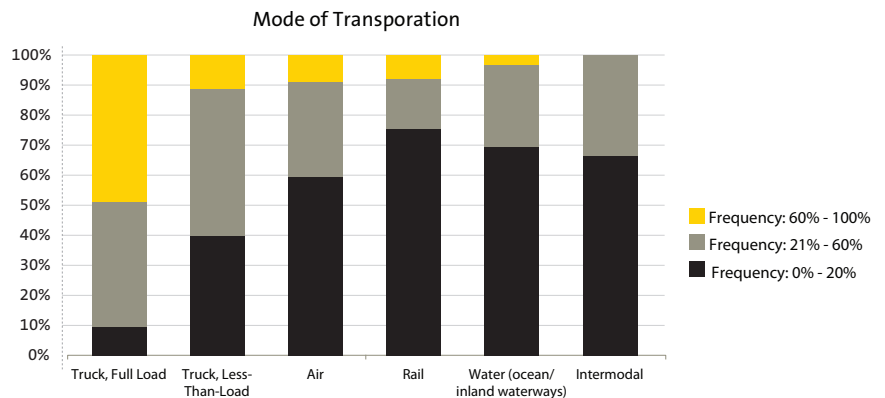
Supply chain growth has had a significant impact on industrial real estate, with the most recent decade producing the most impressive results. Movement toward mega-distribution centers with consolidated inventory, efficient layout and a reduced labor cost has dominated logistics real estate. According to the most recent Grubb & Ellis Logistics Market Trends report, logistics properties have absorbed 410 million square feet since 2000, 20% more than all other industrial properties types during the same period. 85% of logistics space absorbed was in Class A properties characterized by state-of-the-art functionality, minimum 28 foot ceilings, high truck door to building ratios, and truck turning radii designed to accommodate modern trailers. The recent recession has affected logistics real estate in ways similar to other sectors, namely falling rents and negative absorption. Nonetheless, the long-term outlook points to a softer landing than expected for other types of industrial real estate. Much of this can be derived from the view that logistics space is a productivity enhancer, and an integral part of supply chain strategies. The drive toward greater efficiency will continue to positively affect logistics real estate, providing a boost toward recovery.

Survey Respondents

CoreNet Global real estate managers represent an informative cross-section of industries. The focus of the survey was the logistics-driven subset of the organization involved with manufacturing, distribution, retail, and freight movement. Appropriately, the size and scope of the respondents represented those that would be greatly affected by a global recession or shifts in the underlying structure of logistics such as oil price. Almost all are categorized as organizations with over 1,000 employees. More than half indicated they have a global footprint and ship to customers worldwide.

Geographically, the location of respondents' distribution centers mirror the logistics market and were concentrated in well-connected cities near global ports, intermodal hubs and multiple interstate linkages. When asked to rank which distribution center locations have the greatest volume of goods shipped, the responses had a slightly eastern focus with Northern New Jersey and Chicago being the top two locations. Other top logistics inventory markets including L.A./Inland Empire, Dallas and Atlanta also handled large volumes. Popular shipping destinations were clustered along the East Coast and correspond to the location of major population centers.

Consistent with national statistics, the most frequent mode of transportation used is full-load truck, followed by less-than-load truck. Half of those that rely on full-load trucking, use this form of transportation almost exclusively. More specialized forms of transportation such as air, rail and water (ocean and inland waterway) represent a small subset of the respondents although all are used to some extent.



Response to Challenges

First faced with unprecedented transportation costs and then a global recession, CoreNet Global real estate managers deployed a variety of tactics to shore up their bottom line. It was also an opportunity to affirm basic business principles such as maintaining speed to market and customer service as a way to solidify relationships. However, the survey revealed that many did not go far enough to control for the influence of logistics pressures on company operations. Listed among the top challenges to their business were customer service and increased competition, a commodity element to any business. The most noteworthy stories of the past year, oil price volatility and the availability of corporate credit, ranked the lowest. One interpretation of this upside-down view is that business basics - serving the customer and competing effectively - continue to reign over all other challenges.

The low ranking of credit and oil price concerns may be interpreted in a number of ways. Lack of concern over availability of corporate credit could be the optimism of recent reports that the recession is nearing a close. Another interpretation is that credit concerns have been off the radar while businesses emphasize cost cutting. This paralysis may have focused attention on short term survival through maintenance of market share and customer service levels. Similarly, with expansion or reorganization efforts on hold, optimizing logistics networks

to hedge oil prices may not be feasible for capital constrained companies. Regardless of the reason, this view overlooks the impact of oil price volatility on business operations which could prove to be costly for a company that does not fully consider its effect on the network footprint.

How did CoreNet Global members respond to these challenges? The majority of respondents first focused on improving operations at existing facilities, including facility design, workflow management, and inventory management (such as the adoption of RFID technology). An extension of this in-house, cost-reduction focus was the implementation of sustainability techniques. The high scoring of this category points to a greater understanding of the cost saving benefits of sustainability, a departure from the purely PR-related benefits of “green” seen merely a few years ago.

In line with current unemployment figures, the next most commonly selected cost reduction method was workforce reduction, with 20% of respondents having already completed layoffs. Another 50% were currently undergoing jobs cuts on both a wide and limited basis, bringing the total number of those reporting some type of workforce reduction to 70%.

An equally cited cost saving technique was the reduction of distribution facilities. The least popular option was an increase in the number of distribution facilities. From a real estate management perspective, severe cost pressures have demanded the reduction of real estate. However, when considering the total cost structure faced by a logistics company, real estate-specific costs such as rent, inventory and labor, are collectively less than transportation costs. Logistics experts during this period have taken a different approach to their real estate networks. Instead of just reducing the number of facilities to service the distribution network, logisticians have reorganized their footprint in a way to minimize transportation cost. In some cases this has meant the *addition* of distribution centers.

On the surface this approach may seem illogical, but companies involved in logistics have recognized the impact of higher fuel costs on the bottom line. The fuel price shock in 2008 is destined to become a long-term reality according to some logistics experts. Jeff Rubin, author of “Why Your World Is About to Get a Whole Lot Smaller”, predicts the post-recession world will drive up the demand for oil globally.³ With a limited global supply of oil and emerging economies in China and India all vying for their shares, basic economic principles point to higher prices in the long run. Injecting higher oil prices into today’s extensive supply chains will result in a massive emphasis on cost containment. Much of this emphasis will be on creating the most efficient distribution network, one that is designed to best confront rising transportation costs while maintaining existing service levels.

The reorganization has already begun to affect offshoring operations. Even prior to the global recession, rising wages overseas, government intervention and currency weakness eroded some of the benefit. Combined with long supply chains and vulnerability to transportation cost swings, these issues have affected corporate perspectives on overseas production. A recent survey of manufacturing executives found that an overwhelming majority (nearly 90%) of manufacturers are contemplating a change or have already changed their manufacturing and supply strategy.⁴ Whether this will result in a movement of manufacturing back to the United States or just a slowdown in the velocity of offshoring manufacturing operations remains to be seen.

Real Estate Factors in Location Decisions

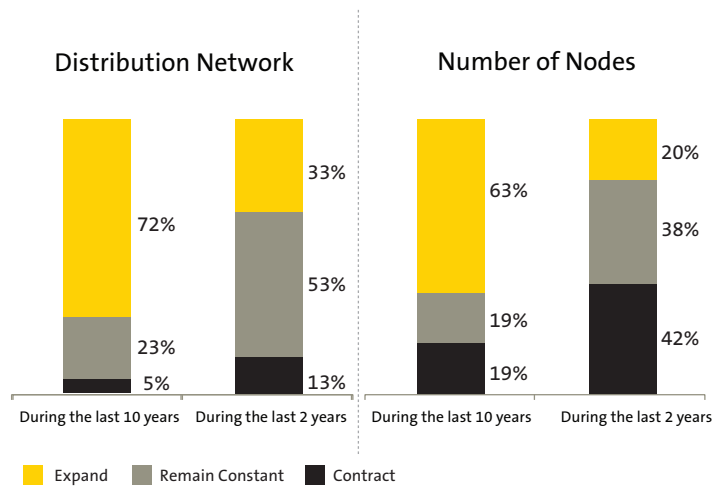
Compared to logisticians, real estate managers have a much larger emphasis on real estate factors when evaluating logistics and facility location decisions. Approximately 60% of survey respondents consider real estate factors simultaneously with other requirements- including facility location. This large response could simply be the result of real estate managers being inserted into the location planning process midstream. However, those that do actually engage in simultaneous logistics and real estate planning allow real estate to influence location and facility decisions early in the process. Logistics experts for leaders in the retail industry often take the opposite approach. With arguably some of the world’s most extensive logistics networks, their approach is to find the optimal point on the map – one that minimizes shipping distances between suppliers and retail centers. Only then will real estate factors such as availability or rental rates be taken into account. With such an enormous portion of cost coming from the supply chain, selecting a facility in the wrong location could generate costs many times the benefits created through the real estate.

Changes to Distribution Network Structure

Evaluating the geographic reach of distribution networks revealed that the vast majority of respondents experienced growth during the last decade, driven in part by a growing economy but also by a need to service the market more effectively. In the current recessionary period, few (13%) contracted the size of their network

while 53% continued to cover the same geography. A significant portion (33%) continued to grow the size of their network over the last two years despite economic pressures. The recession seems to have little, if any impact on the size of distribution networks.

When considering the number of nodes servicing their distribution network, the results present a different view – real estate has fluctuated with the economy. In the last 10 years, 63% of respondents increased the number of distribution nodes to supply the expanded network. The picture is vastly different during the last two years. 42% contracted their real estate, while another 38% remained constant. Shrinking the number of nodes illustrates that as business began to sour, real estate managers traced cost savings back to their real estate. The emphasis on doing more with less is a common tactic to battle falling profits. But when deploying this tactic within the modern supply chain, it may result in goods being shipped greater distances. While this provides a short-term strategy for battling costs it also exposes a company to greater risk from oil price volatility.



The optimal approach is to fit real estate within the framework of logistics. For some this may result in a greater number of small distribution centers closer to population centers. The benefit of this design is to allow for faster delivery, improved customer service and lower fuel and trucking costs. Of course, these benefits must exceed the cost of additional facilities, especially higher inventory cost. Others, such as Whirlpool, will work toward greater savings by adopting a policy of full truckloads whenever possible.⁵ Where full load trucking does not yield large enough savings, utilization of rail and intermodal for greater long-distance efficiency is a practical strategy especially for shipping large, heavy items. It is up to each company to evaluate how best to service their unique network of supplier and customer locations while limiting transportation costs to a reasonable percentage of the total cost structure.

Opportunities and Methods for More Efficient Operation

American manufacturers and distributors have successfully adapted to working within the global supply chain. This is apparent simply by assessing the sheer volume of goods moving across oceans and nations many times over to reach their final destination. But are they prepared to adapt to the global supply chain of the future?

Time is of the essence when considering a realignment of real estate within distribution networks. While the depressed real estate market has presented opportunities for companies interested in reorganizing their real estate portfolio, the primary goal goes beyond reducing rent cost. The objective is to assess networks holistically in light of current trends in logistics and understand how well a company is positioned to adapt to these trends. According to Tim Feemster, Grubb & Ellis’ Director of Global Logistics, the following four elements are proving to have the most impact in current network strategy:

- Shifting of ocean container import traffic coming from Asia to American ports along the Gulf of Mexico and East Coast in lieu of the West Coast and even the potential of nearshoring (moving overseas operations to low-cost locations in the Americas) down the road.
- Volatility of energy prices and its related effect on transportation costs that impact domestic distribution networks.
- The growth in importance of sustainability as it relates to our transportation methods.
- Taking advantage of market vacancy and the current recessionary economy to generate network cost reductions.

Working within this global shift while continuing to meet company metrics on real estate operations is the central challenge for real estate managers. Opportunities for cost reduction and efficiency within facilities are well documented. But can the same be said when looking at an entire portfolio?

The survey confirmed that the pressures faced by real estate managers mirror those faced by the logistics industry. However, the truly valuable lessons come out of exposing the different perspectives of survey respondents and

logistics experts on the influence of logistics pressures on company operations. Logistics experts emphasize the following points in logistics-driven real estate decisions:

- Transportation costs are significantly larger than real estate costs.
- By relying primarily on trucking and underutilizing more efficient forms of transportation, companies are leaving themselves open to the risk of huge transportation cost increases.
- The opinion of a growing number of economists is that higher oil prices will be a long-term reality. Based on this prediction, designing an efficient logistics network better insulates companies from rising fuel costs in the future.
- Real estate factors should be considered after a location has been chosen based on an optimized transportation network.
- Plan for the number of distribution nodes not only from a real estate cost point of view but from within the entire logistics framework. This may indicate a reduction, reorganization or even expansion of nodes.

Time will tell if the major changes expected in the global supply chain will come to fruition. Regardless, some companies are already beginning to place more emphasis on logistics factors ahead of any changes. The majority of survey respondents (69%) have either already made changes to their distribution network or plan to within the next 1-2 years. While this is encouraging, it is important to note that not all of these changes will be made with network optimization in mind.

A growing number of positive corporate role models exist for understanding how to make the correct changes to their distribution networks. As network planning techniques become more refined and widely used by large companies with extensive supply chains, these methods will be adopted by middle tier companies and become commonplace. Within the company, simply putting together a cross-functional team combining logistics and real estate, along with other key departments can drive optimal location decisions. The outcome of this best-in-class approach at a minimum creates an understanding of transportation's role in the total cost structure. At best, the outcome is a greater ability to adapt to changes in the global supply chain and enhance company service and profit stability.

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