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INDUSTRIAL AND LOGISTICS PROPERTY MARKET SNAPSHOT
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WHAT ARE THE IMMEDIATE CHALLENGES AND LONG-TERM IMPLICATIONS OF COVID-19 ON THE INDUSTRIAL AND LOGISTICS PROPERTY MARKET?

With extensive shutdowns across development sites and manufacturing plants, industrial output is likely to see a sharp drop in H1 2020. However, this crisis has shown just how important the logistics sector is to the everyday running of the country.

In this latest update we consider how occupiers, investors and developers have adapted to current market conditions and highlight some potential long-term implications for the industry as a result of this change in behaviour.

'Social distancing' has had a substantial impact on every facet of the industrial and logistics market:

- **All supermarkets have experienced a sustained surge in demand** for food and household goods, consistently surpassing even pre-Christmas levels of demand. Supply chains are struggling to meet demand, especially for home delivery. This has led to some urgent requirements for short term warehouse space.
- Occupiers that manufacture or distribute other essential items are in urgent need of flexible extra space to keep up with the increase in demand. Faced with delays in the supply chain, many companies are forward planning to **bring logistics and production lines back to the UK.**
- **Some 'non-essential' retailers, such as some fashion brands, have shut online stores** because warehouses have been forced to close over staff safety concerns or absences. Those without online platforms have found store closures particularly challenging to cashflow, but even retailers with online-only platforms are reporting reduced sales as discretionary spending is squeezed by reduced consumer confidence.
- Other retailers, especially white goods and home & garden, are making every effort to capitalise on increased demand and keep online channels open. In some instances this has led to **additional short term storage requirements.**
- The industry has come together to collaborate in this crisis, and the NHS reportedly took an extra 14.25 million sq ft of industrial space in one week at the end of March. Clipper Logistics has been contracted by the NHS Supply Chain to provide services to establish a new supply chain for the delivery of personal protective equipment to NHS facilities.
- Developers on site now expect delays to the build process and some are rethinking future development plans, with **a general reluctance to speculatively develop for the rest of 2020.**

Some of the potential longer-term structural shifts to result from this crisis include a sustained switch to online retail for many consumers, and the deglobalisation of supply chains. We expect a renewed focus on supply chain resilience and warehouse automation.

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OCCUPIERS
SHORT TERM CHALLENGES

RETAILERS

Many internet retailers, convenience stores and all major UK supermarkets have large backlogs of orders **and companies have implemented contingency plans to manage demand**. This has led to urgent requirements for flexible or short-term space and, in some instances, former mothballed buildings and unused 'grey' space has been reoccupied. Such requirements are typically for an initial 6 month term with rolling monthly breaks from 3 months. These occupiers require buildings to be fully racked, lit and sprinklered and we have seen landlords with suitable secondhand space open to these short-term deals.

Other **homeware retailers are seeking simpler short term storage solution**s. One example is DFS, the furniture retailer, which has a 400,000 sq ft requirement for immediate occupation to store containerised stock.

Most retailers have introduced extra shifts so warehouse staffing can be phased. Many have implemented alternate picking stations to maintain social distancing. In general, supply chains have been impacted by lockdown-related staff shortages and 'last mile' distribution channels are stretched beyond capacity to meet demand. With traditional retail footfall and retail sales set to post a record low over the coming months, we expect online retail sales to make up a record proportion of overall spend.

Many food wholesalers to businesses are **now looking at home delivery to maintain cash flow** and offload surplus stock. Meanwhile delivery specialists Deliveroo and Uber Eats have offered special terms to restaurants to keep kitchens going, with an attendant strain on delivery capacity.

White goods, home entertainment and electronics retailers have seen a short term positive spike in demand for home deliveries as households adapt to the imposition of lockdown measures.

MANUFACTURERS

All major UK car plants have had to close and some occupational automotive supply chain deals have been put on hold. Related sectors such as the steel industry have significantly reduced production operations, with concerns over the long term viability of some plants.

Some retailers have reported difficulties sourcing packaging for certain goods, given supply chain disruption. Most packaging plants are now temporarily closed, so whilst retailers might have received the raw goods, the ability to get goods to consumers has been interrupted.

There have been hold-ups in the manufacturing supply chain of base components arriving by sea, but it is hoped that the resumption of activity in China will help ease bottlenecks.

Overall demand for electricity is down across the UK as reduced demand from manufacturing sites outweighs the increase in domestic usage. The National Grid is now relying on those power stations capable of offering flexibility in output. We have also seen reduced output from oil refineries given the dramatic fall in demand for jet and road fuels.

The production of concrete has not been as affected as other base products, as existing supplies of the raw materials have been sufficient and it is possible to reactivate mineral extraction fairly quickly. The production of bricks is likely to be slower to resume as the kilns have to be brought back into use more gradually.

Some **manufacturing occupiers are looking to manage cash flow** by deferring rental payments, with landlords seeking to remove break clauses or extending leases in return.

OCCUPIERS
MEDIUM TERM IMPACTS

RETAILERS

As part of supply chain resilience planning, occupiers are preparing for a second wave of Coronavirus spread in the autumn and have plans to stockpile goods in anticipation. For many occupiers, this has meant **dusting off and repurposing the no-deal Brexit planning** implemented late in 2019.

UK supply chains have adjusted quickly to meet the surge in demand for essential items. We expect **additional investment in third party logistics firms and internal fleet operations in the medium term** given difficulties in getting product to stores. There are also likely to be more government schemes to encourage workers into the supply chain, especially given the potential loss of European drivers post-Brexit.

In the medium term, greater supply chain resilience could drive requirements for more storage space. Some food retailers are already negotiating with UK suppliers and are more comfortable holding a greater inventory for just-in-time products that have traditionally relied on delivery from European hauliers.

We are likely to see more retailers look for **dedicated warehouse space for online retail** and expect an increase in demand for warehouse automation processes.

MANUFACTURERS

The current crisis underscores the need for manufacturers to have **visibility on how all parts of their supply chain function** and to identify which parts are most at-risk.

A renewed emphasis on short supply chains, local sourcing and 'reshoring' of operations could be **evident in the UK manufacturing sector once restrictions are lifted**. This is likely to be given government support, especially if the timing of any relaxation of social distancing rules dovetail with Brexit timetables.

The pharmaceuticals industry is an important driver of the UK economy, with both domestic and international businesses choosing the UK because of our world class universities and R&D community. This is a manufacturing sector which could be expected to grow over the medium term.

OCCUPIERS
LONG TERM STRUCTURAL CHANGE

Over the past decade, supply chains have evolved to meet the demands of customers, who increasingly expect cheaper goods on-demand. This has previously led companies to pursue offshoring and outsourcing strategies, and lean supply chains with minimal inventory to keep costs low and supply agile.

However, the current crisis has highlighted that **maintaining inventory is critical,** and we could see that **occupiers require more storage capacity and adopt shorter, more domestic supply chains** in the longer term. Some companies may also increase inventory of raw materials or finished products as a strategic buffer to protect against prolonged production disruptions.

Occupiers are likely to invest further in automation and technology over the longer term, not only in terms of the processing of orders within warehouses, but also in terms of innovative methods of distribution.

Parcel and home delivery networks are likely to be key beneficiaries of the crisis in the long term, given current capacity constraints and expected increase in online spend.

INVESTORS

There is no uniformity in the progress of deals that were underway at the end of Q1. Some are proceeding, largely without interruption; others are in a 'holding pattern', with terms agreed in principle but **both parties agreeing to wait for more market certainty**; and some have fallen through. Overall, the Q2 transaction volume is likely to be very low. There are opportunistic investors and overseas capital keen to access assets, sensing an opportunity, but as yet, there is limited distress on the sell-side.

Little positive rental growth is expected in the short term as occupiers struggle with their own businesses and cashflow positions. As such, we expect a flat rental growth profile for the majority of 2020, although headline rents on some short-term deals may actually show some growth, given the likely rental premium attached to occupier flexibility.

Incentives are likely to move out in 2020 as landlords offer more favourable terms for occupation, especially on longstanding available stock. Those secondary assets which may have been 'carried' with the rising market in recent years may suffer in the short term with investors now being more discerning, and we expect the buyer pool for riskier assets to shrink over the short term, unless prices fall.

Over the course of 2020 there is the prospect of occupiers, especially retailers, entering administration, which could return more industrial stock to the market. Some landlords have had requests for rent reductions, and landlords in markets with above-average supply are likely to acquiesce to demands for flexibility, seeking to **exchange rent holidays or relief for extending leases** or introducing inflation-linked rent reviews in order to maintain occupancy .

Prime assets are likely to be more resilient in the current environment, In the short term, riskier assets with weaker covenants, void potential or capital expenditure commitments will attract more bearish assumptions, which will negatively impact pricing. The severity of this will depend on the length of the lock down and magnitude of the disruption.

For many high street retailers, cashflow constraints mean additional finance will soon be needed. **Measures to mitigate loss of revenue through either implementing sale and leasebacks of warehouses**, suspending buyback programmes, delaying discretionary capital expenditure or even suspending dividends are likely. Topps Tiles and Next are two retailers who have recently instigated sale and leaseback programmes.

The debt markets have seen a short term contraction, with most high street lenders retrenching and refocusing on government business interruption loans. As loan-to-value ratios have reduced and margins increased, **debt-backed buyers will struggle to hit their anticipated returns** on new purchases unless pricing softens.

In the short term, **industrial and logistics remains arguably the most liquid property sector**, albeit with some pricing uncertainty. Over the medium and long term, we anticipate continued strong investor demand as the fundamentals in the sector remain robust in the face of change. There is a lot of committed global equity targeting the sector and it seems that the issue is 'when' investors will return to buying, rather than 'if' they will return.

DEVELOPERS

Covid-19-related **restrictions have created short-term delays in property construction projects** due to disruptions in supply chains and staff shortages. In addition, some developers could face potential issues linked to financing and capital liquidity should delays in construction become protracted.

Most **construction firms have had to extend build periods** as construction teams have been withdrawn from site ahead of practical completion in order to comply with government social distancing measures. In some instances, building control has been unable to gain site access to sign off schemes. Some infrastructure projects are still technically underway but are also struggling to progress around current working practices.

Such has been the immediacy of requirements for occupier space early in Q2 that **some speculative developments, whilst technically completed, have not had sufficient base level fit-out** for immediate occupation. Given the time it would take to install lighting and sprinklers, developers are considering including these enhanced fit-out specifications in future developments and amortising the additional cost in higher rents.

Those with undeveloped sites are considering alternative open storage requirements on a short-term basis to bridge gaps in revenue. And those with older obsolete buildings that were awaiting demolition are looking for potential re-use on a short term basis.

Whilst developers remain keen in principle to purchase new prime sites, **some bid dates have been pushed back 3 months** and in the absence of crisis-related discounts, terms are proving difficult to agree. UK institutional appetite for speculative funding has been put on hold, which in turn is likely to keep supply levels depressed until restrictions are lifted.

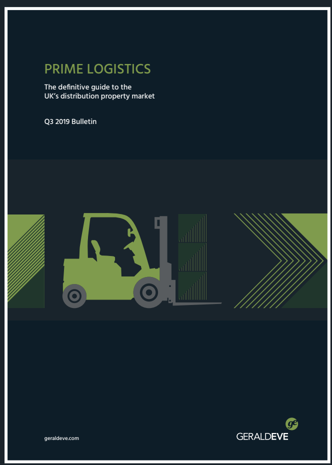
Industrial **sites, especially those with an 18-24-month lead-in period, could prove attractive** for those investors keen to enter the sector, allowing time for off-site and desk-based work to be done around planning and infrastructure. However, residual land prices are expected to be reflective of current market conditions and account will be taken of the potential longer voids and increased incentives as well as more conservative views around future rental growth.

Occupiers that had been heavily dependent on third party providers to their own current detriment may opt to take back control of this increasingly strategic part of the overall business. In other cases, **some retailers will strive to further prioritise their online fulfilment capability** to mitigate future risks of relying on in-store sales.

The ability to cope with and manage future shocks through greater visibility over the supply chain will gain greater prominence for occupiers. Technology is key to this, and **accelerated demand for automation and the use of warehouse robotics** and technology is expected. Whilst already an important consideration, access to a large power supply will be a crucial location factor for occupiers over the long-term.

Current occupier demand profiles suggest that it will be mid-box, edge of urban schemes and pre-let parcel delivery hubs which are likely to be the first type of schemes to commence development once lock down restrictions are lifted. Whilst there is finance for and interest in the large-scale speculative market, **investors are likely to remain concerned over general cash flow on larger projects.**

FURTHER INSIGHT



Investment Brief

What impacts are current events having on UK commercial property markets and how has this changed our forecasts for each sector?

Prime Logistics

How has the UK logistics market performed and how prepared is it for current events and any Brexit impacts?

Multi-Let

How are small industrial properties performing and how well insulated are they against the expected shock?

HOW CAN WE HELP?

Gerald Eve is well-established in the logistics property market and covers the full range of property services, from national occupational and investment agency through to lease consultancy and valuation. Please contact them directly for more information.

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