MULTI-LET INSIGHT SERIES

The definitive guide to the
UK's multi-let industrial property market

ISSUE 3 – RISK

Summer 2020

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INTRODUCTION

Multi-let is Gerald Eve's unique and market-leading syndicated study that provides detailed industry-reference insight into this rapidly changing commercial property segment.

The results are built from the bottom up, using individual tenancy information from 22 leading multi-let industrial institutional property investors. The information spans 11 years, covering over 30,000 individual assets with a sample size in 2019 of 131 million sq ft, valued at £18bn.

This report covers industrial units of over 500 sq ft with a maximum lease length of 30 years.

Units between 500 sq ft and 50,000 sq ft in size are collectively referred to as the multi-let dataset and comprise of:

Micro units
500-5,000 sq ft

Small box units
5,001-25,000 sq ft

Mid box units
25,001-50,000 sq ft

Units larger than 50,000 sq ft are also included in this edition for the first time as a point of comparison to multi-let.

This is Issue 3 of a series of five reports:

Issue 1
Occupiers

Issue 2
Income

Issue 3
Risk

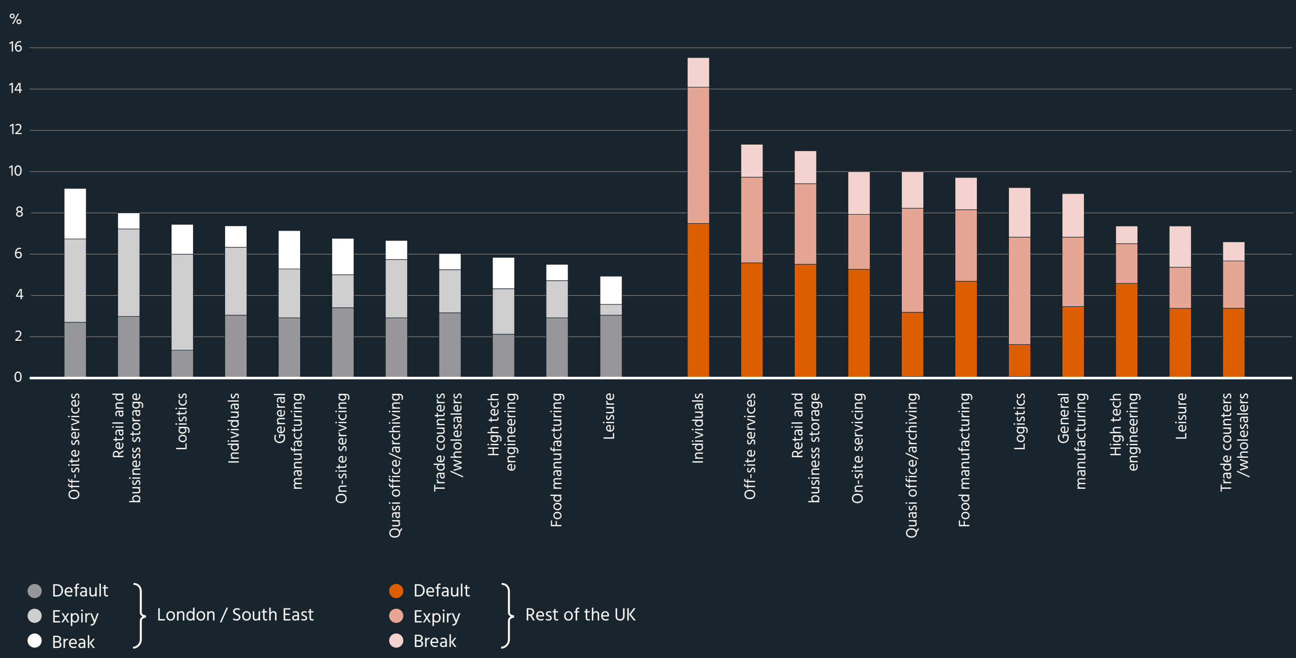
Issue 4
Investment

Issue 5
Outlook

CONTRIBUTORS

CASHFLOW INTERRUPTION RISK

Overall risk/proportion of market with cashflow interruption in a given year
Source: Gerald Eve



EXECUTIVE SUMMARY

The ultimate risk to the flow of multi-let income is a void unit with no tenant in occupation. Voids can arise from either scheduled lease events, such as a break in a tenancy or the end of a letting, or an event can be unscheduled in the form of tenant default.

The multi-let position is historically strong but has weakened in the last couple of years. The UK-wide proportion of multi-let tenants retained after lease expiry fell again in 2019 to 66% from a peak of 75% in 2017. Break clauses are included in around half of all new multi-let lettings and there has been an uptick in the likelihood a tenant will exercise a break to 20% from a low of 13% in 2015.

The UK multi-let default rate edged up to 4% in 2019 from a floor of 2.5% in 2016. The default rate broadly correlates with the UK company insolvency rate, which reflects how multi-let now captures a broad base of economic activity.

Units outside of the South East tend to have a higher chance of cashflow interruption from scheduled and unscheduled lease events than their London & South East counterparts. This is typically because the London & South East units are larger and have a longer income to spread break and expiry risk, plus individual tenants are larger on average and are individually less likely to default.

The risk of cashflow interruption from scheduled and unscheduled events is highest for micro units and gets progressively lower for larger units – mid box having the lowest risk. Expiries pose the greatest threat to cashflow for mid box. Breaks present a relatively small risk to cashflow across all sizes and geographies. Defaults account for the largest factor of cashflow interruption for the micro units, despite their relatively short income.

Vacant units in London & the South East have been re-let less quickly in recent years than their Rest of UK counterparts. This helps to explain the 2019 increase in void rate to 7.2%. The void rate fell in the Rest of the UK to 8.9% in 2019 and narrowed the gap.

London void rates have risen over the past three years – albeit from a low base – and the South East void rate increased for the first time in 2019. Despite strong ERV growth, London & South East micro units have higher and rising void rates than the bigger formats. The mid box void rate continued to fall in 2019, as it did for units of all sizes in the UK regions.

By business activity, the logistics default rate is significantly lower than for the other use types. The quasi-office default rate is also low, especially in the UK regions where a large proportion are occupied in this way by the public sector. In contrast, Individuals that are much more prevalent in the micro units outside of the South East have by far the highest default rate in multi-let.

Trade counters, high-tech engineers and food-related tenants have a relatively low propensity to vacate on expiry and exercise breaks – reflective of the importance of retaining a location for local custom, or for spreading the cost of fit out if a high tech engineer or food producer in the regions.

Leisure operators have the longest leases in multi-let and thus the overall risk to cashflow is typically one of the lowest because breaks and expiries are encountered less frequently. However, the impact from coronavirus will likely have a significant impact on scheduled events and the default rate. This will also be a factor for food producers that are proximate to hospitality either indirectly or part of a direct retail offer.

RETENTION AFTER LEASE EXPIRY

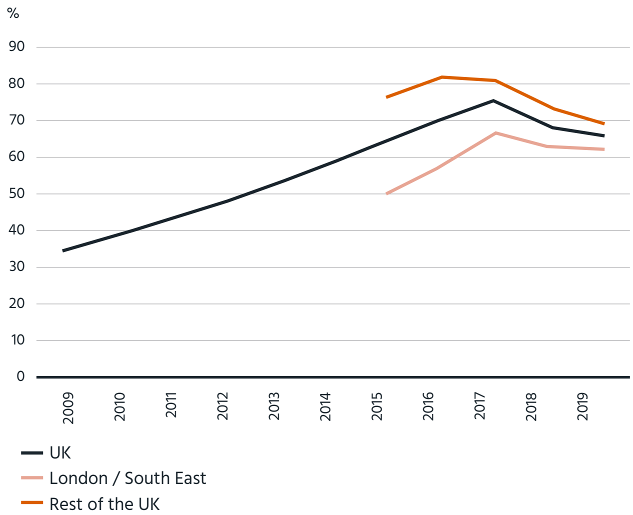
The ultimate risk to the flow of multi-let income described in Issue 2 is a void unit and no paying tenant is in occupation. Voids can arise from either scheduled lease events, such as a break in a tenancy or the end of a letting, or an event can be unscheduled in the form of tenant default.

The proportion of UK multi-let tenants retained after a lease expiry trended upwards from 2009 as the occupier market strengthened and gentrified and the multi-let void rate fell. The retention rate peaked at 75% in 2017 and edged downwards in 2018 and again in 2019 to 66%.

The London and South East retention rate has been lower than in the regions, which is likely to be a reflection of the longer leases in London & the South East described in Issue 2.

Proportion of tenants retained after lease expiry

Source: Gerald Eve

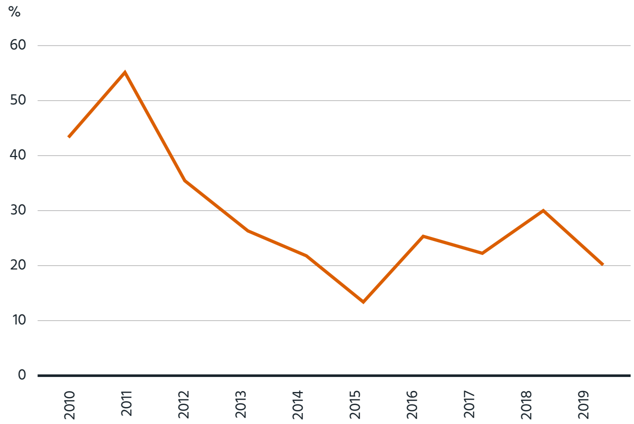


EXERCISED BREAKS

Break clauses are included in around half of all new multi-let lettings and there has been an uptick in the likelihood a tenant will exercise a break to 20% from a low of 13% in 2015. However, it remains historically low.

Multi-let propensity to exercise break

Source: Gerald Eve

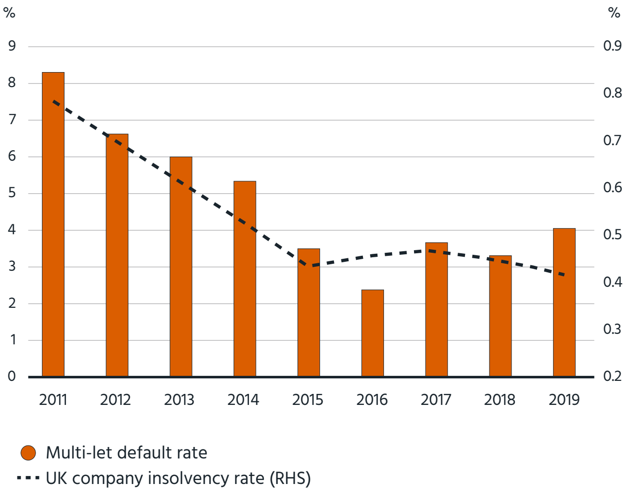


DEFAULT RATE BY REGION

The multi-let default rate has been on a similarly downward trend and reached a floor in 2016 at 2.5%. It has since crept up and was at 4% in 2019. This broadly correlates with the UK company insolvency rate, which reflects how multi-let now captures a broad base of economic activity in the UK.

Multi-let default rate vs company insolvency rate

Source: Gerald Eve



The default rate is generally lower in London & the South East than in the UK regions. Outside of London & the South East there is a greater number of the very smallest units and tenants that are the most vulnerable to default.

Multi-let default rate by major region

Source: Gerald Eve

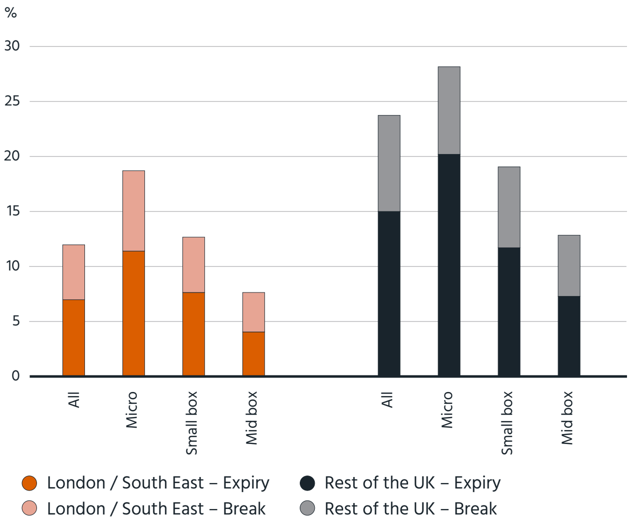
LEASE EVENTS BY SIZE OF UNIT

Looking in more detail, the chart below shows the average proportion of the market with a scheduled lease event over the past five years. These are higher when leases are shorter, so that typically affects the smallest micro units outside of the South East the most, with well over a quarter of the income at risk from a scheduled lease event in any given year. At the other end of the spectrum, the mid box units in London & the South East have the lowest proportion of income at risk from scheduled lease events, of just under 8%.

The chart below shows the proportion of units of different sizes in different locations with an unscheduled lease event (i.e. default) in any given year. This metric is not related to the length of income because it is, by definition, unscheduled. However, there is a similar trend with greater risk of default in the smaller units – as much as 7% in micro units in the regions outside of the South East. These smaller units have a higher proportion of relatively smaller and riskier tenants – for example, it was shown in Issue 1 that individuals occupy a relatively large proportion of micro units in the UK regions.

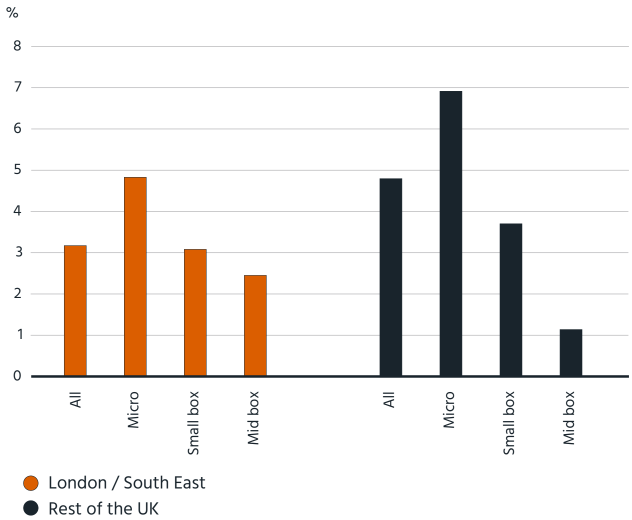
Proportion of market with a scheduled lease event in a given year

Source: Gerald Eve



Proportion of market with an unscheduled lease event in any given year

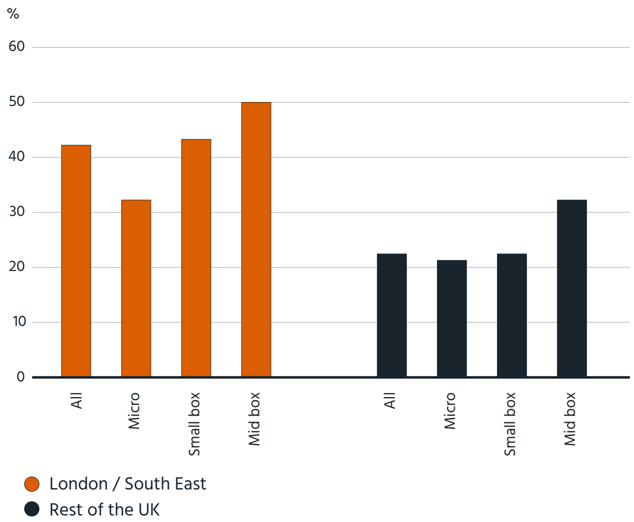
Source: Gerald Eve



The propensity of tenants to exercise a break or vacate after expiry is generally higher in the larger units with the longer income as the events come around less often.

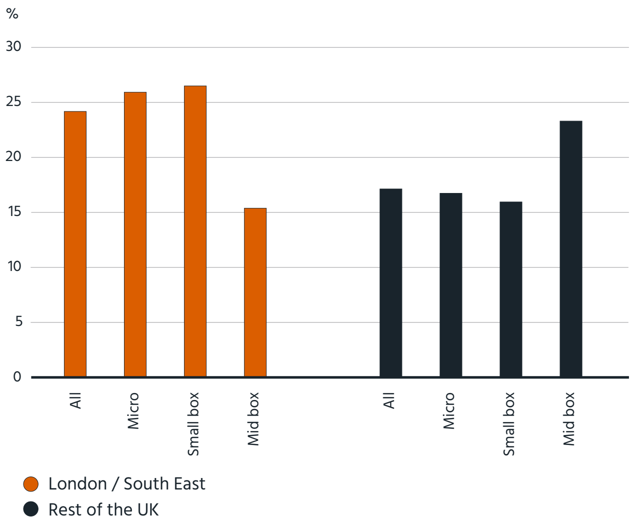
Proportion of tenants that vacate after expiry

Source: Gerald Eve



Proportion of tenants that exercise break

Source: Gerald Eve



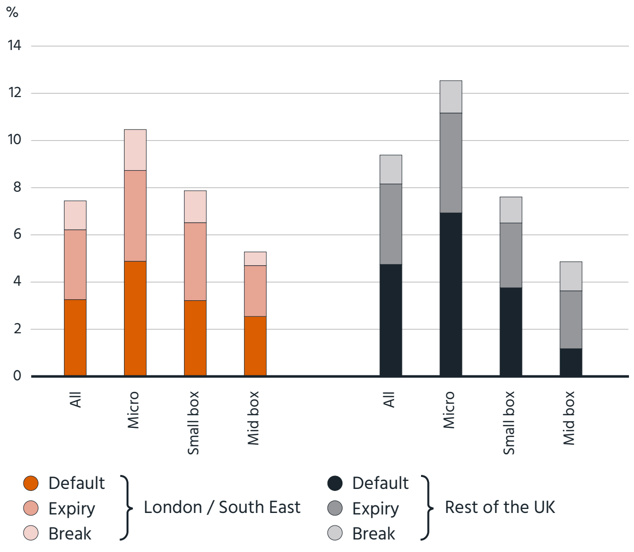
This generally follows for exercising breaks also though in London & the South East the bigger mid box tenants have been less likely to use their break.

With all the factors brought together into the chart opposite it can be said that:

- Rest of the UK units tend to have a higher chance of cashflow interruption from scheduled and unscheduled lease events than their London & South East counterparts
- The risk of cashflow interruption from scheduled and unscheduled events is highest for micro units and gets progressively lower for larger units – mid box having the lowest risk
- Expiries pose the greatest threat to cashflow for mid box
- Breaks present a relatively small risk to cashflow across all sizes and geographies
- Defaults account for the largest factor of cashflow interruption for the micro units, despite their relatively short income

Average proportion of cashflow interruption in a given year

Source: Gerald Eve

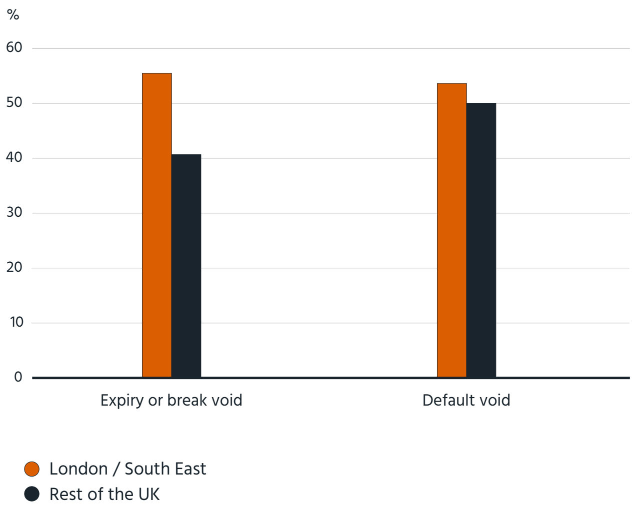


The second element to risk is, if through whatever means, a unit becomes void, how easily is that unit re-let? The multi-let study contains only annual data and so can show if a unit vacated in any given year remains vacant by the year-end.

The chart opposite shows that units in London & the South East are re-let less frequently than their Rest of the UK counterparts, particularly after a break or expiry. This may seem surprising, but it helps to explain the recent trend in void rates in the next section.

Vacating tenant leading to an end-year void, by lease event type

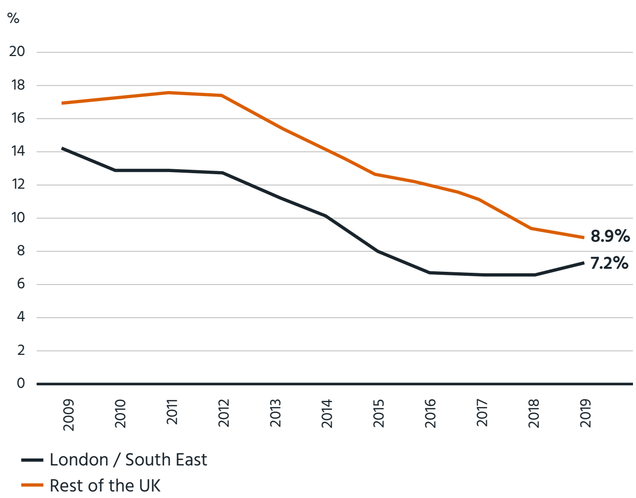
Source: Gerald Eve



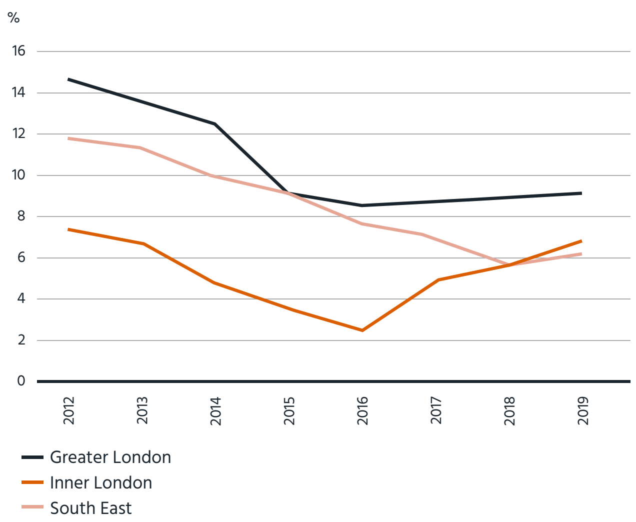
VOID RATES BY REGION

The void rate is lower in London & the South East than in the Rest of the UK, but in 2019 it increased for the first time on these records and narrowed the gap between the two.

Void rates by major region
Source: Gerald Eve



Void rate by London / South East sub-region
Source: Gerald Eve



Historically, void rates were relatively high in the recessionary aftermath of the Global Financial crisis but fell sharply over the subsequent economic recovery and multi-let occupier base rapid gentrification period. Since 2016 the London & South East void rate appeared to have broadly stabilised at around 6.5% while the regional void rate continued to trend downwards and narrow the gap.

Splitting London & the South East into its constituent parts shows some seemingly different dynamics at play.

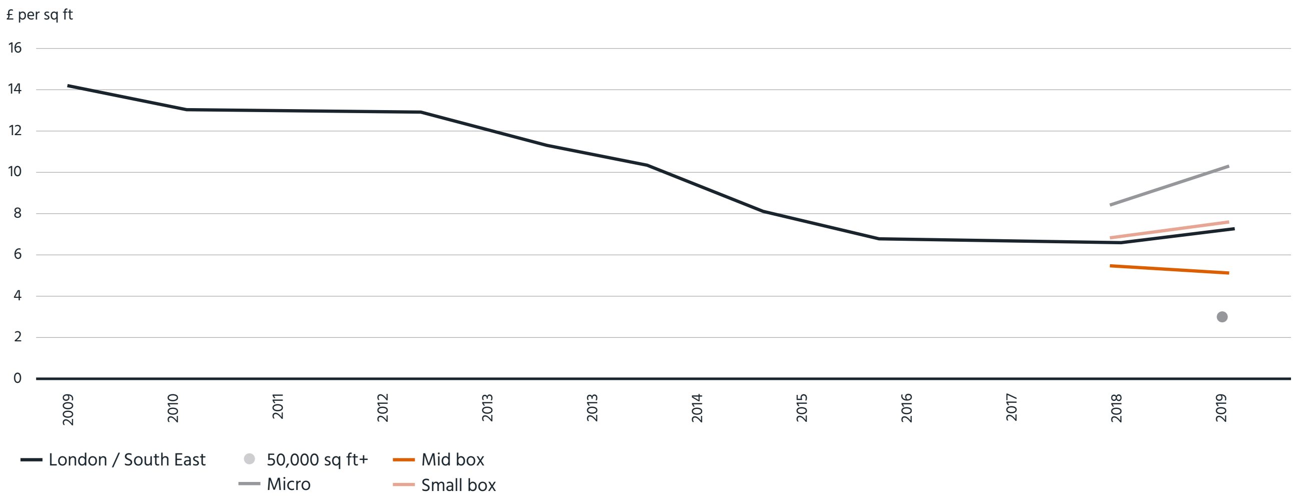
Inner London voids have risen over the past three years – albeit from a low base of only 2.5%. Greater London voids have been relatively higher but stable, at around 9%. Meanwhile South East void rates continued to trend downwards until 2019 when they increased for the first time and finally tipped the balance to push up the entire London & South East aggregate void rate.

VOID RATES BY SIZE OF UNIT

One clear driving factor is an increase in the void rate of the smallest, sub-5,000 sq ft micro units in London & the South East – micro units have higher and rising void rates while void rates for mid box units are lower and still fell in 2019.

London / South East void rates

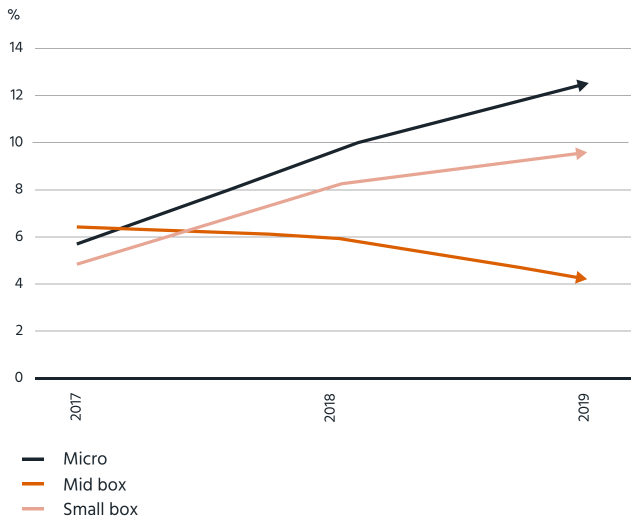
Source: Gerald Eve



This trend has been driven by London over recent years, but the void rates for micro units increased for all three sub-regions in 2018 and 2019.

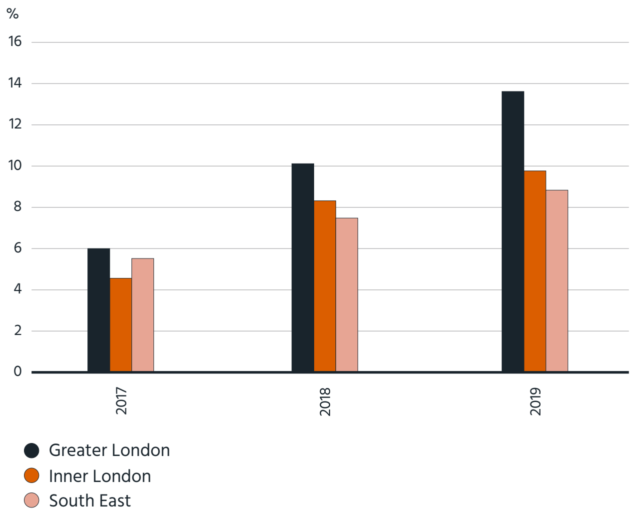
Void rates in London by unit size

Source: Gerald Eve



Micro unit void rate in London / South East

Source: Gerald Eve



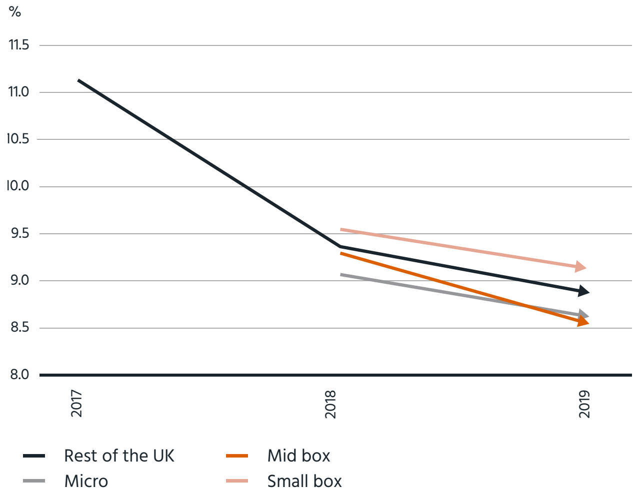
There isn't a clear data trend in recent years of any particular occupier types in London & the South East that have vacated space that has gone on to become void. However, it's worth noting that in 2019 a large share of general manufacturers vacated micro units in Inner London that remained void by the year-end. This suggests that it could potentially be the more obscure/cheaper units that have been affected that do not have so much of an impact on market rent valuation averages despite increasing the void rate.

Similarly there is not a clear data trend for the reasons these occupiers have vacated space and it was from a combination of scheduled and unscheduled lease events.

In the rest of the UK the trend is more straightforward and the overall void rate was still on a downward trend to 2019. Again, the data show strength in the mid box multi-let units. In the Rest of the UK the mid box void rate fell the most quickly in 2019 and was the lowest at 8.5%.

Rest of the UK void rates by unit size

Source: Gerald Eve



BREAKDOWN OF RISK BY BUSINESS ACTIVITY

Logistics operators unambiguously vacate a unit more readily after an expiry and have one of the highest propensities for exercising a break. However, the default rate is significantly lower than for the other use types. Consequently, the overall interruption to cashflow is around average but this risk can be anticipated to a much greater extent than the other business types.

The **quasi-office** occupiers are relatively unlikely to exercise a break but have a high propensity to vacate on expiry, particularly outside of the South East. The default rate is also low, especially in the UK regions, since a large proportion are occupied in this way by the public sector, such as councils, policing and the ambulance service.

Individuals on a multi-let lease are much more prevalent outside of the South East and they tend to occupy the micro units that are also much more common in this region. In contrast to Logistics and Quasi-office, a micro business in a micro unit shows up with by far the highest default rate in multi-let. Some of the shortest income here also adds to a relatively high occupier risk profile.

Trade counters have a relatively low propensity to vacate on expiry and exercise breaks, mainly because of the importance of retaining a location when local custom has been established. The default rate is relatively middling to poor, reflective of the tight margins in this segment and the vulnerabilities of the smaller operations that are not national chains. The overall risk is relatively low in the regions and around average in London & the South East.

The **high-tech engineers** also have a relatively low propensity both to exercise breaks and vacate after expiry – in this case likely due to the relative cost of fit out with specialist equipment. These occupiers also have an average to low default rate, putting them in the bottom third of overall risk.

The **food**-related occupiers similarly have a relatively low propensity both to exercise breaks and vacate after expiry – also likely due to the relative cost of fit out that may include ovens, stoves, cold storage and other equipment with high cleanliness standards. The default rate is low to average and thus the overall risk is relatively low, particularly in London & the South East where it is second only to Leisure. This is all the more positive given the high proportion of micro units food-related tenants occupy in London. However, this occupier type may face a similar coronavirus threat as with Leisure, below, where hospitality is part of the operation (i.e. a bar as part of a microbrewery).

Leisure operators tend to have the longest leases and some of the most front-loaded rent concessions in multi-let. So, while defaults in the regions outside of the South East are relatively high, the overall risk to cashflow from this tenant type is typically one of the lowest simply because of the length of income and reduced expiry rate. However, the impact from coronavirus is likely to negatively impact the risk profile quite dramatically for the next couple of years, as will be shown in the Outlook Issue 5.

On-site servicing occupiers exercise breaks relatively frequently, but those that remain to the end of the tenancy are much "stickier" and are retained more frequently than most other occupier types. The default rate is relatively high, especially for those in London & the South East, which reflects that many of these are small, independently owned businesses.

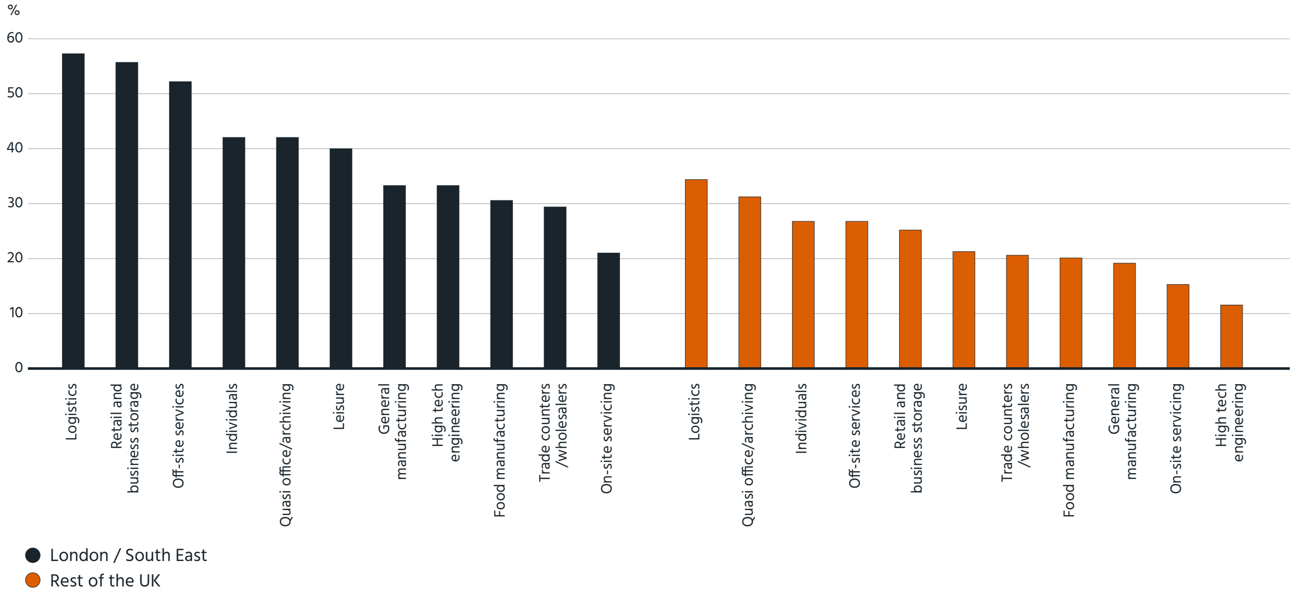
Off-site services have a relatively high propensity to exercise breaks and vacate on expiry and also have a notably higher default rate in the regions (where this business type is more often a construction firm) than in London & the South East (where this business type has a higher proportion of larger and more resilient vehicle and machine hire companies). The typical lease lengths are relatively short also, increasing the impact of breaks and expiries and the overall risk is one of the highest in multi-let.

In-house logistics has a declining footprint in multi-let in London & the South East as these types units switch to third party logistics use. The propensity to vacate after expiry is thus relatively high. In the regions there is a relatively larger proportion of smaller internet-based firms occupting multi-let and the default rate is consequently relatively high. For these different reasons the overall risk is relatively high in both geographies.

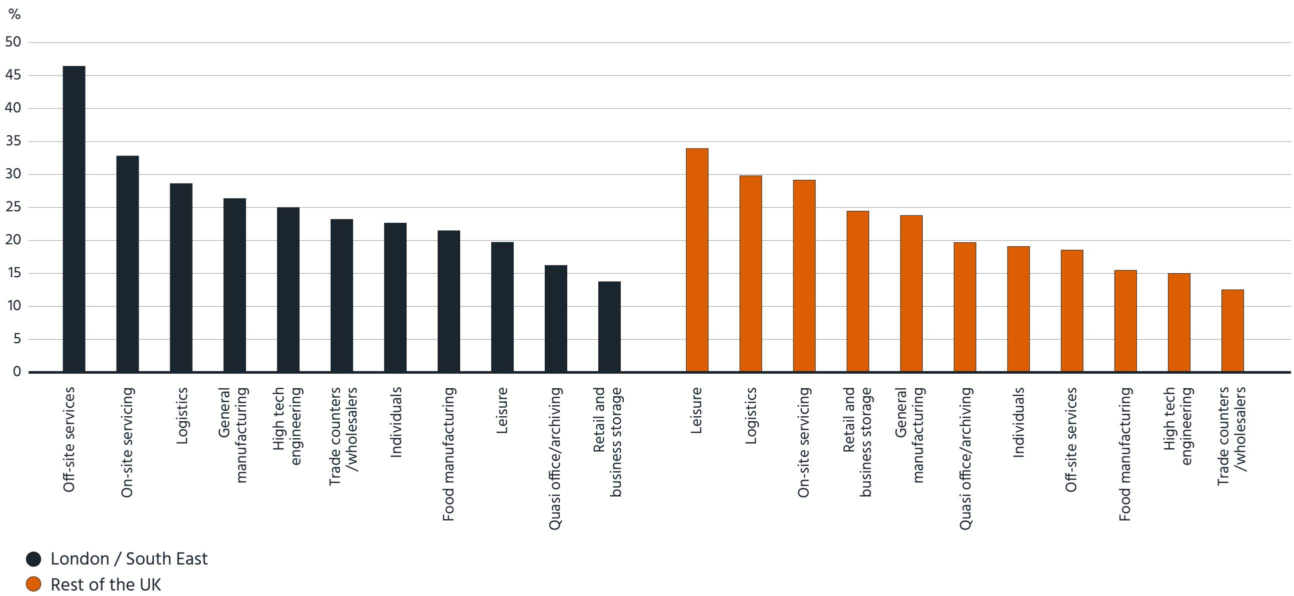
For a segment in decline, the **general manufacturers** reside in a surprisingly middle ground in terms of all metrics and are of an average relative overall risk.

BREAKS, EXPIRIES AND DEFAULTS

Proportion of tenants that vacate after expiry
Source: Gerald Eve

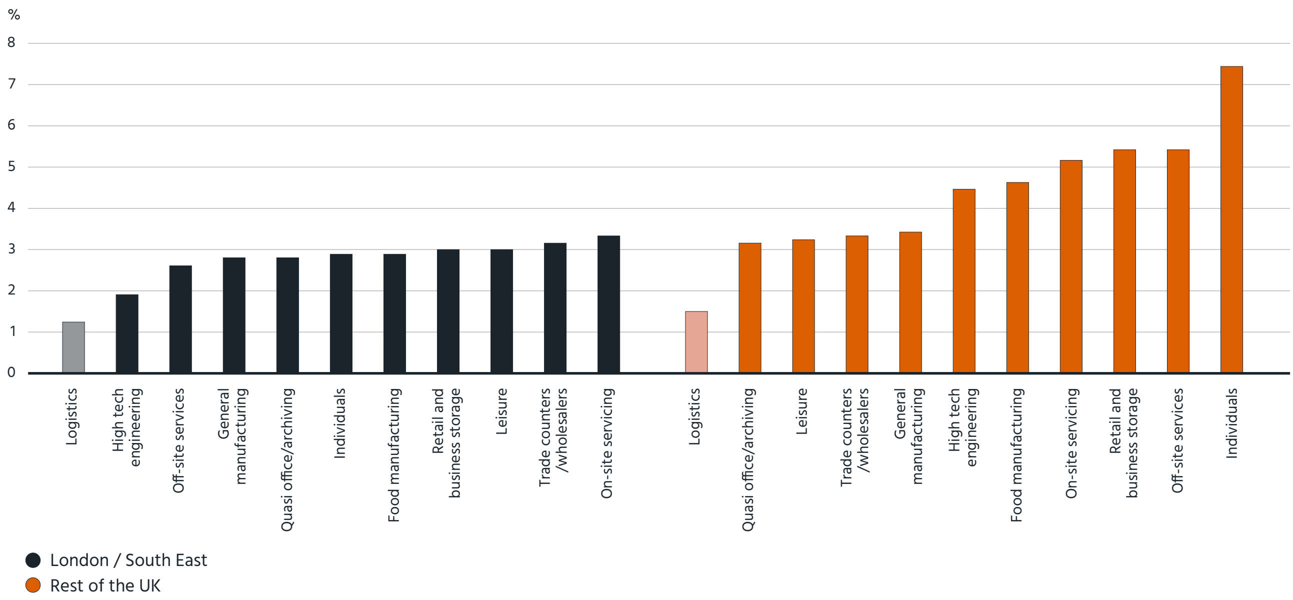


Proportion of tenants that exercise break
Source: Gerald Eve



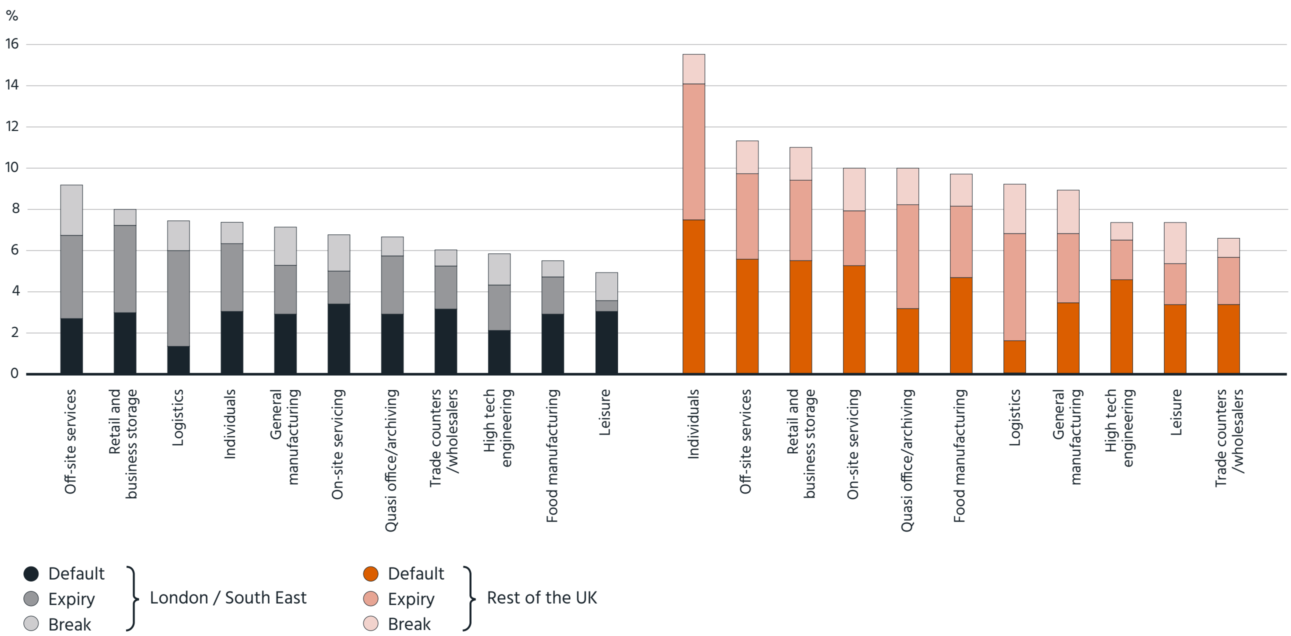
Average default rate by occupier type

Source: Gerald Eve



Overall risk/proportion of market with cashflow interruption in a given year

Source: Gerald Eve



GLOSSARY

STUDY DEFINITIONS

Multi-let industrial
For the purposes of this report, multi-let industrial covers industrial units between 500 and 50,000 sq ft in size on a lease up to 30 years in length located in the UK.

Multi-let industrial estate
An industrial estate usually under single ownership and comprised of different sized units let to multiple occupiers.

Multi-let industrial unit
An individual industrial unit situated in an industrial estate, usually let to one tenant.

Contributor
For the purposes of this report, reference to 'contributor' refers to the landlords or companies who have provided tenancy and valuation information which forms the basis of this study.

Regions
The location of each unit in the multi-let sample is assessed by individual postcode. This report aggregates up these individual postcodes into standard UK Government Office Regions, including Scotland and Wales. "Inner London" includes only the inner London postcodes (E, EC, N, NE, NW, SE, SW, W, WC).

OCCUPIERS

	Description	Examples
Trade counters/ wholesalers	Goods are stored and there is also some kind of on-site sales/retail function for visiting trade and/or the public.	Sellers of windows, doors, carpets, tiles, garden, tools, building supplies.
Retail & in-house logistics	Goods or equipment are stored but solely for the purpose of onward business (such as a retail store, sold remotely to an off-site location or for carrying out business operations). Non-public facing.	Internet retailers, department stores, utilities companies.
Logistics	Dedicated storage and distribution for a third party. Non-public facing.	Parcel and post/3PL
Food manufacturing	Production or processing of foodstuffs for humans or animals occurs on-site. Non-public facing.	Abattoirs, bakeries, breweries, cheese making, coffee roasting, dairies, meat/fish smoking/curing
General manufacturing	Production of relatively basic physical components or products occurs on-site. Non-public facing.	Fabricators, moulders. Includes waste/recycling.
High-tech engineering	Complex construction/ testing. Research and development. Non-public facing.	Incl. electronic, biomedical, nuclear, aerospace industries.
On-site servicing	Third party items are brought on-site by trade or the public for testing/repairing.	M.O.T./servicing, valeting, tyres and other vehicle/machine/ goods repair.
Off-site services	Services to business or residential offered off-site. Potentially a public facing element/small office on-site.	Shopfitters, joiners, builders, plumbers, electricians, scaffolders, machine/car hire.
Leisure	On-site offer of leisure goods and services to the public - typically fitness or play.	Gyms, sports training/ rehabilitation, soft play, trampoline warehouses.
Quasi office/ archiving	Ranges from storage of documents/data to full office or training centre functions.	Public sector bodies, data centres, designers, finance, solicitors, estate agents, employment agencies, call centres.
Individuals	Lease in the name of an individual and a company cannot be traced.	Potentially any of the above.

KEY TERMS

AWULT
Average Weighted Unexpired Lease Term. The product of currently contracted rental income between now (or, in this study case, the end of 2019) and the time the leases expire for any given tenant, summed across tenants, and then divided by the total annual income of the property or portfolio.

Capital value
The market value of an asset that could be reasonably expected to be paid in an open market.

Capital growth
The annual percentage increase in value of an asset.

Churn rate
Proportion of units where there is a change in occupancy between one year and the next (such as a unit let following vacancy, becoming vacant following a let, or a change of tenant). Measured as a % of OMRV.

Contracted rent
The annual rent stipulated in the lease contract. This might be above or below the OMRV if it is over or underrented.

Default rate
Leases in default are calculated by assessing whether a tenant under a contractual lease obligation is no longer in occupation. Expressed as a % of the OMRV total.

Econometrics
Mathematical and statistical analysis aimed to give empirical content to economic relationships. Seeks to exclude all other factors other than the issue at hand to try to isolate and quantify relationships.

ERV
Estimated rental value. A valuation estimate of what could be charged if the unit were let in the open market on the valuation date. This data has been provided by the contributing investors and funds for all units within the sample.

Incentives
This refers to the level of passing rent discount offered to occupiers as part of the lease agreement. Incentives in this report are measured as the differences between the contracted rent agreed and the actual passing rent received.

Income return
The annual compounded rate of net income receivable per year expressed as a percentage of the capital employed over the year.

MSCI
MSCI produce research-based indexes and analytics on the UK property market and are an independent benchmark of property investment market performance. MSCI data used in this report is the 2019 Annual Digest and reference to Standard Industrial refers to all industrials excluding distribution warehouse centres.

Overrented
A term used to describe when the contracted rent is above the open market rental value, which implies a negative reversion.

Passing rent
The annual rent actually paid, which may be more or less than the OMRV and equal to or less than the contracted rent.

Rack rented
Where the contracted rent (and potentially the passing rent) is equal to the OMRV. In a practical sense here, it is within 95%-105% of OMRV to rule out conversion and rounding errors, etc.

Rental growth
The annual percentage change in either the open market rental value, passing or contracted rent, as expressly defined.

Reversionary yield
A valuations-based yield estimate assuming a fully-let property with a rent equal to the ERV and capital value at the market rate at that point in time.

Time to first break
The time duration in months between the start date of a lease contract and the contract expiry or a break that a tenant can exercise, whichever is sooner.

Total return
The annual compounded rate of monthly capital appreciation, net of capital expenditure, plus monthly net income received expressed as a percentage of monthly capital employed.

Transacted yield
Average yields (weighted by capital value) recorded to have actually taken place in a transaction. This is in contrast to the valuations-based reversionary yield.

Underrented
A term used to describe when the contracted rent is below the open market rental value, which implies a positive reversion.

Void rate
The proportion of vacant floorspace, expressed as a percentage of the total.

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