MULTI-LET INSIGHT SERIES

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

ISSUE 4 – INVESTMENT

Summer 2020

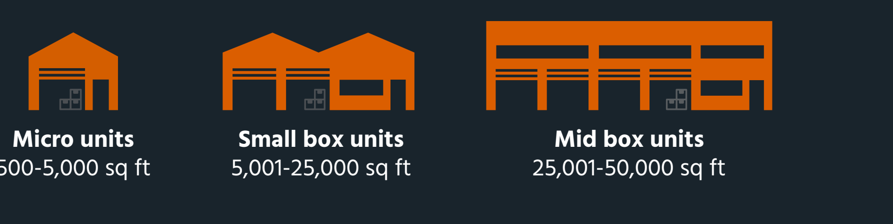
INTRODUCTION

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.

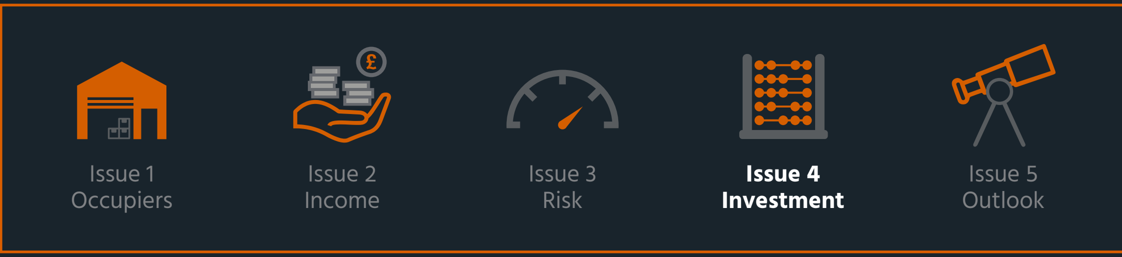
This report covers industrial units of over 500 sq ft with a maximum lease length of 30 years.

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



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 4 of a series of five reports:



CONTRIBUTORS

EXECUTIVE SUMMARY

Peak investment into UK multi-let was at an average £1.5bn per quarter that outsold distribution warehouses and occurred over the period from the second half of 2017 to the end of 2018, boosted by portfolio sales. However, in H1 2020 multi-let market deals dropped off very considerably, particularly in Q2 where recorded transactions were under £100m.

Multi-let has comfortably outperformed other direct property assets, equities and bonds for all time horizons over the past 10 years. The strongest returns occurred during 2014-15 and 2017-19 through yield impact and, uncharacteristically for industrial, strong rental growth, especially in the latter period in London & the South East.

The trend towards e-commerce, accelerated by the coronavirus lockdown, has helped Industrial "pick Retail's pocket". Since mid-2014, Retail property yields have undergone an upward structural transition, while since mid-2016 multi-let yields have had a corresponding downward one. By Q1 2020 the property segment hierarchy had been reversed with Multi-let established as the lowest yielding. Retail yields were in Q1 an estimated 107 basis points higher than they would be at this point in the cycle, while multi-let were 73 basis points lower. This has helped erode Retail capital values by 17% since 2014 while Multi-let increased by 66%.

Multi-let units have been in such investor demand that yields are effectively at parity with the lower risk, longer income and larger Distribution Warehouses. Nevertheless, the spread between multi-let yields and 10-year government bond yields has broadly been maintained despite the yield hardening and is still almost 500 basis points. This continues to underlie the investment attractiveness of the sector from an income perspective.

The micro and small box multi-let units in the regions are arguably priced more defensively than their prime counterparts in London. In the London markets, shorter income riskier small box and micro unit yields are not higher than mid box to compensate for the extra risk – as is the case in other parts of the UK. Historically the strong rental growth of the London micro units has been an offsetting factor and bid the yields down. For the future, this points to some potential pricing issues if compensating rental growth does not materialise.

London and Greater London have a narrow yield distribution across the sample, with almost all assets between 3.5% and 5%. The South East has a wider distribution and the Rest of the UK has a very flat, even spread that covers the full variable range of yields from 4% to 10%+.

The London & South East food producers, many of which are closely gathered in the Inner London postcodes, occupy the highest valued multi-let units, at an average 4.39% yield. Outside of the South East the highest quality units are occupied by logistics, retail storage and the expanding trade counter sector. Food operators outside of the South East perform a very different function to their South Eastern counterparts and occupy some of the cheapest multi-let space.

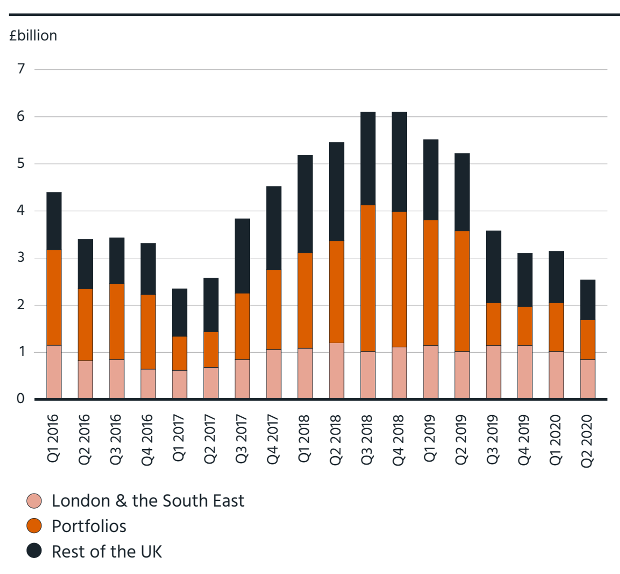
INVESTMENT VOLUMES

Peak investment into UK multi-let occurred over the period from the second half of 2017 to the end of 2018. In the rolling annual investment chart below it is clear that portfolio sales really boosted volumes during this period. Portfolio deals were much more moderate during 2019.

On a quarterly investment basis, multi-let outsold distribution warehouses over H2 2017 and 2018, with an average £1.5bn transacted each quarter. However, in 2020 the multi-let market deals dropped off very considerably. Q1 2020 includes the exceptional £500m Hansteen multi-let portfolio bought by Blackstone. Stripping out this one deal leaves a very low underlying transaction volume in Q1, which falls almost to nothing in Q2. Distribution warehouse investment has undoubtedly faltered but has held up much better.

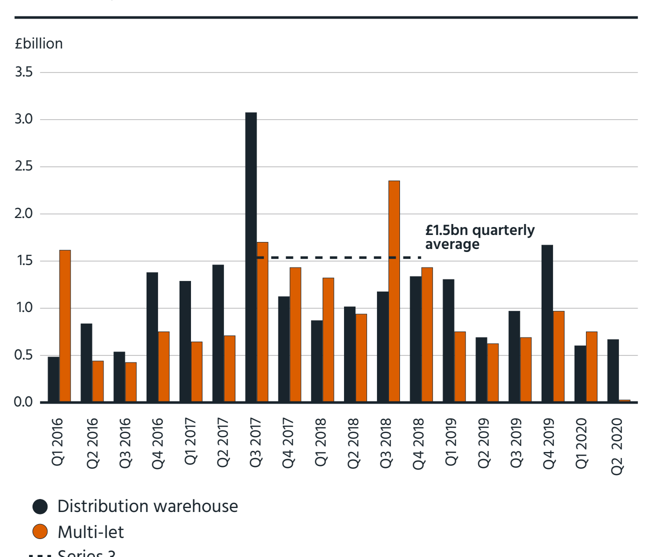
Rolling annual investment in UK multi-let

Sources: Property Data, Gerald Eve



Quarterly industrial investment

Sources: Property Data, Gerald Eve



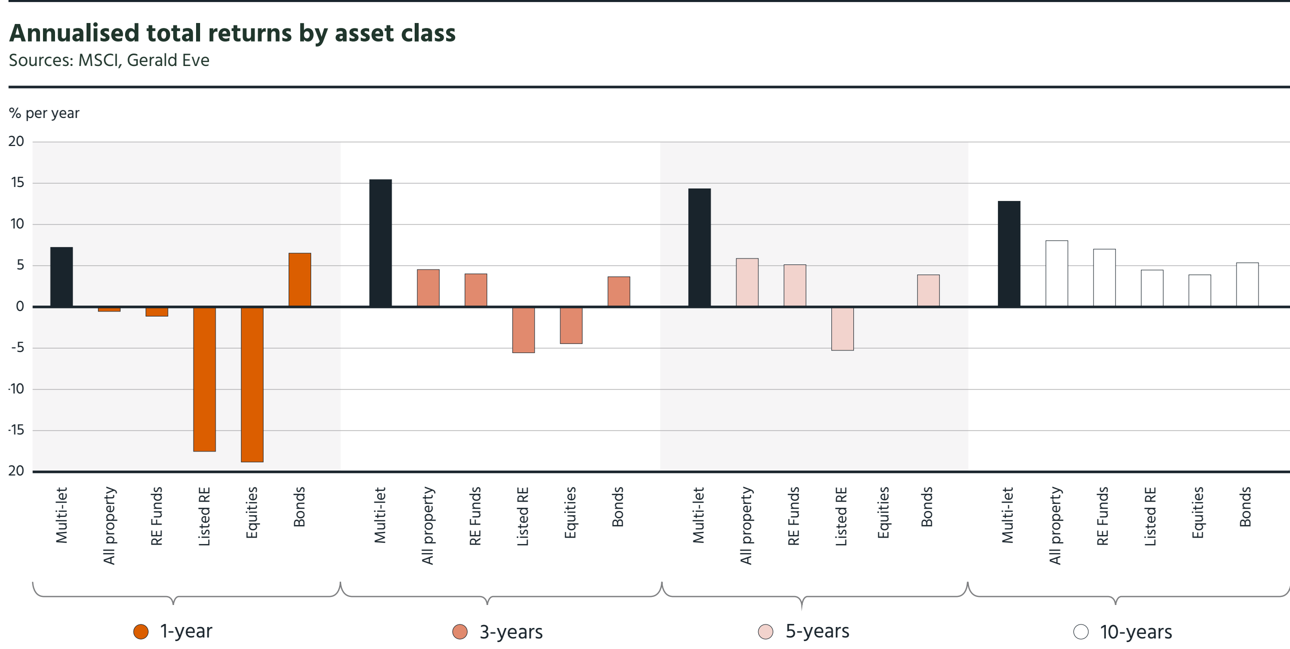
MULTI-LET HAS OUTPERFORMED ALL OTHER ASSET CLASSES OVER THE PAST 10 YEARS

The chart below shows the average annual return for direct industrial multi-let properties versus a range of other financial assets. Multi-let has comfortably outperformed other direct property, property assets, equities and bonds for all time horizons over the past 10 years.

The outperformance relative to other commercial property assets was mainly during two recent periods of relatively strong returns for real estate: 2014-15 and 2017-19. Not only was yield impact relatively significant for multi-let during these two periods but, uncharacteristically for industrial, rental growth was also strong, especially in the latter period in London & the South East.

Annualised total returns by asset class

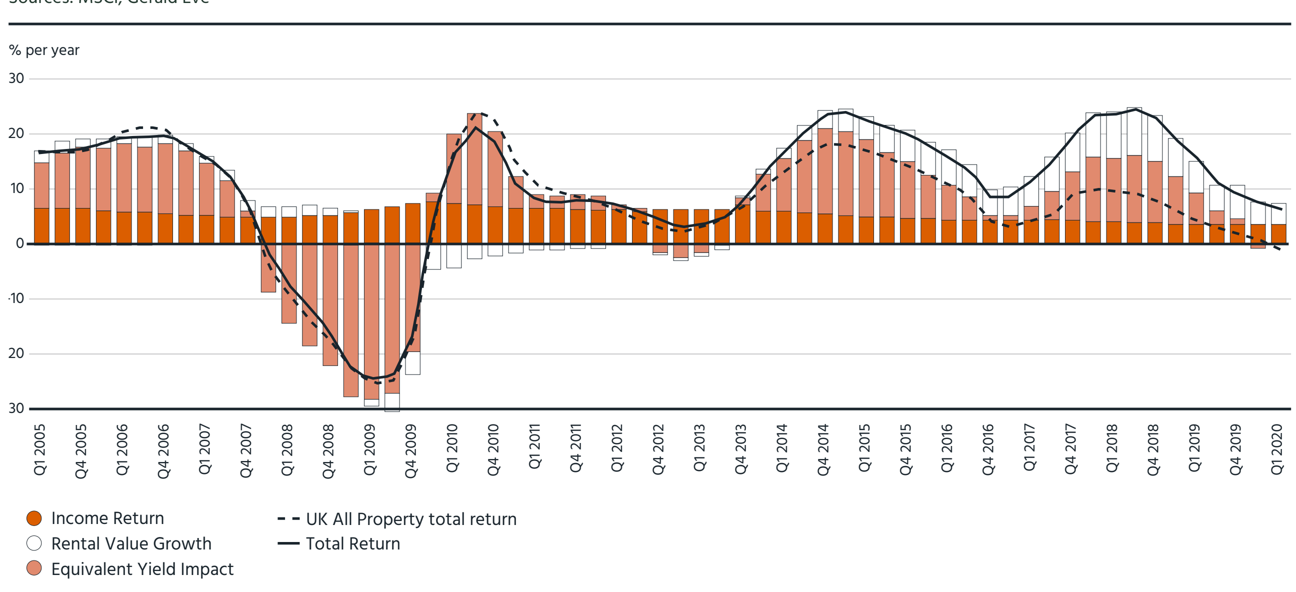
Sources: MSCI, Gerald Eve



In the charts below, it is evident that it is the periods 2014-2015 and 2017-2019 when multi-let returns clearly outperform All Property total returns.

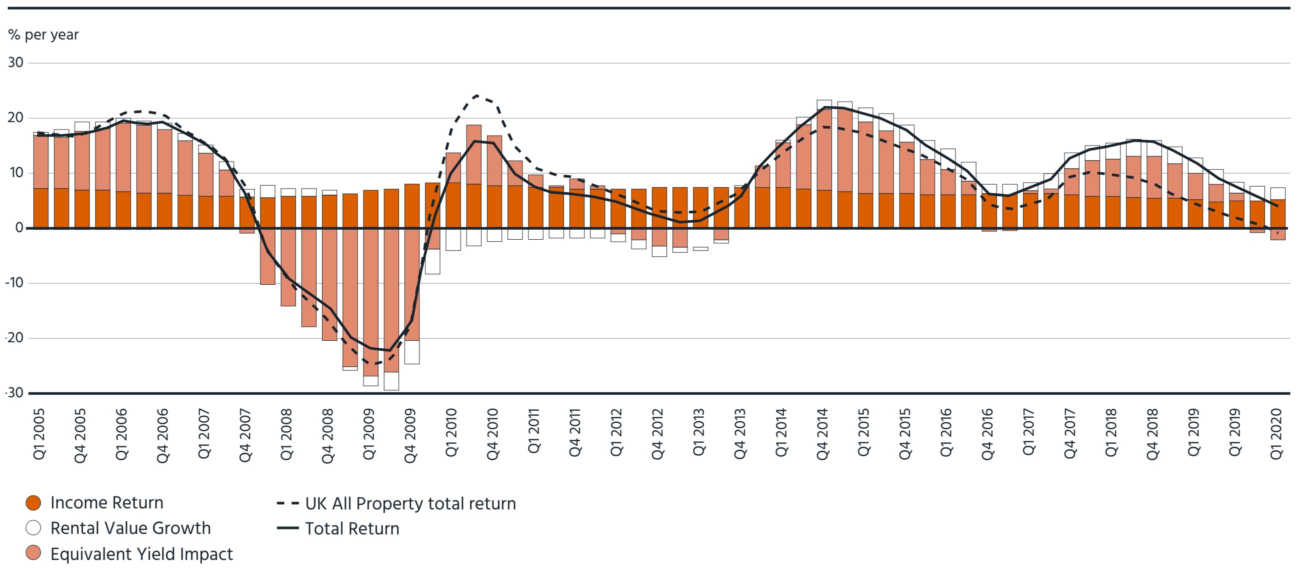
London & the South East multi-let total return and components

Sources: MSCI, Gerald Eve



Rest of UK multi-let total return and components

Sources: MSCI, Gerald Eve



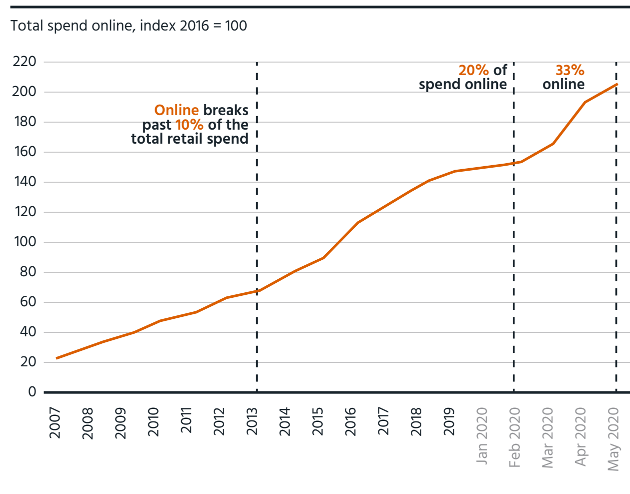
INDUSTRIAL'S EXPOSURE TO THE ONGOING GROWTH OF E-COMMERCE

Industrial's outperformance over the last real estate cycle can in part be explained by the cultural and economic shift towards e-commerce, the subsequent repositioning and creation of businesses in favour of logistics and the revaluation of segments of real estate – industrial has been said to have "picked Retail's pocket".

The chart below shows the steep upward trend of the value of UK retail spending online. By 2013 online accounted for 10% of the total UK retail spend and by February 2020 this had increased to 20% of the total. By May of 2020 the accelerated change in shopping and working habits brought about by the coronavirus-induced social lockdown sharply increased online spending to around a third of all retail spending.

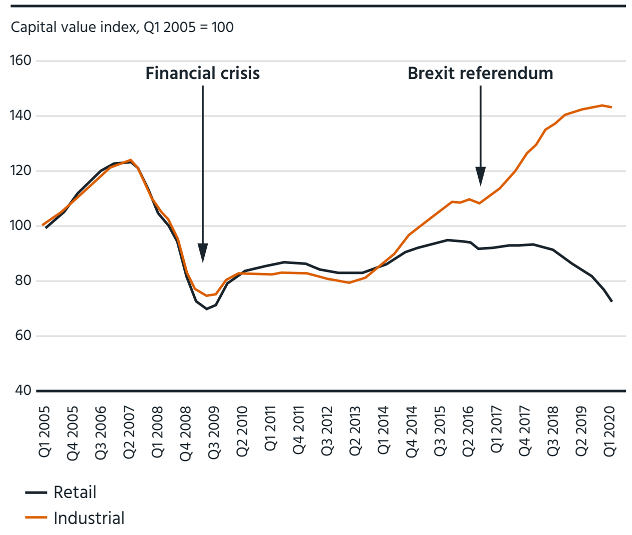
Strong growth in online spending, accelerated by recent coronavirus lockdown

Sources: ONS, Gerald Eve



Indexed retail and industrial capital values

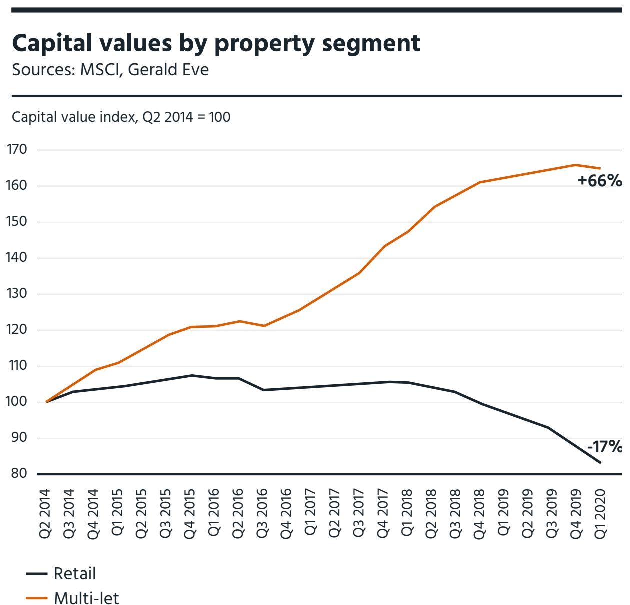
Sources: MSCI, Gerald Eve



Consumers have embraced the convenience and cost effectiveness (and during the 2020 lockdown period, enforcement) of eschewing the high street in favour of home delivery or a quasi-retail experience where goods are collected from multi-let units. Thus the income stream of spending has been funnelled away from retail real estate and into industrial to process the logistics of delivering to households.

The impact on retail and industrial capital values per sq ft is shown above. The two property sectors moved in near lockstep from an index base of 100 in 2005. This continued through the financial crisis, which impacted all assets fairly uniformly, and the initial recovery period. However, by 2014 as soon as online broke past 10% of total retail spend the lines diverge – particularly after the Brexit referendum – and industrial capital values end the period 44% higher, while retail is 26% lower.

More specifically, Multi-let capital values have increased 66% since mid-2014, while Retail values have fallen 17%.



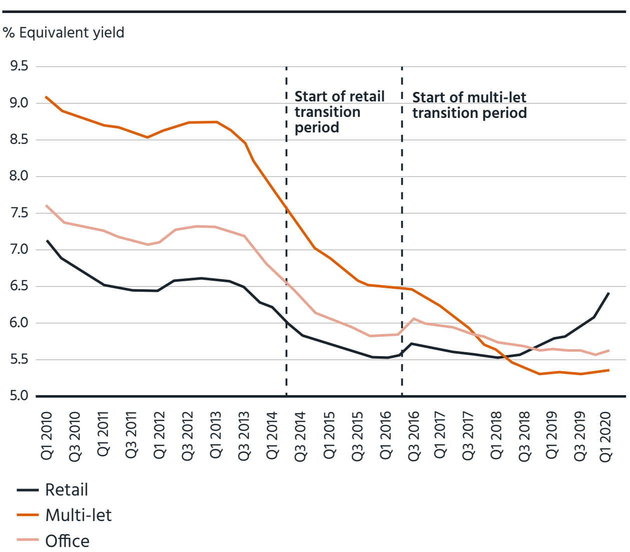
MULTI-LET'S YIELD TRANSITION WITH THE OTHER PROPERTY SEGMENTS

The yield impact component of this outperformance came about following the dramatic and unprecedented yield hierarchy reversal between the major property sectors. This has been covered in previous Gerald Eve Multi-let research and the trends have continued.

Property yields have for decades moved in lockstep according to the generalised level of interest rates in the economy and risk appetite for commercial property, moderated by the relative expectations for rental growth across the different segments. However, there was a structural break to this relationship for Retail in mid-2014 and Multi-let in mid-2016. Consequently the different property yields first converge in 2018 and then spread in opposite directions from 2019. Multi-let yields continue to be the lowest and the spread with Retail continued to rise to Q1 2020, accelerated by the impact of the coronavirus lockdown (as described in Issue 1).

The ongoing transtion of multi-let against the other major property sectors

Sources: MSCI, Gerald Eve

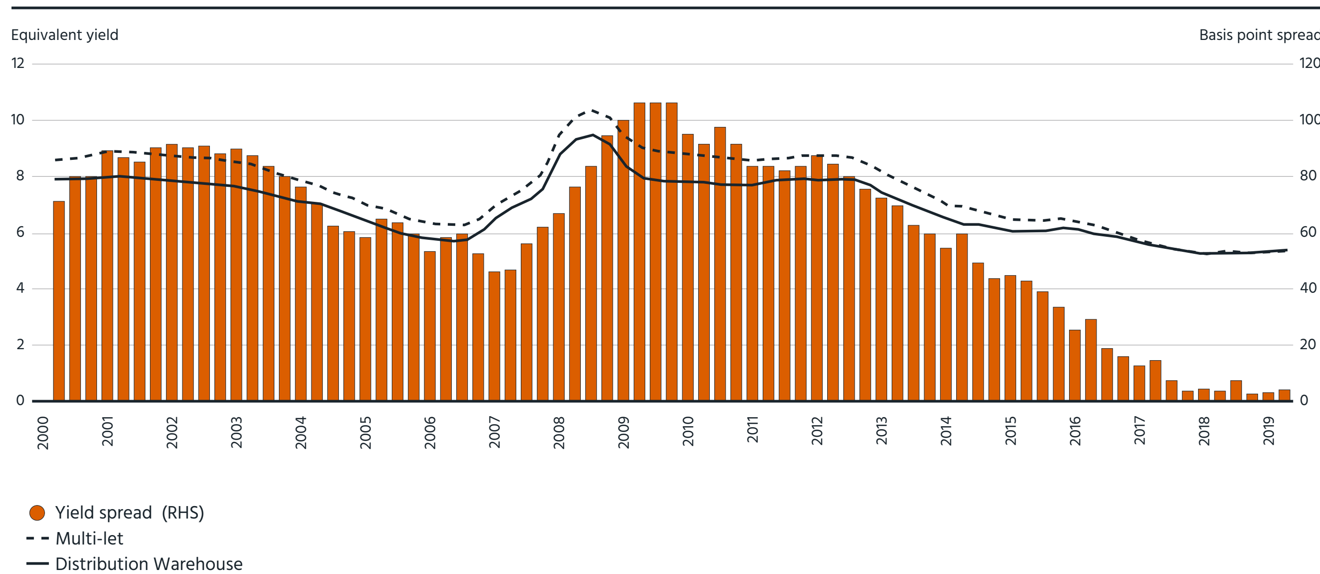


MULTI-LET AND DISTRIBUTION WAREHOUSE AT YIELD PARITY

Distribution warehouses have larger sq ft units and longer lease lengths, which means their income streams typically have less diversification but lower volatility than their multi-let counterparts and thus a lower yield. However, multi-let yields have essentially closed the yield gap with distribution warehouses, meaning that investors no longer need to be compensated with a higher yield to take account of this extra volatility from the smaller units. This transition also started in 2013 at the point when online sales in the UK became more properly established. The gentrification of multi-let and the current and expected growth in the higher-value income stream has offset the cost of its extra volatility.

Multi-let and distribution warehouse yields reach parity

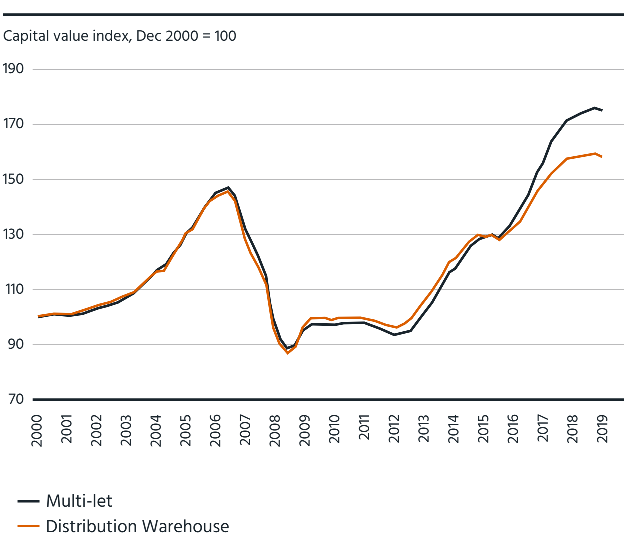
Sources: MSCI, Gerald Eve



This has led to a decoupling of the long-standing capital value trends and excess multi-let capital value growth in the last couple of years.

Multi-let capital value growth outstrips distribution warehouse

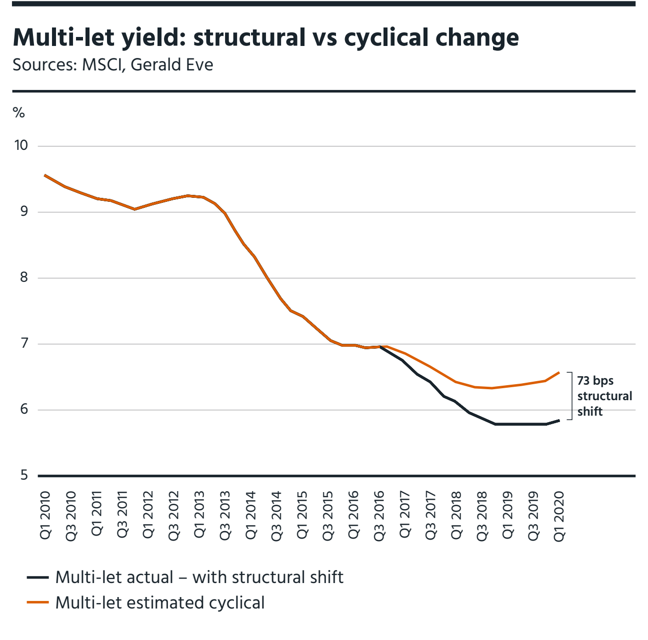
Sources: MSCI, Gerald Eve

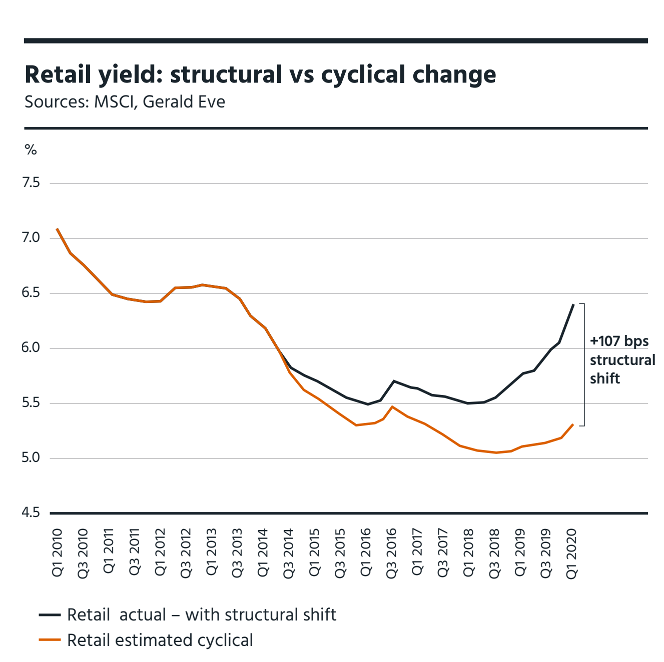


QUANTIFYING THE STRUCTURAL SHIFT FOR MULTI-LET AND RETAIL

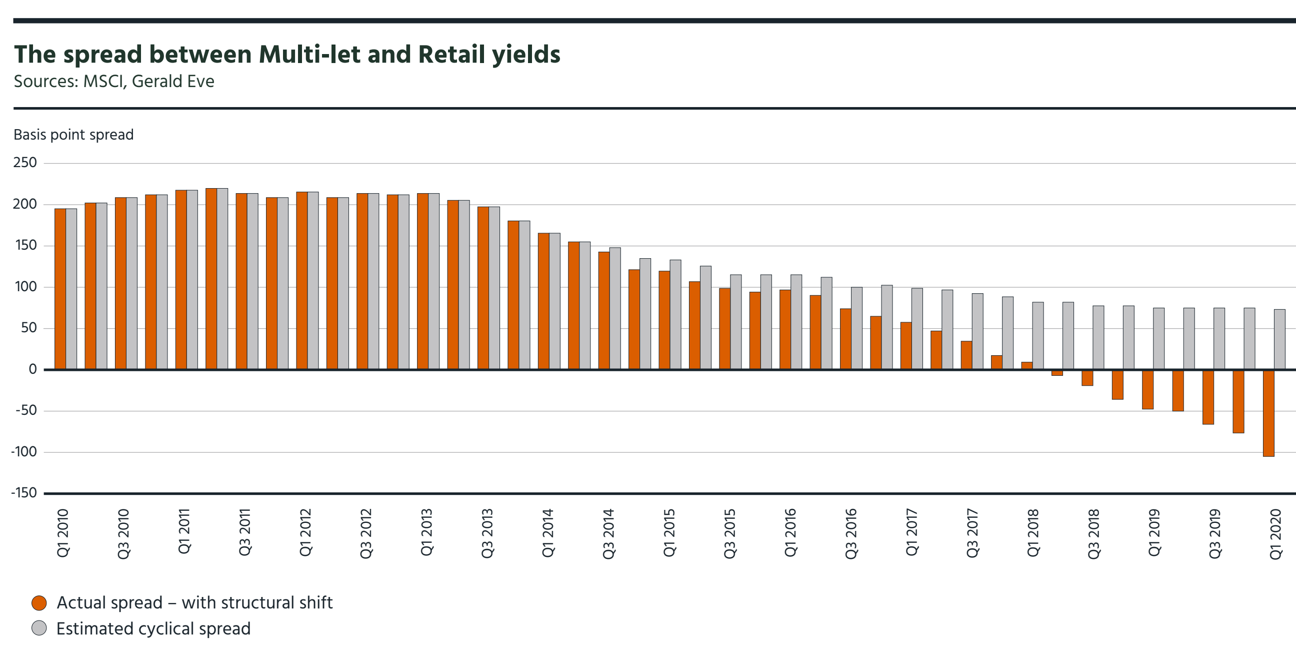
Modelling the yield interactions to take into account relative rental growth expectations up until the start of transitions gives an in-sample estimate of where the Multi-let and retail yields would have gone if the structural shifts did not occur. The differences between these two lines give an estimate of the basis point value of the structural shift.

The charts below show that Multi-let yields have narrowed an extra 73 basis points and Retail yields have softened 107 basis points. Given also that the overall value of multi-let in the UK is smaller than Retail, this shows that *some* of Retail's loss has been Multi-let's gain, but there have also been some bricks-and-mortar losses overall as a result of the trend towards e-commerce.





In the progression of a normal property cycle, the relative strength of rental growth for multi-let over retail – especially now during the coronavirus – would have brought the spread to historic but positive lows. However, the structural shift has switched this spread to more than 100 basis points negative by Q1 2020.



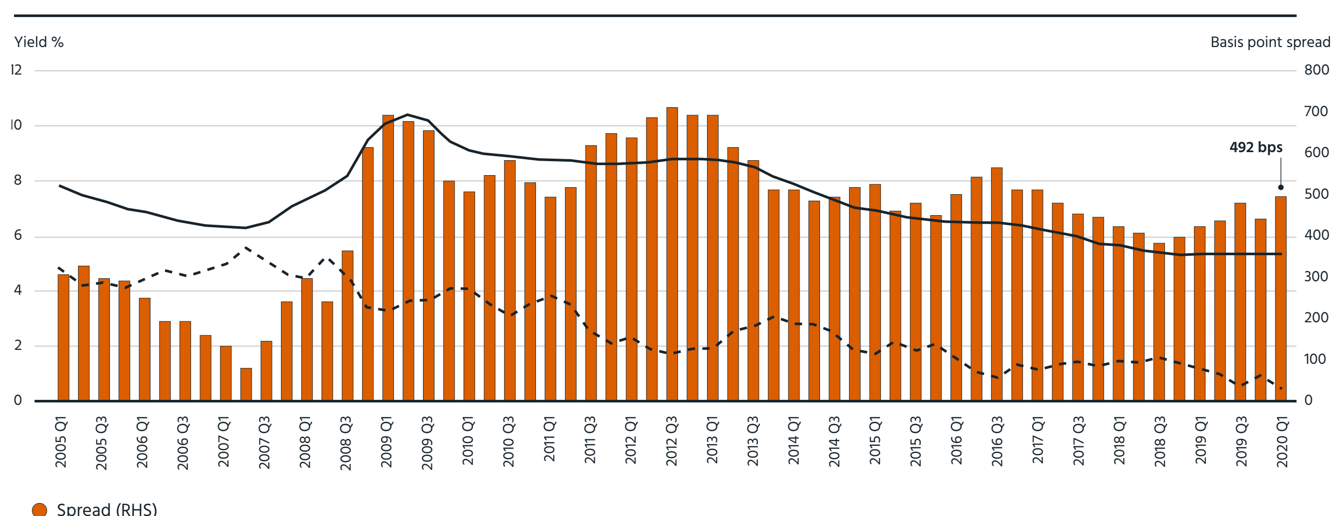
The spread between Multi-let and Retail yields
Sources: MSCI, Gerald Eve

THE MULTI-LET RISK PREMIUM HAS NEVERTHELESS BEEN BROADLY MAINTAINED

The spread between multi-let equivalent yields and 10-year government bond yields is still almost 500 basis points. The income spread has broadly been maintained despite the yield hardening, which continues to underlie the investment attractiveness of the sector from an income perspective.

Ongoing substantial risk premium over bond yields

Sources: Oxford Economics, MSCI, Gerald Eve



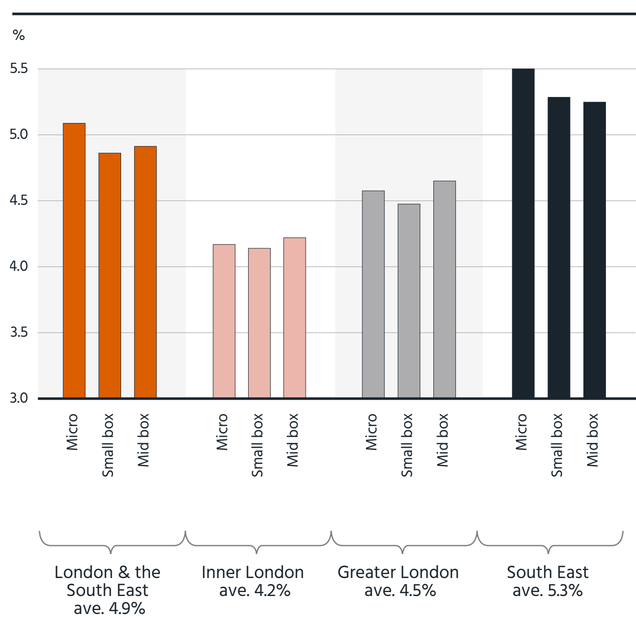
REVERSIONARY YIELDS BY SIZE OF UNIT – LONDON BUCKS THE TREND

Reversionary yields split out by unit size and geography show that the lowest yields are unsurprisingly in Inner London, at 4.2%, followed by Greater London, at 4.5%, and the South East at 5.3%. In the regions, there is one tranche of locations up to the North West that are under 8%, then another group of the much higher-yielding regions of Wales, the North East and Scotland.

The relative yields by unit size hierarchy is maintained in the South East and particularly in the regions – the micro units with their attendant shorter income and riskier tenants (as shown in Issue 3) are higher yielding to compensate. However, in the London markets this pattern is not observed as the strong rental growth of the micro units (as shown in Issue 2) has offset this and the yields have been bid down to a relatively expensive level, despite the increased risk.

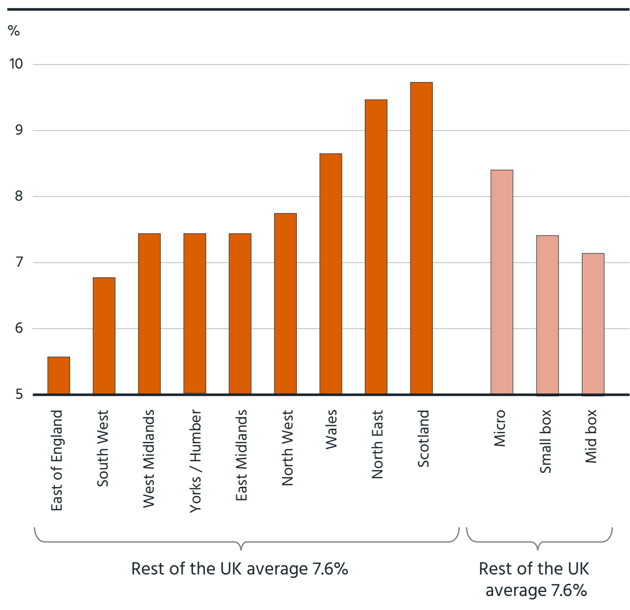
Reversionary yield by unit size and sub-market, end 2019

Source: Gerald Eve



Reversionary yield by unit size and sub-market, end-2019

Source: Gerald Eve



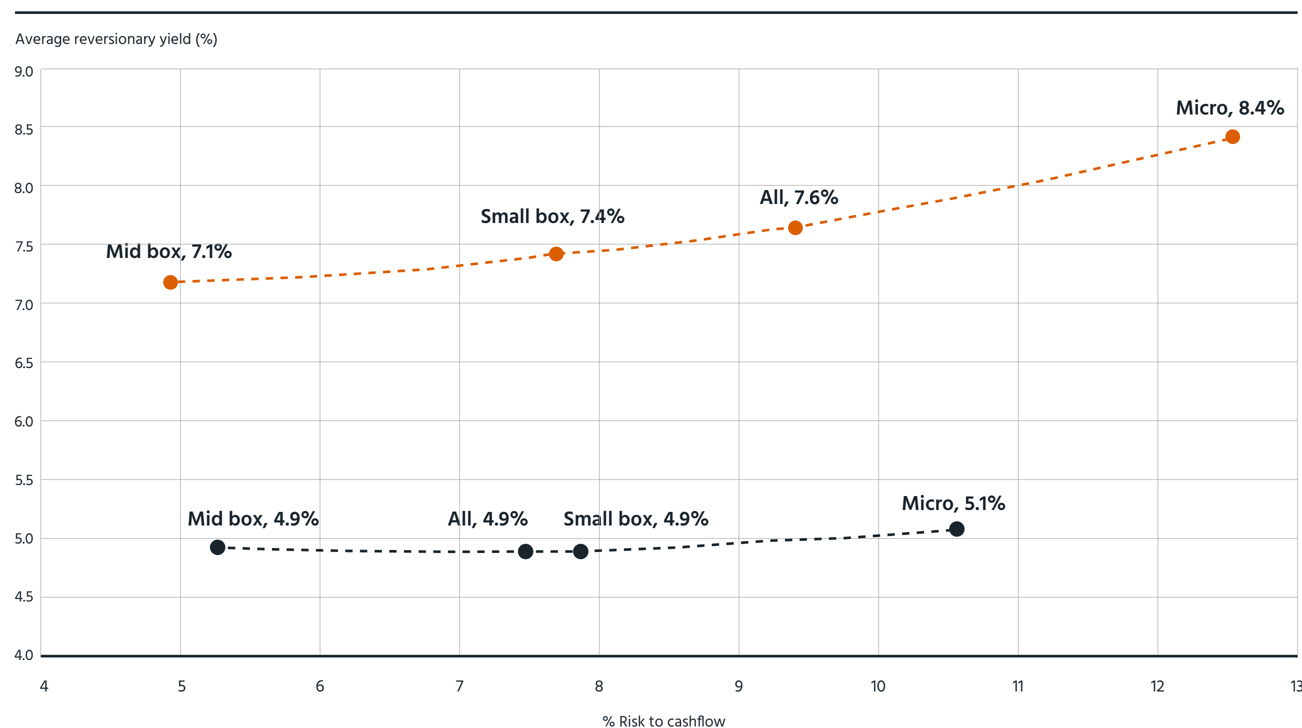
PRICING OF RELATIVE RISK

Within multi-let, the micro and small box units in the regions are arguably priced more defensively than their prime counterparts in London.

The chart below shows the market-wide annual risk to cashflow from breaks, expiries and defaults on the x-axis and the average reversionary yield on the y-axis. The bottom line, influenced heavily by London, is relatively flat – which indicates that the extra risk in the smaller units is not compensated by extra yield; ERV growth is instead assumed to compensate.

The line at the top, which contains data from the UK regions, is steeper. This indicates that reversionary yields rise more when taking on more risk associated with smaller units (more tenants, smaller tenant covenants, shorter leases, etc); and thus this segment of the market is priced to be more protected if expected future rental increases do not materialise.

Multi-let cashflow risk and investment pricing by geography and unit size
Source: Gerald Eve

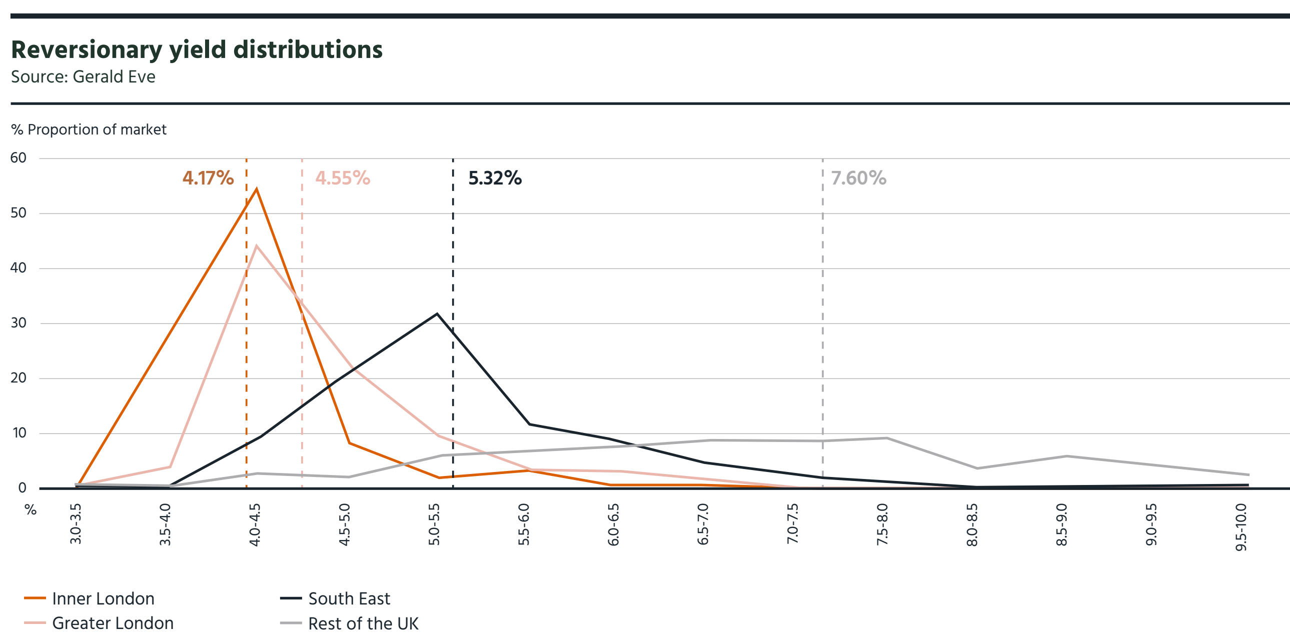


Rest of the UK
London & the South East

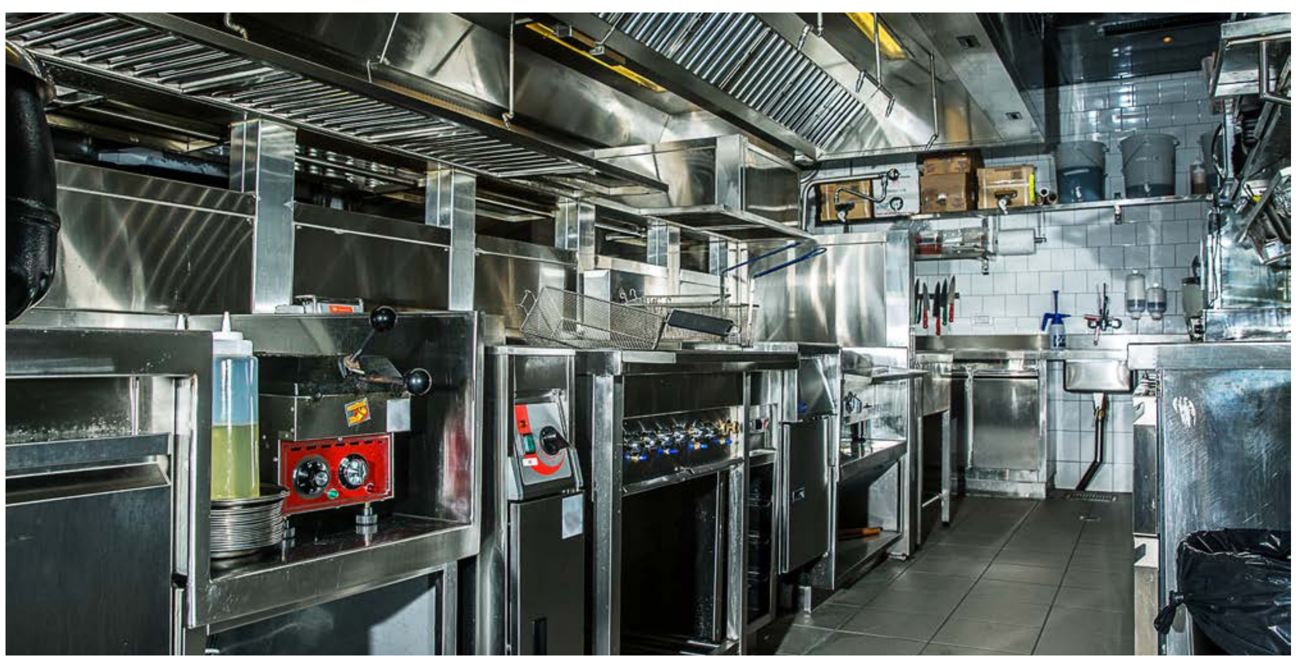
YIELD DISTRIBUTIONS BY REGION

The yield distributions show the proportions of each multi-let market at each yield range at 50 basis point increments. Inner London and Greater London have the largest share of the market at the 4% - 4.5% yield range. These markets have a narrow range, with almost all assets between 3.5% and 5%. The South East has a wider distribution and the Rest of the UK has a very flat, even spread that covers the full variable range of yields.

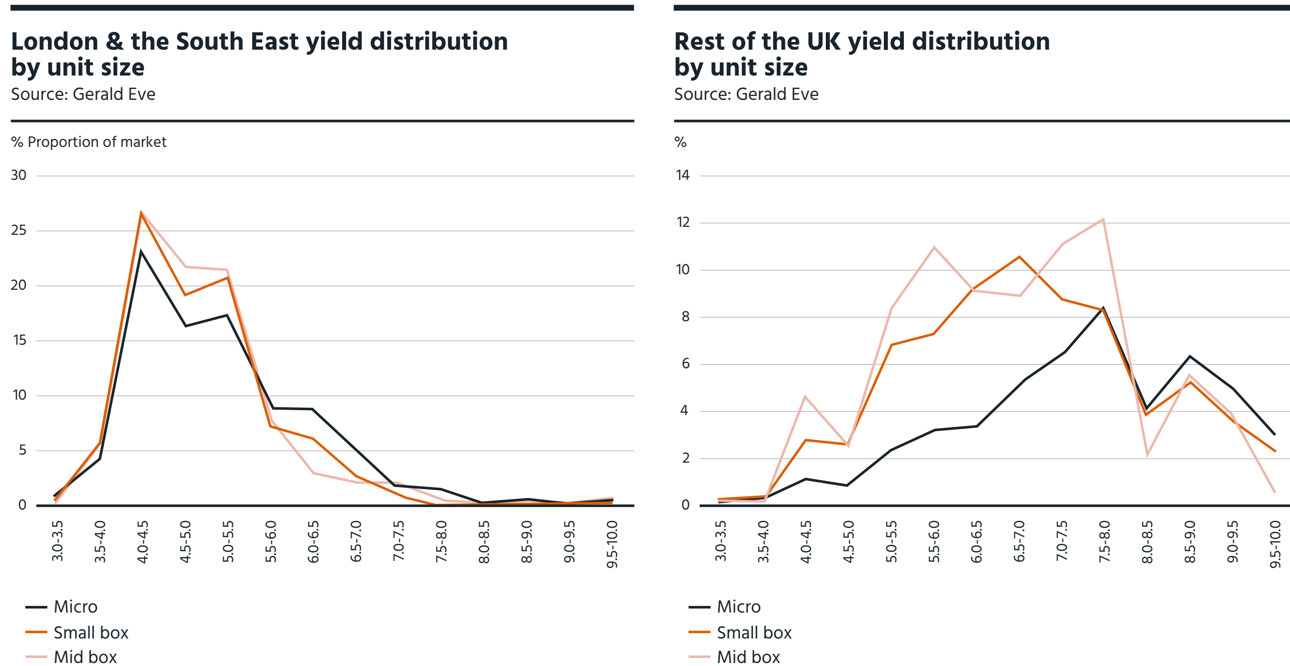
Reversionary yield distributions
Source: Gerald Eve



YIELD DISTRIBUTIONS BY UNIT SIZE



In London & the South East the distributions for the different unit sizes are extremely similar. However, in the regions where micro units have not and cannot rely on stronger rental growth, the relative absence of assets under 7% is clear.

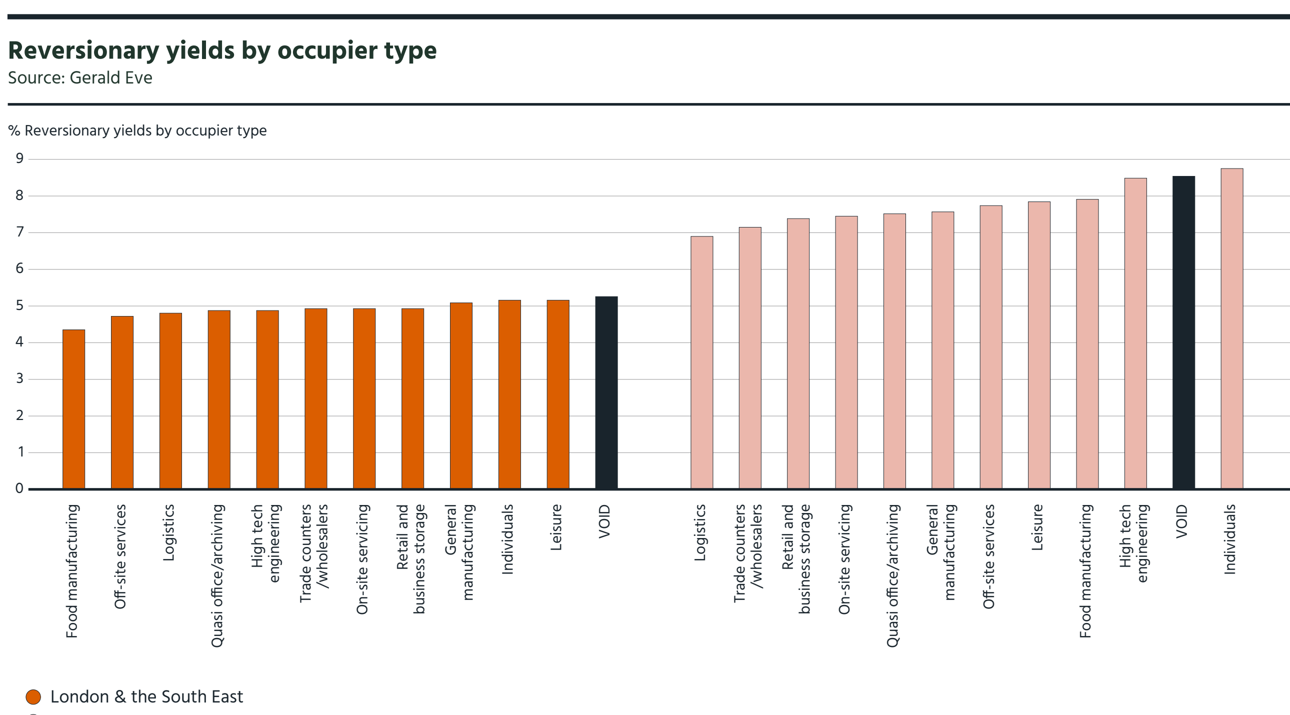


YIELDS BY OCCUPIER TYPE

The London & South East food producers, many of which are closely gathered in the Inner London postcodes (as shown in Issue 1), occupy the highest valued multi-let units, at an average 4.39% yield. The other London & South East use types occupy units with a relatively narrow range of yields.

Outside of the South East the highest quality units are occupied by logistics, retail storage and the expanding trade counter sector. Food operators outside of the South East perform a very different function to their South Eastern counterparts and occupy some of the cheapest multi-let space.

The typical yield on a void unit outside of the South East is higher than that occupied by any business type. Whereas in London & the South East the average yield on a void unit is relatively slightly lower and of a higher quality. This suggests that the regional voids are more structural, while the voids in London & the South East are unoccupied for shorter times.



Reversionary yields by occupier type
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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