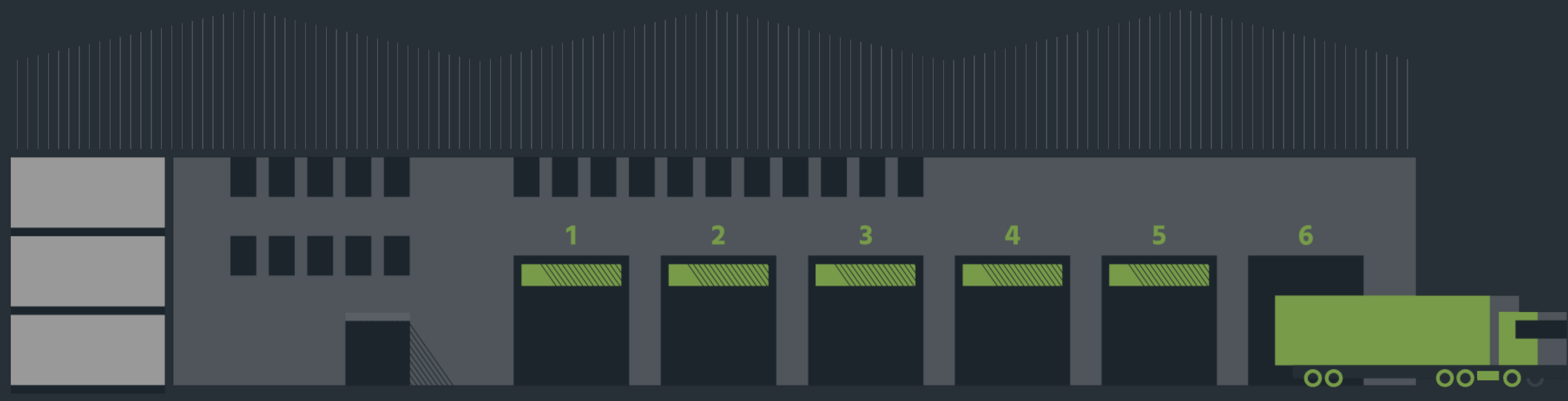
PRIME LOGISTICS

The definitive guide to the
UK's distribution property market

Q2 2022

Read more



MARKET OVERVIEW

SENTIMENT HIT BY COST INCREASES AND CONSUMER SLOWDOWN

It's been another quarter of impressive performance for UK logistics, particularly in the rental market. However, occupiers are looking forward with greater caution. High cost inflation and a stagnant outlook for the economy has forced some occupiers to adjust medium term growth plans. Meanwhile investment pricing has softened. The increased cost of debt has thinned competitive tension in the investment market and reports of 'froth coming off pricing' and 'a pausing for breath' were commonplace in Q2. However, this pause in activity comes at a time of strength for the logistics sector, with established structural drivers, weak supply and broad-based tenant demand.

18.2m sq ft ▲
Take-up Q2 2022

3.9% ▲
Availability rate Q2 2022

1.4% ▲
New/modern availability rate Q2 2022

6.5% ▲
Prime rental growth Q2 2022

3.0m sq ft ▼
Spec development starts Q2 2022

27bps ▲
Outward prime yield shift in Q2 2022

OCCUPIER DEMAND

OCCUPIER DEMAND SETTLING ON A NEW EQUILIBRIUM

It was another quarter of strong occupier activity in Q2, with 18.2m sq ft taken-up. This was up 4% on Q1 and 17% above the five-year average. However, it now seems that we are over the peak in terms of occupier demand and activity is likely to settle back, albeit to a level higher than pre-pandemic. Pre-lets and occupier land purchases accounted for 50% of all activity in Q2, and new speculative buildings accounted for 32% of all demand. Such a large amount of spec space taken-up reflects the urgency with which occupiers need good quality accommodation, the uncertain impact of rising build costs on the D&B rental market and the acute shortage of good quality secondhand space.

RETAILERS BRACE FOR A TOUGHER H2

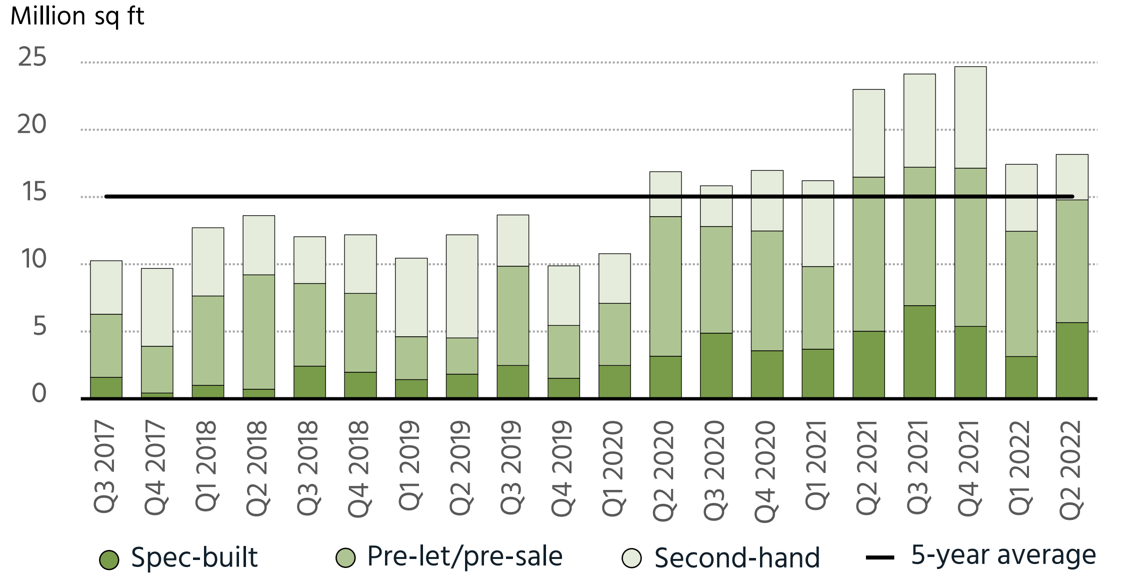
Retailers were the most active occupier group in Q2, driven by Amazon's planning permission for its 2.9m sq ft unit at Roxhill's Northampton Gateway scheme. The Range, Hotel Chocolat, Overclockers and National Vet Supplies were also active. However, H2 2022 will be a tougher period for retailers, with consumer spending power under severe pressure from very high inflation and personal tax rises. E-commerce remains a structural driver of demand for logistics, (with traditionally non-e-commerce retailers such as Primark now selectively trialling click-and-collect services), but the gradual return to pre-pandemic shopping has already reduced the proportion of online spending and internet-related industrial take-up .

REAL DEPTH TO DEMAND OUTSIDE OF AMAZON

In the absence of new occupier demand from Amazon (activity in Q2 was down to planning permission on buildings agreed in principle last year) there remains an impressive depth to the occupier market in the UK. Various growth sectors continue to compete for space. These include green energy, pharma and life sciences, film & TV, and 'onshorers', along with other e-commerce and logistics companies. Housebuilders or home-related manufacturers were notably active in Q2, as were occupiers in the 'services' sector, particularly information and data storage occupiers in the Midlands.

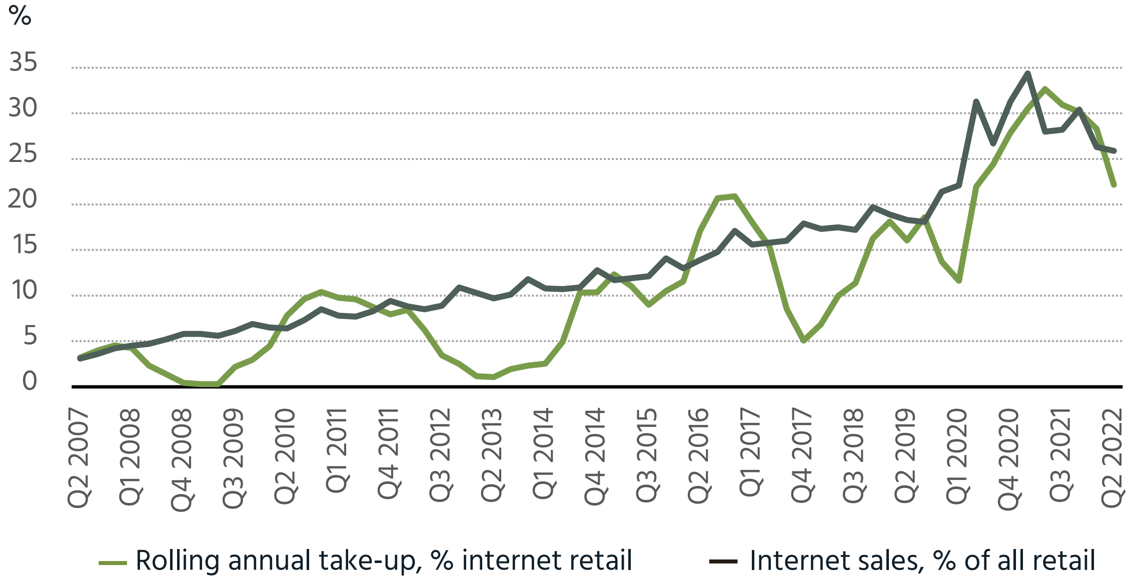
Quarterly take-up by building quality

Source: Gerald Eve



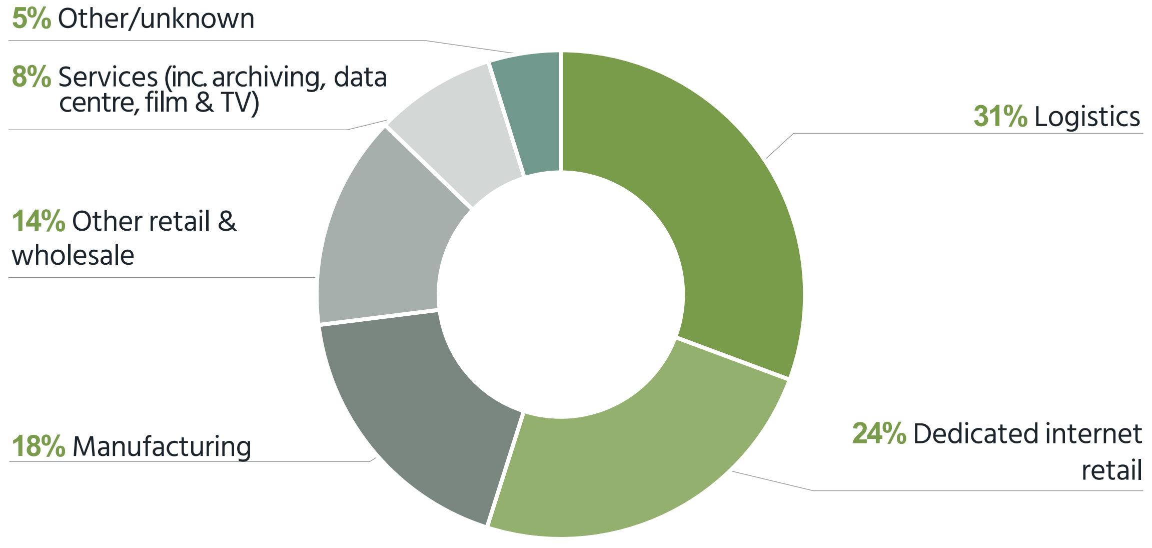
Internet retail and logistics take-up

Source: Gerald Eve, ONS



Q2 2022 take-up by occupier sector

Source: Gerald Eve



SUPPLY AND DEVELOPMENT

AVAILABILITY RATE RISES FOR FIRST TIME IN ALMOST 2 YEARS

The UK availability rate rose to 3.9% in Q2, marking the first increase since Q4 2020. This is still extremely low and only reflected a 0.2 percentage point quarterly increase. Nevertheless, Q1 2022 is now likely to represent the low point in the current cycle. The availability rate of new or modern stock (excluding buildings under construction) rose 0.13 percentage points to 1.4% in Q2, the second quarterly rise. This small increase reflects the addition of almost 1m sq ft of speculative space to the market. There's upward pressure on the availability of the best quality space as more schemes in the pipeline come to fruition. Meanwhile occupiers are likely to have very limited choice of second-hand buildings ready for immediate occupation.

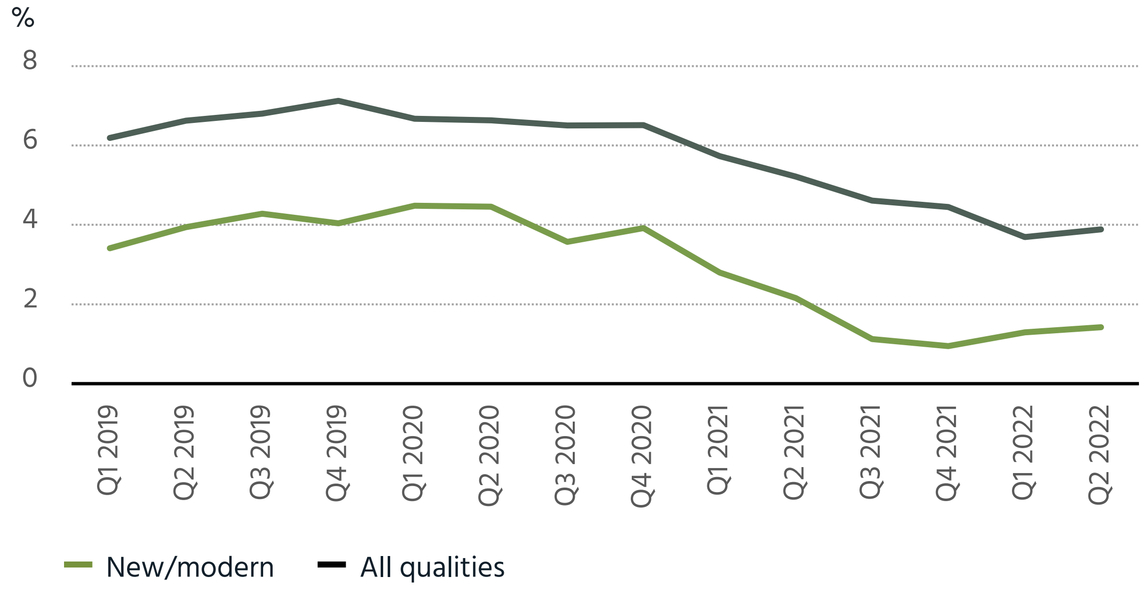
DEVELOPMENT STARTS DOWN 60% IN Q2

The overall volume of development starts (both purpose-built and spec) fell 60% in Q2. In all, 8m sq ft got underway in Q2 and 37% was speculative. This represents a sharp quarterly fall, though Q1 was the most active quarter on record. Difficulties with sourcing materials, highly inflated build costs and a protracted planning process are factors behind this fall. Developer confidence generally remains high (some very large buildings are being pushed through the planning process) although some developers who bought land post-pandemic and are developing on today's construction prices are increasingly concerned about occupier rental affordability and exit positions.

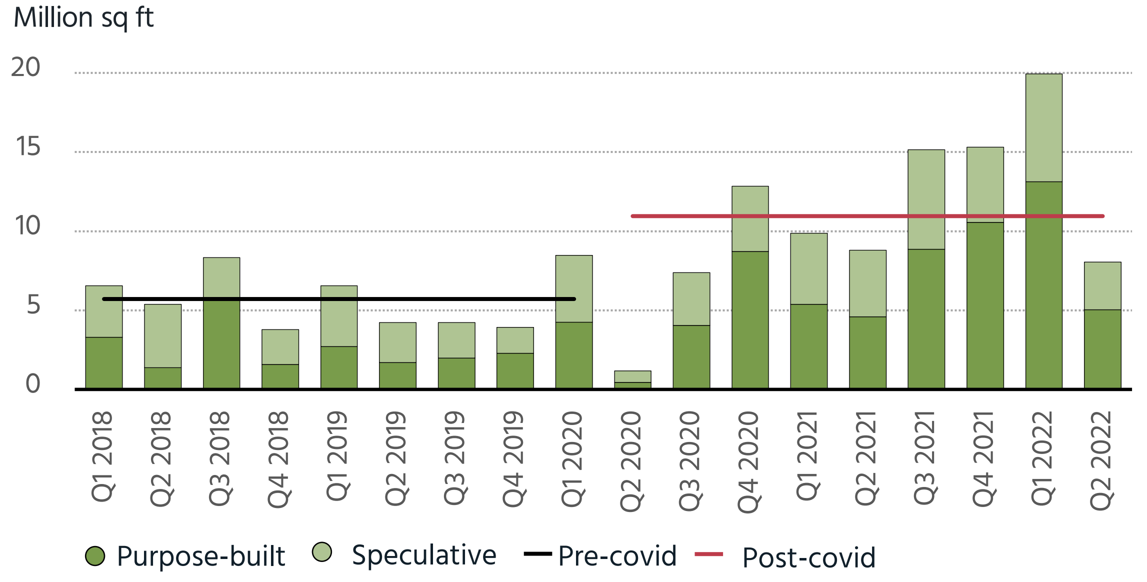
DEVELOPMENT PIPELINE ELEVATED AS TIMESCALES SLIP

There was 6m sq ft of development completions in Q2, 61% of which was speculative. This is down 16% on Q1 and is in part reflective of the slippage of development timescales as a result of difficulties sourcing materials and labour. There was a very large 60m sq ft of space still under construction at the end of Q2, 33% of which was being developed speculatively. Purpose-built schemes reaching PC in Q2 include NewCold Logistics's facility on the site of the former steelworks in Corby, and DHL Supply Chain's 482,000 sq ft unit at London Gateway. Around half of all spec space reaching PC in Q2 had already attracted a tenant during the development process.

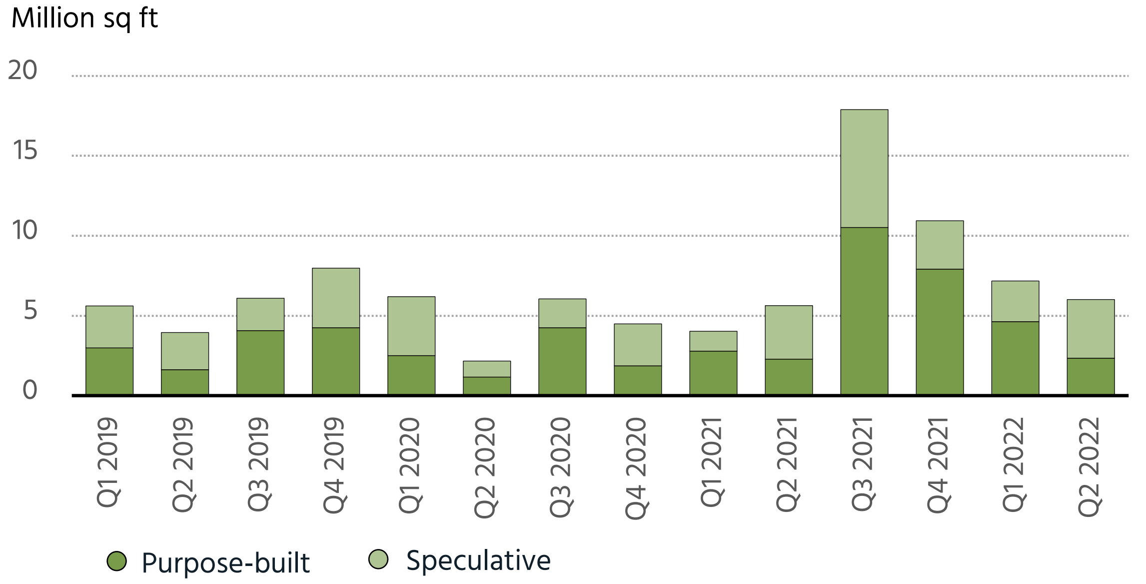
UK availability rate by quality
Source: Gerald Eve



Development starts by type and pre/post-covid averages
Source: Gerald Eve



Development completions by type
Source: Gerald Eve



RENTS AND INCENTIVES

RENTS ROSE AT A RECORD RATE IN Q2

Developers active in the current cycle face expensive purchase prices and high build costs. The majority of landlords are seeking to recoup these costs by maintaining the pressure to push rents on ever higher. Occupier activity on recently-developed speculative buildings, especially in uber-prime locations such as Park Royal, are resetting market tone. Prime headline rents increased in 38 out of our 53 Gerald Eve centres in Q2. These increases totalled to a record 6.5% prime UK average quarterly rental growth, which reflects an additional 62p per sq ft. Prime rents are up an average 12% so far this year and an incredible 22% compared with Q2 2021.

DEVELOPERS INNOVATE TO RECOUP RISING BUILD COSTS

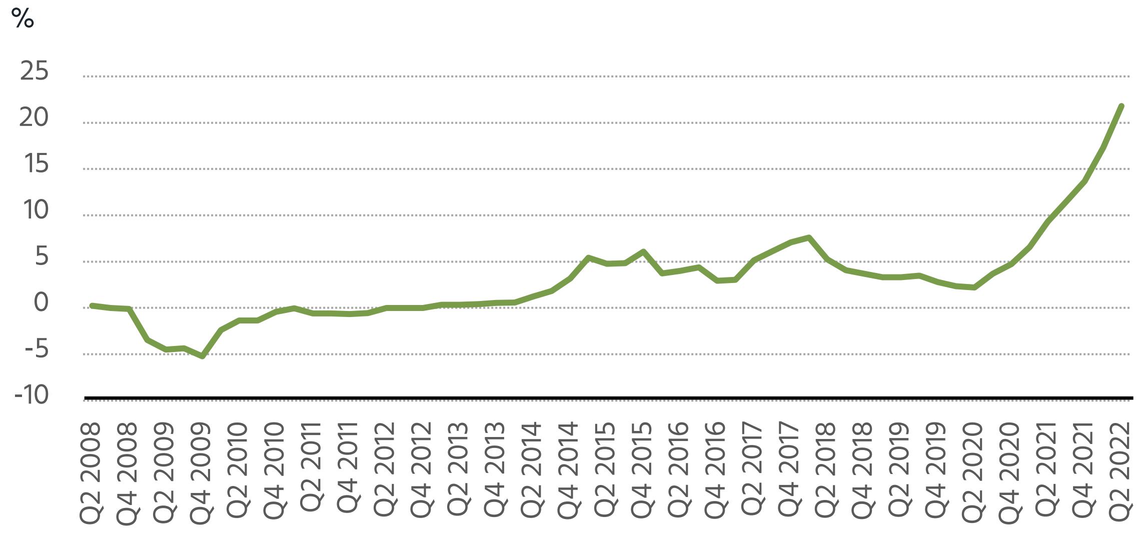
For developers, labour shortages and the significant rise in wholesale building materials has had a substantial impact on delivery schedules and the rent levied at the occupier. Residual land values have risen very sharply over the last couple of years also. However, further increases in build costs are now likely to have a dampening effect on land prices. Day 1 rent reviews are an option to work in build cost increases for D&Bs, although the cost uncertainty this brings is particularly unpopular with occupiers. Some landlords have linked reviews to steel prices, or put a cap on increases (up to 4% in some cases) which offers more certainty, but is still unwelcome.

LARGE REVERSION ADDS TO OCCUPIER COST PRESSURES

Whilst the current rate of prime headline rental growth is unsustainable, rents on newly-developed buildings built since the pandemic will continue to try to reset market tone. Occupiers renewing or regearing their leases are likely to be in for a shock at rent review given the high and widespread levels of market reversion. This is likely to be most keenly felt by occupiers in London, where prime headline rents have grown by 22% so far this year alone. There will be a continued fine balance between developers' rental aspirations and occupier willingness and ability to pay. Buildings with the best ESG credentials are likely to remain popular and continue to attract a rental premium.

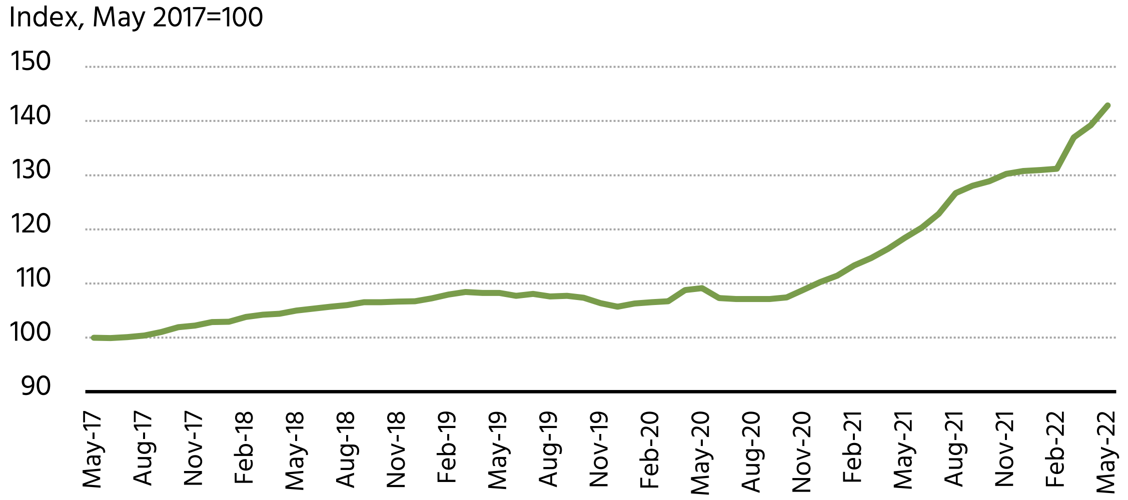
Annual prime logistics rental growth

Source: Gerald Eve



Construction material price index (all work)

Sources: ONS, BEIS



Average regional prime rental growth H1 2022

Source: Gerald Eve

INVESTMENT

FIRST OUTWARD YIELD SHIFT SINCE Q3 2016

Investors still have confidence in the underlying occupier market and void rates remain low, but the investor buyer pool has narrowed and bidding on any one asset has thinned out. Across the market there are now fewer buyers and generally speaking more investment stock as many have brought forward their plans to sell in Q4 this year when the market is typically most active. This drop in competitive tension has knocked the "froth" off prices and resulted in a softening of Q2 prime logistics yields, typically by around 25bps nationally and arguably up to 50bps in London. This is the first average UK outward yield movement since Q3 2016, which was a one-off at the time of peak Brexit referendum uncertainty.

RISING COST OF DEBT NARROWS BUYER POOL

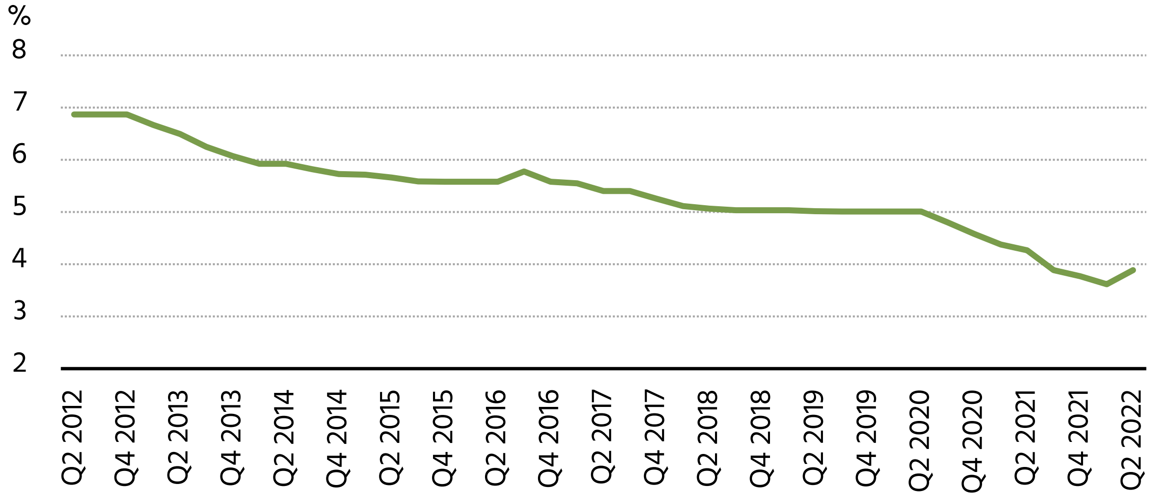
The main underlying reason is the shift in debt markets, both in the UK and USA, which has reduced the number of potential purchasers in the market. There are reports suggesting an overall increase in the all-in cost of debt in the UK of over 150bps over the past 12 months, which has reduced the margin between property yields and financing rates. This has had an immediate impact on the cash-on-cash returns being generated by property for debt-backed buyers unless there's strong rental growth or asset repricing. As such, industrial investment volumes were down 74% to £1.5bn, the lowest quarterly total since the first covid lockdown in Q2 2020.

LACK OF COMPETITION OFFERS SOME AN OPPORTUNITY

The shift in the investment market has translated into a softening in pricing and a far more selective and patient investment strategy by many. This is vastly different from six months ago where every subsector of the industrial market had liquidity and widespread investor appetite. Some investors simply now have less conviction, and many have adopted a 'wait-and-see' approach. However, there are some buyers who see this situation as an opportunity. Pricing is lower than it was six months ago and there is lower competition. These remaining buyers tend to use less debt, and net investment in Q2 was firmly driven by overseas investors.

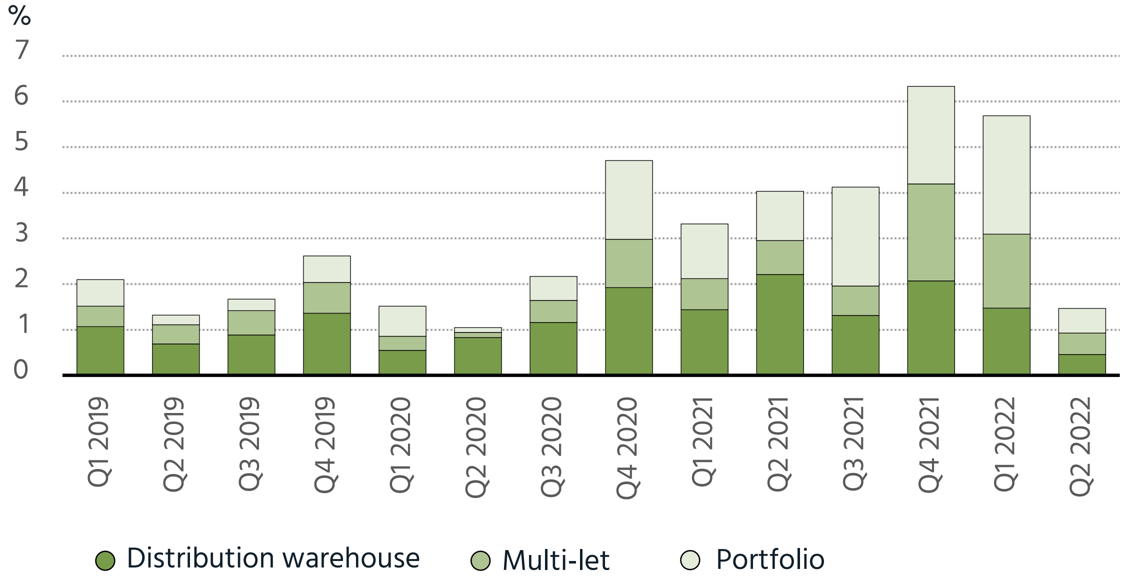
All UK average prime logistics yield

Source: Gerald Eve



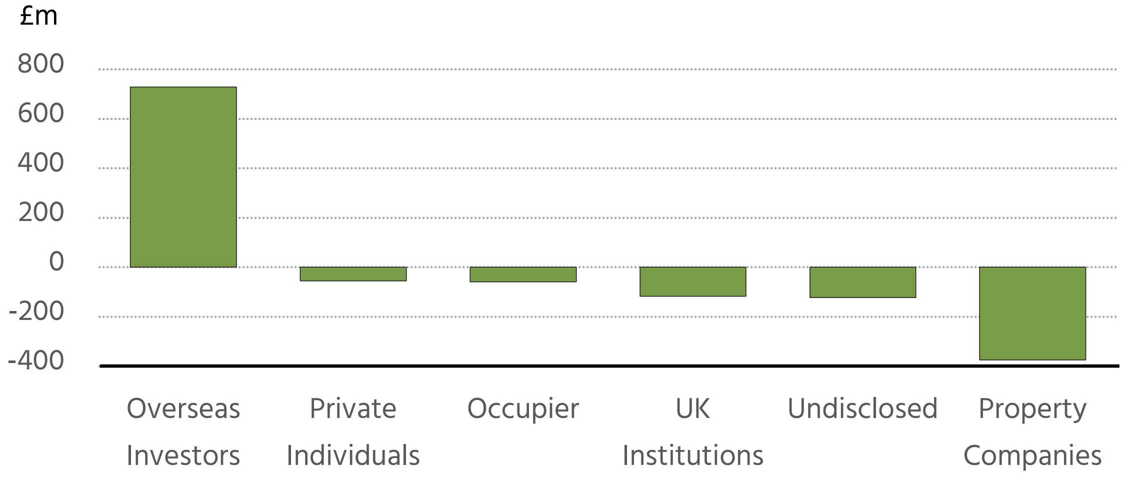
Industrial investment volumes

Sources: Gerald Eve, Property Data



Q2 2022 industrial net investment

Source: Gerald Eve



SPOTLIGHT ON: GOVERNMENT'S 'FUTURE OF FREIGHT' PLAN

RAIL: ALREADY ON TRACK TO SUPPORT NET ZERO TARGETS

The Department for Transport published its 'Future of Freight: a long term plan' report in June. The report acknowledges the challenges facing the sector, including obtaining planning and land allocation, but also recognises the sector's growing importance to the overall economy and the part it can play in the transition to net zero by 2050. The plan encourages the use of more sustainable forms of freight transport and highlights the railway system as an existing greener means of transporting goods.

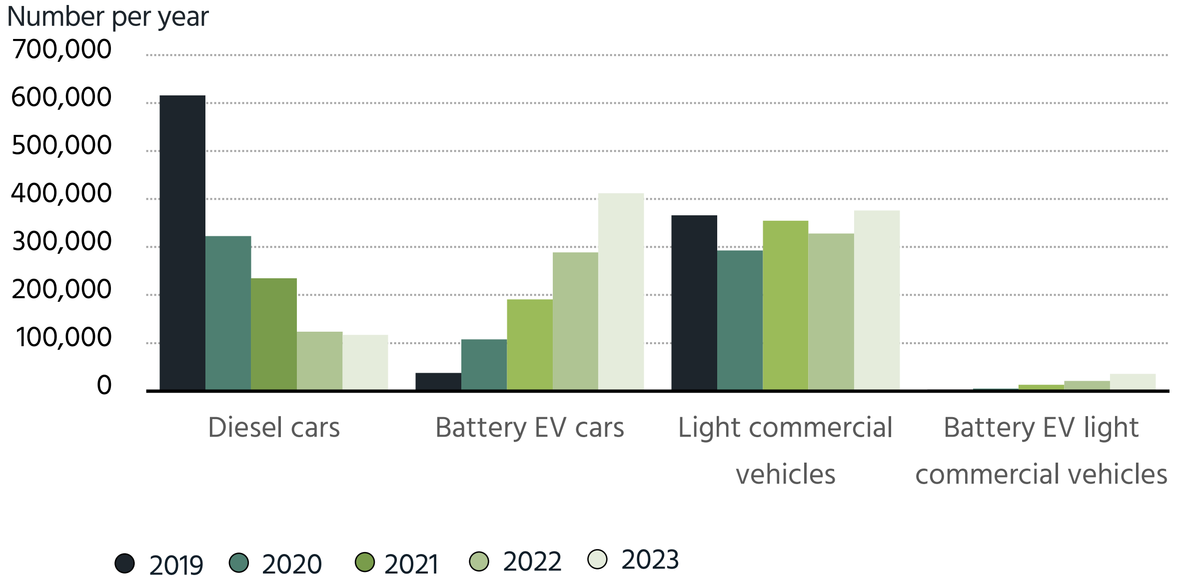
SEGRO and Maritime Transport agreed terms to double the rail freight capacity at SEGRO Logistics Park East Midlands Gateway in June.

ROAD: COMMERCIAL EV SECTOR LAGGING BEHIND

The government has announced the phase-out dates for the sale of new non-zero emission 26 tonne (and under) HGVs by 2035. All new road vehicles sold in the UK must be zero emission by 2040. The delivery of the Strategic Framework for the electricity network is expected to outline potential energy demand scenarios created by increasing electrification, but much more investment is needed in EV infrastructure if targets are to be met. Whilst more registrations of battery EV cars than diesel cars is expected this year, the HGV/LGV commercial sector is far behind, with more infrastructure investment and incentives needed.

New UK car and light commercial vehicle registrations

Source: SMMT

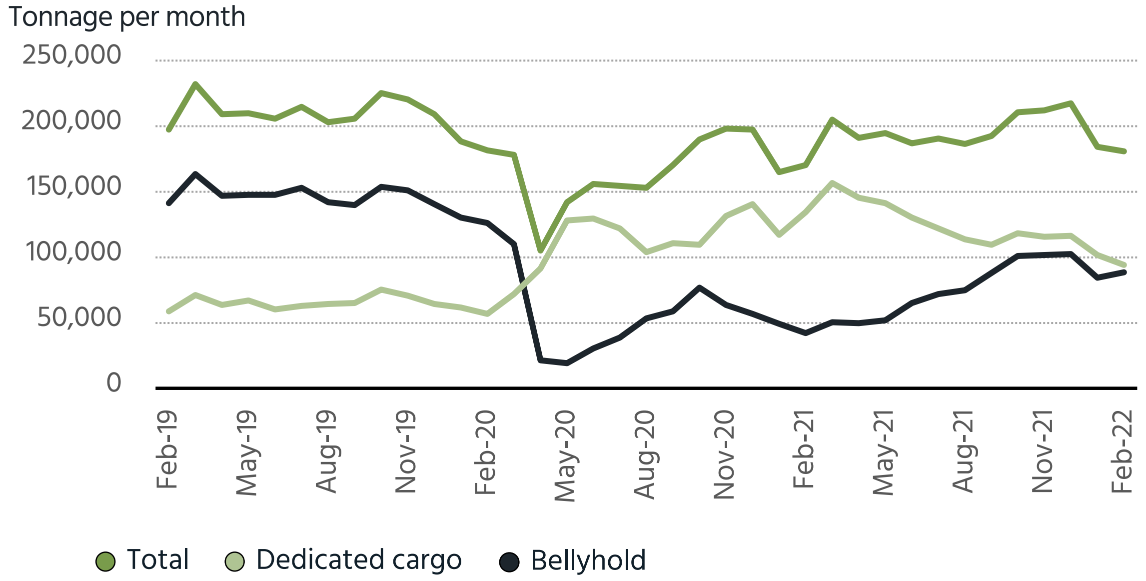


AIR: AIR FREIGHT CRUCIAL TO SUPPLY CHAIN RESILIENCE

There was significant adaptation in the air freight sector during the pandemic. The share of bellyhold freight dropped from 70% of all air freight in 2019 to only 38% in 2020. However, the need to transport critical, time-sensitive, goods during the pandemic, when passenger planes were grounded, highlighted the vital role the sector plays. The increased use of dedicated air freighters meant major cargo hubs at East Midlands and Stansted airports saw strong growth. Passenger volumes may have dropped by 75% in 2020, but air cargo saw only a 21% reduction.

UK air freight tonnage by type

Source: ONS, DfT



OUTLOOK

2022 RENTAL GROWTH TO SURPASS 2021

Prime headline logistics rents grew by an average 13.7% in 2021 across the UK. We forecast that prime logistics rents will grow a further 15.8% in 2022. Around 12% of this growth is already baked-in at the half way point of the year. Demand remains strong, availability is weak and rising build costs will continue to put pressure on developers to pass on cost increases through the rental market.

RISING COST OF DEBT TO WEIGH ON INVESTMENT IN 2022

The main reason behind the drop in competitive tension in Q2 was the shift in debt markets, which has reduced potential purchasers in the market. The margin between property yields and financing rates has significantly reduced and had an immediate impact on the cash-on-cash returns being generated by property for debt-backed buyers. Forward looking financial market interest rate benchmarks such as SONIA suggest continued increases this year which could narrow the buyer pool further up the risk curve.

RETURN TO MORE ‘NORMAL’ GROWTH RATES IN 2023

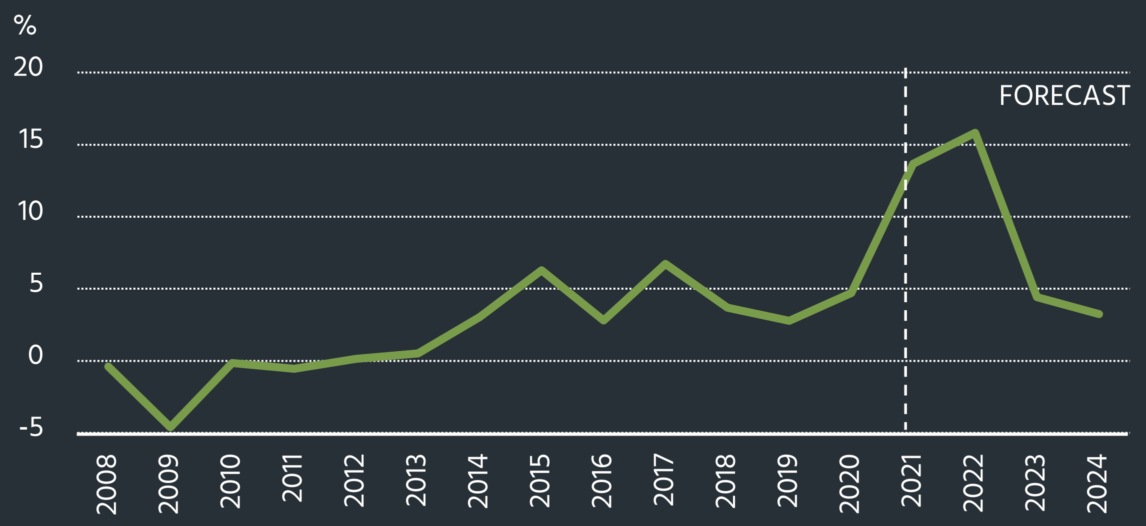
The outlook for 2023 has been reined-in to a more ‘normalised’ average 4.4%, falling to 3.3% in 2024. Reduced occupier ability and willingness to pay, set against input cost pressures and projected weaker order books (especially for consumer-linked occupiers) is expected to mount through 2023. This is likely to thin out occupier interest next year as some occupiers pause non-urgent requirements.

TOTAL RETURN EXPECTATIONS LOWERED

The anticipated outward yield shift in H2 this year is expected to largely correct and offset the inward yield shift recorded in H1. As such, we forecast minimal overall annual yield impact in 2022 and a reduced annual total return. In 2023, rents are expected to normalise to low single digit growth and overall returns are set to be driven more by income than capital return.

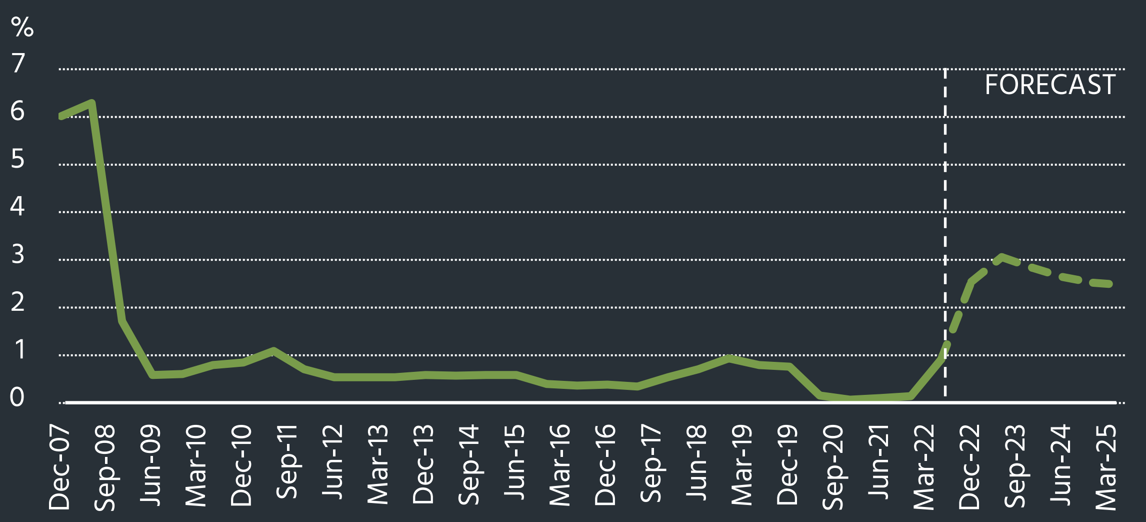
UK average annual prime headline logistics rental growth

Source: Gerald Eve

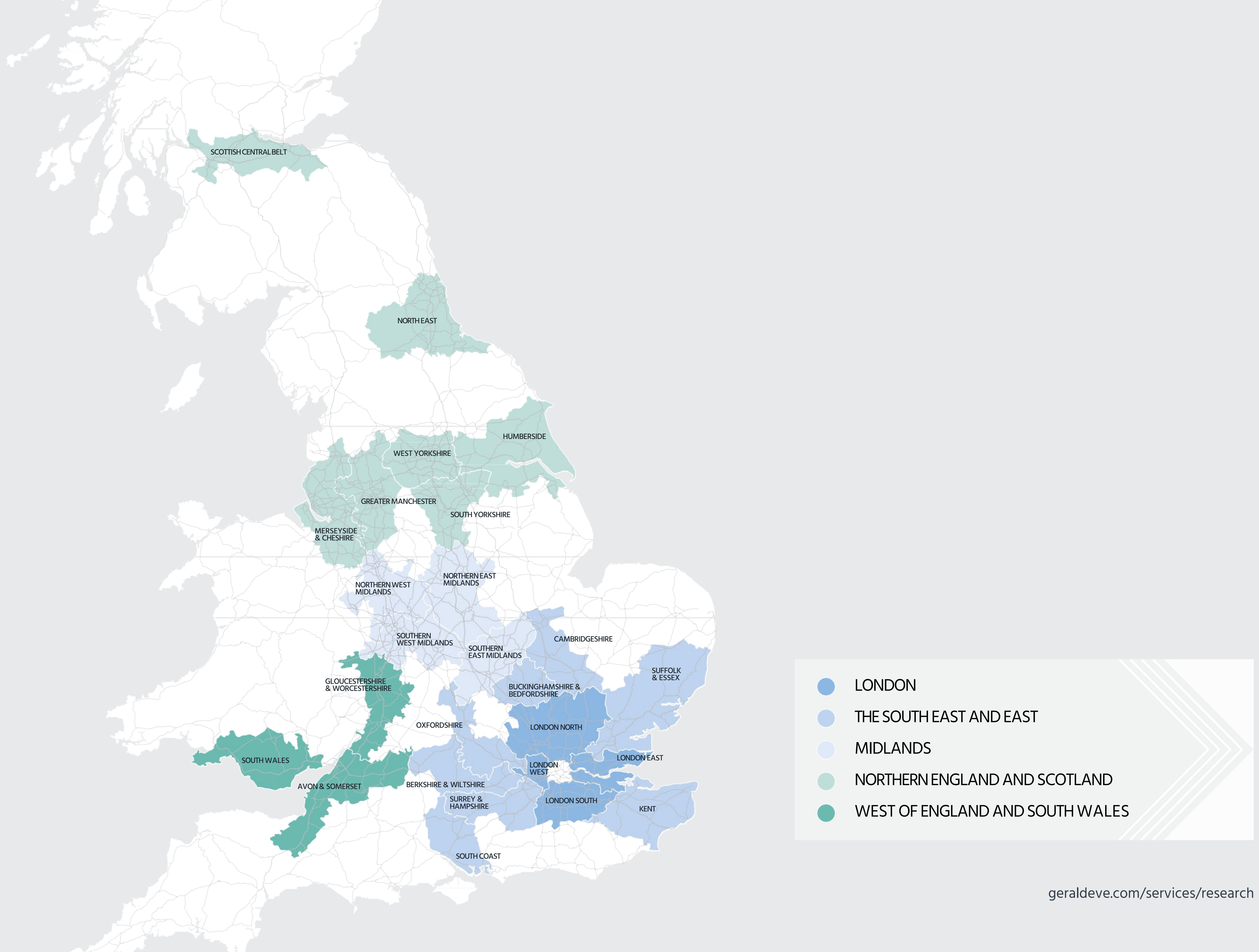


Forward looking financial market interest rate: GBP-LIBOR / SONIA

Source: Bank of England, Chatham Financial

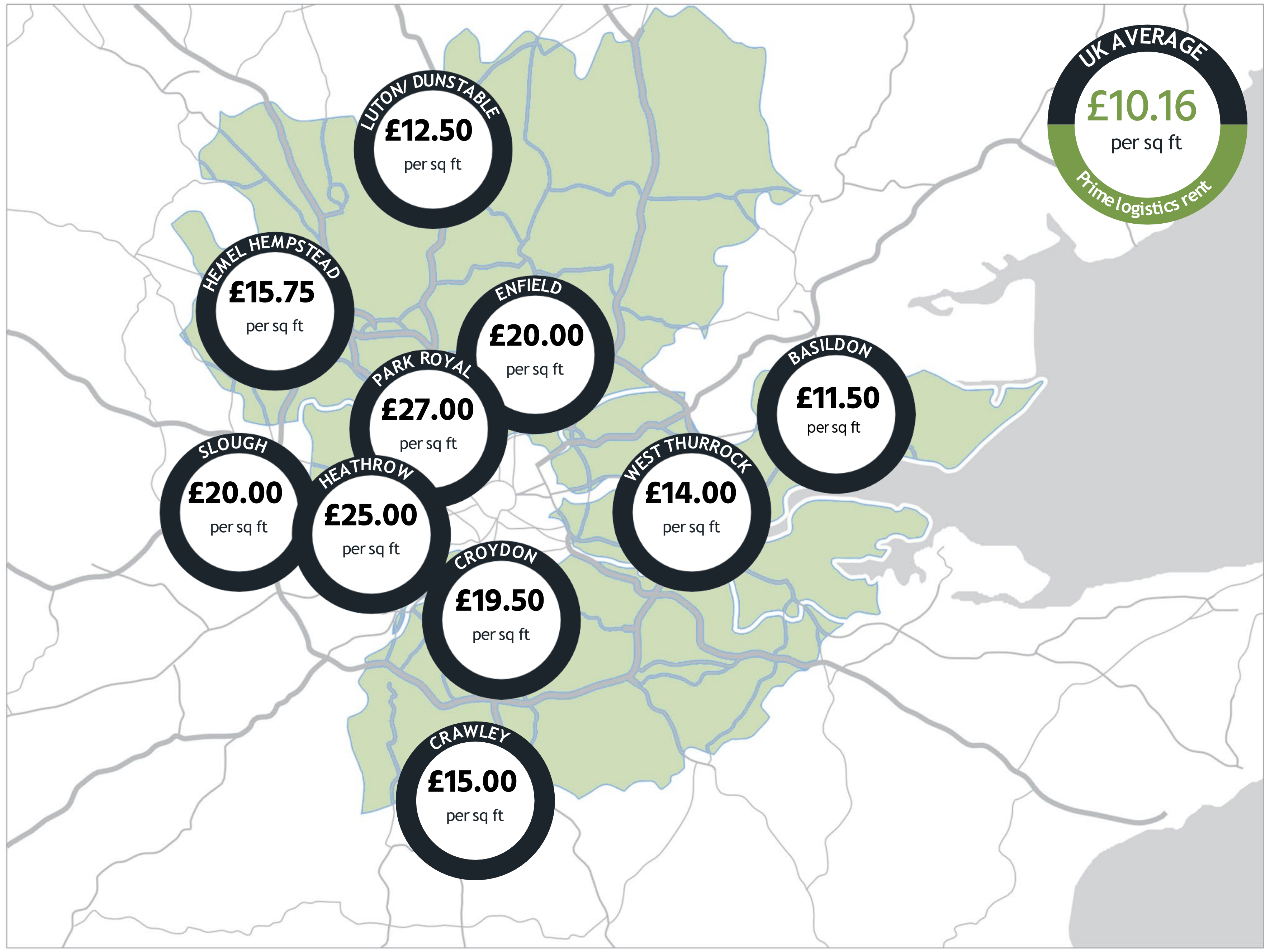


GERALD EVE REGIONS



LONDON

PRIME LOGISTICS RENTS



Prime rent: typical achievable headline rent in £ per sq ft for units of good quality over 50,000 sq ft and let on a typical 10 year lease to a tenant of strong covenant.

DEMAND

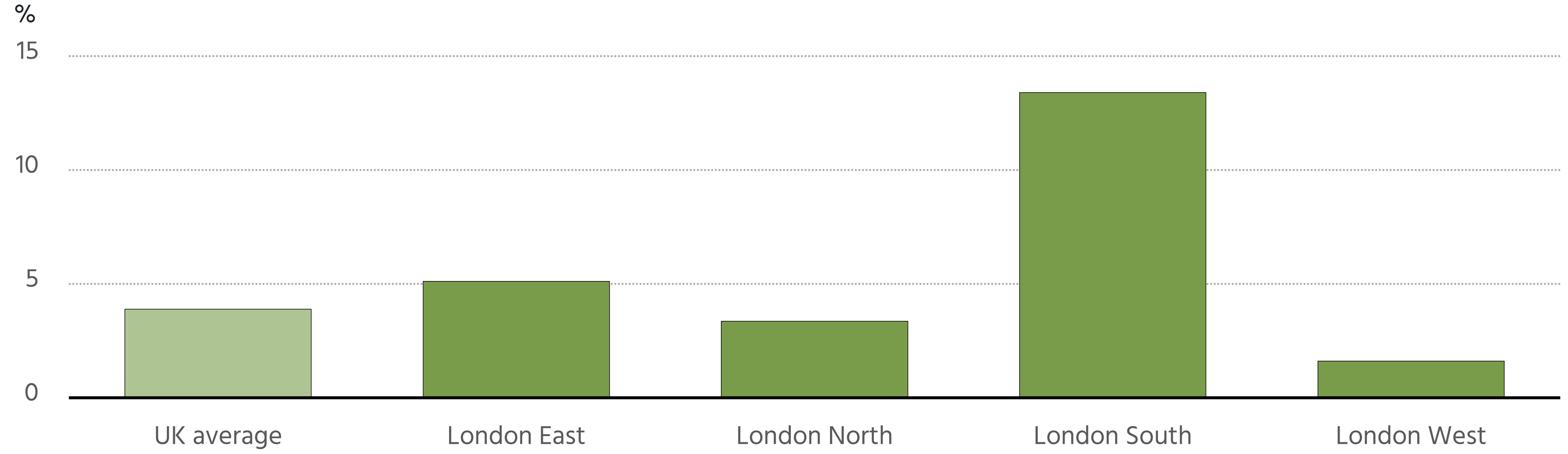
Occupier quarterly take-up

Source: Gerald Eve

AVAILABILITY

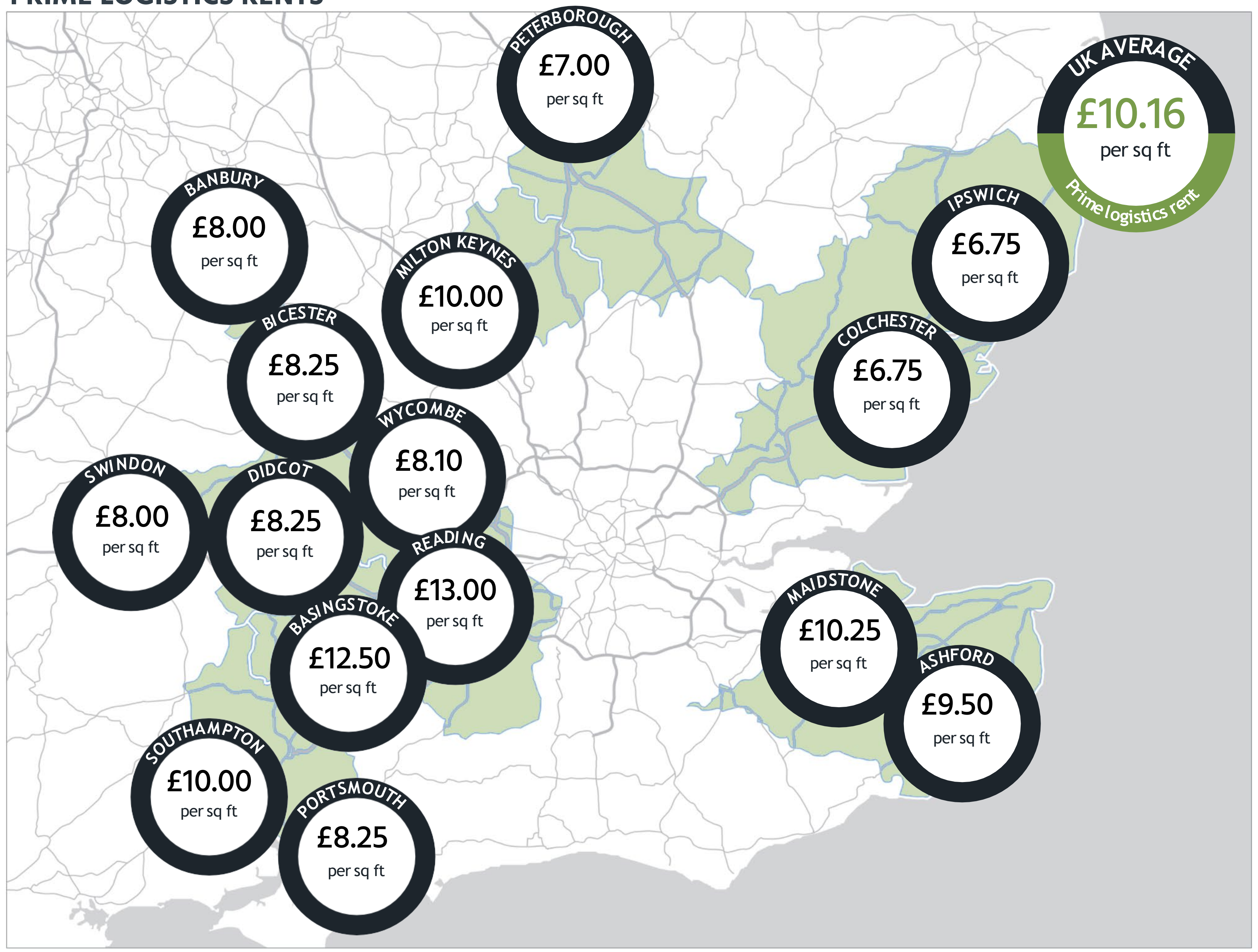
Availability rate

Source: Gerald Eve



THE SOUTH EAST AND EAST

PRIME LOGISTICS RENTS



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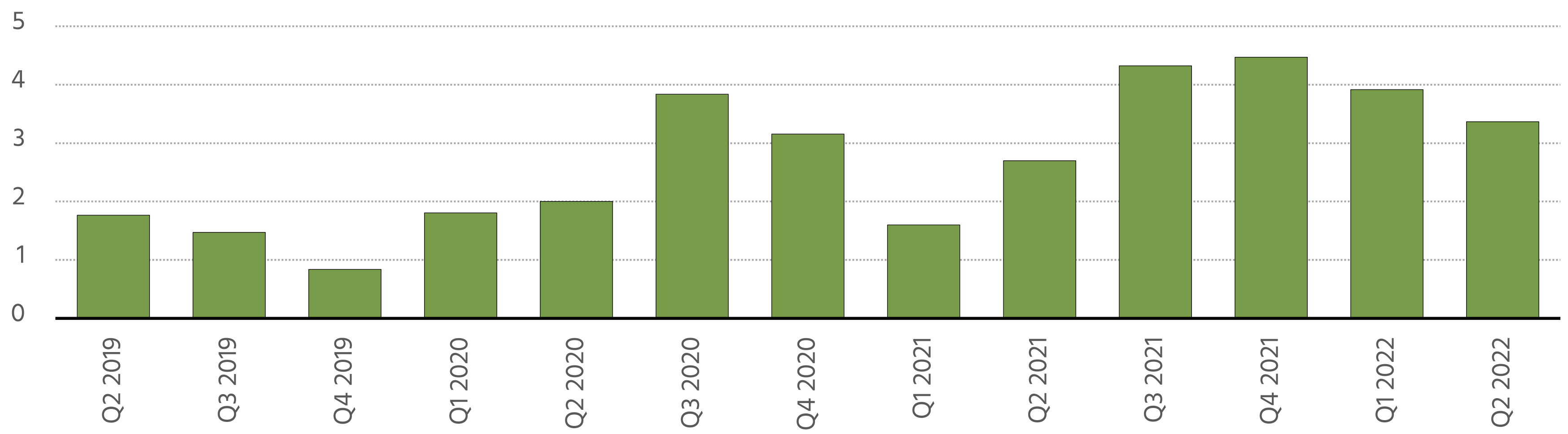
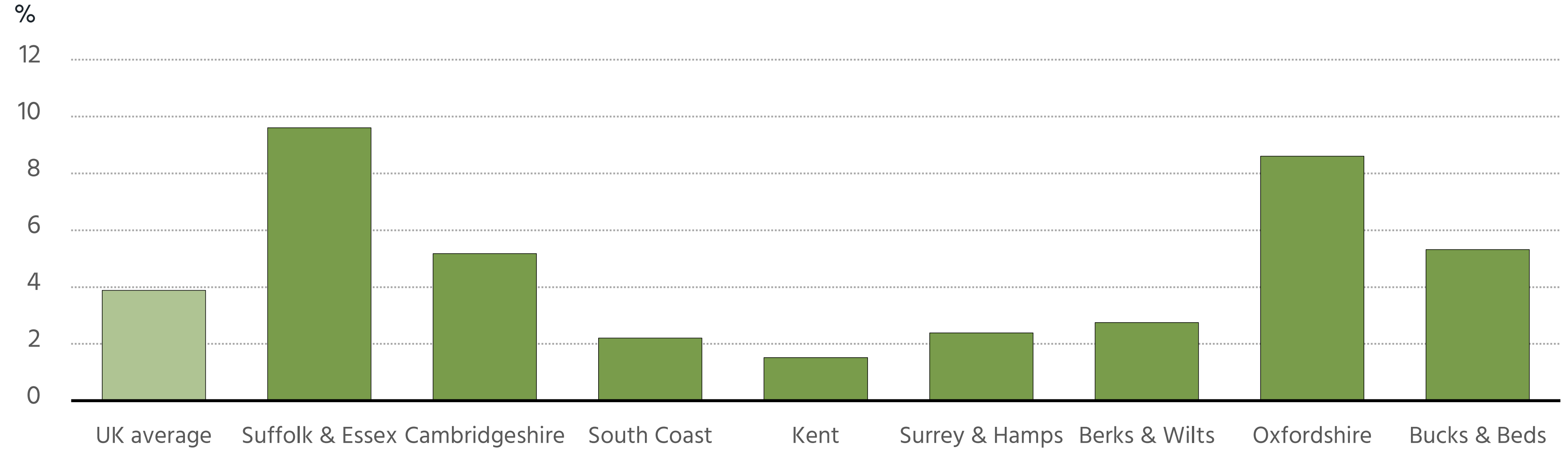


AVAILABILITY

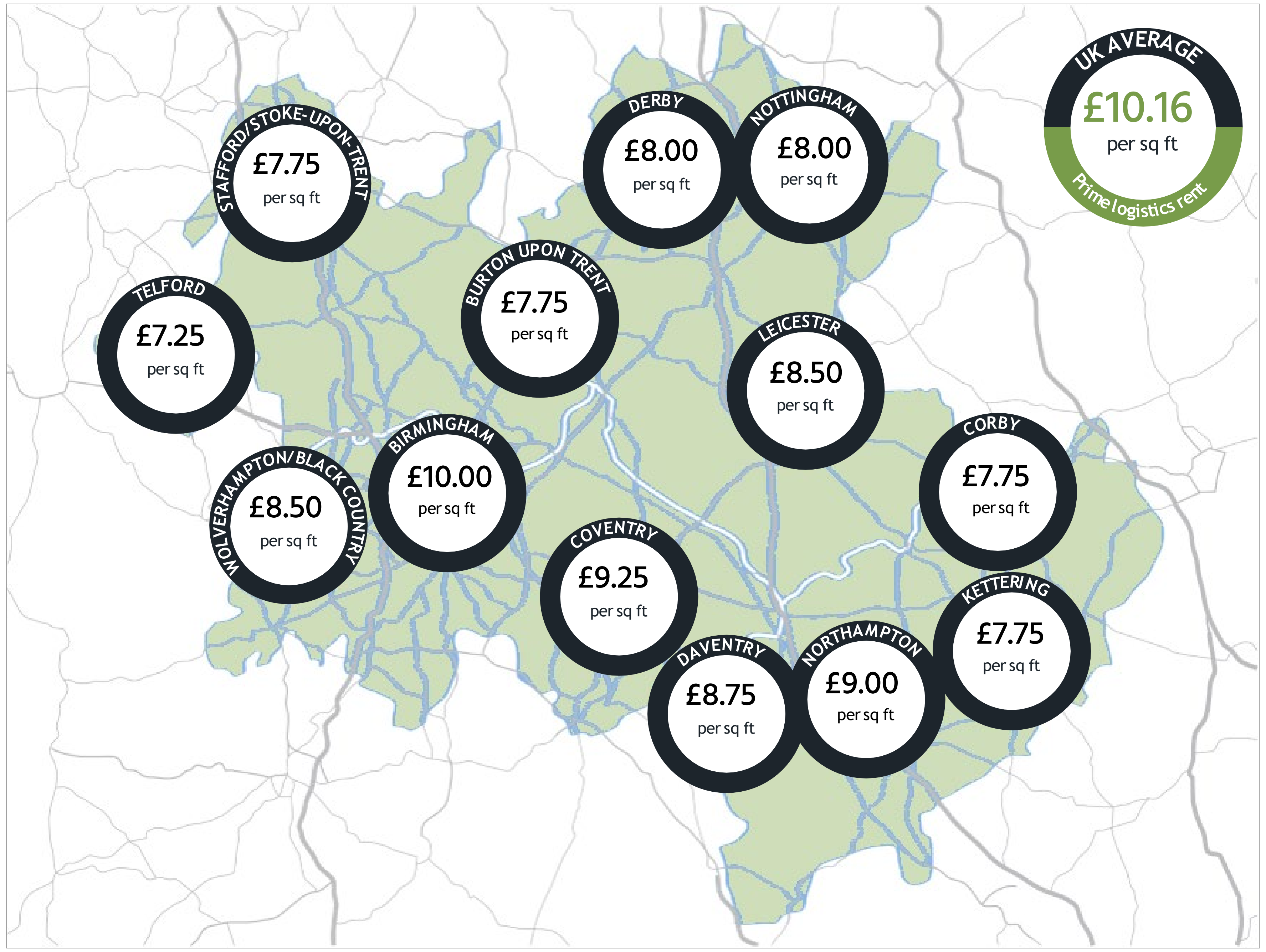
Availability rate

Source: Gerald Eve



MIDLANDS

PRIME LOGISTICS RENTS



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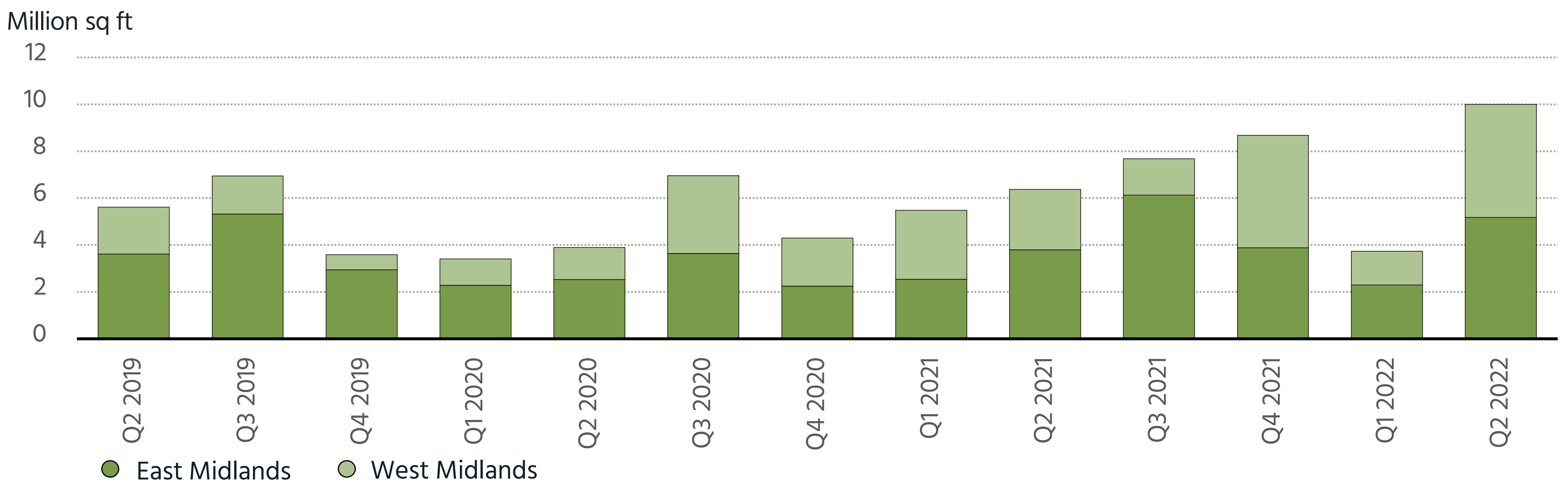


AVAILABILITY

Availability rate

Source: Gerald Eve

WEST OF ENGLAND AND SOUTH WALES

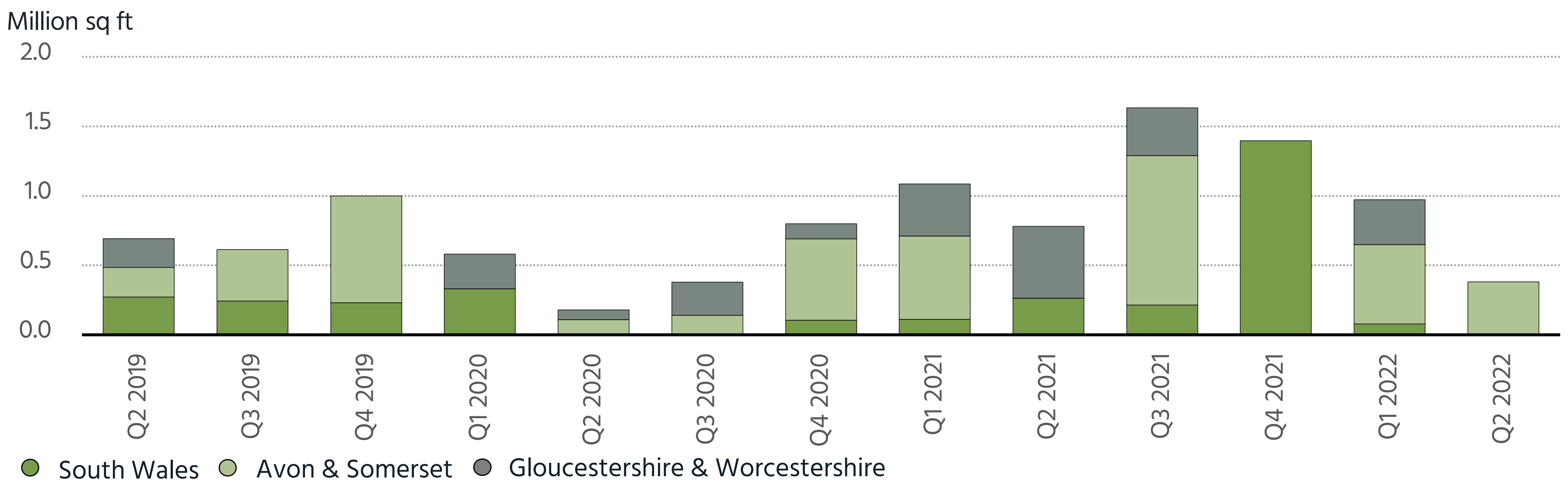
PRIME LOGISTICS RENTS

Prime rent: typical achievable headline rent in £ per sq ft for units of good quality over 50,000 sq ft and let on a typical 10 year lease to a tenant of strong covenant.

DEMAND

Occupier quarterly take-up

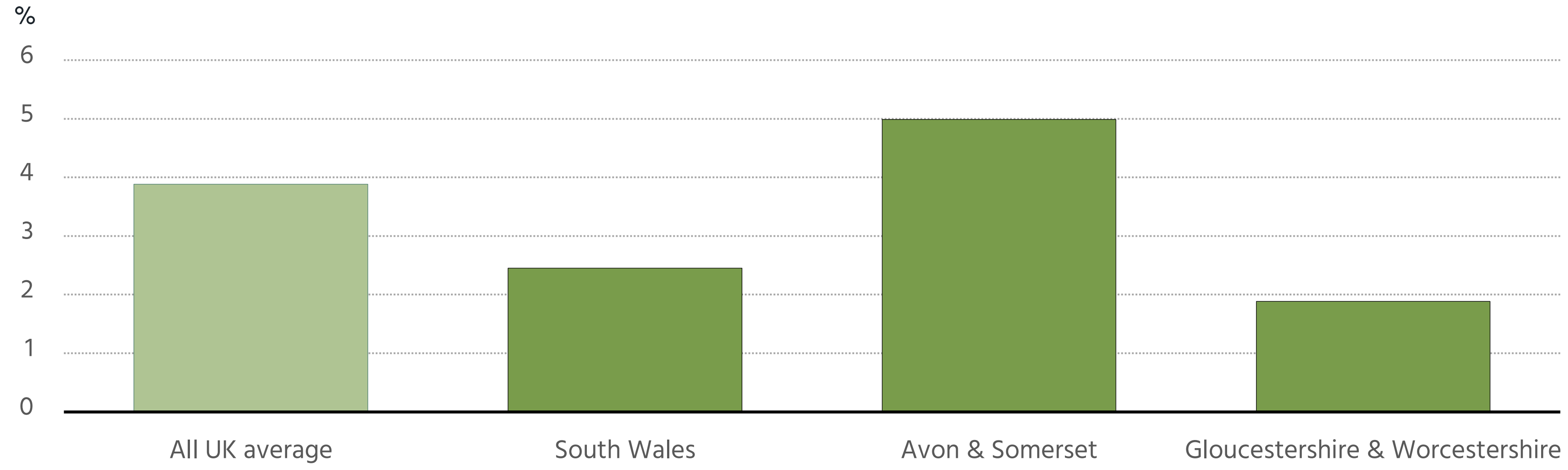
Source: Gerald Eve



AVAILABILITY

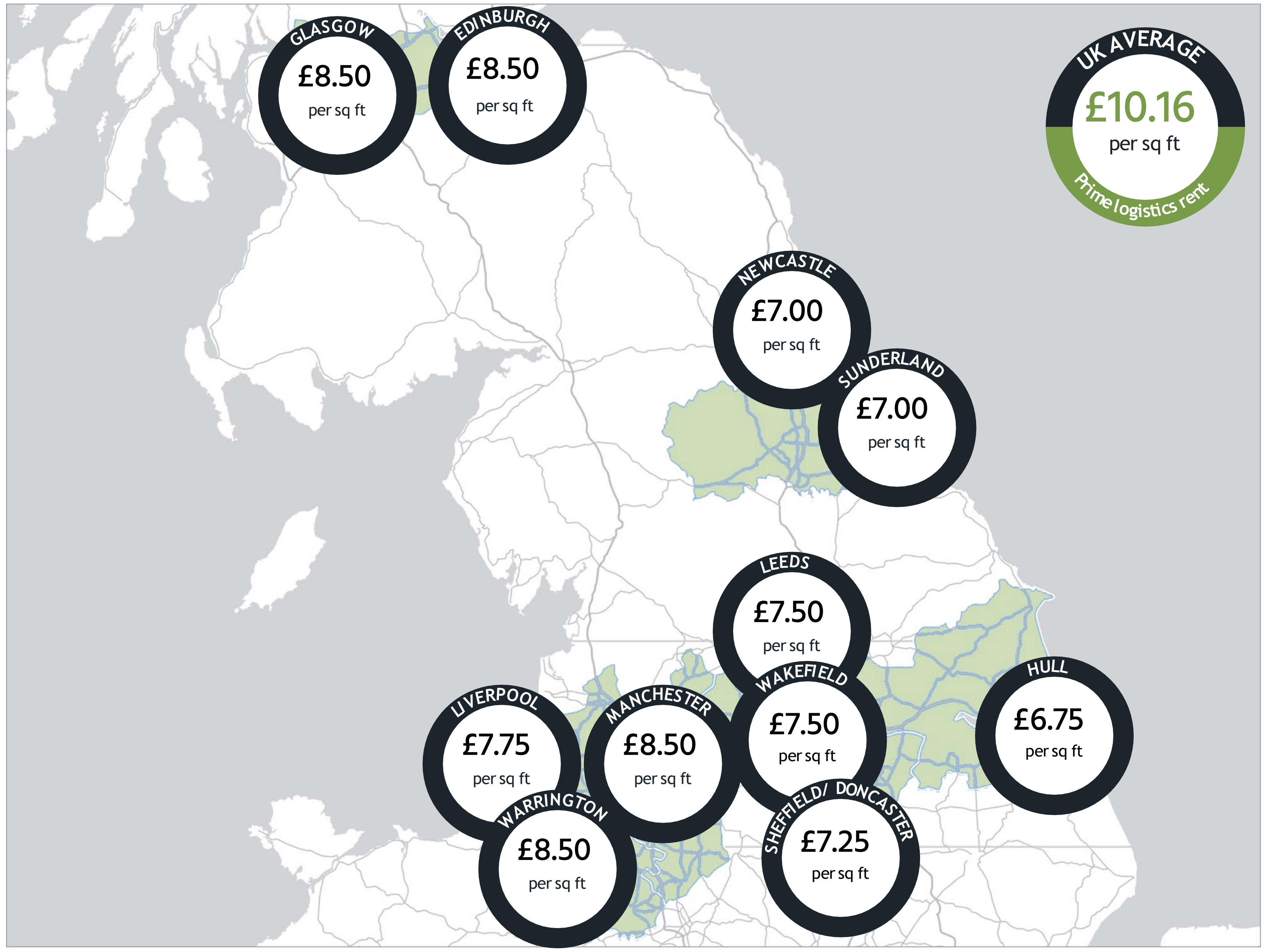
Availability rate

Source: Gerald Eve



NORTHERN ENGLAND AND SCOTLAND

PRIME LOGISTICS RENTS



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DEMAND

Occupier quarterly take-up

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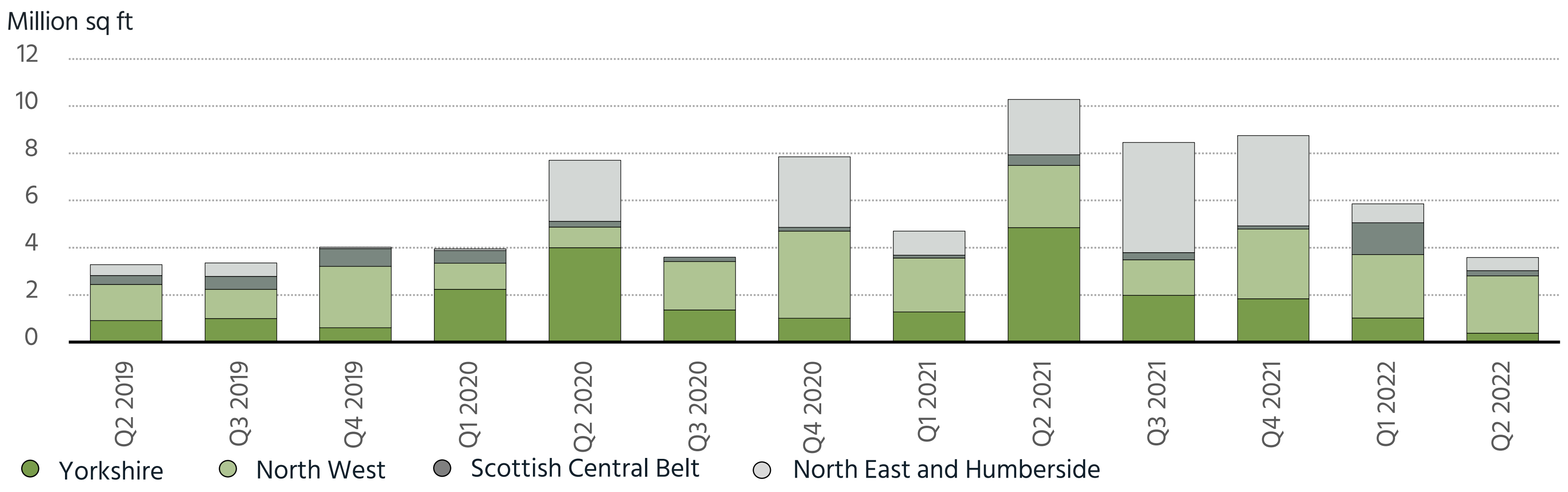

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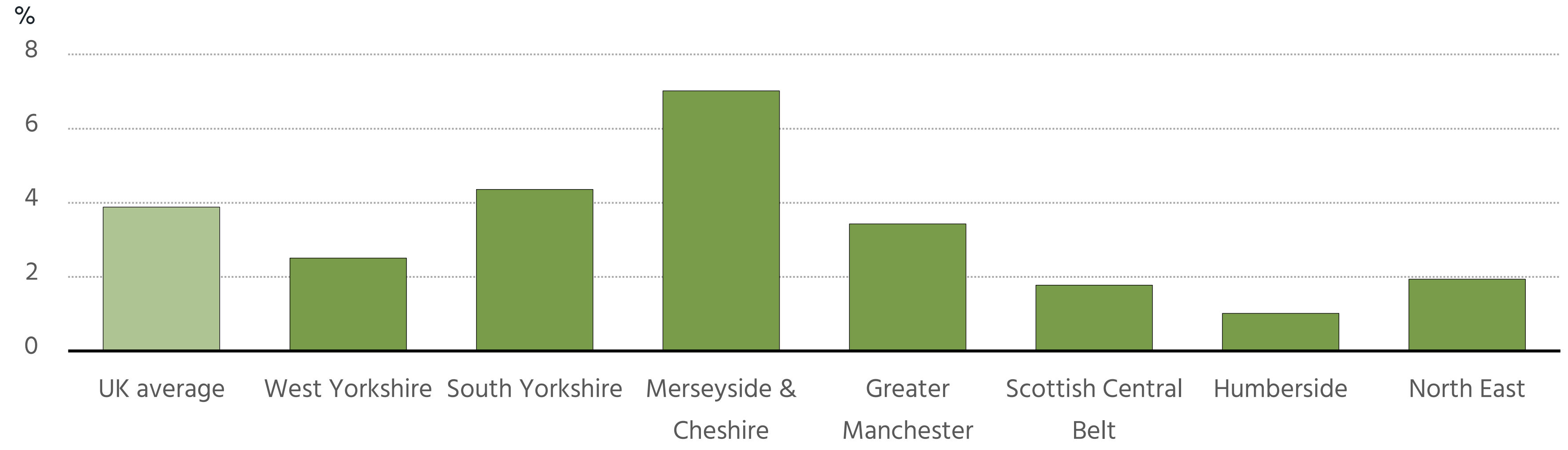

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GERALD EVE IN THE MARKET

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. Our specialists have been involved in several high profile transactions during the quarter. Please contact them directly for more information.

John Sambrooks acted for Birmingham-based logistics and distribution company LTS Global Solutions, on their acquisition of 131,000 sq ft unit at Prologis Park Hams Hall.

Jason Print advised Telereal Trillium on the sale of 28.5 acres to Trammell Crow on J19 of the M62 in Heywood, which at the end of the lease next year is set for redevelopment.

Will Strachan advised Investcorp on the disposal of a 220,164 sq ft warehouse facility in Leeds city centre let to Torque Logistics.

View our full-service offer

Find out how we can help

Prime Logistics is the definitive guide to the UK's distribution property market. Dealing with logistics units of 50,000 sq ft and above, this research report gives detailed analysis and statistics for 26 key distribution areas - from take-up, stock and development statistics to drivers of occupier demand, growth forecasts and regional outlooks. All previous editions can be downloaded from our website.