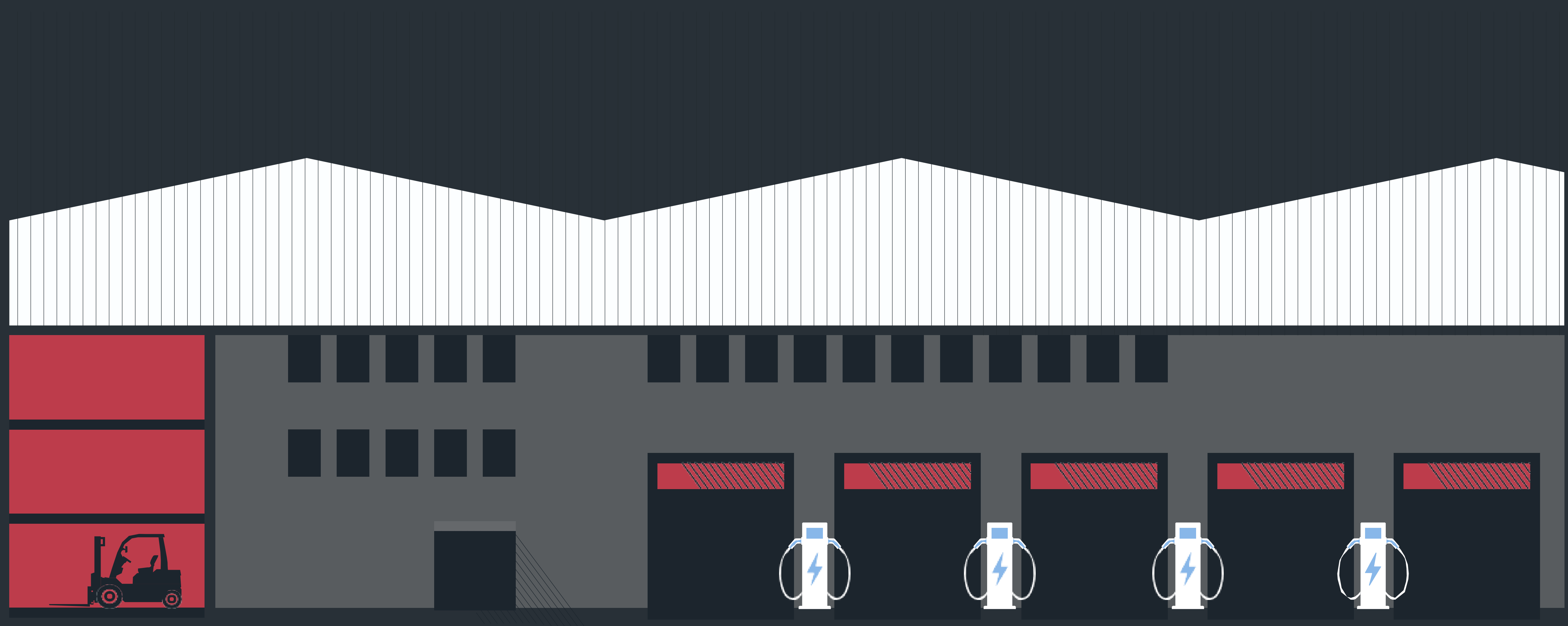
GERALDEVE

PRIME LOGISTICS

The definitive guide to the
UK's distribution property market

Q3 2022



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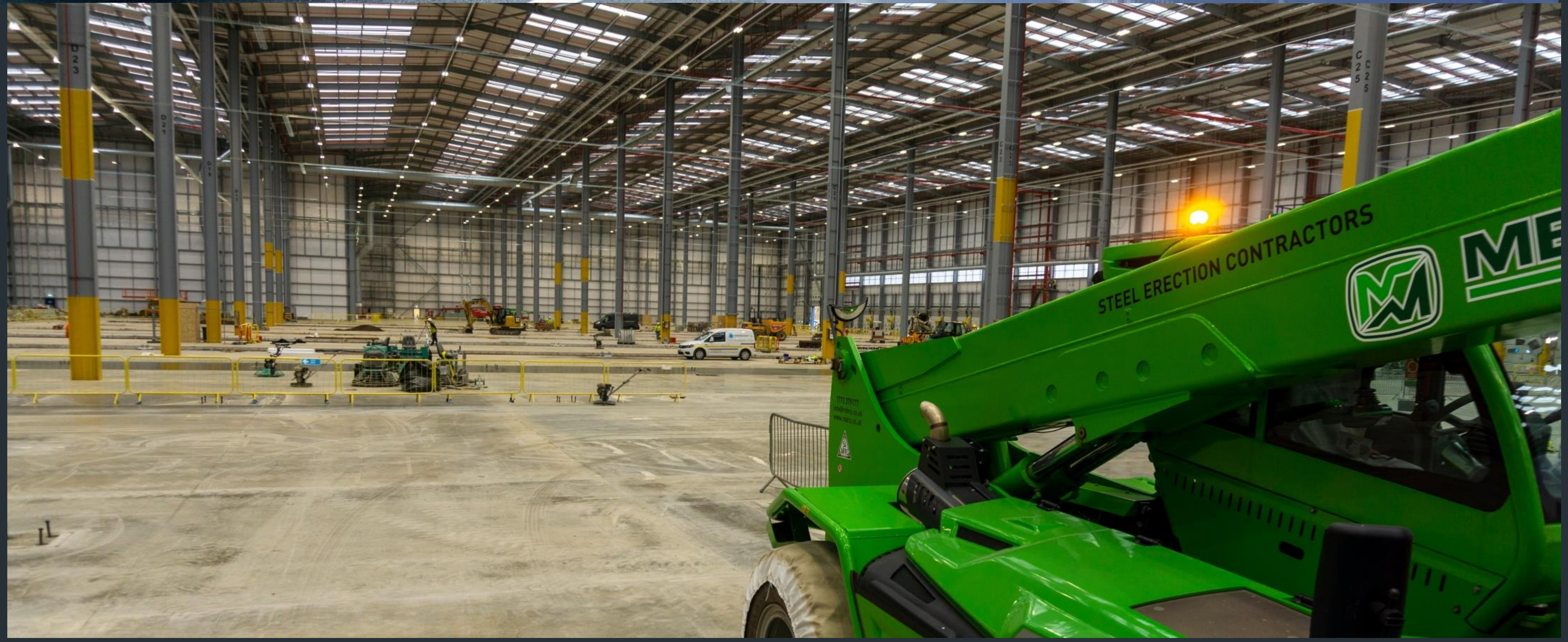
MARKET OVERVIEW

OCCUPIER DEMAND AND INVESTMENT PRICING SOFTEN BUT LIMITED SUPPLY WILL MAINTAIN POSITIVE RENTAL GROWTH

The pandemic boost to occupier demand and rental growth finally petered out in Q3. Some occupiers put acquisitions on hold, with internet retailers notably inactive as cash-strapped consumers reined in spending. Meanwhile, significant uncertainty in the financial markets caused a sharp correction in investment pricing. The rental growth outlook is still positive, however. Supply is extremely low and likely to be kept in check by more expensive development finance and the outward yield shift.

14.1m sq ft Take-up Q3 2022 ▼	**3.7%** Availability rate Q3 2022 ▼	**1.3%** New/modern availability rate Q3 2022 ▼
0.7% Prime rental growth Q3 2022 ▼	**6.3m sq ft** Spec development starts Q3 2022 ▲	**100bps** Outward prime yield shift in Q3 2022 ▲



OCCUPIER DEMAND

PANDEMIC DEMAND BOOST COMES TO AN END

Take-up was 14.1m sq ft in Q3, down 23% on the 18.2m sq ft transacted in Q2. This is the lowest quarterly total since Q1 2020. It seems that we are over the pandemic demand surge and activity is now likely to be more driven by traditional market forces than pandemic-linked requirements. There have certainly been fewer large scale expansionary deals and there are generally fewer super-urgent requirements for space compared with last year. Encouragingly though, even in the absence of pandemic-linked demand, Q3 take-up overall was still around 20% above the pre-pandemic quarterly average.

INTERNET RETAILERS LESS ACQUISITIVE IN Q3

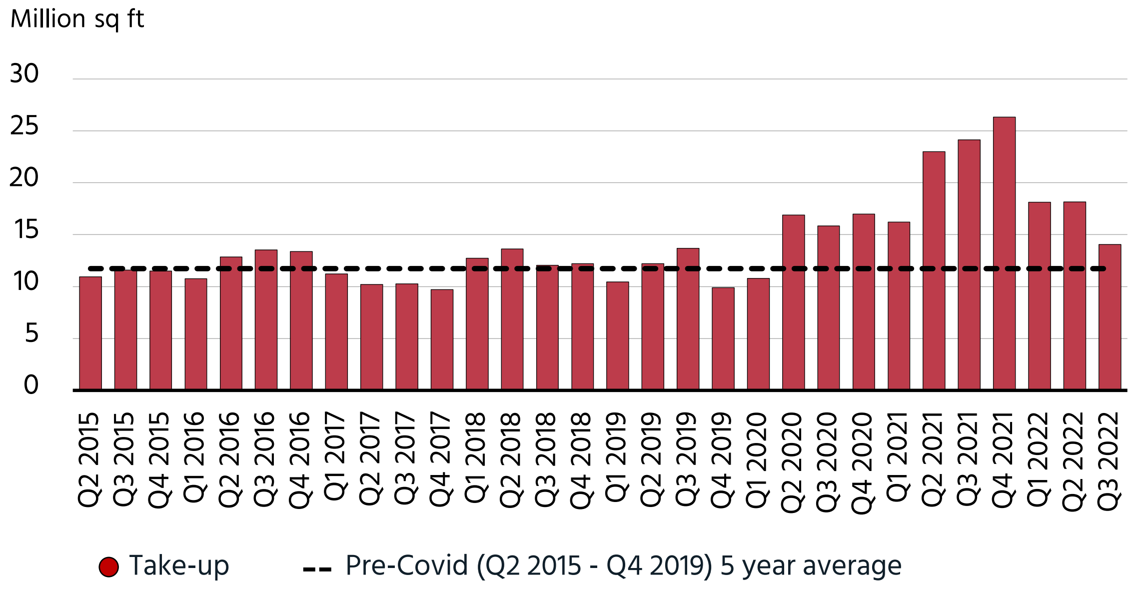
E-commerce remains a structural driver of demand for logistics but the sector is not immune to the impacts of the switch back to pre-pandemic shopping patterns and the retail recession more generally. Internet sales fell to 24% of the retail total in August, the lowest since March 2020. This, combined with weaker consumer demand more generally reduced the sector's need for space in Q3, which dipped below the 5-year average. Operations teams at some of the 'pandemic winners' are reassessing space requirements and some are looking at ways to cut costs or streamline portfolios.

LOGISTICS AND FOOD RETAILERS FILL THE GAP

Despite the slowdown in take-up from internet retailers, the broader retail and wholesale sector was still the most active occupier group in Q3, accounting for 41% of demand. Homeware retailers were active, but it was food-related retailers in the mid-box market that stood out. There were 13 separate deals involving food–related retailers recorded in Q3, including Farm Foods, Albion Fine Foods, AM Fresh and Danish Crown. The logistics sector was active too – accounting for 38% of all occupier demand – as freight specialist Maersk and others signed up to large buildings.

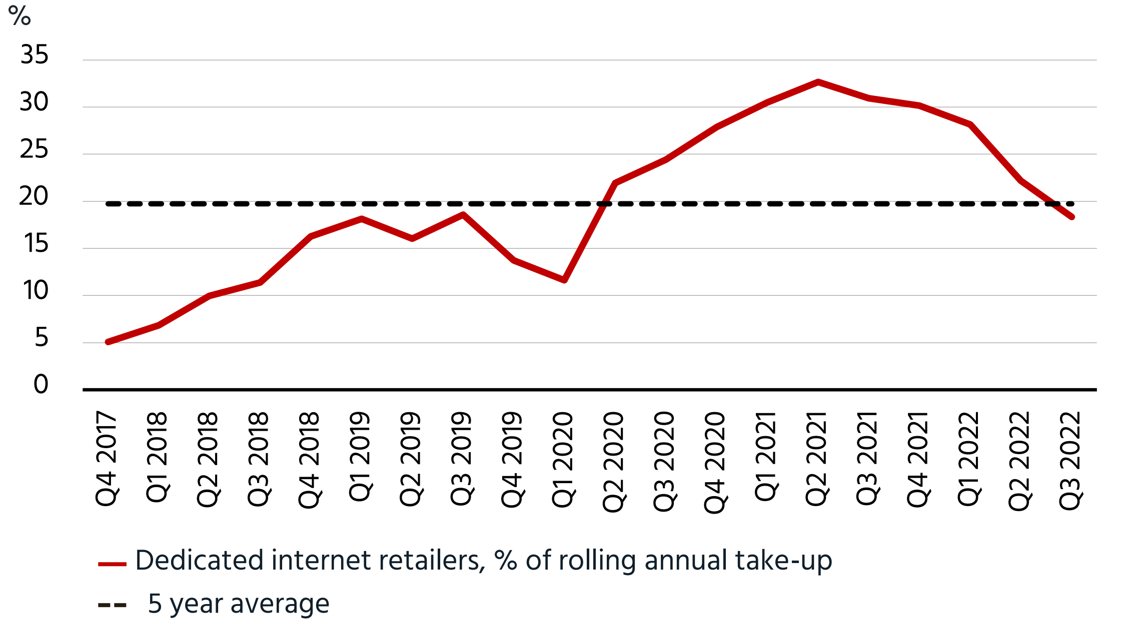
Quarterly take-up and 5-year pre-covid quarterly average

Source: Gerald Eve



Dedicated internet retailers, % rolling annual take-up

Source: Gerald Eve



Several logistics operators including Maersk, DHL, Rhenus Warehousing and Geodis took space in Q3 2022.

SUPPLY AND DEVELOPMENT

BELOW AVERAGE AVAILABILITY IN ALMOST ALL REGIONS

The overall availability rate continues to bump along at extremely low levels, falling from 3.9% in Q2 to 3.7% in Q3. This reflects a fall of over 1 million sq ft of marketed space. The volume of good quality secondary space fell further and offset the slight increase in new spec product on the market in Q3. Nearly all regions now have availability rates lower than their long term averages. Only relatively low stock regions, such as London South or Suffolk & Essex, have higher availability rates.

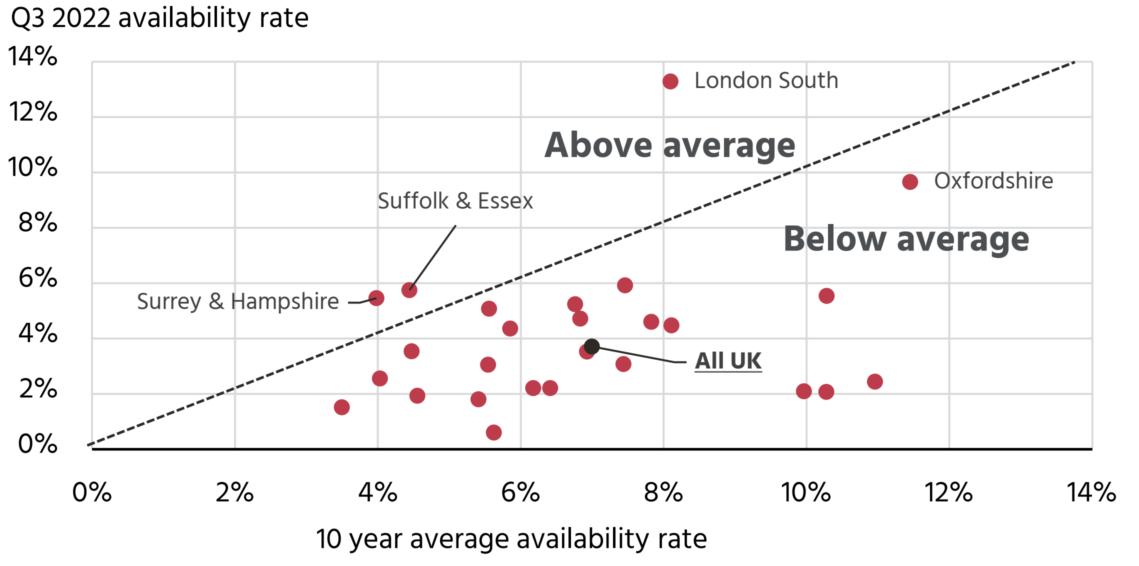
QUARTERLY DEVELOPMENT STARTS UP 55%

The overall volume of development starts (both purpose-built and spec) increased 55% to 12.5m sq ft in Q3, half of which was speculative. Amongst others, Prologis started on site on two big units at DIRFT in Daventry (628k and 327k sq ft) and Panattoni started on its 629,000 sq ft unit in Rotherham, which was subsequently let to Alliance Automotive Group. In the purpose-built market, Stoford started on the 668,000 sq ft unit for Stellantis in Liverpool. The most active speculative developers are those with locked-in construction costs and low debt levels. Those that bought land post-pandemic, looking to develop now at current construction prices have found it increasingly difficult to make the numbers stack up.

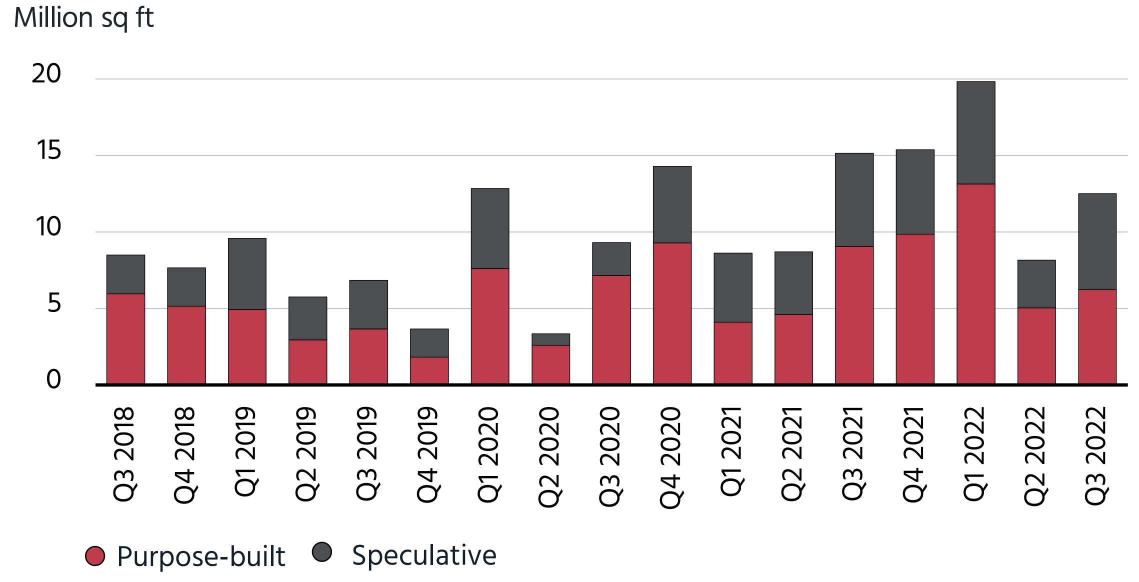
RISING BUILD COSTS AND YIELD SOFTENING TO KEEP A LID ON NEW SUPPLY

Around 9.5m sq ft of new buildings reached practical completion (PC) in Q3, 71% of which was speculative. This is a significant increase on the volume of space completed in Q2 and is in part reflective of the slippage of development timescales. Encouragingly 40% of the speculative space that completed in Q3 was let before PC. It is this healthy occupier hit rate on new developments, together with the rising cost of development finance that is likely to keep new supply in check in 2023. Build cost inflation is expected to be positive in 2023, albeit at a lower rate than 2022.

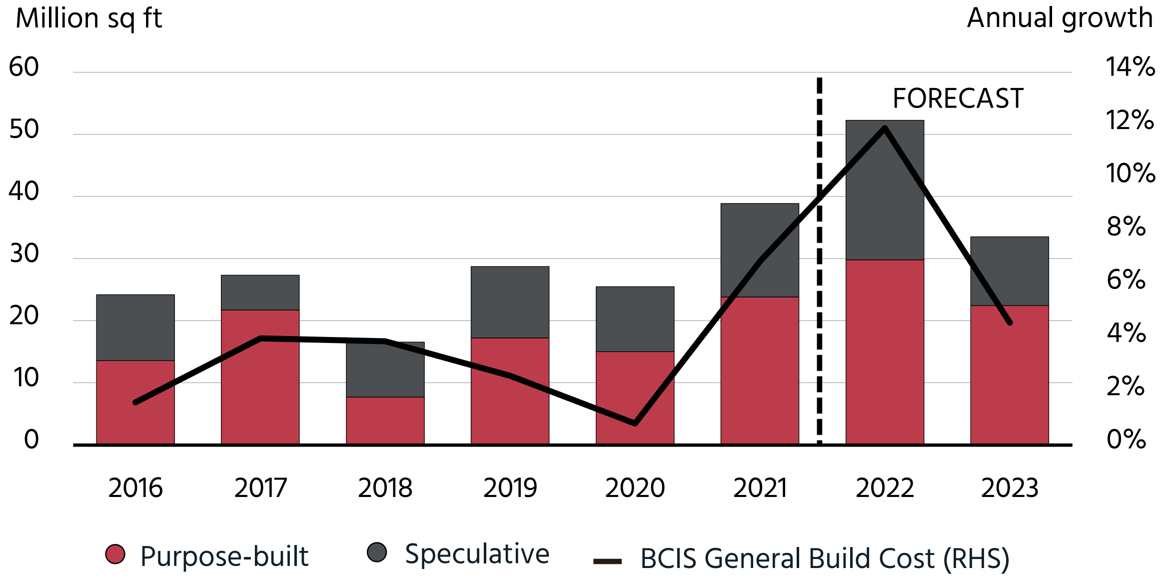
Q3 2022 regional availability rates vs 10-year averages
Source: Gerald Eve



Quarterly development starts by type
Source: Gerald Eve



Annual development completions by type and build cost
Sources: BCIS, Gerald Eve



RENTS AND INCENTIVES

RENTAL GROWTH SLOWED SHARPLY IN Q3

We recorded increases in six out of our 53 Gerald Eve centres in Q3. These equate to a UK average 0.7% prime quarterly rental growth, the lowest since Q2 2020. On an annual basis, rents have grown 13% so far this year and an incredible 17% since Q3 2021. However, this will continue to fall. Deals were done on speculative buildings which nudged on rents in a minority of locations – Park Royal, Enfield, Swindon for example, but on balance sentiment softened in Q3. The post-pandemic period of accelerating rents has come to an end. Occupier purchasing power and appetite for new space is weakened, and several occupiers have put acquisitions on hold.

LIMITED SUPPLY TO MAINTAIN POSITIVE RENTAL GROWTH

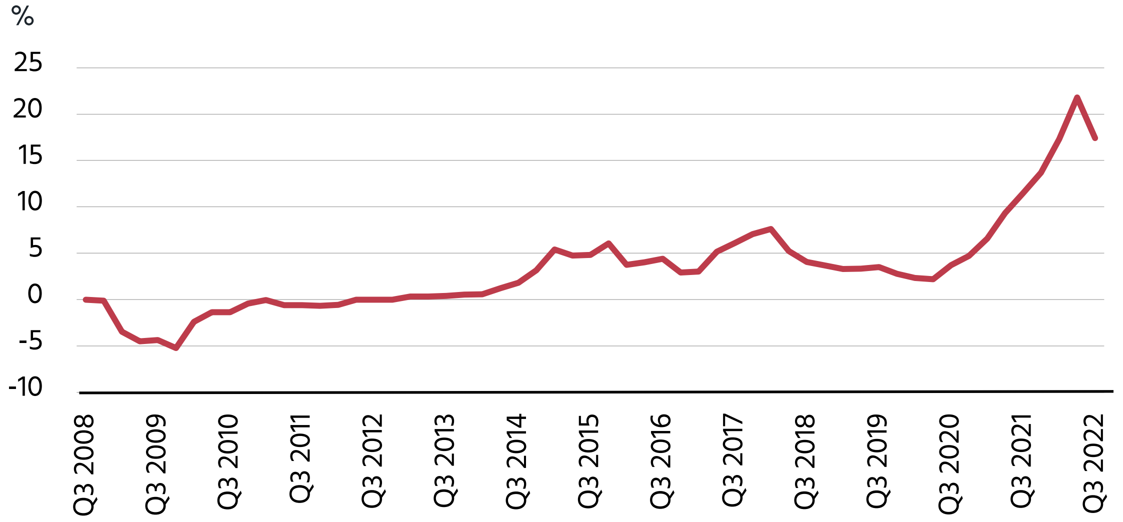
Developers are aware of the projected weaker occupier demand pool in 2023 but need to cover construction costs. Costs will be highest for those that bought recently, particularly if debt-backed and need to refinance. High rents on newly-developed buildings are likely to continue to set market tone, but occupiers will be less willing and able to pay them. Longer void periods are likely if landlords hold out for these rents. Meanwhile more expensive development finance and build cost inflation will likely limit the delivery of future speculative schemes.

BUSINESS RATE RISES TO ADD TO OCCUPIER COST PRESSURE IN 2023

Cost pressures are mounting for occupiers and future order books have been dented by the consumer recession and cost of living crisis. Increased operational, labour and utilities costs, not to mention more expensive debt costs, have put increased pressure on already-tight margins for some. Government support for businesses in the form of the energy price cap is welcome, but will potentially be short-lived, with relief set to end in March 2023. This will coincide with the increase in business rates liabilities, based on the unprecedented period of rental growth in the sector between 2017 and 2021.

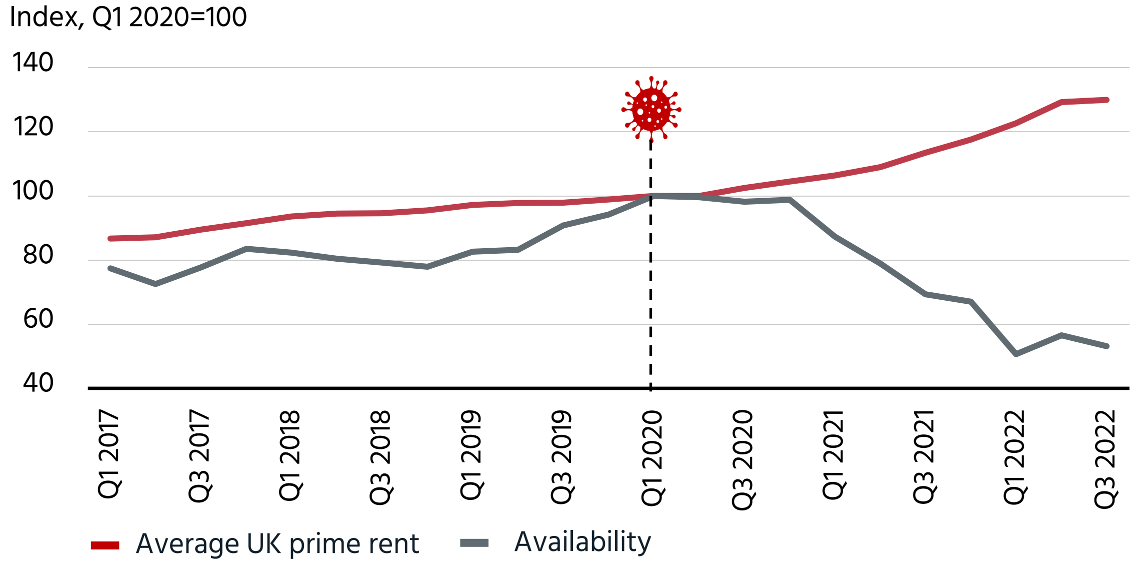
Annual prime logistics rental growth

Source: Gerald Eve



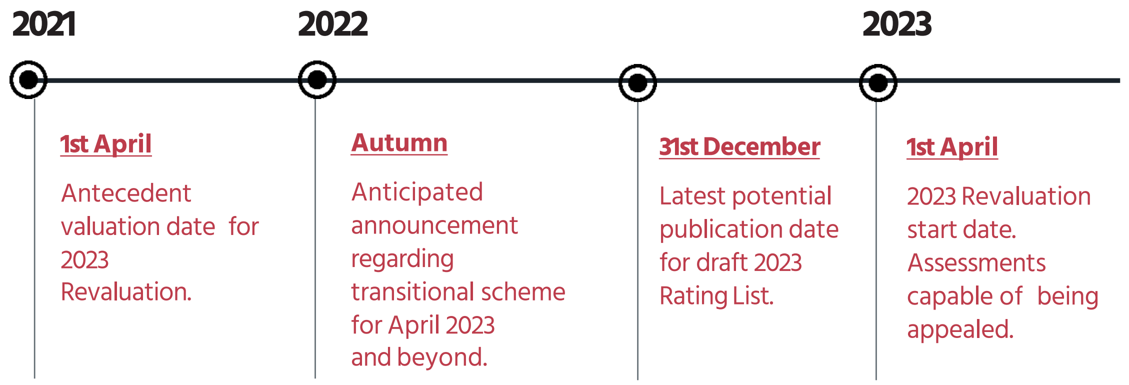
Indexed prime rents and availability

Source: Gerald Eve



Key dates leading up to the 2023 rating revaluation

Source: Gerald Eve



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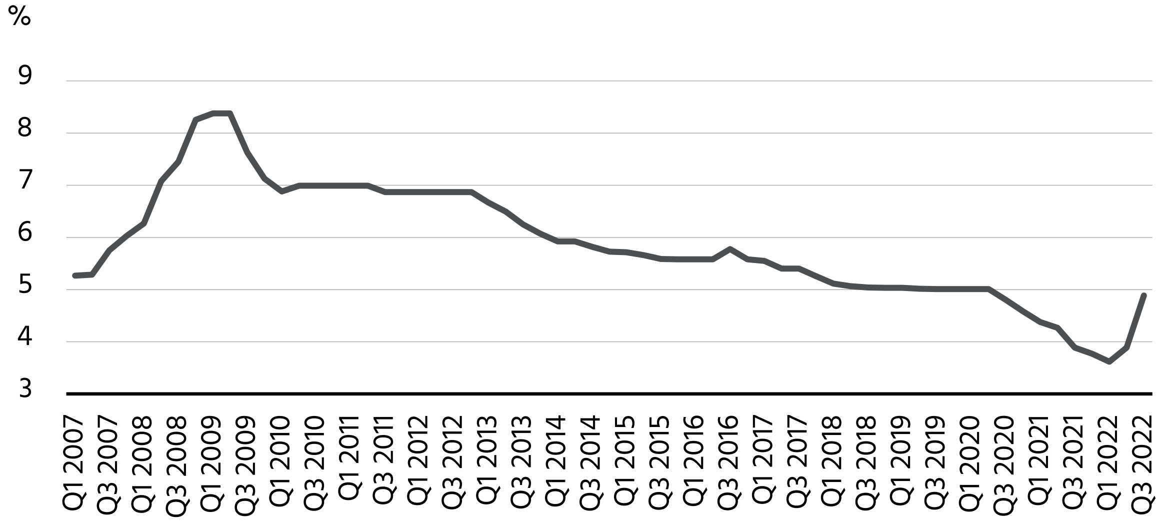
INVESTMENT

LARGEST EVER QUARTERLY OUTWARD YIELD SHIFT

Average prime logistics yields moved out 100bps in Q3, the biggest ever outward quarterly yield shift on record. The previous record was in Q2 2008, when prime yields moved out 81bps to an average 7.08%. Nevertheless, in a reflection of how industrial is now seen more favourably by investors as an asset class, the 100bps outward movement in Q3 2023 still only took average prime yields to 4.89%. Such a sharp correction in pricing reflects the increased economic uncertainty and the low-yielding sector's exposure to rising debt costs. Deals were pulled and reassessed in the light of financial market uncertainty, and on the sell side, we have seen some funds suspend dealings or impose redemption limits in order conduct orderly sales.

All UK average prime logistics yield

Source: Gerald Eve

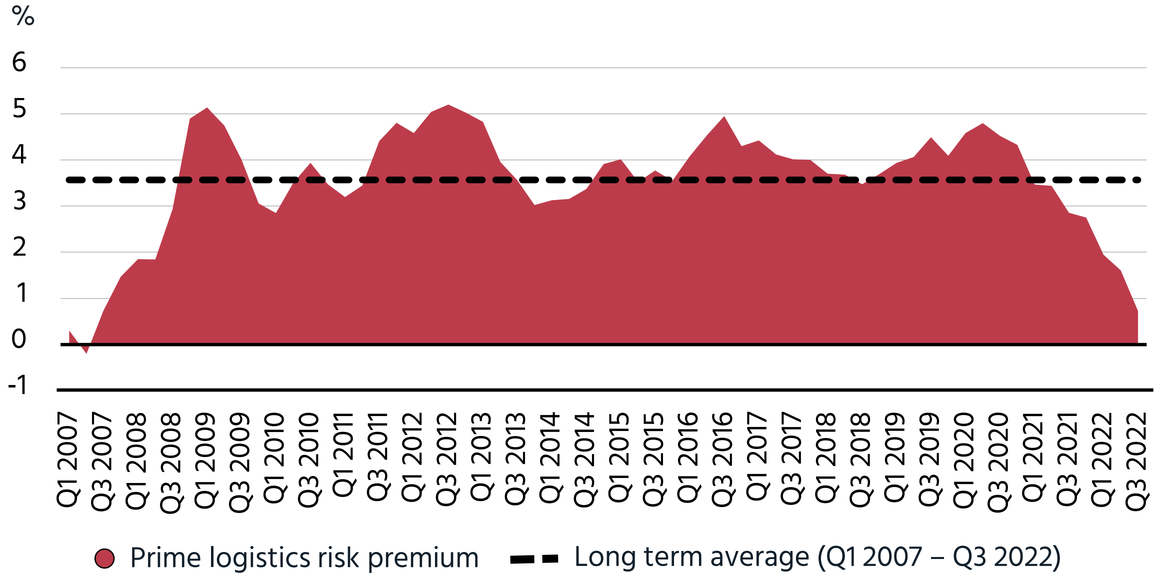


EROSION OF PRIME LOGISTICS RISK PREMIUM

Recent increases in the Bank rate and expectations of further increases next year mark the end of the "cheap money" era of the 2010s. Government bond yields spiked in Q3, but despite prime logistics yields having risen sharply too, the risk premium fell to lows not seen since the years preceding the financial crisis. Projections of further increases in bond yields next year will impact logistics property pricing. Investors will demand a premium over the risk-free rate, but the combination of a higher interest rate environment and the relatively desirable industrial income stream, will mean that premium is likely to be lower than historic averages.

Prime logistics risk premium and long term average

Sources: Bank of England, Gerald Eve

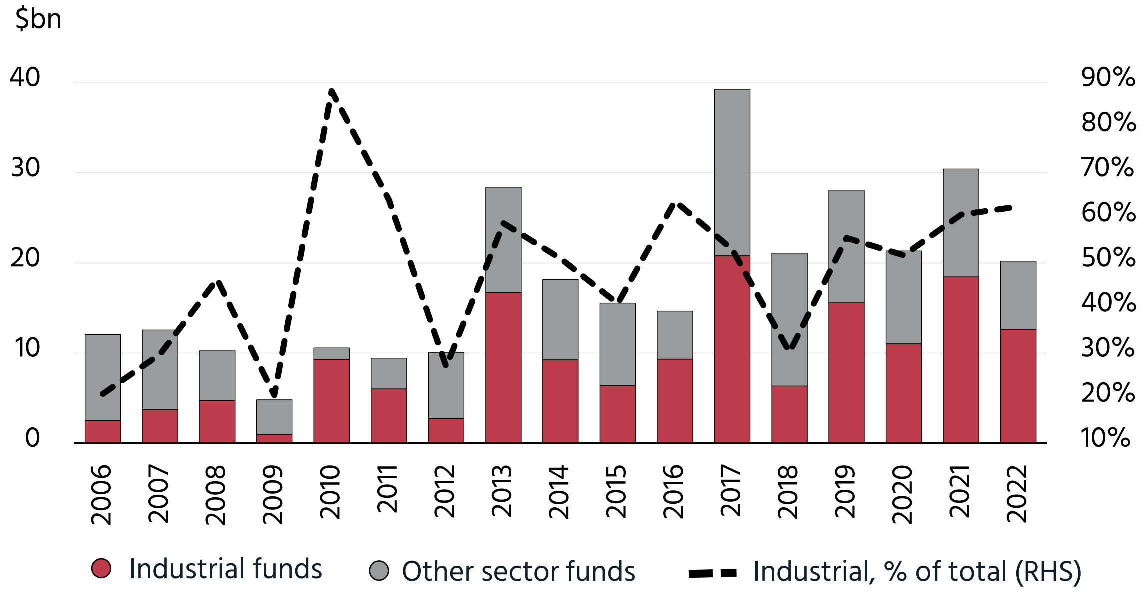


CAPITAL ALLOCATIONS TO INDUSTRIAL REMAIN HIGH

Outward yield shift was evident in nearly all commercial property segments in Q3. The logistics sector, after a prolonged period of yield compression is more exposed to rising debt costs and the narrowing spread with bonds, but still remains one of the most attractive asset classes. The proportional allocation to industrial-focused funds increased from 30% in 2005 to 60% in 2021. Over the last five years, around 52% of raised capital incorporated a UK industrial focus. Such a weight of money will help moderate outward yield movements somewhat.

Capital targeting commercial real estate

Source: Preqin, Gerald Eve



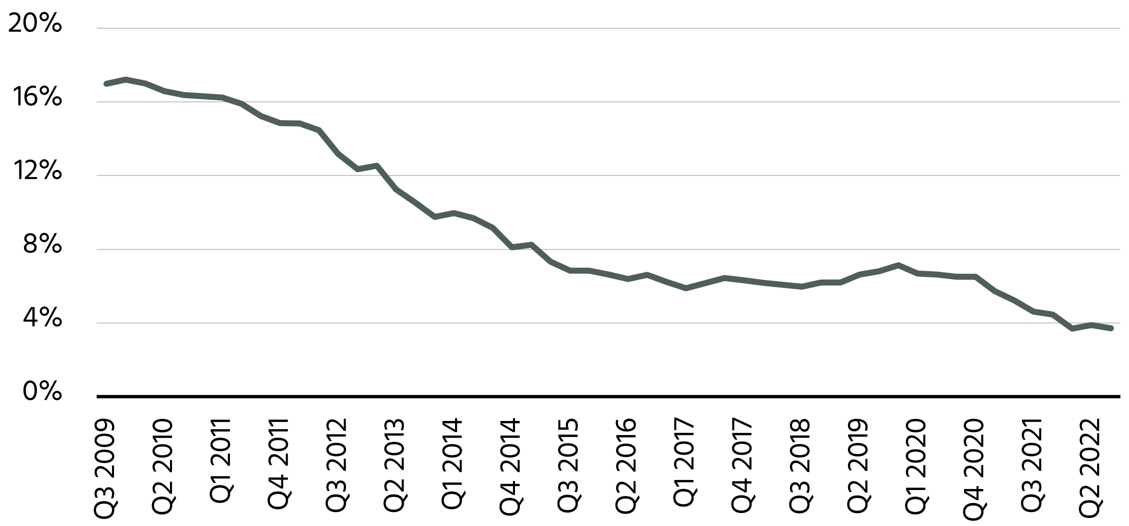
SPOTLIGHT: RENTAL GROWTH OUTLOOK: SUPPLY SIDE RESILIENCE

AVAILABILITY RATE AT NEAR ALL-TIME LOW

The overall rate of availability continues to bump along at extremely low levels, falling from 3.9% in Q2 to 3.7% in Q3. New/modern buildings now account for 62% of all availability, and there are very few secondhand buildings on the market ready for immediate occupation. Secondhand availability has been falling for years now and reflects the low levels of administrations and default rates in the sector. This is likely to change as the impacts of the impending recession are felt, but this will be from a very low base. Some buildings will be returned to the market because of cost-cutting or administrations and 2022 is likely to mark the low point of availability in the current cycle.

All UK average availability rate

Source: Gerald Eve

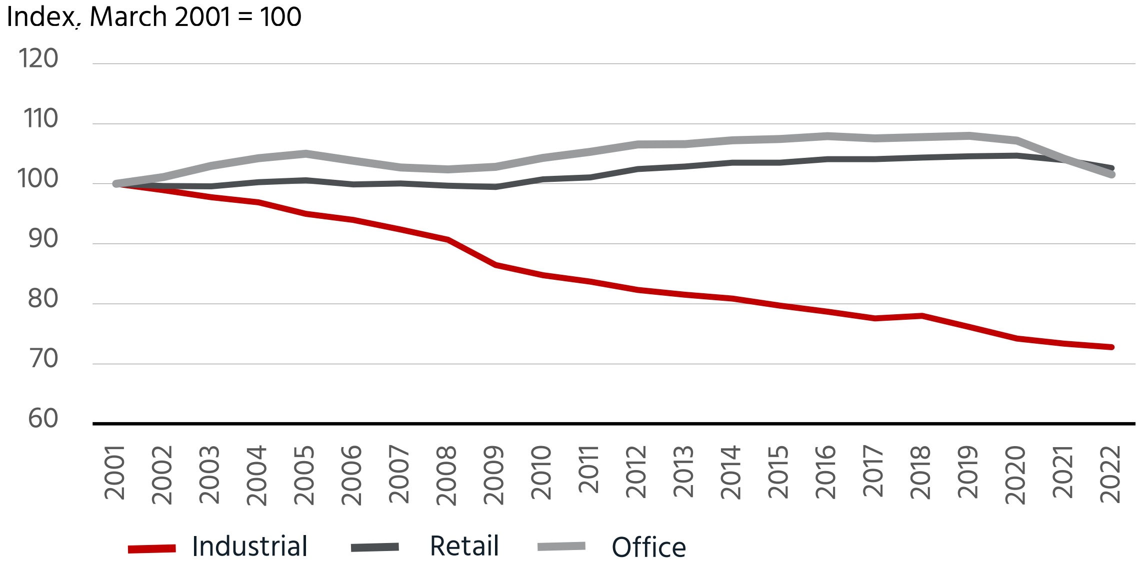


LONG TERM LOSS OF LONDON INDUSTRIAL STOCK

Over the past 20 years, London has lost almost 30% of its industrial floorspace according to the VOA. Higher value uses such as residential, and to a lesser extent, offices, have over time eaten away at overall industrial stock levels in the capital. This in turn has restricted the supply of available land for industrial development and, up until relatively recently, significantly pushed up residual land values. Fewer prime sites in the capital for development is another reason why supply is likely to be kept in check and will help keep upward pressure on rents.

Indexed change in London floorspace by main sector

Source: VOA, Gerald Eve

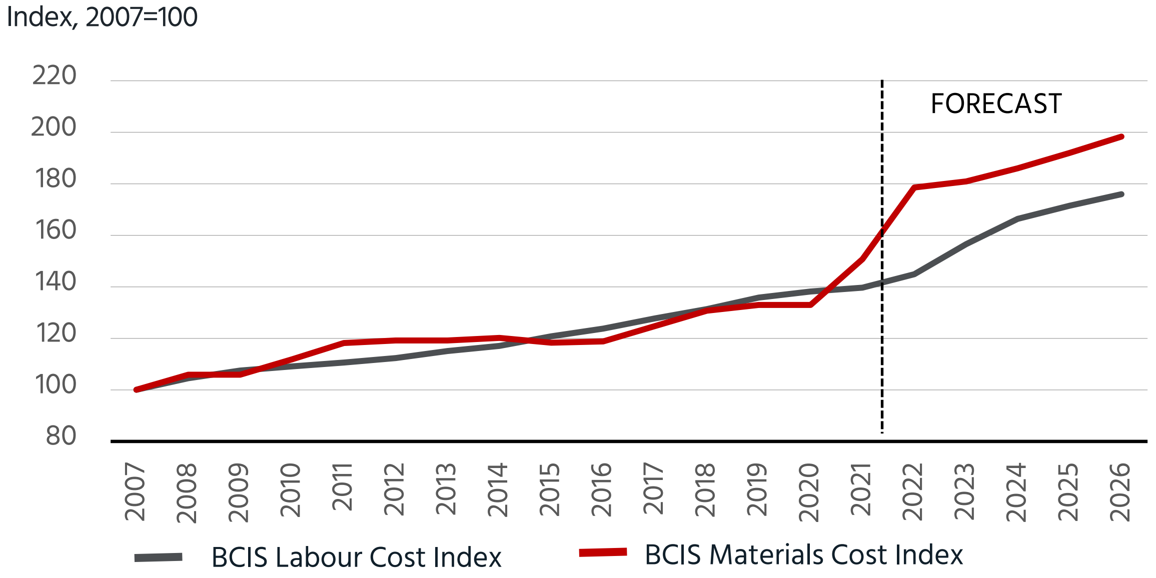


BUILD COST INFLATION LIKELY TO LIMIT DEVELOPMENT RESPONSE NEXT YEAR

The more established specialist developers, with locked-in construction costs and low debt levels, have been relatively less affected by recent economic turbulence than others. If anything, it's renewed the conviction to start schemes and deliver high quality ESG space. However, there are less established developers, notably those that bought land in the past two years, that have seen rising property yields and for whom development appraisals no longer stack up. This will intensify as the cost of labour and materials continues to increase next year and in turn, will help keep supply in check.

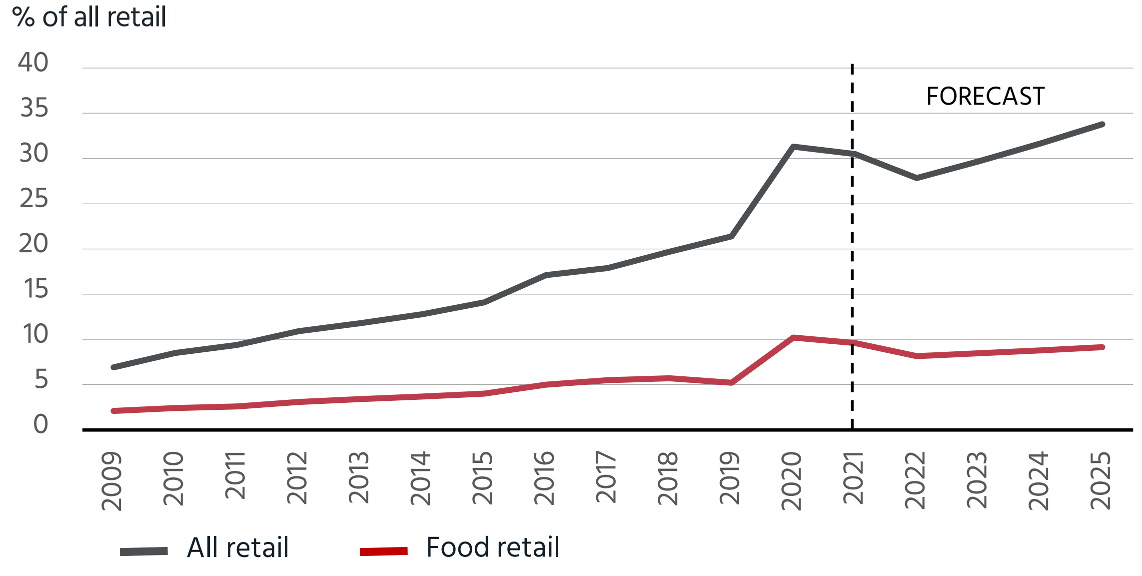
Development costs: labour and materials

Source: BCIS, Gerald Eve

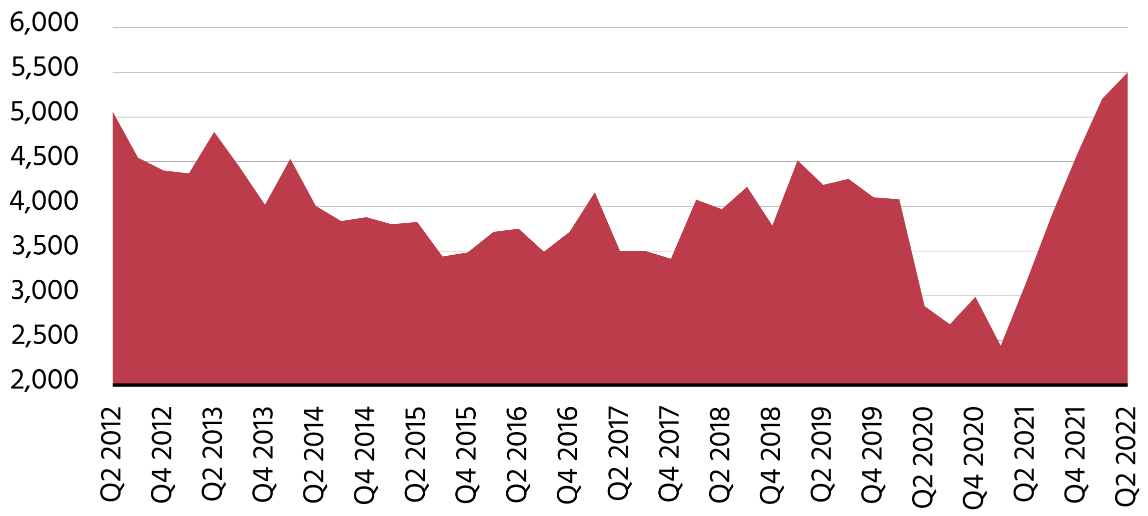


SPOTLIGHT: RENTAL GROWTH OUTLOOK: DEMAND SIDE PRESSURES

Internet retail, % of total retail sales
Sources: ONS, Gerald Eve



Quarterly UK registered company insolvencies
Sources: Companies House and Insolvency Service, Gerald Eve



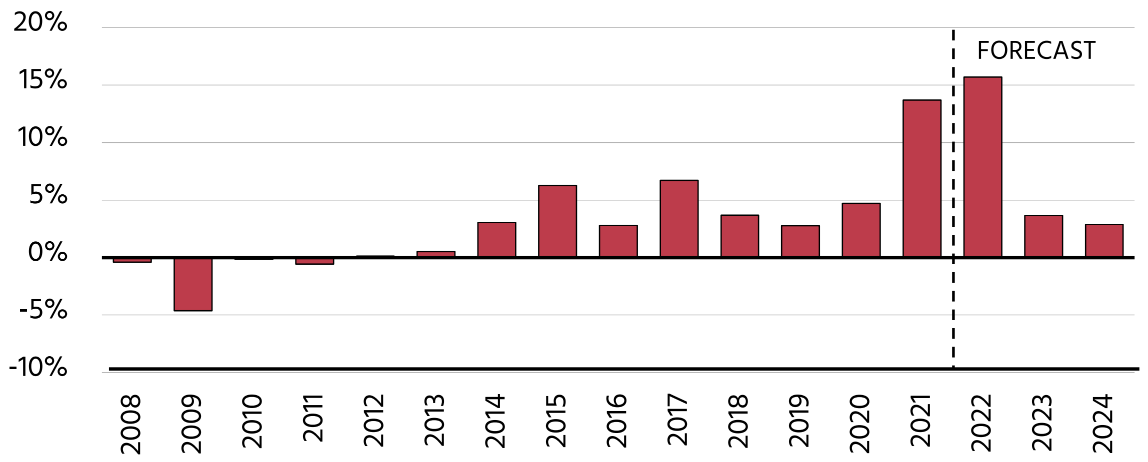
RECESSION TO WEAKEN OCCUPIER DEMAND, BUT STRUCTURAL TAILWINDS STILL SUPPORTIVE

The covid pandemic had a significant positive impact on the UK industrial market. Broadly speaking, occupier demand doubled, availability rates halved, and rents grew by over a quarter. However, this has come to an end with weaker retail sales and as shoppers return to pre-pandemic shopping patterns. The ongoing gradual shift online will still be an underlying support to industrial demand but at a slower rate. Insolvencies are likely to continue rising, given occupier cost pressures and the recessionary backdrop. Most occupiers are hoping to pass on cost increases, but this will be increasingly difficult.

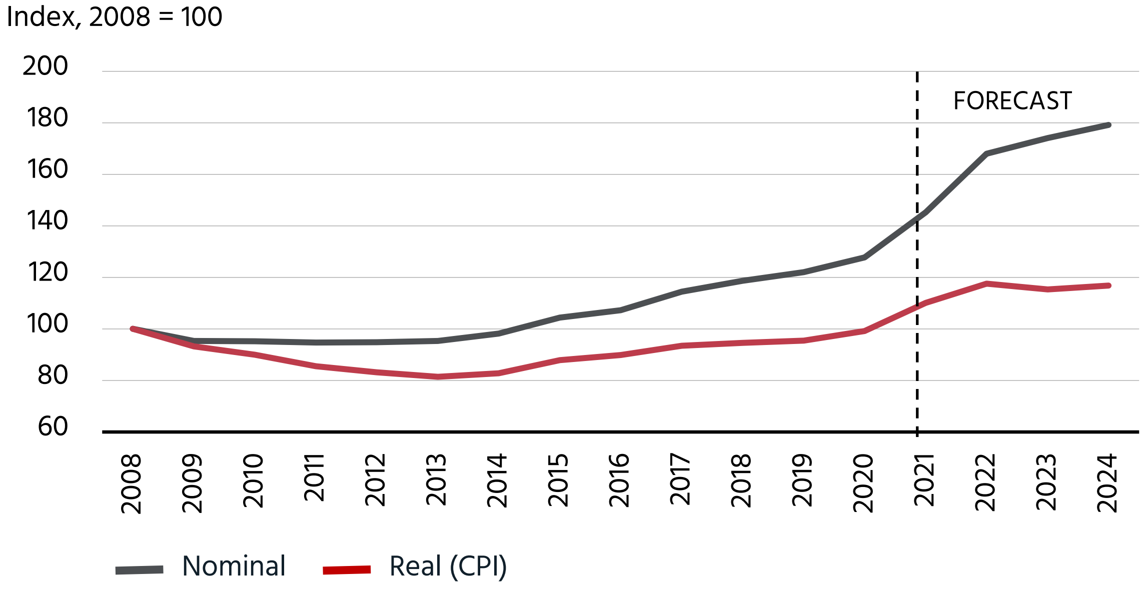
RENTAL GROWTH TO RETURN TO PRE-PANDEMIC NORMS AND TURN NEGATIVE IN REAL TERMS

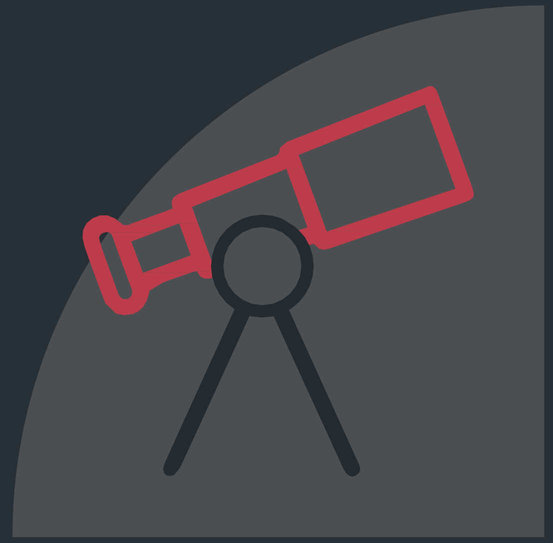
The outlook is for a significantly reduced rental growth profile for UK logistics. Weak supply will continue to support rents and keep growth positive, but real term falls are likely given persistently high inflation. In principle this will provide some more headroom after the above-inflation growth of the last two years. The pandemic winners will not be as expansionary over the coming years and certain sectors look exposed, such as energy-intensive or import-reliant manufacturers, or retailers dependant on discretionary spend.

All UK average annual prime headline rental growth
Source: Gerald Eve



All UK indexed real and nominal prime logistics rents
Sources: Oxford Economics, Gerald Eve





OUTLOOK

HAWKISH MONETARY POLICY RESPONSE EXPECTED

The upshot of political instability at a time of high inflation and low consumer confidence is likely to be an even more aggressive monetary policy response. Market pricing implies that the Bank rate will reach 5.5% by mid-2023. Oxford Economics think this is an overreaction and see the policy rate peaking at 4% in February next year. In either case, the extended period of "cheap money" is over.

LOGISTICS CAPITAL VALUES TO FALL IN 2023

10-year government bond yields were over 4% at the end of Q3. Low-yielding assets such as logistics now look exposed to rising debt costs and the narrowing spread between bonds and income-producing real estate. Yields will need to move out to reflect this, but it is likely that the future risk premium will be somewhat smaller than in the decade or so since the financial crisis. The industrial sector has matured as an asset class and not only is significant capital still chasing it, there are robust structural drivers and low supply. This will continue to be viewed favourably by investors in comparison with other commercial property asset classes.

INCREASED CORPORATE INSOLVENCIES

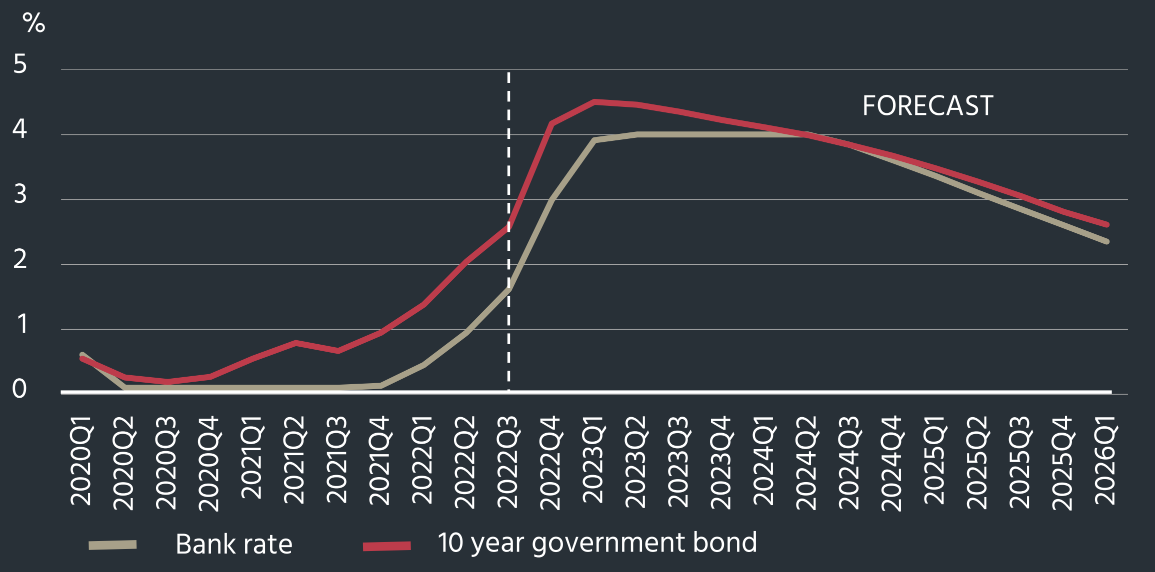
Government support schemes helped cushion businesses from the financial blow of the pandemic. But much of this support came in the form of loans and the stock of outstanding loans is elevated. Firms will have to cope with a sharp rise in debt-servicing costs. This follows higher costs for energy, labour, materials, shipping and imports, with energy support potentially set to end in early 2023.

SELL-SIDE PRESSURES TO INTENSIFY

An increase in fund redemptions and a rebalancing of portfolios will increase sell-side pressures. Some funds now look overweight in property and will need to sell their most liquid assets. Some are organising an orderly sale of assets to meet redemption requests. Some debt-exposed occupiers are investigating sale-and-leasebacks to raise capital. The volume of non-performing loans will increase, but the banking system is relatively more safeguarded through capital buffers now compared with the GFC.

10 year government bond yields and Bank rate forecast

Source: Oxford Economics



GERALD EVE REGIONS

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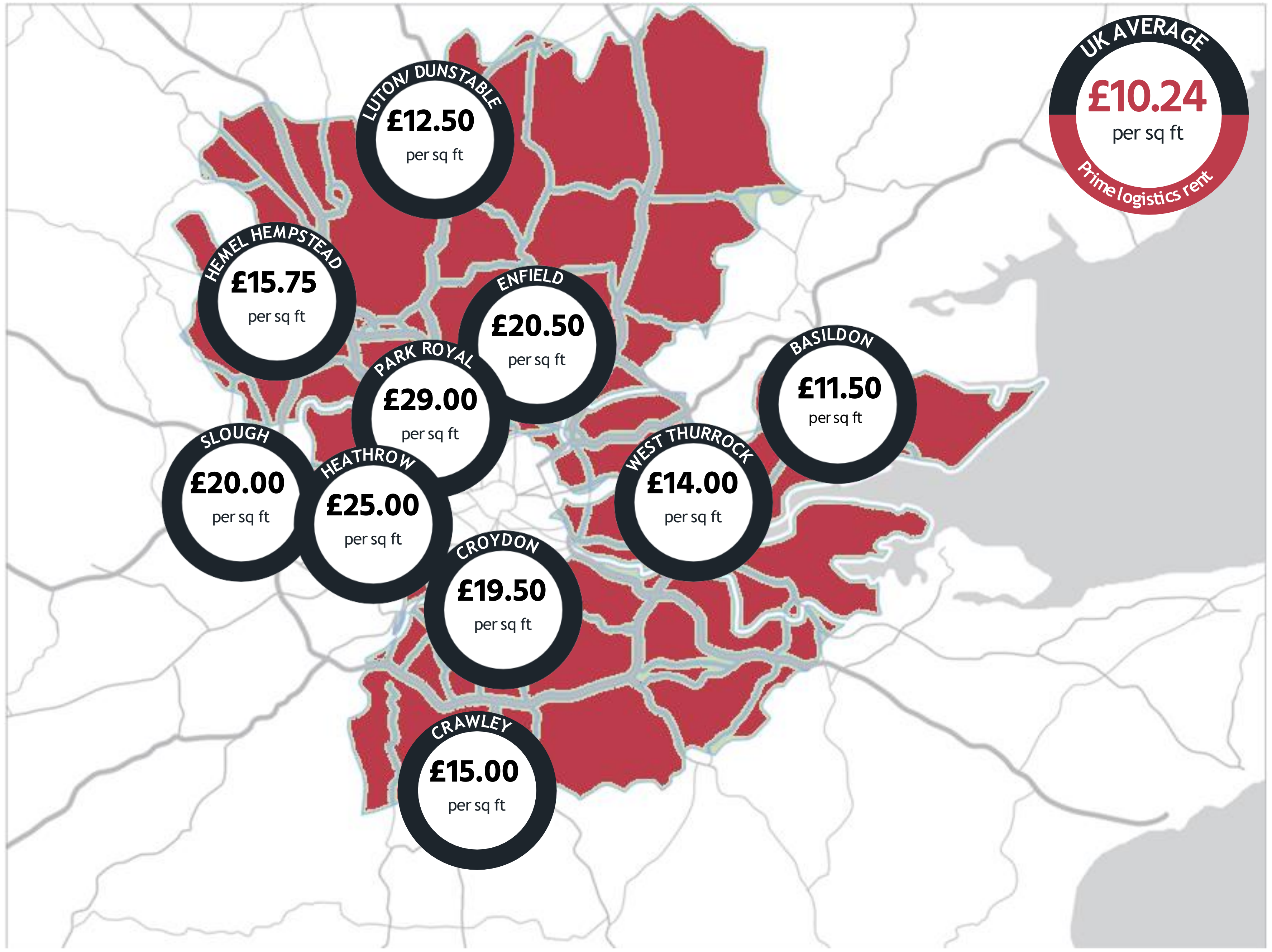
LONDON

PRIME LOGISTICS RENTS

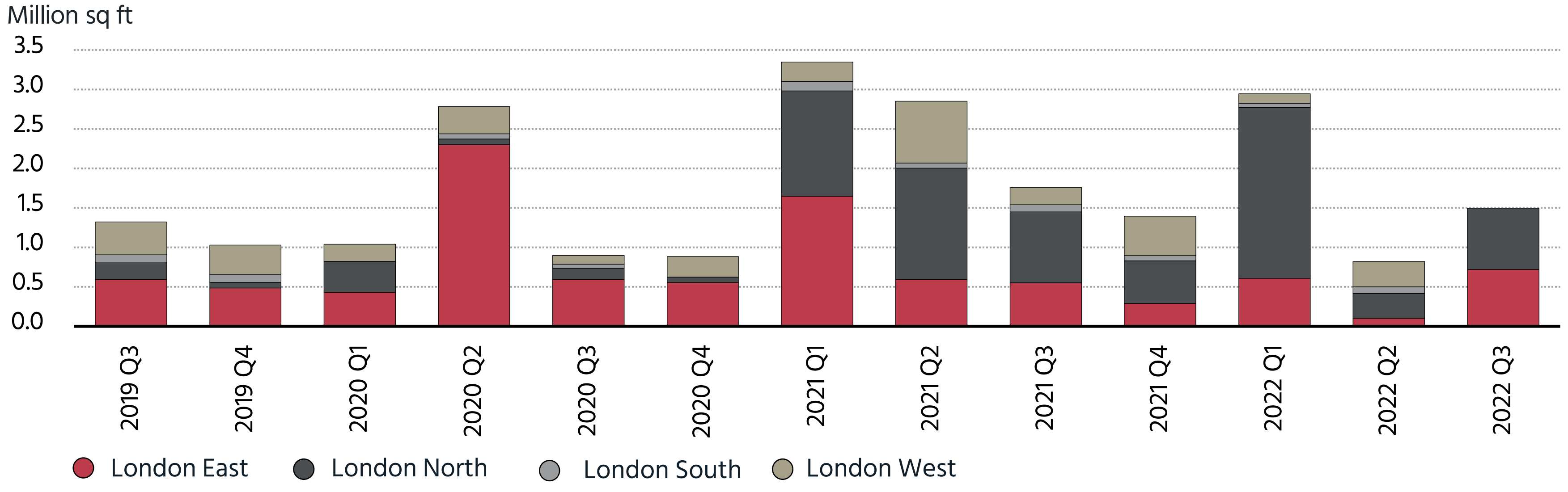


Prime rent: typical achievable headline rent in £ per sq ft for units of good quality over 50,000 sq ft and let on a typical 10 year lease to a tenant of strong covenant.

DEMAND

Occupier quarterly take-up

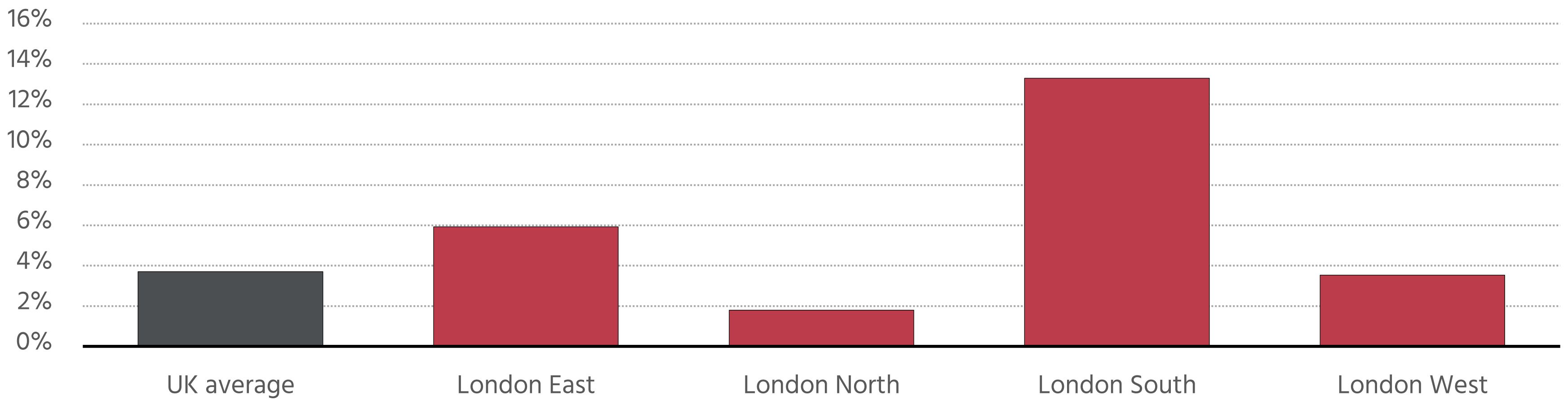
Source: Gerald Eve



AVAILABILITY

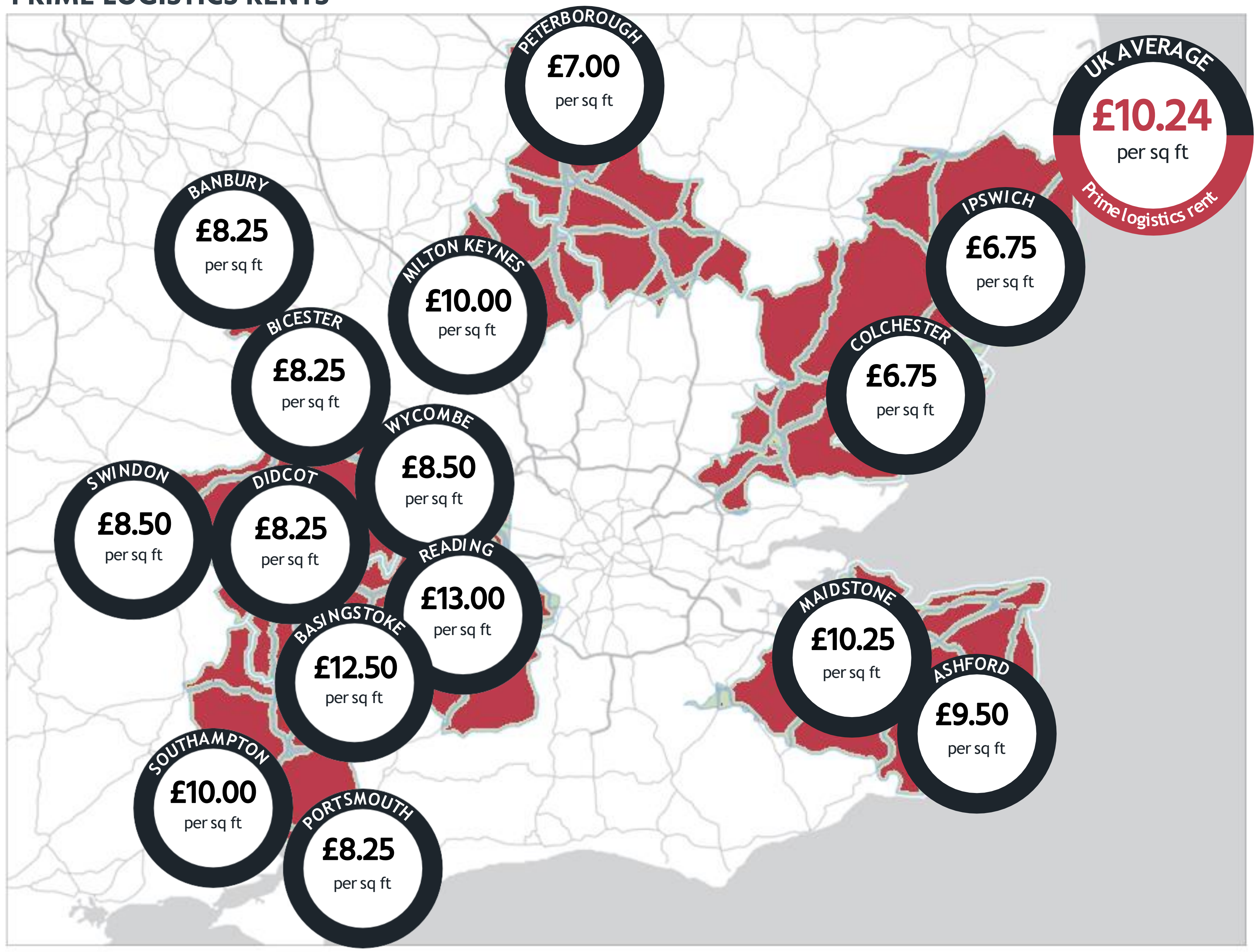
Availability rate

Source: Gerald Eve



THE SOUTH EAST AND EAST

PRIME LOGISTICS RENTS



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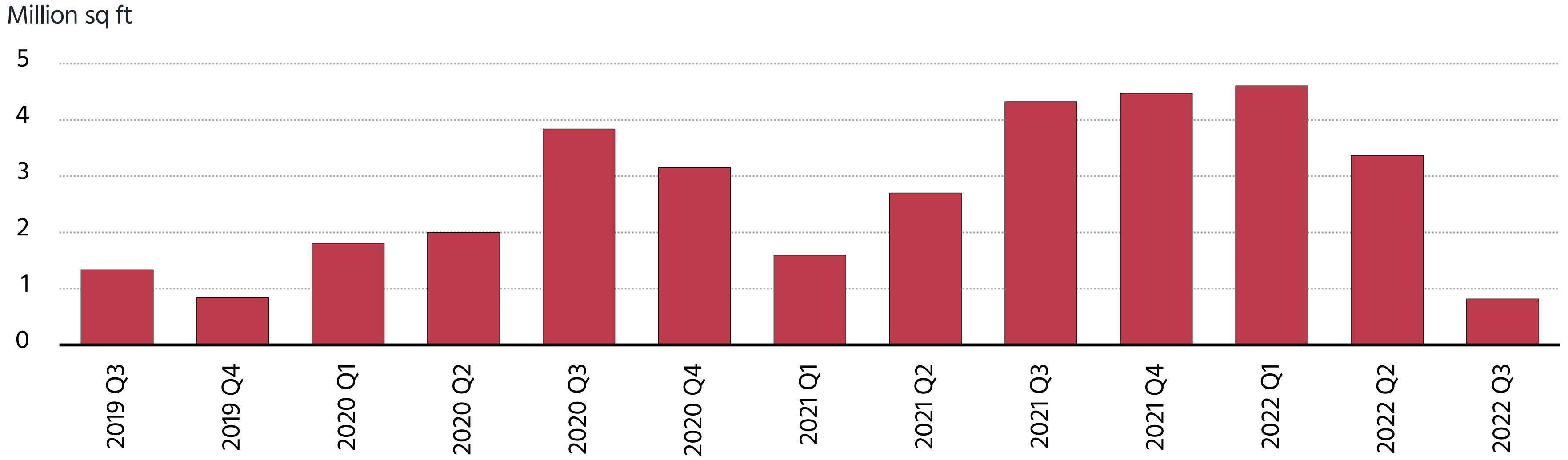
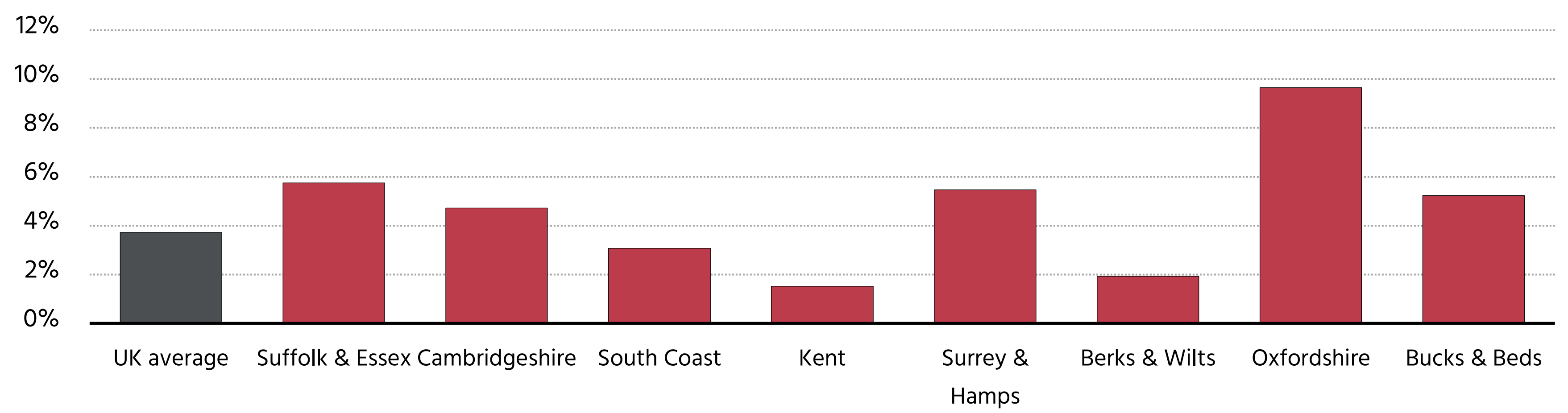


AVAILABILITY

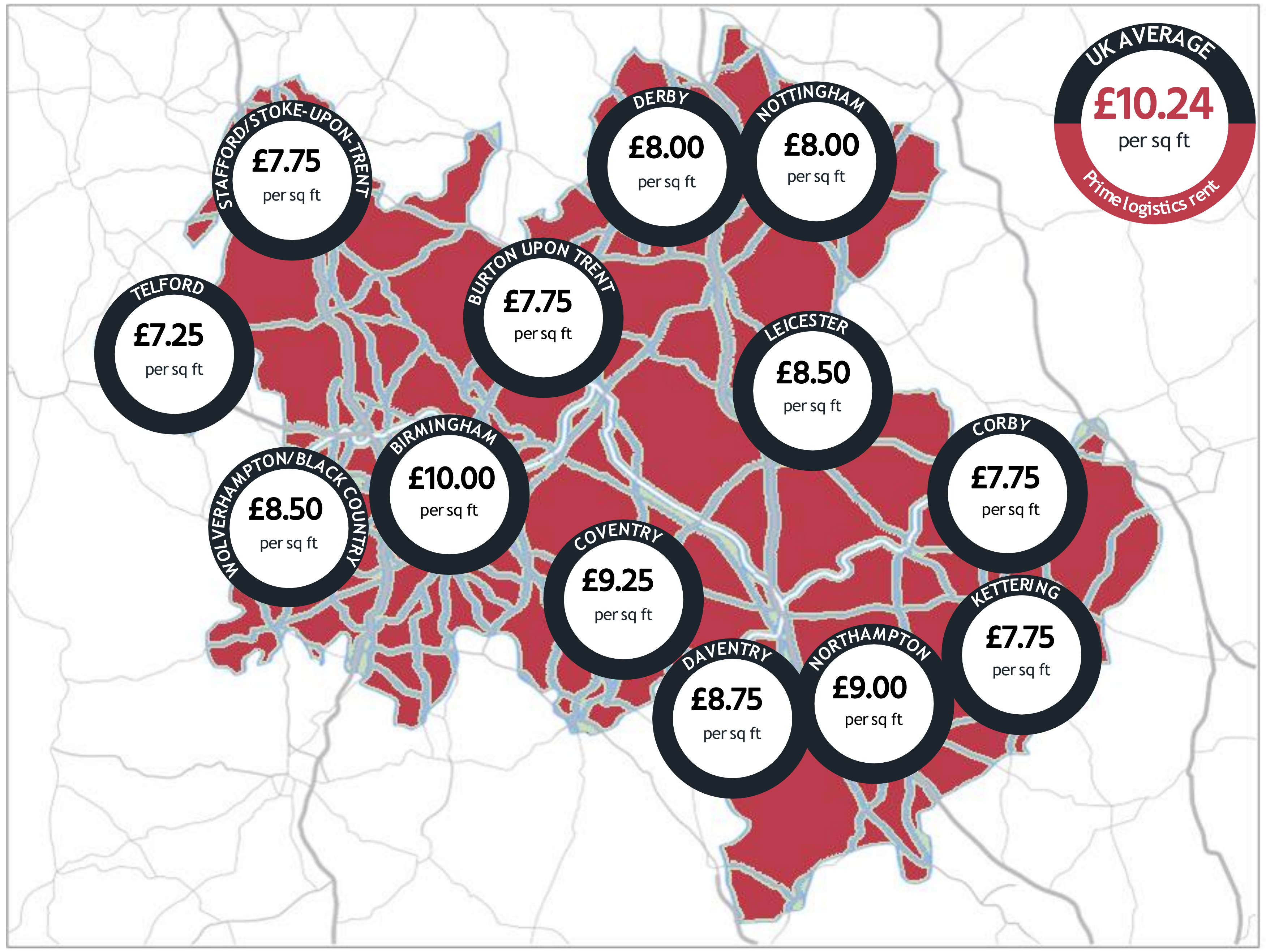
Availability rate

Source: Gerald Eve



MIDLANDS

PRIME LOGISTICS RENTS



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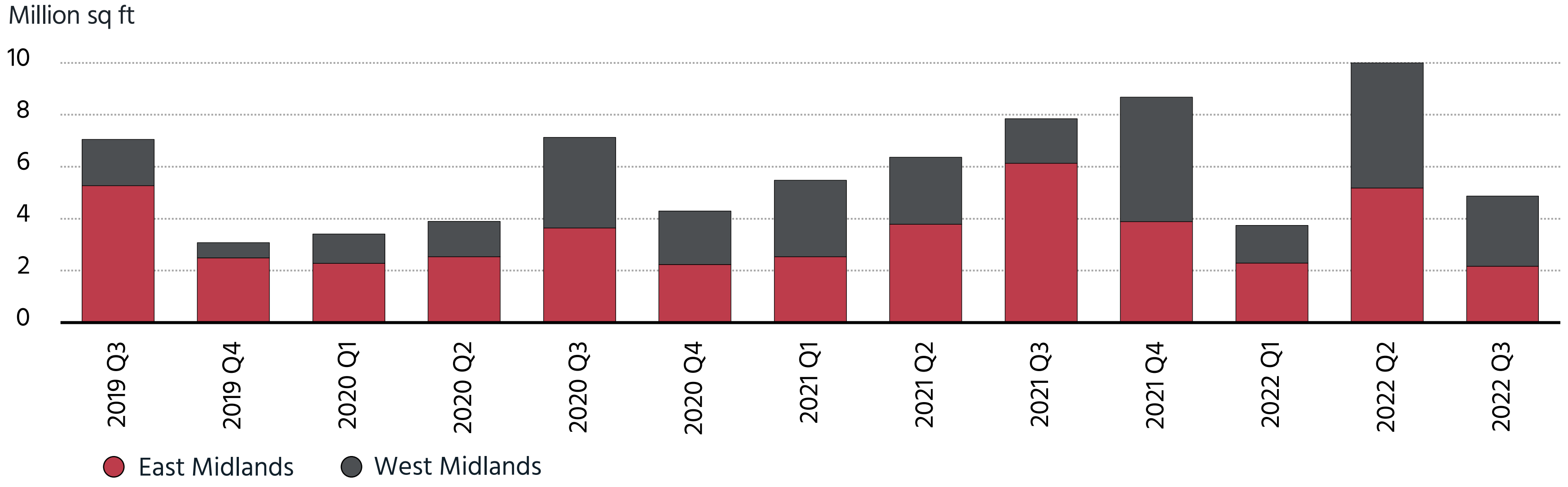


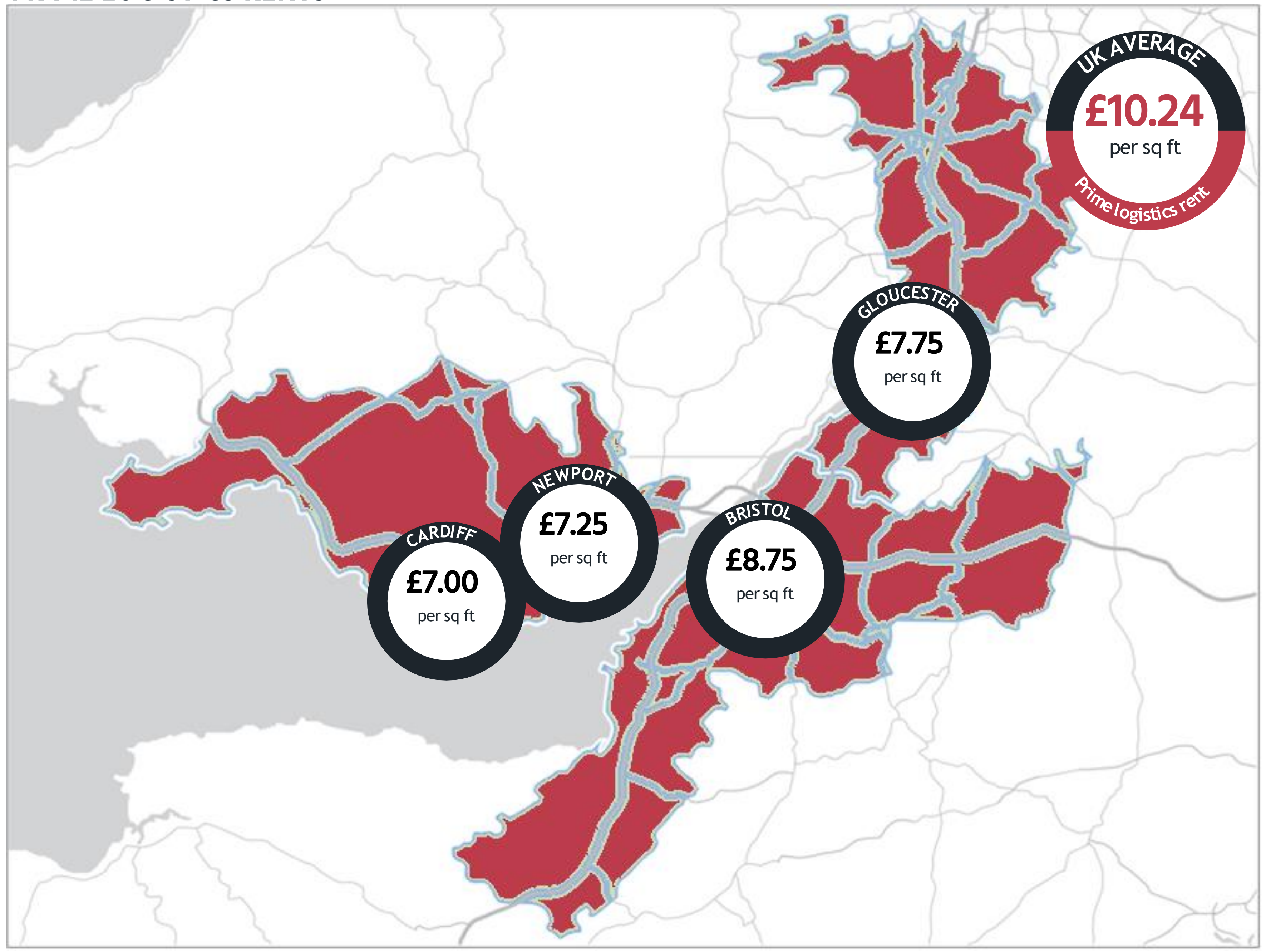
AVAILABILITY

Availability rate

Source: Gerald Eve

WEST OF ENGLAND AND SOUTH WALES

PRIME LOGISTICS RENTS



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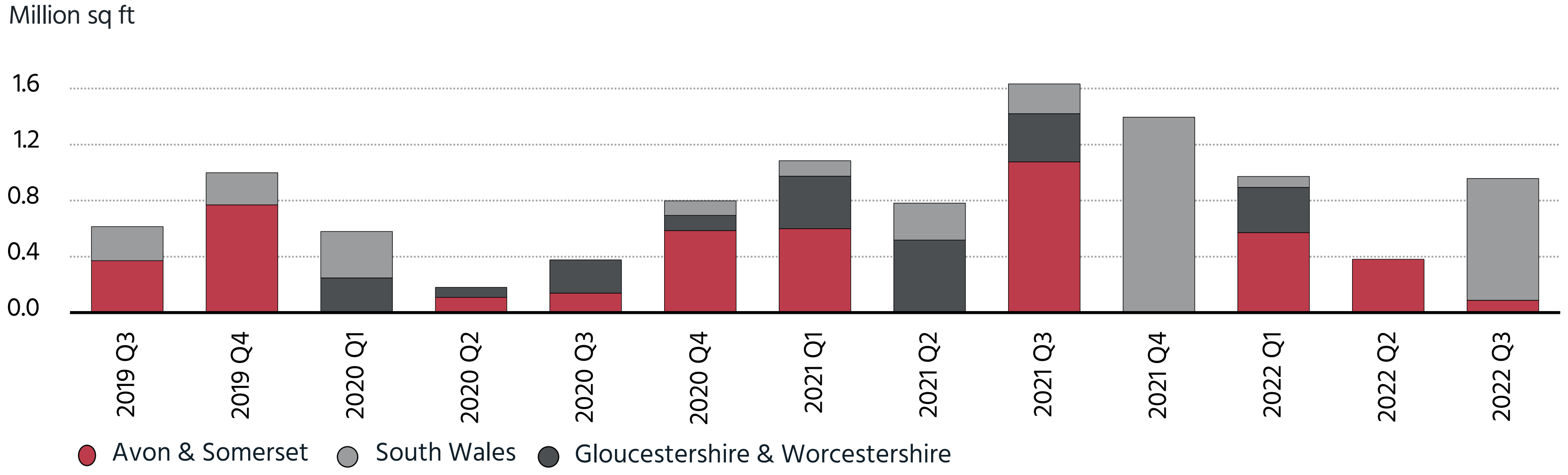


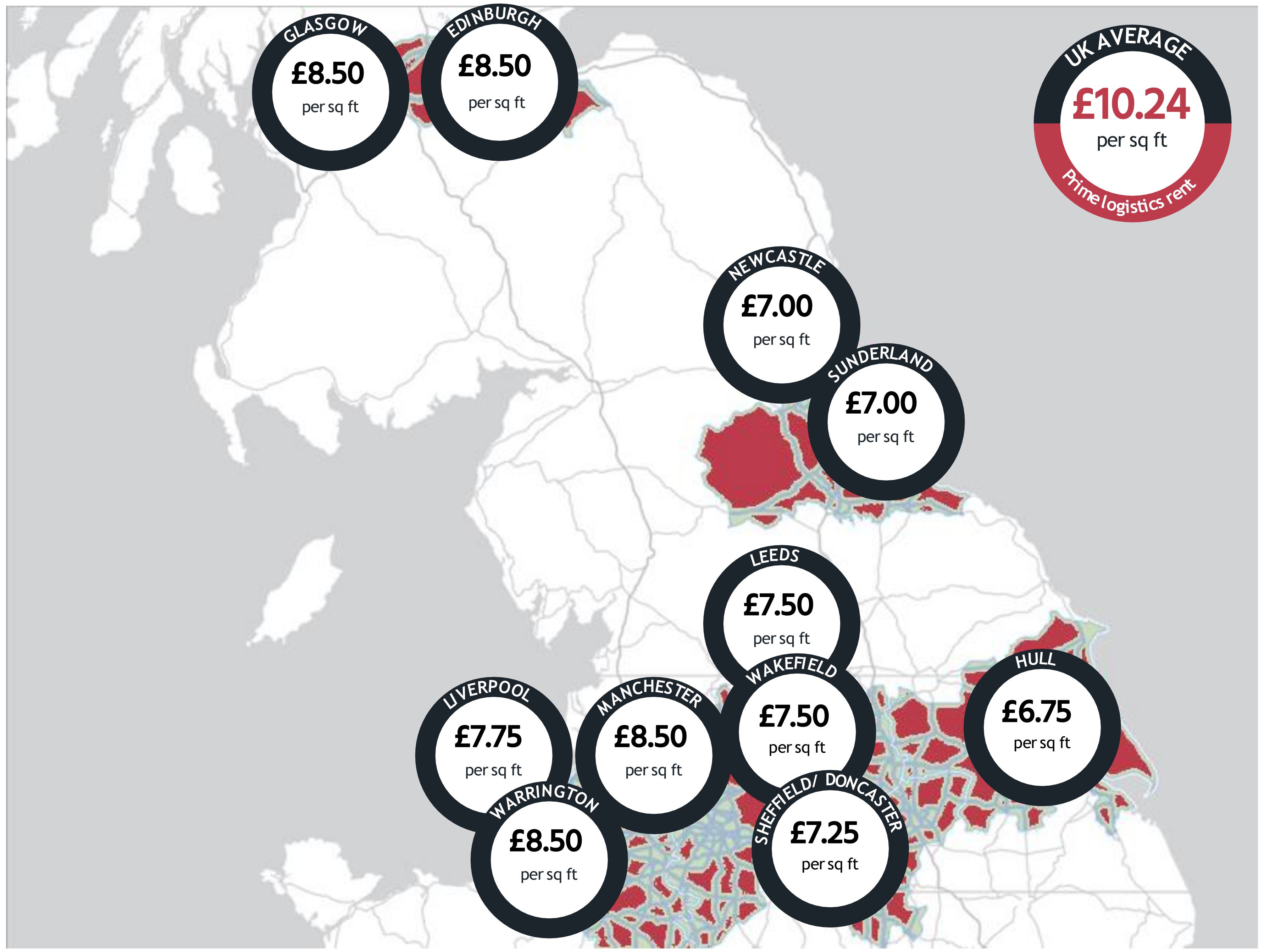
AVAILABILITY

Availability rate

Source: Gerald Eve

NORTHERN ENGLAND AND SCOTLAND

PRIME LOGISTICS RENTS



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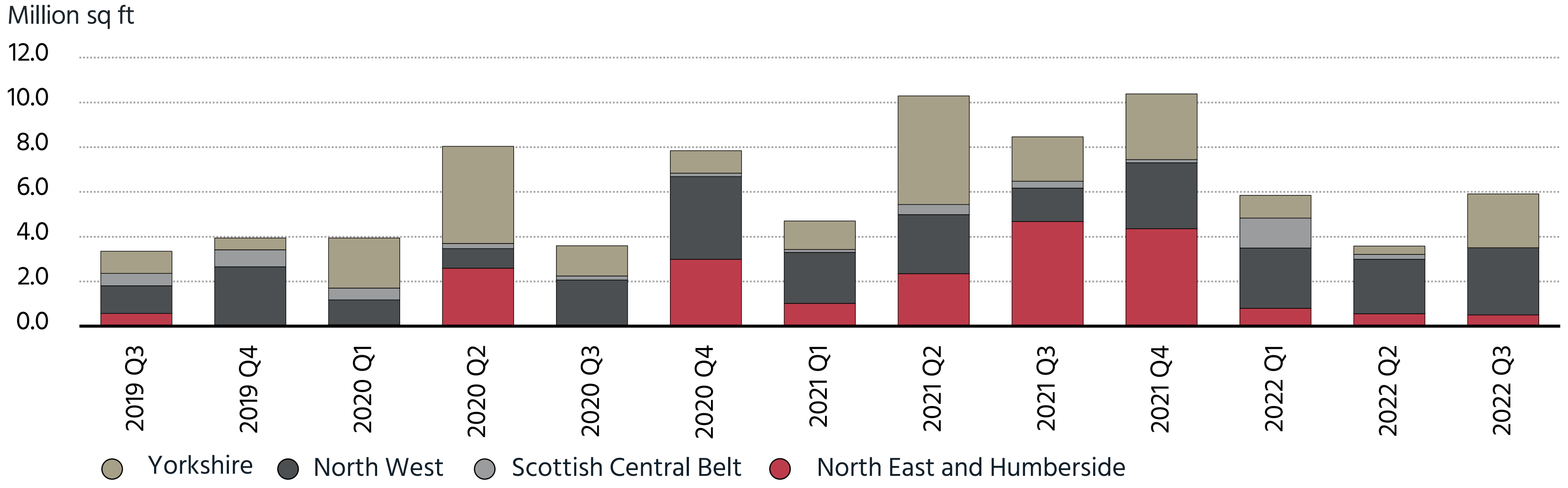

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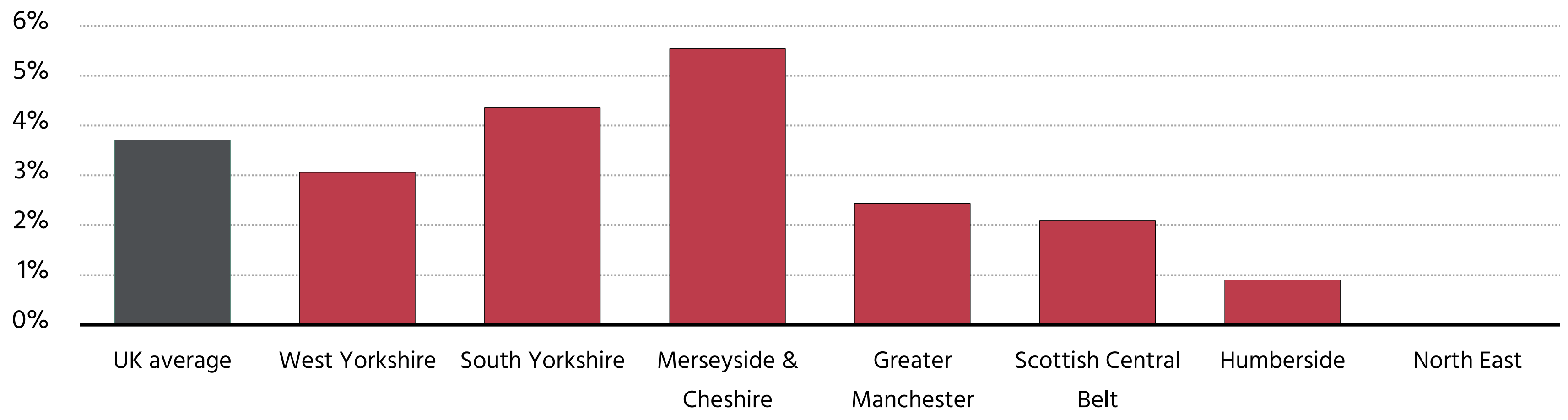

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GERALD EVE IN THE MARKET

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.

Sven Macaulay is advising Belshill Property Limited on Connect 70, a new 69,589 sq ft BREEAM Excellent spec build in Bellshill due to reach PC by November 2023..

Richard Gatehouse advised EDF Energy on the letting of the 350,000 sq ft former Argos distribution unit in Bridgewater from EQT Exeter for use on EDF's new nuclear builds at Hinckley Point C and Sizewell C.

Josh Pater advised SEGRO on the letting of two units totalling 47,627 sq ft at The Heathrow Estate which sees the scheme fully let.

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.