GERALDEVE
A NEWMARK COMPANY

PRIME LOGISTICS

The definitive guide to the
UK's distribution property market

Q2 2023

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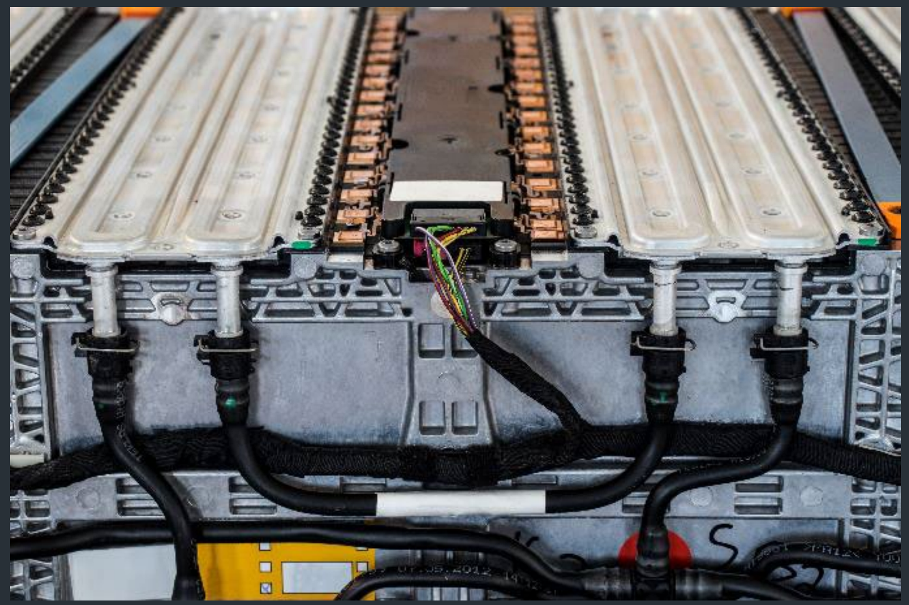
MARKET OVERVIEW

POST-PANDEMIC DEMAND IMPACTED BY HIGH INFLATION AND RISING INTEREST RATES

The UK logistics market continues to cool after the heat of the pandemic, with most metrics covered by this research having softened or flatlined in Q2. Occupier take-up was down 16% in Q2 and availability was up 0.7ppts, meanwhile headline rents and yields were unchanged and speculative development starts slowed. Some form of post-pandemic slowdown was to be expected following the exceptional activity of the last three years. But business plans have been further hampered by a challenging economy of persistent inflation, rising interest rates and weak domestic demand. We nevertheless remain confident in the structural tailwinds supporting the sector and still anticipate continued (albeit more moderate) rental growth.

9.8m sq ft Take-up Q2 2023	5.4% Availability rate Q2 2023	2.8% New/modern availability rate Q2 2023
0.1% Prime rental growth Q2 2023	3.0m sq ft Spec development starts Q2 2023	0 bps Prime yield shift in Q2 2023



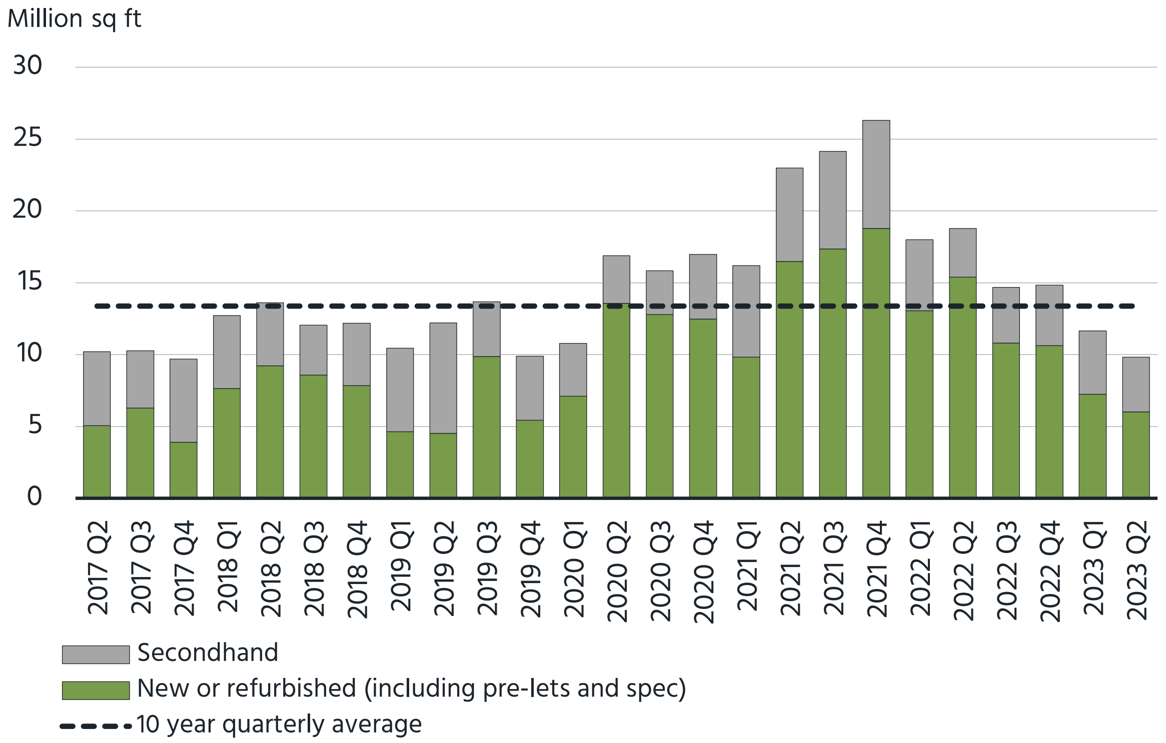
OCCUPIER DEMAND

WEAKEST QUARTER OF TAKE-UP SINCE Q4 2017

Occupier demand in Q2 continued to trend downwards from its recent peak in Q4 2021. Take-up of 9.8m sq ft in Q2 was 16% down on Q1 and the weakest quarter since Q4 2017. The volume traded in Q2 was 27% below the 13.4m sq ft 10-year quarterly average. However, quarterly activity can often be volatile, and a slowdown in demand post-pandemic was to be expected as the market reverts to pre-pandemic levels of activity. Sub-lets and assignments proved popular with occupiers in Q2. The fact that these types of units are fitted-out and often offer cheaper accommodation than D&B options proved attractive to occupiers currently keen to make cost savings.

Quarterly take-up by quality and 10-year average

Source: Gerald Eve

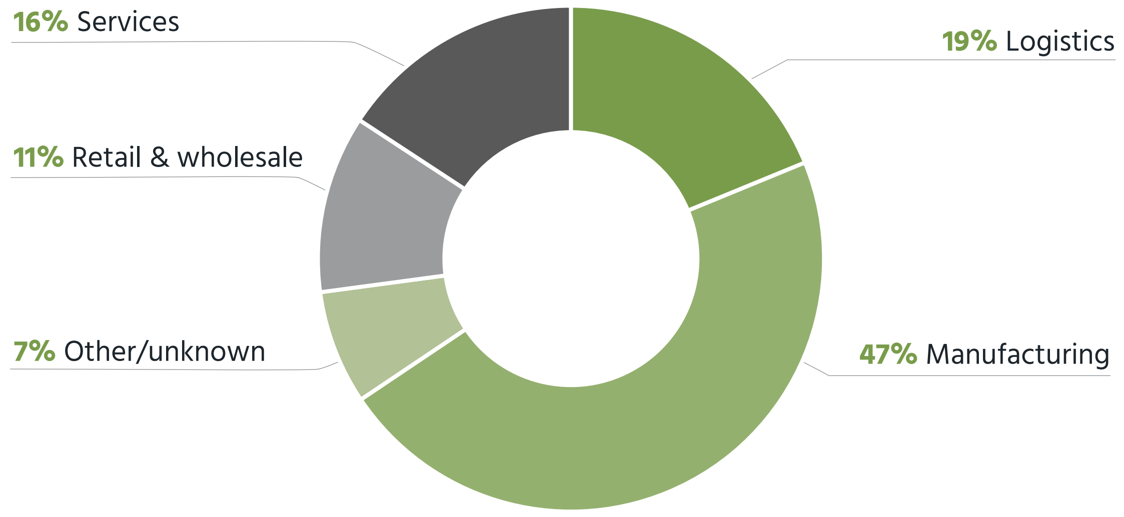


MANUFACTURERS OFFSET SOME OF THE DROP IN DEMAND BY INTERNET RETAILERS

The breakdown of take-up in Q2 stood in contrast to typical occupier activity over the last three years. Manufacturers were particularly active in Q2, with green energy production, automotive, pharmaceutical and house building & construction firms all making commitments. Some of this demand can in part be attributed to nearshoring operations / improving supply chain resilience, but some is also due to the natural churn of lease events. 'Services' occupiers were active too, including telecoms, film & tv, data centres and environmental waste occupiers. In contrast, dedicated internet retailers substantially slowed acquisitions in Q2.

Q2 2023 take-up by main occupier sector

Source: Gerald Eve



The electric vehicle industry will be a key source of future demand for logistics. Tesla recently signed up for space at Trammell Crow's new development in Milton Keynes for use as spare parts storage facility.

SUPPLY AND DEVELOPMENT

UK AVAILABILITY INCREASES AGAIN TO 5.4%

The overall rate of availability increased again from 4.7% in Q1 to 5.4% in Q2. This reflects around 50m sq ft of marketed space in total, a significant increase on the 33m sq ft low point for availability in Q4 2022. The increase this year is due to a combination of additional spec-built stock and an upturn in marketed sub-lets and assignments. Several occupiers are reworking post-pandemic supply chains and choosing to sub-let now-unneeded space. Availability is still below the 10-year average for the UK (6.5%) though and the overall quality of available buildings is high. Around 60% of all marketed space is either new or refurbished.

INTERNET RETAIL AND LOGISTICS THE KEY SUB-LESSORS

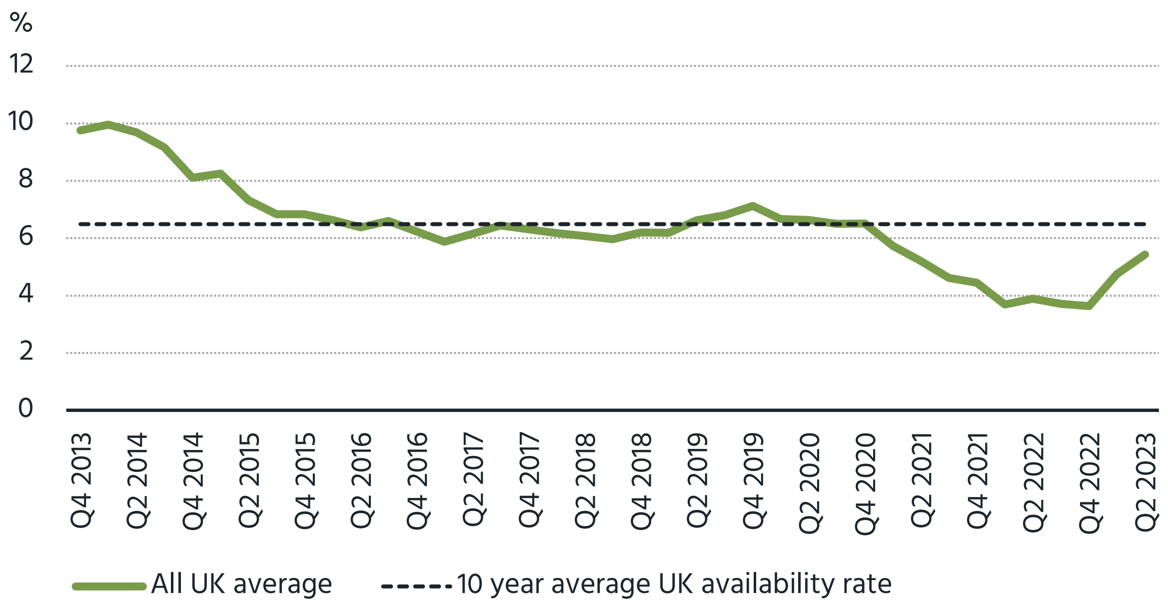
Sub-lets or assignments are now estimated to account for 14% of all availability, up from around 10% in Q1 and the long-term average of 5%. Companies sub-letting include internet retailers such as Amazon and MH Star, but logistics operators are mainly driving this activity. Yodel, Neovia, DHL, The Pallet Network and CEVA all have sub-let space on the market. The reasoning behind this is varied – from having too much space for post-pandemic operating conditions through to a change of business direction or a loss of a contract. The potential cost-savings for incoming sub-lessees of this fitted-out space, especially relative to D&Bs, is proving attractive.

DEVELOPMENT STARTS SLOW AGAIN IN Q2

The quarterly volume of speculative development starts was 3m sq ft in Q2, the lowest since Q3 2020. This slowdown reflects the high cost of development and debt, set against a post-pandemic softening of occupier demand. On a rolling annual basis, we are now over the development peak, and speculative activity is set to slow further through 2023. Land continues to be readied through planning and infrastructure works, but most landlords are increasingly likely to market this land for D&B rather than commence spec schemes in 2023. Larger developers are likely to have greater bargaining power over contractors and materials this year and are more likely to start spec schemes.

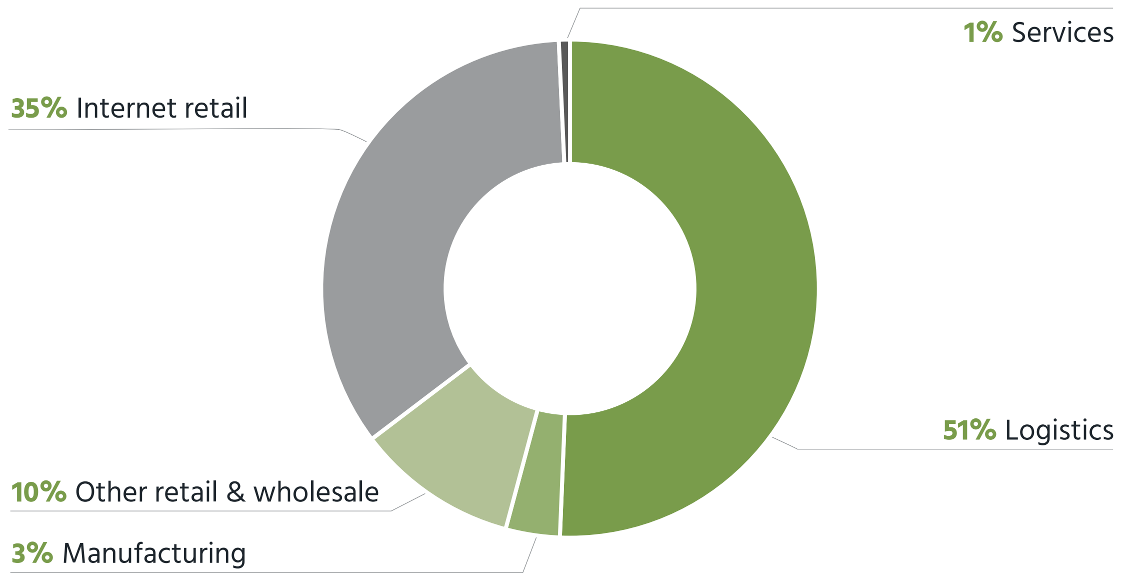
UK logistics availability rate

Source: Gerald Eve



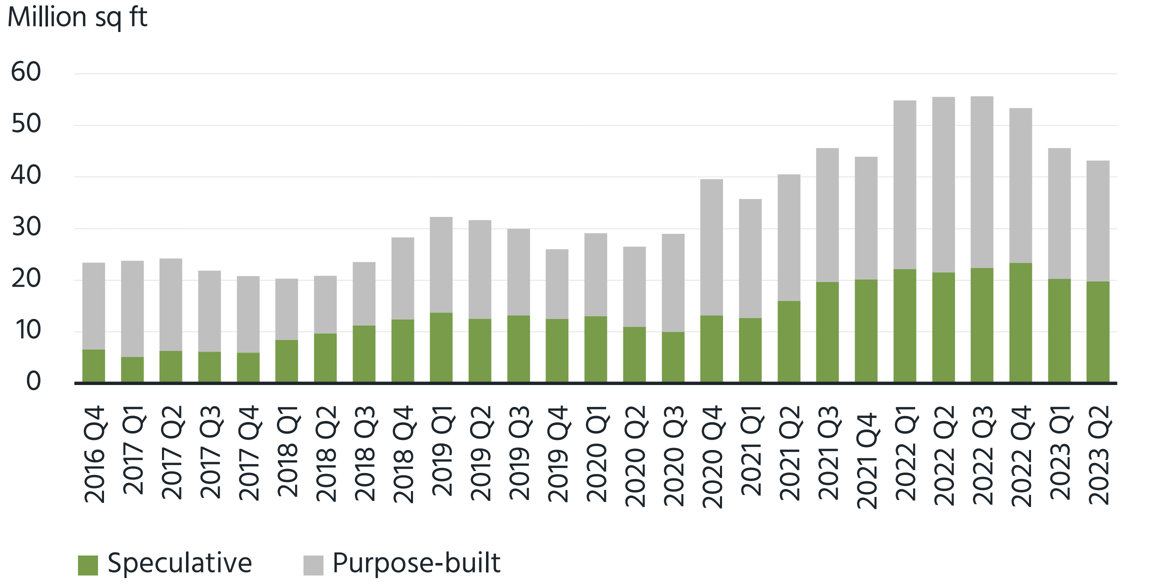
Tenant sectors sub-letting or assigning space in Q2 2023

Source: Gerald Eve



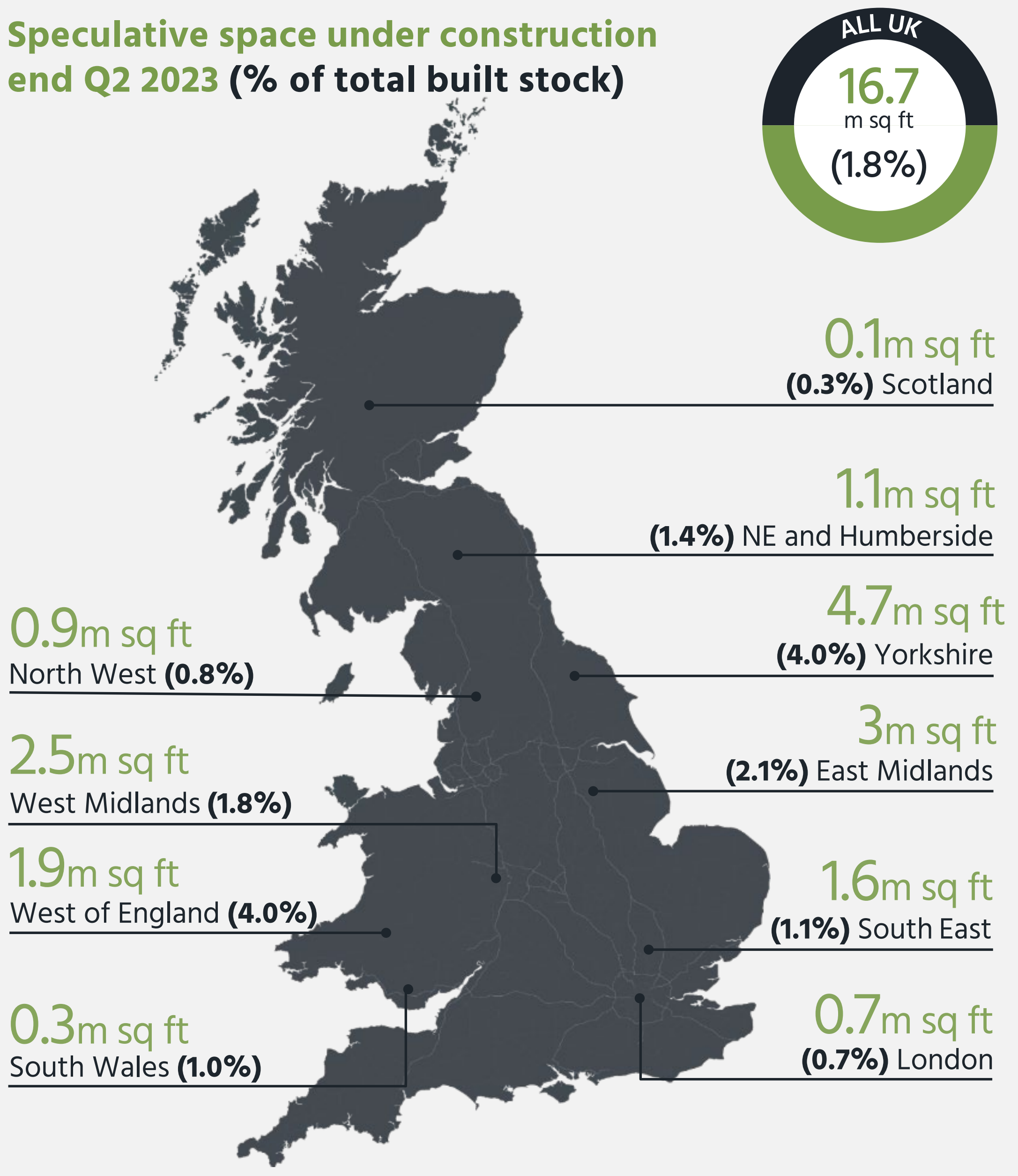
Rolling annual speculative development starts

Source: Gerald Eve



SUPPLY AND DEVELOPMENT

Speculative space under construction end Q2 2023 (% of total built stock)



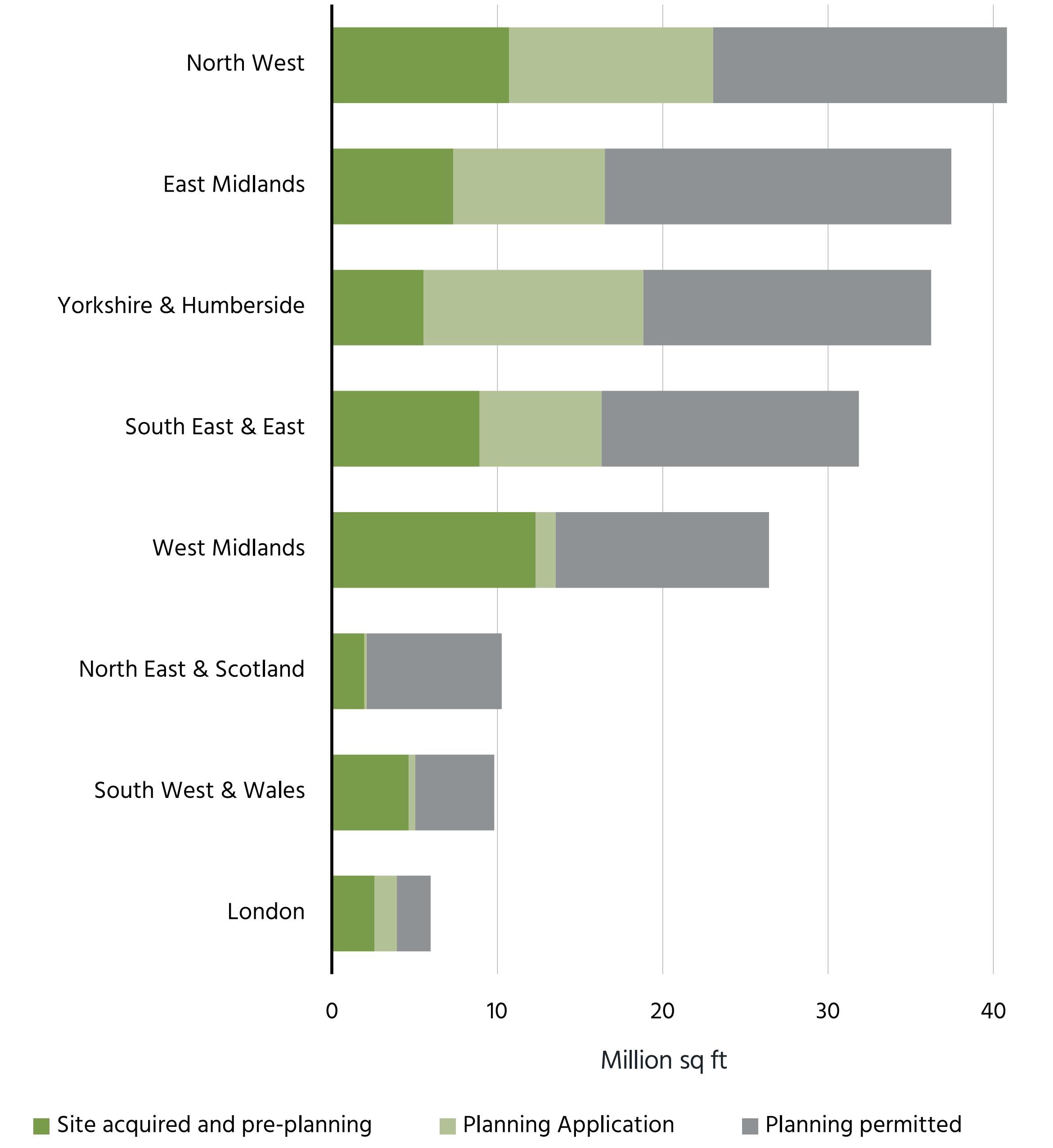
SUPPLY CHAIN PRESSURES HAVE EASED, BUT SPEC DEVELOPMENT SET TO SLOW IN LINE WITH DEMAND

At the end of Q2 2023 there was 16.7m sq ft of space under construction speculatively across the UK. Regionally, this speculative development activity is weighted towards the larger logistics regions such as the Midlands and Yorkshire, and in locations with a proven track record of speculative lettings. Void periods on new spec schemes remain at around 12 months on average, low in an historic context, and the spec space under construction only accounts for 1.8% of total UK logistics stock. Most new developments include the highest standard of environmental credentials, which will suit current requirements.

Supply chain pressures have eased, but the high cost of debt, build cost inflation, softening tenant demand and a protracted planning process still weigh on developer activity. Speculative development could slow further through 2023 as a result. There is also land in the development pipeline, both oven-ready and in the planning process, that could accommodate further development. Regionally this land is concentrated in the North West, East Mids and Yorkshire. The London pipeline was given a boost in Q3 with SEGRO's purchase of 415 acres at the site of the former Radlett Aerodrome, but the region's potential industrial land supply remains low relative to other regions.

Land in the development pipeline

Source: Gerald Eve, Property Data



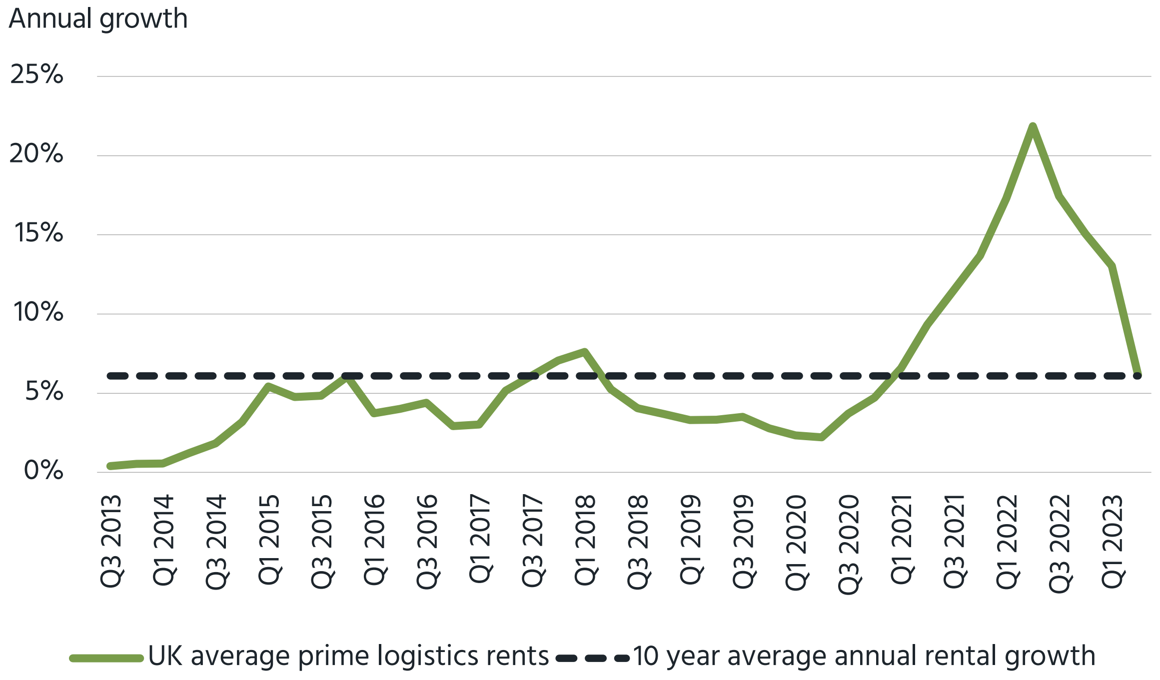
RENTS AND INCENTIVES

ANNUAL PRIME RENTAL GROWTH BACK TO LONG TERM AVERAGE

Following a period of unprecedented growth prime rents increased on average 0.1% in Q2 and 6.1% over the past year - a more 'normal' rate of annual rental growth. Growth has slowed in line with the general reduction in occupier demand, offset to some extent by increased activity by manufacturers, with generally smaller and fewer prime requirements. Occupier interest in more cost-effective sub-let space offering a lower-than-prevailing-market rent is also a dampening factor on prime market rents. However, quoting rents on new developments are as yet unaffected and continue to push prevailing prime benchmarks.

Average annual UK prime rental growth

Source: Gerald Eve



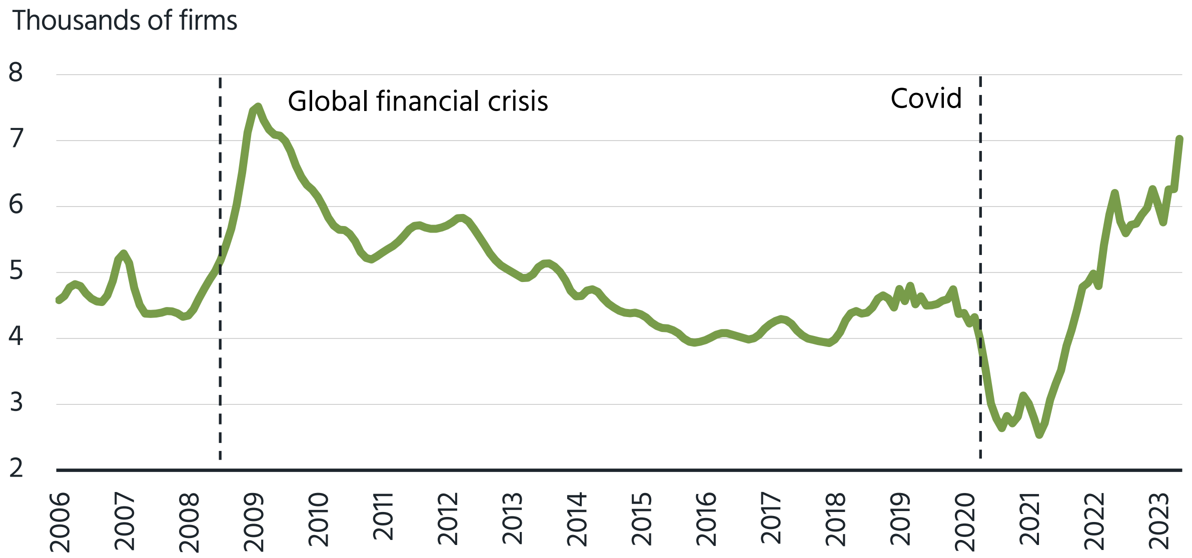
Energy efficiency specifications on buildings with tangible cost-savings on utility costs, and buildings in locations offering reduced transport times / attractive labour pools / power provision are the most popular with occupiers.

WEAK PASSTHROUGH OF INSOLVENCIES TO INDUSTRIAL

In Q2, the number of UK corporate insolvencies was the highest since the GFC. So far, this high level of insolvencies has not had a meaningful impact on the logistics market. Tufnells, the 100-year-old logistics firm went into administration in Q2, occupying a reported 33 depots, but examples like this are so far in the minority. The reasons cited by Tufnells for its collapse are common to many occupiers though: rising costs and increased competition. As occupiers look for efficiencies, deals are taking longer to conclude and lease renewals are increasingly seen as a cost-effective option. Occupiers renewing or regearing leases are still in for a shock, however, given the high and widespread market reversion.

Rolling UK quarterly insolvencies to May 2023

Sources: The Insolvency Service, ONS, Gerald Eve



INVESTMENT

PRIME YIELDS FLAT IN Q2 AS TRANSACTION VOLUMES FALL

As one of the few commercial property asset classes still posting positive rental growth, investor interest in logistics property is high and there's still a weight of money targeted at the sector. This continues to be set against a very weak investment supply, given the lack of forced sellers. Trading volumes remain low although the few sales that have been launched have attracted strong levels of interest and there is renewed appetite for development funding by some of the funds. Debt costs are effectively prohibitive, so those active in the market tend to be buying with all-equity and taking a longer-term view beyond current interest rate volatility.

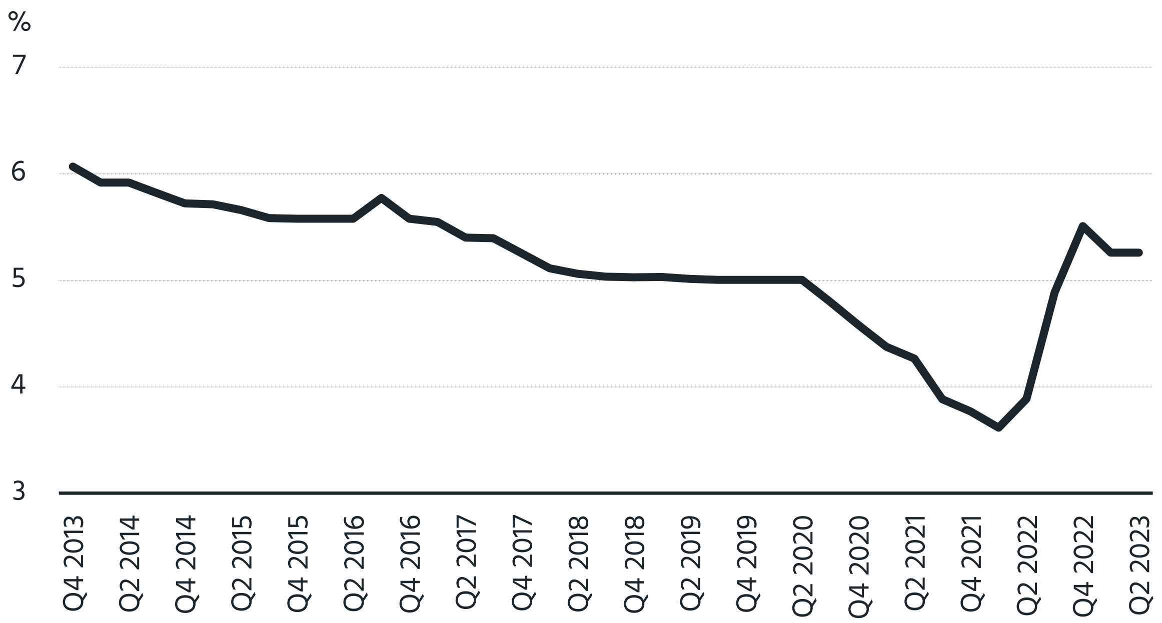
POTENTIAL HIGHER-FOR-LONGER INTEREST RATES A CONCERN FOR INVESTORS

There is now an increasingly hawkish outlook for interest rates after core inflation, private sector wage growth and services sector output inflation all surprised on the upside in Q2. The market-implied SONIA forward projection for interest rates was over 6.5% by March 24 (in early July 23) and investors are assessing the potential impact of this on investment strategies. Live deals are progressing, but there's renewed diligence on exit yields and transactions are taking longer to complete. There is a focus on reversionary assets and high quality, modern units that perform strongly from an ESG perspective.

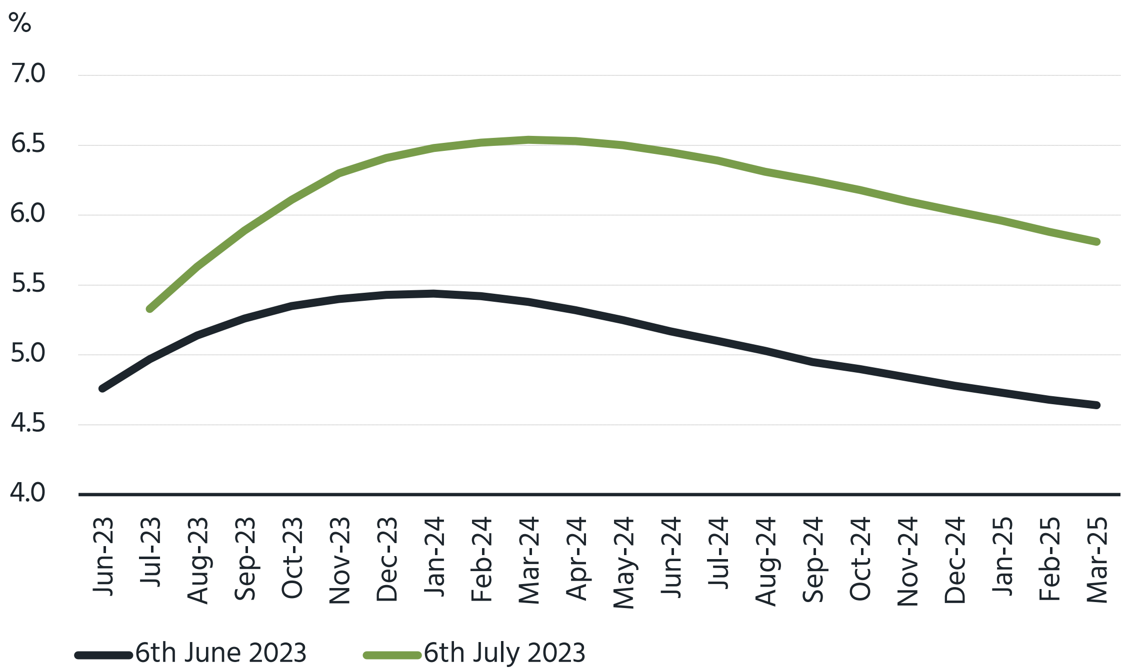
DEBT COST INCREASED, BUT REFI RISK STILL LOW

Based on all-in floating borrowing rates, the cost of accessing debt roughly doubled over 2022 and is set to rise further this year. Low-yielding assets such as logistics have been more exposed to this dramatic change. Investors that have accessed debt at lower interest rates will be on the hunt for assets at discounted prices, but leveraged investors that can only access debt at the current rate are effectively priced out. Higher debt costs also bring increased refinancing risk, but this is expected to be limited to those minority of assets that have not captured rental reversion or those who sought short term finance prior to last year's yield correction.

All UK average prime logistics yield
Source: Gerald Eve



Changing expectations for SONIA forward curve
Source: Chatham Financial, Gerald Eve



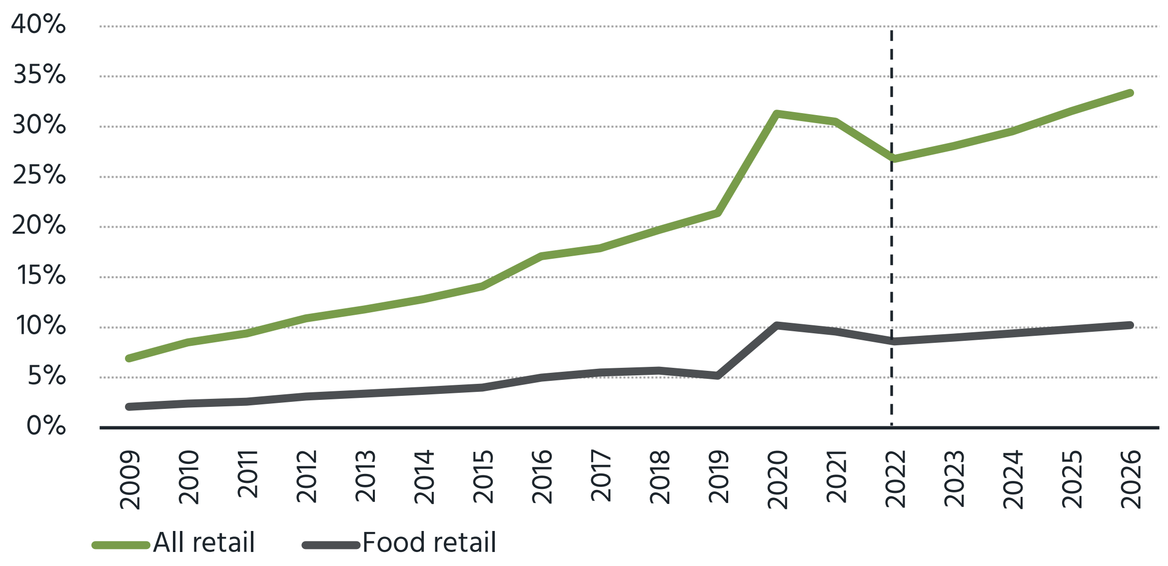
Click here for more detailed insight on the investment market

Click here to contact our lease consultancy team

SPOTLIGHT: FUTURE DRIVERS OF OCCUPIER DEMAND

INTERNET RETAIL

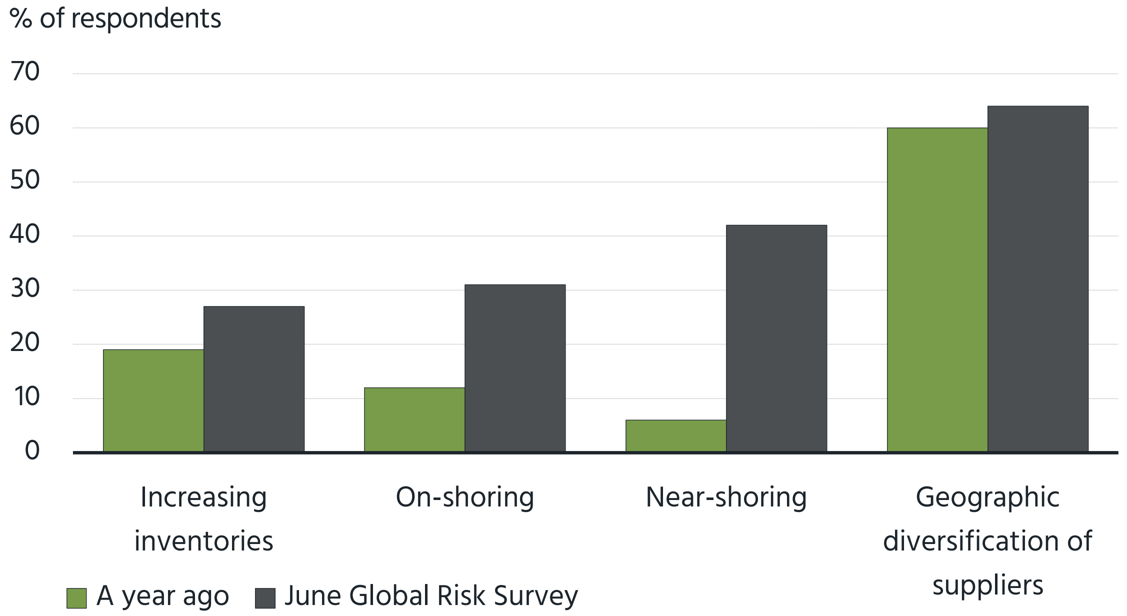
Internet retail sales as a percentage of all retail sales
Sources: Gerald Eve, ONS



Occupier demand from dedicated internet retailers has slowed sharply from the pandemic peak. Many are now revisiting business plans in line with weakened economic conditions and looking for ways to save costs and make efficiencies. E-commerce more generally though is still a structural driver of demand for logistics space. The price transparency on offer by these retailers is a key USP whilst inflation is high and there will be retailers upgrading to better quality accommodation or late adopters that will be net positive for logistics demand.

NEARSHORING AND GREEN ENERGY

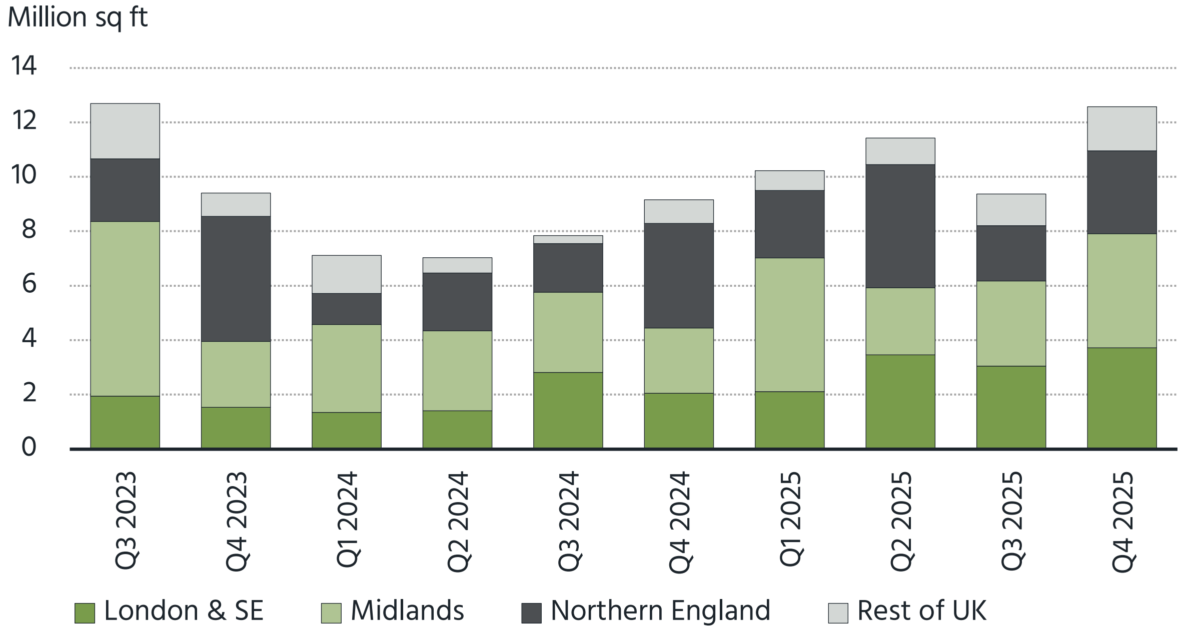
What steps are you taking to improve supply chain resilience?
Sources: Oxford Economics June Risk Survey



Many occupiers are looking for cost-effective avenues to de-risk supply chains. The 'just in time' model was tested and found lacking during the pandemic, and for some this proved expensive. Whilst supply chain volatility is now much reduced, improving resilience is an important part of business plans. This has entailed nearshoring operations closer to domestic markets and increasing inventory levels, both of which will be positive for warehouse demand. Embracing robotics and automation and onsite power generation are also seen as important components of building resilience.

LEASE EXPIRIES

Expected future lease expiries by region
Source: Gerald Eve



Current economic conditions suggest that future demand for logistics is going to be increasingly driven by the natural churn of lease events rather than expansionary activity. The demand boom of the last few years will result in an increase in lease events over the next few years. The overall volume of lease expiries is expected to steadily rise through to the end of 2025, with tenants facing a tricky choice at renewal given the latent rental reversion. This in turn is likely to stimulate additional demand as occupiers decide to either upgrade to better quality accommodation or potentially downsize to save costs.

OUTLOOK

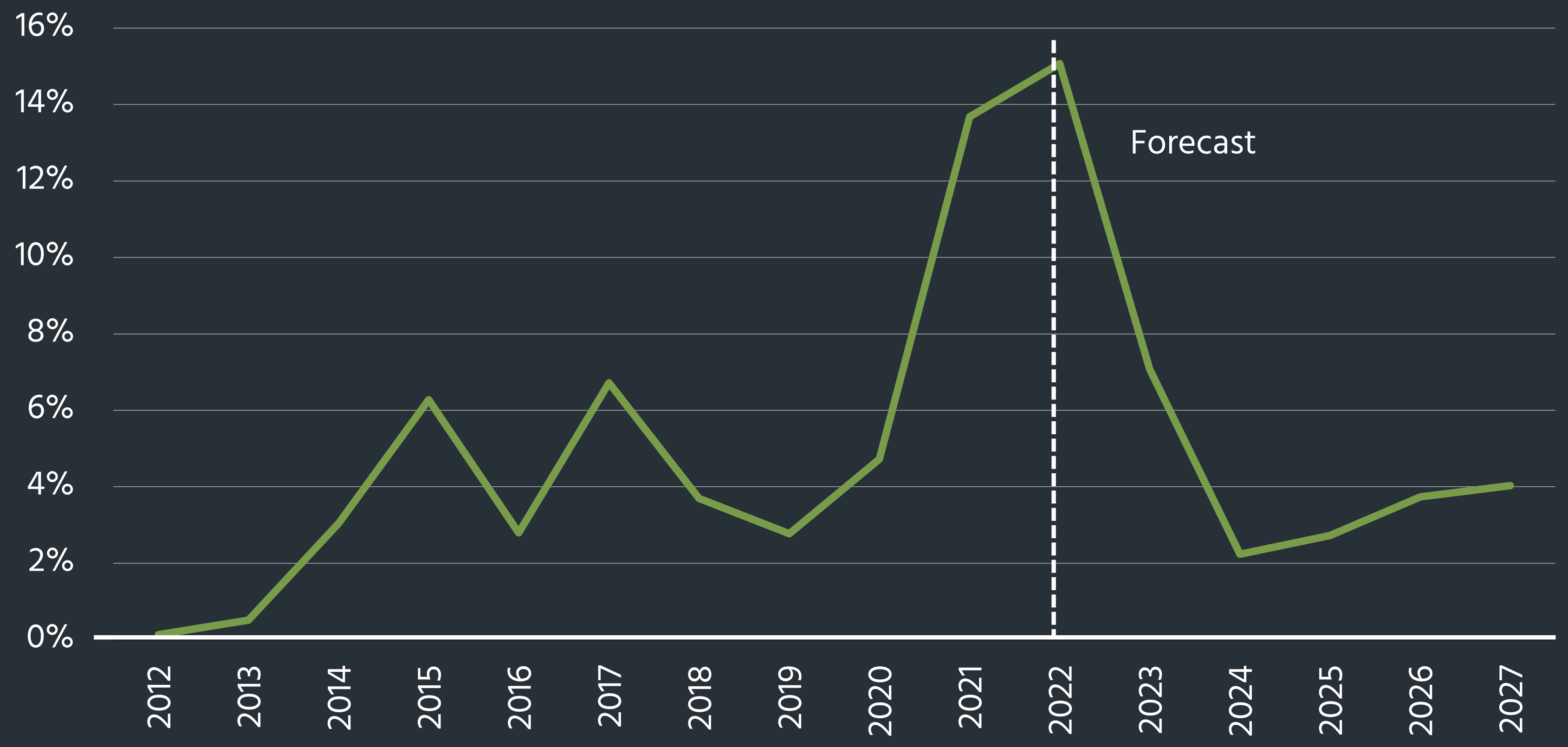
RENTS

The strong energy efficiency credentials of new speculative developments delivered this year will offer occupiers potential cost savings and will likely push on prime rents. This is especially the case whilst prevailing availability of this sort is still relatively low. Concerns over more hawkish interest rate expectations and weak demand will weigh on consumer and business demand for goods and warehouses from next year onwards.

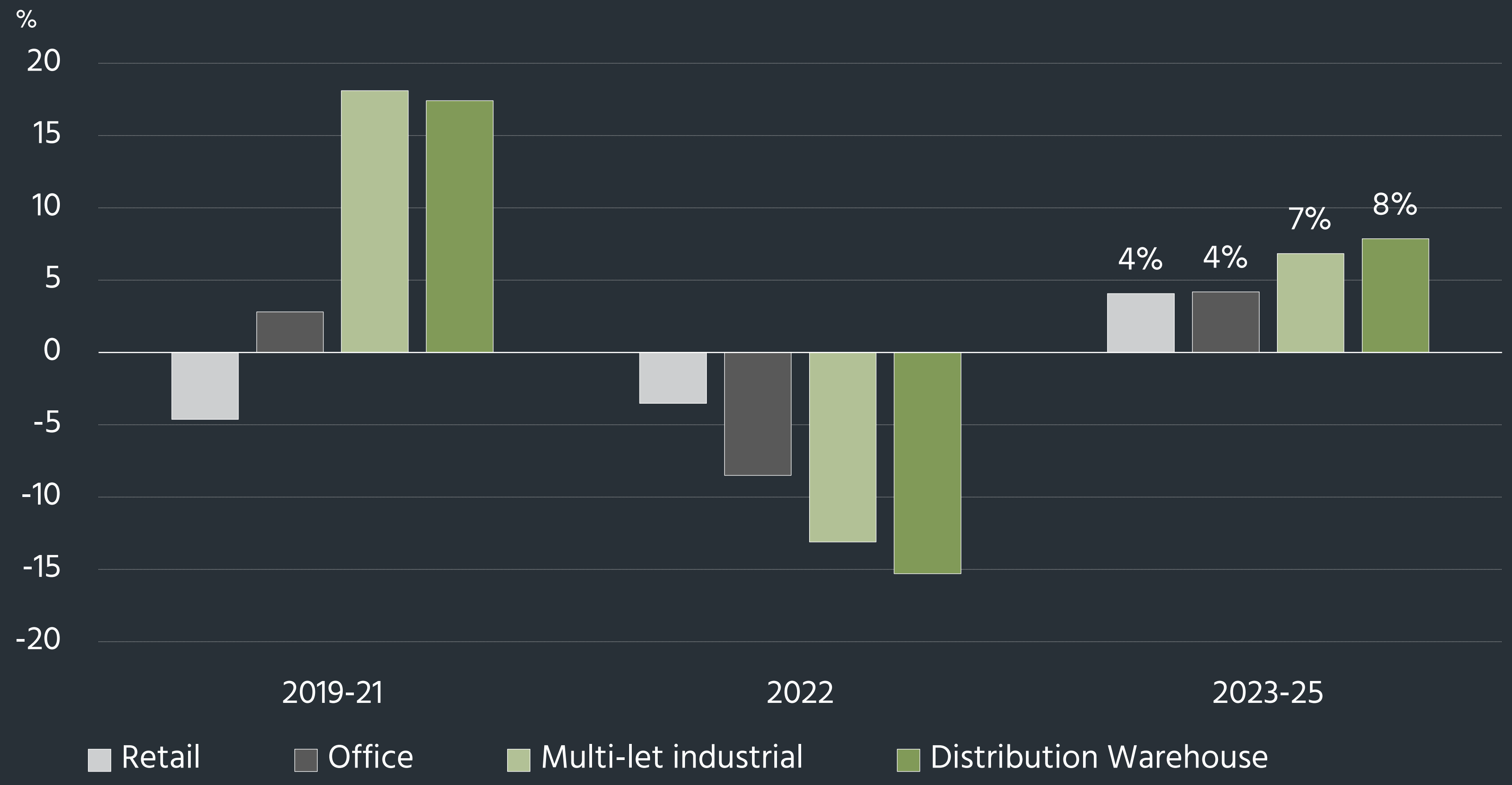
INVESTMENT

There is a significant weight of capital targeting the sector, set against a limited amount of investment supply. A lack of transactional evidence will hamper valuations this year whilst the market prices-in the potential for higher-for-longer interest rates and debt costs. The strong fundamentals of industrial property relative to other sectors will reassert total return sector hierarchies from next year onwards.

Prime logistics annual rental growth forecast
Source: Gerald Eve

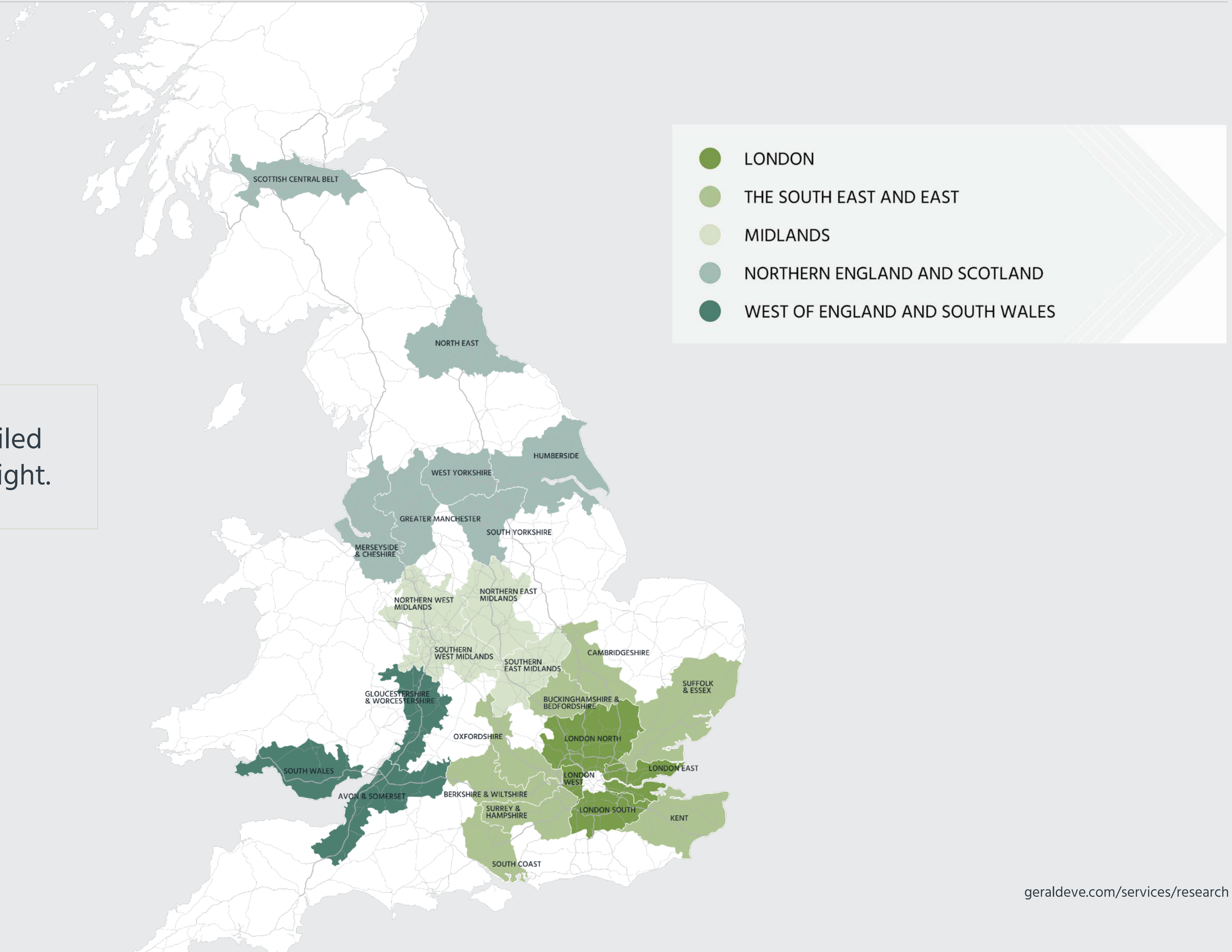


Average annual total returns by sector
Source: Gerald Eve, MSCI



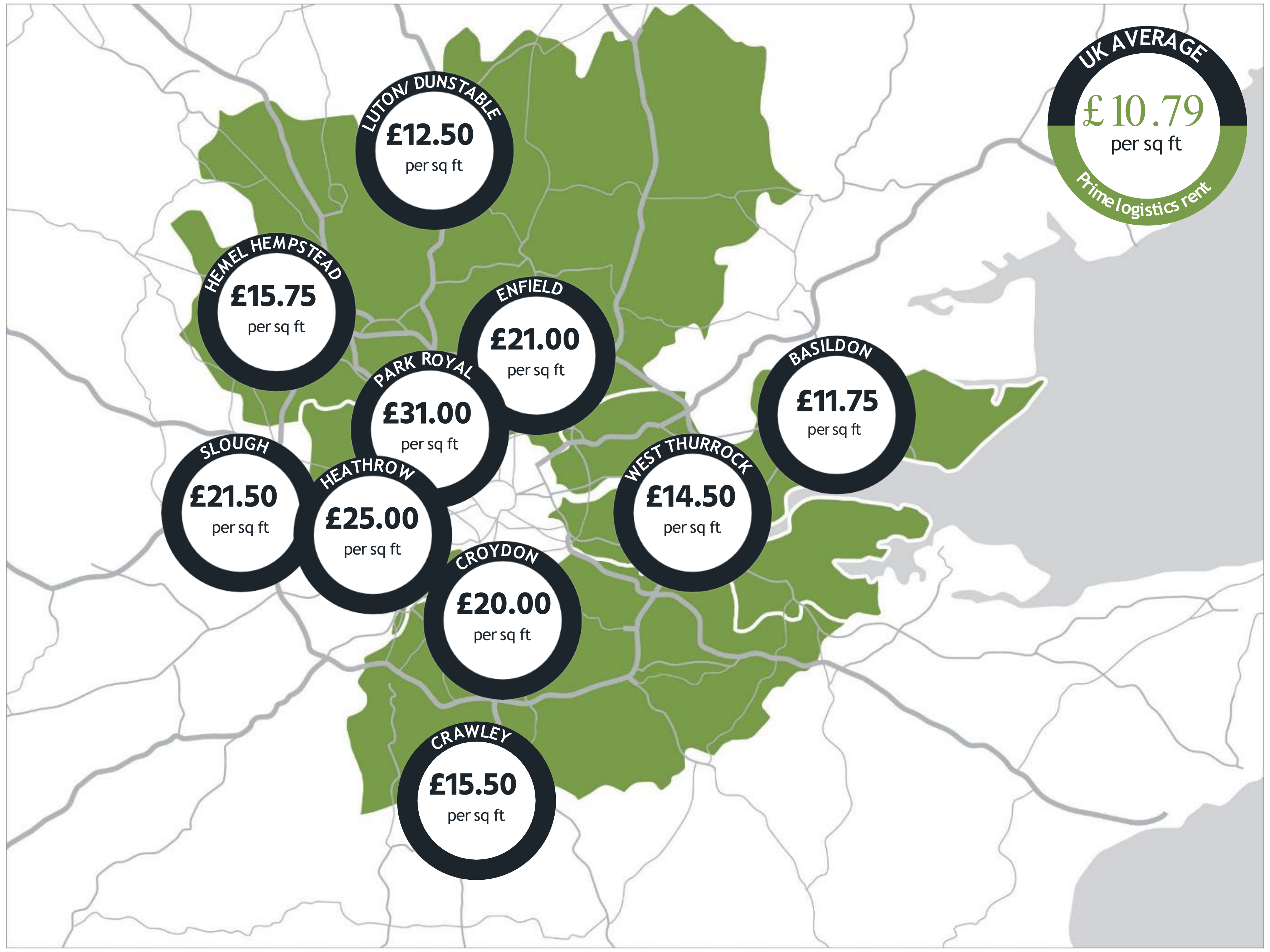
GERALD EVE REGIONS

Click here for more detailed regional analysis and insight.



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.

Quarterly occupier take-up by region

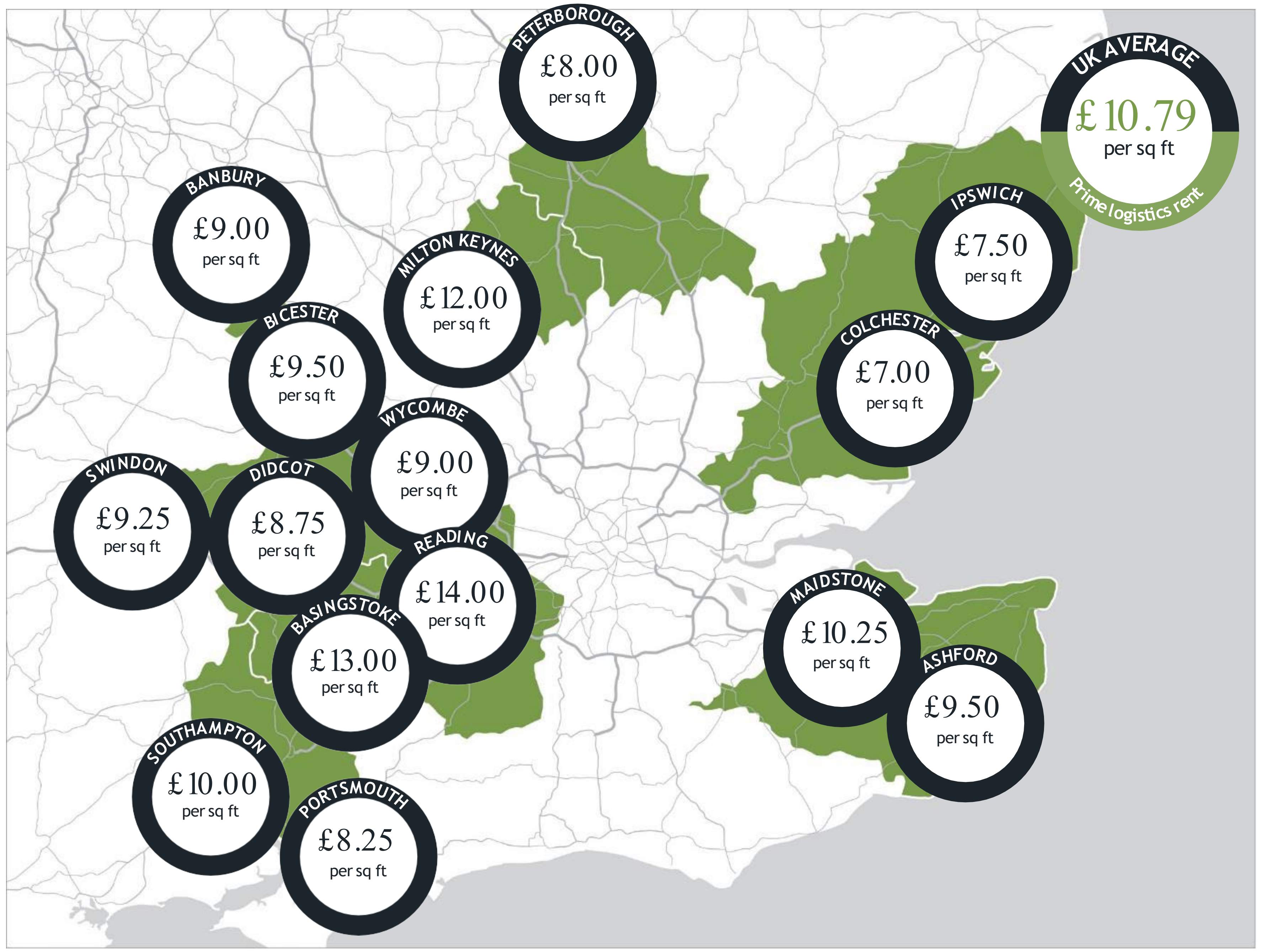
Source: Gerald Eve

Availability rate by region

Source: Gerald Eve

THE SOUTH EAST AND EAST

PRIME LOGISTICS RENTS



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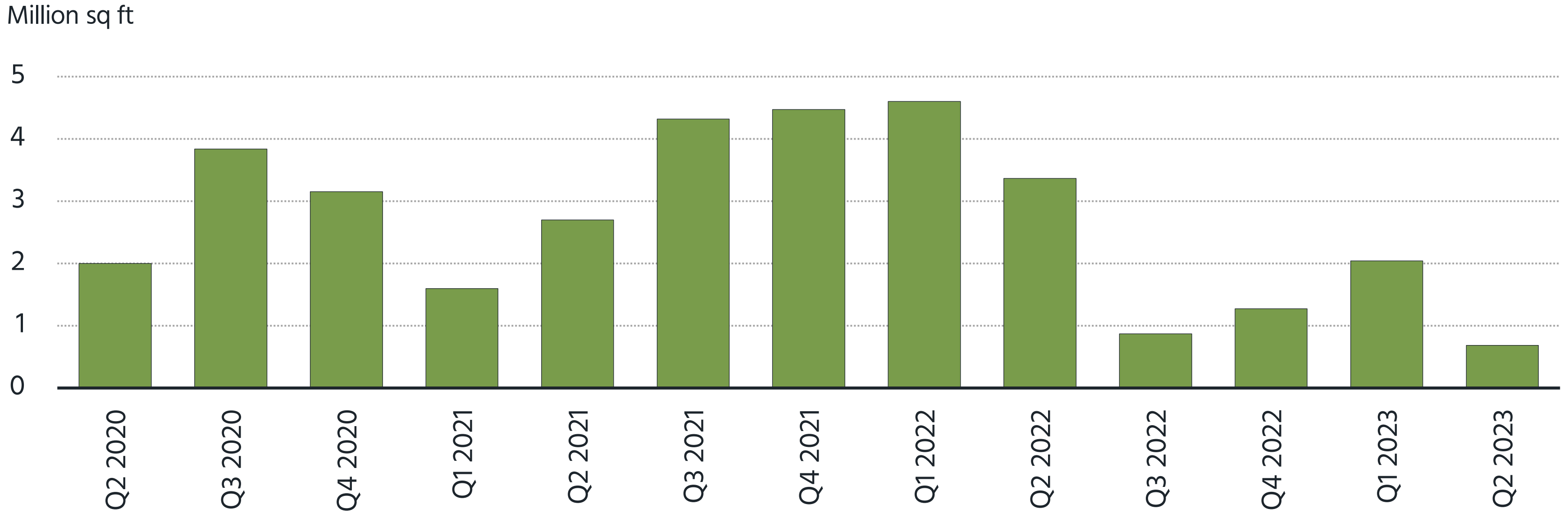

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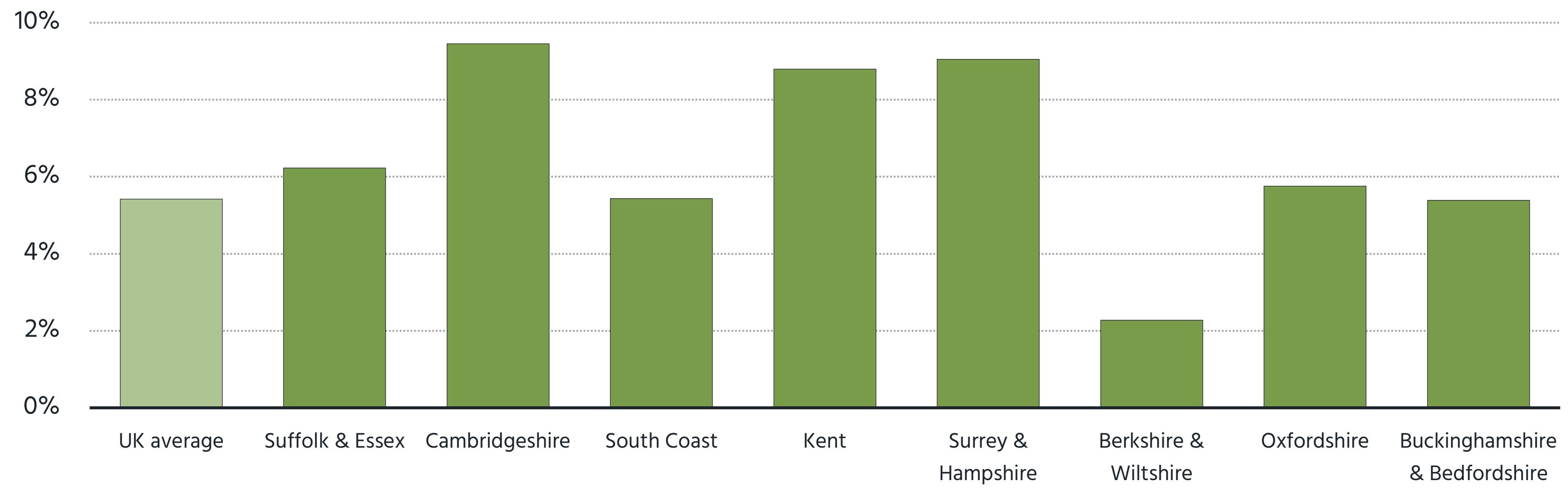
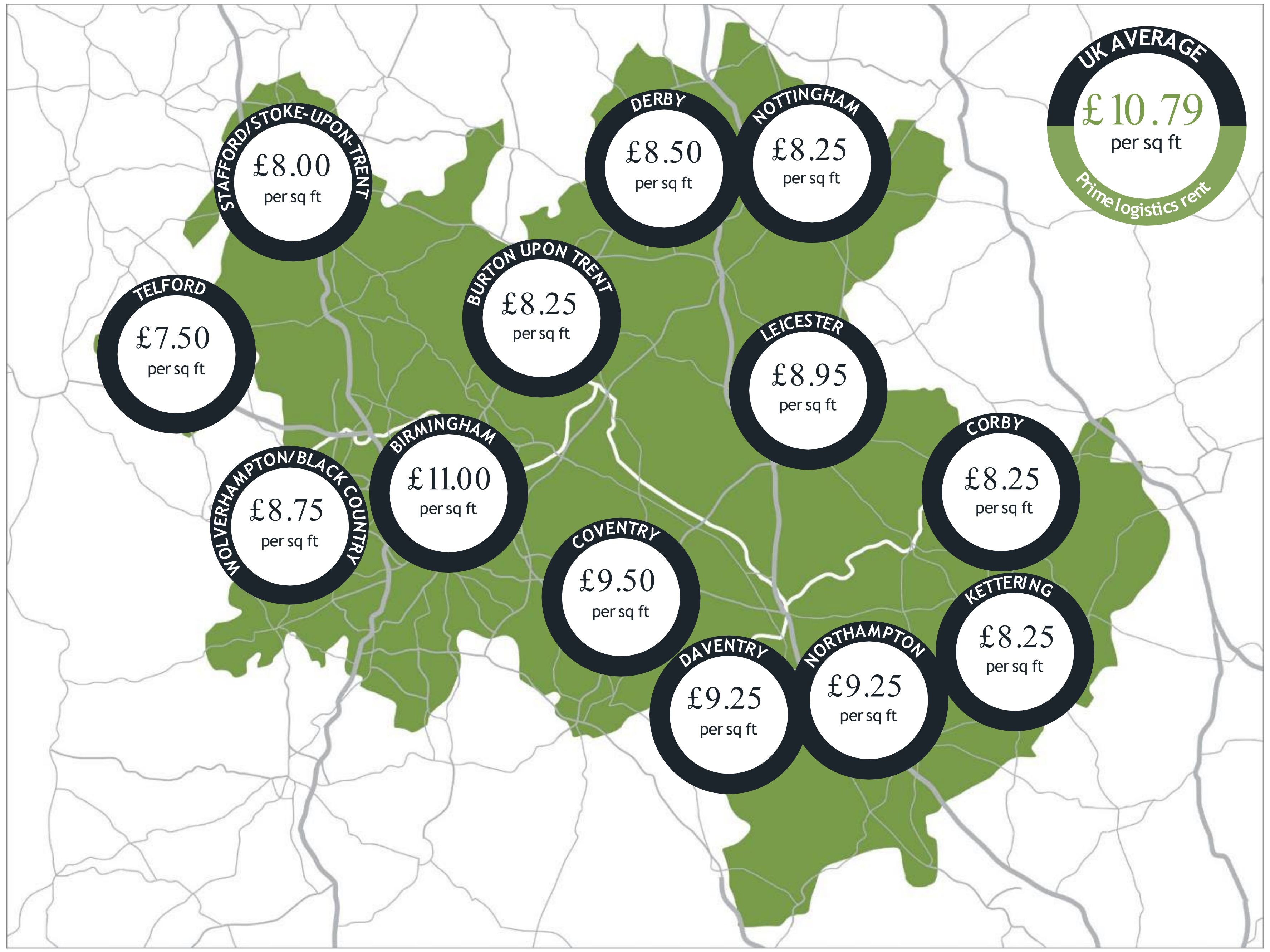


MIDLANDS

PRIME LOGISTICS RENTS



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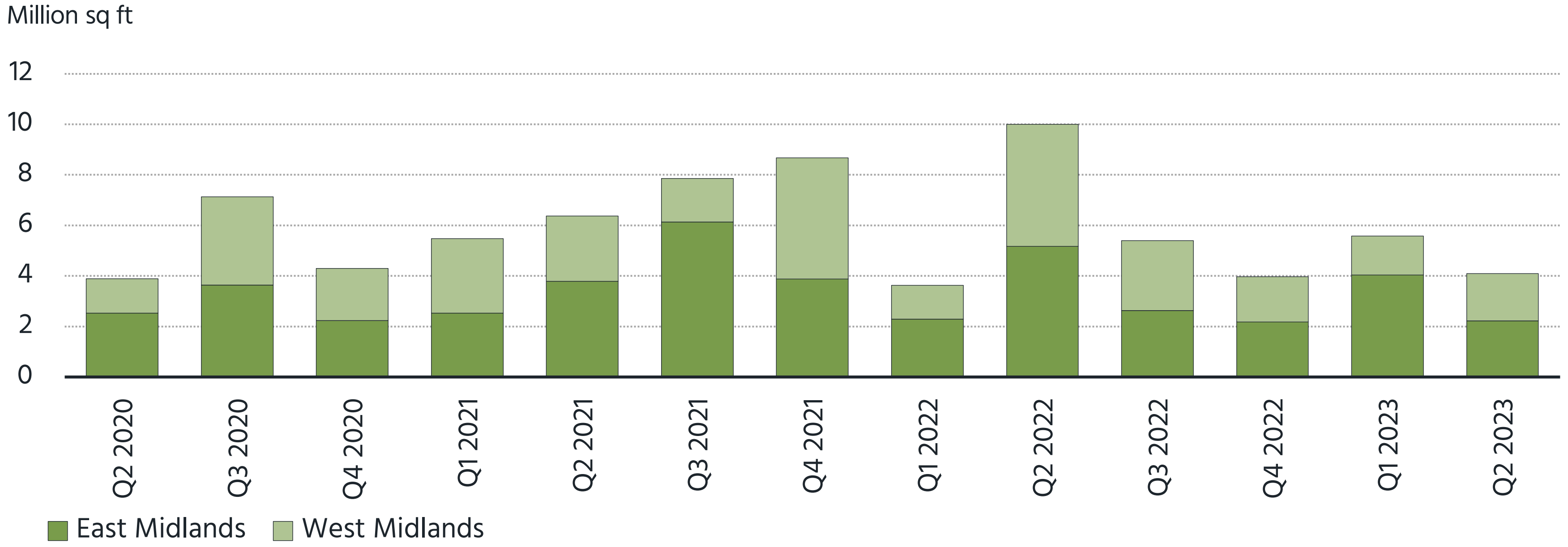
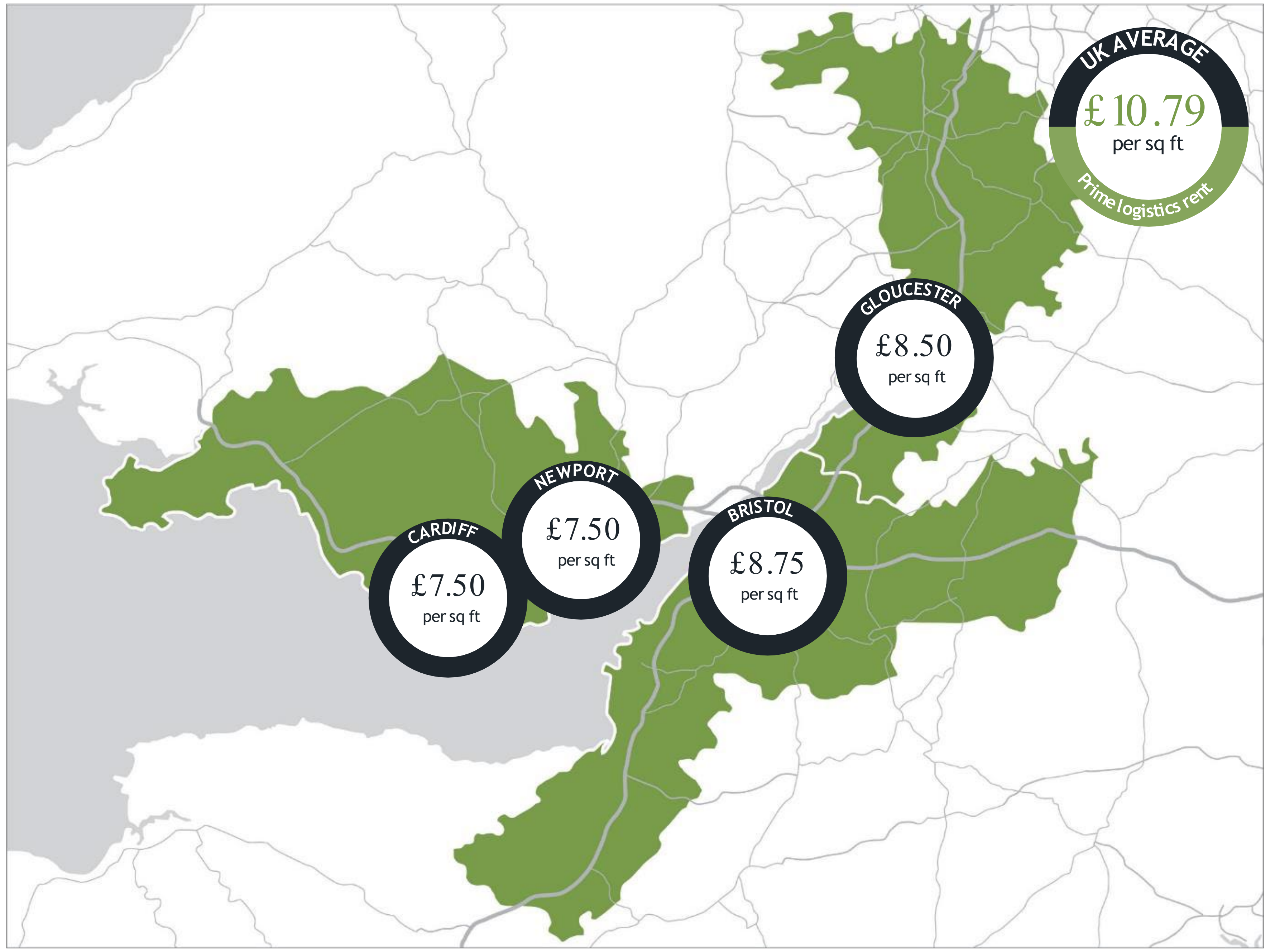
Source: Gerald Eve



Availability rate, by region
Source: Gerald Eve

WEST OF ENGLAND AND SOUTH WALES

PRIME LOGISTICS RENTS



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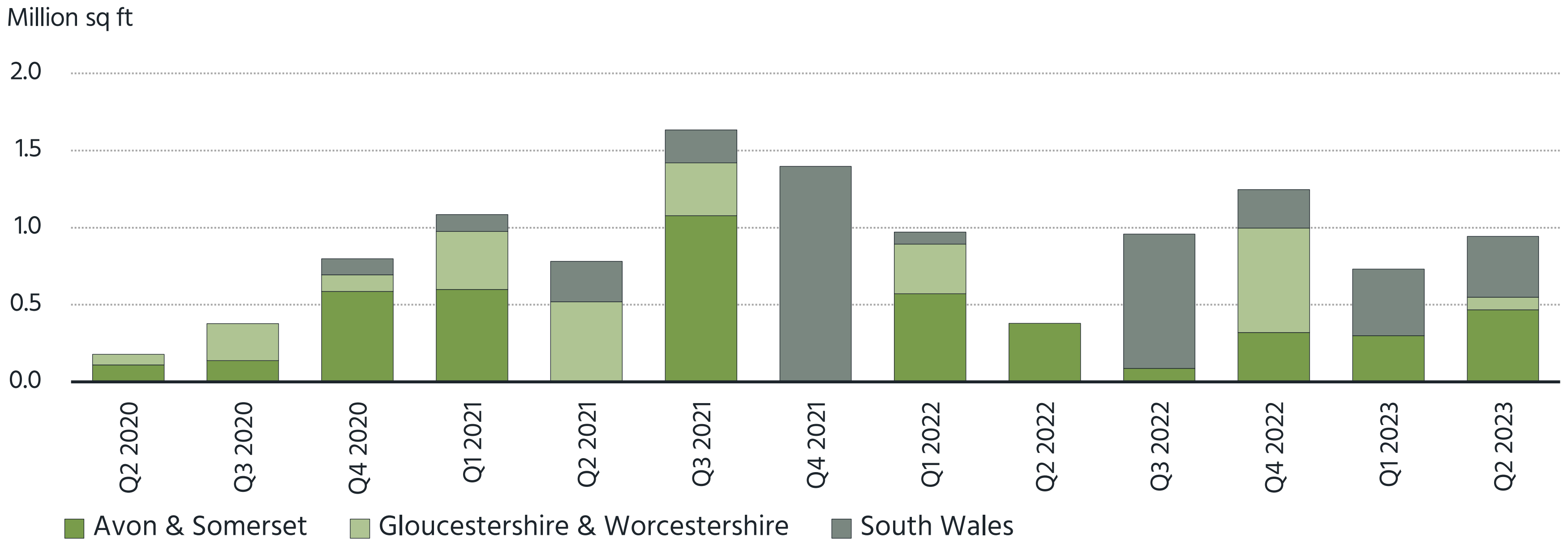
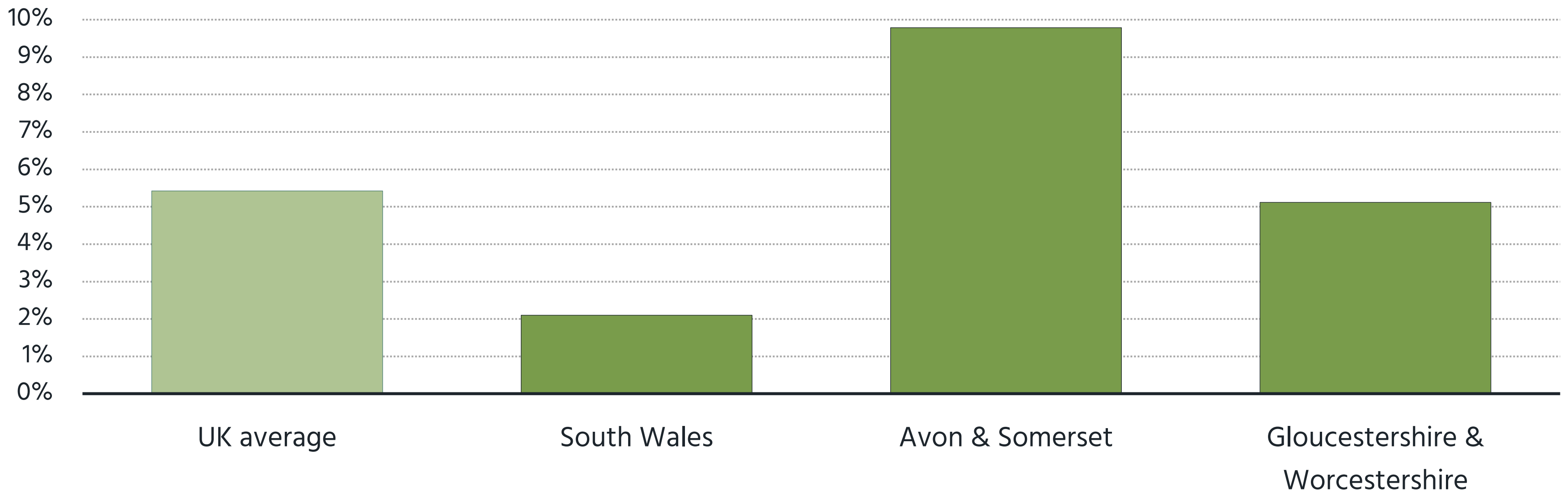


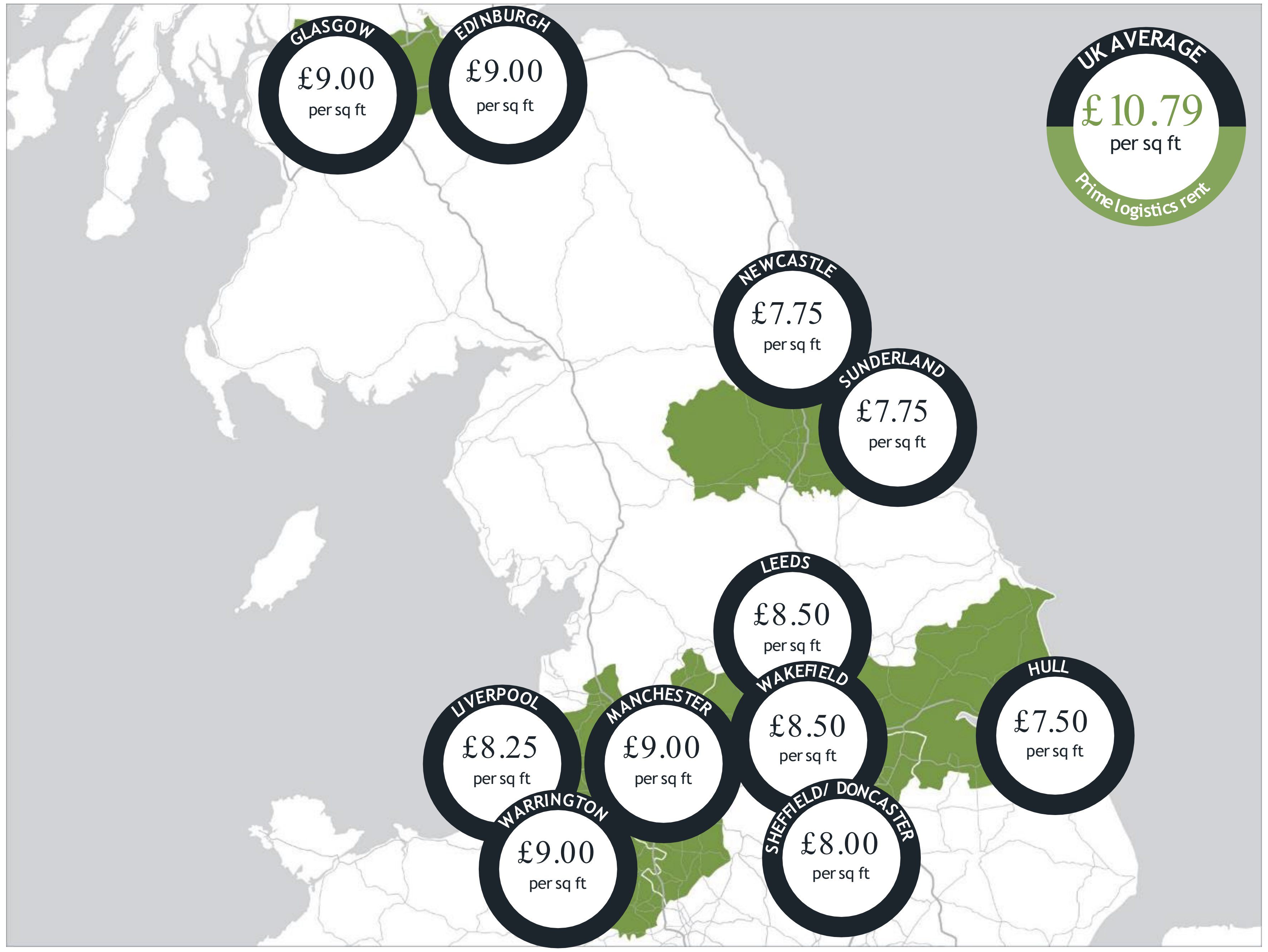
Availability rate by region

Source: Gerald Eve



NORTHERN ENGLAND AND SCOTLAND

PRIME LOGISTICS RENTS



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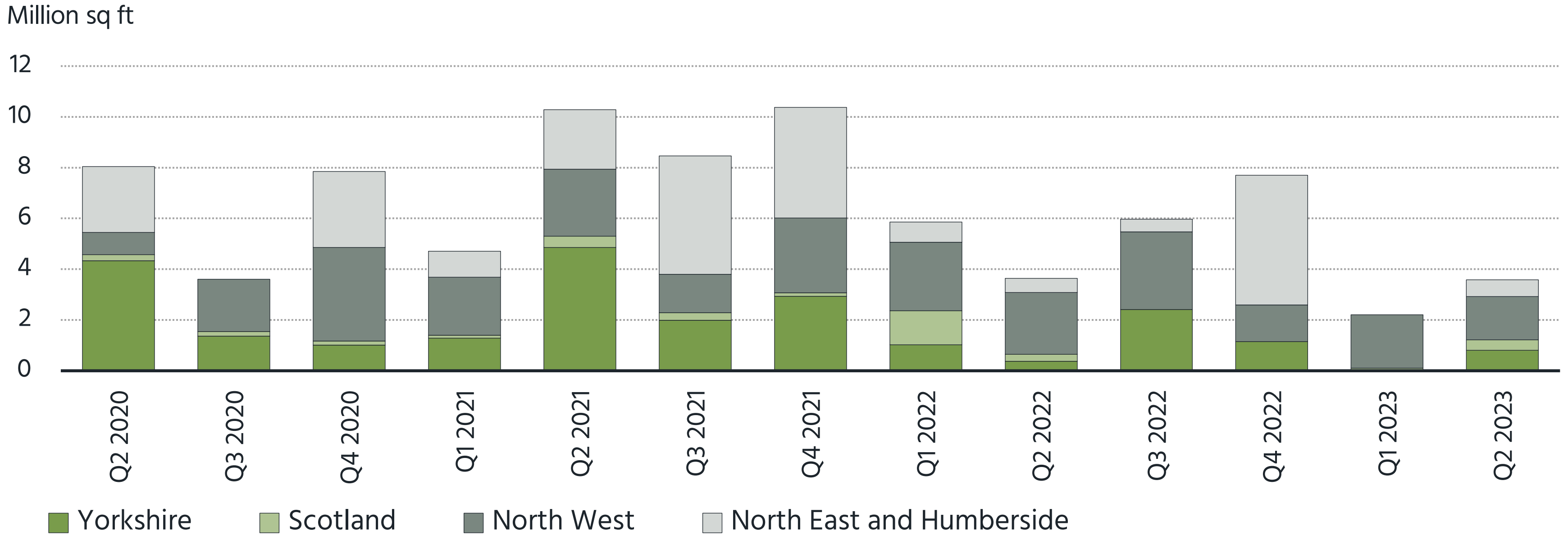

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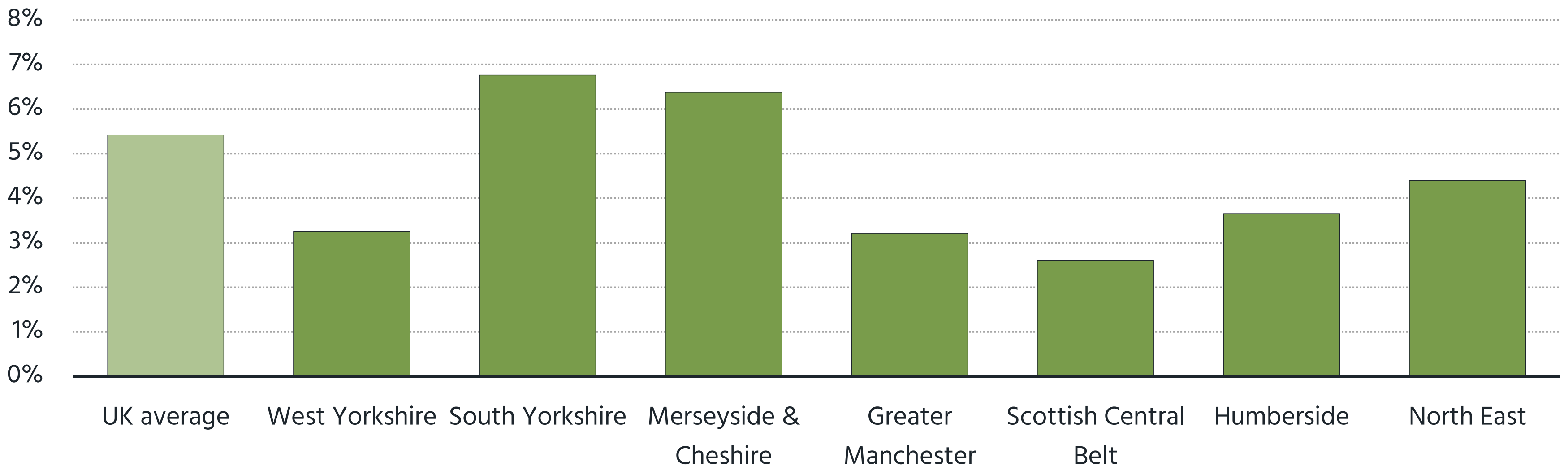

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FURTHER INSIGHT

In Brief
June 2023

Multi-let
July 2023

London Markets
Q1 2023

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