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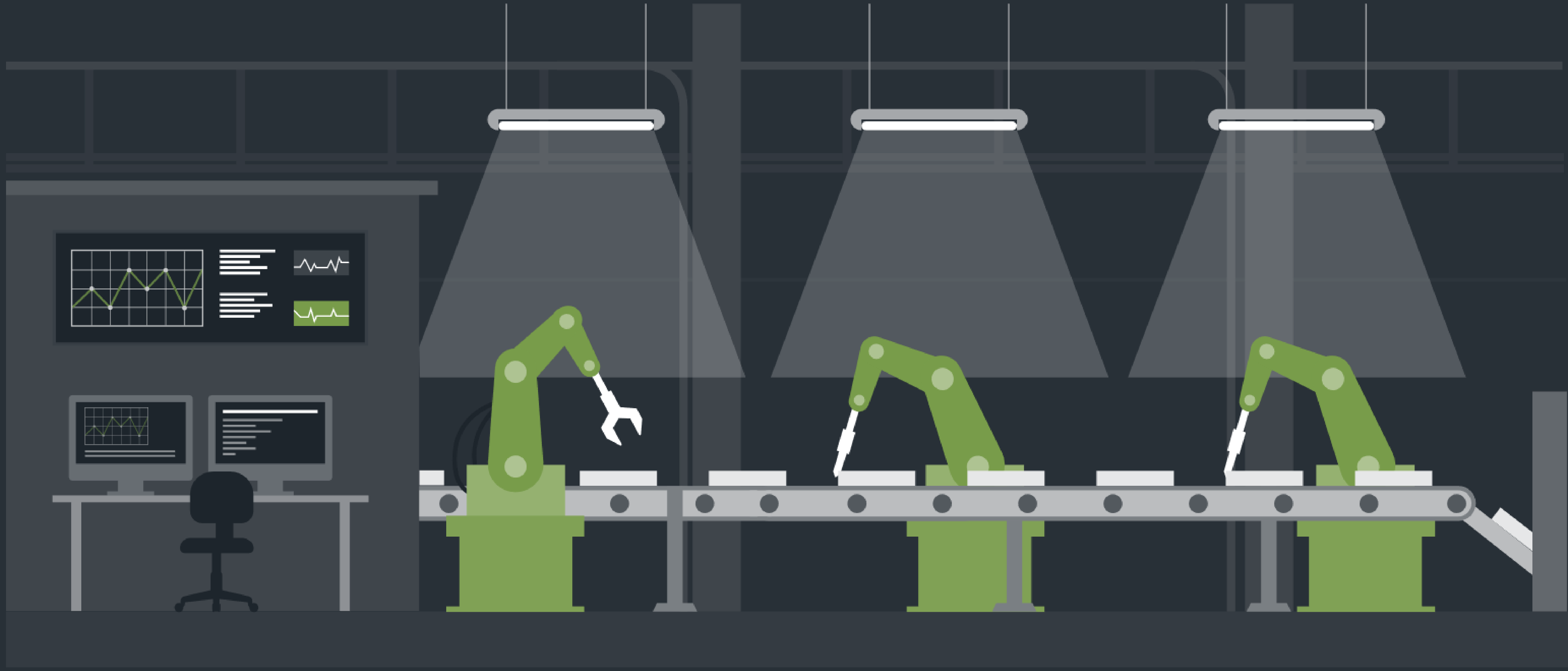
PRIME LOGISTICS

The definitive guide to the
UK's distribution property market

Q3 2023



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MARKET OVERVIEW

MOST UK LOGISTICS MARKET INDICATORS RETURN TO PRE-PANDEMIC TREND

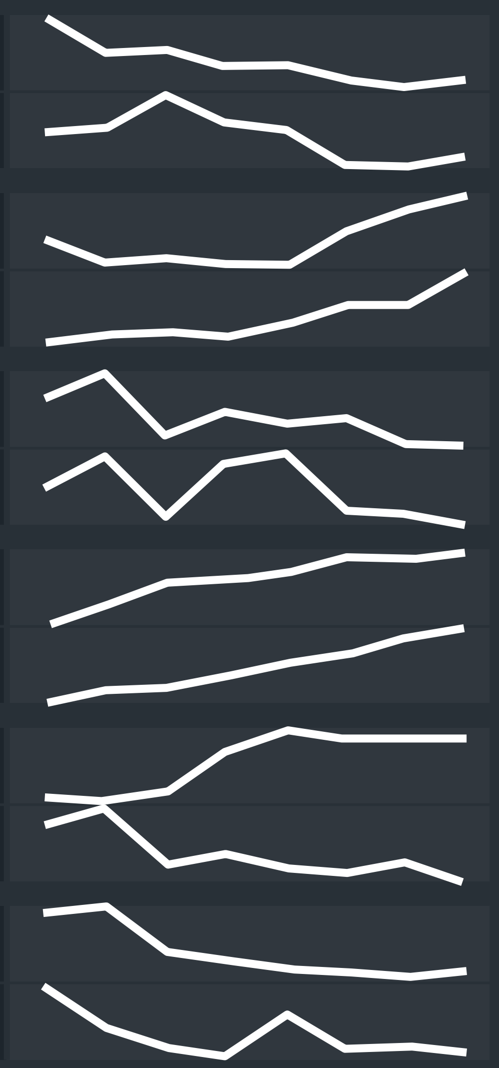
Occupier take-up increased by 12% in Q3, the first quarter-on-quarter rise in a year. Manufacturing occupiers, notably those in the construction and housebuilding sector accounted for roughly half of all activity, going someway to fill the post-pandemic gap left by internet retailers. On a rolling annual basis, occupier demand is now back to the pre-pandemic trend, though business plans continue to be hampered by a challenging economic backdrop.

Headline prime rents increased further in Q3, broadly in line with inflation. Availability also edged-up, largely due to the completion of new speculative buildings. Availability nevertheless remains below the pre-pandemic rate. Speculative development starts slowed further in Q3, which continues to support headline rents.

Q3 2023 UK LOGISTICS MARKET DASHBOARD

Sources: Gerald Eve, ONS, RCA

		Q3 2023	Two-year trend
OCCUPIER DEMAND	Take-up	11.1m sq ft	
	% new/modern	63%	
AVAILABILITY	Availability rate	5.9%	
	New/modern availability rate	4.3%	
DEVELOPMENT	Development starts	6.2m sq ft	
	Spec development starts	2.5m sq ft	
OCCUPIER COSTS	Average prime rent, sq ft	£11.00	
	Average weekly earnings	£666	
INVESTMENT	Average prime yield	5.30%	
	Transaction volume	£0.97bn	
ECONOMY	Annual GDP growth	0.46%	
	Retail sales % online	24.9%	



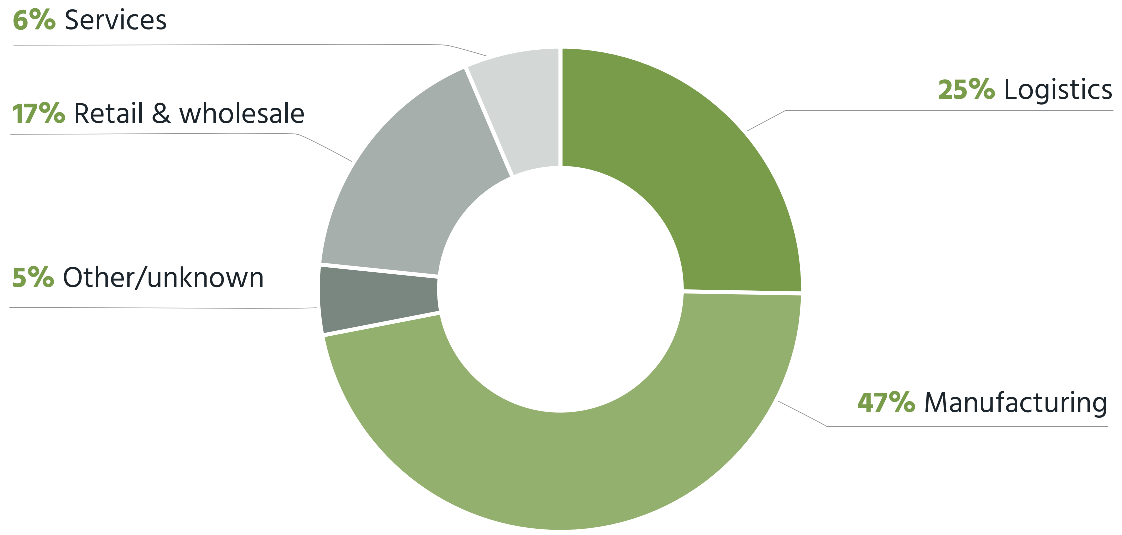
OCCUPIER DEMAND

POST-PANDEMIC TAKE-UP LOOKS TO HAVE REACHED A TROUGH AND PICKED UP IN Q3

Occupier take-up was 11.1m sq ft in Q3, up 12% on Q2. This was the first increase in quarterly demand in a year and put a stop to the post-pandemic downward trend since the peak in Q4 2021. Demand is still subdued though, down 25% on the year and 17% below the 10-year average. The challenging and uncertain economic backdrop has made it difficult for occupiers to business plan with any confidence, and an increased number of occupiers have mothballed units. Activity continues to be focused on the best quality space, both new-build and refurbished secondary.

Q3 2023 take-up by main occupier sector

Source: Gerald Eve

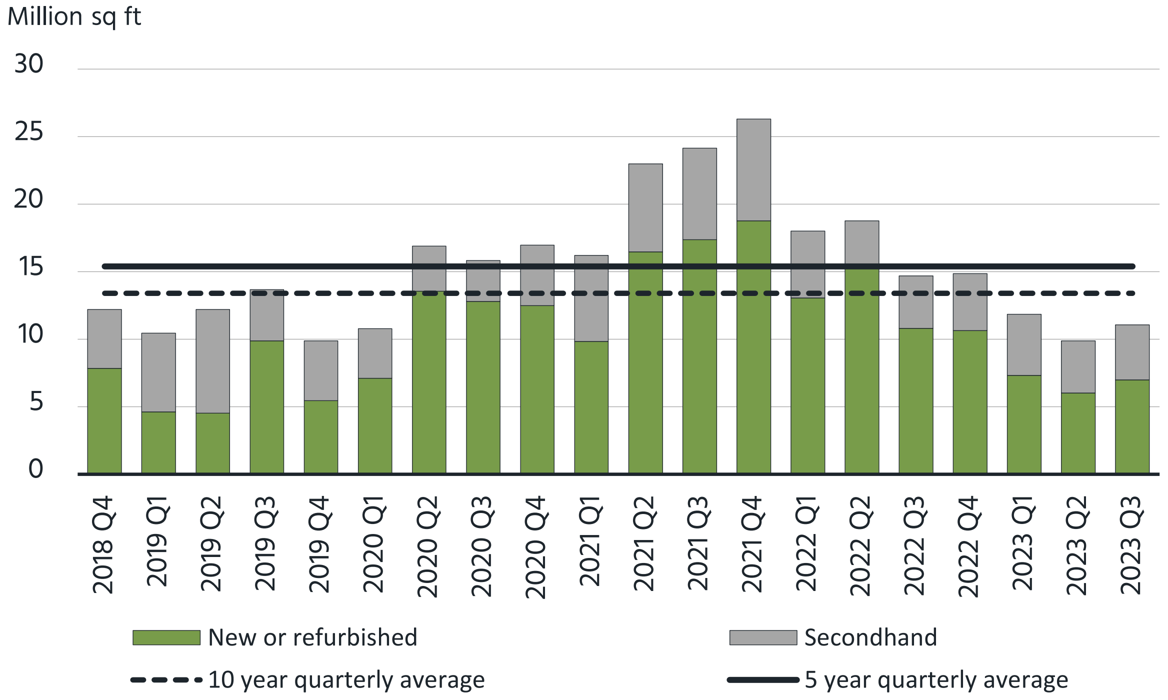


MANUFACTURERS THE DOMINANT OCCUPIER SECTOR

The breakdown of take-up in Q3 stood in contrast to typical occupier activity over the last three years. Manufacturers were notably active, particularly those in the house building /construction, food and automotive sectors. Some of this demand can be attributed to nearshoring operations and improving supply chain resilience, but some is also due to the natural churn of lease events providing the opportunity to upgrade to more energy-efficient accommodation. Given this tilt towards production rather than logistics/storage uses, the average building size taken-up was below the 10-year average, and demand was regionally skewed to the manufacturing heartlands in the North West and West Midlands.

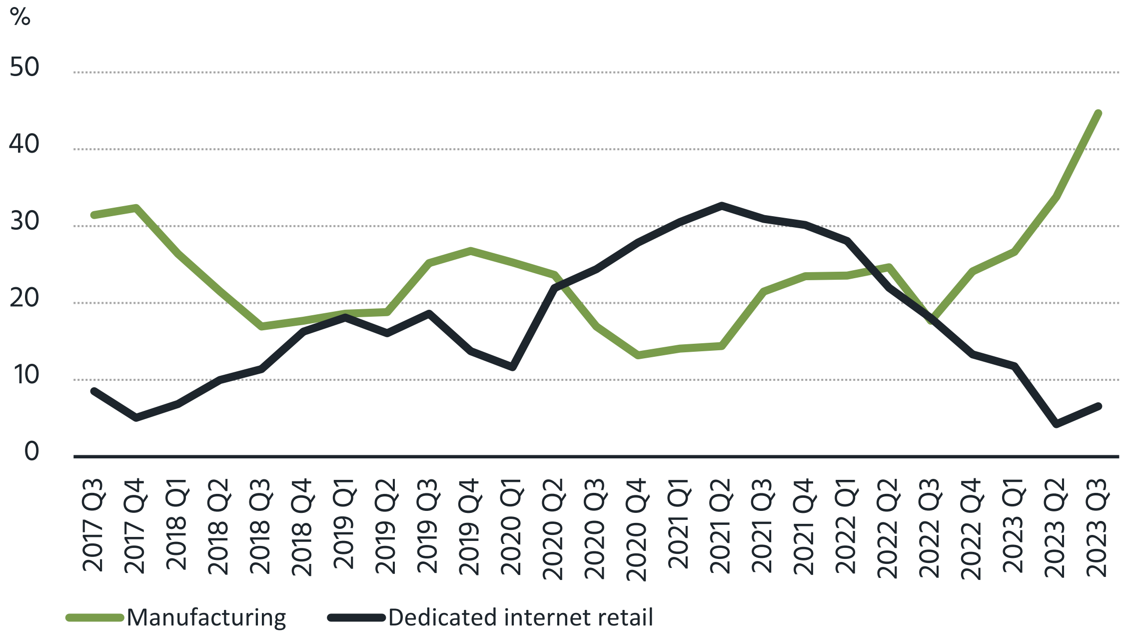
Quarterly take-up by quality

Source: Gerald Eve



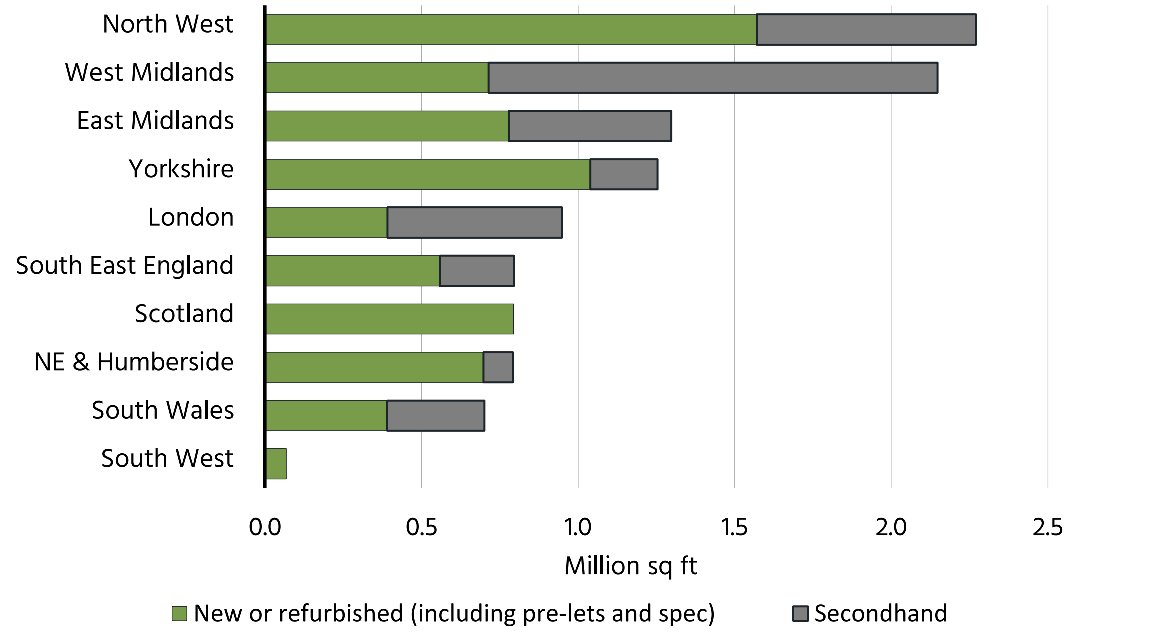
Rolling annual take-up, sector proportions

Source: Gerald Eve



Q3 2023 take-up by region and quality

Source: Gerald Eve



SUPPLY AND DEVELOPMENT

UK AVAILABILITY INCREASES FURTHER TO 5.9%

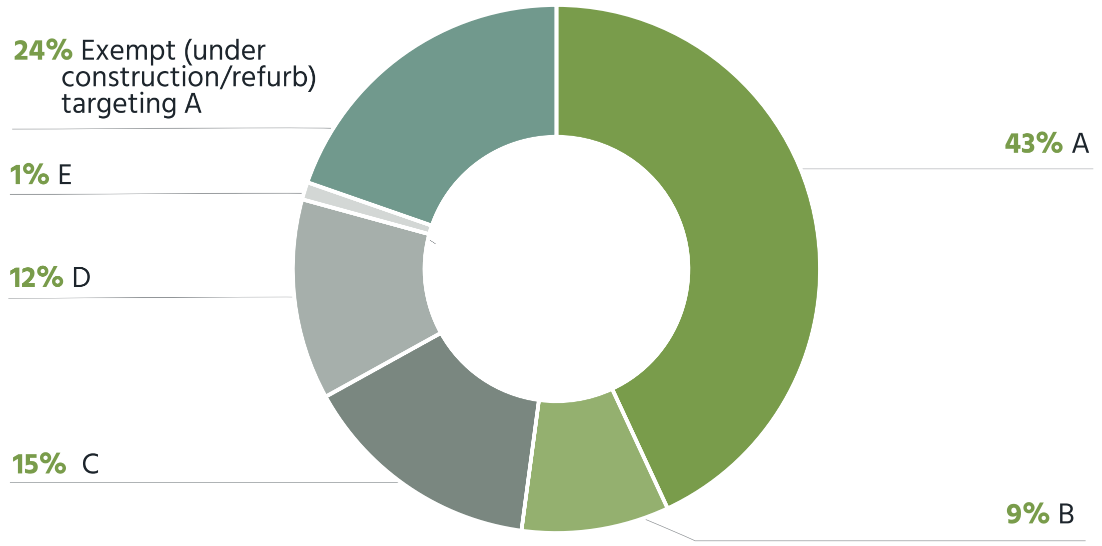
The overall rate of availability increased again from 5.4% in Q2 to 5.9% in Q3. This reflects around 55m sq ft of marketed space in total, a significant increase on the 33m sq ft low point in Q4 2022. The increase was largely due to the completion of spec-built stock rather than the return of unwanted secondhand space, although that component of new availability has edged up also. Availability is now below the 10-year average for the UK (6.4%) but above the 5-year average. The overall quality of available buildings is high, with over 60% of all marketed space either new or refurbished.

AVERAGE TIME ON MARKET REMAINS AROUND 10 MONTHS

While the overall rate and volume of availability has increased over 2023, the average void period of buildings on the market has remained steady at just over 10 months. This stability was largely due to the addition of around 5.5m sq ft of new speculative buildings in Q3, which helped to offset longer- term voids. Regionally, buildings in the South East had the longest average time on the market in Q3, perhaps as landlords held firm on rental aspirations, whilst buildings in the West Midlands, more suited to manufacturing occupiers, had on average the shortest void period at around 8 months.

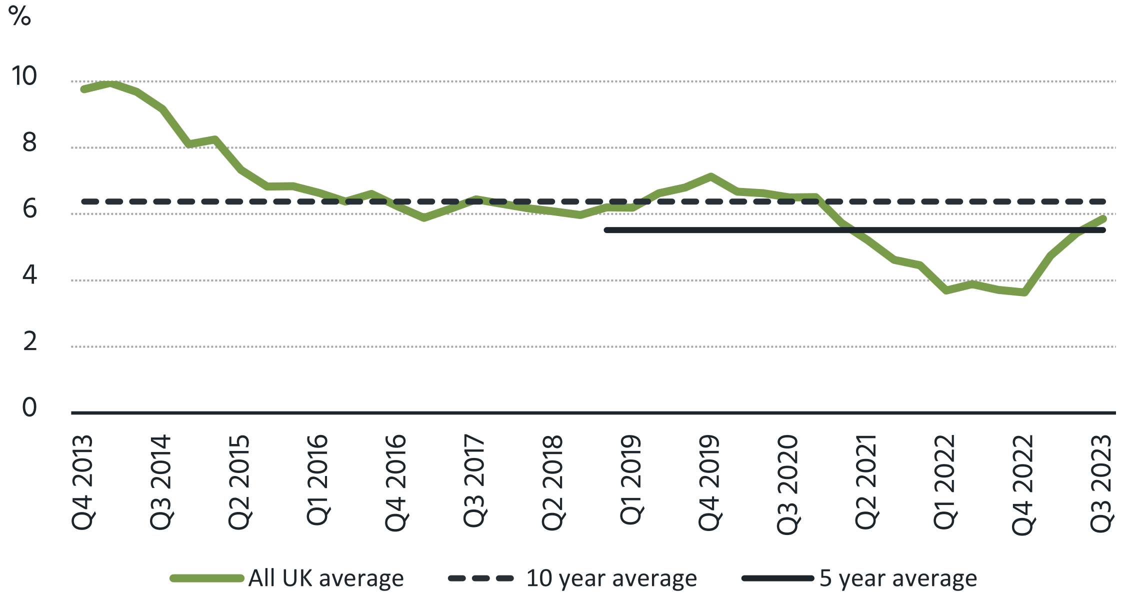
Q3 availability by building EPC grade

Source: Gerald Eve



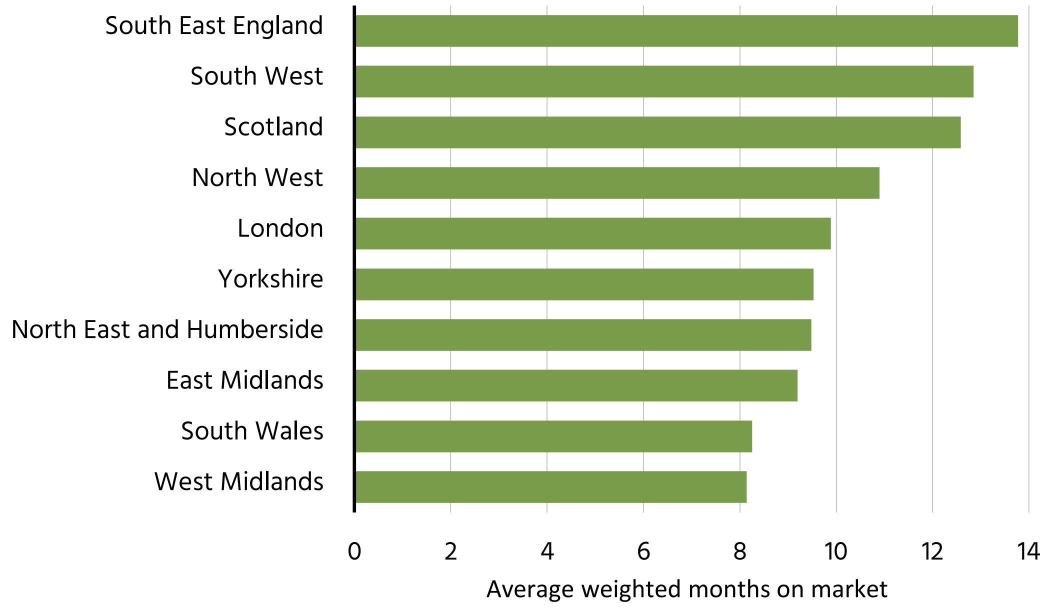
UK logistics availability rate

Source: Gerald Eve



Q3 availability, average weighted time on market by region

Source: Gerald Eve



AVAILABLE UNITS OF A GOOD AVERAGE QUALITY AND ENERGY EFFICIENCY

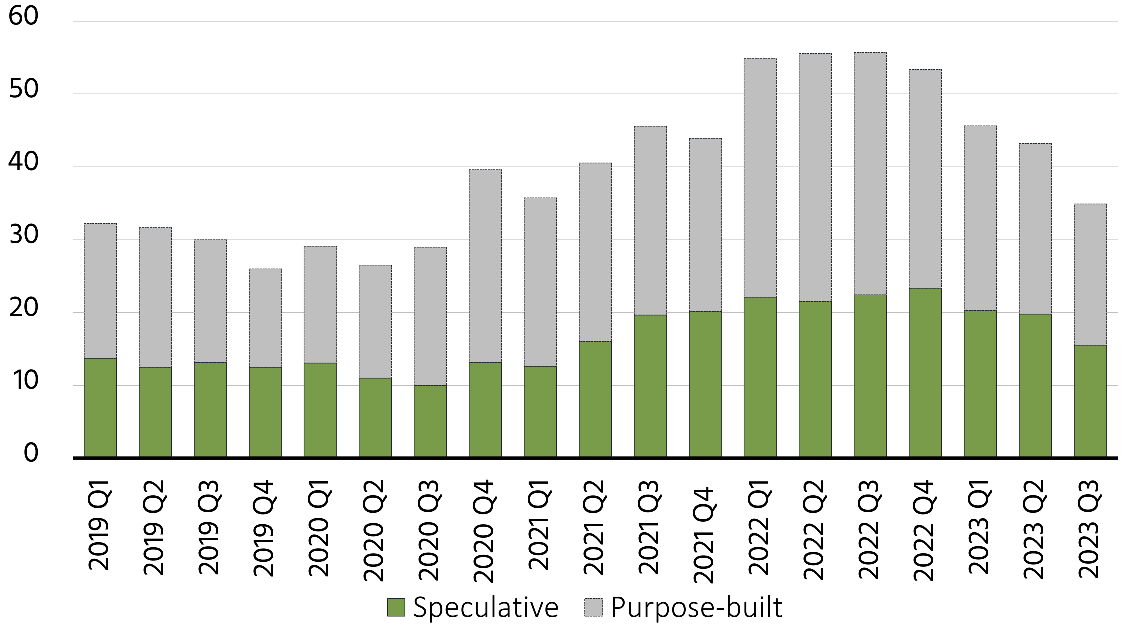
The energy efficiency of marketed available logistics space is high. This reflects the addition of new developments, but also considerable refurbishment activity on less energy-efficient buildings. More than 50% of all available space on the market has an EPC grade of A or B. When new space under construction or space being refurbished and targeting EPC A is included, this rises to 76%. Landlords are aware of occupier preference for more energy-efficient space (and attendant energy cost savings) and are tailoring space to suit. The risk to income of energy efficiency regulation is much reduced for logistics landlords compared with other asset classes, both in terms of relative cost of improvements and void risk.

SUPPLY AND DEVELOPMENT

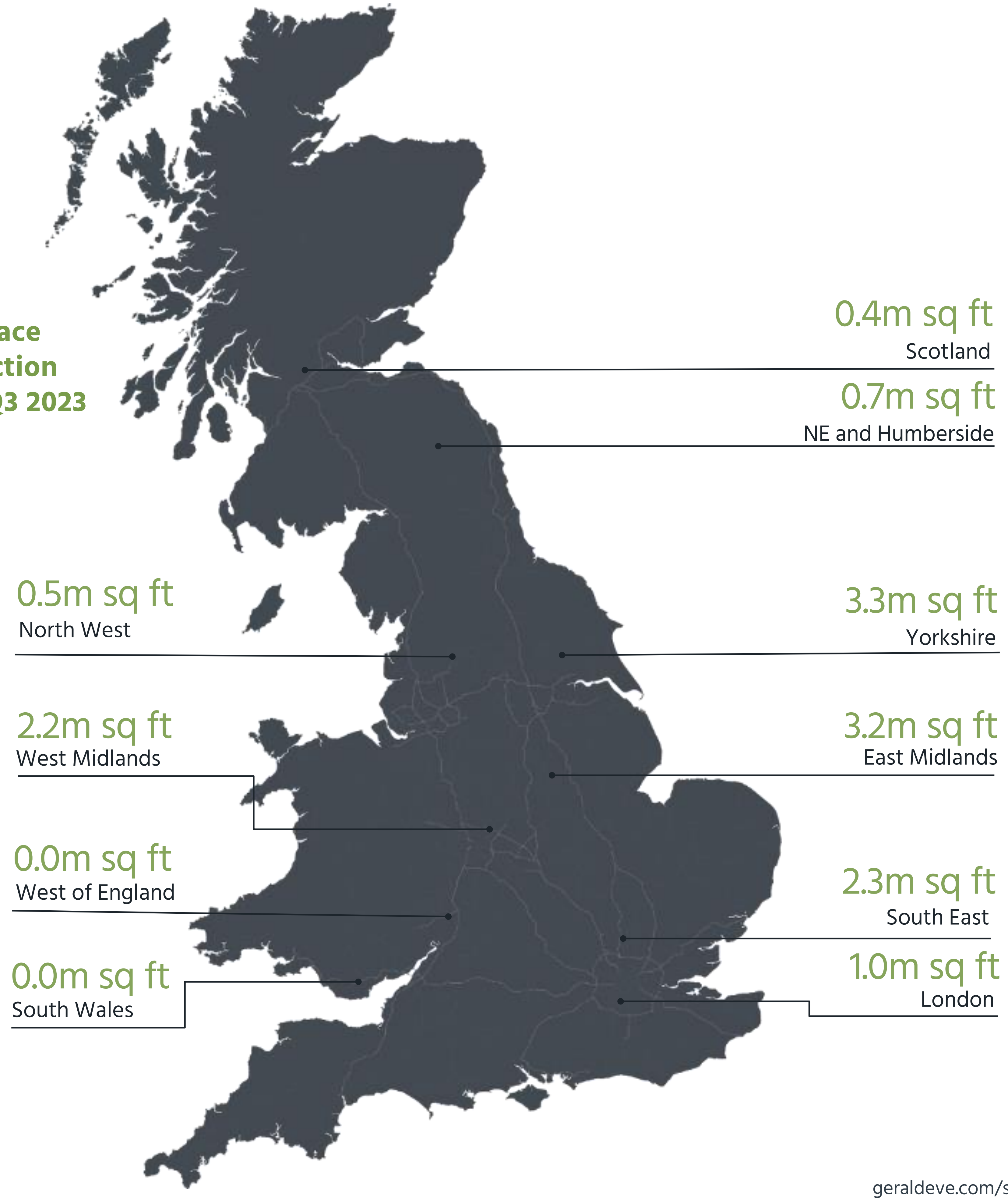
DEVELOPMENT STARTS SLOW AGAIN IN Q3

The quarterly volume of speculative development starts across the UK was 2.5m sq ft in Q3, the lowest since the onset of the pandemic in Q2 2020. This slowdown reflects the high cost of development and debt, set against the post-pandemic softening of occupier demand. On a rolling annual basis, we are now well over the development peak, and speculative activity is likely to remain subdued through to 2024. However, land continues to be readied through planning and infrastructure works - indeed several new schemes were announced in Q3, but most landlords are currently likely to market this land for D&B rather than commence speculative construction.

Rolling annual speculative development starts
Source: Gerald Eve



Speculative space under construction at the end of Q3 2023



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RENTS AND OCCUPIER COSTS

ANNUAL PRIME RENTAL GROWTH RISES TO 6.6%

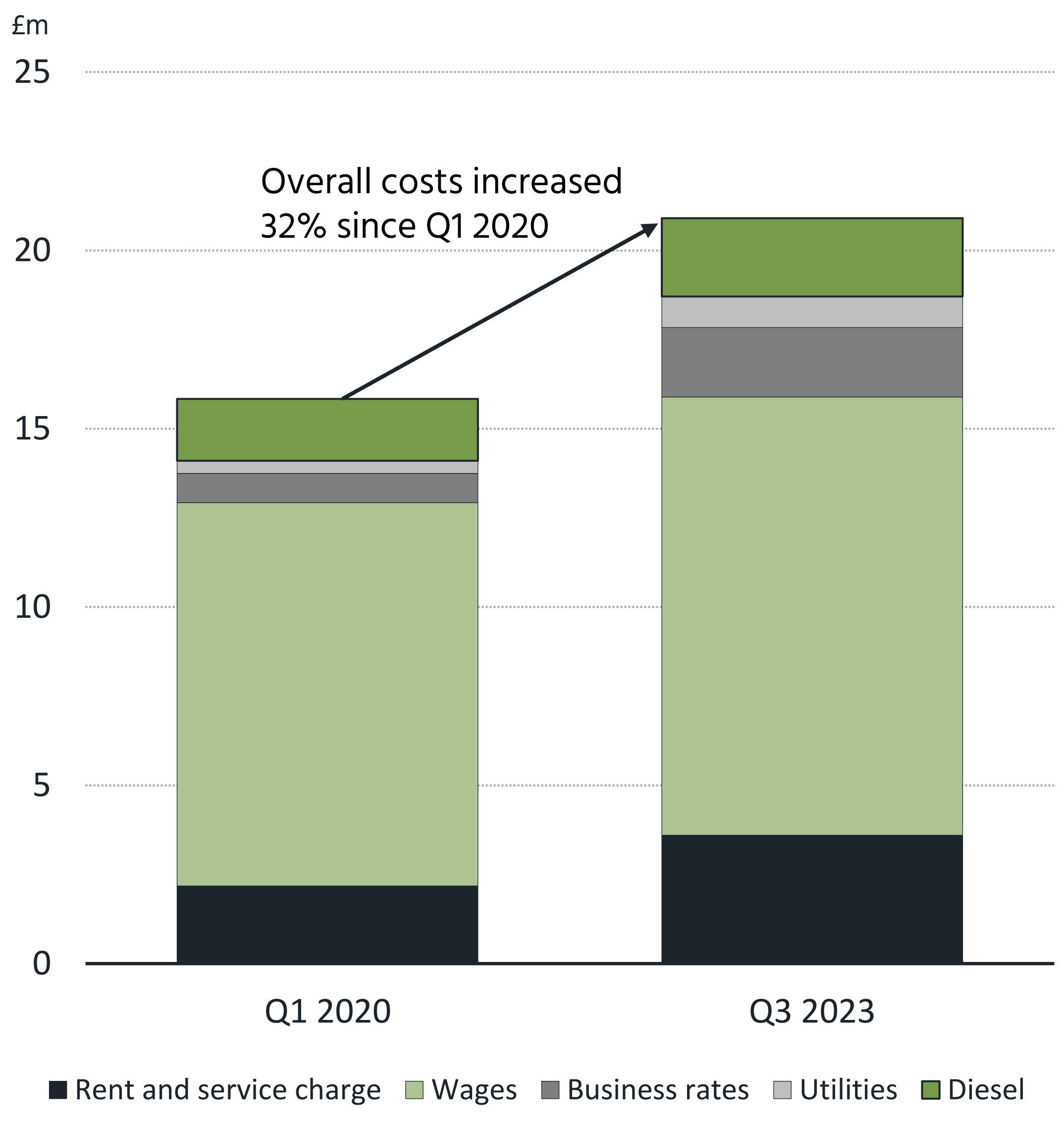
A cooling of the prime rental market following the period of unprecedented growth during 2021-2022 was to be expected and the rate of annual growth fell during H2 2022 and H1 2023. However, this steadied somewhat in Q3 - increasing on average by 1.4% in Q3 and 6.6% over the past year. Such resilience reflects activity on new (smaller) spec buildings and occupier interest in energy-efficient buildings capable of energy cost savings. In real terms accounting for inflation, annual prime rental growth is now broadly flat. Quoting nominal headline rents on new developments continue to push prevailing prime benchmarks.

Average annual UK prime rental growth

Source: Gerald Eve

Indicative annual logistics occupier warehouse operating costs, Q1 2020 and Q3 2023*

Sources: Gerald Eve, ONS, Homes & Communities Agency, Bionic, DfT, UK Power



*based on a prime 300,000 sq ft unit in Milton Keynes, excluding rental incentives and industry-specific costs, 350 employees and average (large business) gas/electricity usage

DROP IN ENERGY COST THIS YEAR SMALL COMFORT TO OCCUPIERS

There's been some respite for occupiers in the cost of utilities this year, with headline gas and electricity prices falling from recent record highs. This has been welcome news to occupiers, though standing charges increased, and most other costs continued to rise in Q3. Wages are the largest individual cost and staffing remains an issue, both in terms of sourcing staff and keeping pace with wage growth. Annual wage growth for transportation and storage workers was around 5% in July 2023.

PROPERTY NOW ACCOUNTS FOR 17% OF OVERALL OCCUPIER COSTS

The average proportion of overall logistics property costs accounted for by rent and service charge (excluding industry-specific costs) has increased from 14% in Q1 2020 to 17% in Q3 2023. Well-located warehouse space is business-critical to most occupiers, but as rent increases in prominence in the overall occupier cost base, there's likely to be renewed focus on potential costs savings elsewhere, either through energy-efficiency measures or savings on labour.

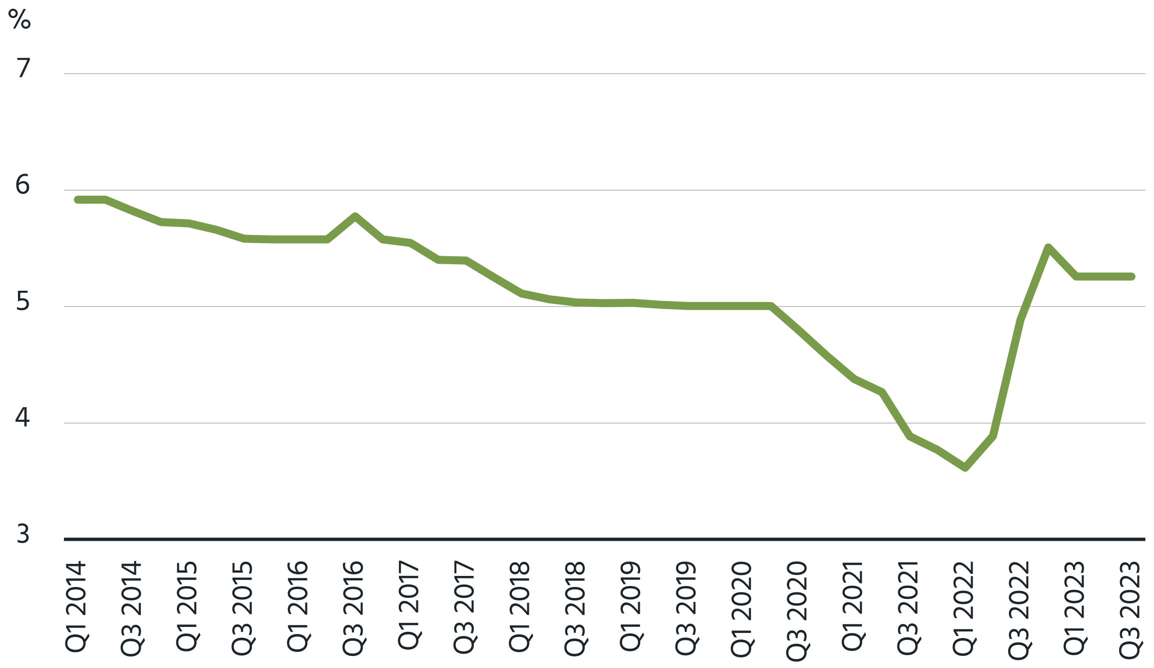
INVESTMENT

WEIGHT OF EQUITY SUSTAINS PRIME PRICING

Investor confidence has been sustained for prime logistics, as one of the few commercial property asset classes still posting positive rental growth. However, with interest rate rises having effectively ruled out debt-backed buyers, and aggregators finding it a more difficult and protracted process to raise capital, the pool of investors with conviction is now much reduced. Prime yields have effectively held constant all year, although secondary pricing has been more significantly impacted and yields have softened in 2023, particularly over the May-June period when interest rate expectations were at a peak and anticipated to reach as much as 6.5%.

All UK average prime logistics yield

Source: Gerald Eve



BASE RATE 'PEAK' RE-ESTABLISHES INVESTOR CONFIDENCE

The Bank of England's narrow vote to maintain the Bank Rate at 5.25% in September after 14 consecutive rises has been a boost to the investment market. The consensus is that we are now at the peak of the current rate cycle, albeit for a sustained period. This has removed a potential barrier to investment in the sector, although secondary assets, which typically have greater exposure to the debt market are less favoured by investors. Lenders have concerns around these types of assets and not only price in a significant amount of capex for EPC refurbishment, but also are increasingly involved to ensure this is carried out.

UK 2024 economic outlook

Source: Oxford Economics

0.4%
2024 GDP growth forecast

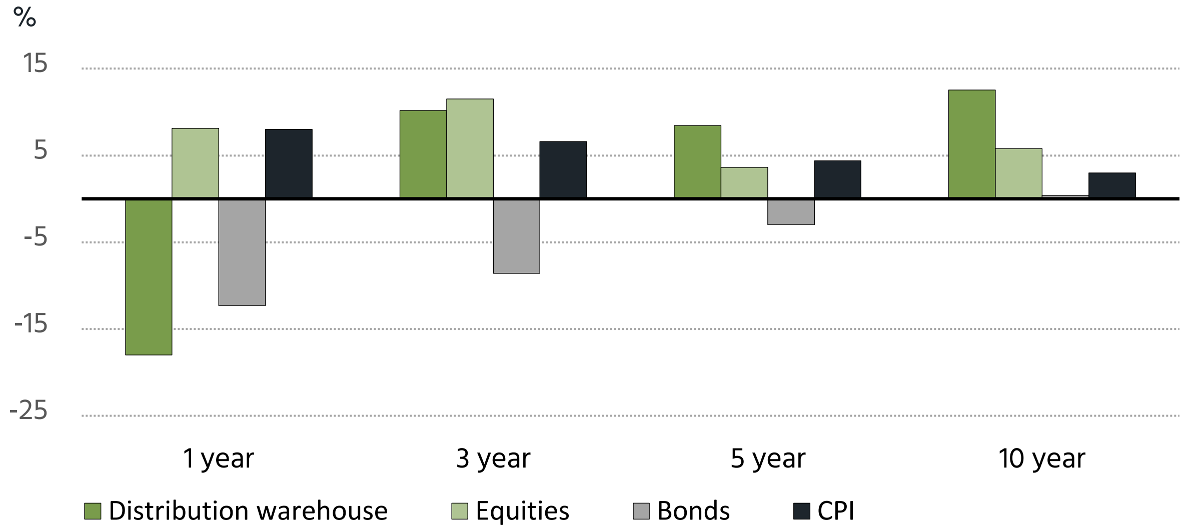
4.3%
End-2024 10-year government bond yield forecast

3.0%
2024 average CPI inflation forecast

4.75%
End-2024 Bank Rate forecast

Annual average returns by investment class and inflation

Source: MSCI, ONS, Gerald Eve



WAREHOUSES A PROVEN PERFORMER AND LONG-TERM INFLATION HEDGE

The relatively lower-yielding distribution warehouse sector was significantly impacted by the yield correction in late 2022, and annual average returns for the sector remain deeply negative. However, over longer time periods, and relative to both other commercial sectors and financial asset classes, distribution warehouses have a proven history of outperformance. The sector has re-established its dominance over the past three months and the 10-year annual average return is 13%, significantly outstripping inflation and more than double the 5.8% recorded for equities.

SPOTLIGHT #1: COVID IMPACT AND LEGACY

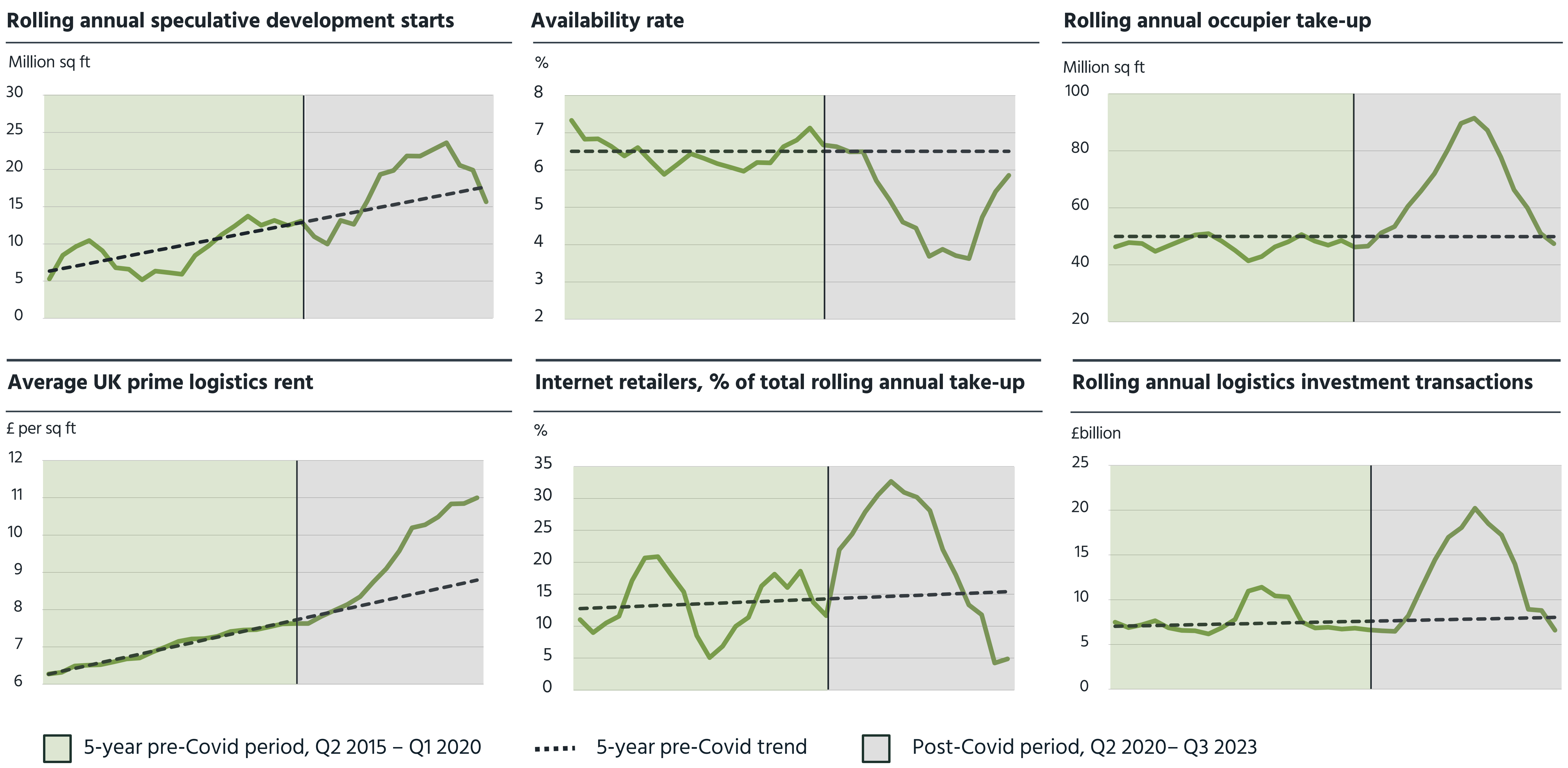
The pandemic was an undeniable boost to the UK logistics market. Demand shot up as retail sales were channelled online, developers followed suit by delivering a wave of speculative buildings and rents grew substantially. As the market comes off this period of intense activity, where are we now relative to the trends pre-pandemic and what has been the overall impact on the different market indicators?

Take-up is largely back to the pre-pandemic trend, having seen an overall 36% increase in demand or an additional 64m sq ft of lettings relative to trend. This increase was largely driven by activity by internet retailers, for which proportionate activity is now well below trend. Nominal UK prime rents on the other hand are £2.21 ahead of pre-pandemic trend.

In terms of supply, availability remains below pre-pandemic trend and speculative developers have responded quickly to recent softening occupier demand. On a rolling annual basis, spec development is below pre-pandemic trend, having seen a total 13% increase in development activity.

UK logistics market: pre- and post-Covid performance and extrapolated 5-year pre-covid trend

Source: Gerald Eve



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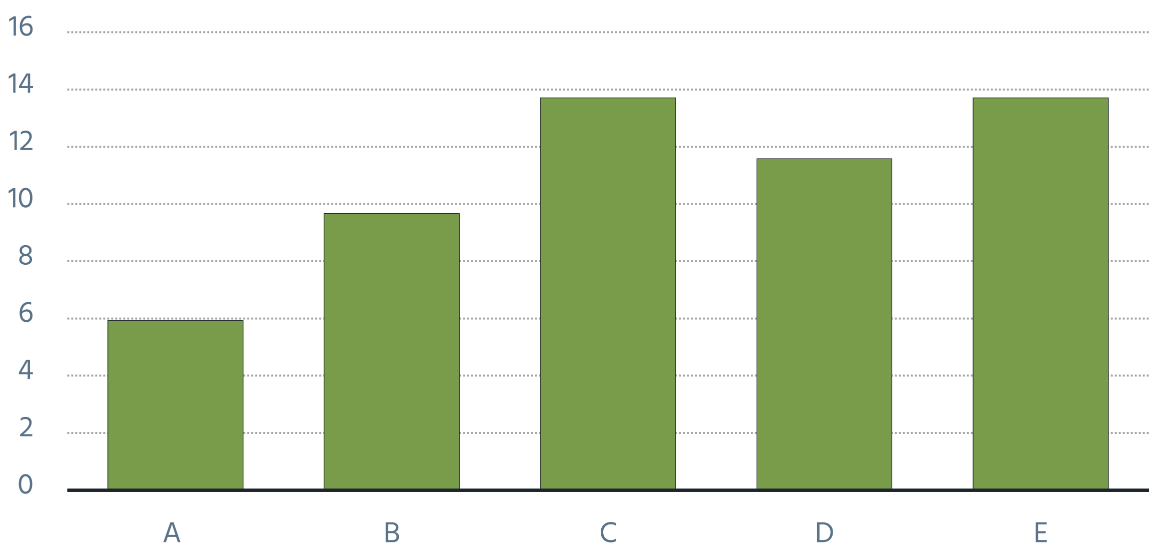
SPOTLIGHT #2: Q3 VOID PERIODS BY EPC AND OCCUPIER ACTIVITY

OCCUPIER DEMAND

Q3 take-up, months on market by building EPC grade
Source: Gerald Eve

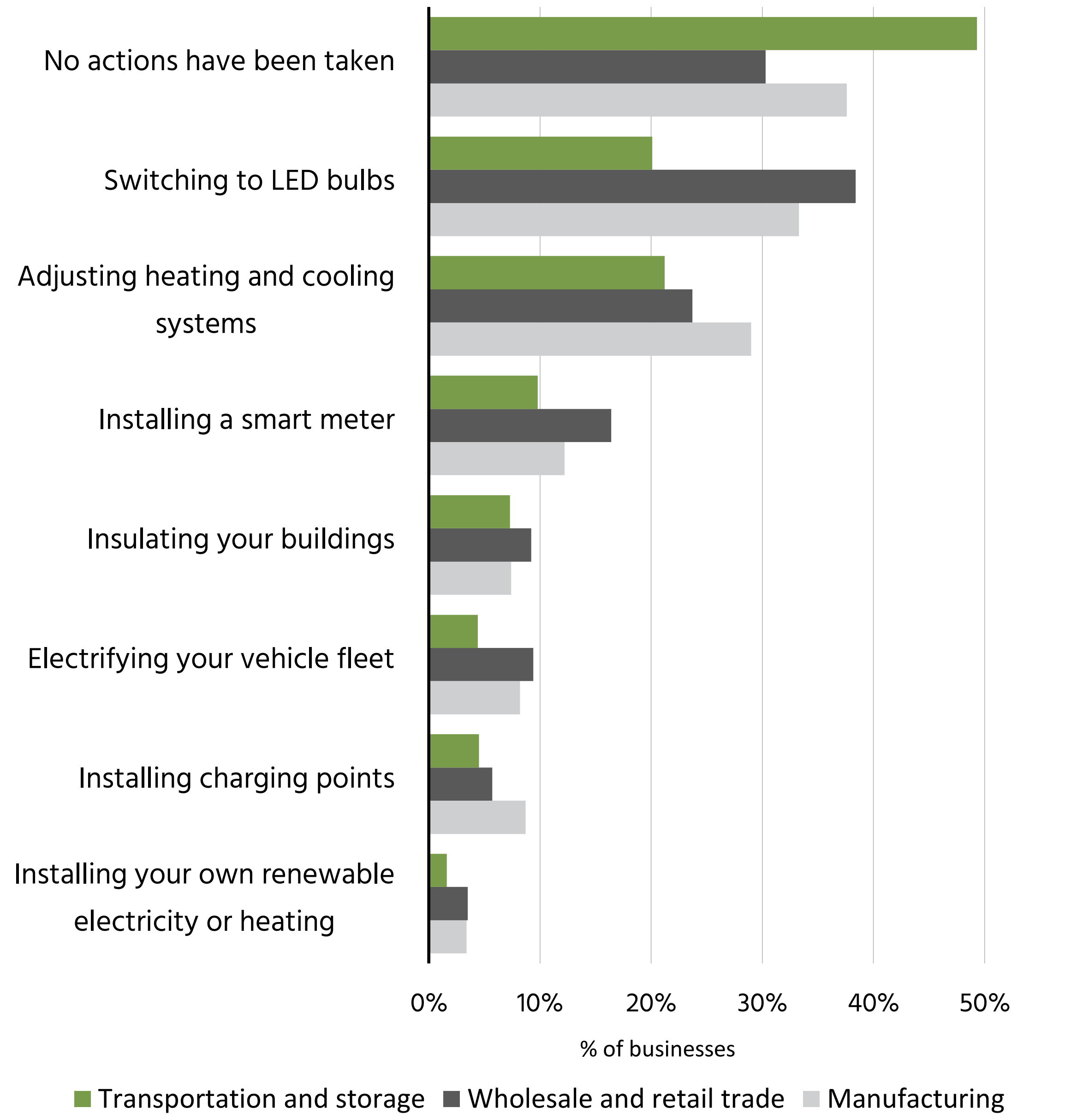


SHORTER VOID PERIOD FOR ENERGY-EFFICIENT BUILDINGS LET IN Q3

Excluding pre-lets or occupier development purchases, which are for the time being exempt from the requirement for an EPC, 29% of all the up-and-built buildings taken-up by occupiers in Q3 had an EPC grade A. These buildings were on the market for an average of six months before they were let, a much shorter void period than lower-EPC-graded buildings which were void for up to 14 months. Whilst this is just a snapshot of activity in Q3 and doesn't prove a trend, it does demonstrate both occupier interest in more energy-efficient buildings and, for those let at least, a shorter void period.

OCCUPIER DECISION-MAKING

What actions have you taken to reduce your carbon emissions?
Source: ONS Business Insights and Conditions Survey, September 2023



OUTLOOK

RENTS

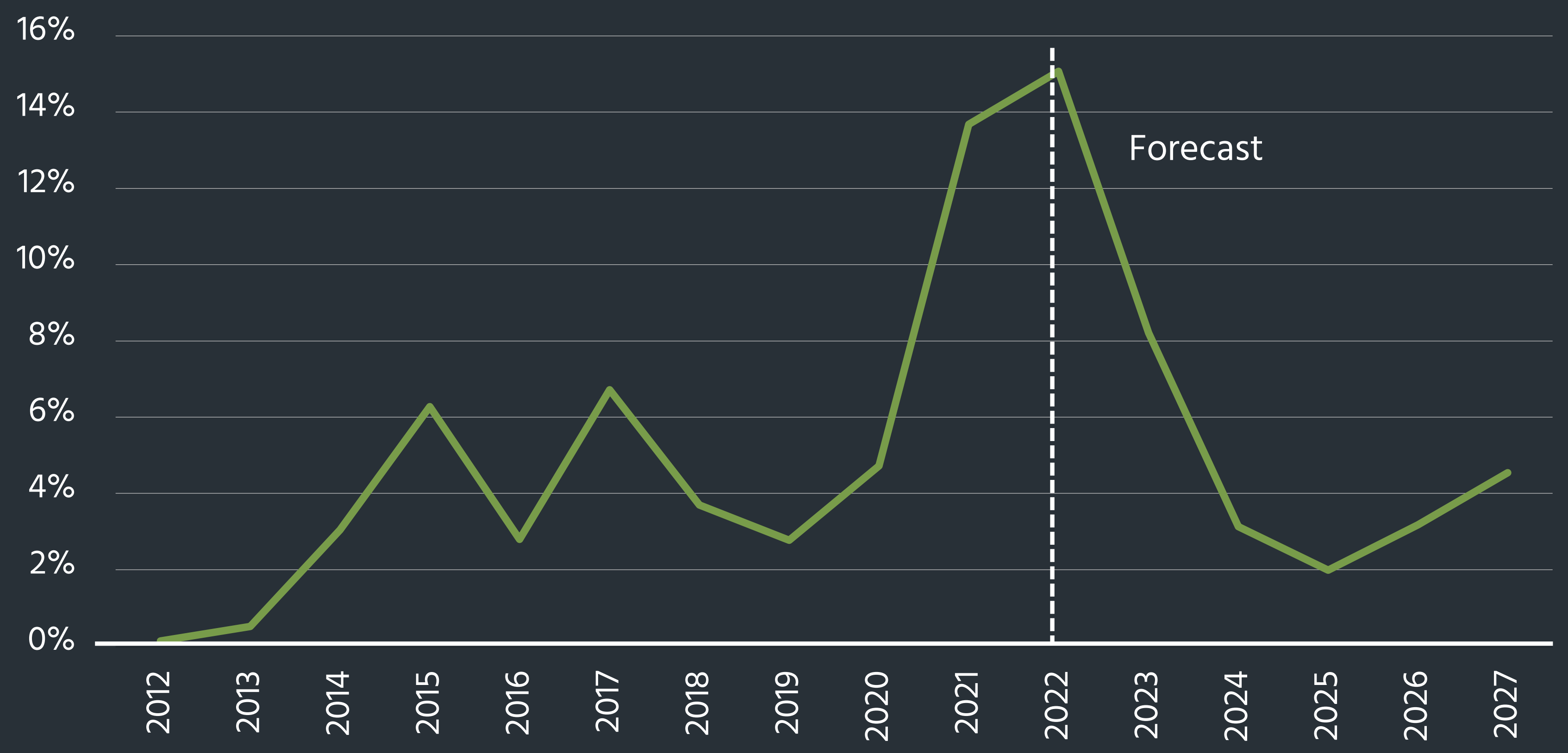
The strong energy-efficiency credentials of new speculative developments delivered this year will offer occupiers potential cost savings and will likely push on prime rents. This is especially the case whilst prevailing availability and spec development activity is still relatively low. The outlook is softened by the impact of weaker business demand for goods and services on occupier activity and record-high levels of rental reversion.

INVESTMENT

Buy-side requirements have narrowed, but there is still competition for high quality assets which will likely sustain yields. Rental growth remains positive, albeit lower than the very strong rates in 2021/22. Void rates are likely to rise and peak in 2024, but well below previous downturns. Investors will be more selective, and most will focus on protecting income. DB pension funds are likely to be a key source of investment stock.

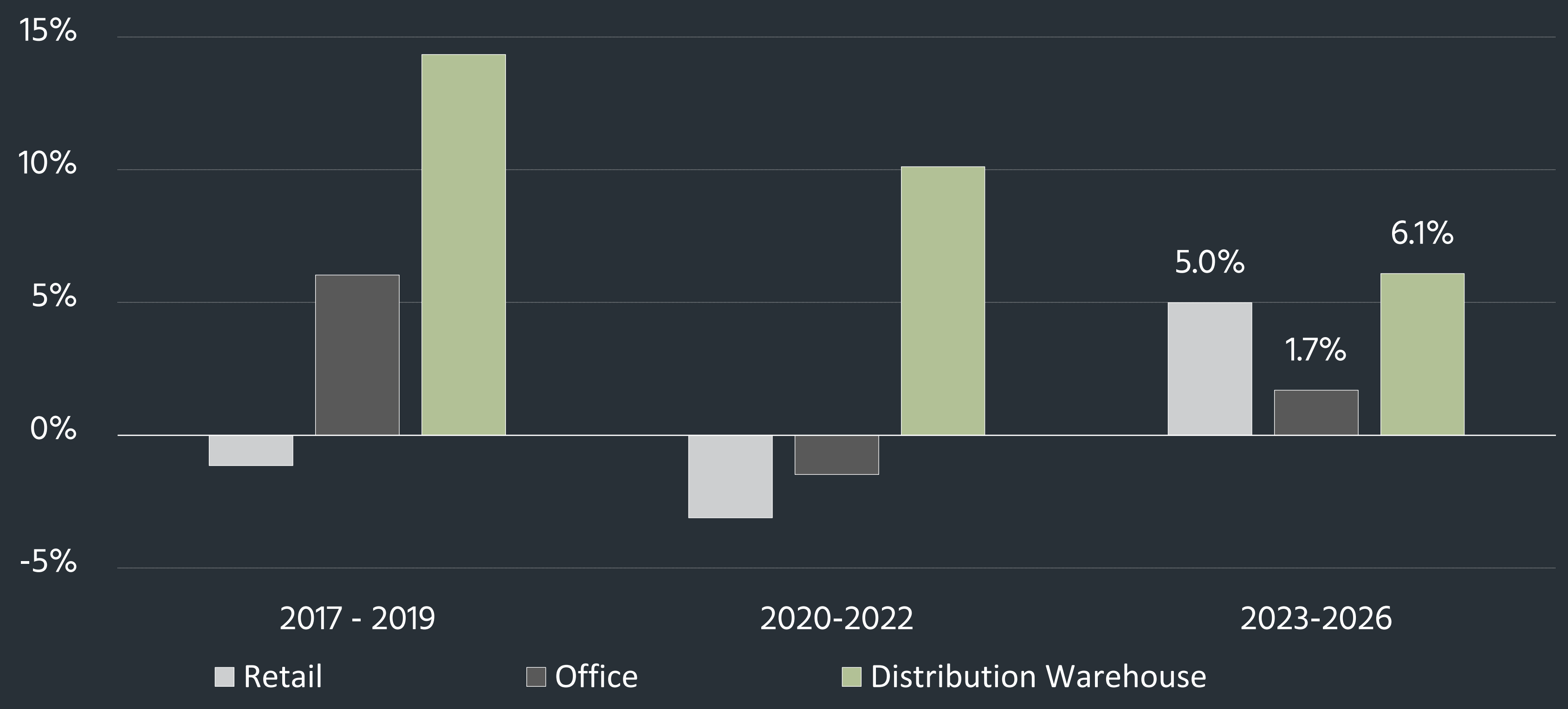
Prime logistics annual rental growth forecast

Source: Gerald Eve

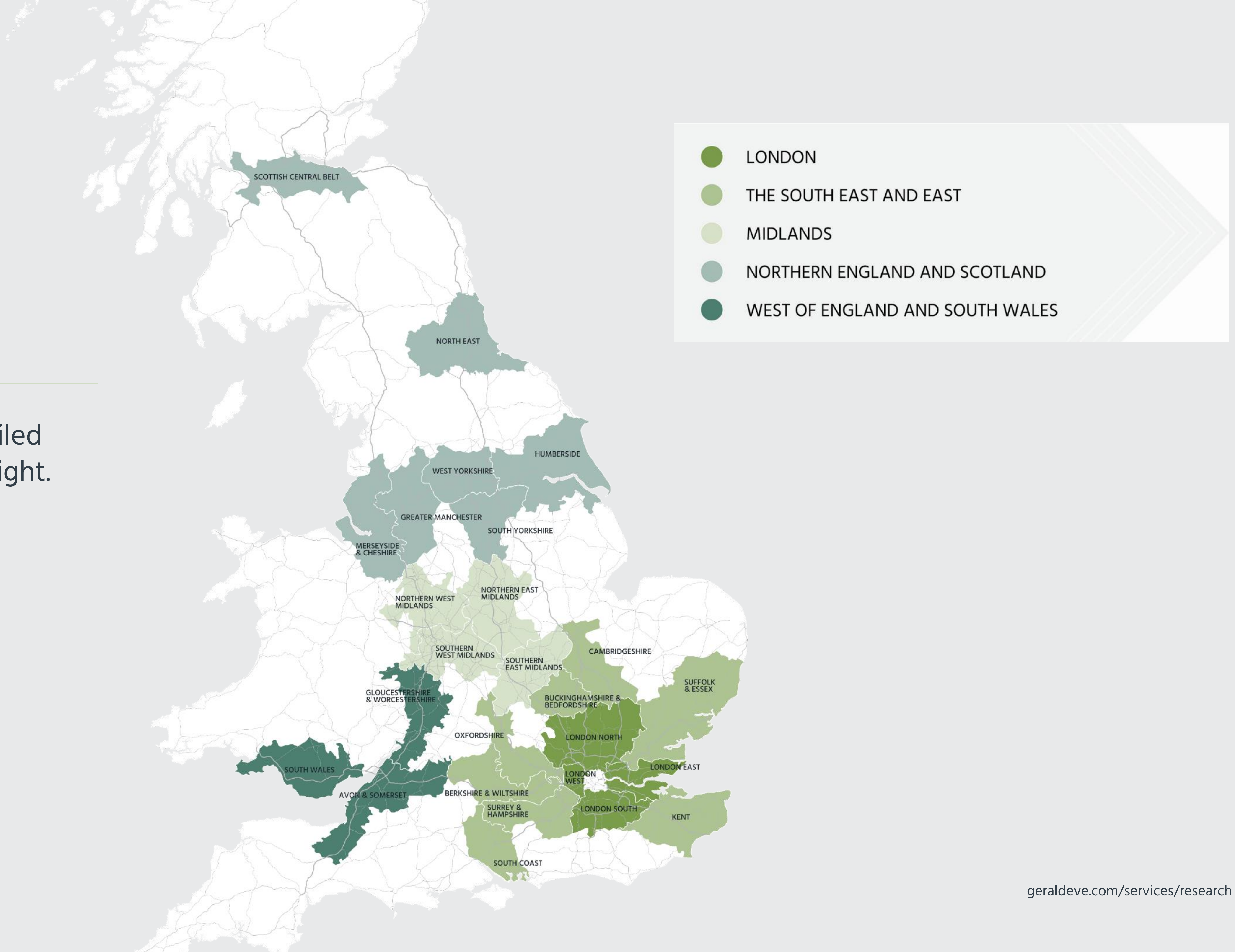


Average annual total returns by sector

Source: Gerald Eve, MSCI



GERALD EVE REGIONS



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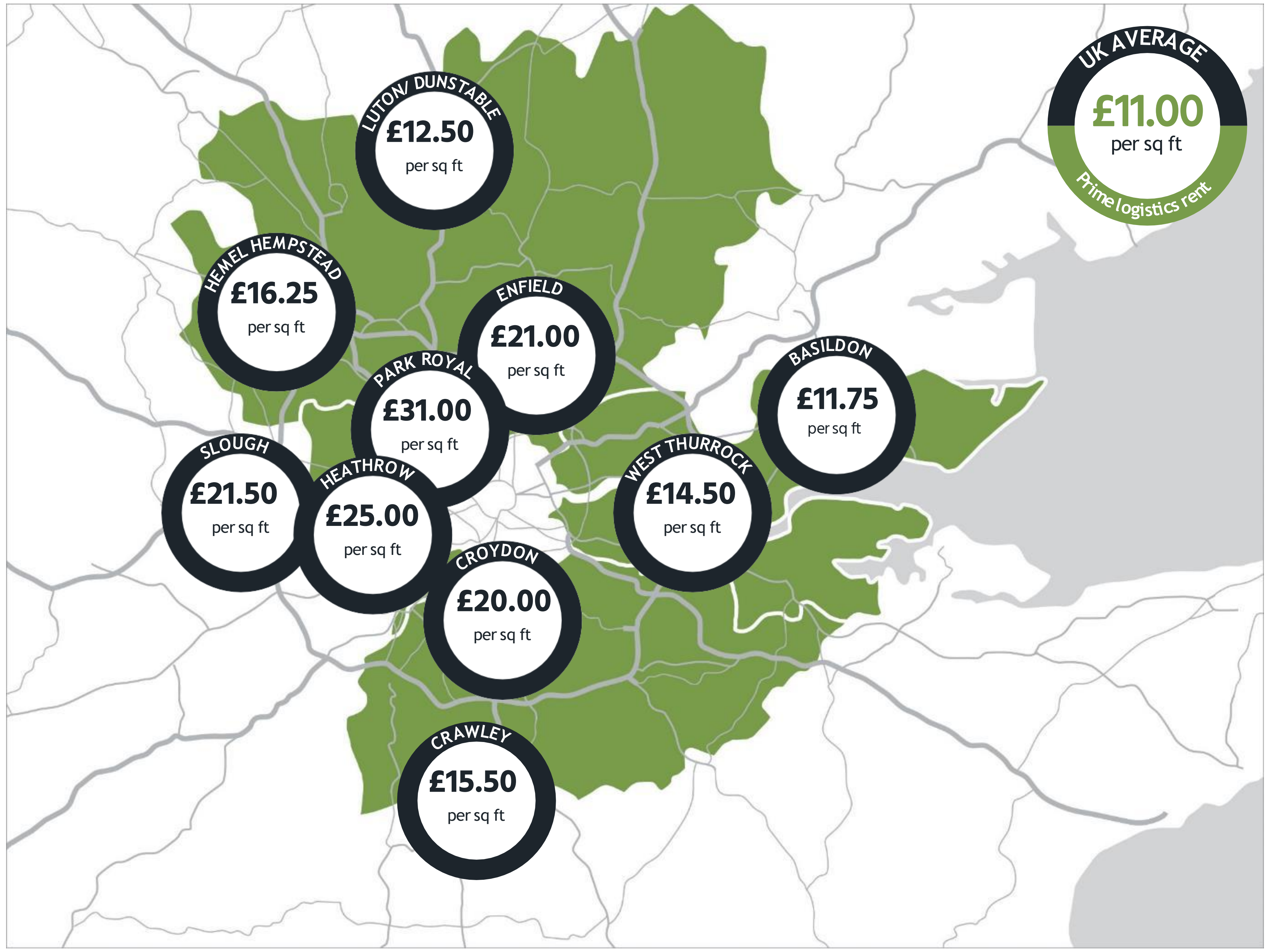
LONDON

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.

Quarterly occupier take-up by region

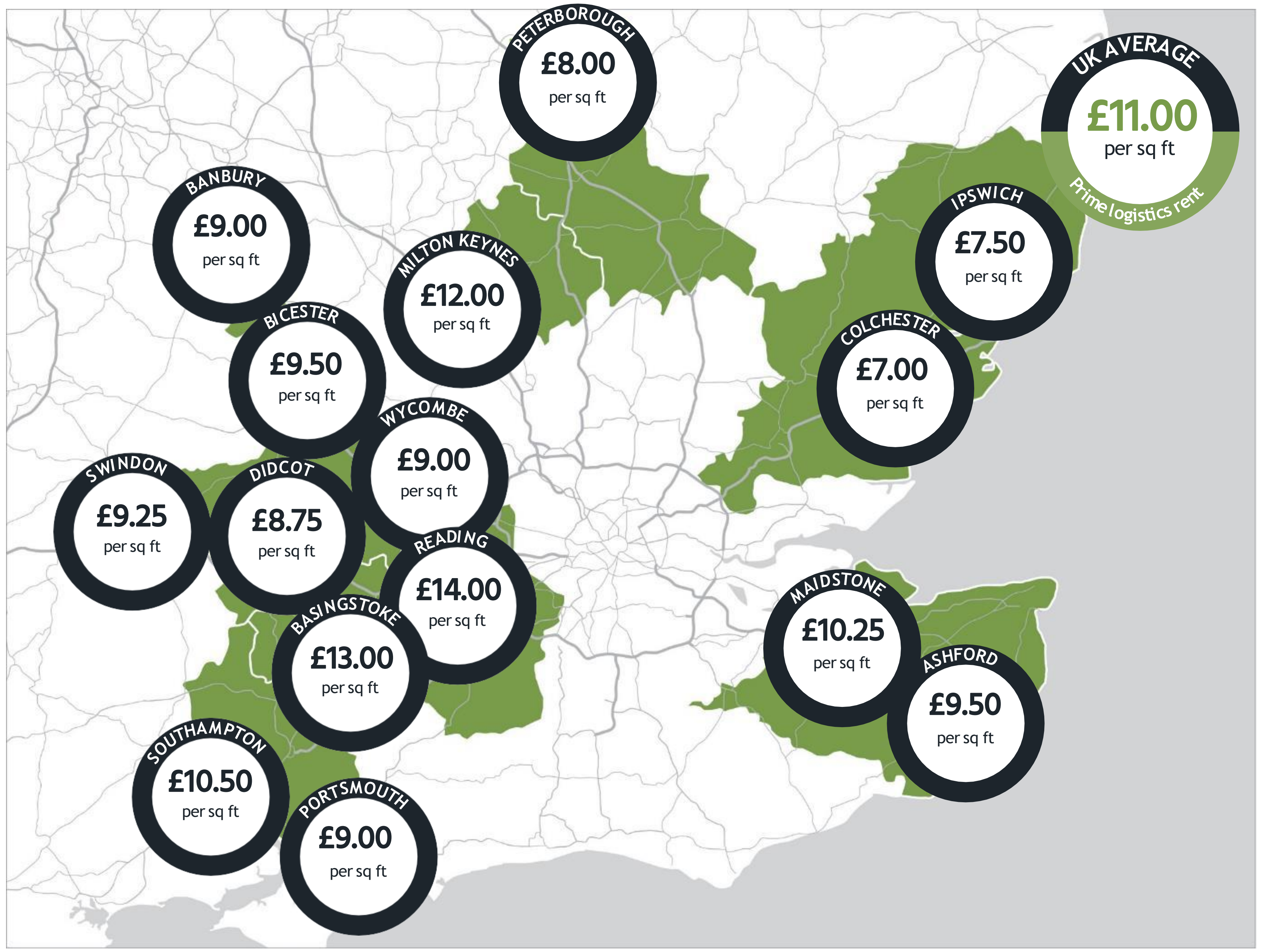
Source: Gerald Eve

Availability rate by region

Source: Gerald Eve

THE SOUTH EAST AND EAST

PRIME LOGISTICS RENTS



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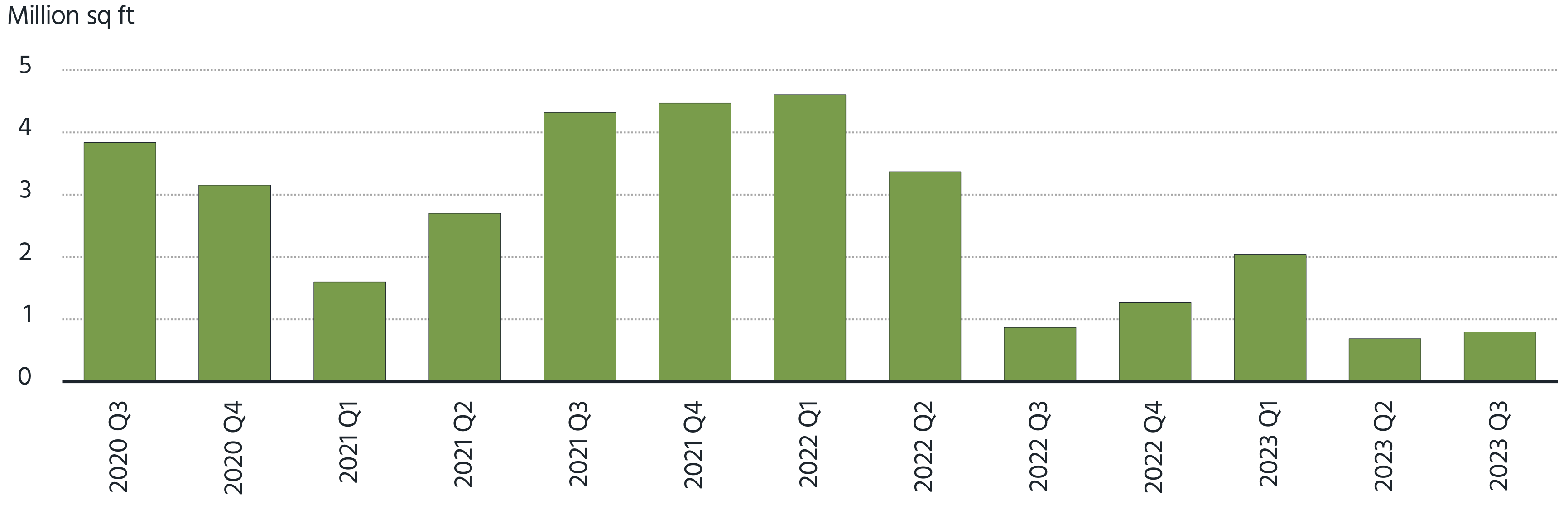
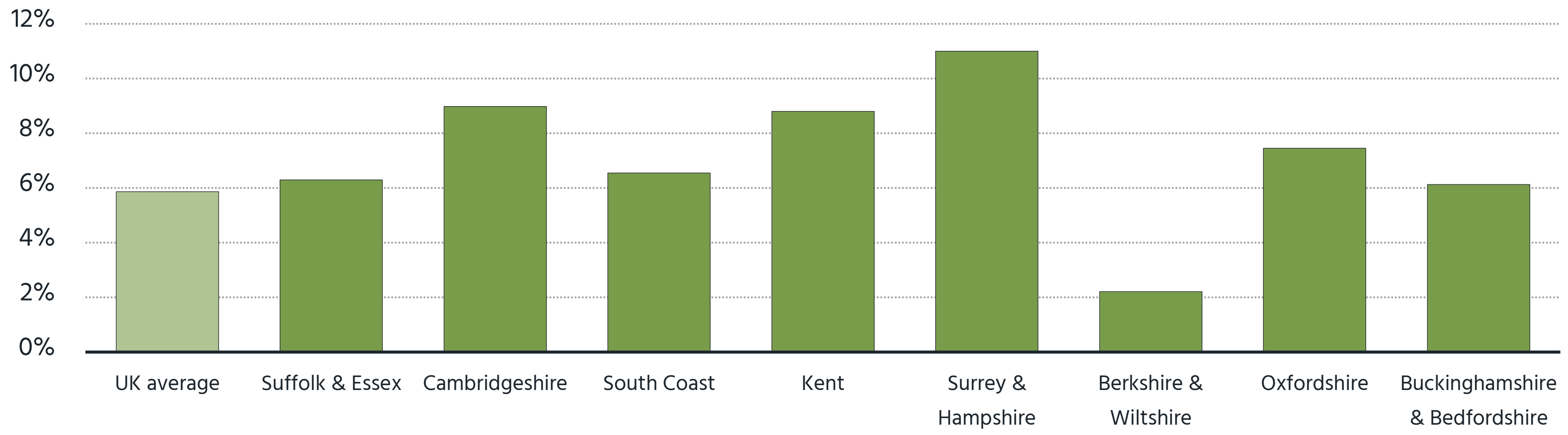


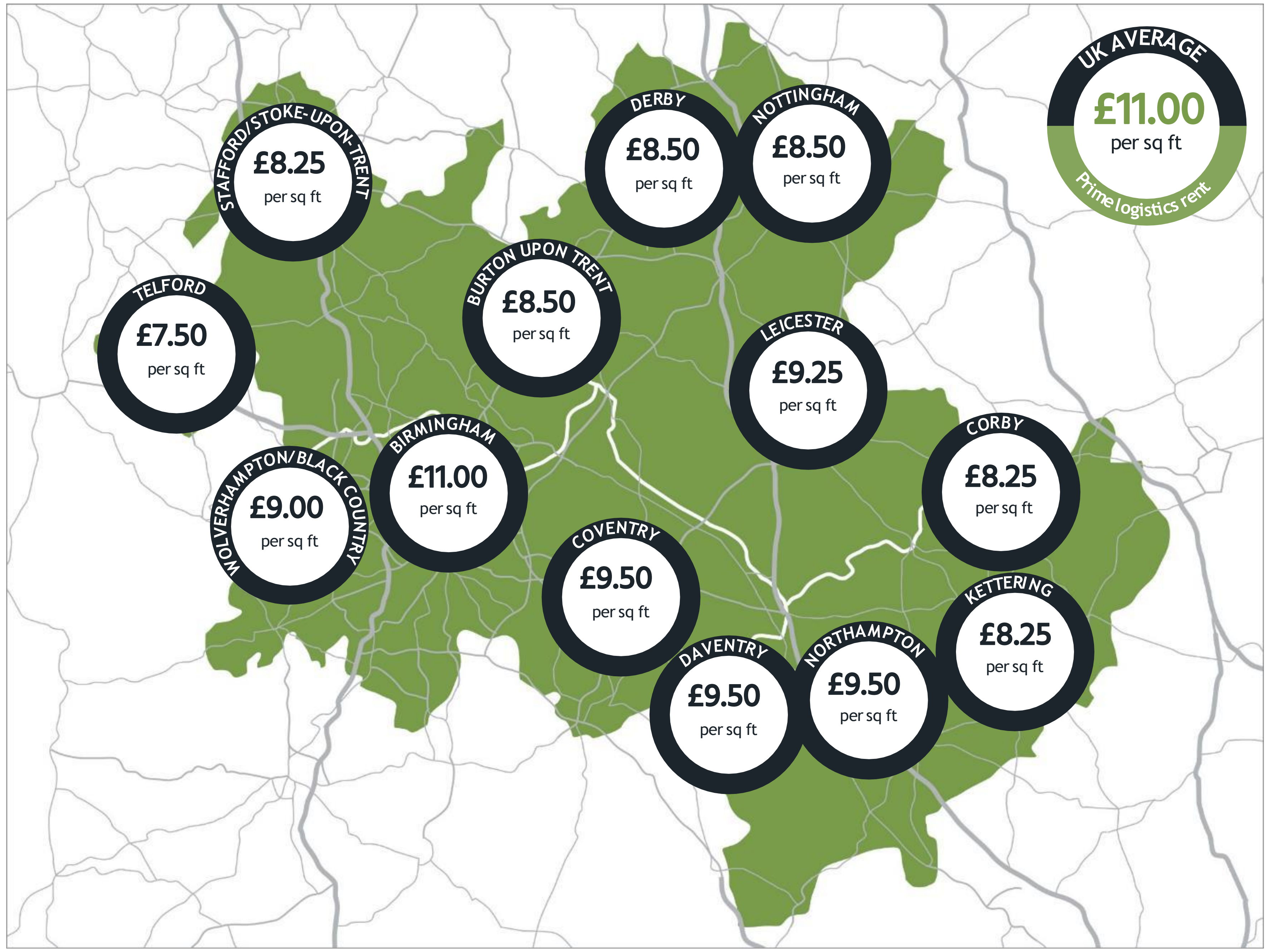
Availability rate by region

Source: Gerald Eve



MIDLANDS

PRIME LOGISTICS RENTS



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Quarterly occupier take-up by region

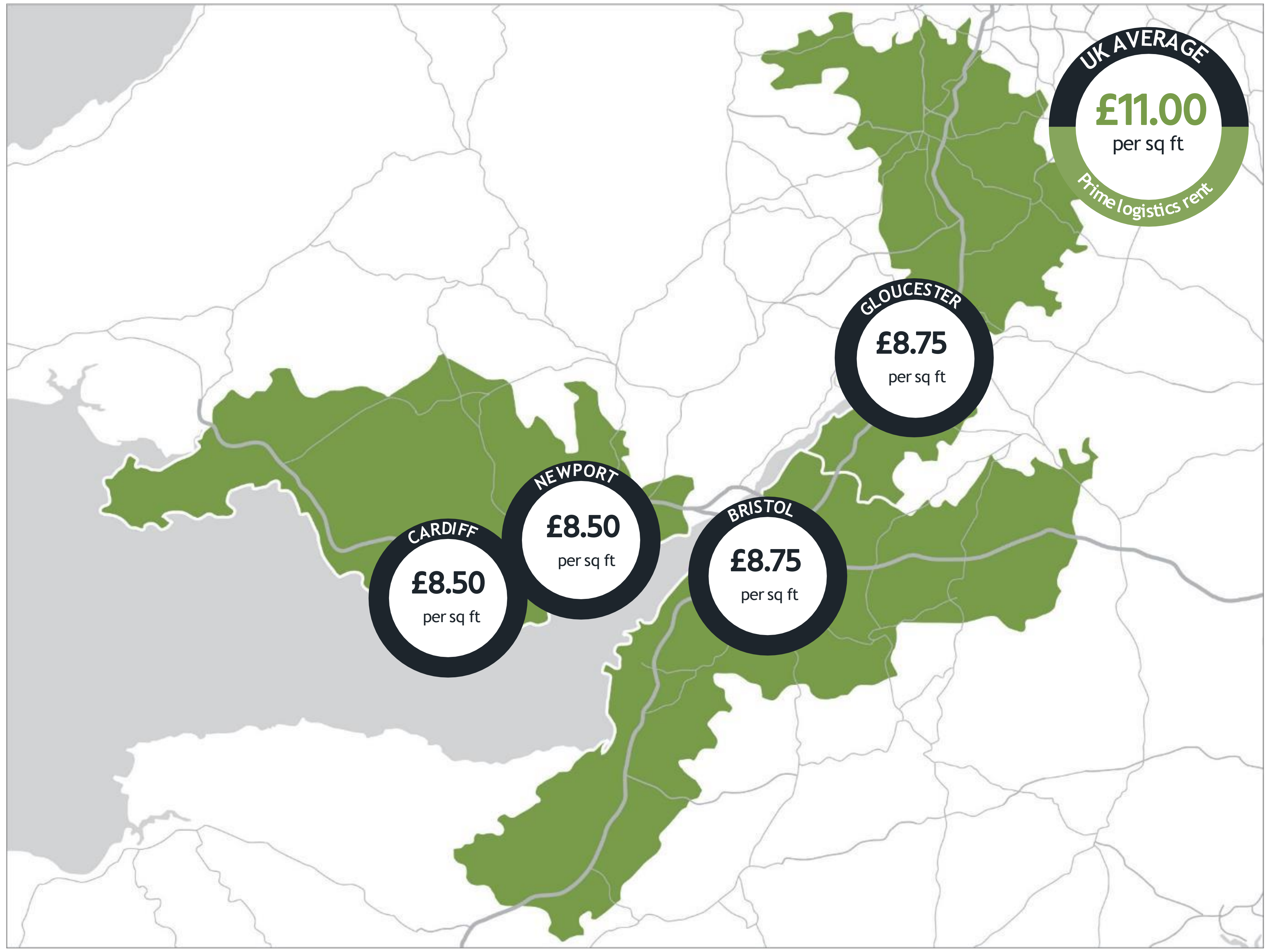
Source: Gerald Eve

Availability rate, by region

Source: Gerald Eve

WEST OF ENGLAND AND SOUTH WALES

PRIME LOGISTICS RENTS



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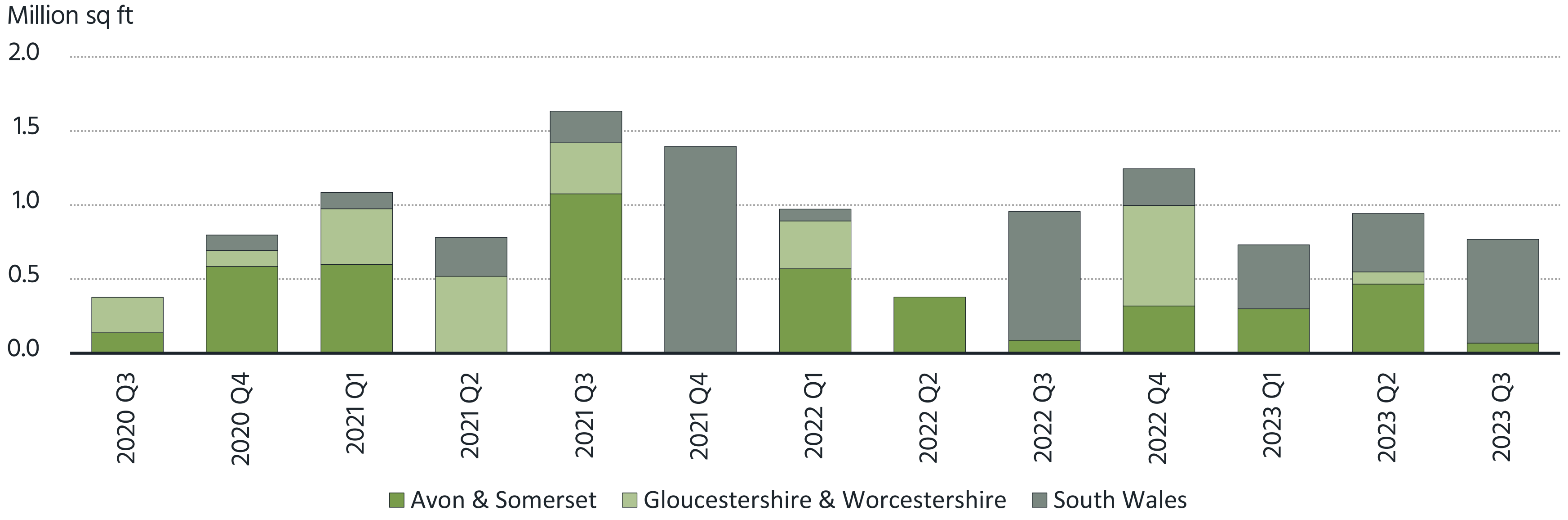
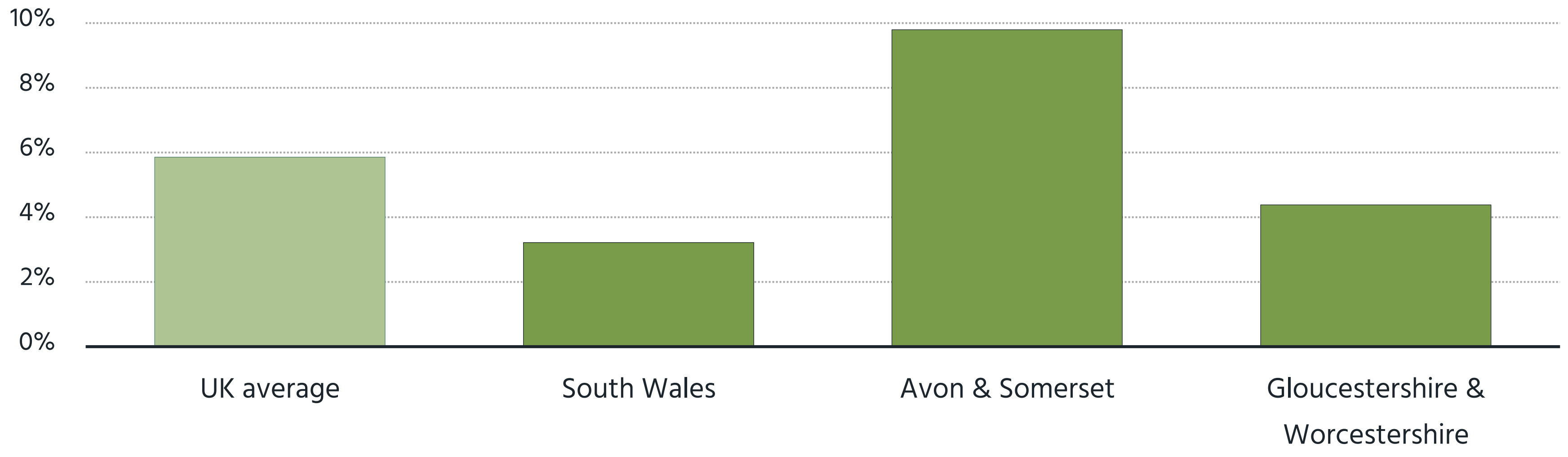


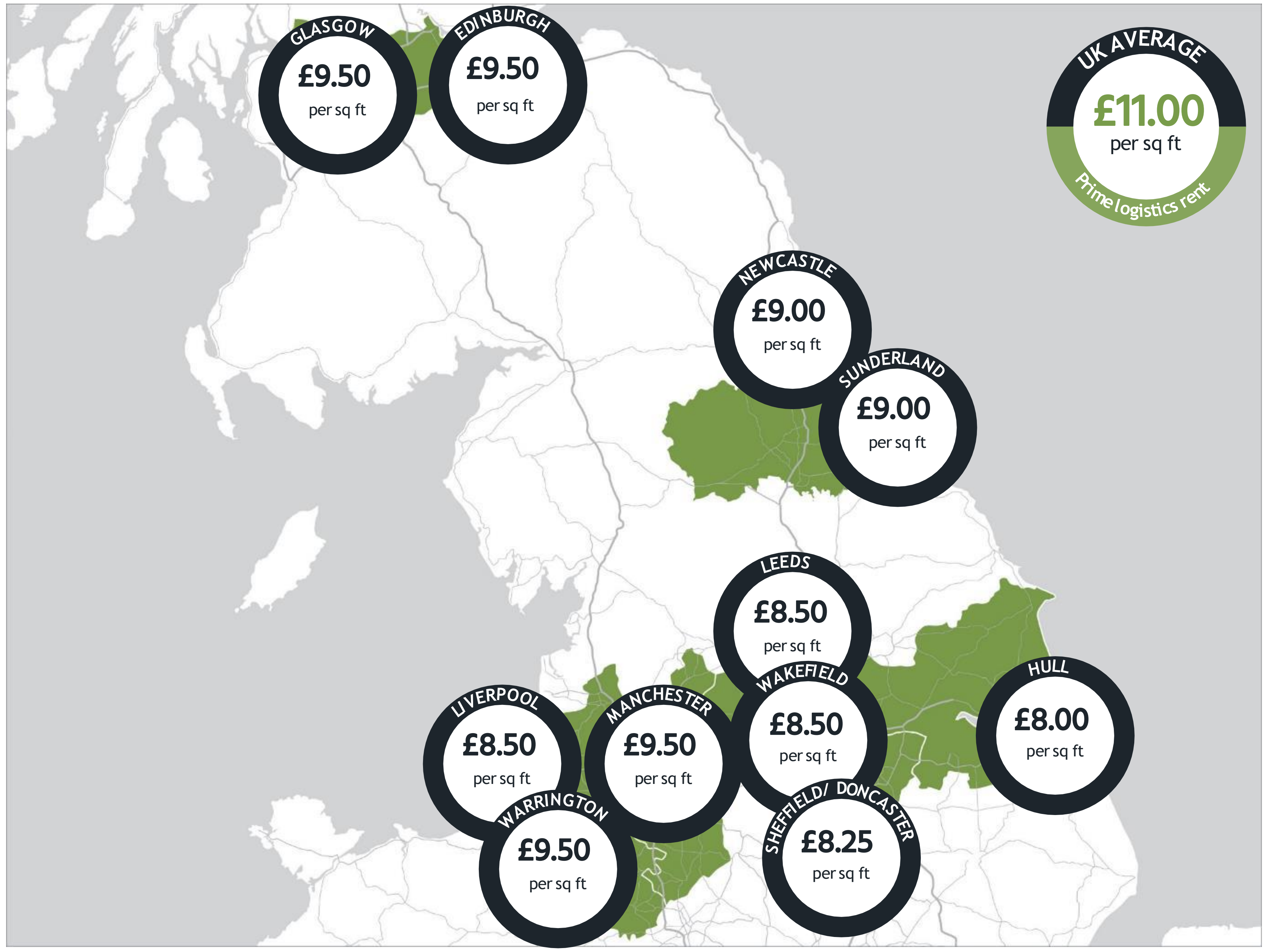
Availability rate by region

Source: Gerald Eve



NORTHERN ENGLAND AND SCOTLAND

PRIME LOGISTICS RENTS



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Quarterly occupier take-up by region

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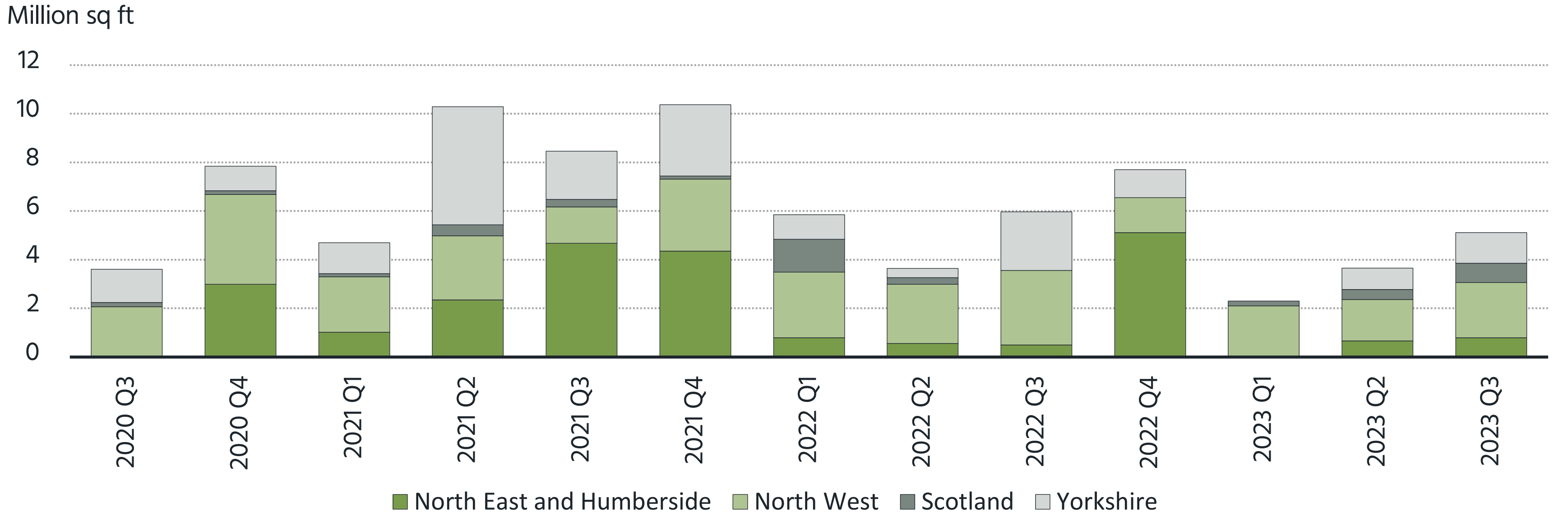
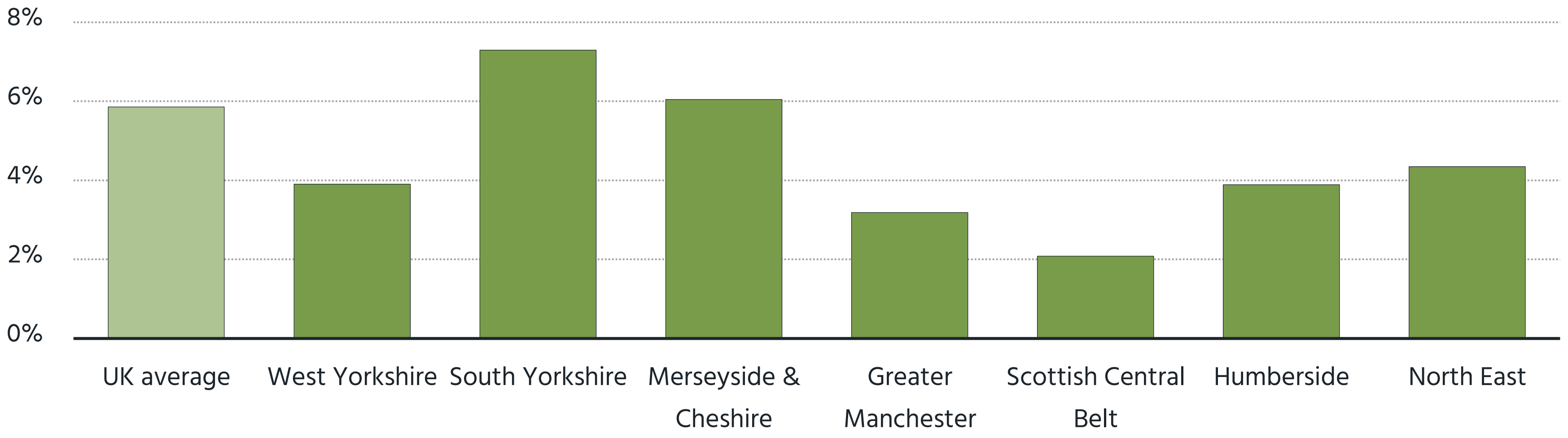


Availability rate by region

Source: Gerald Eve



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FURTHER INSIGHT

In Brief
September 2023

Multi-let
July 2023

London Markets
Q2 2023

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