

PRIME LOGISTICS

The definitive guide to the UK's
distribution property market

Autumn 2011 Bulletin



GERALDEVE

PRIME LOGISTICS – THE MARKET IN PERSPECTIVE

2011 has been a game of two halves. Take-up of buildings over 50,000 sq ft within our regions during Q1 2011 was 7.1 million sq ft – markedly down on the 10 million sq ft transacted during Q4 2010. However, in Q2 2011, take-up increased to 8.5 million sq ft. Although both quarters were below the long-term quarterly average of 8.8 million sq ft, an assessment of why occupiers took space during 2011 has highlighted a positive 'rebalancing' of demand.

In 2010, space transacted was, to a large extent, driven by the realisation of pent-up retailer demand from 2008 and 2009. The executive board-level hiatus on acquiring new space seemingly came to end during 2010 as companies decided to take advantage of the market re-pricing and made adjustments to their supply chains in line with the prevailing market conditions. These transactions were often very large (there were 12 lettings during 2010 over 500,000 sq ft) and were the key drivers of the quarterly increases in take-up. In 2011, we are now in a position where, as the majority of this pent-up demand has been satisfied, the primary drivers of activity are now more contemporary and organic, such as from natural expansion, consolidation or lease events. As such, take-up volumes are now more genuinely reflective of current demand. However, what is perhaps of concern to occupiers is that the gradual erosion of good quality well-located stock has necessitated a substantial rise in the amount of space transacted on a design-and-build basis.

At 2.8 million sq ft, the amount of space pre-let or pre-sold during Q2 was the highest since Q3 2007. We anticipate this trend to continue as occupiers are forced to look to build-to-suit to ensure they secure the space they require. Whilst for secondary stock in off-prime locations the market is still tenant-friendly, the prime end of the market is close to the watershed where there will not be sufficient space available to meet demand. This will ultimately lead to increased rents and reduced incentives in the particularly restricted and in-demand locations.

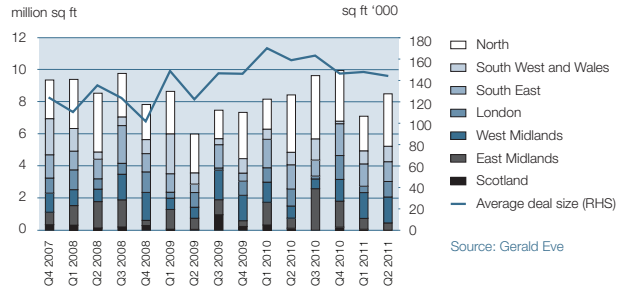
As such, the development market is still very much driven by design-and-build schemes, with almost no market-driven speculative development since the start of 2009. For the large retailers, with the covenant strength and appetite for long leases to justify bespoke development, design-and-build schemes have proved very effective. However, for weaker-covenanted tenants or 3PLs servicing short term contracts, the ability to design-and-build has proved much more difficult. This has been exacerbated by occupiers also coming under the added pressure of securing shorter lease lengths as a result of new lease accounting standards.

A solution may be that developers will begin to be more amenable to tenants with weaker covenant strengths taking shorter leases. In these cases, buildings are more likely to be built to a more generic design than buildings taken on longer lease terms. However, location is key and developers, with an eye on the prospects of rental growth, will be focusing on in-demand locations for such schemes.

Whilst we view recent letting activity positively, we also remain cautious, particularly as consumer confidence is currently not far from the trough reached during the recession. Whilst at one end of the spectrum we are seeing those retailers performing well signing pre-lets on new build space, at the other end of the market, we are seeing underperforming retailers, such as Habitat and Jane Norman, entering administration. We expect this polarisation of fortunes to continue and anticipate more retailer casualties throughout 2011.

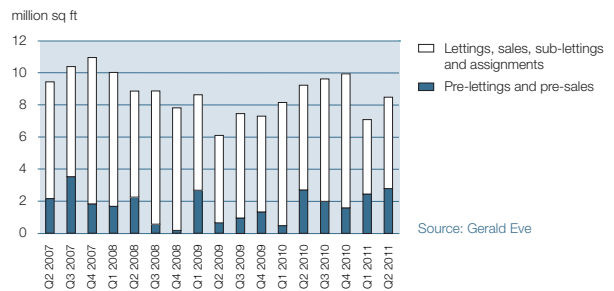
So, our statistics on the big sheds sector show that the market remains active but also highlight that it is changing. The future health of the market depends on the recovery of the stagnant economy and the ability of the development and lending sectors to find ways to meet demand in this supply-constricted market. Whilst we anticipate 2011 headline take-up figures will be down on 2010, perhaps by as much as 20%, the nature of this letting activity makes us cautiously optimistic that there will continue to be deals done in the second half of 2011.

Quarterly take-up by broad geographic region and average deal size, Q4 2007 – Q2 2011



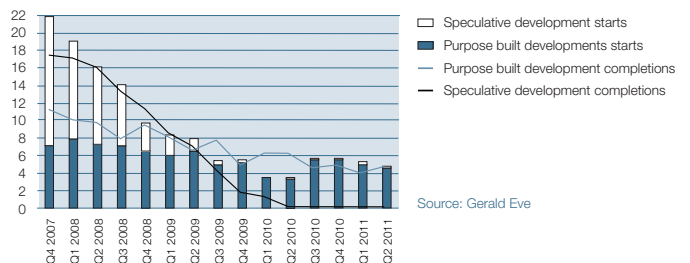
Factors such as the escalating cost of fuel have meant that occupiers have preferred to take space in the traditional distribution locations and the West Midlands, Northern England and the South East have proved popular during 2011. Even accounting for the number of large pre-lets agreed during Q2, the average deal size (144,000 sq ft) is the lowest since Q2 2009, indicating an increased appetite for smaller units.

Quarterly take-up by deal type, Q2 2007 – Q2 2011



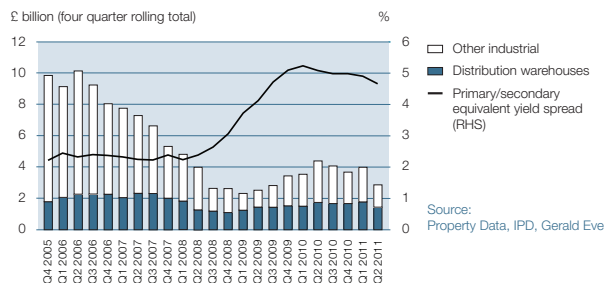
The chart above highlights the amount of space pre-let or pre-sold by occupiers and demonstrates the recent importance of design-and-build schemes to headline take-up figures (over 5 million sq ft of space (out of a total of 15.6 million sq ft) has been pre-let/sold so far in 2011). Demand during 2011 is expected to be driven by lease events and consolidations or expansions, however, the shortage of good quality well-located buildings and lack of speculative development will mean that pre-let space will continue to drive letting activity.

Rolling four quarter total development starts and completions by type, Q4 2007 – Q2 2011



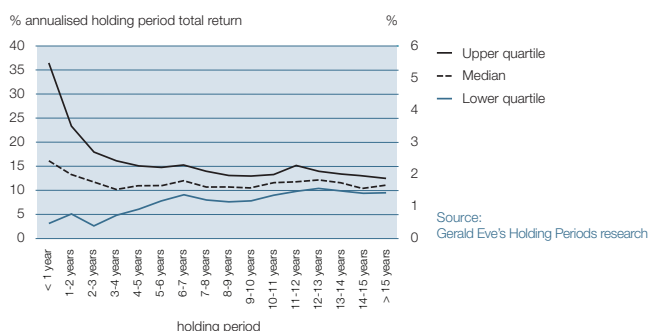
Development starts and completions remain at very low levels. As can be seen from the chart above, purpose-built schemes continue to define the development market and drive headline figures. As predicted in our last bulletin, it is the availability of suitable sites to house these schemes and meet demand which has proved a key sticking point. There is not an abundance of development land with infrastructure and planning ready to service the requirements for bigger sheds, especially around the key distribution locations. We expect to see more strategic land buying during 2011 as developers keep their powder dry and wait to selectively and perhaps speculatively develop in 2012.

Rolling four quarter industrial investment volumes and prime/secondary yield split, Q4 2005 - Q2 2011



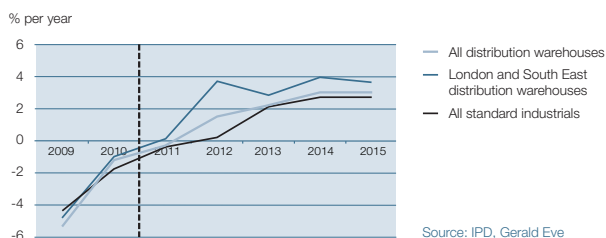
Industrial investment volumes fell 28% in Q2 compared to Q1. However, demand for industrial and logistics product remains resilient. It is the shortage of stock that meets current investor requirements which continues to curtail overall volumes. Requirements typically remain focussed on opposite ends of the income spectrum: long income for the annuity funds and overseas buyers, and short income for the opportunistic investors seeking higher yields. We anticipate prime long income yields to see some degree of inward movement before the end of 2011, and this, coupled with the prospect of banks beginning to offload their distressed assets, could result in some value recovery in better quality secondary properties. We expect this to be reflected in further inward movement in the IPD prime/secondary yield spread depicted on the chart above.

Range of holding period returns for industrial property



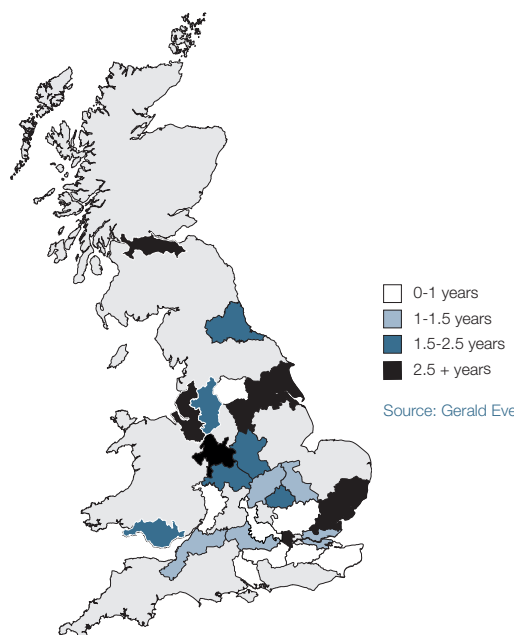
The chart above from the preliminary findings of our Holding Periods research shows the average total return on industrial properties by the length of time each asset was held. The analysis shows that industrial properties traded within the first three years of purchase had significantly higher average total returns but also had a considerable downside risk. Beyond this three year period, the return on investment moves more toward the average as the effects of the characteristics specific to each individual property diminish. These findings rubber-stamp current investor attitudes to industrial property – either holding assets for the longer term to secure a more stable return or trading swiftly to secure higher returns. We expect demand by opportunistic investors for short-hold investments in constrained locations to continue as investors seek higher returns.

IPD rental growth forecast, broken down by type, 2009 - 2015



As evidenced by our flat forecast for 2012 IPD All Standard Industrials rental growth, a reduction in the amount of secondhand stock on the market and the correlating incentives is needed before any significant overall recovery in rents can be sustained. However, with this said, we are cautiously optimistic for distribution warehouses and there are regions such as London and the South East where we expect the supply shortages and the relatively robust demand to generate rental growth next year.

Years of new or refurbished supply



The relative shortage of well-located, modern-quality space in appropriate unit sizes is currently a defining feature of the market. There are now areas of the country where occupiers with urgent requirements for good quality space have very few buildings available to them. Every quarter we hand-check the status and quality of every available building on the market. As the above chart demonstrates, through matching up these results with five year average annual take-up volumes for each of our 26 Gerald Eve regions, we have been able to determine the years of available supply of new or modern built stock for each region. This has highlighted a number of regions, particularly in the South East, as currently having less than one year's supply of new or refurbished stock. Whilst a striking statistic, these regions are also home to substantial amounts of available secondhand stock – in some instances over 20 years supply – and so a review of the total amount of available space is required before locational decisions are made.

The total availability rate for all grades of building and for all our regions at the end of Q2 2011 was 16.0%. This is a further reduction on the 16.8% recorded at the end of Q4 2010. Kent, Surrey & Hampshire and Gloucestershire and Worcestershire have some of the lowest overall availability rates, whilst regions such as South Wales, Merseyside & Cheshire and the Scottish Central Belt continue to have some of the highest.

We will continue to keep you updated on the mechanics of the big shed market through the release of regular and timely Prime Logistics updates. We also produce a detailed full update, with individual market reports and detailed analysis, the next edition of which will be released next year.

If you have any queries or comments, please do not hesitate to contact us.

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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 biennial 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.

Prime Logistics is a short summary and is not intended to be definitive advice. No responsibility can be accepted for loss or damage caused by any reliance on it.

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