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PRIME LOGISTICS

The definitive guide to the
UK's distribution property market

Q1 2023

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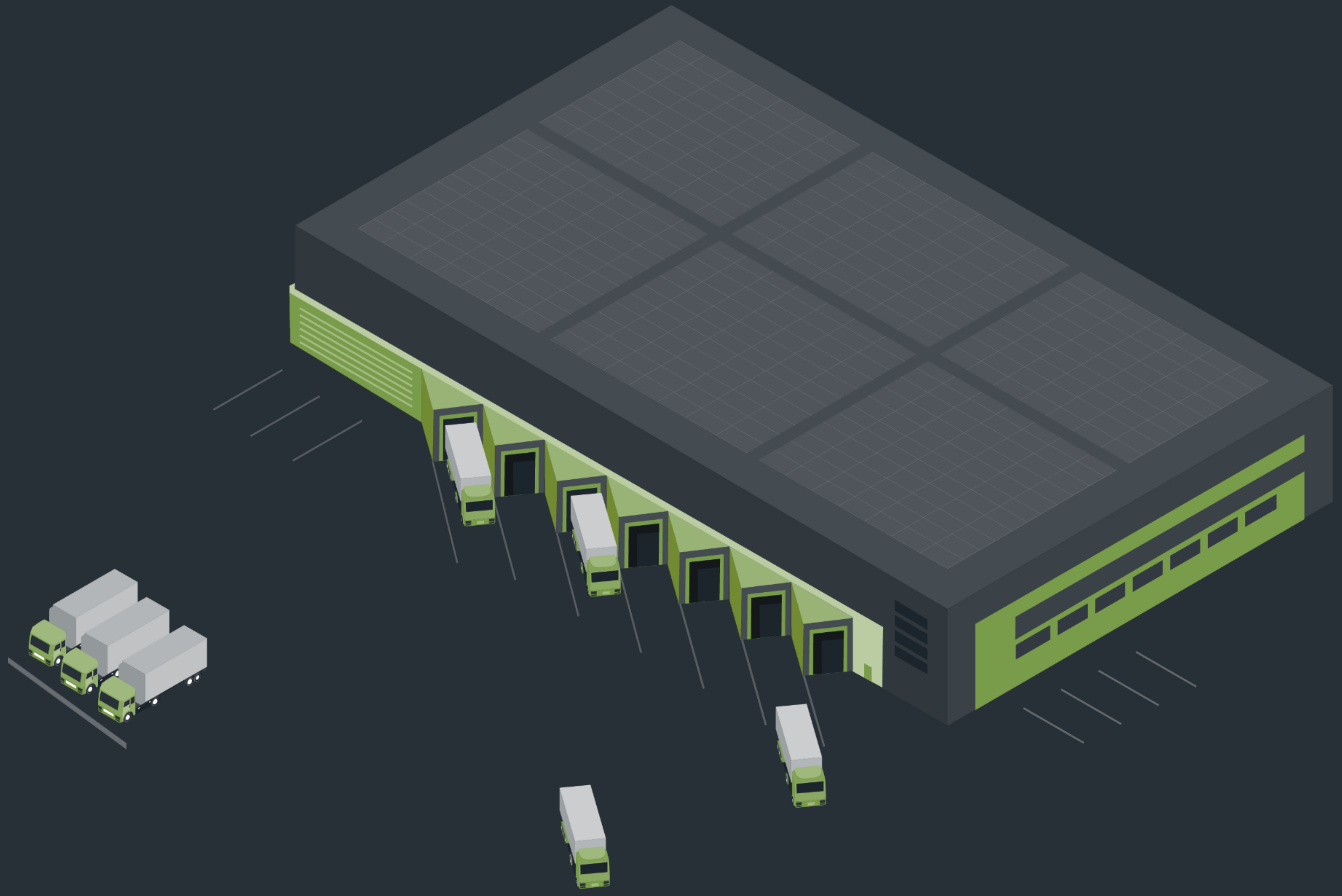


MARKET OVERVIEW

LOWEST TAKE-UP SINCE Q1 2020 BUT MARKET RENTS AND INVESTMENT PRICING BOTH RISE

Logistics take-up fell in Q1 2023 to its lowest since the start of the pandemic in 2020. This reflects the broad economic slowdown and ongoing high cost inflation for occupiers. However, deals in Q1 largely reflect decisions taken last year and the headline figures belie the underlying robustness and diversity of the industrial occupier market and recent improvement in sentiment. Availability remains low and below the historic average, despite the recent increase in tenant sub-let "grey space". Prime rental growth accelerated again in Q1 and investment pricing has recouped some of the lost ground from 2022.

11.7 m sq ft Take-up Q1 2023 ▼	4.7 % Availability rate Q1 2023 ▲	2.7% New/modern availability rate Q1 2023 ▲
3.3 % Prime rental growth Q1 2023 ▲	3.3 m sq ft Spec development starts Q1 2023 ▼	25 bps Inward prime yield shift in Q1 2023 ▼

OCCUPIER DEMAND

WEAKEST QUARTER OF DEMAND SINCE Q1 2020

Take-up was 11.7m sq ft in Q1, down 21% on Q4 and below both the 5 and 10-year quarterly averages. The amount of space taken-up in Q1 was the lowest since the pandemic began in Q1 2020 and comparable to the five-year quarterly average pre-pandemic trend. Demand has slowed as occupiers battle with cost increases and a post-pandemic slowdown in business conditions. Cost-cutting measures are being implemented by most occupiers, including renewing leases where feasible or by taking cheaper secondhand space if available. Secondhand space accounted for 38% of all demand in Q1, the highest since Q1 2021.

STRONG OCCUPIER INTEREST IN THE EAST MIDLANDS

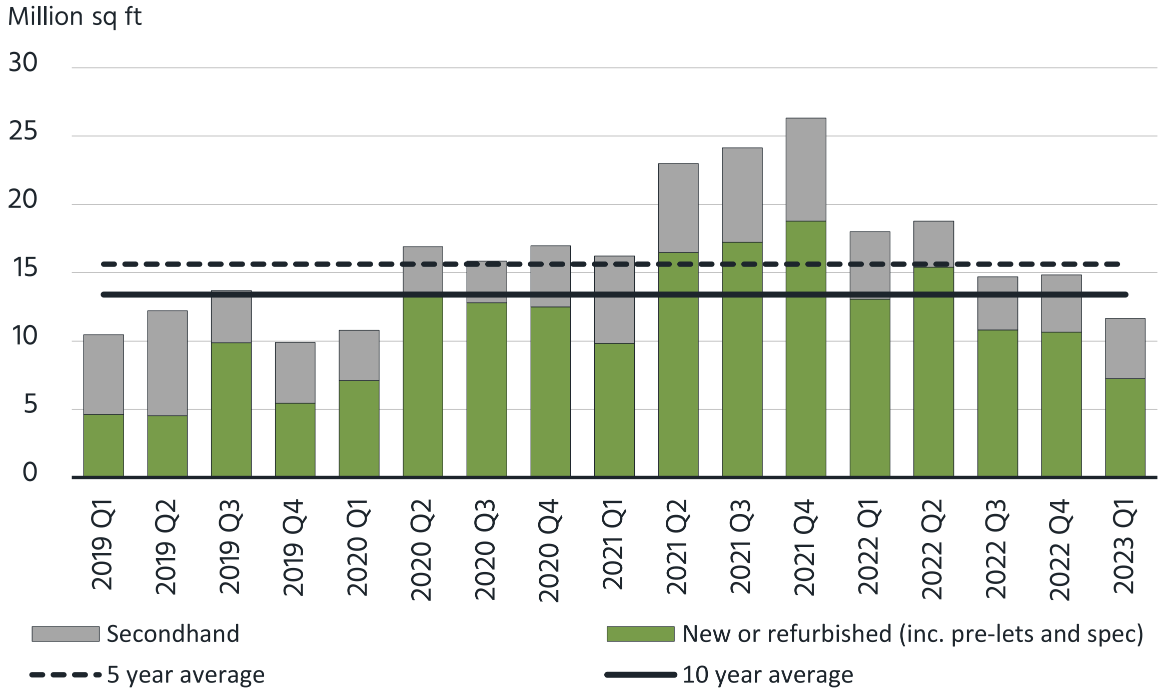
The East Midlands accounted for 38% of UK Q1 take-up. New developments in the region proved attractive to a range of occupiers, including HelloFresh, Hankook Tyres and DSV. The entire Midlands (both East and West) accounted for 48% of Q1 UK take-up. The North West and Oxfordshire were other regions of occupier focus in Q1. Retailers were active in the North West, with TKMaxx taking Crewe 460 and Supreme Imports taking space at the Ark in Trafford Park. Meanwhile healthcare / life sciences-related occupiers were active in the Oxford Cambridge arc in Q1. Siemens Healthineers received planning permission on 603,000 sq ft at Symmetry Park.

THERE'S MORE TO INDUSTRIAL OCCUPIER DEMAND THAN INTERNET RETAIL

The range of occupier sectors taking space in Q1 reflects the diverse nature of post-pandemic demand for industrial property. For instance, traditional high street retailers making a late switch to e-commerce, such as TK Maxx and Primark, were more active than dedicated internet retailers in Q1, which only accounted for 6% of demand. Other sectors taking space included green energy and medical related manufacturers and occupiers linked to the food and housebuilding industries. Tenants seeking supply chain resilience through nearshoring operations closer to end markets (and also furthering sustainability initiatives) are likely to continue to be acquisitive this year.

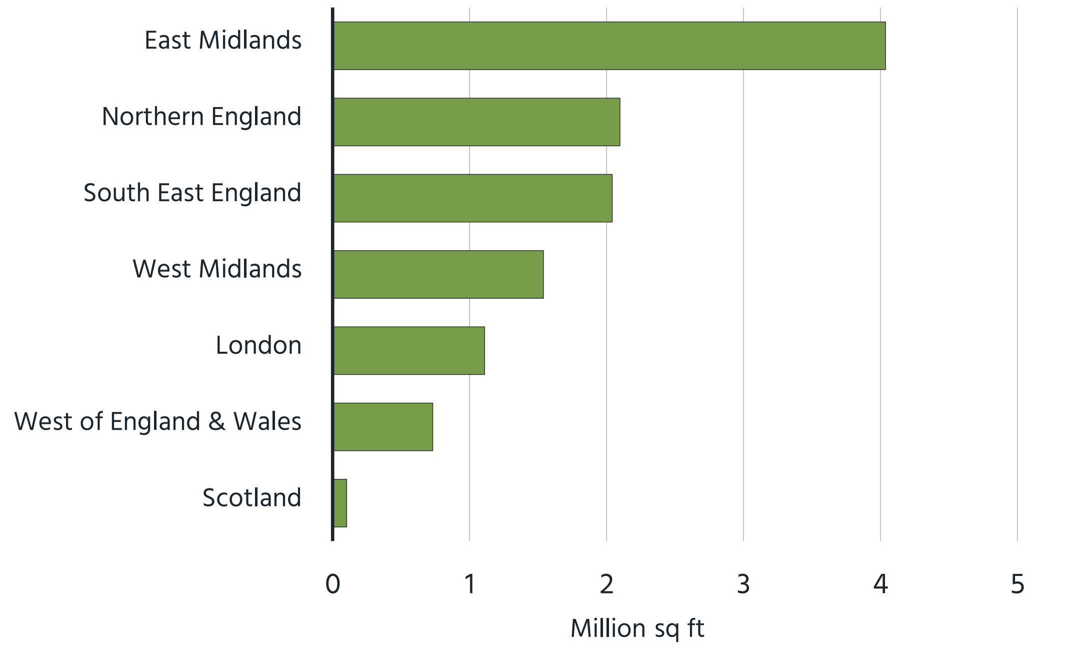
Quarterly take-up by quality and long term averages

Source: Gerald Eve



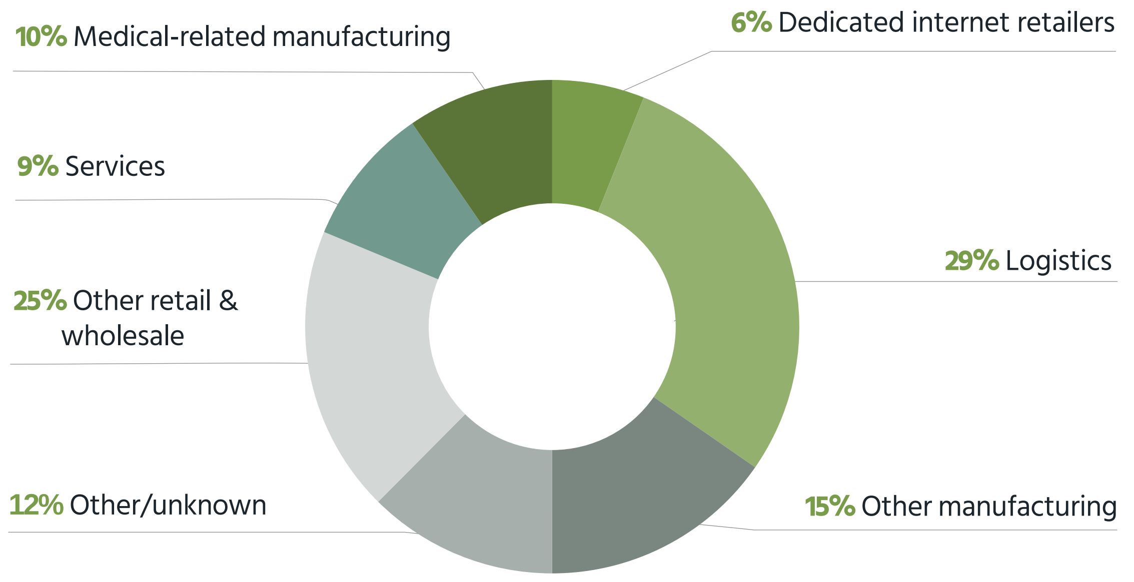
Q1 2023 take-up by region

Source: Gerald Eve



Q1 2023 take-up by occupier sector

Source: Gerald Eve



SUPPLY AND DEVELOPMENT

UK AVAILABILITY RATE INCREASES 1.1%AGE POINTS TO 4.7%

The overall rate of availability increased from 3.6% in Q4 (the lowest on record), to 4.7% in Q1. This reflects around 44 million sq ft of marketed space in total. The increase was due to a combination of additional spec-built stock entering the figures and an increase in tenant grey space. Availability is still below the 5-year average for the UK (5.5%), but this does mark a sharp 1.1 percentage point increase in the overall rate. There are now a handful of markets where there is increased occupier choice and some footloose occupiers are actively targeting these locations in the hope of securing accommodation on more favourable terms. More broadly though, supply remains very restricted.

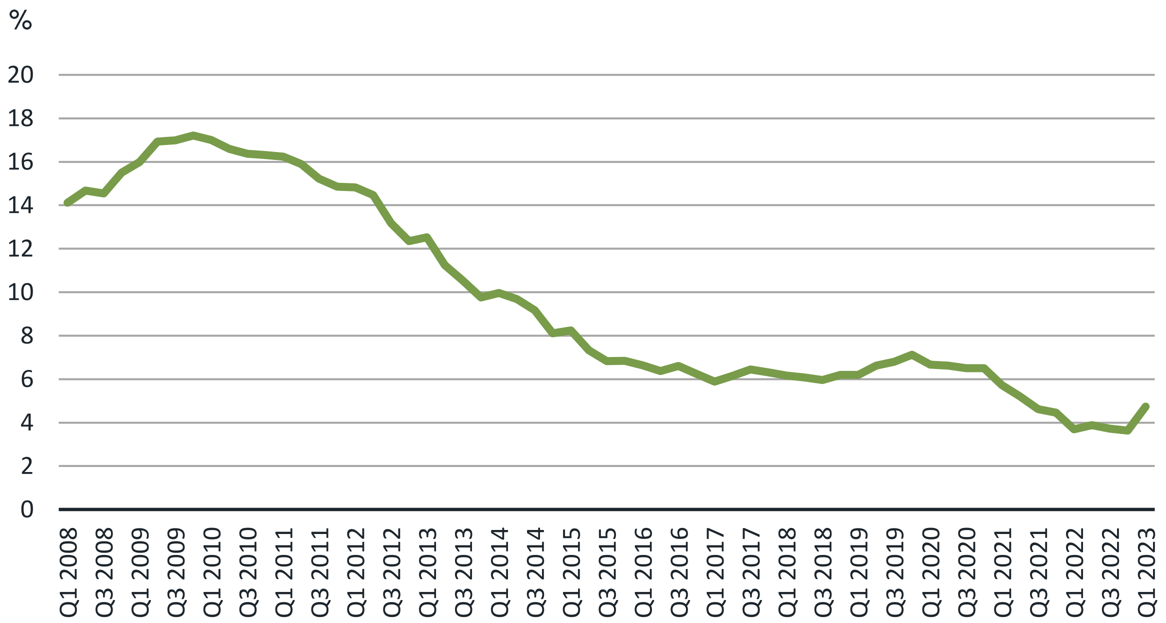
INCREASE IN SUB-LETTING AS OCCUPIERS LOOK TO CAPTURE RENTAL REVERSION

Sub-lets or assignments are now estimated to account for 10% of all availability, up from around 4% in Q4 last year. Companies sub-letting include the pandemic aggregators such as Amazon, and Super Smart, traditional logistics operators such as DB Schenker and the Pallet Network, and traditional retailers such as Sainsbury's and Hotel Chocolat. The reasoning behind these sub-lets 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. What they all have in common though is the desire to make cost savings and capture the market rent reversion, which in some cases is above 30%.

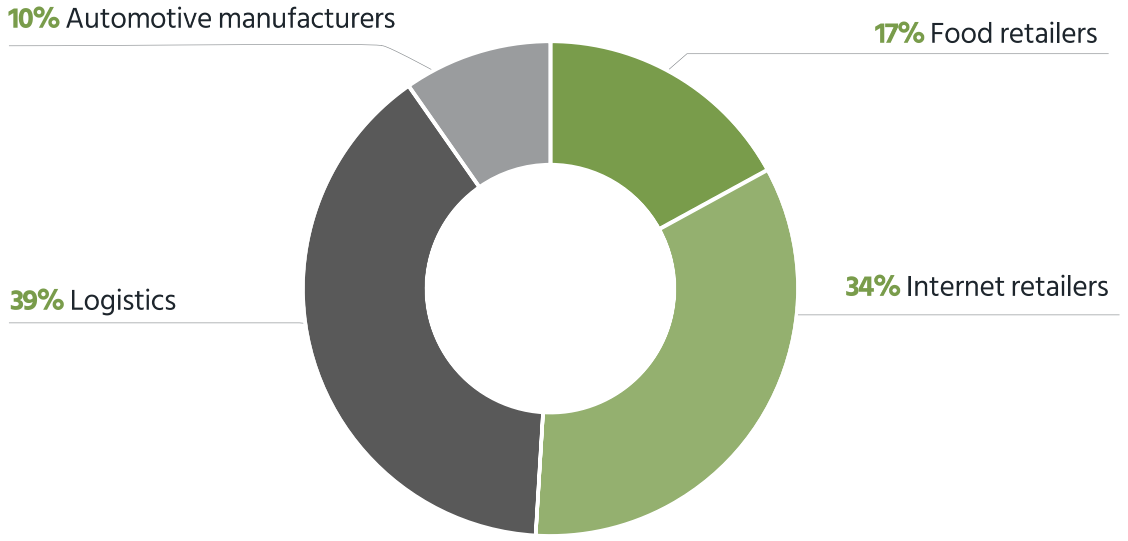
SPEC DEVELOPMENT STARTS SLOW SHARPLY IN Q1

The volume of speculative development starts was 3.3m sq ft in Q1, down 50% on Q2. This slowdown reflects the high cost of development and debt, set against the wider developer perception of softening occupier demand. The availability rate for new or modern stock increased again from 1.8% in Q4 to 2.7% in Q1. This is despite 25% of the 4.5m sq ft of spec space completed in Q1 being let prior to its completion. There is now around 16m sq ft in the development pipeline that is currently available, with hotspots of speculative construction activity in Yorkshire, the West Midlands and the South West.

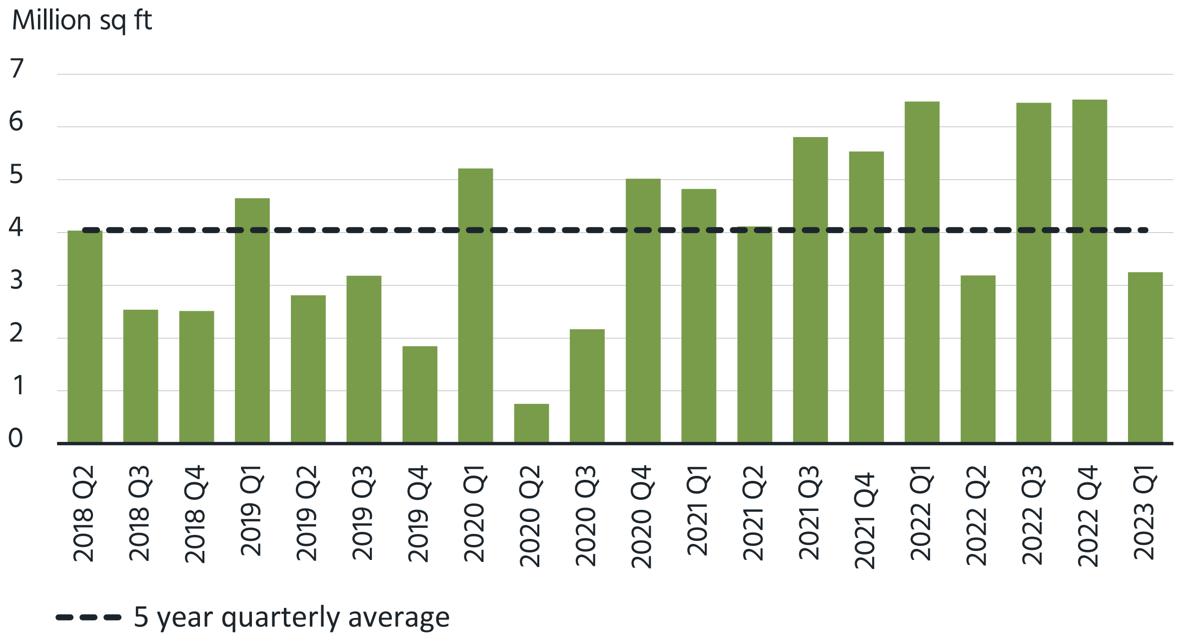
UK long term availability rate
Source: Gerald Eve



Tenant sectors sub-letting or assigning space in Q1 2023
Source: Gerald Eve

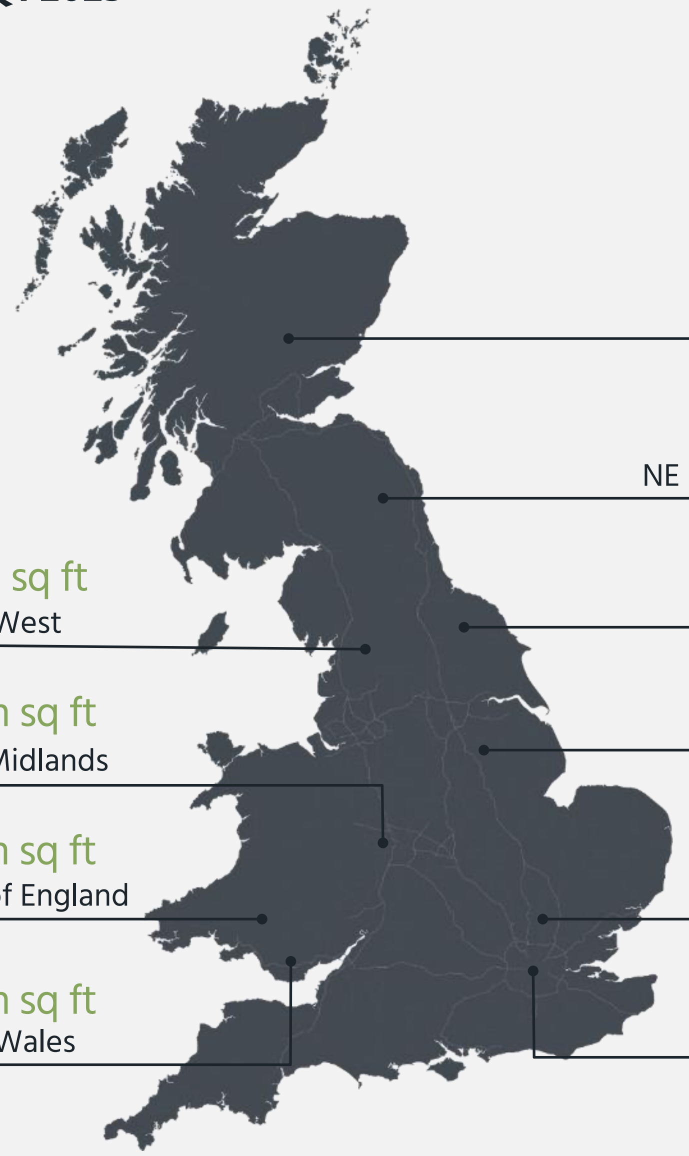


Speculative development starts
Source: Gerald Eve



SUPPLY AND DEVELOPMENT

Speculative space under construction end Q1 2023



SPECULATIVE DEVELOPMENT TO SLOW FURTHER IN 2023

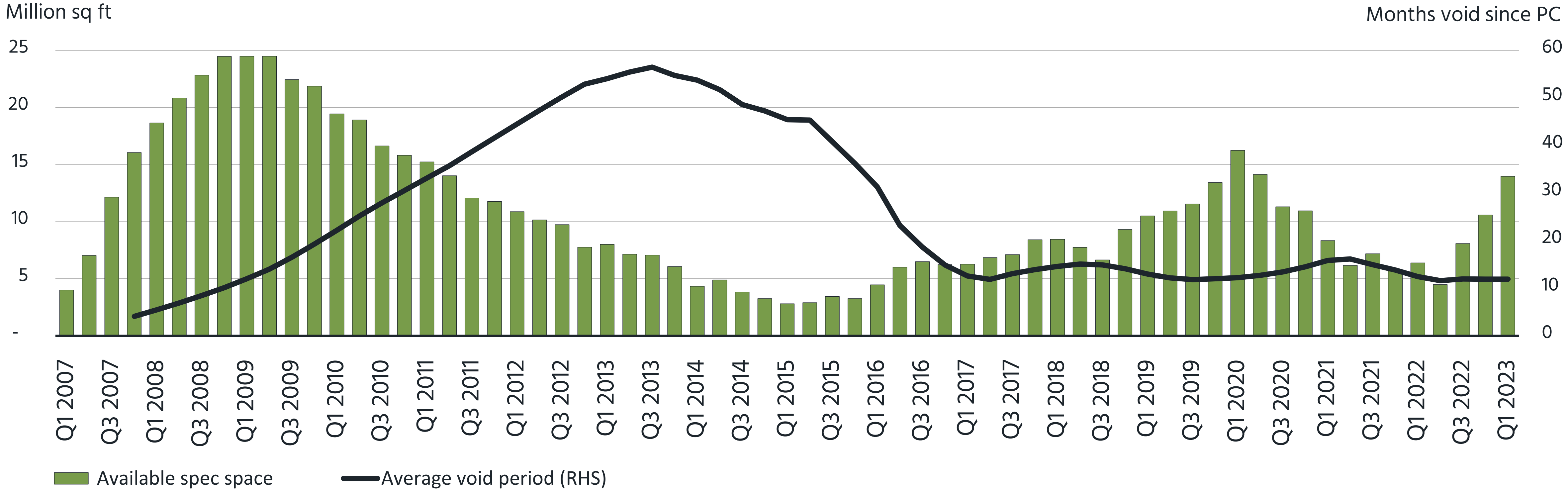
The pandemic demand boom gave speculative developers confidence to start schemes and the volume of spec development under construction is high. But some developers are now feeling the effects of the high cost of debt and construction, and, the impact of last year's outward yield shift on residual land values. We expect spec development to prove responsive to movements in underlying demand this year, with activity set to slow.

VOID PERIOD ON SPEC DEVELOPMENTS STILL LOW

Given the prevailing low supply in most markets, occupier interest in new spec developments is high, even with the often-necessary increase in quoting rents on such schemes. Whilst the volume of available completed spec space on the market is increasing (to roughly 30% of all availability in Q1), the average prevailing void period is still around 12 months. This is far below the average void period during previous downturns.

Available completed speculative development and average void period

Source: Gerald Eve



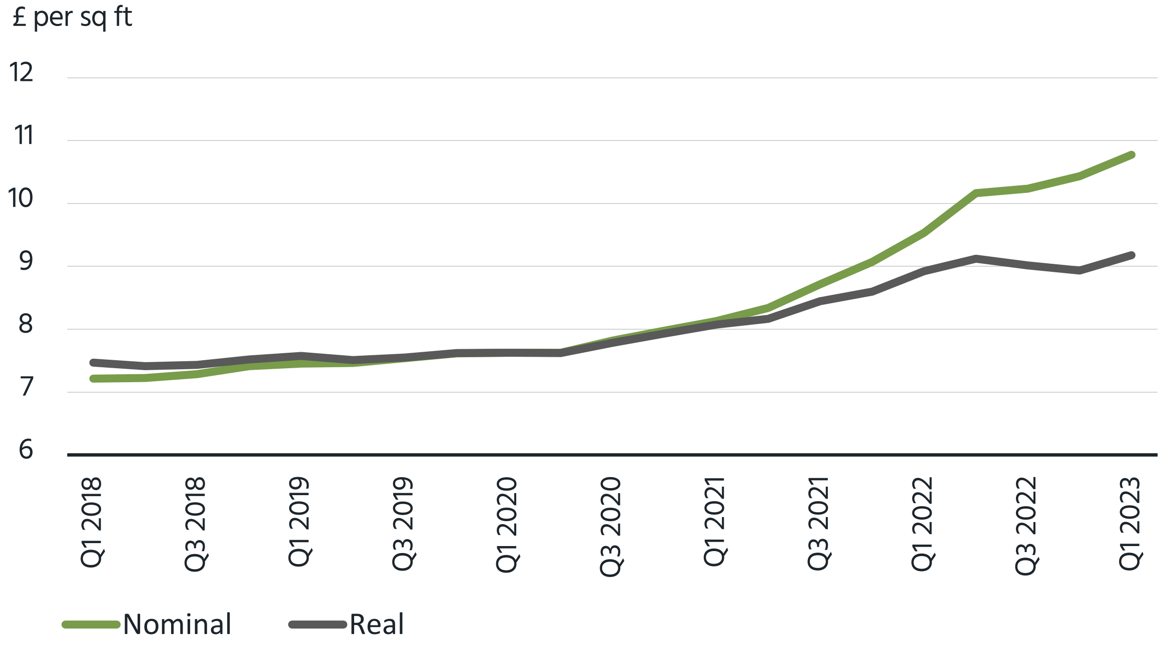
RENTS

WIDESPREAD PRIME RENTAL GROWTH IN Q1

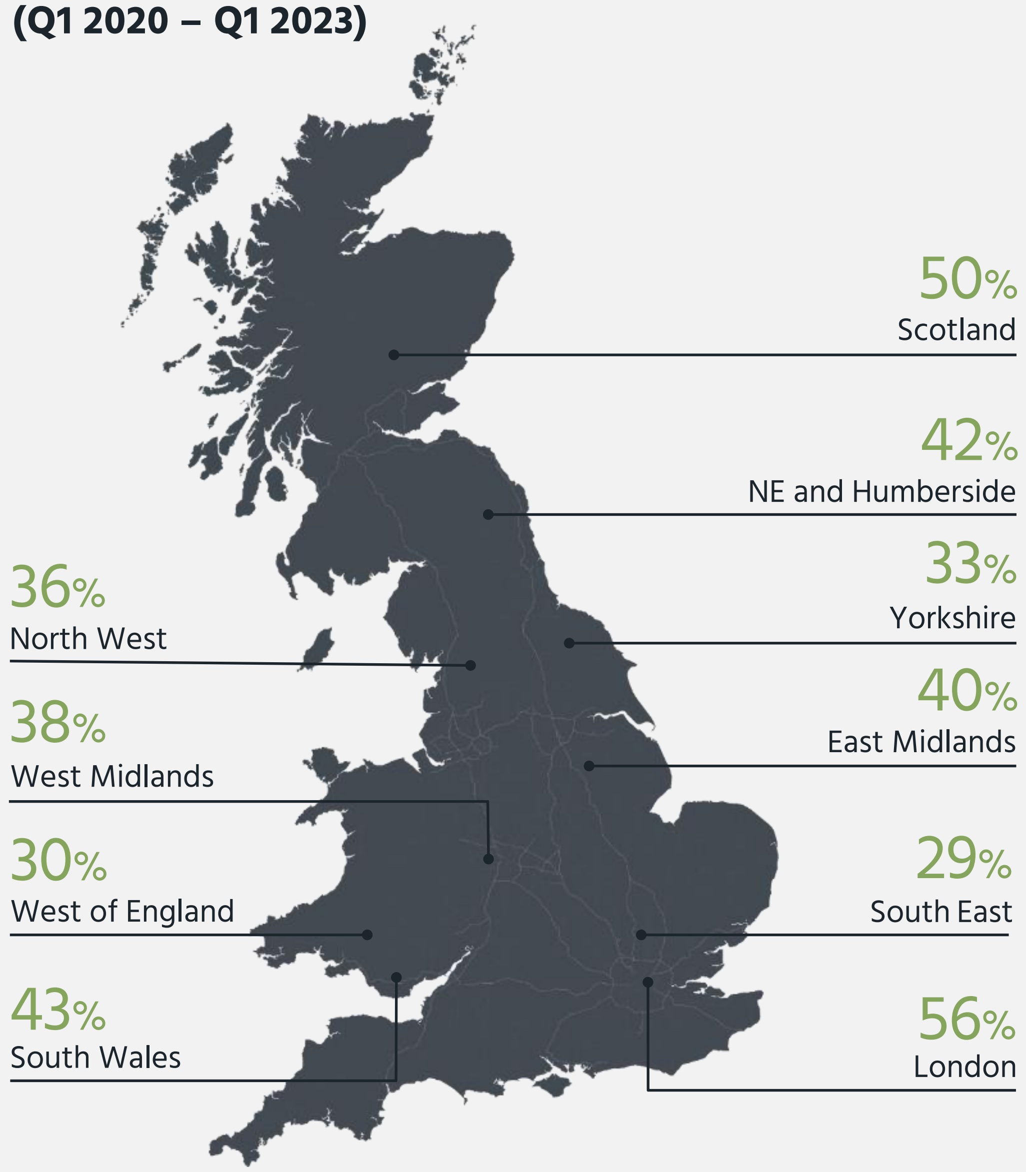
New developments continued to re-set market tone in several markets in Q1. Prime rents increased on average 3.3% in Q1 and 13% over the past year. This is still far above the five-year quarterly average growth rate of 2%. Quoting rents on new developments continue to push benchmarks. Whilst most occupiers expect this given the higher construction costs, they are still unwelcome, especially to those at the sharp end of the energy price spike or consumer slowdown. Nevertheless, rent remains a relatively small proportion of overall costs for most occupiers. Wider inflation continues to outpace prime rental growth, which theoretically provides headroom for nominal rental growth.

Average UK prime real and nominal rents, Q1 2020

Source: Gerald Eve, Oxford Economics



Post-covid prime rental growth (Q1 2020 – Q1 2023)

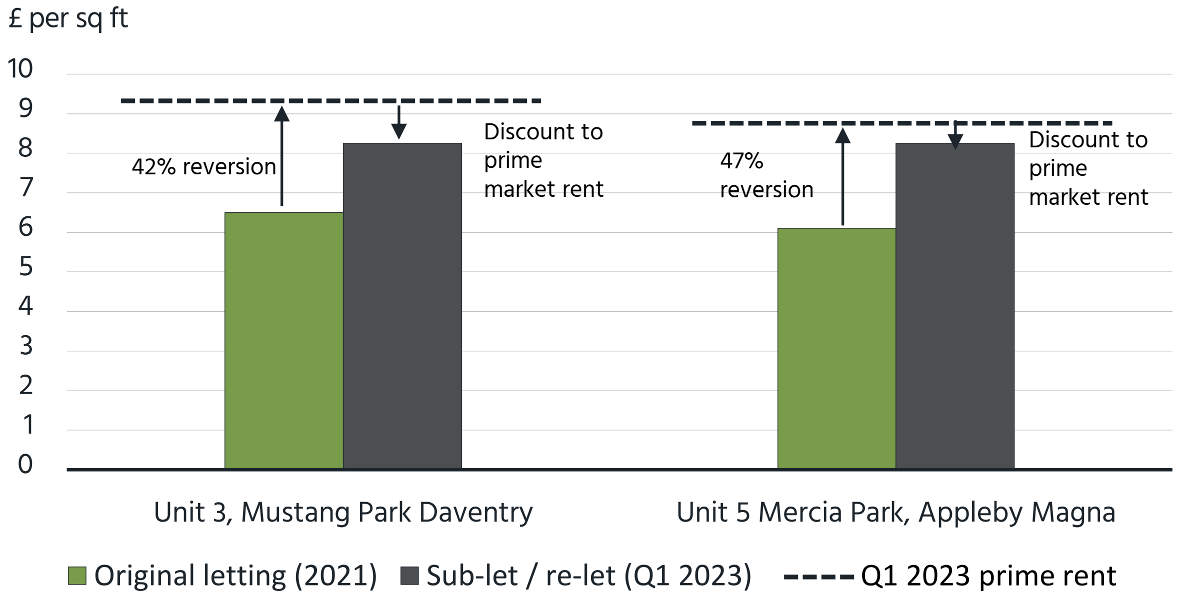


SUB-LETS UNDERMINING MARKET RENTAL GROWTH

Take-up surged in 2020 and 2021, with prime rents growing by an average 41% across the UK since the start of the pandemic. Consequently some occupiers are now seeking to capitalise on this rental growth and capture the reversion on surplus unneeded space. These sub-lets do not work off the same cost base as current landlord developers, which have been at the sharp end of recent increases in build costs. Typically, sub-letting tenants will accept lower than the prevailing market rental tone for what are often very good quality or new buildings with similar incentives. Whilst sub-lets are expected to be a short term feature of the market, such deals have the potential to dampen rental growth.

Sub-letting case studies, Q1 2023

Source: Gerald Eve



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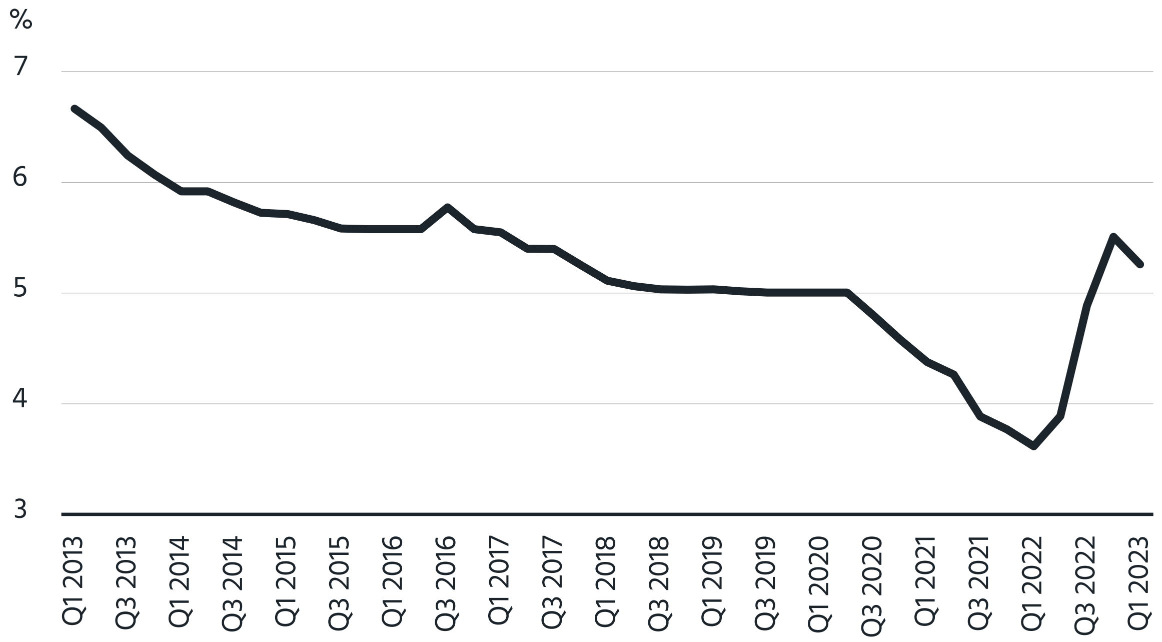
INVESTMENT

INVESTMENT MARKET RECOVERS SOME LOST GROUND IN Q1

Pricing, sentiment and demand all improved dramatically in Q1 and average prime logistics yields moved in an average 25bps. This reverses some of the value loss off the back of the 62bps outward shift in Q4 and 100bps outward shift in Q3. Current investor interest is focused on good quality assets with strong ESG credentials, but appetite is improving up the risk curve. The UK institutions returned to the market in Q1, with the key issue still being able to source suitable assets. Obtaining good quality stock has proved difficult since many owners are now choosing to hold. Consequently any sales have generated strong levels of interest and multiple rounds of bidding.

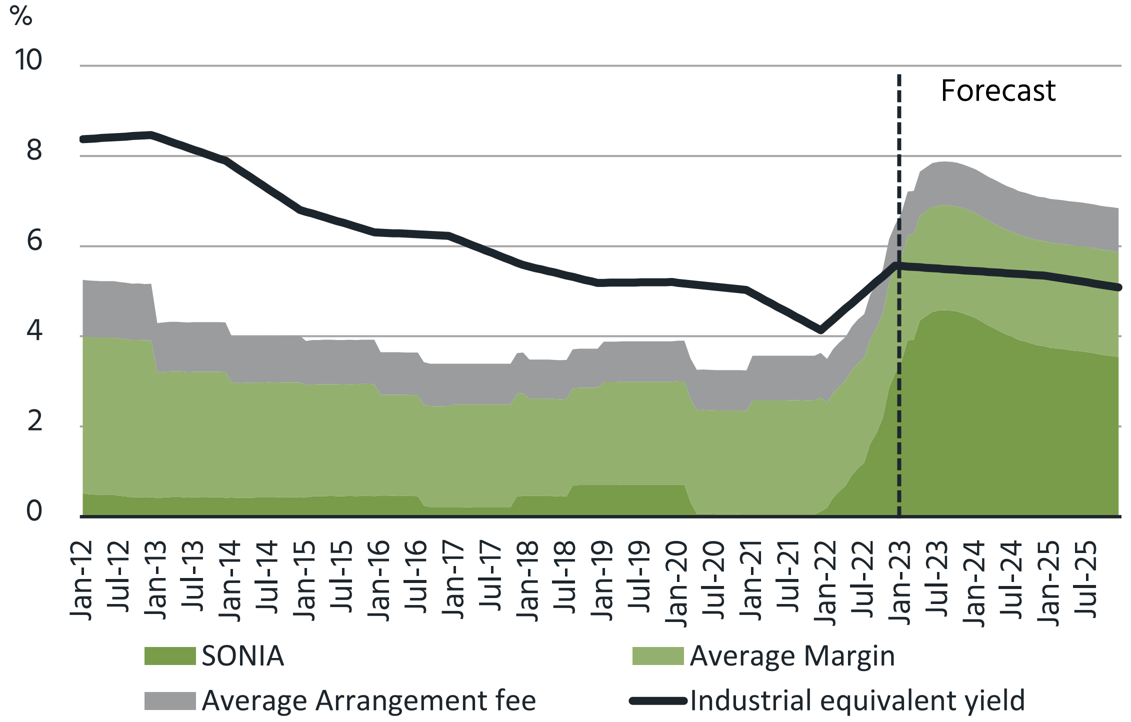
All UK average prime logistics yield
Source: Gerald Eve



DEBT MARKET REMAINS CHALLENGING

Based on all-in floating borrowing rates, the cost of accessing debt roughly doubled over 2022. Low-yielding assets such as logistics have been more exposed to this dramatic change. Conditions have subsequently improved now that some of the worst fears for the path of interest rates are no longer expected, but the debt market remains challenging and is likely to create a two-tier market. Investors that have accessed debt at lower interest rates may be able to pick up assets at discounted prices. But leveraged smaller investors that can only access debt at the current rate will find it difficult to make competitive offers.

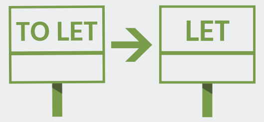
Industrial property debt cost and equivalent yield
Source: Bank of England, Bayes Business School, Chatham Financial, MSCI



HOW TO EVIDENCE THE GREEN PREMIUM?

Buildings or developments with strong ESG credentials are currently the most liquid of all logistics asset types. However, isolating and quantifying the impact on pricing has proved far from straightforward. There are several indirect benefits of such buildings which offer value enhancement:

Potentially reduced void risk



Reduced regulatory risk

Tenant cost savings factored in to rent reviews

Potential for higher rents

Better debt terms

Increased investment market liquidity

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SPOTLIGHT #1: OCCUPIER COSTS

SUSTAINED OCCUPIER COST PRESSURES

We estimate that the overall operating cost for a typical logistics occupier has increased by around 32% since Q1 2020. Sharp increases in fuel, labour, property costs and utilities have, where possible, been passed onto the consumer, but many occupiers are now looking at ways to cut costs. This includes sub-letting space, reviewing headcount and, where possible, investing in renewable energy generation.

LABOUR-INTENSIVE OCCUPIERS

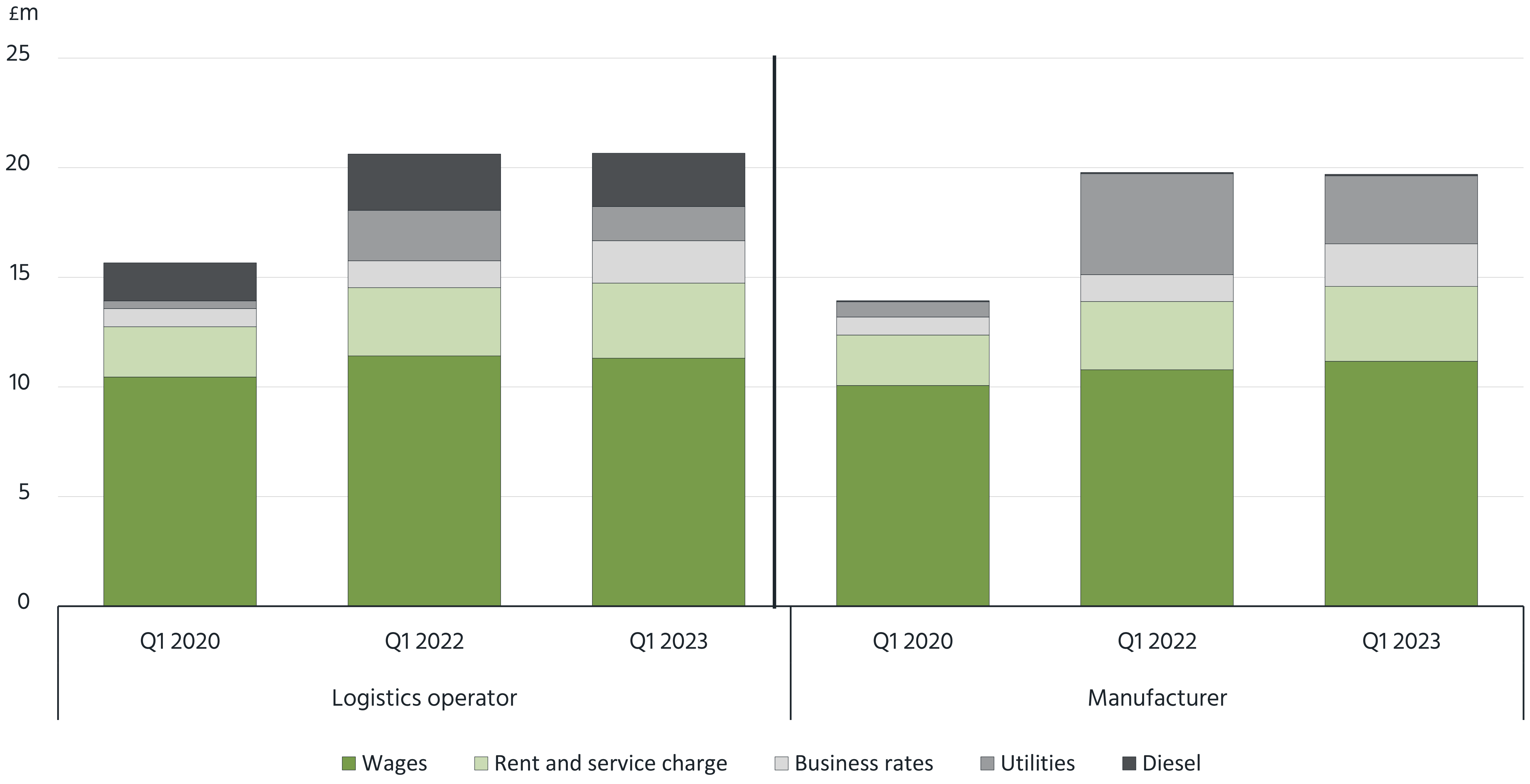
Wages are the biggest individual cost for most operators, and, depending on the sector, these have increased by around 10% since Q1 2020. Further increases are likely this year whilst inflation remains high and staffing shortages are commonplace. As such, the ability of labour-intensive occupiers to invest in their businesses will be compromised and access to labour will be an even more important distinguisher when assessing a building's characteristics.

ENERGY-INTENSIVE MANUFACTURERS

The cost of utilities for the average occupier has more than tripled since Q1 2020. Whilst price rises are now starting to ease, for energy-intensive occupiers such as data centres or heavy industry, these cost increases have been particularly detrimental. Investing in renewable energy is a top priority for these occupiers, but many report that technologies and grid capacity are not yet robust enough to rely on.

Indicative logistics and manufacturer annual operating costs*

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



*based on a prime 300,000 sq ft unit in Milton Keynes, 350 employees and average (large business) gas/electricity usage (excluding government support) for the occupier sector in question.

Click here to read more on EPC uprating

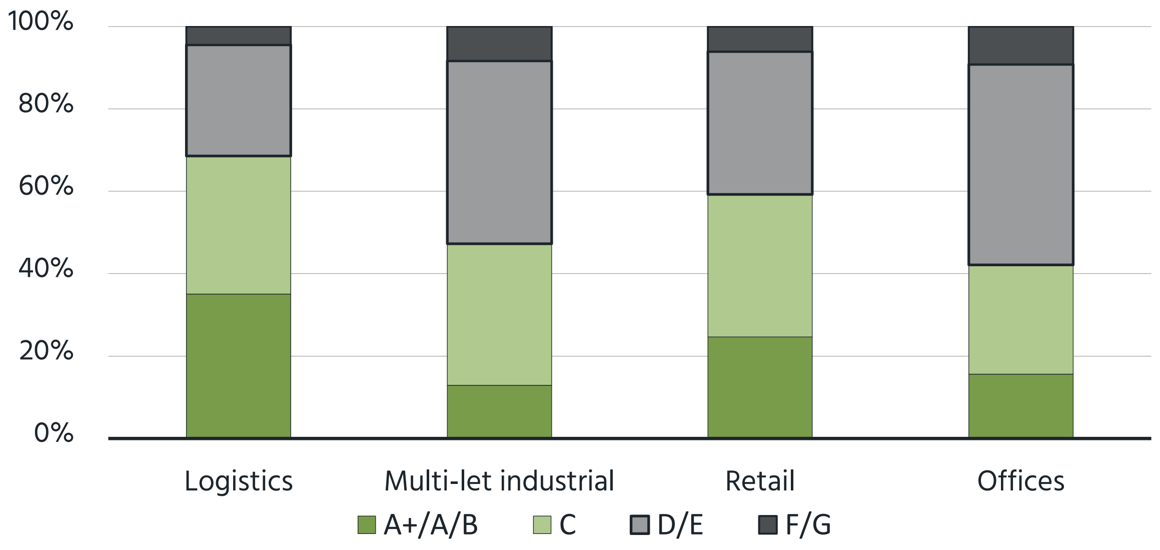
SPOTLIGHT #2: ENERGY PERFORMANCE CERTIFICATES

LOGISTICS IS ONE OF THE MOST ENERGY EFFICIENT COMMERCIAL PROPERTY SECTORS

The recent spike in development activity has significantly improved the overall quality and energy efficiency of logistics stock in the UK. Nearly all new developments target at least an EPC A rating and as one of the few commercial property sectors where development has increased post-pandemic, logistics is now one of the most energy efficient of all the main sectors. 35% of all logistics stock has an EPC grade of A+ to C, compared with 16% of all office stock. The sector poses considerably less regulatory and thus obsolescence risk than other sectors, with proportionately less at-risk EPC grade F&G buildings.

Commercial property stock: EPC ratings by sector

Source: Gerald Eve, Department for Levelling Up, Housing and Communities

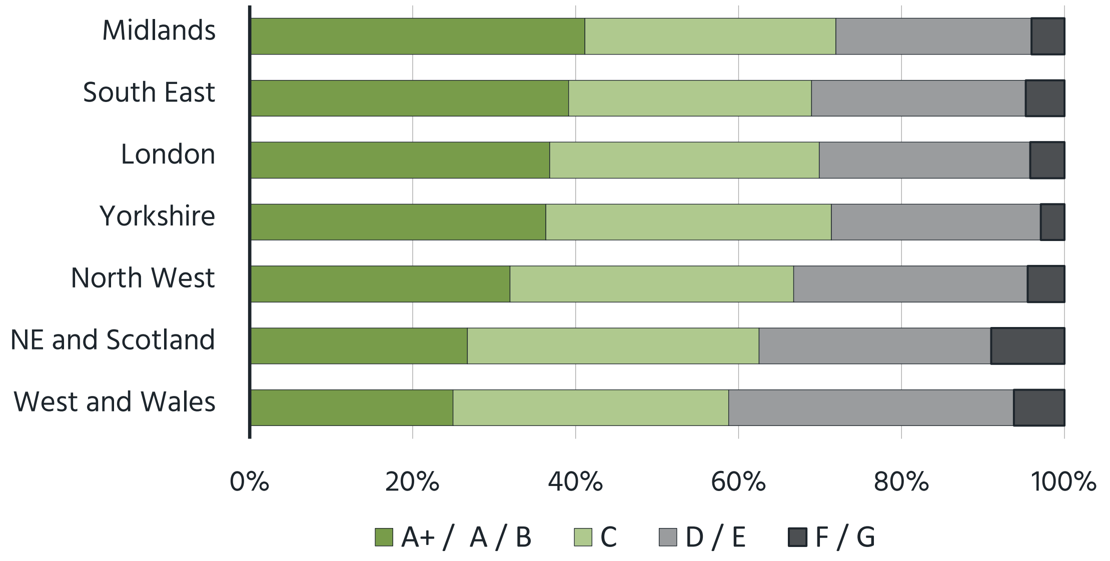


THE MIDLANDS IS HOME TO PROPORTIONATELY THE MOST ENERGY EFFICIENT STOCK

In the Midlands, 41% of the logistics stock is categorised as EPC grade B or above. Current MEES regulations prescribe how these units can continue to be let, without regulatory hindrance, past 2030. This again reflects the recent spike in development activity in the Midlands and makes the region relatively more attractive to both investors and occupiers. The East Midlands in particular stands out, with 48% of all stock EPC grade B or above. Lower value regions such as Scotland and Wales have more regulatory risk, with more than a third of all stock grade D or below.

UK logistics stock: EPC ratings by region

Source: Gerald Eve



OUTLOOK

RENTS

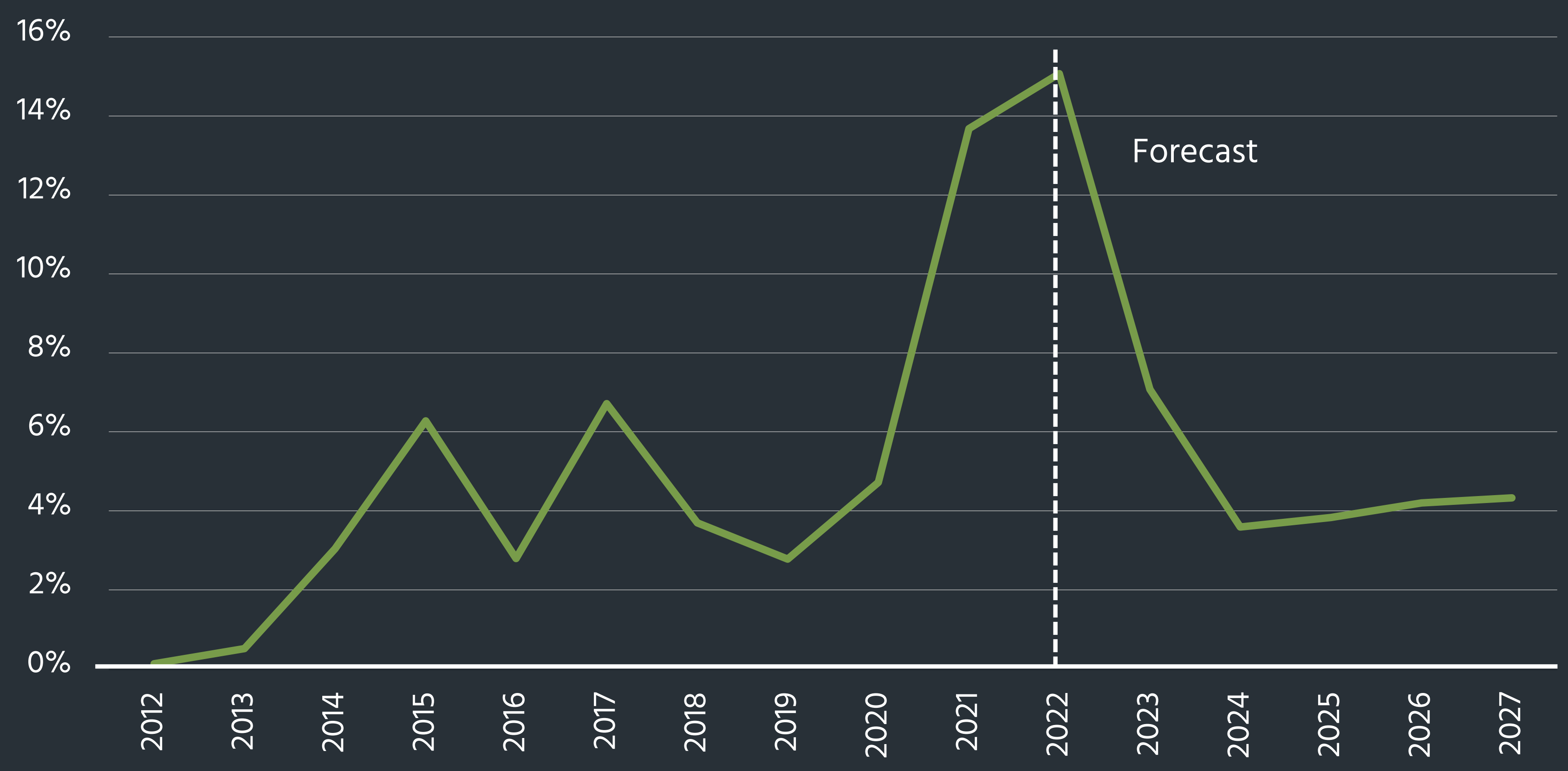
Despite weakening occupier demand, restricted supply is still supportive of a positive rental growth outlook. The increased risk and cost associated with speculative development will keep a lid on the delivery of new product. 2024 is likely to mark the high point in terms of vacancy in the current cycle, with above-average rental growth expected in most markets from 2025 onwards.

INVESTMENT

Recent value falls are likely to result in buy-side opportunities this year, with prime ESG-accredited buildings likely to be most in demand. There is a significant weight of capital targeting the sector, which is driving yield compression in the direct market and will feed through to valuation yields this year.

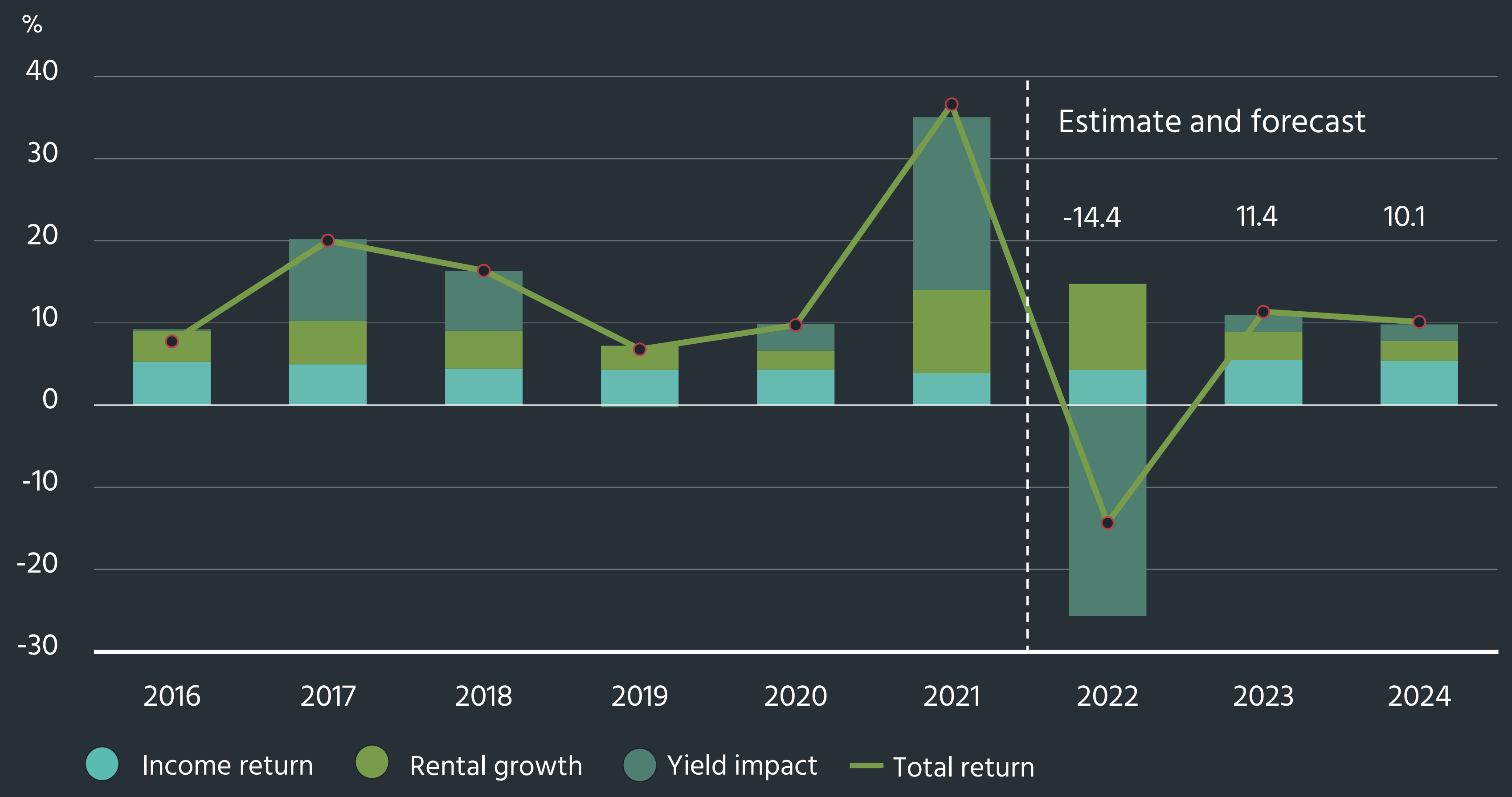
Prime logistics annual rental growth forecast

Source: Gerald Eve



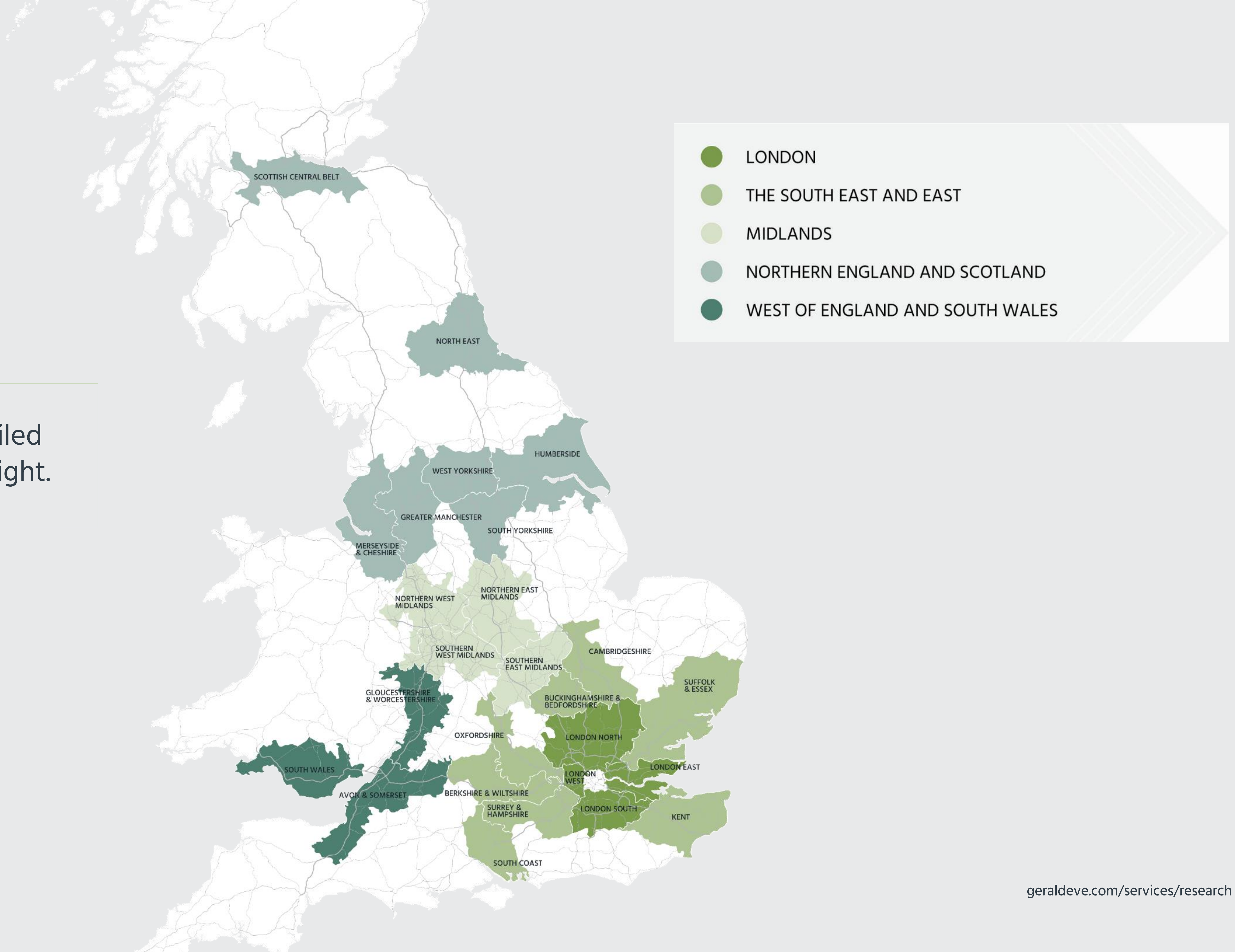
Industrial total return and components

Source: Gerald Eve, MSCI



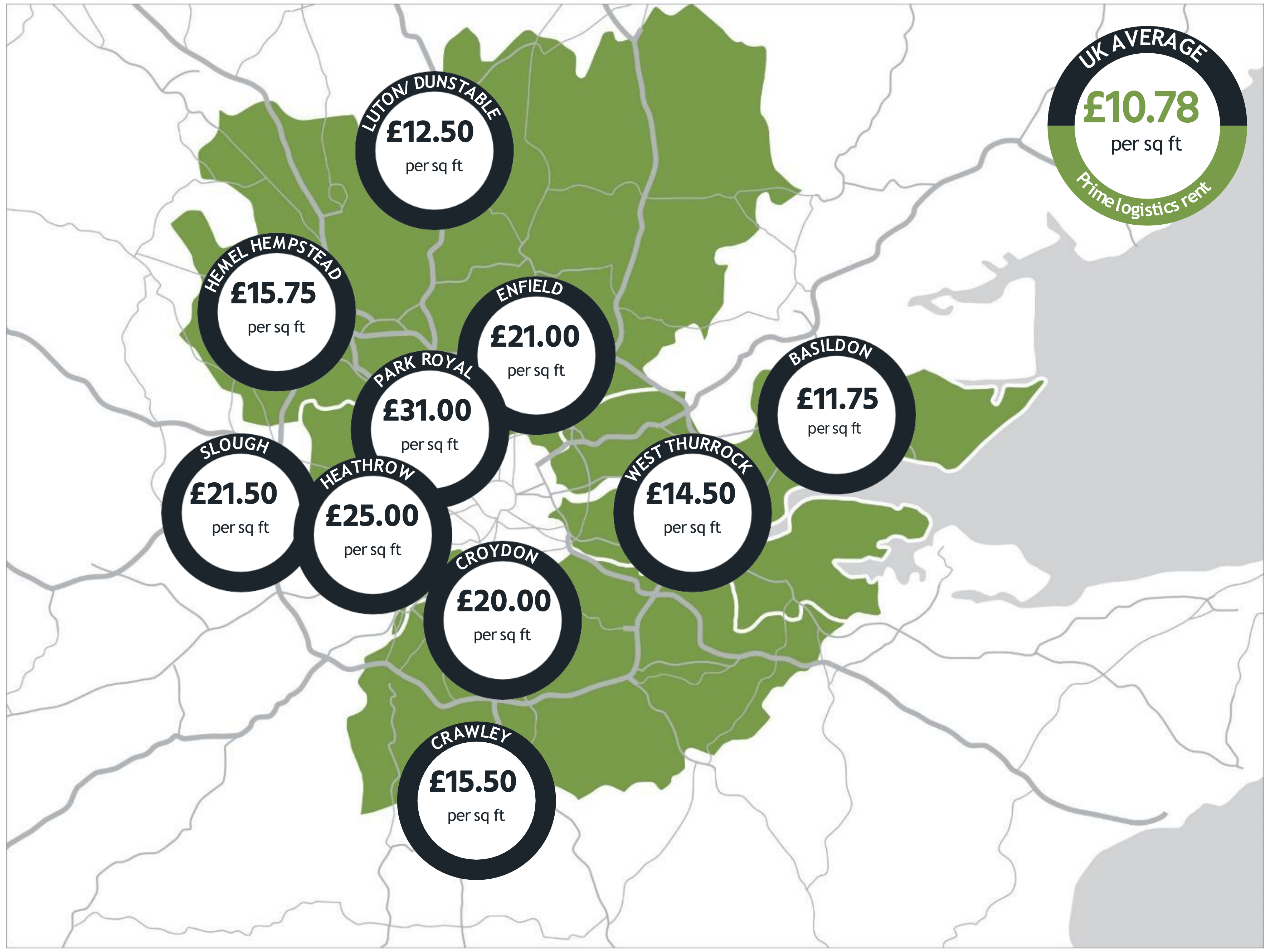
GERALD EVE REGIONS

Click here for more detailed regional analysis and insight.



LONDON

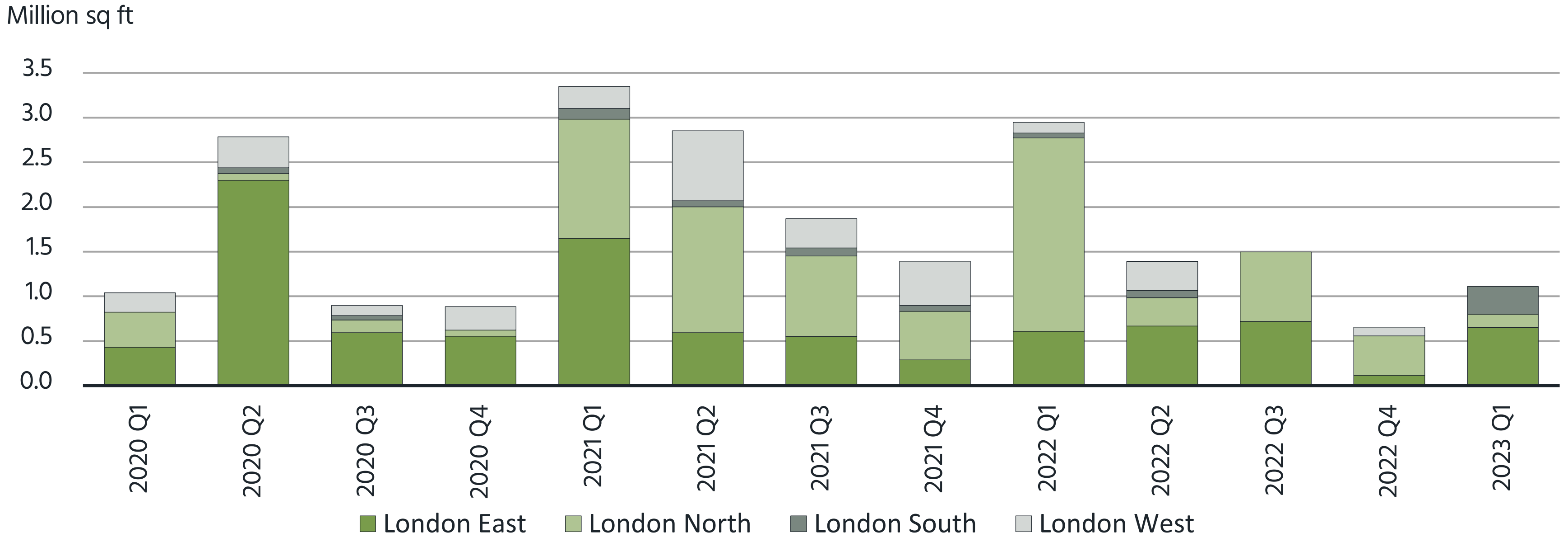
PRIME LOGISTICS RENTS



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.

Occupier quarterly take-up

Source: Gerald Eve

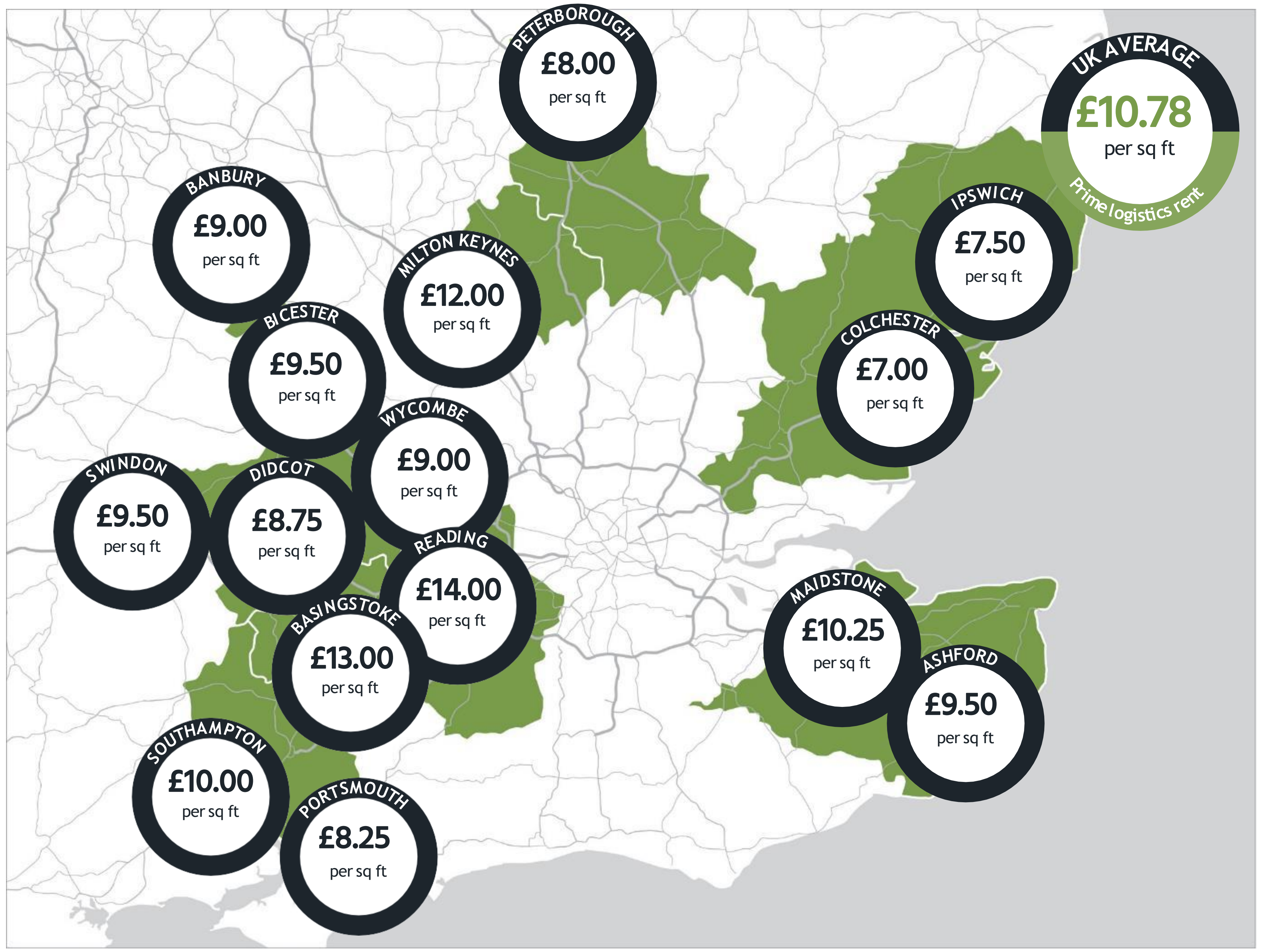


Availability rate

Source: Gerald Eve

THE SOUTH EAST AND EAST

PRIME LOGISTICS RENTS



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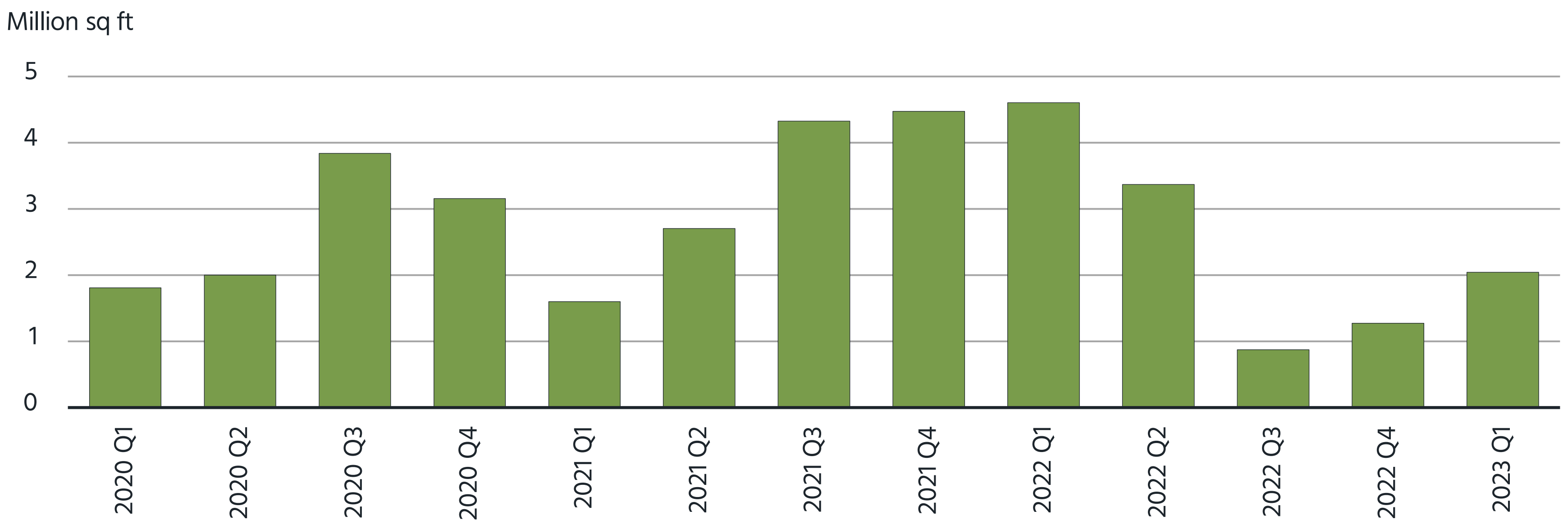
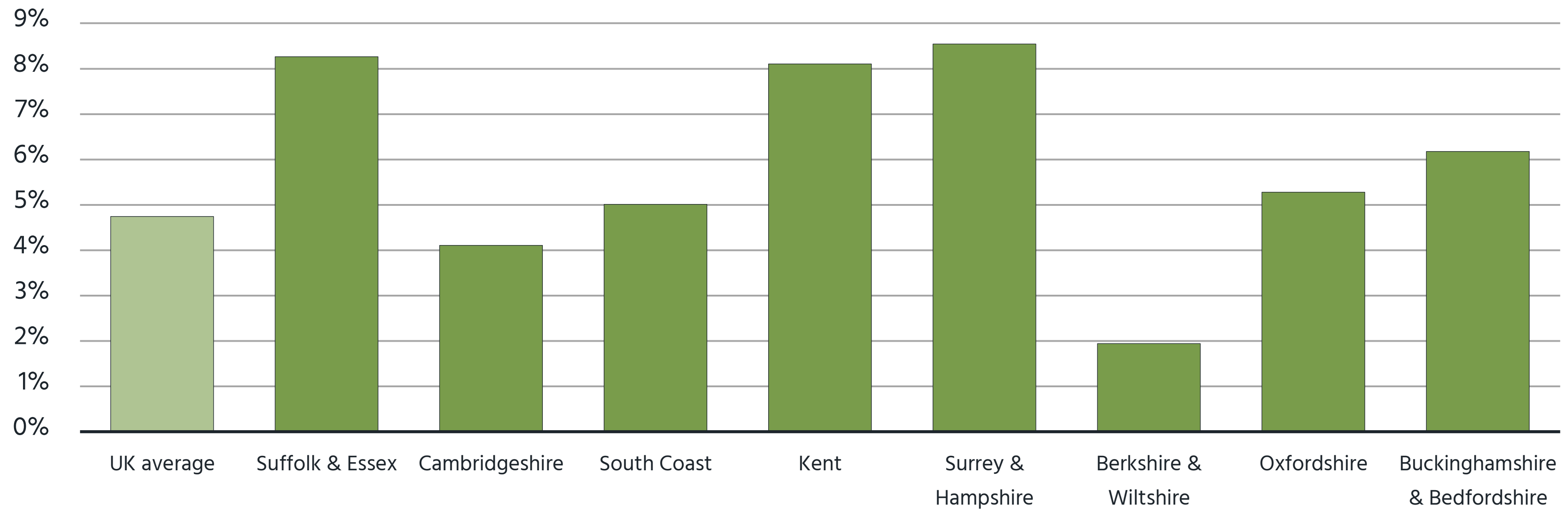


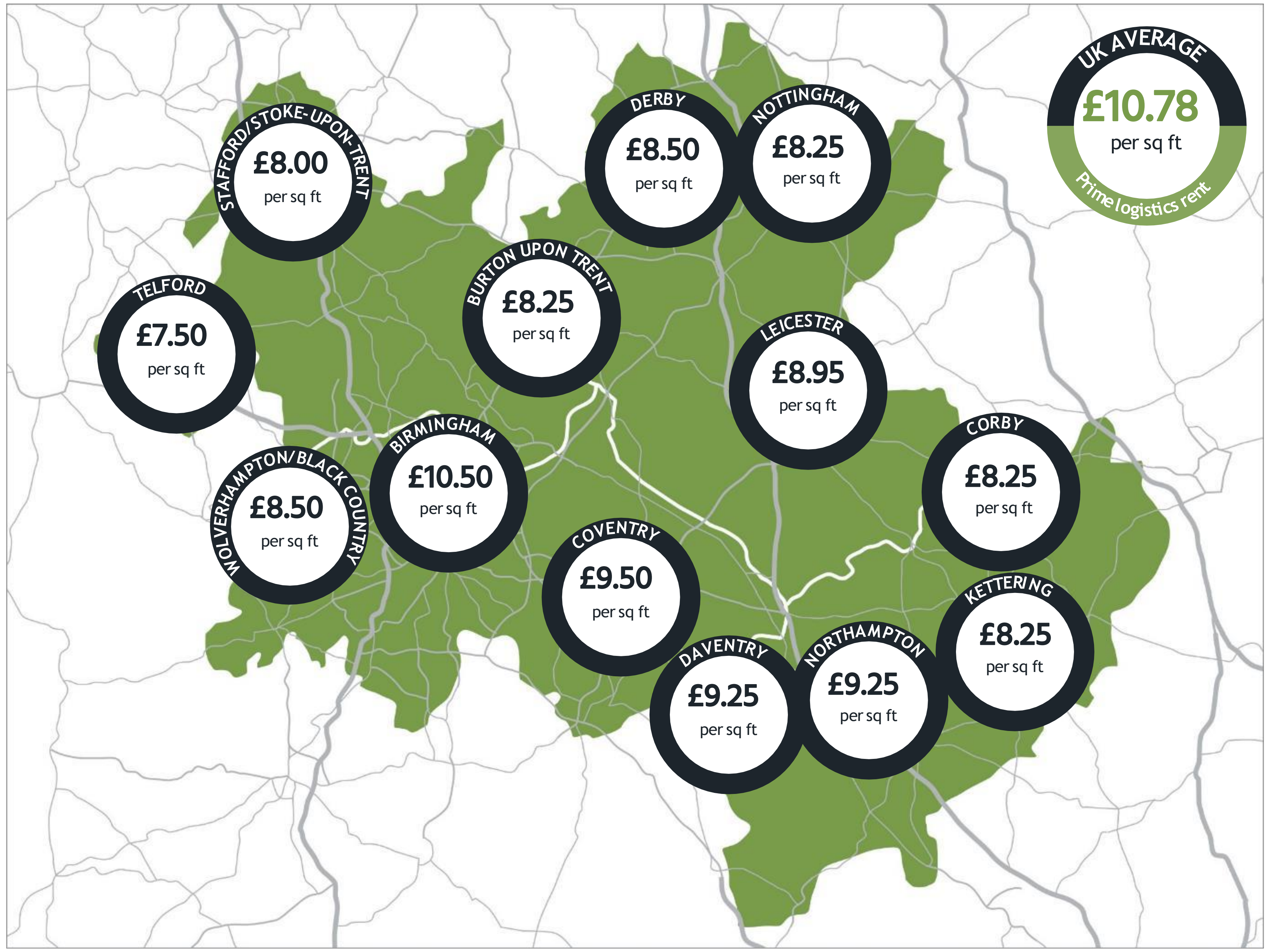
Availability rate

Source: Gerald Eve



MIDLANDS

PRIME LOGISTICS RENTS



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Occupier quarterly take-up

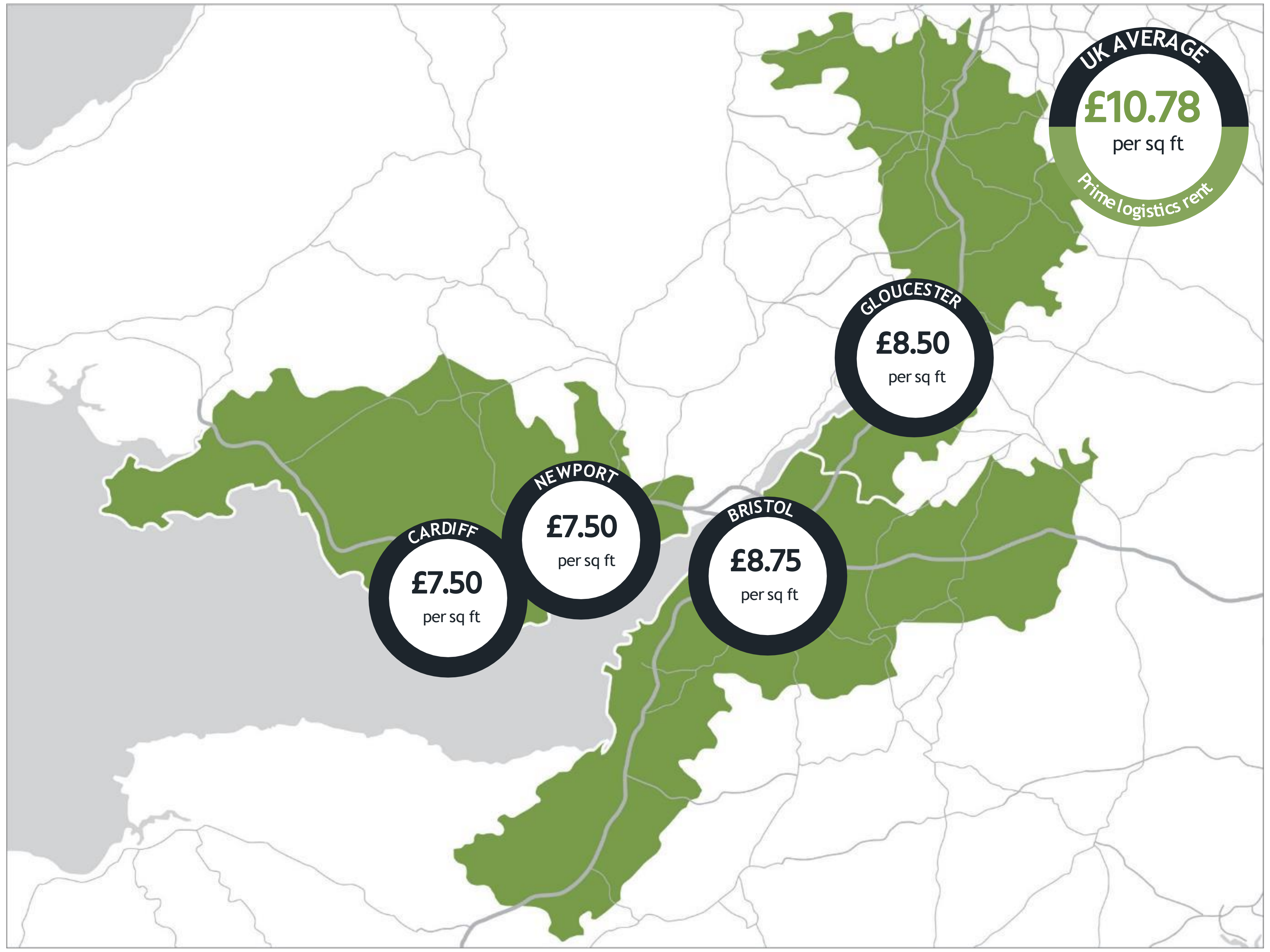
Source: Gerald Eve

Availability rate

Source: Gerald Eve

WEST OF ENGLAND AND SOUTH WALES

PRIME LOGISTICS RENTS



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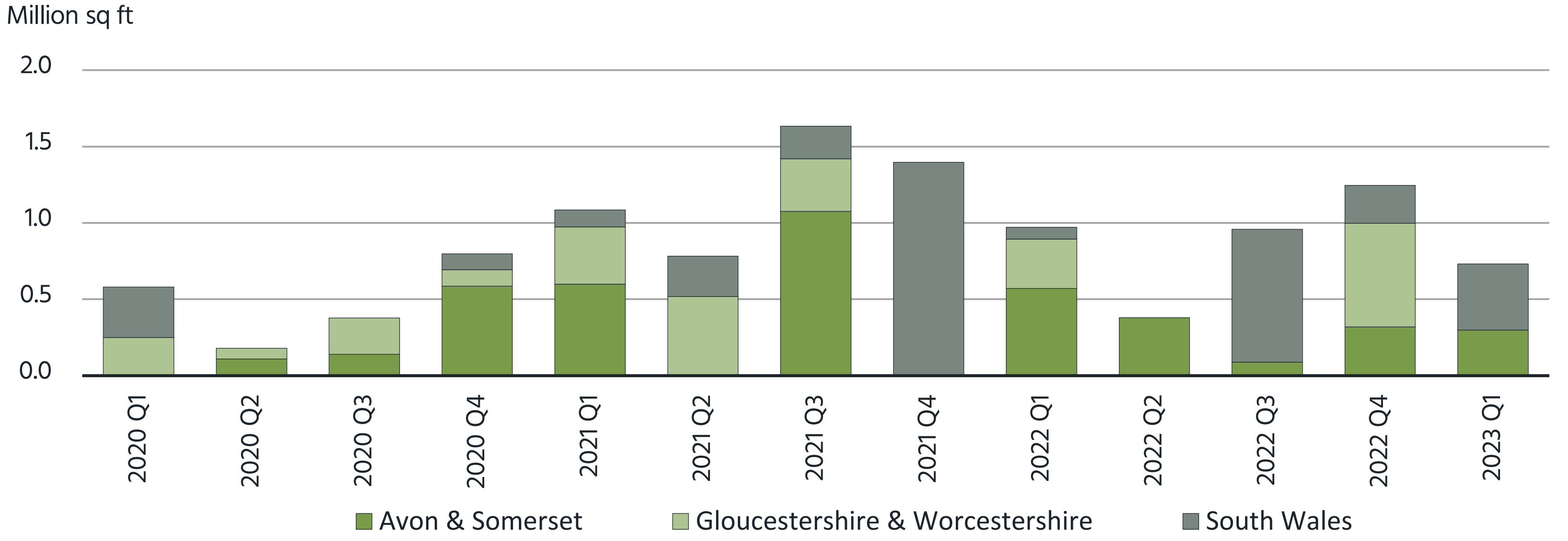
Occupier quarterly take-up

Source: Gerald Eve

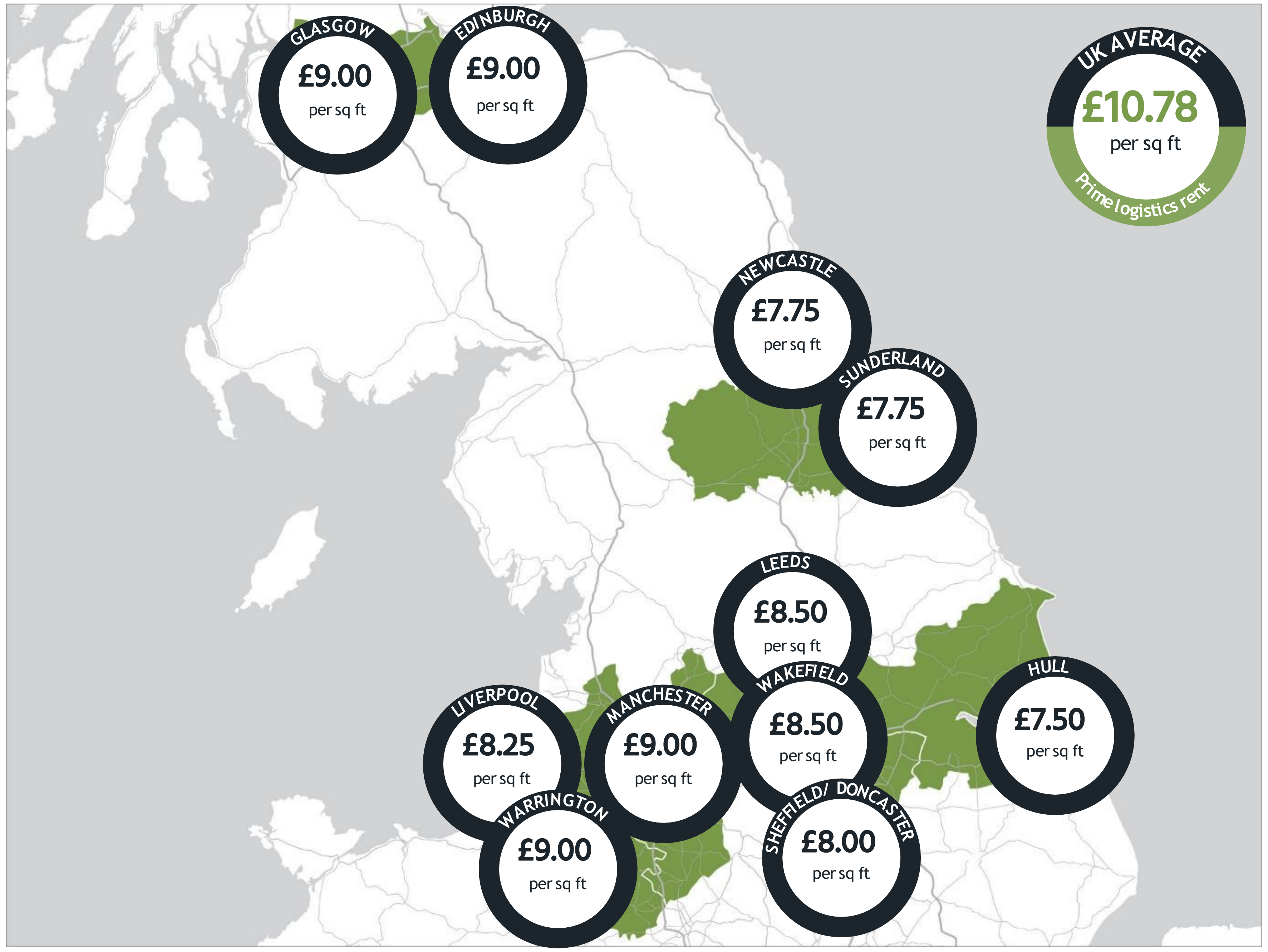


Availability rate

Source: Gerald Eve

NORTHERN ENGLAND AND SCOTLAND

PRIME LOGISTICS RENTS



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Occupier quarterly take-up

Source: Gerald Eve

Availability rate

Source: Gerald Eve

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March 2023

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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 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.

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