RESEARCH

LOGISTICS & INDUSTRIAL

OCCUPIER & INVESTMENT MARKET COMMENTARY **H2 2013**

Economic overview

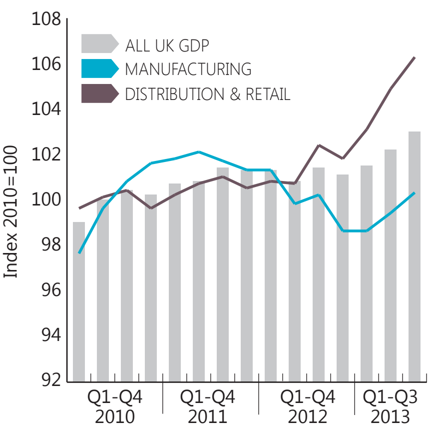
The UK economy is now recording consistent and robust levels of growth, with output rising across all the key sectors and across all UK regions. The near term outlook is also encouraging. Latest official estimates reveal that the economy expanded by 1.9% during 2013, while the Treasury's latest consensus forecast indicates that growth will increase to its long term trend rate of 2.6% in 2014.

With relevance to logistics, the rebound in the UK Distribution & Retail sector has been one of the key drivers of the UK's recent recovery, recording year-on-year growth of 4.7% in Q4 2013, compared with 2.8% for the UK economy as a whole. Conversely, however, while UK manufacturing has returned to growth it continues to lag behind the wider economy, with year-on-year growth of 2.5% (Figure 1).

The UK distribution sector is benefitting from the steady growth of e-commerce, with the UK being home to one of the world's most sophisticated e-tailing markets. Internet-based sales increased to a high of 11.9% of total sales in November 2013, with forecasts suggesting this figure could rise to 20% by 2020 (Figure 2).

FIGURE 1

UK economic output



Source: ONS

Occupier market

A critical shortage of new and good quality distribution space across all size categories is leaving occupiers with a lack of choice, a situation made all the more acute by the improving economic outlook. In the big-shed market, new-build supply of units above 100,000 sq ft now stands at just 5.2m sq ft, down 82% from its peak in Q1 2008 (Figure 3).

Total UK-wide take-up in units above 50,000 sq ft was a relatively robust 19.1m sq ft in H2 2013, up 5% on H1 and 11% above the five year bi-annual average. Reflecting the current supply constraints, design and build deals accounted for a significant 24% of H2 take-up. The Midlands was a major focus of this activity, where 2.7m sq ft was pre-committed across 12 deals.

The UK's largest design and build deal in H2 saw Kuhne + Nagel agree to pre-lease a 632,000 sq ft unit at Derby Commercial Park, followed by CostCo's 585,000 sq ft pre-sale at G-Park, Crick, also in the East Midlands. South Yorkshire was home to the UK's largest deal for new-build standing stock, where Marks & Spencer leased 625,000 sq ft at SIRFT, Sheffield.

The dearth of supply has put distribution landlords firmly in the driving seat. Two years ago, occupiers were able to secure space offering extremely generous terms, but now the pendulum has swung firmly back in the landlord's favour. Incentive levels declined sharply during 2013 and landlords are increasingly capable of commanding 10-year deals on secondhand space. Evidence also suggests that headline rents are increasing, a trend expected to take hold during 2014.

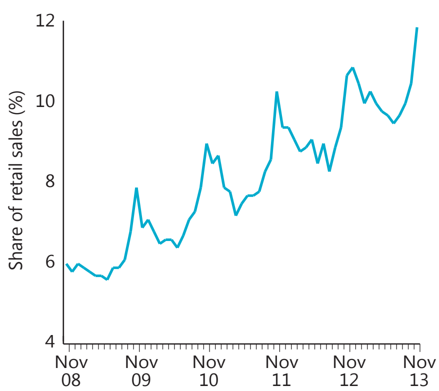
The hardening of lease terms on existing buildings has eroded much of the differential between standing stock and design and build deals. While this is likely to prompt an increasing number of occupiers to opt for pre-commitments, those seeking more flexible terms – such as contract-driven third party logistics providers – are going to be left increasingly frustrated.

While developers largely continue to hold out for pre-commitments, speculative development has now returned to the larger end of the market. Current activity above 100,000 sq ft is confined to four units in the Midlands and South East, although a number of additional large unit schemes are expected to commence in 2014, such as Gateway, Basildon (LaSalle & Roxhill Developments Ltd) and Tower, West Thurrock (Blackrock & Bericote).

For more detailed commentary on the occupier markets, please refer to our regional LOGIC reports.

FIGURE 2

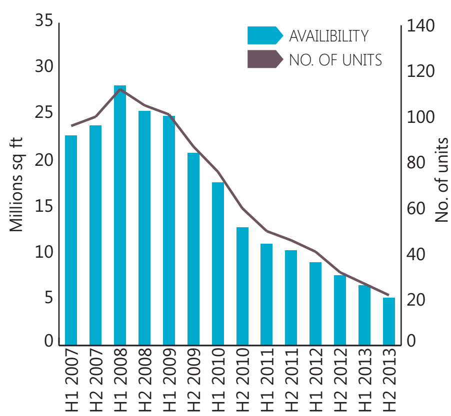
Internet's share of UK retail sales



Source: ONS

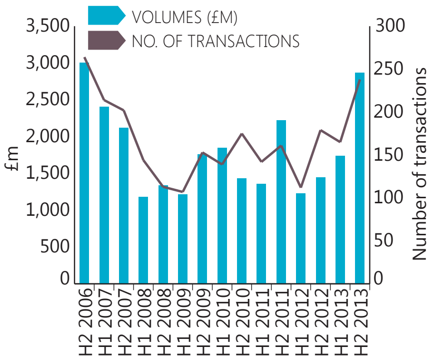
FIGURE 3

New sheds available (100,000 sq ft+)



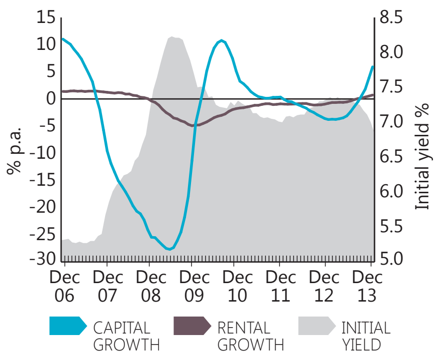
Source: Knight Frank

FIGURE 4
Industrial investment transactions



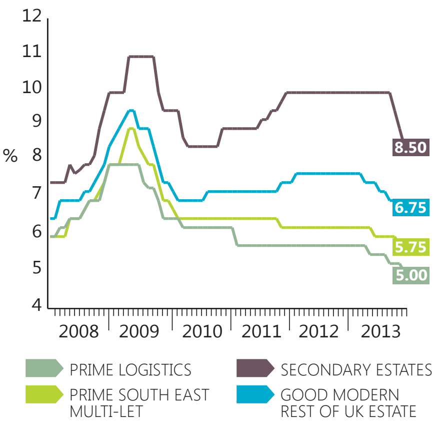
Source: Property Data / Knight Frank

FIGURE 5
Industrial sector performance



Source: IPD

FIGURE 6
Warehouse and industrial yields



Source: Knight Frank

Investment market

Investment volumes in the distribution sector surged in the second half of 2013. H2 2013 saw £2.9bn of assets change hands, up 64% on H1 2013 and its highest half-yearly total since H2 2006 (Figure 4). Transactional activity is also expected to remain buoyant in 2014, driven by an ongoing pressure to spend among the UK Funds, together with healthy interest for single-let distribution among overseas investors from the Middle East and Far East.

While strong demand is apparent for each of the main commercial property sectors, the fundamentals relating to UK distribution provide a key added draw for investors. The sector is under-supplied from the occupier perspective while it also stands to benefit in the long term from the steady growth of e-commerce.

This positive story is reflected in IPF's latest consensus forecast, which places Industrial as the lead performing UK sector over the medium term, with average annual total returns of 9.0% p.a. to 2017. With supply tight, this positive outlook is partly driven by expectations of headline rental growth returning to the sector. According to IPD, Industrial annual rental growth turned positive from August 2013, having been in negative territory for over five years (Figure 5).

The sheer weight of money in the market brought about significant price increases in 2013. Yields for prime, single-let distribution (20-year income with fixed RPI uplifts) hardened by 100 basis points during 2013 to end the year at c.5.00%, with prices discounted to 5.50% for 15-year income. Prices also increased sharply in the multi-let sector during the second half of 2013, with yields for prime South East multi-let estates hardening by 50bps during H2 to stand at c.5.75% at the year-end (Figure 6).

With little sign of investment demand abating, yields for prime assets are expected to harden by a further 25bps at the prime end of the market. However, a key recent trend has been investors' increased appetite for risk, a theme that will continue throughout 2014. In search of higher yield, H2 saw a revival of investment interest in regional multi-let estates and single-let distribution offering circa five year income.

Moving forward, rising capital values combined with indications of a return to rental growth bode well for the development of new distribution stock. The scarcity of supply and associated rise in rental values is likely to stimulate design and build activity, thereby increasing the amount of prime investment product in the market.

Selected warehouse / logistics transactions in H2 2013

Property	Vendor/Purchaser	Price	NIY	Date
PT Portfolio, west London (six multi-let estates)	Hermes REIM / Orchard Street IM	£96.0m	6.50%	Nov-13
M&S East Midlands Distribution Centre, Castle Donington	Apirose / Tritax Big Box REIT	£82.4m	5.20%	Dec-13
Magna Park, Milton Keynes	Gazeley / Lime Property Fund	£74.2m	4.90%	Aug-13
Isis Reach, Belvedere, London	F&C REIT / M&G Property	£48.4m	5.85%	Oct-13
Proteus Portfolio (four mulit-let estates)	CBRE Global Investors / Threadneedle	£23.0m	7.69%	Sep-13
Zenith Industrial Estate, Basildon	The Crown Estate / Cordea Savills	£18.8m	6.05%	Dec-13

Source: Knight Frank

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