UK Logistics Market.

OUTLOOK 2021

EXPECTATIONS FOR THE YEAR AHEAD

Ecommerce

Ecommerce will continue to drive demand for distribution and logistics space with businesses bringing forward their B2C growth plans

Post-Brexit

Retailers, distribution firms and manufacturers will be modifying supply chains and optimising cross-border distribution as they adapt to new regulations post-Brexit

Development Activity

Increasing development activity – low levels of availability and strong occupier demand will encourage both build-to-suit and speculative development

Rental Growth

Competition for assets will drive rental growth, particularly in urban areas and for well-located units offering good levels of specification

Investor Appetite

Investor appetite for the sector is expected to continue, keeping pressure on yields

ONLINE RETAIL CONTINUES TO DRIVE DEMAND

Growth of the e-commerce market was a major driver of demand for warehousing space in 2020 and this is expected to continue through 2021, as retailers and distribution firms seek to expand their online and home delivery capacity and capture a share of the growing online retail market.

Take-up of warehousing space exceeded 50m sq ft in 2020 (compared to 34m sq ft in 2019); driven mainly by retailers and distribution companies, who together accounted for 87% of take up (units 100,000 sq ft +).

"While 2020 was a year for rapid upscaling, in 2021, demand will be driven more by long term strategic planning as retailers pivot their business models towards higher demand for online retail"

In 2020, online sales accounted for 27.9% of total retail sales. With non-essential shops closed, online retail penetration rates reached a record 36.3% in January 2021.

As shops reopen, online penetrations rates will decrease but the pandemic served to accelerate the adoption of online platforms. Post-pandemic, the internet will play a larger role in the retail market. Retailers that have not yet embraced omni-channel retail will need to do so and this will lead to structural changes in their supply chains. John Lewis Partnership expect 60-70% of their sales to be online by 2025 (compared with c.40% pre-pandemic).

27.9%

of **retail sales** were **online** in 2020
Source: ONS

"Knight Frank analysis shows that every £ billion of online sales requires approximately 1.36 million sq ft of warehouse space"

"Online sales rose £34 billion in 2020 and is expected to grow a further £41 billion over the next four years, exceeding £150 billion by 2024. The growth of this market will drive additional space requirements"

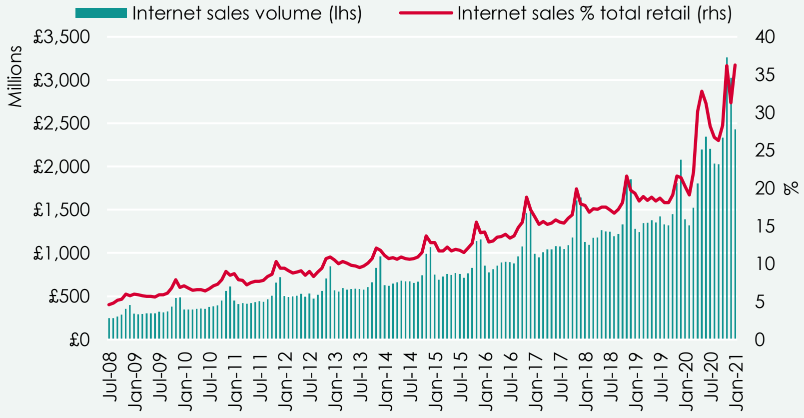
While pure-play online retailers will require additional space to service rising online demand, omni-channel retailers may switch existing space currently supplying their store network, to servicing ecommerce B2C demand and make better use of their store networks to distribute internet retail sales.

The robust forecast for online retail and competition, particularly for well-located assets, is likely to drive positive momentum for the logistics market.

87%

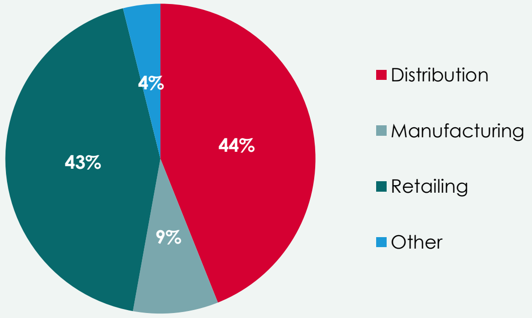
take-up by **retailers and distribution companies** in 2020
Source: Knight Frank, PMA

UK Internet Retail Sales (monthly)



Source: Knight Frank, ONS

Take up by occupier type 2020 (units over 100,000 sq. ft.)



Source: Knight Frank, PMA

NAVIGATING THE POST-BREXIT TERRAIN

- Tightening origin of goods regulations will mean UK industries may need to reshore or nearshore some of their supply chains. UK manufacturers will have to reduce their dependence on components manufactured outside of the region.
- Businesses re-exporting goods will look to customs warehouses to reduce the impact of duty liabilities on their cash flow. This will mean increased demand for logistics and warehousing located close to port locations.
- Warehouse recruitment will become more challenging. Logistics operators will increasingly look to gain efficiencies through automation and mechanisation where possible.

25%

of **staff** working in warehouses in the UK are **EU nationals** (2018)
Source: CBI

Retailers and manufacturing firms now have clarity on the regulations and requirements for trading, tariff-free with EU. In 2021, we will see them adjusting their supply chains and distribution networks to minimise the impact on sales, profits and cash flow.

The UK-EU trade deal (the Trade and Cooperation Agreement, or TCA) means that tariffs have, for the most part, been avoided on goods crossing the border. However, new regulations mean additional paperwork, declarations and checks. These measures mean that cross-border trade will be subject to potential delays and there will be additional compliance costs for businesses.

Industries with long supply chains, just in time inventory management, time-sensitive products and significant industry regulations (such as automotive, aerospace and chemicals), will face disruption as they navigate the new post-Brexit terrain.

> **"There may be a requirement to bring back products destined for the UK market to a warehouse within our domestic borders, or establish a new facility"**

RULES OF ORIGIN

The new "rules of origin" regulations mean that UK industries may need to reshore or nearshore some of their supply chains. UK manufacturers will have to reduce their dependence on components manufactured in Asia. This is particularly important for the automotive sector and battery power for electric vehicles.

A British retailer importing goods for UK stores and then distributing them to branches located in the EU could now face tariffs for re-exporting, depending on where the goods or component parts were manufactured. Goods from outside of the EU or UK are now subject to tariffs (with the exception of duty-free imports) and the rules of origin vary by product.

CUSTOMS WAREHOUSES

The use of customs warehouses (or bonded warehouses), are one way that retailers or 3PLs can facilitate the storage, consolidation and processing of goods imported from outside of the EU, without payment of import duty or VAT, before the goods are re-exported. Businesses re-exporting goods may look to customs warehouses to reduce the impact of duty liabilities on cash flow.

As bonded warehouses are often concerned with re-exporting of goods, they are often located close to international trade ports. In 2021, we expect to see increased demand for logistics and warehousing located close to port locations.

ATTRACTING TALENT

With heavy reliance on EU workers, warehouse operators in the UK may face issues with recruitment due to the new immigration regulations for EU nationals.

According to the CBI, 25% of staff working in warehouses in the UK are (non-UK) EU nationals (2018).

Warehouse and logistics operators may need to look at ways of attracting talent post-Brexit, this will become even more critical as the economy recovers post-COVID and unemployment rates fall. Developers and occupiers need to focus on ways to improve the working environment in warehouses, with high quality facilities that offer better staff facilities and amenities, and features such as air filtration, natural light, and enhanced transport connections.

The number of jobs created in the sector has risen year-on-year. Even before Brexit, the sector faced challenges in attracting and retaining staff and with the labour pool set to shrink further, companies must look at ways to enhance their recruitment prospects or increase their operational efficiencies through the adoption of mechanisation and automation and thus reduce their workforce requirements. Increased adoption of automation will have an impact on occupier requirements, particularly in terms of eaves height and adequate power.

RISING DEVELOPMENT ACTIVITY

“We expect to see a supply-side response in 2021”

Supply is currently tight. Across the UK, there is around 46m sq ft of warehousing space available (in units over 50,000 sq ft). With take-up of 52 million sq ft in 2020, that represents roughly 10.5 months of supply. However, most of that space is in second-hand units that may not be the right specification or in the right location.

Due to robust levels of take-up, the level of availability, particularly of high quality space, has diminished over the course of 2020. Many of the occupier requirements logged in 2020 have not yet been satisfied and a lack of options is likely to encourage higher levels of both build-to-suit and speculative development.

There has been a blip in supply due to COVID. Between April and September 2020, there was a significant drop in the number of planning consents granted as well as the number of development starts. However, there was an uptick in the fourth quarter, with planning consents on a par with the fourth quarter of 2019, though development starts remained down year-on-year.

8.5m sq ft

of speculative development

under construction at the end of 2020

Source: Knight Frank

URBAN LOGISTICS & CONVERSIONS

Ecommerce is a key driver of demand for space at present. Units currently available may not offer the right space, or be in the right locations to support the growth of online sales and B2C deliveries. Particularly in urban areas, the availability of land or suitable sites remains the key constraint on supply.

While large centralised fulfilment centres can incorporate higher levels of automation and greater efficiencies of scale, same day deliveries or even shorter time frames are only possible if inventory is brought close to the consumer. This often means competing with other property uses, such residential or retail.

Over the past few years, we have seen some instances of retail assets being converted to logistics uses. Constrained availability of sites in urban areas means this trend is likely to continue into 2021, as well as co-locating warehouses with other use classes such as residential development.

There are barriers to co-location and conversions however, existing structures may be difficult to reconfigure and there may be restrictions on operating hours or size of vehicles and conversions can face opposition from residents and planning authorities.

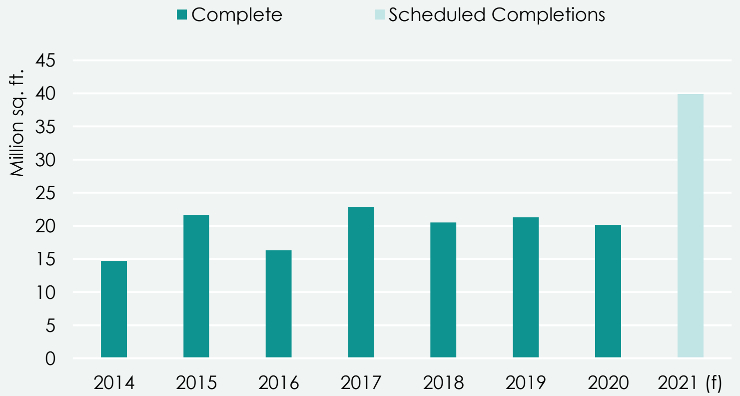
While high street and shopping centres are typically not suitable for conversion, due to restricted access routes and poorly suited structures, retail warehouse parks are better candidates. Prologis purchased Ravenside Retail Park in Edmonton, north London with plans to convert it into warehouses for online retailers.

PLANNING DEREGULATION

The new Class E was introduced into the Use Classes Order in 2020, taking effect in September 2020. Forming a new, amalgamated commercial property use class. This new combined single class, meaning that shops, restaurants, offices and industrial buildings, for example, are all able to convert into other Class E uses without restriction.

This may facilitate the conversion of redundant retail space to be converted into micro-warehouses and drive the growth of new urban fulfilment models. However, despite the increased flexibility, it is not clear exactly how such conversions could play out, for example planning authorities may interpret an intensification of noise and vehicle movements as an effective change of use.

Development completions (units over 50,000 sq. ft.)



Source: Knight Frank, Glenigan

DEMAND WILL DRIVE RENTAL GROWTH

“Competition for space will continue in 2021, which will drive rental growth as well as longer lease lengths”

Rental growth is expected to accelerate over the next few years, with high growth forecast for well-located assets. However, forecast rental growth is not expected to match the rate of growth recorded over the past 3-4 years.

As the economy recovers and grows over the next four years, rental growth is forecast to accelerate. The strongest rental growth is expected in London, followed by the South East and Eastern regions. Growth in ecommerce is driving demand for urban logistics assets. Across the UK, urban locations are expected to outperform the regional average.

Air, sea and rail port locations are expected to develop more importance as logistics locations post-Brexit. UK supply chains are likely to become increasingly domestic in focus, with an increased reliance on UK ports. Rising demand at ports may also drive stronger rental growth at these locations.

The first eight Freeport locations announced by the Chancellor in the March 2021 Budget will also stimulate investment and boost both demand and supply of logistics facilities at these locations, with simplified planning process, cheaper customs and tax breaks. This is likely to boost rental growth in these locations.

Prime rents have risen across several regions in 2020. Prime rents in London and the South East are the highest, with prime rents for large, 50,000 sq ft plus units at £20.00 per sq ft, and prime rents for smaller (under 20,000 sq ft) units now reaching £23.00 per sq ft.

Average rents have also risen across all regions of the UK in 2020. The largest growth in average rents was recorded in London, the South East and Eastern regions. Average rents rose 2.9% in the South East region and 3.7% in London (2020). Prime rents have been increasing faster than average or secondary rents over the past year.

Further business insolvencies are expected which will bring second-hand grade-B space back to the market. While quality second-hand units may compete with new speculative schemes, second-hand grade-B stock is less able to contend. This will drive up void rates and occupier incentives and there is likely to be further increase in the spread between prime and secondary rents.

3.2%

UK average annual **rental growth** recorded in **2020**

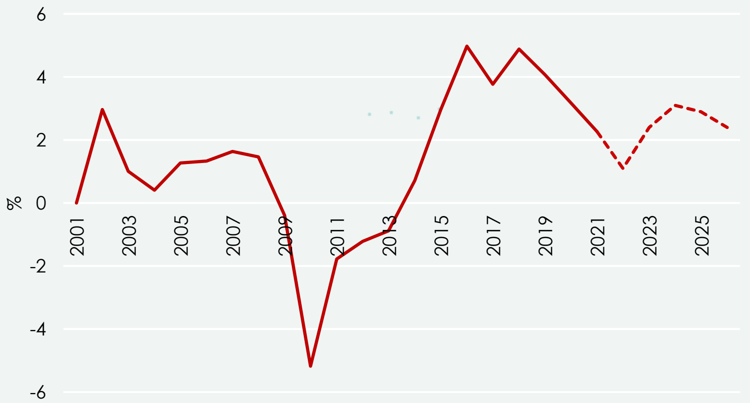
Source: MSCI

2.4%

UK average annual **rental growth** forecast **2021-2025**

Source: RealFor

UK Industrial – Average annual rental growth



Source: Knight Frank, MSCI, RealFor

Average annual rental growth by region (2021-2025)

Source: Knight Frank, RealFor

INVESTORS INCREASING ALLOCATIONS TO LOGISTICS

- Returns for UK industrial and logistics are forecast to outpace those on offer in other real estate sectors and investors are eager to increase their allocations to the sector.
- UK funds have more than doubled their allocations over the past 8 years, from 16% at the end of 2012, to 33% at the end of 2020 (Source: MSCI/ AREF).

"Appetite for the sector remains strong amongst investors, particularly those seeking secure long incomes"

The structural shift towards online retail and favourable occupier market dynamics is encouraging investment into the sector. Investment into UK industrial and logistics totalled £9.3 billion in 2020, up from £7.7 billion in 2019.

Institutional investors are increasing their exposure and allocations to the logistics sector. UK funds have more than doubled their allocations over the past 8 years, from 16% at the end of 2012, to 33% at the end of 2020 (Source: MSCI/ AREF).

The main constraint for investment volumes in 2021 will be supply. Returns for logistics have been outpacing other sectors and other asset classes and investors may be reluctant to sell and the rise in investor – developer partnerships has meant that stock that would have been traded on by developers, is no longer being offered up to the market.

Sale and leaseback transactions have been an important aspect in driving investment volumes since the COVID crisis hit. With businesses seeking to liquidate real estate assets in order to help them survive, or to finance business expansion or redirection plans. This is likely to continue in 2021, with companies looking to unlock capital, particularly as Brexit may necessitate changes to their supply chains.

PORTFOLIO TRANSACTIONS

Portfolios have also been an important part of the investment market of late. They are a convenient way for investors to rapidly achieve scale, deploying large amounts of capital into their sector of choice, through a single transaction. Through bundling assets and increasing the transaction lot size, industrial assets can offer the scale required by institutional investors.

Part of the appeal of portfolios is their relatively attractive risk profile. Grouped assets in a portfolio often have a larger number of tenants, thus spreading the risk of vacancy.

With strong demand from institutional investors, we expect to see further portfolio transactions through 2021.

7.0%

Average annual **total returns forecast (2021-2025)**

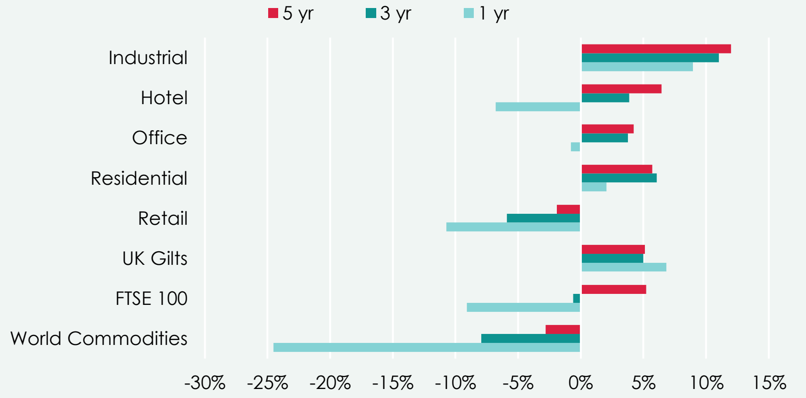
Source: RealFor

RETURNS

The robust returns seen in the industrial and logistics sector have been attracting real estate investment. Returns for UK industrial and logistics are forecast to outpace those on offer in other real estate sectors. Total returns for industrial and logistics are forecast to remain strong over the next five years, expected to average c.7% per annum (2021-2025).

In the second half of 2020, prime yields compressed to just 3.5% (for prime assets offering 20-year income). Demand for high-quality, well-located warehousing as well as a growing need for build-to-suit property, means that prime yields are likely to remain low for the foreseeable future.

Annualized total returns by asset class (to Dec 2020)



Source: Knight Frank, Macrobond, MSCI

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