

# **UK Logistics Market.** **OUTLOOK 2022**



# EXPECTATIONS FOR THE YEAR AHEAD



## Urban logistics market evolution

Ecommerce and evolving consumer demands coupled with intense competition for space will drive evolution in the urban logistics market



## Inflationary pressures for developers

Inflationary pressures and materials shortages will continue to impact on developers this year



## Occupiers face rising costs

Rising occupancy costs and limited supply of labour will lead to changing occupier strategies in terms of location and specification of facilities



## Rental growth to drive returns

Investors are looking to rental growth to drive returns. The supply / demand dynamics in the occupier market support prospects for further rental growth this year



## Investor Opportunities

Geopolitical uncertainties will mean continued demand for long-income assets. Mid-length leases could offer a favourable risk-return profile in 2022



## Sustainability & Resilience

With prime yields now at c.3%, investors are mindful to protect their exit values in the face of rising sustainability criteria

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# EVOLVING URBAN LOGISTICS MARKETS



- Demand for last-mile logistics to continue as retailers and distributors expand and refine their networks. The changing occupier and investor base is shifting occupier requirements.
- Supply constraints continue to put pressure on rents and will increase the need to use land and warehouse space more intensively.

## CONTINUED DEMAND FOR LAST MILE

In our 'Future Gazing' research, we analysed the distribution networks for online retailers that tend to operate a hub-and-spoke model and found that they typically allocate 20-25% of their total warehouse footprint to last mile or spoke facilities. Our analysis shows that each additional billion pounds of online retail sales requires 320,000 sq ft space in last mile or spoke facilities.

Over the past two years, online sales rose by £45 billion, and further growth is anticipated, with annual online sales expected to increase by a further £31bn by 2026. This could drive further requirements of c.10m sq ft of last-mile fulfilment space over the next five years.

## Q-COMMERCE DEMAND TO CONTINUE AND EVOLVE

We anticipate further demand from the q-commerce, or on-demand delivery sector. The rapid growth in this segment of the e-commerce market has driven up competition and rents in highly urban locations, where the availability of space is highly constrained.

Expansion of the 'dark supermarkets' has slowed as the main players near their current targets and consolidation in the market has started to take place, with Getir acquiring Weezy and GoPuff acquiring Diya and Fancy. However, the consumer adoption of q-commerce is likely to see further growth, and players in this arena continue to drive fierce competition for suitable units.

Operators in this market tend to run lean operations, often partnering with a larger retailer to take advantage of their supplier base and logistics infrastructure. As the market matures, we expect operators in this market to focus efforts on improving their margins, this will necessitate dealing directly with suppliers, growing their logistics operations, and taking additional, larger facilities to act as distribution hubs.

We saw this with Getir acquiring three units totalling 110,925 sq ft at the newly completed Waltham X development in Waltham Cross, London. This was a significant departure from their typical MO; targeting units sub-10,000 sq ft to function as dark stores. The Waltham X site benefits from close proximity to major roadways, including the M25 and M11. They are expected to utilise these facilities as distribution hubs from which to restock their dark store network.

## CHANGING OCCUPIER PROFILE AND REQUIREMENTS

Changing occupier profiles are being driven by the rise in e-commerce coupled with rising rents and land values. Increased competition in the urban logistics markets is pushing up pricing and some long-standing owner-occupiers and traditional occupier groups are reassessing their location choices. Some owner-occupiers will be taking the opportunity to realise the strong capital growth recorded over the past few years and tenants approaching lease expiries will be evaluating whether their business can or should absorb the rent increases or relocate.

Increasing emissions regulations may be another factor driving some relocation choices. Last year saw London expand the ULEZ (Ultra Low Emissions Zone) and other UK cities are set to introduce or expand emissions regulations over the coming years. These measures will impact many SMEs that currently operate older, more polluting fleet vehicles.

As the users (and ownership) of urban logistics space evolves, as too will the way the space is utilised and the requirements in terms of specification and facilities. Emissions regulations, traffic congestion, and an increasing number of more sustainably-minded delivery firms are driving increased requirements for bicycle parking and EV charging facilities. As the ownership base shifts, away from private or SME ownership, towards more institutional investors, ESG criteria and institutional building standards will become more important.

**320k sq ft**   
in last mile facilities is required per  
£ billion of online retail sales

Source: Knight Frank Research

## LAND-USE INTENSIFICATION & CO-LOCATION

Historically industrial land has been undervalued and eroded, large swathes have been converted to other uses, often residential. London has lost 24% of its industrial floorspace over the past twenty years, and Manchester 20% (Centre for London).

The lack of industrial land means that operators will need to come up with creative solutions, there is a need to use space more efficiently and policymakers and developers are pursuing policies of intensification and co-location.

Multi-storey logistics facilities are one way of intensifying the use of industrial land but such facilities are expensive to build. Higher site density is also favoured by planners but this is not always practical for operators, parcel carriers, for example, tend to require low site density ratios. Co-location also poses problems and often comes with restrictions in terms of the types of operations, vehicle movements, and operating hours to appease neighbours.

**-24%**   
of London's industrial  
floorspace lost over the past 20 years

Source: Centre for London

# INFLATIONARY PRESSURES FOR DEVELOPERS



- **Industrial land values have risen 42% across the UK over the past year and doubled in the past two and a half years. Pressure on land pricing is set to continue in 2022.**
- **We expect inflationary pressures for construction materials to persist. The war in Ukraine is likely to push up costs and delivery times, with overland Asia-Europe trade routes disrupted and elevated costs for alternatives.**

## 42%

### UK industrial land value growth recorded in 2021

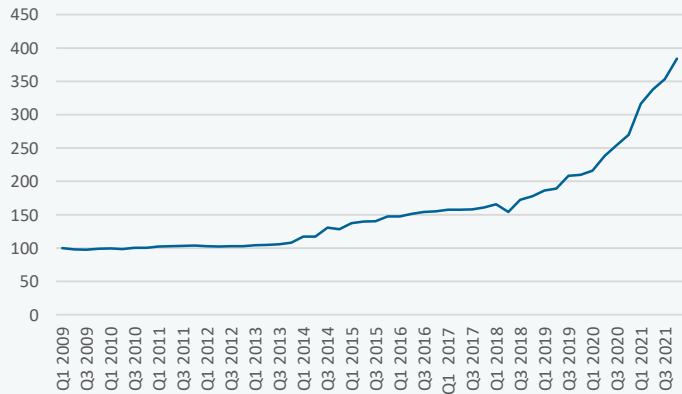
Source: Knight Frank Research

## ISING LAND VALUES

Our UK land values index shows land values have risen 42% over the past year (based on data collected quarterly for c.35 markets), from an average of £1.3 million in Q4 2020 to an average of £1.8 million per acre in Q4 2021. Over the past two and a half years, UK industrial land values have more than doubled (Q2 2019 – Q4 2021).

We expect further growth in land values in 2022.

UK Industrial Land Value Index (Q1 2009 = 100)



Source: Knight Frank Research

## MATERIALS & LABOUR COSTS REMAIN ELEVATED

Construction materials have been in short supply over the past year, with long lead time impacting on build schedules. Supply chain issues were beginning to show signs of easing in early 2022. However, the Russian attack on Ukraine is likely to push up costs and delivery times for construction materials, with Asia-Europe trade via the New Silk Road likely to be disrupted. Though there were signs of price stabilisation in early 2022, we expect inflationary pressures to persist with bottlenecks and elevated costs for shipping and air freight.

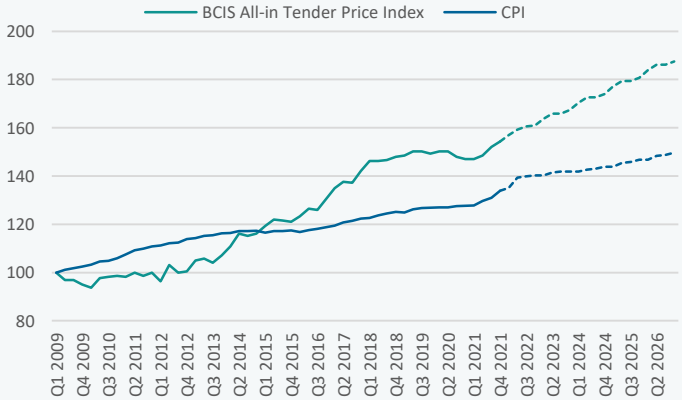
In addition to land values, building materials and labour costs have risen over the past year. The BCIS Materials Cost Index shows that prices have risen 20% over the last year. Structural steel prices have risen a massive 59% y/y (BEIS). However, Oxford Economics is now forecasting the cost of steel will fall by 28% in 2022.

Labour shortages and wage pressures are also impacting build costs and tender pricing. Tender pricing rose 4.9% during 2021 and is expected to rise 4.4% in 2022 (BCIS). It is expected to continue outpacing the rate of inflation over the next five years. This will impact the cost of bringing developments to practical completion.

## ISING FUEL COSTS

The price of diesel has increased significantly and prices are expected to rise further in 2022. The removal of the Red Diesel Rebate from April 2022 will have an effect on the cost of running on-site construction plant. Although Red Diesel only represents a small proportion of the BCIS General Building Cost Index, it will put upward pressure on tender pricing.

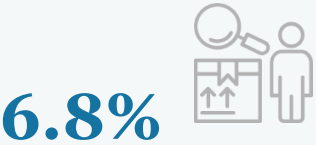
Tender Pricing and inflation (Q1 2009 = 100)



Source: BCIS, Macrobond

# RISING OCCUPANCY COSTS AND LIMITED LABOUR

- As the cost of renting warehousing space rises, space optimisation will be of heightened importance, operators will look to improve how efficiently they use space.
- Operators will need to look more strategically at locations where they can tap into an available labour pool. We foresee the geography of the logistics market widening as labour availability rises up the agenda for occupiers.



Annual wage growth for a warehouse operative

Source: Adzuna

## RENTAL GROWTH

We anticipate sustained rental growth in 2022. Rents have been rising across the country, average rents across the UK rose around 8.9% in 2021, and some markets have seen double-digit growth over the past year. The shortage of space coupled with limited supply is driving competition and rental growth. In London, prime rents have risen 25% (units over 50,000 sq ft) in 2021 and smaller units have recorded even stronger growth, with prime rents for units sub-20,000 sq ft rising 56% over the year.

Rental growth is expected to average 6.7% in 2022, across the UK. In the same pattern as last year, the strongest growth is anticipated in London, the South East, and Eastern regions.

As tenants face rising rents, smaller businesses and those operating on very lean margins will feel the impact most. However, for large operators, rent is a relatively small part of their cost base. That said, for operators looking to move or expand, space optimisation will be of heightened importance, given the higher costs. They may look to make greater use of the height, through the installation of mezzanine levels or implement automation technologies that can help improve the utilization of space.



Average annual rental growth forecast (2022-2026)

Source: RealFor

## LABOUR

The tightening of the labour market and upward pressure on wages is a more significant factor in driving up operational costs.

The average warehouse operative salary is £22,646, having risen 6.8% year-on-year, compared to an annual change of -6.4% for all jobs (Adzuna). With retailers and distribution firms expanding their online retail and home delivery networks, the demand for warehouse workers has risen. Vacancies are highest in the Midlands, though the South East, East, and South West also have high numbers of job vacancies.

As the most established markets face dwindling labour pools, labour availability will be a key factor driving growth outside these locations. Operators will need to look more strategically at locations where they can tap into an available labour pool and this will mean venturing further from the established markets where competition for labour is fierce.

We foresee the geography of the logistics market widening as labour availability rises up the agenda for occupiers.

## MITIGATING SUPPLY CHAIN RISKS

Supply chain risks remain present. While the risks from Covid wane, new risks are present on the horizon. The Russian invasion of Ukraine poses a new threat to commodity supplies and pricing and will have a ripple effect across global manufacturing and supply chains in 2022. Firms will continue to look at ways to broaden their supplier base and hold additional stock to protect their order books.

Supply disruptions will trigger price increases for manufacturers and will impact various sectors, including aerospace and automotive as well as the production of semiconductors, batteries, and some medicines.

## COST OF ENERGY & TRANSPORTATION

Energy and transportation costs will continue to rise and this will have a significant impact on operating costs for manufacturers and distribution firms. The pricing of container rates, especially those servicing transpacific routes, is expected to continue rising, this, along with rising fuel prices is putting upward pressure on occupiers' transportation costs.

In 2021, energy prices were rising rapidly and the war in Ukraine will put additional pressures on energy and fuel prices. This may prompt faster adoption of green, onsite energy production.

## BUSINESS RATES REVALUATION

The next Business Rates Revaluation comes into effect on 1st April 2023 and will result in changes in rates payable across England, Scotland, and Wales. It is 6 years since the last revaluation took place. For England and Wales, the revaluation is based on rental values at 1st April 2021 when the markets were subject to significant turbulence. For Scotland, the revaluation is to be based on rental values as at 1st April 2022. The aim is to redistribute the tax base to reflect changes in rental values.

The rental growth between the two valuation dates will determine the uplift in business rates payable, and with strong rental growth recorded over the period, the impact could be significant, though the impact will be felt differently across different markets. Across the UK as a whole, prime rents rose an average of 29.9% (units over 50,000 sq ft) since the last revaluation date.

The Knight Frank Business Rates team has compiled rental growth data across 10 regional sub-markets to assess the impacts, with projected rates following the revaluation in 2023/24.



# INVESTORS LOOK TO INCOME TO DRIVE RETURNS



- UK funds continue to up their allocations, with 39.7% of the UK All Balanced Property fund index invested in the sector in Q4 2021, compared with 33.2% in Q4 2020 and just 16.4% nine years ago (MSCI/AREF).
- The outlook for rental growth is positive, and rental growth for industrial is expected to outpace those in the retail and office sectors over the next five years.



**39.7%**  
**UK All Balanced Property Fund Index** invested in logistics & industrial in Q4 2021  
 Source: MSCI, AREF

## HOW LOW CAN THEY GO?

Prospects for generating returns from yield compression are diminishing.

There has been a structural driven yield compression witnessed in the sector over the past ten years. A confluence of macro trends, which include the growth of e-commerce, globalisation of trade, technological advancements and the drive for supply-chain optimisation has led to a structural increase in demand for logistics along with higher levels of capital expenditure and improvements in terms of the quality of the underlying assets.

Prime distribution assets offering 15-year income with open market rent reviews are yielding 3.50-3.75%, down from 4.00% a year ago. Yields for prime distribution providing 20-year income (with fixed uplifts or indexation) are now just 3.00%, down from 3.50% a year ago.

Competition for secondary assets has led to yields narrowing over the past year, secondary distribution yields are now 4.00% having recorded 50bps compression over the past year and secondary estates have come in 75bps to 5.00%.

Yields for prime warehouse and logistics properties are expected to remain broadly flat over the next few years. UK gilt yields (10-year government bonds), on the other hand, are on the rise, they are currently around 1.5%, up from 1.0% at the end of 2021, and forecast to reach 2% by the end of 2023 (Source: Oxford Economics). However, a protracted Russian war could lead to bond yields rising faster.

The spread between prime logistics yields (15-yr income) and bond yields has narrowed from 356bps at the end of 2020 to 218bps (end of February) and is likely to narrow further as bond yields rise. Despite this narrowing risk premium, the appeal of logistics property will continue to be driven by strong sector fundamentals.

## INVESTORS BUY IN TO THE RENTAL GROWTH STORY

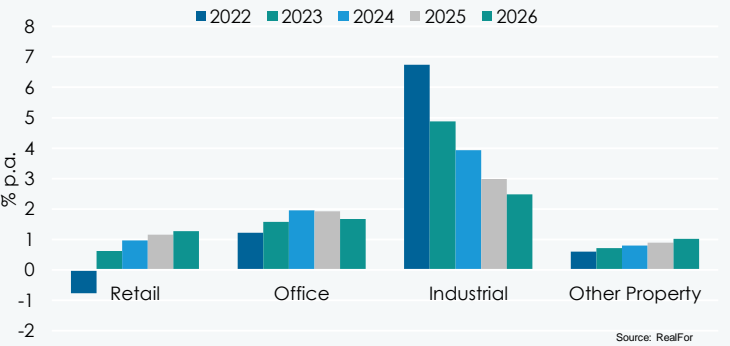
Despite ongoing geopolitical turbulence impacting near-term horizons, the sector's strong occupier market fundamentals are anticipated to persist and it is these market dynamics and the continued structural shift towards higher levels of online spend, that are underpinning investors' rental growth expectations.

The outlook for rental growth is positive, and rental growth for industrial is expected to outpace those in the retail and office sectors over the next five years. Industrial rents are expected to rise an average of 4.2% per annum over the next five years, compared with 1.7% per annum for offices and 0.6% per annum for retail.

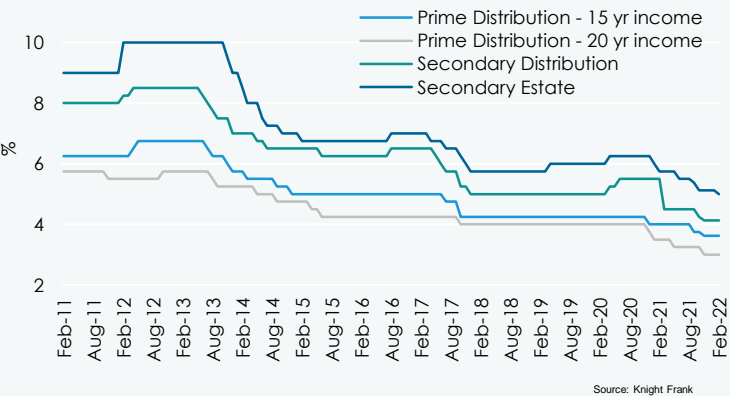
Investors want to increase their exposure to the sector. UK funds continue to up their allocations, with 39.7% of the UK All Balanced Property fund index invested in the sector in Q4 2021, compared with 33.2% in Q4 2020 and just 16.4% nine years ago (MSCI/AREF). UK logistics property funds have been, and continue to trade at a premium to NAV (net asset value) and recent equity issuances have been oversubscribed. With more capital targeting the sector, competition for assets is strong.

Alongside the UK funds, US private equity firms are also increasing their exposure to the UK logistics market, with a series of notable investments recorded over the past few years. Investors with experience in the US market can see the potential for further rental growth in the UK. The US market has demonstrated exceptionally strong rental growth over the past couple of years, with some markets recording in excess of 20% growth – outpacing recent growth in the UK markets. Supply constraints, limited land availability, and robust occupier market fundamentals provide conviction that there is further rental growth to come in the UK and that this will drive future returns.

## Average rental growth forecast by sector



## Industrial yields



# THE LONG AND THE SHORT OF IT



- We expect to see investors continue to target long-income opportunities in 2022, particularly as risk and uncertainty rise for the short to medium-term horizons.
- Assets with mid-length unexpired lease terms may indeed offer the most attractive risk-return profile for investors. Over the 10, 5, 3, and 2-year horizons, assets with mid-length unexpired lease terms outperformed.

## SHORT LEASES, VACANCIES, AND INSOLVENCIES – RISK OR OPPORTUNITY?

Investors want to increase their exposure to the logistics sector, and some are looking to drive returns through rental growth via new lettings, re-gears and rent reviews.

Shorter lease lengths and the potential to boost returns on the back of strong market rental growth piqued investor interest in 2020 driving down yields. Assets and portfolios with unexpired lease terms under three years recorded strong yield compression between 2019-2020, from 6.9% to 6.0% and below the average yields for transactions with longer WAULTs (weighted average unexpired lease terms) of 3-7 years.

The Covid rent moratorium is due to end in March 2022 and given the strong rental growth over the past couple of years, landlords or investors may see assets or portfolios with so-called zombie tenants as an opportunity, with the ability to secure vacant possession and thus realise the growth in market rents through a new letting.

## PLAYING THE LONG GAME

Not all investors are looking to drive returns through active management, however. Uncertainty plays positively to less volatile, long-lease strategies. Through previous market downturns, longer income assets outperform, with secure income profiles providing greater capital stability.

The war in Ukraine and geo-political instabilities are prompting investors to reassess their exposure to risk. With volatility on the rise in 2022, investors will increasingly look to long-income strategies, that offer stable income and a potential hedge against rising inflation and other volatility-triggering events.

The strongest yield compression over the past year has been recorded for transactions with a WAULT (weighted average unexpired lease term) of twenty years or more, with average yields in 2021/22 101bps below where they were in 2020.

Many of these long-lease acquisitions have been through sale-and-leaseback deals. For owner-occupiers offering strong covenant, this can offer an attractive funding option with the strength of their covenant key to driving price. The owner-occupier will remain as a tenant, typically paying inflation-linked rent over a 20 to 25-year period. These offerings have proved popular with liability-matching long income investors such as pension funds.

We expect to see investors continue to target long-income opportunities in 2022, particularly as risk and uncertainty rise for the short to medium-term horizons.

## MIDFIELD OPPORTUNITIES?

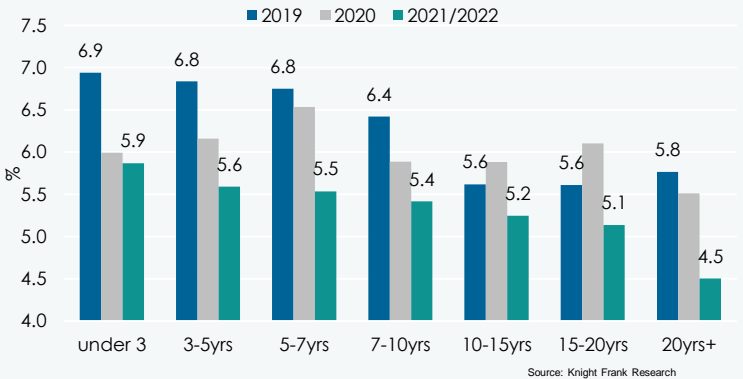
In terms of industrial assets and lease length, leases between 10-20 years have recorded the least yield compression over the past two years. Average yields compressed just 37bps for transactions with 10-15yr WAULTs and 48bps for those with 15-20yr WAULTs. This may be due to a polarisation in terms of investment strategies, with strong competition amongst both the value-add investors and long-income strategies.

Industrial total returns segmented by remaining lease length, demonstrate strong returns for assets with mid-length unexpired lease terms across previous cycles. Over the 10, 5, 3, and 2-year horizons, assets with mid-length unexpired leases (lower-upper quartile range) outperformed those with shorter or longer ones.

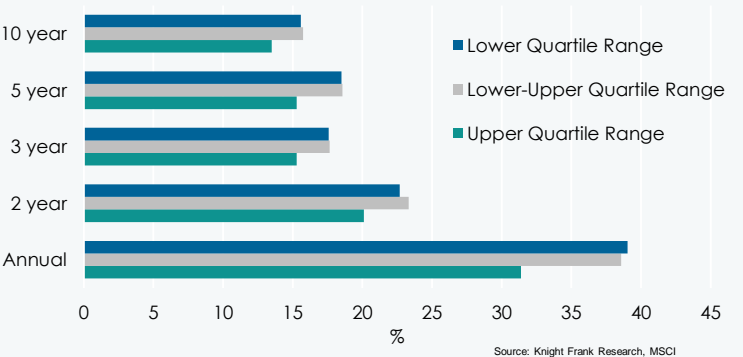
Assets with mid-length lease maturities may indeed offer the most attractive risk-return profile for investors in 2022.

Just **37bps** %  
Average yield compression for  
transactions with 10-15 year WAULT  
2019-2021/22 ytd  
Source: Knight Frank Research

## Average yields by WAULT (%)



## Total returns by remaining lease length (incl. breaks) Annualised



# SUSTAINABILITY & RESILIENCE TO THE FORE



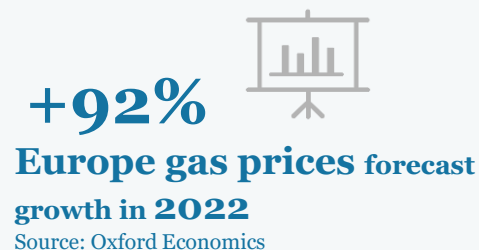
- **Onsite energy generation and storage will become increasingly important to operators, as will electric vehicle charging facilities. Operators will increasingly look for these features when securing a facility.**
- **With prime yields now at c.3%, investors are mindful to protect their exit values. Sustainability standards are rising bringing greater risk of obsolescence, thus protecting exit values is becoming more and more important.**

## ENERGY CRISIS FUELING THE NEED FOR GREEN ENERGY

The need to improve operational resilience and mitigate against rising energy costs means greater self-reliance in terms of generating energy and this may prove critical to profitability. Onsite energy generation and storage will become increasingly important to operators, as will electric vehicle charging facilities. Operators will increasingly look for these features when securing a facility.

Energy security is becoming increasingly important, for government, households and for businesses. Warehouses and logistics operations can be very energy-intensive, with heating/cooling requirements for large buildings, plant and automation equipment, and transport and delivery costs associated with freight and fleet.

The cost of energy has increased significantly throughout the end of 2021 and into 2022. The current geopolitical tensions threaten to fuel further price growth throughout the rest of 2022. Oxford Economics forecast world energy prices to increase 33% in 2022, following a 120% increase in 2021. Gas prices in Europe have risen sharply in recent months and are expected to rise 92% this year. Meanwhile, oil prices are expected to rise 42% in 2022, following 69% growth last year (2021).



## A LONGER-TERM VIEW ON SUSTAINABILITY

Acquisition decisions and development designs are increasingly being made with future sustainability requirements in mind. With prime yields now at c.3%, investors are mindful of the need to protect their exit values. Sustainability standards for investors, operators and policymakers are becoming increasingly stringent, heightening the risk of obsolescence, thus protecting exit values through improved sustainability is becoming more and more important.

Investor-developer partnerships are not new. However, it is this arrangement that encourages a longer-term view of an asset early on in the design and specification of a development. Investors who are looking to acquire assets at lower prices are achieving this by taking on some of the development risk and accessing development profit. These partnerships mean that assets that would have been traded, from developer to investor are no longer changing hands. Few developers are building with a view to trade the asset on an investment basis, and there are currently very few investors buying with a view to trade on.

## ACCESS TO GREEN FINANCE

In the face of rising interest rates, along with land values, and development costs, the ability to access cheaper financing will enable developers to swallow a higher development cost.

Lenders are now bringing the environmental, social and governance (ESG) agenda to the fore when making lending decisions. This is influencing the financing of real estate assets and sustainable design features are becoming an appealing way for investors and developers to mitigate against the rising costs of finance, or refinance costs in the future.

## SUPPLY CHAIN RESILIENCE

Supply chains will face ongoing disruptions in 2022 and this will drive manufacturers to widen their supplier base and hold higher levels of stock to protect their order books.

Industries with long, complex supply chains may look to secure components closer to home and manufacturers operating a "just-in-time" supply chain will need to consider whether this is cost-effective given the additional transportation costs and risks associated with delays.

## FOOD SECURITY

We expect to see further growth in vertical farming in the UK as food manufacturers incorporate vertical farming within their production plants in order to reduce environmental impacts and reliance on third party producers.

It is not just concerns around *energy* security that the war in Ukraine has raised. The vulnerability of the global food system has also been highlighted. Russia is one of the world's largest exporters of fertilizer and the largest exporter of wheat. Ukraine is also a major exporter of oils, grains and cereals. Alongside geopolitical and trade disruptions, there are also risks to agriculture and food security posed by climate change, pollution, and contamination.

Vertical farming operators have been expanding their footprint in the UK, taking larger and larger units from which to grow crops indoors. The need for greater food security, along with a desire to reduce the carbon footprint of the food we consume, and the use of fertilizers, is driving change in the way we produce food.





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