UK Logistics Real Estate

The year ahead

2023

Expectations and considerations of the UK Industrial & Logistics Real Estate Market for the year ahead

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Key expectations for 2023/24

1. RENTAL GROWTH TO CONTINUE... BUT AT A SLOWER PACE

2. VACANCY RATES TO RISE... BUT REMAIN LOW

3. CONSTRAINED DEVELOPMENT ACTIVITY WILL IMPACT AVAILABILITY OF NEW SPACE

4. TAKE UP LEVELS TO RETURN TO PRE-PANDEMIC NORMS

5. OPERATING COSTS TO RISE

6. PRICING HAS STABILISED BUT DOWNSIDE RISKS REMAIN FOR SECONDARY ASSETS

7. RETURNS TO OUTPERFORM OTHER SECTORS

8. INVESTMENT VOLUMES TO IMPROVE, BUT REMAIN MUTED

9. INFLATION HEDGING POTENTIAL WILL SUPPORT INVESTMENT

10. BIFURCATION OF PERFORMANCE

Key expectations – Occupier market

RENTAL GROWTH TO CONTINUE... BUT AT A SLOWER PACE

We expect continued rental growth through 2023 and beyond. Despite the reduced levels of occupier take-up and enquiry levels we have recorded in recent quarters, the market remains supply constrained, and this is continuing to drive rental growth. The MSCI monthly index indicates that 1.1% growth was recorded in the first two months of 2023, with further growth anticipated throughout the rest of the year.

Average rental growth for UK industrial is expected to reach around 4.2% in 2023 (Oxford Economics). While this is below the levels recorded over the past two years, it is in line with pre-pandemic years. If we exclude the pandemic years (2020-2022), the five-year average (2015-2019) rental growth was 4.3% per annum (MSCI).

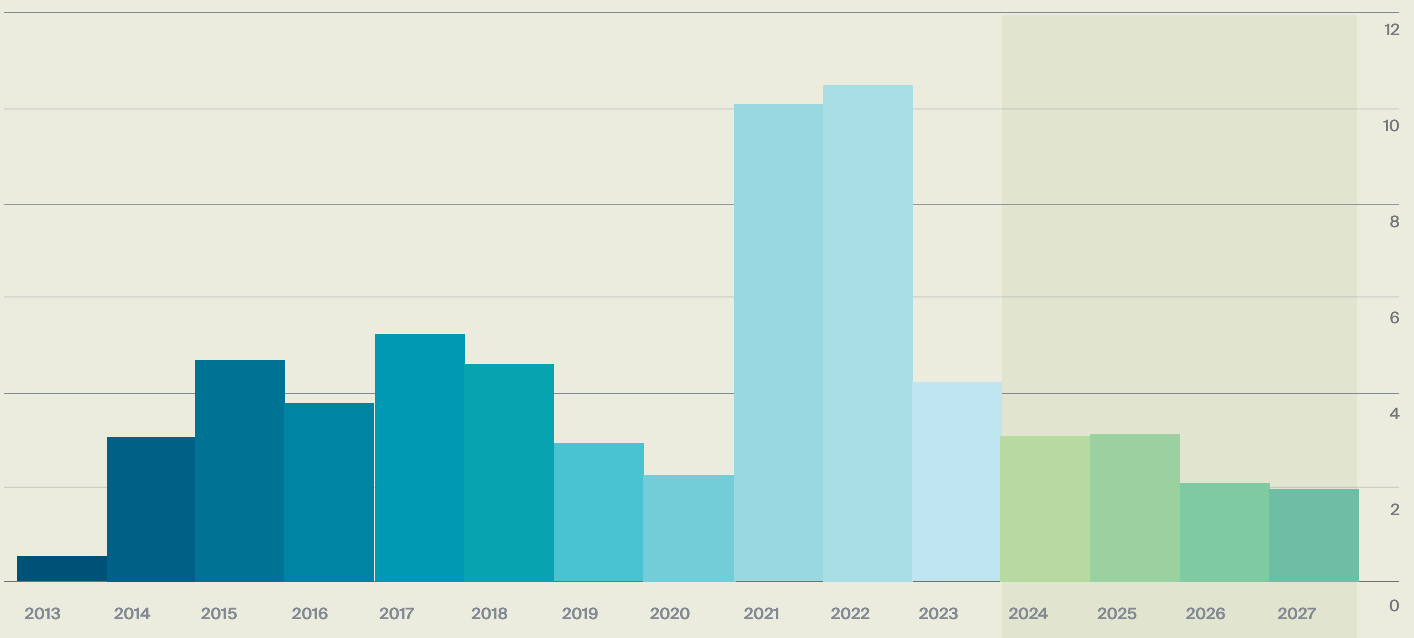
While rental growth is set to continue, the feverish levels of occupier demand seen in 2020/2021 have subsided and a shallower pool of demand is likely to drive up the incentives offered by landlords. We expect rent-free periods to return to more normal, pre-pandemic levels, which will have the effect of moderating rental growth when considered on a net effective basis. In the past three years, the average rent-free period was 10.4 months per a 10-year lease term. How much this increases will be highly influenced by the type of take up that we see this year. There will be significant variation between the incentives offered on new, grade-A space and those on offer for secondary or tertiary grade space.

> "Average rental growth is expected to reach around 4.2% in 2023. While this is below the levels recorded over the past two years, it is in line with pre-pandemic years."

4.2%

Average expected rental growth for UK Industrial in 2023

UK Industrial – Average Rental Growth
% p.a.



Source: MSCI, Oxford Economics

VACANCY RATES TO RISE... BUT REMAIN LOW

At the end of 2022, vacancy rates were just 3.3%. While we expect the amount of vacant space to rise slightly in 2023, through a combination of development completions and secondhand space coming back to the market, vacancy rates will remain below frictional levels (normally considered at around 5-8%) and this will drive continued rental growth.

CONSTRAINED DEVELOPMENT ACTIVITY WILL IMPACT AVAILABILITY

Vacancy rates will remain particularly tight for grade-A buildings. Demand is increasingly focused on well-located, well-specified units where occupiers can maximise their operational efficiencies. There will be several new schemes completing in 2023, with around 33.6 million sq ft of space already completed or expected to complete this year (2023), this includes space already committed. However, new development activity is falling due to a combination of inflated build costs, elevated financing costs and softer exit yields.

There were just ten development starts in the first quarter of 2023 (with more than 50,000 sq ft floorspace, both build-to-suit and speculative development), this compares with 38 in the same period last year. While supply will improve in 2023 as some of the schemes commenced last year reach completion, with fewer developments commencing this year, the availability of new, grade-A stock will weaken towards the end of 2023 and into 2024.

> "The online retail market has been less of a driver of demand over the past few quarters, as online penetration rates recalibrate post-pandemic. Yet the outlook for the longer term is for continued growth, which will support further expansion of the logistics sector."

TAKE UP LEVELS TO RETURN TO PRE-PANDEMIC NORMS

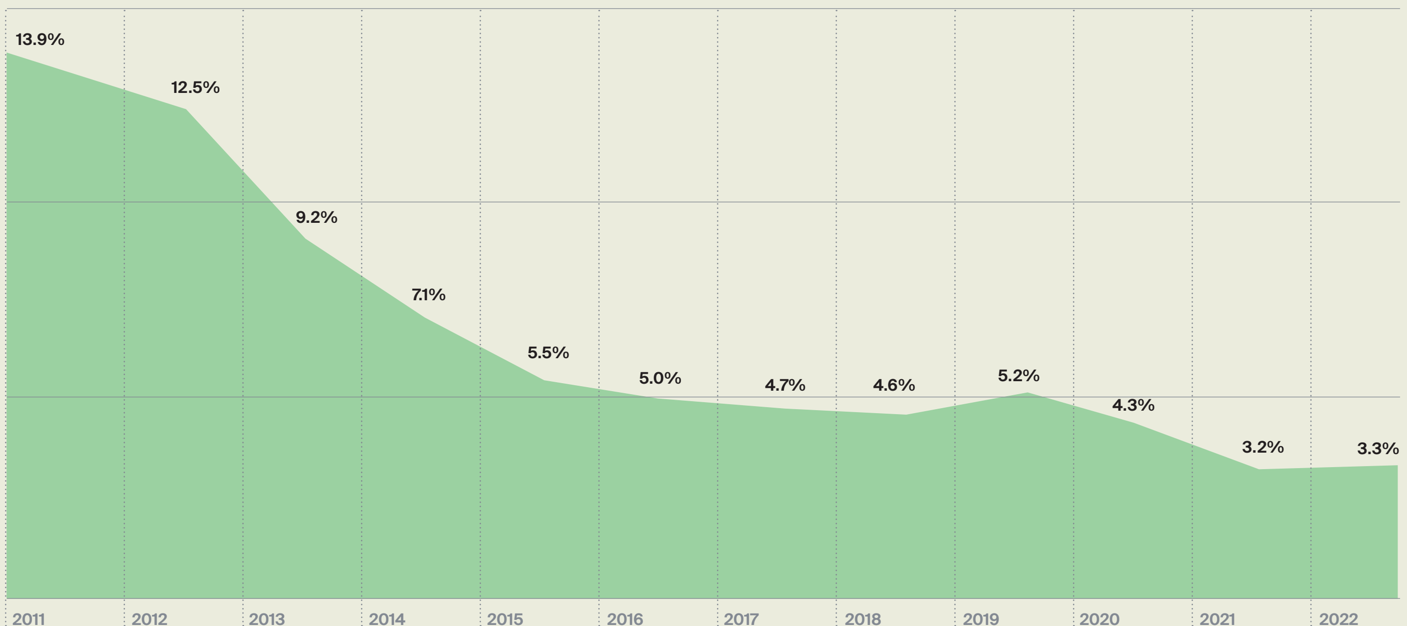
The expansion of online retailers, along with distribution firms led to record levels of take-up over the past three years (2020-2022). As the online retail market grew rapidly, online retailers and distribution networks, sought to scale up their operations, upsizing their facilities or taking more space to service additional demand. Online retail sales and demand for home deliveries declined throughout 2022 as consumer spending shifted away from goods towards services, and demand for warehousing space from this these occupiers has reduced as a result.

The online retail market has been less of a driver of demand over the past few quarters, as online penetration rates recalibrate post-pandemic. Yet, the outlook for the longer term is for continued growth, which will support further expansion of the logistics sector.

The temporary pull-back in demand from online retailers has been replaced by other sectors of the occupier market, and demand is being generated through other mechanisms

Vacancy rate

(units over 50,000 sq ft)



Source: Knight Frank Research

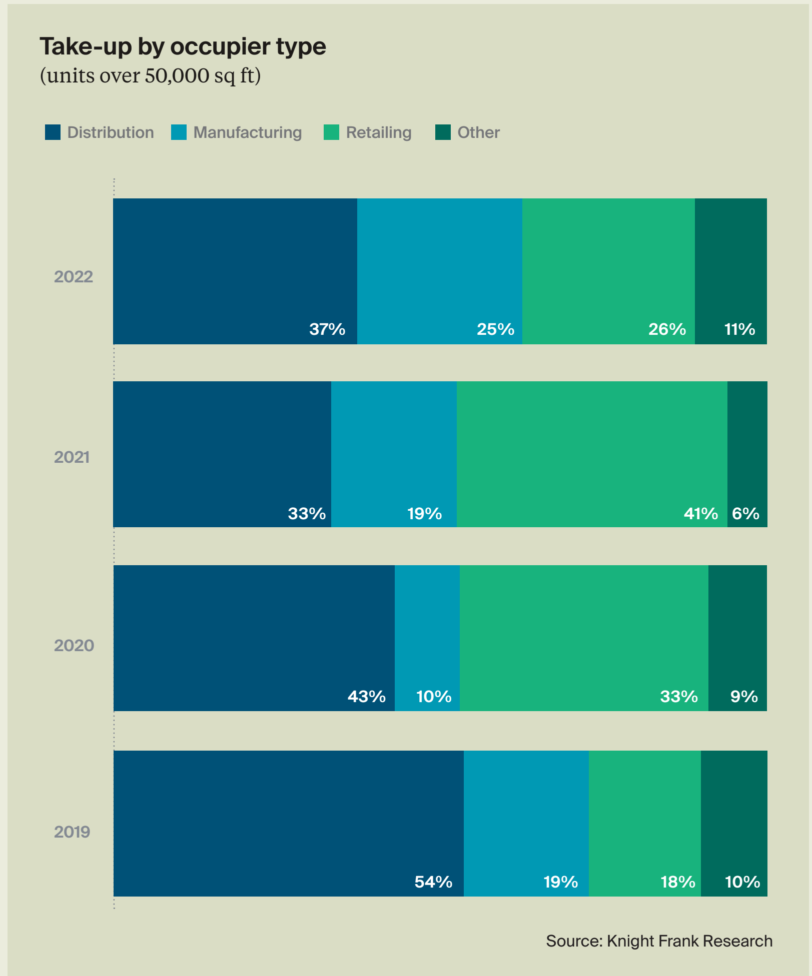
such as a shift away from lean, just-in-time supply chains, with more firms adopting a "just-in-case" approach and holding additional stock to protect against blips in supply. Reshoring or bringing some manufacturing or processing tasks back onshore is another factor influencing demand for space.

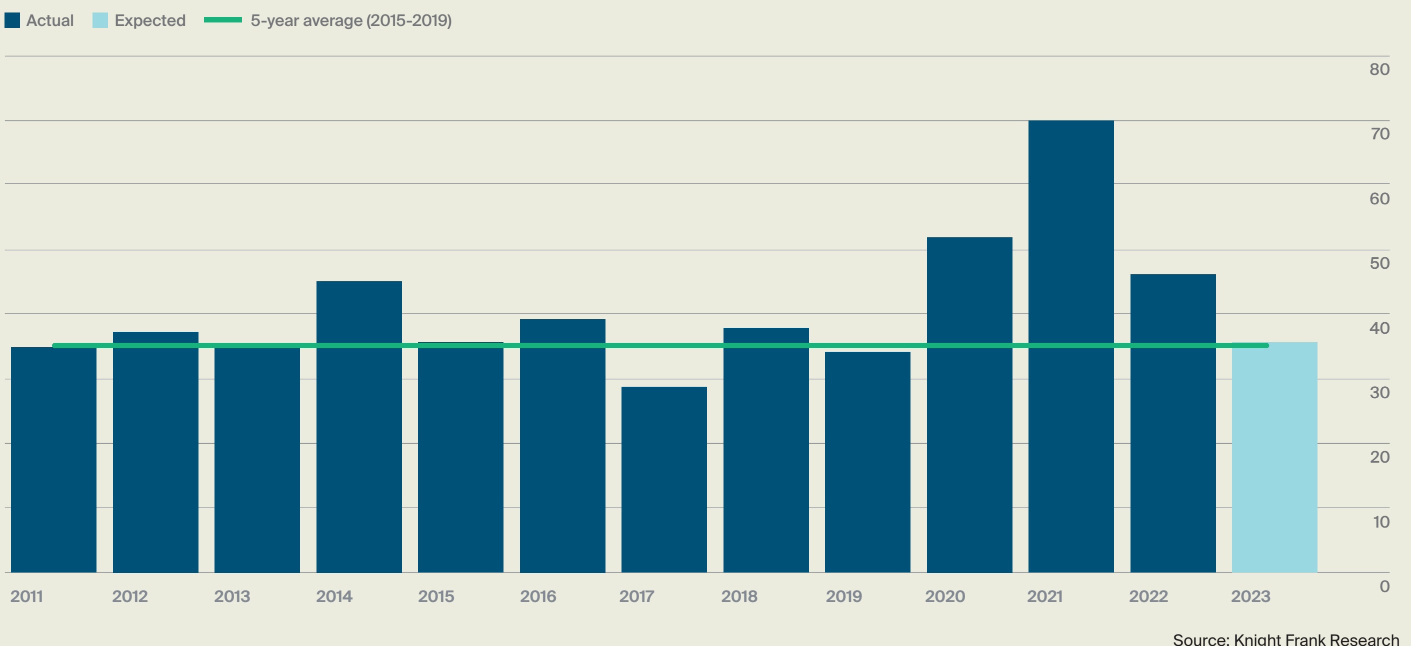
The post-Brexit trade agreement includes "Rules of Origin" which govern whether goods qualify for tariff-free trade and limit the amount of component parts or degree of processing that can take place outside the UK or EU. Firms that produce goods outside of the UK/EU may look to reshore operations to avoid costly tariffs.

Other reasons that firms are increasingly considering reshoring include; a desire for greater supply chain sustainability, falling wage differentials, a drive toward greater automation and also higher levels of investment.

While online retailers are taking less space, other types of occupiers have been increasing their requirements, these include manufacturing and engineering firms and non-traditional users of industrial and logistics space such as data centres, film studios and others.

We expect take-up to total around 36 million sq ft in 2023. Though this is below the levels recorded over the past three years, it is in line with the pre-pandemic 5-year average of 35 million sq ft (2015-2019).





OPERATING COSTS TO RISE

There are testing times ahead for occupiers. From the 1st April 2023, businesses face increases in business rates and corporation tax. They also face the prospect of rising energy bills, with the Energy Bill Relief Scheme replaced with the Energy Bills Discount Scheme on April 1st. The new scheme will continue energy bill support for businesses until 31st March 2024, but at a reduced rate. Along with these rising taxes and energy costs, many businesses also face ongoing inflationary pressures on materials and wages.

Business rates are set to rise sharply for industrial occupiers due to the strong rental growth the sector experienced across the revaluation period (April 2015 – April 2021). Across the UK, average rents rose 26% over the revaluation period, double the rate of rental growth experienced in the office market (MSCI, UK Quarterly Index). Analysis from Knight Frank's Business Rates team demonstrates that occupiers across England and Wales face an average increase in rates of 34%, though transitional relief will limit the increase felt by occupiers this year to a 30% uplift. The impact will vary according to geographies whilst the size and age of the building determines the rate increase. Those areas that have experienced the strongest rental growth, such as London, will face the largest uplifts.

> "Analysis from Knight Frank's Business Rates team demonstrates that occupiers across England and Wales face an average increase in rates of 34%, though the transitional relief will limit the increase felt by occupiers this year to a 30% uplift."

Online retail - The ongoing expansion of online retail will continue to be an important driver for the industrial and logistics market. ▼

In the Spring Budget, the Chancellor confirmed that the rate of corporation tax would rise from 19% to 25% from 1st April 2023. However, companies with profits below £50,000 will continue to pay the 19% rate and companies with profits less than £250,000 will benefit from Marginal Relief, tapering the effect of the rate increase.

The current Energy Bill Relief Scheme announced in September came to an end in March 2023. The new Energy Bills Discount Scheme (EBDS) from April 2023 to April 2024 will be less generous, with the price cap being replaced by maximum discounts, capped at £5.5 billion for 12 months. Energy can be a significant operating cost for some occupiers and businesses now need to think proactively about managing the rise in costs. Firms operating from more energy-efficient facilities will be better able to mitigate against rising prices and this may offer a competitive edge.

Despite these rising operating costs, inflation is falling. The OBR expects the UK inflation rate to fall from 10.7% in Q4 2022 to 2.9% by the end of 2023. This should help to ease cost pressures for occupiers towards the end of 2023.

BEYOND 2023....

The ongoing expansion of online retail will continue to be an important driver for the industrial and logistics market.

The rapid expansion of ecommerce during the pandemic drove occupier take up to record highs and vacancy to record lows. However, the past year has seen a contraction in online sales, with Covid related restrictions lifted and shoppers switching spend to leisure and services along with in-store shopping. This resulted in lower levels of online sales being recorded in 2022; amounting to 26.5% of total retail spend compared with 30.7% in 2021.

However, moving forward from 2022 expectations are for the market to return to and stay in growth mode throughout the five-year forecast horizon. According to Retail Research Consultancy firm Mintel, online sales are forecast to grow by 29.1% to £146.9 billion by 2027. Knight Frank analysis shows that every £ billion of online sales requires approximately 1.36 million sq ft of warehouse space. Based on our calculations, this will require an additional 45 million sq ft of warehousing space.

Key expectations – Investment market

PRICING HAS STABILISED BUT DOWNSIDE RISKS REMAIN FOR SECONDARY ASSETS

The second half of 2022 saw a rapid repricing of industrial assets. According to Knight Frank's yield guide, prime distribution yields (15-year income) rose from 3.5% in June 2022 to 5.25% in January 2023. However, subsequent data (in February and March 2023) has shown no further movement.

Our view is that in general, prices appear to have stabilised. Though there may be some variation in performance according to location and asset specifics, we anticipate that prime yields will harden slightly this year. Indeed, investor activity in Q1 has shown a return to competitive bidding, and recent transactions indicate prime yields are moving back toward c.4.5%.

There are some downside risks to the outlook, however. These have been highlighted by recent bank failures. Greater uncertainty in financial markets and the potential for deposit withdrawals may result in banks becoming more cautious about lending as they seek to lower their credit risk. There is evidence that the major UK banks are tightening their lending standards and adjusting their appetite for risk. While investors' use of debt capital markets may offset the potential fall in bank lending, they are likely to face tightening credit conditions. Lenders may be particularly cautious regarding secondary markets and locations, assets with income underpinned by tenants with a weak-covenant, and over funding speculative developments with no pre-let agreement in place.

For these reasons, the risk for further softening is more acute for secondary assets and markets.

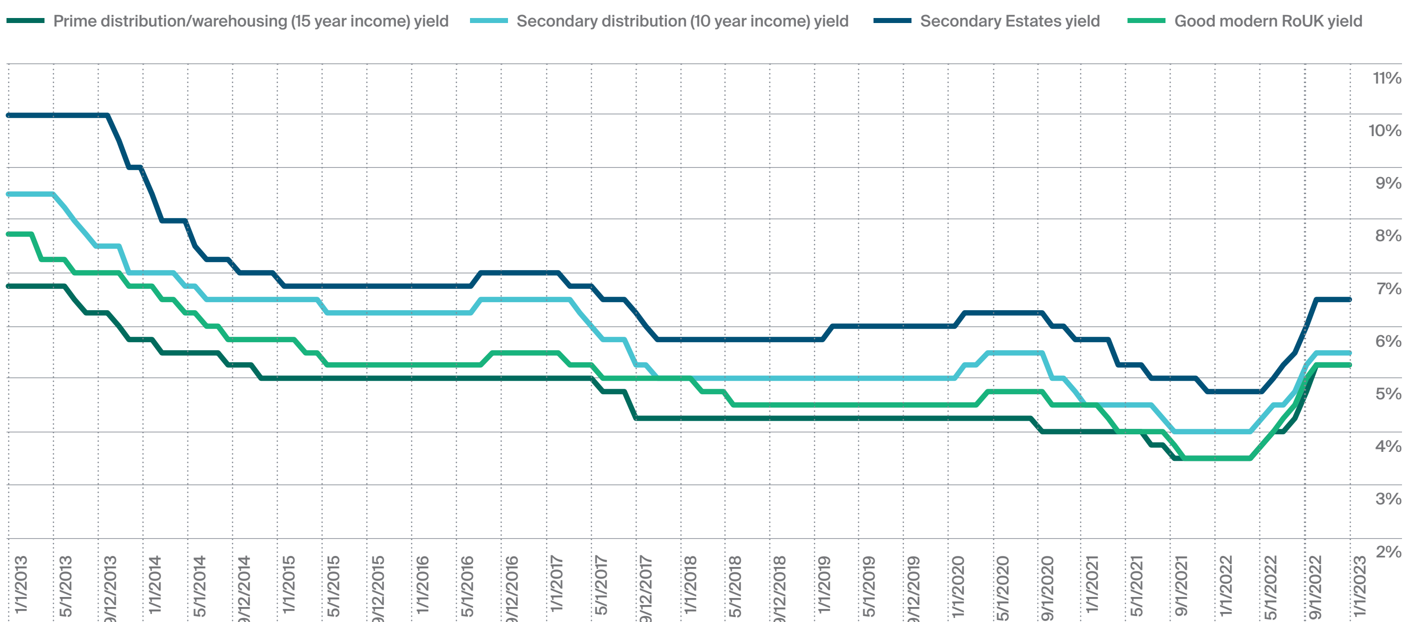
> "Greater uncertainty in financial markets and the potential for deposit withdrawals may result in banks becoming more cautious about lending as they seek to lower their credit risk."

RETURNS TO OUTPERFORM OTHER SECTORS

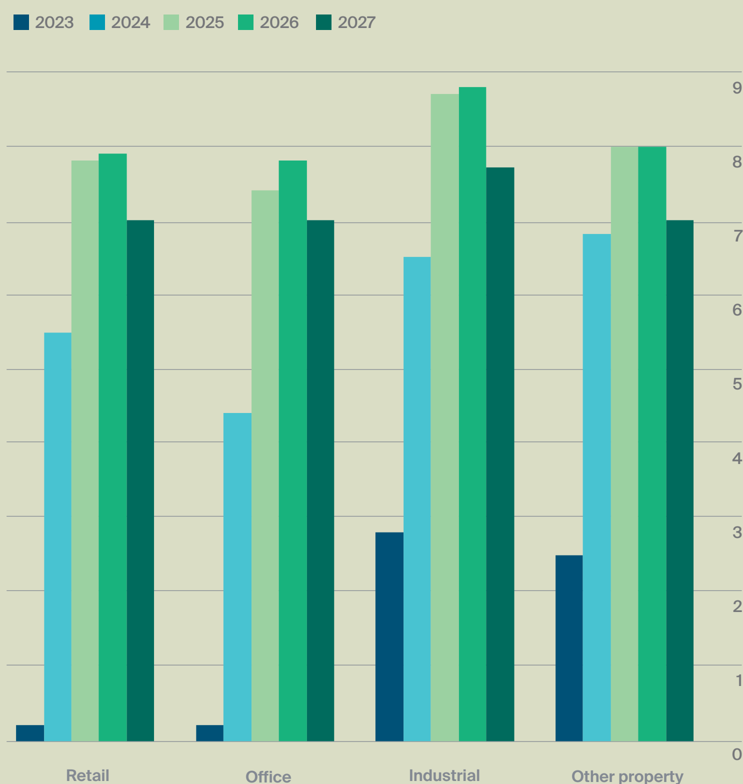
The rapid repricing and negative capital growth in the logistics sector over the past nine months has driven negative returns. According to the MSCI UK Monthly Index, the logistics sector has recorded annual total returns of -19.1% in the year to February 2023. This compares to 6.1% and 11.8% in the retail and office sectors. However, expectations are that the logistics sector will start to rebound in 2023.

In 2023 and over the five-year outlook, returns for the industrial sector are forecast to outpace those of other property sectors (RealFor).

Prime yields



Source: Knight Frank Research



INVESTMENT VOLUMES TO IMPROVE, BUT REMAIN MUTED

The lending environment will continue to exert a strong force over the investment market throughout 2023. Tightening credit conditions and the heightened cost of finance will keep a cap on the volume of capital with investors using less leverage. However, long-term expectations for income growth, coupled with stabilised prices and the favourable demand-supply dynamics within the occupier market will encourage investors.

Investors are already demonstrating a preference for assets located within London and the South East as well as other key regional markets including Birmingham and the Midlands, and Manchester along with the wider North West region. As investment activity returns, it is likely to remain concentrated within more liquid, core markets.

A lack of stock will contribute to lower investment volumes this year. Some sellers may be reluctant to accept today's pricing, and some potential sellers may postpone sales due to a lack of opportunities for reinvestment. While opportunistic investors remain willing to target assets outside of the core markets, their high returns requirements coupled with a lack of distress are likely to keep investment volumes in these markets suppressed.

"While typical lease structures for logistics assets offer some protection against inflation, conventional gilts do not"

"Tightening credit conditions and the heightened cost of finance will keep a cap on the volume of capital with investors using less leverage."

INFLATION HEDGING POTENTIAL WILL SUPPORT INVESTMENT

The income return, partial inflation hedge, and long-hold qualities of the sector will support investor allocations to real estate and to the logistics sector in particular.

In nominal terms, gilt yields have risen sharply over the last year and the yield gap between them and logistics real estate has narrowed as a result. While this may make the risk-return profile for gilts appear relatively more attractive, this ignores the impact of inflation. While typical lease structures for logistics assets offer some protection against inflation, conventional gilts do not.

The past year has brought inflation risk back into focus. Many investors may have previously discounted this risk due to a lengthy stretch of low inflation. Before to the last 18 months, inflation (CPIH) has not exceeded 3% since January 2012 and has not been above 5% since 1992.

While logistics real estate is unlikely to offer a full inflation hedge, due to the cap and collar mechanisms that most leases are subject to, the sector benefits from relatively standardised lease contracts, typically with long lease terms, rent reviews every five years and strong indexation clauses.

Low rates of inflation and strong growth in market rents in recent years have led to a growing preference amongst investors for open market rent reviews. While expectations for future rental growth remain robust, inflation forecasts have also risen. Future rental growth will vary across geographies and some facilities and locations are likely to see rental growth fall short of inflation over the next few years.

Lease structure, as well as the specification and location of assets, will therefore be an increasingly important consideration for investors.

For further considerations on lease structure read our key considerations for the year ahead.

BIFURCATION OF PERFORMANCE

The market is becoming more differentiated. There is currently limited demand for non-core assets. With investors narrowing their sights on core markets and assets in 2023, competition is expected to drive some yield compression. The risks attached to weaker assets and locations, in terms of the potential for higher vacancy, higher rental incentives and lower rents could lead to further yield softening.

The rising importance of ESG factors for investors, along with the prospect of tightening credit conditions and shifting preferences in the occupier market mean that we will see a divergence in the performance of assets, with well-specified, grade-A assets increasingly outperforming secondary assets. Older, or poorly specified units may previously have been redeveloped or refurbished but now face a greater risk of obsolescence due to the rising costs associated with construction and financing.

Key considerations for the year ahead

Positioning for the next phase of the cycle

A complex mix of factors are impacting investment decisions in 2023. Higher interest rates and inflationary pressures as well as geopolitical considerations, tightening environmental performance requirements and the prospect of a weakening economic outlook, mean that logistics investors face a new set of strategic considerations.

PROTECTING VALUE - TENANT AND ASSET QUALITY

Covenant

The strength of covenant will be of heightened importance for investors as they adopt more defensive strategies and seek to protect their income from the risk of voids.

Sustainability

Investors are increasingly considering both the impacts of climate change and increasing sustainability requirements when assessing both their existing portfolios and any potential acquisitions or developments.

The International Renewable Energy Agency has estimated that $7.5 trillion worth of global real estate could be stranded, with major write-downs in value due to climate risks and the economic transition. From April 2023, Minimum Energy Efficiency Standard regulations (MEES) apply to all commercial buildings in England and Wales, and those buildings with an Energy Performance Certificate (EPC) below a certain standard (EPC E) cannot be leased. Investors are keen to protect their assets and income from these downside risks and the potential for obsolescence.

> "There are also opportunities associated with climate change. This may involve decarbonising and upgrading existing buildings, through better insulation, rooftop solar or more efficient lighting."

There are also *opportunities* associated with climate change. This may involve decarbonising and upgrading existing buildings, through better insulation, rooftop solar, or more efficient lighting. These measures not only help to future-proof assets and better align them to institutional investor mandates, they can also help lower operating costs which may boost leasing prospects.

Some operators are increasingly discounting facilities that do not fit with their (or their customers') sustainability strategies. Green credentials are becoming an important tool for third-party logistics firms (3PLs) in securing contracts with retailers. To ensure they can enhance the sustainability credentials of their tender bid, they may need to focus on more sustainable facilities that can provide strong environmental performance and offer features such as electric vehicle charging.

Electric vehicle charging - Green credentials are becoming an important tool for third party logistics firms in securing contracts with retailers

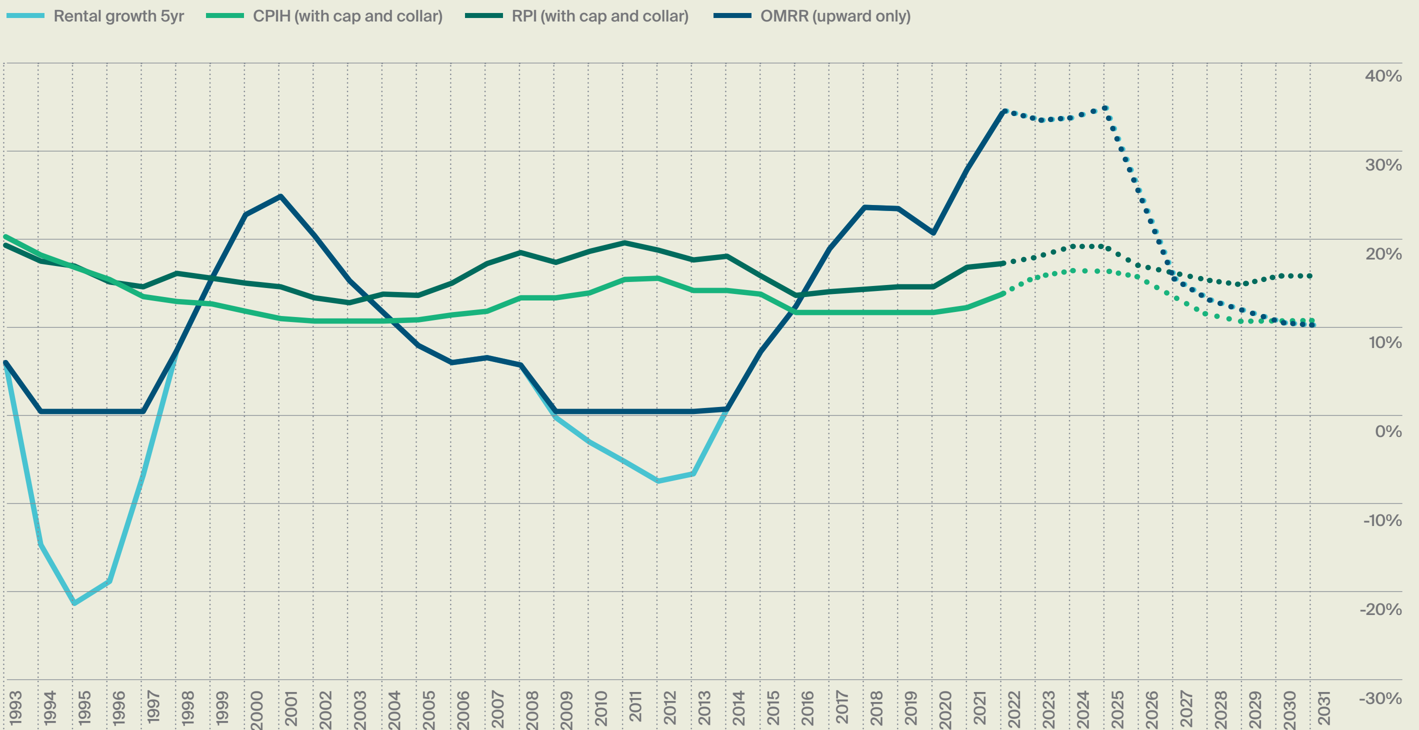
Specification

As well as sustainability measures and energy costs, operators are looking at other building features such as eaves height and power availability as they seek to improve their operational efficiencies. With supply pressures expected to ease in 2023, investors and developers will be minded to ensure that buildings offered to the market provide a good level of specification in order to protect against void risks.

CREATING VALUE THROUGHOUT THE LIFECYCLE

Over the past decade, the logistics sector has recorded strong yield compression providing investors with strong returns. Despite the recent softening in yields, prospects for future yield compression are limited. As a result, investors with adequate scale are increasingly looking at driving returns by taking on an operational role. Several investors have launched or expanded their logistics investment platforms recently. M7, Logicor and St Modwen (Blackstone) have all expanded their platforms with recent acquisitions in the UK logistics market. Last year, Norway's Norges Bank Investment Management (NBIM) acquired a 50%

5 yr Income growth by different types of rent review



Source: Knight Frank Research, ONS, Oxford Economics

stake in a UK logistics properties portfolio managed by Prologis. Prologis owns the other 50% and serves as asset manager for the portfolio, which has 14 logistics properties in the UK.

LEASE STRUCTURE CONSIDERATIONS

Over the past five years, rental growth for UK industrial has averaged 6.1% per annum, compared with 3.1% for CPIH and 4.6% for RPI. As a result, landlords have typically benefitted from stronger income growth if rental uplifts are determined by open market rent reviews, rather than being index-linked.

However, the past five years is a relatively short horizon, it cannot answer as to relative performance over the long term, nor give an indication of the relative performance over the next five years. It is also worth noting that index-linked rent reviews tend to include a "cap and collar" mechanism to ensure that the increase is between certain parameters and an open market rent review (OMRR) may include an "upward-only" clause. A cap and collar is typically set at 2% and 4%.

A typical lease structure includes rent reviews every five years. Analysing data over the past 30 years we have looked to assess hypothetical 5-year rent reviews each year, based on either average UK rental growth, CPIH (with a cap and collar), or RPI (with a cap and collar).

Over the 30-year time series, we found that rental growth at a review based on open market rental growth (using UK average rental growth), would have outperformed rental growth at an index-linked rent review based on CPIH (with a cap and collar of 2% and 4% per annum) for 13 out of the 30 years, and would outperform an index-linked rent review based on RPI (with the same cap and collar) for just 11 out of the 30 years. Over the 30-year horizon, RPI-linked

INCOME GROWTH OVER TIME BY TYPE OF RENT REVIEW

	PERIOD				
	LAST 30 YRS	LAST 20 YRS	LAST 10 YRS	LAST 5 YRS	NEXT 5 YRS
OMRR (up and down)	73%	55%	59%	34%	15%
OMRR (upward only)	103%	69%	59%	34%	15%
CPIH (4% cap and 2% collar)	103%	62%	26%	13%	13%
CPI (4% cap and 2% collar)	105%	65%	27%	14%	13%
RPI (4% cap and 2% collar)	137%	84%	33%	17%	16%

Source: Knight Frank Research calculations based on data from ONS and Oxford Economics

rent reviews have outperformed OMRRs for 19 of the 30 years.

However, this does not consider the rate of uplift. While index-linked reviews are typically subject to a cap and collar, OMRRs are not, though they may be "upward only". This can allow landlords to capture exceptional rates of rental growth during periods of growth, though low or negative growth periods may result in very low, or no income growth. However, index-linked rents can still capture growth during these periods due to the cap and collar mechanism, which will ensure that index-linked rent reviews realise 2% per annum as a minimum. The table below demonstrates the relative performance of different types of rent review over different periods.

Over the past 30 years, index-linked rent reviews have performed best, not just for *stability* of income growth but also the *total growth* in income. RPI-linked rent reviews resulted in 137% growth in rents over the past 30 years. In terms of the level of growth, the performance of CPIH-linked rent reviews and OMRRs was equal over the long term, both recording 103% growth. The past 20-year horizon also shows a broadly similar performance between CPI (and CPIH)-linked rent reviews and OMRRs. However, over the past five or 10 years, there has been a divergence, with OMRRs having performed significantly better than index-linked rent reviews.

But what about leases being negotiated this year? A five-year review would mean that a lease agreed in 2023, would be up for renewal in 2028. Our analysis based on forecasts from Oxford Economics shows that, based on the UK average, an RPI-linked rent review would give the strongest growth in income (2022-27), while an OMRR should provide stronger rental growth than a CPI/CPIH-linked rent review. However, the differences are not significant and there are much greater downside risks attached to the rental growth forecast.

> "Over the past 30 years, index-linked rent reviews have performed best, not just for stability of income growth but also total growth in income."

It is important to note that the rental growth figures, including forecasts, are for UK average rental growth, with significant variation across different markets. While the UK average is set to outperform over the next, not all regions are expected to. The chart below demonstrates the variation by market and region. All the London markets are expected to outperform CPIH-linked rental growth, however expectations for markets outside of London vary, with many markets expected to fall short of the projected rental growth for a CPIH-linked review. It is important to note that this analysis is based on forecasts of *average* rental growth in these markets and *actual* rental growth will vary according to the location and specification of a property.

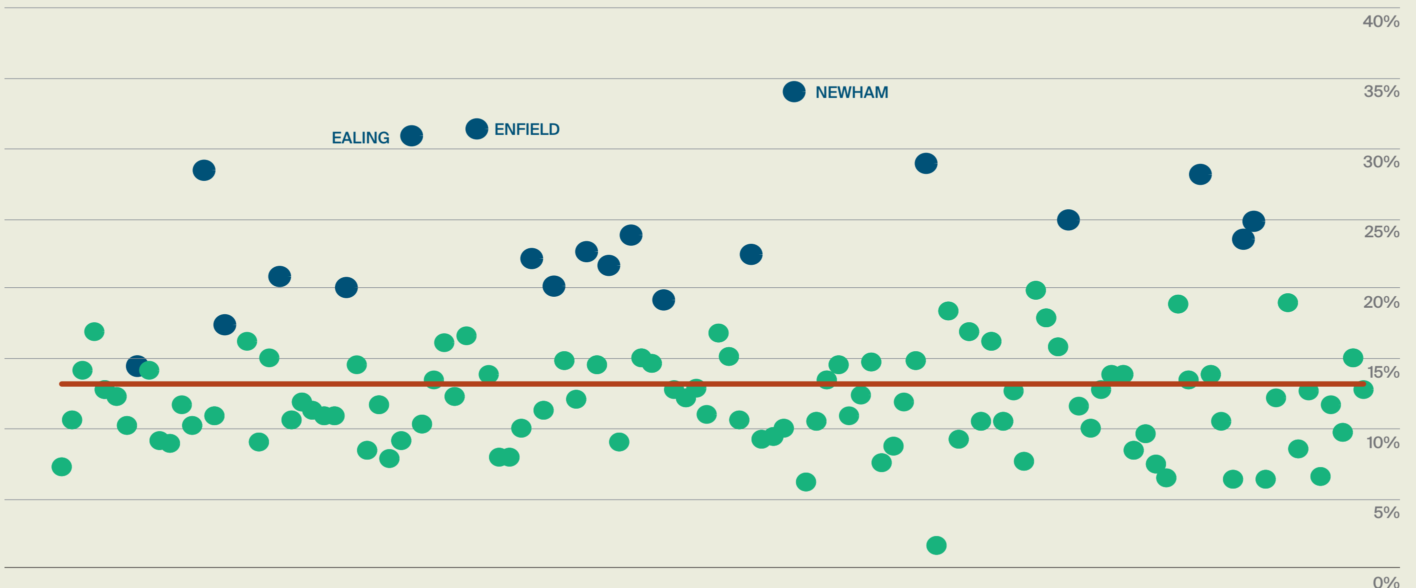
137%

Growth in UK average income over the past 30-years for RPI-indexed rent reviews

Forecast open market rental growth by market and region vs rental growth for a CPIH-linked rent review

(2022-2027)

London | Rest of UK | CPIH-linked rental growth



Source: Knight Frank Research, calculations based on data from ONS, Oxford Economics and RealFor

We like questions, if you've got one about our research,
or would like some property advice, we would love to hear from you.

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