

Welcome



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Reflecting on a tumultuous 2016, it is remarkable just how good a year it turned out to be for the UK industrial & logistics sector.

Rental growth not only continued but accelerated, logistics take-up surged to a new record, while pricing in the investment market stands higher now than its pre-Referendum level.

But the punchy headlines do not quite tally with how 2016 felt. It was certainly a decent year in view of what happened, but not to my mind as active as the year before. Amazon's unprecedented impact on the market was clearly pivotal, and underlines how the drivers of demand have changed radically from the last cycle.

As an asset class, industrial & logistics also finds itself even more in the spotlight than it was prior to the Referendum. Greater uncertainty in the economic outlook engendered by last summer's vote has intensified investor demand, with tight supply and underlying structural change in consumer patterns elevating the sector into something of a safe haven.

After the initial shock of last summer, confidence has returned to the occupier market. Indeed, unsatisfied active demand stands higher now than it did a year ago, which is clear testament to the resilience of the sector and bodes well for levels of activity over the coming year.

While the fundamentals around the sector are extremely positive, 2017 is set to be quite a challenging year in some respects. Investors and developers are finding value harder to come by, while occupiers in search of more flexible, economical solutions have been left with very little choice.

I am nonetheless confident that the market will continue to move in a positive direction in 2017. Tight supply will support further rental growth and, while opportunities may be harder to find, they remain considerable, both geographically and sectorally. More than ever, key to identifying those opportunities is a forensic knowledge of market dynamics at the regional and even local level.

As the UK economy starts its journey towards Brexit, these are undoubtedly intriguing times for the industrial and logistics sector, and I hope this research will be of help as you traverse the market during 2017.

EXECUTIVE SUMMARY

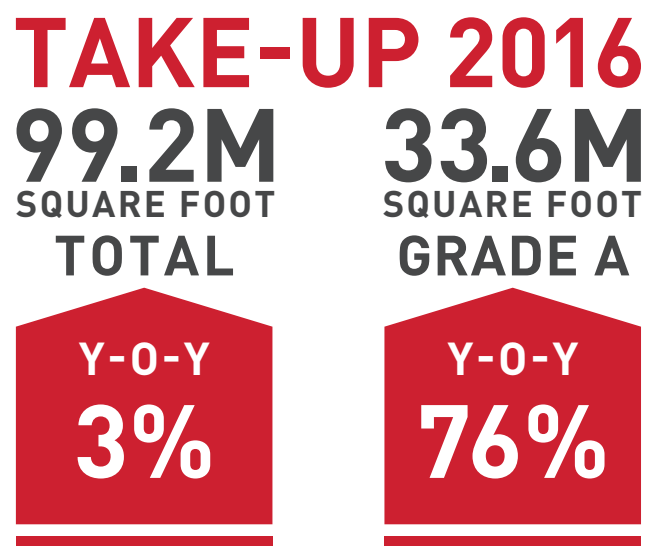
RECORD YEAR FOR LOGISTICS

Viewed overall, 2016 was a good year for the UK industrial and logistics occupier market. Across all sectors, UK-wide take-up totalled 99.2m sq ft, up 3% on 2015 and 6% above the five-year annual average. Notably, reflecting strong pent-up demand for quality premises, grade A space accounted for a record 34% share of total take-up.

The uplift was driven by a record year of activity in the logistics sector, where take-up of 37.3m sq ft surpassed 2014's previous high by 6%. Amazon was pivotal to this, by itself accounting for 20% of logistics take-up, a record share of the market by a single occupier.

While take-up improved year-on-year, there was arguably a greater depth to market activity in 2015. 2016 take-up in each of the other size-bands fell short of 2015's volume, notably mid box where take-up was down 24% year-on-year.

Influenced to a large degree by logistics activity, it was generally a positive picture across the eight UK regions recording take-up above their respective five-year annual averages. Greater London and the South West were 2016's standout performers, albeit both were boosted by major deals.



DEVELOPMENT FAILS TO ARREST FALL IN SUPPLY

Despite a resurgence of development, overall supply fell by a further 18% in 2016 to stand at a new low of 161.1m sq ft. However, reflecting over 10m sq ft of speculative completions during 2016, the underlying nature of supply is changing; grade A space accounted for 19% of total supply at the end of 2016, improving from a low of 9% in 2013.

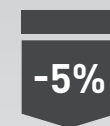
Sector-wise, the logistics and small and medium-sized categories saw a reduction in supply, falling 5% and 30% year-on-year respectively. In contrast, mid box supply increased by 21% during 2016, driven by an increase of second-hand space coming back to the market.

While Greater London and the South West remain tightly supplied markets, both saw modest increases in supply in 2016 following speculative development. All other regions witnessed a fall in supply, most notably the West Midlands where it fell 27% year-on-year.

The focus of developer attention has shifted towards the smaller end of the market, reflecting increasing confidence in the sector and the availability of funding. While speculative development was down 34% year-on-year overall, it has doubled in the medium-sized sector to 2.4m sq ft.

SUPPLY Y-O-Y CHANGE

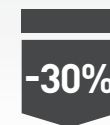
LOGISTICS



MID BOX



SMALL & MEDIUM



UNCERTAINTY FAILS TO HINDER RENTAL GROWTH

Despite the uncertainty generated by the EU Referendum, an ongoing lack of supply has driven another year of strong rental growth. Across 60 UK markets, prime headline rents increased by 5.3% in 2016, rising from 3.9% in 2015. Notably, growth in secondary rents continued to outperform prime in 2016, albeit marginally, rising by 5.4% on average.

Except for Yorkshire & the Humber, growth was seen across all regions. The North West was the star performer, seeing the strongest growth in both prime and secondary stock, rising by an average of 10.3% and 12.9% respectively.

2015 RENTS



2016 RENTS



TOTAL GRADE A

MARKET IMBALANCE MOST PROMINENT IN THE MIDLANDS AND EAST

Lambert Smith Hampton's comprehensive survey of active demand reveals that the volume of requirements has increased by 18% compared with a year ago. While all sectors have seen an increase in demand to some degree, it has been strongest in the medium-sized sector.

An analysis of active demand set against several key indicators of supply shows that the East Midlands is the most supply-imbalanced region among small and medium-sized units, while the West Midlands is the most imbalanced UK region in the mid box sector. The East region has the highest imbalance within the logistics sector.

INVESTOR DEMAND FRUSTRATED BY LACK OF STOCK

A strong finish to the year took the total volume for 2016 to £5.2bn, down 9% on 2015 but 7% above the five-year annual average. Investors continue to be lured to the sector's attractive occupier market fundamentals with industrial & logistics accounting for 11.1% of All Property volume in 2016, its highest share of activity since 2009.

The sector is so coveted by a range of buyer types that assets of all qualities in reasonable locations are commanding very high prices. The main challenge to activity in 2017 is likely to be the lack of buying opportunities as potential sellers opt to hold, a fact not helped by the sector's relatively defensive attributes.

2015 DEALS

DEALS

392

VOLUME £5.7BN

2016 RENTS

DEALS

388

VOLUME £5.2BN

SECTOR DEFINITIONS

SMALL UNITS	< 10,000 SQ FT
MEDIUM UNITS	10,001 - 49,999 SQ FT
MID BOX	50,000 - 99,999 SQ FT
LOGISTICS	> 100,000 SQ FT

INFLATION IS MAIN RISK
LOWER POUND
TO BOOST TRADE
ONLINE'S SHARE
OF RETAIL CLIMBS

ECONOMIC BACKDROP

The industrial and logistics sector is well-placed to deal with whatever bumps lie ahead in the road to Brexit. Even if consumer confidence is materially impacted, ongoing structural change in retailing will continue to drive occupier demand, while sterling's devaluation may provide a shot in the arm for UK manufacturers.

Notwithstanding turbulence in the financial markets, the UK economy was not suddenly or materially impacted by last summer's Brexit vote as many had feared. While GDP growth for 2016 was recently revised down from 2.0% to 1.8%, momentum in the economy picked up over the course of the year with growth of 0.7% in Q4.

Of particular relevance to the logistics sector, consumers played an important part in the UK economy's apparent resilience to the shock of the Referendum result. UK growth in 2016 was driven by the dominant services industry, and included particularly strong growth in the sub-sector of retail trade which expanded by 5.0% year-on-year.

Even with the days counting down to the Government's anticipated triggering of Article 50, evidence from key business surveys also suggests the economy has made a solid start to 2017. On the basis of past form, the latest Markit/CIPS Purchasing Managers' Index remains consistent with growth of circa 0.5% in Q1.

RISING INFLATION EXPECTATIONS TO WEIGH ON CONSUMERS

However, rising inflation – or rather 'reflation' – is expected to weigh on growth during 2017. A combination of rising import costs stemming from sterling's post-Referendum devaluation and resurgent global oil prices is already feeding through to consumer prices, with CPI rising from 0.5% last June to a two-year high of 1.8% in January.

The consensus is pointing to inflation peaking at around 3% during 2017, a level which the Bank of England is likely to overlook in order to support growth. Nonetheless, with inflation set to outstrip wage increases, and greater caution in consumer spending, GDP growth is expected to moderate to circa 1.5% in 2017.

A MORE COMPETITIVE MANUFACTURING BASE

The post-Brexit prospects for UK industry are hotly debated, but until more clarity emerges on the UK's trading relationship with the EU, and indeed bi-laterally with the rest of the world, it is too early to speculate how it will be affected in the medium to long term. The prime minister's stance has been one of a clean break from the EU single market but the reality may turn out to be quite different.

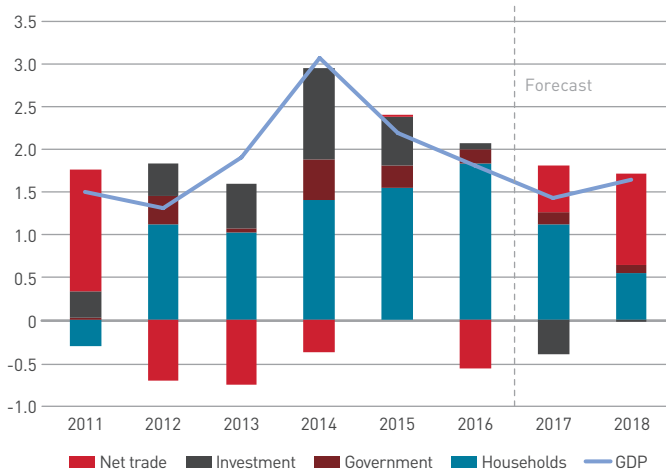
Much more clear is the instant boost sterling's devaluation has given to the competitiveness of UK export manufacturers. While inflation is feeding through into input costs, the lower pound should help to drive a stronger net trade performance than in recent years, provided of course that conditions in the global economy remain sound.

STRUCTURAL CHANGE IN RETAIL TO SUPPORT LOGISTICS

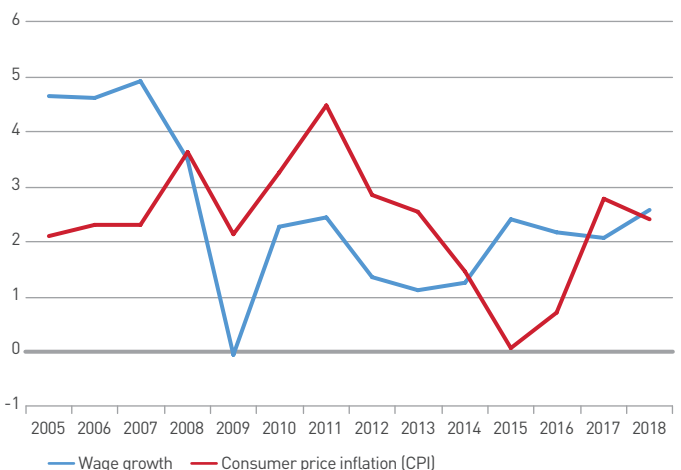
With a great deal of uncertainty over the road ahead, strong investor demand for logistics reflects its positive growth fundamentals relative to other assets. Even if consumer spending is materially affected, the ongoing evolution of the retail sector will continue to underpin growth and demand in logistics.

As if by clockwork, November of every year spells a new record for the proportion of retail sales made online, climbing to a new high of 18.3% last time. Moreover, even if a plateau of circa 20-25% is on the horizon, demand will continue to be supported by the drive to ever more efficient, agile means of servicing customer requirements, from retailers, logistics operators and parcel carriers alike.

CONTRIBUTIONS TO UK GDP GROWTH (%)

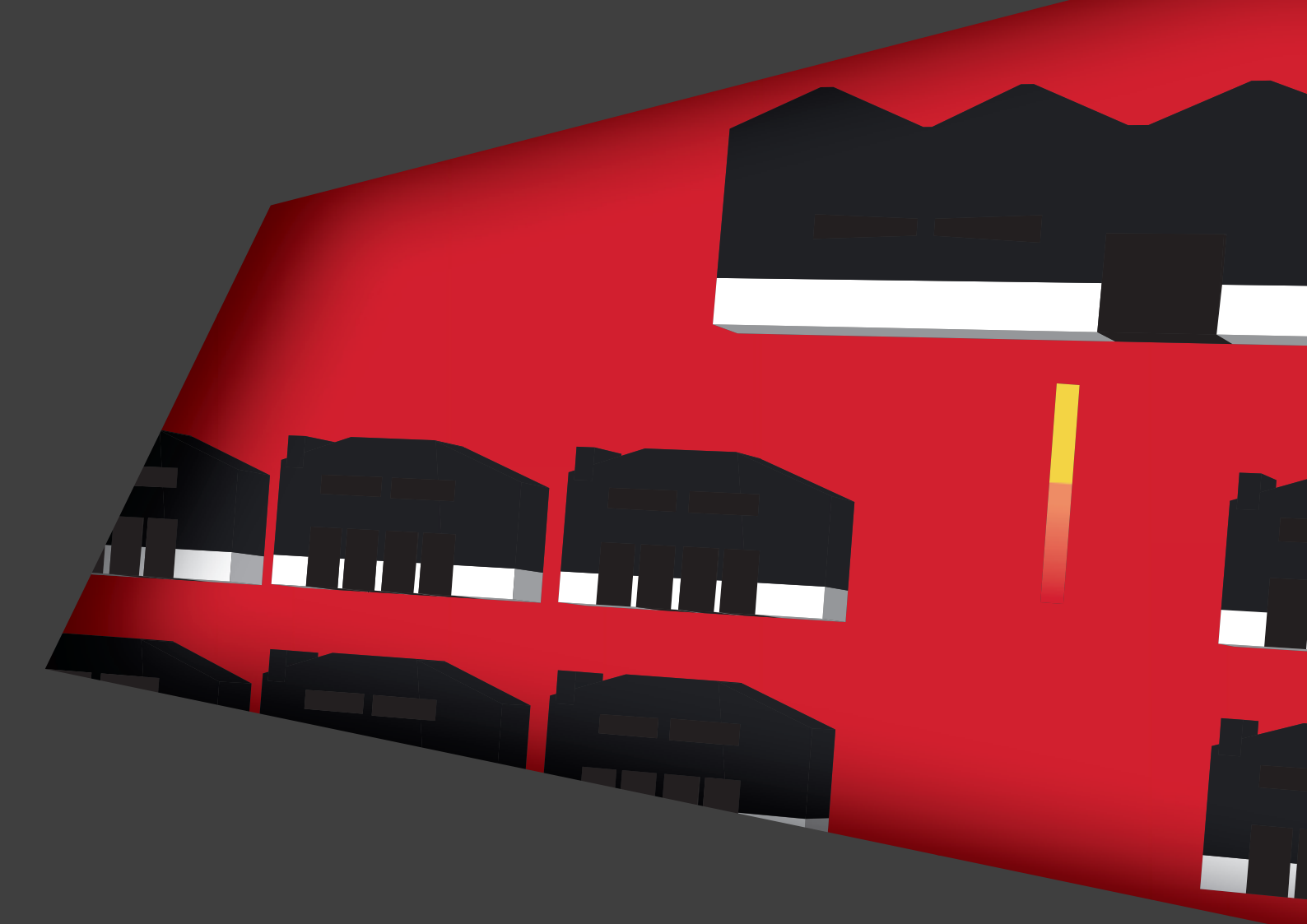


WAGES VS INFLATION (%)

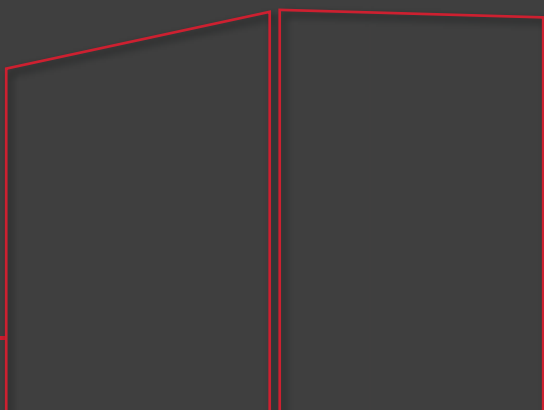


INTERNET'S SHARE OF UK RETAIL SALES (%)

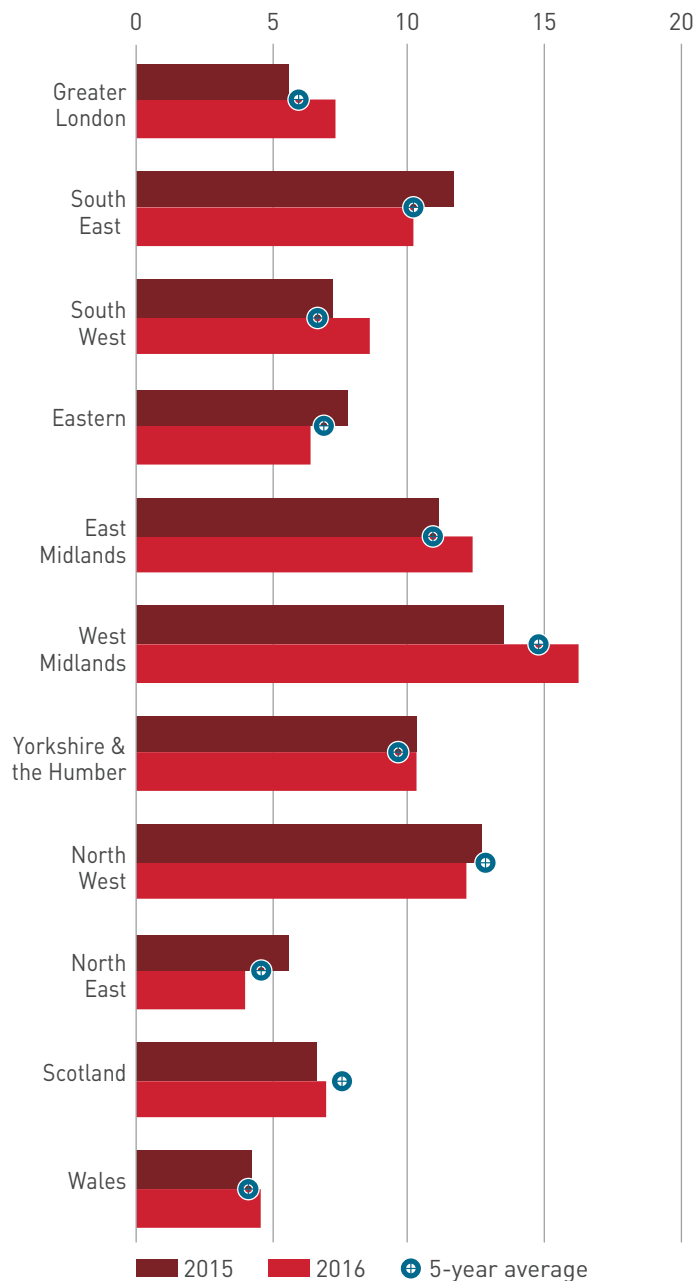




MARKET OVERVIEW



UK TAKE-UP BY REGION (M SQ FT)



RECORDS TUMBLE IN LOGISTICS

2016 was a record year for logistics with take-up of 37.3m sq ft, up 32% on 2015 and eclipsing 2014's previous high by 6%. Despite the more uncertain economic environment in the wake of last summer's Referendum result, logistics take-up was 32% higher in the second half of the year than the first half.

Amazon was pivotal to the record year, accounting for 20% of logistics take-up, a record share of the market by a single occupier. 2016 also saw record take-up of both grade A space and build to suit activity in logistics, a clear reflection of the imbalance of demand and supply.

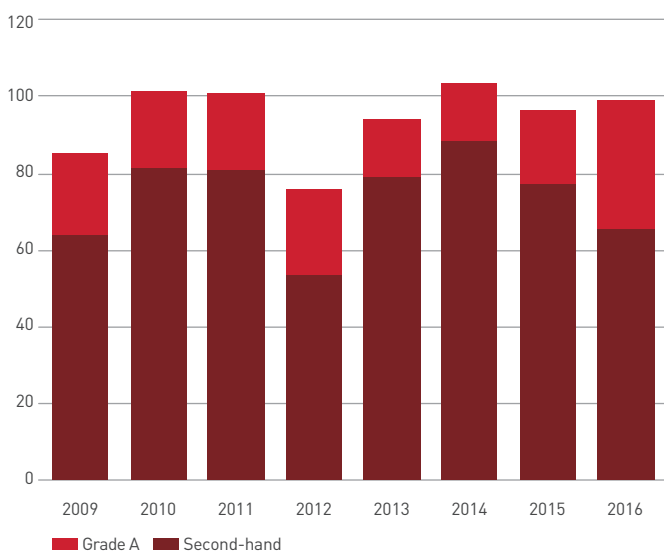
2016 was a more mixed year elsewhere in the market. Mid box take-up slipped by 24% from 2015's record total, although grade A space accounted for a significant 23% of activity, reflecting the delivery of much-needed new space to this sector. Meanwhile, activity in the small and medium-sized sectors was relatively stable, down 4% on 2015 and closely in line with the five-year average.

MOST REGIONS ENJOY ROBUST ACTIVITY

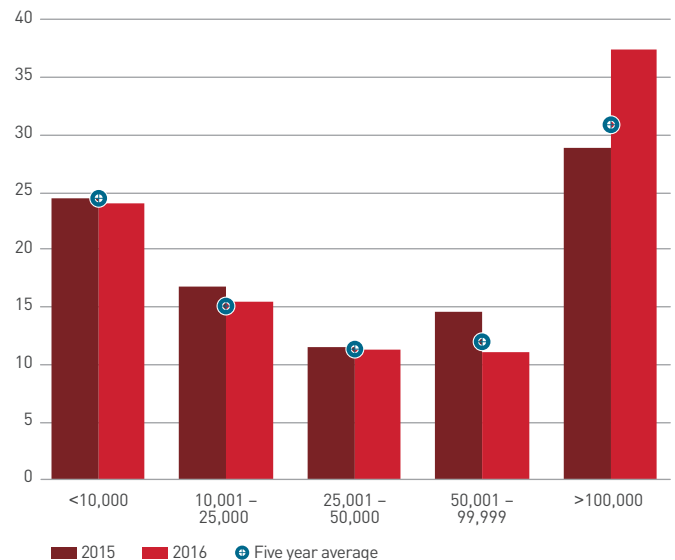
The majority of UK regions saw robust take-up in 2016, with the pattern largely dictated by the level of activity in the logistics sector. This was especially true of Greater London and the South West, where major deals skewed overall take-up, and also the two Midlands regions, where combined logistics take-up increased by a substantial 58% year-on-year.

With notably subdued logistics activity, the East, North West and North East regions each saw overall 2016 take-up fall short of their five-year annual average. That said, these regions saw respectable take-up in other smaller size-bands, indicating ongoing depth to market activity.

UK TAKE-UP (M SQ FT)



UK TAKE-UP BY SIZE (M SQ FT)



OVERALL SUPPLY KEEPS ON FALLING

In spite of a wave of development completions over the past 12 months, totalling in excess of 10m sq ft, overall supply continues its steady downward path. For a fourth successive year, UK-wide availability fell by exactly 18% in 2016 to stand at a new record low of 161m sq ft, with the UK availability rate falling from 5.4% to only 4.6% of built stock.

However, there were significant contrasts in the supply movements between size-bands. Despite circa 8m sq ft of logistics completions, overall supply edged down by a further 5% during 2016. Meanwhile, robust take-up alongside pressure from alternative uses and viability challenges at the smaller end of the market saw overall UK supply of units under 50,000 sq ft fall by 30% year-on-year to 89m sq ft, just half its level from three years ago.

Mid box was the exception, with overall UK supply increasing by 21% year-on-year to 22.1m sq ft. Notably, this was driven by an increase in second-hand space, with occupiers relocating into better quality premises following the delivery of much needed new supply to the market.

REGIONS SEE CONTRASTING PATTERNS OF SUPPLY

While supply is tight across all regions and sectors, there was significant variation in supply movements during 2016. Speculative development contributed to a modest rise in overall supply in both Greater London and the South West, albeit the two regions remain among the UK's most tightly supplied in relation to take-up.

While all other regions saw supply fall year-on-year, it was extremely marked in the West Midlands, down 27%, and in spite of the fact it has provided a key focus of development. The North West also witnessed a substantial 21% fall in supply during 2016, although the supply position is arguably less acute in relation to average rates of take-up.

RENTAL GROWTH ACCELERATES IN 2016

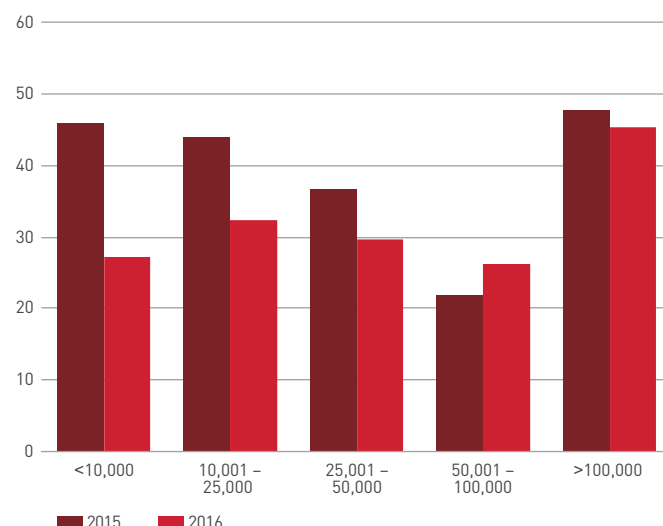
Rental growth continued unabated in 2016. For 60 key UK markets, average rental growth for prime stock was 5.3% in 2016, rising from 3.9% in 2015. Moreover, despite the uncertainty immediately generated by last summer's vote for Brexit, rental growth in the second half of 2016 alone was 3.6%, a result which indicates a rapid return to 'business as usual' in such a supply-constrained market.

Meanwhile, secondary rents outperformed prime for a fourth consecutive year, albeit marginally in 2016, rising by 5.4% on average. With our rental figures based on 20,000 sq ft units, the result indicates that strong competition remains for dwindling levels of secondary space in the smaller part of the market.

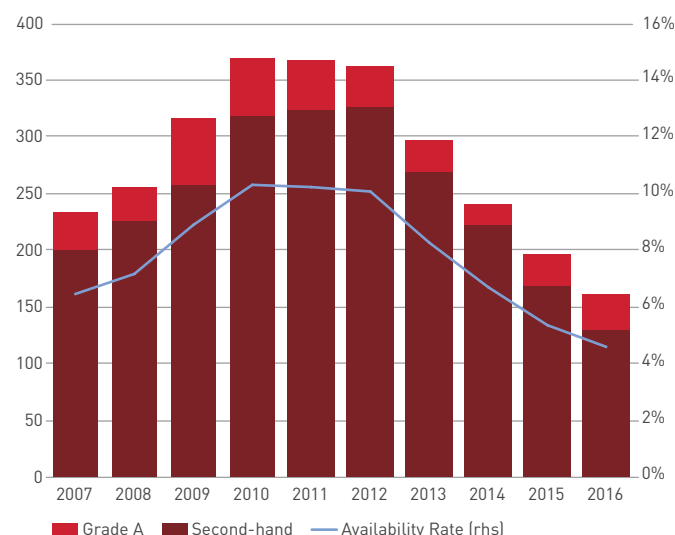
RENTAL GROWTH EVIDENT IN MOST REGIONS

With the exception of Yorkshire & the Humber, the pattern of rising rental levels was familiar to all UK regions, for both prime and secondary stock. However, the extent of the growth varied considerably. While prime rents were flat in Yorkshire, the North West region saw the strongest growth for both prime and secondary stock, rising by an average of 10.3% and 12.9% respectively. Of all locations, Manchester saw the strongest growth in prime rents, rising 23% year-on-year.

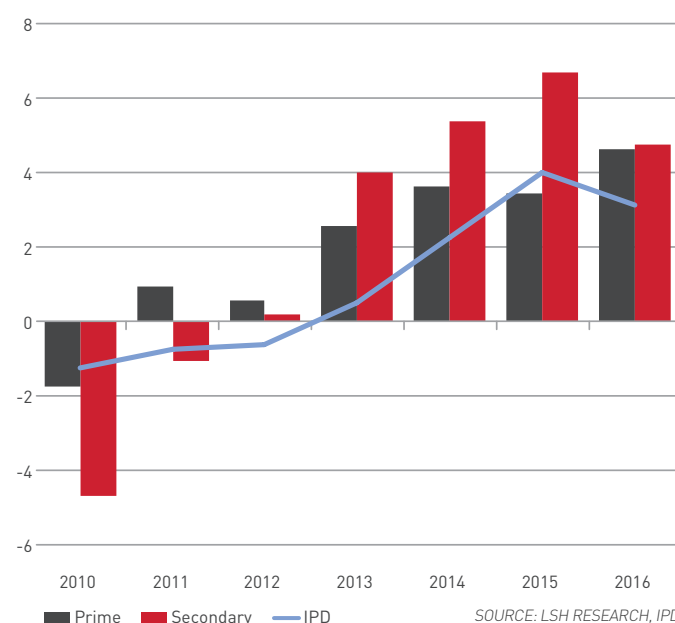
UK AVAILABILITY BY SIZE (M SQ FT)



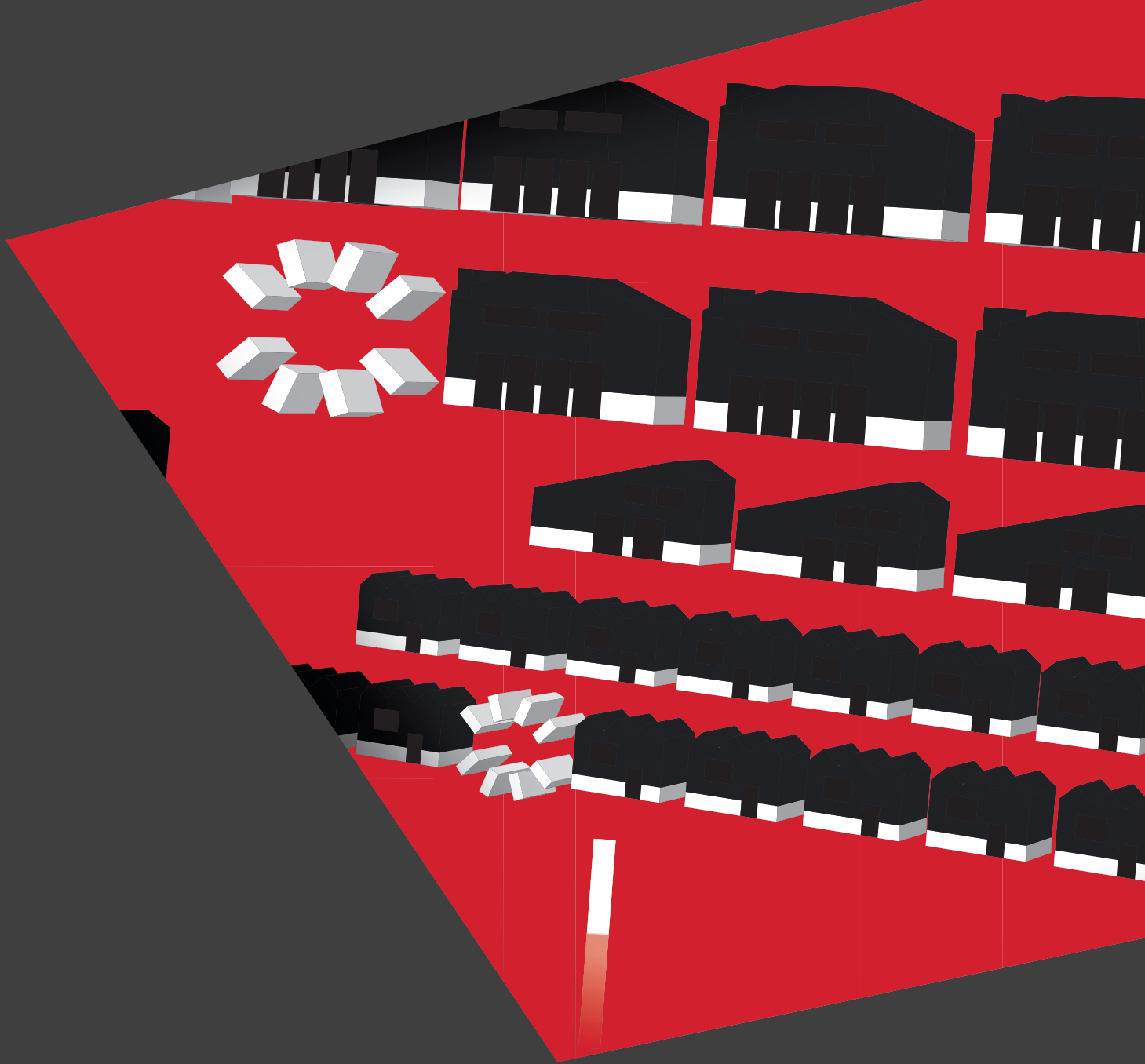
UK AVAILABILITY BY GRADE (M SQ FT)



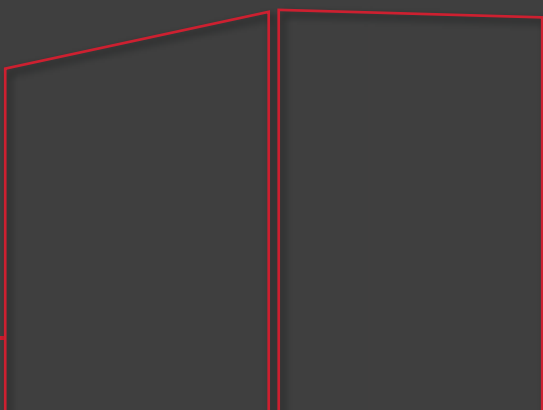
AVERAGE UK RENTAL GROWTH (% P.A.)



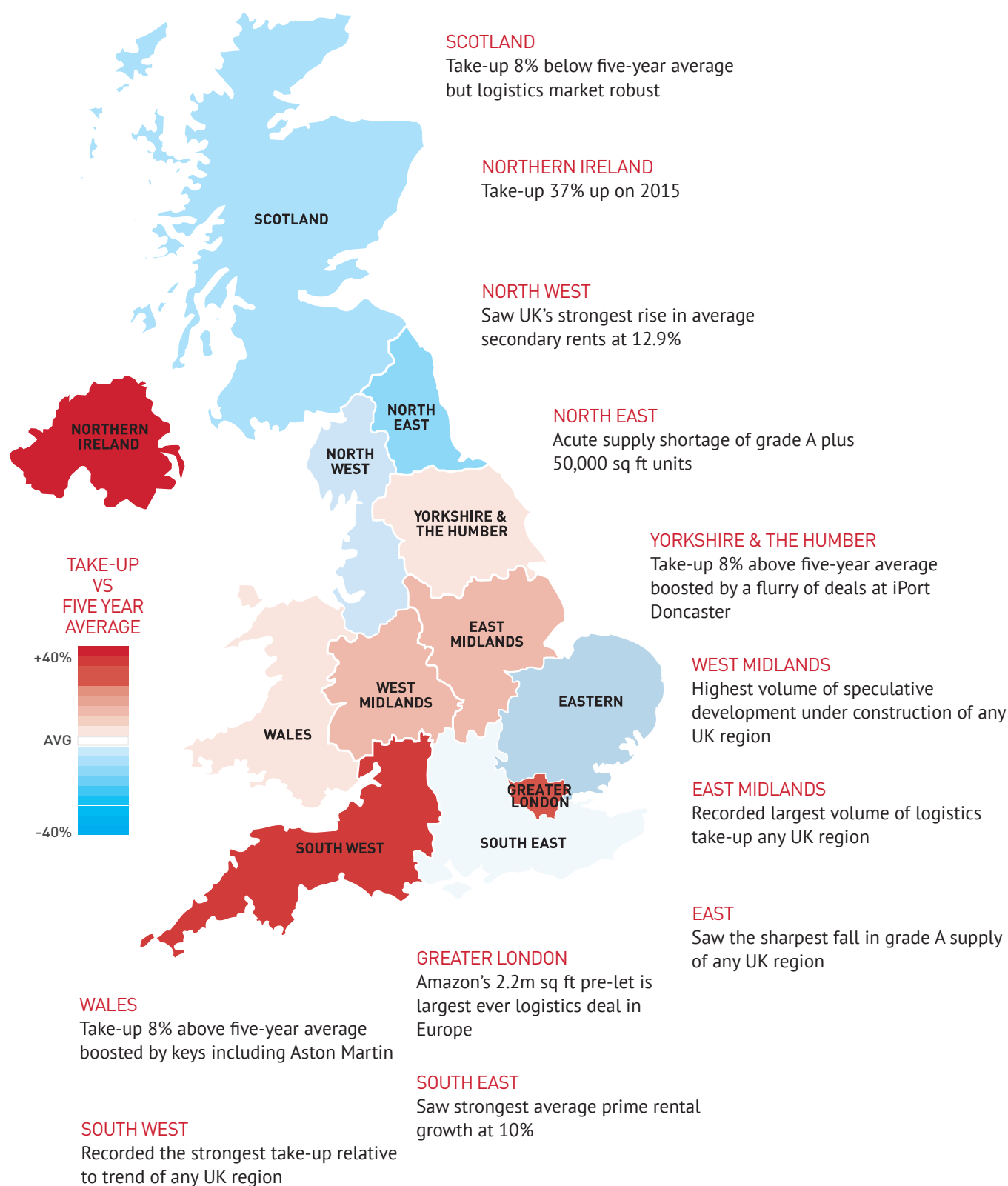
SOURCE: LSH RESEARCH, IPD



REGIONAL MARKETS



REGIONAL OVERVIEW





2017: THE YEAR AHEAD

The fundamentals around industrial & logistics bode well for its performance prospects in 2017. However, the environment has become more challenging, both for occupiers seeking more flexible options and for would-be developers and investors searching for opportunities in the market.

RISING DEMAND AT ODDS WITH MORE UNCERTAIN OUTLOOK

Despite the spectre of rising inflation and uncertainty on the road to Brexit, the outlook for occupier demand remains positive for 2017. The sector has been a clear beneficiary of low inflation in recent years, giving greater substance to rental growth and supporting healthy consumer spending.

While rising inflation may erode some of the momentum in the market, our analysis of active demand indicates that sentiment remains positive which bodes well for healthy occupier activity in 2017. Moreover, even if household finances do become more cautious, structural change around ecommerce and the need for ever greater efficiencies in delivery supply chains will continue to drive demand in the sector.

BREXIT IMPACT IS FAR FROM CLEAR

The days may be counting down to the Government's triggering of Article 50 of the EU Treaty, but that will only mark the very start of negotiations over the terms of the UK's trading relationship. So far, the only clear consequence of the vote to leave is the significant fall in the pound, and while this is putting pressure on import prices, it has in fact boosted the competitiveness of UK manufacturing.

With sentiment changing regularly, only time will tell what Brexit ultimately means for UK producers. One moment, the UK is back to 'the front of the queue' with a bilateral US trade deal following Trump's election to president, and the next we see concerns over future UK car production flowing from GM's possible sale of Opel.

A MORE CHALLENGING DEVELOPMENT ENVIRONMENT

Arguably the central challenge for the market in 2017 is on the supply side. The fundamentals in the occupier market continue to make a compelling case for more development, not only to arrest the critical lack of existing supply but also to accommodate the steady structural growth in demand for omni-channel fulfilment. The challenge is, as always, ensuring the right product is delivered to the right market at the right time.

Despite active demand standing higher now than a year ago, indications are that development appetite has receded. This not only reflects caution over the economic outlook, but the acute lack of sites in prime locations, a disconnect in buyers' and vendors' price aspirations on land values and rising build costs, both recent and anticipated.

However, there are undoubtedly untapped opportunities in the market, both geographically and sectorally. Braver developers may benefit from considering sub-optimal locations, offsetting that risk with more attractive rental values, while the recent focus of development in the lower size-bracket of logistics gives increasing scope for larger units in prime areas.

Innovation and creativity is going to be increasingly important in delivering new supply in densely populated areas. It is only a matter of time before developers start to provide multi-storey buildings to multiple occupiers, while evidence of closer integration between residential and light industrial uses could in future play a key role in addressing critical lack of supply at the smaller end of the market.

TIGHT SUPPLY TO SUPPORT FURTHER RENTAL GROWTH

In this more uncertain economic environment, tight supply in the industrial & logistics sector forms a key part of its strong investor appeal. Even if occupier demand was to take a significant turn for the worse, the supply situation is such that rental values are unlikely to be materially impacted.

Indeed, while rental growth expectations have been scaled back post-Referendum, we envisage continued growth throughout 2017. At the all UK level, prime headline rents are forecast to increase between 2% to 3% over the coming year, easing down from the 5.3% seen in 2016.

However, rental levels in many UK locations will be stable, with limited potential for further growth in areas where new development has brought greater equilibrium to the market. As growth ripples out, secondary locations now have the best prospects for growth, particularly those in close proximity to much more expensive locations.

LACK OF STOCK IS MAIN CHALLENGE TO ACTIVITY

Last summer's Referendum result is something of a double-edged sword for logistics & industrial. With greater uncertainty in the outlook, the sector's positive fundamentals continue to make it a prime target for investors, in recognition of its attractive income qualities and growth prospects vis-à-vis offices and retail.

The fact industrial & logistics is set to outperform other key sectors is reassuring for those who hold the stock. But with little incentive to sell and sellers' aspirations typically ahead of buyers' expectations, stock may be the single major challenge to volume in 2017.