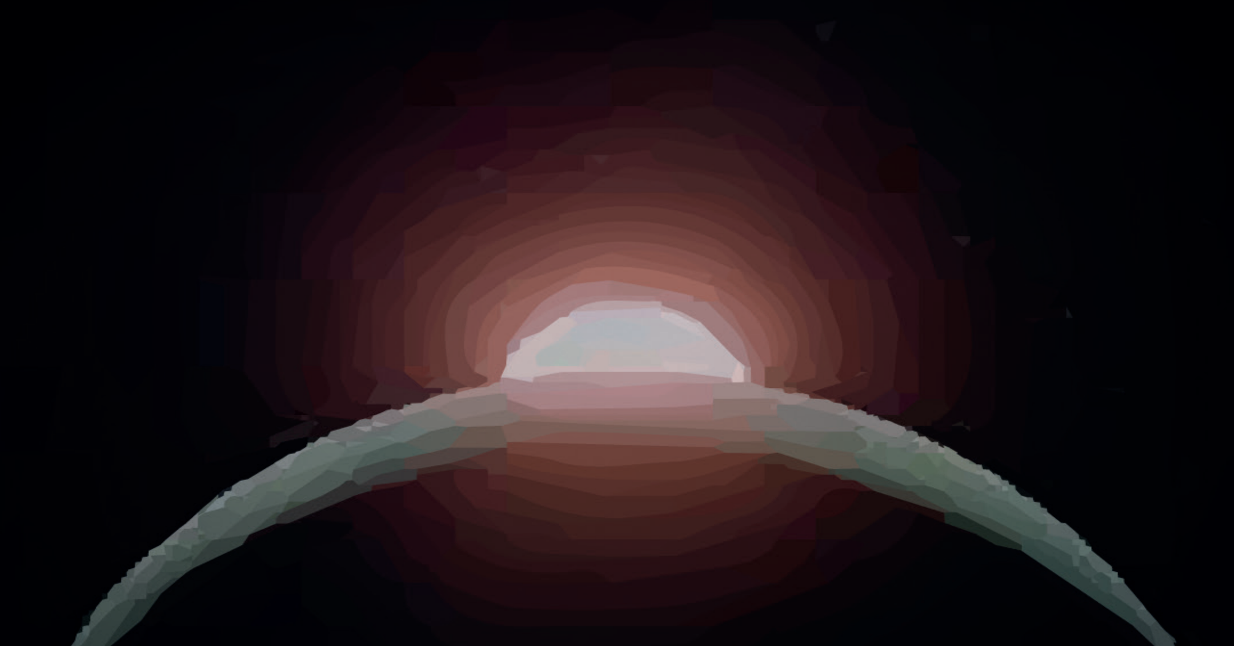
Lambert Smith Hampton



NEW DAWN

THE TRANSFORMATION OF UK INDUSTRIAL & LOGISTICS

ILM2019

INDUSTRIAL & LOGISTICS MARKET

WELCOME

A new dawn is rising for the industrial and logistics sector.

JAMES POLSON
National Head of
Industrial & Logistics

Albert Einstein once famously said, "The definition of insanity is to do the same thing over and over again and expect a different result". This could not be any more appropriate for the current industrial and logistics market.

The landscapes of the industrial and retail markets are shifting rapidly. Shopping habits have become more advanced in the digital age with consumers wanting, and expecting, to receive goods ever faster and more efficiently.

The industrial and logistics sector is now at a crossroads. In general terms, significant yield compression has left yields with little room for further movement, meaning attention must be resolutely focused on driving income. If yields can't fall any further, industrial land values in some areas can only be justified with further rental growth. Without changing the offering to the modern consumer, how is that rental growth going to be realised?

Surely good old-fashioned supply and demand dynamics will drive rental growth? Will a "build it and they will come" mentality prevail? But what do we build? A conventional logistics facility with 12 metre eaves, 45% site density, 1:10,000 sq ft loading door ratio and 350 kVA power supply? We have always done it this way, and it's what occupiers want...

Except for many, it is now not. The logistics market is splitting into a two-tier sector before our very eyes. Occupiers are having to cater for an ecommerce demand boom while also continuing to operate efficiencies for the more traditional logistics model. How can one size now fit all? The answer is it can't.

What was once seen as a bottom line cost for businesses is now viewed as the single most important growth initiative – a business's entire supply chain operation and its warehouse efficiency.

New obstacles are emerging, which the sector will need to address. The rise of automation, driven by the need to satisfy ever-growing online demand, is bringing with it power capacity challenges. In relation to operations transport and fleet modelling, this is now having to cater for a wider range of solutions.

The mid box sector, which was benefiting from the boom times, now seems to be stagnating in some areas. Labour availability in core locations is another challenge for the sector, but the quality of labour is also a growing issue given the evolution of supply chains.

While immediate concerns such as Brexit are grabbing the headlines, there are clearly other issues that are likely to have a greater long-term impact on the sector. With land values at an all-time high and yields at an all-time low, unlocking future value is the challenge we face.

We hope you enjoy this report. LSH's market-leading experts will be happy to discuss with you any of the topics covered on the following pages.

SUMMARY AND OUTLOOK

As the dust settles on another remarkable year for the UK industrial and logistics market, the positive underlying fundamentals associated with the sector are presenting growing challenges for both occupiers and investors alike. Despite this, the sector is nonetheless set to continue to outperform the rest of the property market over the coming years.

SUPER-SIZE ME

Amid another record-breaking year for investment volume, viewed overall, 2018 was a decent year for occupier market activity. UK-wide take-up for the year was marginally down on 2017 and 4% below the five-year annual average. Given the slowdown seen in the UK economy in the second half of the year, and growing anxiety around Brexit generally, the result paints a picture of real resilience across the market.

The main take-away from 2018 was the reversal of fortunes between the mid box and logistics segments. Logistics activity was back to boom levels, fuelled by a proliferation of 'mega deals' to retailers, both pure play and omni-channel. Conversely, the mid box sector endured a real fall from grace, with take-up in 2018 falling to a nine-year low after a record year in 2017.

BREXIT UNCERTAINTY

Occupier market activity in 2019 to date has, understandably, been tempered by Brexit, with still no certainty as to whether a no deal will be avoided. Activity has not ground to a halt, with headline grabbing deals still to report, but inertia may continue until the end of March. Thereafter, assuming a no deal Brexit is avoided, we can be confident that pent-up demand will be released with a rebound in activity.

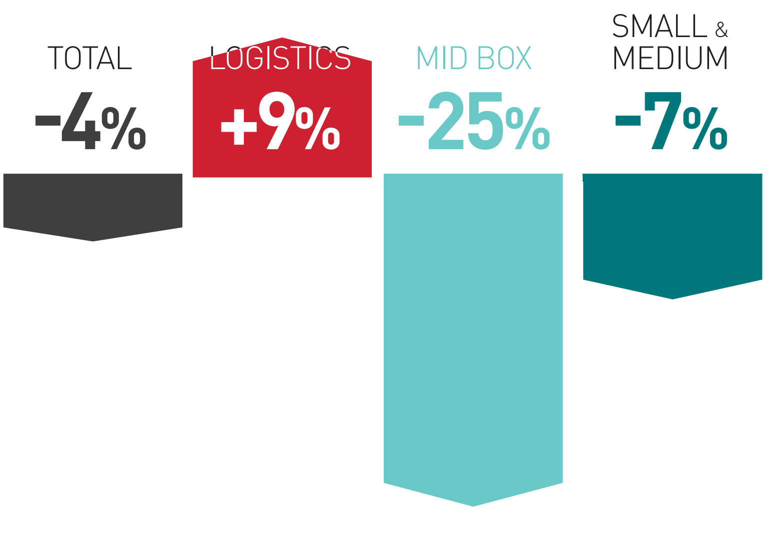
Amid the uncertainty, UK employment remains a major bright spot for the economy and has delivered consistently positive news in recent quarters. The tightness of the labour market has accelerated wage growth to an 11-year high of 3.4%, and a continuation of rising wages and low inflation could spur further spending growth, which would be significant boost to an otherwise uncertain outlook for the UK economy.

NO DEAL DISASTER?

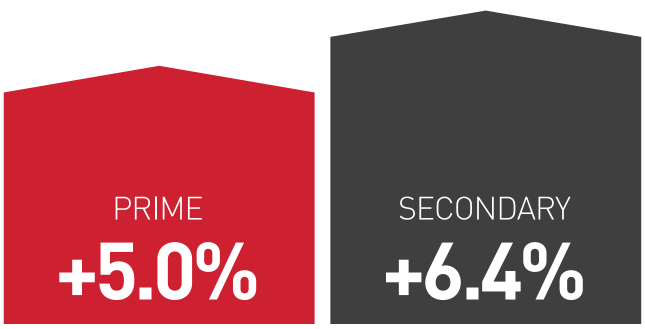
While the bookmakers continue to price a no deal Brexit outcome at the end of March as very much the outside bet, there are no guarantees. Reflecting the interdependency of supply chains across Europe, the initial disruption caused by a no deal would have massive short-term implications for logistics occupiers, while the expected hit to the economy more generally would put the brakes on occupier demand across the wider market.

Putting the short-term disruption aside, an end to frictionless trade with the EU would have both positive and negative ramifications for the logistics market and the manufacturing sector. While some occupiers could opt to retreat or consolidate their operations back to the European mainland, others will opt for a greater focus in the UK.

UK 2018 TAKE-UP VS FIVE-YEAR AVERAGE



AVERAGE UK RENTAL GROWTH 2018



Regardless of Brexit, it is important not to lose sight of the fact that the UK is home to over 60 million consumers. While the UK high street grapples with fundamental changes to shopping patterns, the growing challenges posed by ever more tech savvy and discerning UK consumers will continue to drive demand for logistics solutions from omni-channel retailers.

LABOUR PAINS

Ironically, perhaps the greatest challenge for occupiers and indeed developers is linked to the very fact that the UK employment market is in such strong shape. With the UK more or less at full employment, the days of easily tapping into large, largely unskilled pools of labour are long gone. Meanwhile, the prospect of stemming the flow of EU workers to the UK on the back of Brexit will only exacerbate the problem. Developers must consider prevailing supply levels in terms of both stock and labour in equal measure to minimise letting risk.

The move towards greater automation will mitigate some of the problem but, for the time-being, only a minority of market occupiers boast the sort of advanced facilities that are capturing public attention. We are aware of some prime locations which are now losing some of their competitive edge purely on the back of labour supply issues, with a number of occupiers exchanging higher transport costs for access to labour by moving into hitherto secondary locations.

RECORD (LOGISTICS) DEVELOPMENT

As predicted, a wave of speculative development has come through over the past 12 months and, at the end of 2018, a record 9.4m sq ft of space was under construction in units above 50,000 sq ft. Development appetite has not waned either; a number of notable spec schemes started in the first weeks of 2019 while LSH's industrial agency network collectively anticipates 11.7m sq ft to come forward speculatively over the coming year.

While considerable development is gradually restoring the balance of supply at the larger end of the market, lower return expectations on smaller unit developments continue to act as a barrier to a meaningful supply response, reflecting the impact of build costs on development viability. This is looking increasingly like a classic case of market failure, with decent demand and uptake of new small unit schemes being seen when they do occur. Given local authorities' increasing exposure to property investing in recent years, this is arguably a potential area of opportunity to generate income and support local economies.

WHERE NEXT FOR PERFORMANCE?

The meteoric rise of investment interest in UK industrial & logistics was reflected in a second successive record year for volume, with £8.4bn of assets changing hands in 2018. Investors have also been able to reap substantial rewards over the past few years, with sector-leading returns for a third consecutive year seen in 2018, led by London & South East industrials, with returns at over 20%.

But where does the market go from here? With yield compression considered largely exhausted, one thing we can be sure of is that returns will begin to ease down to more 'normal' levels and, by 2020, we expect income to be the main driver of performance in sector returns. UK industrial nonetheless remains forecast to continue to outperform the other key property sectors over the five year time horizon, albeit to a more modest degree than recent years.

2018 volume is also likely to represent the high watermark for investment activity. Whereas historically industrial developers tended to trade stock once complete, many are now retaining stock in their own funds and maximising income returns. Alongside greater caution towards shorter-leased secondary assets, we see this as a key contributing factor to a lowering of transactional volume in 2019.

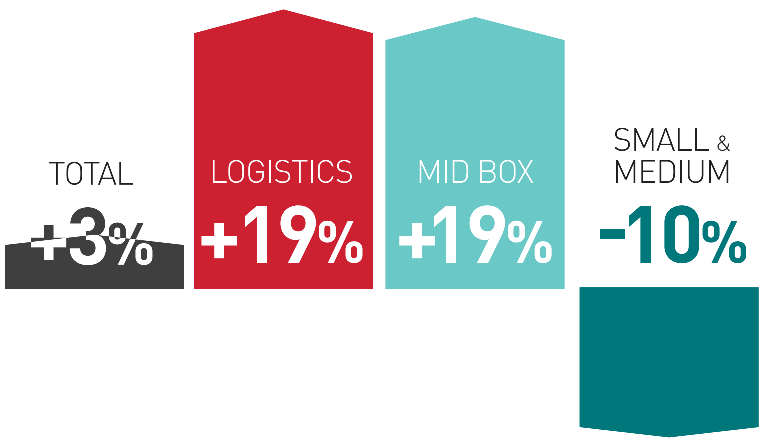
BANKING ON RENTAL GROWTH

In the absence of yield compression, industrial's forecast outperformance is largely predicated on further rental growth coming through. For logistics, in certain parts of the country, the supply response we have seen will weigh down on further growth prospects. But, beyond that, there is continuing scope for robust growth and arguably even headroom for this to be stronger than portrayed in the forecasts.

What the econometrically-driven forecast model cannot readily factor in is the substitution effect, arising from the downturn in retailers' requirements for retail space in view of structural changes to shopping patterns. Just as UK retail warehousing rents went through a sustained two decade period of growth, could urban logistics be embarking on a similar journey? Moreover, with high void rates and falling rents being seen across many retail parks, there could just be a ready supply of future sites waiting in the wings. Food for thought.

2018 INVESTMENT

UK CHANGE IN SUPPLY, Y-ON-Y



DELIVERING INNOVATION

EDMOND LEAHY
Estates Manager,
Hermes

The parcel delivery business continues to grow exponentially. However, the increasing choice that consumers require poses real challenges, particularly in final mile delivery. To ensure these challenges become opportunities, Hermes is at the forefront of technological innovation.

According to Ofcom's latest update on the postal market, the volume of parcel deliveries in the UK increased by 11% between 2016-17 and 2017-18 to reach 2.4 billion. Hermes itself delivered more than 330m parcels in 2018 and has seen double-digit growth every year for the past six years. The seemingly exponential rise in e-tailing is also characterised by discerning consumer expectations over delivery efficiency.

However, the conventional warehouse seems to struggle at a local level to efficiently serve the parcel delivery market. Properties available are sometimes not ideal for Hermes' needs; institutional, 1980s-built, multi-let industrial estates can be compromised or unsuitable, disproportionately expensive and, in a buoyant market, often only available on onerous and unacceptable terms. Particularly in London, the move to house a growing population has resulted in land being lost by commercial to residential, resulting in soaring rents.

HERMES, RUGBY
comprising a 271,000 sq ft building on a 34 acre site.

A REVISED STRATEGY

In contrast to what is available, today's final mile parcel delivery strategies are increasingly agile and risk averse, requiring property solutions with a local community approach that involve flexible lease commitments. Put simply, the mantra is spread the risk and keep flexible.

As ideal property solutions become harder to find, parcel delivery businesses need to find innovative ways to meet customers' increasing expectations to receive what they want, when they want it. Greater automation will increase efficiency and productivity and final mile delivery is fast evolving. While this provides a real set of challenges, it may also provide opportunities.

INNOVATION

Hermes is trialling and exploring various cutting-edge technologies. The emergence of 5G and artificial intelligence (AI) is bringing opportunities to offer more choice to customers. AI will introduce more automation, not just in delivery centres. In Southwark, Hermes trialled self-driving robots in partnership with Starship Technologies to collect parcels from customers in 30-minute time slots. The robots have several advantages over aerial drones, from being able to carry heavier payloads to being less likely to fall foul of aviation laws.

Hermes was the first UK parcel delivery company to integrate its end-to-end tracking system with Amazon's Echo smart speakers, powered by Alexa. Customers can use voice commands to get an update on where their parcel is and view a photo of the parcel when it is delivered to a designated safe place.

As for customer choice, Hermes is exploring the areas of connected homes and one-time keys. The homeowner gives the courier a one-time passcode for their car or their front door, for example, so the parcel is delivered in a place convenient for them. Not only will the customer have more flexibility, but the courier can deliver the parcel at any time convenient to the rest of their journey.

5G will be widespread across the UK by 2022, which means we will be able to connect millions of devices at the same time, providing real time information on a parcel's location with granular accuracy. Vehicles will also be able to talk to each other, reducing overlap in delivery journeys.

SUSTAINABILITY

Sustainability is high on Hermes' agenda. Customer decisions are of course motivated by price and quality, but increasingly they consider sustainability. Hermes' new 81,000 sq ft flagship depot in Hemel Hempstead incorporates a long list of building sustainability criteria, including the sponsorship of indigenous tribes in Peru to preserve Amazonian rainforest and offset embedded carbon in the development.

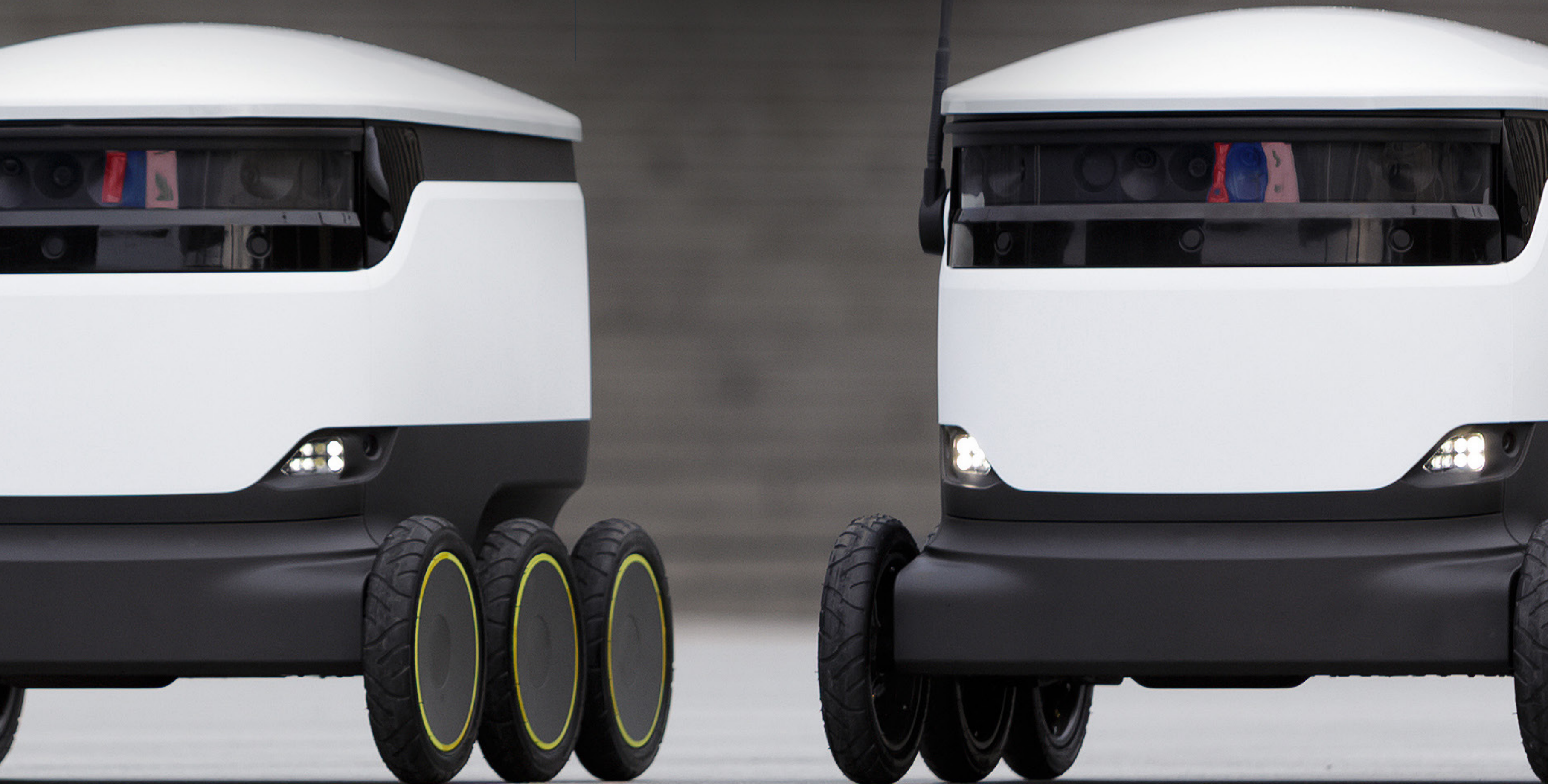
On 8 April 2019, an Ultra Low Emission Zone will be in place in central London, expanding to include inner London in 2021, and Hermes is prepared for this positive step. Most vehicles will need to meet tighter exhaust emission standards or pay a daily charge within the ULEZ, a phenomenon that will spread nationwide. Increased use of electric and compressed natural gas (CNG) vehicles is a key initiative if business as usual is to be maintained. In 2018, Hermes placed an order for 30 CNG vehicles in the UK, the largest initial order of any business to date, and plans to add a further 50 to its fleet this year.

A HAND FOR THE HIGH STREET?

While Hermes strives to offer increased choice to consumers, the ailing high street may provide an opportunity to help rather than merely observe bricks-and-mortar retailers, who are competing with pure play e-tailers offering next-day, or even same-day, delivery. The concept of out-of-town consolidation centres may be a solution; parcel delivery firms could operate fulfilment centres, effectively storing stock for retailers.

The tough times that could lie ahead, not only for retailers, are particularly unclear as we face Brexit. No one yet knows what the full extent of any impact will be. There is real short-term potential for the already rapid evolution in parcel delivery to increase as supply chains adjust.

What is not in doubt, however, is that the marketplace for parcel delivery will remain highly competitive and parcel volumes will continue to increase. Hermes is determined that innovation will counteract any lack in efficiency between final mile property and final mile customer requirements.



BIG BOXES ARE GETTING BIGGER

EDWARD PLUMLEY
Tritax Management LLP,
on behalf of Tritax Big Box REIT plc

In the five years since the launch of Tritax Big Box REIT Plc (TBBR) the big box market has grown – and so have the boxes themselves.

At launch in 2014, we had 14 assets with an average of 500,000 sq ft. Today it is 54 buildings and the average size has grown by 10%. That growth is reflected across the market.

ECOMMERCE AND AUTOMATION

The obvious reason for this is the rise of ecommerce, responsible for c. 18% of total retail sales last year and expected to grow to c. 27% by 2022. In the past six years, UK parcel delivery volumes have doubled, requiring three times as much big box space for online fulfilment.

Spikes in demand are particularly challenging. Online retail sales during Black Friday week have increased from 33% in 2014 to 61% of total retail sales in 2018. This is driving more retailers to automation, which can also help with another perennial retail challenge – dealing with customer returns.

Approximately 80% of our assets over 500,000 sqft have automation, as does over 50% of our total portfolio by value.

EVOLVING OCCUPATIONAL NEEDS

Automation requires significant investment by our customers who therefore tend to take longer leases for these mission-critical buildings. Five years ago, our weighted average unexpired lease term was just under 14 years. It now stands at over 14 years, reflecting the longer lease trend.

This commitment is encouraging our customers to move towards larger volume facilities, sometimes with multiple floors for economies of scale. This could eventually see rents assessed on a volume rather than per sq ft basis, which would be more attuned to the way customers perceive the space they are renting.

BBOX FACILITY AT RAUNDS DELIVERED IN 2016 (658,971 SQ FT)

BBOX FACILITY UNDER CONSTRUCTION AT DARLINGTON (1.5M SQ FT)

Larger, increasingly automated sites can still be people-heavy. Some of our big box facilities require over 3,000 warehouse staff to run efficiently in various shift patterns. This in turn shapes location requirements, which have broadened. Proximity to suitable and adequate population centres becomes more important, as does the need to be located near sufficient power. There is growing interest in onsite generation initiatives to power the automation.

COMPELLING INVESTMENT FUNDAMENTALS

Perhaps not surprisingly there remains a shortage of suitable big box supply for occupiers. This has meant that since 2011 the market has seen an overall headline rental increase of over 20% for modern facilities over 100,000 sq ft.

This has not gone unnoticed by investors and nor has ecommerce growth. The insatiable appetite for UK logistics investment opportunities and the weight of money in the sector have seen prime yields compress, although prime distribution yields still have a c. 300 bps spread over 10-year UK gilts. This suggests that yields are sustainable in the short-to-medium term in a low inflationary environment, even amid Brexit uncertainty.

BIG BOX AND BREXIT

Yes, we need to discuss Brexit. Last year we predicted an increase in take-up due to the challenges that Brexit presents to customer supply chains. In fact, for units over 250,000 sq ft, annual take-up increased by around 42%, according to our research.

As I write, the final UK position is no clearer and it still risks crashing out of the EU on WTO terms.

Lack of clarity has led many occupiers to stockpile products in additional facilities or increase existing volumes within current facilities. This is perfectly rational. Research has shown that a four-minute delay at Dover, which accounts for 30% of food imports from the EU, could potentially lead to a five-hour queue in the retail supply chain. This could have a meaningful impact on UK food flows.

Brexit aside, it is clear that investment fundamentals remain attractive and compelling for the big box subsector, with continuous strong occupational demand and a supply-demand imbalance for bigger and bigger boxes.

NEW DEVELOPMENT PARTNER

This makes TBBR's 87% purchase of DB Symmetry (DBS) all the more exciting. The deal offers shareholders an exciting pipeline of strategic sites that are well placed to capture new big box pre-let forward fundings over the next decade. These have a targeted yield on cost of between 7% and 8% (compared with the current 15-year prime distribution valuation yield of c. 4.5%).

The DBS portfolio offers opportunity to capitalise on over 2,500 acres, capable of delivering 38m sq ft of logistics space in strong and growing big box locations, complementing the existing 29m sq ft portfolio. It also gives us a 'best in class' development management team with the expertise required to capture these opportunities. The future remains bright.

MIXING IT UP

ALAN HOLLAND
Director
Greater London Business Unit
SEGRO

In a city of competing pressures, SEGRO's development at Nestlé's former site in Hayes, London is a pioneering example of co-locating residential and light industrial uses.

SEEING THE OPPORTUNITY

When Nestlé decided to close its factory in Hayes in 2014 and relocate the production of coffee and cocoa to Derbyshire there was uncertainty around the future development of the 30 acre site. While there was the potential to return the site to industrial use, we saw a unique opportunity to apply our thinking on mixed-use and deliver a mix of homes and industrial space aligned with the future needs of London.

With decades of experience in West London, we were well aware of the challenges facing local authorities in meeting demand for employment space, whilst delivering much-needed new homes. Indeed, our 2016 report, Keep London Working, highlighted the need to promote and protect the capital's industrial land to meet demand driven by ecommerce, despite the pressure to increase the delivery of housing.

AN INTEGRATED APPROACH

We embarked on the regeneration of the site with the clear objective to address these competing needs, whilst retaining elements of the art deco building which had been part of the community for several decades. To do this, we partnered with Barratt London, a residential specialist with a similar long-term outlook.

Together we advanced a masterplan for the site, collaborating on all aspects of the design to ensure the industrial and residential elements were complementary and integrated, as opposed to discrete developments side-by-side. The result is a scheme that delivers 240,000 sq ft of light industrial space, which will support up to 500 jobs, as part of a new neighbourhood of 1,400 homes set on the canalside.

It is worth remembering that the adjacency of industrial and residential uses is not new. It has been happening organically across London for some time with developers recognising the need for homes in areas of high employment, and vice versa. The key difference at Hayes is that our ownership of the 30-acre site allows us to properly integrate the two uses within an enhanced public realm. There will be areas of extensively landscaped public green space, improvements to the canal frontage and surrounding roads as well as a 3 km public trim trail, ensuring the residential and industrial zones are permeable and there is a coherency to the scheme overall.

FROM CHALLENGES TO SOLUTIONS

One of the primary challenges when integrating these uses is access and egress points. We have masterplanned the site so there are designated entrances for the warehouse units, separate to the entrance used by residents and in addition to pedestrian walkways and cycle paths which link the scheme to the canal.

Noise is also a consideration when marrying employment and residential uses. The term 'industrial' suggests heavy manufacturing, but in fact this type of modern light industrial space tends to be utilised by retailers, local SMEs or logistics companies who do not cause a lot of noise. Furthermore, we have invested in high quality design, including additional insulation for the residential units, which will mean noise from the workspace is barely audible from inside the apartments.

Looking ahead, one challenge in replicating this co-location elsewhere is the UK's rigid town planning rules which prescribe zones for land uses. The zoning of land makes it difficult to deliver this type of dynamic co-location, although we are encouraged by the latest draft of the new London Plan which is supportive of more innovative intensification of land. However, London still has some way to go to match the planning flexibility in some European cities.

In addition to planning flexibility, this type of mixed-use development requires scale, making the outer London boroughs most viable.

CONNECTIONS ARE KEY

Transport infrastructure is also crucial, not just for residents but also to enable the quick transit of goods. The site at Hayes benefits from good connections to the M4, M25 and A40 and is also within 5 miles of Heathrow Airport, which is a major pull for many logistics companies.

Moreover, the arrival of Crossrail at Hayes & Harlington in 2020 brings the site to within 20 minutes of Central London, considerably expanding the pool of workers occupiers can draw on.

With demolition now underway we are poised to begin construction of the 240,000 sq ft industrial space during 2019, with 1,400 homes to follow in phases over the coming three years. On completion we believe the scheme will offer a template for how London's diminishing land can be utilised to meet the growing need for homes as well as employment space.

REGIONAL MARKETS OVERVIEW

SCOTLAND

- Take-up decreased in all size bands in 2018.
- A lack of speculative development has constrained grade A activity.
- The availability rate of 7.3% is one of the highest in the UK.

NORTHERN IRELAND

- The sale of the former Michelin factory in Ballymena supported a 30% rise in take-up.
- Despite a 38% increase in overall availability, grade A availability remains constrained.
- Prime and secondary rents were unchanged across the key Northern Irish markets.

NORTH EAST

- The North East saw the UK's two largest deals of 2018, both to Amazon.
- Big box take-up skyrocketed by over 700% to 5.3m sq ft.
- Grade A availability of 0.8m sq ft is the lowest of any UK region.

NORTH WEST

- A total of 10.6m sq ft was taken up in 2018, down by 13% on 2017.
- Bucking the overall trend, grade A take-up increased by 51%.
- Rental growth was recorded across the region, and was strongest in Crewe.

YORKSHIRE & THE HUMBER

- Take-up rebounded to 8.7m sq ft, 8% higher than 2017.
- Online retailers fuelled a 51% increase in big box logistics take-up.
- There is a growing cluster of speculative development near Doncaster's iPort.

EAST MIDLANDS

- Take-up hit a record 14.6m sq ft, the highest of any UK region in 2018.
- Big box logistics take-up increased by 93% to pass the 10m sq ft mark.
- Significant rental growth was recorded in the Golden Triangle markets.

WEST MIDLANDS

- Due to a lack of large logistics deals, take-up dropped to a six-year low in 2018.
- Mid box take-up was 1.3m sq ft, the highest total among the UK regions.
- Rental growth was widespread, led by Birmingham and Coventry.

EAST

- Boosted by several major build to suit deals, take-up increased by 10%.
- Speculative development has increased, with Bedford being a key focus of activity.
- The availability rate of 2.6% is the lowest in the UK.

GREATER LONDON

- Despite a relative absence of large transactions, take-up rose by 13%.
- Mid box take-up increased by 47%, the UK's strongest growth in this size-band.
- Prime rents rose by an average of 7.3%, with double-digit growth in several markets.

WALES

- Take-up fell to 4.3m sq ft in 2018, down 17% on the previous year.
- There is a severe shortage of grade A space, with just 0.4m sq ft available.
- The South Wales markets have been boosted by removal of the Severn bridges tolls.

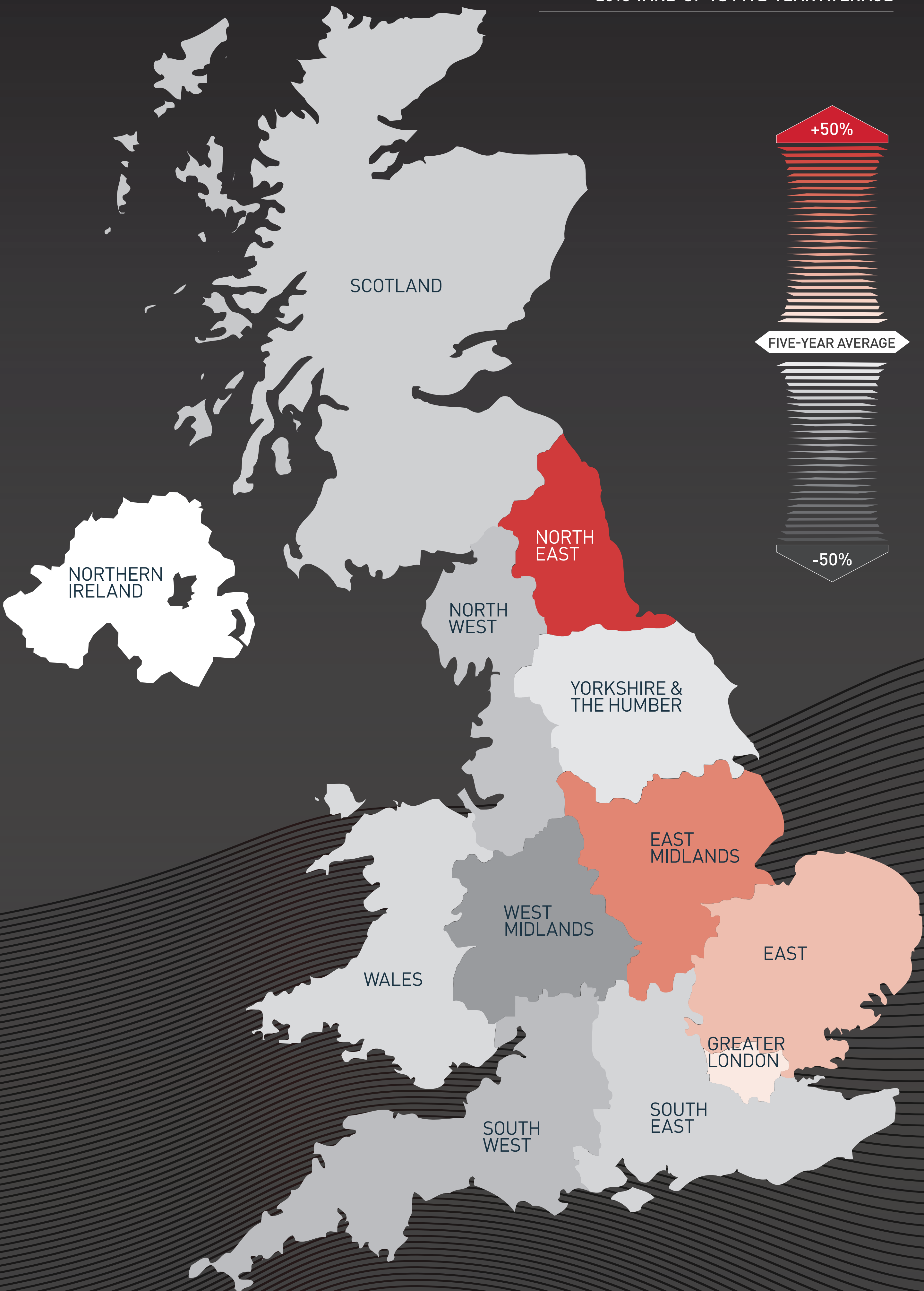
SOUTH EAST

- Take-up decreased by 14%, partly due to a lack of grade A deals.
- Logistics availability soared by 81%, on the back of new speculative deliveries.
- The margin between prime and secondary rents has narrowed significantly.

SOUTH WEST

- Take-up normalised, after being boosted by large-scale transactions in recent years.
- Availability increased by 17%, rising from an all-time low 12 months earlier.
- Secondary rents grew at a faster rate than prime rents across much of the region.

2018 TAKE-UP VS FIVE-YEAR AVERAGE



Source for all data unless stated: LSH Research

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