DTRE

Q3 2022 RESEARCH

Big Box Logistics

OCCUPIER & INVESTMENT
MARKET REVIEW

5 Things You Need to Know

ABOUT **BIG BOX LOGISTICS** IN Q3'22

1. **8.2 million sq ft** of take-up in Q3'22, **11% ahead of the quarterly average since 2012,** however, volumes have been hindered significantly by a slowdown in the design & build market

2. The DTRE Big Box National **Vacancy Rate has ticked up and now stands at 3.2%** - as spec development comes on-stream

3. Q3'22 saw a huge slowdown in trading volumes, just **£1.1bn traded - the lowest quarterly volume since Q3'20**

4. Net Initial Yields for Distribution Warehouses now stands at **4.1%,** according to the MSCI Monthly Index, **an outward shift of around 40 bps in a month - however there's little evidence to support this level**

5. DTRE expects the market to now settle after the appointment of Sunak as PM, however, **don't expect yields to tighten anytime soon**

Occupational

Despite the well documented economic challenges facing many businesses and consumers, the UK's Big Box Logistics occupational market has continued to outperform expectations. Q3 2022 has seen just over 8.2 million sq ft of take-up, 11% ahead of the quarterly average since 2012, but down on the Covid-induced peaks of 2020 and 2021.

WRITTEN BY
Robert Taylor
Research Partner

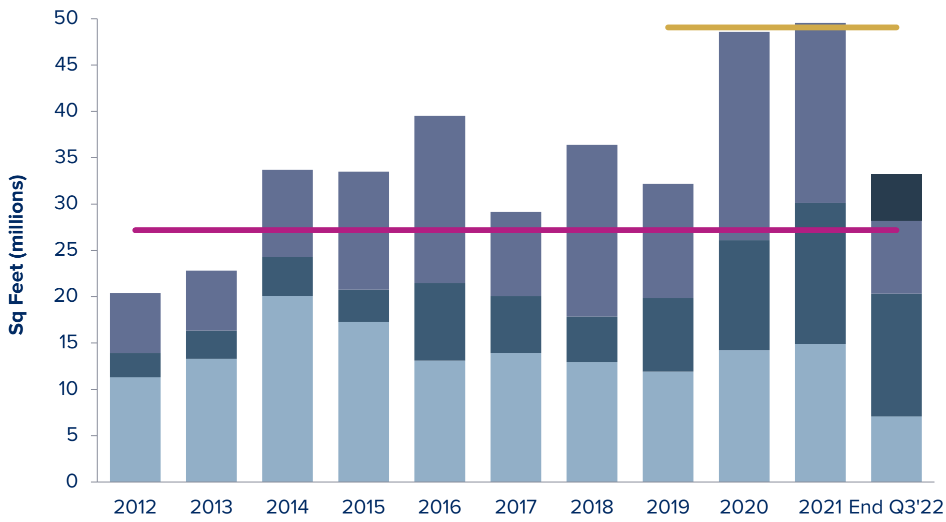

Fig 1
Take-up reaches 8.2m sq ft in Q3'22

- Under Offer
- Design & Build / Pre-let
- New / Spec Built
- 2nd Hand
- Average Take-up (2007-19)
- Average Take-up (2020-21)

Source | DTRE Research

Take up in the last quarter from April to end-June has been supported predominantly by two large lettings, the first being the letting of Mammoth 602 to Maersk, and the design and build letting of MPC2 at Magna Park Corby, to TopHat, totalling 1.2 million sq ft. Other significant lettings include DHL taking 322,000 sq ft at Segro Park Coventry and Iron Mountain expanding in the Midlands, taking a further 313,000 sq ft at Symmetry Park Kettering.

> Logistics and 3PL firms have been the most dominant business type this year. They have taken close to 13 million sq ft of space, just over 45% of the market.

With the absence of Amazon from the Big Box market, retailers are not the most dominant business sector taking space this year, instead that honour is bestowed upon the logistics and 3PL firms. They have taken close to 13 million sq ft of space, just over 45% of the market.

Amazon's absence from the market has also impacted the type and size of warehouse being taken this year. Demand for design and build units has fallen from 23.3 million sq ft last year to just over 7.8 million sq ft year-to-date.

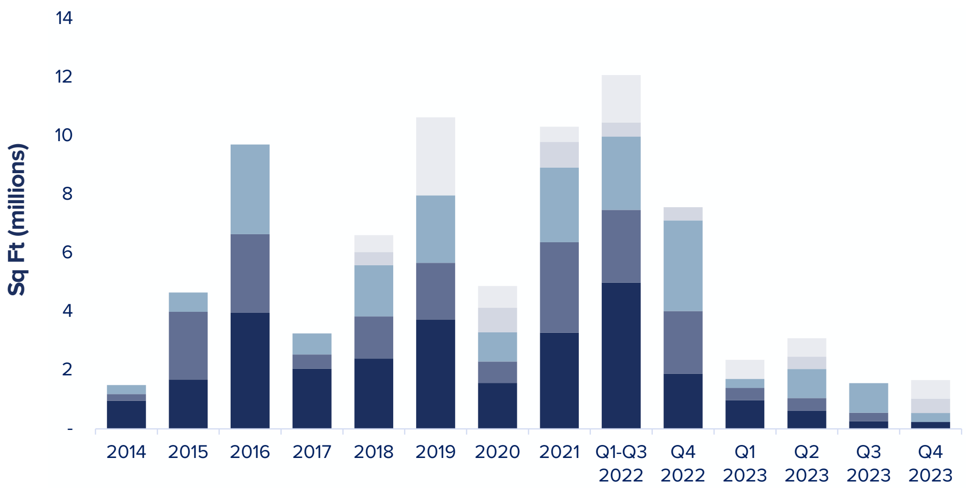

Fig 2

A Drop in Speculative Development is Coming in 2023

- 500,000+ sq ft
- 400-500,000 sq ft
- 300-400,000 sq ft
- 200-300,000 sq ft
- 100-200,000 sq ft

Source | DTRE Research

The other big change has been in the size of units being taken up this year. By end Q3'22, 13.2m sq ft had transacted in units of 300,000 sq ft or greater, down c.60% on the 32m sq ft transacted in both 2020 and 2021.

Encouragingly, in the face of mounting economic issues, demand in the more SME-range of between 100-200,000 sq ft has held up well. 9.1m sq ft of take-up has been recorded in this bracket by end Q3'22, 12% ahead of the annual average from 2007-19, with three months of the year still to go.

In terms of supply the DTRE Big Box vacancy rate, for the first time this year, has risen above the lows seen in 2021, but still remains low by historic standards at 3.2%. There continues to be an extreme lack of supply in the 300,000+ sq ft market, with only 3 units available for immediate occupation in the entirety of the UK, which is a factor in holding back demand in this size range.

There has been an increasing amount of speculative development coming on-stream, largely sub 300,000 sq ft, pushing up that vacancy rate and there is currently 17 million sq ft of spec development underway. However, according to 10-year average take-up figures, this equates to just 6 months of supply and should current trends continue much of this incoming stock will be let prior to reaching practical completion.

All in all, and as we highlighted earlier in the year, **we expect demand to hold up in the face of wider economic issues**, the long run-average of 28 million sq ft we saw annually from 2007 to 2019 has already been surpassed and we expect end-year 2022 take-up numbers to be the third best on record.

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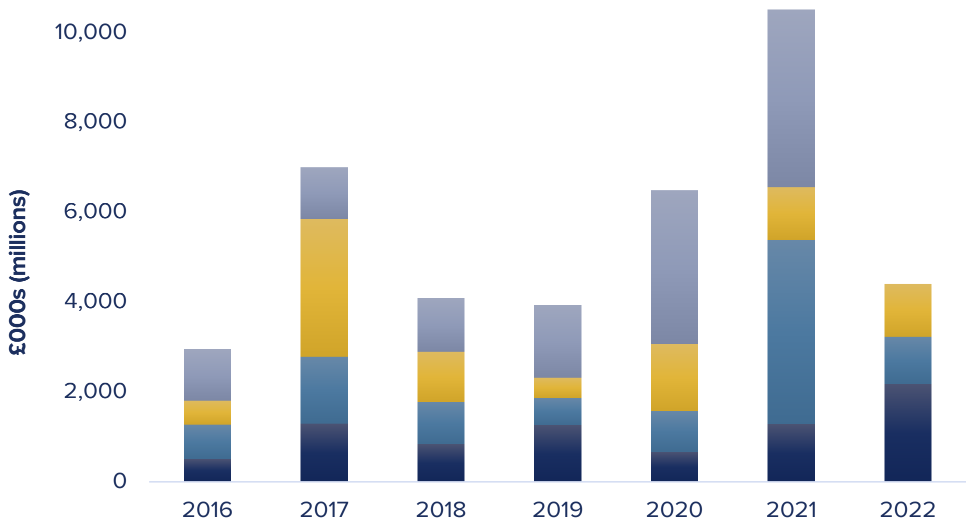
Investment

The increasing cost of financing brought about a swift market correction in the early part of the summer, with Truss and Kwarteng's 'Mini-Budget' adding fuel to the fire. As a result, **Q3'22 saw just £1.1bn of single-let assets traded**, the lowest quarterly volume since Q3'2020.

The largest single-let logistics deal of Q3 came when Barings Real Estate acquired the Zeus Portfolio, a seven unit portfolio from NFU Mutual for £222.5mn/3.6% NIY in June. The top five deals, the Zeus Portfolio, Peugeot Sale & Leaseback in Ellesmere Port, LCN's purchase of an Amazon unit in Havant and two Abrdn sales to Prologis in Greater London (Royal Mail in Croydon and Ocado in Erith), made up exactly half of the total volume transacted.

The main underlying cause of the recent market correction had been the increasing cost of debt, as rising (and stickier than first imagined) inflation, on both sides of the Atlantic pushed central banks into action. The resulting increasing base rates pushed up the cost of debt and five-year swap rates increased by a factor of seven, from less than 0.5% a year ago to almost 3.6% at the start of September, when Truss assumed power.



> Q3'22 saw the lowest volume of logistics assets traded since the quarter immediately following the onset of Covid in 2020

Fig 3

Investment Volumes by Quarter

- Qtr4
- Qtr3
- Qtr2
- Qtr1

Source | DTRE Research

Over the course of the next month, Liz Truss and Kwasi Kwarteng sent the UK economy, and particularly the gilt markets, into a tailspin. Recovering from the hole we have been put in will take much longer than it took to get us there.

Truss and Kwarteng's 'Growth Strategy' and their mini-budget which laid out the fiscal policies they would undertake to achieve their strategy, went down badly with the markets. The result being 5-year swaps jumped nearly 200 bps to 5.5% by 6th October (today 25/10 - 4.3%) and UK 10-year gilts rose c.150 bps to 4.5% (today 25/10 - 3.6%).

As a result property yields had to move out, but with the correction happening so quickly, the market essentially became paralysed, with deals being dropped and 'chipped' on a daily basis during the last four weeks.

Where yields settle is still up for debate, since the start of 2017 the spread between the UK 10-year gilt, 5-year swaps and MSCI's Distribution Warehouse NIY has averaged around 350 bps, **therefore it's not difficult to see that a correction in yields will and is coming about.**

However, given the rental growth and future prospects of the logistics sector, particularly compared to offices and retail, then the spread can be narrower than the 350 bps mentioned above and closer to 150-200 bps.

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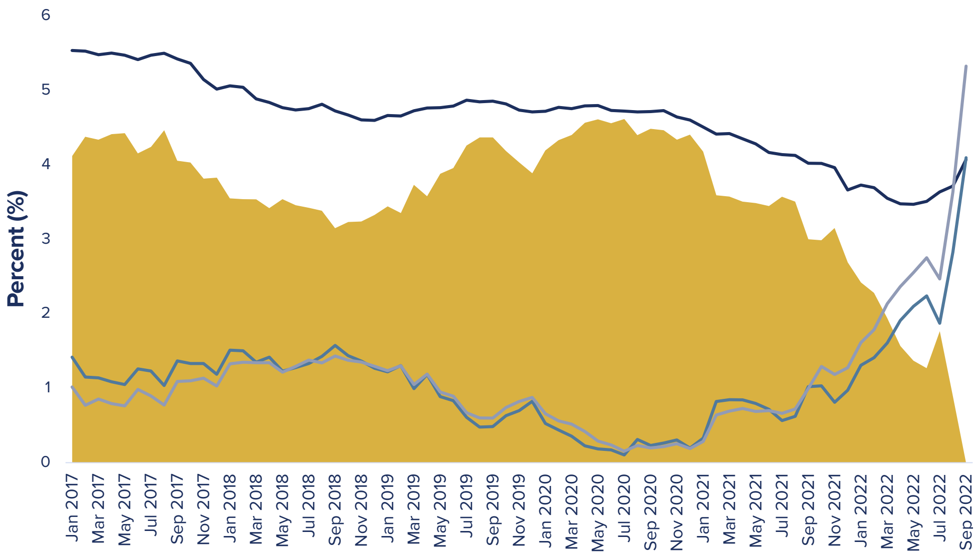

Fig 4

Spread between 5-Year Swaps, 10-Year Gilts and Distribution Warehouses Net Initial Yields

- Spread
- Dist warehouse NIY
- UK 10-year
- 5-year swap

Source | MSCI / Bank of England

Moving forward, as investors continue on their 'price discovery journey' and the pool of buyers gets shallower, volumes will be impacted negatively and be down significantly on a year-on-year basis.

However, one chink of light is that should the interest rate hiking season end prematurely, and inflation comes under control quicker than currently imagined, then we could see debt-backed buyers return, as long as vendor expectations are realistic and rental growth remains positive.

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RESEARCH
Robert Taylor
Research Partner
robert.taylor@dtre.com
07732 804 410

RESEARCH
Jamie Poole
Data Analyst
jamie.poole@dtre.com
07833 230 414

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