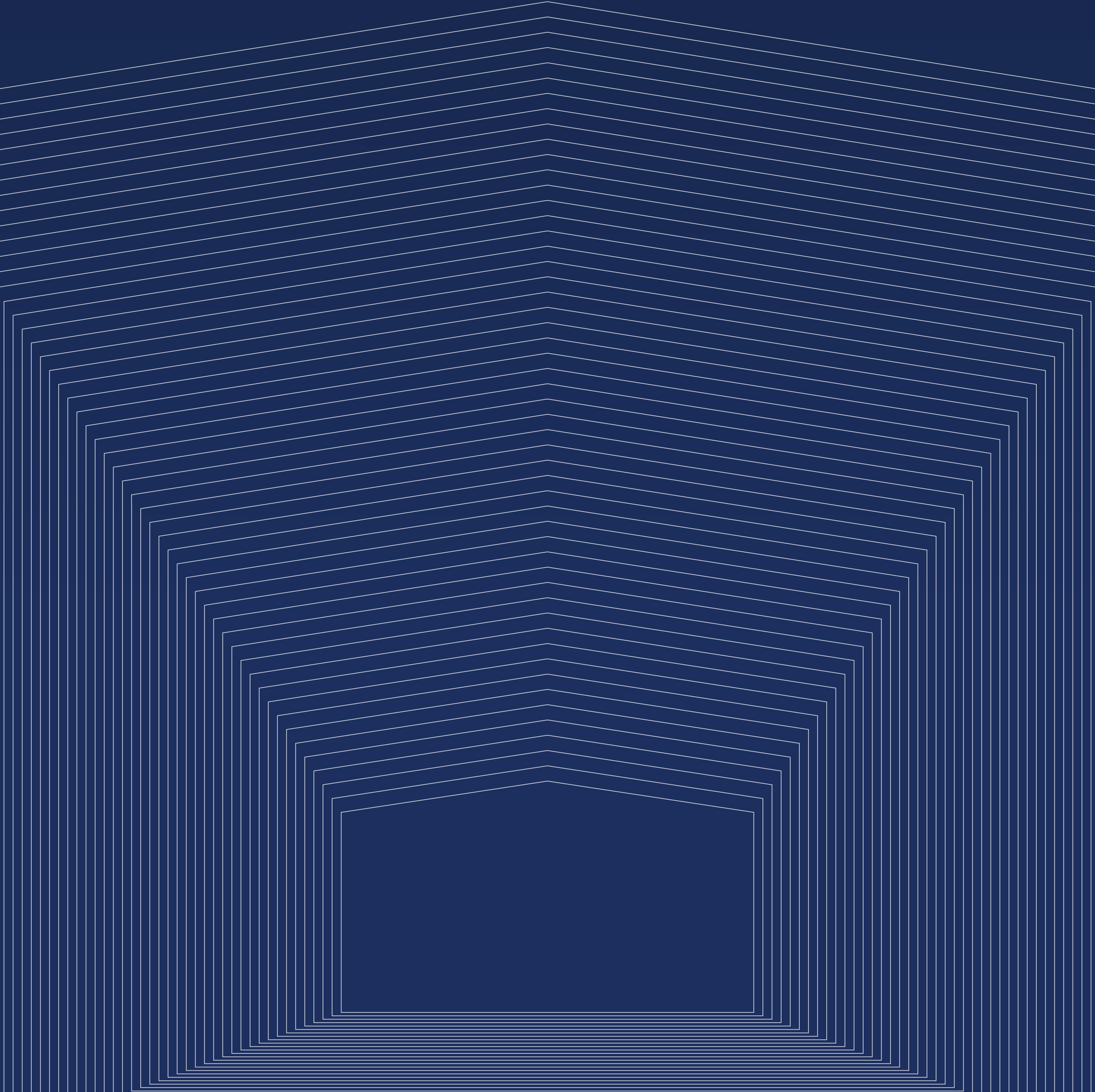
BIG BOX LOGISTICS

OCCUPIER & INVESTMENT MARKET REVIEW

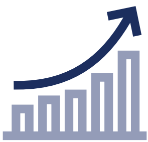
DTRE

Q1 2023 RESEARCH

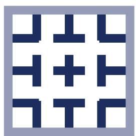


5 Things You Need to Know

ABOUT **BIG BOX LOGISTICS** IN Q1'23



Take-up during Q1 2023 reached **5.6 million sq ft**



There is currently **8 million sq ft** under offer

Grey space has added to the supply, therefore pushing the DTRE Big Box vacancy rate to **4.2%**

The first three months of 2023 has seen just over **£600m transacted**, the absence of large portfolio deals suppressing volumes

Inflation is forecasted to drop, interest rates won't go any higher and by late summer we are expecting a more normal market

Occupational

After three record breaking years, the occupational market has seen a slowdown from the pandemic induced retail highs thus far in 2023. Given the wider macro-economic picture, this is not an unjustified concern. Nonetheless, the fundamentals within the sector still remain considerably in the landlord's favour, with supply remaining tight and record rents continuing to be set across the board, particularly for new and/or well located units.

WRITTEN BY
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Take up so far this year has slowed by 19% on its pre-Covid quarterly average, with tenants signing for just over 5.6 million sq ft across twenty-two deals. However, with a further 8 million sq ft currently under offer or in solicitor's hands then we don't expect this slowdown to continue through Q2 (see Fig 1).

> **Take up so far this year has slowed... with tenants signing for just 5.6 million sq ft across twenty-two deals.**

In terms of the stats, the slowdown has been most marked in the XL Boxes, with only six deals over 300,000 sq ft in Q1'23, down 50% year-on-year, holding back overall volumes, with a complete absence of any deals over 700,000 sq ft, which had become commonplace in recent quarters. In contrast, the 100-300,000 sq ft size band has performed well and remains in-line with historic averages.

A slowdown from the pandemic fuelled growth in e-commerce was not unexpected but given the wider macro headwinds the occupational market has continued to perform well. In addition, we believe three trends will bolster demand for Big Boxes through the remainder of 2023.

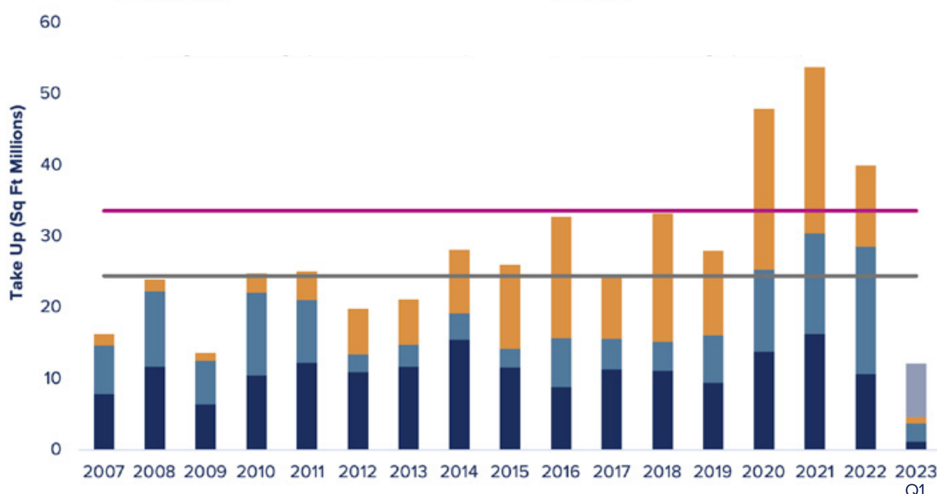

Fig 1
Take-up per annum

- 2nd hand
- New
- D&B
- Under offer
- Long Run Average (2007-19 'Pre Covid')
- 10 Year Average (2013-22)

Source | DTRE Research

Firstly, the shift to ESG compliant buildings is no longer avoidable for many occupiers but especially those blue-chip organisations, although this trend is not limited to them, with their own ESG goals to hit. Secondly, the continued re-organisation of supply chains, including on-shoring, to protect against any future external shocks and bolster occupiers' plans for growth, whilst thirdly, occupiers will move to address the structural labour shortages by taking newer units fit for robotics and automation.

The main story of the occupational market continues to be rental growth, with the latest MSCI Monthly Index for February showing annualised rental growth of 9.9% for distribution warehouses. This is evidenced in several deals that have occurred during the quarter.

> **The main story of the occupational market continues to be rental growth**

Firstly, DPD acquired the 203,000 sq ft Big Box Bow unit in Bromley-by-Bow, London at a rent in the mid-twenties and over 40% ahead of the guiding rent when launched. TritaxSymmetry achieved a rent in the high £9s on their Symmetry Park, Bicester scheme when letting Unit C to Syncreon and there are several deals under offer in prime Golden Triangle and prime North West locations that should they complete will set a new rental tone in those locations.

One of the key reasons we continue to forecast strong rental growth, is that despite a slowdown in take-up, the vacancy rate remains tight. The latest DTRE Big Box Vacancy Rate is 4.2%, with the recent additions of some 'grey space' from tenants pushing up the vacancy rate in Q1, whilst, there is also c.15.5 million sq ft of new, speculative product currently under construction.

In many respects the market has avoided an oversupply by luck rather than judgement, with firstly, Brexit, then Covid and then last year's pricing correction in land values (see Fig.2) holding back further development. For that reason, from late summer this year the spec development pipeline drops off a cliff, with just 3.5 million sq ft of new units due to complete from Q4'23 onwards.

As a result, we expect vacancy to remain tight providing buoyant support to rental growth and should forecasts be proven correct and a recession is avoided then we'll see take-up numbers reach ≈34 million sq ft by year-end, 20% ahead of its long-term average.

	Mar-22	Mar-23
Rent (£psf)	£10.00	£10.00
Land Value (£psf)	**£70**	**£40**
Construction Cost (£psf)	£75.00	£75.00
Profit on Cost	**15.00%**	**15.00%**
Yield on Cost	5.71%	7.03%
Exit NIY	**4.25%**	**5.00%**

Fig 2
Land Values Have Adjusted to Maintain Profit Margins

Source | DTRE Research

Investment

Driven in large part by higher inflation than most forecast and the resultant rises in interest rates, all the way from 0.5% in March 2022 to 4.25% in March 2023, the logistics investment market has witnessed a significant slowdown. As a result, volumes for the first three months of 2023 have reached just over £600m for single-let Big Boxes, with a lack of large deals, particularly portfolio and platform level deals, holding back overall volumes (see Fig 3). However, where we are seeing activity is from conviction buyers, using all cash to buy trophy assets at pricing that is back at pre-pandemic levels. Those buyers may yet be seen to have been the clever investors.

Back in late January and early February there was a sense of purposeful optimism, with the FTSE reaching record highs, inflation was trending downwards, and the interest rate hiking season looked set to close out at 4% here in the UK. As vendors came to terms with their new valuations off the back of a turbulent debt market, purchasers saw opportunity in revised pricing and the shoots of a market was forming.

Fast-forward six weeks, the collapse of SVB and Credit Suisse and a hotter than expected inflation print (10.4%) for February has placed another roadblock in the way to doing deals as some investors pulled back to ensure they avoid any contagion from the banking sector. Nevertheless, this pause is proving to be temporary, and we don't expect to see any further significant correction in pricing as a result. In fact, if anything we've seen prime yields harden, particularly for smaller lot sizes.

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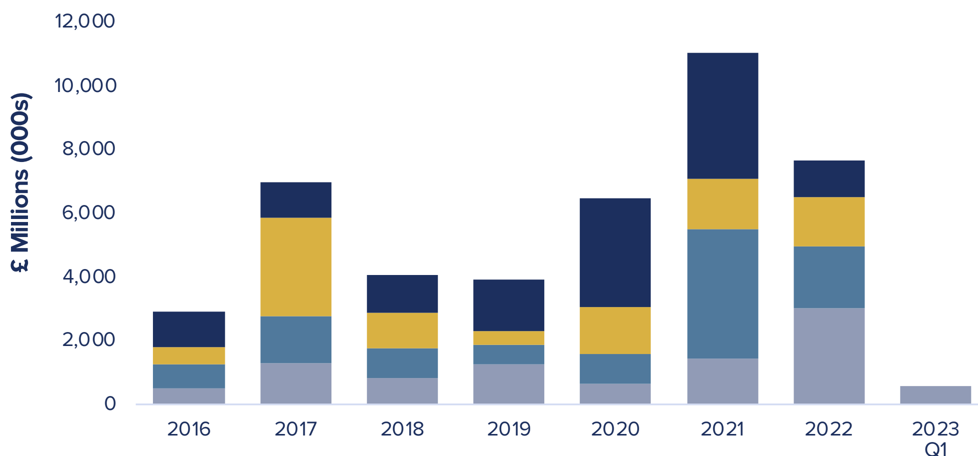

Fig 3
Single-Let Investment Volumes by Quarter

- Q1
- Q2
- Q3
- Q4

Source | DTRE Research

This year's choppiness has meant that deal volumes have been down significantly so far. The year's biggest deal year-to-date saw DTRE advise Tritax Big Box REIT on the disposal of a portfolio of three assets to Copley Point, whilst Leftfield with their two purchases of a ProDrive unit in a sale-and-leaseback deal (£15m/5.6%NIY) and a Smyths Toys unit in Corby (£30m/4.55% NIY) have also been active.

Outside of the Big Box sector, Blackstone via its Mileway platform has deployed £142m into the multi and urban sector. Mileway's purchase of the Garrison Portfolio (£46m/5.8% NIY) was its biggest purchase as Blackstone remaining unwavering in their conviction in the industrial and logistics sector.

If one phrase could summarise the first three months of 2023 it would be "access to reversion". With the all-in cost of debt soaring to ≈5.75% for a single-let standard unit, from ≈2.5% just 12 months ago, then sales getting the most traction are those whereby purchasers can get their running yield up in the 6%'s quite quickly. Moving forward we don't see this trend changing anytime soon, as the rental growth story in the occupier markets continues to underpin this investment thesis (see Fig 4).

One other investment theme that's tentatively emerging so far this year has been the return of investors keen to partner with developers to undertake spec funding or forward fundings. Investors, with an eye on both future ESG risk and tenant flight to quality, are taking advantage of the attractive yield spread between taking on development risk versus purchasing standing stock, given the leasing fundamentals.

Moving forward, the next three months will see additional bumps with deal volumes remaining suppressed, as we wait for the banking sector turmoil to play out and particularly if any problems in the US office sector come to the fore. However, thereafter, **inflation is forecasted to drop like a stone, interest rates won't go any higher than they currently are and by late summer we are expecting a more normal, albeit two-tiered, market will be underway.**

We expect pricing for prime located, ESG compliant assets with limited capital expenditure to trade at a premium to where they are currently valued, whilst the market for secondary assets which require significant capex to remain future proofed will have less depth.

> **... inflation is forecasted to drop like a stone, interest rates won't go any higher than they currently are and by late summer we are expecting a more normal, albeit two-tiered, market...**

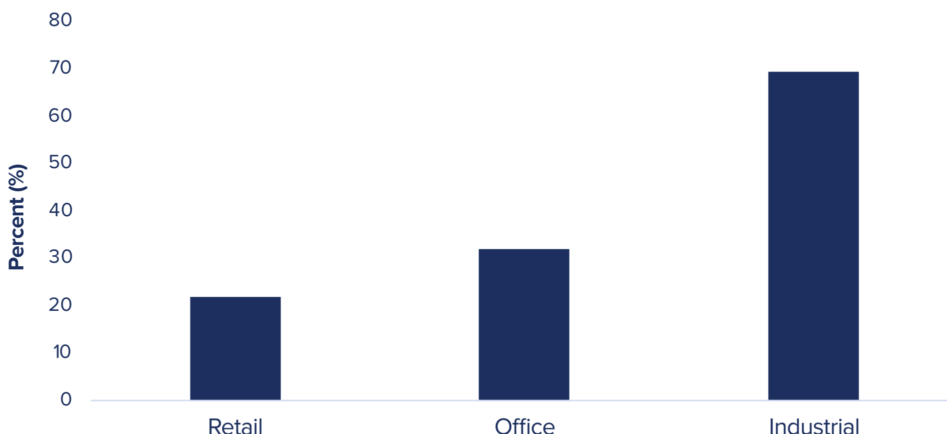

Fig 4
Percentage of Under-rented Leases
(% of MSCI Total)

Source | DTRE Research

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