MONTAGU EVANS PRESENTS...
LONDON INDUSTRIAL & LOGISTICS
STATE OF THE MARKET

OCTOBER 2024

ECONOMIC BACKDROP

AFTER TWO YEARS OF FLAT OR VERY WEAK GROWTH, THE FIGURES FOR 2024 SO FAR SUGGEST THE UK ECONOMY HAS MOVED UP A GEAR.

GDP is estimated to have risen by 0.7% in the first three months and by 0.6% in the second quarter. The timelier evidence suggests that Q3 will see another positive result, albeit perhaps not quite so strong.

Growth in the industrial sector has been more volatile. The production element of GDP saw a 0.6% increase in the first quarter followed by a 0.1% decrease in the second quarter, but the manufacturing Purchasing Managers Index (PMI), a widely used leading indicator, rose to 52.1 in July and 52.5 in August, the highest level since Summer 2022, auguring stronger growth in Q3.

Retail volume growth, which is arguably more important for the logistics sector, has become modestly positive over recent months. But with inflation now well below 3.0%, strong wage growth (5.4%, excluding bonuses) and mortgage rates on a downward trajectory, the next few months should see stronger sales.

With internet sales (as a percentage of the total) also now starting to slightly trend upwards again following the post-covid decline, there are plenty of reasons why retailers, both online and conventional, as well as those supplying them, will continue to look to expand and improve their logistics facilities.

For the purposes of this report, 'London' refers to the entire area within the M25.

THE LAND ISSUE...

WHILE THE IMPROVING ECONOMIC OUTLOOK IS UNLIKELY TO LEAD TO A REPEAT OF THE BOOM SEEN A FEW YEARS AGO, IT DOES SUGGEST THAT DEMAND FOR LOGISTICS SPACE IS LIKELY TO INCREASE OVER THE REMAINDER OF 2024 AND INTO 2025.

The urban logistics market will continue to have the strongest fundamentals, given the lack of supply.

This is a particular issue in London. According to the Greater London Authority's (GLA's) Industrial Land Supply Study, published last year, the amount of land in the C apital in industrial use declined from 8,282 hectares in 2001 to 6,799 hectares in 2020 – a loss of some 1,483 hectares, or 18%, over almost two decades. Much of this land has been converted to residential use. This implies a continued supply/demand imbalance in the sector and rising rents and capital values.

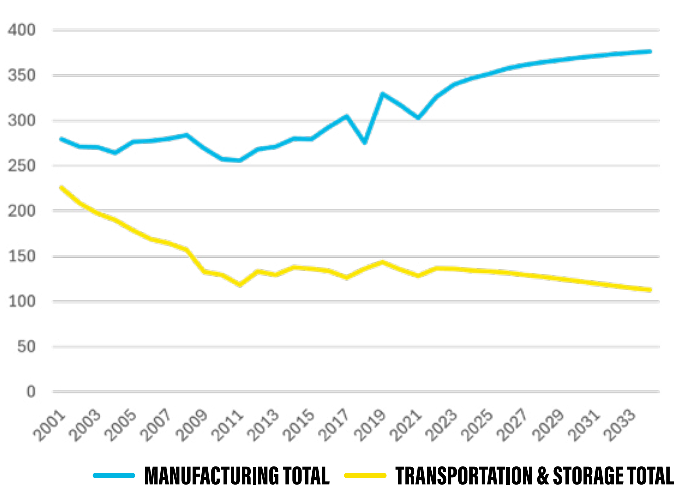
While the GLA is increasingly aware of the need to provide appropriate industrial land, planning policy at a national level has not focussed on land supply for this sector. The recently published National Planning Policy Framework is understandably orientated around the need to increase housing supply, but there is almost no mention of industrial or logistics space.

Providing appropriate land will be critical not just to retail and industrial supply chains, but also to broader national political issues such as housing, national security and health. Greater global geopolitical uncertainty and rising trade barriers have led to a greater tendency to "nearshore" or "reshore" supply chains while also keeping greater inventories to guard against supply shocks, which will all increase aggregate demand for UK logistics.

This is already evident the from the increasing number of workers in the sector, which has occurred despite the greater use of new technologies to improve efficiencies.

This is set to continue, with total employment in transportation and storage in the Capital forecast to rise from 326,000 to 362,000 between 2022 and 2027, an increase of 10.9%, slightly ahead of all London figure of 10.6%. Manufacturing employment in the Capital, on the other hand is set to employ shrinking numbers of people.

LONDON EMPLOYMENT BY BROAD SECTOR



Important in this land supply issue is the shifting relationship between industrial and residential land values, with the latter historically far higher. However, the situation has changed over the past decade or so as logistics property has become more sought-after.

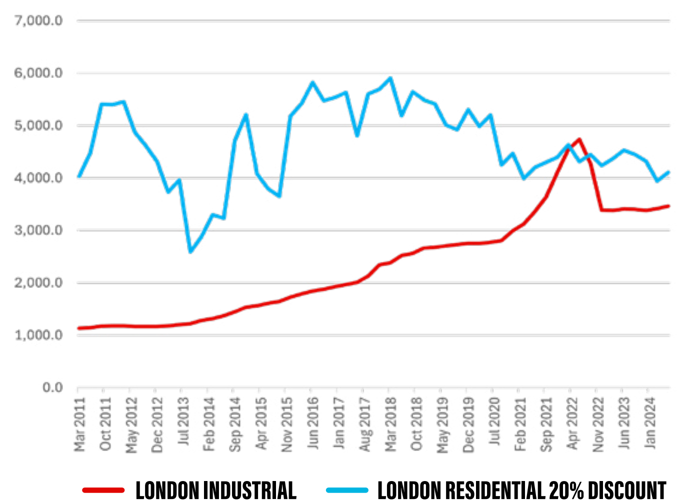
CAPITAL VALUES IN THE SEGMENT ROSE BY 169% OVER THE TEN YEARS TO JUNE 2022 ACROSS THE WHOLE COUNTRY, WITH THE LONDON FIGURE EVEN HIGHER AT 273%.

Residential as measured by the Nationwide House Price Index saw just 64% gain over same period, with London only slightly higher at 71%. As a result, industrial values in many parts of Outer London and around the M25 – for example in Bexley, Redbridge, Bromley, Thurrock, Dartford and Spelthorne – began to overtake residential values, depending on planning requirements.

However, the past two years have not been as kind to industrial values, which fell by 26% nationally over the two years to June 2024 (29% in London). In contrast, while house prices have fallen, the drops have been very modest at -2% nationally, and -3% in London. This has pushed open the gap in land values once again in Outer London, although values are likely to remain close in M25 locations such as Dartford and Thurrock where the difference remains minimal.

The chart below shows capital values for the MSCI index for industrial and residential. Clearly, this is not the same as land values, but it does demonstrate how the relationship has changed over time, particularly if the residential values are adjusted to account for the need to provide affordable housing (in this case a discount of 20% has been applied). The MSCI index is skewed towards more affluent parts of the C apital, so this is likely an understatement.

CAPITAL VALUES - LONDON RESI & LAND



This potential issue is already being compounded by the loss of industrial to another, potentially even more valuable use – data centres. In May this year, for example, Royal London Asset Management sold a consented 33.6-acre industrial site in Southall to a data centre operator for £315m. Given the rising demands for data, driven by digitalisation, cloud computing and more recently by the rise of AI technologies, sites with sufficient power and fibre connectivity will continue to be attractive for this use.

CASE STUDY

CLAVERINGS INDUSTRIAL ESTATE (Q2 2024)

- MONTAGU EVANS SOLD ON BEHALF OF ENFIELD BOROUGH COUNCIL
- 5.56-ACRE DEVELOPMENT SITE
- ACQUIRED BY DANESCROFT FOR £21.4M
- PRICE PER ACRE: £3.85M

This is the largest industrial London land deal. The fact a strong unconditional sale price was achieved through a competitive bidding process demonstrates that demand for London land remains strong and that there is still an appetite for speculative development. Against the backdrop of a tough economic climate and build cost inflation, this demonstrates the resilience of the London development market as well as the undersupply of space in the Capital.

THE IMPLICATIONS FOR INVESTMENT MARKET OVERVIEW...

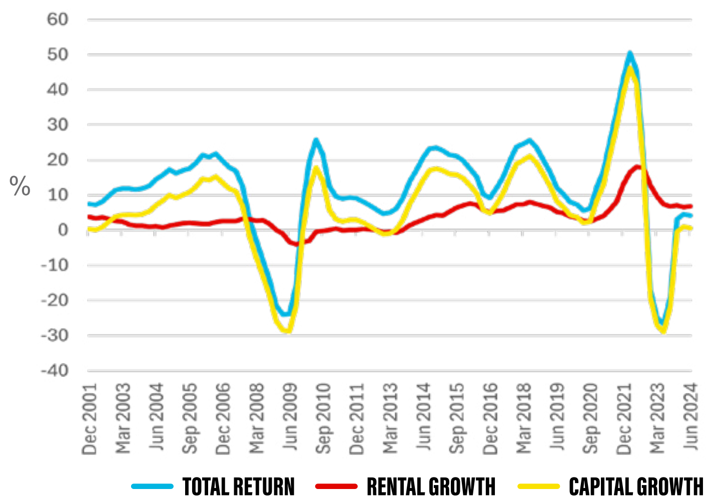
DESPITE THE GREATER COMPETITION FOR LAND, THE BROADER TRENDS DRIVING THE GROWTH OF LOGISTICS ARE UNCHANGED.

If the land issues do lead to lower development volumes and ultimately shortages, it will push up rents and values leading to another boom as the cycle develops, albeit perhaps not on the scale of that seen a few years ago.

This is also a result of international investor demand for logistics property remaining strong, while other traditional commercial sectors seem less appealing. Indeed, UK performance has remained attractive compared to other sectors, as the chart below shows. With the Bank of England cutting the base rate by 25bps in August, with more cuts likely to come, risk-free rates are now falling, which will help to stabilise values and attract more capital to the sector.

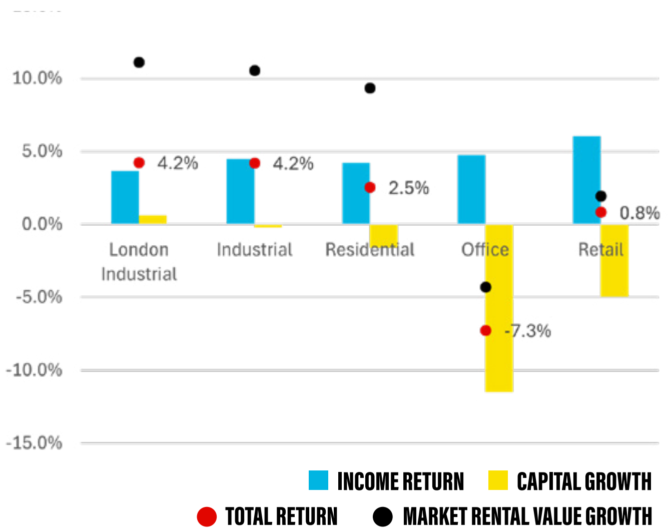
THE GLOBAL SENTIMENT TOWARDS LOGISTICS REMAINS VERY STRONG. INVESTORS RECOGNISE THE SECTORS UNDENIABLY ROBUST SUPPLY AND DEMAND MARKET FUNDAMENTALS.

LONDON INDUSTRIAL - INVESTMENT PERFORMANCE



Source: MSCI Quarterly UK Real Estate Index, Q2 2024

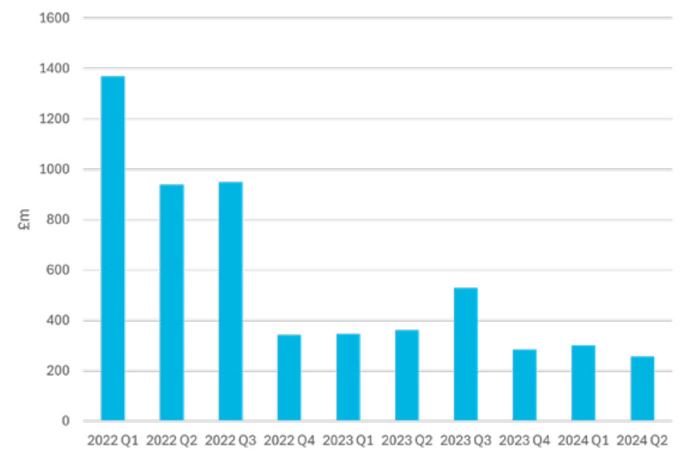
COMPARISON TO OTHER SECTORS



LONDON INDUSTRIAL VOLUMES REMAINED SUBDUED IN THE FIRST HALF OF 2024, WITH £301M AND £256M TRANSACTED IN THE FIRST AND SECOND QUARTERS RESPECTIVELY. THIS IS SIGNIFICANTLY BELOW THE £800M+ PER QUARTER SEEN DURING MOST OF 2022 IN THE WAKE OF THE PANDEMIC.

With risk-free rates and debt costs still highly elevated compared to recent trends, many vendors will be waiting for the rate-cutting cycle to begin in earnest before considering any sale. In any case, different opinions over the likely timetable of cuts (and their speed) have made it difficult for either party to price properties, something complicated further by the recent relative lack of transactional evidence. Furthermore, given still-strong rental growth in the sector, investors may simply be holding onto well-performing assets, meaning there is little supply.

LONDON INDUSTRIAL - INVESTMENT VOLUMES



Source: Montagu Evans

Despite weak activity, there have been some notable deals involving major REITs and institutions – demonstrating the continuing appetite of major players for this sector. **The largest was Kennedy Wilson's purchase in June (with an unnamed partner) of the 4-property, 300,000 sq. ft Heathrow Estate from SEGRO for £87m.** The scheme is only 84% let and offers opportunities for asset management.

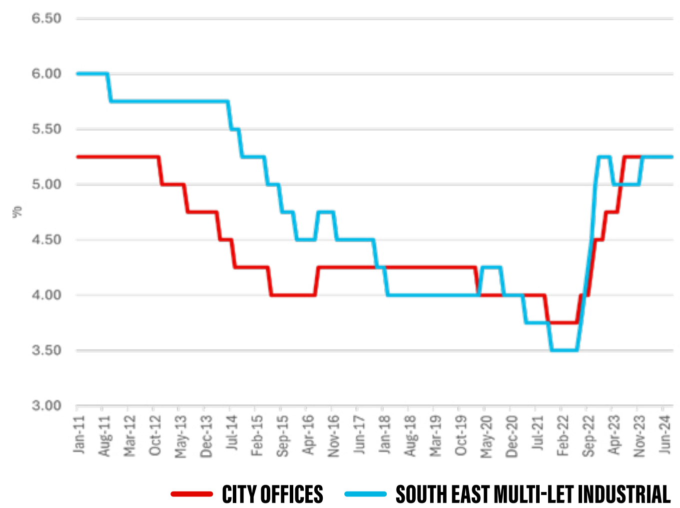
The first quarter of the year had also seen two relatively large deals, both taking place in March. M&G Real Estate's purchase of 1 & 3 Capacity Dartford from abdrn for £55.6m, reflected a net initial yield of 4.75%. M&G already owned the adjacent unit 2 which was forward purchased from the original developers. Meanwhile, investors represented by DTZi sold 1-12 Waterway Park in Hayes to Tritax, with the £46.7m price reflecting a 3.64% net initial yield, with a significant reversion. There has been much less of the corporate M&A activity that characterised 2022, but at the time of writing there are signs that this may be about to change.

The sector is, however, now well placed for a recovery. Firstly, the global sentiment towards logistics remains very strong. Investors almost universally recognise the sector's economic and geopolitical tailwinds and continue to allocate to it.

Perhaps more importantly, the leasing and development fundamentals remain compelling (see below for more detail at a London level). While there has clearly been a slowdown, there has been nothing like the issues seen in the retail or offices.

Yields in the UK also repriced quickly following the 2022 rate shock compared to other sectors, meaning that the market has had more time to get used to more realistic pricing. These trends can all be seen in the chart below, which firstly shows how the spread between City office and South East industrial yields closed over the decade to 2022, and how the correction was much faster in the latter. Interestingly, prime yields for both now stand at 5.25%.

PRIME YIELDS



Source: Montagu Evans, Market Averages

WITH INFLATION NOW BELOW THE 3.0% LEVEL FOR SEVERAL MONTHS, AND THE BANK OF ENGLAND BEGINNING ITS CUTTING CYCLE, IT SEEMS LIKELY THAT RISK-FREE RATES AND DEBT COSTS WILL FALL GRADUALLY OVER THE COMING YEAR, ALBEIT NOT REACHING THE LOW LEVELS SEEN BEFORE AND DURING THE PANDEMIC.

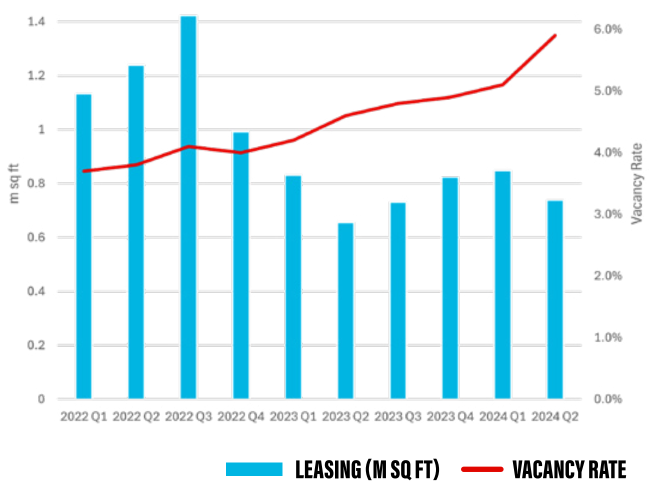
This will increase the incentives for buyers, putting downward pressure on yields and producing prices more acceptable to vendors. As a result, deal volumes are likely to rise over the year ahead, although again not to the level seen before the recent slowdown. The key question, then, is whether recovering pricing can persuade more vendors to sell.

THE MARKET FUNDAMENTALS...

THE INDUSTRIAL LEASING MARKET IN LONDON HAS ALSO SEEN A SLOWDOWN SINCE THE LAST FEW QUARTERS OF 2022 WHEN OVER 1M SQ FT OF SPACE WAS LET, ALTHOUGH SINCE EARLY 2023 ACTIVITY HAS BEEN FAIRLY STEADY AT BETWEEN 600,000 AND 800,000 SQ FT PER QUARTER.

Vacancy rates have pushed up from around 4.0% in 2022 to almost 6.0% as of Q2 2024, somewhat above the long-term average but below the level seen in many office markets. This increasing vacancy explains the trend in rental growth in London, falling from a peak of almost 18% per annum in Autumn 2022 to just under 6.0% in Q2 this year.

LONDON INDUSTRIAL - LEASING VOLUMES & VACANCY RATES



Source: Montagu Evans / CoStar

ANNUALISED RENTAL GROWTH - LONDON INDUSTRIAL

Source: Montagu Evans / CoStar

RECENT LEASING DEALS

PARK ROYAL

UNIT 4B, GRAND UNION RECORD RENT PARK ROYAL - £35.00 PSF

- **Q4 23**
- RF: 5.5 months
- **3,952** sq ft
- Refurbished unit
- Let to **ZYBER**
- **Client: Segro**
- **Top rent** achieved in Park Royal

CANNING TOWN

UNIT A, VALOR PARK NORTH CRESCENT

- **Q1 24**
- **£34** psf
- **8,834** sq ft
- 8 months RF
- Let to Tangible Benefit
- **Client: Valor**
- **Top rent** achieved in Canning Town

"THESE RECORD RENT DEALS SHOW THAT LONDON RENTS ARE CONTINUING TO GROW DESPITE A WEAKER OCCUPATIONAL PICTURE. HOWEVER, GROWTH HAS BEEN TEMPERED AND EVIDENCE IS MORE SPORADIC DUE TO A LOWER VOLUME OF DEALS WHICH HAS LED TO A MORE STAGGARD RENTAL GROWTH PICTURE. TIED INTO THIS, WE ARE SEEING RENT REVIEWS OUTPERFORM OPEN MARKET LETTINGS WHICH IS AGAIN TESTAMENT TO THE ONGOING STRENGTH OF THE MARKET."

The recent increase in vacancy rates is partly explained by the rise in construction levels. The drop between Q1 and Q2 this year reflects a high level of completions in the early part of the year, including Henry Boot Developments and Barings' c. 400,000 sq ft Momentum in Rainham and SEGRO's 134,500 sq ft V-Park Grand Union in Park Royal.

Of the 1.85m sq ft under construction at the end of Q2, notable projects included MX Park Maple Cross, a 178,368 scheme in Rickmansworth developed by Ashford Developments and funded by Barwood Capital, due in December 2024, and the c.150,000 sq ft Evo/Pinebridge Industrial in Leyton, which has a completion date of Q2 2025.

There are other larger schemes under construction such as Blue Coast Capital's Pulse 92,000–324,500 sq ft scheme in Hangar Lane, Legal & General's Firestone LDN in Brentford (90,000 sq ft, due Q4 2025) and KSP's Queensway in Croydon (c. 107,000 sq ft, scheduled for completion in October 2024

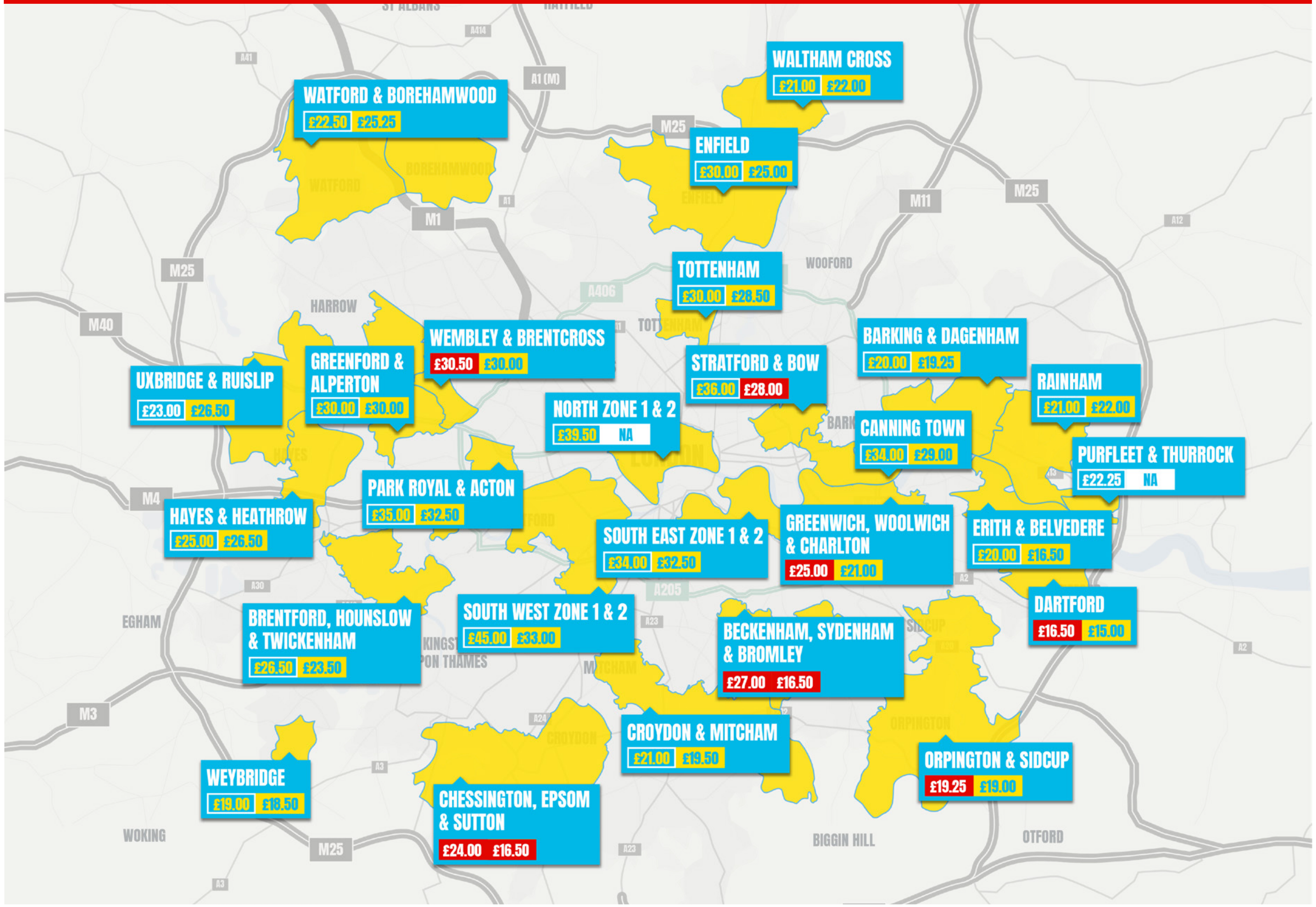
THE AMOUNT OF SPACE UNDER CONSTRUCTION IS LIKELY TO FALL SLIGHTLY IN THE SHORT TERM. THIS REFLECTS BOTH AWARENESS OF RISING VACANCY LEVELS (SEE ABOVE) BUT ALSO HISTORIC VIABILITY ISSUES CAUSED BY THE SPIKE IN CONSTRUCTION COSTS AND THE FALL IN VALUES IN 2022/3.

The availability of appropriate sites – partly outlined in the introduction to this paper – may also be a factor. This does mean that vacancy rates should fall in the medium term. While there is 10.2m sq ft of potential development in the pipeline in London, it is highly unlikely that a significant part of this will begin construction in the near term.

As a result, vacancy levels are likely to begin to fall again towards the end of the year, as supply drops and demand picks up again. This will encourage a return to sustainable rental growth, helping to maintain the attraction for investors as the wider financial conditions increasingly support a higher level of transactions.

SMALL BOX	2,000 - 15,000 SQ FT
MID BOX	15,000 - 75,000 SQ FT
UNDER OFFER	
N/A	NO DEAL IN 24 MONTHS
TBC	

LONDON INDUSTRIAL RENT MAP



This map includes details of completed or under offer open market transactions. It does not include rent reviews, lease renewal or quoting rents.

Source: Montagu Evans

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