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UK INDUSTRIAL AND DISTRIBUTION INVESTMENT

Q2 REVIEW

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TRANSACTION VOLUMES DECLINED DURING LOCKDOWN, WITH INVESTMENT INTO DISTRIBUTION MOST FAVOURED.

The security of (future) income, the basis of investment value, found itself on sudden shaky ground this year. Economic, leasing and investment activity nosedived during the second quarter (Q2 2020) after a national lockdown was imposed on 23rd March to decrease the spread of COVID-19. A halt in all but the most essential activity put a strain on cash flows for occupiers and investors. Genuine distress and opportunism by some tenants meant that rent payments to landlords were lower than usual. The crisis gave a whole new meaning to what constitutes a strong covenant: some of the stronger rated tenants used their might to renegotiate rents or rent free periods, while some 'weaker' tenants paid rent in full and on time.

Low availability of quality assets, uncertainty and hurdles to doing business led to UK industrial & distribution (I&D) investment activity falling by 52% during Q2 2020 to £671m. This compares favourably to investment into offices and retail which fell 78-79% compared to the 5-year average. Low investment activity meant that property valuations, based on market comparables, frequently invoked a valuation uncertainty clause during Q2.

In Q2 £553m was invested into distribution and another £118m into industrial assets across the UK. Table 1 shows investment by region for London and the South East against the rest of the UK. London distribution saw a positive bounce at £194m invested in Q2, much above the 5-year quarterly average (please note the figures in Table 1 do not add up fully due to portfolio sales and mixed-use assets apportioning).

Table 1 shows investment by region, for London and the South East against the rest of the UK. London distribution saw a positive bounce at £263m invested, much above the 5-year quarterly average).

SEGRO plc has acquired Perivale Park, a 34-acre urban warehouse estate in Perivale, West London, from Federated Hermes for £202.5m. Together with another small property in London SEGRO spent £211m in total in Q2. The topped-up net initial yield upon acquisition of Perivale Park (excluding the land) is 3.5% and the equivalent yield is 4.3%. The deal includes 8 acres of land with medium-term development potential. The WAULT is 3.4 years to the break and 5.5 year to lease expiry, with further growth potential coming from the asset being under-rented. SEGRO has other holdings nearby at Park Royal at much higher rental levels. In the current climate, investments are only made in very compelling cases.

The second biggest I&D transaction in Q2 was the sale & leaseback of three assets totalling 1.2m sq ft in South Elmsall, Pontefract, by NEXT for £118.93m to AVIVA Investors at a NIY of 4.5% on a 25-year lease. The biggest (light) industrial investor in Q2 2020 was Pacific Investments, who bought two portfolios and one asset across the UK for £92.966m.

TABLE 1: QUARTERLY I&D INVESTMENT ACTIVITY VS 5-YEAR AVERAGE IN Q2 2020

	UK INDUSTRIAL & DISTRIBUTION INVESTMENT ACTIVITY IN £'000					INVESTMENT	Q2 2020
	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	5-yr avg	vs 5yr avg
UK industrial & distribution	**1,159,980**	**1,548,543**	**1,954,728**	**918,870**	**671,369**	**1,402,392**	**-52.1%**
UK industrial	**284,198**	**335,782**	**290,956**	**188,938**	**118,168**	**256,596**	**-53.9%**
UK Distribution	**875,782**	**1,212,761**	**1,663,772**	**729,931**	**553,201**	**1,145,796**	**-51.7%**
London & South East I&D	**417,975**	**702,551**	**971,333**	**299,449**	**292,491**	**683,408**	**-57.2%**
London industrial	68,149	92,171	92,675	43,367	18,443	57,980	-68.2%
London distribution	109,192	196,768	179,439	47,648	193,910	155,070	25.0%
South East industrial	134,241	66,250	96,588	23,985	50,482	74,443	-32.2%
South East distribution	106,394	347,362	602,632	184,448	29,654	395,916	-92.5%
Rest of UK I&D	1,370,283	1,780,717	2,121,658	1,092,744	839,319	1,541,784	-45.6%
Rest of UK industrial	293,075	408,661	324,721	242,754	119,112	296,591	-59.8%
Rest of UK distribution	1,077,209	1,372,056	1,796,936	849,990	720,208	1,245,193	-42.2%
Other sub markets:							
London Distribution Ring	**53,527**	**165,753**	**148,618**	**65,291**	**210,917**	**119,564**	**76.4%**
London Ring industrial	18,697	39,047	27,188	34,541	6,050	22,354	-72.9%
London Ring distribution	34,830	126,706	121,431	30,750	204,867	97,210	110.7%
Greater Park Royal	**10,961**	**86,423**	**32,090**	**42,547**	**158,836**	**35,219**	**351.0%**
Grtr Park Royal industrial	4,663	5,251	5,493	21,758	3,376	6,612	-48.9%
Grtr Park Royal distribution	6,298	81,173	26,597	20,789	155,460	28,607	443.4%
M25 West	**114,746**	**92,419**	**220,810**	**101,248**	**35,441**	**142,347**	**-75.1%**
M25 West industrial	72,812	24,946	22,133	13,294	32,601	28,013	16.4%
M25 West distribution	41,934	67,473	198,677	87,954	2,840	114,334	-97.5%
Golden Triangle	**452,772**	**323,664**	**586,122**	**179,925**	**128,916**	**365,259**	**-64.7%**
Golden Triangle industrial	41,828	73,507	41,393	47,022	11,843	46,778	-74.7%
Golden Triangle distribution	410,944	250,158	544,729	132,903	117,073	318,481	-63.2%

Source: Cluttons, Property Data

TABLE 2: PRIME EQUIVALENT YIELD INDICATION FOR I&D ASSETS ACROSS THE UK, BY TYPE

ASSET TYPE	DEC-19	MAR-20	JUN-20	TRENDING	COMMENTS
Prime distribution sheds	4.50	4.50	4.50	stable	Assumes 15yr lease, RR to open market rent
Secondary distribution sheds	5.25-5.50	5.25-5.50	5.25-5.50	stable	Assumes 10yr lease
Prime industrial within M25	4.00	4.00	4.25	weaker	Yields are slightly weaker on smaller estates
Prime regional industrial	4.50-4.75	4.50-4.75	4.75-5.00	weaker	Good modern estate, mixed covenant

Source: Cluttons

A deal not included but worth mentioning is the sale of a Mill Hill retail park for £65m to Amazon. The site, with permission for residential development, has been purchased for a last-mile hub development. Repurposing of redundant retail space will be a major play now there is an acceleration in oversupply of physical retail. Retail parks are in an unusual position: some parks and retailers trade well because consumers feel safer travelling to them, while others have been hit by a high number of insolvencies. Many Toys-R-Us units are still vacant.

Investment deals were delayed, postponed or cancelled for a variety of reasons in Q2. With a relaxation of the lockdown in Q3 2020 activity is expected to come back noticeably. But things will be relatively subdued going forward, with many investors keen to wait and see. Investors wish to buy at distressed pricing which is not present in the current market. In a crisis there is a flight to core, and the sale & leaseback transaction with NEXT is an example of the type of assets and lease lengths investors would be keen to invest in.

Cluttons' prime equivalent yield estimates for Q2 2020 show that prime industrial sheds and secondary distribution sheds are seen as stable even though there is some slight upward pressure here, too. The lack of transactions during Q2 2020 mean the values (shown in Table 2) are indicative only.

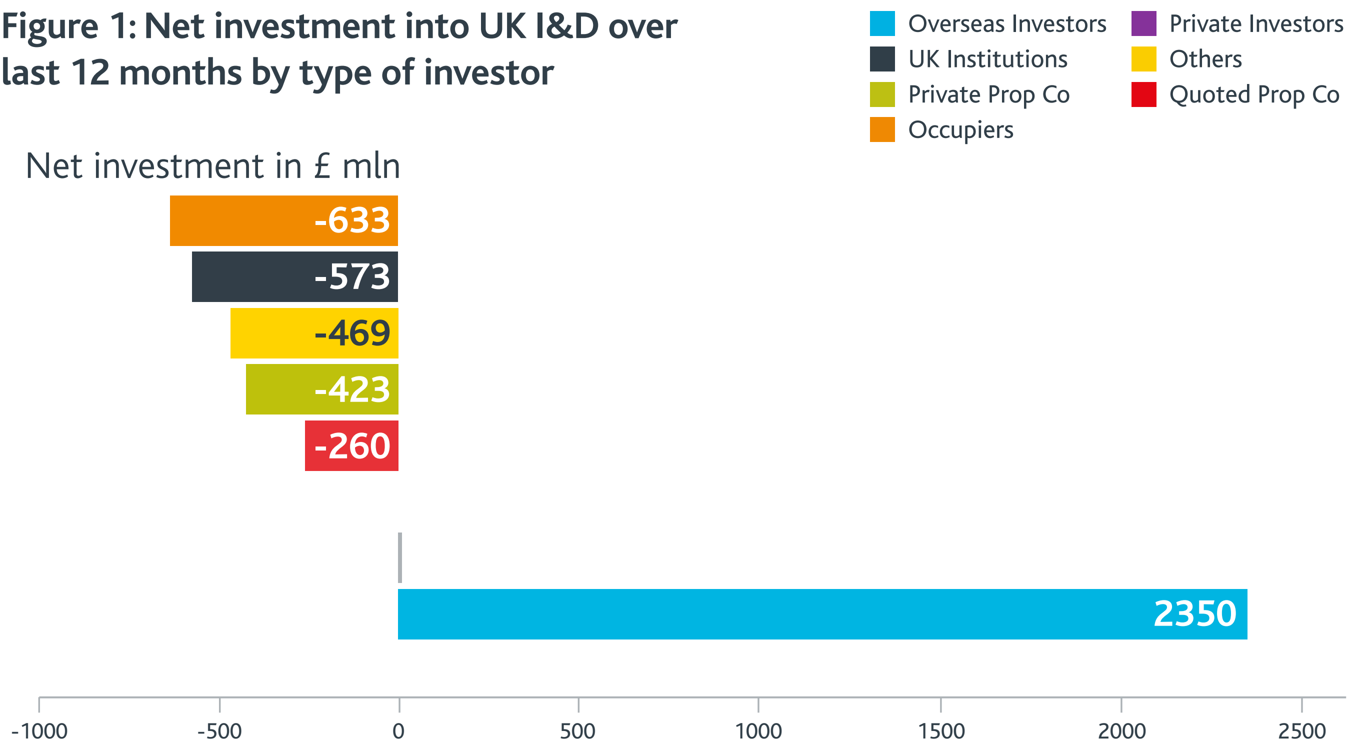
Pressure on the economy means negative sentiment, even though the economy and the UK property sector was relatively healthy prior to the onset of the pandemic. The I&D sector is partially shielded from the COVID-storm with a diversified tenant base paying 84% of rent on time during Q2, better than the retail sector, but less than offices and residential. This data reflects rent that was due at the March quarter payday and was not collected 90 days later.

Industrial tenants have seen supply and production lines disrupted due to falls in demand and difficulty implementing social distancing for workers. Retailers might end up having to store unsold stock and require more space, but those that are struggling to survive or have gone bust will return space to the market. The boom in online sales during lockdown means demand for logistics space has increased. There has been musical chairs between occupiers to an extent, and use has flexibly adapted. Running costs have increased for occupiers, and profit margins remain under pressure. Rental income expectations and asset valuations will be affected to an unknown extent. Broadly speaking, prime assets with longer leases are holding up better than non-prime assets and distribution units better than industrial. Secondary and industrial asset yields have softened more and will remain weaker for the foreseeable future while the health crisis lays siege on the economy.

Despite current weaker market sentiment, investment into real estate remains relatively attractive when compared to other asset classes such as stocks and bonds. Property fits into a multi-asset portfolio due to its low volatility, with lagging and smoothing of valuations aiding diversification and steadying the ship. Investors like to buy into distribution assets due to the continued growth in online retail sales (and asset and covenant quality, which have improved).

The stock market true to form showed huge levels of volatility in Q2 with some companies actually going bust and investors losing all. This does not happen in direct property investment where in the worst-case scenario a tenant goes bust and an asset can be re-let or repurposed. The bond market faces a lower-for-longer environment, and property yields – akin to 'fixed income' – remain relatively attractive on that basis. Listed real estate became an interesting tactical play for many large investors during Q2 due to strong discounts to NAV for REITS and other listed companies.

Figure 1: Net investment into UK I&D over last 12 months by type of investor



Source: Property Data, Cluttons

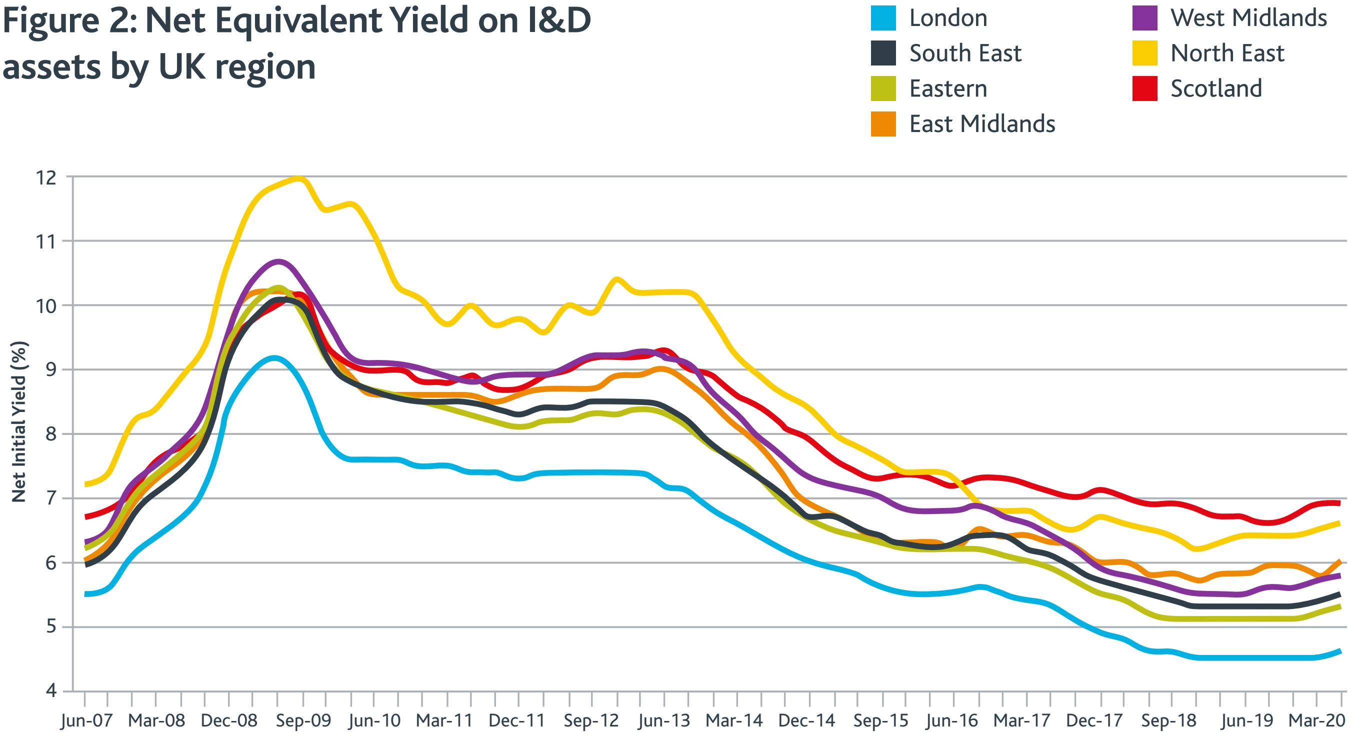
QUOTED PROPERTY COMPANIES ARE THE DOMINANT INVESTOR GROUP

Acquisitions by UK-based investors SEGRO, AVIVA and Pacific Investments dominated acquisitions in Q2. Overseas investors are one of the largest investor groups for UK property. However, they play a lesser role in the I&D investment market where traditionally UK players dominate.

Overseas investors have grown their share of total sales from 14% in 2006 to a peak of c.35% in 2017 and 2019. In Q2 2020 they made up 19% of I&D investment, third largest after UK institutions with a 24.6% share of transactions and quoted property companies like SEGRO at 34.5% a lesser share in the I&D market, these investors have been driving peaks of market activity to a large extent.

Overseas investors tend to be net investors into the UK property market, including into the I&D market (Figure 1). They are still building up their investment portfolio in the UK, whereas UK-based companies are regularly re-weighting their portfolios. Going forward, we expect the investment market to remain crowded with a high weight of money looking to invest after an initial hiatus and investors competing for the best assets. What is seen as the best might change going forward, and a focus will be on who pays rent on time and whether they have a sustainable business model.

Figure 2: Net Equivalent Yield on I&D assets by UK region



Source: MSCI UK quarterly index, Cluttons

HOW HAVE YIELDS BEEN AFFECTED AMIDST THE CURRENT LEVEL OF UNCERTAINTY?

The MSCI UK Quarterly Property Index tracks performance of more than 8,000 property investments, with a total capital value of more £150bn. Figure 2 shows the net equivalent yields for industrial space reported in this index between Q2 2007 and Q2 2020. While London yields remain the lowest, they started moving upwards in Q2 (equivalent yields for I&D in London added 10bps reaching 4.6% in Q2 2020 according to MSCI). Peak-to-trough movements elsewhere in the UK vary from 350bps for Scotland to 580bps for the North East Midlands. The recent lowest point across the regions was generally between Q4 2018 and Q3 2019.

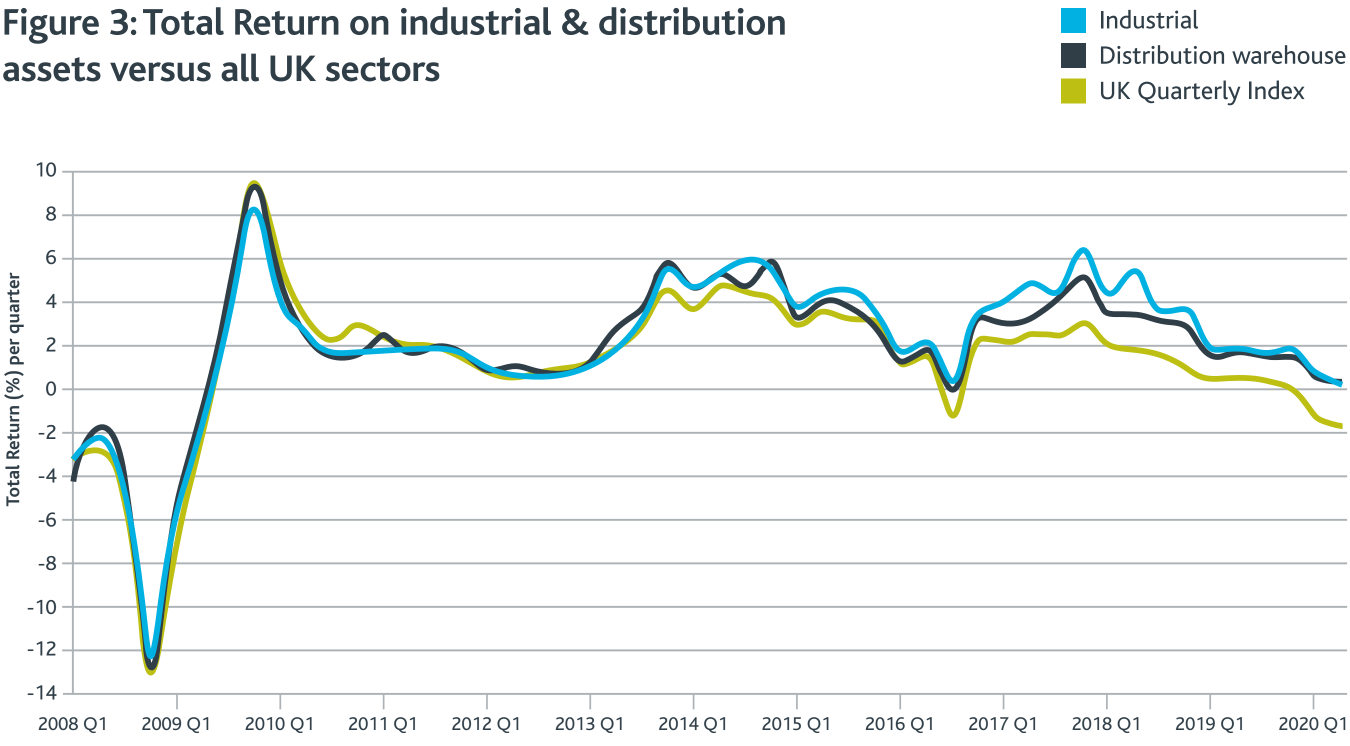
The North East has benefitted from investment in the region, while London has always been perceived as the most liquid, transparent and safest market commanding the lowest risk premium and thus yield. Park Royal achieves a very low yield, but as rents are high in this area, too high for many occupiers, other areas like Enfield and Thurrock might rise.

Shopping behaviours have been changing for many years, particularly preferences around online shopping, and I&D assets have gained interest from investors as a result. Redevelopment of redundant retail warehousing into I&D is becoming more popular and increasingly financially viable—but planning needs to become more amenable to this kind of redevelopment.

Retailers have changed how they organise their warehousing and distribution, at first consolidating into large warehouses, later moving to smaller distribution centres close to consumers. The growth in 3PL (third party logistics) continues unabated with many companies externalising the distribution function to 3PL providers. The latter can achieve greater efficiency due to scale. Larger sheds have been built at a consequence, and this segment will be closely monitored to see how vacancy levels develop.

Institutional investors have been reweighting their investment portfolios, decreasing the share of retail and increasing the amount invested into I&D, residential and alternatives. They are searching for higher yields, longer leases and diversification related to low correlation. Many see investing into I&D as a hedge for their retail holdings: where physical retail suffers from the growth of online shopping distribution is expected to benefit.

Figure 3: Total Return on industrial & distribution assets versus all UK sectors



Source: MSCI UK quarterly index, Cluttons

From 2014 onwards total returns on I&D assets across the UK started to outperform the MSCI UK index, and since early 2017 this has become more pronounced (Figure 3). In late 2017 the quarterly total return for I&D was 3% per quarter, falling to 0% in late 2019 before entering negative territory. The industrial market was considered a bit expensive at this point. Investors were also worried about the outcome of the UK election and a possible no-deal Brexit. Just as the election outcome was (well) received by the investment industry COVID-19 started to rear its head.

TABLE 3: INVESTMENT PERFORMANCE OF I&D PROPERTY VS ALL PROPERTIES IN THE QUARTERLY INDEX, Q2 2020

INDUSTRIAL MARKET PERFORMANCE	3 MONTHS	12 MONTHS	3 YEAR	5 YEAR	10 YEAR
Income return (%)	1.1	4.4	4.5	4.8	5.7
Capital Growth (%)	-1.0	-0.4	6.7	6.5	5.5
Total Return (%)	0.0	4.0	11.4	11.6	11.5
Market Rental Value Growth	0.2	2.2	3.7	3.9	2.3
OFFICE MARKET PERFORMANCE	**3 MONTHS**	**12 MONTHS**	**3 YEAR**	**5 YEAR**	**10 YEAR**
Income return (%)	0.9	4.0	4.0	4.1	4.7
Capital Growth (%)	-1.9	-2.5	0.6	1.4	4.1
Total Return (%)	-0.9	1.4	4.6	5.5	8.9
Market Rental Value Growth	-0.3	0.8	1.0	2.1	3.0
RETAIL MARKET PERFORMANCE	**3 MONTHS**	**12 MONTHS**	**3 YEAR**	**5 YEAR**	**10 YEAR**
Income return (%)	1.3	5.4	5.2	5.2	5.5
Capital Growth (%)	-5.5	-17.3	-9.1	-5.7	-1.8
Total Return (%)	-4.2	-12.7	-4.3	-0.8	3.6
Market Rental Value Growth	-3.0	-7.7	-3.8	-1.8	-0.9
ALL SECTORS	**3 MONTHS**	**12 MONTHS**	**3 YEAR**	**5 YEAR**	**10 YEAR**
Income return (%)	1.1	4.6	4.6	4.7	5.3
Capital Growth (%)	-3.0	-7.2	-1.5	0.0	2.0
Total Return (%)	-1.9	-2.9	3.0	4.7	7.4
Market Rental Value Growth	-1.1	-2.0	-0.1	0.9	1.1

Source: MSCI UK Quarterly Property Index, Q2 2020

Table 3 allows a comparison of the resulting historical performance by sector. I&D has outperformed over all time periods (note that the performance of the index has been dragged down by retail assets which saw rental and capital values decline).

The investment market is already in retreat and will suffer more. A bounce-back, to an extent, is expected from Q3 2020 onwards as the lockdown eases across the country. How fast the epidemic can be brought under control, how secure the population feel going back to their usual routine and how much support the government can give to business and the economy have an impact on the future performance of the I&D sector. Of course, the question of the deal the UK gets when leaving the EU also hangs over the head of companies across the country.

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FORECASTING PERFORMANCE IS HARDER THAN EVER

Forecasting is difficult at the best of times. In the current market, with income hit in a way the property industry has not seen before, it is even harder. If economic output continues to recover from the COVID-19 recession and a vaccine can be supplied in 2021 there is likely to be a meaningful uptick (>5%) in I&D total returns in 2021.

In a worse-case scenario, with no trade deal between the UK and EU by the end of the year, and if social distancing is required throughout 2021, the economic recovery will lose pace; I&D total returns could decline relatively modestly (<1%) this year, but more severely (>5%) in 2021.

Industrial assets in the most expensive area of prime London & South East could see total returns affected more severely as the industry is disrupted. The distribution segment is not immune, it might see growth from online shopping, but also faces increased costs and other challenges such as retailers and other companies going bust. The silver lining is that more efficient business practices can arise due to this crisis leading to a higher productivity and more sustainable economy within the UK.

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