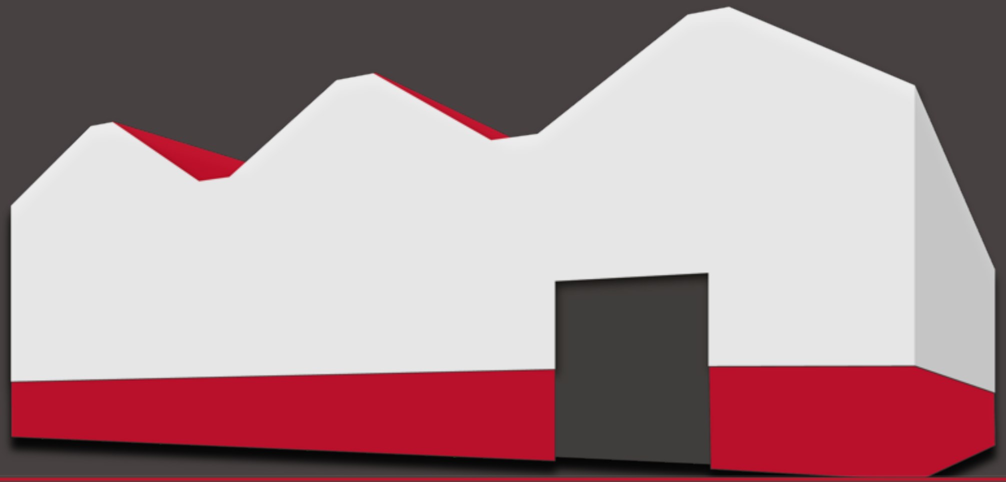
INDUSTRIAL & LOGISTICS MARKET

H1 2016

Lambert Smith Hampton

OCCUPIER MARKET



H1 TAKE-UP FOCUSES ON QUALITY

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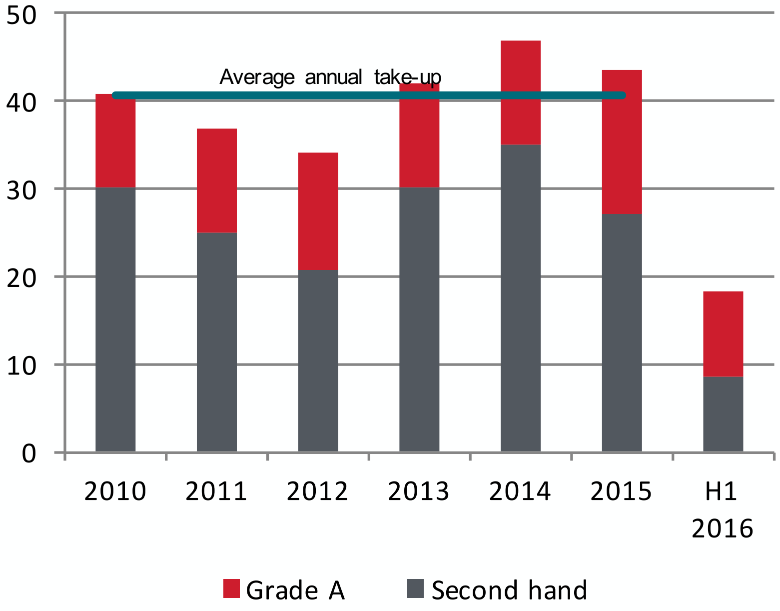
TAKE-UP (M SQ FT)
>50,000 SQ FT UNITS



- A mixed picture for occupier demand. Take-up was 10% below average and 7% below H2 2015, reflecting a natural slowing in demand following near record take-up.
- While mid box take-up was 24% below the five-year biannual average, big box fared better with take-up only down 5%.
- A clear focus on quality space with grade A take-up a record half, 9.4m sq ft, accounting for over 50% of total activity.
- Take-up of speculative space (built and still under construction) reached 3.9m sq ft, highest on record
- Build to suit take-up was only slightly higher at 4.0m sq ft, however, this was skewed by several major deals: The Range (1.2m sq ft), Amazon (1.0m sq ft) and Lidl (0.6m sq ft).

Source: LSH

SOUTH WEST REGION STARS IN H1

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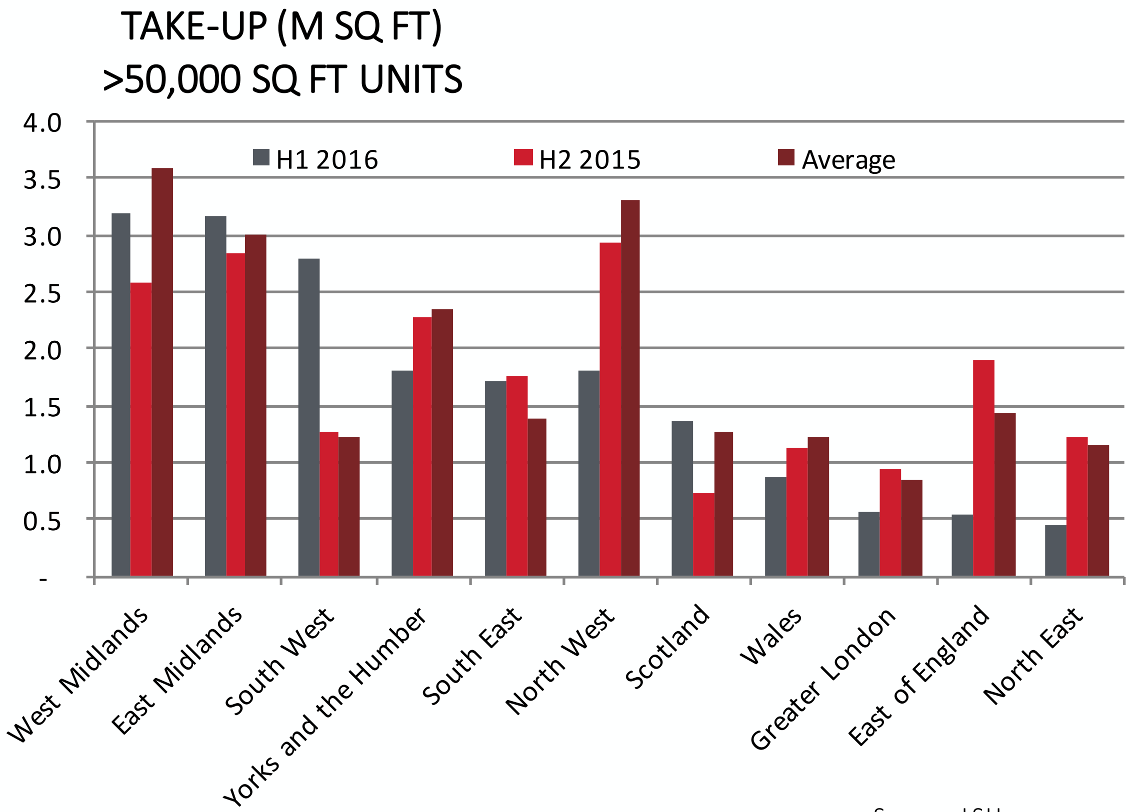

Source: LSH

- The South West was the best performing region relative to H2 2015 and biannual average, and was home to two of the UK's three largest deals: The Range (1.2m sq ft) and Lidl (0.6m sq ft).
- Both Midlands regions saw healthy take-up, with significant absorption of speculatively built space. Largest such deals were JLR at DC1, Ryton (328,000 sq ft) and Clipper Logistics at Northampton Commercial Park (304,000 sq ft).
- The East of England and North East displayed the weakest performance with the North West also subdued, despite Amazon's multiple acquisitions.

THE 'BIG ONES'

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BUILDING	LOCATION	REGION	SIZE (SQ FT)	OCCUPIER	GRADE
THE RANGE	BRISTOL	SOUTH WEST	1,200,000	THE RANGE	BUILD TO SUIT
MOUNTPARK BARDON	COALVILLE	EAST MIDLANDS	1,000,000	AMAZON	BUILD TO SUIT
LIDL	BRISTOL	SOUTH WEST	600,000	LIDL	BUILD TO SUIT
THE BIG 555, SHERBURN DISTRIBUTION PARK	LEEDS	YORKS & HUMBER	556,000	LEGAL & GENERAL HOMES	GRADE A
J4M8 380	BATHGATE	SCOTLAND	382,391	AMAZON	GRADE A
CROSS FLOW 380	CREWE	NORTH WEST	380,000	AO.COM	GRADE A
DC1 PROLOGIS PARK	RYTON	WEST MIDLANDS	327,730	JAGUAR LAND ROVER	GRADE A
CELESTIA	MILTON KEYNES	SOUTH EAST	318,526	DS SMITH	SECOND HAND
NORTHAMPTON COMMERCIAL PARK	NORTHAMPTON	EAST MIDLANDS	303,700	CLIPPER LOGISTICS	GRADE A

PURE-PLAY RETAIL DRIVES H1 ACTIVITY

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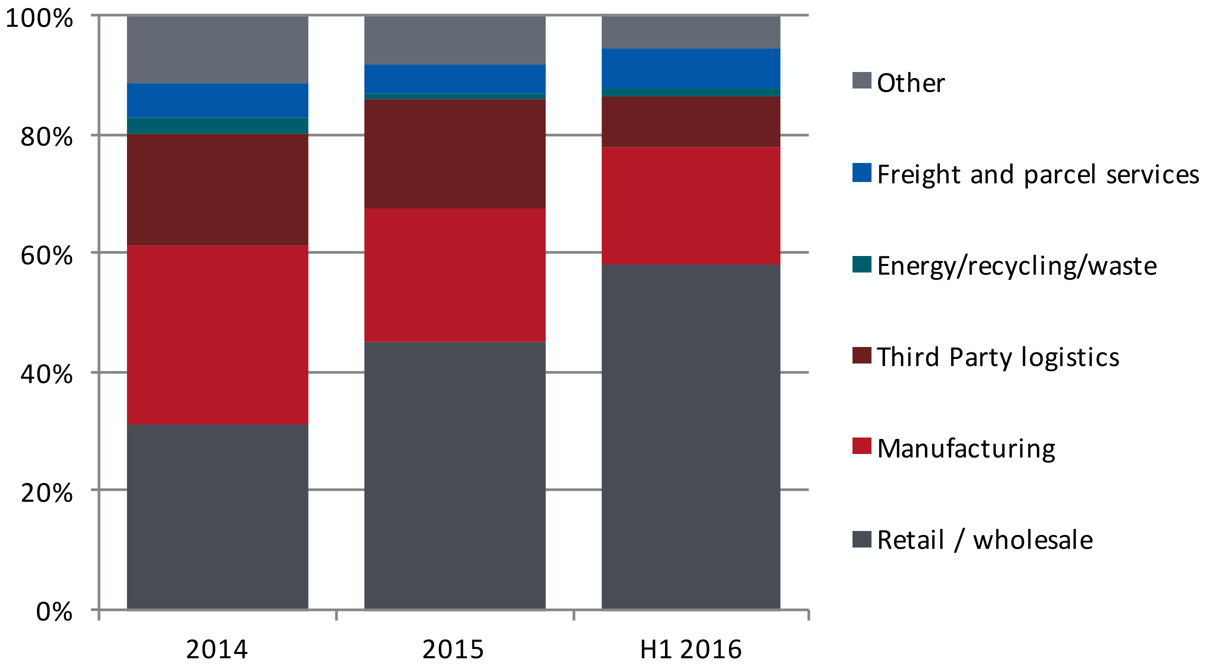
TAKE-UP BY SECTOR



Source: LSH

- Retail and Wholesale dominated activity, accounting for 58% of take-up, boosted by the three largest deals of the year, with The Range, Amazon and Lidl committing to major design and build units.
- Pure-play retailers were responsible for 50% of Retail / Wholesale take-up in H1.
- Amazon were responsible for over 2.4m sq ft of H1 take-up and, in July, committed to a substantial 2.2m sq ft operation at London Distribution Park, Tilbury.

RENTAL GROWTH BEGINS TO EASE DOWN

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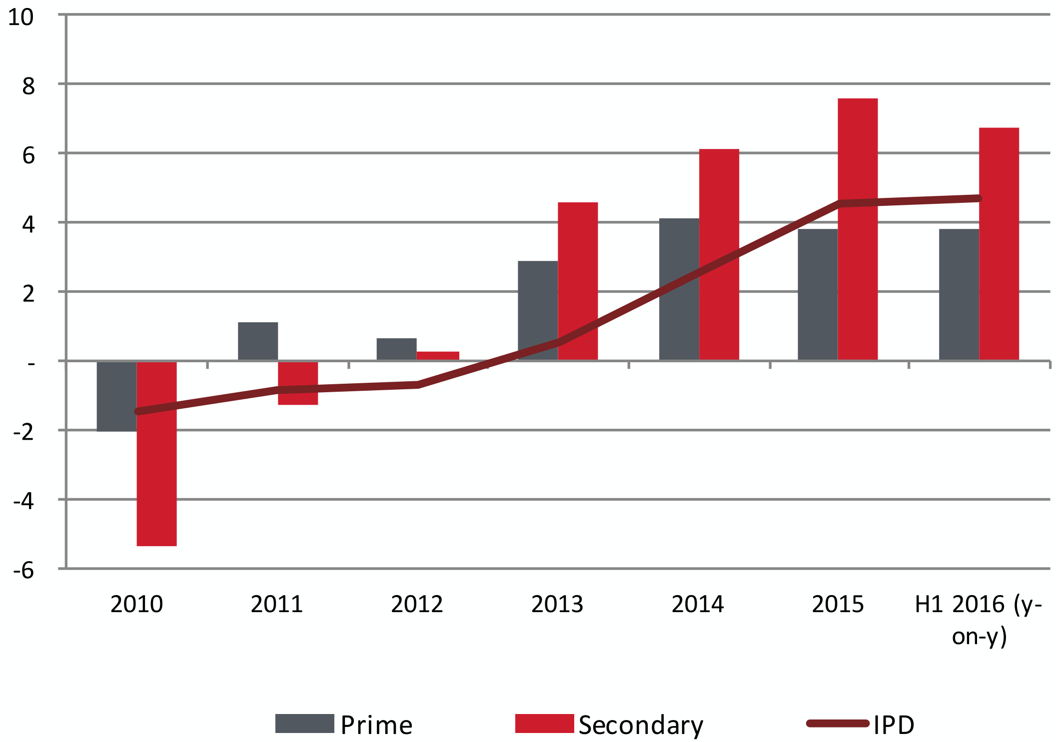
AVERAGE RENTAL GROWTH (% P.A.)



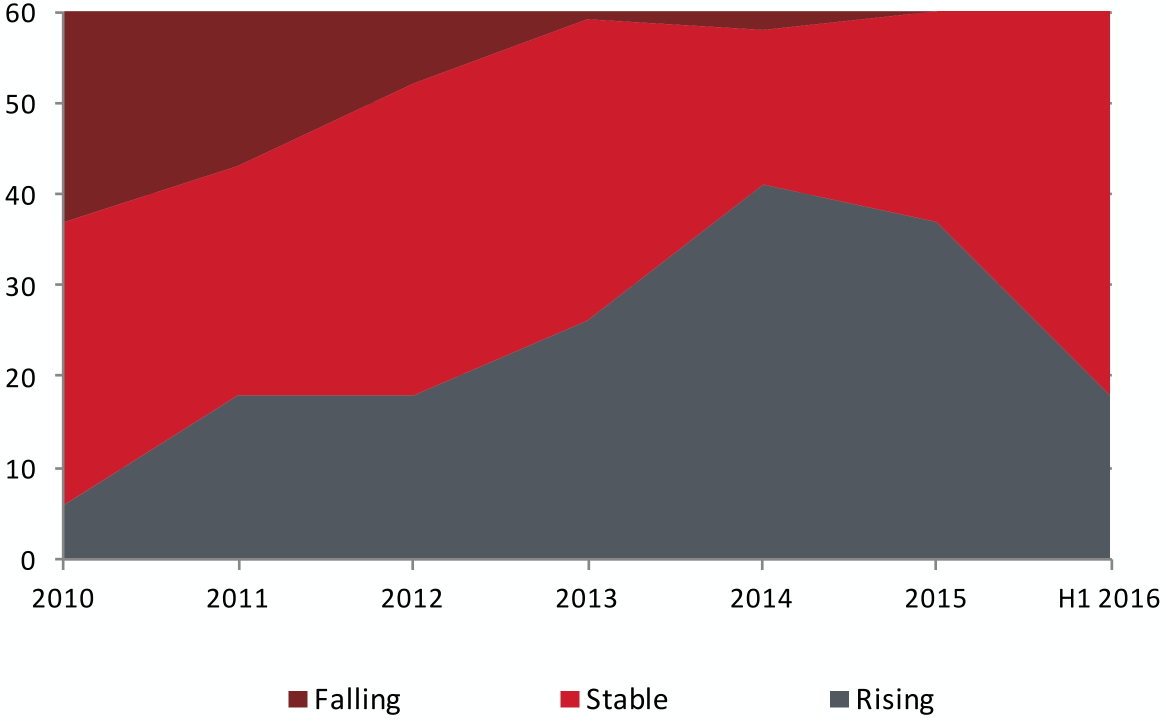
Source: LSH, MSCI

- While constrained supply market remains supportive of continuing rental growth over the next 12 to 18 months, evidence suggests the rate of growth has peaked.
- While year-on-year prime rental growth was relatively stable, at 3.8%, H1 saw an increase of 1.6%, down from 2.2% in H2 2015.
- Secondary rental growth continues to significantly outpace prime rental growth, increasing by 6.8% year-on-year.
- That said, slowdown in secondary rental growth was clearer. Average growth in H1 was 2.4%, down from 4.2% in H2 2015.

PRIME RENTS STABLE IN MAJORITY OF MARKETS

RENTAL MOVERS

NUMBER OF MARKETS



Source: LSH

- 18 out of 60 markets recorded an increase in their prime headline rent during H1, while the remaining 42 locations were stable.
- The uncertainty prompted by June's Referendum result is expected to weigh on prime rental growth, but the supply position will prevent a fall in headline rental levels, with rental negotiations likely to centre on incentive packages.

UNCERTAIN OUTLOOK FOR OCCUPIER DEMAND

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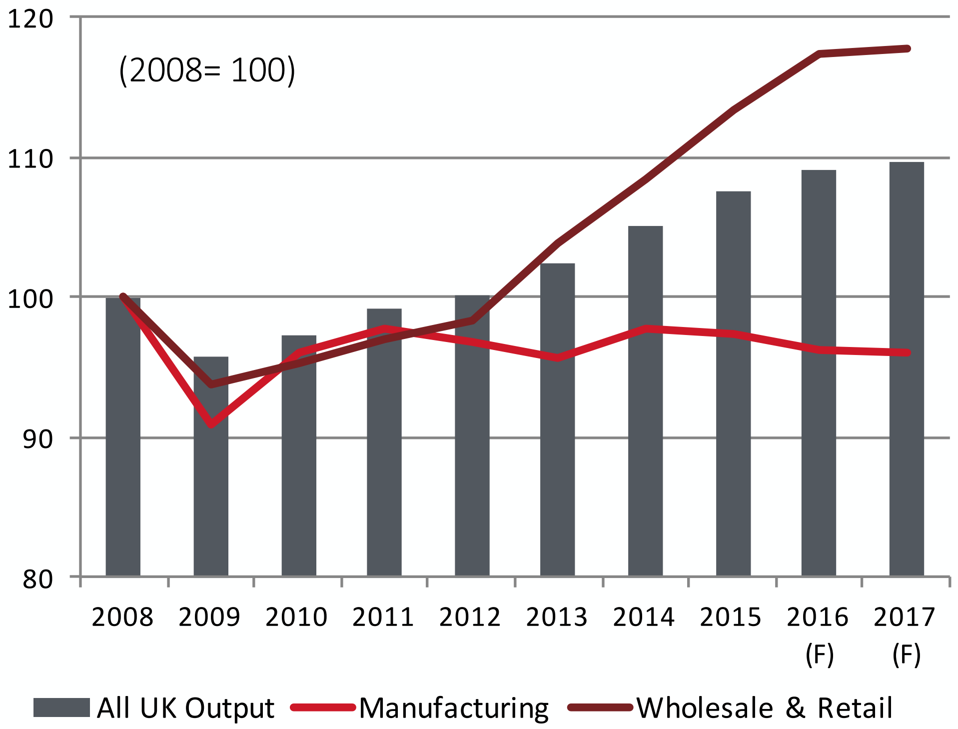
UK ECONOMIC OUTPUT INDEX



Source: ONS, Experian

- June's EU Referendum result prompted an immediate downgrade to the near-term outlook for the UK economy among leading forecasters. However, initial evidence 'business as usual' has returned to a degree.
- As shown by Markit's PMI for Manufacturing rebounding in August to its highest level for almost a year, with retail sales surging in July by 1.4% month-on-month.
- The retail and distribution sector is forecast to continue to outperform, as consumers continue to benefit from low interest rates. However, the boost to UK manufacturing stemming from sterling's post-Brexit depreciation may not help in the short term.
- Initial evidence suggests a pause in demand since the vote, as occupiers postpone property decisions until there is greater clarity over what Brexit ultimately means.
- Any fall in activity will not come near what was seen in the last recession, with structural change to ecommerce supporting demand as occupiers optimise supply chain efficiencies.

GRADE A AVAILABILTY REDUCES

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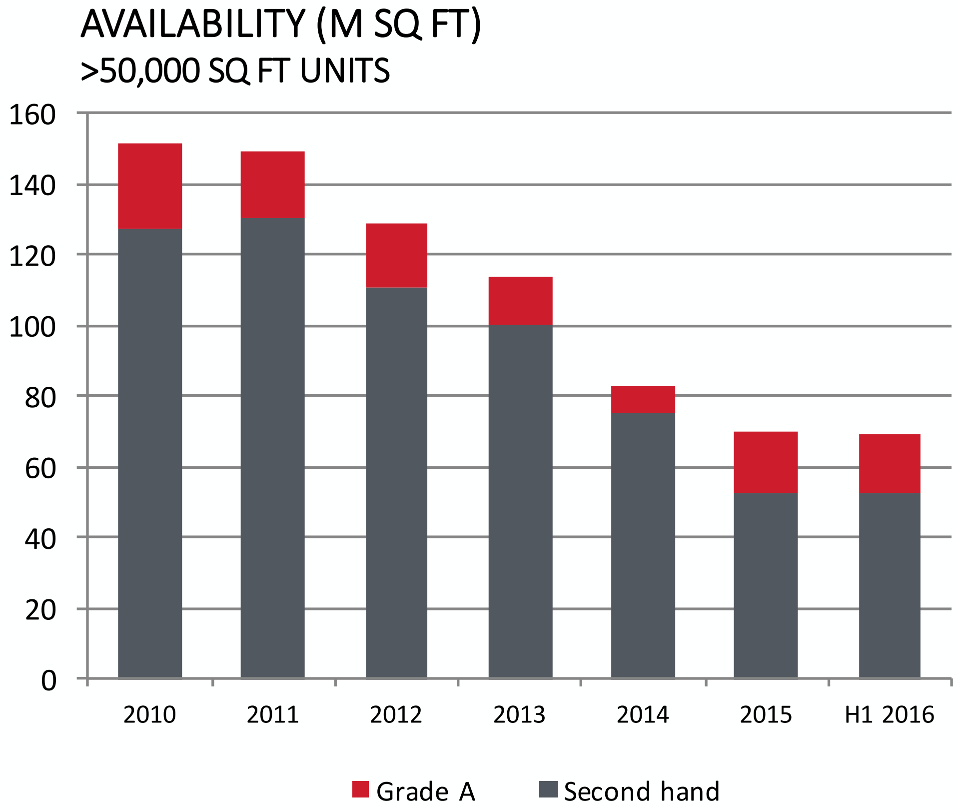

Source: LSH

- UK-wide availability continues its downward trend, albeit, the fall in H1 was the smallest since 2011. Overall supply reduced by 1% to stand at 68.9m sq ft, with grade A supply decreasing by 4% to 16.5m sq ft.
- The reduction in grade A supply reflects the demand for high quality space, as spec has been taken-up. Many spec-built units were let during construction but 20 units that completed in H1 remain available.
- Meanwhile, second-hand supply remained constant, indicating that very little good quality (location and/or spec) second-hand space remains available, having been largely absorbed.
- Accordingly, the fall in good quality second-hand options has influenced a flight to new-build space.

NEW-BUILD SUPPLY EDGES DOWN

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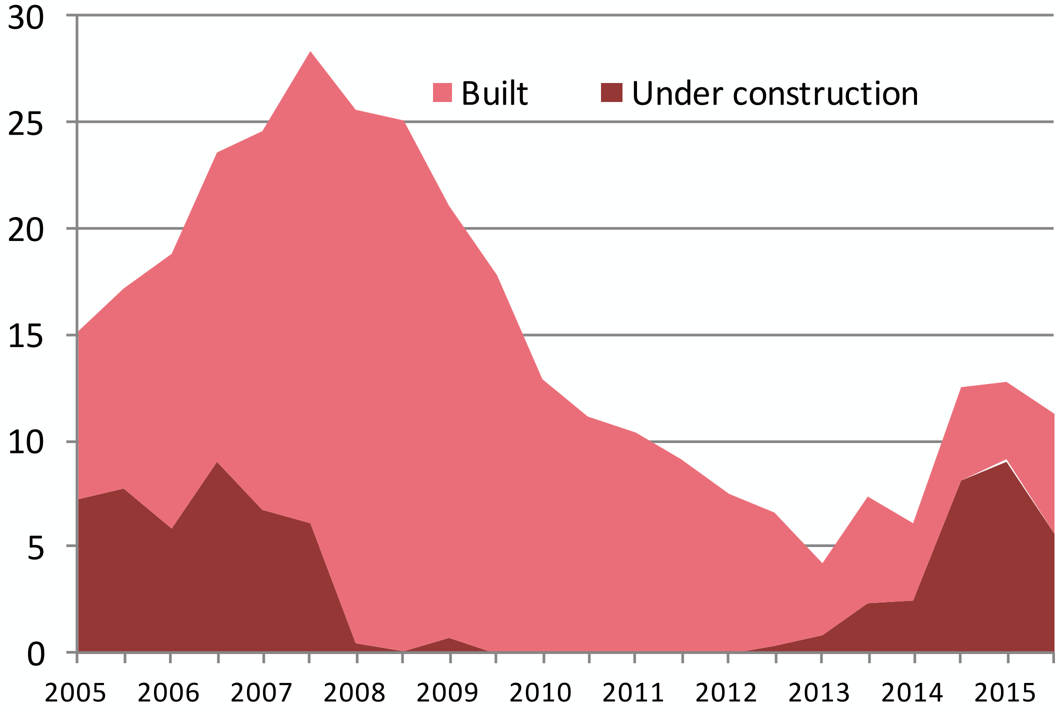
NEW BUILD SUPPLY
>50,000 sq ft units



Source: LSH

- The UK-wide availability of new-build space fell 12% during H1 2016 to stand at 11.3m sq ft, comprising 80 units.
- A flurry of completions in H1 took the level of ready to occupy new-build supply to 5.7m sq ft, up 52% from the start of the year.
- Total available space under construction fell by almost 40%, reflecting a slowing in the rate of new development starts and take-up of a number of schemes prior to practical completion.
- The uncertainty stemming from summer's Referendum result has weighed on the prospects of further speculative development starts during H2, with many projects now on hold.

AVERAGE SIZE OF NEW-BUILD UNITS, THEN AND NOW

2008 - 251,000 sq ft

H1 2016 - 141,000 sq ft

- The average size of new-build units (from 50,000 sq ft upwards) has almost halved in this development cycle compared with the last cycle in 2006/07.
- The shift reflects the changing nature of demand, as parcel carriers and retailers have sought to optimise their supply chains for customer delivery.

Source: LSH

NORTH WEST LEADS DEVELOPMENT

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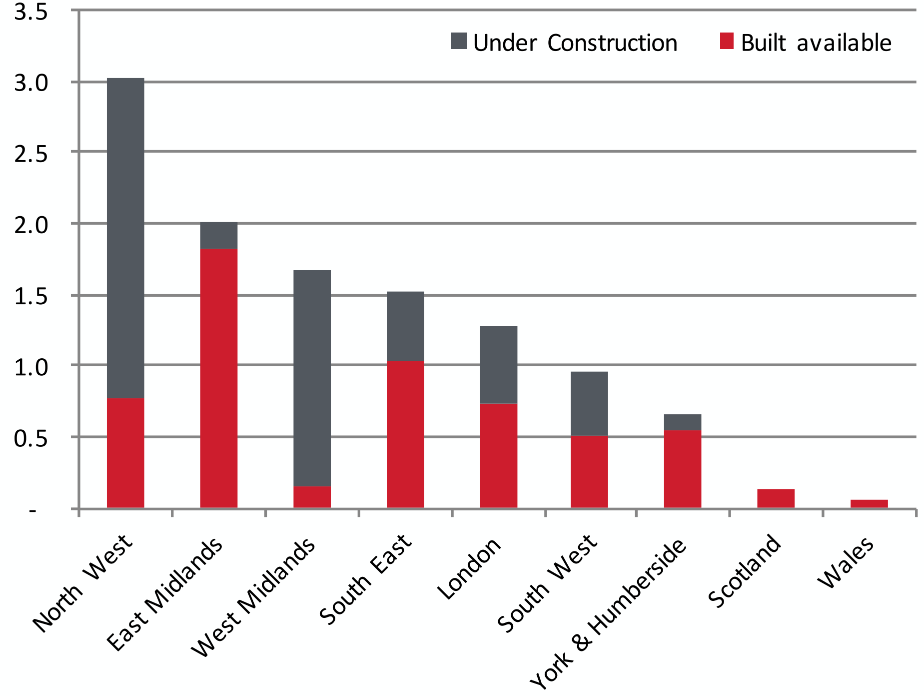
NEW BUILT SUPPLY (M SQ FT)
>50,000 sq ft



Source: LSH

- The North West now has the highest volume of speculative development underway of any region, at 2.2m sq ft. Three new schemes commenced in H1, including two units in excess of 350,000 sq ft (360 Logistics North, Bolton and Prime, Omega, Warrington).
- The South West was the only other UK region to see speculative development increase during H1, albeit off a low base. Three units in excess of 50,000 sq ft are underway at Mountpark, Bristol.
- In the West Midlands, the majority of new space was under construction at the end of H1, although the majority are set to be delivered in H2 2016. The West Midlands is home to one of the only schemes in the UK to commence post Referendum, with three units totalling 590,000 sq ft progressing at M&G's Imperial Park, Coventry.
- Scotland is the only part of the UK to have seen no space delivered speculatively in this cycle. Following the lease of Max380 in H1, the sole new-build unit still available is Vertex, Eurocentral.

DEARTH OF QUALITY SUPPLY REMAINS

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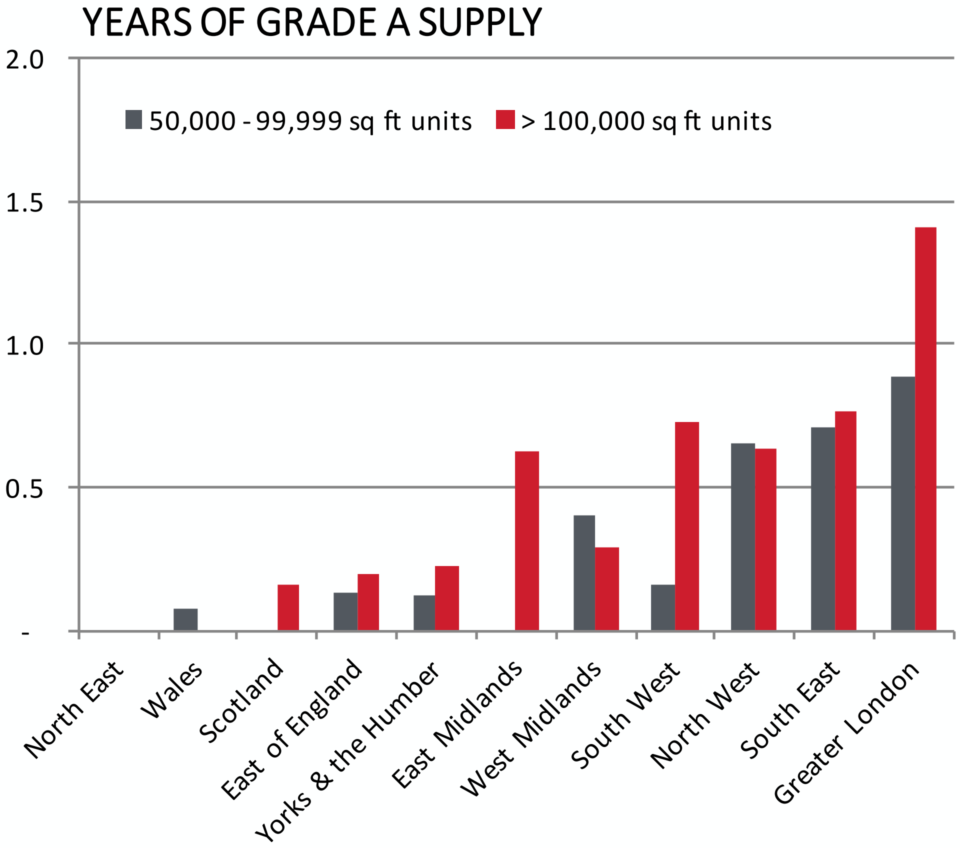

Source: LSH

- Despite the revival of development since 2014, there remains a dearth of good quality supply. This is particularly true of the mid-box sector (50,000 sq ft – 99,999 sq ft) where grade A supply is equivalent to 0.3 years of average take-up across the UK.
- The focus of development on larger-sized units (100,000 sq ft+) means grade A supply is slightly less acute in the big-box sector (100,000 sq ft+), albeit still equivalent to only 0.4 years of average annual take-up across the UK.
- While supply is relatively tight across all regions, there is notable intra-regional variation. Three major speculative development starts in the North West have rapidly switched the dynamics in the big box sector.
- Greater London also appears 'well-supplied' with big-box space, with grade A 17 units available at the end of H1. However, a number of these have let during Q3 2016, changing the position from H1.

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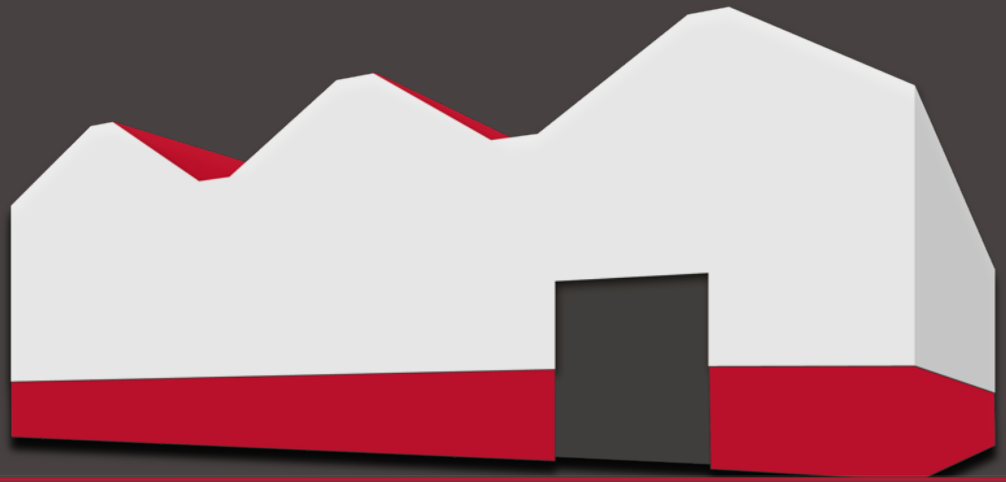
INVESTMENT



VOLUME SLOWS IN REFERENDUM RUN-UP

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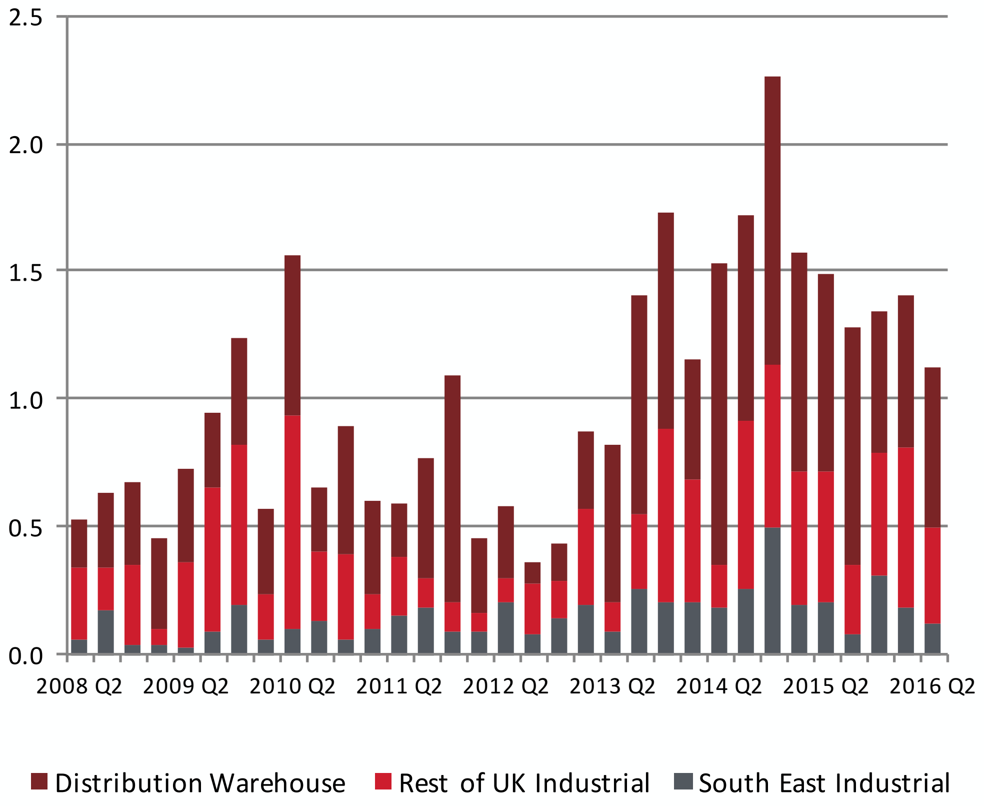
INVESTMENT VOLUME (£BN)



Source: LSH

- The run-up to the EU Referendum weighed on industrial investment activity, albeit to a lesser extent than other sectors. Q2 Industrial volume was £1.1bn, down 20% from Q1 but only 4% below the five-year quarterly average, whereas All Property investment was 20% below average in Q2.
- With the major institutions retreating to the sidelines in the wake of the Referendum result and stock withdrawn from the market, volume is likely to decline further in H2 2016. However, appetite for quality industrial assets remains strong among other buyer-types, including overseas and quoted property companies, albeit there is a lack of stock on the open market. That said, there is a lot of ‘quiet marketing’ taking place to protect investor reputation.
- While the Referendum has affected sentiment, the sector is regarded as defensive relative to other key assets. Occupationally, the sector in undersupplied with good quality space, mitigating rental declines, while occupier demand continues to be supported by structural change in retail towards increasing ecommerce.

BUYER PROFILE CHANGES AS INSTITUTIONS GO QUIET

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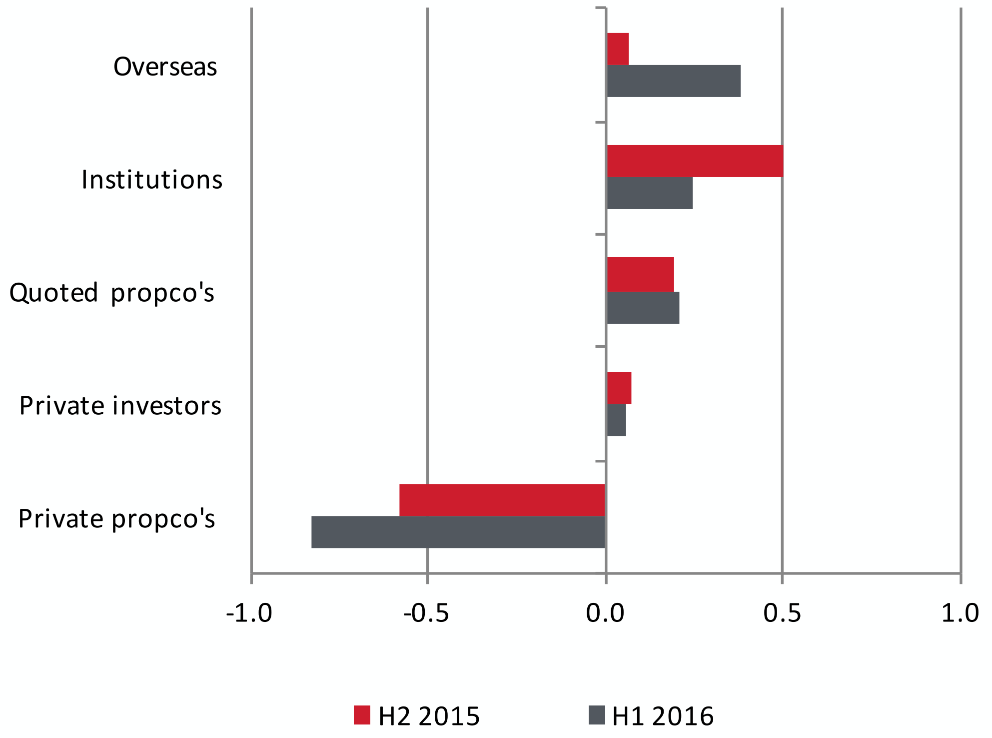
NET INVESTMENT BY BUYER TYPE (£BN)



Source: LSH

- The months leading up to Referendum and weeks following the vote have coincided with a notable change to the buyer profile for industrial and logistics assets.
- Having been major investors into industrial in recent years, net investment by UK institutions fell to just £0.2bn, being prominent net sellers of UK commercial property as a whole during H1.
- Overseas investors were the largest net buyers of industrial assets at £0.4bn. Sterling's post-Referendum depreciation will help to support overseas interest in prime single-let stock.
- Alongside the REITS, local authorities have emerged as a key source of demand in the sector. In the current austere financial environment, they are under pressure to secure alternative revenue streams while benefitting from low borrowing costs available to public sector bodies.
- At the beginning of September we started to see institutional activity, predominantly from mandated funds within the sector again. We are now beginning to see cash flow positions stabilising.

NOTABLE POST-REFERENDUM DEALS

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ASSET TYPE	PROPERTY	SIZE (sq ft)	TERM (years)	RENT (per sq ft)	TENANT	PRICE	NIY	CAP VAL (per sq ft)	DATE	VENDOR	PURCHASER
SINGLE-LET DISTRIBUTION	FOUR ASHES, WOLVERHAMPTON	543,692	25	£5.70	GESTAMP	£56.3M	5.16%	£103.55	AUG 16	BERICOTE	TRITAX BIG BOX REIT
SINGLE-LET DISTRIBUTION	MERLIN 310, TRAFFORD PARK, MANCHESTER	311,280	1.75	£4.77	KELLOGGS	£23.1M	5.95%	£74.20	AUG 16	TH REAL ESTATE	TRITAX BIG BOX REIT
SINGLE-LET DISTRIBUTION	UNION SQUARE, TRAFFORD PARK	176,080	10	£5.95	AMAZON	£19.5M	5.05%	£110.46	AUG 16	M&G	ABERDEEN
SINGLE-LET DISTRIBUTION	CHROME 102, MINWORTH	102,750	10	£6.50	DHL	£12.4M	5.05%	£120.68	JUL 16	ROCKSPRING	PORTSMOUTH CITY COUNCIL
SOUTH EAST MULTI-LET	PUMA TRADE PARK, MITCHAM	47,599	7.1	£11.78	VARIOUS	£10.8M	4.89%	£225.85	AUG 16	STANDARD LIFE	DTZ INVESTORS
SOUTH EAST MULTI-LET	CENTRUS, WAXLOW ROAD, LONDON	51,363	5	£10.80	VARIOUS	£12.7M	4.10%	£247.25	AUG 16	CANADA LIFE	CBRE GI
SOUTH EAST MULTI-LET	HESTON & AIRLINKS IE, HEATHROW	481,000	5.4	£9.04	VARIOUS	£79.5M	5.10%	£165.28	AUG 16	SEGRO	CAPITAL INDUSTRIAL
SOUTH EAST MULTI-LET	SOUTHWOOD SUMMIT CENTRE, FARNBOROUGH	41,119	8.75	£9.26	VARIOUS	£6.1M	5.90%	£147.13	JUL 16	KNIGHT FRANK IM	LONDON BOROUGH OF BROMLEY
REGIONAL MULTI-LET	BRACKMILLS INDUSTRIAL ESTATE, NORTHAMPTON	216,118	3.47	£4.34	VARIOUS	£12.66M	7.00%	£58.58	U/O	IPIF	ROYAL LONDON
REGIONAL MULTI-LET	MANORSIDE INDUSTRIAL ESTATE, REDDITCH	187,430	3.3	£4.68	VARIOUS	£9.8M	7.50%	£52.49	SEP 16	CBRE GI	PALOMA
REGIONAL MULTI-LET	WILLENHALL INDUSTRIAL ESTATE, WILLENHALL	401,669	7.6	£3.93	VARIOUS	£18.8M	7.90%	£46.68	AUG 16	CBRE GI	CANMOOR
REGIONAL MULTI-LET	NEWNHAM INDUSTRIAL ESTATE, PLYMOUTH	75,648	2.34	£4.95	VARIOUS	£4.1M	8.61%	£54.00	AUG 16	CBRE GI	PLYMOUTH CITY COUNCIL

Source: LSH

PRIME DISTRIBUTION YIELDS HOLD FIRM

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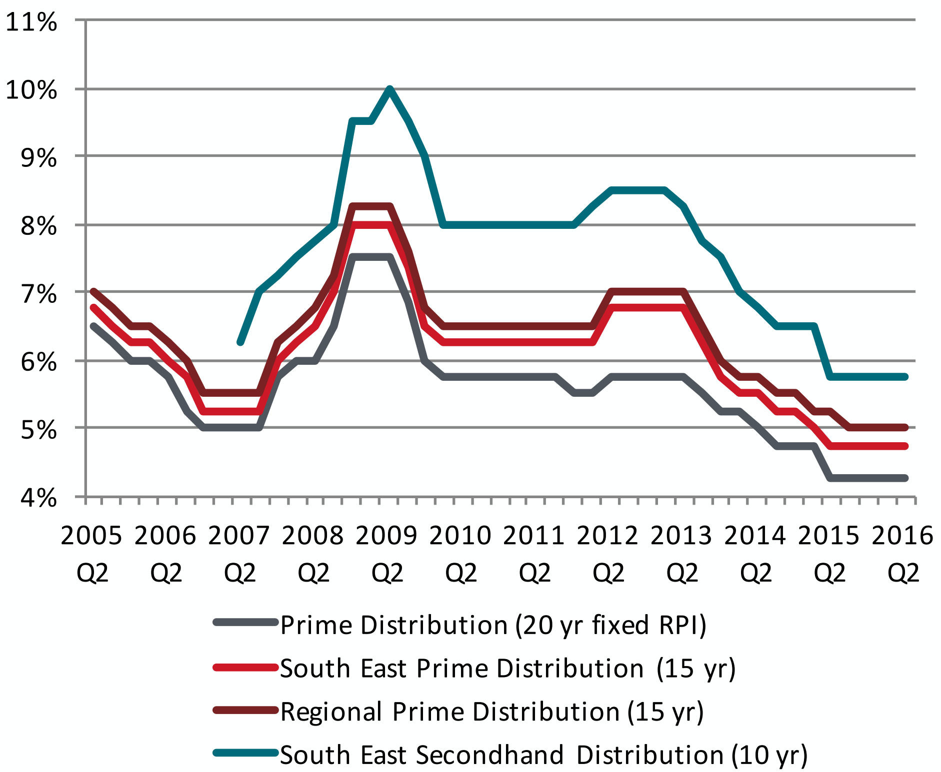
DISTRIBUTION YIELDS



Source: LSH

- Pricing is holding firm for prime distribution, with prices paid for prime distribution appearing unchanged between pre and post Referendum, including for second-hand stock offering long-income.
- Increased caution over the Referendum result has only increased investor focus on prime product, where the fundamentals remain sound.
- In sharp contrast with the 2008 downturn, the yield differential between prime industrial and 10-year government bonds has grown even wider after the Referendum, supporting pricing at the current levels.
- Post-Referendum uncertainty and prolonged interest rates have seen a drive for income returns and an even greater emphasis on covenant strength, location has also become more important.
- While prime distribution yields are holding firm, the speculative development market has paused in the most part, albeit we anticipate investors appetite to return in the next 6 months. We do however expect a discount to reflect the added risk of such developments.

LACK OF STOCK SUPPORTS MULTI-LET PRICES

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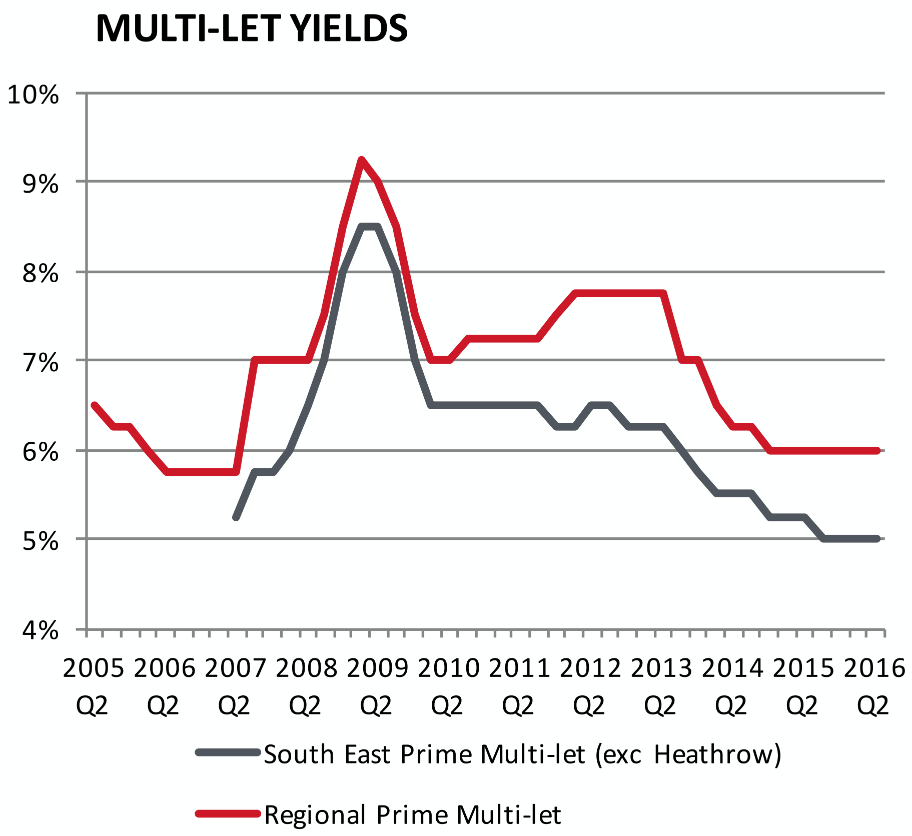

Source: LSH

- Pricing is also holding firm for prime multi-let stock, supported by an acute shortage of product on the market. Prices for the prime London locations is under continued pressure, with yields of up to 4.75% seen after the Referendum result.
- The buyer profile for prime south east multi let remains competitive with the likes of CBRE GI, DTZIM, KFI, Royal London and UBS all actively bidding on stock.
- In contrast, poorer quality multi-let product in the UK regions is the most likely to experience a price correction in the wake of the Referendum result. Investors return hurdles have increased on these opportunities. Accordingly they are more wary about these sort of opportunities in view of the increased void risk, should demand be reduced by Brexit.
- A distinct lack of multi-let stock traded in first half of the year, combined with a competitive buyer pool will lead to pricing for good regional estates continuing to harden.

CONSENSUS CONTINUES TO BACK INDUSTRIAL

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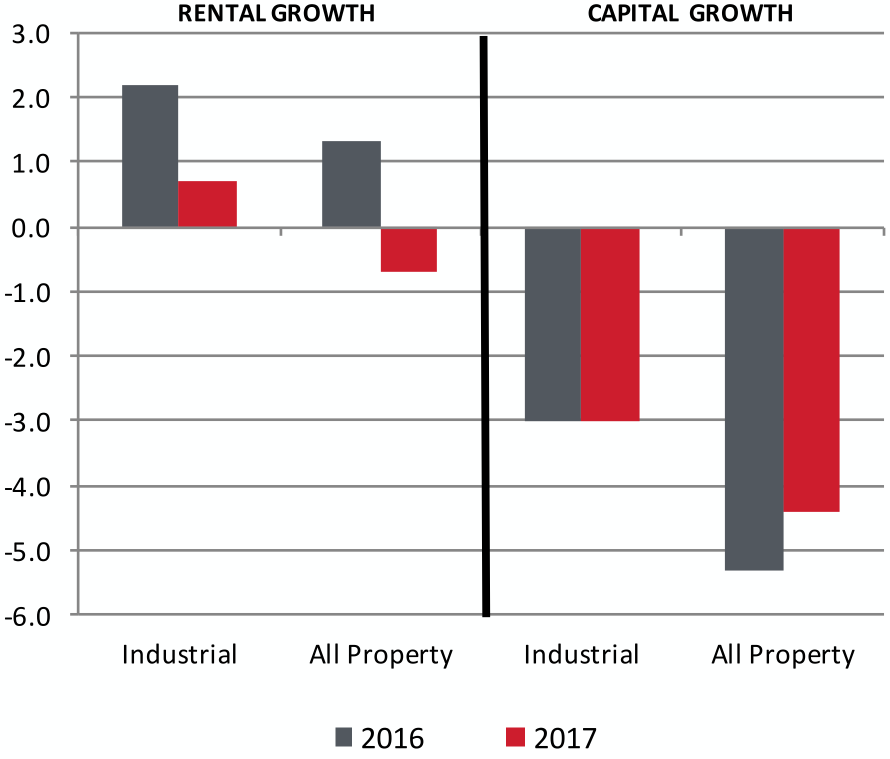
CONSENSUS FORECAST (% PA)



Source: IPF

- The Investment Property Forum's August consensus forecast revealed a significant downgrade to the outlook for property performance, across all sectors.
- The investment community continues to put Industrial as the lead performing of the core property sectors for 2016 and 2017. This is a reflection of the relatively defensive nature of the sector and the supportive supply conditions in the occupier markets.
- Industrial rental growth is forecast to continue into 2017, against a projected fall for All Property.
- Industrial is forecast to see a reduction in average capital values in 2016 and 2017, but to a lesser extent than All Commercial Property.
- Individual asset quality will likely determine the level of reduction experienced in 2016 & 2017 and our view is that prime, well specified assets will likely maintain current values.

OUTLOOK

OCCUPIER DEMAND

- Take-up will fall below average in H2, reflecting increased caution to commit to location strategies in the uncertain post Referendum economic environment.
- Structural changes in retail towards ecommerce will continue to support demand among pure-play retailers, although manufacturing supply-chain occupiers will shelve requirements until more clarity emerges over Brexit terms.

SUPPLY & RENTS

- Quality supply remains under pressure, despite sharp increase in development since 2014.
- Rental growth will be dampened by the Referendum result, but will not cease entirely in the prime locations.
- No risk of oversupply. Anticipated spec development starts on hold in view of investor uncertainty over occupier demand.

INVESTMENT

- The Referendum result has prompted a flight to quality. Pricing will hold firm for prime, secure income assets, both multi-let and distribution with secondary product likely to experience slight price correction.
- Volume will reduce in H2 to below average levels, although the market will be held back by lack of stock rather than demand.
- Industrial & logistics is relatively defensive to the current market, given the supply-demand dynamics in the occupier markets and structural support.

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