

Schroder Property Multi-let industrial estates: more than just your average manufacturer



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Introduction

What is a multi-let industrial asset? Located near urban areas, estates are comprised of different sized units let to multiple occupiers and are usually under single ownership. The function of these assets is to provide affordable space for a wide range of activities. Tenants include those associated with lower-skilled or high-tech manufacturing, wholesale, transport and construction. There are some regional specialisms: manufacturing in the North West and the Midlands, high-tech firms in the East of England and wholesalers, communications and transport in London and the South East.

What drives demand for space on industrial estates?

The UK economy continues to improve with each passing quarter, but how and why has this translated into demand for industrial space? At 66 million sq ft, take up of units on multi-let estates was robust in 2013, with new lettings up 21% year-on-year for units below 100,000 sq ft¹. Encouragingly; increased levels of activity were recorded across all UK regions, with the exception of the North West.

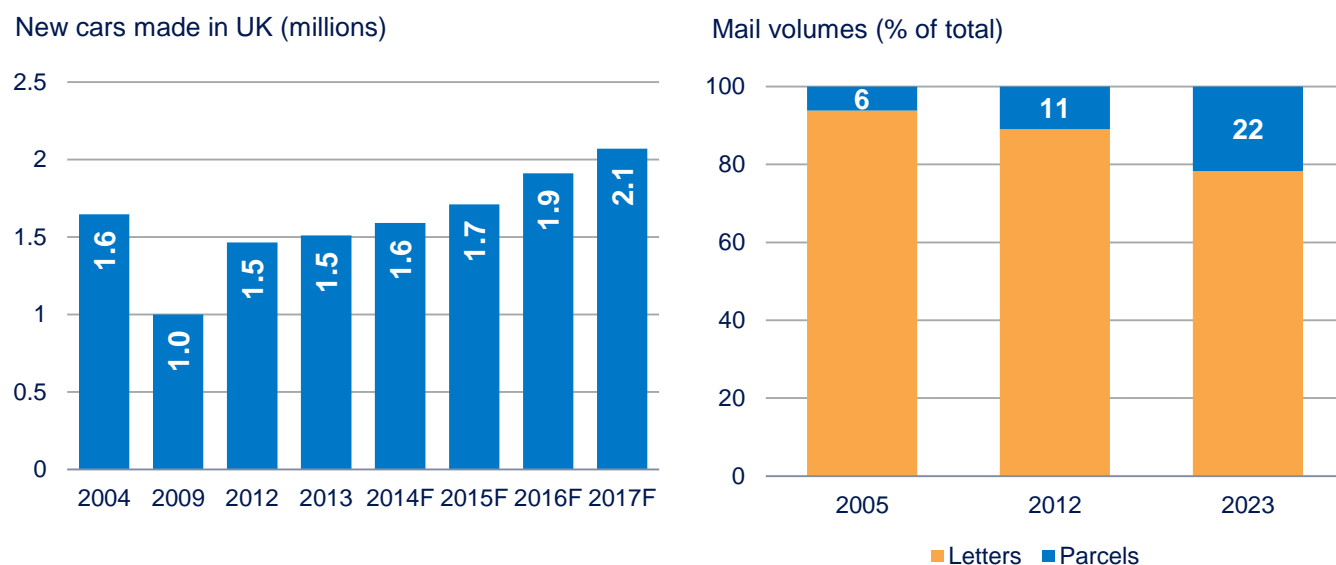
The reason behind this uptick in demand is the strengthening and diversification of the tenant base. Manufacturing has been a traditional driver of requirements for standard industrial space. In long-term decline in many developed economies, output from UK firms has proven to be (relatively) more resilient due to the strength of its key industries. The automotive sector has been one recent British success story; car production is now back to pre-recession levels² (**Figure 1**) and brands such as Nissan, Mini, Rolls Royce and Jaguar Land Rover are investing in new plants and storage in the UK. This additional capacity also generates demand for floor space further down the chain. For instance, suppliers are often located close to warehouses to assist 'just in time' delivery commitments.

¹ *Industrial Property Trends Today*. JLL, 2014

² The Society of Motor Manufacturers and Traders, 2014



Figure 1 and Figure 2: growth in the automotive and parcel delivery sectors will strengthen demand for space



Source: SMMT, 2014, PwC, 2013

An interesting feature of the UK manufacturing sector is the geographical clustering of companies producing similar goods. Examples include aerospace in Lancashire, precision engineering in Gloucestershire, car and motorsport production in Birmingham and life sciences in Berkshire and Surrey. Being in close proximity benefits firms by facilitating the sharing of technology, knowledge and suppliers. This means a diverse range of buildings are required in one local area for functions such as research and development, production and delivery.

Manufacturing is more than just making things

Multi-let is not just reliant on manufacturing; it has also been a direct beneficiary of the resurgence in parcel deliveries. The advent of the internet and e-commerce had a huge structural impact on both the traditional postal system and the retail market. However, the number of parcels from online retailers increased by 3.7% per annum between 2008 and 2013 and volumes are forecast to grow by a further 3% per annum out of 2018 (**Figure 2**)³. A reduction in expected delivery times has created demand from parcel operators for multi-let space close to large urban areas and transport systems; they will often compromise on a bespoke hub over location.

Two further developments that will positively influence demand for multi-let estates are ‘3D printing’ and ‘re-shoring’. 3D printing, or additive manufacturing, is a technique that builds solid objects using a digital file as a reference point. Whilst still very much in its infancy, this process has the potential to generate future requirements for space in the production and delivery of the printer, its base materials and final outputs.

Finally, there is increased evidence of ‘re-shoring’ by domestic firms such as Dyson, Hornby and John Lewis; the repatriation of industrial production back to the UK from overseas. In 2013, 15% of companies surveyed by the Manufacturing Advisory Service reported they have or are re-shoring, compared to 4% actively off-shoring⁴. Rising wages in many countries, particularly China, alongside a desire to control quality and reduce lead times have driven this turnaround.

³ *The Outlook for UK Mail Volumes to 2023*. PwC, 2013

⁴ *MAS Barometer*. Manufacturing Advisory Service, 2013

Market conditions have tipped back in favour of the landlord

The increased demand for space on multi-let industrial estates is outstripping the availability of good quality space. At the end of 2013, total vacant space in multi-let industrial buildings equated to 199 million sq ft, below the three year average of 229 million sq ft, with the greatest supply/demand imbalance in greater London⁵. This problem is exacerbated further by the poor quality of space available; JLL (2014) estimate that only 7% of empty units are in new or refurbished stock. In addition, despite market conditions making development potentially viable, restricted access to finance will inhibit new starts. The small number of new builds that have entered the market recently have been distribution warehouses⁶, and with some industrial units being converted into alternative uses, the standing stock of multi-let estates has fallen by approximately 8% over the last ten years⁷.

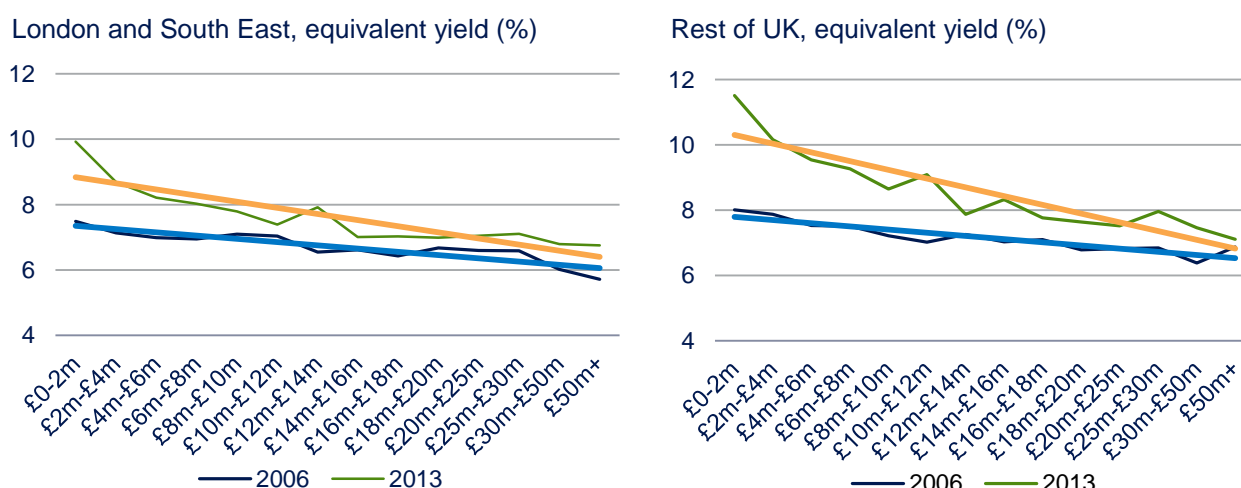
This market dynamic is one that should encourage rental growth on good quality assets. Anecdotally, the lack of prime supply has already pushed down incentives such as rent-free periods, and continued improvements in the wider economy should translate into an uptick in headline rental values.

Strength of investor sentiment has shifted pricing

The attractive market fundamentals and potential for growth have not gone unnoticed by investors. The weight of money chasing a relatively constrained amount of opportunities has pushed yields down 100 basis points in the 12 months to March 2014. Multi-let estates in the South East are now priced at 5.75%, whilst net initial yields are 6.25% - 6.50% in the major regional markets⁸. However, despite the shift in pricing, institutional-quality industrial assets remain relatively high yielding compared to other sectors, with this spread reasonably stable over time.

Analysis of valuation data suggests that demand from investors is skewed towards larger lot sizes, and that the yield premium for smaller units has widened significantly since the peak of the market in 2006 (**Figures 3 and 4**). This is a result of institutional investors unwilling to consider lot sizes under £10 million but financing restrictions during the downturn inhibiting purchases by private property companies.

Figure 3 and Figure 4: the yield premium for smaller lot sizes has increased since the downturn



Source: Schroders, IPD 2013

⁵ Industrial Property Trends Today. JLL, 2014

⁶ UK Logistics H2 2013. CBRE, 2013

⁷ Schroders, Investment Property Forum, JLL 2014

⁸ Industrial Property Trends Today. JLL, 2014

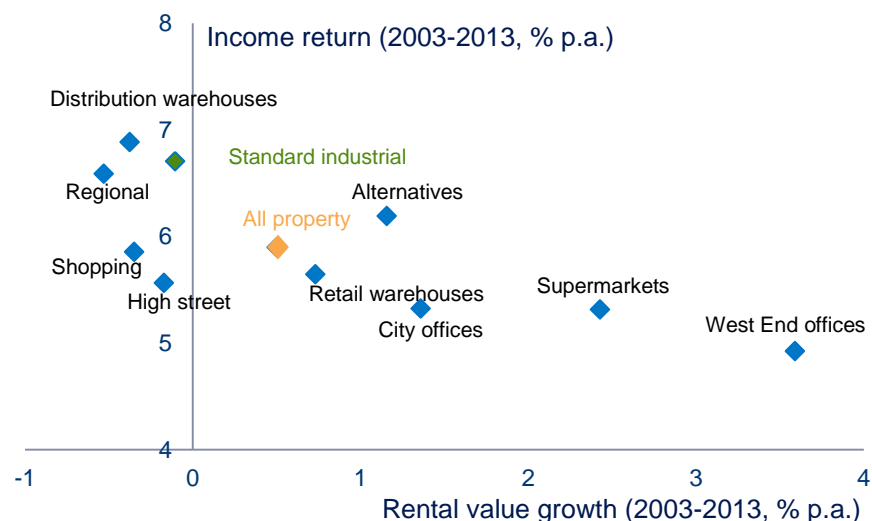
Over the long term, the standard industrial sector (which incorporates multi-let estates) has performed in line with the market. Total returns have averaged 6.0% per annum over the ten years to 2013, against 6.1% per annum for all property⁹. Industrial investments typically have one of the highest income returns in the market, which offsets a weaker rental profile (**Figure 5**). Whilst the sector is not characterised by significant increases in rental values, the current low availability of quality stock and cost of relocating should offer asset managers significant opportunities to re-gear leases. Industrial buildings also have the potential to be converted, subject to planning permission. Alternative uses include conversion to offices or even residential flats, both of which have higher average capital values per sq ft than warehousing.

Forecasts and outlook

The outlook for the multi-let industrial sector is upbeat. Manufacturing is still very important to the UK economy. But it is now more than just production: it encompasses a diverse range of activities across the supply chain alongside an evolving parcel delivery network, technological innovations such as 3D printing and structural changes including re-shoring. These factors, accompanied by improving economic conditions and little in the way of a supply response, should equate to further demand for space from occupiers in 2014 and beyond. The broad base of occupiers will require a diverse and flexible range of industrial units.

Schroders is forecasting average total returns of between 7.5% and 8.0% per annum out to 2018 for standard industrial units in London and the South East, and in the regional markets. Both segments are expected to outperform the market average. A relatively high income return of between 5.5% and 6.0% in the South East and above 6.5% in the regions will moderate against a softer rental outlook than in other sectors. Investment demand is not expected to weaken, with yields on prime assets expected to move down a further 25 basis points.

Figure 5: standard industrial assets have one of the highest income returns in the market



Source: Schroders, IPD 2013

⁹ IPD Annual Digest, 2013

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