European Commercial – November 2023

SPOTLIGHT
Savills Research

European Logistics Outlook

● Occupational ● Investment ● Outlook

Manufacturing activity continues to slow amid tepid global trade

The October meeting of the the ECB governing council saw the body choosing to keep interest rates unchanged, with the latest data broadly confirming previous assessments for inflation in the medium term: that inflation is still expected to stay too high for too long. Crucially inflation has dropped and measures of underlying inflation are also easing. The council believes that the current levels will, given time, allow it to ensure that inflation returns to its 2% medium-term target.

With no cuts to interest rates on the horizon and with some way to go in terms of tackling inflation the overall euro area economic outlook remains gloomy. Manufacturing activity has continue to fall with November's reading of the EZ Manufacturing Purchasing Managers Index (PMI) showing the sector contracting at its fastest rate since 2020. At the same time the tighter financing conditions and tepid foreign demand are increasingly weighing on investment and consumer spending.

There are some reasons to be cheerful however, as inflation falls, so too does the pressure on real household incomes and the labour market has remained robust throughout the year with unemployment data showing an historical low of 6.4% in August. When inflation is brought back in line we would expect to see not only a recovery in real household incomes but also in euro area exports allowing the economy to strengthen later in 2024 and beyond.

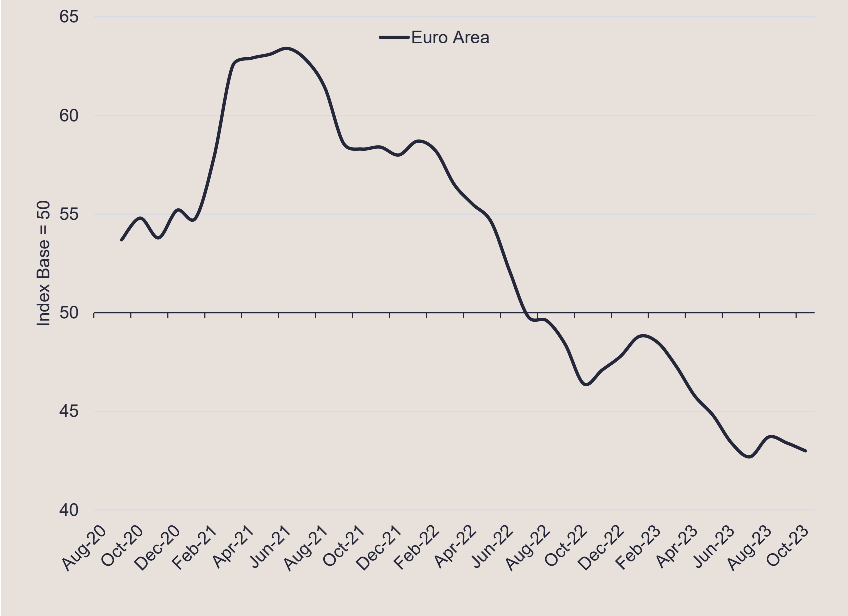
Weak global trade is weighing on the manufacturing sector with EU27 export data showing a steady decelleration in annual growth. This is reflected in PMI data on new export orders and industrial production highlight sluggish demand for goods. While the supply disruption experienced during and after the pandemic has now eased, we are also seeing a build-up of inventories decline as businesses destock, which is negative in terms of the flow of goods through trade and the requirements of occupiers.

Key market stats

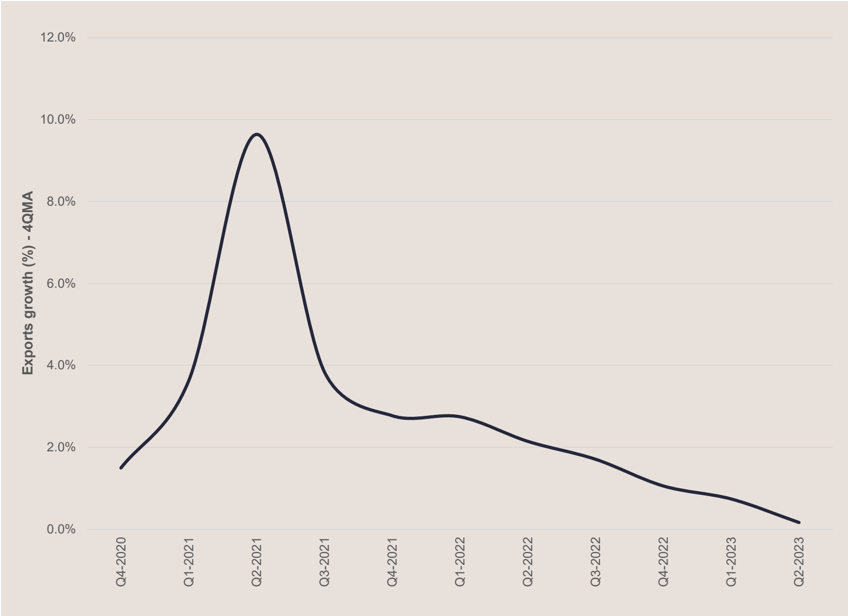
Indicator	Level	Q/Q	Y/Y	vs. 5yr Average
Take-up (sq m)	7.3m	+20%	-9%	-12%
Investment	€6.9bn	+9%	-48%	-34%
Vacancy Rate	4.70%	+74bps	+117bps	+17bps
Prime Yields	5.3%	+60bps	+200bps	+77bps

> "Tighter credit conditions and tepid foreign demand are increasingly weighing on investment and consumer spending."

EZ manufacturing PMI indicate further contractions in Q3



OECD exports are seeing a gradual but consistent decline



Source: Eurostat

Leasing activity rebounds in Q3 2023

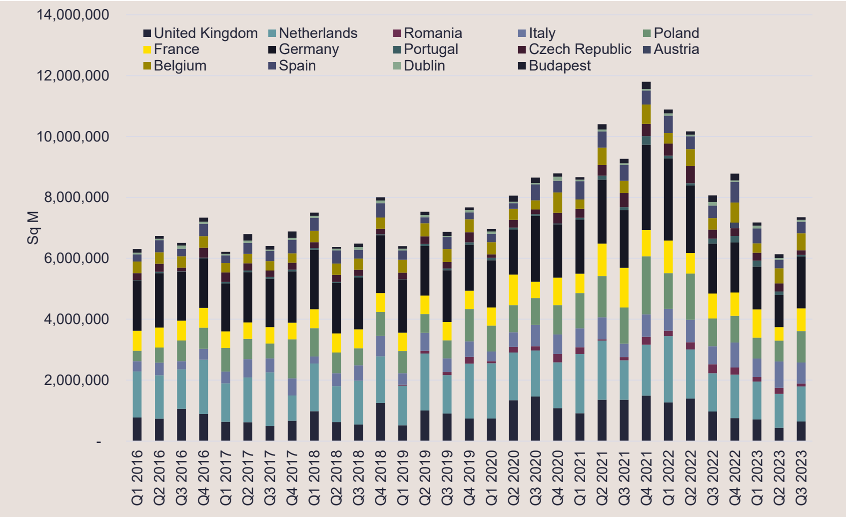
The occupier market rebounded in the third quarter of the year, which may reflect some occupiers acting on business requirements despite the current economic uncertainty. Take-up in Q3 totaled 7.39 million sq m, bringing total year-to-date take-up for 2023 to 20.7 million sq m. This represents an increase of 20% compared to Q2 2023. As we previously noted it would appear that the worst of the annual declines are now over with a decline of just 8% compared to Q3 2022.

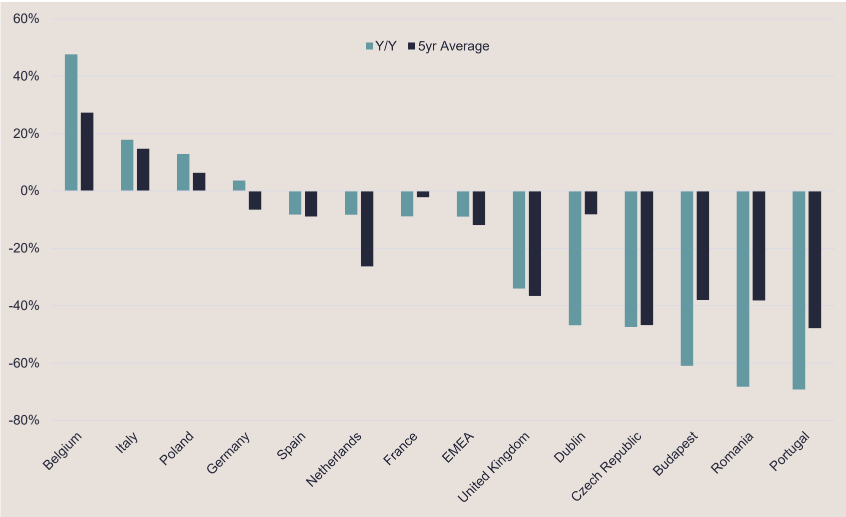
If Q2 was, indeed, the nadir of this cycle then this potentially suggests a secular shift to higher levels of logistics demand. While take-up remains below the five-year average this quarter it is promising that anecdotal reports from our agents suggest a sustained uptick in requirements across a number of markets. Higher levels of enquiries should provide support for take-up over the coming quarters as deals reach completion.

While the majority of markets are still underperforming against their five-year averages in Q3 2023, the rebound in leasing activity in Q3 saw Belgium (+27.3%), Italy (14.7%) and Poland (+11%) all achieve positive results compared to their five-year averages, with overall European take-up just 12% below its five-year average. Poland notably saw one mega deal in the quarter with 120,000 sq m being leased to an international fashion retailer, a strong vote of confidence in the market.

The same markets registered annual increases in the quarter: Belgium (+47.6%), Italy (+17.8%) and Poland (+17.4%). Poland notably saw a sharp rise this quarter with take-up increasing by 56.1% q/q. Many markets continued to struggle however with the steepest annual declines in Portugal (-69.2%), Romania (-68.3%), and Budapest (-61.0%). While this quarter's results are certainly positive, 2023 remains a lackluster year compared to 2022, with year-to-date take-up 29% lower than the year before and 27% lower than 2021.

European logistics take-up is in line with pre-pandemic levels





Source: Savills Research

Despite higher take-up vacancy is still rising

Despite a rebound in take-up this quarter the vacancy rates upward trajectory continued in Q3, increasing by 50bps to 5.2% by the end of the quarter. Notably this does represent a deceleration in the vacancy rates rise, which rose by 80bps in the previous quarter.

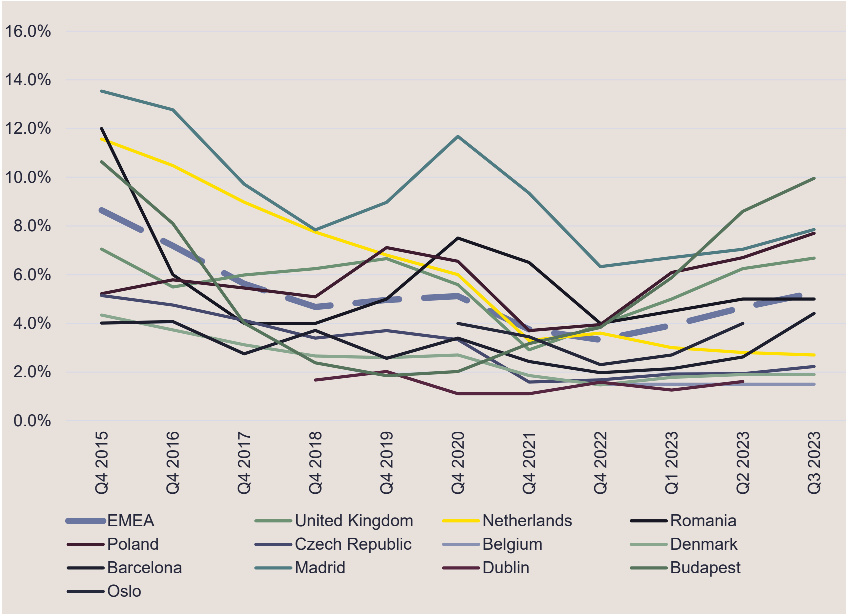
With speculative development announcements in the UK continuing to decline, our data shows that the pipeline has contracted to a 10-quarter low in Q3. We expect the pipeline to continue to contract limiting the scope for speculatively developed stock to increase the vacancy rate in the coming quarters. The Euro Area Construction PMI has continued to report sharp contractions. In combination with a slower increase in the vacancy rate, this implies that this trend is occurring across Europe. With that said further economic pressure could increase the quantum of second-hand space coming back to the market next year driving further increases in the vacancy rate.

With vacancy rates continuing to rise the Netherlands remains the only market experiencing a declining vacancy rate (2.7%) falling by 10bps over the quarter. The fastest rates of increase were in Barcelona (+179bps), Budapest (+136bps) and Poland (+100bps). Despite persistent increases in the vacancy rate this year we still do not believe the market is at an accute risk of oversupply.

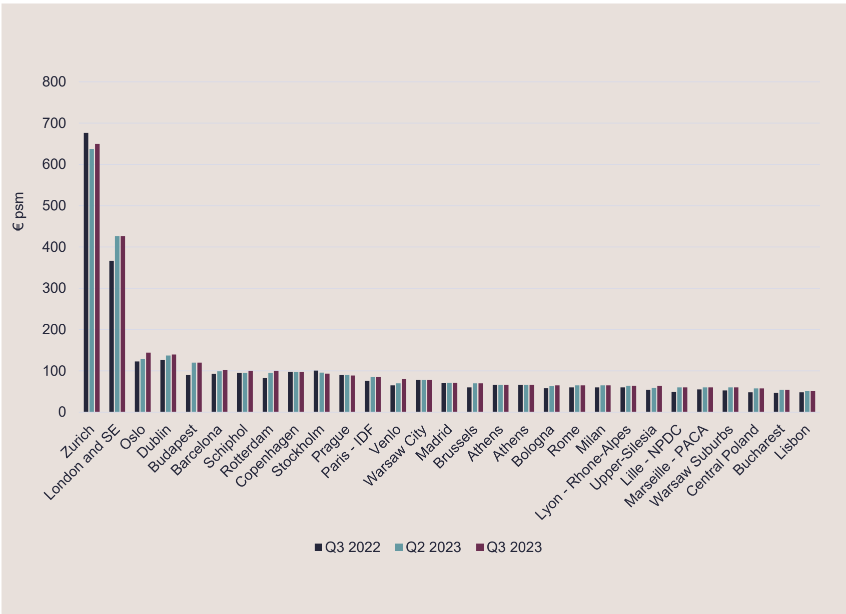
Rental growth has remained resilient throughout the year with quarterly positive rental growth in Q3 2023, increasing by an average of 2% across Europe. While most markets are reporting flat rental growth there are pockets of rental growth with Venlo (+14.3%), Oslo (+12.3%) and Upper-Silesia (+8.2%) reporting strong growth. Rental growth has reaccelerated this quarter from 1% in the second quarter of the year.

Average rents have increased by 10.1% over the last four quarters, slightly behind the 10.9% growth seen over the four quarters to Q2 2023. As we note in our investment section below continued rental growth is likely to be what underpins investor interest in the sector as the market starts to recover and it is positive to see rental growth continuing.

Upward pressure remains on the vacancy rate



Rental growth has continued over the last quarter despite weaker take-up and rising vacancy



Source: Savills Research

> “We expect the pipeline to continue to contract limiting the scope for speculatively developed stock to increase the vacancy rate in the coming quarters.”

Investment volumes build on previous quarters momentum in Q3

Investment volumes continued to climb from the Q1 2023 trough, this quarter, totaling €6.9bn over the course of Q3 2023. Quarterly comparisons remained positive increasing by 8.7% compared to Q2 2023, which could optimistically be pointed to as a sign that the investment market has begun to stabilize. Comparisons against Q3 2022 and the five-year average remain negative however, with declines of 48% and 34% respectively. We do not expect to see a return to annual growth until next year, as investment volumes remained elevated until late 2022. Year-to-date investment shows a starker picture with a 60% decline year-on-year and 26% lower than the same period in 2019.

With a period of tightening monetary policy seemingly coming to an end, many investors may be more willing to re-enter the market from this point. Crucially one of the key reasons that have been disincentivizing purchasers from closing deals, interest rate risk to asset prices, has decreased substantially. Looking ahead growth in asset values is likely to be driven by rental growth, with the Logistics sector well positioned to benefit from this shift in attitudes.

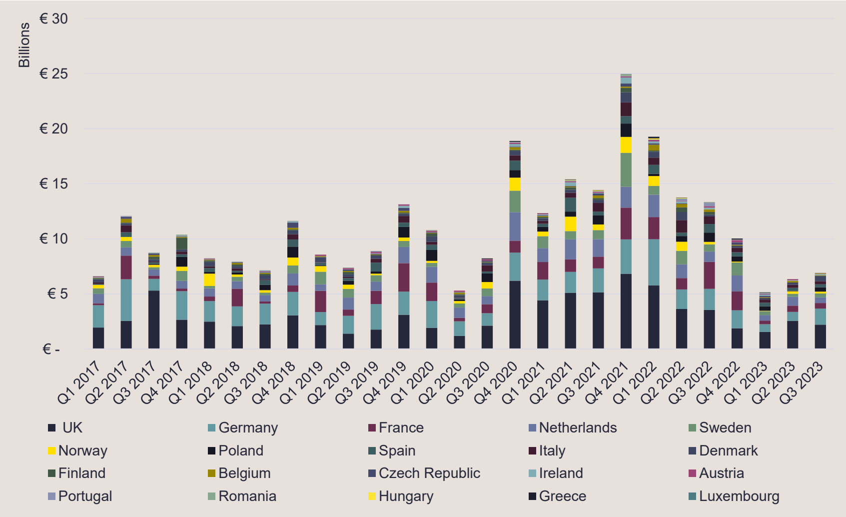
Logistics assets were in high demand amongst investors in Q3 relative to other assets with the sector accounting for 23% of total investment volumes. This brings the year-date share of investment from 18% to 21%. This leaves logistics investment in line with the previous record of 21% in 2022. This puts logistics just behind Offices (27%) and well ahead of multifamily (16%). Indeed, our recent European Investor Sentiment Survey found that big-box logistics and urban logistics were the most desired assets this quarter, suggesting continued investment activity in the sector.

Quarterly comparisons remain challenging this quarter, with the Czech Republic, Portugal, Romania and Hungary seeing no investment in Q2. Indeed market volatility remains evident with substantial quarterly and annual changes. Most markets continue to see annual declines in investment volumes but Hungary, Greece and Denmark all saw substantial annual increases. These markets in addition to Ireland all outperformed their five-year averages, but the majority remain below their five-year averages. The markets with the sharpest declines were Portugal (no deals), Austria (-89%) and Belgium (-83%).

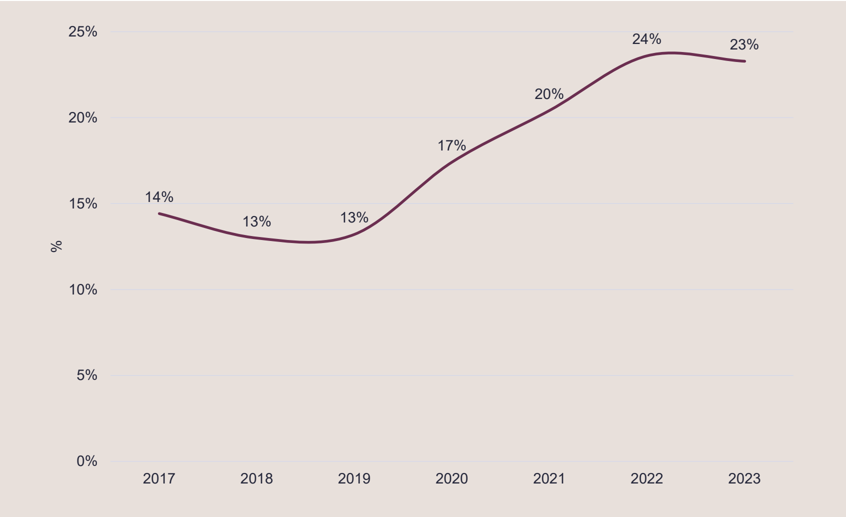
Prime yields continued to rise across most of Europe, with the average prime yield for European logistics assets increasing from 5.03% in Q2 2023 to 5.13% in Q3 2023. This is an increase of 20bps since Q1 2023 and an increase of 69bps y/y. Average European prime yields are still 25bps lower than the pre- COVID average (5.38%, 2017-2019).

Most markets remained flat during the quarter with, with yields tightening to 5.04%. Overall movements in yields have slowed this quarter with the largest increases in prime yields in Oslo (+35bps), London, Barcelona and Dublin (+25bps). While we believe some markets are likely to see further upward shifts in yields, the market appears to be stabilizing with the further base rate hikes from central banks declining

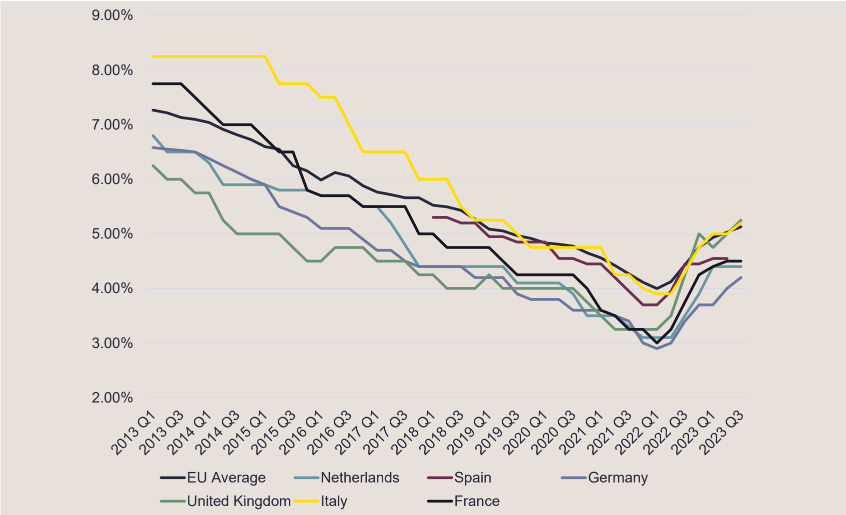
Investment volumes show signs of stabilising



Logistics investment continues to account for a significant share of total investment volumes



Prime yields have continue to trend upwards



Source: Savills Research

Where now for Logistics?

With the ECB and BoE opting to leave key policy rates unchanged in the last in their most recent meetings, which the market had anticipated, investors are now questioning when the first interest rate cuts will come. Crucially the BoE has noted that a further hike is not out of the question which would put further pressure on the pricing of logistics assets. The ECB meanwhile highlighted the risk of a Eurozone recession led by a downturn in Germany, where a sharp decline in manufacturing has led to four months of decline in business activity.

While a pause in rate hikes is certainly welcome news, inflation in the bloc is still twice that of the target rate "higher for longer" and looks set to become the latest economic catchphrase with economists expecting borrowing costs to remain high for the foreseeable future. The market is currently pricing in a 50bps cut by July 2024, with high interest rates likely to continue to weigh on investment activity in the interim.

Analysis of the European Union's Beveridge Curve, which examines the relationship between job vacancies and the unemployment rate, shows that as of the latest data in Q2 2023, the labour market in the EU remains incredibly tight. Job vacancies remain high and the unemployment rate is low. The effect of this has been higher wage growth and can partially explain the resilience of the consumer economy despite macroeconomic pressure. If this trend continues we would expect to see real wages increasing as inflation falls. Additionally, a tighter labour market can be linked to higher consumer confidence, which would further increase households' propensity to consume.

While the labour market has so far remained robust to the impacts of tighter monetary policy, there are signs that this trend is coming to an end. Within both the manufacturing and services sectors future higher expectations are trending downwards which will likely result in a decline in job vacancies and an increase in the unemployment rate. While this would be negative for individual consumers this is not an unintended side effect of the ECB's monetary policy, indeed, it is generally accepted that increasing unemployment is required to bring down inflation. With less upward pressure on wages, average costs of production would face less inflationary pressure.

Looking ahead growth in eCommerce penetration which will resume next year may provide some support for the occupier market moving forward. Total European eCommerce revenue is expected to rise by €79bn driving demand for some 5.6m sq m of logistics space. While some of this space will be absorbed by excess space held by occupiers who expanded too quickly during and after the pandemic, this should provide support for the market with a net increase in required space. Growth is expected to be fastest in Belgium (+12%), Italy and Austria (+11%) so we may see further deal activity in these markets as online retailers and 3PLs expand their capacity to capitalize on this growth.

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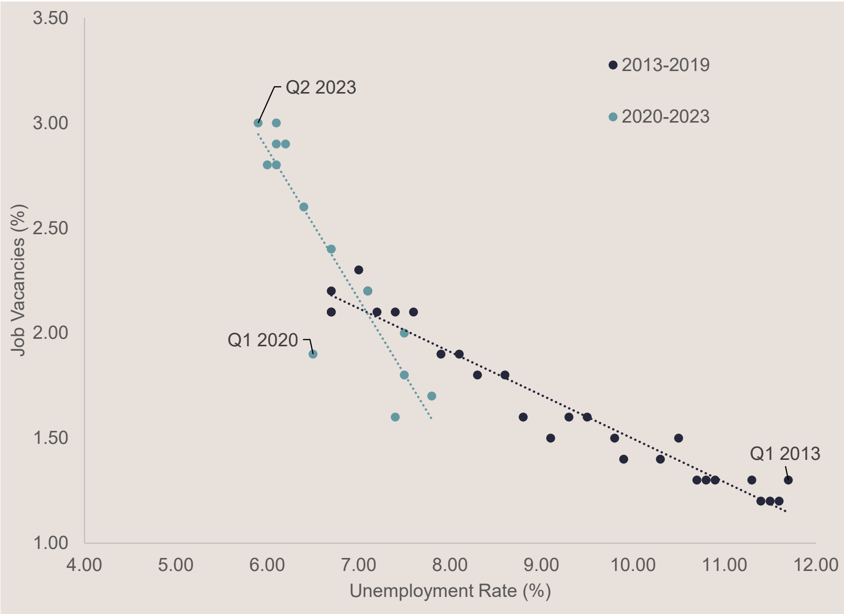
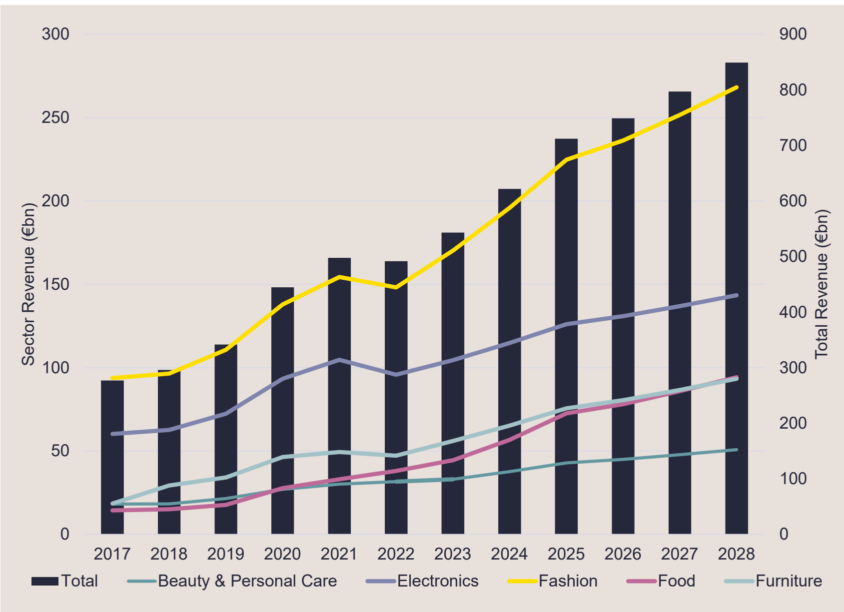
Europe's labour market is still tight despite the slowdown



Source: Eurostat

2024 will see stronger growth in eCommerce



Source: Statista

Summary

Five key considerations

1. A slowdown in global trade is weighing on manufacturing: OECD export data has shown a steady deceleration in growth since 2021 and is forecast to turn negative. This is likely to be a significant factor in the continued decline in the European manufacturing sector, which has fallen on the back of weaker orders and export demand.

2. Leasing activity increased this quarter: After Q2 take-up hit its lowest level since 2015, we saw an uptick in activity in Q3. Take-up totalled 7.4m sq m and rose by 20% q/q, with the annual rate of change also becoming less negative. This brings total take-up in 2023 to 20.7m sq ft, a decline of 29% y/y.

3. The impact of newly built stock appears to have peaked in some markets: The vacancy rate continued to rise this quarter, increasing from 3.3% at the end of Q4 2022 to 5.3% at the end of Q3 2023. That said our analysis of the pipeline of speculatively developed space indicates that the inflationary impact of newly built stock will likely ease from here on out.

4. Investment volumes continued to rise in Q3: Investment volumes into European logistics real estate totalled €6.9bn, an increase of 9% compared to Q2 2023 and a second consecutive quarterly increase. With commentary from the ECB suggesting a decreased risk of further interest rate hikes, we may see investment volumes stabilise at this level.

5. Europes labour market remains tight: Analysis of the European labour market shows that jobs vacancies remain high and unemployment rates remain low. Indeed, combining these two metrics into a Beveridge curve, it becomes clear that the the market is at it's tightest in the last two decades, having tightened substantially since Q1 2020.

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