European Commercial – September 2022

SPOTLIGHT
Savills Research

European Logistics Outlook

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● Occupational ● Investment ● Outlook

Europe's economy is shaking

Most metrics indicate that the Eurozone is heading towards a recession by the end of this year as GDP forecasts keep being revised downwards. GDP growth is currently expected to reach 2.6% by the end of 2022 and to drop further to 0.5% in 2023. The uplift in GDP growth in the last quarter was mainly fuelled by the reopening of the services sectors across Europe and is higher than the consensus forecast.

Especially southern European economies have seen GDP growth during the first half of the year with the services and tourism sectors rebounding. Whilst Germany has seen a relative weak performance since its economy is a large, energy-intensive manufacturing sector and has been hit harder by the supply chain disruption and not benefiting from the reopening of Europe's tourism sector. Furthermore, the outlook for Germany is not too bright either, with the expected further increases in gas prices due to the ongoing Ukraine conflict.

Although the Eurozone is likely heading towards a recession, the labour market remains tight, with unemployment sitting at 6.6%, an all-time low, whilst job vacancies stay at record highs, accelerating wage growth to attract talent and counter inflation.

These high inflation rates and the ongoing Ukraine conflict caused consumer confidence to plummet to -27.3 in July 2022, matching the all-time low of April 2020 (the peak of pandemic), which is more than double the long-term average.

We also foresee that there will be a decline in the high household saving rates seen last year and at the beginning of this year to withstand the increasing cost of living.

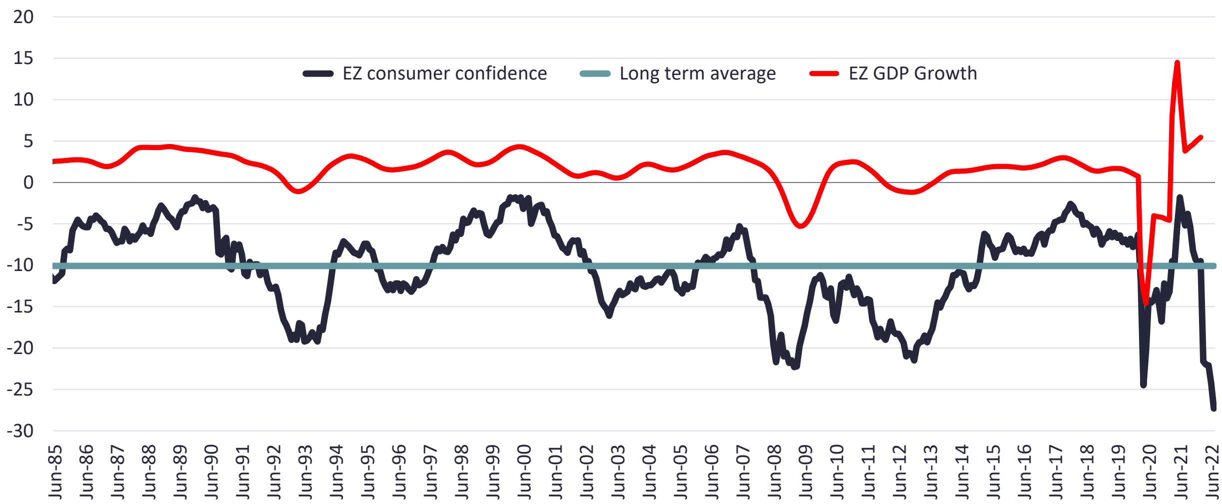
Europe's sector PMIs lost further momentum, signalling that the Eurozone is heading towards a recession. The Eurozone composite PMI declined further to 51.9 in June (from 54.8 in May), sitting below the consensus forecast. The manufacturing PMI dropped even below the 50 mark, indicating a slowdown in the sector.

Steel prices fell by 20% in June, with demand slowing down ahead of the expected recession in the Eurozone. Also reflected in the declining number of new orders and future activity across the manufacturing and services sectors.

However, this low consumer confidence does not seem to have reached consumer spending yet. Although a small dip in retail sales volumes in June (down by 0.2%), there was a surprising increase of 0.3% a month later. In the UK, the latest ONS figures showed that this increase in retail sales was mainly aided by (online) promotions.

Nevertheless, we expect that the pressing inflation figures and the record low consumer confidence will eventually impact consumer spending. Therefore, we expect a decline in household real consumption rates in the second half of the year as consumers will most likely hold back on big-ticket purchases to withstand the increasing costs of living.

Chart 1: Consumer confidence & GDP growth time series



Source: European Commission; OECD; Eurostat

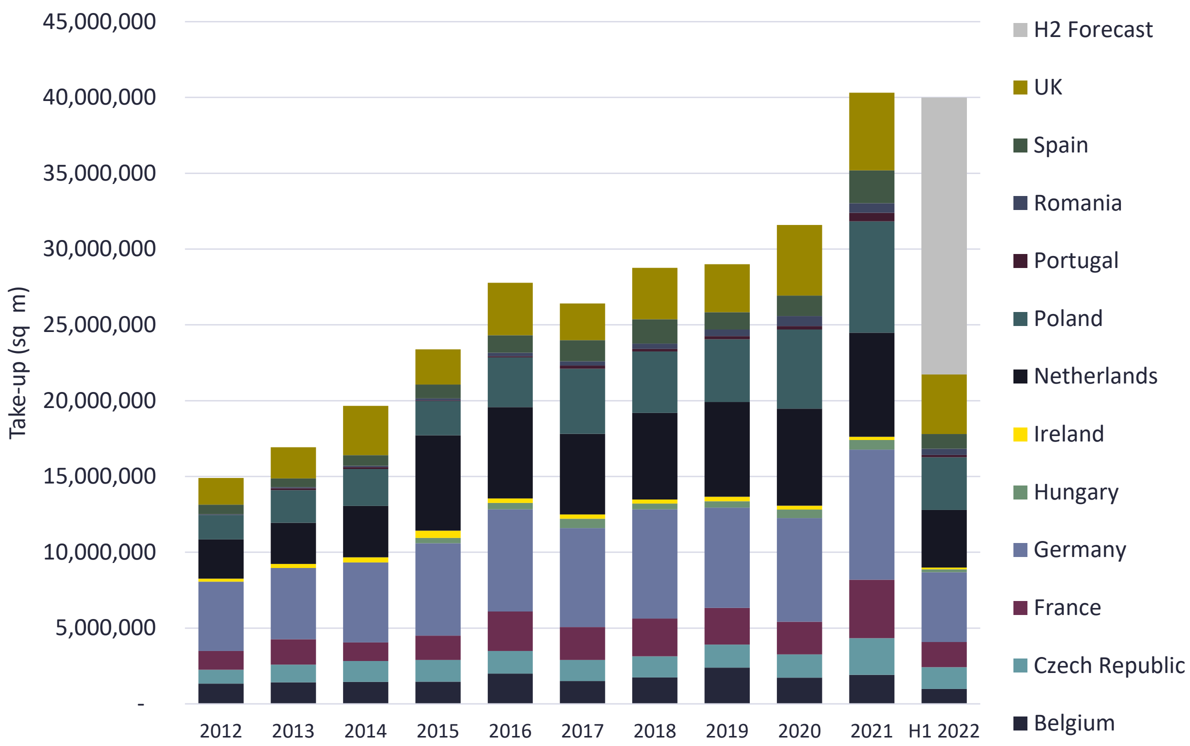
Logistics continues to outperform

This uncertainty in Europe's economy did not have an impact on the logistics demand during the first half of the year. The strong momentum of the logistics sector continued in the first half of the year, with take-up across Europe reaching approximately 20 million sq m, up by 12% compared to the same period last year. Mainly driven by the uplift in take-up in the UK and Germany.

Expectations for the full year are that take-up figures will match or even surpass the record of last year. Especially since occupiers will keep looking to take up logistics space to mitigate and limit their exposure to supply chain disruptions and to facilitate high online sales numbers. Although the retail trade volumes have seen a decline, the proportion of online sales remains elevated.

Mainly the transportation and logistics and the (e-)retailer sectors will keep taking space, with the most sought-after places being in France, Germany, and southern Europe.

Chart 2: European logistics take-up (sq m)



Source: Savills

As a result, vacancy rates across Europe dropped further by 60 bps to set another record low to average of 2.9% across Europe, showing the strong demand for space and the difficulty in finding suitable available land for new developments alongside constraints in labour cost and availability, rising energy prices, and limited approved permits.

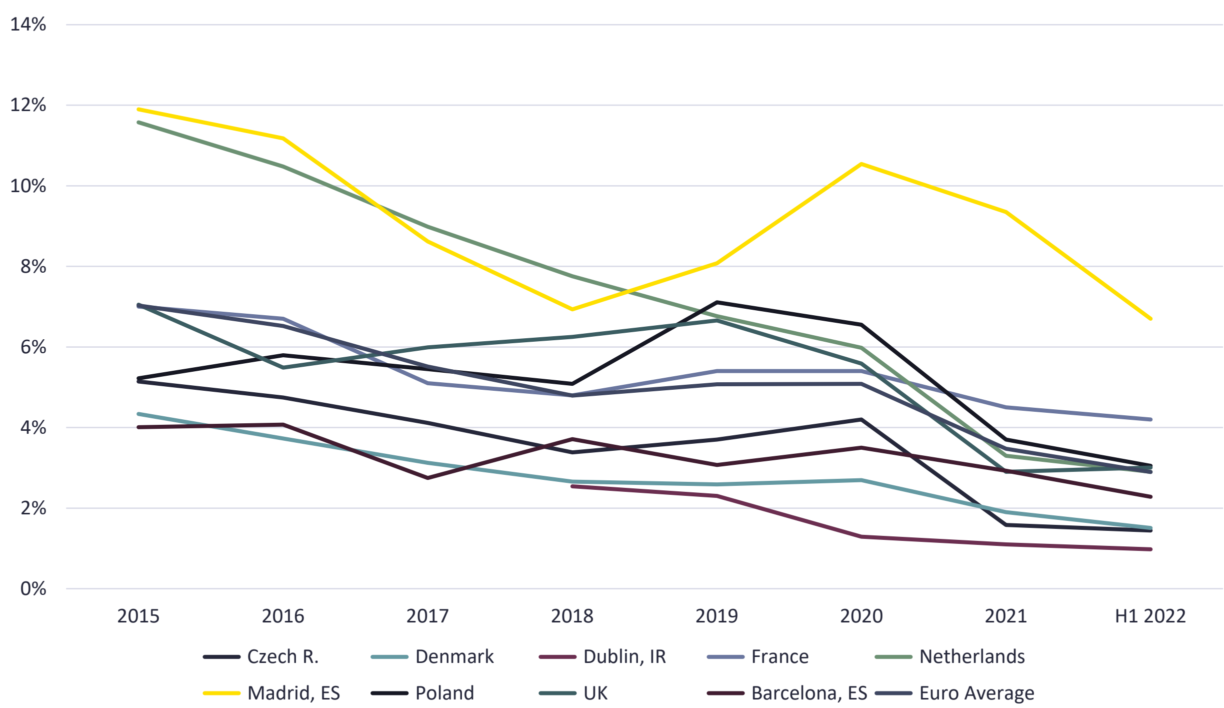
The most notable drop in vacancy is found in Spain, with the vacancy rates in Madrid dropping by 270 bps to 6.7%, well below the 8% mark. This is mainly driven by the take-up of many of the completed speculative developments during the first half of the year. In Barcelona, the vacancy rates dropped by 60 bps and now sits at 2.3%. Whilst the vacancy rates in the UK, France, and the Netherlands dropped slightly or remained stable at all-time lows.

These record low vacancy rates caused headline rents across Europe to increase by an average of 8.2% over the past 12 months, led by Prague, Warsaw, Île-de-France and Venlo.

We anticipate that the rental growth in core markets will continue in the second half of the year, driven by the undersupply of existing and future stock.

We expect that urban facilities will see the strongest rental growth in 2022, partially fuelled by the increase in costs, due to aforementioned inflation rates and the Ukraine conflict, causing occupiers to find facilities in close proximity to their customers to limit their transportation costs.

Chart 3: European logistics vacancy rates (%)



Source: Savills

Investors remain hungry for logistics

The strong record in total volume in logistics investments across Europe of 2021 continued in the first half of this year, reaching nearly €30bn, up by approximately 9% YoY and 59% above the previous five-year H1 average. These figures confirm the strong investors' appetite in logistics and the larger share (20%) of the logistics sector in the total real estate investments across Europe.

Portugal saw the biggest uplift compared to the same period last year (+11566%), mainly driven by two big transactions by Blackstone, followed by Belgium (376%), Italy (150%), Czech Republic (+63%), Finland (+56%), Denmark (52%) and Germany (+50%). Whilst Romania (-39%), Spain (-36%), and Poland (-22%) lost some momentum which is not a big surprise given the high investment figures from last year.

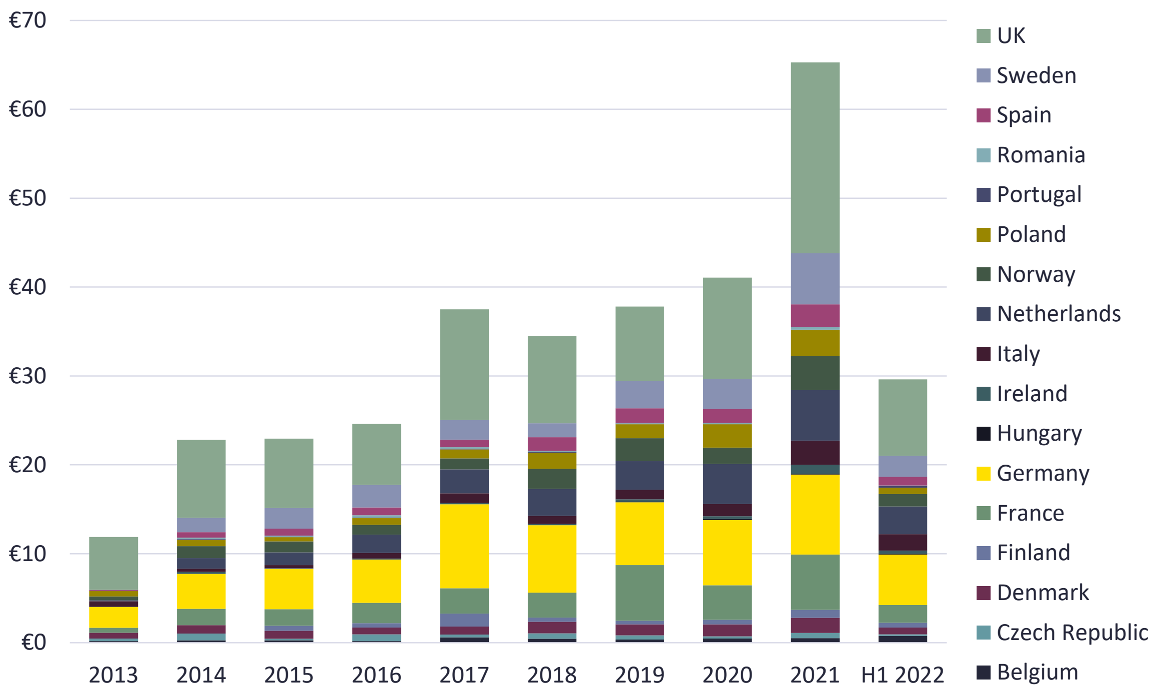
In Q2, the most active logistics investors were American and Asian investors (Blackstone, Prologis, GIP, GLP) trying to find the right allocation for their raised capital and dry powder to facilitate their shareholders with healthy profit margins.

This high amount of capital finding its way into the logistics sector caused yields to remain at record lows or to drop even further during the first half of the year, with average prime yields dropping by 23 bps to 4.08% across Europe, with the lowest yields found in western Europe markets sitting around or below the 3% mark.

The total logistics investment volumes in H1 2022 are mainly driven by the investment volumes during the first quarter of the year as investment volumes dropped by 34% during the second quarter of this year which was not only related to logistics but common across all sectors. This could indicate a slowdown in investments ahead of the recession.

However, the question arises on how long the hotness of logistics will last and if it will cool down due to the effects of the high inflation rates, slowing down of consumer spending, and the increased

Chart 4: European logistics investment volumes (€bn)



Source: Savills

cost of debts. Especially, upcoming refinancing might face increasing costs, which could result in price corrections.

We have seen the first sign of this over the summer with a dramatic pause in investment activity across Europe trigged by the volatility in the debt market, with central banks having increased their interest rates with more hikes planned further in the year.

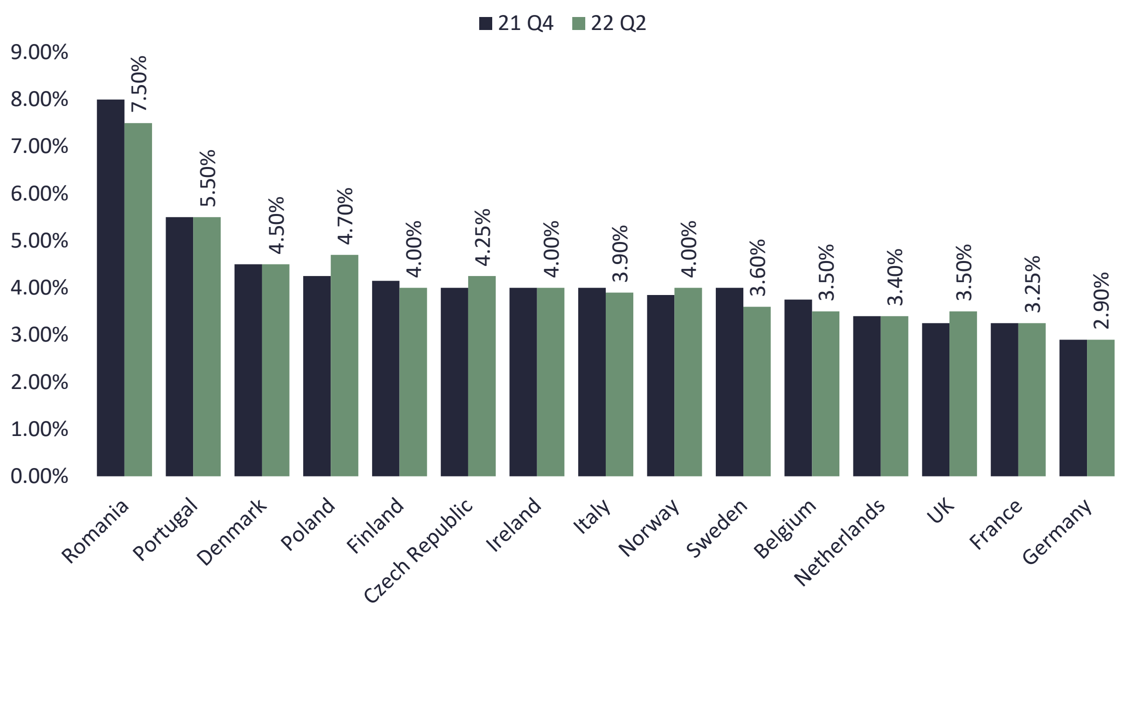
Secondly, we are witnessing a slowdown in the number of bids for premium portfolios, where usually a large number of investors show interest for portfolios coming to the market; there are nowadays just a few parties showing interest. Are these the first signs of investors holding back and playing the waiting game, whilst sellers might struggle to get the pricing close to the valuation?

Nevertheless, the allocations remain high, but buyers are pricing in this volatility as well as wider market uncertainty, which is creating a bid / ask spread. This raises the question of a fundamental need of repricing the logistics product, where the record low yields of sub 4 and even sub 3 in prime locations might not be sustainable with the increasing costs of debt.

The recorded prime yields do show a trend of moving out, but the lack of activity over summer causes a gap in evidence of the expectations and sentiment in the market.

It seems just a matter of time before the prime yields will move out, since the majority of completed transactions in the last quarter were on terms agreed prior to the interest rate uplifts. As we approach the third and fourth quarters of this year, we expect activity levels to increase after a summer low but investors are increasingly cautious. Furthermore, we expect to witness the first repricing appear by the end of this year, starting in the UK, followed by mainland Europe.

Chart 5: European logistics yields (%)



Source: Savills

Outlook: challenges and opportunities

The ongoing challenge with finding suitable labour, the rising labour costs, and the rising energy costs will cut down the profit margins of many occupiers, which are generally operating on minimum profit margins.

We will keep a close eye on rental growth rates to assess if the rental growth we have seen so far will continue and can compensate for the ongoing compressing yields without forcing occupiers into bankruptcy. This could result in increasing vacancy rates and yields, which then creates then more incentives to attract tenants, thus slowing down or even reversing rental growth.

Furthermore, the logistics sector is increasingly facing competition from the residential sector in finding suitable space for developments. The high demand for new residential projects makes it difficult for the urban logistics to expand further, whilst the big box market faces more and more NIMBYism from the public causing difficulties in the zoning and permit process.

On a more positive note, the latest financial and operational results from occupiers in the dark kitchen and same-day delivery sectors highlight that the uplift from the pandemic in the sector is here to stay and causes the demand for (ultra-) urban logistics to remain high.

Secondly, if central banks and local governments are able to tackle the continuously increasing inflation, the price gap between sellers and buyers can move in closer, and if there is some relief in the Ukraine-Russia conflict, it could result in positive business and consumer sentiment with uplifts in investment volumes across all sectors after a small summer break as a result.

Logistics will continue to be one of the hottest markets as it has proven to be one of the most resilient sector s throughout the pandemic and is most likely able to withstand the current and coming economic uncertainty.

Last but certainly not least, the continuous rate of innovations and digitalization will further impact the logistics sector. The developments of automation in warehouses and distribution centres can result in the optimization and efficiency in usage of logistics space.

Furthermore, digitalization can contribute to the ESG strategy of investors and occupiers. For example, implementing more sensors in properties can improve the monitoring of energy usage. Innovations in solar panels can increase the generation of renewable energy at the properties themselves and stimulate EV vehicles usage by facilitating more EV charging stations at the properties.

This not only contributes to the ESG strategy of investors and occupiers, but it can also result in higher rents and green premiums since occupiers are increasingly looking to mitigate the rising transportation costs and are, therefore, more willing to pay for them. This results in investors seeking out or developing sustainable buildings to future-proof their operations.

Source: Savills

Savills Commercial Research
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Investment and Agency
Marcus De Minckwitz
Head of EMEA Industrial and Logistics
+44 (0) 207 409 8755
MdeMinckwitz@savills.com

Research
Kevin Mofid
Head of European Logistics Research
+44 (0) 207 499 8644
kmofid@savills.com

Research
Bram de Rijk
European Research Associate
+44 (0) 7816 252 153
bram.derijk@savills.com