European Commercial – September 2021

SPOTLIGHT

Savills Research

European Logistics Outlook

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● Occupational ● Investment ● Outlook

Consumer recovery resilient

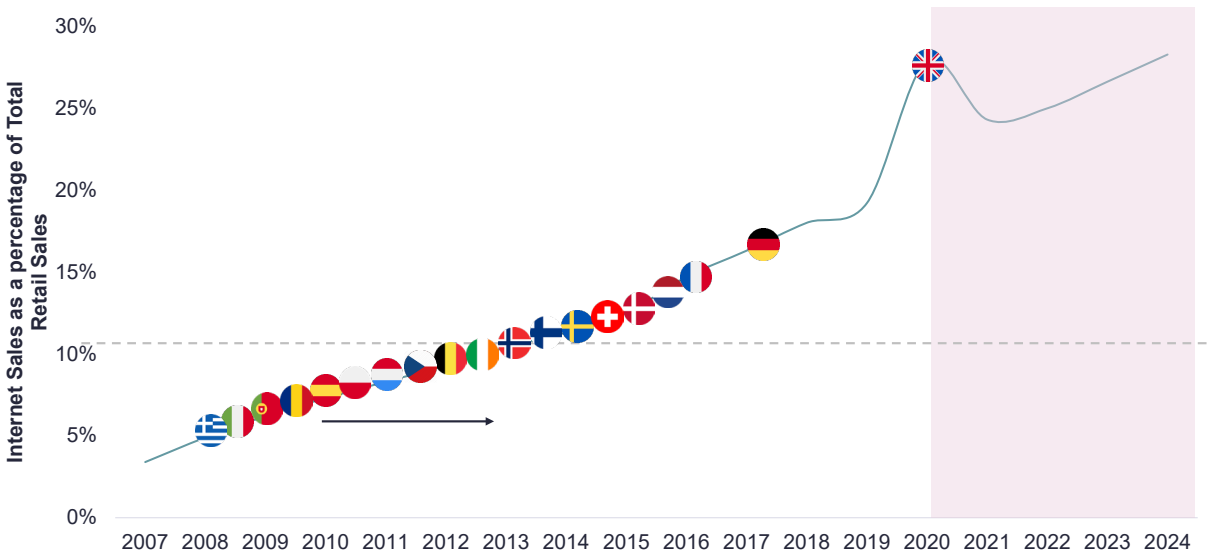
Europe's economies continue to show a positive recovery, with improving GDP growth forecasts, albeit the Delta variant will continue to pose headwinds to the positive momentum. Overall, the Euro Area is forecast to see 4.6% growth in 2021, up from -6.7% in 2020. Much of southern Europe will be recovering economic losses in the remainder of the year as international tourism shortfalls continue to drag on domestic economies.

Eurozone unemployment sits at 7.7% in June 2021 which has risen by 120 bps since end 2019 and remains supported by furlough schemes across the majority of European markets.

Consumer confidence has recovered positively following the pandemic. The Euro Area consumer confidence indicator was confirmed at -4.4 in July 2021, the highest level since 2018. Households' assessments of the future general economic situation, their future financial conditions, as well as their intentions to make major purchases, all remained resilient.

Extended lockdown periods have continued to support the growth of online retail across Europe. Western Europe's ecommerce penetration rate jumped from an average of 11% to 15% between 2019 and 2020, as retailers adapt their supply chains to cater for changing consumer habits. By this measure, the western European average penetration rate remains around five years behind the growth trajectory observed within the UK, although this is boosted by the likes of France, Netherlands and Germany. We anticipate a marginal reduction in annual ecommerce penetration growth rate as several restrictions have been lifted, although some consumer habits will remain.

Chart 1: Ecommerce penetration rate by country



Source: Forrester

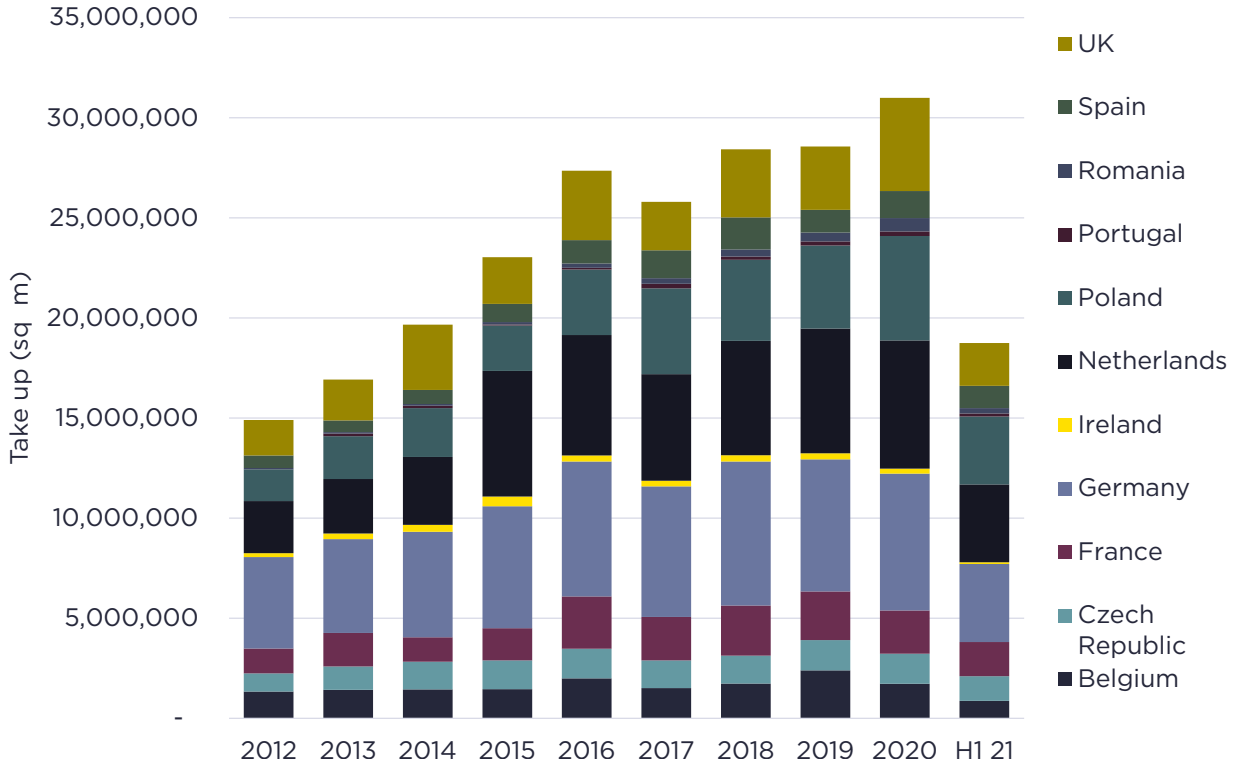
Take up set for another record year

European logistics take up reached 18.7 million sq m in H1 2021, 63% above the half year average. Germany (3.9m sq m, +28%), Netherlands (3.9m sq m (industrial and logistics), +64%) and Poland (3.4m sq m, +102%) performed the strongest against their five year H1 averages.

Retailers and ecommerce operators continue to drive the market, accounting for 30% of demand in the Czech Republic, for example. In the UK, take up for H1 2021 was 82% above the long term average, driven by demand for units between 10-20,000 sq m from online retailers taking smaller parcel delivery style units. Manufacturing also rose from 8% of take up to 15% yoy in the UK, as the economic recovery begins to take shape.

We are still seeing some British companies seeking to mitigate the effects of Brexit, as UK exporters now have to pay additional import tariffs on goods exported from Asia to Europe via the UK, driving logistics demand in mainland Europe.

Chart 2: European logistics take up (sq m)



Source: Savills

Vacancy remains at record lows

Vacancy rates for logistics space across Europe continue to creep downwards given the constrained land, particularly in Western Europe. Overall, European logistics vacancy rates have fallen by an average of 80 bps over the past 12 months to 4.6%, helped by high levels of take up in Spain. The Czech Republic (2.4%), Denmark (2.6%), Barcelona (3.3%), Oslo (3.8%) and Helsinki (4.3%) remain the most undersupplied markets. Development activity is not keeping up with demand, constrained by access to labour, rising material costs and supply chain challenges impacting speed of delivery. Obtaining planning permission for new developments in constrained markets such as Germany and Netherlands has also increased timeframes.

As a result, prime rents have risen by an average of 2% over the past 12 months, led by Lisbon (20%) and Warsaw suburbs (16%). We anticipate rental growth to accelerate again over the next 12-18 months, particularly in core markets, driven by undersupply of existing and future stock.

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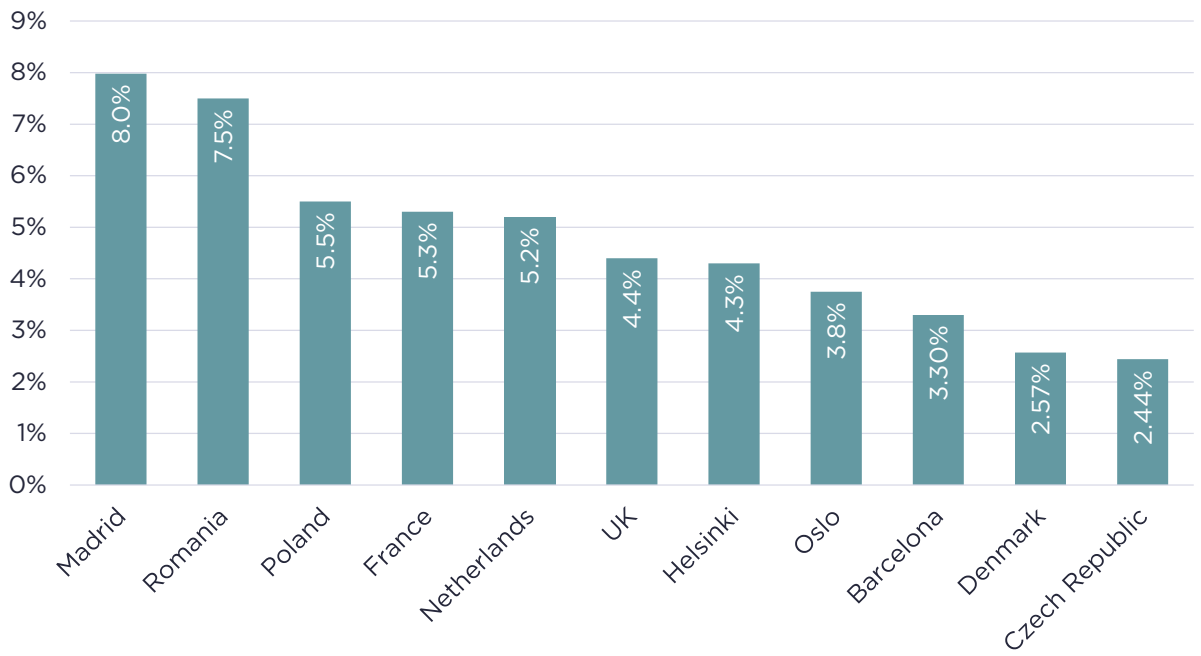
Particularly in Germany, obtaining planning permission is becoming stricter to the extent that it becomes difficult to develop logistics on brownfield sites. This is applying additional pressure on rents and land prices.

One big shift we have observed is that landlords are no longer willing to sign beyond a five year contract as continental rents are more frequently index-linked and landlords are anticipating that rents will increase far above that of CPI. Tenants are no longer being offered renewal options as landlords test the market for the anticipated 4-5% pa rental growth. We expect significant reversionary uplift to be delivered on leases expiring in the next couple of years. Rent free periods on a five year lease are generally only around two months, whilst fit-out contributions from landlords have been withdrawn due to the market dynamics.

Chinese forwarding companies are among the fastest expanding occupier subgroup, who want to be in close proximity to Amazon hubs or container terminals. 3PLs are also growing although labour availability remains an issue for the sector, raising costs. The manufacturing sector is becoming less dominant due to rising energy prices and CO2 tax prices. Due to further environmental concerns, some nuclear power stations are being shut down and operations are moving to cheaper CEE locations.

We are observing rising demand for last mile and food delivery space across larger conurbations from quick commerce companies like Gorillas, Picnic and Flink with fast access to a wide consumer base. The traditional food retailers like ALDI and Lidl remain active on high streets and are able to sign for longer term leases on discounted rents.

Chart 3: European logistics vacancy rates (%)



Source: Savills

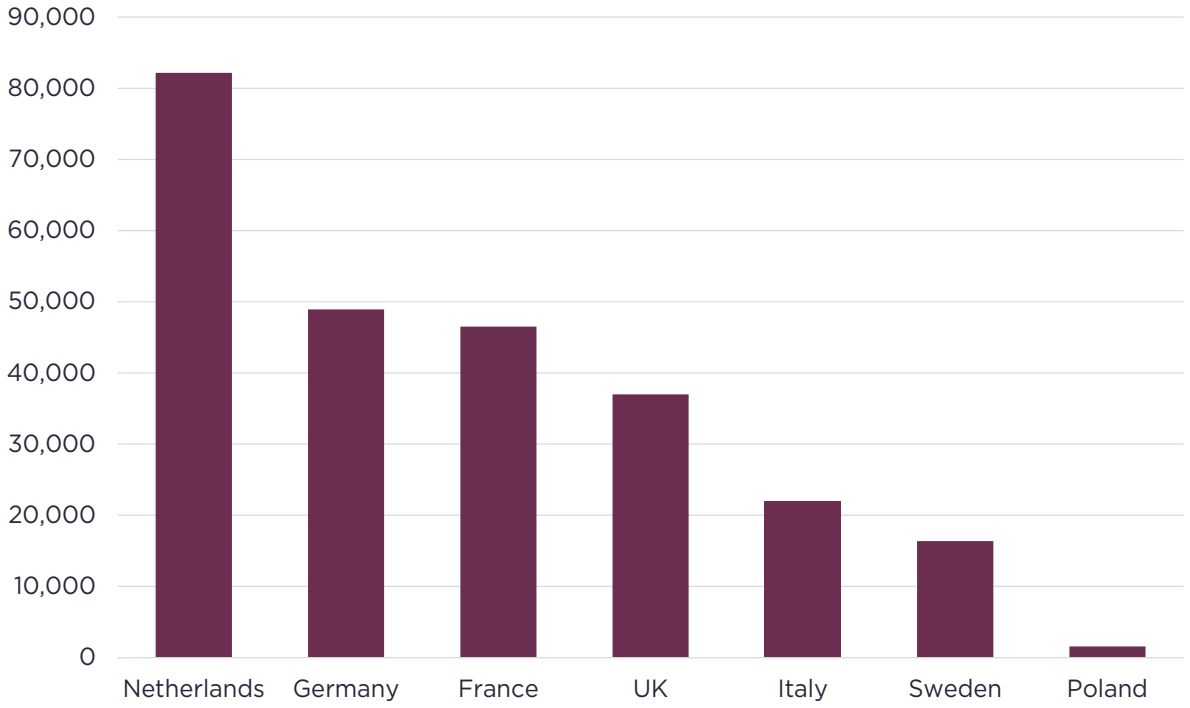
Supply chain sustainability

Occupiers, particularly retailers, are now more focussed on the levels of carbon emissions and are adjusting their supply chains to meet targets. Across the EU, the number of electric light commercial vehicles has increased by 250% over the past five years, according to the European Alternative Fuels Observatory (EAFO) and is now the fastest growing alternative fuel type for light commercial vehicles.

One infrastructure challenge comes from the provision of charging points across Europe. Currently, the Netherlands leads the way in Europe, with 82,000 public recharging points, followed by Germany (49,000) and France (46,000). More electric charging points will need to be installed in order to meet the EU's climate neutrality target by 2050 and ensure retailers can meet the rising demand for online delivery.

According to the European Commission, transport currently accounts for a quarter of Europe's greenhouse gases and is the main cause of air pollution in cities. Road transport accounts for over 70% of the total transport greenhouse gas emissions, and €70bn of EU funding is available through the European Structural and Investment Fund, including €39bn to support the move towards low emission mobility.

Chart 4: Number of public vehicle recharging points by country



Source: EAFO

Yields continue to harden

European logistics investment reached a record €22.5bn during H1 2021, a 60% increase on the H1 five year average. Although logistics has traditionally only accounted for 10-12% of the investment market, the weight of capital targeting the sector has accounted for 21% of total investment so far this year.

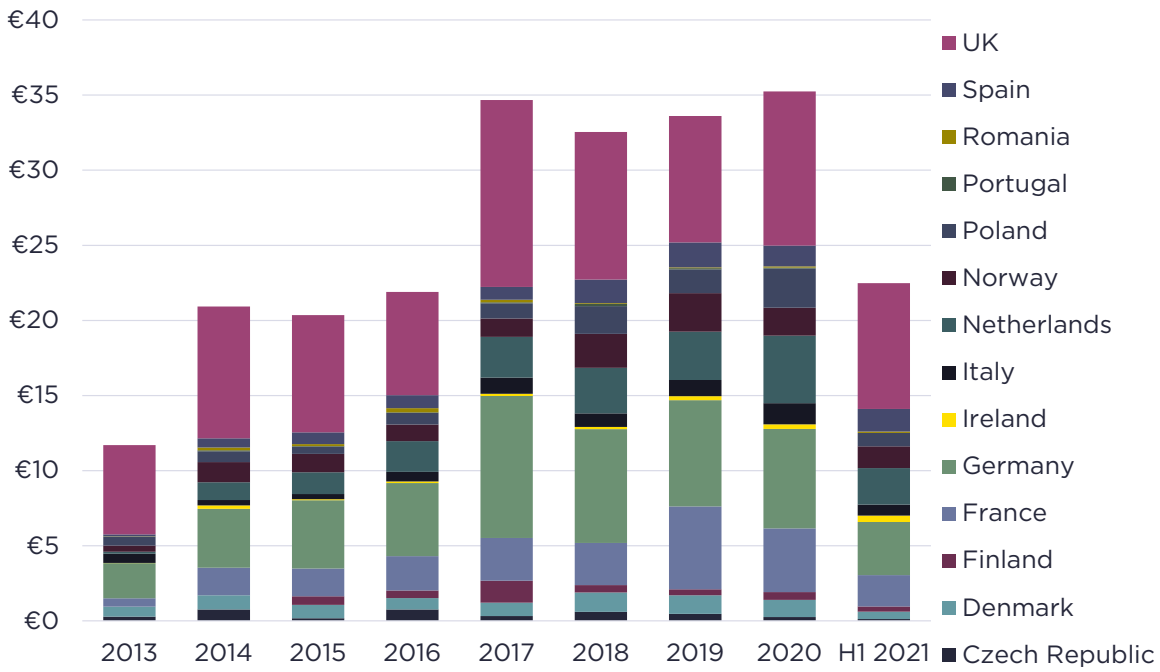
Ireland (+1008%, driven by portfolio acquisitions), Spain (+212%), the UK (+115%) and the Netherlands (+66%) performed the strongest against their respective five year H1 averages. H1 2021 European logistics investment volumes are already 64% of the record full year 2020 and the UK accounted for 37% of overall deal volumes, above the five year average of 30%. All indicators suggest that this will be another record year of logistics investment for Europe.

RCA data indicates that there has been an increase in the level of US investment targeting European logistics in H1 2021 as travel restrictions are being lifted. Private individuals have been among the major sellers of space this year, who are seeking to cash in on the aggressive yield compression which has been observed over the last 24 months.

Looking forward, record volumes of new capital are being raised and allocated towards logistics each month. Savills analysis of new capital raised by funds indicates that 39% of the volume of new funds raised in 2021 has been allocated towards the logistics sector, more than any other sector.

Yields continue to compress further into the 3-4% range across most core European markets due to the nature of record low vacancy rates presenting solid fundamentals for rental growth and the falling risk premium against risk-free rates. Prime European logistics yields have compressed by an average of 40bps to 4.40% over the past 12 months, most noticeably in the UK (-75 bps to 3.25%) and France (-75 bps to 3.50%). Pan European investors are becoming increasingly willing to look

Chart 5: European logistics investment volumes (€bn)



Source: Savills

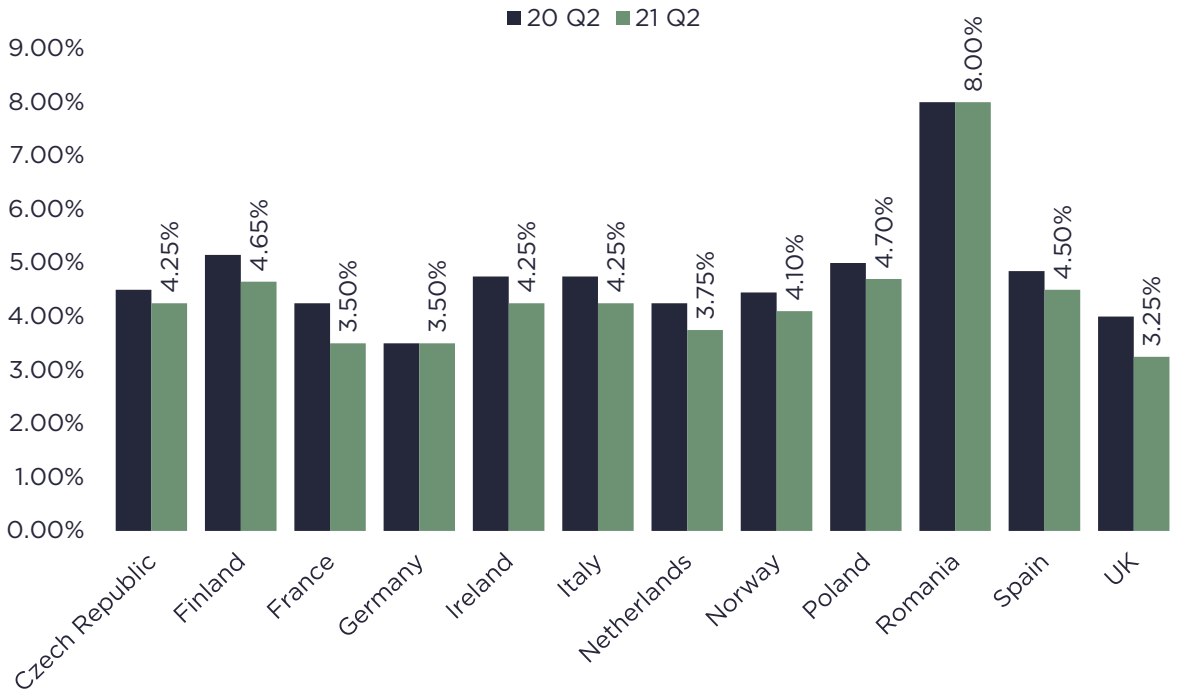
outside the core markets in order to find more attractive income returns and we anticipate southern Europe and CEE will continue to compress throughout the remainder of the year.

Where there was previously a discount for prime logistics stock in non-core locations, yields have compressed over the past six months. Debt terms remain very buoyant across the sector.

Portfolio premiums of between 5-15% are now being achieved on portfolios that allow investors to deploy large amounts of equity in a single transaction, such is the volume of frustrated capital seeking to gain exposure to the sector. We are also seeing the yield discount for specialist logistics assets such as cold storage coming in as a result of intense competition. Investors are also increasingly turning to developers to form joint ventures to gain access to the logistics sector and as a way of hitting their return criteria, albeit the spread between investment and development yields is being eroded.

Development appetite remains positive across all locations, and we are seeing secondary assets trade more freely now, including those with vacant possession. However rising development costs are likely to temper appetite for development and further support yield compression for standing stock.

Chart 6: European prime logistics yields (%)



Source: Savills

Outlook

Kevin Mofid, Head of European Logistics Research, examines the trajectory for rents and yields in Europe.

With rental levels in many European markets rising and yields continuing to fall and show further downward pressure, many commentators are starting to ask how far can both metrics go?

There is little doubt that the onset of the Covid-19 pandemic has accelerated many structural changes already underway, such as the growth of online retail, and whilst some volatility should be expected in the way online retail levels normalise, the accepted consensus is that we have seen five or more years of growth condensed into 18 months. Indeed, Forrester are currently forecasting that by 2025, online retail will average 25% of all retail sales across Europe, meaning an extra €342bn will be spent online within the next four and a half years. This surge in online retail will require a significant amount of warehouse space, using research from Prologis which states that for each additional €1bn spent online an additional 77,000 sq m of warehouse space is required. This will mean that for the online retail sector alone an additional 26.3m sq m of warehouse space needs to be found.

It isn't just online retail driving things forward however, as manufacturing companies get to grips with a post Covid supply chain and consider moving towards a "just in case" supply chain, rather than "just in time". If we start to see companies bringing manufacturing processes closer to home and increasing the amount of inventory held to mitigate for delays then it is also likely that manufacturing companies will start to require more warehouse space too.

The problem for occupiers however is supply. The average vacancy rate in Europe has fallen by 80bps in the last 12 months and now stands at 4.6%, which is structurally low by historical standards. Whilst speculative development is taking place across the continent, many developers are struggling to source concrete, timber, steel and cladding which are the key components of any new warehouse. The problems in the construction pipeline are therefore set to exasperate the issue of low supply further. Coupled with the fact that, across many markets, permitting for new warehouse development is becoming harder to achieve it is unlikely that we will see a development led spike in warehouse supply.

This heady mix of ever increasing occupier demand and low levels of supply leads us to conclude that many rental growth forecasts are underestimating the localised market conditions which ultimately drive rental growth.

Taking London as an example, where vacancy has remained close to 2% for the last decade and occupier demand has risen sharply due to ever increasing growth in online retail, shows that since 2010, rents have increased by 58%. It would be no surprise, therefore, if the current forecasts from Capital Economics of 1.8% rental growth per year, as a European average are easily exceeded.

The drivers of low supply and high demand in the occupational market show no sign of changing in the medium term, which in turn will allow investors to underwrite their acquisitions with increasing rental growth assumptions. With the average European logistics yield now standing at 4.35% there is little reason to doubt that, in markets where the occupational market conditions are right, that yields will not follow France, Germany and the UK to sit comfortably below 4% and potentially sub 3% for the most prime assets.

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Investment and Agency

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

Will Percival
Regional Investment Advisory
+44 (0) 207 330 8628
will.percival@savills.com

Research

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

Mike Barnes
European Commercial
+44 (0) 207 075 2864
mike.barnes@savills.com