European Commercial – Spring 2020

SPOTLIGHT
Savills Research

European Logistics Outlook

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● Occupational Demand ● Investment Outlook ● COVID-19

Policy measures to stimulate consumption levels

Economic Overview

In many respects, it is too early to estimate the full economic and property impact of COVID-19. A number of major economies have launched initial monetary and fiscal stimuli packages to boost economic growth. Initial responses show the US Fed cut interest rates to 0 - 0.25% and launched a $700bn stimulus programme. In Europe, several EU28 countries have shut borders and the European Central Bank (ECB) has responded by announcing a €750bn government bond acquisition programme to stimulate domestic demand. Similarly, the Bank of England (BoE) has responded by cutting interest rates from 0.25% to 0.1% and will subsequently increase government bond acquisitions. As a result, there has been continued volatility of European 10 year sovereign bond yields.

The European Union (EU28)'s economy grew by 1.2% in 2019 down from 1.5% the previous year, amid an environment of stagnant wage growth, low inflation and sluggish domestic demand. Unemployment remains at record lows across several of European's advanced and developing economies, as labour shortages remains rife.

As of 19th March 2020, Capital Economics forecast that the Eurozone economy will contract by 10-15% q/q in Q2 2020 as numerous businesses come to a standstill, and governments will have no choice but to provide support to businesses and households on an unprecedented scale. The Eurozone consumer confidence index marked a monthly fall of 5 points to -11.6, the lowest level since November 2014, which will drag on consumption. This is expected to fall further over the next couple of months following social distancing guidelines and will deliver below average levels of inflation during 2020. As it stands, Eurozone GDP is set to contract by 6% in 2020, but is likely to rebound by the same level during 2021.

Labour availability remains one of logistics operators' biggest concerns in 2020. The EU28 average unemployment rate dropped from 6.9% to 6.4% during the course of 2019 (Table 1). However, various fiscal policy measures are attempting to encourage businesses to keep hold of their workers during times of uncertainty. These measures will increase government debt in the short term, although intend to maintain consumption levels.

Table 1: European Unemployment Rates (%)

Country	2018 (%)	2019 (%)
Austria	4.9	4.6
Belgium	6	5.5
Czech Republic	2.2	2.1
Denmark	5.1	5
EU28	6.9	6.4
Finland	7.4	6.7
France	9.1	8.6
Germany	3.4	3.1
Greece	19.4	17.3
Hungary	3.7	3.4
Ireland	5.8	5.1
Italy	10.6	9.9
Netherlands	3.8	3.4
Norway	3.9	3.6
Poland	3.9	3.3
Portugal	7	6.5
Romania	4.2	3.9
Slovakia	6.6	5.7
Slovenia	5.1	4.6
Spain	15.3	14.1
Sweden	6.3	6.9
United Kingdom	4.1	3.8

Source: Oxford Economics

“Initial forecasts indicate that Eurozone GDP is set to contract by 6% in 2020, but is likely to rebound by the same level during 2021.”

COVID-19 to accelerate the shift to online retail sales

Occupational Review

European logistics take up reached 26.5m sq m in 2019, 5% above the five year average for the markets Savills covers (Chart 2). 2019 marked an 8% fall in leasing activity on the previous year, as a result of the shortage of supply. Average vacancy rates remain low across European markets, including the Netherlands (6.5%), Spain (5.8%), Poland, (7.1%), Czech Republic (3.7%), Romania (5.0%) and the UK (6.7%).

2019's US/ China trade wars, Brexit negotiations and lower EU28 domestic growth marked a weaker year for the Eurozone manufacturing sector. Euro area manufacturing PMIs (Purchasing Managers Indices) delivered readings well below the 50 mark (separating expansion from contraction) throughout the year, although this has since recovered towards the start of 2020. German automotive production contracted and countries in the associated supply chain observed the knock on effects. Despite this, the second highest ever level of logistics take up was recorded in Poland last year, whilst Czech Republic marked a 9% increase yoy as production facilities accounted for 43% of total space.

Prime rents grew by an average of 6% across the European markets, with Lisbon, Warsaw Suburbs, Stockholm and Dublin all observing double digit growth last year and this sentiment has been carried into early 2020.

Occupational Outlook

Following the COVID-19 outbreak, a number of European countries have temporarily shut their borders and instructed workers to stay at home in order to contain the virus, which has created warehouse labour shortages. Likewise, the contraction in China's manufacturing output and the shortages of workers offloading shipping containers at port terminals is creating global supply constraints.

We have observed some logistics operators increasing stockpiling activity given the increased online retail spend by consumers and to shelter themselves from any disruption to the upstream supply chain. Amazon, for example reported that off the back of "a significant increase" in online retail sales, they are creating 100,000 full and part time jobs in the US. Lower levels of consumer confidence has led consumers to stockpile necessity goods, whilst delaying luxury purchases. As a result, more luxury goods are being stored in warehouses for longer periods, adding further pressure on supply.

Online retail sales growth continues to exceed analysts' expectations and given the COVID-19 outbreak has increased consumer dependence on e-commerce, it is likely that this shift will accelerate faster. At end 2019, online retail sales accounted for an estimated 11.8% of Western Europe's total retail sales during 2019, above the 10.7% tipping point where demand for logistics space increased significantly in the UK. Forrester's latest forecasts indicate that online retail will account for 17.8% of Western Europe's total retail sales by 2024. Assuming industry standards of 75,000 sq m space for every €1bn spent online, this indicates a need for an additional 16.7 million sq m of logistics facilities in Western Europe to cater for the growth on online retail over the next five years. Although Forrester's data indicates that online spend only accounts for 3% of the total food and drink sales in Europe, COVID-19 could be a catalyst to ignite the online sales growth in this sector.

Development

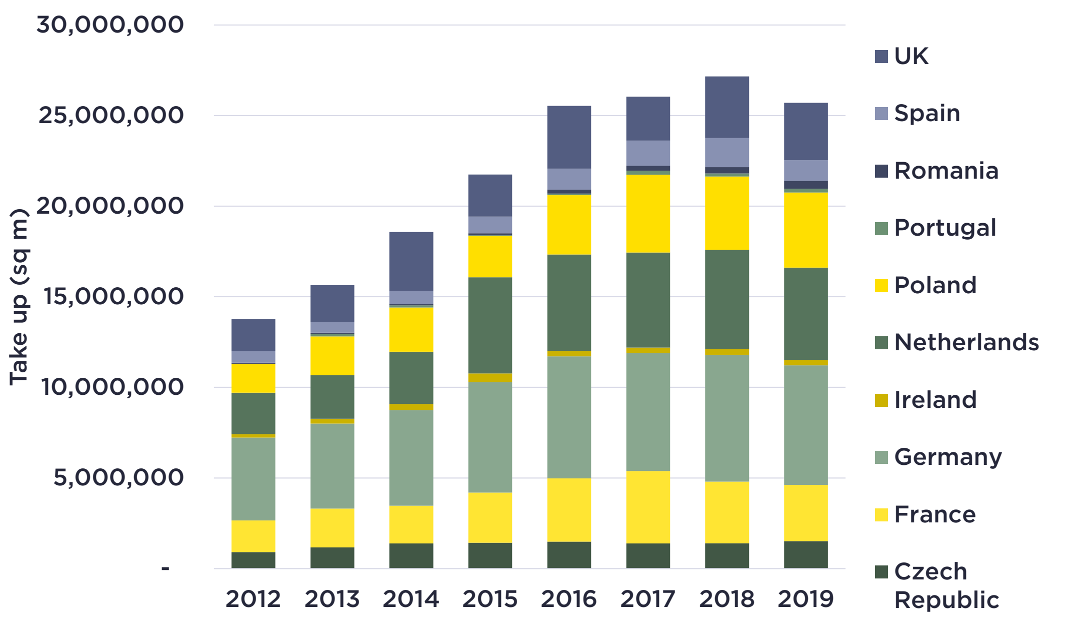
The speed of getting materials to construction site is being delayed due to labour and mobility issues and it is likely that some of the development forecast for completion in the second half of 2020 will be delivered into early 2021. Likewise, some developers are likely to take stock of the current situation before committing to new schemes, which will add further pressure onto Europe's already undersupplied warehouse markets.

We generally expect leasing demand to remain resilient during 2020, with online retailers and 3PLs competing for remaining logistics facilities in response to consumer trends. Lease negotiation periods are likely to extend and in this respect, it is possible that the rental growth anticipated for 2020 rental growth will be delayed until 2021.

2019 logistics take up was 5% above the five year average.

16.7 million sq m of logistics space will be required over the next five years to cater for the growth of online retail sales in Western Europe.

Chart 1: European Logistics Take Up (sq m)



Source, Savills Research

Positive macro fundamentals maintains logistics investor appeal

Investment Review

European logistics investment transaction volumes reached €36 billion during 2019, 6.4% above the volume recorded in 2018 (Chart 2). Among the strongest performers were France (€5.1bn, +82% yoy), the Netherlands (€2.6bn, +1% yoy) and Sweden (€3.0bn, +96% yoy). As in previous years, the largest contributors were the UK (€8.4bn, -14% yoy) and Germany (€6.7bn, -12% yoy) and these are the countries with the highest online retail penetration rates across Europe.

The weight of capital targeting logistics real estate compressed prime yields by an average of 37 basis points in 2019, from 5.35% to 4.98% (Table 2). Czech Republic prime yields hardened by 150 basis points (bps), more than any other country, followed by Denmark (-125 bps) as most markets reported record low yields.

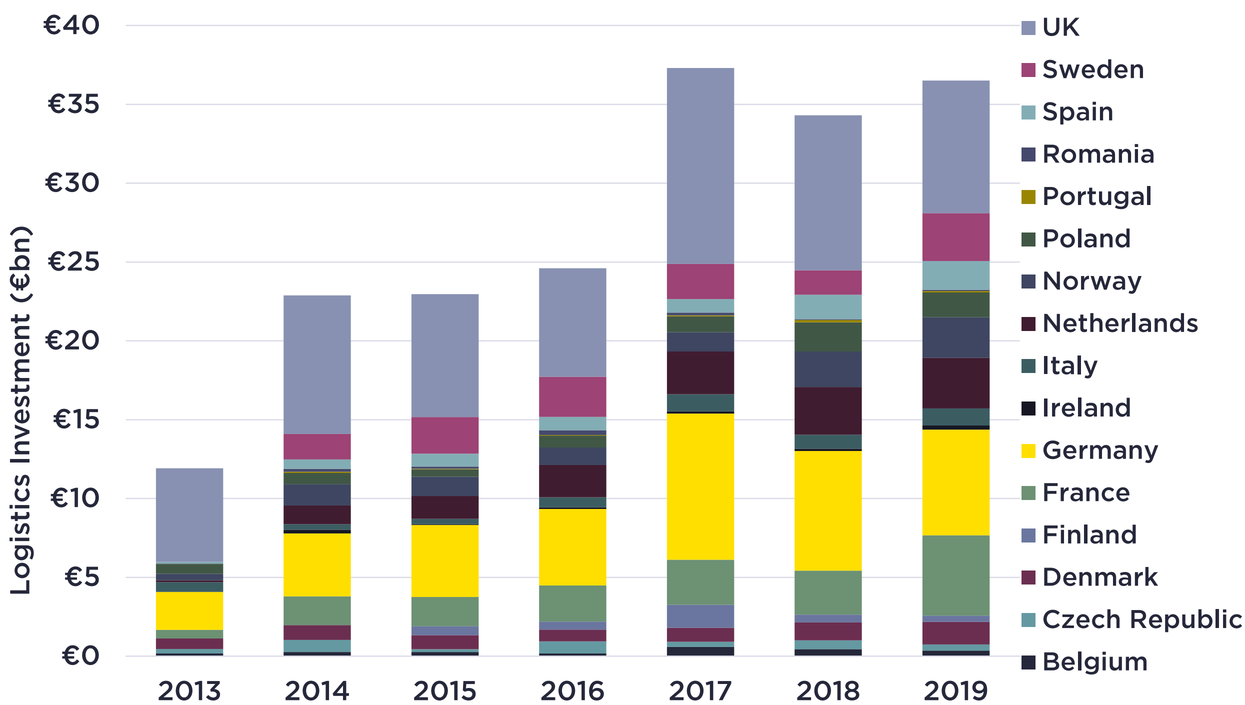
Investment Outlook

The macro themes of 2019 remain consistent into 2020, however, many landlords and developers are coming to reality with the significance of the coronavirus. The "under the radar" policy rate cuts from the US Fed and Bank of England present opportunity for an earlier European Central Bank (ECB) rate cut, which would further widen prime industrial/ sovereign bond yield spreads. Going into the year, Savills anticipated an average of 17 bps prime yield compression across European markets over the course of the year. The underlying risk of investing in real estate ahead of sovereign bonds remains constant and given the pressure of built up equity committed to institutional real estate, we believe the pricing story remains attractive.

We also expect that the structural changes affecting the logistics sector will continue to pique investor interest and that the logistics sector will be one of the most sheltered commercial property sectors from the pandemic. Landlords may look to impose monthly rent payment upon tenants with lower covenant ratings in order to even out cash flow.

During times of increased uncertainty, investors have shifted acquisition activity to core product in core markets, which we expect to be the case

Chart 2: European Logistics Investment Volumes (€)



Source: Savills Research

over the course of 2020. There is a strong possibility that investment transactions volumes will recede over the course of the year, particularly as there remains a shortage of openly marketed stock. Bans on travel and self-isolation guidance will make inspecting assets and conducting technical due diligence, as virtual tours will become increasingly important. We expect the more liquid markets to account for a higher proportion of transactions this year.

Debt will become increasingly difficult to obtain unless terms have been already agreed, which could present buying opportunities for unleveraged funds. Acquisition activity from non-European capital is likely to ease as part of a shift to core markets, as domestic institutions account for a higher share of investment transactions of markets they are more familiar with.

Where is the long income available?

The hunt for long, secure income is likely to be magnified over the next 12 months due to the levels of uncertainty. Savills research indicates the average lease length for new, purpose built logistics facilities (Chart 3). The UK (13 years), Finland (12 years) and Poland, Sweden and Germany (each 10 years) offer some of the longest term industrial lease lengths and we expect prime warehouses secured to strong covenants in these locations to be particularly sought after over the next 12-18 months, subject to the number of willing vendors.

Table 2: European Logistics Prime Yields (%)

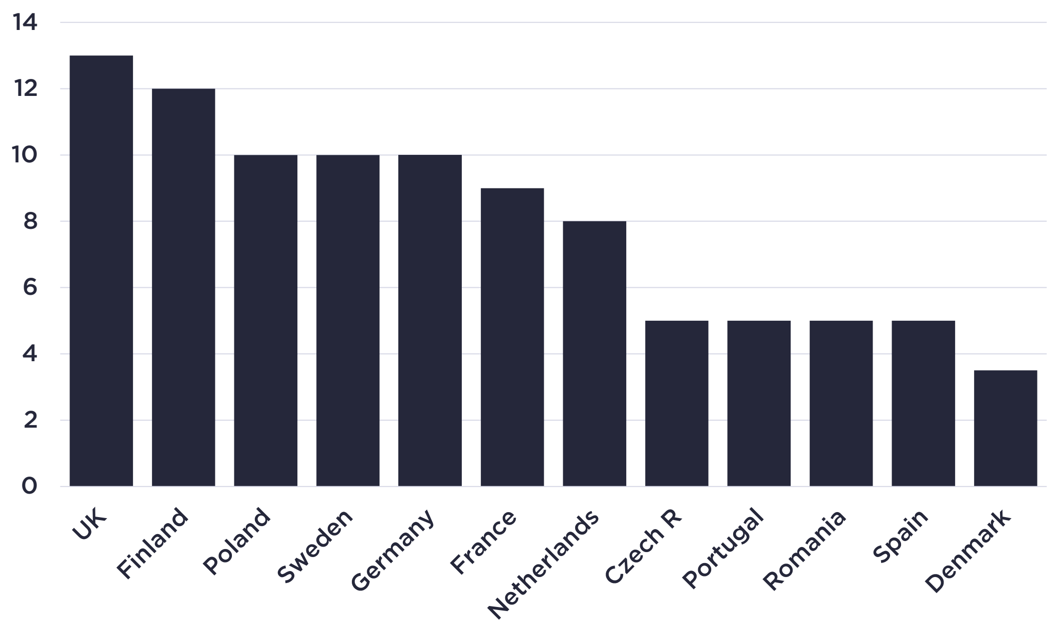
Country	2018	2019	2019 change (bps)
Czech R.	5.75%	4.25%	-150
Denmark	6.50%	5.25%	-125
Finland	5.10%	5.10%	-
France	4.75%	4.25%	-50
Germany	4.10%	3.60%	-50
Ireland	5.00%	5.00%	-
Italy	5.25%	4.75%	-50
Netherlands	4.50%	4.25%	-25
Norway	4.90%	4.80%	-10
Poland	5.10%	5.00%	-10
Portugal	6.50%	6.25%	-25
Romania	8.50%	8.00%	-50
Spain	5.50%	5.15%	-35
Sweden	4.80%	4.50%	-30
UK	4.00%	4.00%	-

Source, Savills Research

Prime logistics yields compressed by an average of 37bps during 2019.

Average lease length for purpose built UK logistics facilities stands at 13 years.

Chart 3: European Logistics Average Lease Length (years)



Source, Savills Research

Could COVID-19 catalyse the shift in the way we shop?

Will Percival, Regional Investment Advisory, examines how the equity markets have initially responded.

In the constantly evolving world we find ourselves living in, the equity markets are one of the few barometers able to keep pace with the rapid rate of change. By taking a view on how baskets of stocks have performed since the World Health Organisation (WHO) declared a Global Health Emergency, we can begin to form an impression of how markets perceive different groups of retailers are going to be impacted by COVID-19 in the immediate future and possibly beyond.

As would be expected, those retailers who predominantly sell their goods in physical stores have been the hardest hit, registering a drop of 45%. It's estimated that one quarter of the world's population are currently on lockdown, which has been accompanied by widespread store closures for shops selling non-essential goods. With revenues from their bricks-and-mortar stores drying up, it's never been more important for traditional retailers to have an omnichannel strategy to continue to meet consumer demands by other means.

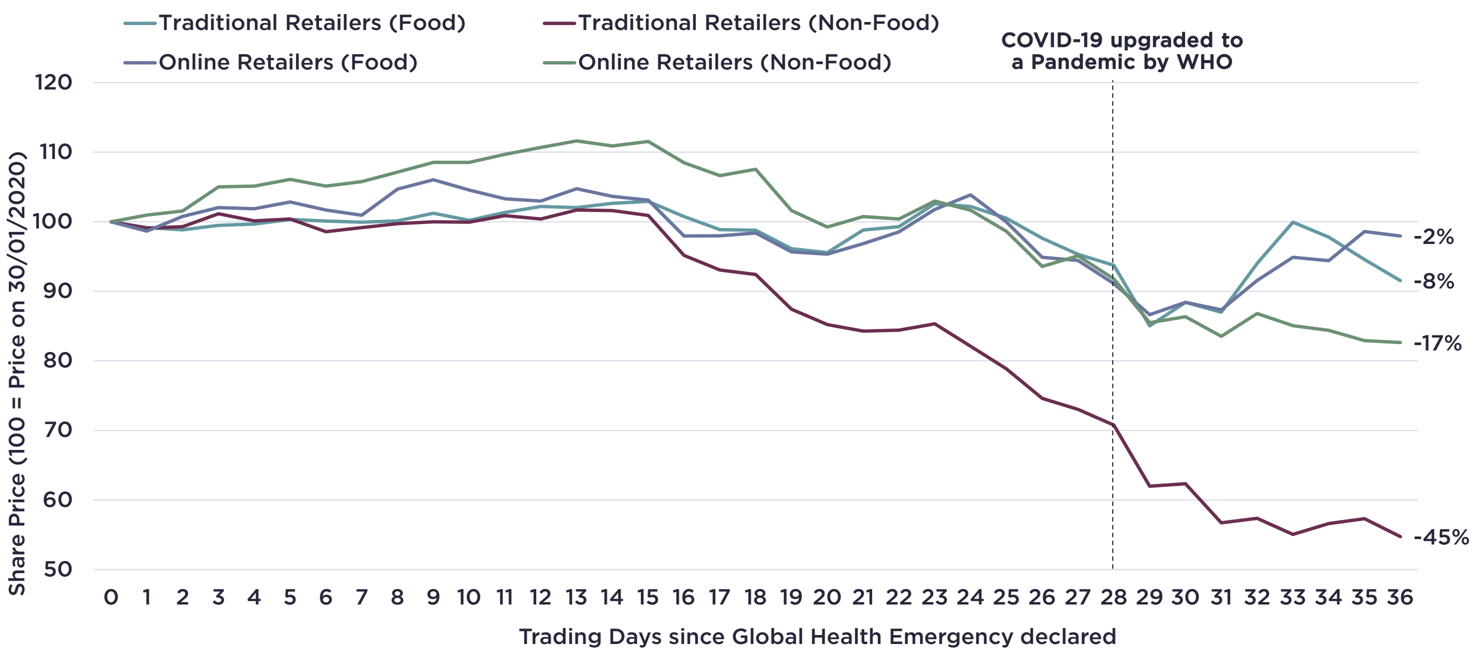
The one exception amongst traditional retailers are the supermarket chains that are benefitting from a huge spike in demand as a result of consumers' stockpiling behaviours. It has been widely reported in the UK that shoppers hoarded an additional £1bn of food over a three week period, as fears over the virus mounted. The outperformance of the traditional food retail sector was reflected by a modest 8% drop in share price amongst our basket of stocks.

Online food retailers have seemingly been even more unscathed by this global crisis, with those in self-isolation left with little option but to purchase food online. For example, the German recipe box delivery service, HelloFresh, recorded a 14% increase in share price and the online grocery retailer, Ocado, has seen a spike in demand, causing them to start placing customers in a "virtual queue" to avoid crashing their website.

Online retailers offering predominantly non-food products have shown polarised performance, with those offering essential items outperforming those selling non-essential goods. During this time of uncertainty, consumers are expected to delay any non-essential purchases, which was reflected in the 32% drop in share price for the online fashion retailer, Zalando. On the other hand, the online retailing giant Amazon, who have blocked all non-essential items from their warehouses, recorded a 2% rise.

One thing for certain is that, through necessity, the pandemic has driven more people online and we anticipate there to be a spike in e-commerce growth in 2020. Those who may not have considered shopping online previously could now become converts as they become accustomed to the convenience of having their goods delivered to their door. Whether these early indications from the stock market are reflecting the short-term pain for traditional retailers or a more fundamental turning point in the way we shop, only time will tell.

Chart 4: Equity market response to COVID-19



Source: Savills, Yahoo Finance

Savills Commercial Research
We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

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