SPOTLIGHT
Savills Research

European Commercial – May 2023

European Logistics Outlook

● Occupational ● Investment ● Credit Conditions

Europe avoids falling into recession

The European economy narrowly avoided a recession in Q1 as the seasonally adjusted GDP in the Euro Area and European Union edged up by 0.1% Q/Q and 0.3% Q/Q, respectively. Although GDP growth has slowed in recent quarters, both economic zones expanded by 1.3% compared to Q1 2022. Notably, these aggregate figures hide variations within member states. Germany remained stagnant in Q1 2023, following a decline of 0.5% in the final quarter of 2022, while Italy and Spain experienced growth of 0.5% each, and France grew by 0.2%.

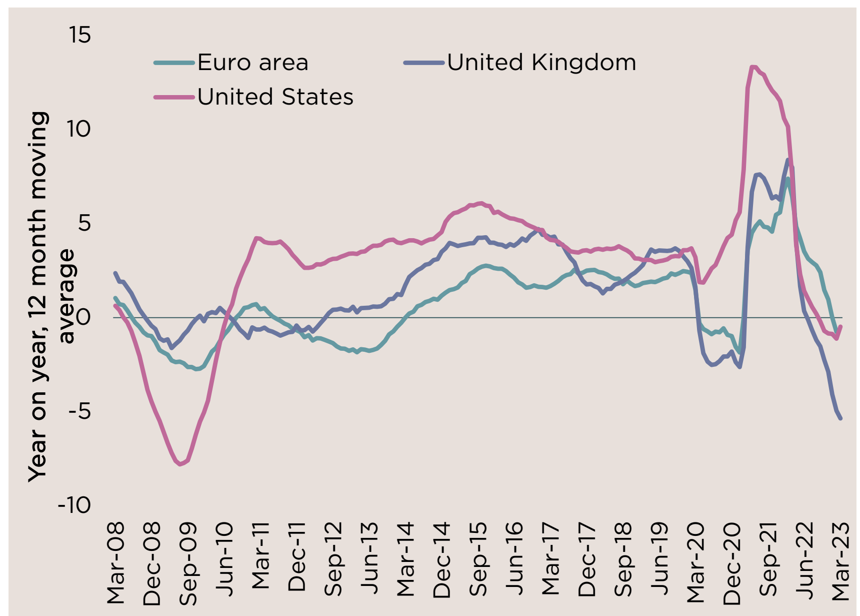
Despite challenges in the industrial and logistics market, retail sales volumes continued to decline in Q1 2023, which will inevitably have a negative impact on occupiers. The high inflation rates expected in the Eurozone will reduce real disposable incomes, which are forecast to fall by 0.6% in 2022 and 0.1% in 2023 before returning to growth next year. Considering the weak economic sentiment at the end of 2022, a decrease in retail sales was to be anticipated. Crucially, the European Economic Sentiment Index has started to recover and now sits just below the long-term average of a series dating back to the early 1990s. Unemployment expectations remain low, and although consumers have become more pessimistic about their own household finances, their overall outlook on the economy is improving compared to the end of 2022.

One driver of this optimism is likely to be a decline in energy prices, as energy bills and petrol prices are typically one of the strongest influences on a consumer's perception of inflation. Indeed, a warm winter, and policy and behavioural changes in mainland Europe, mitigated the energy crisis in Winter 2022, leading to a recent decrease in energy prices. Both food and energy prices, which were major contributors to last year's inflation, now account for a considerably smaller share of the overall inflation rate. While core inflation is on the rise, it is worth noting that nominal wage growth is increasing at a slower pace, indicating that inflation expectations remain stable.

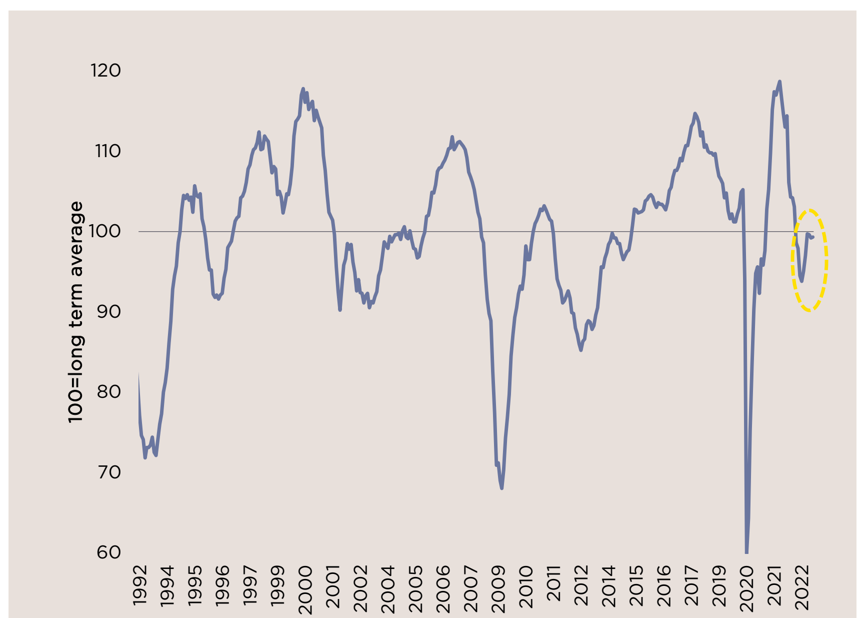
At the core of the economic narrative in Q1 2023 is the impressive performance relative to the forecasts made in 2022. The overall economy has demonstrated resilience and performed relatively well. The Citi Economic Surprise Index reveals that the EU continued to exceed expectations in the first quarter of 2023, and the UK has also surpassed consensus forecasts by achieving modest economic growth during the quarter. Looking ahead, the European economic outlook should continue to improve, with inflation expectations trending downward. As we have previously highlighted, consumer expenditure growth in 2023 is forecast to rise by 0.2%, and the decline in employment is anticipated to be significantly less severe compared to the Global Financial Crisis. These key metrics should sustain occupier demand this year.

Europe		Change		
Metric	**Level**	**Annual Growth**	**vs. 5yr average**	**vs. 2019**
Take-up (million sq ft)	7.02	-37%	-16%	1%
Investment volumes	€5.1bn	-73%	-57%	-40%
Vacancy rates	3.53%	-26bps	-60bps	+55bps
Prime yields	4.93%	-93bps	+13bps	+1bps

Retail Sales volumes continued to decline in Q1 2023



European Economic Sentiment is approaching its long-term average



Source: Savills Research using Macrobond

Occupier activity remains weak in the face of economic uncertainty

While the macroeconomic outlook is expected to become clearer, if not improve, by the end of the year, the overall slowdown in retail sales volumes and weak economic sentiment are starting to impact the occupier market. According to estimates, European logistics take-up in Q1 2023 amounted to 7.0 million sq m, reflecting a 16% decline compared to the five-year Q1 average. When examining take-up in the context of historic take-up levels in the first quarter of the year, it becomes apparent that there has been a significant decrease in take-up compared to the pandemic years, with Q1 showing a year-on-year decline of 37%.

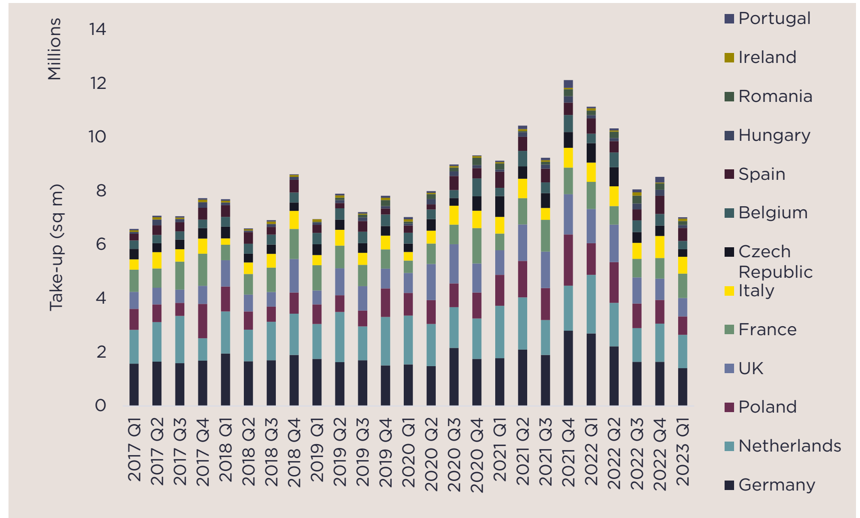
Context is crucial in our analysis of the market, which experienced a period of explosive expansion, with a period of moderation after this always probable. When comparing annual figures against Q1 2022, it is crucial to note that this is in line with the three years before the pandemic and that annual comparisons are against the strongest Q1 on record. Anecdotally, our local teams are increasingly reporting that the occupational market's trajectory is mirroring that of the investment market, albeit with a slight delay. Deals are still taking place, but the process is taking significantly longer. Further to this, if we take a comparison against Q1 2019, when the market was still considered strong by pre-Covid standards, take-up has increased by 1% suggesting a reversion to a pre-pandemic mean. When the economy improves and e-commerce firms like Amazon become more active we would expect a strong recovery in the medium term.

Occupiers are increasingly prioritizing cost-consciousness due to growing concerns about affordability. This shift in mindset has led to a decline in demand for big-box units, which typically require significant capital expenditure for fit-out costs. As a result, occupiers are opting to maintain their current footprints rather than seeking larger spaces.

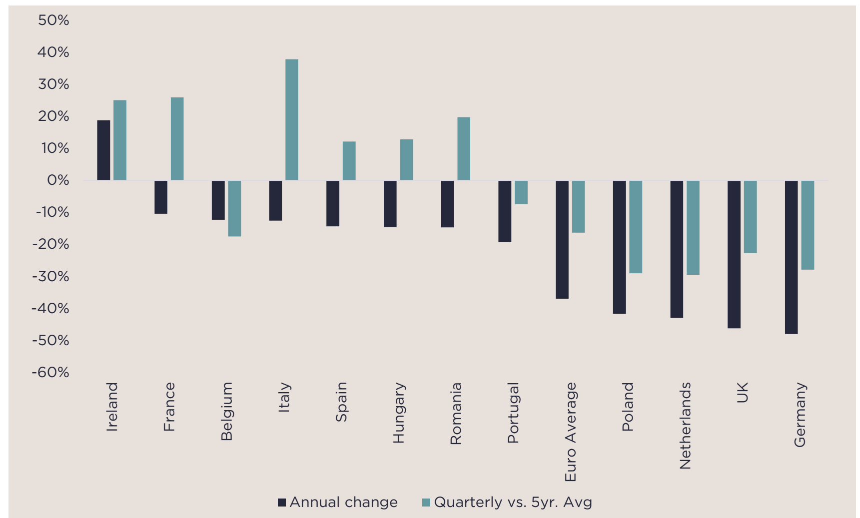
While most markets experienced declines on both quarterly and annual bases, it is noteworthy that many locations still outperformed their five-year averages in the second half of 2022. However, as the markets continued to cool in Q1 2023, they are now reporting take-up levels below their five-year quarterly averages. The steepest declines were observed in Poland (-29%), the Netherlands (-29%), and Germany (-28%). These markets also experienced significant annual declines of 54%, 43%, and 48%, respectively. On the other hand, only three markets surpassed their five-year averages in Q1: Italy (+38%), France (+26%), and Ireland (+25%). Notably, Ireland bucked the trend of declining annual growth as its take-up reached an all-time high for the period, marking a 19% year-on-year increase.

Declining take-up in Germany, Poland and the UK has seen each their share of take-up decline by 2% in the first quarter of the year relative to 2022. At the same time, a higher share of take-up has taken place in France (+5%), Spain (+2%) and Italy (+1%). We do not currently expect any structural shift in logistics take-up in the near term but notably, many of the largest markets by volume have seen sharper slowdowns in Q1.

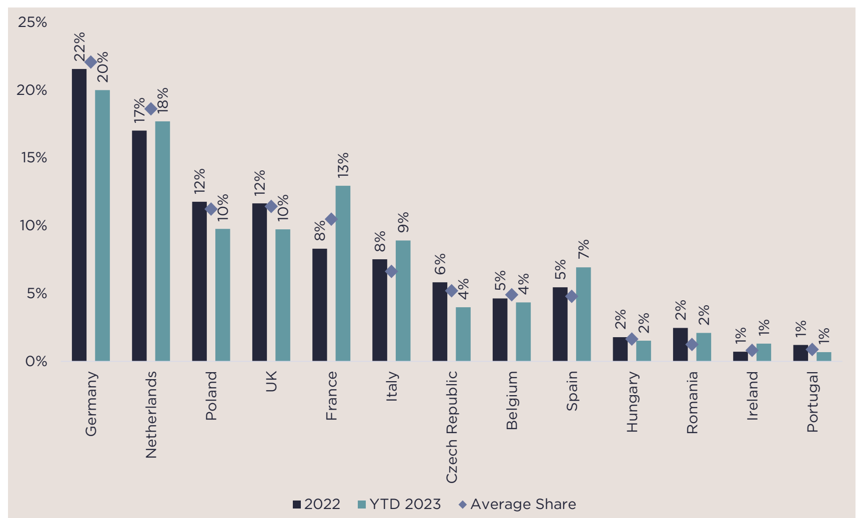
European logistics take-up totals 7m sq m in Q1 2023



Europe's larger markets have seen the sharpest fall in take-up



Germany, UK and Poland have accounted for a smaller share



Source: Savills Research

Vacancy is trending upwards but remains critically low in many markets

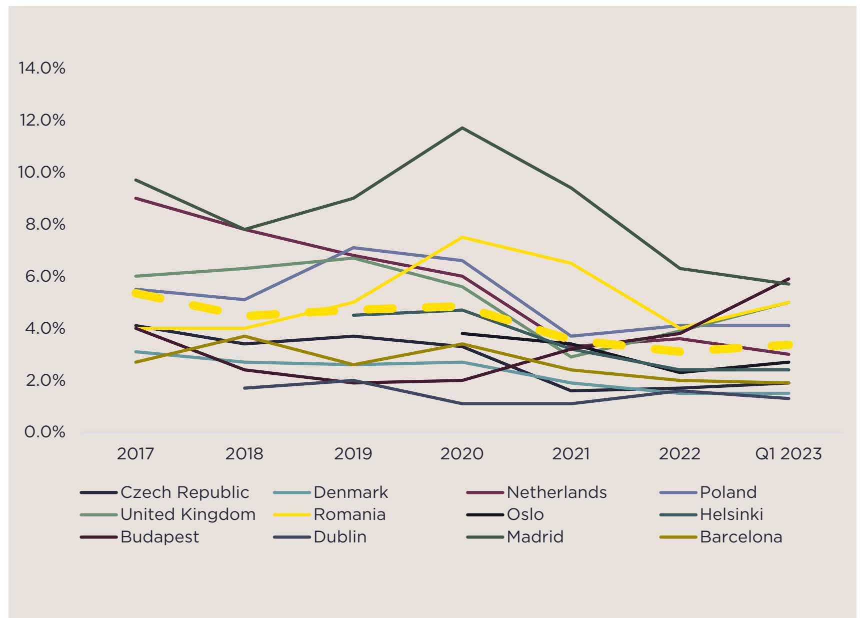
The average vacancy rate, which had been gradually declining in recent years, increased from 3.1% to 3.5% in Q1 2023, reflecting the impact of slower leasing activity. Several factors contribute to this trend. In addition to weaker take-up, we are witnessing the completion of pipeline projects that broke ground when take-up was at an all-time high. As a result, there is an upward pressure on the vacancy rate.

An upwards trend the in the vacancy rate is likely to continue in Q2 2023 until a slowdown in construction starts translates into reduced completions later in the year. Furthermore, some occupiers who previously occupied excess space have sought to optimize their footprints by subleasing excess space as their requirements have decreased. Anecdotally this decline in required space by occupiers will likely be temporary, a view clearly mirrored by the occupiers bringing these units to the market. Although the volume of available grey space has increased in the last two quarters - a significant quantum of this space is available on short-term leases, with occupiers expecting to reclaim it within the next one to two years.

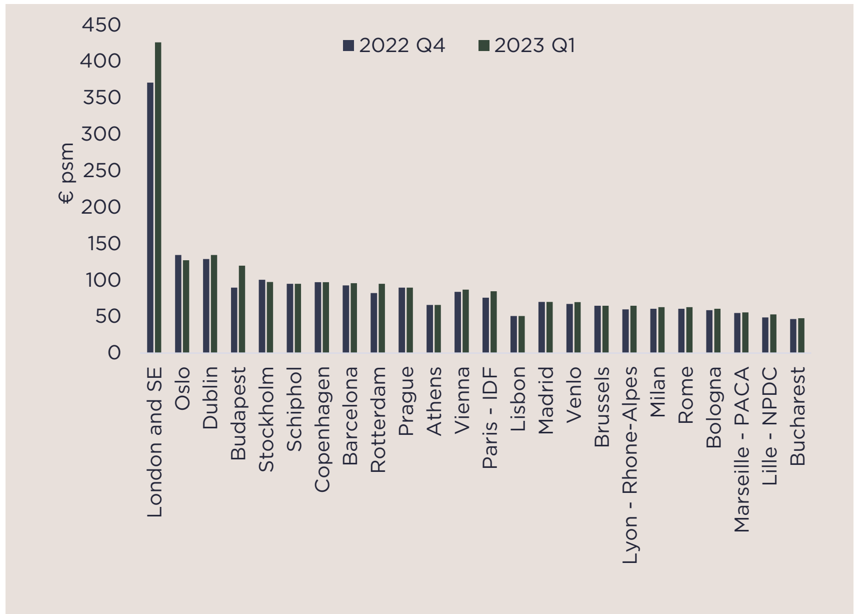
Vacancy rates are still falling in two markets, dropping by 60bps in the Netherlands (3.0%), and 30bps in Dublin (1.3%) in Q1 2023. Conversely, the vacancy rate rose in the majority of markets with increases of 210bps in Budapest (5.9%), 200 bps in Poland (6.1%) and 100bps in the UK (5.0%). Oslo experienced an increase in its vacancy rate to 2.7% (+40bps) after reaching a series low in Q4 2022. While vacancy rates are rising in most markets, the constrained pipeline development over the past decade and strong take-up in recent years allow for further rate increases without triggering negative rental growth.

Despite the rising vacancy rates in recent quarters, growth in prime rents has remained robust. Prime rents across Europe have increased by 10.4% in the last four quarters. Suggesting that even with declining take-up, most markets remain below their natural vacancy rate, enabling landlords to demand higher headline rents throughout the year. Notably, rents continued to grow in Q1 2023, rising by 4.7% compared to Q4 2022. While this is positive for landlords and developers, there are potential risks, and rental affordability may become a concern in certain markets.

Vacancy is trending upwards in the first quarter of 2023



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



Source: Savills Research

> “Despite the rising vacancy rates in recent quarters, growth in prime rents has remained robust. Prime rents across Europe have increased by 10.4% in the last four quarters.”

Investment volumes have slowed significantly but deals are happening

The deceleration in European real estate transactions witnessed during the final months of 2022 slowed more sharply during the first three months of 2023, with transactions coming to a virtual standstill compared to previous years. Investment volumes, which totalled €5.1bn, declined by 49% quarter-on-quarter and by 73% compared to Q1 2022, which was notably a record high. This comparison is starker still when we consider that investment volumes in Q1 were the lowest since the GFC, and 57% lower than the five-year average.

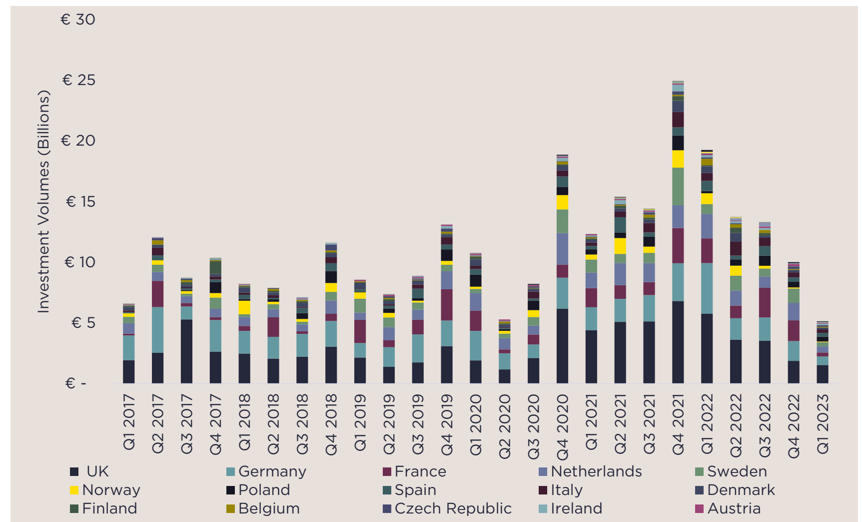
A primary factor in this deceleration has been tighter monetary policy, as central banks continued to hike interest rates resulting in higher finance costs, negatively impacting investor sentiment. Although this affects all real estate sectors, the industrial and logistics sector took the biggest hit. The relatively adverse impact on the sector is reflected in a decline in its share of total investment volumes. The industrial and logistics sector's share of total investment volumes had grown in recent years, from 12% of total investment volumes in the first quarter of 2017 to 25% in Q1 2022, before declining to 19% in the first quarter of this year.

Compared to the same period last year, investment volumes dropped most in Hungary, where no deals were completed in the quarter, Norway (-92%), Belgium (-88%) and France (-84%). Whilst the Czech Republic (-3%), Ireland (-29%) and Portugal (-45%) recorded the smallest declines in investment volumes year-on-year. Only Poland and Romania witnessed an uplift in investment. Poland saw a 110% increase year on year, mainly driven by the purchase of a 185k sqm industrial warehouse by P3 Logistics Parks from Panattoni, while Romania had recorded no investment transactions in Q1 2022.

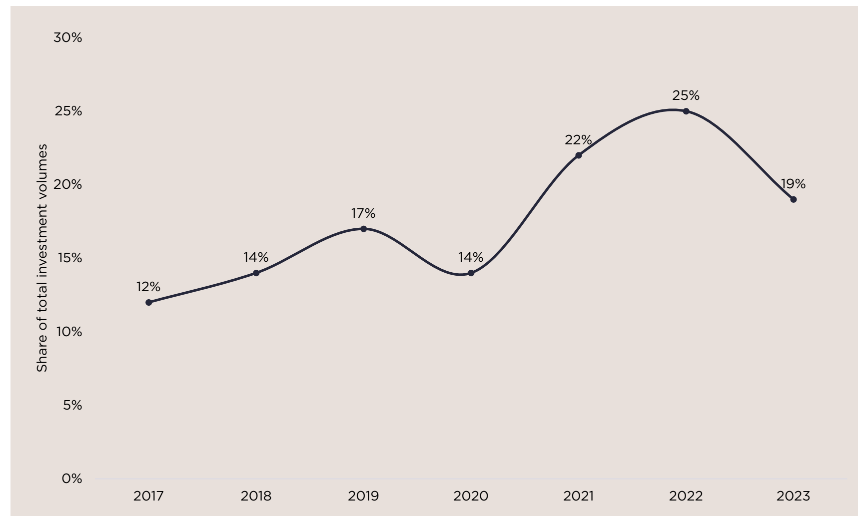
The pricing gap between buyers and sellers persisted throughout the first quarter of this year, with the cooldown in investment volumes exacerbating the situation providing buyers and sellers only limited transactional evidence to gauge current price levels. A shortage in transactional evidence can, in turn, lead to further declines in investments as it increases uncertainty amongst market participants. The deals that signed during the quarter were smaller in deal size, with owners of larger assets waiting to bring product to the market in the absence of transactional evidence for the right pricing. Indeed, given the relatively robust state of the occupational market and persistent rental growth, asset owners who can afford to do so are well-placed to continue to hold on to their income-generating assets.

Analysing RCA data shows that vendors were mainly publicly listed REITs and developers. Developers are typically more susceptible to rising financing costs and thus may have been more motivated to sell. Goodman, LondonMetric and Panattoni were the most active vendors in the market this quarter. Private equity and investment management firms were the most active buyers, which is typical at this point in a cycle as these firms typically have more dry powder available to deploy. The biggest buyers by volume were BentalGreenOak, Blackstone and AGC Equity.

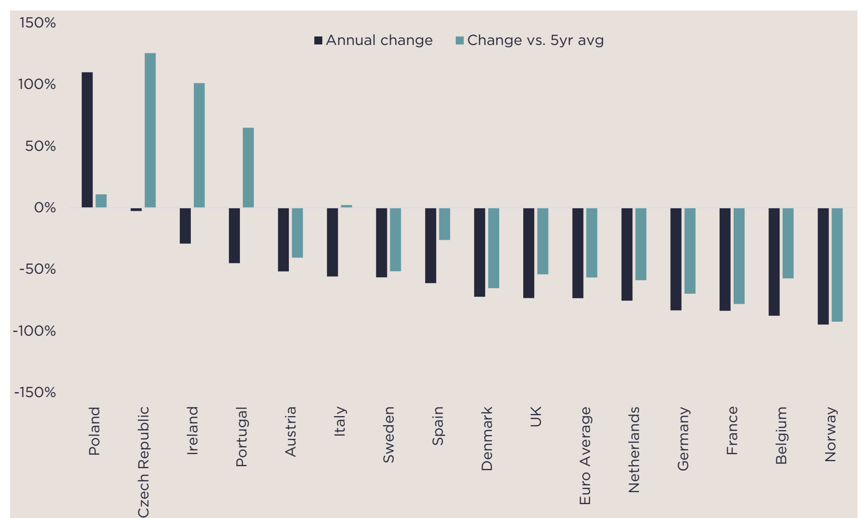
Q1 investment volumes are below historical levels



Logistics investment has been more adversely affected by interest rate hikes



Investment volumes have fallen below their five-year averages in most markets

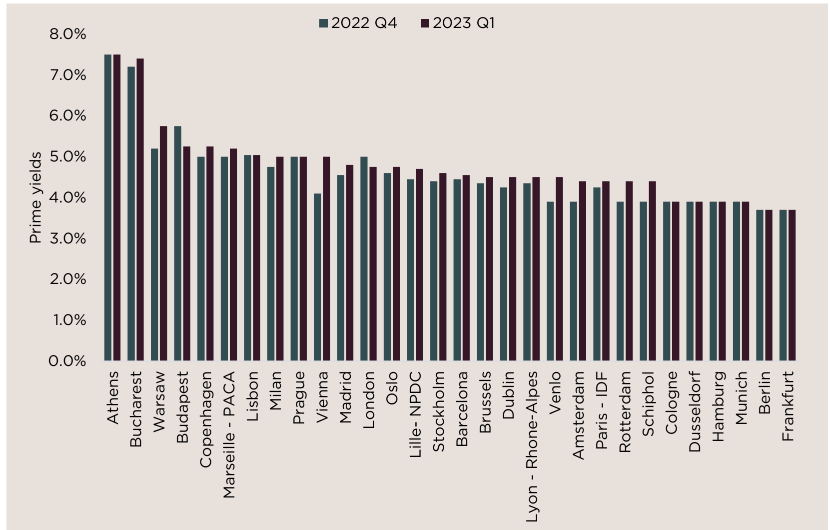


Source: Savills Research

Prime yields were flat or on an upward trajectory in most markets this quarter, with the average prime yield for European industrial and logistics assets rising to 4.80% during the first quarter of this year. This translates to an increase of 21bps compared to Q4 2022 and an increase of 93bps in the last year, reflecting the impact of the interest rate hikes over the last year. Despite this, average European prime yields remain more than 60bps below the pre covid average (5.38%, 2017-2019).

London was the exception to this trend tightening by 25 bps as capital continues to chase best-in-class assets that remain in short supply. The greatest movements in prime yields were in Vienna (+90bps), Venlo (+60bps) and Warsaw (+55bps). Budapest (-35bps) and Athens (-25bps) saw yields tighten year-on-year, with most markets yields moving out by more than 75bps with the biggest moves in London, Warsaw, Venlo (all +150bps), Stockholm (+145bps), and Paris – IDF and Lille (both +140bps).

Prime yields are rising in every market but London



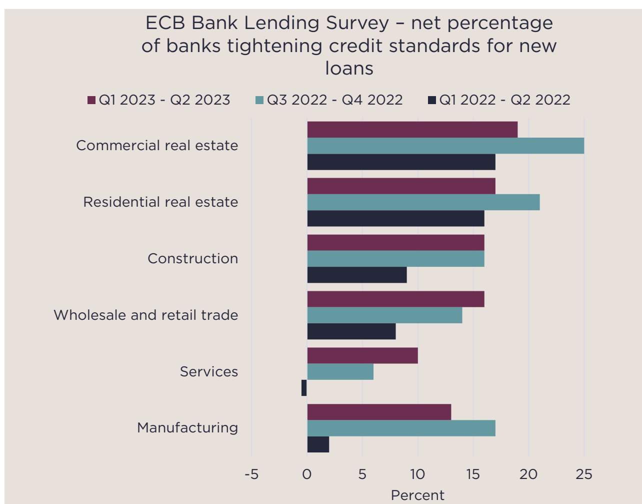
Source: Savills Research

Credit conditions are tightening

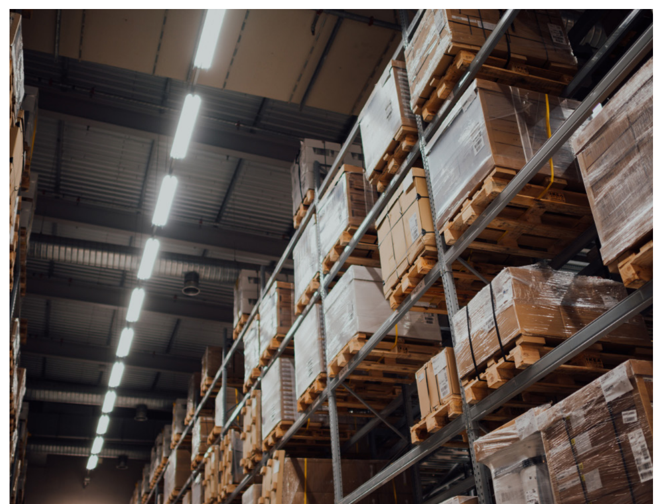
The beginning of 2023 saw not insignificant instability in the banking sector. The failure of three small-to-mid-size U.S. banks in March led to a global decline in bank stock prices and prompted the U.S. Federal Reserve to step in and guarantee deposits in two of the failed banks. In response to the fear of contagion, the European Central Bank (ECB), Bank of England (BoE), and Swiss National Bank intervened in their respective markets to provide liquidity. However, Credit Suisse, a global investment bank and financial services provider already under pressure, faced a wave of deposit withdrawals following the regional banks' failures. The Swiss National Bank, considering Credit Suisse to be systemically important, quickly brokered a deal for UBS, the main competitor, to acquire the bank. Additionally, the failure of another regional bank in the U.S. in May has further eroded confidence in the overall health of the banking system. Coupled with rising interest rates, this is likely to result in tighter lending conditions for households and businesses.

Tighter lending conditions would reduce business investment and constrain household consumption. The duration of this trend would determine its various effects. In the short term, weaker consumption would increase pressure on logistics occupiers, particularly online and physical retailers. Weaker lending activity is expected to have a negative impact on investment volumes in the property market as leveraged buyers find it more difficult to finance transactions. Furthermore, an extended period of tight constraints on businesses would reduce investment in capital goods, resulting in lower overall productivity, which would have implications for total consumption.

The Euro Area is already experiencing signs of a lending slowdown, as banks reported to the ECB that they have significantly tightened credit standards for loans in the first quarter of the year. Credit standards have tightened at the fastest rate since the euro area sovereign debt crisis in 2011. Simultaneously, demand for loans from private firms has sharply declined (-38% q/q) due to higher interest rates, according to the ECB. Banks anticipate further tightening of credit standards in Q2 2023, albeit at a more moderate pace. Importantly, the survey revealed that the net percentage of banks tightening credit standards for loans was highest for commercial real estate compared to other assets. This, combined with anticipated interest rate hikes in 2023, is likely to put upward pressure on prime yields in Europe.



Source: ECB



Summary

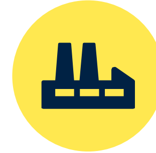
Five key considerations

1. Europe's consumers have become more confident: European Economic Sentiment Index has started to recover and now sits just below the long-term average of a series dating back to the early 1990s. Unemployment expectations remain low, and although consumers have become more pessimistic about their own household finances, their overall outlook on the economy is improving compared to the end of 2022.

2.A weaker consumer economy is weighing on occupier demand: While the macroeconomic outlook is expected to become clearer, if not improve, by the end of the year, the overall slowdown in retail sales volumes and weak economic sentiment are starting to impact the occupier market leading to a 16% decline vs. the five-year average

Vacancy rates are rising from record lows: After gradually declining in recent years, slower leasing activity is starting to be reflected in the average vacancy rate which rose from 3.1% to 3.5% in Q1 2023. Further increases are likely but we would note that many markets remain constrained in terms of supply.

4. The deceleration in European real estate transactions intensified in Q1 2023: Investment volumes, which totalled €5.1bn, declined by 58% quarter-on-quarter and by 73% compared to Q1 2022's record high. A primary factor in this deceleration has been tighter monetary policy, as central banks continued to hike interest rates resulting in higher finance costs, negatively impacting investor sentiment.



5. Instability in the banking sector may have negative rammifications for consumer and investor demand: The failure of regional banks in the U.S and Switzerland. has eroded confidence in the overall health of the banking system. Coupled with rising interest rates, this is likely to result in tighter lending conditions for households and businesses.

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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
Andrew Blennerhassett
European Logistics Research Associate
+44 (0) 7977 149 770
andrew.blennerhassett@savills.com

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

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