European Commercial – September 2023

SPOTLIGHT
Savills Research

European Logistics Outlook

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● Occupational ● Investment ● Outlook

Slowing economic activity is slowing manufacturing activity

European economic output, as measured by GDP, remained stable in the second quarter of the year, edging up by 0.3% in the Euro Area. At the same time, headline inflation has also continued to fall as interest rate hikes from the ECB start to take effect. Crucially, core inflation, which excludes food and energy prices and has proven more resilient to base rate hikes, appears to have peaked in the Eurozone. So far, the bloc has largely followed the US economy on a lag of about six months, which may suggest that core goods inflation is likely to follow that of the US and drop sharply in the coming months. That said, service price inflation may persist for longer depending on the evolution of wage growth.

While there are reasons for optimism in the wider economy, the manufacturing sector has taken a significant beating in the last year. Overall demand for manufactured goods is declining, with high-frequency data looking increasingly gloomy. The sector had received a degree of support from unwinding supply chain disruption, but these effects appear to have passed. Electrical equipment and automotive manufacturers, who account for about 13% of total manufacturing in aggregate, are both forecasting declining output.

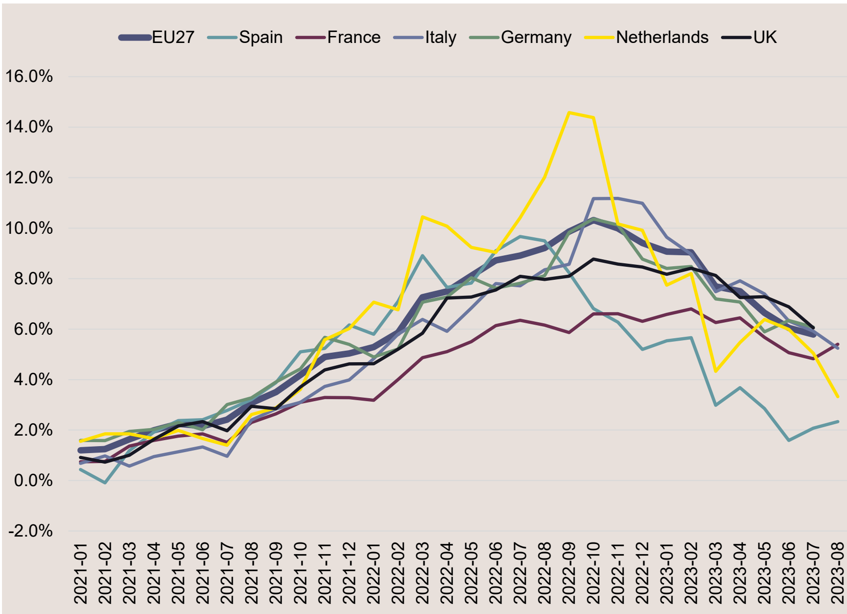
One driver of this was the energy price shock last year, which appears to have had a lasting adverse impact on the sector, starting the downward trend in output as gas prices rose but with no corresponding increase in activity as energy prices receded. Indeed, the Eurozone's purchasing managers index has continued to report monthly contractions in the sector, with July registering a particularly weak 42.7 – anything under a score of 50 indicates a contraction. The biggest driver of this decline in the index has been new orders. Capital Economics is forecasting negative growth in the sector for the rest of 2023, which will have a negative impact on occupier demand for logistics space from manufacturers and the logistics firms that transport their goods.

Key market stats

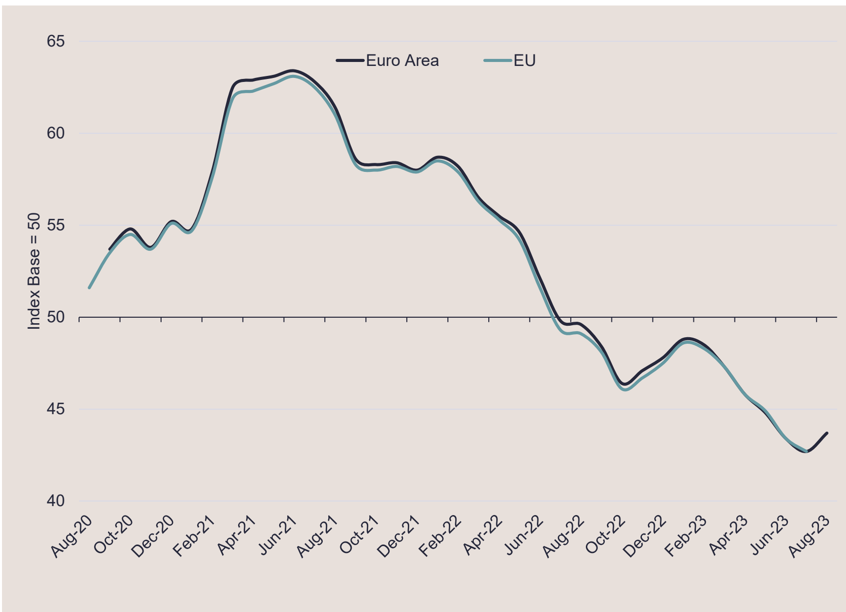
Indicator	Level	Q/Q	Y/Y	vs. 5yr Average
Take-up (sq m)	6.0m	-17%	-41%	-28%
Investment	€6.3bn	+23%	-54%	-36%
Vacancy Rate	4.70%	+74bps	+117bps	+17bps
Prime Yields	5.08%	+15bps	+96bps	+33bps

> “Core inflation, which excludes food and energy prices and has proven more resilient to base rate hikes, appears to have peaked in the Eurozone.”

Inflation has peaked but is declining at varying rates



European Manufacturing PMIs indicate a sustained contraction in the sector



Source: Savills Research using Macrobond

Leasing activity is in line with pre-pandemic levels in H1

Activity in the occupier market remains muted, reflecting the weakness of the overall economy. Take-up in Q2 totalled 6 million sq m, bringing total take-up in the first half of the year to 13.2 million sq m. On an annual basis, this is a decline of 37% on the record set in H1 2022 and a decline of 22% compared to H2 2022, when the market began to cool last year.

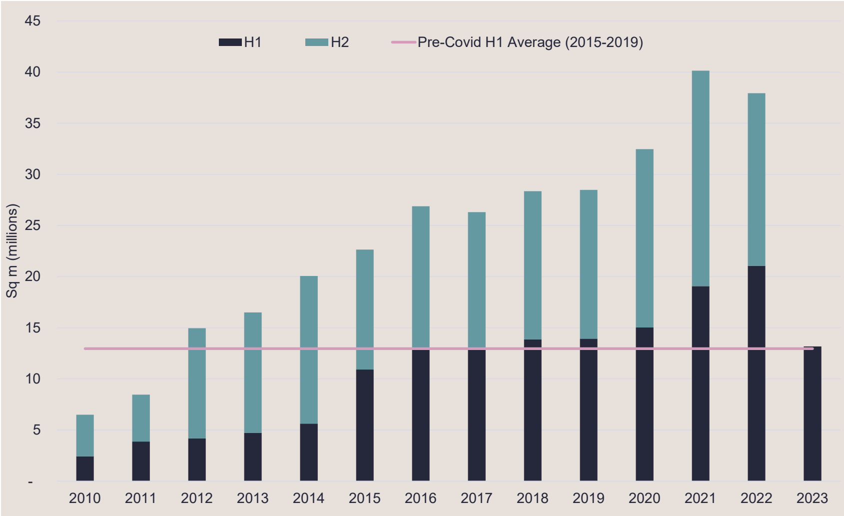
While the Q2 figure is the lowest level of take-up since 2015, we would note that H1 2023 has been in line (+1.7%) with the pre-pandemic H1 average (2015-2019). We remain confident in our prognosis that the slowdown in the market reflects a return to the market's long-run trends as the pandemic era tailwinds slow. Anecdotally, we have seen an uptick in requirements in a number of markets in the last quarter, which may start to translate into growth in take-up.

While some markets managed to outperform their five-year averages in the second half of 2022, further declines in leasing activity in H1 saw most markets underperforming their five-year averages, with overall take-up falling by 28.3% on its five-year average.

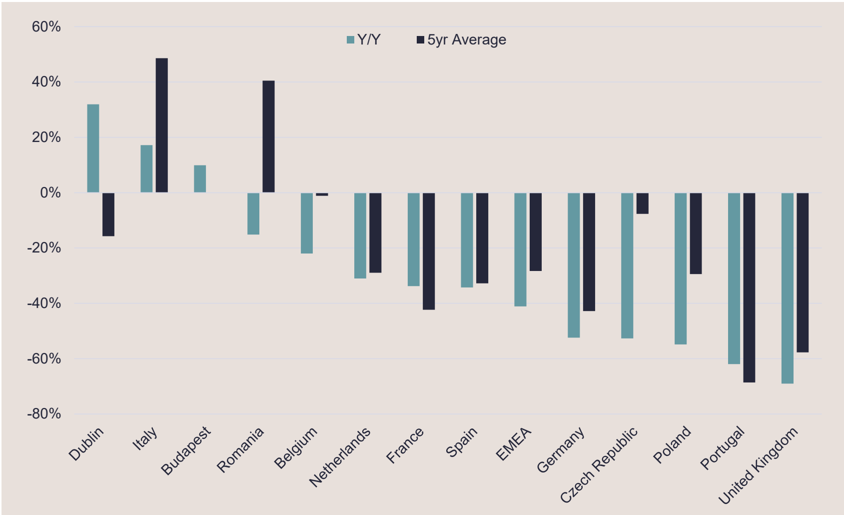
Just three markets registered annual increases in the quarter: Ireland (+32.0%), Italy (+17.2%) and Hungary (+9.9%). Of these, only Italy outperformed its five-year average (+48.6%). The steepest annual declines were in the United Kingdom (-69.0%), Poland (-62.0%), and Portugal (-54.9%).

More established locations like Germany (-3%), Poland (-1%) and the UK (-3%) have seen their shares of total EMEA take-up decline in the first half of the year relative to 2022. At the same time, a higher share of take-up has taken place in Italy (+4%), France (+2%) and the Netherlands (+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 H1.

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



Europe's established markets continue to see larger declines



Source: Savills Research

Prime rents continue to rise despite increasing vacancy rates

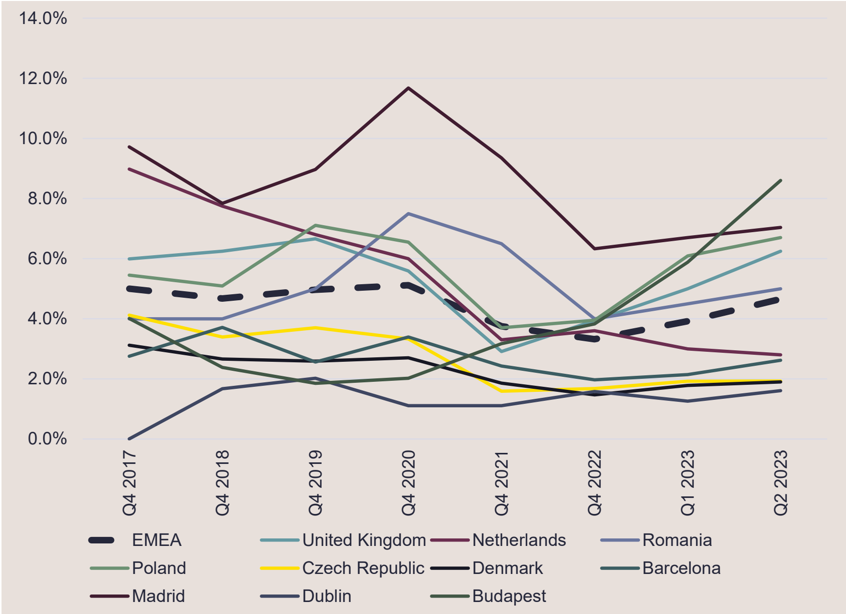
The vacancy rate continued to rise this quarter, increasing from 3.3% at the end of Q4 2022 to 4.7% at the end of Q2 2023. There has been no significant change to the drivers of this trend in Q2; rising vacancy rates are a symptom of weaker take-up and speculative construction that commenced before market conditions began to deteriorate.

There has been a fall in speculative announcements in the UK, which suggests that the impact of new stock coming to the market will wane over the coming quarters. There are signs of a similar trend in Europe, with the Euro Area Construction PMI showing a sharp contraction in recent months and European Union construction sector output declining since the start of the year. Despite this, we expect vacancy rates increases to persist into H1 2024 until this slowdown in construction activity is reflected in falling completion volumes.

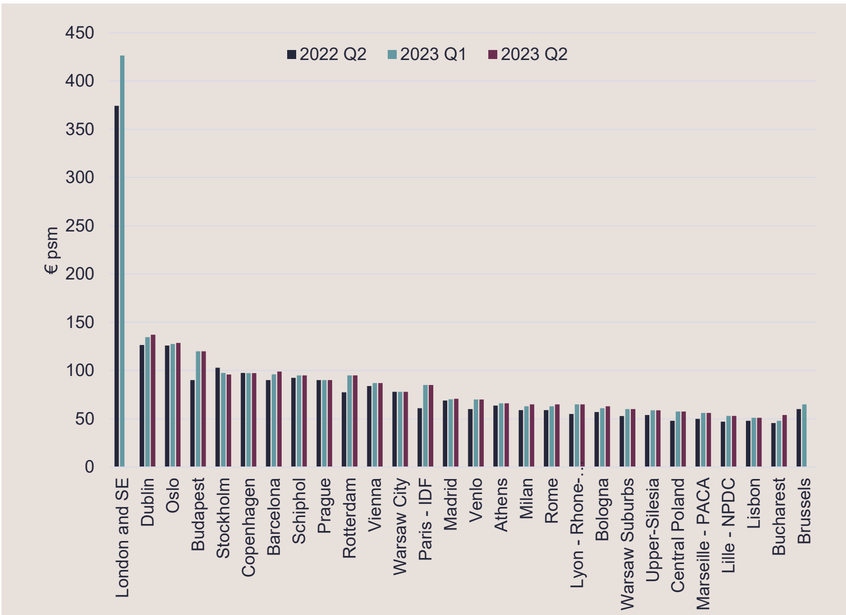
Vacancy rates rose by an average of 62bps in Q2, with only the Netherlands (2.8%) seeing a fall in the vacancy rate, which declined by 20bps. The fastest rates of increase were in Budapest (+272bps), Poland (+61bps) and Barcelona (+48bps). Budapest has experienced a sharp increase in supply in recent quarters. Notably, this has been driven by completions of new stock rather than second-hand stock returning to the market, with development typically being speculatively led. While vacancy rates have risen across all European markets, we would note that pipeline development has remained relatively constrained over the past decade, and the low vacancy rates reached in early 2022 mean that we believe it that vacancy rates will peak well below the levels seen in the GFC. Indeed, we expect that the market should absorb further increases in supply without triggering negative rental growth.

Quarterly rental growth remained positive in Q2 2023, increasing by an average of 1% across Europe. This was driven by strong rental growth in Bucharest of 13%, with most markets reporting no rental growth. This represents a deceleration in rental growth compared to last quarter, which saw an average increase of 4.7%. Average rents have increased by 10.9% over the last four quarters, slightly ahead of the 10.4% growth seen over the four quarters to Q1 2023. Continuing rental growth is important here as it gives confidence to investors looking to hold logistics assets over long time horizons.

Vacancy continues to trend upwards in the Q2 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 rebound in Q2 but does this signal a recovery?

Investment volumes into European logistics real estate totalled €6.3bn - a decline of 54% year-on-year and 36% below the Q2 five-year average. Notably, this represents an increase of 23% compared to Q1 2023, but we would caution that one swallow does not make a summer. With the potential for a further interest rate hike in September, it is unlikely that this marks the inflection point in the market.

Tighter monetary policy has been the primary driver of weaker investment demand over the last year, which has led to a decline in investment volumes across the commercial real estate sector. Although this affects all real estate sectors, the industrial and logistics sector has seen one of the sharpest declines in asset values. Notably, offices and retail were already struggling post-pandemic, which meant that price adjustments had already happened before the advent of interest rate hikes.

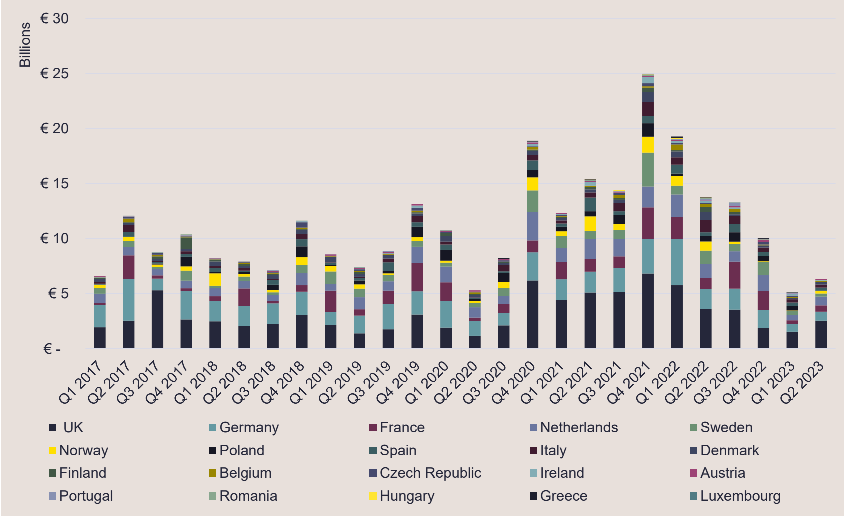
With investors adjusting to declining values, the sector's share of total H1 investment volumes edged down from 20% in 2021 and 2022 to 19% in 2023. Notably, this is still well ahead of the average of 13% in the three years before the pandemic. The sector maintaining its share of total investment indicates that, despite declining investment volumes, logistics assets are still attractive to investors. Indeed, data from our recent logistics census shows that 24% of investors believe they are underweight in logistics assets.

Year-on-year comparisons are difficult this quarter, with the Czech Republic, Portugal, Romania and Hungary seeing no investment in logistics assets. With the exception of Austria (+65% y/y), all markets saw investment volumes falling year-on-year and below their five-year averages. The markets with the sharpest declines were Poland (-93%), Sweden (-77%) and Italy (-75%). Whilst Spain (-12%), the UK (-30%) and the Netherlands (-35%) recorded the smallest declines in investment volumes year-on-year.

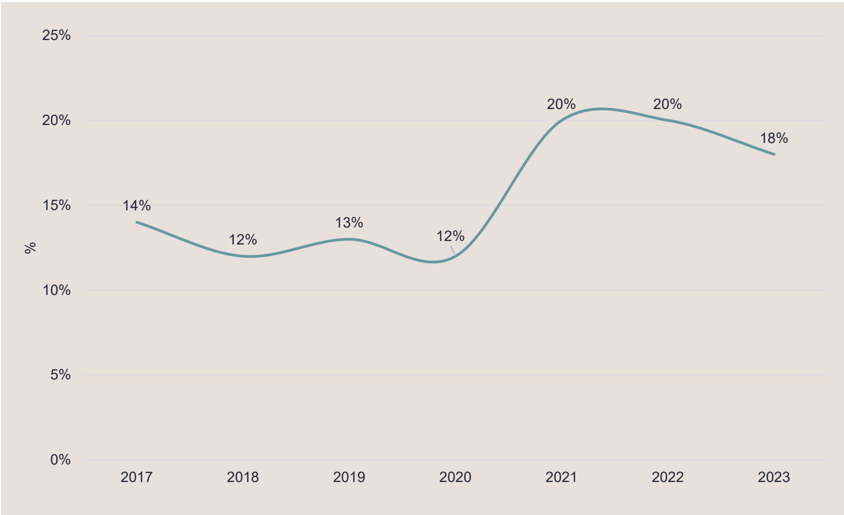
Prime yields remained flat or on an upward trajectory in most of Europe this quarter, which caused the average prime yield for European industrial and logistics assets to rise from 4.93% in Q1 2023 to 5.08% in Q2 2023. This translates to an increase of 32bps since the start of the year and an increase of 95bps over the last four quarters. Average European prime yields are still 22bps lower than the pre-COVID average (5.38%, 2017-2019).

Greece was the exception to this trend, with yields tightening by five basis points during the quarter. The largest movements in prime yields were in Warsaw (+50bps), Stockholm (+30bps), Berlin, Paris and Frankfurt (+30bps). It is notable that we have not seen any major shifts in prime yields this quarter after several pricing adjustments in the last year. Notably, with the ECB base rate rising by 50bps in the second quarter of the year and a further 25bps in August, leveraged buyers will likely wait until prices adjust to reflect higher costs of debt.

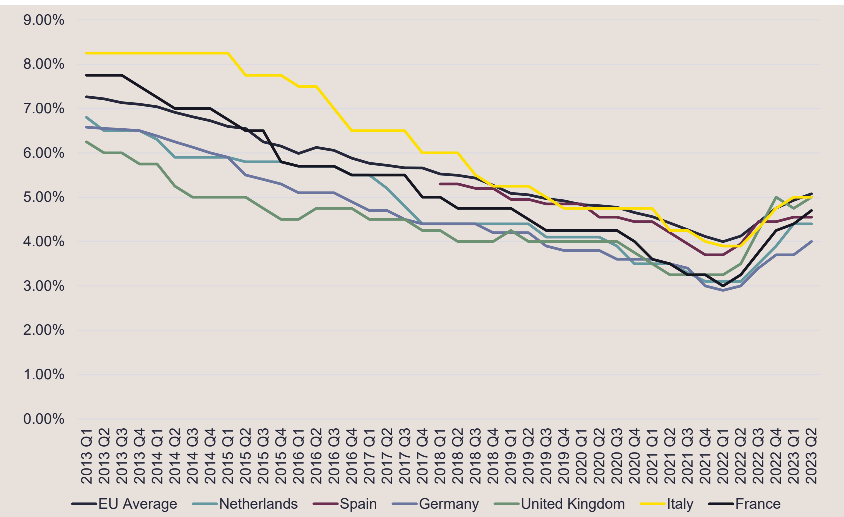
Q2 2023 investment volumes rebound from a potential trough in Q1



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



Prime yields have continue to trend upwards, driven by interest rate hikes



Source: Savills Research

Where now for the investment and occupier markets?

While inflation has continued to decline in most of the Euro Zone and an economic slowdown in the bloc is expected to dampen demand, updated inflation projections from the ECB don't differ much from their June forecasts. In previous cycles of tightening monetary policy, central banks have typically cut rates when economic growth is weakening but still positive. This is certainly the case now as indicators for business activity plunge and an increasingly negative GDP outlook.

Unfortunately, inflation has remained more stubborn than expected, and high wage growth will likely put further upward pressure on business costs, leaving policymakers in a difficult situation. The ECB has reiterated its target rate of just above 2%, and members of the monetary policy committee have publicly stated they would rather cut rates sufficiently now rather than pause and be forced to resume rate hikes at a later date. With market consensus not seeing rate cuts until Q2 2024, we are likely to see low levels of investment turnover unless the pricing gap between vendors and purchasers narrows.

Euro Area retail sales experienced a 0.2% month-on-month decline in July, with many analysts forecasting a continued decline in the coming months. Notably, this decline followed a significant revision of June's figures, which shifted from a 0.3% contraction to a 0.2% expansion, indicating a volatile retail environment. In Q2, retail sales registered a modest 0.2% quarter-on-quarter increase, contrasting with previous estimates of stagnation, and the three-month-on-three-month growth rate saw a positive uptick of +0.5% in July.

July's decline in Euro Area retail sales was primarily attributed to a substantial 0.8% drop in Germany. This negative performance overshadowed the positive rises observed in France, Spain, and Portugal, possibly reflecting the resilience of tourist-related spending in these nations.

While some data, such as growing new car registrations, suggest rising spending on non-retail items in the Euro Area, the broader outlook for household spending appears gloomy. Consumer confidence remains significantly below the average level of the past decade. Factors such as elevated interest rates and stagnant real incomes are expected to continue constraining households' purchasing power, potentially leading to a further decline in consumption throughout the remainder of the year.

The weakening consumer sentiment and expected reduction in household spending pose challenges for logistics real estate in the Euro Area. Sluggish retail sales growth may translate into reduced warehousing and distribution demand. One reason for optimism is that when the consumer sentiment index is split into its constituent indices, individual consumers' views of their own household finances remain relatively strong even as their views of the overall economic situation have worsened. This is likely to translate into cautious behaviour amongst households but may provide some support for consumption and through this logistics demand.

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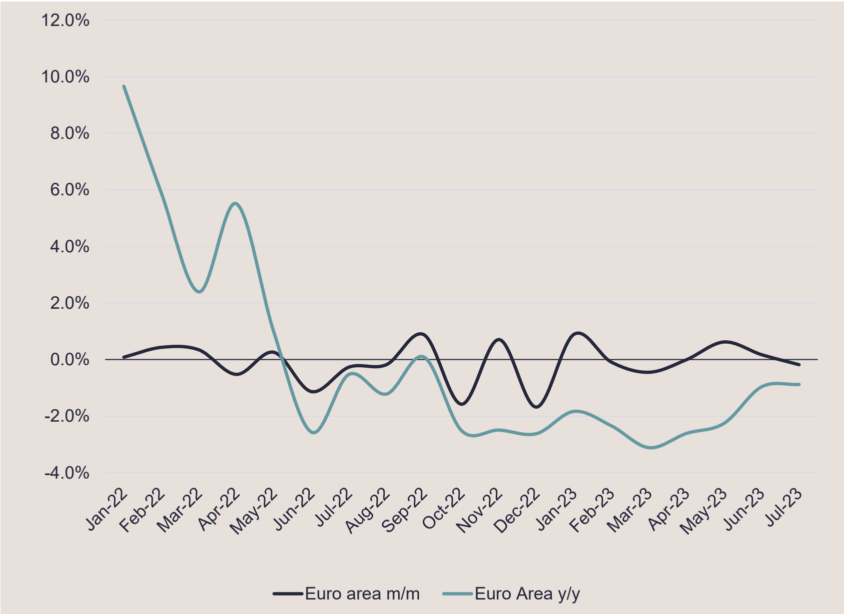
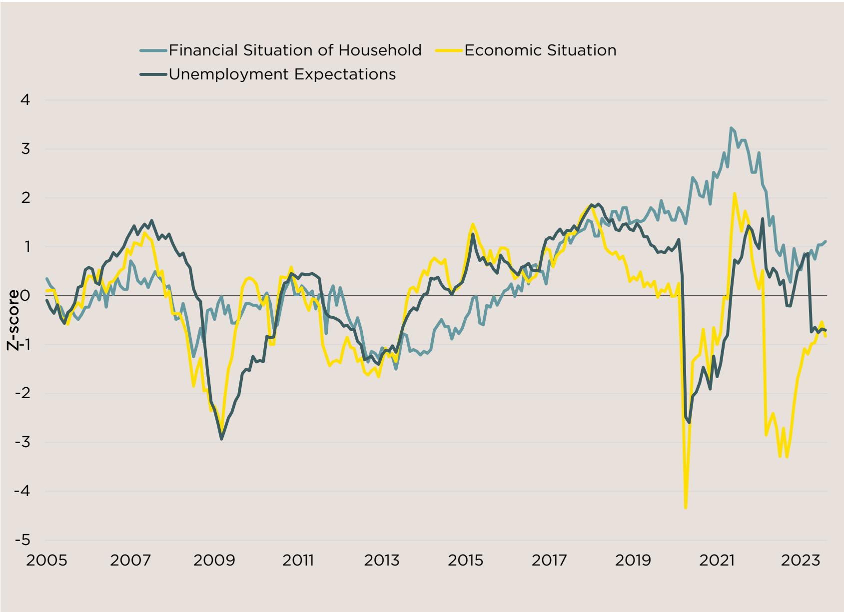
Retail sales growth has been volatile in recent months



Source: Eurostat

Consumers remain confident in their own financial situation even as unemployment expectations decline



Source: Macrobond

Summary

Five key considerations

1. The manufacturing sector is struggling: Overall demand for manufactured goods is declining, with high-frequency data looking increasingly gloomy. Indeed, the Eurozone's purchasing managers index has continued to report monthly contractions in the sector, with July registering a particularly weak 42.7 – anything under a score of 50 indicates a contraction.

2.Leasing activity is in line with pre-pandemic averages: While Q2 take-up is at itslowest level since 2015, we would note that H1 2023 has been in line (+1.7%) with the pre-pandemic H1 average (2015-2019). We remain confident in our prognosis that the slowdown in the market reflects a return to the market's long-run trends as the pandemic era tailwinds slow.

Rental growth remains positive even as vacancy rises: The vacancy rate continued to rise this quarter, increasing from 3.3% at the end of Q4 2022 to 4.7% at the end of Q2 2023. In spite of this rental growth remained positive in Q2 2023, increasing by an average of 1% across Europe in Q2 and growing by 10.4% over the last four-quarters.

4. Investment volumes grew quarter-on-quarter in Q2: Investment volumes into European logistics real estate totalled €6.3bn, which represents an increase of 23% compared to Q1 2023, but we would caution that one swallow does not make a summer. With the potential for a further interest rate hike in September, it is unlikely that this marks the inflection point in the market.

5. The consumer economy is set to continue to struggle: Euro Area retail sales experienced a 0.2% month-on-month decline in July, with many analysts forecasting a continued decline in the coming months. While some data, such as growing new car registrations, suggest rising spending on non-retail items in the Euro Area, the broader outlook for household spending appears gloomy.

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