Taking Stock: Capital Markets Quarterly Logistics Q1 2023

Global outlook

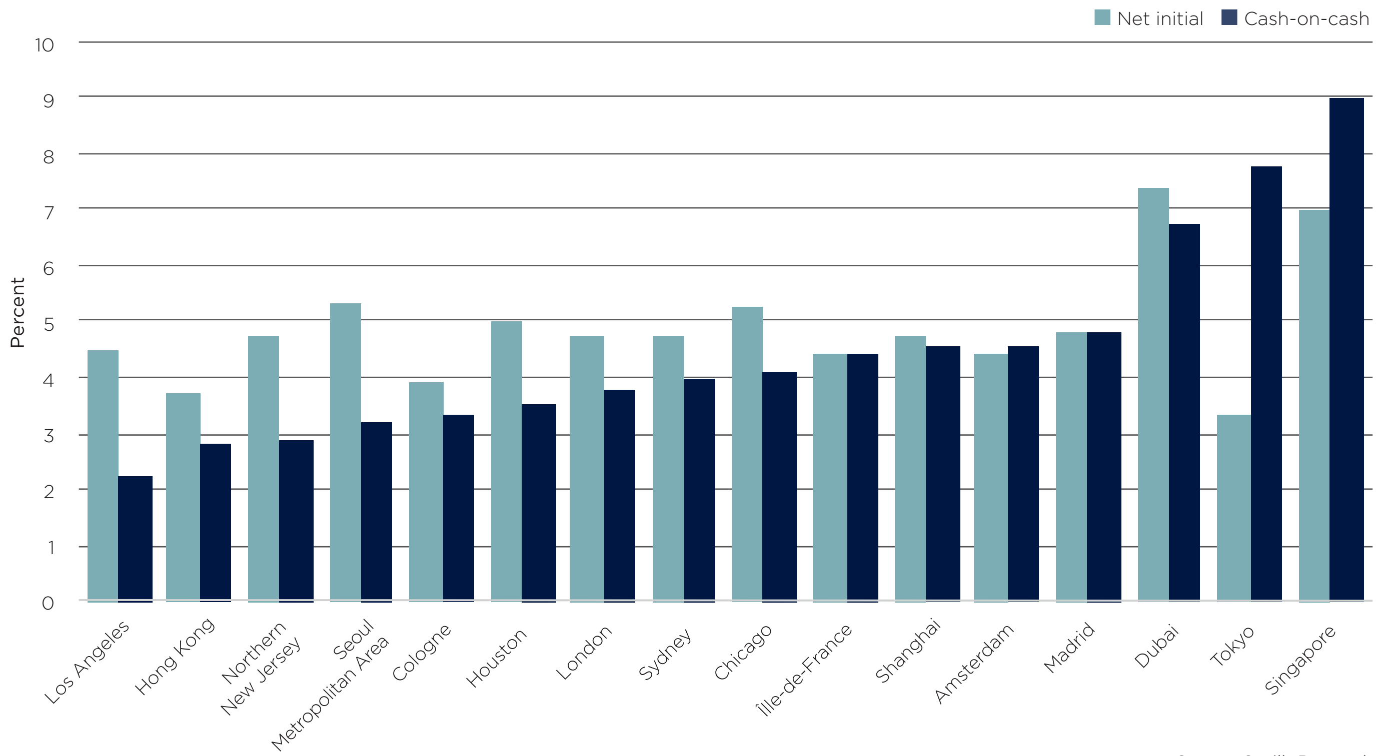
A recession in global consumer goods demand and world trade present significant downside risks to logistics occupational markets, although low vacancy rates provide some cushion to landlords.

Investment in the global logistics and industrial markets surged to unprecedented levels in the past two years, reaching a historic peak in the first quarter of 2022. However, the momentum shifted in the first quarter of 2023, as transaction activity experienced a significant decline with a year-on-year fall of 57%. This downturn can be attributed to swift fluctuations in interest rates, resulting in price corrections and constraining the number of successful transactions.

Despite the downturn, investor confidence in the sector remains relatively resilient. Turnover in the first quarter was just 5.8% below the ten-year average. This suggests that market activity is normalising after the recent frenzy, reflecting a return to a more stable and sustainable level.

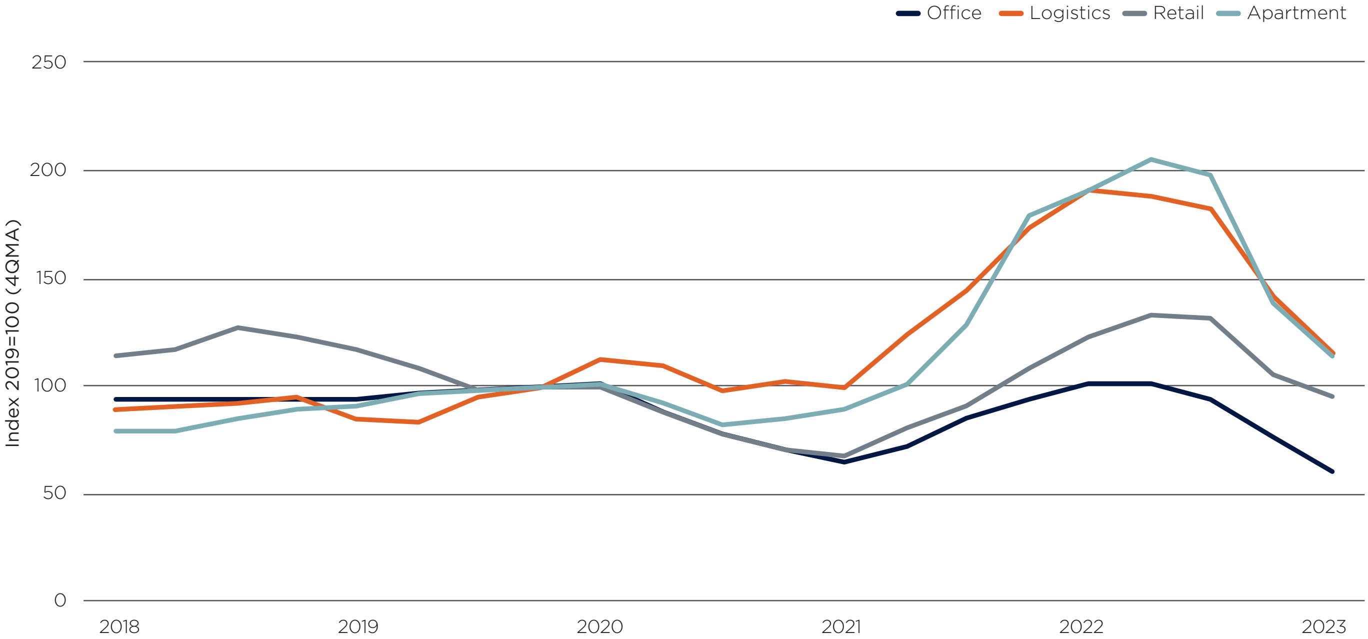
Nevertheless, investment criteria are becoming more stringent, with a focus on best in class assets and price adjusted value-add opportunities. The market is in a state of anticipation, awaiting stability in the macroeconomic environment. Once there is more clarity around pricing levels and interest rates, we anticipate an uptick in activity. This is already evident in the UK.

Prime logistics yields, Q1 2023 (as at end-March)



Source: Savills Research

Global investment volumes by sector



Source Savills Research using MSCI Real Capital Analytics

A cautious recovery in sentiment

Inflation has peaked, and interest rates will soon reach a crescendo. Europe survived the winter without rationing energy, US consumers continue to spend pandemic-era excess savings, and authorities in China have relaxed tight Covid-19 restrictions, supporting a rebound in domestic activity. This improvement in the economic outlook has supported a recovery in risk sentiment, and equity markets have recouped some of the losses of last year, with the MSCI World All Cap Index rising by 6.5% in Q1.

Yet there remains a sense of foreboding that more pain is on the horizon. Markets are skittish as a result, and measures of volatility remain elevated. The IMF expects a soft landing. Economists and policymakers generally agree. But dissenters refer to this outlook as the 'immaculate disinflation scenario,' which hints at a potential lack of realism from consensus forecasters. Indeed, history suggests that recession is a pre-requisite to tame 'sticky' inflation, and past periods of rapid monetary policy tightening have mostly ended in pain.

However, history is also a poor predictor of the future, and there remains no obvious catalyst for a more severe economic downturn in this cycle. Even a crisis in the US banking system, arguably the most systemic sector in the global economy, looks unlikely to materially shift the outlook. Forecasting is a futile exercise, but conditioned on the information available to us now, a soft landing remains the most likely outcome. But the most likely outcome can still be a low probability scenario, and recent events highlight the risk of a black swan.

Context is everything

The recovery in global risk sentiment is yet to feed into investment activity in commercial real estate, which slowed down significantly in the first quarter of the year. The logistics sector was no exception, with the US$34.8 billion of logistics assets transacted globally representing a 57% decline in comparison with the US$81.0 billion in Q1 last year. But while this headline represents the steepest decline in investment since the height of the GFC nearly 14 years ago, it is important to consider base effect following exceptionally high levels of activity over the past two years, and volumes remain above pre-Covid levels.

The US was the overwhelmingly largest market – accounting for more than 50% of global volumes in Q1 – followed by Canada and the UK. In the Asia Pacific region, Japan recorded the highest transaction volume, followed by China and South Korea. Institutional investors and REITs were net sellers of assets, which reflects their cautious approach in the current market conditions. Cross border investors were the most active buyer group with positive net acquisitions, accounting for nearly 40% of global transactions, followed closely by private investors. There was more liquidity for smaller lot sizes as a consequence – with the average deal size falling by around one-fifth compared with the last few years – while portfolio transactions dropped by 69% on the year.

Adaptive expectations

Despite the limited transaction evidence, it is clear that property prices are adjusting to the changing market conditions. The largest corrections this quarter were noted in the US sub-markets at 75bps, as well as the Seoul Metropolitan area at 80bps. The only markets where pricing remained stable were Tokyo, Singapore, and Dubai. In Tokyo the risk premium remains high, supported by the low interest rate environment, while prime yields in Singapore and Dubai were higher, at 7.0% and 7.4% respectively, comparing favourably to other asset classes and offering healthy cash-on-cash returns of over 6%.

Investors are adapting to the shift towards higher interest rates and they anticipate slower rental growth in the mid-term due to the weaker economic backdrop. As a result, they have adjusted their underwriting processes to reflect this new reality. Seller expectations are also slowly adapting to the shifting market dynamics. However, additional repricing is probably necessary to stimulate market activity.

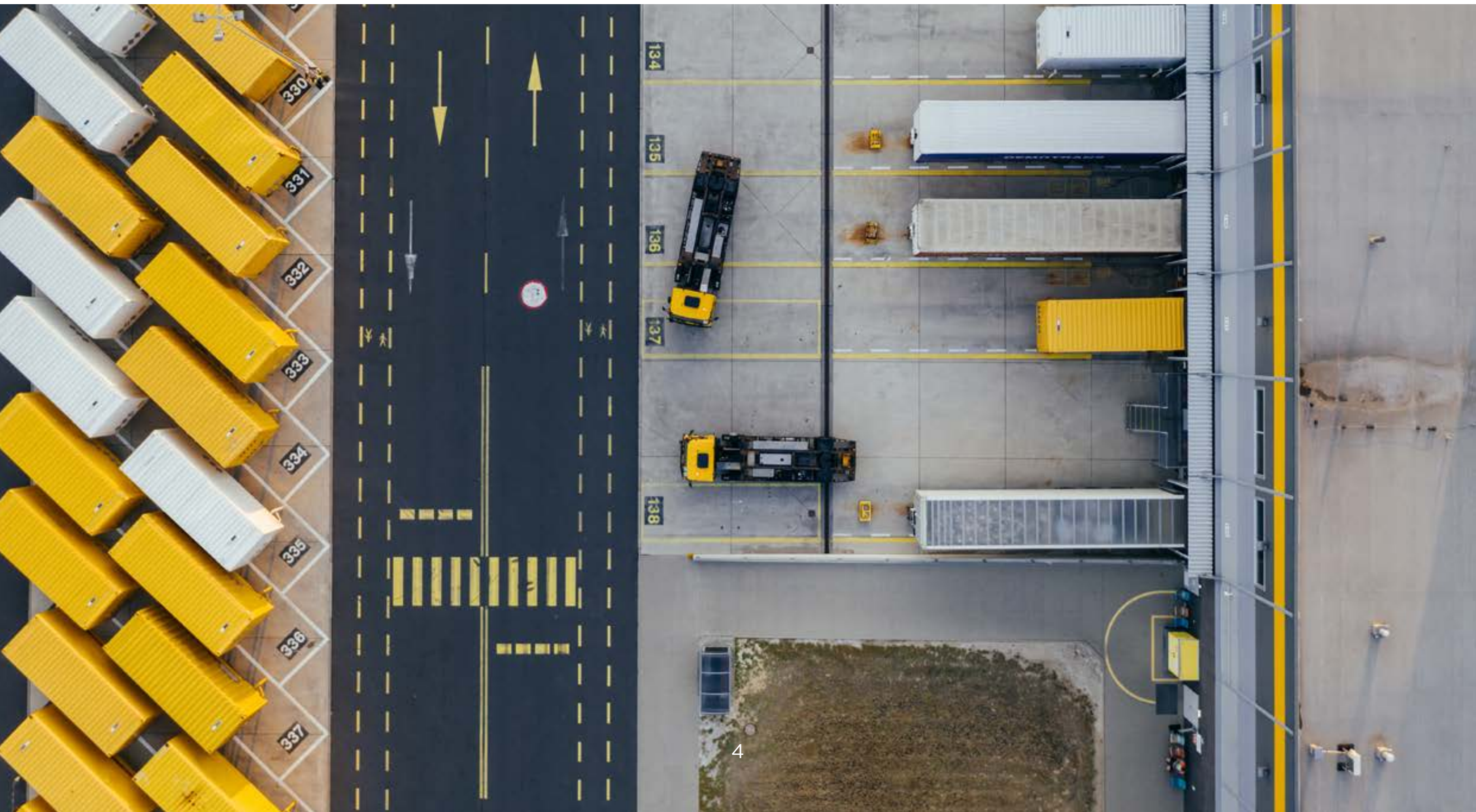
London stands as the outlier in this context, benefiting from swift repricing that has supported investor confidence and market liquidity. Healthy market fundamentals, including an increasing number of inquiries and a limited development pipeline, further enhance investor demand with UK funds and institutions beginning to re-emerge with active buy-side requirements. As a result, the benchmark yield for a prime asset in London experienced a 25bps compression this quarter, settling at 4.75%. Moving forward, we anticipate yields to move in further over the next 12 months.

Eyes on the prize

Interest rates remain a key driver of pricing expectations, and we anticipate further outward yield movements in 14 out of the 16 markets that we cover in this report over the next 12 months. The exceptions are London, as mentioned, and Tokyo, where we expect yields to remain stable.

Stability and growth of income are the most important factors for investment strategies going forward. A soft landing of the global economy remains the baseline, but a consumer-led slowdown provides a heightened risk to the occupational market for logistics, which is inextricably linked to retail sales and global goods trade, both of which are already in recession. In the US for example, net absorption hit a two and a half year low this quarter.

In this context investors should remain focused on the reasons why so many were attracted to the sector in recent years – including the rise of ecommerce, investment in green technologies, and the relocation of major manufacturing firms – all of which will continue to support a growing need for fulfilment centres, distribution hubs, and last-mile delivery facilities in the future. Many markets do not have sufficient supply to accommodate future requirements; with the exception of Shanghai, which has seen significant supply onboarding in recent years, vacancy rate rates are generally low across all markets covered in this report, with Sydney virtually out of free space.



Regional outlook

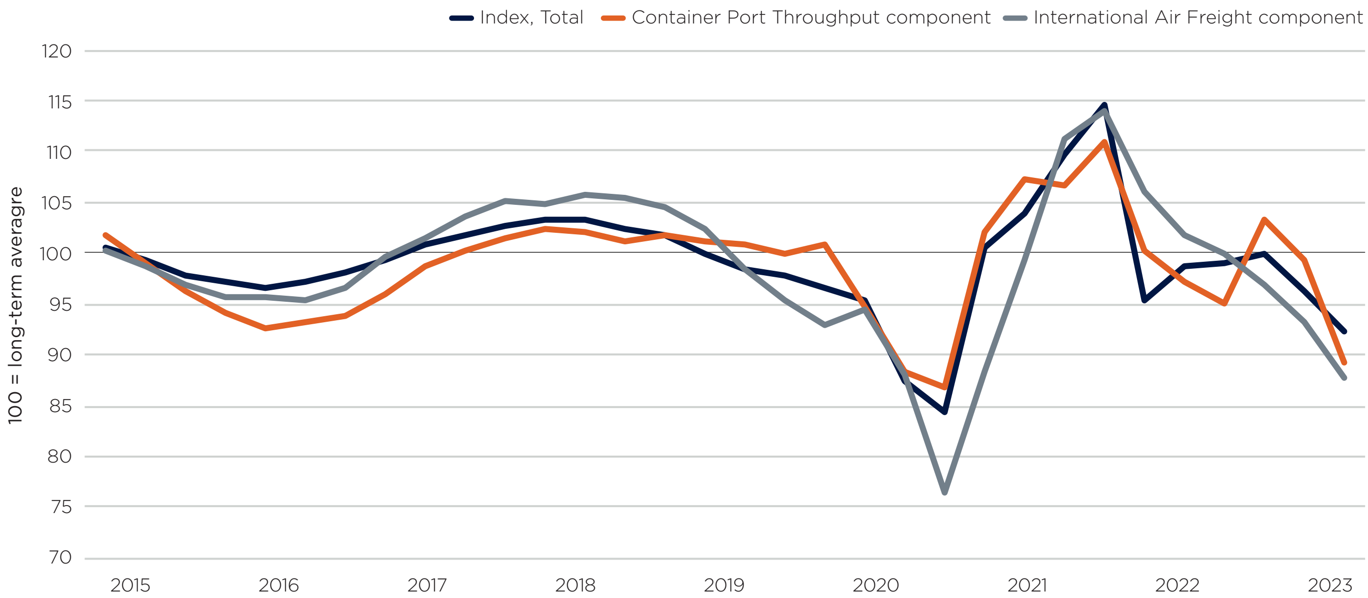
"We continue to expect activity to pick up in the second half of this year, but this may be conditional on further price corrections in the short term"

Europe, Middle East, and Africa (EMEA)

Investment volumes fell by more than 75% in comparison to the same period a year ago, with the quarterly total of US$5.6 billion across the EMEA region representing the lowest since Q3 2016. Differing price expectations between buyers and sellers continue to hinder transactions, especially in the core segment. The strong decline in turnover is also due to the fact that trading of large volume properties and portfolios has declined.

The limited transactional evidence available paints a mixed picture on pricing developments in Q1. Prime yields moved out by 40bps in both Île-de-France and Amsterdam to 4.4%, and by 30bps in Madrid to 4.8%. Cologne held steady at a relatively tight 3.9% following 80bps of outward movement over the course of last year.

WTO Global Goods Trade Barometer index



Source Savills Research using Macrobond

Note The World Trade Organization (WTO) Barometer is a leading indicator of global trade volumes

Meanwhile, the benchmark yield on a prime asset in London actually came in by 25bps to 4.75% in the quarter. More yield compression is expected to follow, with investors returning to the UK following a significant 35% price fall that was grounded more in fear than fundamentals.

In the rest of the region, we continue to expect activity to pick up in the second half of this year, but this may be conditional on further price corrections in the short term, as investors demand higher returns in the current capital market environment.

As a result, we believe that yields will see further softening over the next 12 months across core mainland European markets, as well as Dubai, despite the latter already providing very attractive returns relative to other markets. In the meantime, activity is driven by equity-rich buyers for smaller lot sizes. But specialised institutional investors remain committed to the sector, providing the price is right, as the UK experience shows.

Logistics take-up in the first quarter of the year in Europe and UK was 39% below Q1 2021. However, this is broadly in line with the long term average, and occupational metrics in some key markets point to a quick recovery; requirements in the UK were 74% ahead of Q4 in the first quarter, suggesting take-up will rise during in second half of this year.

Meanwhile, vacancy rates in the region remain low, with the UK at 5.4%, Madrid at 5.7%, and Amsterdam at 6.3%. So with no signs of oversupply in the construction pipeline, vacancy should remain in check and support modest rental growth, particularly for larger assets with strong corporate occupiers, although incentives may increase and lease lengths can get shorter as a response to the normalisation of occupier activity.

> While transaction volumes are sharply down in comparison with the same period last year, this represents a normalisation in activity following a two-year investment boom.

North America

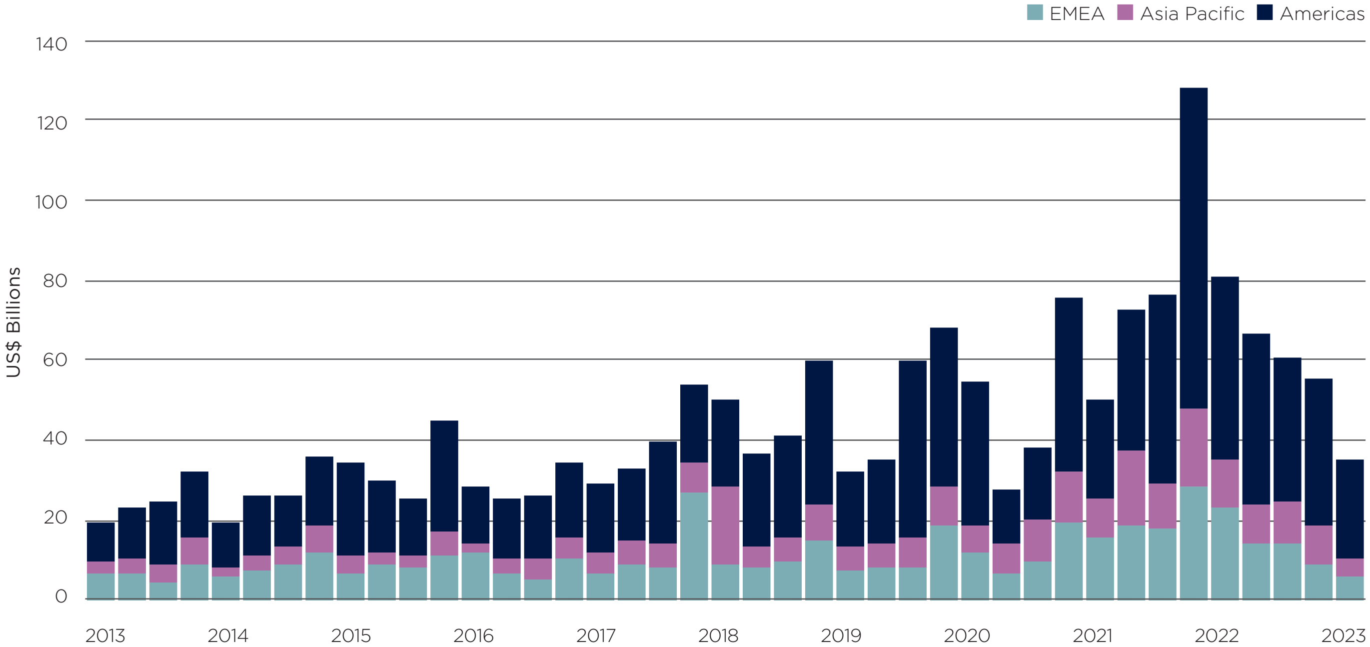
Transactional activity in the US experienced a significant slowdown in the first quarter of 2023, with investment volumes totalling US$18.5 billion. This represented a decline of 54% compared to the record high of over US$40 billion in Q1 2022. But wider context suggests this represented more of a normalisation in activity rather than a collapse; with volumes remaining comfortably above the longer term average.

Yields in the sector are softening nevertheless, with an average prime logistics yield of 4.9% across the four markets monitored in this report. This reflects a 75bps increase quarter-on-quarter, providing a more palatable risk premium of 140bps to US Treasury yields, compared with the 25bps from Q4. The high cost of debt is still putting pressure on cash-on-cash returns however, which averaged just 3.2% in Q1. This discrepancy between prime yields and the cost of debt is expected to support a further adjustment in pricing over the next 12 months to close this gap.

The fear of a recession has become more apparent, impacting occupier demand. Leasing velocity has slowed down relative to the exceptional levels witnessed in the past two years, returning to levels similar to 2018-2019, albeit when market conditions were still considered robust. Meanwhile, although construction starts have declined, there is still a significant amount of space due to complete in the next six to nine months, all with low pre-leasing rates. Vacancy rates are rising as a result, and rental growth has decelerated.

It is however important to emphasise that vacancy rates continue to be low by historical standards, averaging 4.4% across the four markets under consideration. Markets with strong fundamentals like LA (3.2%) and Northern New Jersey (3.1%) remain particularly undersupplied. So although it is unreasonable to assume the double-digit rental growth of the recent past can be sustained, these markets should still experience positive rental growth due to a demand and supply balance that continues to favour landlords.

Global logistics investment volumes



Source Savills Research and MSCI Real Capital Analytics

Asia Pacific

Investors in the logistics sector scaled back their ambition in Asia Pacific in the first quarter of the year. Acquisitions dropped by more than 60% on the year to US$4.8 billion. Two markets seeing the greatest pressure from rising interest rates, South Korea and Australia, experienced the steepest declines in investment volumes, falling by 67% and 74%, respectively. The lack of liquidity in the former is driving a polarisation in investor preferences for the best locations.

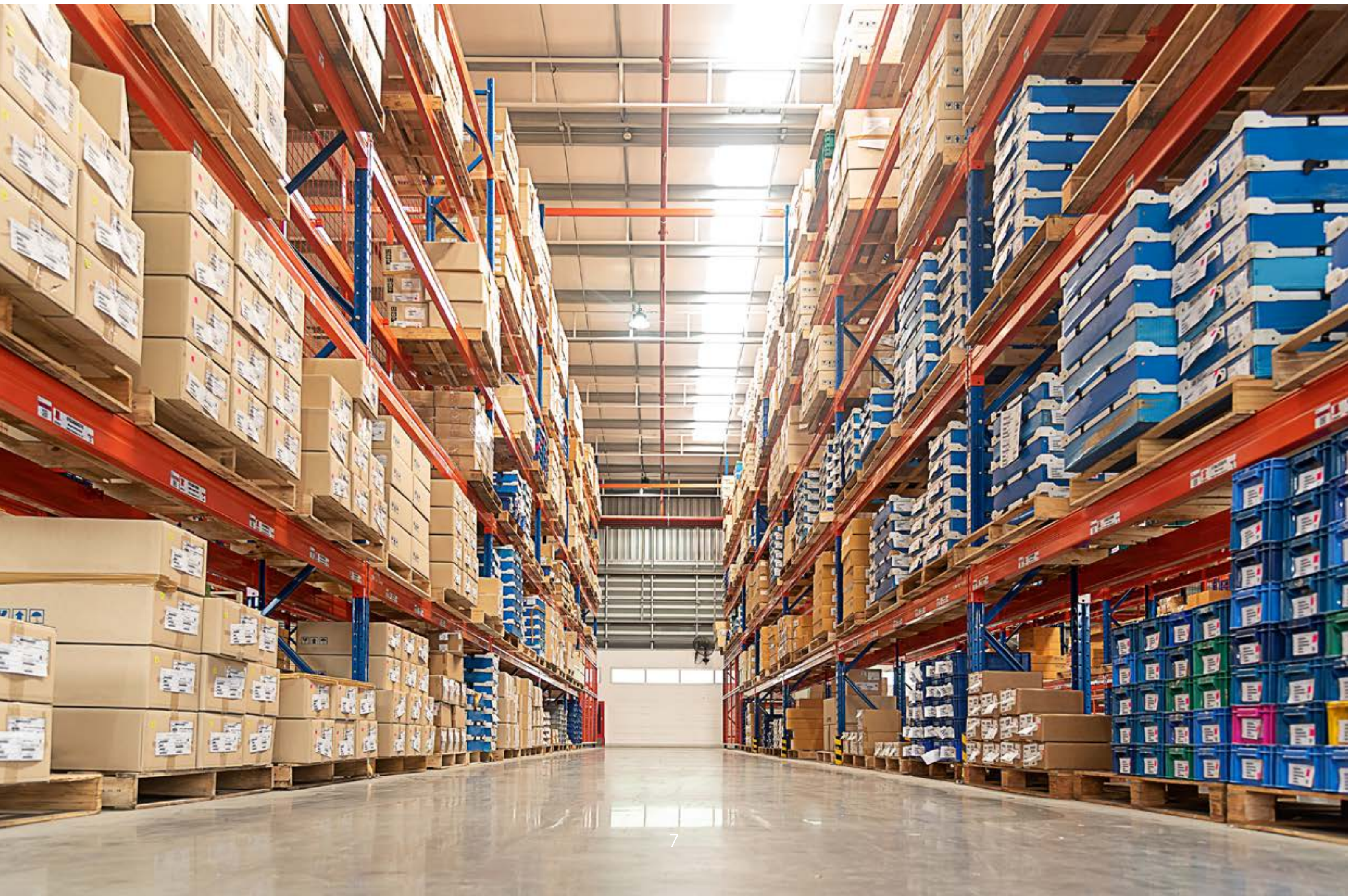
By contrast, Singapore saw investment almost quadruple to over half a billion US dollars in the first quarter, supported by several notable transactions, including the city-state's largest deal in four years.

With the exception of Singapore, where the prime logistics yield is a healthy 7.0%, the average prime yield across the regional markets covered by this report was a much tighter 4.4% in Q1. Pricing corrections have not been as drastic as in Europe and the US which could be a factor holding investors back, particularly in those markets where interest rates have risen the most.

Our outlook for prime yields over the next 12 months is that they will move out further, with the exception of Tokyo. The cost of debt is above 5% in all markets except Tokyo, peaking at 7% in Seoul. Cash-on-cash returns have been squeezed as a result, with a typical debt-financed transaction yielding a paltry 2.8% in Hong Kong and 3.2% in Seoul.

Investors can continue to leverage returns in Singapore and Tokyo; the former due to the high net initial yields on offer (subject to local restrictions on land tenure), and the latter owing to the Bank of Japan's steadfast commitment to retaining an ultra-loose monetary policy. Tokyo also benefits from a typical LTV of 65%, which is also high when benchmarked across regional peers, meaning that investors can expect a healthy 7.8% cash-on-cash return on a prime logistics asset.

The strength of the occupational market varies across the region, depending on the local market dynamics. In Sydney, despite the current economic headwinds, occupiers are still competing hard for space, as there is virtually no availability with a vacancy rate of less than 1%. Rents are being pushed above previous benchmarks as a consequence – with prime net face rents rising by 36.4% over the year in Q1, creating concerns around affordability for occupiers. In Tokyo on the other hand rents declined last year, due to ample new supply coming onto the market, which pushed up the vacancy rate. Excess supply is also a concern in Hong Kong and Seoul, with rents in the former expected to remain broadly stable this year as a result. Investors are also re-examining asset values in Shanghai due to rising supply.



Market view

Marcus de Minckwitz, Head of EMEA Industrial and Logistics

It has been a truly remarkable twelve months. The logistics market has been riding a wave like no other for over ten years in Europe, driven by structural changes and the rise of e-commerce. Initially, Covid-19 was a catalyst for this growth as remote work and disrupted supply chains underpinned surging demand for logistics space. Investors followed suit and demand reached unprecedented levels. Issues in other sectors, namely offices, only compounded this sense of fervour. Yields compressed fast to historic lows, against a backdrop of cheap credit.

However, Covid has given way to other unforeseen disruptions, which have had the opposite effect. Occupier demand has returned to pre-pandemic levels more quickly than expected, leading to increased vacancy rates in certain markets. Rapidly rising inflation and interest rate hikes have further impacted the market. The war in Ukraine exacerbated the situation by increasing construction costs and reducing liquidity. It was described as a perfect storm.

The biggest impact on capital markets through the past year has been the rapid increase in interest rates. Yields had been pushed to such low levels that the numbers simply didn't work in this new environment. But the market adjusted quickly – asset values dropped by up to 30% in some geographies – driven by a real acceptance of the shift in the macro environment. It could also be argued that there was an over-reaction to the first negative news to impact the logistics market for a long time. As a result, we have seen sentiment bounce back to its highest point in twelve months.

Looking ahead, as inflation peaks and rates stabilise, this should filter through into pricing on the upside. Focus is shifting towards the occupational markets, which are experiencing a slowdown from record highs. Vacancy rates are rising and will continue to do so, although we have reduced supply coming through the pipeline. And the impact of nearshoring and increased demand in other segments beyond e-commerce is becoming evident. Stock selection is more critical than ever and consideration of ESG factors is crucial.

We cannot escape the uncertainty that has crept into all markets and the negative impact this has on confidence. As the industry navigates the inflationary environment, there may be a challenging period ahead for investors. However, the strong underlying fundamentals that have underpinned the market over the past decade remain intact and will continue to do so for a long time.

> "...in the first quarter of 2023 we have seen sentiment bounce back..."

Global prime logistics yields, Q1 2023 (as at end-March)

City	Prime net initial yield	Outlook for yields, next 12 months	Typical LTV	Total cost of debt	Cash-on-cash yield	Risk premium
Los Angeles	4.50%	↑	60.0%	6.00%	2.25%	1.02%
Hong Kong	3.70%	↑	40.0%	5.00%	2.83%	0.52%
Northern New Jersey	4.75%	↑	60.0%	6.00%	2.88%	1.27%
Seoul Metropolitan Area	5.30%	↑	55.0%	7.00%	3.22%	1.96%
Cologne	3.90%	↑	55.0%	4.38%	3.31%	1.59%
Houston	5.00%	↑	60.0%	6.00%	3.50%	1.52%
London	4.75%	↓	55.0%	5.56%	3.76%	1.24%
Sydney	4.75%	↑	50.0%	5.56%	3.94%	1.61%
Chicago	5.25%	↑	60.0%	6.00%	4.13%	1.77%
Île-de-France	4.40%	↑	55.0%	4.38%	4.42%	1.60%
Shanghai	4.75%	↑	40.0%	5.10%	4.52%	1.90%
Amsterdam	4.40%	↑	55.0%	4.28%	4.55%	1.73%
Madrid	4.80%	↑	55.0%	4.78%	4.82%	1.49%
Dubai	7.38%	↔	50.0%	8.00%	6.76%	3.90%
Tokyo	3.30%	↔	65.0%	0.90%	7.76%	2.89%
Singapore	7.00%	↑	50.0%	5.00%	9.00%	4.06%

Source Savills Research and Macrobond

Note: Yields may be different to quoted values in markets where the convention is to use a gross rather than net value. Values based on end-of-quarter data. Yields in Singapore reflect the domestic land tenure system, where the longest lease for new industrial properties is 30 years. See Methodology for details.

Key transactions

TOKYO

Building: ESR Ichikawa Distribution Centre
Tenant: Softbank, Sagawa Global Logistics
Lease length (WAULT): Unknown
Area: 2.16 million sq ft
Price/NIY: ¥34 billion (US$267 million) / Unknown
Vendor: Unknown
Vendor nationality: Unknown
Purchaser: M&G Real Estate Asia
Purchaser nationality: UK
Other comments: After first investing in May 2021, M&G have increased their stake in the asset from 25% to over 58%, valuing the property at ¥102 billion (US$802 million). The terms of the purchase represent a 7-8% decline in US$ valuation of the property since the initial investment. The facility meets the highest sustainability standards in Japan, and now represents the largest logistics asset in M&G's Asia core property strategy fund.

LOS ANGELES

Building: 10545 Production Avenue
Tenant: Tireco
Lease length (WAULT): Unknown
Area: 1.1 million sq ft
Price/NIY: US$365 million / 5.0%
Vendor: Tireco
Vendor nationality: US
Purchaser: Rexford Industrial Realty
Purchaser nationality: US
Other comments: Sale-leaseback deal represents one of the largest transactions to complete in the quarter, reflecting continued interest in logistics assets in the Southern California region, within close proximity to major West Coast ports.

UK

Building: Tritax Big Box UK Portfolio
Tenant: DHL, Matalan, Cerealto
Lease length (WAULT): 9.2 years
Area: 1.4 million sq ft
Price/NIY: £125 million (US$151 million) / 4.6%
Vendor: Tritax
Vendor nationality: UK
Purchaser: Brookfield and Copley Point Capital
Purchaser nationality: Canada/UK
Other comments: Portfolio includes three Grade A assets located in Skelmersdale, Knowsley, and Worksop. Pricing reflects the stabilisation of the UK logistics market following prices falls in 2022.

Methodology

Net initial yields are estimated by local Savills experts to represent the achievable yield, including transaction and non-recoverable costs, on a hypothetical grade A building big-box logistics facility located in a prime location, fully let to a single good profile tenant on a 10-15 year open market lease. The typical LTV and cost of debt represent the anticipated competitive lending terms available in each market. Cash-on-cash returns illustrate the initial yield on equity, assuming the aforementioned LTV and debt costs. The risk premium is calculated by subtracting the end-of-period domestic ten-year government bond yield (as a proxy for the relevant risk free rate of return) from the net initial yield. Data is end-of-quarter values.

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World Research

Eri Mitsostergiou
Director
World Research
+30 69 4650 0104
EMitso@savills.com

Oliver Salmon
Global Capital Markets
World Research
+44 (0) 20 7535 2984
oliver.salmon@savills.com

Rasheed Hassan
Global Capital Markets
Head of Global Cross Border Investment
+44 (0) 20 7409 8836
rhassan@savills.com

Marcus de Minckwitz
Head of EMEA Industrial and Logistics
Regional Investment Advisory EMEA
+44 (0) 20 7409 8755
MdeMinckwitz@savills.com