European Commercial – December 2022

SPOTLIGHT
Savills Research

European Logistics Outlook

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● Occupational ● Investment ● Outlook

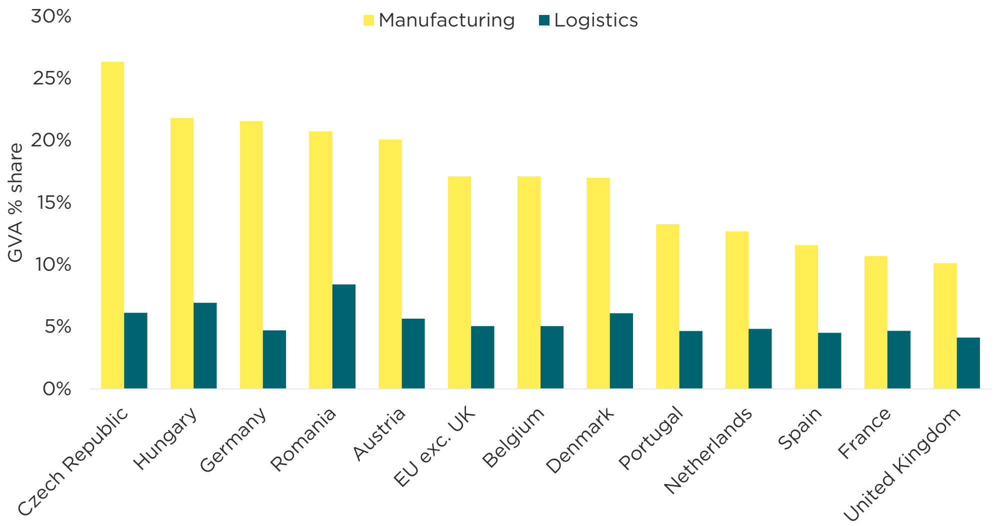
A chill in Europe's economy

The European economy entered 2022 buoyed by unwinding pandemic-era savings, but the second half of the year saw headwinds intensify, with economic turmoil forecast to persist into 2023. Supply chain disruptions from Covid continue to reverberate throughout the global economy. Meanwhile, the geopolitical instability that has driven energy and commodity price growth has worsened as the year has progressed. In September, Russian state-owned energy company Gazprom announced that its exports to the non-Commonwealth of Independent States (e.g., Europe) had fallen by 38.8% y/y, which has applied upward pressure on commodity prices.

The ensuing supply shock drove up energy prices which were one of the primary drivers of the high rates of inflation that have dominated public discourse and monetary policy this year. Higher energy prices have inevitably eroded household disposable incomes, which are forecast to decline by 0.7% y/y in 2022 and 2023 in the EU, and weighed on production, in particular manufacturing output. Declines in disposable income typically depress demand, which reduced economic activity in Q3 and led to negative revisions to economic growth forecasts, with many economies now expected to fall into recession in the final quarter of 2022.

We expect that the logistics sectors in economies with a heavier reliance on manufacturing may be more sensitive to this downturn as local logistics occupiers see less demand for their services. As such, we have analysed the Gross Value Added (GVA) by the manufacturing sectors of key European markets. From our analysis, the economies of Germany and many of the Central and Eastern Europe countries are most vulnerable to this shift in economic conditions as we move into the final quarter of the year.

Chart 1: Manufacturing and Logistics GVA



Source: Oxford Economics

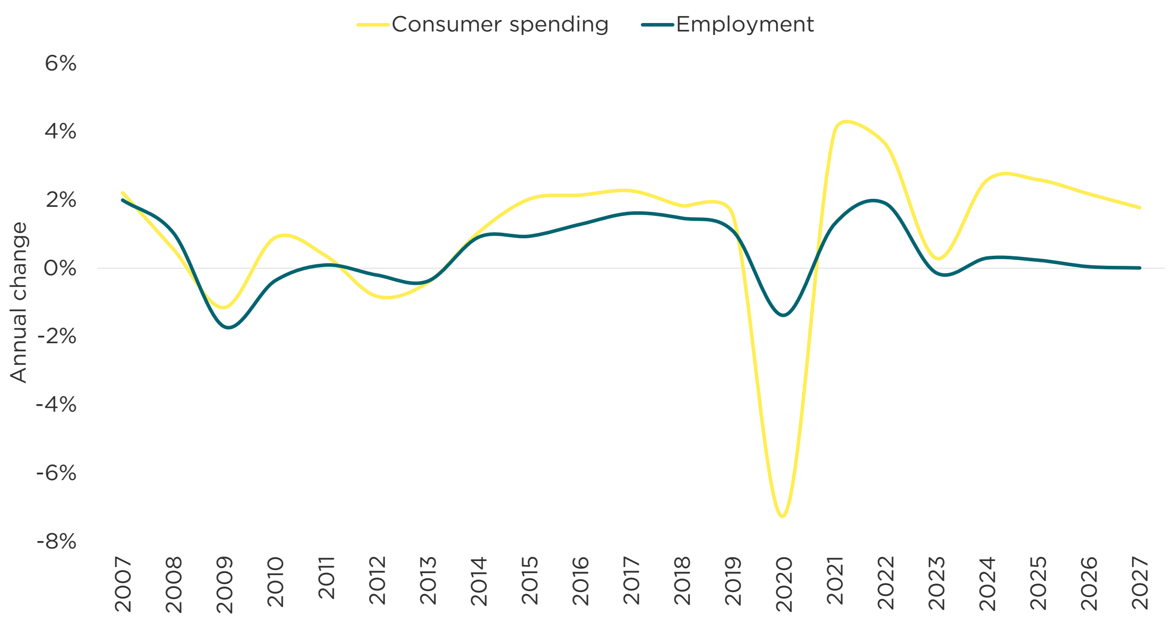
> “Furthermore, despite disposable incomes declining, consumer spending growth, which is expected to slow, will remain positive, falling from 3.6% in 2022 to 0.3% in 2023 before growing by 2.6% over the following two years.”

Indeed, even as consumer demand declines, occupiers also face rising production costs from higher energy prices, putting further pressure on the viability of their business models. To offset this the EU responded to energy supply pressures with a coordinated approach to reducing demand and shoring up supplies for the winter. These measures have been broadly successful with gas storage surpassing the targeted rate of 80% capacity to stand at 95% in November.

While negative economic sentiment has risen significantly as the year progressed it is worth considering the overall economic outlook as it stands. Oxford Economics' forecasts for 2023 show negative or slowing growth in most indicators but expect a recovery in the European economy beginning in 2024. Furthermore, despite disposable incomes declining, consumer spending growth, which is expected to slow, will remain positive, falling from 3.6% in 2022 to 0.3% in 2023 before growing by 2.6% over the following two years.

Consumer spending growth is a strong indicator of the quantity of goods moving through the economy, which stimulates demand for warehousing to facilitate logistics. In contrast, during the GFC, consumer spending fell by 1.1% in 2009 and 0.8% in 2012.

Chart 2: Consumer spending and employment growth forecasts



Source: Oxford Economics

Shivers reach the occupier market

European logistics take-up reached nearly 29m sq m in the first three quarters of 2022, an increase of 2% on 2021's record and 28% higher than the period's five-year average. Romania (87%), Ireland (37%), and Hungary (15%) saw the highest growth in take-up in the first three quarters compared to the same period last year, while declines were sharpest in Denmark (-40%), Spain, reflecting Madrid and Barcelona (-15%), and France (-14%).

Like the rest of the commercial real estate sector, the logistics market has not escaped the impact of the economic turmoil, which is evident in the slowdown recorded last quarter: take-up across Europe totalled 8m sq m, a decline of 22% q/q and 13% y/y. Last quarter's take-up is in line with the five-year quarterly average for Q3, but represents a decline of 8% and 13% relative to 2020 and 2021, respectively. Indeed, the record-breaking YTD take-up in Q3 2022 was almost entirely a result of the exceptional take-up numbers from H1. This slowdown, coupled with a record Q4 last year, makes it unlikely that take-up will exceed 2021's series high.

Declines in take-up compared to Q3 2021 were sharpest in Denmark (-71%), France (-41%), and the UK (-39%). Whilst growth was strongest in Romania (175%), Ireland (107%), and Hungary (52%) over the period.

If we assume take-up in Q4 stays level with the long-term Q4 average of 8.6m sq m, we would expect overall annual take-up in 2022 to reach 37m sq m, a decline of 7% y/y. This would be 18% higher than the five-year average, but the final figure is likely to fall short of this level given the deteriorating macroeconomic situation in Q4. One mitigating factor has been a dramatic shift towards reshoring/nearshoring in the last year. Many occupiers have already sought to secure their supply chains by reshoring and stocking up on inventory. Survey data suggests that this trend will continue, with many occupiers looking for more space to insulate their positions against supply chain disruption.

Chart 3: European take-up

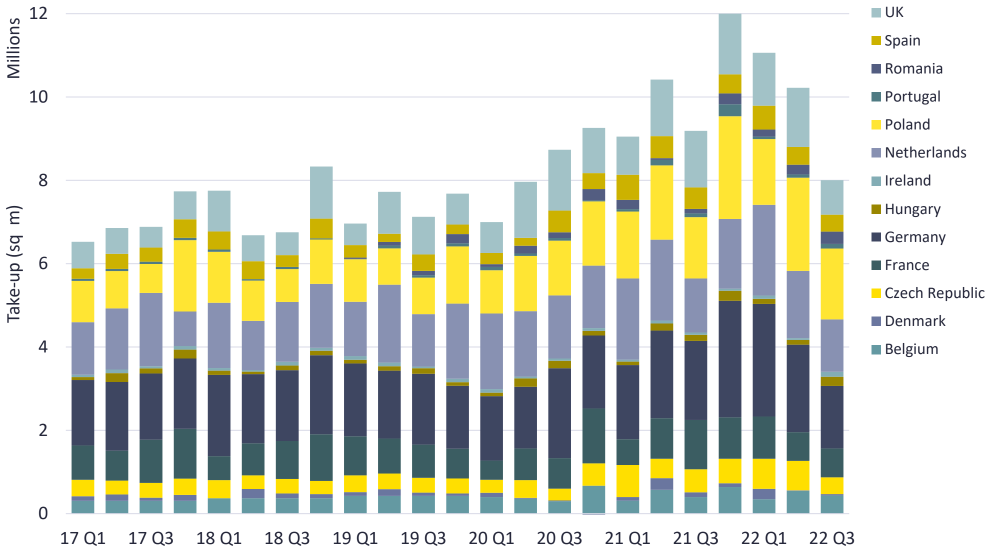
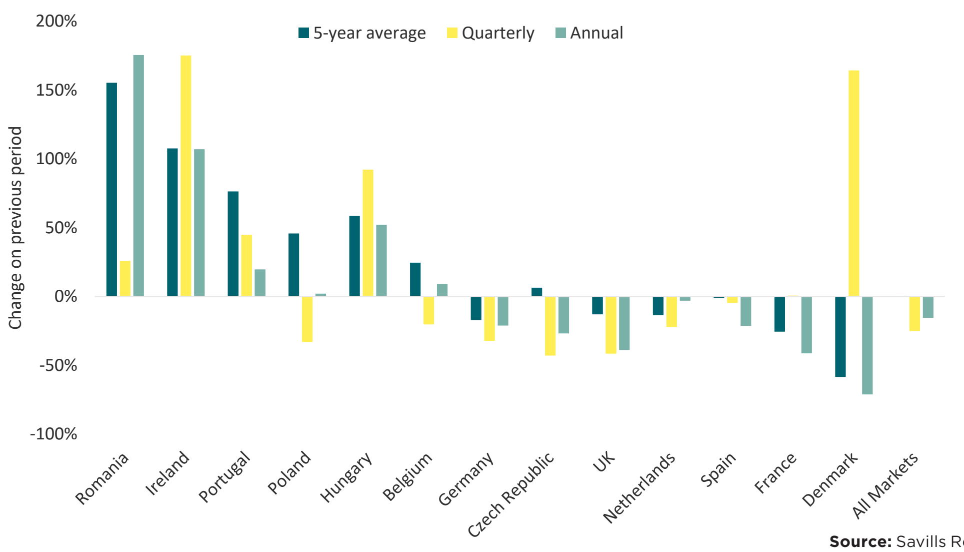


Chart 4: Take-up – Q3 2022 vs quarterly/annual/five-year average



Source: Savills Research

Supply constraints expected to support rental levels

Record take-up in H1 fed through into strong absorption, pushing down vacancy rates across Europe. Vacancy rates in major European cities have fallen by an average of 80bps since the start of the year and remain at record-breaking lows. The average European logistics vacancy rate in Q3 2022 was circa 3%.

In the last four quarters, vacancy rates have tightened to 6.4% in Madrid (-300bps), 4.0% in Romania (-250bps), and 2.6% in the Netherlands in Q3 2022. Indeed, vacancy tightened across Europe, with the exception of two markets where vacancy rates increased: with the vacancy rate rising to 4.9% in Budapest (+130bps) and rebounding from a series low in Dublin to 1.4% (+80bps).

As vacancy has tightened in recent years, competition for limited stock has intensified amongst occupiers allowing landlords to command higher rents for their properties. Across Europe, prime rents grew by 10.7% between Q3 2021 and Q3 2022. Annual growth in prime rents was highest in Paris (38%) and Prague (36%). Rental growth slowed in London (+2.0%) and was flat in Copenhagen, Lisbon and Madrid.

While leasing activity has shown signs of slowing, the historically low levels of available space are likely to continue to support rental growth in the short term. In the absence of a pre-existing oversupply of stock, there is room for an increase in occupiers handing back space due to a stronger-than-forecast downturn without leading to a sharp correction in rents. As our research in the UK shows, transport costs account for a significantly higher share of logistics occupiers operating costs than rent. This suggests that well-located prime stock will remain in high demand, particularly amongst occupiers facing rising fuel costs, seeking to increase fuel efficiencies by reducing average journey distance.

Looking further ahead, rising building costs and market uncertainty will likely dampen construction activity in already constrained construction pipelines. In this scenario, as economic turmoil abates and the European economy returns to growth, the pre-existing supply issues will have intensified, driving sharp rental growth as occupiers look to expand their footprints in response to rising demand.

Chart 5: European vacancy rates

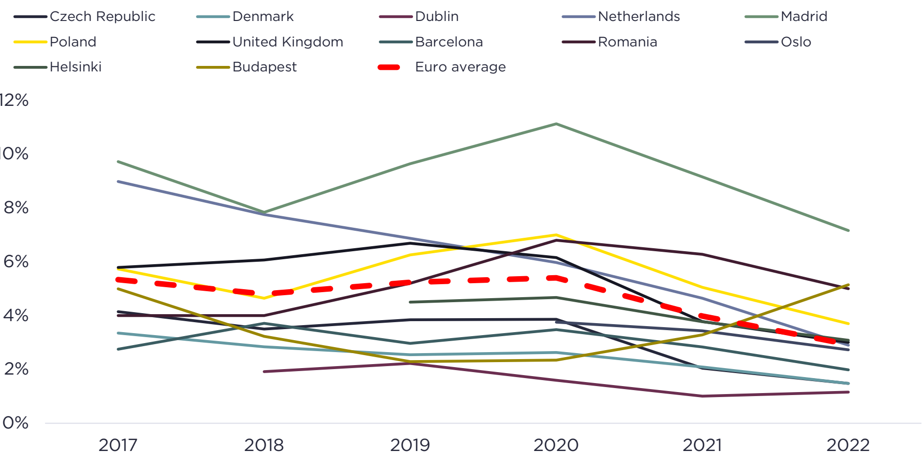
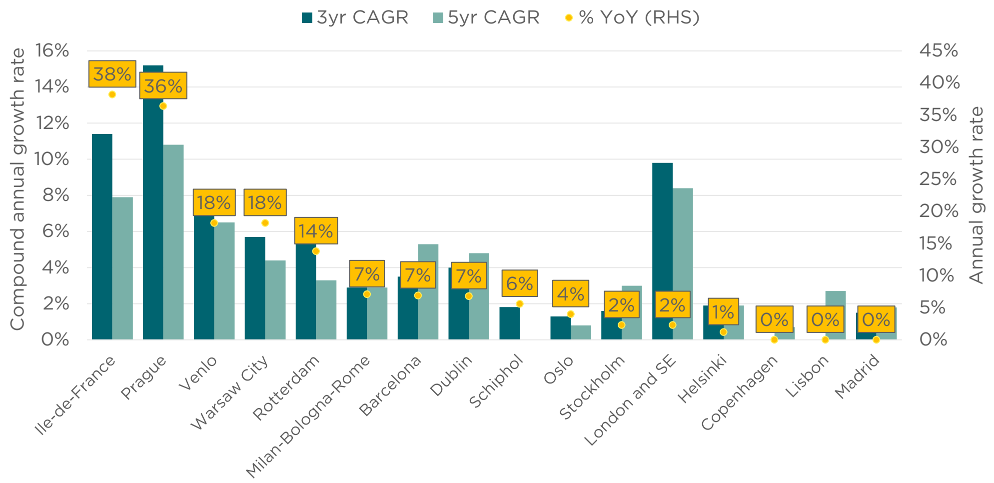


Chart 6: Rental Growth Rates



Source: Savills

Price expectation disparities cools investment activity

Investment flows into industrial assets continue to reflect the strong performance in the occupational market in recent years. Investment volumes totalled €42bn in Europe in the first three quarters of 2022, an increase of 2% on last year, which saw a series high for the period, and 50% above the five-year average. Investment volumes in Portugal (595%), Belgium (124%), and Italy (93%) outperformed their five-year averages by the widest margin.

In line with trends in take-up, H1 investment volumes were the primary driver of this year's strong performance. Investment volumes across Europe slowed in Q3, with a total investment volume of €9.7bn, falling by 4% q/q and 16% y/y. That said, investment volumes in Q3 2022 are strong relative to their pre-pandemic levels and were 28% higher than the Q3 five-year average.

Portugal had a record quarter for investment as two large portfolios traded, leading to a significant uplift in investment volumes in Q3 2022 compared to the same period last year (+1513%). France (+117%) and Spain (+76%) also experienced strong growth, while momentum slowed in the Czech Republic and Hungary with no transactions in Q3, while declines were recorded in Romania (-69%), Netherlands (-66%), and the UK (-46%).

The third quarter of the year saw a decline in both the supply of assets coming to market and the number of bidders in the deals process. The dramatic shift in monetary policy from the FED, BOE and, to a lesser degree, the ECB is at the heart of this change. After several years of accommodative monetary policy with deposit rates close to or below zero, central banks have reacted to sharp inflation by swiftly tightening their monetary policy. After almost a decade of cheap capital, rising interest rates have driven up borrowing costs, leaving the commercial real estate sector to adjust to the growing costs of debt.

Chart 7: European investment volumes

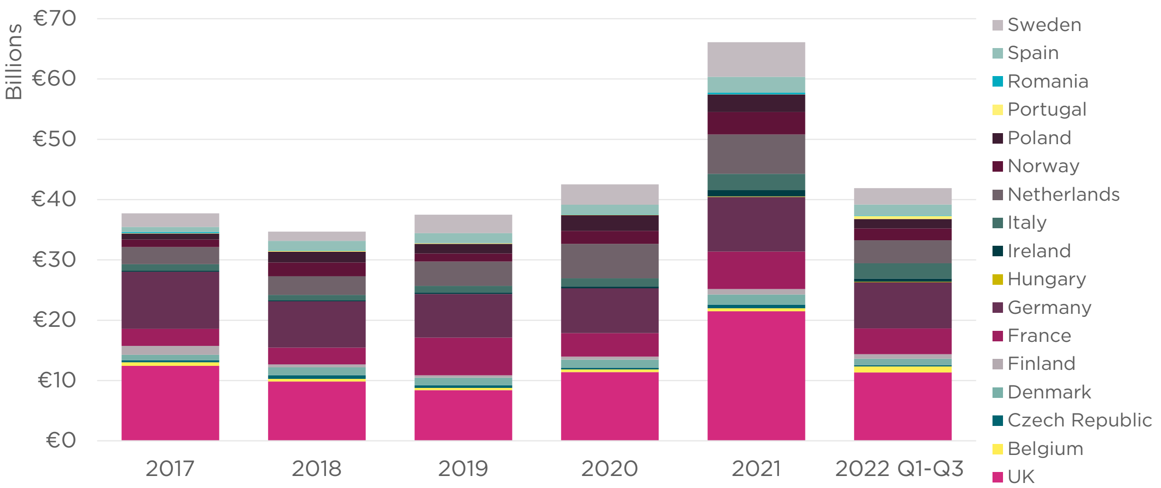
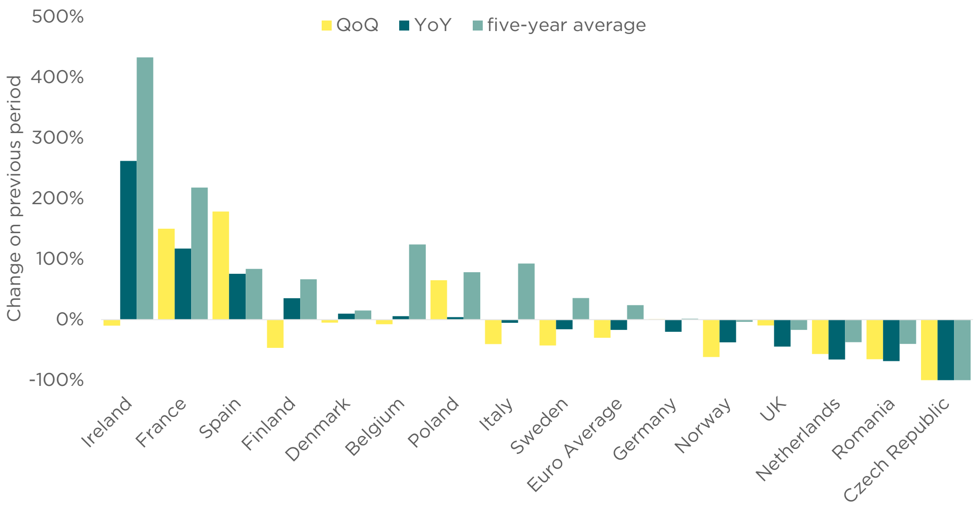


Chart 8: Investment volume growth – Quarterly/Annual/Five-year Average



Source: Savills

> “While leasing activity has shown signs of slowing, the historically low levels of available space are likely to continue to support rental growth in the short term.”

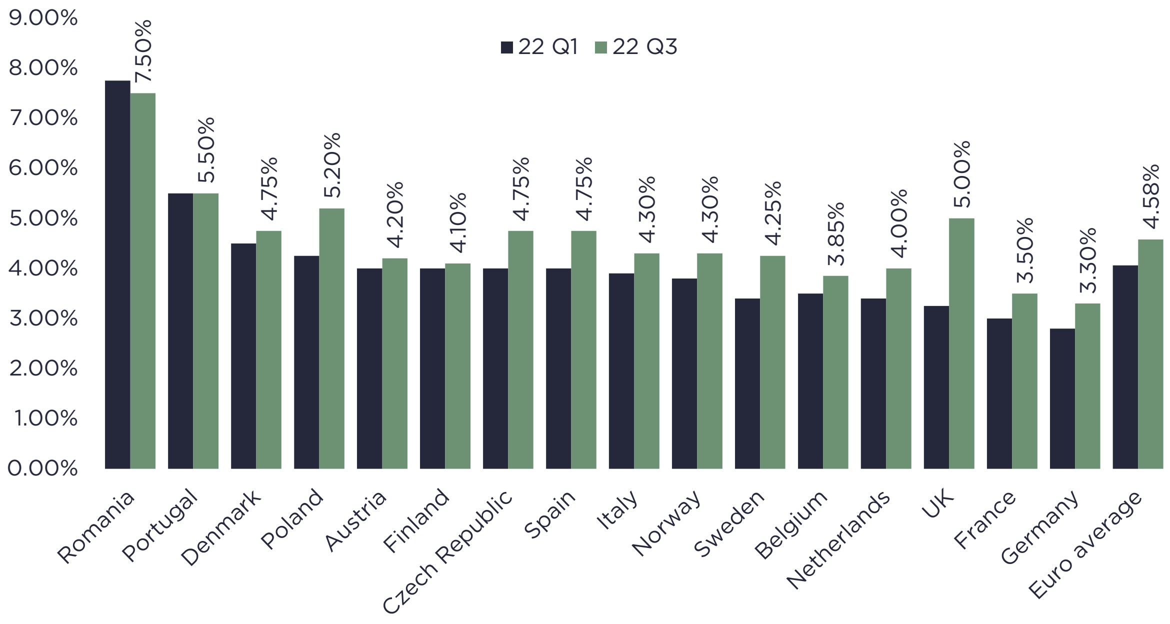
The change in interest rates has led to a disconnect between buyers and sellers. Many leveraged buyers are either unwilling or unable to close deals at levels that meet the seller's expectations. Spreads between prime and secondary yields are now increasing with the number of buyers able or willing to meet vendor expectations for prime assets falling. With debt-financed buyers priced out of the market, cash buyers may be able to pursue opportunities where they present themselves, but with yields rising in Q3, we would expect those who can adopt a wait-and-see approach in the short term. We have entered a period of price discovery, but because the flow of deals remains muted due to the spread between expectations of buyers and sellers, transactional evidence for ‘new’ market prices remains sparse.

Anecdotally, vendors have tended to withdraw from the market entirely rather than transacting at a discount, and the deals that have closed suggest price chips ranging from 10-20%. However, as we enter the final quarter of the year, the picture may become clearer, as some sellers might be forced to transact to close their books/funds.

Prime yields edged up in Q3 2022, with exception of Romania (tightening) and Portugal (no change). Across Europe, the average prime logistics yield rose to 4.26%, an increase of 20bps since the start of the year. Although yields are softening across Europe, they remain well below the those recorded pre-pandemic; 5.57% (Q3'18) and 5.04% (Q3'19). This may reflect the sector's transition from an alternative to a Core/Core+ asset in the eyes of many investors.

Prime yields moved out by 175 bps in the UK (5.00%), 95bps in Poland (5.2%), 75 bps in the Czech Republic (4.75%), and 75bps in Spain (4.75%) over the last two quarters.

Chart 9: European logistics yields (%)



Source: Savills Research

A gloomy outlook but a well positioned sector

All of this raises the question: Will slowing momentum from an occupational standpoint continue towards the year's end, and for how long? On the one hand, many occupiers face increasing costs (e.g., energy and labour) and lower demand, and may have to downsize or hand back space. On the other hand, occupiers are still seeking more space to secure their supply chains and facilitate expanding inventories.

This trend is evident in the value of European inventory levels, which reached €75bn in Q2 2022, their highest point in over a decade and almost double the five-year quarterly average. Rising inventory levels further reinforce the data we have seen from occupier surveys pointing towards a move away from the inventory light 'just-in-time' model and towards a 'just-in-case' model, which will require occupiers to maintain or increase their warehousing footprints.

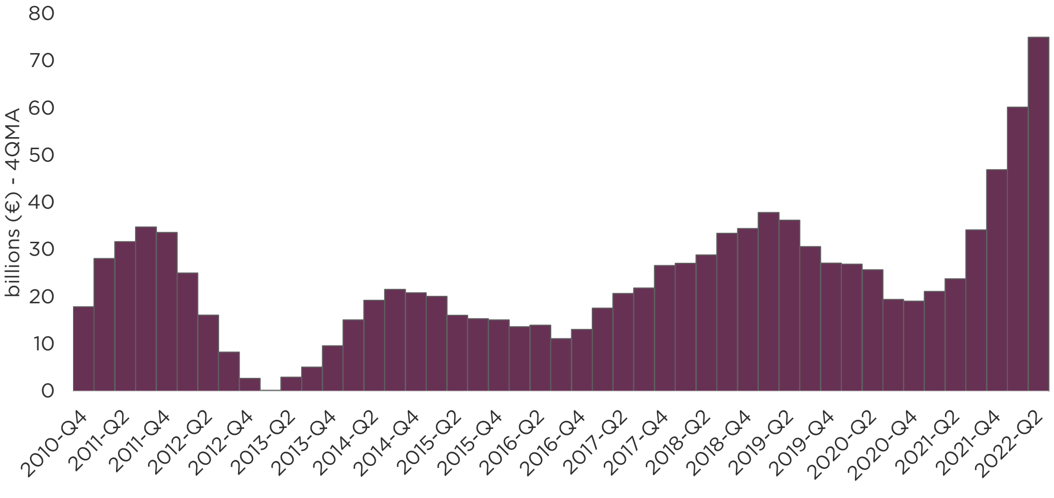
The supply chain disruption that emerged during the pandemic drove the shift to a 'just-in-case' model. According to the Federal Reserve Bank of New York's, Global Supply Chain Pressure Index disruption peaked in December 2021 at 4.3 standard deviations from its average and has since declined to 1.0 standard deviation. A lower standard deviation from the mean suggests global supply chain pressure may be normalizing. Similarly, freight costs which rose dramatically during the pandemic continued to move back towards their long-run average in November 2022 and are now 73% lower than their peak in September 2021. While this may help ease inflation as transport costs fall, it will potentially reduce demand for logistics space over time as occupiers adjust to shorter lead times on goods. However, the lessons occupiers have learned from the last two years are likely to coalesce in a structural shift in the market. The next major disruption to global supply chains will likely be as unpredictable as the last, with many economists predicting a period of de-globalisation and further disruption to trade. Indeed, as the cost of living rises, it is increasingly likely we will see disruption to trade in the form of strike action stemming form labour disputes.

While declines in trade disruption are positive for consumers, they may also reflect declines in trade volumes in the latter half of 2022. The World Trade Organisation expects world trade to lose momentum in H2 2022 and remain muted into 2023 in response to the various shocks affecting the global economy. Forecasts show global merchandise trade will grow by 3.0% y/y in 2022 before declining by 1.0% y/y in 2023 - a sharp downward revision on the growth of 3.4% previously forecast. Europe looks particularly vulnerable: the Tradeshift Index of Global Trade Health shows that trade transaction volumes in Europe fell three times faster than that of the US as energy costs weighed on demand. Slowing trade may reduce occupational demand in the logistics sector as fewer goods move through the economy.

Another trend that drove more intensive use of warehouse space during the pandemic was an acceleration of the shift towards online retail. Growth in online retail will likely face stronger headwinds in 2023, with consumption growth forecast to slow and retail sales expected to decline. Indeed, while Forrester forecasted online retail sales compound annual growth of 12.7% between 2020 and 2025, the expansion is unlikely to continue at this rate, given developments in the economy in the last year. That said, Statista's timelier forecast in 2022, which accounts for the fallout from the Russian invasion of Ukraine, expects compound annual revenue growth of 13% between 2022 and 2027, with annual growth of 30% in 2023 after a dip in 2022. Notably, inflation will have played a part here, driving up the nominal revenue of goods sold.

Much now depends on the trajectory of inflation and the success of central banks in quenching it. Some analysts are now predicting that inflation has peaked, certainly in the US, stock markets rallied in November as inflation slowed more than initially forecast. Peaking inflation would suggest that central banks could start to cut interest rates, although this is less likely until the full impact of rate rises has taken place. However, cuts to interest rates would lower the cost of debt and disincentivise saving, allowing households and businesses to increase their consumption and investment. Higher economic activity would increase the flow of goods through the economy, easing pressure on firms struggling to cover their debt costs. The net result would be higher demand in the occupational market and healthier levels of investment activity.

Chart 10: European inventory levels



Source: Savills

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