Taking Stock: Capital Markets Quarterly Logistics Q2 2023

Global outlook

While the US$41.6 billion of investment in the global logistics sector was around 41% down on the year, it was nearly 10% above the equivalent Q2 level in 2019. Investors remain bullish on the long-term prospects for the sector, suggesting bust will not follow boom in the next 12 months

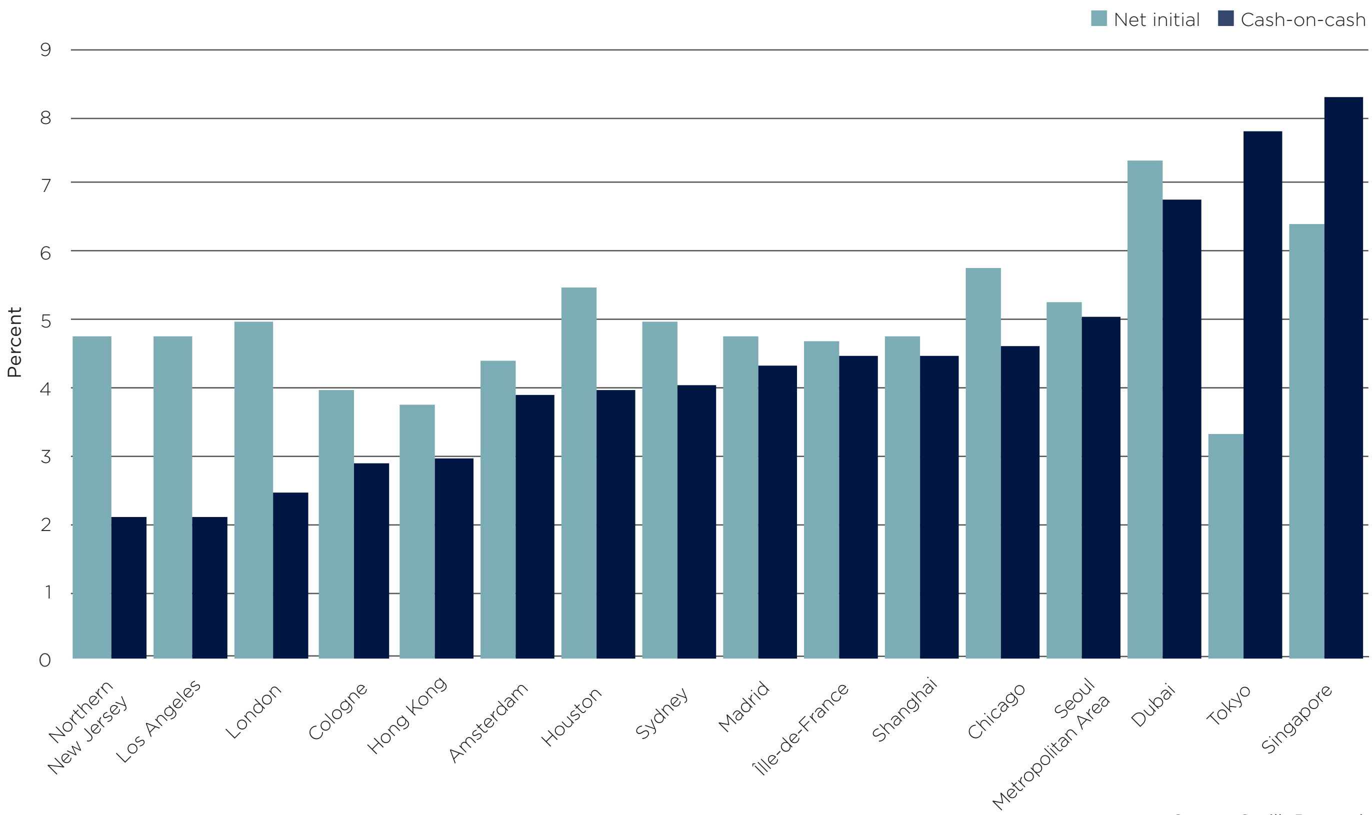
Many metrics across both capital and occupational markets are broadly comparable to pre-Covid levels, suggesting a normalisation in activity in the logistics sector.

Benchmark prime yields rose again this quarter in Los Angeles, Chicago, and Houston in the US, Hong Kong and Sydney in Asia Pacific, and London, Cologne, and the Île-de-France region in Europe. However, there is a sense that conditions are stabilising in many markets, particularly in the US.

Investors have not wavered in their conviction for logistics through this down cycle, but have rather chosen to sit out the volatility. The tide is beginning to turn. A yield of around 5% in the US, Australia, and UK is beginning to look attractive again, given prospects for more stability in interest rates over the coming 12 months and continued upward pressure on rents.

Indeed, as evidence of this bottoming out in the cycle, interspersed through the overall decline in investment volumes this quarter were several major portfolio deals involving some of the largest asset managers in the world. This should help act as a catalyst for more activity in the second half of the year; where the big players go, others tend to follow.

Prime logistics yields, Q2 2023 (as at end-June)



Source: Savills Research

Citi Global Economic Surprise Index

Source: Savills Research using Macrobond. The index compares actual economic data with consensus forecasts, with positive values indicating positive surprises in the data.

Groundhog day

Inflation has peaked, and interest rates will soon reach a crescendo.

Sound familiar? That's because there is a sense of déjà vu in the economic backdrop; since the beginning of this year, the narrative underpinning the global economic outlook has remained broadly consistent (notwithstanding a mini banking crisis in the US). Only the dates have changed. This is weighing on sentiment across real estate markets; investing in illiquid asset classes requires a level of conviction in the future that simply many are struggling with in the current environment. It's no wonder that many investors are choosing instead to sit on their hands.

A paradox exists in the global economy which is making economists sound even more enigmatic than usual: good news is bad news, and bad news is good news. Economic growth has proven to be resilient this year, and incoming data has consistently beat expectations. But this is supporting 'sticky' inflation, forcing central banks to ratchet up interest rates in response. Expectations of the terminal rate have risen too, such that we are no closer to the peak than we were at the beginning of the year.

Slow burn downturn

An economic outlook that closely resembles what was expected at the beginning of the year implies that recession calls have been pushed back rather than removed completely. There remains an expectation, or indeed a conviction, that the rapid tightening of monetary policy over the last 18 months will have consequences. Better growth now merely delays the pain. Slower growth is a pre-requisite for inflation to return to target, so central banks will continue to push hard, even at the risk of causing a more severe downturn.

Indeed, the evidence would suggest that the drivers of economic resilience are beginning to roll over as we enter the second half of the year, meaning the slowdown expected at the beginning of the year was merely delayed.

Tighter credit conditions are feeding into interest rate sensitive sectors, such as housing. PMI activity data is slipping from recent highs, even in the services sector. In the US, weaker job growth and falling vacancies are starting to relieve some tension in labour markets and ease the upward pressure on wages. The euro area is already in recession after two consecutive quarters of negative growth. China's economic recovery is stalling, and weak global trade is hitting growth in export-dependent economies across Asia.

This is good news for global inflation, and good news for those investors eager to see the end of the rate hiking cycle. It is also good news for global supply chains – which have largely fallen out of the news cycle – as weaker global goods demand eases the pressure on the networks supporting their production and transport. Businesses are reporting shortening supplier delivery times as a consequence, and freight costs are returning back to pre-Covid levels.

Return to normal

But it also implies a slowdown in the drivers of demand for logistics space, including the volume of global trade, which was down by nearly 2.5% y/y in May according to the CPB World Trade Monitor, as well as retail sales. This is reflected in occupational demand, which is falling back from the exceptional, yet unsustainable, levels of recent years.

Markets that are inextricably linked to major ports, such as Los Angeles and Shanghai, are seeing a notable slowdown in take-up as container volumes fall in line with weaker trade growth. Sublease space is also rising in some markets, with many tenants finding themselves with more space than they need in an economy where household demand is rotating away from goods and towards services. Elsewhere, risk aversion is impacting tenants as well as landlords, leading to fewer large-scale new lease agreements.

With most markets seeing a slowdown in demand following the fervour of the last few years, differences in the supply backdrop will be important in dictating the prospects for continued rental growth over the next few years. In many markets, construction activity accelerated in the aftermath of Covid-19, given rock-bottom financing costs and strong growth in capital values.

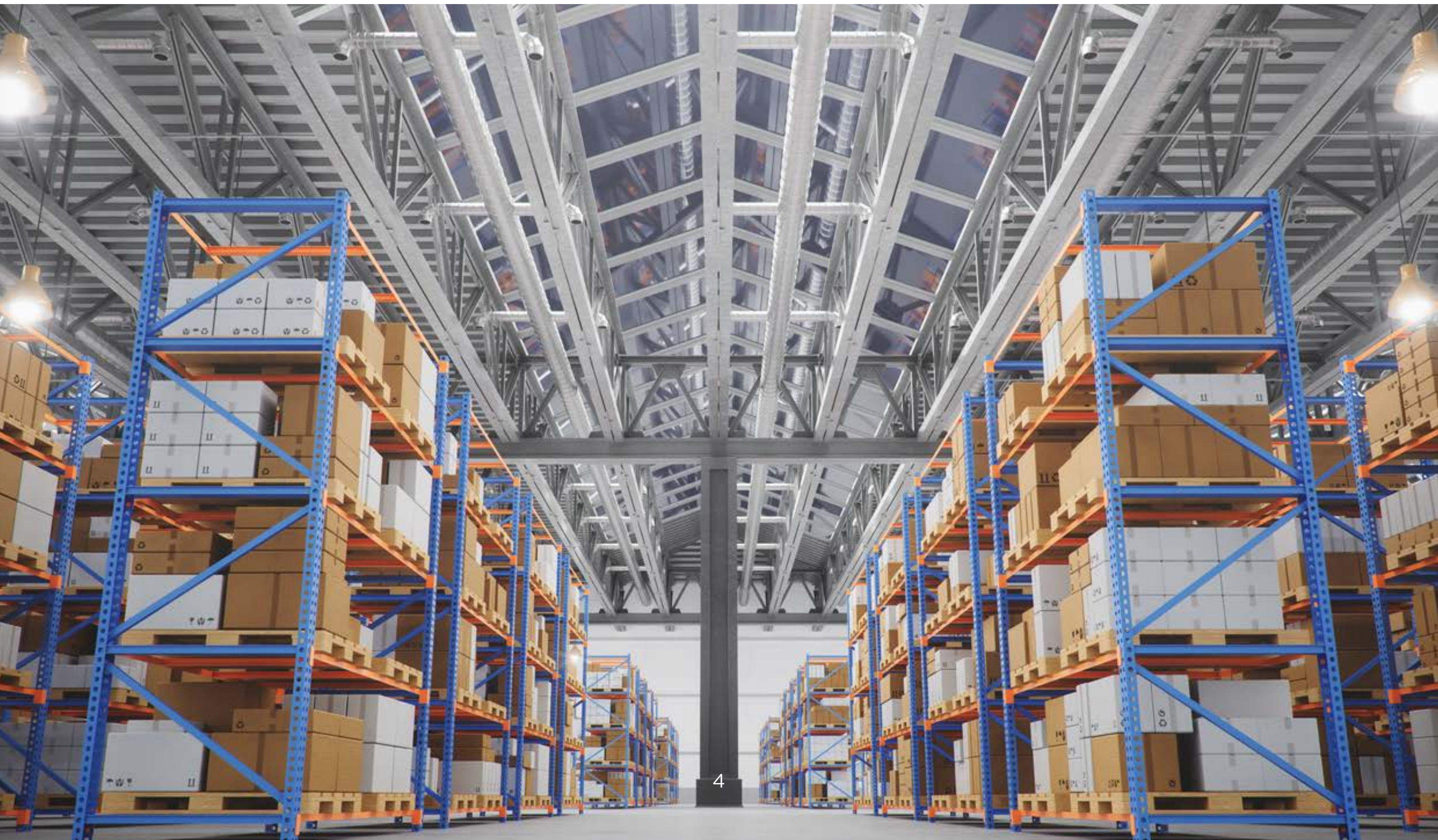
Much of this new supply is only now hitting the market; in the US for example, construction starts peaked in Q2 2022 at around 220 million sq ft, and has only fallen below in the long-term average in this quarter.

This is putting upward pressure on vacancy rates, which have risen since the beginning of this year in the majority of markets covered by this report.

Fortunately, this new supply does not yet pose a significant risk to the short-term outlook, barring a more concerted decline in occupational demand, which is unlikely given some of the longer-term tailwinds, such as e-commerce and nearshoring, remain. In the UK for example, while the vacancy rate has more than doubled in the last 12 months, this remains lower than the pre-Covid average, and is much lower than levels that in the past have triggered falling rents.

Indeed, in some markets such as Australia, investors are favouring assets with a short lease expiry, happy to take on the leasing risk in order to capitalise on the potential for upward revisions in rent. The markets where future supply is likely to be more disruptive include South Korea and Shanghai, and we expect further upward pressure on yields despite the stability in interest rates.

Sustainability remains a key consideration for both landlords and tenants, especially in Europe where space will need to meet minimum energy performance standards to be lettable in the future due to rising regulation stringency. Investors and occupiers continue to focus more on best-in-class assets that meet their criteria.



Regional outlook

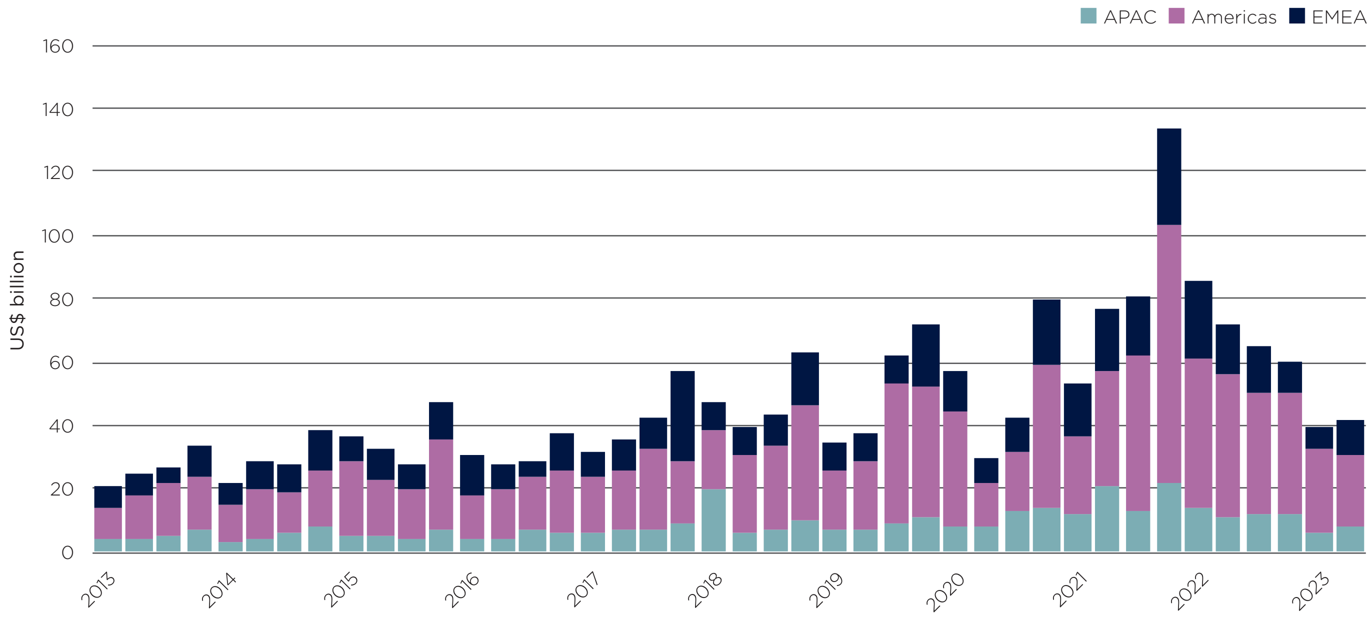
Investors are increasingly cautious when deploying capital into logistics, despite the fact that many institutions continue to openly back the sector

Europe, Middle East, and Africa (EMEA)

Investment volumes declined by 50% y/y across Europe in the second quarter. Investors are increasingly cautious when deploying capital into logistics, despite the fact that many institutions continue to openly back the sector (one could argue that this is more reflective of a hesitation to invest in real estate full stop as opposed to being specifically focused on logistics). Risk aversion is pervasive. Investors are increasingly demanding properties that meet very specific criteria, including super prime locations, long leases, strong covenants, and robust ESG credentials. Any shortfall across these criteria provides an excuse not to transact, which represents a major about-turn in attitude from the feeding frenzy of the last few years.

When investors do commit, there is a bias towards transacting on smaller, more liquid lot sizes, particularly given debt financing is proving difficult to secure on larger assets. In Germany for example, very few transactions in excess of €50 million have exchanged so far this year. Transactions are also taking much longer to complete as risk aversion elongates the due diligence process.

Global logistics investment volumes



Source: Savills Research using MSCI Real Capital Analytics

Occupational demand in Europe is also experiencing a cyclical slowdown in line with the deteriorating economic environment, with the euro area slipping into recession. In general, the larger, more mature markets are bearing the brunt of the downturn. Across Spain, France, and the Netherlands, for example, take-up in Q2 was down by around one-third in comparison with last year. Secondary markets, including Eastern Europe, Ireland, Italy, and Portugal, are showing more resilience and performing better than their core peers.

Some markets are also seeing an influx of new supply, exacerbating the decline in demand in the occupational market. Madrid is expected to onboard around 11.8 million sq ft of space in 2023, equivalent to around 9% of existing stock. This will push the vacancy rate higher, which has already risen by nearly one percentage point in the first half of this year.

However, it is important to consider the context behind all these figures: vacancy rates are a long way from critical levels. Returning to Madrid for example, the current vacancy rate of 7.2% remains below the pre-Covid record low of 7.8%. Similar trends are playing out across other European markets.

Even in the UK, where take-up experienced a much more pronounced 70% decline y/y in the second quarter, a vacancy rate of 6.3% remains well below historical thresholds that would imply a turning point in rental growth. Furthermore, active requirements in the market, which typically lead take-up by nine months, are around 64% up on the year, suggesting the slowdown will be short-lived. Leasing deals, much like transactions, are just taking longer to finalise.

North America

Investment in the US logistics sector fell by nearly 46% y/y in Q2 to US$21.9 billion. However, base effects are also important in contextualizing this decline. Investment volumes are still above the pre-Covid five-year average, following a several years of extraordinary market activity. Well-located assets, in close proximity to major transportation hubs and with access to densely populated areas, continue to attract buyers at very competitive prices.

Nevertheless, this return to 'normal' is presenting some challenges for investors. The primary issue is – as ever – with rising interest rates, which has underpinned an outward movement in yields and compressed risk premiums. In the second quarter, prime benchmark yields rose by a further 50bps in Chicago and Houston, and 25bps in Los Angeles. This implies that those investors who bought at the peak of the market are now sitting on unrealised capital value losses of up to 25% based on the shift in yields.

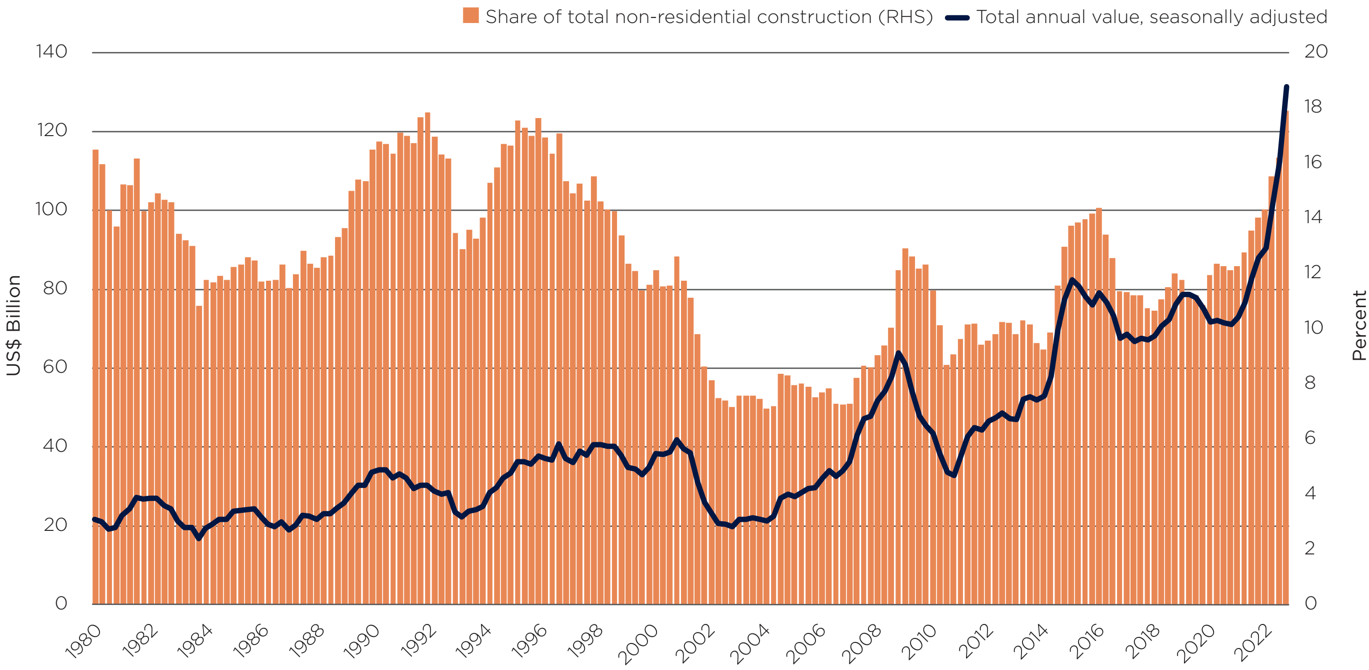
The second issue is with a slowdown in occupational demand. The Los Angeles market, for example, has now experienced three consecutive quarters of negative net absorption, in line with a slowdown in container throughput at the nearby ports of Los Angeles and Long Beach. This has underpinned a rise in the vacancy rate of more than 200bps over the last 12 months. Northern New Jersey is also experiencing a slowdown in demand, which is prompting many occupiers to return sublease space to the market. In Houston, meanwhile, the problem is that a record amount of new supply is hitting the market this year, which is outrunning still healthy demand, pushing the vacancy rate up by 70bps in Q2 alone.

Nevertheless, vacancy rates remain below pre-Covid levels in most markets, and the sector is considered healthy enough to absorb new stock without materially changing the outlook. High supply markets are generally well-matched with the high growth markets. And once we are through the wave of completions, new starts are falling off a cliff as developers react to the evolving economic landscape, which will put a cap on any future rise in vacancy.

Landlords retain pricing power as a consequence, and strong rental growth over the last 12 months is more than enough to cushion the impact of higher yields. Average asking rents across the four markets covered here are up by more than 9% over the last 12 months, outstripping the headline 3% inflation rate over the same period. The Los Angeles market is still one of the healthiest given the persistent tight market conditions, with a vacancy rate of 3.7%, below the nationwide average of 4.8%. Recent rental growth is clearly unsustainable, but landlords remain confident of solid gains in the future.

While economic uncertainty continues to weigh on market sentiment in the short-term, institutional investors still hold a bullish long-term outlook, and the outward shift in yields is attracting more interest in the sector again. New investors continue to enter the market with a view to building exposure to the logistics sector. Increasing clarity on both market conditions and the eventual resolution of inflation and interest rate hikes will further support investor confidence and lead to stable pricing and higher transaction volumes. This is underpinned by the sector's strong mid to long-term growth potential, driven by the continuous growth of e-commerce and a policy-induced resurgence in domestic manufacturing, which is supporting a boom in the construction of production facilities in the US.

Construction expenditure by manufacturing firms in the US



Source: Savills Research using Macrobond

Asia Pacific

Asia Pacific experienced a relatively modest 14% y/y decline in investment volumes in the second quarter of 2023. While the region adapts to a rapidly evolving economic environment, investors on the whole retain strong interest in the sector and the fundamentals support long-term growth, seeking opportunities in various markets and capitalising on the growing demand for logistics and warehousing facilities.

This optimism is tempered in some markets, where a combination of new supply onboarding and weaker demand is weighing on the outlook for vacancy and rent. This is true in Shanghai for example, where the recent stability in rents will be challenged by a vacancy rate that rose to 14.8% in Q2.

Oversupply is also a concern in South Korea, where the vacancy rate rose by 70bps to 7.0% in the second quarter. Investors are increasingly cautious as a result; transactions which were closed or under discussion during the quarter mostly involved well-located, high-quality, or fully-occupied assets at market rental levels, with few investors willing to accept any leasing risk. The benchmark yield remained steady at 5.3% in Q2 as the Bank of Korea paused the policy rate tightening cycle, but a deteriorating occupier outlook will put upward pressure on yields in the next 12 months.

In Japan, the logistics sector retains its allure amongst investors, particularly those cross border investors looking to gain exposure to the Japanese market, but unwilling to look at offices. However, again, a large supply overhang, particularly in the Greater Tokyo and Greater Osaka markets, is leading to a noticeable rise in vacancy, which is weighing on the pricing power of landlords. Poorly located and older facilities will struggle as a consequence, and prospects for rental growth is limited at a time when the Japanese economy is finally experiencing sustained inflation.

In Australia, deal activity remains limited, although there are a number of transactions that are in the pipeline, which should help to support investment volumes and advance price discovery, which is relying more on evidence than sentiment (and is therefore slow to adjust). Supply is not an issue in Australia, and investors remain largely positive on the sector, underpinned by the very low vacancy rate, which in Sydney is below 1%. This should continue to support positive rental growth, which favours short-lease assets with reversionary upside potential. The benchmark yield for Sydney rose by 25bps to 5.0% in Q2, but this should be sufficient to unlock more transactional activity, with the RBA nearing the end of its tightening cycle.

In India, the first half of 2023 saw a substantial absorption of around 11.2 million sq ft in tier 1 cities, with the 3PL sector playing a pivotal role in driving demand, accounting for 40% to 50% of the total absorption. Additionally, the manufacturing sector witnessed a significant surge in activity, fuelled by various incentive schemes such as the Production Linked Incentive Scheme (PLI). We anticipate increased interest from investors in 2023 underpinned by inherent domestic demand and the expansion of distribution networks in tier 2 and tier 3 cities, indicating a broader interest in regional growth opportunities.

Market view

Mark Russo, Senior Director, Head of Industrial Research, North America

If the previous three years were characterised by the unprecedented, then 2023 is shaping up to be the year of normalisation for the logistics sector. Across many metrics, we are getting back to pre-Covid levels, which still implies quite a robust market, albeit a far cry from the frenzied activity of 2020-22. While this return to normal is creating some stress in the short term, ultimately, stability coupled with modest growth will lift all boats.

The significant softening of absorption and vacancy statistics is jarring at a glance, but it is key to understand the impact of base effects. The appropriate comparison point is not 2022, but rather 2019. And that is exactly where most metrics are starting to align. While US industrial vacancy has risen by nearly one percentage point from last year, it is still only about 5%, more or less in line with the 2019 level. It is a similar story for net absorption, which is down by nearly 50% from 2022, but remains above pre-Covid levels.

Construction activity is pulling back from recent highs, with new groundbreakings falling substantially in recent quarters due to a constrained debt market. Many analysts expect that this will have a tightening impact on the market come this time next year, but that may be overly optimistic.

Looking ahead, market rent trends are top of mind for investors. Certainly, no one expects rental growth to continue at the recent pace of 14% per annum since 2020 (and much higher in coastal markets). Instead, the expectation is a return to steady but perhaps relatively unremarkable growth from our current vantage point. However, the mark-to-market of industrial property due to lease rollover is substantial and will continue to be a tailwind lifting valuations and returns for at least the next five years.

The return to normal has not been painless, of course. Price discovery has characterised capital markets since 2022, but clarity is now emerging around the fundamentals, especially given there is light at the end of the tunnel for inflation and interest rate hikes. Yields have risen sharply since 2021, but are starting to stabilise. This bodes well for transaction volumes going forward as fears of catching the falling knife evaporate.

The sector remains the darling of commercial real estate, with the persistent tailwinds of e-commerce growth still at play, while the onshoring of manufacturing is only just getting started. Overall, despite recent cooling, investors remain as enthusiastic as ever regarding the medium and long-term growth prospects for industrial and logistics real estate.

“2023 is shaping up to be the year of normalisation for the logistics sector”

Global prime logistics yields, Q2 2023 (as at end-June)

City	Prime net initial yield	Outlook for next 12 months	Typical LTV	Total cost of debt	Cash-on-cash yield	Risk premium
Northern New Jersey	4.75%	↔	60%	6.50%	2.13%	0.94%
Los Angeles	4.75%	↔	60%	6.50%	2.13%	0.94%
London	5.00%	↑	55%	7.06%	2.48%	0.63%
Cologne	4.00%	↑	55%	4.88%	2.92%	1.62%
Hong Kong	3.80%	↑	40%	5.00%	3.00%	0.12%
Amsterdam	4.40%	↑	55%	4.78%	3.94%	1.66%
Houston	5.50%	↔	60%	6.50%	4.00%	1.69%
Sydney	5.00%	↔	50%	5.95%	4.05%	0.98%
Madrid	4.80%	↑	50%	5.28%	4.32%	1.42%
Île-de-France	4.70%	↑	55%	4.88%	4.48%	1.77%
Shanghai	4.75%	↑	40%	5.10%	4.52%	2.11%
Chicago	5.75%	↔	60%	6.50%	4.63%	1.94%
Seoul Metropolitan Area	5.30%	↑	55%	5.50%	5.06%	1.63%
Dubai	7.38%	↑	50%	8.00%	6.76%	3.57%
Tokyo	3.30%	↔	65%	0.90%	7.76%	2.89%
Singapore	6.40%	↔	50%	4.50%	8.30%	3.32%

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

JAPAN, MULTIPLE

Building: Portfolio of six logistics assets
Tenant: Multiple
Lease length (WAULT): Various
Area: 4 million sq ft
Price/NIY: US$ 800 million / unknown
Vendor: Blackstone
Vendor nationality: US
Purchaser: GIC
Purchaser nationality: Singapore
Other comments: This portfolio, which consists of six modern warehouses with an average age of just five years, all fully let, represents the largest real estate deal this year and one of the largest logistics portfolio transactions ever completed in Japan.

UK, MULTIPLE

Building: Portfolio of logistics assets located at the estates of Trafford Park and Heywood Distribution Park in the North West of England
Tenant: Multiple
Lease length (WAULT): Various
Area: 7.0 million sq ft
Price/NIY: £480 million (US$592.6 million) / mid-high 4% (rumoured)
Vendor: Harbert Management Corporation
Vendor nationality: US
Purchaser: Blackstone
Purchaser nationality: US
Other comments: The purchase of this portfolio follows the takeover of Industrials REIT for £700 million, showcasing Blackstone's continued conviction in the fundamentals supporting UK logistics by continuing to deploy significant capital into the sector despite the challenging cyclical backdrop.

US, MULTIPLE

Building: Portfolio of around 70 US logistics assets
Tenant: Multiple
Lease length (WAULT): Various
Area: 14 million sq ft
Price/NIY: US$ 3.1 billion / 4.0%
Vendor: Blackstone
Vendor nationality: US
Purchaser: Prologis
Purchaser nationality: US
Other comments: This all-cash deal represents one of the world's largest real estate deals this year. The reported yield will adjust upwards to 5.75% when rents are rebased to market levels, according to Prologis.

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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