Taking Stock:
Capital Markets Quarterly
Logistics Q3 2023

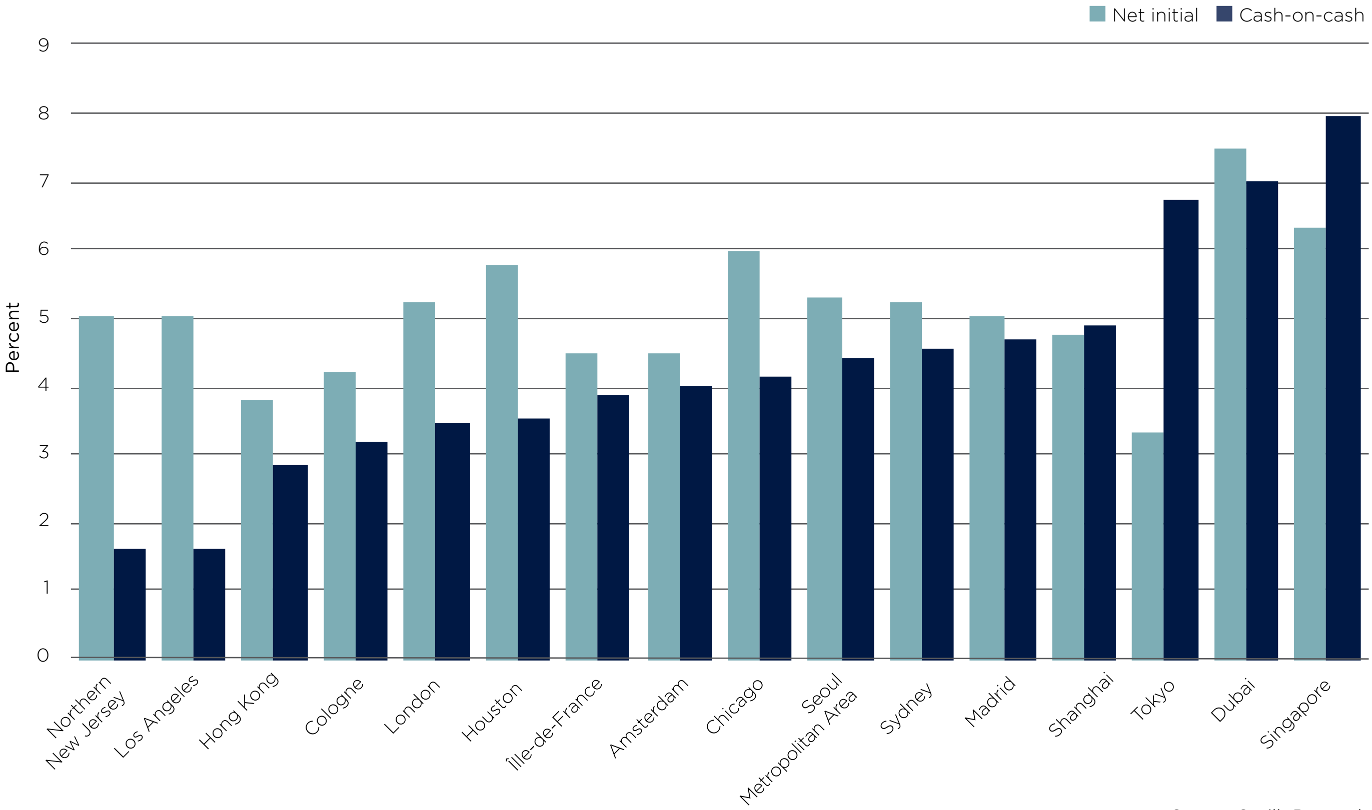
Global outlook

The logistics market can be characterised as one of long term gain, short term pain. Investors continue to back the structural drivers around e-commerce and evolving supply chains. But uncertainty in the economic environment and future path of interest rates is encouraging caution in the short term. Not so long ago, investors would pick up any shed they could get their hands on, but now the definition of prime is being squeezed by a shrinking pool of active buyers.

Nearly US$40 billion of logistics transactions completed in the third quarter of this year, representing a 40% decline on Q3 2022. Year-to-date, total investment of US$130 billion is 43% down on the same period last year. However, comparisons with 2022 are distorted by base effects, following a two-year investment boom. Instead, total investment this year has broadly returned to 2019 levels, although when comparing the number of individual properties transacted, activity is down by around 10% in comparison with 2019, given recent growth in capital values.

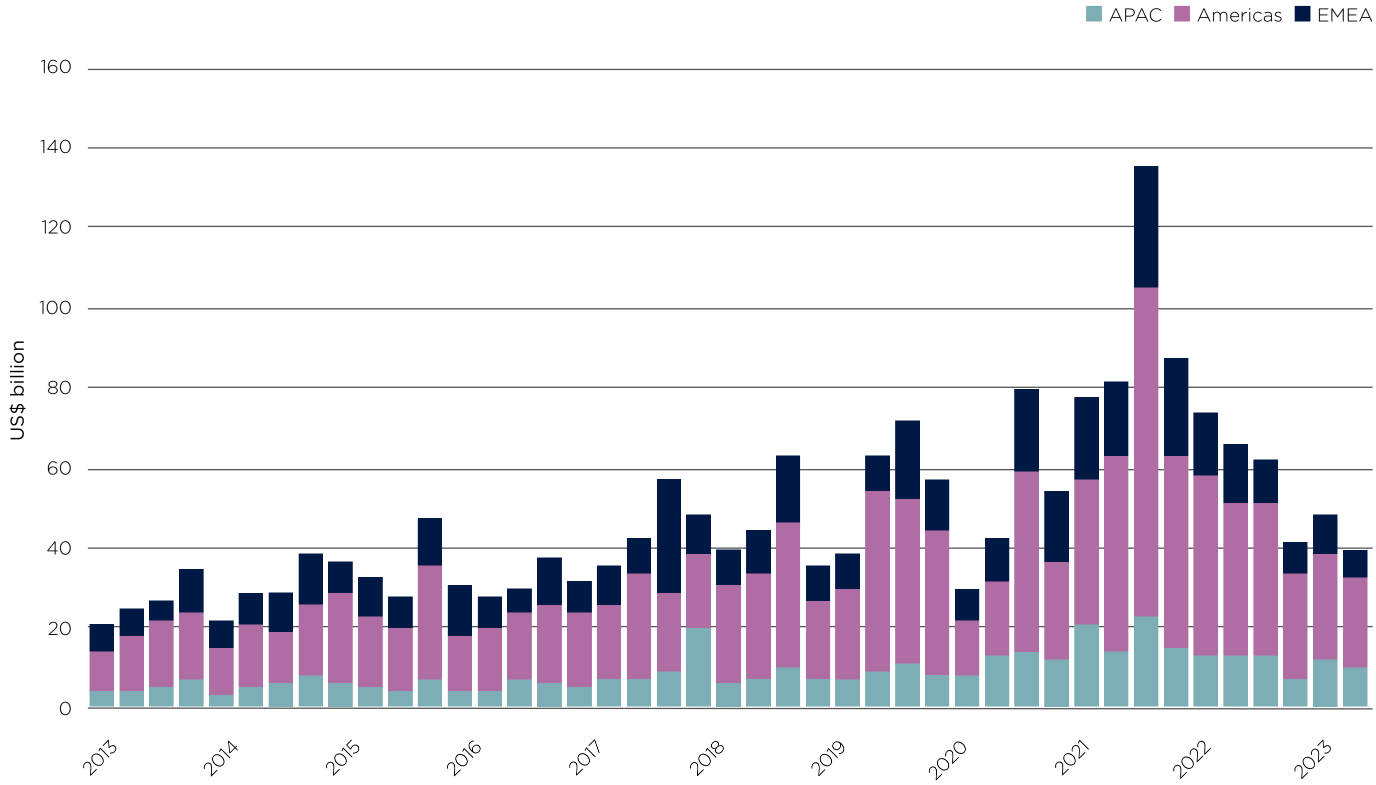
Prime yields continued to shift outwards this quarter, by 25bps in all US markets, and by 10-25bps across the EMEA markets covered. Nevertheless, a sharp rise in global bond yields further compressed risk premiums in the quarter (i.e., the spread between prime yields and the prevailing risk free rate of return), and we see upward pressure on yields in all markets except Dubai, Singapore, and Tokyo (of which all continue to deliver solid cash-on-cash returns to investors). Increasingly, we are likely to see more motivated sellers in the market, which should support the correction.

Prime logistics yields, Q3 2023 (as at end-September)



Source: Savills Research

Global logistics investment volumes



Source: Savills Research using MSCI Real Capital Analytics

~~Transitory inflation~~ Higher for longer

With transitory inflation now behind us, 'higher for longer' is the new slogan doing the rounds, summarising the outlook for the future path of policy rates. Central banks have gone to great lengths to convince markets that they are not cutting soon. Forward guidance has taken a hit in recent times, but this proves that central bankers still hold sway over the market (don't bet against the Fed!). By convincing investors that rates will remain elevated, global bond yields have continued to rise in recent months, with the 10-year US Treasury briefly pushing past 5% in mid-October.

The question is whether higher for longer ultimately proves transitory (cue narrative klaxon!). History suggests it will; in the past 30+ years, the US Fed has typically held out for just six months before cutting rates again. Given they last raised rates in July, this would imply a rate cut at their first soirée next year. And yet, markets are currently pricing a 99% probability that the Fed Funds rate is at or above current levels following the January 2024 meeting.

Markets are nearly always wrong, but a fast about-turn is predicated on something going bang in the global economy, fundamentally shifting the narrative on growth and inflation. The proposition that 'the Fed hikes until something breaks' is grounded in fact; financial crises often follow rapid monetary policy tightening cycles. Investors want lower interest rates, but higher for longer is inextricably linked to a soft landing, so it's a case of be careful what you wish for.

The good news then is that, in their recent forecast update, the IMF declared that the 'likelihood of a soft landing has increased.' Those expecting a more severe downturn in the global economy are using more intuition than fact to form their opinion; a soft landing in the global economy is the right call, conditioned on what we know today. Households, corporations, and the transparent parts of the financial system are generally in good financial health, able to weather the higher rate environment. Labour markets are showing few signs of rolling over, and real wage growth should support household consumption.

Tomorrow is another day

There are however plenty of vulnerabilities in the global economy right now; the property market in China, conflict in Ukraine and the Middle East, concerns over the US regional banking sector, etc. Given the historical context, we are perhaps embarking on a period of peak anxiety that makes it very difficult for investors to make long term decisions. This is reflected in public markets, with the VIX index of equity market volatility in the US up from mid-year lows.

Follow my deed

Even a soft landing may not be the fillip that real estate investors want; a global economy that is 'limping along' in the words of the IMF does not provide much comfort. If investors follow the occupiers, then weak global demand is not necessarily an environment that will support strong leasing and rents. Global manufacturing has been in recession for a while now, underpinned by a rotation in consumer demand away from goods to services. Retail sales are struggling in most markets, except in the US, where consumer spending has defied expectations of a slowdown (but for how long?). And global trade volumes are also in decline, hitting cargo levels at some of the major global ports that support some of the largest logistics markets.

This is already feeding into occupational demand. In the US, leasing activity is down by around 25% year-to-date, with the vacancy rate rising by as much as 150bps over the last year with new supply hitting the market at the wrong time. The European leasing market is also slowing, with take-up down by approximately 29% y/y so far this year. Japan, like the US, is struggling to absorb a glut of new supply, with Tokyo welcoming a record 47.4 million sqft of new logistics stock this year. With vacancy rising above 6% this quarter (up 300bps on the year), rents are down by 3.4% y/y in the capital city.

However, base effects are important to consider in the logistics market, with both occupational and investment activity on somewhat of a come down from the last two years. Comparisons with 2019 are probably more appropriate, being the last 'normal' year to benchmark activity levels, and providing a more balanced perspective. US leasing activity is stable when compared with 2019, while European take-up is 20% higher. In Asia Pacific, investment volumes year-to-date are up by 19% on the pre-pandemic benchmark.

This is not to say that the sector does not face some challenges; on the occupational side, for example, from too much supply onboarding and softer demand, and on the capital markets side, from the high cost of borrowing. But the prevailing narrative remains one of a normalising market that is still supported by longer term structural tailwinds.

Regional outlook

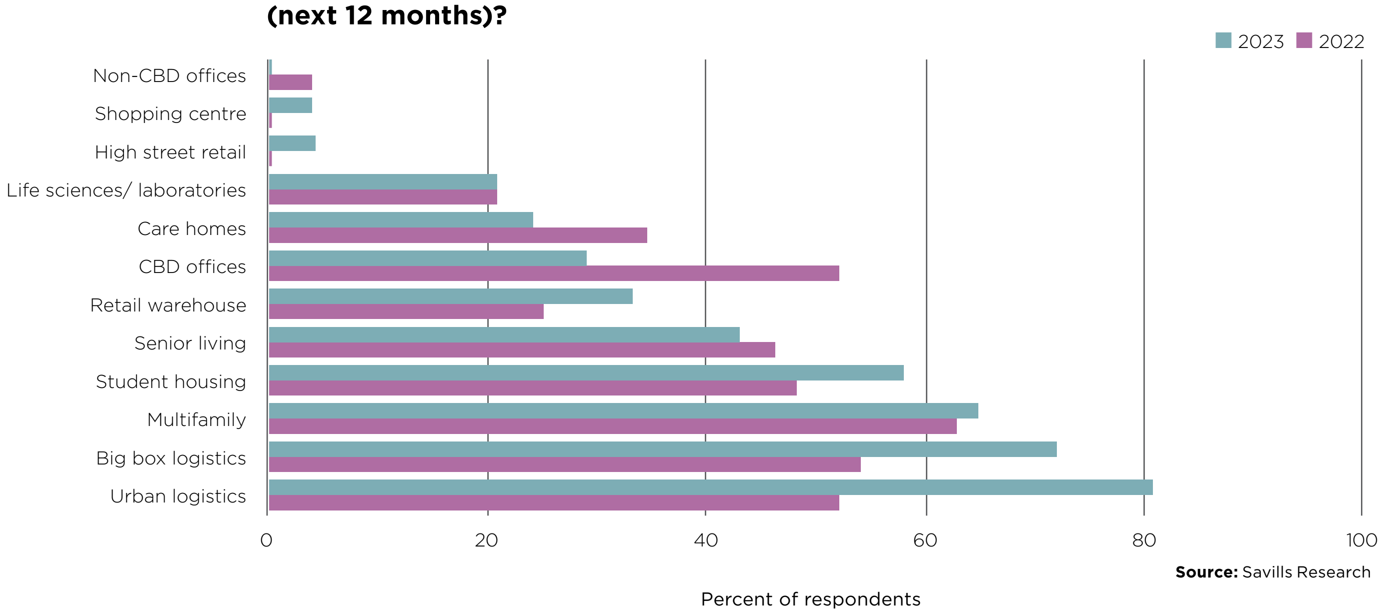
Europe, Middle East, and Africa (EMEA)

Across Europe, over US$6.8 billion of logistics assets transacted in Q3. This represents a decline of around 55% on the year, bringing year-to-date investment down by a similar amount. Base effects continue to be important in providing some context to these numbers; investment volumes have fallen by a more modest 11% year-to-date in comparison with the same period in 2019 (the strong US dollar also makes this look worse than it is). But activity is nevertheless subdued, with the 1,500 transactions recorded by MSCI Real Capital Analytics so far this year, representing the lowest deal count since 2013.

From individual country perspectives, the Netherlands and France are weighing on the regional average, while the German and Spanish markets are showing more resilience so far this year. The UK, while down by around 50% year-to-date, is one of the few markets where investment is outperforming pre-Covid comparisons, and barring an exceptionally weak final quarter, total investment in 2023 should improve on 2019 (albeit that capital values are above 2019 levels, which somewhat flatters this comparison).

Cross border investors remain the dominant buyer type, accounting for nearly 60% of deal activity this year, not too dissimilar to the longer term average. This is supported by non-European investors, and primarily US-headquartered institutions; Blackstone in particular has been an active buyer in the last 12 months. Singaporean and Canadian

European investor sentiment survey: which sectors are you likely to invest in (next 12 months)?



Source: Savills Research

investors also remain active, with the former driven by a single investor, the Sovereign Wealth Fund GIC. By contrast, Chinese money has largely withdrawn from European real estate capital markets, as they have the US market.

Institutions have been net buyers through this year, but this is unlikely to continue. Major core investors are on hold as the definition of prime is squeezed – the limited pool of active buyers means they can be more fastidious on location, tenant, and building quality etc. – as well as a deteriorating occupational market. There will be disposals amongst open-ended funds, who face growing pressure from client redemption requests. When deciding which assets to sell, those with large office portfolios are likely to be attracted by the increased liquidity available in the logistics sector. Sector specialist REITs and developers will also need to sell in order to fund ongoing activity.

A lack of stock has been the principle constraint on pricing through this cycle, so more motivated sellers should help to bring forward the correction. Prime yields continued to move out this quarter in most markets, including Amsterdam (+10bps), Cologne (+20bps), Madrid, and London (both +25bps), but all markets are expected to see further upward movement in the next 12 months.

From a wider perspective, however, investors continue to favour the sector. According to our latest regional sentiment survey, over 80% of respondents expressed an intention to invest in urban logistics (up from around 50% in 2022), and over 70% were interested in big box logistics (up from 55%) over the next 12 months[1] If inflation continues to follow the path of least resistance in Europe, the ECB may be encouraged to bring forward interest rate cuts in order to support the flailing economy. This may provide a catalyst for a more functioning market in 2024.

[1] Savills EME Investor Sentiment Survey, based on pan European investors representing over €500bn of Assets Under Management (AUM), with responses collected between 5-19th September 2023.

North America

US deal activity experienced a significant slowdown in Q3, with investment volumes falling by 41% y/y to US$21 billion. Year-to-date, the US$64 billion in transactions represents a 46% decline on the same period last year. However, using 2022 as a benchmark for comparison is somewhat disingenuous given the state of investor fervour for logistics assets in recent years. Instead, year-to-date investment volumes are down by a more palatable 20% in comparison with the same period in 2019.

Nevertheless, the market is relatively quiet. Activity was supported by individual asset sales, with larger portfolio and entity-level deal volumes down sharply on the year, as larger institutions show more reticence when deploying capital. Indeed, on aggregate, institutions are net sellers this year for the first time since 2017. Average deal size in 2023 is down by around 18% y/y as a consequence, with private buyers capitalising on the reduced liquidity.

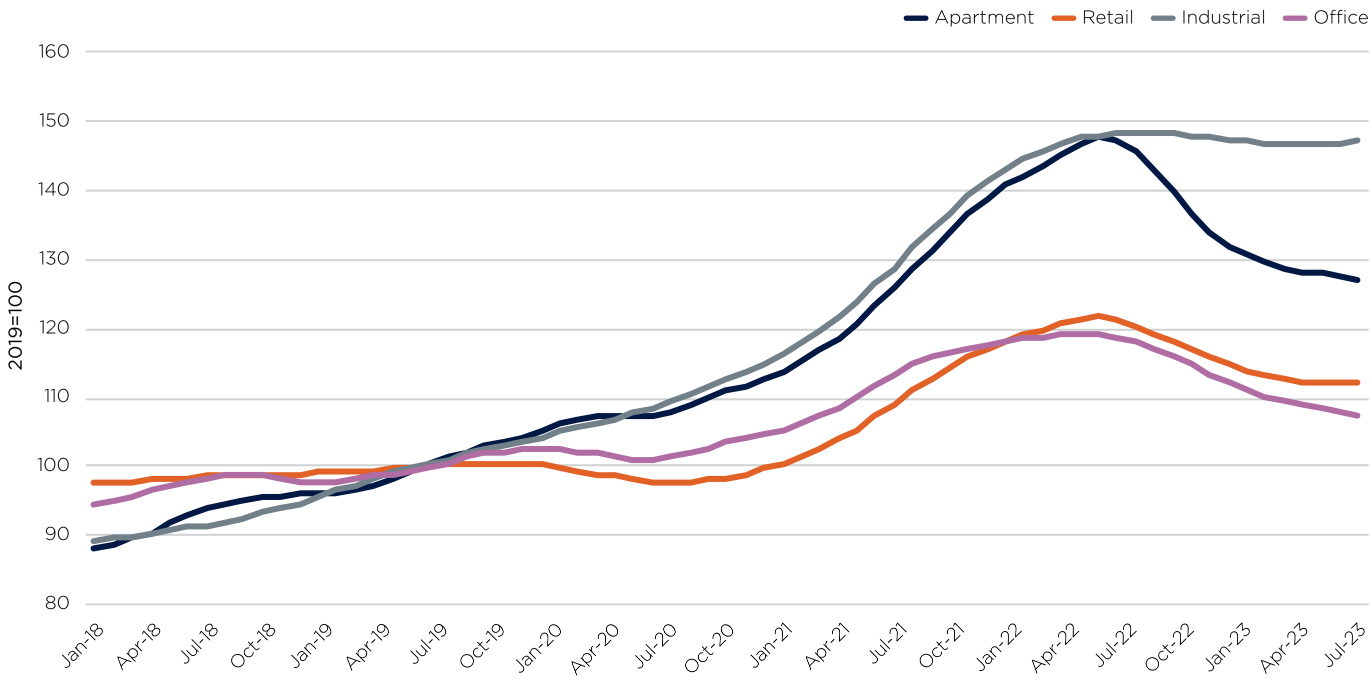
Pricing remains mostly interest-rate driven in the US. Benchmark yields moved out by another 25bps across all four markets covered in this report, and now sit between 5-6%. Any hope of stabilisation in Q2 was quickly dismissed following a recent rout in bond markets, with US Treasury yields rising by 80bps in the quarter. While the US Fed is almost certainly done raising rates in this cycle, market interest rates have continued to push higher, in part a result of investors pushing back their expectations for a policy pivot. This dynamic will continue to put upward pressure on property yields, especially given the negative spread to borrowing costs.

Notably, there is however minimal distress in the sector, and there is little evidence to suggest delinquencies will rise much. While yields have shifted outwards, continued rental growth has supported capital values throughout the current cycle, which in aggregate, remain stable since peaking in mid-2022 even while other sectors have seen prices fall. This makes the arithmetic a little more palatable for those investors needing to refinance existing debt.

Looking ahead, rental growth is slowing as new supply onboarding outpaces net absorption; a legacy of a two-year construction boom that came to an abrupt end earlier this year. Southern California has experienced a mild correction in rents, with Los Angeles the only major market to see negative net absorption over the last 12 months.

However, the national vacancy rate is low enough at 5.4% to absorb more supply in the short term without major disruptions (although with some vulnerability showing in Sun Belt markets), and with construction starts now at a 5-year low, vacancy will soon stabilise. Overall, rents should hold steady through this cycle (although that landlords have become somewhat more flexible, offering concessions where none were previously available). And any small decline should be benchmarked against a 64% rise in average rents across the US since 2019.

US commerical property price index



Source: Savills Research using MSCI

Asia Pacific

Investment volumes across the Asia Pacific region experienced a more modest decline in comparison with Europe and North America, falling by 25% y/y to US$9.7 billion in Q3. The year-to-date decline in investment was broadly in line with Q3, similar to the trend apparent in other regions. Notably, with investment in regional offices falling by nearly 50% year-to-date, the logistics sector attracted more capital than offices in both Q2 and Q3 of this year for the first time on record (spanning a period of nearly 17 years).

While risk aversion has induced many larger global investors to be more circumspect this year, private investors have stepped into the void. This is a common theme playing out across all regions and sectors, however it very pronounced in the Asia Pacific logistics market. Private investors are the only net buyers this year, accounting for nearly 40% of transaction volumes, more than double the long term average.

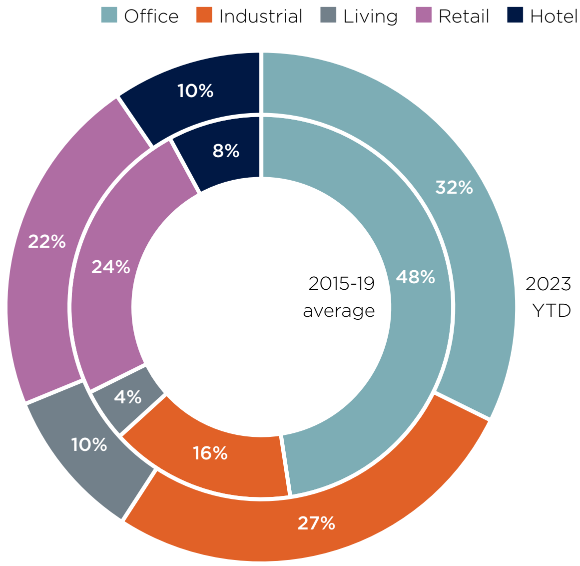
Two contrasting trends are emerging in cross-border capital flows: Global investors are scaling back their activity in the region, with investment volumes originating from investors headquartered in Europe and North America down 70% year-to-date. By contrast, regional investors remain relatively active and have increased their presence as a consequence, with Singaporean investors at the forefront of this trend, accounting for around 10% of regional investment this year (with GIC leading the charge).

The high interest rate environment is yet to significantly influence pricing in key Asia Pacific industrial markets. But it is feeding into activity levels; those markets which have seen policy rates rise significantly over the last 18 months, including Hong Kong, New Zealand, South Korea, and Australia, have also experienced the sharpest slowdown in investment volumes.

In Australia, the prime yield for Sydney rose by 25bps to 5.25% this quarter. However valuations are more sticky when benchmarked to markets in Europe, and REITs are generally reporting only modest yield expansion and small declines in capital values, relative to the change in interest rates and funding costs. In Seoul, the stability in yields is more a function of the limited transactional evidence, rather than anything else, with investors reluctant to explore new opportunities while the cost of borrowing is squeezing cash-on-cash returns. In both markets, we expect yields to rise over the next 12 months.

Shanghai and Tokyo, of course, do not face the same pressure of rising interest rates, albeit that the Bank of Japan has recently taken tentative steps to relax its grip on bond yields. But neither market is totally immune to a wider shift in investor sentiment. In Japan, while investors are yet to be undeterred by rising vacancy rates, we have lowered the benchmark LTV this quarter following a notable shift in the risk appetite of domestic lenders. In Shanghai, investor demand is tempered by the uncertain occupational outlook, where a sustained period of elevated supply is weighing on rental growth, pushing the vacancy rate to 16.3% in Q3, up from less than 6% this time last year.

Asia Pacific investment volumes by property type



Source: Savills Research using MSCI Real Capital Analytics

Market view

Simon Smith, Regional Head, Research & Consultancy, Asia Pacific and **Katy Dean**, Head of Research, Australia

Driven by growth in manufactured exports, e-commerce, and infrastructure development, Southeast Asia, China, and India have seen particularly significant advances in logistics capabilities over recent years while, more mature markets such as Australia, have been faced with supply constraints during a period of steadily rising demand. Investors and end-users alike have been willing participants, evidenced by year-on-year rises in investment volumes.

In 2023, while the combination of a tepid post-pandemic rebound, weak export markets, slowing e-commerce penetration, and rising interest rates have combined to take some of the shine off the sector, bright prospects remain in emerging markets and rapidly growing areas such as last mile logistics and cold supply chains.

In Australia, while the expansion of the industrial and logistics sector over the past three years has been extraordinary, as we enter the tail end of 2023, there are signs that a return to normal is underway. This echoes what we are seeing in the wider region where most markets are in a late upswing after years of heady capital growth and yield compression.

At its peak in mid-2022, the frenzied level of competition pushed vacancy to below 1.0%, with precincts in Sydney, Melbourne, and Brisbane sitting on rates as low as 0.3%. Fast forward to Q3 2023 and vacancy has edged up to average 1.85% on Australia's east coast, which seems remarkably tight but still a far cry from its peak.

Against this backdrop of low vacancy, a super-cycle of growth emerged, with prime rents growing at nearly seven times their average annual pace. However, this cycle of strong double digit rental growth is nearing its end, and 2024 is likely to align more with pre-pandemic trends as competitive tension for space eases and decision making elongates.

Enquiry levels have subsided and in some markets on the east coast of Australia, there are early signs of an increase in sublease availability as occupiers reduce inventory holdings. On the back of this, developers are taking a more cautious approach to future development plans and rental growth assumptions, despite recent record growth rates even to this point in the cycle.

The bid-ask spread between purchasers and vendors has widened further in recent months, with the cooldown in investment volumes limiting sales evidence used to gauge current price levels. Prices have not yet adjusted enough to restore deal activity to long-term levels, and we are seeing this come through in the return profiles as yields continue to expand. The trend suggests that the period of price discovery still has further to run. Importantly, up to this point in the cycle, rental growth has helped to offset any capital value decline.

The cost of debt remains prohibitive to some deals and there are select investor groups finding it harder to raise capital, while others are simply opting to wait out this part of the cycle. There has been some capital recycling to allow redeployment but no signs of distress. Of the assets which have traded, prices have been at or near book values.

While conditions are expected to moderate, alongside the impact of more subdued economic prospects, the sector has compelling structural tailwinds including persistent e-commerce growth. Australia's population is also growing faster than most other developed economies, making it well positioned to overcome cyclical macroeconomic challenges and keep investors on side.

Some repricing is unavoidable but investors with capital, particularly those with little or no need for debt funding, including pension funds, privates and syndicator groups, will use this time to act opportunistically, and those investors sitting on the side-lines will be poised for a return once the interest rate outlook becomes clearer. This will set the tone for recovery and start to unlock activity, as well as establishing a floor in pricing.

> "2023 is shaping up to be the year of normalisation for the logistics sector"

Global prime logistics yields, Q3 2023 (as at end-September)

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	5.00%	↑	60%	7.25%	1.63%	0.41%
Los Angeles	5.00%	↑	60%	7.25%	1.63%	0.41%
Hong Kong	3.80%	↑	40%	5.20%	2.87%	-0.41%
Cologne	4.20%	↑	55%	5.01%	3.21%	1.37%
London	5.25%	↑	55%	6.72%	3.45%	0.82%
Houston	5.75%	↑	60%	7.25%	3.50%	1.16%
Île-de-France	4.50%	↑	55%	5.01%	3.88%	1.12%
Amsterdam	4.50%	↑	55%	4.91%	4.00%	1.33%
Chicago	6.00%	↑	60%	7.25%	4.13%	1.41%
Seoul Metropolitan Area	5.30%	↑	55%	6.00%	4.44%	1.27%
Sydney	5.25%	↑	50%	5.95%	4.55%	0.77%
Madrid	5.05%	↑	50%	5.41%	4.69%	1.14%
Shanghai	4.75%	↑	40%	4.50%	4.92%	2.07%
Tokyo	3.30%	↔	60%	1.00%	6.75%	2.53%
Dubai	7.50%	↔	50%	8.00%	7.00%	2.91%
Singapore	6.35%	↔	50%	4.75%	7.95%	2.95%

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

US, CALIFORNIA

Building: Odyssey Portfolio, comprising 16 buildings across three locations in California
Tenant: Multiple
Lease length (WAULT): Unknown
Area: 3.5 million sqft
Price/NIY: US$ 1.0 billion/Low-mid 5% (reported)
Vendor: BentallGreenOak (BGO)
Vendor nationality: US
Purchaser: Westcore Properties
Purchaser nationality: US
Other comments: Highlights continued institutional demand for core industrial assets in US gateway markets. According to Westcore, all buildings are 100% occupied with staggered lease expirations, allowing them to make capital improvements, with the portfolio consisting of Class A, A- and B+ buildings with an average age of 19 years.

GERMANY

Building: Seed Portfolio, comprising 20 buildings in Germany
Tenant: Tenants include Amazon, Rhenus, Zalando, Connox, Mediamarkt, and Rieck Gruppe
Lease length (WAULT): Unknown
Area: 3.8 million sqft
Price/NIY: US$ 1.3 billion (€1.1 billion)/Unknown
Vendor: VGP Group
Vendor nationality: Belgium
Purchaser: Deka Immobilien
Purchaser nationality: Germany
Other comments: In the largest logistics transaction of 2023, German investment manager Deka entered a joint venture with the original developer VGP, who retained a 50% interest in the portfolio. As part of the agreement, two further deals will complete in Q1 and Q3 2024.

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

Katy Dean
Head of Research,
Australia
+61 2 8215 6079
kadean@savills.com.au

Simon Smith
Regional Head, Research
& Consultancy, Asia
Pacific
+852 9408 0370
ssmith@savills.asia