PROPERTY TIMES

# On track for another record year

## Europe Industrial & Logistics Q2 2015

28 August 2015

### Contents



- The global economic outlook remains positive for the European economy even if the Greek and more recently Chinese situation remain a concern for the future. With the end of the recession in Italy, all the European countries are now back on track with the CEE region and the UK forecast to lead the way of the recovery over the next five years.

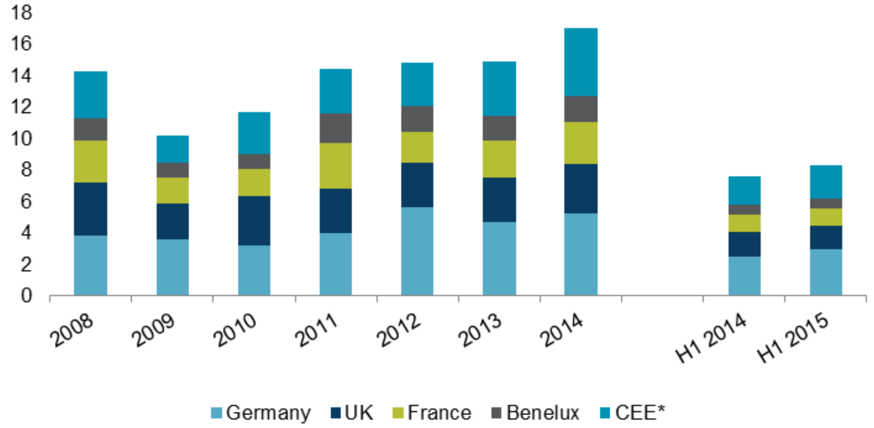
- With 8.3 million sq m of industrial and logistics space transacted in Europe in H1 2015, occupier activity and leasing increased by 9% in one year. This is a remarkable performance given that 2014 was already a record year. Germany was the driver of this activity with 2.9 million sq m leased in H1 2015, a 19% increase year-on-year. The CEE submarket (including Ukraine) also performed well with almost 2 million sq m transacted up to July this year. Poland is now the third most active European industrial market surpassing France with 1.3 million sq m let in H1 2015.

- Facing a lack of Grade A supply, corporates are reshaping their supply chain in an environment turned upside down by the e-retail boost. In recent months we have seen several occupiers looking at built-to-suit (BTS) solutions. The growing imbalance between strong demand and a supply shortage put upward pressure on rents, at least for the Grade A buildings. Cost-wise, we expect rental values to grow firmly in the UK and Ireland and at a more moderate pace in France and Germany.

- In recent months we have witnessed an enhanced industrial investment market with EUR 4.2bn of transactions closed in Q2 2015. With almost EUR 9bn closed in H1 2015, the performance of H1 2014, a record year, was almost equalled. Domestic players remained dominant but non-European investors and North-Americans in particular, showed a growing interest for this asset class. At the end of Q2, prime yields hit their historical low in almost 4 markets out of 10.

Figure 1

**Logistics space take-up – Main European markets, million sq m**




*Source: DTZ Research* **Ukraine included*


### Author

**Massinissa Fedala**
Senior Analyst
+33 (0)1 49 64 46 29
massinissa.fedala@dtz.com

### Contact

**Magali Marton**
Head of EMEA Research
+33 (0)1 49 64 49 54
magali.marton@dtz.com

## Economic climate

### European economy presses the pause button

The Greek situation remains on European minds following the election of the Syriza party at the beginning of 2015. Negotiations between Greece and its creditors have strained since then with a peak reached in early July with the referendum on the bailout program offered by the troika. As the scenario of a Grexit is not anymore a complete fantasy, forecasts have been slightly downgraded across the board.

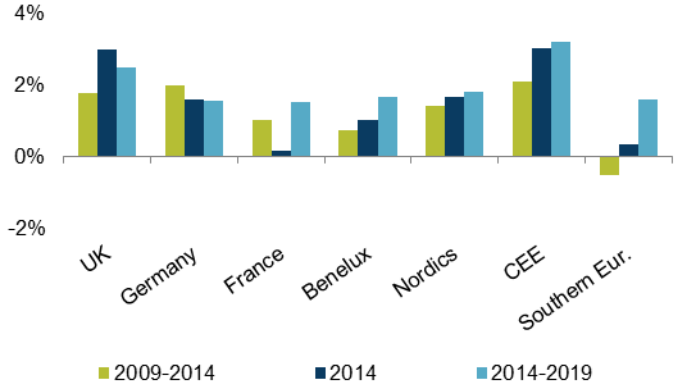
The PMI composite index for the Euro area is down to 53.7 at the start of the third quarter from a high of 54.2 in June. Signs of increasing cautiousness from both consumers and corporate companies are becoming visible. Major decisions are being postponed at short notice because of a lack of economic certainty.

Notwithstanding this, the global picture remains positive and the European economy gained momentum in the first part of 2015. Italy, the last European economy in recession is now back to positive territory.

After strong results in 2014, the CEE countries should keep the leading position in the region with an expected GDP growth of 3.2% p.a. over the next five years. The performance of the UK is also noticeable with a forecast GDP growth of 2.5% p.a. between 2015 and 2019. By contrast, the Eurozone giants, Germany and France, are expected to lag behind with GDP growth of 1.6% and 1.5% p.a. over the same period (Figure 2).

Figure 2

**Annual GDP growth**



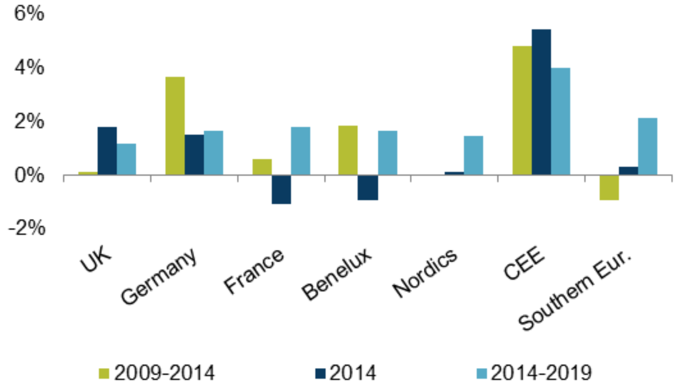

*Source: Oxford Economics*

### European industrial production back to positive growth

After a difficult year in 2014, industrial production is expected to gain momentum in the next few quarters, especially in peripheral countries. The CEE region remains Europe's factory with industrial production growing at a strong 4.8% p.a. over the previous five years and expected to remain at a robust 4.0% p.a. over the next five years. The PMI manufacturing index for the Euro area decreased to 52.2 in July but remained in positive territory. One of the strongest recoveries is set to take place in Southern Europe with 2.1% p.a. growth expected up to 2019 while activity was stuck below the water line in the previous years (Figure 3). The PMI manufacturing index already past its 2010 peak in Spain and is on its way to the 2006 one. Manufacturers have benefited from new competitiveness gains from the falling Euro and energy prices.

Figure 3

**Industrial production growth**




*Source: Oxford Economics*

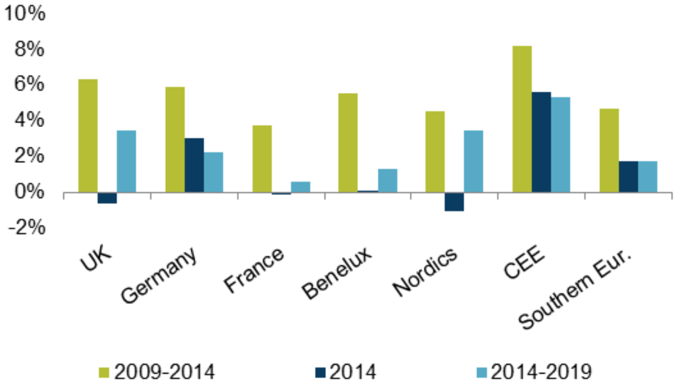
### Foreign exchanges not boosted by a weak Euro

Surprisingly, the weak Euro, the low inflation and the improving global economy did not contribute to more exports or international trade for the Eurozone countries in 2014.

As for the other macro aggregates, CEE is expected to remain the most active with international trade to expected to grow at a solid pace of 5.3% p.a. until 2019. International trade is expected to rebound in the UK as well, mainly through high level of imports while exports remain relatively dull.

Figure 4

**Cross border trade growth**




*Source: Oxford Economics*

## Occupier market

### Strengthen occupier activity across Europe

In the first half of 2015 the European industrial occupiers transacted 8.3 million sq m, a 9% increase in comparison with H1 2014. We forecast the upward trend to continue for the remainder of the year with the full year figure likely to surpass the 2014 record year.

Location-wise, in H1 2015 Germany attracted corporates with almost 2.9 million sq m of transacted space, a 19% increase from last year.

The CEE submarket (including Ukraine) had 2 million sq m leased, up by 18% as opposed to the H1 2014 figure. The main drivers of the region were the Czech Republic and Poland with 33% and 65% share respectively.

The occupier activity grew in the Czech Republic with 670,000 sq m occupied, a 65% increase in one year and the highest growth at a European level. At the year-end we forecast the Czech industrial market activity to reach a record of 1 million sq m.

Poland continued to be the main front-runner of the CEE industrial market with 1.3 million sq m transacted in H1 2015. Since 2014 Poland ranked third in the European industrial market in terms of letting activity. Demand from tenants remained high despite a slowdown in the eastern part of the country given the instability of the Ukrainian situation. Competitive rental values, transport infrastructure and qualitative supply are just a few benefits that attract occupiers in this particular location. Examples include AMAZON preparing to develop of its fourth Polish warehouse (120,000 sq m) in Lodz.

### Market driven by BTS solutions due to lack of quality supply

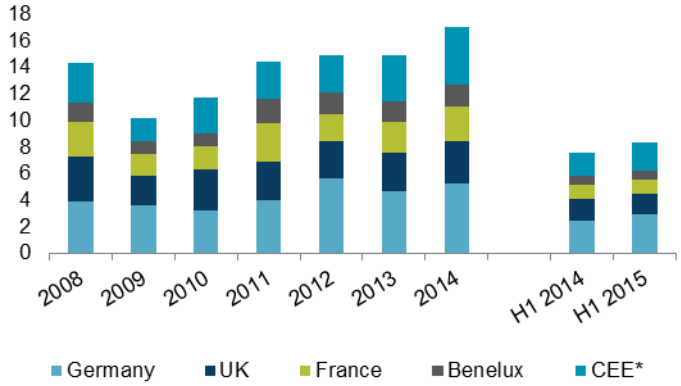
As e-retail related development continues and with few modern supply options available on the market, retailers, industrial and logistic companies have no other solution but to choose the BTS schemes. In the UK, these projects accounted for 80% of the Grade A occupier activity.

A similar pattern was noticed in France where nine out of the ten most significant logistic transactions that have been signed since the beginning of the year were through turnkeys or owner-occupier deals. Large retailers were the drivers of this activity with CARREFOUR signing two turnkey operations in Q2 2015 for 63,000 sq m and 68,000 sq m respectively in the French regional markets.

Vacancy rates remain rather low across Europe, with a range from 5.6% in Poland to 12.1% in Ukraine. In the UK, the market is characterised by low Grade A availability and therefore pushing rents up across the country.

Figure 5

**Logistics space take-up – Main European markets, million sq m**




*Source: DTZ Research* ** CEE and Ukraine*

## Rental growth in Dublin returns from the post crisis period

In line with the economic environment that is gaining momentum, the rental values are expected to increase in the coming years. Across Europe, these are expected to grow at an average rate of 1.7% p.a. up to 2019.

The highest increase is forecast in Dublin with an expected rental growth of 6.7% p.a. up to 2019. Highly impacted by the global crisis since 2008, the Irish market went through a decline in both activity volume and rental values. A robust GDP growth outlook since 2015 (+3.8% upon the ICB) coupled with a lack of modern premises will put upward pressure on the rental values.

With UK rental values amongst the most expensive in Europe they are still expected to continue growing at a sustained pace of 3.1% p.a. up to 2019 in Birmingham and 1.9% p.a. in Greater London. Rents have already risen by 10% in these sought after locations over the past 12 months and the lack of Grade A options will continue putting upward pressure on the rental values.

With a shortage of quality space in the Benelux markets as well rental levels are forecasted to increase. In Belgium, logistics prime rents returned to its pre-crisis level at EUR 55/ sq m p.a. following several deals in good quality premises. In the Netherlands, Rotterdam is expected to lead the recovery with an expected rental growth of 1.7% p.a. over the five next years.

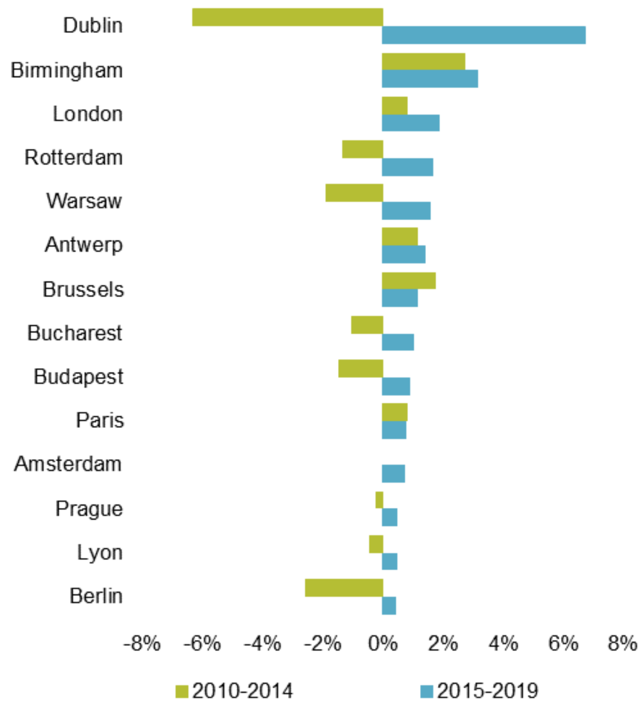
The CEE's leading logistics market, Warsaw, is returning to positive territory after a decreasing period (-1.9% p.a. between 2010 and 2014) with rental values expected to increase by 1.6% until 2019.

In Germany, rental values remained unchanged and are not expected to change dramatically in the coming years. Rental growth is forecasted at a subdued +0.4% p.a. in Berlin and +0.7% p.a. in Frankfurt.

Finally, French markets rental values are expected to remain relatively flat although they are amongst the lowest in Western Europe.

Figure 6

**Industrial rental values growth**




*Source: DTZ Research*

## Investment market

### European industrial market remained strong

The European industrial investment market maintained its momentum with EUR 4.2bn of transactions closed in Q2 2015. It was the sixth quarter in a row with an investment volume of more than EUR 4bn, an unprecedented growth pattern. With almost EUR 9bn invested in the first half of the year, 2015 is in line with the 2014 performance, which was a decade record year for the European industrial market with EUR 21.7bn signed (Figure 7).

Nevertheless, the industrial sector's market share sharply shrunk in an improving global commercial real estate investment market passing from 13% in H1 2014 to only 8% in H1 2015. The industrial sector remains a specialists' playground or an asset diversification tool.

As for the other asset classes, the UK is the main European investment spot with EUR 3.1bn transacted in H1 2015 (-7% in one year). Germany followed with EUR1.7bn of investment. The Nordics built upon their strong 2014 performance with EUR1.5bn invested in H1 2015, the equivalent of the average full-year volume registered over the past decade in this sub-region. By way of an example, a Swedish 28-asset portfolio changed hands in Q2 2015 for a total amount of EUR 474m.

The most improving market was Southern Europe with EUR 1bn invested in the first half of 2015. It is almost five times the volume recorded in the same period in 2014 and already almost twice the usual full-year volume exchanged on this submarket over the past decade. Here again, a large portfolio deal boosted the market with the acquisition by CERBERUS CAPITAL MANAGEMENT of a EUR 323m industrial assets portfolio from the UNICREDIT bank in Italy.

### Non-European investors increasingly active

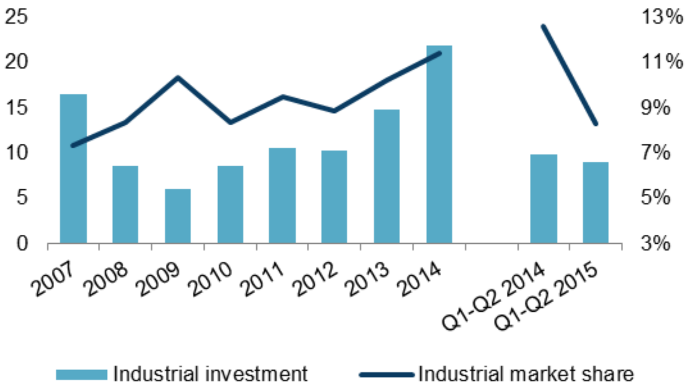
Almost absent from the industrial investment market during the crisis peak, international investors have shown a steadily growing interest for the asset class since then. 2014 was a record year with EUR 5.9bn of capital flows coming from outside of Europe. 2015 increased still further with EUR 2.7bn acquired by non-Europeans in the first six months, a 16% increase in comparison with the same period in 2014.

These investors remained mainly focused on the core markets with the bulk of their acquisitions taking place in the UK and Germany.

Nevertheless, the industrial market remained dominated by European players even if their market share shrank to 69% in H1 2015 from 76% in H1 2014. They acquired EUR 4.7bn in their domestic market but also EUR 1.4bn into their European neighbours markets. The Nordics particularly benefited from these European cross-border investments with domestic investors which do not hesitate to invest in their neighbours markets, as for the aforementioned deal with money from Denmark acquiring a Swedish portfolio.

Figure 7

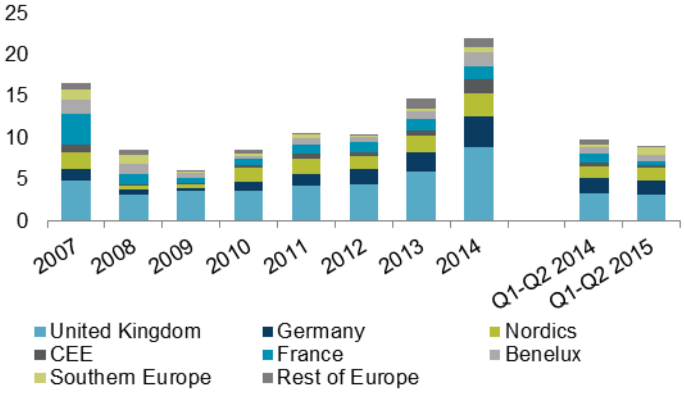
**European industrial investment market, €bn**




*Source: DTZ Research*

Figure 8

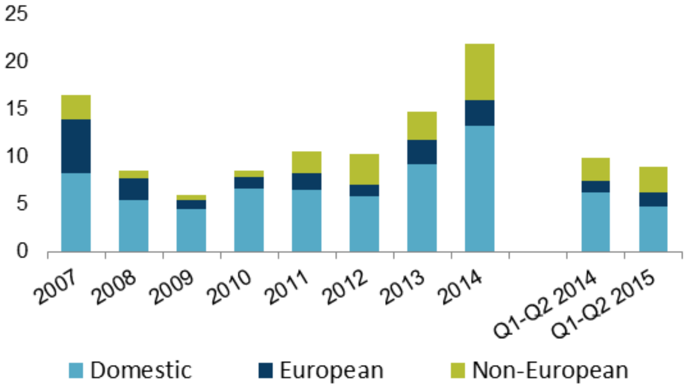
**European industrial investment market, €bn**




*Source: DTZ Research*

Figure 9

**European industrial investment market, €Bn**




*Source: DTZ Research*

## Yields

### In the core markets yield compression should come to an end by the end of the year

Investors are still showing a strong appetite for the industrial sector. Looking for higher yields (Figure 11) and a positive outlook on income returns, they are facing a lack of opportunities available in the market, putting upward pressure on prices. Prime yields decreased by an average of 15 bps over the course of Q2 2015, and by 30 bps since the beginning of the year.

Nevertheless, yields are stabilising in half of the markets covered, notably in Belgium and France. By contrast, after a pause in Q1 2015, yields dropped in Germany by an average 75 bps in Q2 2015.

Given the strong demand from investors, yields have also come in both in London and the main UK regional markets such as Birmingham and Manchester, by 25 bps in Q2 2015.

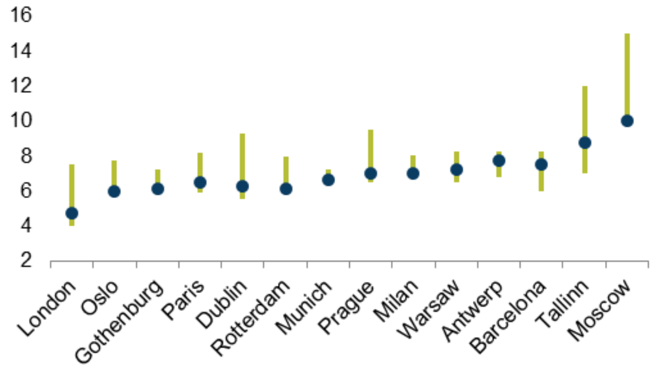
If the yield gap with other asset classes remains relatively important, industrial prime yields are now close to their historical low in the bulk of the European markets (Figures 10 and 11).

Room for further yield compression is almost non-existent. 23 markets out of the 58 that we monitor have already hit their historical low point. In the core markets we expect that the current yield compression cycle is coming to an end and forecast that yields will move upwards in the second part of 2015. In the more peripheral markets such as Southern Europe and CEE, the markets are expected to lag by few quarters and to stabilise only in 2017.

Figure 10

**European prime industrial yields**

**(Q2 2015 = dot, Q2 2005 – Q4 2014 max and min = line)**




*Source: DTZ Research*

Figure 11

**Prime yield spread between industrial and other asset classes – in basis points**


*Source: DTZ Research*

## Definitions

### Classification
Warehouses are classified according to their technical characteristics (hardness at ground level, unimpeded height, etc.), their accessibility (distance from the motorway, not being shut into an urban area), and their capacity for growth (adaptation to present and future ICPE standards and to the constraints of insurers).

### New building
A building that has never been used. Also called "first-hand" in contrast with "second-hand" buildings

### Non-speculative building
A building for which all the steps preliminary to launching the project have been taken (purchase of the land, preparatory studies, obtaining of the building permit, etc.), while actual construction will only begin once a user has committed to all or part of the project.

### Old or second-hand building
A building that has already been occupied by a user. Also called "second-hand" buildings in contrast with "first-hand" or new buildings.

### Operating licences
Licences required to operate a warehouse building. There are around a hundred different kinds, the most frequent being numbered as follows: 1510 (Covered warehouses), 1530 (Wood and/or paper stocks), 2662 (Honeycombed Plastics storage), 2663 (Storage of manufactured plastics, tires), 1412 (Container storage of flammable gases or aerosols), and 1432 (Container storage of inflammable liquids).

### Owner-occupier project
A building whose occupier is the owner

### Speculative building
A building whose construction is begun without previous sale or letting to one or several users.

### Take-up
The total deals, whether rentals or sales, carried out by users, including pre-let, turnkey rentals, and owner-occupier projects.

### Turn-key transaction
A building whose construction begins after a definite commitment from an occupier/tenant, even if a developer's project existed previously without construction having begun. These operations are included in take-up only when the preconditions (such as permits and financing) have been fulfilled.

### Warehouse
A building for stocking, distribution, or light assembly. Such premises are ranked in different categories: Class A for a highly functional or "new generation" warehouse, Class B for a building up to the standards of a modern warehouse, and Class C which includes all other warehouse buildings. Classification is done according to a number of criteria, such as the building's construction date, ceiling height, manoeuvring area, hardness of the floor, etc.

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## EMEA

**John Forrester**
Chief Executive
+44 (0)20 3296 2002
john.forrester@dtz.com

**Robert Hall**
Head of EMEA Logistics
+44 (0)20 3296 3100
robert.a.hall@dtz.com

**Paul Boursican**
Head of EMEA Investment
+44 (0)20 3296 2019
paul.boursican@dtz.com



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Global Headquarters
77 West Wacker Drive
18th Floor
Chicago, IL 60601 USA
phone +1 312 424 8000
fax +1 312 424 8080
email info@dtz.com

EMEA
125 Old Broad Street

London
EC2N 1AR, UK
phone :+44 (0)20 3296 3000