Market in Minutes
Are markets diverging again?

April 2013

Economic outlook deteriorates

The ongoing political instability in Italy and the recent developments with regards to the Cyprus bail-out/in agreement have destabilised the markets and increased the economic uncertainty in Europe once again.

In March the Economic Sentiment Indicator (ESI) decreased in both the Euro area and the European Union (EU), putting on hold the recovery that had started in November of last year. Sentiment declined by 1.1 points in the Euro area (to 90.0) and by 0.6 points in the EU (to 91.4).

The European economy contracted in the final quarter of last year. GDP fell by 0.6% in the Euro area and by 0.5% in the EU27 on a quarterly basis. As the negative effects of the debt crisis have spread from the European periphery to the core, the three largest economies of Europe, Germany, UK and France experienced negative growth.

According to Eurostat, unemployment in the EU stood at 12% in February, the highest in the euro area's history.

In February the inflation rate moved below the European Central Bank's (ECB) 2% ceiling for the first time in more than two years. In March the annual price growth stood at 1.7% in the Euro area. This has allowed the ECB to maintain unchanged its interest rate at 0.75%.

Following these developments most economists have revised downwards their economic projections for the Euro area, which is expected to contract mildly for another year (-0.3%).

Deal making momentum eases

The momentum gained in the second half of last year, in terms of investment deal completions, has slowed down in the first quarter of this year, with the total deal volume about 4% lower compared to Q1 2012, according to our first estimates. UK, Germany and France have continued to monopolise investment flows. We expect the three markets to account for about 85% of the total turnover in our survey area. Q1 investment activity is estimated to be about 40% higher in France and more than 15% higher in Germany on an annual basis, while it is estimated to drop by about 6.5% in the UK.

The record rise however is expected to be seen in Ireland, where a recovery in sentiment and a strong market correction have initiated renewed investor interest. We expect the turnover in Q1 13 to reach €300m, which double the amount of the first half of 2012.

In the remaining markets estimated investment volumes in Q1 13 compare unfavourably to last year's achievements, a result of a market which is drained from prime product and unsettled by the unpredictable shocks in the Euro zone economic and political terrain.

Pricing for prime and core hardens

Prime yields have generally been stable in Q1 compared to Q4 12. Prime CBD yields, which are the most representative indicator of pricing as offices continue to be the most sought after assets, have not changed significantly on a quarterly basis either. Compared to last year, prime achievable CBD yields have hardened

TABLE 1

Prime achievable market and triple net yields Q1 2013

City	Prime office gross yield	Prime office triple net yield	Annual yield shift
Amsterdam	6.35%	5.60%	-15
Athens	8.75%	8.60%	50
Berlin	5.40%	4.80%	0
Brussels	5.25%	4.45%	0
Dublin	7.00%	6.75%	-125
Frankfurt	5.20%	4.60%	-10
Hamburg	5.10%	4.60%	-10
Lisbon	8.00%	7.00%	50
London WE	3.70%	3.50%	-25
London City	5.00%	4.75%	-50
Madrid	6.00%	5.90%	50
Milan	6.25%	5.70%	25
Munich	4.65%	4.25%	0
Oslo	6.00%	5.50%	25
Paris	4.00%	3.95%	-50
Stockholm	5.00%	4.75%	-25
Vienna	5.25%	4.80%	-13
Warsaw	6.00%	5.70%	0

Table source: Savills, EHL, Abacus

in all major markets, from as much as 125 bp in Dublin to 10 bp in the German cities. Yields continue to soften in Athens (50 bp), Milan (25 bp) Madrid (50 bp) and Oslo (25 bp).

What converged is diverging

About a decade ago, the introduction of the Euro created a single market based on the convergence of the European economies to a common standard. The common currency made trading amongst the member states easier, spurring a rising cross-border investment activity and a convergence of yields. Until then market yields were reflecting the different characteristics and growth potential of the local economies. Today, the divergence of pricing between core and peripheral markets is here to confirm that the underlying differences within the single European economy have intensified.

Based on our historic data of prime achievable CBD market yields, two years after the outbreak of the credit crunch, the gap between what used to be the mature and developing European markets had come back to the 2001 level (about 110 bp), after having converged to just 14 bp in Q4 07. Today this gap has doubled (225 bp) implying that investors see again major differences in risk and fundamentals amongst the core and peripheral Euro zone markets.

Cross border share on the rise again

According to RCA historic deal data, at the peak of the market cycle (Q1 07) the share of deals generated by cross border investors had exceeded 60%, before falling to 30% by Q4 2008, following the credit crunch. As the markets find their new equilibrium and investor confidence is gradually regained, the share of domestic and cross border investment activity has started converging again and now they are almost on a par.

Triple net yields

Prime office yields can be as low as 3.5% in London West End and up to 8.75% in Athens CBD. Nevertheless, the definition of market yield differs across the European markets. Yields are quoted net in the UK, Germany, Sweden, Netherlands, Norway and Ireland, but gross in other markets.

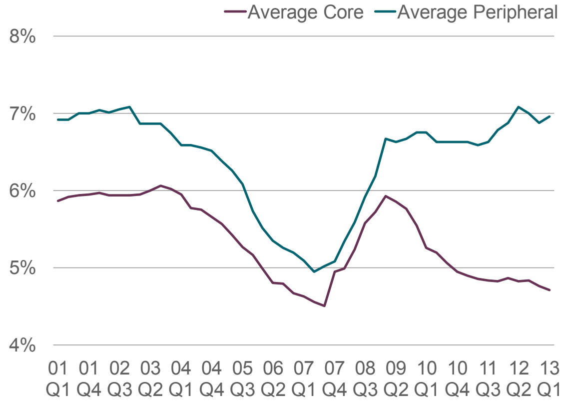
We have assumed a prime 5,000 sq m multilet office buidling and some standard, non-recoverable and purchase costs (including property transfer tax) in order to calculate the triple net yield for our survey markets.

The biggest differences (45 bp to 100 bp) between market and triple net yield are noted in Lisbon, Brussels, Milan, and Vienna, where the total impact of costs is more significant.

GRAPH 1

Core-periphery prime office yields

Different economies lead to divergence

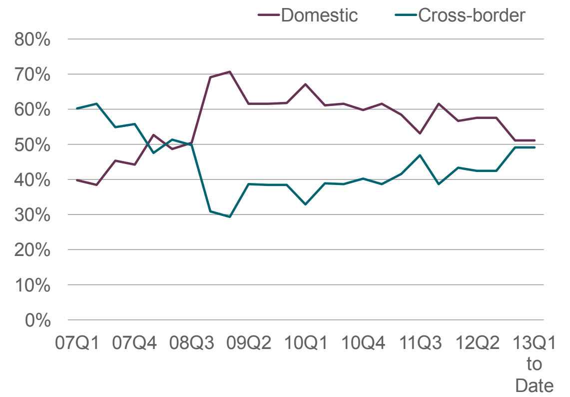


Graph source: Savills

GRAPH 2

Cross border - domestic investment

Cross border players increase their activity



Graph source: RCA

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