SPOTLIGHT

Savills Research

European Commercial - Q2 2022

EME Office Value Analysis

savills

• Risk Premium • Rental Growth • Inflation

Imminent eurozone recession

Rising energy prices to drag on economic growth.

Economic overview
Eurozone inflation continues to rise, reaching 9.1% in August 2022, with business confidence beginning to weaken amid economists' increasing consensus for an impending recession during Q4 2022.

There remains a wide range in headline inflation rates across Europe, with those countries most dependent on Russian energy exports observing the highest price increases. Poland (+15.6%, where Gazprom has stopped supplying Russian gas), Spain (+10.8%), the Netherlands (+10.3%) and the UK (10.1%) observed some of the fastest price rises as inflation continues to surprise bond markets on the upside. France, in comparison, recorded only a 6.1% annual increase.

The European Central Bank (ECB) rose interest rates by 75 bps to 1.25% during its September meeting. Capital Economics anticipate base rates to reach 2.00% by the end of 2022.

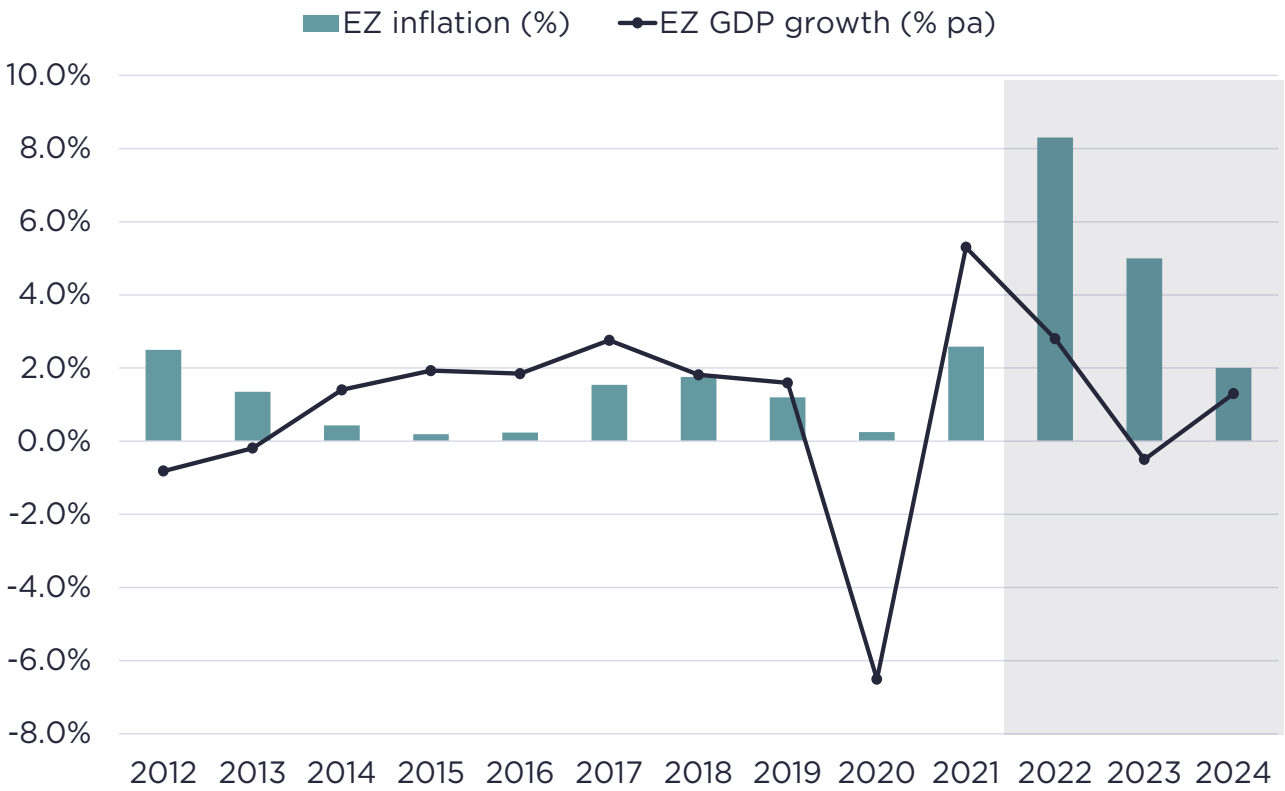
EU countries have committed to reducing their gas usage by 15% this winter as gas imports from Russia have dropped to just 20% of capacity. Europe's governments are also introducing fiscal measures to assist with the rising energy costs, including energy price caps in France, fuel tax cuts in Germany and Spain and energy allowances in the Netherlands..

Steel production is likely to be constrained due to rising input costs and a shortage of materials, although European steel prices have begun to plunge as Eurozone manufacturing demand declines, off the back of a weaker consumer outlook.

On a more positive note for the office market, occupancy rates continue to increase across Europe and averaged 43% during June 2022, boosted by Paris and Madrid and the highest level since the pre-pandemic levels of 70-75%. Bloomberg recently reported that Apple will require their employees to work a minimum of 3 days per week in the office from September 5th.

What's more, unemployment rates remain at a record low of 6.6% across the Eurozone. A recession is likely to increase the overall unemployment rate, although given current labour shortages, the impact is expected to be fairly limited.

Chart 1: Eurozone inflation and GDP growth



Source Capital Economics

Investment and yields: what has changed?

Bond market volatility has pushed out average prime office yields.

Methodology
Savills EME Office Value Analysis compares the fair-market (calculated) yield relative to current market pricing across 24 EME markets, covering London-City, Stockholm, London-WE, Manchester, Lisbon, Oslo, Berlin, Paris, Copenhagen, Dublin, Amsterdam, La-Defense, Prague, Hamburg, Madrid, Barcelona, Helsinki, Munich, Warsaw, Brussels, Frankfurt, Milan, Dubai and Bucharest.

An investor must be compensated for bearing the risk of investing in real estate over sovereign bonds. The calculated yield is derived as the current risk free rate plus five year average office risk premium, discounting for nominal rental growth, inflation and expected depreciation forecasts across each market. The calculated yield represents a hypothetical yield assuming a fully liquid market and that the investor is fully hedged against currency risk.

Calculated market yield pricing > 50 basis points above market pricing we consider under-priced

Calculated market yield pricing within 50 basis points of market pricing we consider fairly priced

Calculated market yield pricing > 50 basis points below market pricing we consider fully priced

Analysis
Savills Q2 2022 EME Office Value Analysis indicates that seven EME office markets appear fairly priced, up from three markets at end Q1 2022, largely due to the reduction in risk-free rates over the past three months.

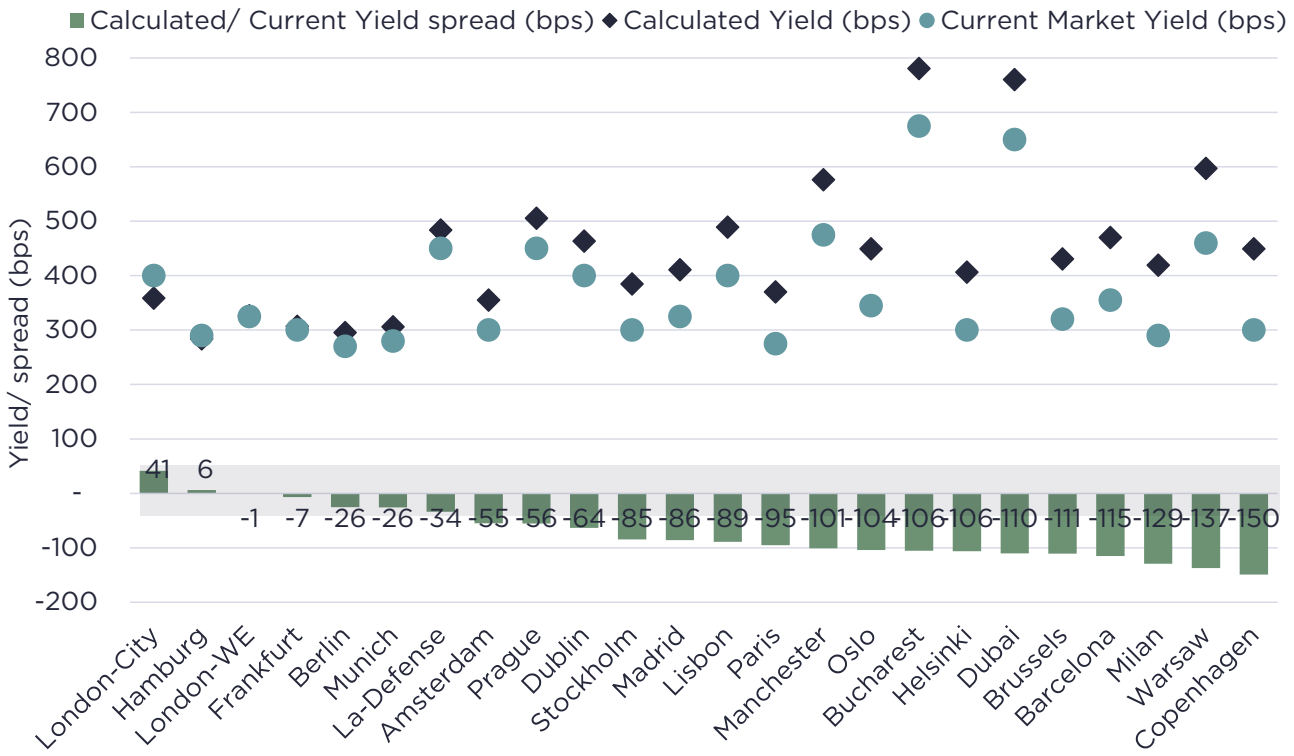
London City, Hamburg, London West End, Frankfurt and Berlin's office markets remains the most attractively priced market in Europe, buoyed by a more positive rental outlook over the next five years and recent yield softening in the top 7 German office markets. German ten year bond yields hover around 1.2% during mid-August, although markets appear to be pricing in a 50 bps interest rate rise from the European Central Bank in September.

Since the last quarter, the average European office yield spread between calculated market yields and current market yields has reduced from 101 bps to 73 bps, reflecting both an inward movement of risk free rates, and an outward movement of prime office yields in some European markets.

The German cities of Hamburg, Frankfurt, Berlin and Munich (+30 bps), Paris CBD (+15 bps) and Madrid (+15 bps) have moved first, perhaps due to higher liquidity within these markets, and we anticipate a similar trend across less liquid markets in the next quarter. In the CEE, Warsaw (+25 bps) and Prague (+50 bps) both observed outward movement, with debt margins increasing, reducing cash on cash returns.

Tracking prime yield movement over a longer time period illustrates the compression mainland Europe has observed compared to London. London City's Q2 2022 prime yield of 4.00% is in line with the level during Q2 2015, whereas the rest of Europe's prime yields have moved in by an average of 121 bps over the same period, led by Lisbon (-225 bps to 4.00%), Milan (-185 bps to 2.90%) and Amsterdam (-180 bps to 3.00%). Mainland Europe's yields are lowest and perhaps more sensitive to higher interest rates, but there is still a Brexit discount in play for London stock.

Chart 2: EME office value analysis, Q2 2022



Source Savills Research

Outlook- are we at a turning point?

Weakening real estate dry powder allocations provides a challenge for pricing.

Investor sentiment around the office sector remains polarised. European office investment reached €43bn during the first half of 2022, in line with the previous five year average, as we observed a slowdown in German office transactions and an increase within the UK.

Q3 2022 is marking a period of price discovery, as we see sales processes taking longer to complete and vendors deciding whether to bring stock back to the market by the turn of the year. 2023/24 will provide more transparency on pricing as investors seek to refinance at the most competitive rates. Investors may seek to lock in for shorter refinancing periods over 2/3 years during this time in the anticipation of lower rates once the energy crisis eases.

Dry powder allocations indicate a weakening in investor sentiment. PERE's H1 2022 fundraising report indicates total fundraising reached $72bn during the first half of 2022, 14% down on the same period in 2021. Unsurprisingly, we are observing a rising proportion of capital allocated to debt financing, with 33% of capital allocated towards debt strategies in H1 2022, up from only 16% in 2021, and more than any other investment strategy.

All in debt costs have risen in line with prime office yields in some European cities, making financing more difficult for lenders, which is requiring higher rental growth to justify valuations. Over the last 12 months, average European prime rents have increased by 4.3%, led by Amsterdam (+16%), Munich (+16%) and Cologne (+10%). With vacancy rates stable at 7.3% during Q2 2022, and an undersupply of higher quality space, we anticipate further rental growth over the next 12 months as occupiers seek higher quality, amenity driven office space. Of course, higher all in debt costs present an opportunity for cash-rich buyers to acquire and refinance at a later date on their own terms.

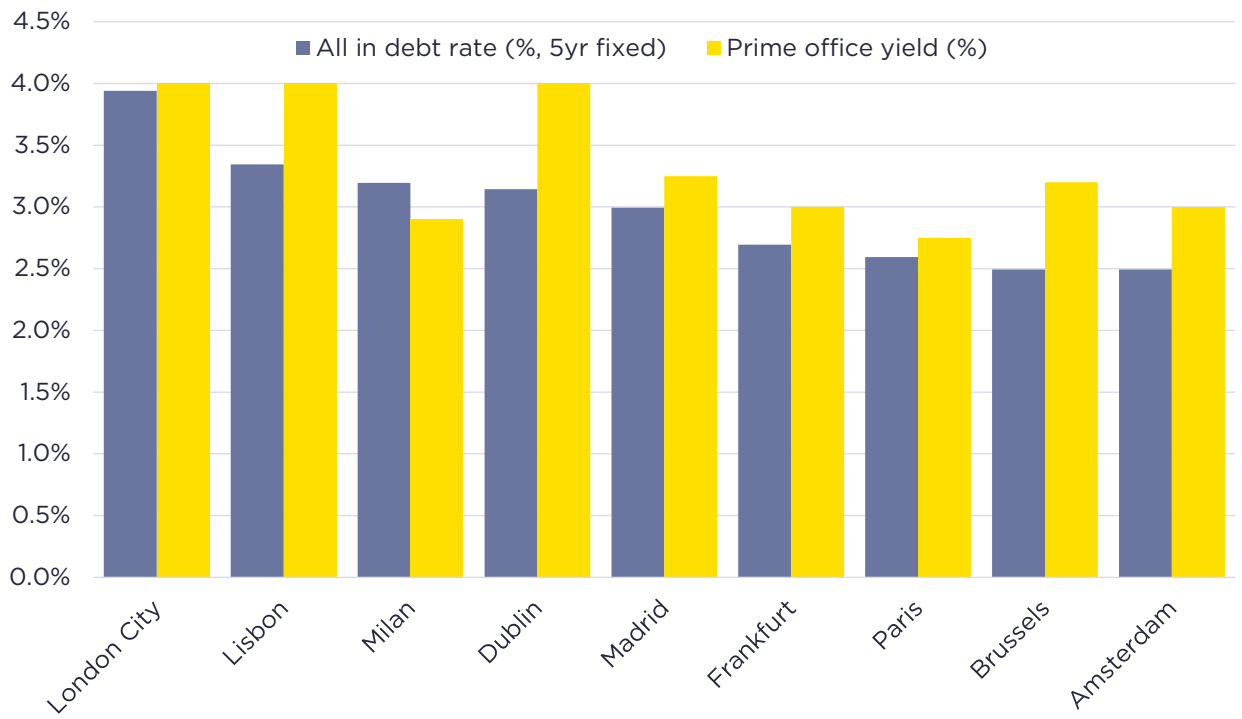
What is more obvious is an outward movement in secondary yields. During Q2 22, secondary yields moved out by an average of 26 bps, against an average of 15 bps for prime. We anticipate secondary yields to observe further outward movement, particularly for older assets in need of capital expenditure.

Multi asset portfolio allocations to real estate remain resilient which will help support demand, rising from 11.7% in 2021 to 12.3% in 2022, according to Cornell University's asset allocation survey. Multi-asset investors may seek to further increase their exposure to real estate in a bid to hedge their returns from rising inflation.

Previous analyses indicate that negative economic growth, rather than higher inflation has been the key determinant of real estate investment performance historically, given its impact on vacancy rates and achievable rents. Should economic growth begin to decline faster than expected, we may begin to see a reversal in rates during 2023.

Of course, there are several unknowns which lie ahead- business confidence will also greatly depend on the supply of Russian gas. If Russia cuts off the supply of gas to Europe entirely, we are likely to see a further weakening in Europe's GDP growth, providing an additional downside risk to investment pricing.

Chart 3: Prime office yields and indicative debt costs, Q2 2022



Source: Savills Research

Savills Commercial Research
We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

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