SPOTLIGHT
Savills Research

European Commercial - Q2 2023

EME Office Value Analysis

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• Inflation • Yields • Transactions

Core inflation slowing

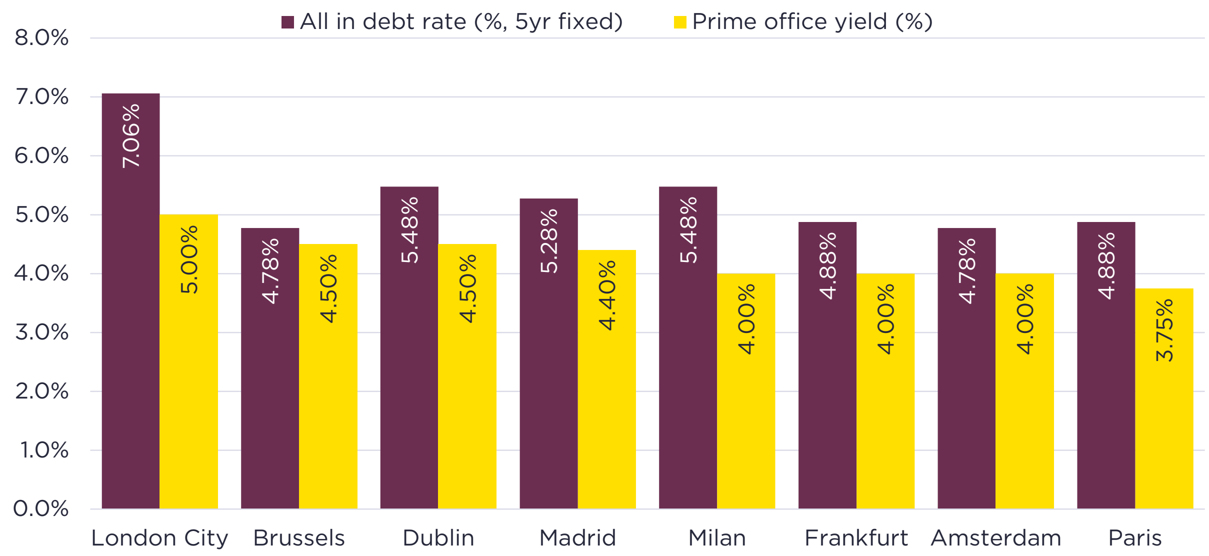
Pressure on interest rates beginning to ease across Euro Area.

Economic overview
Reasons for positivity emerge across Europe based on July inflation data, as core inflation in the Euro Area fell from 5.7% to 5.5% yoy since end March, as pricing pressures show early signs of easing.

Bond markets, which have been increasingly sensitive to inflation data, subsequently rebounded back by 20 bps to 4.2% in the UK, whilst the 10Y German Bund yield remains at 2.4%. All in debt costs subsequently increased by 60 bps during Q2 2023, in part, by an increase in debt margins. Given all in debt costs now stand on average 100 bps above prime office yields, debt is not accretive to returns and the majority of office transactional activity this year will be in the €20-€50m lot size, with H1 office investment volumes down by 64% yoy.

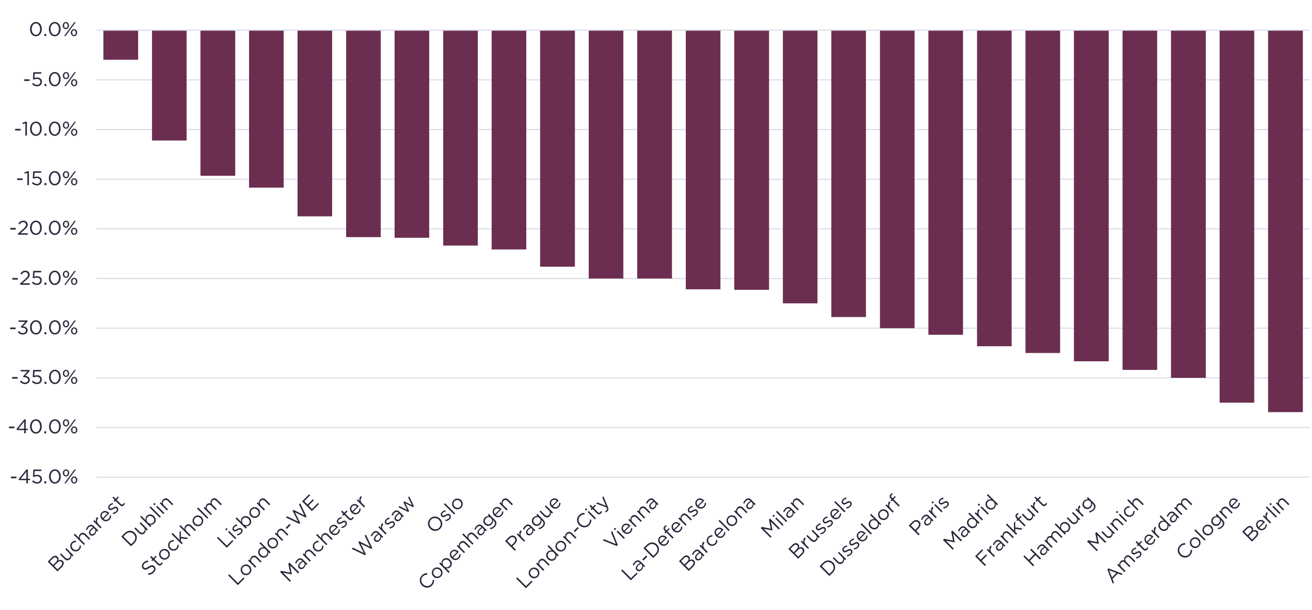
As expected, higher interest rates are beginning to impact private investment, although the Eurozone GDP growth remained in positive territory during Q2 2023, but is expected to enter recession during H2 2023. A weaker economic outlook is thus, likely to further weaken employer sentiment, and have a lagged negative impact on overall office take up figures later this year- for example, German top 6 office take up has already fallen by 34% yoy during H1 2023. Overall, we expect this to hamper prime rental growth prospects across European offices over the next 12 months as average vacancy rates move closer to 8%.

Chart 1: Prime office yields and all in debt rates (%)



Source Savills

Chart 2: Yield impact on capital values since Q1 2022 (%)



Source Savills

Office value analysis

Prime office yields move out by an average 18 bps during Q2 2023.

Methodology

Savills EME Office Value Analysis compares the fundamental (calculated) yield relative to current market pricing across 23 EME markets, covering London-City, Stockholm, London-WE, Manchester, Lisbon, Oslo, Berlin, Paris, Copenhagen, Dublin, Amsterdam, La-Defense, Prague, Hamburg, Madrid, Barcelona, 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 risk premium. The calculated yield is derived as the current risk free rate plus five year average office risk premium, discounting for nominal rental growth (source: IPF, Savills), inflation (source: Oxford Economics) and depreciation across each market. The fundamental yield represents a hypothetical yield assuming a fully liquid market and that the investor is fully hedged against currency risk.

Given the inverse relationship between yields and capital value, we use the following definitions for fair-pricing;

Market capital value >10% above fundamental capital value, we consider over-priced

Market capital value within 10% of fundamental capital value, we consider fairly priced
Market capital value >10% below fundamental capital value, we consider under-priced

What's happened to pricing so far?

During Q2 2023, European prime net office yields moved out by an average of 18 bps to 4.46%. London City moved out by 50 bps to 5.00%, whilst Cologne and Berlin both moved out 30 bps to 4.00% and 3.90% respectively.

Since Q1 2022, prime net office yields have moved out by an average of 110 bps, indicating an average yield impact on capital values of -25%. Prime rents, on the other hand, have risen by an average of +7% over the same period.

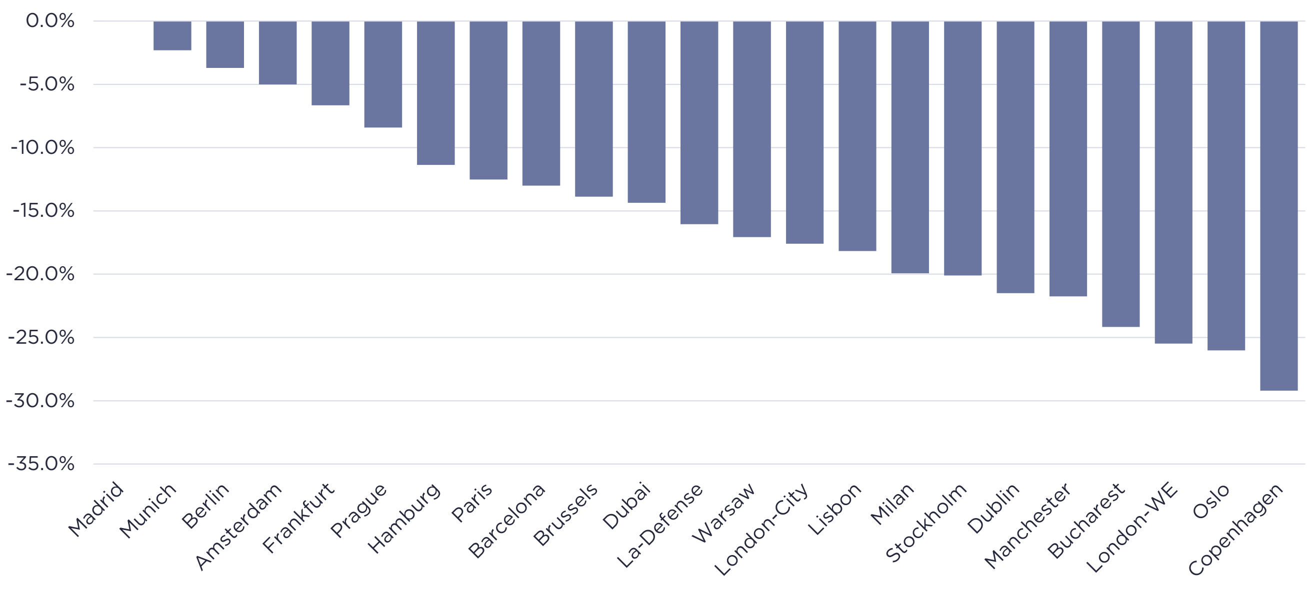
Berlin (-38%), Cologne (-38%) and Amsterdam (-35%) have observed the largest yield impact on capital values, whilst higher-yielding Bucharest and Dublin have adjusted by only -3% and -11% respectively. Clearly, those previously lower yielding office markets have been most impacted by the higher debt costs, and core markets are adjusting most quickly. Core European markets (UK, Germany, France) are also seeing a higher proportion of office investment transactions, rising from 63% to 77% yoy, as investors opt for value-add product in more liquid markets. With fewer assets coming to the market, and transactions taking longer in general, we forecast investment transaction volumes to fall by 44% yoy during 2023.

How far do prices need to adjust?

Based on current pricing against the five year average risk premiums, six European office markets (Madrid, Munich, Berlin, Amsterdam, Frankfurt and Prague) sit within fair value territory during Q2 2023. On average, prime office capital values require an average -15% adjustment, in line with last quarter.

Based on our office value analysis model, Madrid (0%) Munich (-2%), Berlin (-4%) now require the lowest capital value corrections following further outward yield movement during Q2 2023. Inflation in Spain has dropped significantly, allowing real rental growth prospects for Madrid. In Munich and Berlin, outward yield movement and (relatively) low 10 year Bund yields maintain Germany's appeal, supported by low vacancy rates.

Chart 3: Capital value correction required at current pricing (%), Q2 2023



Source Savills

Outlook

Value add to drive office transactional activity during H2 2023.

Pricing expectations remain problematic for transactions to complete, particularly with large lot sizes- buyers and sellers are at a standoff.

The focus is primarily refinancing, where this is possible. It is clear that banks do not want to take control of assets and will only do so if there is no alternative. However, banks are generally only willing to refinance assets where the interest coverage ratios remain above the 1.4/1.5x mark.

In some cases, there is no alternative but for sellers to bring stock back to the market. However, the numbers of full equity buyers who are able to acquire large lot sizes are thin, and therefore the bid-ask spread between buyers and sellers remains wide for core assets. Consequently, we have seen a number of sales pulled from the market. We are therefore seeing bidding activity generally restricted to the €20-50m lot size from full equity buyers, with the caveat now that sellers are asking agents to pre-qualify buyers to ensure a smooth transaction. Anything much larger is becoming difficult to receive approval from investment committees unless it meets all criteria. Following steady net inflows, we expect some of the French SCPI funds to become more active, along with private family offices who are seeking to take advantage of price discounts.

Of course, many landlords will not accept that they will have to sell at a loss, and are opting to refinance on short term fixed rates and hold the assets until further yield compression resumes.

From a transaction volumes perspective, we do not expect activity to significantly recover during H2 2023. Investors will wait for inflation and bond yields to fall before acquiring large assets, which will make price discovery more difficult over the next couple of years.

Banks are also asking themselves, "are we achieving a sufficient return on lending to prime offices?" In the European Central Bank's latest Bank Lending survey, a net balance of +30% of respondents reported that credit standards for loans to commercial real estate have tightened, indicating that debt margins could increase further. Banks reported a net decrease in demand of -42% for commercial real estate loans and expect a further decrease in demand for loans across during H2 2023.

Some of the higher-risk loans no longer suit the traditional banks' risk profiles, so alternative lenders are poised to step in for higher risk debt. Loan to value ratios are significantly lower than during GFC which is making the current speed of adjustment slower than previous cycles.

Overall, we feel there is further room for prime yields to move out across Europe, although the core mainland European markets have adjusted most quickly, which is where we expect activity to resume first. Investors will first wait for bond markets to recover before focussing on repriced core acquisitions in 2024.

Savills Commercial Research
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