European Commercial - Q4 2022

SPOTLIGHT
Savills Research

EME Office Value Analysis

savills

● Risk Premium ● Rental Growth ● Inflation

Inflation fears easing

A more positive outlook for 2023 following a weaker Q4 2022 of investment transactions

Economic overview

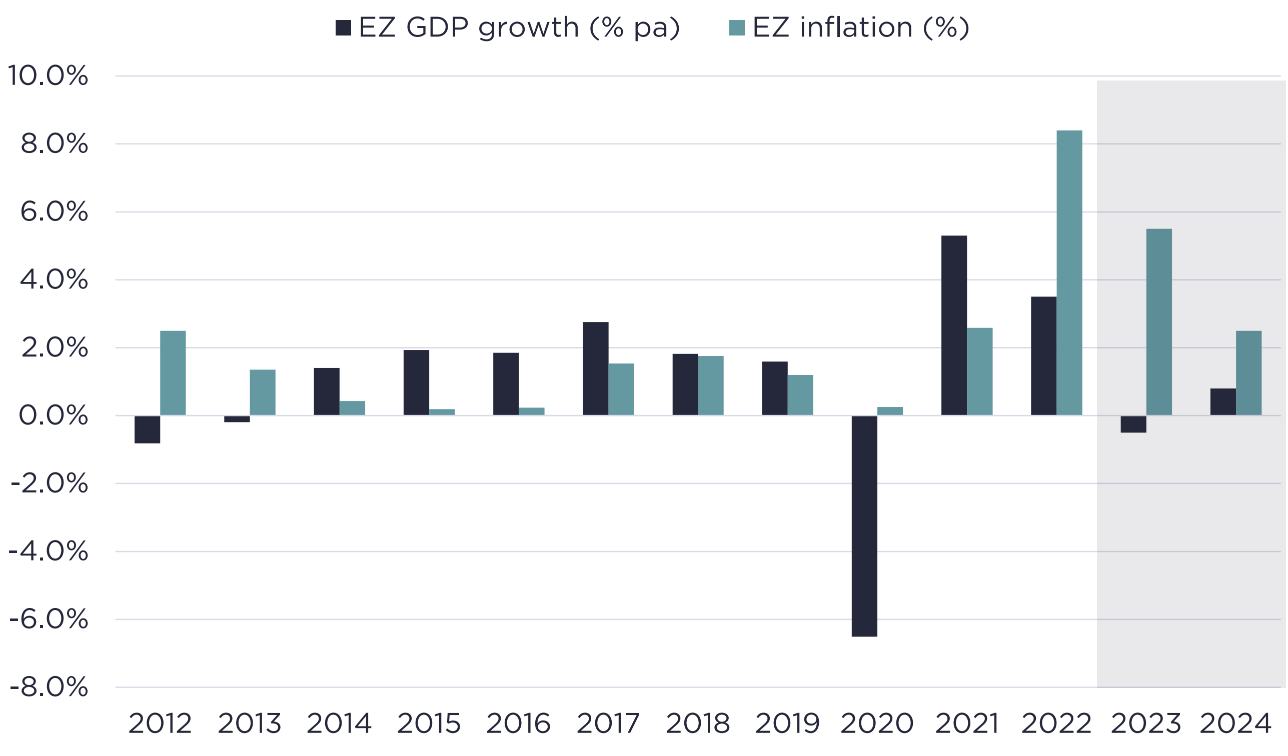
Some of the latest European economic indicators are pointing to an improvement in sentiment since end 2022. Eurozone GDP appears to have flatlined in 2022, against the consensus view for a recession, and January's PMI activity points to a small improvement in economic output across Southern European economies. However, growth prospects still remain weak, with Capital Economics forecasting -0.5% growth during 2023, followed by 0.8% growth in 2024. On a more positive note for the office sector, employer sentiment is less subdued, with Oxford Economics forecasting a total of 3% office based employment growth over the next five years.

Inflation appears to have peaked, amid signs that Europe's gas storage levels are higher than were anticipated, although headline levels of inflation are set to average 5.5% in 2023, and recover to 2.5% in 2024. Nevertheless, there are concerns around the core rate of inflation which is expected to remain around the 5-6% mark as workers collectively campaign for higher wages.

Further rate hikes to 3% are expected by end April, with several economists now expecting interest rates to move out further to 3.5%. There remains a high level of volatility in the bond markets which is likely to remain until rate hikes are finished, which will support investor decision making. Rate hikes have subsequently raised all-in-debt costs for prime European offices from an average of 150bps at end 2021 to 450bps at end 2022.

European office investment transaction volumes dropped by 20% yoy in 2022, driven by a 27% decline in Germany, a 23% decline in UK and a 63% fall in Sweden, according to Savills Research. The market remains in a price discovery phase amid rising bond yields and debt rates.

Chart 1: Eurozone GDP growth and inflation (%)



Source Capital Economics

Value correction underway

An 18% correction in values has been observed, but there is still some way to go.

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 calculated yield is derived as the current risk free rate plus five year average office risk premium, discounting for nominal rental growth (source: IPF), inflation (source: Oxford Economics) and depreciation forecasts 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.

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

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

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

Analysis- what's happened to pricing so far?

Q4 2022 has witnessed the most significant outward movement in European CBD office yields so far during the energy crisis, as average prime yields moved out by 30 bps to 4.2% during the quarter. Since Q1 2022, we have observed an 18% decline in capital values as a result of interest rate rises, marking an average 75 bps of outward movement since the peak in Q1 2022.

In nominal terms, Manchester, Prague, Amsterdam, Milan and La Defense have all moved out by 100 bps since Q1 2022. Whilst Paris CBD, Brussels, Madrid, Cologne, Munich and Berlin each moved out by 90 bps.

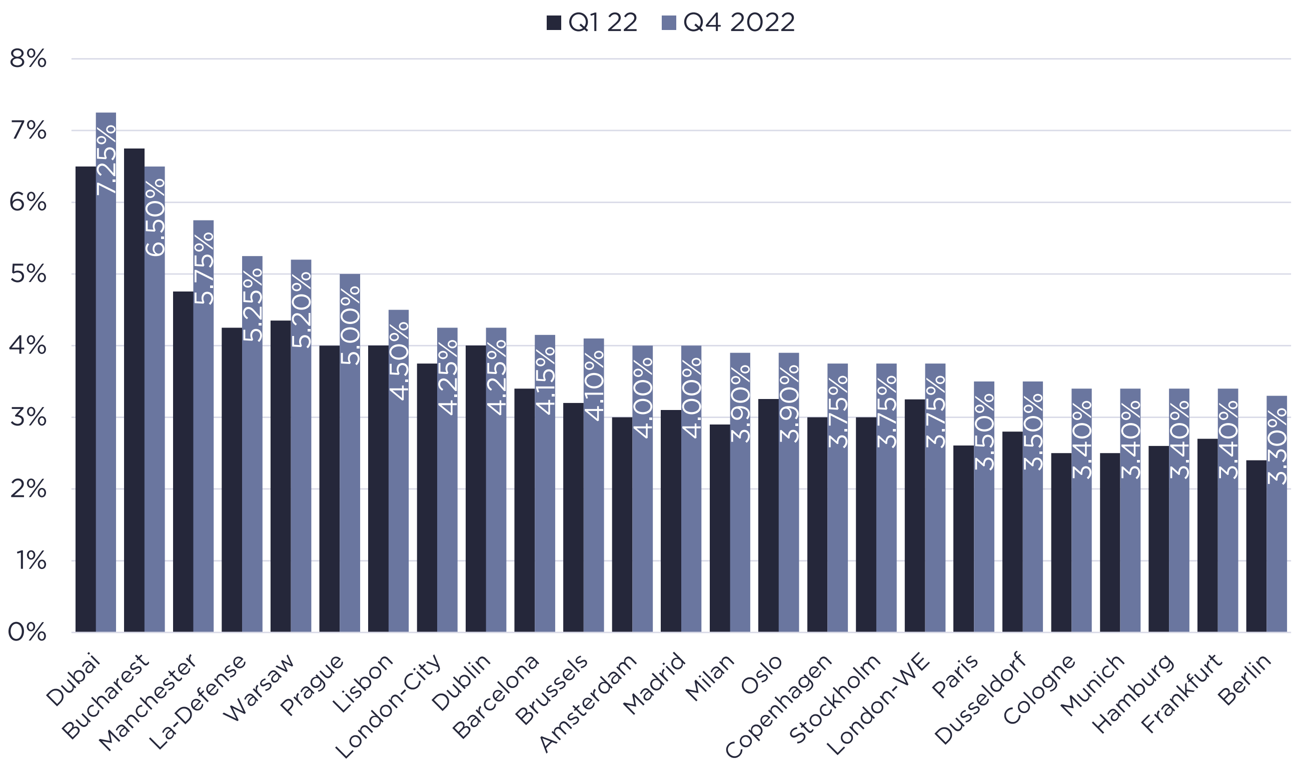
Higher yielding office markets have been less responsive to the interest rate rise, with prime yields moving out in Dublin (+25 bps), London City and WE (+50 bps) and Lisbon (+50 bps) over the same period.

How far do prices need to adjust?

Despite the yield adjustment, all markets remain in fully priced territory at end 2022 and as we move through the first quarter of the year, the office sector continues to reprice. On average, we calculate that a further 19% correction in European office capital values is required to maintain risk premiums in line with the five year average. This would represent an overall 37% capital value correction from Q1 2022, with core markets, and cities which observed late cycle yield compression, most exposed.

The markets edging nearest to fair value at end Q4 2022 are London City (-16% capital adjustment required) and La Defense, which has seen prime yields move out by 100 bps from 4.25% to 5.25% since Q1 2022. Refinancing terms for big-ticket assets have been more stretched in recent months, with landlords seeking alternative lenders to fill the funding gap. Similarly, the Nordic cities of Oslo and Stockholm raised interest rates earlier and as such, office yields have followed suit.

Chart 2: EME prime office yields (%)



Source Savills Research

However, pricing models should be taken with caution as they tend to provide an indication of when an adjustment is expected, rather than the full extent of the correction.

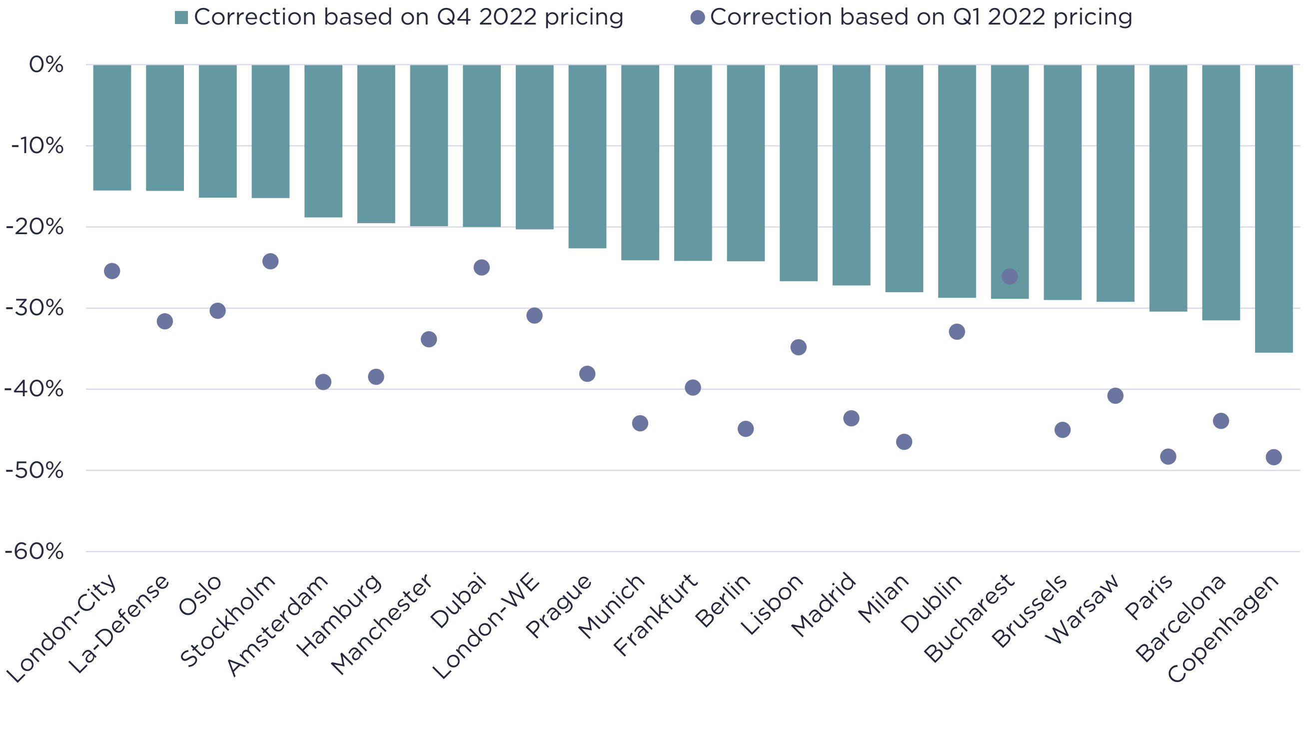
The next question posed is of course, "What is the right risk premium?"- casting our minds back to end 2007 and pre-global financial crisis (GFC), risk premiums over government bond yields stood at 110 bps in Amsterdam, 70 bps in Berlin and zero for London West End offices. With the current five year average risk premium between 175-200 bps across Europe, investors have benefitted from low risk-adjusted returns in recent years, and as real estate has become a more institutional asset class with higher levels of fundraising, the risk premium over bonds should, in theory, have decreased.

The IPF's latest European rental growth forecasts indicate a modest average 1.9% prime rental growth per annum for the office markets that Savills tracks. Prime rental growth over the past 12 months has averaged 5.5% according to Savills data, and with resilient occupier requirements for green space, office based employment growth and a shortage of new Grade A supply, there is a case to suggest that rental growth could exceed 3% per annum over the next five years, lifting current valuations.

What's more, INREV's latest European Investor Sentiment Survey shows that offices has reclaimed its position as the most sought-after real estate sector, ahead of residential and industrial, providing a positive asset allocation story for the sector. Albeit, due to rising rates, overall European real estate fundraising fell by 50% yoy, according to Realfin data, suggesting investors are likely to become more price sensitive. What is clear, is that we are observing a faster adjustment in pricing compared to the GFC, with more private equity investors enquiring about new stock returning to the market, and testing vendor willingness.

As such, we believe an overall 25-30% correction from Q1 2022 values is appearing more likely. As previously mentioned, our 18% adjustment so far, indicates that we are deep into the period of "price discovery" as yields have corrected faster than during previous cycles, which supports our expectation for investment transaction volumes to gather pace during H2 2023. The speed of correction will be varied across Europe and during January 2023- London City office yields moved out a further 25 bps and now appear within the fairly priced threshold, albeit, much of mainland Europe will require 40-50 bps of further outward movement in H1 2023.

Chart 3: EME office capital value correction required at current pricing (%)



Source Savills Research

Savills Commercial Research
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