European Commercial - Q1 2022

EME Office Value Analysis

SPOTLIGHT
Savills Research

• Risk Premium • Rental Growth • Inflation

Economic headwinds

Eurozone inflation will eat into real rental growth

Economic overview
Rising energy prices as a result of the Ukraine/Russia conflict continue to drive up headline inflation, reaching 7.5% in April 2022, the highest level on record with economists revising their 2022 inflation forecasts upwards on a monthly basis.

More recently, the core level of Eurozone inflation has increased to 3.5% with surveys indicating energy prices will remain high for the rest of the year. Latest readings indicate inflation is rising at different levels across Europe, with the Netherlands (+9.6% yoy), UK (+9.0% yoy), Spain (+8.3% yoy) most impacted, , whilst France (4.8%) has been less impacted due to a lower dependency on imported energy.

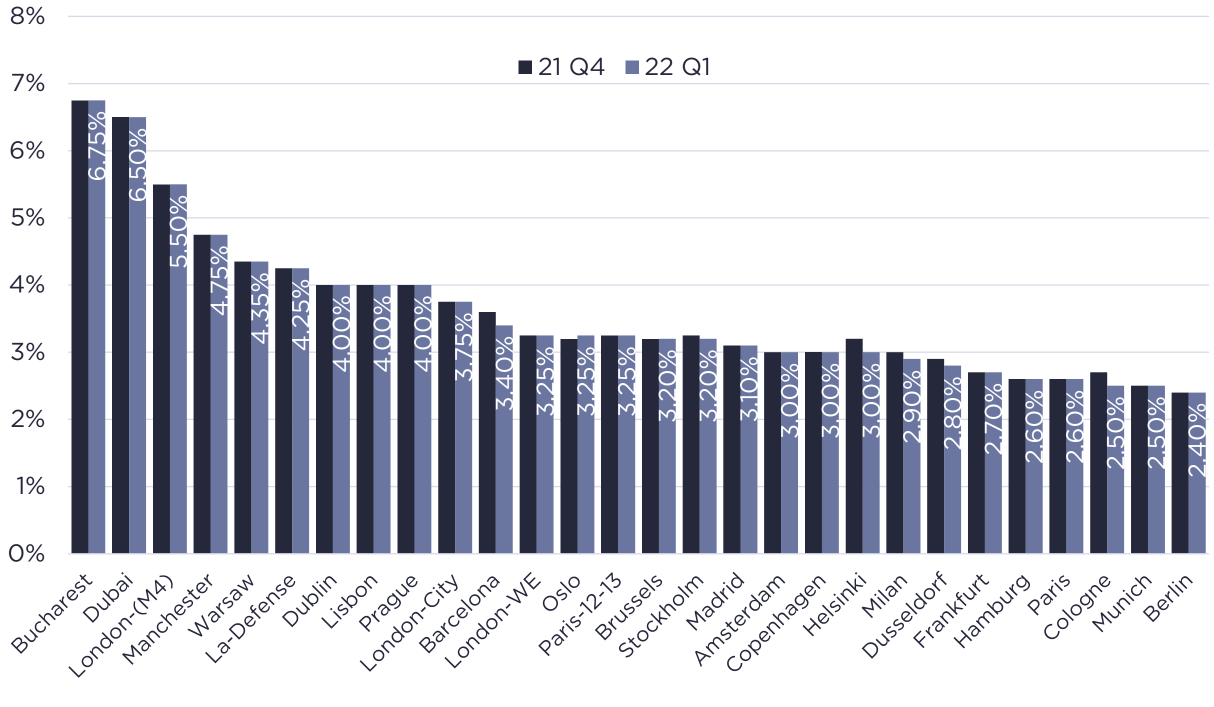
European steel prices have been one of the main construction input costs to rise given the supply chain shortages, and Oxford Economics anticipate this will reach around three times the pre pandemic level before recovering in 2023, which is ultimately adding to overall office development costs.

10 year German government bond yields are subsequently yielding in excess of 1% as at May 2022, a 120 bps increase yoy, amid rising expectations of an interest rate rise. The European Central Bank is under pressure to both spur economic growth, but also to curb inflation and are expected to increase interest rates three times during H2 2022, with the deposit rate set to reach 1.5% by end 2023.

We have also observed rising global interest rates, with the Federal Reserve increasing US interest rates to 0.75% to 1% during its May meeting. The USDEUR exchange rate has subsequently increased to €0.95 in mid-May, the highest level since 2002, with Capital Economics expecting exchange rate parity by the end of 2022.

Eurozone GDP growth grew by 0.2% during the first quarter of 2022. Pricing pressures are now beginning to weigh in on consumer confidence, which is expected to drag down GDP by 0.3% during the second quarter of the year. However, business confidence has remained more stable thus far, and overall, economic growth is expected to rise by 1.8% for the full year 2022, down from 5.4% in 2021. Economists are pointing to a period of stagflation (high inflation and stagnant economic growth) across the Eurozone economy as consumers and businesses hold off on their decision making.

Chart 1: EME prime office yields (%)



Source Savills Research

Investment and yields: what has changed?

Stronger rental growth prospects in core markets will support prime yields.

Investment transactions
European office investment transactions remained buoyant in Q1 2022, carrying positive momentum from 2021 and marking the second strongest Q1 in the last 10 years, reaching €25.5bn, and 21% above the previous five year average. The UK (+35%) and Germany (+92%) drove the overall level of activity, whilst the CEE locations of Czech Republic (+138%), Romania (+124%) and Poland (+82%) all performed significantly above the previous five year Q1 average. We are beginning to see more capital focussing on prime assets outside core markets including towards southern Europe in order to achieve higher yields and meet return targets, particularly from US private equity firms.

Office yields
Prime office yields generally remained stable or a marginal inward movement over Q1 2022 (Chart 1), compressing by an average of 7 bps across Europe. Helsinki (-20 bps), Barcelona (-20 bps) and Cologne (-20 bps) observed some of the strongest yield compression. The recovery in occupier demand and shortage of prime stock continues to support investor demand.

Bond yields
European government bond yields observed an average increase of 110 bps over the last six months, on the basis of rising interest rate expectations. Amid rising risk free rates, the spread between average core Eurozone government bond yields and prime office yields has dropped from 292 bps to 139 bps against the previous year, positioning a number of mainland European office markets as fully priced.

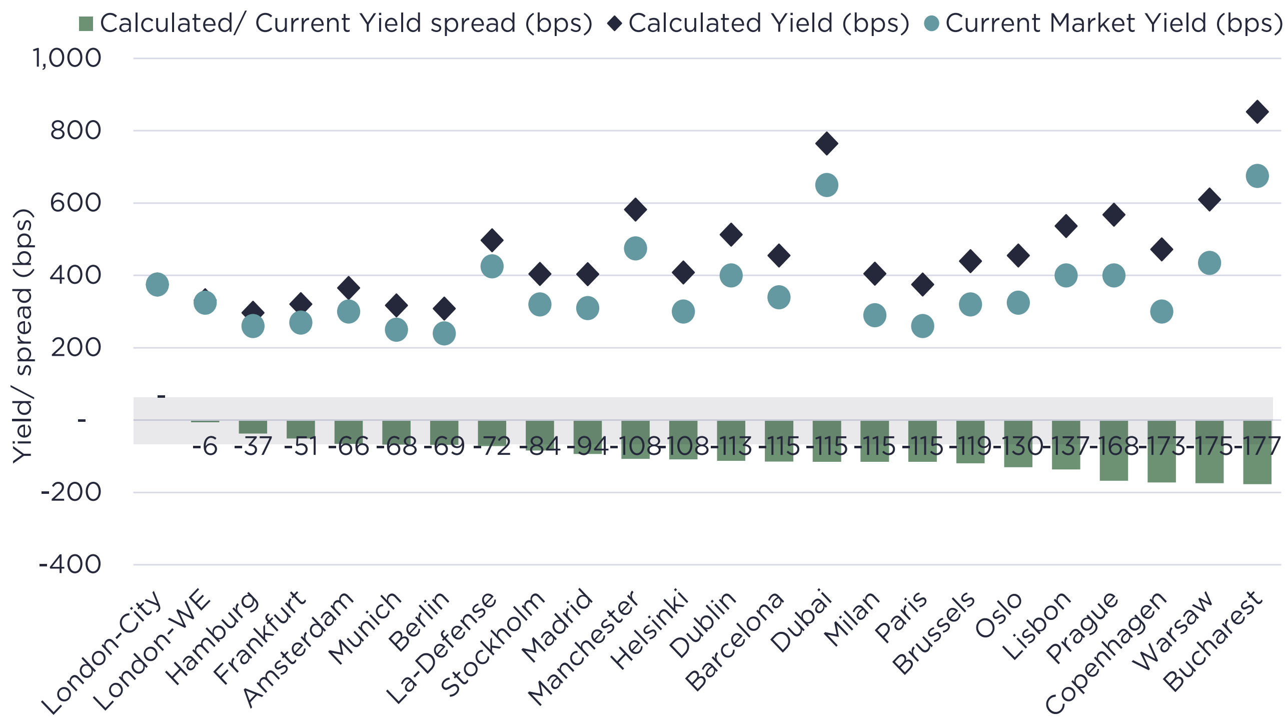
Debt markets are now responding across Europe, with all in borrowing costs are eating into real estate returns across Europe as lenders require larger margins, with all in debt rates rising by an average of 140 bps against the previous year, assuming a 55-60% leverage. Debt costs have more than doubled across German office markets from circa 1% to in excess of 2% and in certain European markets now sit above prime office yields, squeezing levered returns.

Rental growth
Prime nominal rental growth forecasts continue to recover, driven by a strengthening office market and undersupply of prime office space, rising from 0.9% to 1.8% pa, according to Capital Economics. However, the latest evidence indicates that prime rents have risen well above these levels over the last 12 months, led by Munich (+17% yoy), London City (+12% yoy) and Amsterdam (+11% yoy) and we anticipate stronger rental growth to come, which would therefore support pricing.

Given that average European office vacancy rates remain low at 7.2%, the market remains in the landlord's favour and we expect that the rising fitout costs will be partly absorbed by the landlord and partly passed on in higher rents to tenants, particularly in markets where leases are index linked. In Milan, for example, the high competition for grade A assets in the sought-after locations of CBD and historic centre will support rental levels. We anticipate an increase in headline rents, partially incorporating the inflation trend.

Depreciation
We are seeing a green premium emerge for BREEAM certified assets, with the average yield spread between Very Good certified assets or above against all office yields widening by 44 bps over the last 12 months. Savills office depreciation forecast remains at 1.5% pa, an increase from the 1.0% pa since our initial office value analyses, to reflect the intensification in investor demand for ESG certified assets and rising obsolescence risk. We anticipate the depreciation risk to be highest in the markets where we see some of the stricter EPC regulation, including the UK and the Netherlands.

Chart 2: EME office value analysis (bps)



Source Savills Research

Office value analysis and outlook

Rising debt costs will begin to squeeze levered returns

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 and outlook
London City and West End markets moved from under-priced to fairly priced territory, whilst Hamburg remains in fairly priced territory (Chart 2). All three markets values are supported by their forecast real rental growth over the next five years.

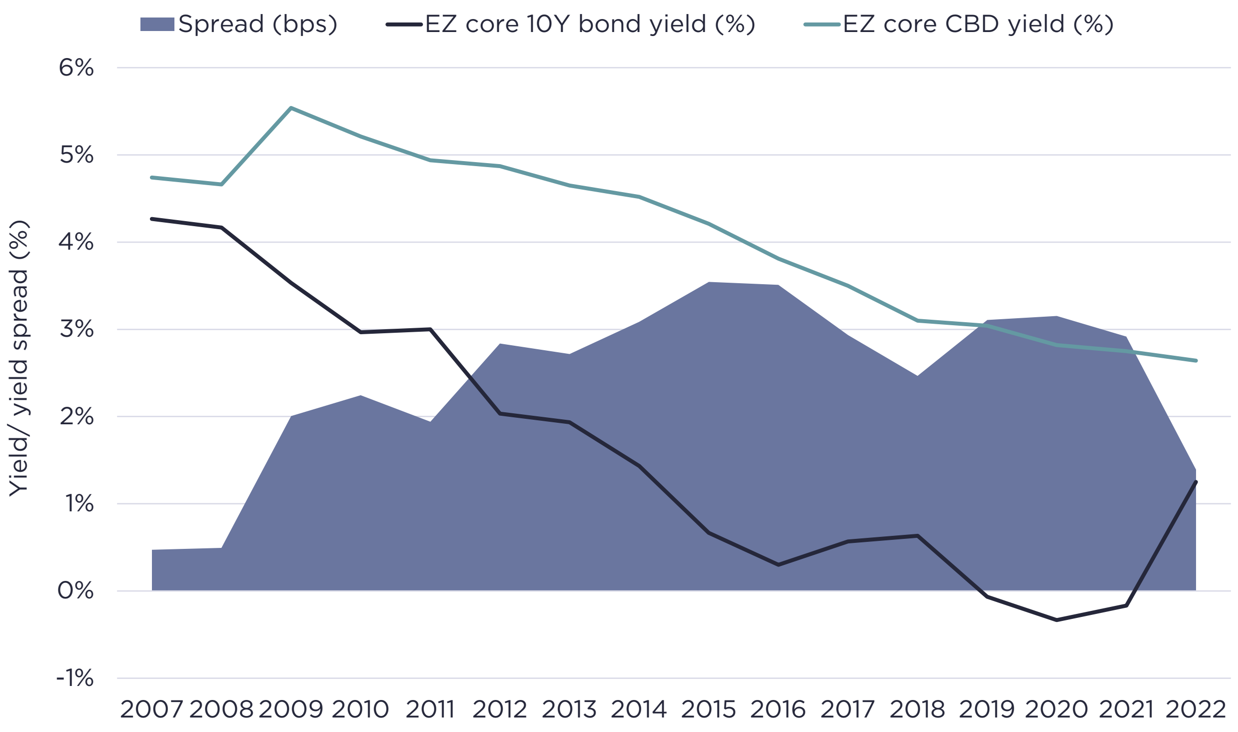
However, the remaining EME markets have moved into fully priced territory due to rising risk free rates. Western European cities are performing among the most resiliently, with Frankfurt, Amsterdam, Berlin, Munich all marginally entering fully priced territory. Buyer and seller expectations are increasingly disparate, and we are seeing a reduction in the number of bids as a result. This being said, vendors are holding firm on pricing requirements.

Given office investment transactions for CEE markets are most frequently transacted in euros, the relative volatility in government bond yields in Poland, Czech Republic, Romania is not fully reflective of office investment markets and therefore we expect pricing to follow a similar trend to that of western Europe.

Dry powder allocations to real estate remain resilient, with €76bn of capital raised for European non-listed real estate during 2021, in line with the record in 2019, according to INREV's latest capital raising survey. Of course, not all buyers borrow- rising interest rates will not impact cash buyers, with many cash-rich investors opting to borrow against their assets once debt is more affordable. Cash buyers may see this as a buying opportunity and will be at an advantage in years to come.

However, after a period of ultra-low interest rates, and ultra-high yield spreads, we can now expect a normalisation in yield spreads to pre Global Financial Crisis. Casting our minds back to 2006/07 average yield spreads ranged between 50-100 bps, significantly lower than the 250-300 bps spread we have observed in recent years (Chart 3). Total returns will be influenced by landlords' ability to lift rents, as we have already observed in undersupplied western European markets over the past year.

Chart 3: Eurozone "core" prime office yields and government bond yields (%)



Source: Savills Research, core represents unweighted prime yields for Munich, Berlin, Frankfurt, Paris CBD, Amsterdam

Savills Commercial Research
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