European Commercial - Q1 2023

EME Office Value Analysis

SPOTLIGHT
Savills Research

● Debt Costs ● Price Adjustment ● Outlook

Credit conditions tighten

Interest rates to peak in H1 2023 before falling in 2024.

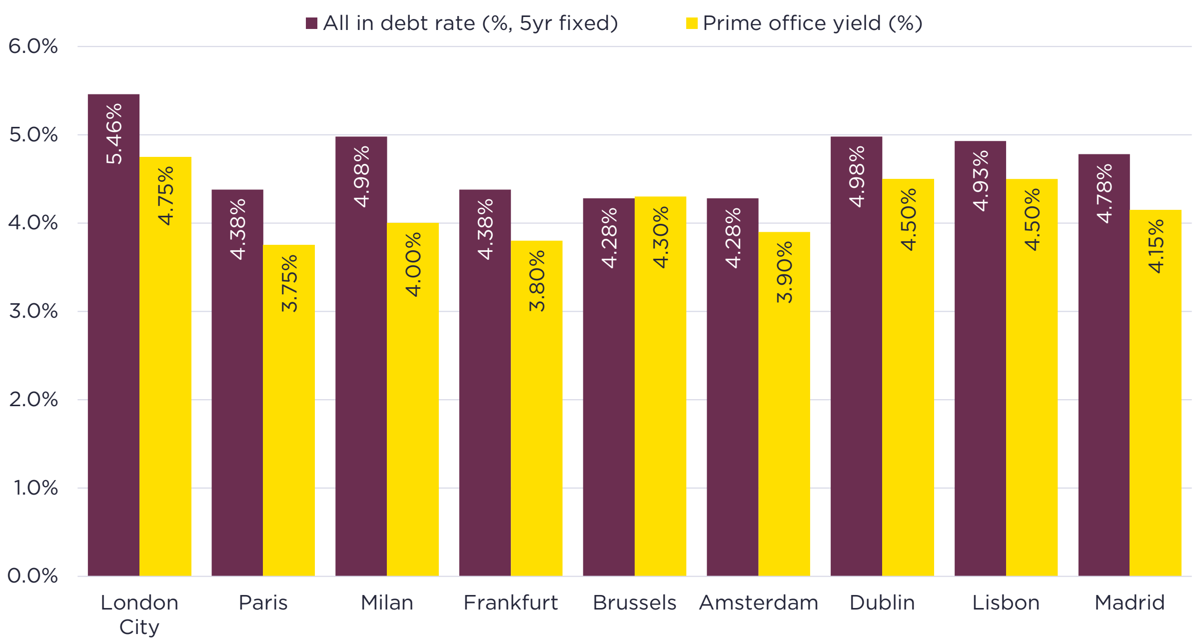
Economic overview
The Eurozone economy surprised economists by narrowly avoiding a recession during Q1 2023, setting the stage for a year of zero growth in 2023. The European Central Bank is expected to raise interest rates to 4.00% by mid-2023 as managing core inflation remains a priority, according to Capital Economics. However, given a weaker economic backdrop, expectations remain in line for an interest rate reduction to 3.00% in 2024 and 2.00% in 2025, which will support the recovery in investor demand.

Following HSBC's acquisition of Silicon Valley Bank UK, and UBS' shotgun merger with Credit Suisse, credit conditions have tightened, particularly around lending to commercial real estate. However, European banks are less exposed to commercial real estate than their American counterparts- in Europe, commercial real estate lending accounts for circa 7%, compared to 13% for large US banks, and 43% for regional US banks.

Whilst swap rates eased back in the UK during Q1, Euribor rates rose further, coupled with lender margins increasing across the board. All-in-debt costs rose by an average of 20 bps during Q1 2023 and now range between 4.3% to 5% for mainland European core stock. Debt costs remain above prime yields during Q1 2023, which continues to hamper investment transactions.

The BF quarterly barometer of German real estate lenders' sentiment has fallen to a record low, as lenders ultimately remain concerned over liquidity. However, banks are better capitalised than pre-GFC and are offering lower loan to value ratios, with more alternative lenders primed to step in and plug the refinancing gap at higher rates.

Chart 1: Prime office yields and all in debt rates (%), Q1 2023



Source Savills, yields indicate net, London City indicates April 2023

Core markets move into fair pricing

Seven European markets now move into fairly priced territory.

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 fundamental yield is derived as the current risk free rate plus five year average office risk premium, discounting for nominal rental growth forecast (source: IPF), 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.

Fundamental market yield > 10% above market yield we consider under-priced
Fundamental market yield within 10% of market yield we consider fairly priced
Fundamental market yield > 10% below market yield we consider fully priced

What's happened to pricing so far?

Prime office yields increased by an average of 19 bps during Q1 2023, led by Amsterdam (+40 bps), Frankfurt (+40 bps), and Berlin (+30 bps). On an annualised basis, yields have moved out by +90 bps, reflecting an average of -22% capital value fall since the peak in Q1 2022.

In percentage terms, the core markets of Amsterdam (-33%), Berlin (-33%), Cologne (-32%) and Paris (-31%) have observed the most significant capital value adjustments- clearly, the previously lowest-yielding markets have been most impacted by the rising debt costs. Previously higher-yielding markets including Lisbon (-11%), Dubai (-10%) and Stockholm (-9%) have observed a smaller correction so far. Pricing currently remains resilient in Stockholm given the CPI-linked rental agreements.

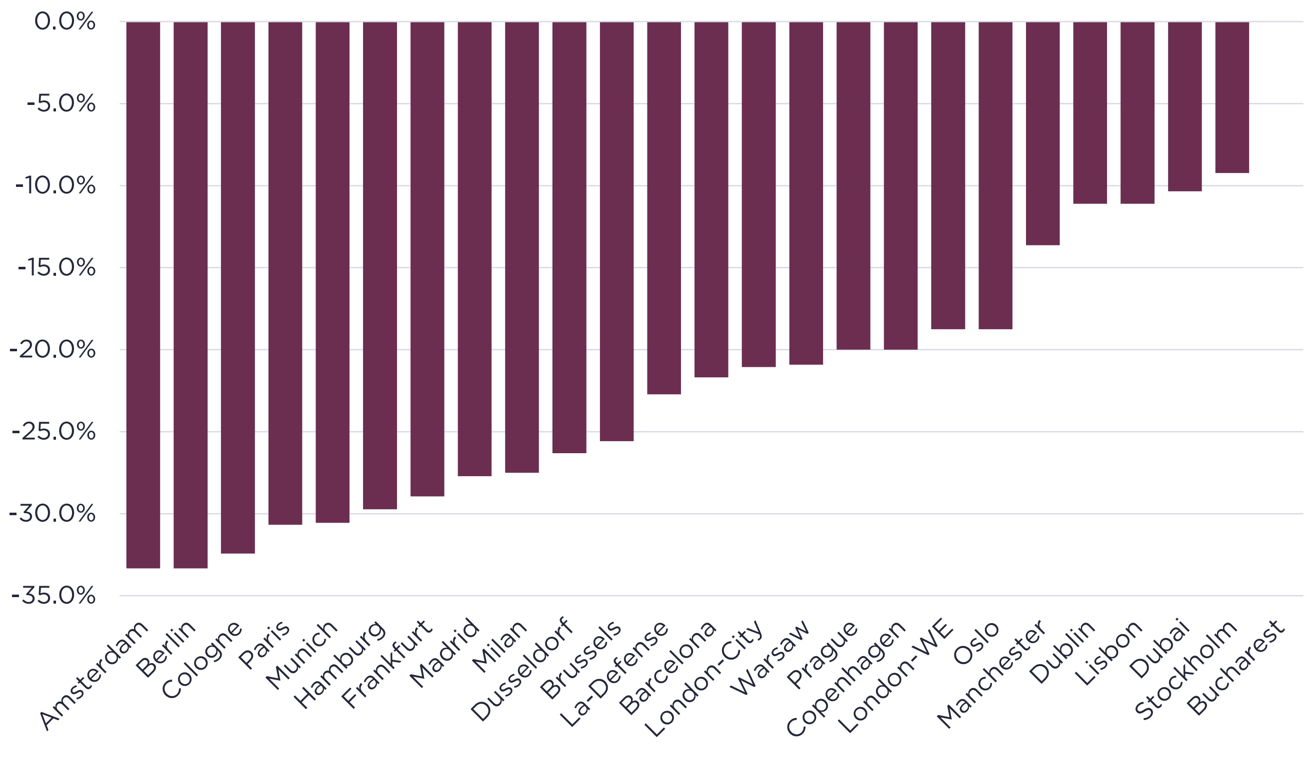
How far do prices need to adjust?

Based on current pricing against the five year average risk premiums, seven European office markets (Hamburg, Amsterdam, London City, La Défense, Frankfurt, Oslo and Berlin) have moved into fair value territory. European prime office capital values require an average -15% correction at current pricing to meet fair value pricing, with a number of Western European markets now in fairly priced territory (+-10% of calculated market pricing). As at April 2023, London City appears to have fully corrected, followed by Hamburg (-3%) and Amsterdam (-5%) which appear the markets closest to fair pricing.

Alongside outward yield movement, the shift to fair value territory has been supported by lower inflation forecasts and stronger rental growth prospects, with Western European markets now expecting positive real rental growth over the next five years.

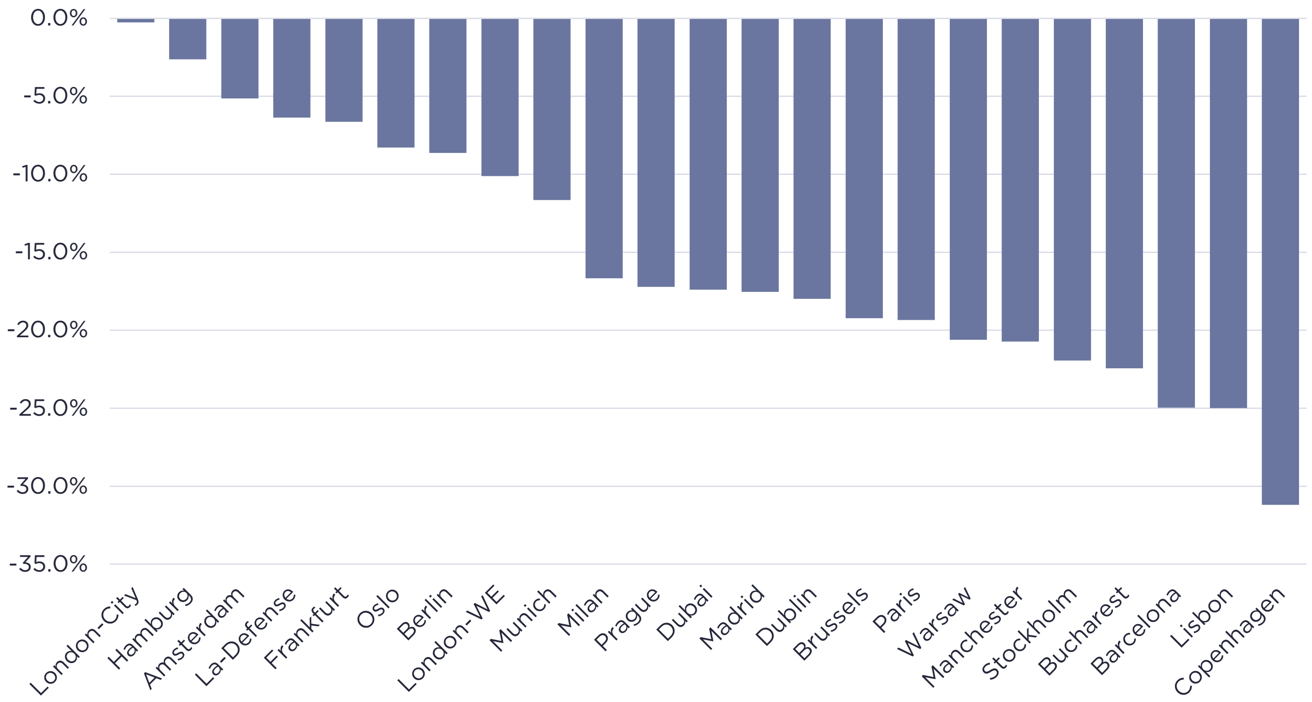
At the other end of the scale, markets with lower levels of liquidity such as Copenhagen, Lisbon and Barcelona have not seen prices adjust as significantly so far, and we anticipate further corrections during Q2 2023.

Chart 2: European prime office capital values adjustment since Q1 2022 (%)



Source Savills Research, London City indicates April 2023

Chart 3: Capital value correction required at current pricing (%), Q1 2023



Source Savills Research, London City indicates April 2023

Outlook

Overall, we appear to be nearly two thirds of the way through the price correction in Europe, although this varies significantly by market, indicating that price discovery for average prime stock is likely to have completed by Q4 2023. Indeed, our analysis of MSCI UK capital values indicates we are observing the fastest correction of any recent downturn, twice as quickly as during the global financial crisis.

Investor demand appears to have rebounded faster in London than in mainland European markets as a result of the speed of repricing, and London's heightened appeal to non-European investors. UK office capital values also appear proportionally less impacted by rising interest rates than Eurozone markets, given previous negatively yielding Eurozone government bonds.

However, prices also appear to be adjusting more quickly than ever recorded in mainland Europe, for example, prime Frankfurt office yields have moved out by 110 bps to 3.8% during the last four quarters- the trough to peak post GFC took eight quarters.

There is clearly a lack of evidence for prime pricing. Willing buyers are sparse and are focussing on their own refinancing, rather than new acquisitions as capital raising remains difficult. Our preliminary data for Q1 2023 indicates European office investment transactions are down by 64% yoy.

We are seeing the majority of transactional activity at the value add end, with cash investors seeking to refinance at more favourable rates next year. Average lot sizes are significantly smaller, as buyers become more selective on building specifications and sales are withdrawn. As it stands, some private equity investors are adjusting their business plans from a buy-fix-sell to a buy-fix-hold strategy and are only likely to launch sales when buyer sentiment improves.

However, the distress is not obvious so far, as we have seen limited evidence of any bank repossessions. Those vendors that are seeking to sell are justifying this on an asset reallocation basis, rather than due to any distress, and are still seeking competitive pricing. Likewise, there remains dry powder available to invest, although buyers are more selective over when they choose to invest- likely in the second half of the year.

It is worth considering that pricing is not always based on fundamentals however, and yields reflect what a buyer and seller are willing to transact at. What is interesting, is that if we apply the average 10 year risk premium from before Russia's invasion of Ukraine, to current pricing adjustments, London City and West End appear relatively more attractively priced, given the lack of yield compression post-Brexit referendum, and relatively higher Eurozone interest rates in the preceding five years. Given ultra-low interest rates in the last five years, a lower Eurozone property risk premium seems a fair assumption moving forward, in which case, a full price correction is unlikely.

Savills Commercial Research
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