European Commercial - Q4 2023

SPOTLIGHT
Savills Research

European Office Value Analysis

● Inflation ● Yields ● Outlook

Inflation expectations slashed

Government bond yields drop, heightening European offices' investment appeal.

Economic overview

The Eurozone economy outperformed expectations during 2023, although will remain close to, or in recession in 2024 as higher interest rates continue to hamper investment and growth prospects.

Inflation remains on a downward trend, and fell faster than economists had predicted during Q4 2023, reflected in December's Eurozone inflation reading of 2.9%. Government bond yields have risen in early 2024 as expectations for an early interest rate rise have moderated, although the German 10Y bond yield remains 70 basis points below the levels at end Q3 2023.

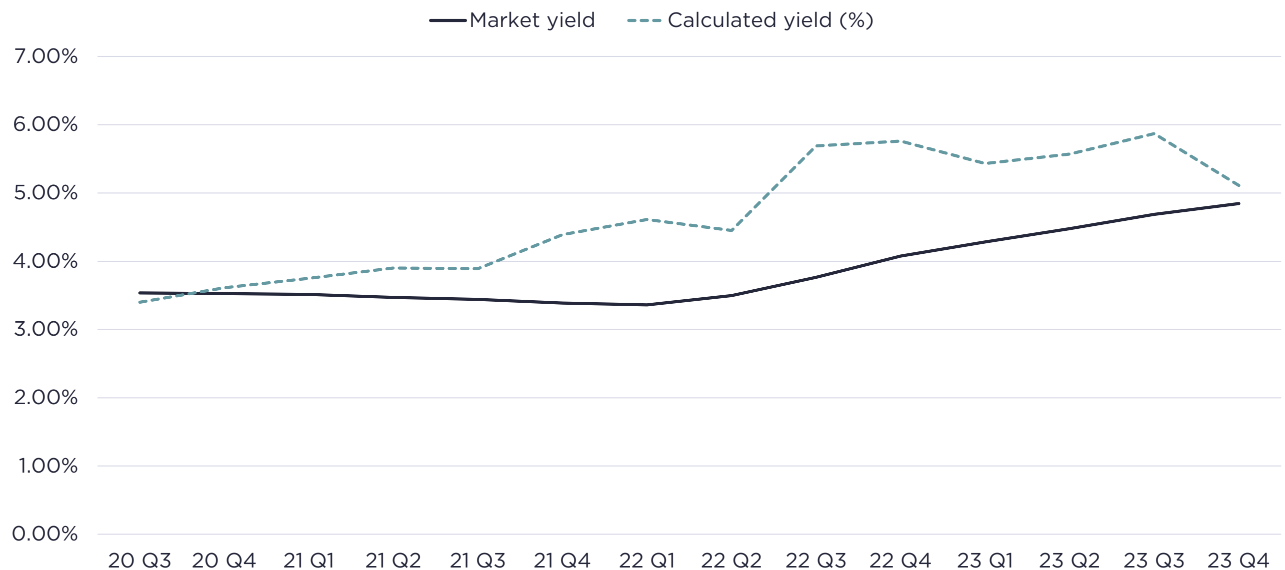
Investors' attention is now focussed on when the first interest rate cut will come- Capital Economics are predicting a first 25 bps cut in Q2 2024, with rates to fall from 4.00% to 2.75% by end 2024, which will heighten real estate's investment appeal.

European office investment volumes fell by circa 60% YoY in 2023, preliminary data shows, although Q4 reflected a marginal increase on a quarterly basis.

Chart 1: European office prime yields (%)

Source Savills

Chart 2: European average prime office yields: market yield vs calculated yield



Source Savills

Office value analysis

Prime office yield decompression begins to slow with core markets now underpriced.

Methodology

Savills European Office Value Analysis compares the fundamental (calculated) yield relative to current market pricing across 20 European markets, covering London-City, Stockholm, Manchester, Lisbon, Oslo, Berlin, Paris, Copenhagen, Dublin, Amsterdam, La-Defense, Prague, Hamburg, Madrid, Barcelona, Munich, Warsaw, Brussels, Frankfurt 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?

Prime office yields moved out by an average of +16 bps during Q4 2023 to 4.85%, as yield decompression slowed from +21 bps during the previous quarter. Vienna (+50 bps), Manchester (+50 bps) and Bucharest (+50 bps) observed the strongest outward movement on a quarterly basis.

However, what is noticeable over the past 3-6 months is the slowing speed of outward yield movement in core (London City, Paris CBD, Frankfurt and Berlin) markets. Core markets were previously leading yield compression across Europe, but moved out by an average of only +14 bps during Q4 2023, down from +30 bps in the previous quarter. Prime yields are now adjusting at a faster rate across non-core markets, given lower levels of liquidity than core markets. For core markets, we expect average prime yields to stabilise during Q1 2024, with yield compression to return during H2 2024.

Looking back at the global financial crisis (GFC), Savills data indicates that average prime European office yields took 21 months to rise from trough to peak, rising 140 bps. This time round, average prime yields have similarly risen for 21 consecutive months since Q1 2022, by 150 bps. However, LTVs are lower than during the GFC, whilst banks have extended debt terms, which has prolonged the price adjustment phase during this cycle.

What next? If we adopt the Mark Twain refrain – “History may not repeat itself. But it rhymes” – then the previous cycle and GFC may offer some clues. It took 72 months for average prime European office yields to return to pre-GFC levels, following the global financial crisis, but the fastest yield compression came in the first 24 months. Of course, timing the market is crucial, and once the peak of the market has been established, it is often too late to benefit from early-cycle capital growth.

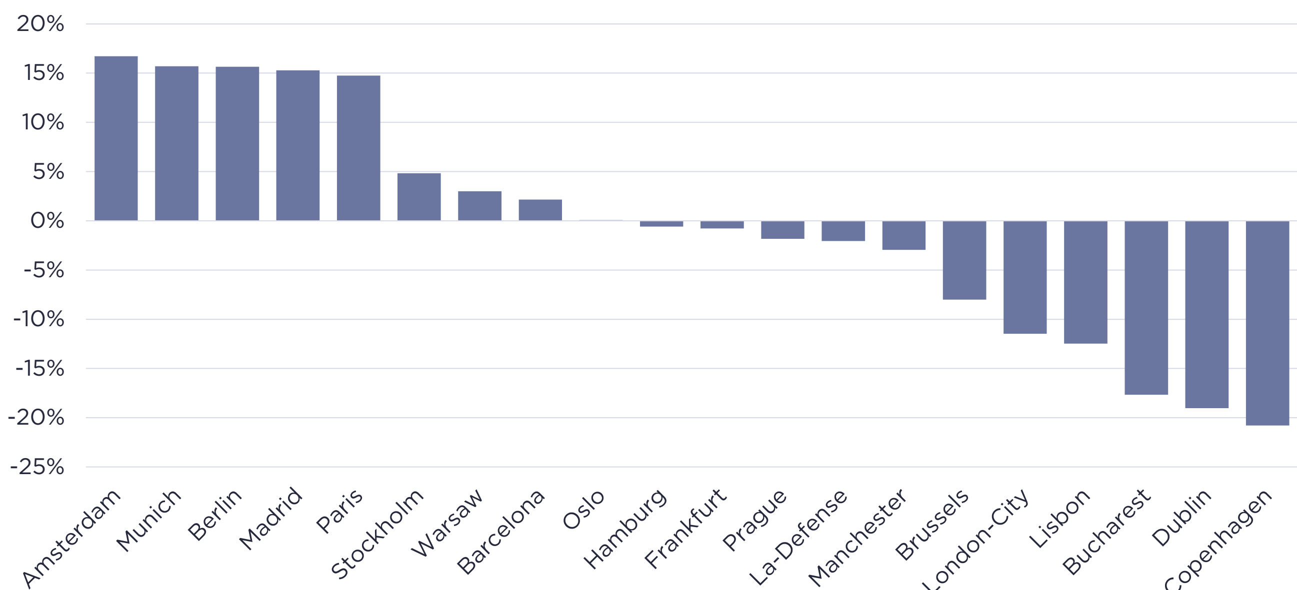
How far do prices need to adjust?

Analysing market pricing on a fundamental basis, average European prime office yields are now in fair-value territory and require a further capital value adjustment of only -3%. This is as a result of outward movement of prime yields and falls in government bond yields during Q4 2023, along with lower inflation expectations over the next five years.

However, not all cities report the same narrative. In fact, Amsterdam (+17%), Munich (+16%), Berlin (+16%), Paris CBD (+15%), and Madrid (+15%) have now moved into under-priced territory, following faster price adjustments and falling bond yields. These cities had the lowest yields and have been most impacted by the rising cost of debt and we can expect some yield compression to return during the second half of 2024.

Conversely, Bucharest (-18%), Dublin (-19%) and Copenhagen (-21%) appear fully priced, although there was already a larger buffer over government bonds before the interest rate rises, so much further outward yield movement appears unlikely. During a higher interest rate environment, risk-adjusted returns will be lower than prior to the rate rises.

Chart 3: Capital value correction required at Q4 2023 (%)



Source Savills

Outlook

Yields to compress in H2 2024, boosting investment transaction volumes.

A lower interest rate environment is boosting real estate's appeal and after a year of inactivity in 2023, pricing is now beginning to pique investor interest. The gap in buyer and seller price expectations is beginning to close, as vendor expectations ease towards the buyers' stance, from which we can expect to see a recovery in larger lot size transactions.

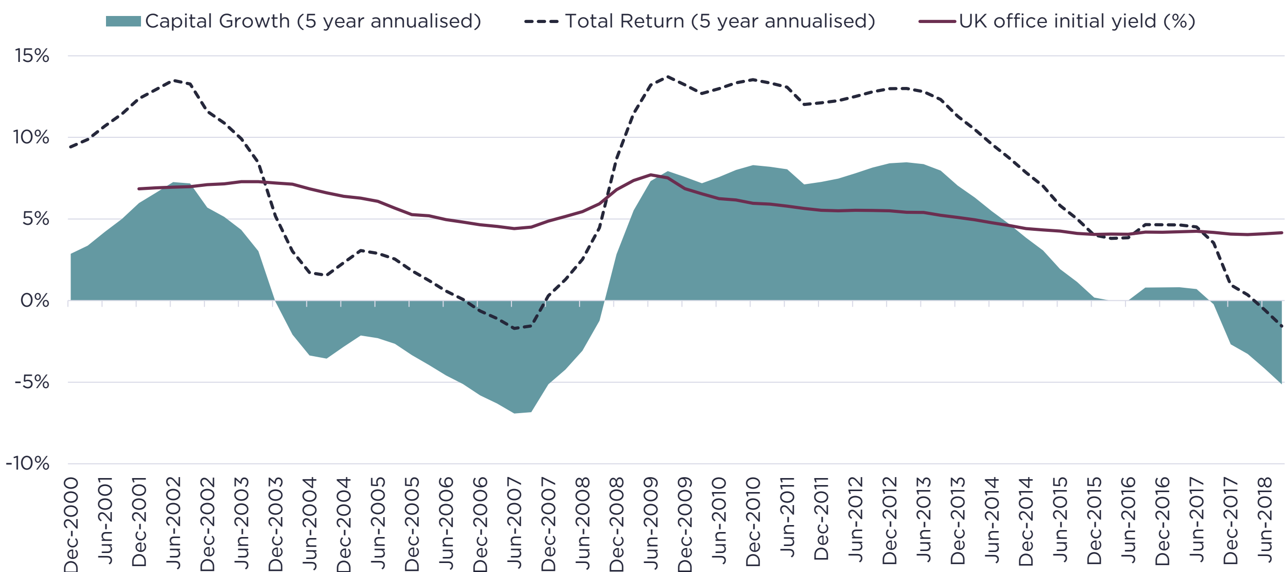
This report looks at the sovereign bond market as the risk free rate to give a view of fair value for offices on a relative basis. However, investors need to keep in mind the ongoing changes to the fundamentals of the office market. Changes in WFH, net capital inflows and debt maturities among other factors will impacts values. The definition of prime offices is continuing to change as investors exercise caution, which has led to a bifurcation in the market which we expect to continue.

Although pricing appears close to fair value, the funding environment is providing barriers for investment transactions to resume immediately. INREV's latest investor survey indicates European investors are seeking to reduce their investment allocation to real estate, with the proportion of investors seeking to deploy into offices falling from 69% in 2023 to 52% in 2024. German open-ended real estate funds have reported quarterly net outflows since Q3 2022, according to data from the ECB, and with upcoming refinancing events in 2024, the German open ended funds are likely to be net sellers throughout the year.

For core markets, offices now appear attractively priced against government bond yields, and with low vacancy rates and resilient rental growth prospects, we expect yield compression to gradually return for the very best stock during H2 2024. We are seeing the return of positive leverage for prime stock in France and Germany, as swap rates have fallen back.

In the UK, office net initial yields peaked in September 2009, at the same time as the five-year forward annualised total returns peaked, at 14% pa. So investors are likely to see their returns maximised by taking advantage of the strongest period of capital growth and investing now, before the competition returns.

Chart 4: UK office five-year forward annualised returns (% pa)



Source MSCI

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