

European Commercial - Q3 2024

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SPOTLIGHT
Savills Research

European Office Value Analysis



● Inflation ● Yields ● Outlook

Eurozone inflation falls to 1.7%

Interest rate cuts pave way for a transactional recovery.

Economic overview

September and October 2024 have provided a series of economic indicators suggesting the global and eurozone economies are set for slowing growth. Eurozone economic growth fell to 0.2% during Q3 2024, and Capital Economics anticipates a further 0.2% of growth for Q4 2024.

In the eurozone, inflation fell to 1.7% during September 2024, as services inflation fell below the 4% mark where it had been for most of the year. Economists consensus is that the upside risk to energy inflation as a result of escalating hostilities in the Middle East is relatively low, and given weaker

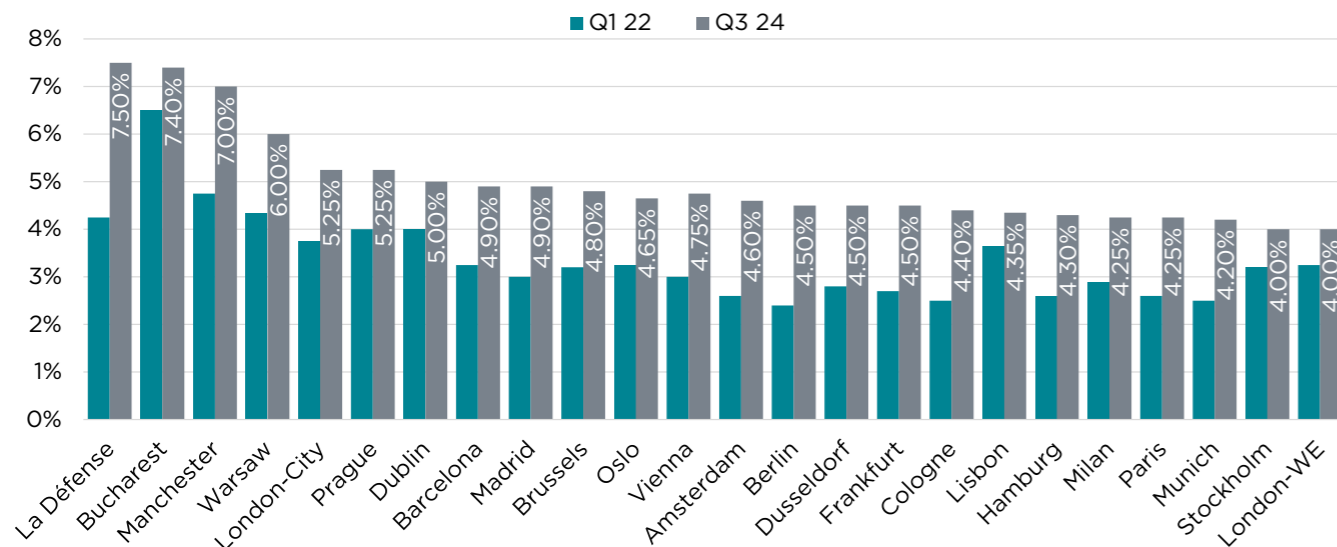
demand in the economy, fuel inflation is expected to remain negative over the next few years.

Following the US Federal Reserve's 50 bps interest rate cut, Capital Economics now expects the European Central Bank (ECB) to cut interest rates from 3.25% by 25 bps at each meeting until March 2025, which would leave rates at 2.50%. German 10Y government bond yields fell by 30 bps to 2.20% during Q3 2024, as investors anticipate faster interest rate cuts.

Savills preliminary total European investment data indicates that Q1-Q3

transaction volumes rose 5% year-on-year (YoY) and we forecast full year 2024 will rise by 15% YoY, reflecting a stronger final quarter.

Chart 1: European prime office yields



Source Savills

Prime office yields stable in Q3

A modelled approach: How far do capital values need to adjust?

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 CBD, Dublin, Amsterdam, La-Défense, Prague, Hamburg, Madrid, Barcelona, Munich, Brussels, Warsaw, Frankfurt, Milan 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 2017-21 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 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 underpriced

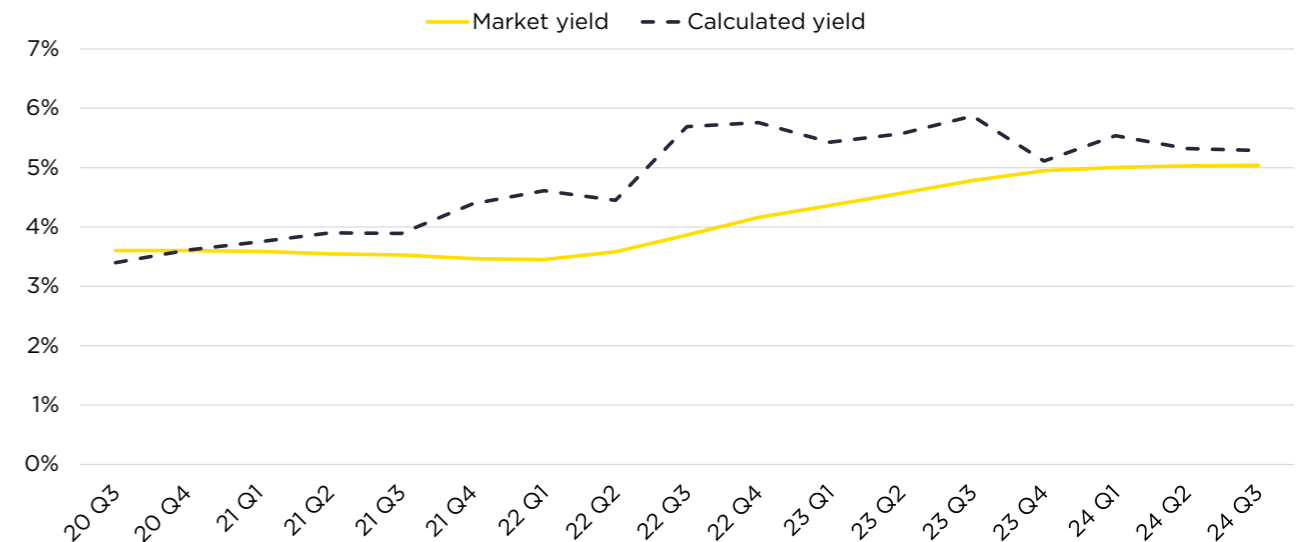
What's happened to pricing so far?

Average prime European office yields remained stable during Q3 2024 at 4.9%, for the third consecutive quarter. The only inward movement was Oslo prime yields moving in by 10 bps, whilst Stockholm had moved in by 10 bps during Q2, reflecting the resilience of investor appetite in the Nordic region. Conversely, Brussels moved out by 20 bps QoQ to 4.80% as investor demand remains subdued.

European offices remained in fair value territory during Q3 2024, as government bond yields fell and expectations for inflation

fell sharply. At a city level, Madrid, Oslo and Amsterdam appear most attractively priced compared to their respective historic levels, given strong real rental growth fundamentals and more significant price adjustment, creating a larger spread against government bond yields.

Chart 2: Average European market yield and calculated yield



Source Savills

Chart 3: Capital value adjustment required for fair value pricing

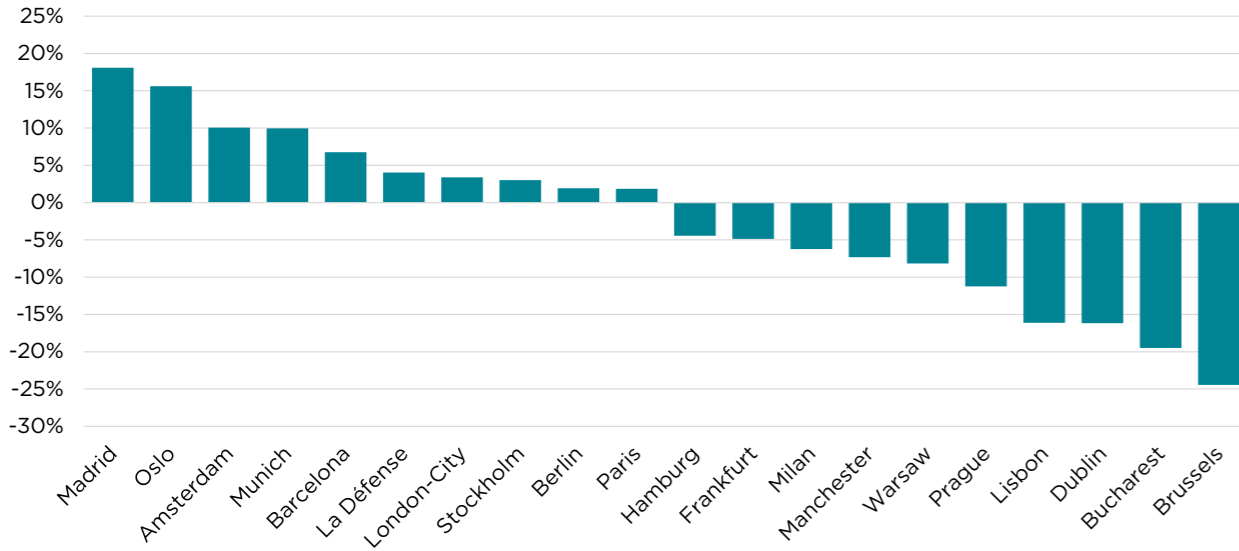


Chart 4: European average prime office yield and all-in debt costs

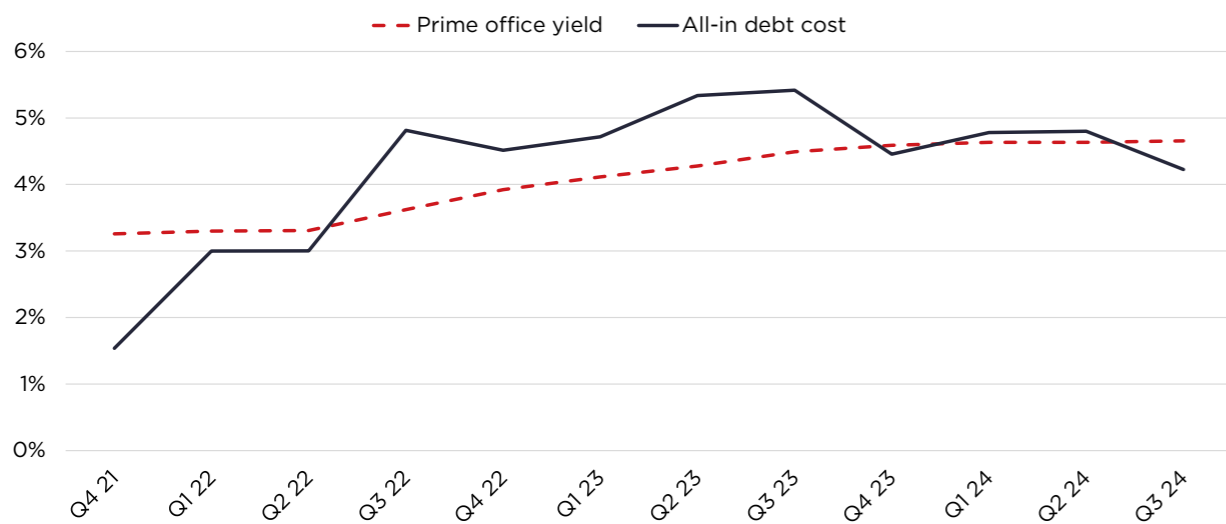
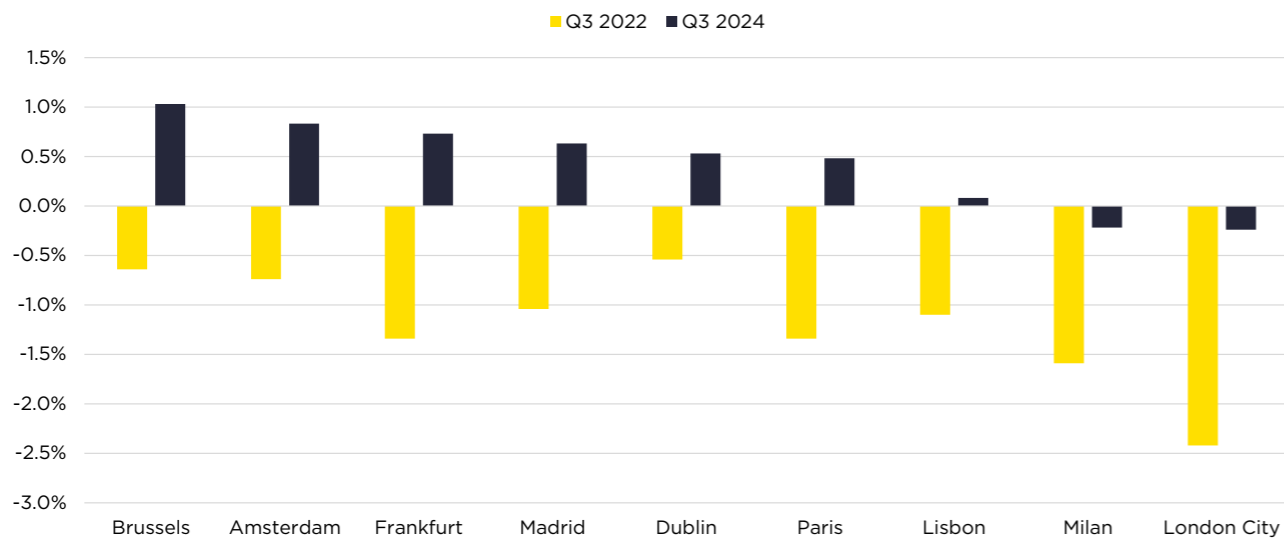


Chart 5: Prime office yield - all in debt cost spread, by city



Source Savills

2025: a furore for core

The return of accretive debt to support core investment demand in 2025.

The tide is turning in the European office investment market as buyers prepare themselves for the start of 2025. Vendors are seeking to hold onto prime stock where possible, and buyers are readjusting their price expectations towards the vendors' stance. For secondary offices, on the other hand, vendors are willing to listen to bids from developers and private equity funds, but there is very little distress and buyer demand remains thin for now, due to reservations over future capex costs, or general lettability of a scheme.

Debt liquidity

More focus than ever is now being placed on the European debt markets, and as swap rates fall and debt margins begin to move in, debt is becoming accretive to total returns.

Five-year Euribor swap rates fell by 60 bps to 2.0% during Q3 2024, before moving out to 2.3% by 15th October. Lender margins moved in by 10 bps for London City, Paris, Frankfurt, Amsterdam and Brussels during Q3 2024, as the lending environment becomes more competitive. However, banks remain particularly sensitive to the quality of building, and are generally only seeking to lend on buildings which have achieved at least EPC B. Alternative lenders are stepping in for refinancing of older, secondary stock.

All-in debt costs have now fallen below prime office yields across several markets, including Paris CBD, Frankfurt, Brussels, Amsterdam, Dublin, Lisbon and Madrid, which we anticipate will support core transactions during 2025. Although debt

costs still remain higher than London City prime yields, we forecast prime rental growth to exceed 4% pa over the next five years, supporting total returns. In London, we are seeing more banks willing to lend at 60% loan-to-value (LTV), up from 55% in Q2, improving liquidity.

The number of €100m+ European office transactions per quarter this year has fallen by over 70% compared to the peak in 2019, but lower debt costs are supporting the return of buyer demand for larger transactions. As interest rates fall and fixed-rate loans mature over the next 12 months, distress is likely to remain limited.

European banks' lending books remain in relatively good health too. The European Union's average proportion of non-performing real estate loans (NPLs) as a percentage of total real estate loans remains low and has only risen marginally from 3.9% to 4.4% since Q4 2022. There are of course regional variations - whilst Germany's NPL exposure has risen from 2.1% to 5.2%, in Southern European markets, the proportion of NPLs has fallen over the same period.

Finally, banks are gradually becoming more willing to lend to real estate. The ECB's latest bank lending survey reports that banks' credit standards stabilised in Q3 2024, bringing to an end two years of tightening and we are seeing German and Austrian banks increase lending activity. The main type of assets which are facing refinancing challenges are non-ESG-compliant assets in secondary markets,

which lack good transport accessibility and amenities.

Recovering investor sentiment

Buyer demand is on the up too, with Sentix's European real estate investor sentiment index reaching its highest level since March 2022. More anecdotally, investor sentiment arriving back from EXPO marked a big improvement from last year, with an increased optimism around offices. Spanish, French and German insurance companies are targeting prime Western European office stock, which will support demand for big-ticket transactions from early next year. As reported in Green Street News, close attention is being paid to Signa's insolvent Upper West Tower, Berlin, which will act as a bellwether for prime German office stock.

Outlook

The real estate fundraising market remains difficult, but with lower interest rates and improved sentiment from lenders and investors, we expect transactions to gather pace and buyers' expectations to move closer to vendors' aspirations, supporting inward yield movement for prime stock during early 2025. Core markets will rebound in 2025, supported by rental growth prospects and improving perceptions of the future of the office. Focus should be not only on well-positioned cities, but strongly performing local submarkets and quality of buildings.



Savills Commercial Research

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