SPOTLIGHT

Savills Research

European Commercial - October 2020

European Office Value Analysis

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● Risk Premium ● Rental Growth ● Inflation

Lower rates for longer

Low eurozone inflation forecasts will maintain low sovereign bond yields and cheap debt levels.

Economic Overview
Eurozone inflation fell into negative territory during August 2020 for the first time in four years due to weak demand, as eurozone retail sales fell for the second consecutive month indicating the hopes for a V-shaped recovery are fading. The growing realisation of a second wave of coronavirus has knocked consumer confidence, in which the European Central Bank (ECB) must act to avoid a deflationary spiral.

Given previously weak inflation levels, the US Fed and Bank of England have adopted average inflation targeting since the COVID-19 outbreak, to ensure that market expectations of future inflation do not become detached from reality. Economists are now anticipating that the ECB could follow suit and wait for inflation to rise above the 2% target rate in the short/ medium term, in order to compensate for underachieving inflation targets in previous years.

The ECB's additional €1.3 trillion of asset purchases as part of the Pandemic Emergency Purchase Programme (PEPP) will add further liquidity in order to increase inflation levels and boost demand. A number of developed European economies are seeing government debt to GDP ratios increase by circa 20% and are expected to see this exceed 100% of national GDP by the end of 2020 as a result of the COVID pandemic, and growing debt burdens are likely to drag on the economic recovery into 2021/22.

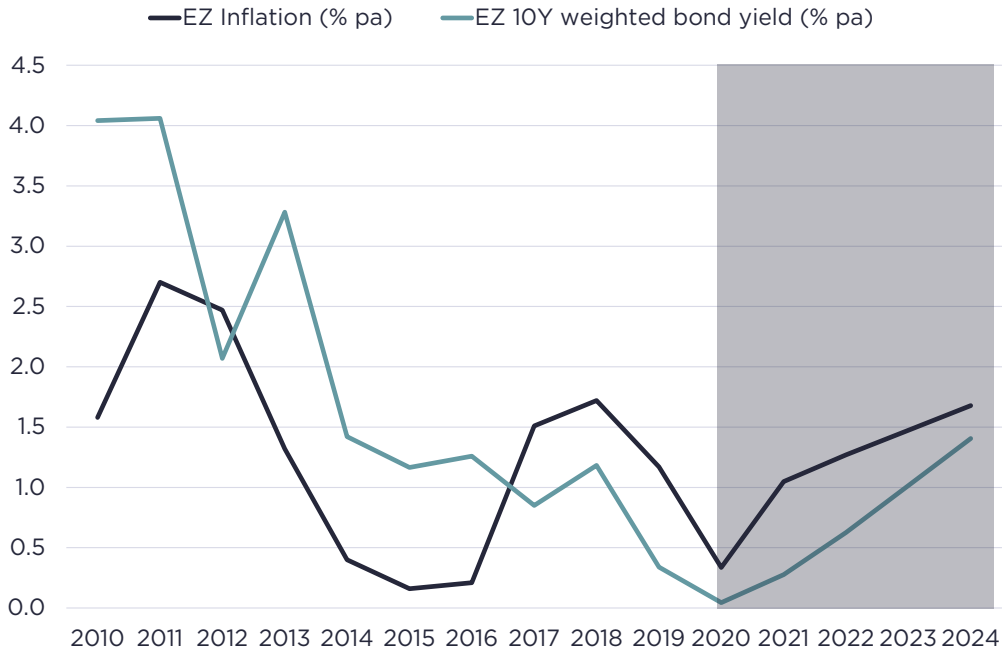
The impact of this indicates that interest rates will remain lower for longer which is likely to maintain property yields at historic low levels. Focus Economics anticipate the eurozone weighted ten year government bond yield to remain below 1.5% until at least end 2024 (Chart 1).

With many European government bond yields now in negative territory, our analysis shows that the current average yield spread between European prime offices and eurozone government bonds is 325 basis points (bps), over 100 bps above the historic average of 223 bps.

Average office yield spread has reached 325 bps, over 100 bps above the historic average.

EZ weighted 10Y bond yield will remain below 1.5% until at least end 2024.

Chart 1: Eurozone (EZ) inflation and sovereign bond yields



Source: Focus Economics

Office Value Analysis

London City, Stockholm, London West End, Manchester, Lisbon and Oslo office markets appear underpriced, according to Savills office value analysis Q2 2020.

Methodology
An investor must be compensated for bearing the risk of investing in real estate over sovereign bonds, the "risk-free" rate, factoring in future real rental growth and depreciation. Savills European Office Yield Analysis adopts the following methodology to assess prime 'fundamental' office pricing relative to market pricing across 23 European 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 and Bucharest.

Fundamental yield pricing > 50 basis points above market pricing we consider underpriced

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

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

n.b.Savills European Office Value Analysis adopts a pan European view into the relative attractiveness of office pricing based on macro fundamentals and does not cover local market drivers e.g. vacancy rates.

The risk premium of investing in CBD offices against sovereign bond yields in a low return environment should be lower that of the long term average. For that reason, we have now adjusted our methodology to compare the five year average risk premium, rather than the long term average risk premium.

Sovereign bonds
Ten year government bond yields fell from an average of 0.6% pa to 0.4% pa during H1 2020 as long term economic outlook softened. Risk free rates in Germany (-0.3% pa), Netherlands (-0.2% pa) remain negative, as French ten year government bonds fell back into negative territory during Q3 2020. Falling government bond yields are widening the gap between prime office yields and fixed income, increasing property's appeal.

Rents
Capital Economics' five year European office rental growth forecasts have fallen from an average of 1.9% pa to 1.4% pa in response to the coronavirus pandemic. Savills anticipate the strongest rental growth in London City over the next five years given modest future development and low vacancy levels, although we have revised our forecast down from 3.4% pa to 2.5% pa since Q1 2020.

Stockholm (2.4% pa), Amsterdam (+2.0% pa) and Copenhagen (+1.8% pa) are likewise forecast to observe among some of the strongest rental growth over the forecast period. This is partly underpinned by some of the fastest working age population growth, exceeding 1% pa over the next ten years across several Nordic cities. Berlin's sub 2% vacancy rate is also likely to generate positive rental growth of 1.9% pa according to Capital Economics, although this is below the levels we have observed in more recent years.

Inflation
More modest rental growth forecasts have been offset to some extent by lower inflation expectations. As a result of weaker demand in the economy, five year eurozone inflation forecasts have reduced from 1.7% pa to 1.5% pa since Q1 2020, according to Oxford Economics.

We have held all other inputs constant, although in some markets, we are observing landlords increasing internal capex in order to attract tenants at existing rental levels, which has effectively reduced net effective rents. Rent free periods have remained stable over the past 12 months across we are observing some early signs of incentives increasing as we head into the final quarter.

Liquidity
Investors will be paying particular attention to the liquidity risk premium associated with each office market. Despite the constraints due to tighter lending criteria, liquidity of global capital remains high and is mostly in search of safe havens amidst the uncertainty caused by the pandemic. Core cities including London City, Paris CBD and Frankfurt stand out as the most transacted office markets over the last ten years, which will pique investor interest.

Since Q1 2020, the risk premium of investing in prime CBD offices over sovereign bonds has risen from 304 bps to 325 basis points. This is partially reflective of some minor outward prime yield movement in Prague and Warsaw during H1 2020, although the majority of prime yields held firm during H1 2020, although the more significant driver has been the average ten year eurozone bond yield falling a further 12 basis points.

The other factor at play is value of the Euro against the US dollar which has risen by 12% since the start of the pandemic. However, this repositions the euro in line with the long term average, so is unlikely to have any major impact on cross border capital flows.

> "Liquidity of global capital remains high and is mostly in search of safe havens amidst the uncertainty caused by the pandemic," Savills Research

Conclusion and findings

Eurozone inflation is forecast to reach 1.5% pa over the next five years.

London City five year rental growth prospects appear strongest at 2.5% pa.

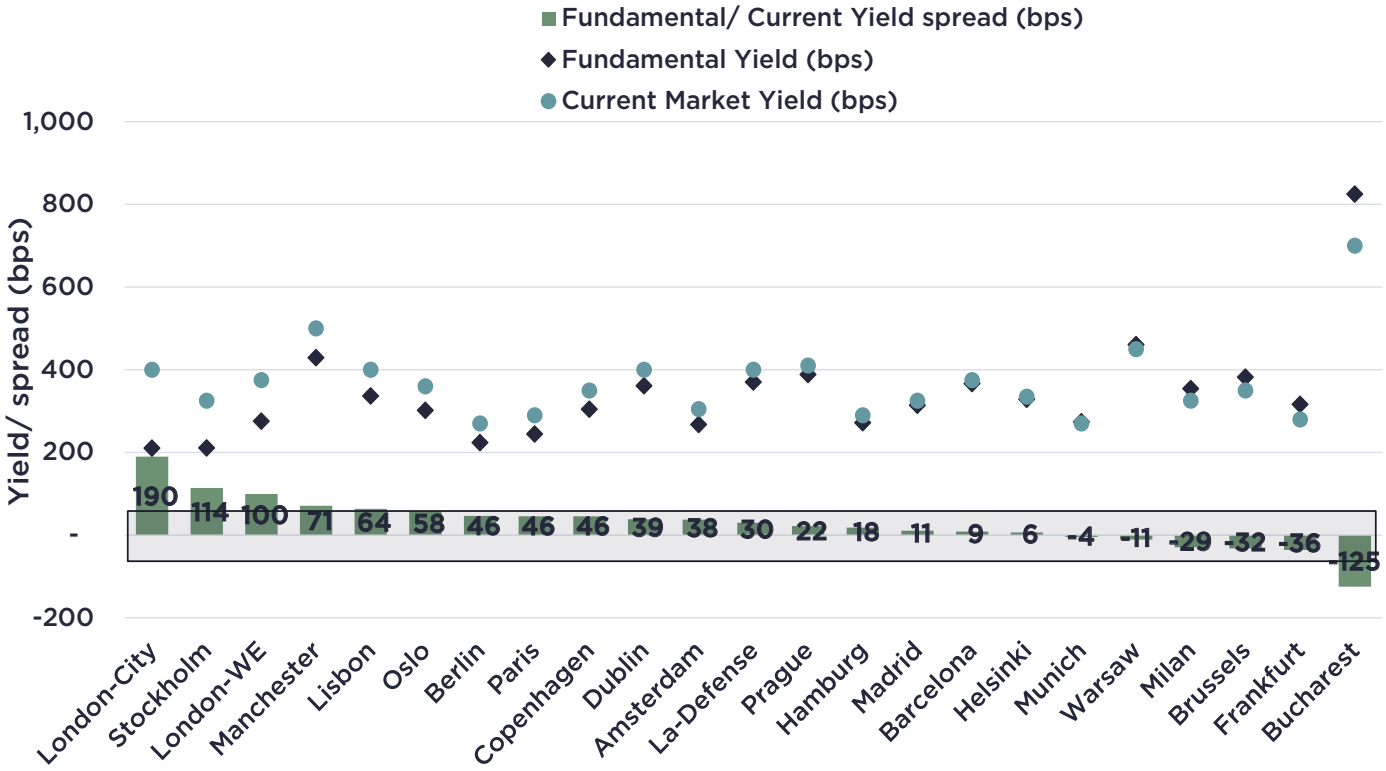
London City, Stockholm, London West End, Manchester, Lisbon and Oslo office markets appear underpriced, according to Savills European office value analysis Q2 2020 (Chart 2).

London and Manchester appear cheap, even compared with respective pre-GFC (Global Financial Crisis) prime yields, whilst many of mainland Europe's office yields remain below their pre-GFC nadirs. This trend is particularly evident since the UK voted to leave the EU in 2016; Europe (excluding UK) average office yields have moved in an average of 76 bps, whilst UK office yields have remained stable during this time. London also offers the best rental growth prospects as highlighted above.

Lisbon and Oslo appear underpriced partly due to falling Portuguese and Norwegian bond yields over the last 6-12 months. Lower levels of future inflation in Portugal will also maintain real rental growth over the forecast period.

Given that European offices are at a late stage of the investment cycle, there is less scope for the levels of yield compression we have observed in recent years and we see the majority (15 of 23) office markets appear fairly priced at end Q2 2020, despite more limited rental growth prospects. Record low sovereign bond yields will continue to maintain prime offices' investor appeal, as multi-asset managers seek to increase their exposure to real estate.

Chart 2: European Office Value Analysis, Q2 2020 (bps)



Source Savills Research

Savills Commercial Research
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