European Commercial - Q1 2021

SPOTLIGHT
Savills Research

European Office Value Analysis

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● Risk Premium ● Rental Growth ● Inflation

Bond yields rise

Eurozone inflation to rise in 2021 before easing back in 2022.

Economic Overview
The European Central Bank (ECB) left few surprises holding policy rate unchanged in its April meeting. In previous meetings, the bank hinted at increasing government bond purchases, although any evidence thus far has been limited. With money supply increasing at a lower than anticipated rate, German 10 year bond yields rose from -0.6% to -0.3% during Q1 2021.

A first quarter spike in new Covid cases across Europe and the subsequent negative impact on Euro Area GDP in the first half of 2021, is likely to temper any chance of an interest rate rise over the near future. Indeed, Oxford Economics anticipate Eurozone inflation to undershoot the 2% target over the five year period, and are not scheduling in a rate hike until at least 2023. However, a rise in energy prices in 2021 is likely to raise the headline rate of Eurozone inflation to 1.6% this year before easing back to 1.3% in 2022.

In the offices sector, governments are still generally advising to work from home where possible, although we are seeing more restrictions lifted across Europe in the second quarter of the year as vaccines are gradually rolled out.

Vacancy rates have increased by an average of 170 bps to 7.1% across European markets in the year to Q1 2021, due to the level of grey space returning to the market. Occupier sentiment has however improved in the first quarter of 2021, and into Q2 2021, we are seeing more examples of occupiers removing grey space from the market. We expect this to gather momentum throughout the rest of H1 2021 as businesses begin to contemplate life beyond the pandemic.

Investment Markets
Despite the role of the future of the office continuing to divide opinions, investor demand for Europe's prime CBD offices has remained resilient. However, Q1 2021 office investment activity was down 32% against the Q1 five year average due to a shortage of vendors openly marketing prime assets.

Focussing on the core markets, Paris CBD yields remained stable at 2.75% during the first quarter, while Berlin hardened by 10 bps to 2.6% as German investors remain in the market for long term income.

Core European bond yields have risen throughout Q2 2021 but remain in negative territory.

London still remains at a discount to mainland European core markets, as West End yields remain at 3.50% and City yields at 4.00%. UK debt rates remain more expensive than other core markets, with UK sovereign bonds currently yielding 0.7% pa, providing a similar yield spread to that of core German and French markets. London's global liquidity and rental growth expectations will continue to attract cash-rich buyers.

Lending to European offices increased towards the end of 2020 after a difficult six months, although securing debt for non-core markets has become more costly as credit committees have become more sensitive to location. Indeed, banks appear more cautious on core plus/ value add properties, with a maximum 60% LTV ratio on offer for offices in need of capital expenditure. Lender appetite for speculative development projects remains limited. Nevertheless, the overall debt finance environment is healthy with a variety of traditional and alternative providers covering the entire risk curve.

Prime Brussels offices have remained stable at 3.25%, with some resilient demand for ultra-long income outside non-core markets trading around the 3% mark.

Across Southern Europe, prime yields remain unchanged over the course of the pandemic and insurance companies are still bidding aggressively for strong covenants, although product remains hard to find. Non CBD stock is subsequently taking longer to transact.

Investors remain in search for long income within the non-core markets, and are more price sensitive to the tenant covenant strength. Since Q3 2020, Warsaw prime yields have moved out 10 bps to 4.6%, although Prague (4.10%) and Bucharest (7.00%) have held stable.

Rising energy prices are forecast to impact the Nordics markets more heavily, lifting inflation forecasts. Prime stock in Oslo and Stockholm office stock has not traded as actively over the last 12 months, with prime yields remaining stable at 3.25%.

Office value analysis

London West End continues to offer attractive pricing.

Methodology

Savills European Office Value Analysis compares the fair-market (calculated) yield relative to current 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.

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, factoring in real rental growth, inflation and expected depreciation costs across each market.

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

Savills Q1 2021 European Office Value Analysis indicates that of the 23 European office markets, one market appears undervalued, 16 markets are fairly priced and six markets now appear fully priced.

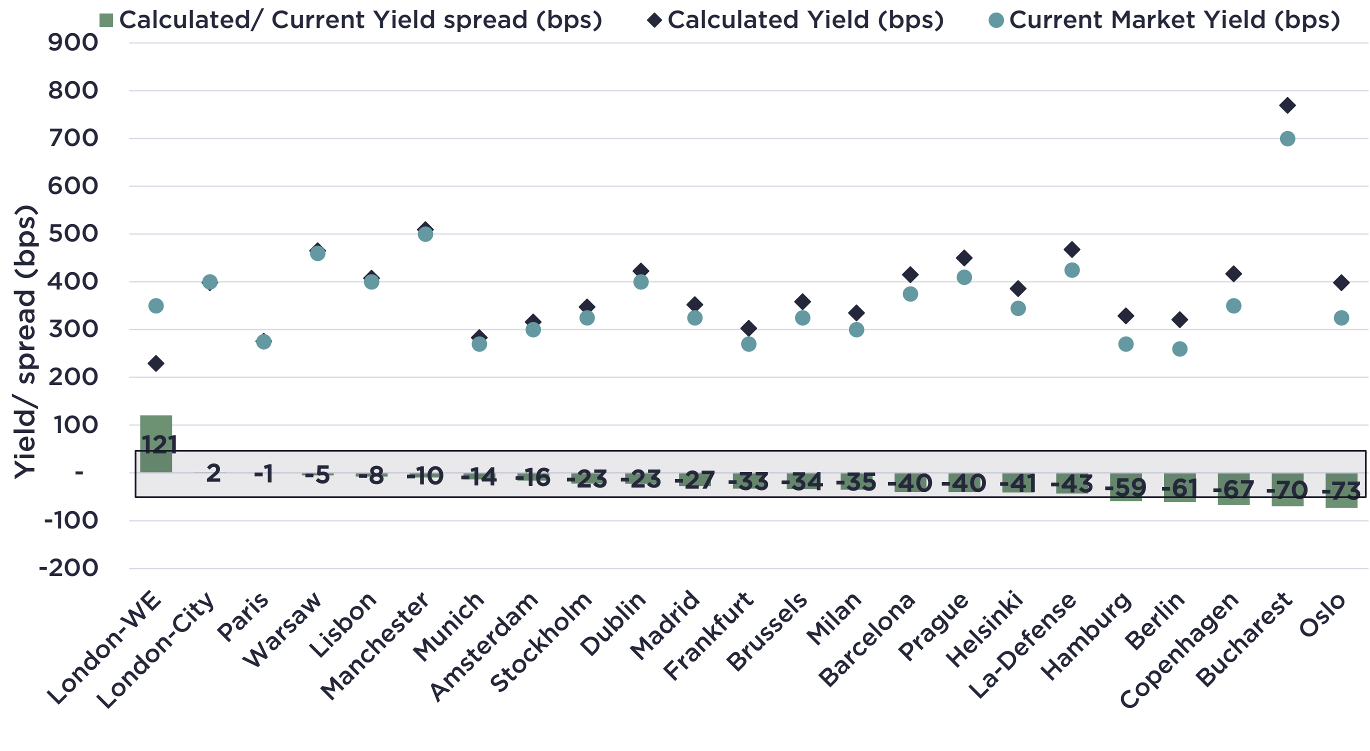
The big shift since our last derivation has been due to softer rental growth assumptions, factoring the potential downside of lower office occupancy, which has raised the calculated market yields. Capital Economics' European five year prime rental growth forecasts have fallen by an average of 50bps pa to 0.9% pa between Q3 2020 and Q1 2021. Coupled with rising inflation forecasts, this has reduced real rental growth prospects from -0.1% pa to -0.9% pa since our last derivation.

London West End remains attractively priced relative to the majority of European markets due to its positive prime rental growth prospects and given investor appetite from non-European capital, we see further opportunity for yield compression. Towards the other end of the spectrum, Hamburg and Berlin feature as fully priced, although this can be explained by the investor demand for ultra-core assets, and given lower levels of remote working pre-pandemic, we expect rental prospects to pick up again. Milan's index linked office rents hedge inflation risk, while investor demand for offices with WAULTs above five years continue to outstrip the limited supply.

However, Savills latest market evidence suggests that prime headline rents are holding up relatively firmly as we begin to see some evidence of resumed occupational decision-making and that rental discounts and incentives are more visible on secondary stock.

Occupiers' behavioural changes and the speed of return to the workplace will act as the main determinants for rental growth prospects across the major European markets. Despite an increase in vacancy rates, high quality vacant office space remains limited in the core Western European markets. Should rental growth prospects improve in the coming months as we expect, then the markets currently shown as fairly-priced will become under-priced. However, interest rates appear to remain at a standstill and landlords who are able to unlock rental value uplift through reversionary leases and active asset management will stand to benefit.

Chart 1: European Office Value Analysis, Q1 2021 (bps)



Source Savills Research

Savills Commercial Research

We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

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