European Commercial - Q2 2024

SPOTLIGHT
Savills Research

European Office Value Analysis

• Inflation • Yields • Outlook

UK dominates European office deals

Interest rate cuts pave way for a transactional recovery.

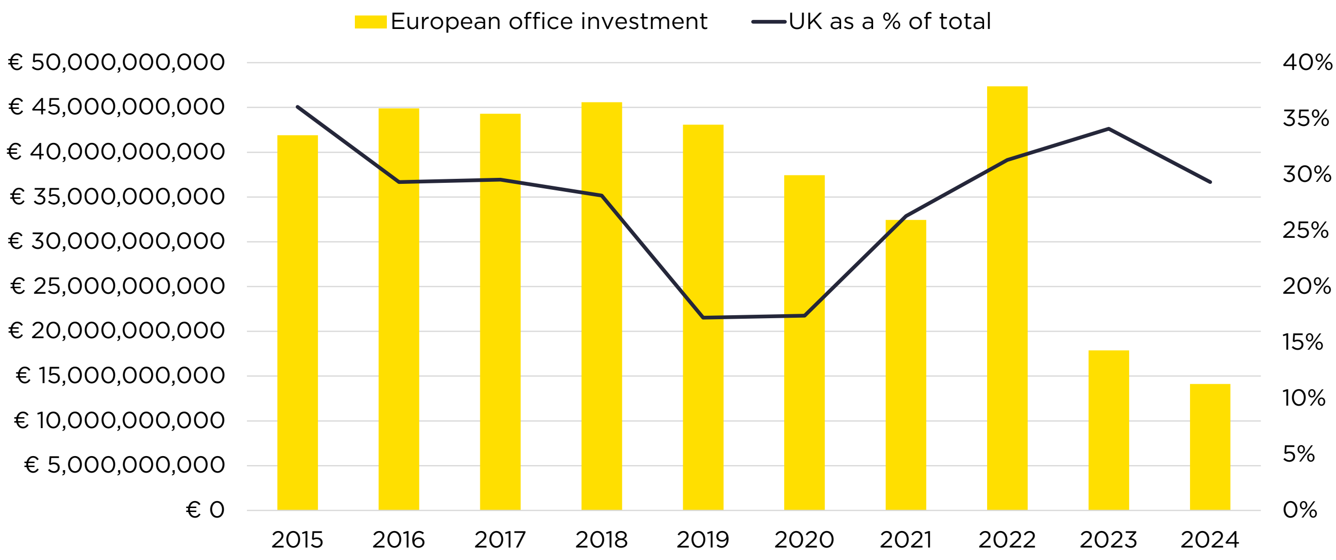
Economic overview
Eurozone headline inflation rose to 2.6% in July 2024, as services inflation fell marginally to 4.0%. Headline inflation is expected to fall gradually during Q3 and Q4, and average 1.8% during 2025. In the European Central Bank's (ECB's) July meeting, interest rates were left on hold as expected, with no clear signals as to the future path of interest rates. Capital Economics maintains the view that a September cut is most likely, followed by a further cut during Q4 2024, to bring down rates to 3.25% by end 2024. Positive news came from the UK with a first rate cut in August, with expectations for the US to cut rates in September.

The eurozone economy continues to outperform its modest expectations, and grew by 0.3% during Q2 2024 as hiring intentions fall below the long-term average.

Higher interest rates continue to restrict office investment transactions. H1 2024 European office investment transactions reached €14.1bn, down 21% YoY, and down 60% against the five-year H1 average of €36bn (Chart 1). The UK continues to dominate, with a 29% share of European office investment volumes, above its five year average of 24%, driven by the faster initial price adjustment and attractive yields for cash buyers.

European average prime office yields remained stable QoQ at 4.9% during Q2 2024. Vienna office yields moved out by 25 bps, along with a 50 bps outward movement in La Défense as the only significant yield movements during the quarter. Since Q1 2022, prime office yields have moved out by an average of 157 bps (Chart 2).

Chart 1: H1 European office investment volumes (€) and UK share (%)



Source Savills

Prime office yields stable

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 19 European markets, covering London-City, Stockholm, Manchester, Lisbon, Oslo, Berlin, Paris CBD, Copenhagen, Dublin, Amsterdam, La Défense, Prague, Hamburg, Madrid, Barcelona, Munich, Warsaw, 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 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.

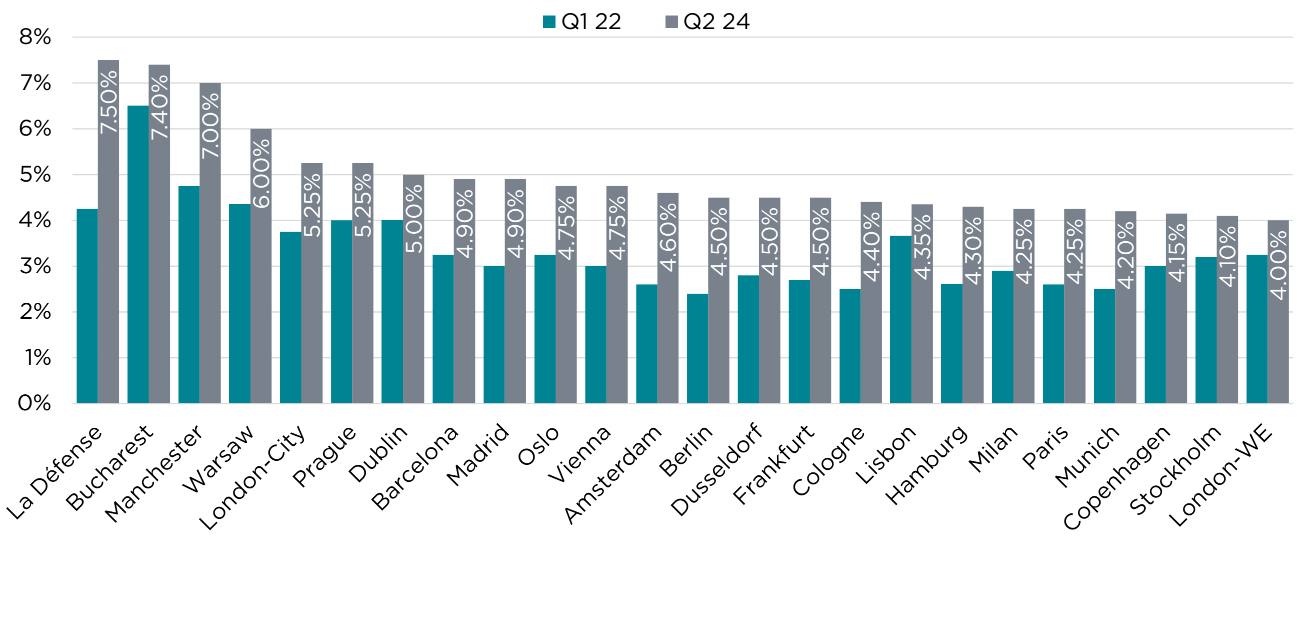
Given the inverse relationship between yields and capital value, we use the following definitions for fair pricing:
Market capital value >10% above fundamental capital value, we consider over-priced
Market capital value within 10% of fundamental capital value, we consider fairly priced
Market capital value >10% below fundamental capital value, we consider underpriced

How far do prices need to adjust?
Analysing market pricing on a fundamental basis, European offices remain in fair-value territory. France 10Y bond yields initially rose 50 bps following the French elections, although have started on a downward trajectory during Q3 2024 since peaking at end June. As at early August, average European government bond yields remain 20-30 bps below the end Q1 levels, buoyed by UK and eurozone rate cuts.

Against the 2017-21 average yield spread against sovereign bonds, this indicates a further -3% adjustment in capital values is required (Chart 3&4). Oslo (4.75%) and Madrid (4.90%) appear the most underpriced markets relative to sovereign bond yields. At the other end of the spectrum, Lisbon, Bucharest and Copenhagen have observed relatively little prime yield movement compared to sovereign yields. The gap between average market yield and calculated yield remained stable on a quarterly basis.

We are beginning to see a relationship emerge between the markets where office capital values have adjusted most significantly and the markets where investment volumes are beginning to recover most quickly (Chart 5). Spain and Norway office investment volumes appear closest to their five-year average during H1 following more significant price adjustments, whilst Ireland and Romania have seen relatively lower price adjustments and investment transaction volumes remain more subdued. The core markets of France and Germany have been impacted by the rising debt costs due to LTV breaches, and as interest rates ease, we expect investment transactions will recover for larger lot sizes.

Chart 2: European prime office yields



Source Savills

Chart 3: Capital value adjustment required for fair value pricing

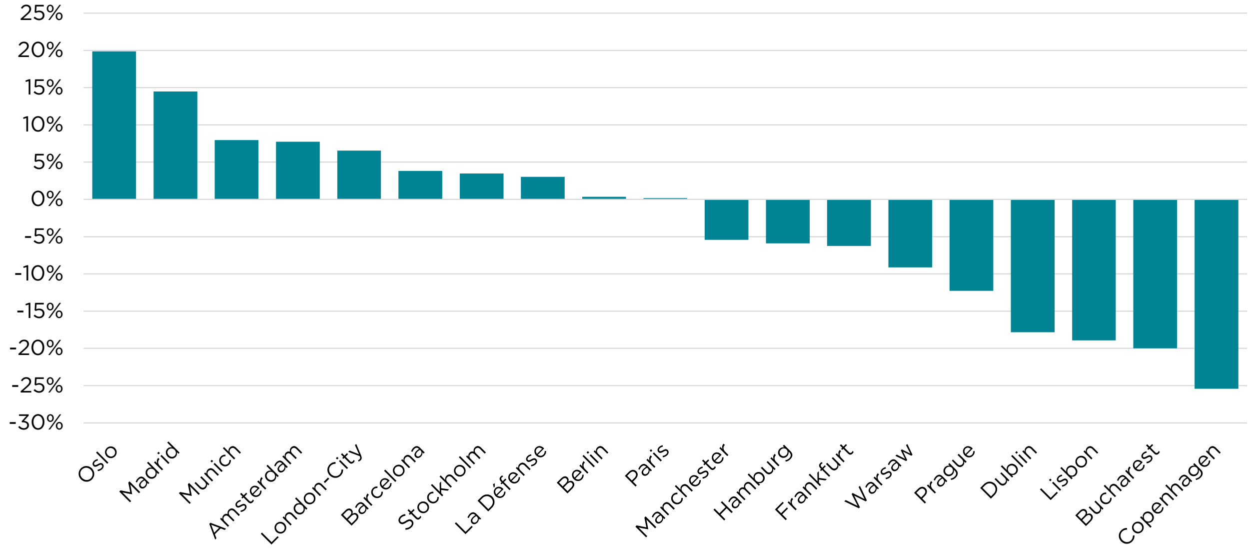


Chart 4: Average European market yield and calculated yield

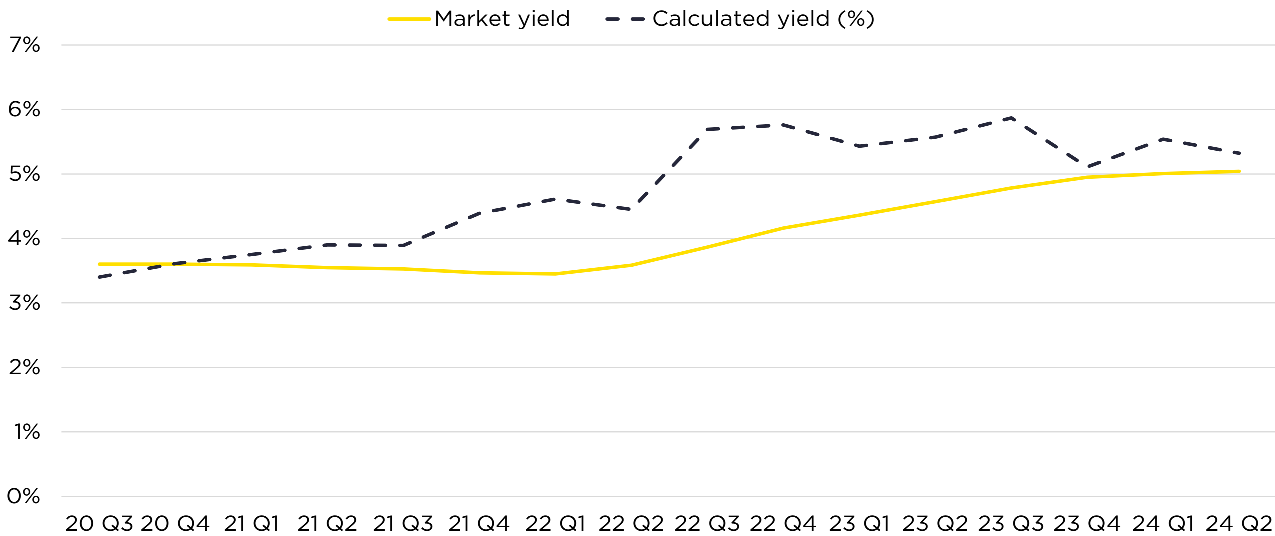
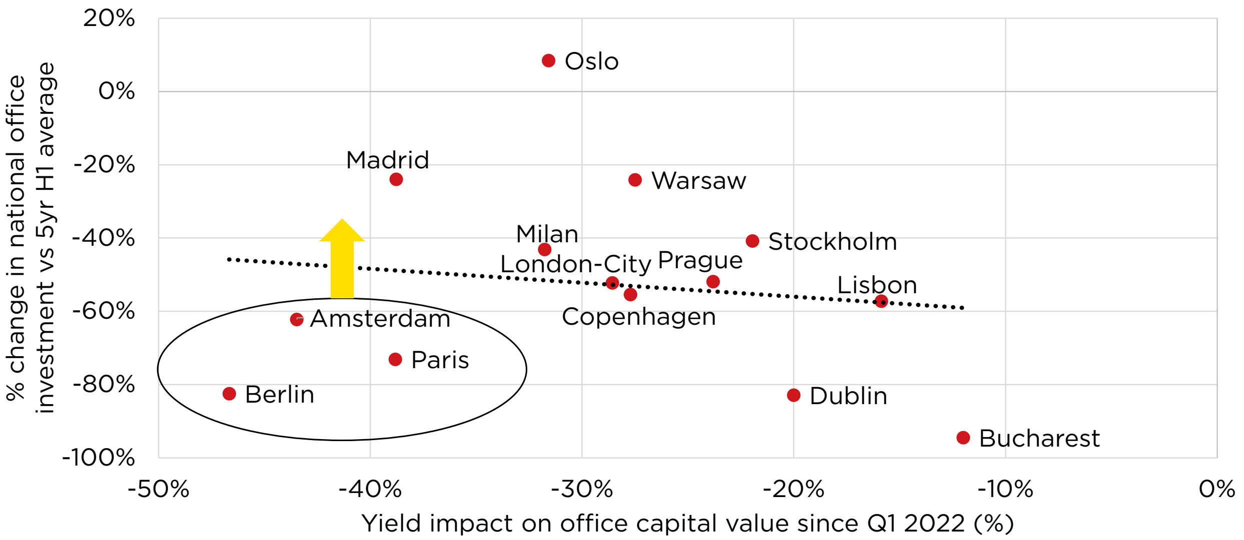


Chart 5: European office yield impact since Q1 2022 and national office investment volumes vs five-year average (% change)



Source Savills

Investment outlook

Price expectations gap is closing as interest rate cuts gather pace.

The lack of distress in European markets is hampering transactional activity, although positive news on interest rate cuts is beginning to spur buyer sentiment. There remains a gap in buyer-seller expectations, although this appears to be gradually closing, with both buyers and sellers adjusting their pricing ambitions. MSCI reported a record number of pulled/terminated deals in Europe during Q2 2024, as vendors become more willing to test the depth of buyer demand, and buyers equally test vendors' resolve. This reflects an improved position from Q1 2024, as more stock returns to the market, and buyers and sellers become closer to agreeing a price point.

Where is the distress?
Distress remains limited, although we are seeing an increasing level of pressure on loan renewals from the banks. From an occupational market perspective, vacancy rates remain low and tenants continue to pay their rent, so landlords continue to meet loan repayment schedules.

The ECB's latest bank lending survey indicates that EU banks' CRE non-performing loan (NPL) exposure has more than doubled since Q4 2022, with the largest NPL exposure increases in German and Dutch lenders. Markets which have seen the highest capital value falls have increased pressure on loan-to-value ratios. Banks are continuing to tighten lending criteria on new loans, more so in commercial real estate than any other sector, although banks expect to moderate the tightening of CRE loans during the second half of 2024.

One loan servicing provider reported that last year 67% of the maturing loans it services had been extended and this year, that figure dropped to only 43%, as banks are not willing to extend last year's terms indefinitely. However, more alternative lenders are bridging the gap as they are willing to take on higher risk.

There has been a rising number of German real estate insolvencies during H1 2024, with a number of developers impacted by rising funding costs for new schemes. German lenders generally remain cautious, although are more willing to lend on UK offices than across mainland Europe, given faster price adjustment, which has supported the UK's transactional recovery.

Who are the buyers?
Global real estate fundraising fell by 44% YoY during H1 2024, although we are seeing a gradual increase in the depth and breadth of buyer demand for European office product:

- German, French and Spanish insurance companies continue to engage on core office opportunities in key gateway markets. Swedish institutions are also returning, with more of a domestic focus.

- Private German, Israeli and Spanish investors are active cash buyers for office investments across western Europe.

- US private equity is gradually returning to European offices with a view to harnessing potential rental growth and yield decompression in the sector. For the time being, this interest has been most concentrated in the London market, with initial investigations for product in Dublin as well. We expect that this capital will further expand in the near term to the continental European markets as pricing adjustments feed through.

- It is anticipated that markets will see continued activity from certain French SCPIs through the second half of the year, albeit for smaller and higher yielding stock.

Whilst demand for new CRE loans continued to decline during the first half of 2024, banks expect loan demand to increase marginally during the second half of the year amid interest rate falls.

Pricing and transaction outlook
The office sector does however face a headwind of institutional investors seeking to reduce their portfolio exposure, and we do not expect European office transaction volumes to return to pre-pandemic levels in the near future.

Nevertheless, we are witnessing a rise in the number of inspections and, gradually, underbidders in investment sales and expect this to gather pace from September to year end, starting with London.

A first rate cut in the UK and eurozone has piqued investor interest, and we believe the momentum will gather throughout H2 2024 as deals complete before year end. The office investment market remains bifurcated, and secondary stock, which is off-pitch or not meeting ESG criteria, will remain uncompetitive during the second half of this year.

Prime yields are likely to remain stable for Q3, and we expect to see yield compression during Q4 and into early 2025 across selected markets.

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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