European Commercial - Q1 2024

SPOTLIGHT
Savills Research

European Office Value Analysis

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● Inflation ● Yields ● Outlook

Prime yields begin to stabilise

Expectations for Eurozone interest rates to fall by 125 bps in 2024.

Economic overview

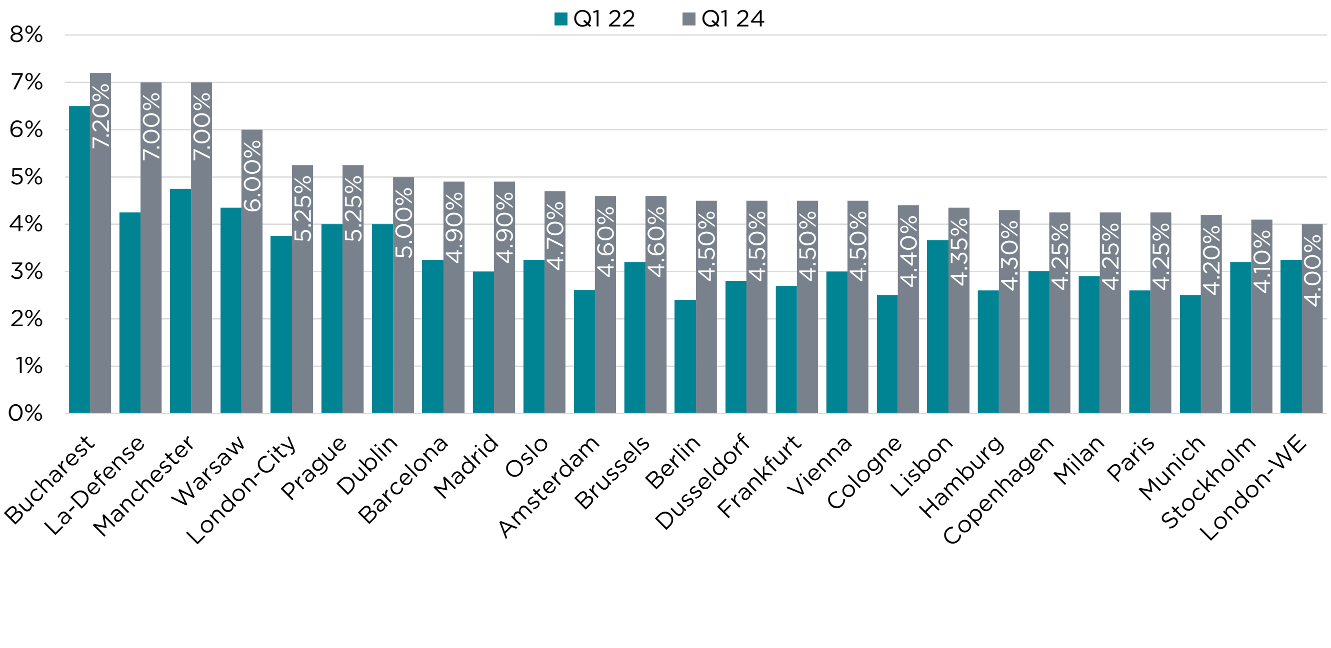
Expectations for an early Eurozone interest rate cut faded during the first quarter of 2024 as government bond yields rose. Eurozone core inflation fell further to 2.7% in April 2024 and Capital Economics expect core inflation to average 2.6% in 2024 and 2.3% in 2025. Capital Economics expect Eurozone interest rates will fall by 125 bps to 2.75% by end 2024, with a further 50 bps cut by mid-2025. The UK is expected to see the first interest rate cut in Q2, with rates to drop 75 bps to 4.50% by end 2024, with a further 100 bps cut in 2025.

Despite ECB president, Christine Lagarde, indicating that the ECB would act independently of the Federal Reserve in the April press conference, investors are expecting higher US inflation to dampen the Euro Area rate cuts. Upside risks to inflation remain as geopolitical events continue to add upward pressure on energy prices, whilst a weaker Euro would raise overall Eurozone import prices, adding to headline inflation. However, overall demand remains weak, and employer hiring sentiment is expected to soften this year, reducing wage growth.

Prime yields

European prime office yields moved out by an average of +5 bps to 4.90% during Q1 2024, down from +17 bps the previous quarter, as yields begins to stabilise. Copenhagen (+25 bps), Manchester (+25 bps), Barcelona (+15 bps), Milan (+15 bps), Madrid (+15 bps), Berlin (+10 bps), Cologne (+10 bps) and Hamburg (+10 bps) all moved out during Q1 2024. Since Q1 2022, prime yields have moved out by an average of 155 bps, indicating an average yield impact on capital values of -31%.

Chart 1: European prime office yields



Source Savills

Office value analysis

Sovereign bond yields increased during Q1, as prime office yields begin to stabilise.

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, 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.

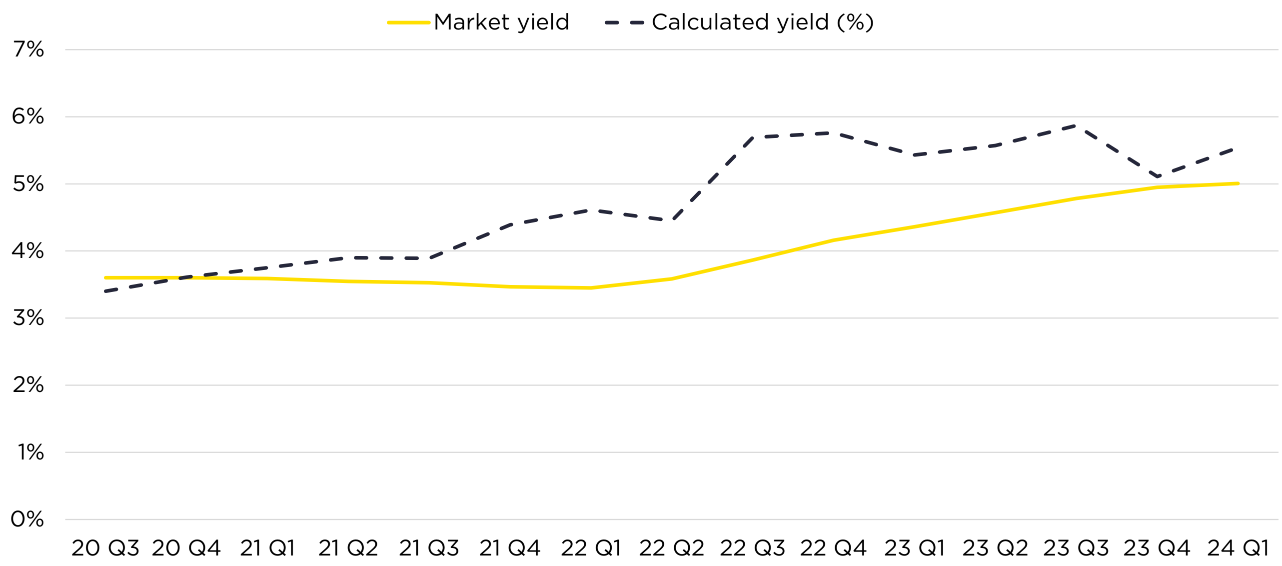
How far do prices need to adjust?

Analysing market pricing on a fundamental basis, European offices remain in fair-value territory. However, the minor outward prime office yield movement has been offset by higher government bond yields in Q1 2024 and therefore, a further capital value adjustment of -8% is required for average prime European offices to be in line with their fundamental values.

However, not all cities report the same story. Following further outward yield movement to 4.90% during Q1, Madrid offices appear under-priced, given the relatively higher sovereign bond yields pre-2022, and resilient rental growth prospects. The core markets of Berlin, Amsterdam, Munich and Paris CBD appear fairly priced, relative to pricing during 2017-21, given the extent to which yields have decompressed over the last two years.

Conversely, Bucharest and Copenhagen appear in fully priced territory. However, there was already a large yield spread over government bonds before the interest rate rises, so much further outward yield movement appears unlikely- if yields did not originally compress to a great degree, then they are unlikely to decompress significantly.

Chart 2: European average prime office yields



Source Savills

Investment and pricing outlook

Gap remains in buyer/vendor price expectations.

Quite simply, the market needs interest rates to fall before transactional activity will gather pace.

MSCI data indicates that European office investment fell by 45% YoY to €7.6bn during Q1 2024. Vendors are pointing to imminent interest rate cuts and are anticipating a recovery in capital values, whilst buyers are pointing to the higher levels of US inflation and caution from the ECB with respect to rate cuts, as an opportunity to buy at a discount. Hence, the bid-ask spread has widened since the start of the year.

One such challenge to completing transactions is the shortage of motivated sellers. As banks are not calling on their debt, some landlords are sat on losses and are waiting for the market to recover. We have seen some examples of receivership sales in UK and Ireland, although distress is limited.

However, we can expect to see more non-domestic sales of core-plus office stock, from investors who are unable, or unwilling, to commit to capex programmes. Likewise, German and French open-ended real estate funds continued to record net outflows during Q4 2023, which is likely to add pressure on institutional sales.

In terms of the quality of stock, core buyers are seeking to buy the best 10% of stock, although sellers only want to sell the bottom 90% of the market, so where do values sit for the 'best' and the 'rest'?

Generally, investor demand is more resilient for smaller lot sizes (circa €20-40m) from private investors and smaller SCPIs (who have observed resilient inflows, albeit at lower levels), and are willing to make cross border acquisitions. We are seeing some private equity funds bidding for value-add stock for conversion to residential in non-CBD locations.

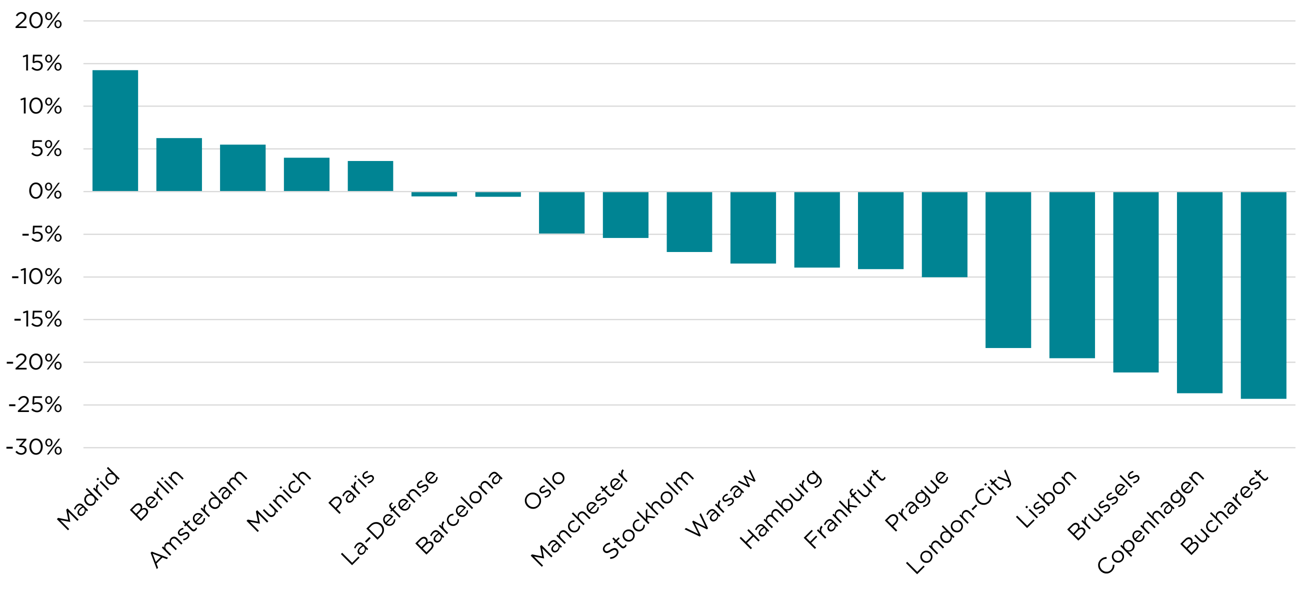
Debt for CBD offices is still non-accretive to returns, so demand for new loans remains subdued and there are very limited core buyers. Banks continued to tighten their lending criteria during Q1 2024, according to the ECB's latest bank lending survey. We are therefore seeing more alternative lenders step in to refinance value-add stock.

INREV's 2024 investor allocations survey indicates that European investors are currently over-allocated to real estate, however, as property valuations have fallen and equity markets have rebounded, we can expect to see current allocations edge closer to target allocations later this year.

It shouldn't be forgotten, that from an occupational standpoint, offices continue to perform well. Savills preliminary data for Q1 2024 indicates that average European vacancy rates remained stable at 8.4%, prime rents rose by 3.6% YoY, and take up rose by 2% YoY, buoyed by a stronger Southern European market. European office occupancy rates also continue to rise and remain at 59% on average, throughout the course of the week (below the pre-pandemic average of 70%).

As we have mentioned in previous spotlights, the strongest period of capital growth comes immediately after the nadir in capital values. With prime yields stabilising, now is an appealing time to buy, although the return of yield compression is likely to be delayed, as interest rates fall at a slower rate. We believe the H2 2024 investment rebound will be weaker than previously expected, as investor demand will remain cautious.

Chart 3: Capital value correction required for fair pricing, Q1 2024 (%)



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Savills Commercial Research
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