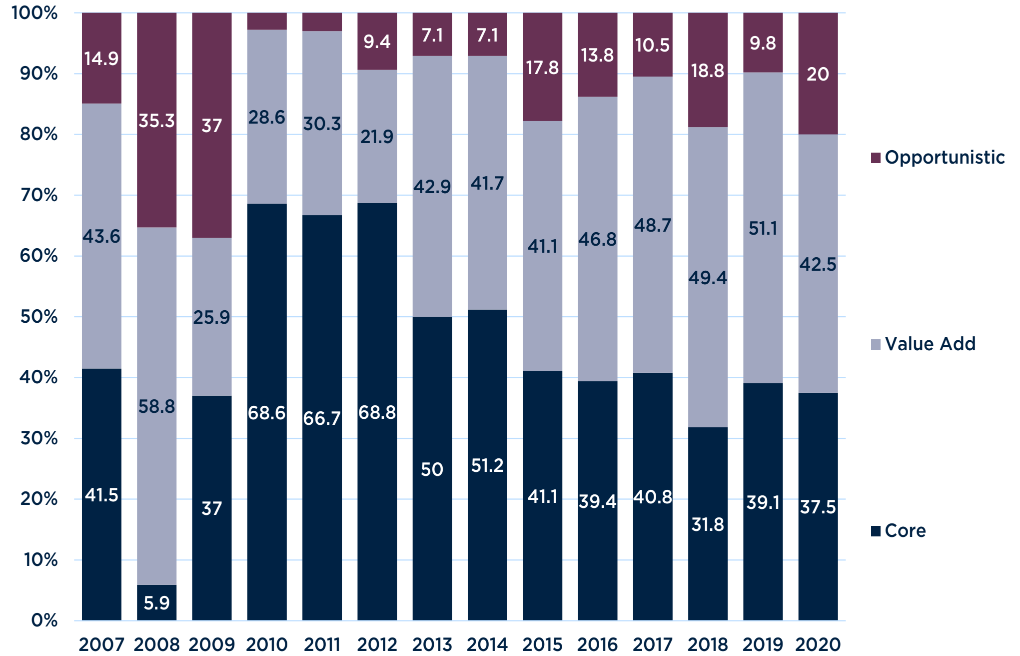
European Commercial – March 2020

SPOTLIGHT
Savills Research

Where does the value remain in European CBD offices?

● Prime office yields ● Risk premium ● Fair value

Chart 1: Institutional Investor Style Preference (%)



Source: INREV Investor Intentions Survey

Increased asset allocations to real estate is driving down prime office yields

Economic Overview
Incoming European Central Bank (ECB) president, Christine Lagarde, held deposit rates at -0.5% in her first meeting, and despite claiming that she is "neither a monetary dove nor hawk", analysts are now forecasting ten year German government bond yields to remain in negative territory until 2022.

Investor Demand
Traditionally core investors are now faced with two options- either to taper their total return expectations, or increase their risk appetite and we are now seeing more investment managers launch new core-plus/ value add funds to meet investor requirements. INREV's latest investor survey results show that investor preference for an opportunistic style increased from 9.8% to 20% between 2019 and 2020 (Chart 1). Europe's ageing demographic profile, particularly in Southern Europe, has created a further need for long, secure income for pension funds. Over the next ten years, the EU's working age population is set to fall by 4% and the population aged over 65 is set to increase by 18%, increasing both the age-dependency ratio, and ultimately, the level of redemptions required to service this outflow. As the shadow of "Japanification" looms over Europe, persistent low inflation will keep interest rates low, as aging populations require increased savings.

What's more, multi asset managers are increasing their asset allocation to real estate, further intensifying pricing.

Cornell University's latest investor survey shows multi asset managers' target allocation to real estate has increased from 8.9% in 2013 to 10.6% in 2020, marking the sixth consecutive year of rising allocations, as investor demand continues to outweigh supply.

"Cornell University's latest investor survey shows multi asset managers' target allocation to real estate has increased from 8.9% in 2013 to 10.6% in 2020."

Limited investible stock will further intensify office pricing

Supply Constraints

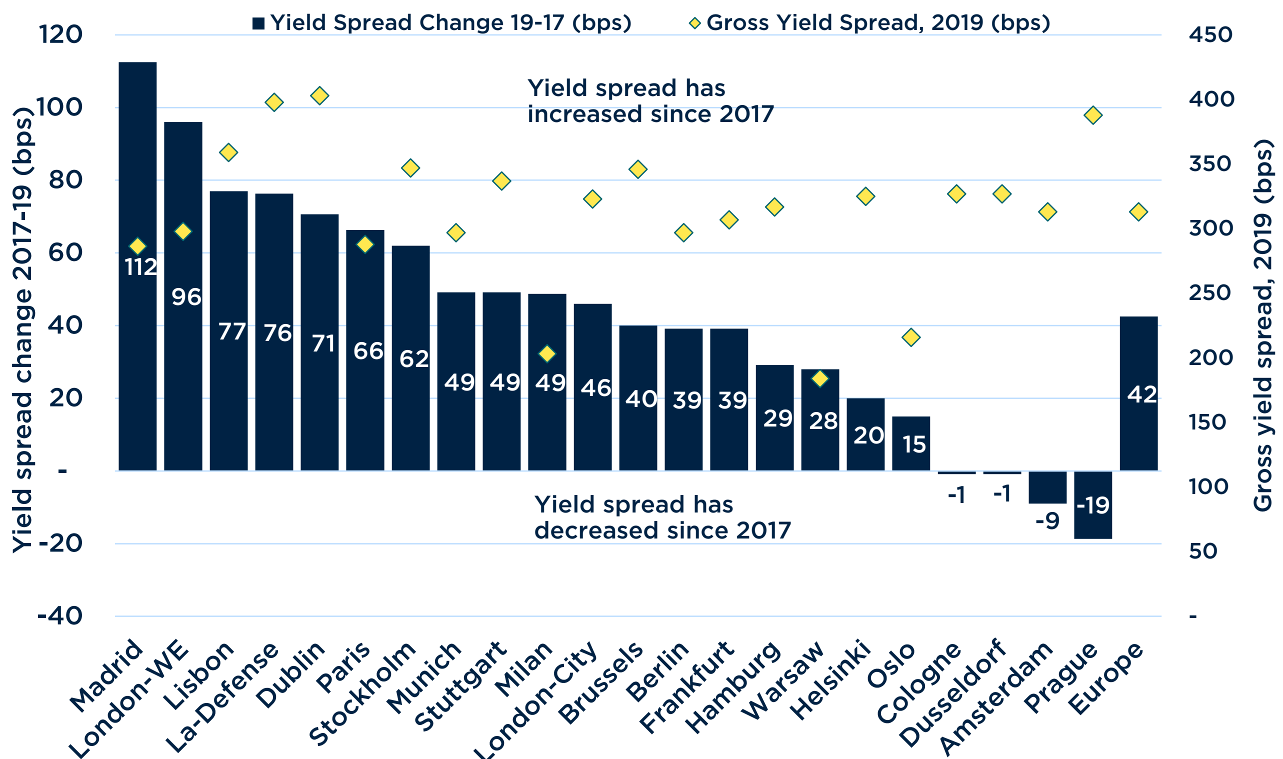
European office investment transactions reached €122bn during 2019 and continued to dominate, accounting for 40% of the total volumes, in line with 2018's proportion. However, a shortage of openly marketed CBD offices has continued to compress prime yields over the last two years. Indeed, the European average prime CBD yield compressed a further six basis points to 3.38% during Q4 2019, led by Milan (-25bps to 3.25%), Warsaw (-25bps to 4.25%) and Helsinki (-20 bps to 3.30%). We are seeing an increasing number of "evergreen" vendors who are holding income producing assets for longer periods in order to avoid round-trip costs of disposing and acquiring new assets. Thus, we expect to see a further tightening of office stock in the market since the number of re-trades will reduce.

In this piece of analysis, we have examined the two year change in the European CBD office risk premium, as 2019's European office investment volumes was the strongest year since 2017. Comparing the prime CBD office yield spread over the 10 year sovereign bond yield from Q4 2017 to Q4 2019 across the key European cities provides an indication of the change in relative pricing. Over the last two years, the average European spread has increased by an average of 42 basis points (bps) from 271 bps to 313 bps. Thus, the market risk premium of investing in European CBD offices over sovereign bonds is now higher than at the end of 2017, although we feel the underlying risk premium of investing in property over bonds has not changed during this time.

Madrid (+112 bps), London West End (+96 bps) and Lisbon (+77 bps) CBD offices now appear the most discounted relative to two years ago. Madrid's prime yield has remained stable at 3.25%, whilst West End's 3.75% prime yield marks a 50 bps increase on the end 2017 level. Despite 75 bps of prime yield compression in Lisbon, sovereign bond yields have fallen from 1.9% to 0.4%, as the Portuguese economy has strengthened. In reality, many financial institutions are willing to lend to standing CBD offices at rates even below one percent across some of Europe's core cities, which will increase the proportion of landlords looking to refinance at cheaper rates in 2020 in order to maximise cash on cash return.

Czech 10 year government bond yields actually increased by 39 bps to 1.4% during this two year period, against the trend we have witnessed in the Eurozone and the UK. The Czech National Bank acted to reduce inflationary pressures and maintain exchange rates, although French and German buyers generally borrow euro-denominated debt for Czech acquisitions, so we have used German denominated debt as an indicator in this instance. The yield spread change could be considered as a price correction as Prague had appeared cheap previously to its European counterparts- prime yields have compressed 95bps from 4.85% to 3.9% over the past 24 months, whereas the European average yield compression was only 29bps. Even at this record low level, Prague offers over 100 bps of income above Paris, Berlin and Munich and we expect further compression this year.

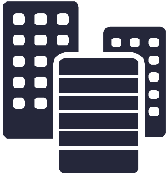
Chart 2: Change in prime office yield spread over sovereign bonds 2017 to 2019



Source Savills, Oxford Economics

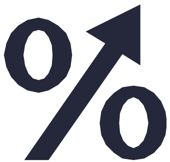
42 bps

The average yield spread between prime offices and sovereign bonds has increased by 42 basis points over the last two years.



2.0% pa

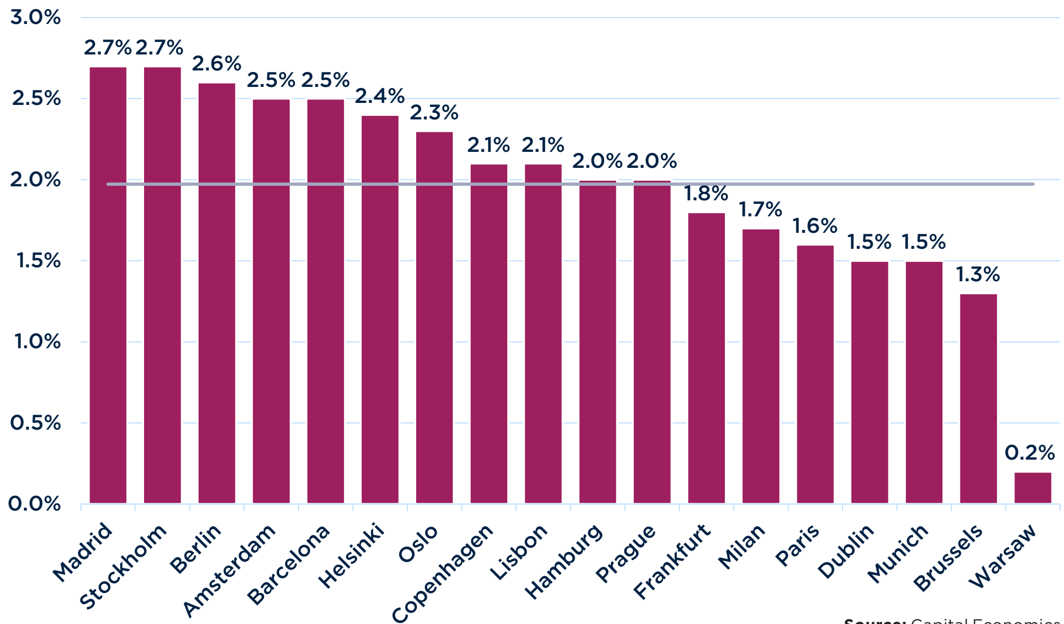
Capital Economics forecast 2.0% per annum office rental growth forecast over the next five years.



5.4%

Average European office vacancy rate now stands at only 5.4%, down from 6.3% 12 months ago.

Chart 3: European office rental growth forecasts (2020-24 % pa, average)



Source: Capital Economics

Rental growth outlook remains positive

The final reason why we see more opportunities for yield compression across European offices in 2020 is the prospect of further rental growth. Vacancy rates remain low at an average of 5.4%, down from 6.3% at end 2018, which has limited occupier options. Future developments also remain limited, as Europe's office based employment growth is forecast to grow by an average of 3.9% over the next five years. This is of the back of more positive Service Purchasing Managers' Indices (PMIs) in both Germany and the UK at the start of 2020. As a result, Capital Economics forecast an average of 2.0% pa office rental growth across Europe over the next five years, led by Madrid (+2.7% pa), Stockholm (+2.7% pa) and Berlin (+2.6% pa) (Chart 3).

What next?

Given pent-up investor demand, low debt rates presenting attractive pricing, increasing institutions allocation to real estate and positive rental growth prospects, we anticipate further yield compression across European CBD offices in 2020.

As a result, we expect that even a minor interest rate increase will have very limited impact on property yields. A shortage of vendors will continue to be the key challenge for institutions this year, which will further shift core investor focus to core plus and value add strategies.

> "We expect that even a minor interest rate increase will have very limited impact on property yields."

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Investment

Chris Gillum
Regional Investment Advisory - EMEA
+44 (0) 207 409 5918
cgillum@savills.com

James Burke
Regional Investment Advisory - EMEA
+44 (0) 207 409 8874
jburke@savills.com

Research

Mike Barnes
Commercial
+44 (0) 207 075 2864
mike.barnes@savills.com

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