European Commercial – March 2023

SPOTLIGHT
Savills Research

European Investment

Q1 2023 preliminary results

savills

A market in flux

The European Commission expects a modest expansion of real GDP in 2023 (0.8%) and 2024 (1.6%), as the continent anticipates an economic recovery from summer 2023 onwards. February 2023's PMI activity points to an expansion in economic output, particularly across southern European economies and driven by the service sector. The disbursement of EU funds will also support activity. At the same time, a less supportive global economy will weigh on the external sector, and still-elevated inflation, higher interest rates, and lower savings will hit consumer spending. Moreover, large public debts and energy price swings pose downside risks to these forecasts.

Capital Economics predicts that fuel inflation, which rose from 11.3% in December to 12.2% in January, will fall below zero in March, provided oil prices do not surge. Nonetheless, the International Energy Agency's forecast of record oil demand this year may complicate matters, given China's reopening and a boost in international travel.

On the other hand, the rising core price pressure remains a growing concern for the economy and policymakers. Core inflation is forecast to be 6.4% in 2023 as European workers campaign for higher wages. This has stirred the European Central Bank to press on with significant further rate hikes, with several economists anticipating interest rates to move out further to 3.5% from 3.0% expected by the end of April.

Bond markets' volatility is expected to persist until interest rates stabilise. Despite the significant speed at which prices adjusted during the latter half of the previous year - recording an annual average increase of 56 bps for prime offices across Europe – this remains far below the surge in borrowing costs, which has been a nearly +300 bps on average in EU 27. This financial equation is simply not viable. The prime European office all-in-debt costs have surged from an average of 150 bps at the end of 2021 to 450 bps at the end of 2022. Thus, investors face significant financial challenges and must navigate a treacherous economic landscape to succeed.

Fig 1: GDP growth forecasts

Source: Oxford Economics

European Investment - Q1 2023 preliminary results

Drop in investment volumes in the first quarter of 2023

Preliminary results suggest that the total investment volume for the year's first quarter will reach approximately €36bn, a record low since the years following the global financial crisis (GFC) and approximately 59% YoY compared to Q1 last year. Whilst this is a big hit, it comes as no surprise given the slowing down of investment activity that was already felt since the second half of last year. Both the range of market players and suitable assets narrowed significantly over the course of the past 12 months, restraining the number of deals. Investors that typically require leverage have been gradually leaving the European investment scene, whilst equity-rich investors target long-term income growth assets with a strong appetite for discounts.

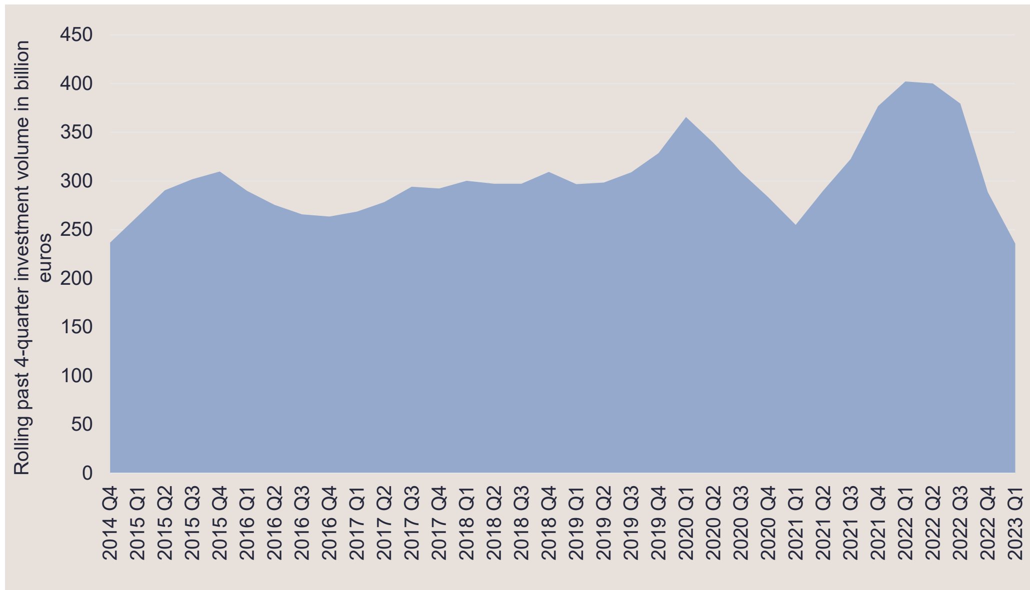
Looking ahead, occupier markets are anticipated to come under pressure, with demand for space expected to plateau or decrease across all asset types. Particularly vulnerable sectors like retail and offices are expected to be hit the hardest. Nevertheless, the scale of this downturn is unlikely to match that of the years after the GFC, when many markets overflowed with new developments. Indeed, construction costs, which have outpaced CPI inflation, made any new developments inviable as yields move out and rents trend downwards, hence maintaining vacancy rates low.

Given historically high valuations, even moderate loan-to-values (LTVs) of less than 60% could result in covenant breaches. Consequently, we anticipate some distressed sales along the way, but with an abundance of capital available to take advantage of opportunities, a total collapse in pricing should be avoided. Investors seeking to remain on a steady course should focus on strategies for income-driven assets, as well as the most appealing locations and sectors in Europe. These should be chosen based on long-term trends, offering greater stability and resilience in market fluctuations.

All in all, we expect the investment activity to remain subdued until the second half of the year when the economy will start slowly picking up. We expect the annual investment volume in Europe to range between €330bn and €340bn by the end of the year, representing a yearly decrease of 17% to 20%. This would make it the lowest level since 2015.

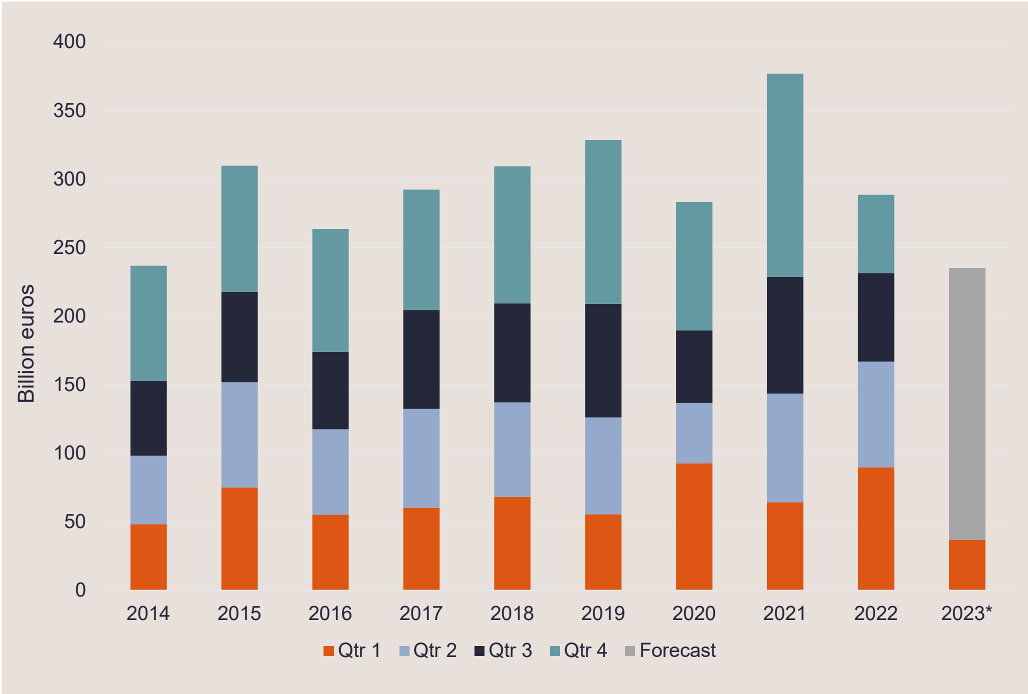
Beds and sheds will remain the preferred asset classes as both sectors benefit from a structural supply and demand imbalance. However, none of the property sectors will be immune to the downturn. High inflation puts cost pressure on residential operators, including multifamily, PBSA and senior living. Logistics will have to rely more on demand from the manufacturing sector as distribution needs are likely to reduce due to lower retail sales.

Fig 2: Slowing down investment activity



Source: Savills

Fig 3: Investment volume end-year forecasts



Source: Savills / * Q1 preliminary figures

European Investment - Q1 2023 preliminary results

High financing costs to trigger outward yield shifts across real estate sectors

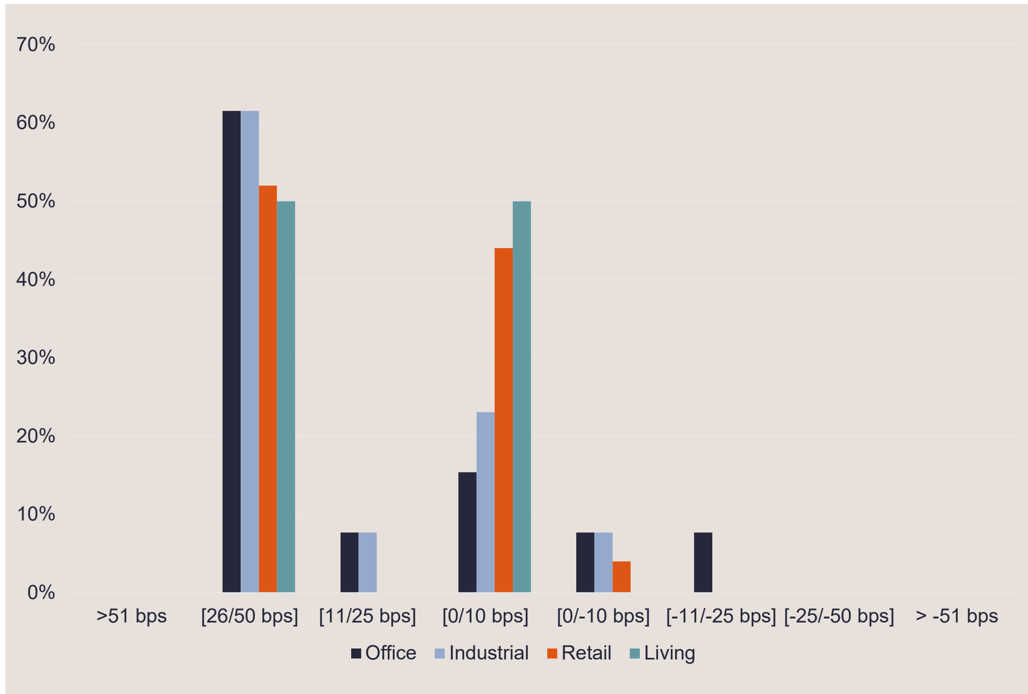
With financing costs on the rise, the ability to achieve desirable yields on investments is increasingly complex, with refinancings facing negative leverage across almost all sectors. In light of these challenges, we anticipate that the property market will experience further yield shifts as sellers are likely to become more willing to sell at higher yields in order to offload their properties.

For both CBD offices and logistics, in 62% of the jurisdictions we cover, we expect further outward prime yields movement ranging from 26 and 50 bps. On average, across Europe, the prime CBD yield was at 4.2% (+56 bps YoY) in Q4 2022, and the prime logistics yield was at 4.7% (+37 bps YoY).

For retail properties, in 52% of the locations we survey, we expect prime yields to move out by 26 and 50 bps, and in 44% of the locations, we expect prime yields to move out from 0 and 10 bps. The average prime shopping centre yield was 5.7% (+31 bps YoY) in Q4 2022, and the prime high street yield was 3.9% (+25 bps YoY).

Regarding the living sector, on half of the jurisdictions we cover, we expect prime yields to move out from 26 and 50 bps, whilst for the other half, we expect the prime yield to remain stable or move out slightly (10 bps). The prime multifamily yield was at 3.7% (+39 bps YoY) on average across Europe in Q4 2022.

Fig 4: Annual yield movement expected at year-end



Source: Savills

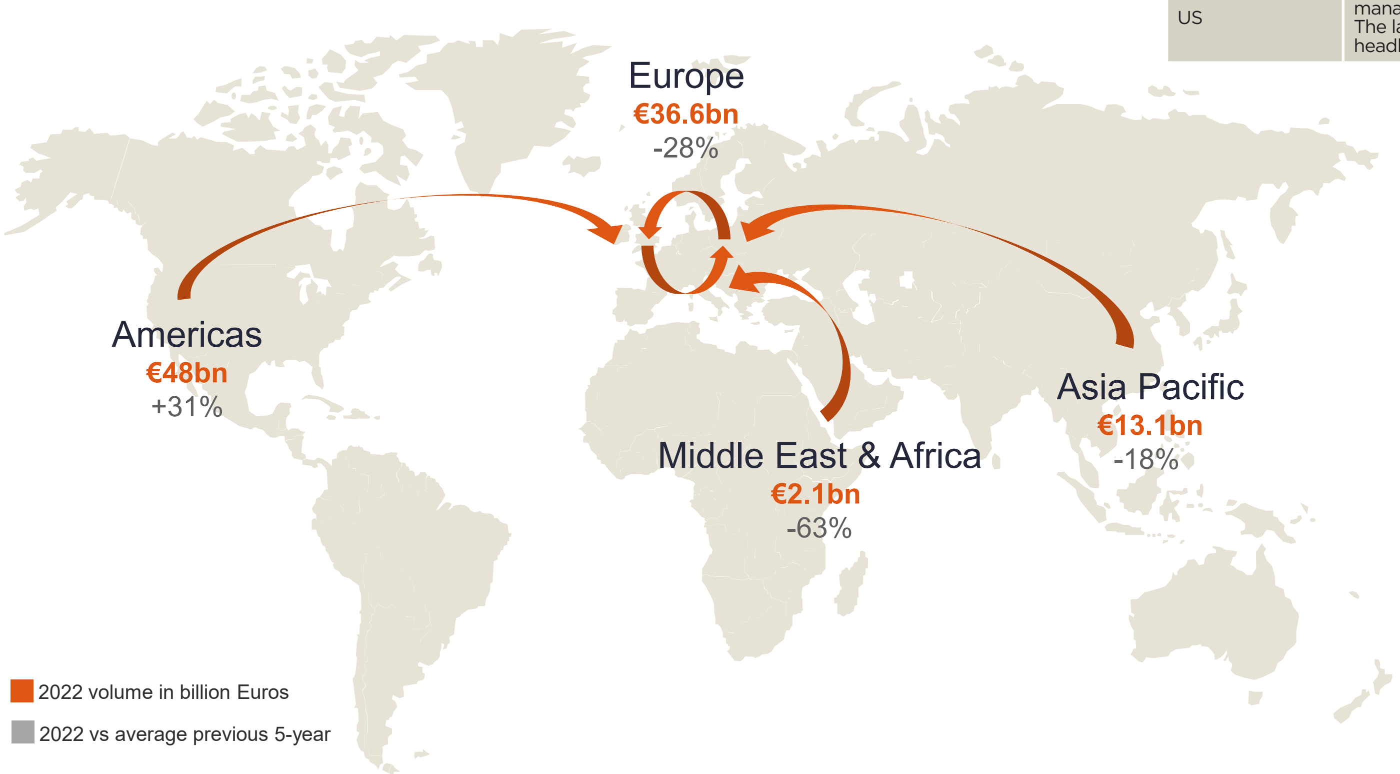
Opportunity-led cross border investors enticed by the prospect of pricing adjustments

The amount of cross border capital invested in Europe totalled approximately €114bn last year. Whilst this is down by nearly a quarter on the previous year's volumes, as a proportion of total investment, cross border flows actually registered a small 4.00% rise on 2021 (47% in 2022, 43% in 2021)

The withdrawal of European investors from the European cross border market is the leading cause of this decline. Last year, intra-European investment totalled €36.6bn (-28% compared to the average previous past 5-year), accounting for 32% of the total cross border volume, on par with the share of capital from Nort America.

For the remainder of the year, we anticipate that the share of cross border investment will continue growing as a variety of cross border investors seek to capitalise on increasingly attractive pricing levels across different European jurisdictions and asset classes.

Fig 5: Cross border investment volumes



European Investment - Q1 2023 preliminary results

Fig 6: Cross border investor intentions for 2023

Investors' origin	Investment targets
Australia	Australian superannuation capital will continue to focus on alternatives, much of which will be executed indirectly via local partners. There is also appetite to deploy into stabilised office product in core locations across Europe's key markets.
Canada	Canadian pension funds are still targeting core plus to value add returns, primarily focusing their attention on the living and logistics sectors across Europe. These Canadian LPs will continue to invest behind preferred GP/operational platforms for their different thematic strategies.
China	Government capital controls remain in place for Chinese buyers. We do not expect significant activity from Chinese investors this year in Europe, with principal sources of investment deriving from private investors channelling capital via Hong Kong or Singapore.
Europe	We anticipate that activity from German funds will likely return in the second half of 2023, whilst inflows into French SCPIs remain robust, indicating that deployment into income-producing assets in western Europe should persist in the short term. More generally, those European outfits that are not dependent on employing financing to transact deals are unsurprisingly most competitive in the current environment. We do expect to see elevated activity levels from European privates who are most comfortable investing intra-continentally.
Hong Kong	There has been a steady re-emergence from Hong Kong private investors looking back to London offices as a result of softening prime yields and FX position, albeit this is a 'trickle' rather than a 'flood' at the moment.
Israel	There has been an increase in the number of investors that are coming out of Israel, with a mix of both institutional and private prop-cos looking to invest in the UK and mainland Europe. As an investor pool, they typically target a core plus risk profile, seeking assets which offer a combination of income return with opportunities to undertake rolling asset management opportunities to extract further rental/capital value.
Malaysia	We expect sovereign and pension funds from Malaysia to increasingly pivot towards indirect investment into alternatives, in particular the living sub-sectors as well as data centres behind local operating partners. We also anticipate continued interest in the logistics sector.
Gulf Cooperation Council	Since higher yielding, cash-on-cash returns typically drive Middle Eastern investors, particularly those who syndicate in the region, we expect appetite for European properties to be relatively muted given the current high cost of debt. That said, we also envisage that oil receipts from the region will drive private HNWIs to invest in trophy assets, taking advantage of price adjustments and their agility in comparison to other investor groups.
Singapore	Given the typical flexibility of Singaporean investors, we expect continued deployment across various sectors and geographies in Europe during the course of 2023. Singapore is increasingly viewed as the emerging hub for economic activity in the region and as such acts as a funnel for outbound capital flows from other Asia Pacific jurisdictions.
South Korea	South Korean investors will not be in acquisition mode in the near term - their focus will be on sales and asset management initiatives which are required to take their current holdings through their refinancing cycle. It may be that we see some activity in the form of the provision of debt where returns are currently more appealing.
Taiwan	Taiwanese life insurers are showing renewed interest in the office sector with a focus on sizeable core properties in European gateways such as Paris, Amsterdam, London and the key German cities. Their ability to acquire assets on an all-equity basis is clearly a significant attribute for Taiwanese investors in the current environment.
US	The large North American institutions are typically amongst the most dominant buyers globally, across the risk spectrum. Most of the established managers and pension funds are sitting on significant amounts of dry powder, waiting for opportunities to arise. The large private equity funds are beginning to opportunistically review assets and portfolios where they sense distress but we are yet to see a headline trade which may be seen as a call for the bottom of the market.

Source: Savills

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.

Rasheed Hassan
Head of Global Cross Border Investment
+44 (0) 7870 999 776
RHassan@savills.com

James Burke
Director Global Cross Border Investment
+44 (0) 79 7631 8623
JBurke@savills.com

Emma Steele
Director Global Cross Border Investment
+44 (0) 207 409 8892
ESteele@savills.com

Tristam Larder
Head of European Capital Market
+44 (0) 7870 999 673
TLarder@savills.com

Marcus de Minckwitz
Head of European Capital Market
+44 (0) 7967 555 731
MdeMinckwitz@savills.com

Lydia Brissy
Director Europe Research
+33 624 623 644
LBrissy@savills.fr