World Research – Q1 2022

SPOTLIGHT
Savills Research

Savills Global Capital Markets Quarterly

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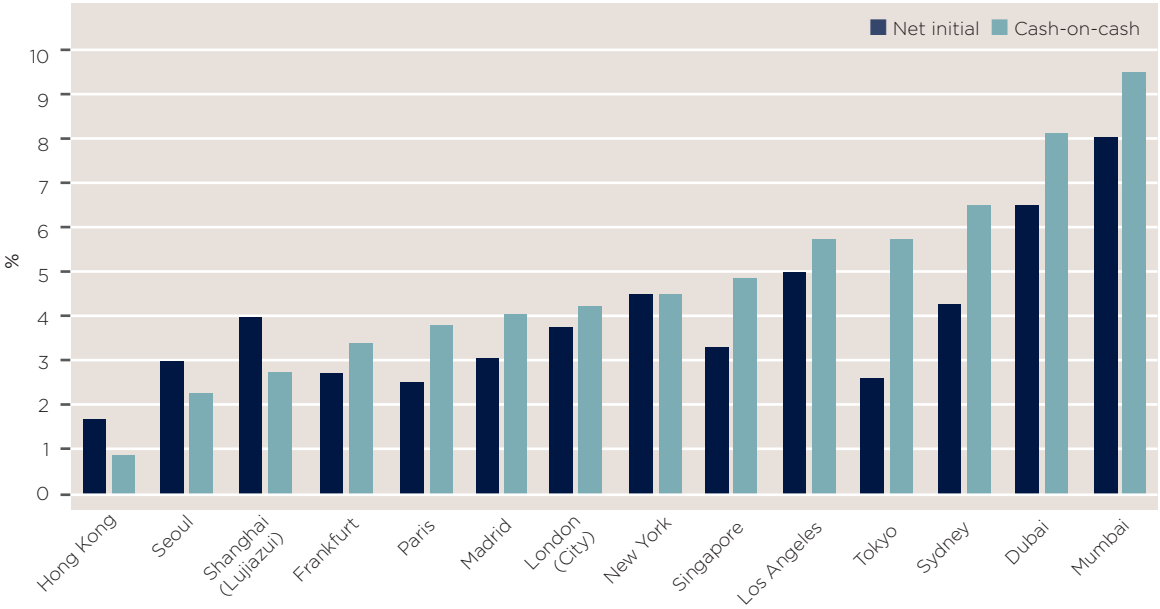
Global outlook

The strong economic recovery in 2021 supported a rebound in labour markets and pick up in office-based employment.

Reduced Covid-19 restrictions and higher immunity levels have encouraged workers back to the office. This trend is more evident in Asia, while hybrid working is becoming the standard across Europe and the US. But vacancy rates remain low in Europe – stabilising at around 7.2% across the region – while even the US saw occupancy levels hit a post-Covid high in Q1 2022.

The recovery in occupier demand and a shortage of prime office stock across most major markets has encouraged greater investor activity. Global investment in offices hit a record of US$130 billion in the final quarter of 2021, with momentum spilling into the beginning of this year. The US$82 billion transacted globally in Q1 was up 25% on the year, and only 3.5% shy of the five-year average leading up to Covid-19.

Prime office yields, Q1 2022 (as at end-March)



Source: Savills Research

Focal points

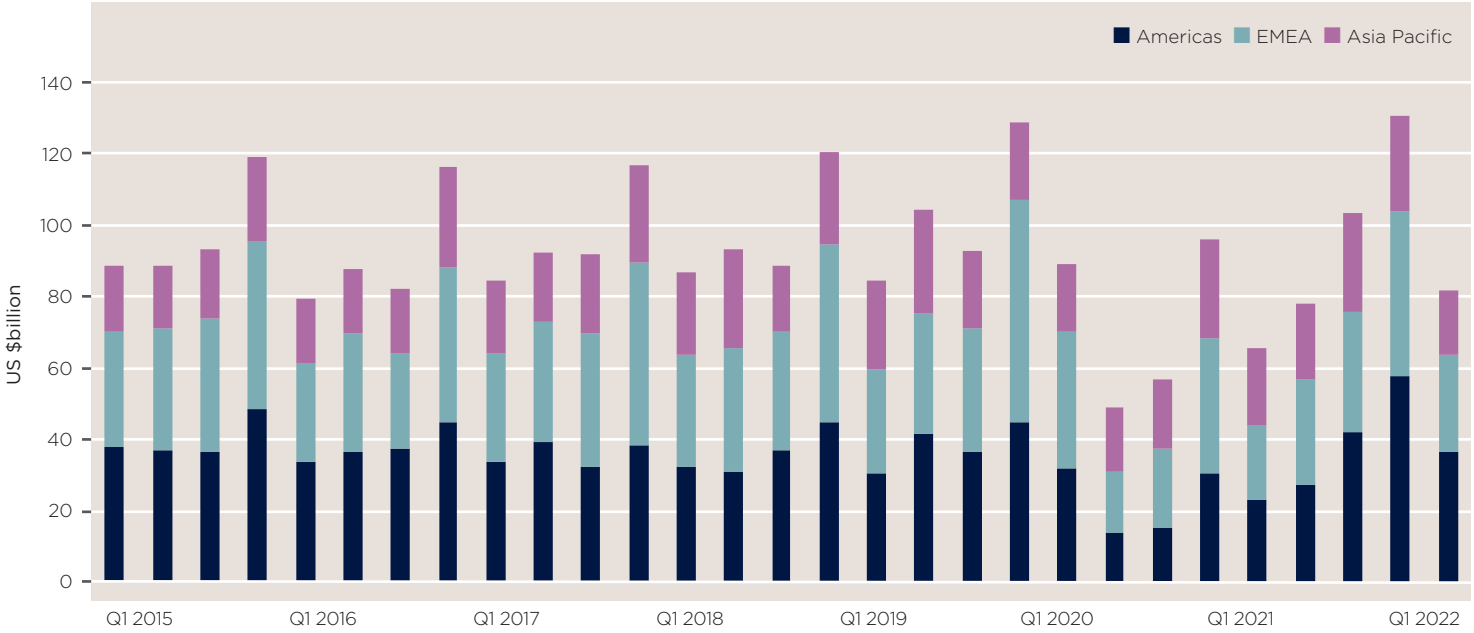
The interplay between top-down and bottom-up factors will determine pricing over the next 12 months. Economic growth is slowing due to inflation, interest rates, and the war in Ukraine. Investor sentiment has declined and recession warning lights are blinking.

Fundamentals provide for a more upbeat outlook; occupier demand is robust and there remains plenty of money targeting a limited stock of buildings. There is a clear bifurcation between prime and secondary assets for both occupiers and investors.

Macro trends are expected to prevail in the US, amid expectations of a significant tightening in financial conditions. European investors should benefit from robust occupier demand and a lack of supply. In Asia, market-specific characteristics dominate the regional narrative.

> Increased uncertainty will underpin a flight to safety which, combined with an increasing focus on ESG, will favour Grade A buildings in major cities

Global commercial office investment volumes



Source Savills Research and RCA

Outlook deteriorating in 2022

By the end of the first quarter, the outlook has fundamentally changed. Inflation has soared following a post-pandemic splurge on goods that clogged up global supply chains. Expectations of a significant tightening in monetary policy have pushed bond yields sharply upwards, leading to a decline in global risk sentiment and volatility in financial markets. In China, while the PBoC is moving in the opposite direction, policymakers are struggling with a real estate slowdown and outbreaks of Covid-19.

Russia's invasion of Ukraine has provided a further source of uncertainty for global investors. Russian investors are not major participants in global commercial real estate markets, but the conflict is having a major negative impact on sentiment, particularly in Europe, while Russia's position as a major commodity producer has added further fuel to global inflation. The latest IMF World Economic Outlook is a depressing read, while business news is awash with references to stagflation.

Central bankers now face a delicate balancing act between trying to cool multi-decade high inflation while also engineering a soft landing for growth. History highlights the difficulty in achieving this; in the US, the majority of past tightening cycles have ended in recession and the recent inversion of the 2s/10s yield curve suggests investors are increasingly betting against them succeeding this time.

Occupier demand key to outlook

Higher inflation and tightening financial conditions have underpinned a rapid repricing in debt across many markets; five-year swap rates rose by around 100 basis points in Q1 2022 alone across Australia, Europe, and the US. The trend has continued at the beginning of the second quarter, further squeezing cash-on-cash returns.

Surging inflation has also put the spotlight on the perceived hedge that real estate can provide. In the absence of indexation, this hedge is only valid when inflation is accompanied by economic growth; landlord pricing power is contingent on competition for space to drive rental growth that at the very least tracks inflation.

In the UK, for example, office sector returns are strongly correlated with GDP growth in the three decades prior to Covid-19, whereas there is no obvious relationship with inflation.

This highlights the importance of occupier demand in determining the outlook for the office market. While labour markets are generally in a healthy position, they typically lag other economic activity indicators, which provide for a more mixed assessment on the outlook. Occupiers may increasingly reassess their requirements for space, given so much uncertainty on the horizon.

Limited supply and weight of money to support pricing

Inelastic supply in some markets will help ensure some stability in rents however, particularly for Grade A office space (there is already downward pricing pressure on secondary assets). Europe and some Asian markets, in particular, look undersupplied with prime stock. Supply chain disruptions, together with rising construction costs, will continue to impede the development pipeline this year and next.

Weight of money is also a factor that will help to sustain competition for the best assets. The amount of capital being raised for deployment continues to rise to unprecedented levels – in the US for example, at the end of 2021, private equity funds were sitting on a record US$290 billion of dry powder targeting commercial real estate, up 11% on 2020 and 57% on 2019 – with more and more lower returning core/core plus vehicles emerging.

Increased uncertainty will underpin a flight to safety which, combined with an increasing focus on ESG, will favour Grade A office buildings in major cities. The alternatives in an increasingly stagflationary environment means that investors may be willing to accept lower cash-on-cash returns on a least-worst basis.

> Europe is well positioned in the current inflationary environment, given the widespread use of indexation in leases, which is unique to much of the region

Regional outlook

UK, Europe, Middle East, and Africa (EMEA)

In Europe, we expect yields to remain broadly stable. While the decline in investor sentiment is most pronounced given proximity and exposure to the war in Ukraine, there remains a weight of money targeting a limited stock of assets; in Frankfurt, for example, over €1.17 billion (US$1.32 billion) was transacted in Q1 2022, more than double the value in Q1 last year, and 30% up on Q1 2019.

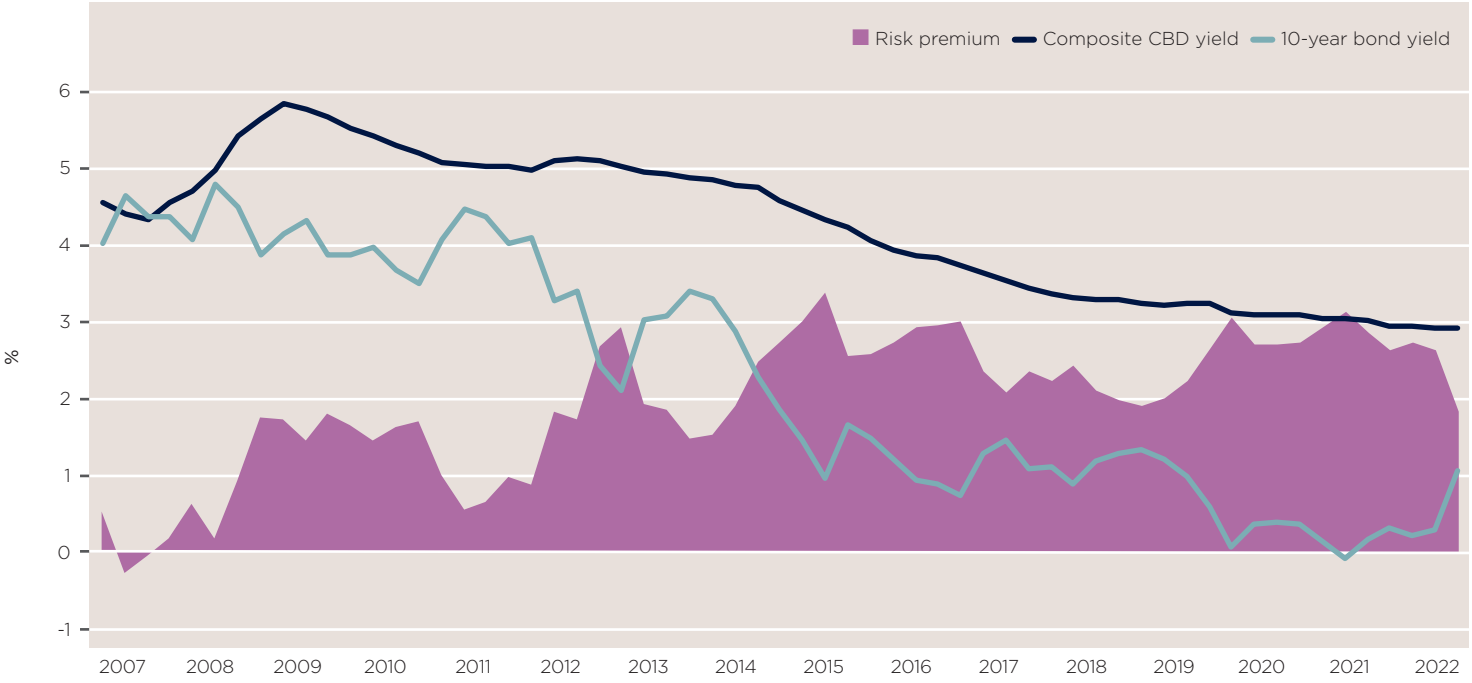
Headline growth forecasts for the euro area remain above trend at 2.8% and 2.3% for 2022 and 2023, respectively, according to the IMF, supporting continued employment growth.

Even though headline inflation in the euro area hit 7.5% in April – the highest on record since the single currency was introduced – core inflation remains much lower, and so the ECB is expected to pursue a more gradual pace of policy tightening compared with other major central banks.

Low vacancy rates for prime offices are supporting rental growth across the region, reducing the need for lease incentives. Europe is also well positioned in the current inflationary environment, given the widespread use of indexation in leases, which is unique to much of the region (particularly in Paris and Madrid).

In turn, widening rate differentials and a weaker euro should encourage greater interest from cross border investors, particularly from source markets where interest rates have already risen sharply, driving a positive return from currency hedging.

Euro area CBD office yield and sovereign spread



Source Savills Research, RCA, and Macrobond

Note Euro area composite yield based on average of major markets, weighted by investment volumes 2012-2019

In the City of London, investment volumes hit an all-time high of £3.8 billion (US$ 5.1 billion) for the first quarter, according to Savills data, up 27% on the previous high of Q1 2007. In the West End, investment turnover of over £1.9 billion (US$ 2.6 billion) was comfortably above the long-term average.

Prime office space remains slightly undersupplied amid strong occupier demand, and weight of money is again a factor supporting our assessment for a stable prime yield outlook over the next 12 months. Higher yields underpin relative value in London, although this changes when comparing on a real returns basis (given higher inflation expectations in comparison with European competitors), while the rapidly rising cost of debt is also squeezing cash-on-cash returns.

North America

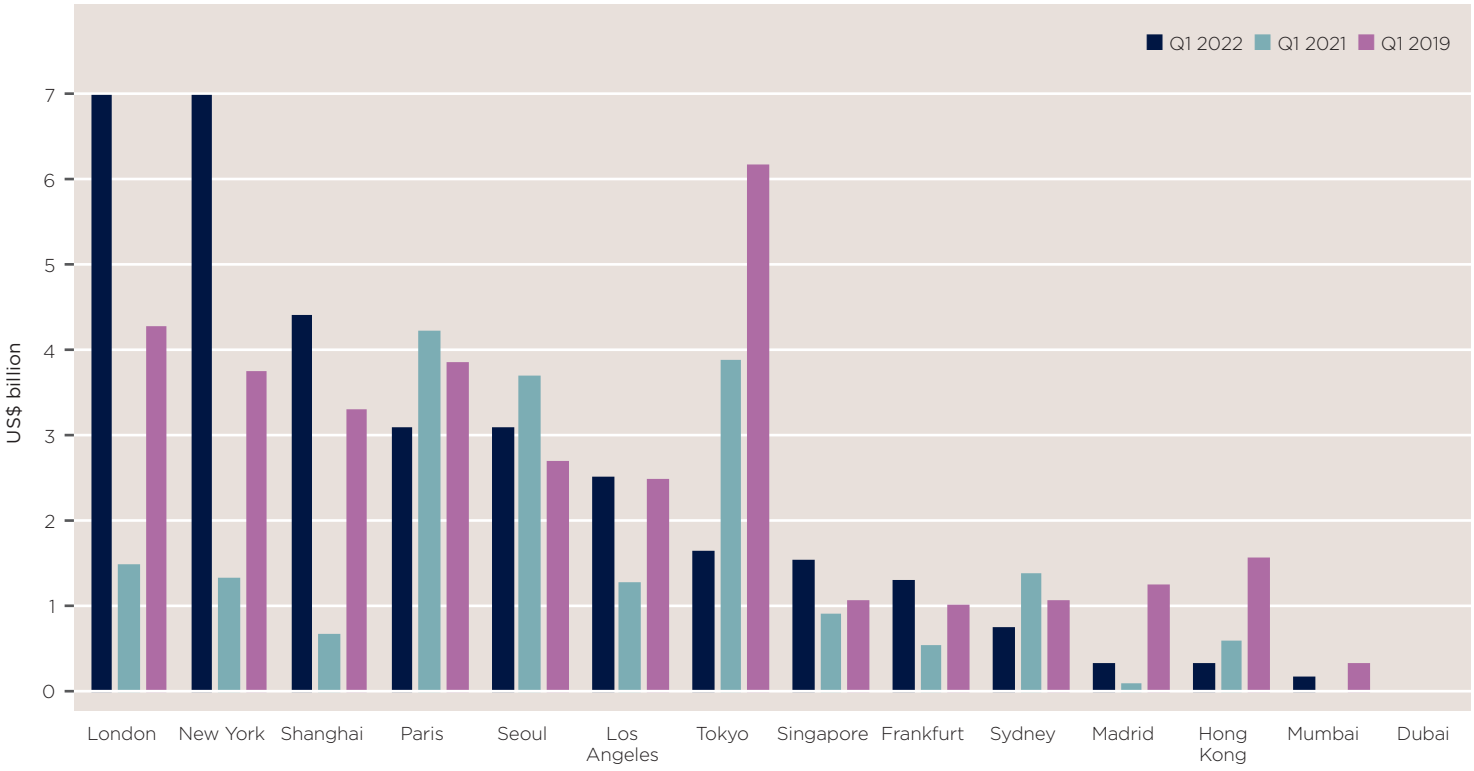
In the US, rising interest rates will put upward pressure on yields over the next 12 months, especially given relatively weak fundamentals in the office market. This is despite a strong start to the year, particularly in Manhattan, where leasing activity was up by 90% year on year in the first quarter and above the five-year average.

The Federal Reserve is expected to raise the policy rate to around 2.5% by the end of 2022 – even signalling that it may tighten policy beyond the 'neutral rate' in a bid to control inflation – which is quickly having an impact on market rates. Not only do higher rates reduce risk-adjusted returns, but they are rapidly impacting the cost of debt.

Vacancy rates are also high, at 27.4% in Los Angeles and 19.7% in New York. The onboarding of new space over the last 12 months has not been matched by occupational demand, despite the very strong labour market, as US workers have been slower to return to the office than their international counterparts. This environment is not conducive to strong rental growth, which is important, particularly in New York where the current cash-on-cash yield is broadly equal to forward-looking inflation expectations, implying near-zero real returns. In Los Angeles, concessions such as rental abatement are expected to increase.

Cross border activity is not significant in either market, but the strong US$ dollar and high hedging costs will likely deter many inbound investors, although the US remains the global safe haven in times of uncertainty.

Commercial office investment volumes by city



Source Savills Research and RCA

Note Data is based on public sources and will therefore underestimate investment volumes in some jurisdictions where most transaction details are undisclosed.

Asia Pacific

Geopolitical tensions in Europe are less relevant for Asian economies, and inflationary pressures are also less pronounced, given weaker demand-side pressure. Instead, idiosyncratic domestic issues are primarily driving the outlook across markets.

Japanese institutions remain active in Tokyo, with very low interest rates helping to support cash-on-cash returns despite low net initial yields. Rents have been falling since the onset of the Covid-19 pandemic – in Q1 2022, the average Grade A office rent was 7% down on the year before – but there are signs of a turnaround amid an improvement in occupier demand.

The precipitous decline in the yen will keep domestic investors in Japan while also encouraging greater inbound cross border interest. And with a limited supply pipeline, we expect some yield compression over the next 12 months. However, inflation-adjusted returns will remain healthy.

Inflation pressure is more pronounced in Australia, Singapore, and South Korea. In the latter, the Bank of Korea has already increased interest rates beyond pre-pandemic levels, while market rates have risen sharply in Australia even though the Reserve Bank of Australia (RBA) has only recently raised the policy rate. Hong Kong is also exposed to higher rates owing to the US$ peg.

In Singapore, we suspect yields may rise in the next 12 months, where occupier demand is relatively muted. Medium term, this trend may reverse given a very weak development pipeline. In South Korea, an increase in the cost of debt is squeezing cash-on-cash returns, implying a negative real rate of return when compared to forward-looking inflation forecasts. However, the market favours landlords; vacancy rates in Seoul have fallen sharply due to net absorption of nearly 46,000 sq m (493,800 sq ft) in 2021 – the strongest in over a decade – and with no new prime office space expected to hit the market this year, there is an expectation that rental growth will remain robust.

Finally, it has been a difficult start to the year in Shanghai, subjected to a citywide lockdown in a bid to contain an outbreak of Covid-19. We expect some upward movement in yields over the next 12 months. Financing remains a challenge despite some incremental policy easing from the central bank, and the cost of debt is weighing on cash-on-cash returns. Given uncertainty around the economic outlook, and over future policies on Covid-19, investor demand is likely to cool.

Market view

Rasheed Hassan, Head of Global Cross Border Investment

There is no doubt that we are currently at an inflection point in the market, where it feels like there are more questions than answers on where the appropriate pricing for real estate sits. While this publication orients around offices, the same questions are being asked across sectors and indeed across asset classes beyond real estate.

The challenge for investors, in particular those that have raised third party money, is that they need to invest in something and we may be moving to a search for the 'least-worst' return as opposed to enjoying a great value proposition.

While much is being made of rising interest rates, they currently sit well below inflation levels. Cash deposits may finally be getting a slightly more positive return, but in real terms the value of the cash is deteriorating and therefore money in the bank is a negative prospect. On a relative basis real estate returns remain attractive, although this could change if long-term real interest rates continue to rise.

The increasing cost of debt, set against a compressed yield environment means that some investors, such as those that are entirely cash-on-cash focused, are struggling to participate in core markets. However, they can explore new geographies and sectors to try and find real estate products that do meet their returns (we are already seeing strong evidence of this).

The absence of these investors in the most core markets provides an opportunity for others, who are not so reliant on bank debt or who take debt at a corporate level, to have more room to enter the market with less competition. Less competition could lead to some price softening, but such is the demand, we believe that small rises in yields will quite possibly result in a disproportionately positive reaction from buyers, thus actually keeping pricing relatively stable.

Put simply, it is harder to create high yielding financial instruments out of real estate right now and therefore people will have to revert to looking at the market on a fundamental basis (arguably as they should). Those who do this may well be able to participate as there are some strong positives in many office markets, in particular in terms of tenant advisory and rental growth prospects.

Global prime office yields, Q1 2022 (as at end-March)

City	Prime net initial yield	Outlook for yields, next 12 months	Typical LTV	Total cost of debt	Cash-on-cash yield	Risk premium
Hong Kong	1.70%	↔	50%	2.50%	0.90%	-0.36%
Seoul	3.00%	↔	55%	3.60%	2.27%	0.03%
Shanghai (Lujiazui)	4.00%	↑	50%	5.25%	2.75%	1.21%
Frankfurt	2.70%	↓	50%	2.00%	3.40%	2.10%
Paris	2.50%	↔	65%	1.80%	3.80%	1.52%
Madrid	3.00%	↔	60%	2.30%	4.05%	1.55%
London (City)	3.75%	↔	55%	3.37%	4.21%	2.12%
New York	4.50%	↑	60%	4.50%	4.50%	2.18%
Singapore	3.30%	↑	50%	1.75%	4.85%	0.96%
Los Angeles	5.00%	↑	60%	4.50%	5.75%	2.68%
Tokyo	2.60%	↓	65%	0.90%	5.76%	2.39%
Sydney	4.25%	↔	50%	2.00%	6.50%	1.41%
Dubai	6.50%	↔	50%	4.89%	8.11%	4.18%
Mumbai	8.00%	↔	60%	7.00%	9.50%	1.14%

Source Savills Research and Macrobond

Note Yields may be different to quoted values in markets where the convention is to use a gross rather than net value. Values based on end-of-quarter data. See Methodology for details.

Key transactions

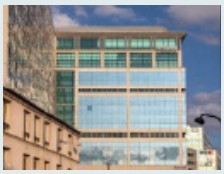
FRANKFURT

Building: Marienturm
Tenant: Goldman Sachs, Bank of America, and Mastercard
Lease Length (WAULT): 10 years
Area: 45,000 sq m
Price/NIY: €830 million / 3.2% (estimated)
Vendor: Aermont Capital
Vendor Nationality: UK
Purchaser: DWS Group
Purchaser Nationality: Germany
Other Comments: Landmark building in the heart of Frankfurt's CBD with high-profile tenants and leading ESG certification (LEED Platinum). The yield is discounted to the prime benchmark due to the size of the transaction.

SYDNEY

Building: Darling Quarter, 1-25 Harbour St
Tenant: Commonwealth Bank of Australia
Lease Length (WAULT): 12 years
Area: 61,000 sq m
Price/NIY: US$ 445 million / 4.0% (estimated)
Vendor: Abu Dhabi Investment Authority
Vendor Nationality: UAE
Purchaser: Allianz Real Estate
Purchaser Nationality: Germany
Other Comments: Allianz purchased a 50% stake at a record yield for the Australian office market.

PARIS



Building: 91-93 Boulevard Pasteur
Tenant: Amundi
Lease Length (WAULT): 12 years
Area: 39,500 sq m
Price/NIY: €550 million / 3.9% (estimated)
Vendor: Primonial
Vendor Nationality: France
Purchaser: Société Foncière Lyonnaise (French REIT)
Purchaser Nationality: France
Other Comments: The high yield reflects the larger lot size, which attracts fewer competitors, as well as the redevelopment needs of the building once the existing lease expires.

SEOUL

Building: Alpharium Tower
Tenant: NCSoft and Samsung
Lease Length (WAULT): Undisclosed
Area: 112,300 sq m
Price/NIY: US$ 853 million / undisclosed
Vendor: ARA Asset Management (now a subsidiary of ESR Group of Hong Kong)
Vendor Nationality: Singapore
Purchaser: Mastern Asset Management
Purchaser Nationality: South Korea
Other Comments: One of the largest transactions in South Korea since Covid-19, reportedly drawing interest from major international investors, including GIC and M&G.

LONDON

Building: Central Saint Giles
Tenant: Google
Lease Length (WAULT): 6 years
Area: 38,000 sq m
Price/NIY: £770 million / 3.9%
Vendor: Joint venture between Legal & General Investment Management Real Assets and Mitsubishi Estate London Limited
Vendor Nationality: UK
Purchaser: Google
Purchaser Nationality: US
Other Comments: The transaction represents a significant vote of confidence for London after Google reportedly backed away from the deal in June 2021.

NEW YORK

Building: One Manhattan West
Tenant: Skadden, Accenture, EY, and National Hockey League
Lease Length (WAULT): Undisclosed
Area: 195,100 sq m
Price/NIY: US$ 1.4 billion / undisclosed
Vendor: Joint Venture between Brookfield Asset Management and Qatar Investment Authority
Vendor Nationality: Canada and Qatar
Purchaser: Blackstone
Purchaser Nationality: US
Other Comments: Blackstone acquired a 49% stake, valuing the tower at US$ 2.85 billion, a value that would represent the largest single office transaction since the sale of the GM building in 2008.

Methodology

Net initial yields are estimated by local Savills experts to represent the achievable yield, including transaction and non-recoverable costs, on a hypothetical grade A building located in the CBD, over 50,000 sq ft in size, fully let to a single good profile tenant on a long lease.

The typical LTV and cost of debt represent the anticipated competitive lending terms available in each market. Cash-on-cash returns illustrate the initial yield on equity, assuming the aforementioned LTV and debt costs. The risk premium is calculated by subtracting the end-of-period domestic ten-year government bond yield (as a proxy for the relevant risk free rate of return) from the net initial yield. Data is end-of-quarter values.

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