

Savills Global Capital Markets Quarterly



Global outlook

The economic outlook continued to deteriorate through the second quarter. A realisation that the global economy cannot easily withstand both higher inflation and higher interest rates is starting to shape the market narrative. Investors are fixated on the dreaded R-word: recession.

A global recession remains a possible, rather than the probable,

outcome. But the risk of recession is enough to weigh on investor sentiment. An economic slowdown would help to bring inflation under control and put a ceiling on interest rates, but it would also derail the one bright spot across most office markets: the strength in occupier demand.

It is therefore unsurprising to see investors scale back their

ambitions this quarter; just over US\$69 billion of office space was transacted globally, down by nearly 12% compared with the same period last year. Given it typically takes many months to complete a transaction, these figures likely overestimate the amount of liquidity in the market as we begin the second half of the year.

Focal points



The economic outlook has deteriorated. Weaker investor sentiment has underpinned a decline in transaction volumes. While many investors are taking a step back, there is still liquidity in most markets, but buyers and sellers are diverging in their price expectations.

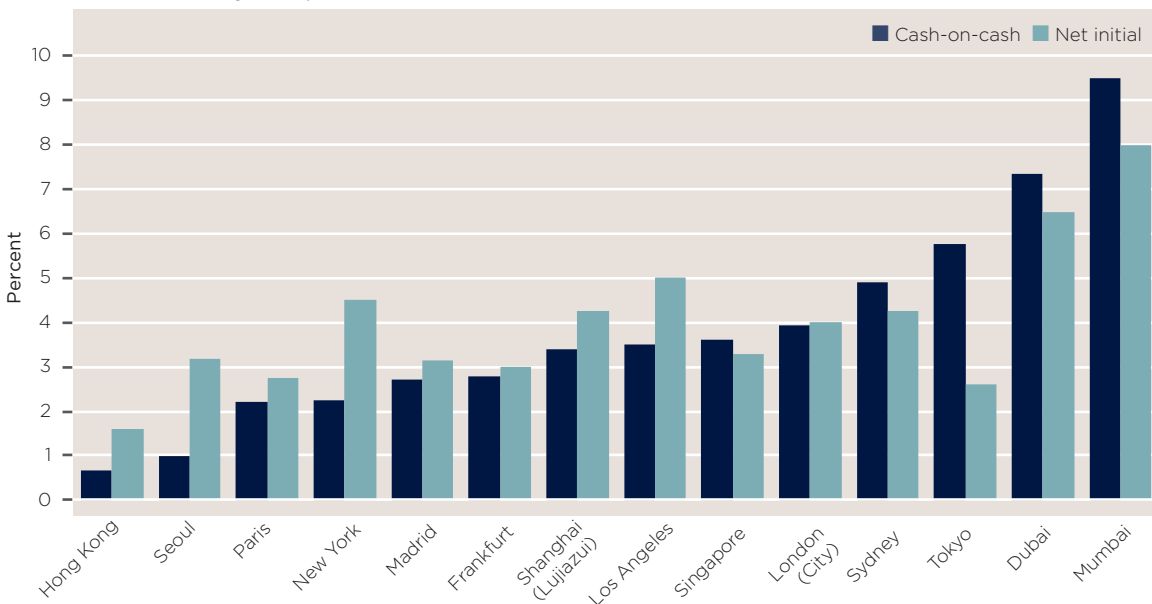


Occupier demand has shown resilience to these headwinds, amid strong employment growth and rising office occupancy levels, but an economic slowdown will challenge this narrative, and undermine the rental growth forecasts needed to justify pricing in some markets.



Inevitably prices are adjusting. This process is already underway in Europe, where yields were lowest, making them most sensitive to higher interest rates. However, in other markets, it is more a case of when and not if.

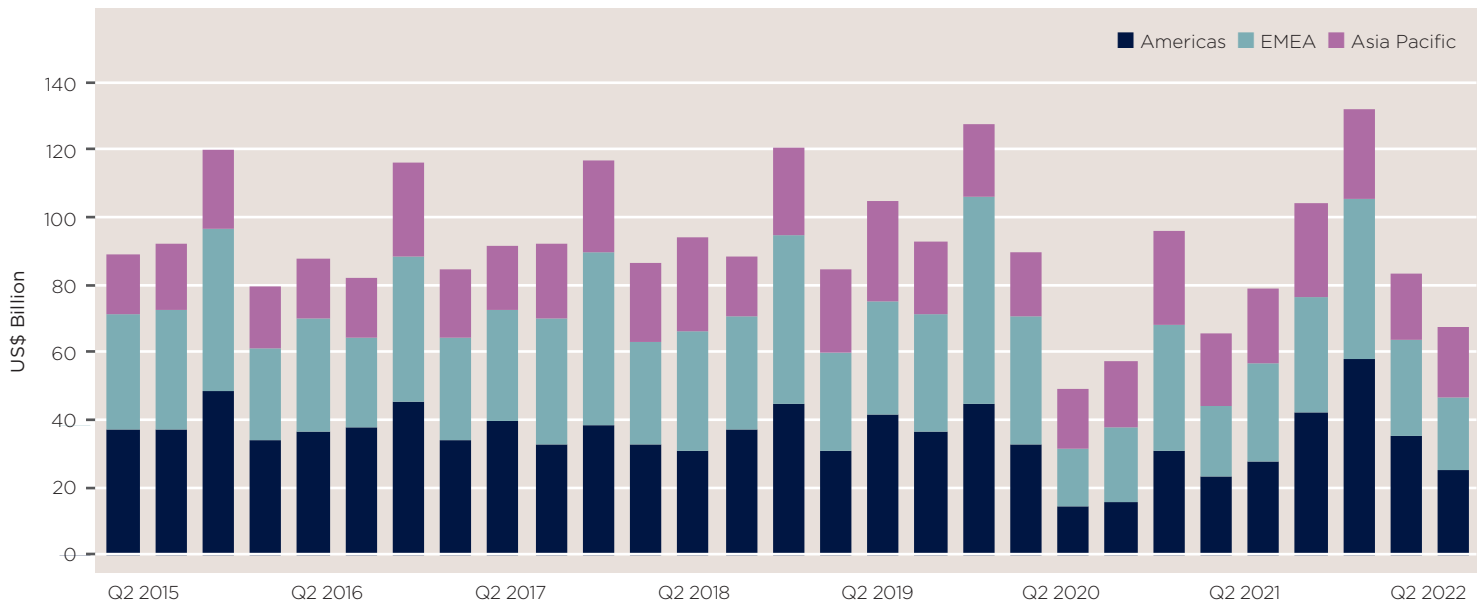
Prime office yields, Q2 2022 (as at end of June)



Source: Savills Research

👁️ There are still buyers and sellers active in the market, but they are reduced in number, and across many jurisdictions their price expectations are diverging 🗨️

Global commercial office investment volumes



Source Savills Research and RCA

Soft landing or recession?

The question troubling investors is not if there will be a slowdown in growth, but rather how severe that slowdown will be. The answer will largely be determined by the stickiness of inflation, and the resolve of global central banks to bring it under control. By raising interest rates, central bankers are trying to engineer some disinflation, or outright deflation, by reducing demand for goods and services. The big unknown is just how much demand destruction is needed to bring inflation back towards target, typically 2% in major advanced economies, given much of the ongoing inflationary impulse is driven by factors outside of their control (i.e. energy and food prices, supply chain bottlenecks, etc.).

Markets are relatively sanguine about the prospects of inflation coming down next year, allowing central banks to again resume counter-cyclical monetary policy. Short-term interest rates in the US, for example, are expected to peak in early 2023 before falling thereafter, which would help to cushion the ensuing downturn. Economic forecasts produced by the likes of the IMF and OECD tend to agree that a significant global recession is avoidable.

Assuming we get a soft landing, then interest rates may have already peaked in this cycle. Indeed, by the end of the second quarter of 2022, long-term US Treasury yields had fallen by around 50 bps from recent highs, despite continued tightening from central banks, which is already priced in to market rates. Of course, this does not necessarily mean that debt costs will also stabilise – lenders typically increase margins during economic downturns, compensating for

higher default risks – while deteriorating credit conditions will impact the LTVs that banks are willing to lend at.

Impaired price discovery

In the interim, the combination of increased volatility and higher interest rates is weighing on investment volumes. In private real estate markets, where assets are heterogeneous and rarely exchanged, establishing a price is difficult. This is especially true in periods of heightened uncertainty; a decline in transactions distorts the tried-and-tested ‘mark to market’ valuation process. Instead, we rely largely on anecdotes to size up the market and establish a direction of travel.

There are still buyers and sellers active in the market, but they are reduced in number, and across many jurisdictions their price expectations are diverging. For a market to exist, some compromise on price is needed between the two, but unlike in listed markets, this adjustment process takes time. In the interim, we are hearing of sales being paused or at least processes taking longer, as the interested parties try to agree on pricing. Investors who don’t need to sell won’t, particularly core assets, where they have likely faced significant competition to attain them in the first place. But at some point, we may start seeing distressed sales as investors, facing the need to refinance existing debt, are either unable or unwilling to meet the worse terms that will inevitably be offered by lenders.

Investors may, however, adopt ever-more innovative strategies to avoid selling their prime buildings. This is because, in the midst of the ensuing turmoil, occupier demand for

best-in-class assets has continued apace. This is driving a wedge between prime and secondary asset valuations; the wall of money still exists – as evidenced by Blackstone’s recent record-breaking fundraising antics – but it is increasingly following occupiers into the best and most ESG-compliant buildings. These are in short supply, a situation that is unlikely to change soon given the precipitous rise in construction costs.

Occupier demand still key

The optimists hope that the labour market will put a floor on the economic slowdown and continue to support high take-up rates and solid rental growth. The labour market is, however, a lagging economic indicator. It takes time, and sometimes plenty of bureaucracy, to hire and fire people. In the US, for example, which has one of the most flexible labour markets, at the point at which the former investment bank Lehman Brothers filed for bankruptcy in late 2008, the unemployment rate was 6.1%. It eventually peaked at 10% a full 12 months later.

Given the sharp rise in interest rates, investors are looking to rental growth forecasts to help support their underwriting. Even if recession is avoided, it is becoming apparent that current pricing is being challenged. In some markets, the adjustment is already happening, and we have moved net initial yields out in several markets this quarter. But these changes do not fully offset the rise in debt costs, with nearly all markets seeing a decline in cash-on-cash returns this quarter for a typical investor using a mix of debt and equity. More price adjustments are therefore expected in the next 12 months.

“ The wall of money still exists, but it is increasingly following occupiers into the best and most ESG-compliant buildings. These are in short supply ”

Regional outlook

Europe, Middle East, and Africa (EMEA)

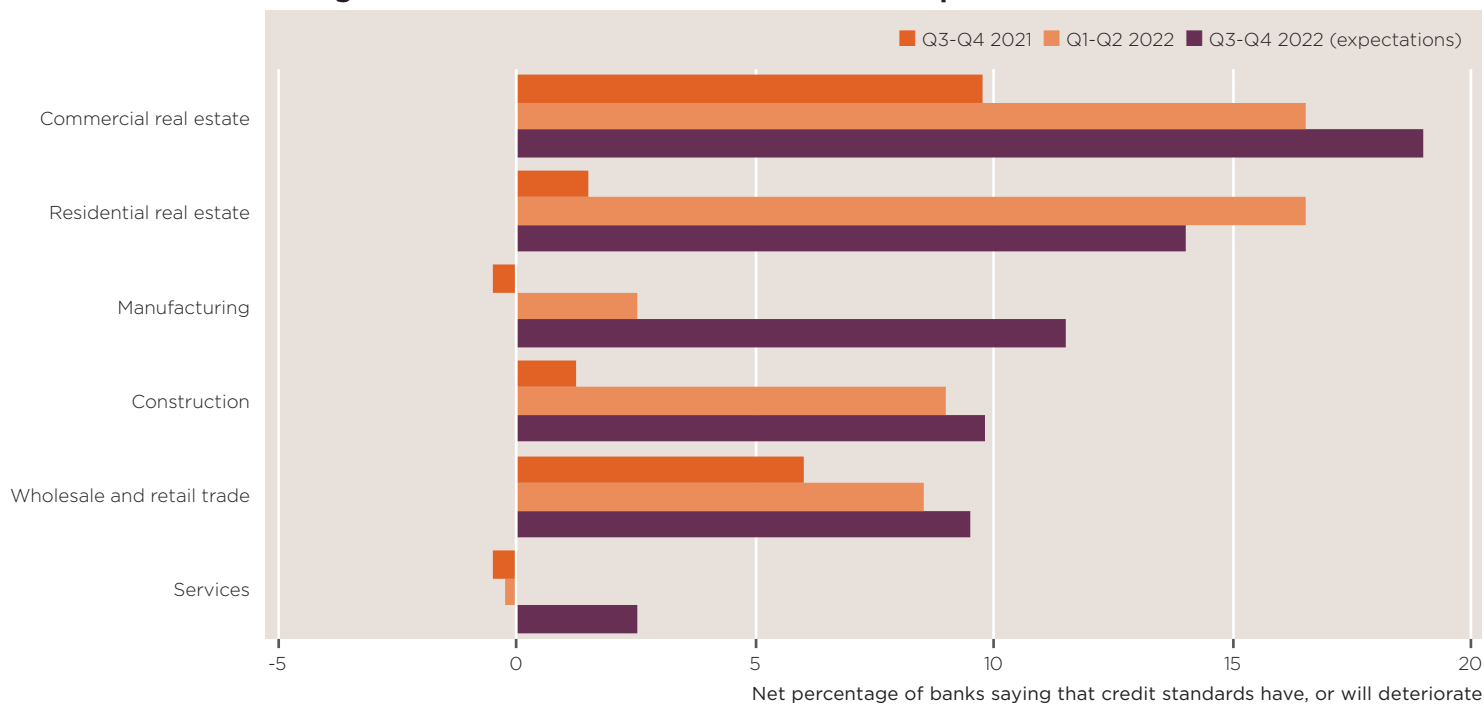
Even by usual standards, this summer is likely to be quiet in Europe. After an encouraging start to the year, investment in office space across the region fell by around 26% year-on-year in the second quarter. Germany was at the forefront of this decline; investment in the first half of this

year was around 50% lower than the same period last year.

The reticence being displayed by investors is understandable. Market interest rates have continued to rise despite limited action from the ECB, with higher inflation prompting markets to bring forward expectations of monetary policy tightening. This has underpinned an increase

in the total cost of debt of around 120-140 bps in Frankfurt, Madrid, and Paris, compared with the first quarter. Credit conditions are unlikely to ease up in the second half of the year either; in the latest ECB Bank Lending Survey, the commercial real estate sector is expected to experience a further tightening in financial conditions (see chart below).

Change in credit standards for new loans to enterprises in the euro area



With net initial yields hovering around 3% and lower going into the downturn, there was little room for manoeuvre at the core end of the European market. So it was perhaps inevitable that yields would rise in response to such a major repricing in debt. Indeed, we have revised our prime office yields across key regional markets this quarter, implying a 5-10% decline in capital values.

Meanwhile, the outlook for growth is deteriorating in response to news that Russia is restricting natural gas supplies ahead of the winter months, prompting concerns that an energy supply crisis will necessitate the rationing of gas across the region. This will have a major impact on economic growth, particularly across the CEE, as well as Italy and Germany, where exposure is highest. Vacancy rates have remained

stable across the region this quarter, partly due to a shortage of prime office space, in turn supporting rental growth. But this trend could quickly reverse in the event of a major economic slowdown. A further correction in prices may be needed to keep the market functioning.

In the UK, the movement in debt costs this quarter was less pronounced, primarily because the Bank of England is much further advanced in its tightening cycle. Weight of money and supply shortages are still important factors in the City of London, but investment activity was also more subdued after breaking records in the first quarter, and investors face a similar set of challenges as in the euro area.

We have moved the London City prime yield out by 25 bps to 4% this quarter, although the

outlook for the next 12 months is a little more encouraging. In particular the depreciation in sterling – which has lost around 13% in value against the USD since the beginning of the year, and 5% against a basket of the UK’s major trading partners – provides a relative value opportunity for international investors (who typically account for around three-quarters of all transaction volumes).

In Dubai, while not immune to rising interest rates and other global headwinds, investor demand continues to hold up amid a lack of investment-grade opportunities. When supply does come to the market, there is a large amount of capital to ensure good competition, which is likely to keep pricing steady despite falling cash-on-cash returns.

North America

A similar narrative is playing out in the US as in Europe. Debt costs have continued to rise quickly as the US Fed pursues its fastest tightening cycle in decades; investors can now expect to pay 6% on a typical loan to finance the purchase of prime office space in local markets.

This is feeding through to expected returns, with cash-on-cash yields down by more than 200 bps in comparison with Q1. In New York for example, the return on a typical 60% LTV debt-financed deal for prime office space in Manhattan would be equivalent to just half the yield for a pure equity investment. This is

a far cry from the days when investors could enhance their returns by introducing debt into their capital structures.

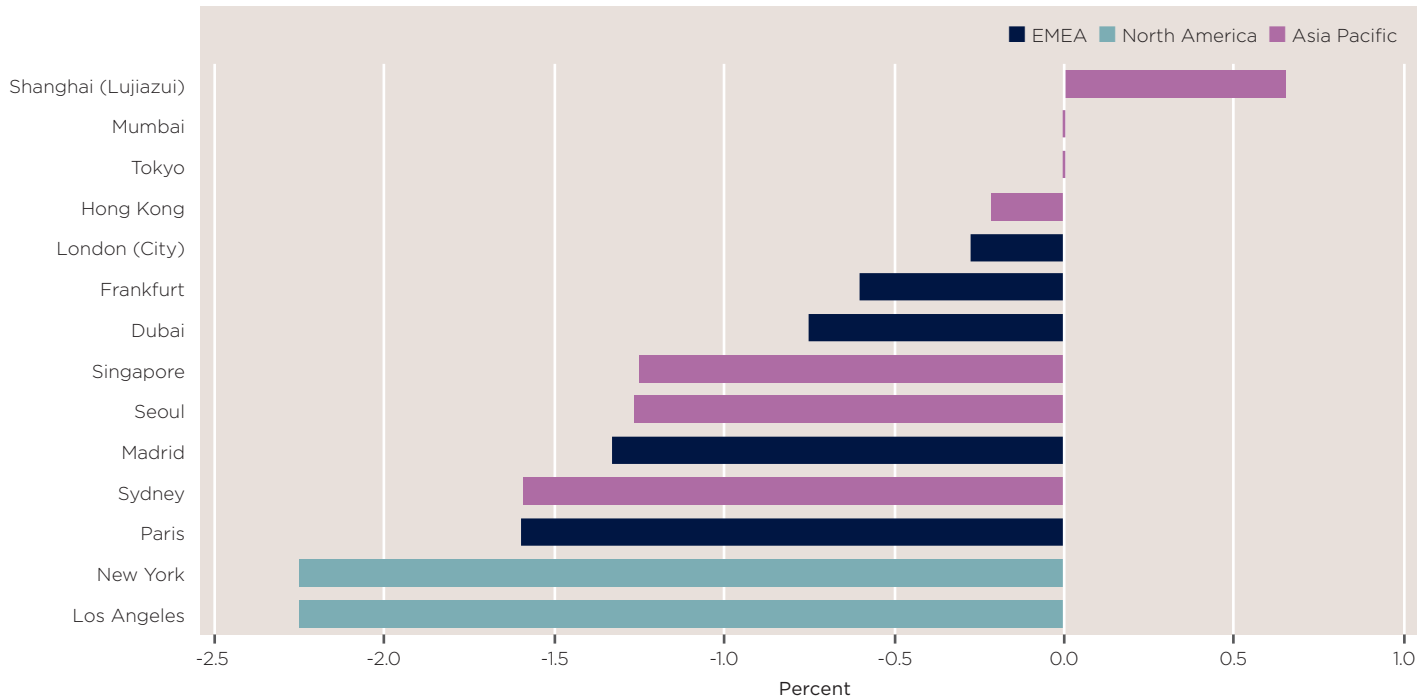
The composition of buyers still active in the market is changing as a consequence; private money accounted for over 43% of US office transactions in the first six months of this year, more than 10 percentage points above the long-term average. Cross-border investors are also less active, given the strong USD and negative carry when hedging some exchange rate exposure, notably the euro.

Market pricing has yet to respond – we have held our prime yields at 4.5% and 5% for New York and Los Angeles respectively this quarter

– primarily due to a lack of suitable transactions from which to benchmark current valuations. However, in both cases, we expect yields to rise in the next 12 months, particularly as the outlook for occupier demand is also softening. In LA for example, leasing activity was down by 20% on the quarter, and landlords are having to offer generous concession terms and stable rents to attract and retain tenants amid some oversupply.

Hybrid working trends are not helping; occupancy levels have stabilised at around 40% of pre-Covid levels across the US, limiting the feed-through from the strong labour market to office take-up.

Change in cash-on-cash yields since Q1 2022



Source Savills Research

Asia Pacific

In the Asia Pacific region, prime yields have shifted in Shanghai and Seoul in the second quarter, while Sydney is also likely to see a softening in prices in the next 12 months.

In Seoul, while fundamentals continue to support solid rental growth, the repricing is underpinned by a rapid increase in the cost of capital, with total debt costs rising by 140 bps in comparison with Q1. Even at the revised yield, this leaves the cash-on-cash return at a very low 1%, implying a negative premium over the prevailing risk-free rate. Yields are likely to move out further over the next 12 months as a consequence.

In Sydney, much like in the US, yields remained unchanged on Q1, as the large decline in transaction activity made it difficult to

benchmark the market. However, investor sentiment has fallen sharply amid a significant repricing in debt: the all-in cost of debt rose by 160 bps in Q2 alone after the Reserve Bank of Australia hiked interest rates at successive meetings. Australians have also adopted hybrid working styles more aligned with the west than with regional norms, putting a ceiling on the recovery in occupier demand. Yields are likely to move out in the coming year as a consequence, but cash-on-cash returns remain relatively healthy at nearly 5%, implying a real return of over 2% per annum when considering forward-looking inflation expectations.

Leasing activity in Singapore was relatively subdued in the second quarter, but low vacancy rates and a lack of new stock coming to market will help to support rental growth. Debt is

still accretive at the current net initial yield, supporting a cash-on-cash return of 3.6%. Investors remain active despite uncertainty over the future path of interest rates, as well as other economic headwinds (as a small open economy, Singapore is exposed to a global slowdown), given the socio-political stability that it offers, as well as its attraction as a regional hub.

In Tokyo, while the vacancy rate of 3% across prime office space is low by global comparison, it is higher than the five-year average. This is giving tenants more options, putting downward pressure on Grade A rents. But there remains little upward pressure on debt costs as the Bank of Japan remains steadfastly committed to its current ultra-loose monetary policy stance.

Market view

Rasheed Hassan, Head of Global Cross Border Investment

Lots of rumour, not enough fact

It seems we may be at, or at least approaching, the point of maximum uncertainty in the market. It is very hard to read where we are going.

Inflation is still widespread, central banks are trying to use evermore dramatic rate rises to control this, and we have been all but promised a recession. Yet, unemployment levels are looking very strong in many markets, there is still a lot of rhetoric about a store of wealth that will help cushion us from the blow of rising costs, and the cost of borrowing in the commercial markets has actually dropped in recent weeks.

Last quarter we were feeling a change in the water in the global real estate markets. It is now the case that this rumour has become a fact, albeit there is a dearth of true data points and it is hard to know how deep into the fact we are.

Transaction volumes are down and we are

seeing pricing soften in most markets and sectors globally. However, like the unemployment rate, the occupational markets in most sectors are still posting strong stats. As such, most of the move so far is just down to a readjustment in cost of money, inflationary pressure on build costs and, of course, sentiment.

The question in the real estate market is now, to what degree will the abundance of equity and rental growth be able to cushion and limit price corrections?

We are hearing about some investment committees being closed for the summer and investors pausing, but we are still seeing bidding from these same groups as they try to identify 'special situations' and those owners that 'have' to sell.

We talk about being in a period of price discovery. It is certainly not a case of no 'bid',

it is now simply waiting to see how frequently and far 'the ask' moves. This will determine short-term transactional activity.

The press often portrays examples of 'failed sales.' But in every example I have seen, I know there have been bidders, albeit perhaps not quite meeting seller aspirations. The owners could have sold, but have just taken the view that there is more value for them in holding. They are comfortable holding real estate, and either think pricing will improve, or were maybe just testing the market in the first place because they thought they could get something extraordinary.

We aren't seeing desperation or panic. If sellers stay robust while things are adjusting from some heady highs, the amount of dry powder and appetite for real estate should mean we will avoid a major fall in values.

Global prime office yields, Q2 2022 (as at end of June)

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	1.61%	↔	40%	3.00%	0.68%	-1.40%
Seoul	3.20%	↑	55%	5.00%	1.00%	-0.44%
Paris	2.75%	↑	55%	3.20%	2.20%	0.79%
New York	4.50%	↑	60%	6.00%	2.25%	1.52%
Madrid	3.15%	↑	55%	3.50%	2.72%	0.60%
Frankfurt	3.00%	↑	50%	3.20%	2.80%	1.56%
Shanghai (Lujiazui)	4.25%	↑	50%	5.10%	3.40%	1.43%
Los Angeles	5.00%	↑	60%	6.00%	3.50%	2.02%
Singapore	3.30%	↔	50%	3.00%	3.60%	0.32%
London (City)	4.00%	↑	55%	4.05%	3.94%	1.74%
Sydney	4.25%	↑	50%	3.59%	4.91%	0.59%
Tokyo	2.60%	↔	65%	0.90%	5.76%	2.38%
Dubai	6.50%	↔	50%	5.64%	7.36%	3.52%
Mumbai	8.00%	↔	60%	7.00%	9.50%	0.55%

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.

The risk premium is calculated by subtracting the domestic 10-year government bond yield from the net initial yield. Values based on end-of-quarter data. See Methodology for details.

Key transactions

PARIS



Building: 2 Place Rio de Janeiro
Tenant: Morgan Stanley, King & Spalding, Andera Partners, Amala Partners, and Blackfin Capital Partners
Lease length (WAULT): Unknown
Area: 8,700 sq m
Price/NIY: €280 million / 2.8%
Vendor: Ardian Real Estate
Vendor nationality: France
Purchaser: M&G Investments
Purchaser nationality: UK
Other comments: Sale follows the completion of a €24.5 million renovation project, bringing the building up to BREEAM Excellent standard and so supporting the low transaction yield.

NEW YORK



Building: 450 Park Avenue
Tenant: Multiple tenants including JPM Securities, Banco Bradesco, BDT Capital Partners, and Oxford Properties
Lease length (WAULT): Unknown
Area: 31,300 sq m
Price/NIY: US\$445 million / 4.0%
Vendor: Joint Venture between Oxford Properties Group and Crown Acquisitions
Vendor nationality: US
Purchaser: SL Green Realty
Purchaser nationality: Canadian/US
Other comments: The building was purchased at a large discount to the US\$545 million paid in 2014, which at the time represented a 3.3% net initial yield. The new owners are planning capital investment that will include "a new amenity offering, providing high-quality, tailored programs and services for building tenants."

SINGAPORE



Building: Westgate Tower
Tenant: Mercedes Benz, Great Eastern Life
Lease length (WAULT): Undisclosed
Area: 28,332 sq m
Price/NIY: S\$680 million / Undisclosed
Vendor: Sun Venture
Vendor nationality: Singapore
Purchaser: AEW
Purchaser nationality: US
Other comments: Westgate Tower represents just one of several large sales in Singapore, including Income@Raffles and the AXA Tower. The out-of-town location highlighted the strength of the occupier market in Singapore, which has attracted a number of multinational companies switching headquarters from Hong Kong.

SEOUL



Building: M Tower, Bundang
Tenant: Naver, Samsung, and Linde
Lease length (WAULT): Undisclosed
Area: 4,285 sq m
Price/NIY: KRW264 billion / Undisclosed
Vendor: Undisclosed
Vendor nationality: Undisclosed
Purchaser: M&G Real Estate
Purchaser nationality: UK
Other comments: Purchase represents M&G's fourth acquisition in South Korea in the last two years, with the out-of-town location highlighting that investor demand remains strong when high-quality assets come to market.

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 10-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.



Savills Research

We're a dedicated team with an unrivalled reputation for producing well-informed and accurate analysis, research and commentary across all sectors.

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