

A low-angle, upward-looking photograph of several modern skyscrapers with glass facades, creating a sense of height and architectural scale. The sky is a clear, pale blue.

# Taking Stock: — Capital Markets Quarterly Offices Q3 2023



# Global outlook

Global investment volumes hit a post-GFC low in the third quarter of 2023, as both cyclical and structural concerns continue to weigh on investor sentiment.

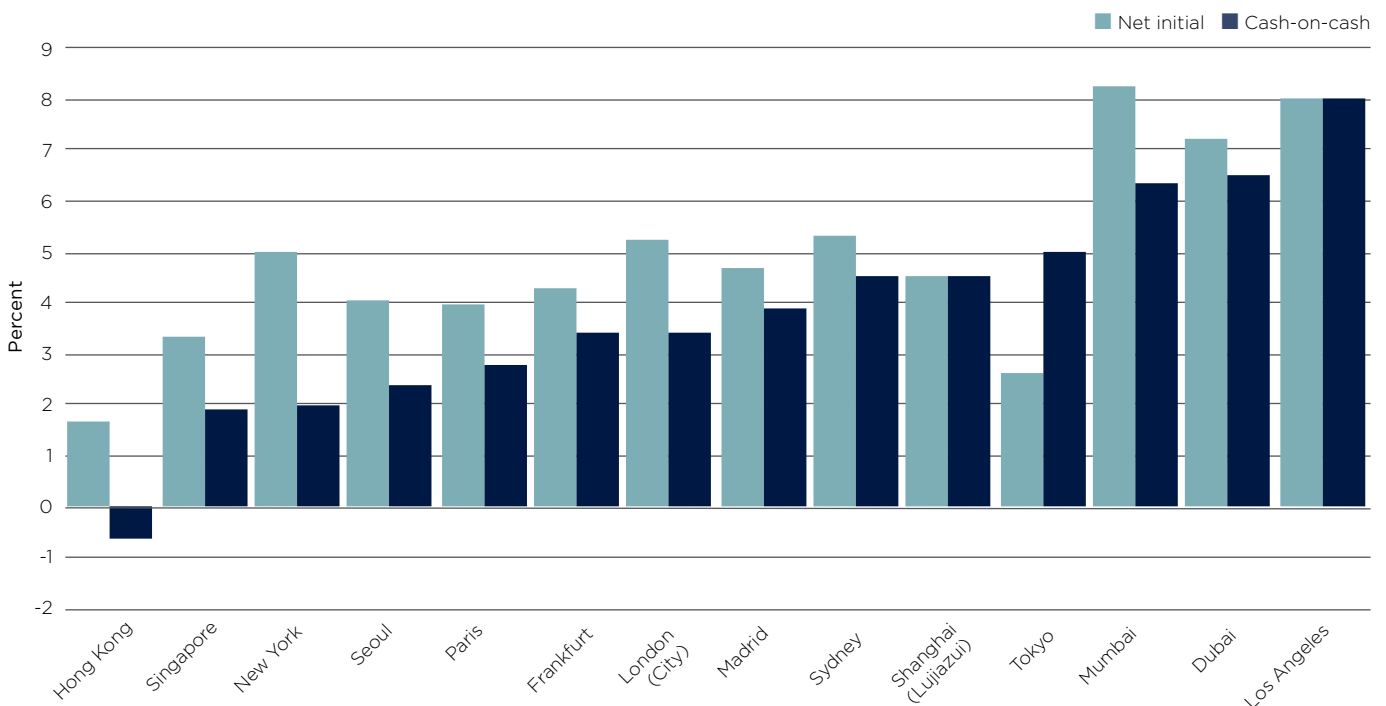
Around US\$32 billion in office transactions were closed in the third quarter of this year, representing a near 59% decline in comparison with the same period last year. To give this some context, it was the weakest outturn since Q3 2009, when the global economy was in the midst of the GFC (albeit that Q3 2009 did not represent the lowest point of that year).

Institutions remain somewhat circumspect towards offices, accounting for less than 22% of transactions this year, however this is only marginally down from a long term average of 27%. Unfavourable market conditions - including high interest rates and a slowing global economy - favour a wait-and-see approach from investors, while uncertainty over the future viability of some offices is making it hard to plan some exit strategies. However, the global

narrative is dominated by the somewhat bleak news coverage of the US market, and there remains plenty of nuance, both in the US, and the rest of the world.

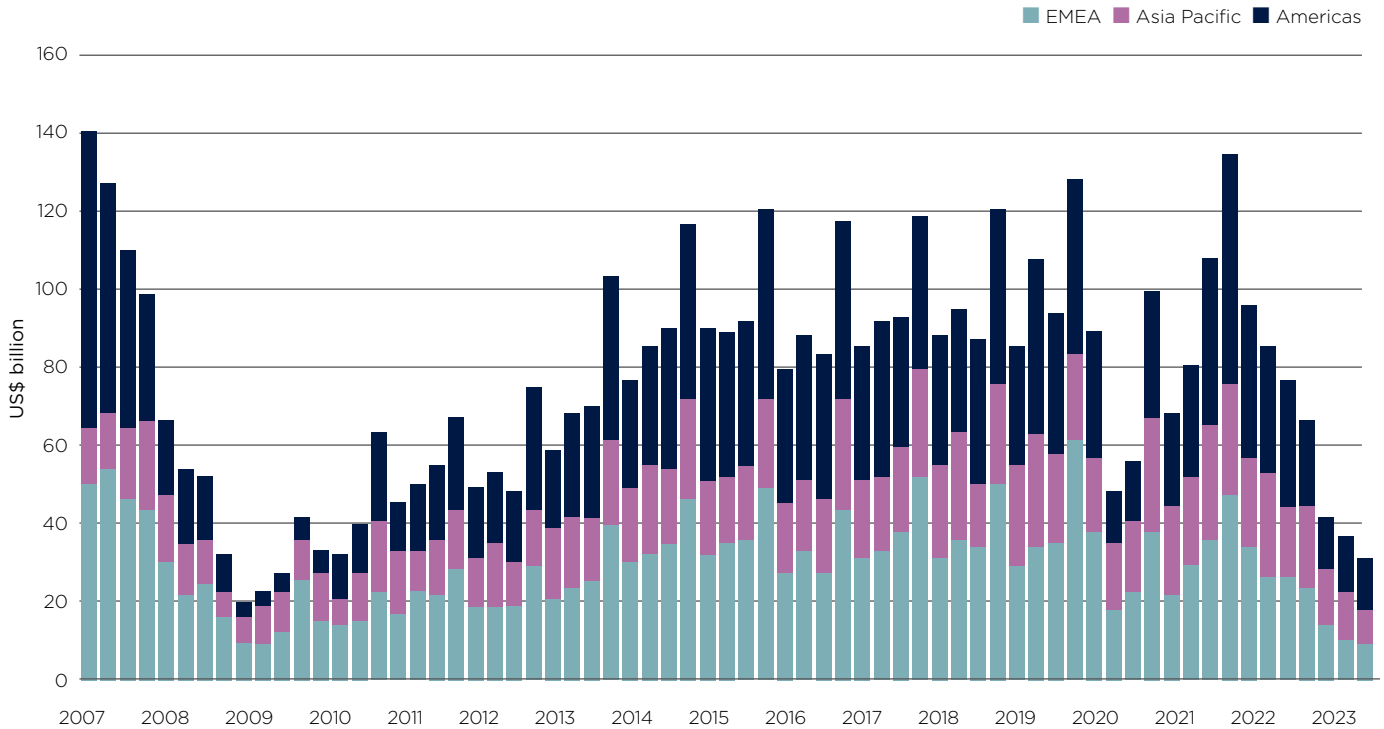
Prime yields continued to move outwards this quarter in Sydney (10bps), London, Madrid, Paris, and Shanghai (all 25bps), and Frankfurt (30bps). Some markets will continue to see upward pressure in the coming months. However, with interest rates now peaking, the first pre-condition for stability has been met. Commercial real estate is slow moving at the best of times, but nevertheless some more certainty around interest rates and borrowing costs should help to facilitate a floor in pricing, and eventually a recovery in investment activity, particularly for those investors who can separate the art from the artist.

**Prime office yields, Q3 2023 (as at end-September)**



Source: Savills Research

### Global office investment volumes



Source: Savills Research using MSCI Real Capital Analytics

### Transitory inflation Higher for longer

With transitory inflation now behind us, ‘higher for longer’ is the new slogan doing the rounds, summarising the outlook for the future path of policy rates. Central banks have gone to great lengths to convince markets that they are not cutting soon. Forward guidance has taken a hit in recent times, but this proves that central bankers still hold sway over the market (don’t bet against the Fed!). By convincing investors that rates will remain elevated, global bond yields have continued to rise in recent months, with the 10-year US Treasury briefly pushing past 5% in mid-October.

The question is whether higher for longer ultimately proves transitory (cue narrative klaxon!). History suggests it will; in the past 30+ years, the US Fed has typically held out for just 6 months before cutting rates again. Given they last raised rates in July, this would imply a rate cut at their first soirée next year. And yet, markets are currently pricing a 99% probability that the Fed Funds rate is at or above current levels following the January 2024 meeting.

Markets are nearly always wrong, but a fast about-turn is predicated on something going bang in the global economy, fundamentally shifting the narrative on growth and inflation. The proposition that the ‘Fed hikes until something breaks’ is grounded in fact; financial crises often follow rapid monetary policy tightening cycles.

Investors want lower interest rates, but higher for longer is inextricably linked to a soft landing, so it’s a case of be careful what you wish for.

The good news then is that, in their recent forecast update, the IMF declared that the ‘likelihood of a soft landing has increased.’ Those expecting a more severe downturn in the global economy are using more intuition than fact to form their opinion; a soft landing in the global economy is the right call, conditioned on what we know today. Households, corporations, and the transparent parts of the financial system are generally in good financial health, able to weather the higher rate environment. Labour markets are showing few signs of rolling over, and real wage growth should support household consumption.

### Tomorrow is another day

There are however plenty of vulnerabilities in the global economy right now; the property market in China, conflict in Ukraine and the Middle East, concerns over the US regional banking sector, etc. Given the historical context, we are perhaps embarking on a period of peak anxiety that makes it very difficult for investors to make long term decisions. This is reflected in public markets, with the VIX index of equity market volatility in the US up from mid-year lows.

## Follow my deed

Even a soft landing may not be the fillip that real estate investors want; a global economy that is 'limping along' in the words of the IMF does not provide much comfort. If investors follow the occupiers, then weak global demand is not an environment that will stimulate a strong recovery in office leasing and rents. In the US for example, some markets are now seeing a decline in office-based employment.

However, the soft landing is predicated on labour markets remaining relatively resilient, with only a limited rise in unemployment across most major economies. This should help to put a floor on occupational demand. 'Wait and see' is as relevant in the occupational market as it is in the capital market, but in many cases, occupiers do not have a choice. Much of the current office leasing activity is driven by non-discretionary activity, and this will continue to churn providing firms are not shedding jobs.

Furthermore, it is important not to generalise. There is plenty of nuance in the office market, much of which is now well-versed; most markets are seeing a bifurcation between the best quality buildings, which continue to attract tenants, and the older, poorly located stock. In Germany, while overall take-up in Q3 was down by nearly 29% on the year, average prime rents have risen by over 9% y/y across the top six markets.

In Seoul, where the vacancy rate remains well below 5%, prime rents are up by 7.1% y/y. The caveat is that concessions are rising in some markets, with landlords reluctant to reduce rents. But nevertheless, the right office, in the right location, will continue to deliver strong returns. Capital values are a function of both rents and yields, something that is often lost in the conversation about offices.



# Regional outlook

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

Summer is traditionally a quiet period for real estate investors in Europe. In any given year, investment volumes are typically 10-15% lower in Q3. But even by these standards, the current stagnation is unusual (a common theme across most sectors and geographies). The US \$10.1 billion of office investment recorded in Europe this quarter represents a 14-year low going back to the GFC. Currency fluctuations make this comparison appear worse than it is, but when looking at the number of individual property transactions, Q3 activity was 8% down on 2009.

Overall office investment volumes in Europe fell by 62% y/y in Q3, bringing the full year-to-date figures down by 60%. The country breakdown is somewhat mixed. Germany and Italy are notable laggards, both seeing greater falls than the regional average. France year-to-date investment has held up relatively well (-43% y/y), albeit that Q3 was 64% down on the same period last year. Spain meanwhile has continued to show some resilience – total volumes are down by around 50% y/y both in terms of Q3 and year-to-date comparisons – flattered somewhat by a lower base in 2022, but also supported by strong inflows of private capital.

Cross border investment has fallen by a similar scale to the total market. Sentiment in the US is clearly impacting appetite for European offices; inflows of capital from US and Canadian investors are down by a combined 81% year-to-date, underpinning a near 78% decline in inflows from outside Europe. But despite this, the US remains the primary source of capital originating outside of Europe. Elsewhere, Japanese and Singaporean investors are the most active from Asia Pacific, with the South Koreans notable only by their absence.

By contrast, intra-European flows of cross border capital are holding up relatively better. German and French investors in particular are supporting this trend – possibly as a means to diversify away from struggling domestic markets, but also due to the higher yields available

elsewhere. French outbound investment is linked to the local SCPI funds, who have remained active this year when others have retrenched (particularly in the first six months).

Major institutions are marginal net sellers of offices so far this year. This trend is likely to continue in the short term, with the large open-ended funds in Germany and France expected to bring more stock to market as they face pressure from growing client redemption requests. This may provide a catalyst for greater liquidity, but the question remains whether there will be much competition on the buy side, particularly for larger assets.

In part, this is driven by pricing expectations. Yields have continued to push outwards this quarter, but ongoing discrepancies between buyer and seller expectations would suggest they have further to go in some markets. And even if they do rebase further, according to our latest regional sentiment survey, investors are scaling back interest in CBD offices, with the proportion of respondents looking to deploy into offices over the next 12 months falling from 52% in 2022 to 29% 2023<sup>1</sup>

A further constraint to deal activity in mainland Europe is a perceived yield arbitrage favouring UK offices. This is feeding into a more encouraging outlook in the UK, as we look ahead to what is traditionally the busiest period of the year. September was the most active month for London City office transaction since March, and some larger deals have successfully completed in recent months. Asia Pacific capital remains steadfastly committed to London, accounting for around 60% of volumes this year. In particular, Asia Pacific investors are the most prevalent buyer group when it comes to larger lot sizes.

A lack of available stock is a big factor in the lower transactional volumes and vendors should be encouraged by an apparent narrowing in buyer and seller price expectations – which in combination with interest rate stability and a positive outlook for rental growth, should presage a stabilisation in yields.

<sup>1</sup> Savills EME Investor Sentiment Survey, based on pan European investors representing over €500bn of Assets Under Management (AUM), with responses collected between 5-19th September 2023.



### North America

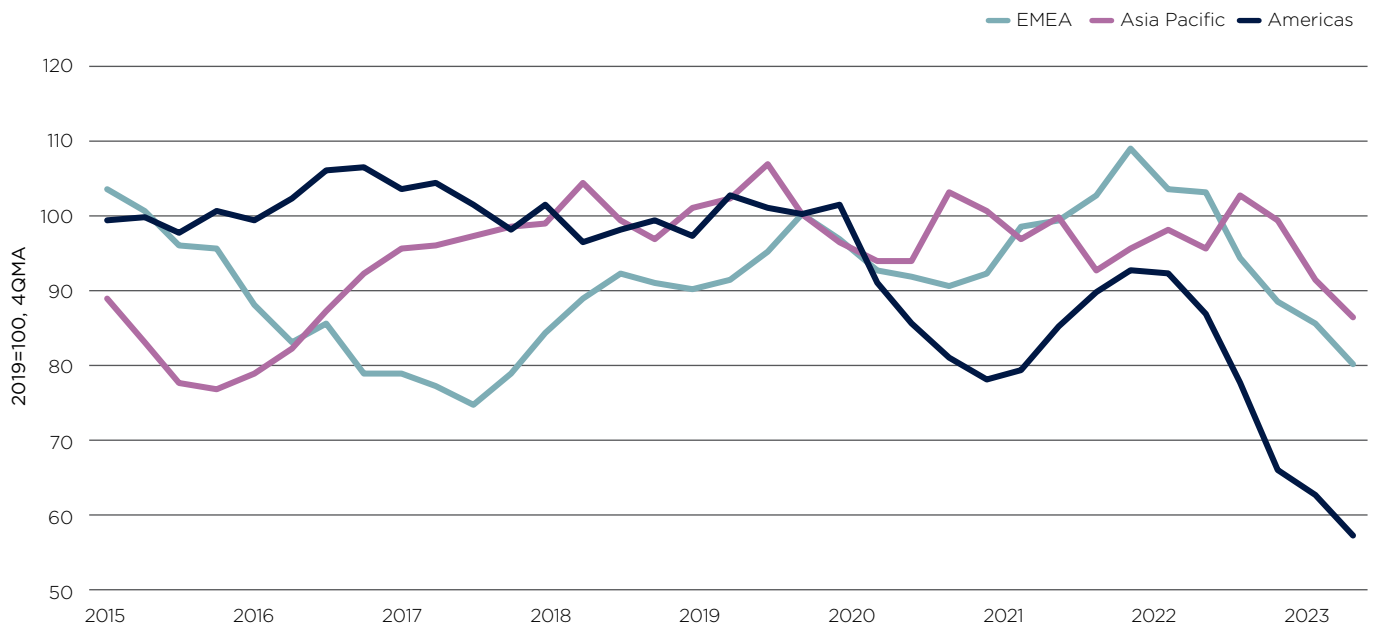
US investment volumes fell by nearly 63% y/y in Q3, leaving them down by 62% year-to-date. The decline in activity is underpinned by the withdrawal of major institutions from the market as they recalibrate their portfolios into other sectors. This represents an acceleration of a longer term trend; Blackstone, for example, have reduced their exposure to US offices from around 60% in 2007 to just 2% today. Overall, institutional investment volumes are down by 78% year-to-date and 86% in comparison with the same period in 2019, and now account for just 11% of total office investment in the US, down from over 40% a decade ago.

Cross border volumes are also a fraction of the recent past. The strong dollar and high interest rate environment make it difficult for non-USD denominated investors to find value in the US, even before you consider the added uncertainty around the outlook for offices in comparison with other regions.

The absence of institutional and cross border money is impacting the average deal size, with around 54% of deals backed by private money this year. The number of individual property transactions valued at greater than US\$100 million is down by 75% year-to-date, while there is virtually no activity for deals above US\$500 million. This does mean however that there remains an active pool of buyers for smaller lot sizes, and this is bringing some life to suburban office markets, which also benefit from a more straightforward redevelopment proposition on lease expiry.

Yields are unchanged this quarter, but the expectation remains that the correction has further to run. This sentiment is reflected in public markets; at end-October, the median discount to NAV for US office sector REITs was around 46%, compared to an all-property average of 28%, according to S&P Global. Meanwhile, debt costs have continued to rise in line with higher interest rates, with bond yields pushing ever higher as markets acquiesce to 'higher for longer.'

### Average deal size of global office investment



Source Savills Research using MSCI Real Capital Analytics

On the occupier outlook, fundamentals remain challenged. The return to office is resisting the shift in corporate mandates, and utilisation rates continue to lag behind the rest of the world. Leasing activity is primarily 'expiration driven,' with overall take-up down on the year. Rents are 'sticky,' with class A properties continuing to see some growth, even in places like Los Angeles where the availability rate is 26.5% (albeit with record-level concessions). As such, discretionary leasing deals may just be waiting for a more significant rental repricing. Some markets, such as New York,

are now seeing a decline in office-based employment, which will only reinforce the slowdown.

Excess supply remains a significant constraint. But the market is responding, and there are a number of cities where inventory is falling as older offices are repurposed. In New York, office inventory is down by 2.1 million sqft over the last 12 months. This trend will continue to snowball through a combination of stick (falling values, rising obsolescence, and distressed assets) and carrot (state and local government incentives).

### Asia Pacific

Asia Pacific has proven relatively resilient in comparison with other regions, with Q3 investment falling by 52% y/y, bringing year-to-date volumes down by 50%. Asia Pacific remains the only region where institutional investors remain net buyers of offices. Cross border investors also remain active, particularly those also domiciled in the region, with intra-Asia Pacific capital accounting for nearly 80% of total cross border investment this year, up from a near 50:50 split in the same period last year.

The major Canadian investors have virtually withdrawn from regional office markets this year, while US funds are showing a more circumspect 68% decline year-to-date, mainly driven by a slowdown in capital deployed into Japan. By contrast, Singapore (led by the sovereign wealth fund GIC) and Hong Kong investors continue to favour office markets in the region; 8 of the largest 10 cross border buyers over last 12 months are headquartered in either Singapore or Hong Kong.

Australia and Singapore have experienced the steepest decline in activity this year (of the core markets), with investment volumes falling by 71% and 51% respectively, year-to-date. In the former, the sharp slowdown is underpinned by a mixture of high interest rates and a slow adjustment in valuations. Yields have risen by a mere 90bps since the beginning of 2022, compared with a greater than 400bps rise in the cost of debt. The Australian market often looks to Europe for a comparator, which has seen yields move by 150bps or more in response to a comparably moderate rise in debt costs. There is little wrong with the occupational market; demand for prime CBD buildings remains robust, supported by resilient economic growth and a flight to quality, and face rents continue to grow as a consequence.

In Tokyo, the market is more active, with office investment down by less than 33% year-to-date. The occupational outlook equally looks set to remain largely stable, with some marginal quarterly rental growth expected given falling vacancy. Bifurcation based on office age and

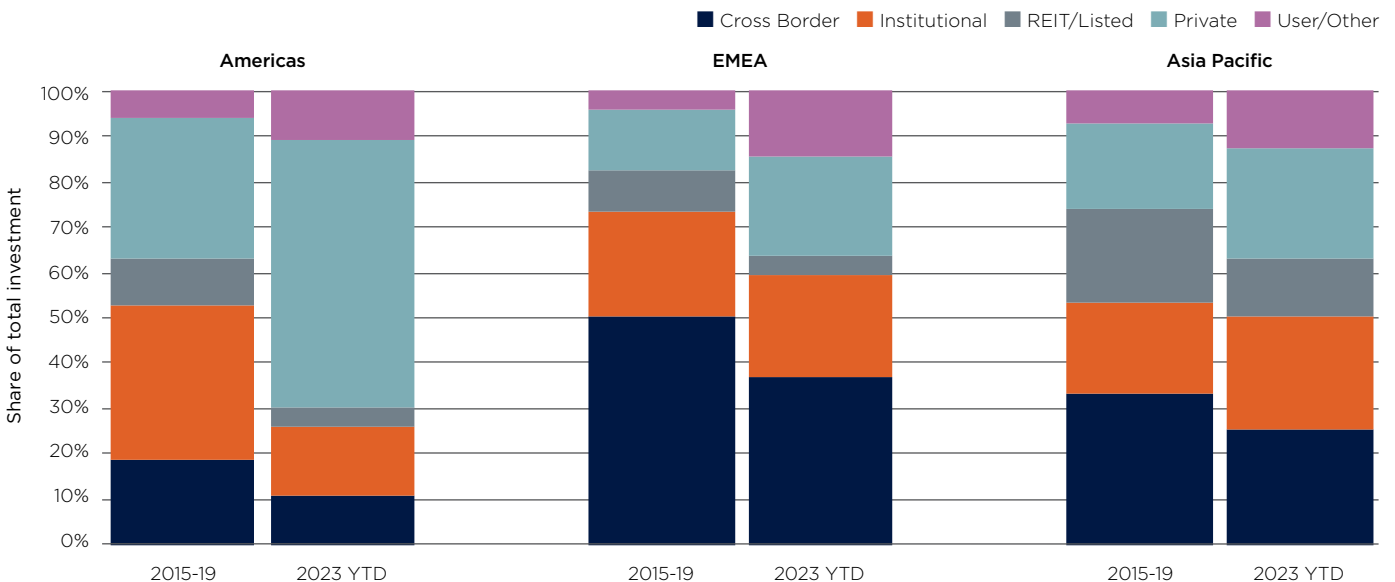
location is a narrative shared with most global markets, and while a large pipeline of new supply may upset the current balance, a majority of new major developments have been absorbed with minimal issues so far.

The high cost of borrowing remains a significant constraint in Hong Kong, with 3-month HIBOR stabilising above 5% this quarter. End-users are supporting some liquidity in the strata office market, but there are very few en-bloc transactions, with Mainland Chinese capital notable in its absence. More sales are likely to come to market in the coming months, primarily those owned by troubled Mainland developers, but it remains to be seen who will buy them, especially given rents continue to fall amid elevated vacancy.

In South Korea, investment volumes were down by just 33% y/y in Q3. But despite the growing number of sellers eager to introduce new deals to the market, there is a limited pool of institutions with readily available capital. Domestic buyers are more active, possibly following their near total withdrawal from international markets. But the cost of debt continues to move against would-be investors. The prime yield in Seoul has moved out by around 100bps so far during this cycle, but we continue to expect a further outward shift. A limited supply of good quality buildings is helping to prop up the occupational market for existing landlords, with a vacancy rate of just 3.4%, supporting relatively robust rental growth and so limiting capital value losses from rising yields.

In India, yields have risen marginally since the end of last year (+25bps in Mumbai), underpinned by the rise in government bonds and some weakness in IT occupier demand. But investors remain bullish on India nevertheless, and private equity inflows into the domestic real estate sector in general continue to grow despite the challenging global backdrop. The office sector remains the most liquid asset class, accounting for over 80% of investment in Q3 2023. GIC has been particularly active this year, most notably in embarking on a joint venture with Brookfield India REIT on two grade A offices for combined value of US\$1.4 billion.

### Buyer composition of global offices



Source Savills Research using MSCI Real Capital Analytics

# Market view

## Rasheed Hassan, Head of Global Cross Border Investment

This quarter I am finding myself getting increasingly concerned by some of the views being expressed about offices:

*"No-one wants to buy offices."* But US\$110 billion of office transactions have happened globally year-to-date.

*"The drop in transaction volumes is much worse in offices than other sectors, like living."* But year- to-date figures show a 60% decline in global office volumes versus a 58% drop in living.

*"The reason people are happy buying living and logistics at yields below the cost of finance is because at least there's rental growth, which you don't get in offices."* But rents are rising (to varying degrees) for prime offices in most of the major gateway markets across the world.

In London, for example, we are seeing rents on major pre-lets moving up dramatically. Clifford Chance agreed a rent of around £77.00 per sq ft at 2 Aldermanbury, a new build development, back in November 2022. Now HSBC have signed a pre-let at around £87.50 per sq ft in Panorama, 81 Newgate Street, an extensive refurbishment. That's a 13.6% uplift in 12 months. We are even still seeing marginal growth in prime office rents in Los Angeles, despite a reported vacancy rate north of 25%.

Additionally, we have plenty of evidence of investment acquisitions being made below the cost of finance, maybe because these investors see the growth potential, maybe because they just believe in the long term fundamentals of well-located office buildings. We therefore need to challenge some of the negative views about the sector, or at least not automatically dismiss positive news or research as unbelievable and/or biased.

The biggest driver for the drop in office volumes is exactly the same as the drop in volumes in all the other sectors; interest rates and the investor discomfort of paying yields for real estate that are deeply below the cost of money. In offices, investors are also grappling with the rise in the cost of cap-ex. Again, extreme cost inflation is not unique to offices, but common to all sectors. The difference for offices is that there is an extra focus on meeting sustainability expectations and standards, which is generating

additional cost at a time of market dislocation. So we have a double hit on value.

There is a well-rehearsed historical theme in the office sector of an under-valuation of depreciation and future cap-ex requirements in appraisals. People got away with this in rising markets, but not now. Cap-ex is something that can and is just being factored in to appraisals right now. Once this happens, the bid gets lower and then we get to the other biggest cause for the drop in volumes; vendor price aspirations.

We are seeing some transactions going through right now, particularly in the UK and US, where price moves are 50%+ down on previous highs, in particular for development opportunities. Once again, if a like-for-like appraisal was done on a site for logistics development today versus 2021, the effects of rising costs, wider exit yields, and higher financing costs would also have an extreme impact on the residual number.

The next response I would expect at this point is that *"there is at least leasing demand for logistics, which isn't there in offices."* To that, I would say the evidence suggests there is demand for both, if one wants to believe it, and in fact in the UK take-up in central London offices this year is 11% down on the five year average, while on logistics it is 41% below.

I am clearly strongly defending offices in this segment, but that is because this is a publication about offices. For clarity, I am absolutely not advocating offices above other sectors. What I am advocating is working with real evidence in the market across all sectors and geographies, and identifying areas that really have reacted to the change in the cost of money and other key fundamentals that are relevant to them and re-priced.

Tenants are leasing offices and investors are buying them, and with the scale of asset value moves in certain situations, I can absolutely see why.

“In London we are seeing rents on major pre-lets moving up dramatically”



**Global prime office yields, Q3 2023 (as at end-September)**

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%	↑	40%	5.20%	-0.63%	-2.51%
Singapore	3.32%	↔	50%	4.75%	1.89%	-0.08%
New York	5.00%	↑	50%	8.00%	2.00%	0.41%
Seoul	4.05%	↑	55%	5.40%	2.40%	0.02%
Paris	4.00%	↑	55%	5.01%	2.77%	0.62%
Frankfurt	4.30%	↑	55%	5.01%	3.43%	1.47%
London (City)	5.25%	↔	55%	6.72%	3.45%	0.82%
Madrid	4.65%	↑	50%	5.41%	3.89%	0.74%
Sydney	5.30%	↑	50%	6.10%	4.50%	0.82%
Shanghai (Lujiazui)	4.50%	↑	50%	4.50%	4.50%	1.82%
Tokyo	2.60%	↔	60%	1.00%	5.00%	1.83%
Mumbai	8.25%	↑	60%	9.50%	6.38%	1.03%
Dubai	7.25%	↑	50%	8.00%	6.50%	2.66%
Los Angeles	8.00%	↑	50%	8.00%	8.00%	3.41%

**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

## INDIA



**Building:** Portfolio of two buildings: Downtown Powai in Mumbai, and Candor TechSpace, Sector 48, in Gurugram, near New Dehli.

**Tenant:** Includes Tata Consultancy Services, Credit Suisse, Nomura, JP Morgan (Downtown Powai) and Capgemini and Fidelity (Candor Techspace)

**Lease length (WAULT):** 6.7 years (Candor TechSpace)

**Area:** 6.5 million sqft

**Price/NIY:** US\$1.4 billion/7.0% (Downtown Powai) and 5.9% (Candor TechSpace)

**Vendor:** Brookfield Asset Management

**Vendor nationality:** Canada

**Purchaser:** Brookfield India REIT and GIC Joint Venture

**Purchaser nationality:** Canada and Singapore  
**Other comments:** Announced in May, this represents the first-of-its-kind partnership between a listed REIT and institutional investor in India, according to GIC.

## PARIS



**Building:** Anjou

**Tenant:** Hermès

**Lease length (WAULT):** N/A

**Area:** 100,000 sqft

**Price/NIY:** US\$250 million (€230 million)/4.0%

**Vendor:** Covivio

**Vendor nationality:** France

**Purchaser:** Hermès

**Purchaser nationality:** France

**Other comments:** Covivio purchased the Anjou building in 2006 and is undergoing a full refurbishment due for completion in 2025, with an aim to acquire BREEAM Excellent accreditation (plus others).

The building was acquired for occupation, with Hermès previously signing a 10-year lease for the entire building in 2022.

## LONDON



**Building:** Bloom Clerkenwell

**Tenant:** Snap Group

**Lease length (WAULT):** 8 years

**Area:** 144,000 sqft

**Price/NIY:** Undisclosed

**Vendor:** HB Reavis

**Vendor nationality:** Luxembourg

**Purchaser:** UBS

**Purchaser nationality:** Switzerland

**Other comments:** Representing the largest deal in the City of London in September, final pricing was reflective of bifurcation in the market and continued demand for best-in-class assets. Bloom was the first commercial building in the UK to achieve the highest accreditations for BREEAM Outstanding, WELL Platinum Savills, and others. Savills acted on behalf of the Seller.

## 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.

### Savills Research

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