European Commercial - Q3 2023

SPOTLIGHT

Savills Research

European Office Value Analysis

● Inflation ● Yields ● Outlook

Government bond yields rise further

European services PMIs in negative territory indicating economic contraction.

Economic overview

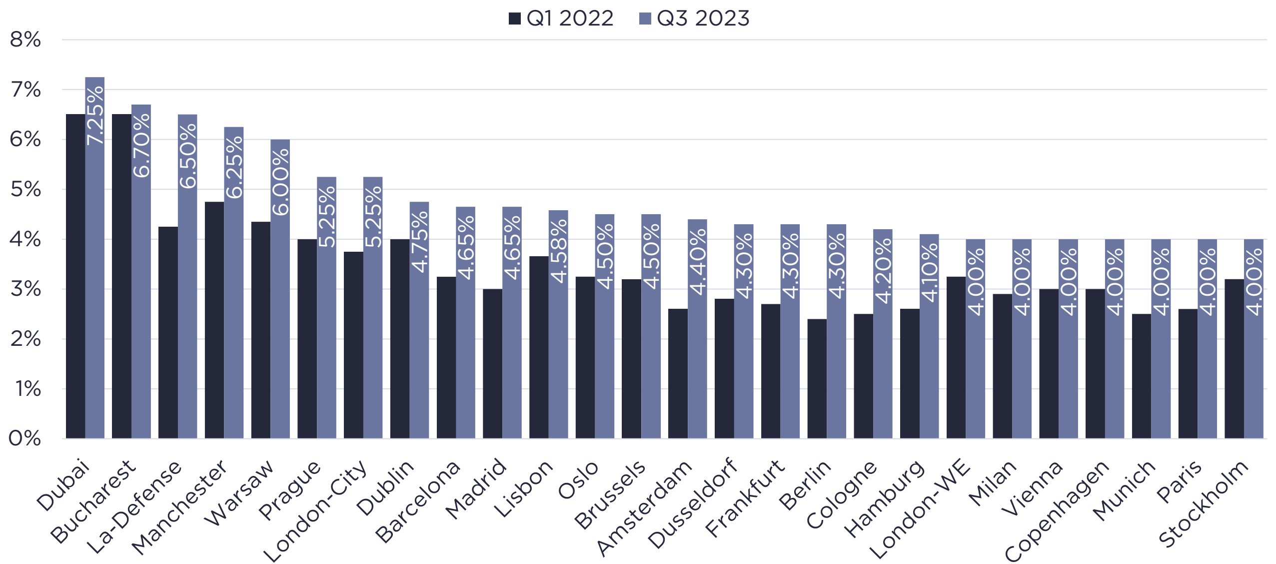
Eurozone government bond yields recorded significant increases during Q3 2023, as global investors sold off bonds, driven by concerns that interest rates will remain elevated for longer periods. As such, Eurozone five years swaps rose a further 30 bps during Q3 2023, increasing debt costs and adding additional pressure on capital values.

But on a more positive note, the inflation reading for September fell to 4.3%, the lowest level since October 2021, largely due to base effects from Germany. Capital Economics do not expect interest rates to fall from the current level of 4% until H2 2024.

Latest data from Savills Germany data indicates that office investment activity has fallen by 79% yoy during Q1-Q3 2023, as yields continue to move outward to reflect higher debt costs.

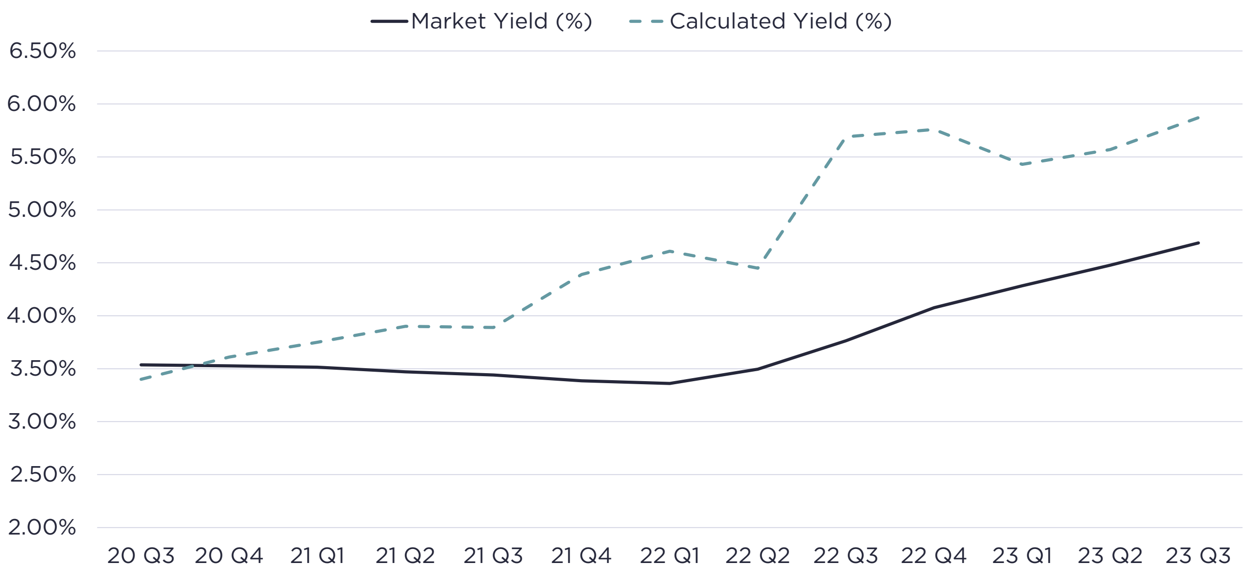
October's Euro Area Services PMI data indicates that the Eurozone economy dipped further into negative growth territory, dragged down by France. However, the European Commission's latest Employer Intentions Indicator suggests employers are still seeking to recruit, rather than shed headcount, supporting occupier demand, although this is likely to result in higher than expected wage inflation in the near future.

Chart 1: EME prime office yields



Source Savills

Chart 2: Average European prime market yield vs calculated yield



Source Savills

Office value analysis

Prime office yields move out by an average 20 bps during Q3 2023.

Methodology

Savills European Office Value Analysis compares the fundamental (calculated) yield relative to current market pricing across 22 European markets, covering London-City, Stockholm, London-WE, Manchester, Lisbon, Oslo, Berlin, Paris, Copenhagen, Dublin, Amsterdam, La-Defense, Prague, Hamburg, Madrid, Barcelona, Munich, Warsaw, Brussels, Frankfurt, Milan and Bucharest.

An investor must be compensated for bearing the risk of investing in real estate over sovereign bonds- the risk premium. The calculated yield is derived as the current risk free rate plus five year average office risk premium, discounting for nominal rental growth (source: IPF, Savills), inflation (source: Oxford Economics) and depreciation across each market. The fundamental yield represents a hypothetical yield assuming a fully liquid market and that the investor is fully hedged against currency risk.

Given the inverse relationship between yields and capital value, we use the following definitions for fair-pricing;
Market capital value >10% above fundamental capital value, we consider over-priced.
Market capital value within 10% of fundamental capital value, we consider fairly priced.
Market capital value >10% below fundamental capital value, we consider under-priced.

What's happened to pricing so far?

Since Q1 2022, average European office prime yields have moved out by an average of 130 bps from 3.4% to 4.7%, reflecting a yield impact of -28%. Berlin (-44%), Amsterdam (-41%) and Cologne (-40%) are the cities which have observed the largest yield impact since Q1 2022, although rental growth have been supported by low vacancy rates. Non-core market yields have been less impacted by the rising cost of debt, and have been slower to adjust as investors wait for core pricing to settle first.

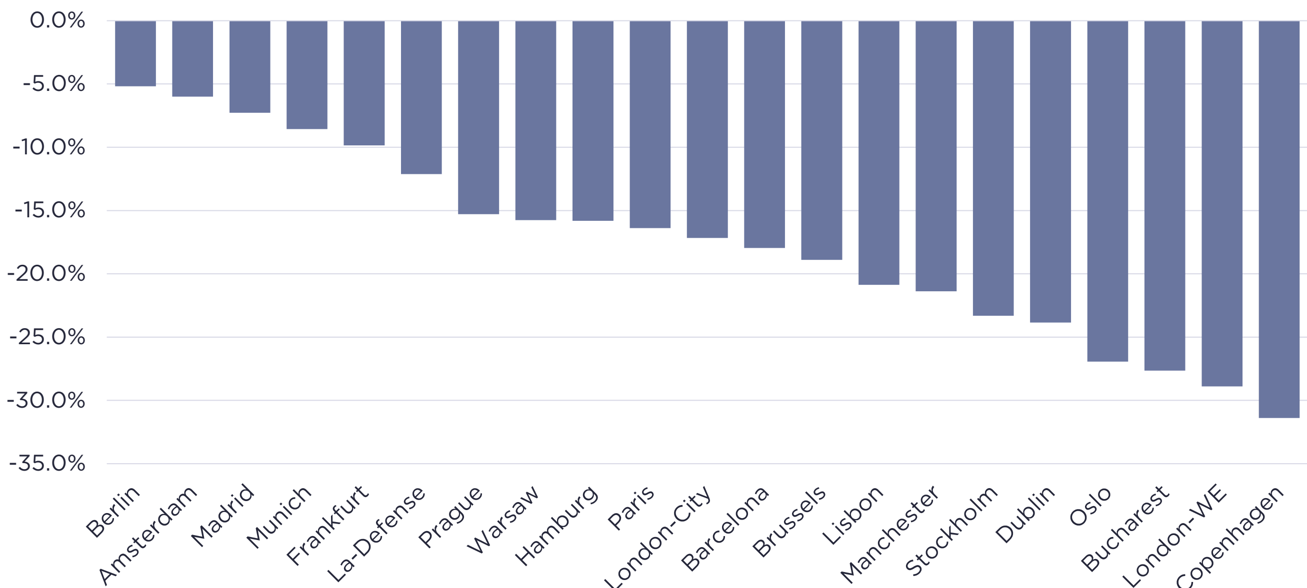
During Q3, average prime yields moved out by 20 bps, a movement in line with the past two quarters, indicating that outward yield movement is not slowing yet. During Q3, Berlin (+40 bps), Amsterdam (+30 bps), La Defense (+75 bps) and Oslo (+35 bps) observed the largest outward movements in yield.

How far do prices need to adjust?

Based against the previous five year average risk premium, average European prime office capital values require a further -18% adjustment to return to fair value pricing. We examine the likelihood of this correction in the Outlook section.

The four markets of Berlin, Amsterdam, Madrid and Munich now all sit within fair pricing territory and require the lowest capital value corrections in Europe. All of these markets observed outward yield movement in Q3 2023, whilst low vacancies continue to support rental growth over the next 12-18 months.

Chart 3: Capital value correction required at current pricing (%), Q3 2023



Source Savills

Outlook

Prime office yields to move out further in Q4, as value-add dominates transactions.

"Survive 'til '25" was the phrase coined at EXPO 2023 as focus remains on refinancing existing portfolios, reflecting investors' acceptance that values have fallen, but unwillingness to realise their losses (if they can avoid it). The annual real estate check-in proved a sobering reality check that price discovery is not yet complete.

Against the backdrop of weaker investor sentiment towards the office sector, we expect transaction volumes to recover later than in other commercial sectors as prices continue to adjust. Indeed, Savills latest EME investor sentiment survey indicates that sentiment towards CBD offices fell significantly YoY, although US investors remain more bearish than Europeans. Investors also favour the UK, whilst Southern Europe has performed relatively resiliently. On the other hand, investor demand for Germany and Benelux markets is weaker despite the larger price movement.

Buyers

Based on market fundamentals, there is still further room for outward yield movement, and current buyer sentiment reflects this. US private equity firms have not yet returned to the market and are awaiting for distress to come through in 2024. Although, we are seeing a cautious increase in the number of underbidders, who are more willing to test vendors' resolve and secure good quality stock at a discount.

Sellers

Pricing evidence is limited and hypothetical capital values are currently below book values, so vendors are unwilling to sell. As such, commercial valuers are now under increasing pressure from the European Central Bank regarding growing concerns over the speed of marking down values, although a shortage of transactional evidence makes it difficult to form valuations.

With global real estate fundraising down 60% yoy during Q3 2023 according to Preqin data, landlords face the ultimatum of either pumping in more capital to their existing assets to avoid loan breaches, or acquiring new assets at a discount.

Increasingly though, forced sales are coming to the market- most recently JP Morgan returned the keys of a €100m Paris office to the lender after scrapping plans to redevelop the scheme. Following their latest portfolio valuations, many of the larger SCPIs are also reporting redemptions, and are likely to be net sellers over the next 12 months.

Where might pricing settle?

At end Q3 2023, preliminary data indicates European office investment volumes are down by 61% YoY, underlining the bid-ask spread which must close through outward yield movement, for the transactions market to normalise. This being said, we are emerging from a record low interest rate environment, so a full correction is unlikely, particularly for the markets with a higher proportion of cash buyers and a global buyer pool, such as London West End and Paris CBD. Risk premiums will be more comparable with pre-GFC levels, than what we have observed pre-pandemic. A good illustration of this is Chart 2, where the spread between market yield and calculated yield is beginning to stabilise.

Nonetheless, all investors reported that they have an ESG strategy in place, with a quarter of those only willing to invest in ESG compliant assets. There remains a significant opportunity for value-add investors willing to take on asset management risk to improve the EPC ratings of office stock in undersupplied Western European markets with low vacancy rates. We expect the funds raising capital for asset management strategies will reap the rewards.

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