FMBusinessDaily

# Global office investment facing some pressures, but strong fundamentals in many key cities to help maintain volumes

3 years ago

The global office investment sector, like other types of real estate, is coming under some pressure from the macro-economic environment, but strong fundamentals should keep investment yields largely stable in many key markets, including Paris, London, Sydney, Mumbai and Dubai, says Savills, with yields actually forecast to harden in Frankfurt and Tokyo due to specific local conditions.

The international real estate advisor has assessed the likely interplay between the top-down (inflation, interest rate rises, geopolitical uncertainty) and bottom-up factors (limited availability of stock and weight of money causing competition between investors) that will determine the pricing of office assets over the next 12 months in major global cities. It says that the US may be most exposed to macro top-down factors, with expectations of a significant tightening in financial conditions and limited pricing power for landlords potentially leading to yields rising in New York and Los Angeles. European investors meanwhile may continue to benefit from solid occupier demand and a lack of supply in the prime and core segments of the market, keeping yields stable. Interest rate differentials with the US are also making Europe an increasingly attractive destination for cross border capital.

In Asia, Savills says that market-specific characteristics dominate the regional narrative. In Tokyo for example, cash-on-cash returns will remain attractive given little upward pressure on interest rates, which will support further yield compression, while the outlook for Shanghai has deteriorated amid a challenging domestic economic backdrop.

Global prime office yields, Q1 2022

| 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, based on end-of-quarter data. See Methodology for details.

Oliver Salmon, Director of Capital Markets Research, comments: “Surging inflation has put the spotlight on the perceived hedge that real estate can provide to investors compared to many other asset classes. Outside of some European cities where office rents are often index-linked, this hedge only works for investors when inflation is accompanied by robust economic growth; office landlord pricing power is contingent on strong occupier demand. But with so much uncertainty on the horizon, occupiers in some markets may reassess their requirements for space. A limited supply of grade A offices – particularly in Europe and some Asian markets – will help to offset this trend and support rental growth in these locations, maintaining yields at current levels."

Rasheed Hassan, Head of Global Cross Border Investment at Savills, adds: "There's no doubt that we're at an inflection point in the market; debating where the appropriate pricing for real estate is given geo-political headwinds. On a relative basis, however, real estate returns remain attractive, with the amount of capital being raised for deployment continuing to rise to unprecedented levels, although this could change if long-term real interest rates continue to increase.

"Robust competition among buyers, and the growing cost of debt set against a compressed yield environment, means that investors whom are entirely cash-on-cash focused are struggling to participate in key gateway markets. However, we are seeing evidence that many groups are exploring new geographies and sectors to try and find real estate products that do meet their returns. The absence of these investors in the most core markets provides an opportunity for others who are not reliant on bank debt, or whom take debt at a corporate level, to buy 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."

Read the full Savills Global Capital Markets Quarterly for Q1 2022 online here

*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 relevant 10-year government bond yield (as a proxy for the relevant risk free rate of return) from the net initial yield. Data is based on end-of-quarter values.