

London and core mainland European occupier markets will support office values says Savills

4 years ago



According to Savills latest research, London City and West End, and core mainland European cities' occupier markets will support office values.

This is driven by a combination of low vacancy rates and landlords' ability to pass rents on to their tenants. At the same time, the international real estate advisor expects to see minor corrections in yields for non-core markets and an increase in off-market deals across the board as more investors are reluctant to go to the open market until financial markets stabilise.

Asia-Pacific investors, led by Singaporeans and South Koreans, are firmly back in the UK and mainland Europe after the lifting of travel restrictions and acquired €5.7 billion of real estate in the first quarter of 2022, with a strong focus on offices. This is the second highest Q1 investment volume recorded since 2016 according to RCA data. The weak Euro and the spread against US bonds is continuing to offer them attractive yields.

Prime nominal rental growth forecasts continue to recover, driven by a strengthening office market and undersupply of prime office space in most of EME, rising from 0.9% to 1.8% per year, according to Capital Economics. However, the latest evidence indicates that prime rents have risen well above these levels over the last 12 months, led by Munich (+17% year on year), London City (+12% yoy) and Amsterdam (+11% yoy). Savills anticipates stronger rental growth to come, which would support pricing.

Given that average European office vacancy rates remain low at 7.2%, the market remains in the

landlords' favour and the international real estate advisor expects to see higher rents passed onto tenants, particularly in markets where leases are index linked.

Mike Barnes, Associate Director, Commercial Research, at Savills, says: "Since our last office value analysis 12 months ago, London City and West End markets moved from under-priced to fairly priced territory, supported by their forecast real rental growth over the next five years.

However, the remaining EME markets have moved into fully priced territory due to rising risk free rates, and we may begin to notice a minor correction in non-core markets unless bond yields settle. Buyer and seller expectations are increasingly disparate, and we are seeing the buyer pool for prime assets thin as a result. This being said, for now, vendors are holding firm on pricing requirements."

Nick Harris, Head of UK and Cross Border Valuations and Joint Head of Strategic Advisory EMEA at Savills, says: "European government bond yields observed an average increase of 110 bps over the last six months, on the basis of rising interest rate expectations. Amid rising risk free rates, the spread between average core Eurozone government bond yields and prime office yields has dropped from 292 bps to 139 bps against the previous year, positioning a number of mainland European office markets as fully priced.

Debt markets are now responding across Europe, and all-in borrowing costs are eating into real estate returns as lenders require larger margins, with all-in debt rates rising by an average of 140 bps against the previous year, assuming a 55-60% leverage. Debt costs have more than doubled across German office markets from circa 1% to in excess of 2% and in certain European markets now sit above prime office yields, squeezing levered returns."

Chris Gillum, Head of Offices, Savills European Capital Markets, says: "Dry powder remains resilient, with €76bn of capital raised for European non-listed real estate during 2021, in line with the record in 2019.

However, after a period of ultra-low interest rates, and ultra-high yield spreads, we can now expect a normalisation in office yield spreads in non-core markets to pre Global Financial Crisis levels. We anticipate more resilience in markets with low vacancy rates where landlords are able to raise rents as income becomes the main driver of returns."

Image credit: Shutterstock