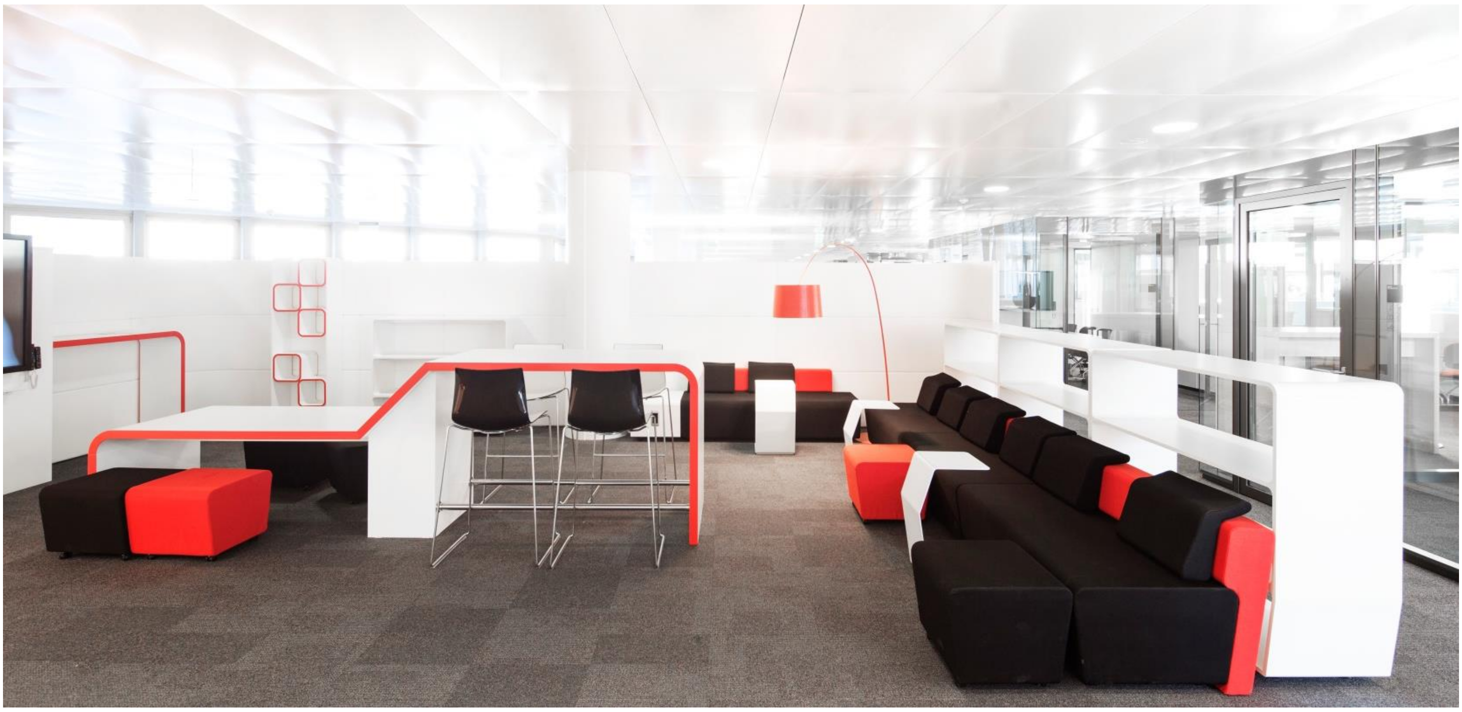
Research Blast

COVID-19 European Office Markets Series, Edition 3 – June 2020



Deal flow has returned to most European markets, but heavily focused towards the core end of the risk spectrum.

Pricing in this segment of the market appears to be holding up, but discounts expected as assets move up the risk curve.

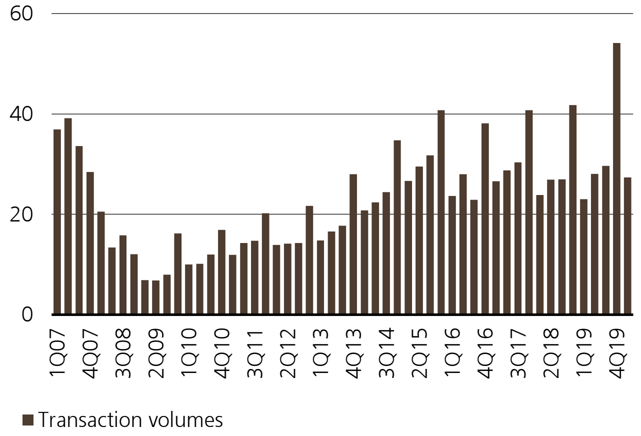
Historically low leverage levels should help prevent forced sales. But rising costs of new lending may stifle a recovery in activity and place outward pressure on yields.

Demand for core product holding up

The final quarter of 2019 saw European office transactions reach a record high, surpassing the previous record by a staggering 30% (see Figure 1). Six months on, clearly the market is in a very different place. Inevitably transactions in 2Q20 will fall significantly in most markets. But the key question is whether the liquidity that was recorded prior to the crisis will return in 3Q20 and beyond and how will this affect office pricing when transactions start to normalize?

So far, the anecdotal evidence we have observed has been relatively encouraging for a rebound in activity. After the initial lockdowns started, deal flow almost dried up completely. But over the past two months, we have observed an increasing number of assets being brought forward for sale. The types of assets which are coming forward are generally those where the vendor has a good indication that they can achieve a price which is not far off pre COVID-19 levels. So most of the assets we are seeing come to market are in the core locations, with a good length of income to robust tenants, which largely reflects investors' appetite for risk at the moment i.e. not much at all.

Figure 1: Quarterly European office investment volumes (EUR billion)



Source: Real Capital Analytics; May 2020

There still appears to be a reasonable depth of demand for this type of product. Inevitably, travel restrictions are limiting the interest which is coming from foreign buyers, but domestic buyers remain relatively active across most European markets With a stable, albeit thinner, base of buyers for core product, the signs are encouraging for a further pick-up in market activity as physical restrictions on movement continue to be eased down and the logistics of buying offices becomes easier. This should also lead to more price discovery, and encourage more buyers back into the market.

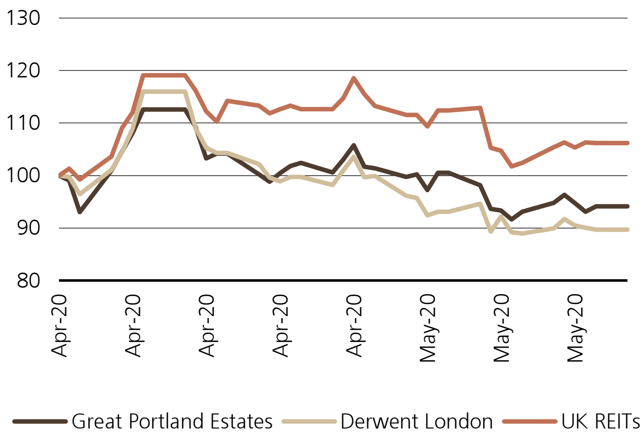
requirements. As Figure 2 illustrates, office-focused REITs in Central London have actually underperformed the wider listed market in the past two months, despite offices being one of the most resilient sectors in terms of rent collection. Although it is not completely black and white, one of the reasons behind the recent weakness in the share price does appear to be a growing concern over the future of the office building, which has dominated analyst calls in recent weeks.

Implications for pricing

The evidence which we have seen suggests that for very core, secure income assets pricing has barely moved since before COVID-19. And when we consider the weight of capital which is still targeting this part of the real estate market, and what has happened to corporate and government bond yields (see Figure 3) since the start of the crisis, this is not surprising.

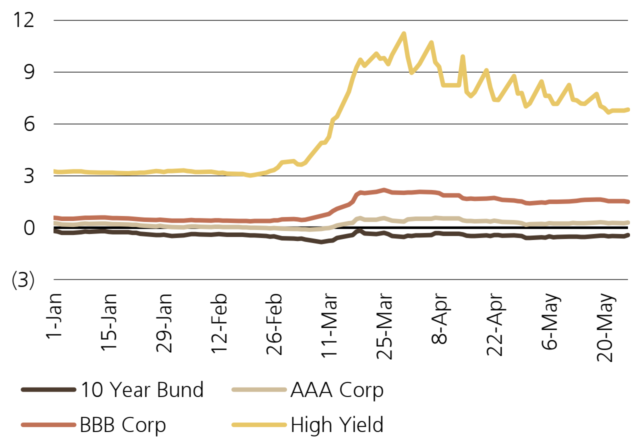
Moving up the risk scale from here however, things become more opaque. Even for "standard" core offices without an exceptionally strong lease and covenant, there is more of a standoff in pricing. Buyers typically want some form of discount, but vendors are in no rush to sell. And once we move into the true value-add space, there is even less transactional evidence to indicate a movement in pricing. However, reflecting the way risk has repriced in more liquid markets and the drop in liquidity in this space, when activity resumes there could be some significant price reductions from pre COVID-19 levels.

Figure 2: Share price index 1 April = 100



Source: Datastream, May 2020

Figure 3: Eurozone bond yields (%)



Source: Datastream, May 2020

Outside of the core space however, the situation is more volatile. Assets with shorter leases are more exposed to downturns in the occupational market. This is now largely accepted as an inevitable part of the economic challenges COVID-19 has delivered. And on top of that, there has been growing concerns in recent weeks over the future of office building as companies are expected to adopt more flexible working arrangements and lead to a net reduction in space

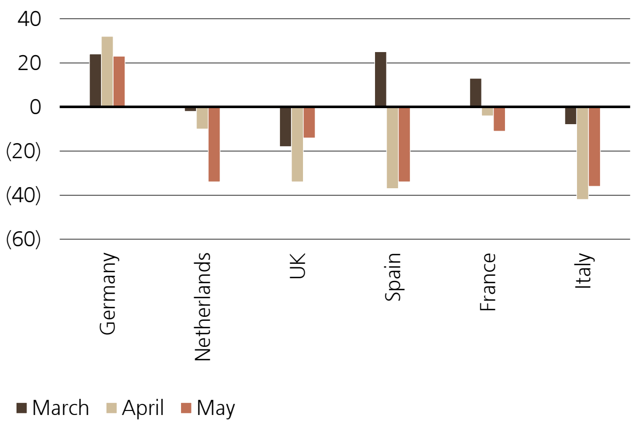
How much distress is in the market?

The main driver of where pricing goes from here is the level of distress which emerges, from both the capital markets and the occupational side. Thus far, there has been limited distress in the office sector, but rather a level of stress in some parts of the market. Forced sales have not yet become a feature of this crisis, which will be a key component of pricing staying relatively stable in the coming quarters. Without the pressure to sell, landlords of offices which are likely to struggle in the current market conditions can delay transacting, or pull deals off the market if a suitable level of pricing cannot be met. How long this can last for is questionable. The first pressure point is likely to be distress within the occupational market. There will be office assets where a significant proportion of the cash flow comes under pressure as insolvencies start to build. And with remote working likely to persist throughout the summer, and potentially beyond, the 2Q and 3Q rent collections from tenants who may be perfectly solvent but barely occupying space, may become increasingly tenuous.

If income starts to dry up, then any assets with leverage start to look more vulnerable. The good news is, the market is in a much more resilient position in this regard to previous crises. Loan-to-value ratios (LTV) are much lower which on the value side at least should give a sizeable protection before any foreclosures become necessary. But it is perfectly realistic that some assets would see a sharp drop in income which would breach the income cover ratio covenants. Now this is not the same, or as severe as an erosion of the value of an asset into negative equity. The lender does not have to take the asset back if income falls below the covenant. And, hopefully lenders and borrowers can work together and come up with an amicable solution which takes into account the extraordinary nature of the situation.

But leverage is not the only reason that sales may start to be forced through the market. Closed ended funds will need to unwind, and some investors who have purchased assets comparatively cheaply in the years after the Global Financial Crisis (GFC) may be prepared to accept discounts to sell into a weakened market, but still delivering a very strong Internal Rate of Return (IRR) based on market timing, or successful value-add initiatives. If liquidity is able to return to somewhat normal levels by the end of the summer, then there should be enough willing buyers to moderate some of the pricing declines. However, if transacting remains difficult, or buyers have a reason to become more cautious, then there is a risk more assets will be forced into the market at a challenging time. Therefore, pricing could fall sharply accordingly.

Figure 4: 2019 versus 2020 investment volumes* (%)



Source: Real Capital Analytics, May 2020
*Based on all commercial property, cumulative from January

Germany in a world of its own?

An interesting dynamic which has emerged over the past few weeks is the apparent two pace recovery between Germany and the rest of Europe. Now this can of course partly be explained by the lower infection rate and shorter and less severe lockdown measures which were implemented compared to other core European markets. But when we consider that cumulative monthly investment volumes in Germany actually increased year-on-year in March, April and May, it suggests that the direct impact of COVID-19 is not the only factor (see Figure 4).

The exceptionally strong appetite for German real estate is likely being triggered by indirect effects of COVID-19. To many European investors Germany is the most stable and defensive market during a crisis. And with Bund yields moving sharply negative, the attractive spreads to real estate – even at very low yields – appears to be continuing to draw capital from large scale institutional investors who can't rebuy into the bond market at negative yields when their existing holdings mature.

Perhaps surprisingly though, the debt market does appear to be pricing in some significant increase in risks to the German market, even as equity investors pile ahead. Even for core German offices, lending rates have doubled since COVID-19, and LTVs have moved in from around 65% to a new normal of 55%. So far, there appears to be enough equity, or low leverage buyers in the market for this to not have a significant impact on activity. How sustainable this level of activity can be with higher debt costs, and lower LTVs remains to be seen.

It may not be until the end of the year that we start to get an accurate picture of the short-term impact of COVID-19 on office pricing, across all segments of the market. It's likely core assets will hold onto their value reasonably well, although outside of Germany we are starting to see some early signs of tension even being felt here. The key challenges are going to be higher debt costs limiting the number of buyers that can make their returns work off very low yields, and the general air of caution which has developed towards offices over recent weeks with concerns over the accelerating structural shifts to working from home. Value-add we expect to see more significant movements in pricing when the market returns.

And it's in this space, that we actually think some of the best opportunities will emerge. We take a relatively positive view on the future of offices – yes they will have to evolve and look different in a post-COVID world - but there will still ultimately be strong demand for the right product in the right location. On this basis, we would be comfortable to take on some asset level risk, in the strong locations. If purchased at a discounted rate there should be an opportunity to produce strong returns, through redevelopment or repositioning when the short-term income expires, to line up with the new requirements of occupiers, which will become clearer in the coming quarters.

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