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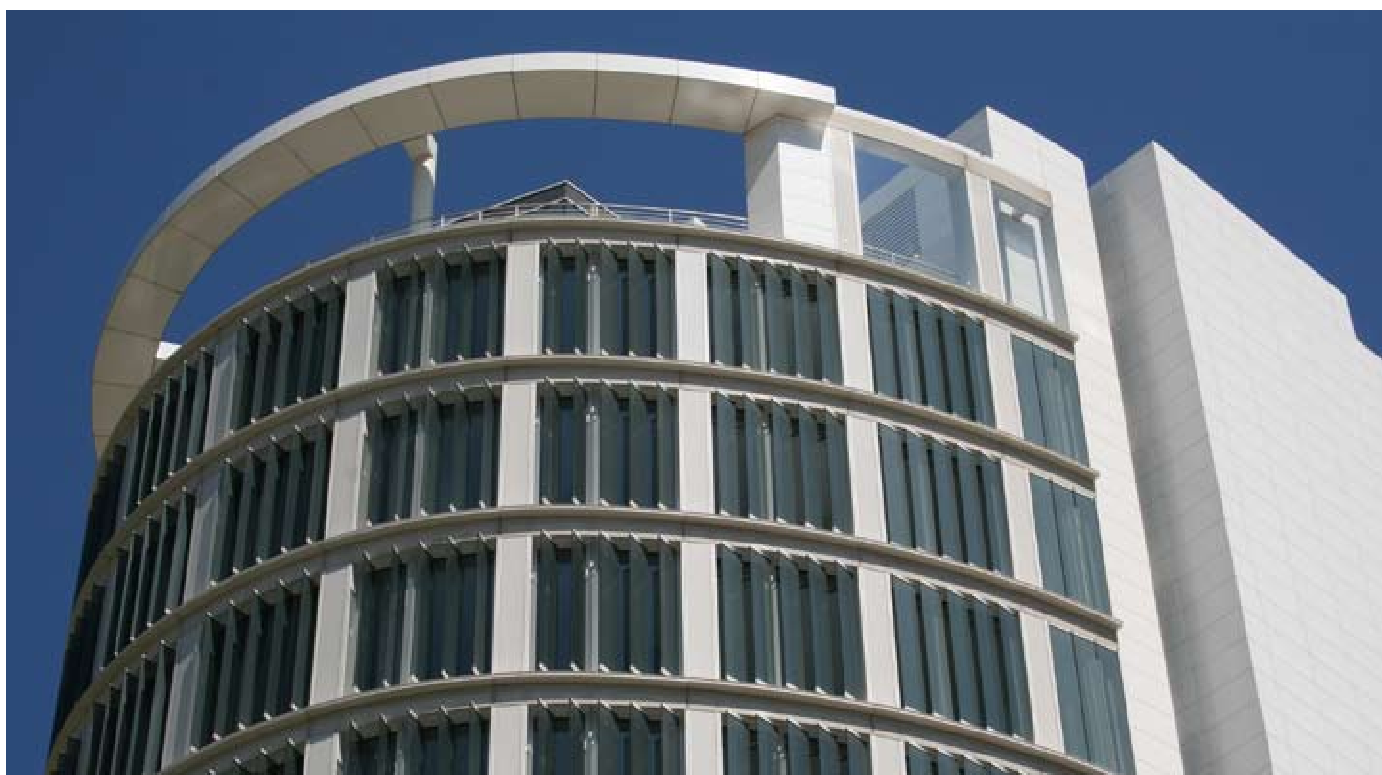
PATRIZIA OFFICE INVESTMENT COMPASS EUROPE

02 | 2012



Office Real Estate: Daring to Peek Outside the Box

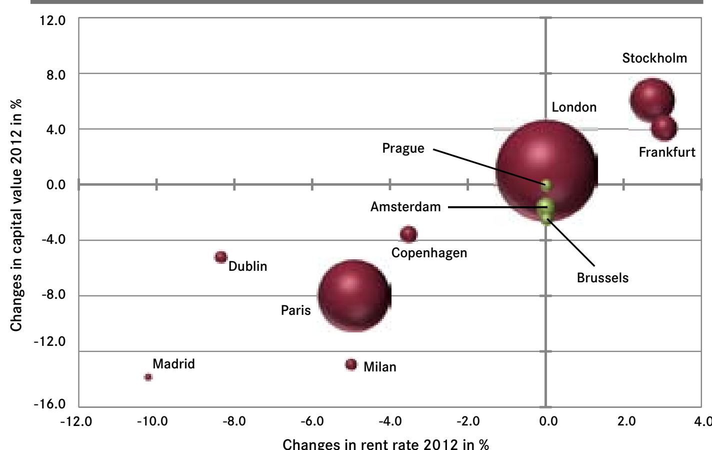
Places of growing productivity are likely to need more office space. Our office investment compass shows a favourable development at least in some regards: As far as white-collar jobs go, many European office markets have outperformed the expectations ventured as recently as this past spring. Especially the major German cities reported a – sometime substantial – increase in office jobs, Munich leading the way with a job growth of 3.4 percent. Expectations were also exceeded in cities such as Brussels, Milan, Rome, and Dublin, where the down-trend was halted, and employment rebounded, at least in some cities. Aside from London with its 2.4-percent increase, secondary UK locations such as Birmingham, Glasgow and Manchester registered unexpected job growth in the business and service sectors. Then again, the positive trend has not yet translated into rising prime rents, but has at best helped to stabilise rent rates.

QUEST FOR SAFETY TENDS TO INSPIRE NEARSIGHTED DECISIONS

Everybody just wants one thing: core properties, meaning real estate promising the highest possible degree of safety. Clinging firmly to this strategy, investors continue to play what they consider safe bets. Against the background of an ongoing debate revolving around crisis issues, this is perfectly plausible and rationally sound: Markets registering rental growth tend to report sizeable capital growth as a result.

Our observations suggest that the most recent appreciations are predominantly the result of rent increases effected in 2012 – such as in the cities Berlin,

RENT RATE CHANGES – CAPITAL VALUE MOVEMENTS – MARKET LIQUIDITY



Sources: PATRIZIA, data provided by estate agencies, PMA

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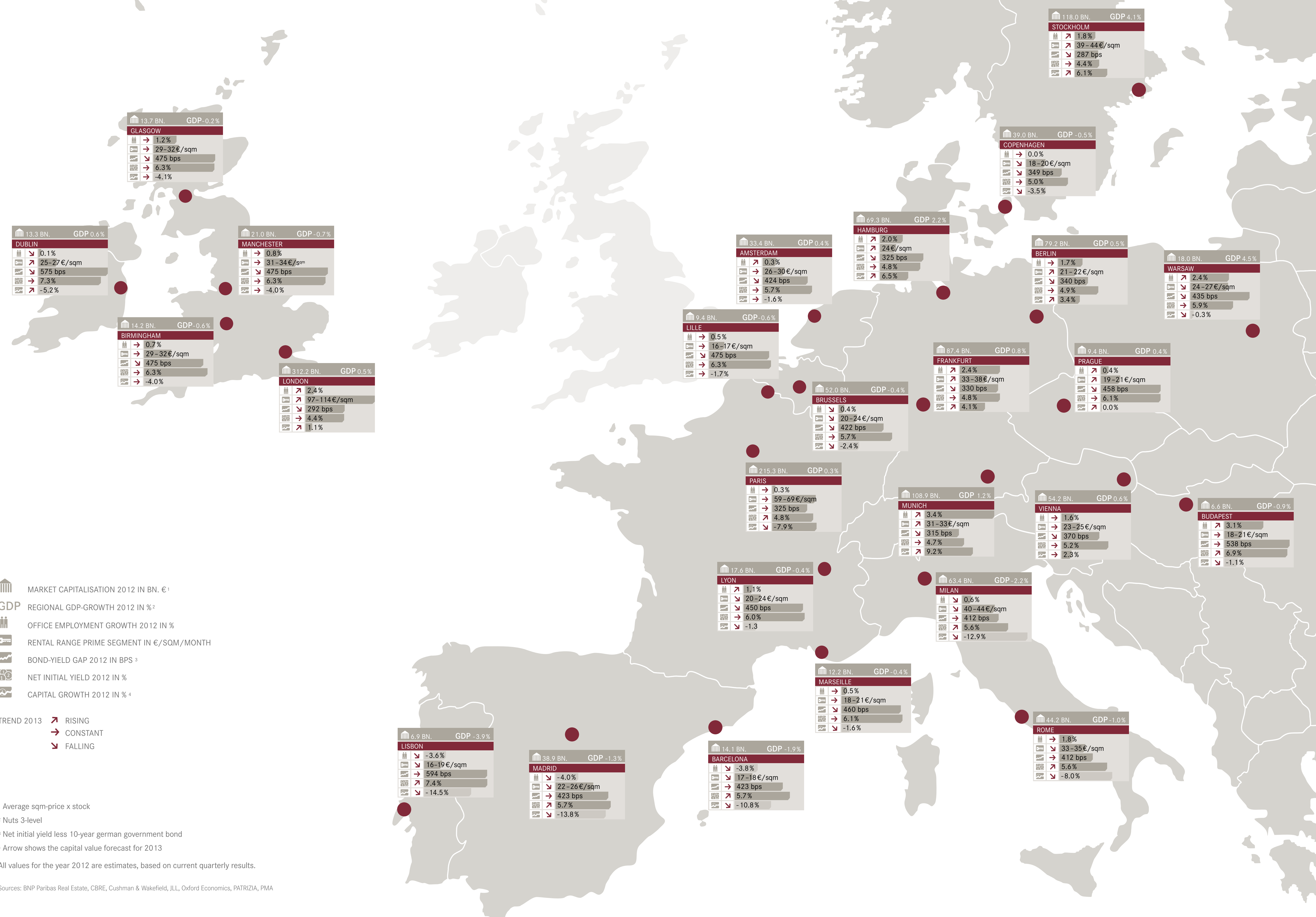
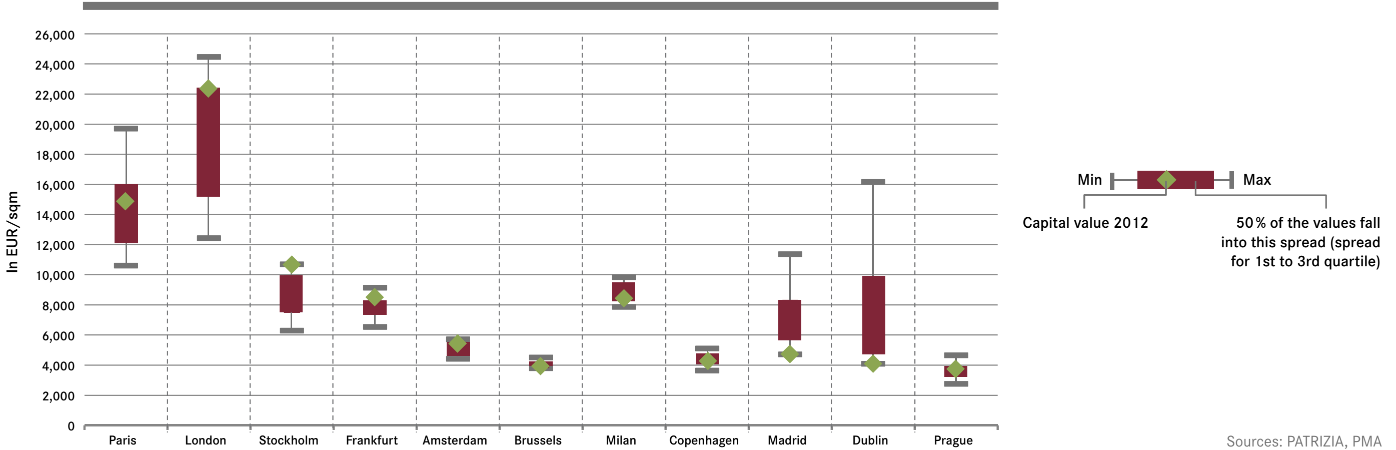


CAPITAL VALUE SPREAD, 2003 THROUGH 2012



Sources: PATRIZIA, PMA

Frankfurt, Hamburg, Stockholm, and Vienna. In these metropolises with their solidly high market capitalisation, prime rents grew at rates of two to seven percent, while capital growth achieved rates between two and nine percent.

All of this suggests a sound investment story. At the same time, the facts suggest that size alone does not suffice to guarantee stable prices. Amsterdam and Brussels, for instance, lag behind expectations, and in some ways the same can be said for Paris and Copenhagen. While all four of these cities have reported high transaction volumes, they were struggling to keep rents from softening in a difficult economic environment. Accordingly, purchase price multiples in Amsterdam and Brussels dropped from well over 18 times the annual net rent down to 17.4 times, while lingering more or less on last year's level in Paris and Copenhagen. Asset impairments were more conspicuous: Dropping by around eight percent in Paris, capital values slipped by 2.4 percent in Brussels, 3.5 percent in Copenhagen, and by 1.6 percent in Amsterdam.

These represent relatively modest impairments compared to properties in Italy and on the Iberian Peninsula – these being on record with asset impairments between just below ten and 15 percent – and yet the discounts in the aforesaid, well-established markets come somewhat unexpectedly.

The question remains which conclusions investors should draw from these trends. Are German top locations, the Nordics, London, and Warsaw with its catch-up demand truly the only locations worth a commitment? There is every reason to be sceptical: A look at the spread of capital values of the past ten years shows that these markets are close to peaking. The only reason why yield rates on fiercely contested core markets, where the bulk of the investors are flocking, remain attractive is that German government bonds, the principal risk-free investment alternative, pay a yet lower rate of interest. As soon as the "bunds" rebound from their all-time low, many investors will reshuffle their portfolios because the risk-return ratio is likely to be superior to that of real estate, be it core or not.

Add to this that the number of properties available on the core markets is simply insufficient to accommodate all of the investors willing to commit. Especially the most coveted of German markets are close to a bottleneck situation. Seen against the background of Germany's slowing economic momentum and the persistent recession in many parts of Europe, it therefore makes sense to carefully scrutinise the applicable investment guidelines.

Locations that real estate investors continue to perceive as negative, and which they shun as a result, include Prague and Dublin. Even if employment trends in the business and service sectors were already positive, the markets have yet to reflect the fact in the form of appreciating capital values and/or declining initial net yields. Despite the negligible construction volumes, office real estate markets are still burdened by oversupply. So vacancies need to be scaled back before price hikes become likely.

This aspect should not obscure the development prospects, though: Ireland's brisk privatisation progress and successful savings have been rewarded by the so-called EU troika with special conditions. Weak exports are balanced by rising revenues in Dublin's international financial centre IFSC and in ITC services. Facebook and Ebay, for instance, have their European headquarters here, and Ireland is already considered Europe's cloud computing capital. Notwithstanding many distress factors – such as a persistent unemployment rate of 15 percent, and a lingering crisis in the construction sector – the service sector promises ample growth potential, especially in Dublin. This adds up to a foreseeable effect for the office space demand and a corresponding rise in real estate values. The assessment is borne out by slight increase in take-up during the second and third quarters of 2012.

In the Czech Republic, consistent reports from the sectors of forward-looking technologies as well as research and development (R&D) suggest that the structural deficits in the economy are being eliminated even if the economy continues to stall: The fiscal law re-enacted this summer provides tax breaks for the next ten years on R&D projects, while government grants and EU subsidies boosted R&D investments by 20 percent as early as 2011. As it is, the Czechs have outpaced their Eastern European neighbours. Formerly a blue-collar location, the upgrade has helped to put the country on broader and more autonomous footing. This is clearly not about short-term success. The measures taken to jumpstart the economy, the all-time low in interest rates, and a less restrictive budget consolidation policy all represent additional impulses that back the forecasts predicting a slight economic growth in 2013. For the time being, the commercial real estate market remains slow, too. The investment volume for commercial real estate will drop to a modest 1 billion Euros in 2012, while 12 percent of the floor space in Prague is vacant. However, the situation does not compromise the growth potential of rents and prices that we identified specifically for new and high-end floor areas.

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