Savills Research
Ireland

Market in Minutes
Dublin Offices

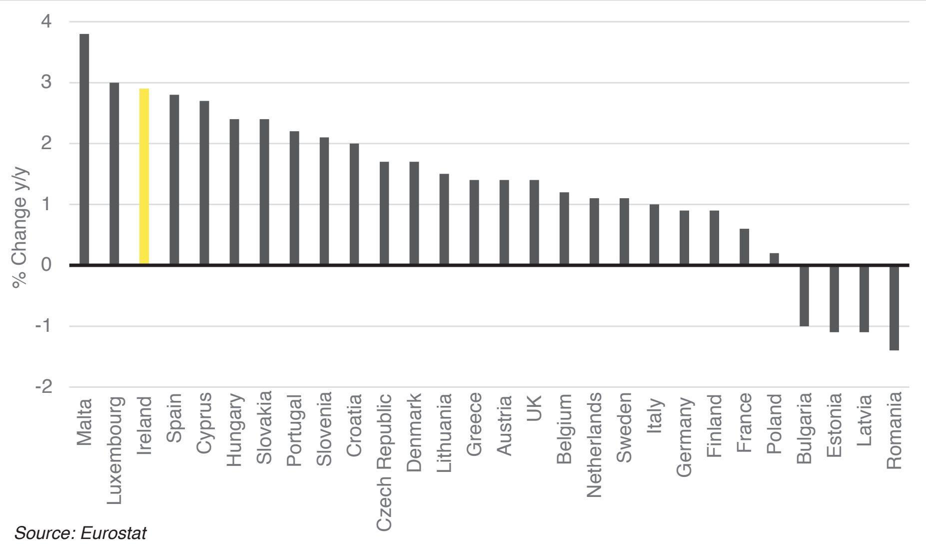
Q4 2016

Introduction

Economy Market

Despite increased political uncertainty across the world, Ireland's economy continues to perform well. Total employment is now rising by 2.9% per annum – the 3rd fastest growth rate in the EU. Gross earnings are only edging-up but, by easing pressure on the public finances, jobs growth has allowed the Government to reduce income taxes in three successive budgets. This has led to a meaningful improvement in disposable incomes and a broadening of the economic growth base.

FIGURE 1:
Total Employment Growth – Q3 2016

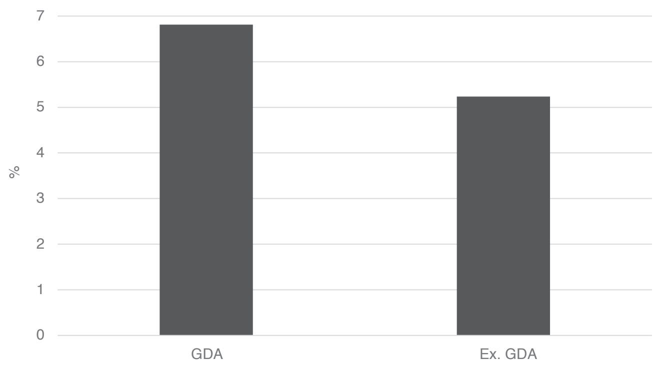


Source: Eurostat

Rapid economic expansion has caused a swing from net out-migration between 2009-2015 to a modest inflow in 2016. Ireland is still a net exporter of human capital to the UK but, given a favourable economic outlook and the potential for Brexit to provoke a migratory outflow from Britain, this should turnaround in 2017 leading to stronger overall in-migration.

Population and jobs growth has been concentrated in the Greater Dublin Area (GDA) which includes Dublin and the neighbouring counties of Wicklow, Kildare and Meath. The headcount here is currently rising by 1.5% per annum, and nearly half of all the net additional jobs over the last two years have been created in this region.

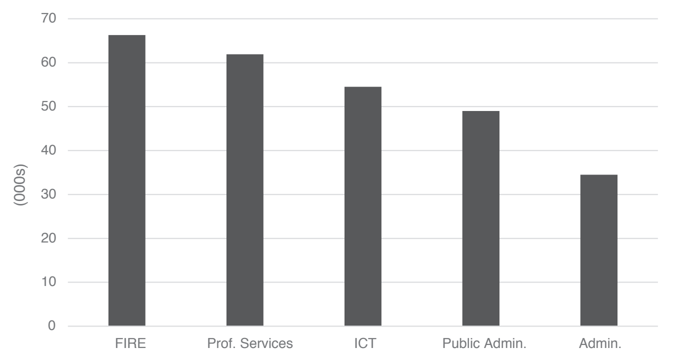
FIGURE 2:
Jobs Growth By Region (Q3 2014 – Q3 2016)



Source: CSO

Thirty four percent of employment in Dublin (and 31% in the GDA) is in the office dominated sectors of financial services, professional and technical services, Information and Communications Technology (ICT), public and private administration.

FIGURE 3:
Office Based Employment by Sector - Dublin

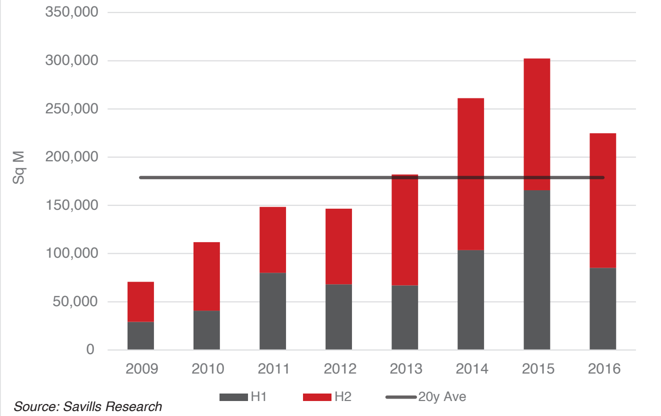


Source: CSO

Lettings

For a third successive year 2016 saw Dublin office lettings exceed 200,000 sq.m. In total just under 225,000 sq.m. of purpose-built space was taken-up in the year – a 26% spread over the 20-year average. 2016 activity was down by a quarter on the lettings record set in 2015. However there was a strong surge in the second half of the year; 62 percent of transactions occurred between July and December as an increased flow of refurbishments, new completions and pre-lets provided opportunities for occupiers to access high quality accommodation.

FIGURE 4:
Gross Letting Activity Dublin Office Market



Source: Savills Research

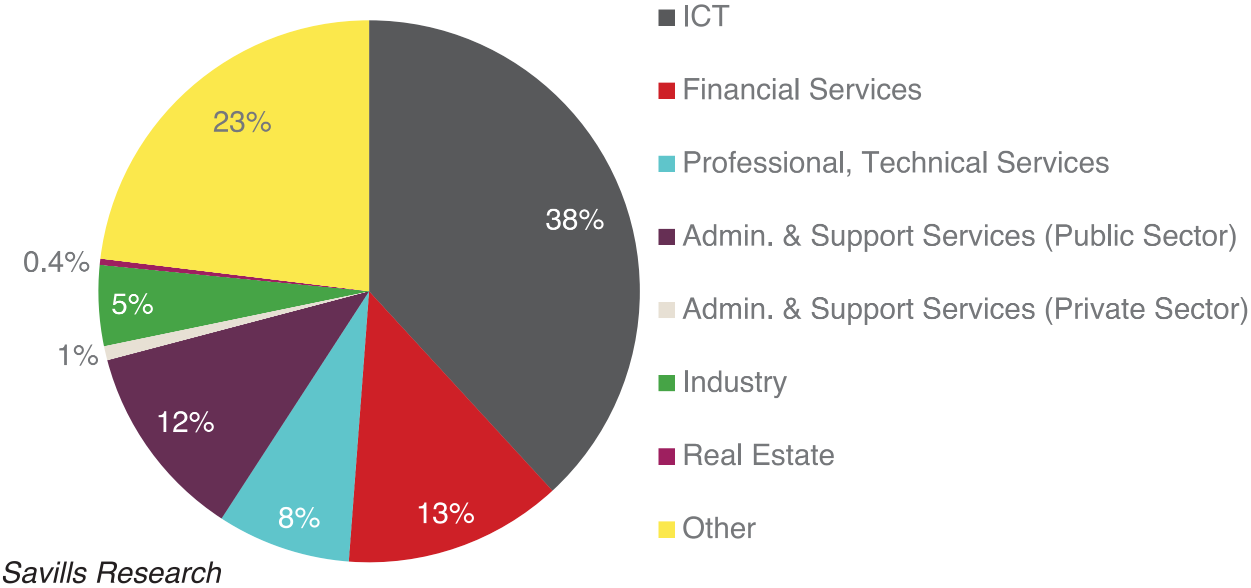
To a large extent the distribution of lettings by occupier type reflects employment patterns within Dublin. While fewer people work in ICT than in financial or professional services, employment in the technology sector has grown by 14.25% over the last two years. Reflecting this, ICT companies accounted for almost two-fifths of 2016 lettings (Figure 5).

Beaux Lane House, Dublin 2. Savills handled three successful lettings in this building during 2016.

Notably, the public sector accounted for over 26,000 sq.m. of office lettings in 2016, representing 12% of the annual total. This is by far the strongest level of public sector take-up since the recession and reflects an 11% increase in public administration employee numbers since the recruitment moratorium was lifted in Budget 2015 (see Table 1).

The effective absence of the State in recent years makes the resilience of the Dublin market between 2013-2015 all the more remarkable. However the re-emergence of this key occupier is a major positive in underpinning stable demand within the market.

FIGURE 5:
Dublin Office Take-Up by Sector 2016



Source: Savills Research

TABLE 1:
Public Admin. as a Percentage of Take-Up

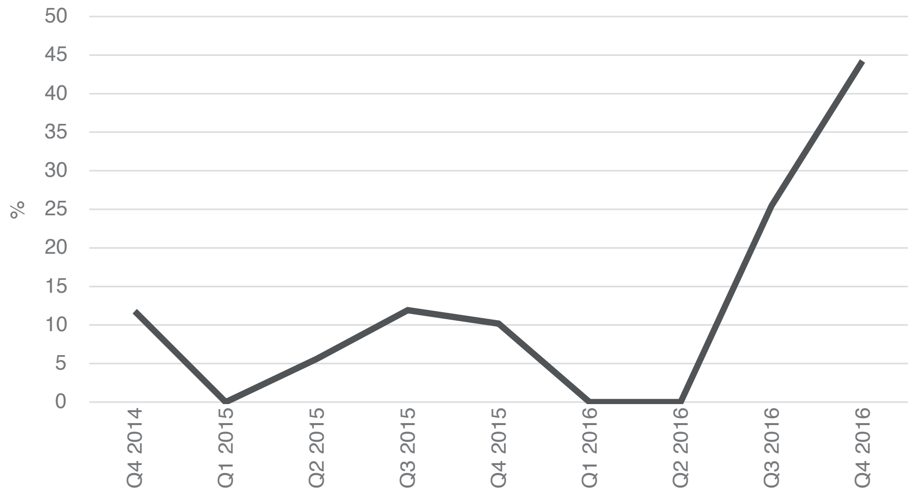
	sq.m.	% of Total Take-Up
2016	26,369	11.7
2015	19,837	6.7
2014	22,722	8.7
2013	3,075	1.8
2012	1,118	0.8

Pelham House where Savills acquired 2,470 sq. m. for a client.

Drilling down to specific locations we see quite a different distribution of lettings by sector. In Dublin 2 – the city's premier business district – financial and professional services occupiers who are typically willing to pay for prime locations accounted for a much higher share of total take-up (25.1% and 17.1% respectively). In contrast more price sensitive occupiers such as the public sector were underweight in this location (5% of take-up compared with 12% of the overall market).

Pre-letting has not traditionally been a major feature of the Dublin market. This reflects the nature of core demand with the average occupier having a space requirement of only around 1,000 sq.m. However pre-lets have become much more common in recent years. On one hand this is due to the scarcity and cost of funding for speculative development which is requiring many developers to secure contracted income before they can finance office construction schemes. On the other hand it reflects the tightness of the occupier market – very low vacancy rates for high-quality space in prime locations mean an increasing number of occupiers – particularly those with larger space requirements - are willing to pre-commit to space which is under development. The upside is that they get a greater choice of buildings, CAT A credits to put towards fit-out costs and, perhaps, some limited influence on shell and core finishes. To illustrate the scale of this phenomenon, 12.7 percent of all lettings since the start of Q4 2014 have been prelets and this figure rises to 23.5% and 19.4% in Dublin 2 and Dublin 4 respectively. In addition, as shown in Figure 6, the incidence of pre-letting is becoming greater as we move deeper into the development cycle.

FIGURE 6:
Pre-lets as Proportion of Total Lettings

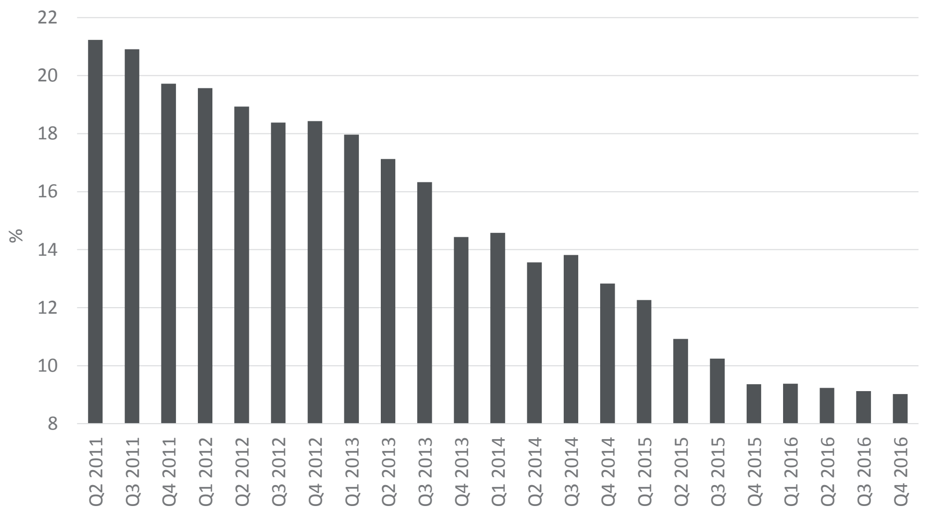


Source: Savills Research

Availability

Currently just under 325,000 sq.m. of purpose-built office space is available to let in Dublin – amounting to 9 percent of the standing stock. Compared with the cyclical trough in Q2 2010 when vacancy stood at 22.8%, more than 520,000 sq.m. of overhanging space has been absorbed through strong lettings in a resurgent economy.

FIGURE 7:
Vacancy Rate Dublin Offices



Source: Savills Research

As shown in Figure 7 the vacancy rate has begun edging down more slowly in the last year. Rather than signifying a weakening in demand this reflects three dynamics. Firstly, after a five year construction hiatus between 2011–2015, much of the good quality vacant stock that had been overhanging the market has now been taken. A significant proportion of what remains is obsolete and perhaps subject to planned refurbishment/redevelopment.

While just under 26,000 sq.m. of Grade A office space is still available across Dublin – enough to house approximately 2,200 staff - choice has become quite restricted in some prime locations. This is particularly true for occupiers requiring large parcels of space for immediate occupation. Inevitably this has begun to drag somewhat on absorption.

Secondly, increased pre-letting of buildings that are not yet complete is allowing strong take-up to occur without a commensurate deduction from the overhang of vacant space. Finally, at the margin, the slowing reduction in vacancy rates is being caused by shrinkage of the total stock. At this stage of the development cycle more space has been withdrawn for redevelopment than has been returned to the market as newly completed stock. This means the continuing decline in absolute vacant space (the numerator in our vacancy rate calculation) is being partially offset by a falling total stock (the denominator). All else equal this effect has added 13 basis points to the current vacancy rate.

As ever vacancy rates vary considerably by location and building quality. Current vacancy rates range from over 30% in some suburban postcodes to 4.8% in the Central Business District (CBD). Within this, the vacancy rate for Grade A buildings is just 1.6%, and this becomes even lower in specific sub-markets such as the South Docks (0.5% Grade A). Given the tightness of the CBD market the decline in vacant space over the last 12 months has been most pronounced in City Fringe areas. This is in sharp contrast to the pattern seen in the last cycle when non-CBD demand focused heavily on suburban locations around the newly developed M50 ring road. Demand has been particularly strong in Dublin 3 and North East County Dublin where almost 28,000 sq.m. of space has been absorbed in the last year. This reflects the continued availability of modern space in these areas that can be leased on more flexible terms and at a significant discount to more central locations. However rents and terms have hardened in these fringe locations of late.

Supply Pipeline

After a halt on office construction between 2011-2015 the development cycle has now started in earnest. While the numbers are changing every day, 388,000 sq.m. of space is currently on-site and under construction. Given a typical 18-24 month build programme this space should be delivered by end-2018. Looking further ahead there is an elastic supply of further space that can potentially be developed and completed before 2021. However, the amount that gets built and the timing of delivery is heavily conditional on how the supply / demand balance in the market evolves over the coming years. If current macro-economic forecasts prove correct occupier demand will remain robust over the next two years. This implies strong absorption of the space that is currently under construction, containing the potential for vacancy rates to increase sharply. In this scenario rents will continue to rise, justifying construction and enabling additional projects to get funded and completed. Obviously, if Brexit were to precipitate an influx of occupier demand from re-domiciling UK financial services firms (or part operations), this effect would be even more pronounced. On the other hand, if demand evolves more sluggishly, vacancy rates will rise more rapidly towards their equilibrium, leading to lower rental growth expectations. In this case some schemes that could potentially be delivered later in the cycle will not be triggered.

The availability of funding also adds uncertainty to the scale and timing of projects that are not yet onsite. A consistent theme over recent years has been the deferment of proposed schemes as developers often have to find scarce pre-lets before they can get their schemes funded.

The Vertium, 15,992 sq.m. of office space pre-let by Savills in Q4 2016. The six-storey building will be ready for occupation in Q2 2017.

Rents

Headline rents for high quality business space in prime locations have more than doubled since Q1 2012, and the tone of rents at the top end of the market stood at €646 per sq.m. (€60 per sq.ft.) per annum in Q4 2016.

Rental growth has slowed from well over 20% in 2015 to around 5% in 2016. To a large extent this derives from the growing influence of pre-lets. Somewhat unusually, rents for pre-let space are currently trading at a discount to those applying to space for immediate occupation. The reasons for this are clear. On the supply side, many developers are willing to offer competitive rent deals to de-risk their projects and ensure they get funded and completed within the current cycle. On the demand side, the number of developers with ambitions to build means occupiers who are prepared to pre-commit for later delivery have stronger negotiating leverage due to the increased options available.

Another possible reason for the slowdown in the measured rate of rental growth in prime locations is that the scarcity of good quality space has diverted demand to secondary pitches, (particularly the city fringe, as noted above). This has resulted in a displacement of rental growth from prime to secondary markets which are not necessarily well tracked by rent indices. To illustrate this the Figure below shows that secondary headline ERVs have risen from 56% of prime values in Q1 2011 to 83% currently as the overall market has tightened.

Finally it is worth noting that, because modern lease structures with upward and downward rent reviews leave less headroom for tenant incentives, a squeeze on incentives (notably shorter rent-frees, penalties on break options and longer terms certain - especially in the CBD) has led to stronger growth in net effective rents than headline rent indices suggest.

FIGURE 8:
Secondary Rents as a Proportion of Prime

Source: Savills Research

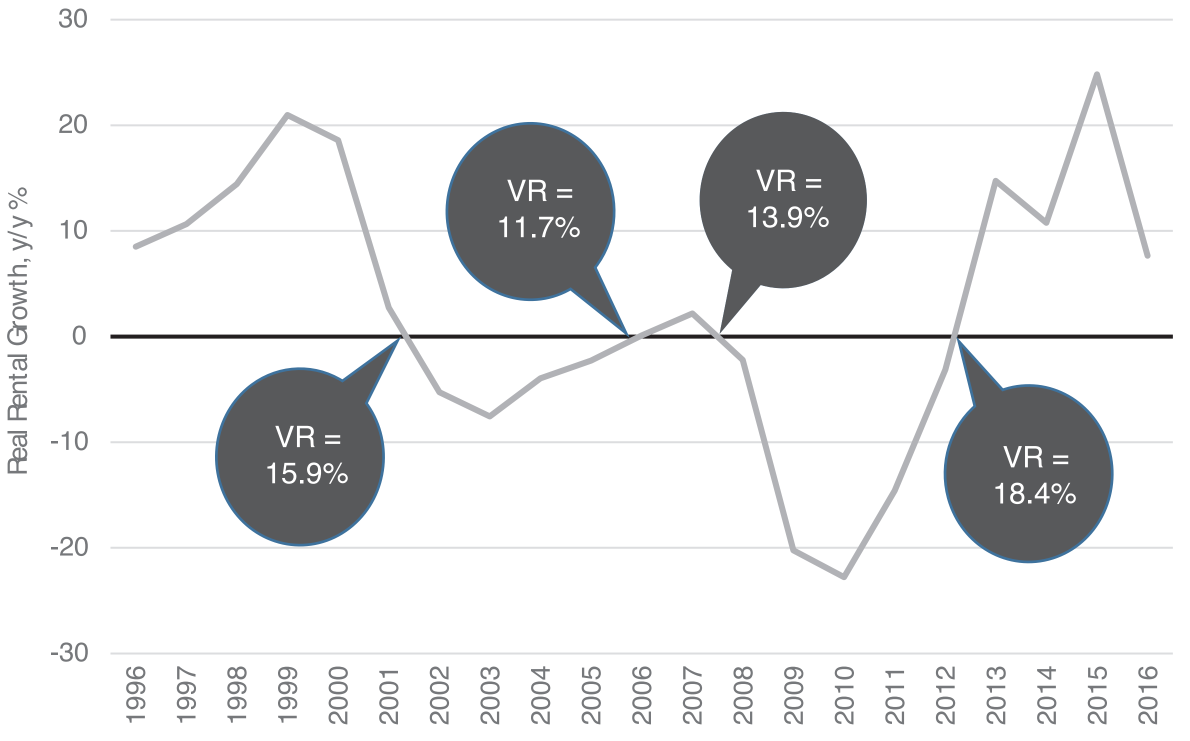
OUTLOOK

Recent global events – particularly Brexit and the US election results – introduce an element of uncertainty into the outlook for Dublin office demand. However, macroeconomic forecasters have now had time to digest these factors and incorporate them into their projections. The consensus forecast is that Ireland's economy will continue to expand strongly, growing by 3.3% in 2017 and 3.1% next year. This, and the likelihood that any Brexit effects are likely to asymmetrically impact on Dublin and the regional economy, suggest that the demand for office space in the capital should remain robust.

Factoring this into our net absorption assumptions, and profiling expected net completions over the next two years (without any allowance for slippage in delivery schedules), we believe that the overall vacancy rate in Dublin will fall to around 8% by December before rising again to around 9% by December 2018. On the face of it, this would leave the vacancy rate well below its equilibrium level – i.e. the vacancy rate which has proved over previous cycles to be a tipping point between positive and negative rental growth. Indeed, as shown in Figure 9, at no point over the last 20 years have rents flipped from positive to negative growth (or vice-versa) when the vacancy rate was below 11.7%. Unsurprisingly therefore, when we feed these assumptions into our econometric model, prime ERVs are forecast to rise further over the next two years. From their current level of €646 per sq.m. per annum (€60 per sq.ft.) the model predicts prime headline rents will reach €678 per sq.m. (€63 per sq.ft.) by Q4 2017 and €721 (€67 per sq.ft.) by December 2018.

We are in interesting times with a number of fundamentally new dynamics in the market. These include the unusually high volume of pre-lets, shorter leases, upward and downward rent reviews, and the changing ownership of much of the prime stock which is now held by European long-term institutional owners. It will be fascinating to see how these unprecedented circumstances impact on rental growth. For now, however, our model which is informed by long-term relationships between lagged vacancy rates and the rents index suggests further upside for Dublin office rents over the next two years.

FIGURE 9:
Natural Vacancy Rate for Dublin Office Space



Source: Savills Research

40 Molesworth Street. Up to 2,787 sq.m. of Grade A space, ready for occupation in June 2017.

Ireland Office and Research teams

Please contact us for further information

John McCartney
Director Research
+353 (0)1 618 1427
john.mccartney@savills.ie

Andrew Cunningham
Director Head of Offices
+353 1 618 1720
andrew.cunningham@savills.ie

Roland O'Connell
Chairman and Director Office Agency
+353 1 618 1315
roland.oconnell@savills.ie

Michael Healy
Divisional Director Office Agency
+353 1 618 1367
michael.healy@savills.ie

David O'Malley
Associate Office Agency
+353 (1) 618 1458
david.omalley@savills.ie

Peter Owens
Senior Surveyor Office Agency
Central London and International
+44 (0) 20 3320 8282
peter.owens@savills.com

Kellie O'Brien
Senior Surveyor Office Agency
+353 (1) 618 1348
kelly.obrien@savills.ie

Conor Egan
Graduate Surveyor
Office Agency
+353 (1) 618 1746
conor.egan@savills.ie