Global Growth Shock

From a V to a U- The prospects of a swift economic recovery are dampening

As health professionals point to falling coronavirus cases across much of Europe, questions are mounting as to the speed of return to normal working practices and the impact on the economy.

Government stimulus packages are keeping Europe’s economy on life support, with public debt levels forecast to rise by an average of 20% in the Eurozone (EZ) area during 2020, in order to maintain employment levels through furlough schemes. The optimism for a V shaped recession with a strong bounce back are waning, with the EZ unemployment rate forecast to rise from 7.4% at end 2019 to over 10% by the end of 2020. Early evidence is present with Germany’s unemployment rate rising from 5.0% to 5.8% during April alone. Longer term repercussions of the increased government debt burdens across Europe could likely point to higher corporate taxes/ introduction of a solidarity tax once the pandemic has passed in order to service debt levels and avoid sovereign default.

GDP growth figures during the first quarter of the year showed -5.8% for France, -5.3% for Spain, whilst Germany is expected to be the most resilient major European economy. However, we expect the true depth of the negative spike to be revealed in the Q2 2020 figures as the full weight of the lockdown only came into play during the second half of March. Although we are still at relatively early stages of predicting the full extent of the downturn, April’s Eurozone Services Purchasing Managers Index (PMI) reading of 11.7 marks the lowest level on record (a reading of 50 separates expansion from contraction in the services sector), which was largely dragged down by the hospitality, restaurants and travel subsectors. However, due to the depth of this decline, previous relationships between PMI readings and GDP growth levels are unlikely to hold.

Capital Economics May 2020 forecasts indicate GDP growth of -12% for the Eurozone (EZ) during 2020, with a bounceback of 10% in 2021.

On a brighter note, a number of European economies are beginning to lift some lockdown restrictions as office workers gradually return to the workplace. Office landlords will be gratified by the fact that 80% of office rent was collected during the April period, marking the most resilient of the commercial property sectors.

Most government lockdowns across Europe were not fully implemented until March, which has limited some of the office leasing deals to be completed by the end of the first quarter. European office take up reached 2.1 million sq m, 21% below the five year average level (Chart 1). This was largely dragged down by lower take up levels in the larger cities of Paris IDF (-37% yoy), Berlin (-33% yoy) and Madrid (-47% yoy). We should of course remember that the first quarter of leasing volumes is often influenced by the number of deals which are completed during the

![Chart 1: European office take up: first quarter (sq m)](chart1)

-12% forecast GDP growth for Eurozone during 2020, according to Capital Economics.
Occupational Resilience

What happened to core office rents during the Global Financial Crisis?

final quarter of the previous year, with companies taking stock during Q1. We expect to see more evidence as to the impact on the leasing sector during the second quarter of the year, with many viewings postponed and surveyors unable to undergo technical due diligence on properties. We doubt whether the number of virtual video tours being introduced will much compensate for potential occupiers’ inability to view offices during lockdown.

Although each economic downturn is usually different in nature, we can draw on evidence from the Global Financial Crisis (GFC), to analyse the resilience of Europe’s office market. During the GFC, unemployment rates rose from 7.5% in 2007 to 12% in 2013 in the Euro Area, according to data from Oxford Economics. Analysis of the core European office markets during the GFC indicates that vacancy rates rose from 7.9% to 9.6% from 2007 to 2009 which subsequently reduced prime rents by an average of 18% from the 2007 peak to the 2009 trough (Chart 2). This analysis shows the c9% vacancy rate level is the equilibrium for stable office rents across the core cities.

We feel the prospect of prime rental declines to the same extent as those witnessed during the GFC are unlikely, for a number of reasons. Firstly, supply/demand fundamentals present a more landlord-friendly market. At the beginning of the pandemic in Q1 2020, the average European office vacancy rates stood at 5.2%, consistent with the previous quarter, as Berlin and Paris CBD both remain under 2% vacancy (Chart 3). This is significantly below the 7.9% vacancy rate in 2007, with more capacity to withstand the 9% vacancy rate threshold.

---

**Chart 2: European core office vacancy rate and prime rents (€ per sq m)**

- **Vacancy rate: Increased by 170 bps**
- **Prime rents: 18% drop from peak**

**Chart 3: European office vacancy rates, Q1 2020 (%)**

- **Average, 5.2%**

---

Source: Savills Research, Core European cities includes London City, Paris CBD, Munich, Berlin, Frankfurt and Madrid.
Secondly, the government “bazookas” introduced to provide business aid in response to lockdowns have been faster and firmer than during the GFC. This will limit the number of jobs lost in the short term, assuming a second wave of infections does not materialise. This will also depend on the length of time each government will be able to sustain furlough payments. However, once this aid is wound back, we expect some small and medium sized businesses to observe some job losses.

What’s more, 2020/21 office development pipelines are significantly lower than the level of new space set for completion during 2008/09. With new office deliveries likely to be delayed by 9-12 months, prime rent levels are expected to hold relatively firm and tenant incentives to increase, impacting net effective rents for prime stock. For example, Savills latest Global Sentiment Survey from 15th April outlines how concessions/terms for occupiers have changed within the office sector. Results of the survey show that 10 out of 16 European office markets are observing a change in payment structure, with three markets observing deferred service charges as landlords and tenants show more signs of working together to find short term solutions alongside government intervention. More evidence will be visible with May’s monthly rent collection stats.

Landlords will be paying particular attention to tenant covenant strengths of existing occupied space to avoid high levels of second hand space being released back to the market in the wake of business casualties. Although unemployment will rise, Oxford Economics forecast the overall number of Eurozone office based workers to increase by 1.3 million by 2024, marking a 3.1% increase. Luxembourg, (+12.2%), Stockholm (+10.4%) and Oslo (+8.0%) top the most resilient cities for office based employment.

Capital Economics forecast average European city office rental growth to fall by 0.6% across the major European markets during 2020, against the previous set of forecasts released during Q4 2019 indicating 3.8% growth. However, based on a five year forecast, European office rental forecasts appear relatively unmoved, falling by -0.1% pa on the previous quarter to 1.8% pa by 2024. This is largely indicated by a bounceback in office rents during 2021 as businesses resume occupational activity.
The Return To Work

What changes could take place in response to COVID-19?

We believe it is still too early to be futuregazing as to the long term change in working behaviour post COVID-19 and how new working from home practices and adoption of new technology will affect office demand. Data from Eurostat shows the proportion of workers who have worked at home prior to the coronavirus by country. 35.7% of Dutch and 34.7% of Swedish workers have previously worked from home (Table 1), more than any other European country. As a result, we anticipate office demand could be more resilient in these countries as companies have already put home working to the test.

The initial return to work is likely to include staggered working hours, with only essential teams returning to the workplace firstly due to social distancing measures. Research from Workthere indicates that flexible office enquiries fell by 80% during the lockdown. We expect to see a bounceback in the short-medium term, as occupiers reassess their portfolios on the return to work. In the medium-longer term, we may see a shift to lower occupational densities and more demand for agile workspace. On the other hand, we expect the number of workers choosing to work from home could soften space requirements.

Of course, many workers are eager to return to the office. Some occupiers are reviewing whether business parks may better suit their needs in the light of Covid-19, given their suburban location and lower occupational density. This could see new demand for flexible office hubs in satellite cities to provide short-medium term accommodation for workers. For example, we are seeing a number of major investment banks using their emergency trading floors across satellite cities to mitigate the risk of infection. In the longer term, transport connectivity and proximity to key transport nodes will play an increasingly important role across Europe to minimise commutes as workers are more able to carry out certain tasks at home. Tenants with upcoming lease expiries will have two options- renew or relocate to more cost effective/ less-dense locations.

### Table 1: Proportion of employed people that can work from home in Europe (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of employed people that can work from home in Europe, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>35.7%</td>
</tr>
<tr>
<td>Sweden</td>
<td>34.7%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>30.8%</td>
</tr>
<tr>
<td>Finland</td>
<td>30.3%</td>
</tr>
<tr>
<td>Denmark</td>
<td>27.4%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>23.8%</td>
</tr>
<tr>
<td>Belgium</td>
<td>22.7%</td>
</tr>
<tr>
<td>Austria</td>
<td>21.7%</td>
</tr>
<tr>
<td>France</td>
<td>20.7%</td>
</tr>
<tr>
<td>Ireland</td>
<td>19.3%</td>
</tr>
<tr>
<td>EU28</td>
<td>15%</td>
</tr>
<tr>
<td>Portugal</td>
<td>14.7%</td>
</tr>
<tr>
<td>Poland</td>
<td>13.2%</td>
</tr>
<tr>
<td>Germany</td>
<td>11.6%</td>
</tr>
<tr>
<td>Norway</td>
<td>11.4%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>11%</td>
</tr>
<tr>
<td>Czechia</td>
<td>9.4%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>9%</td>
</tr>
<tr>
<td>Spain</td>
<td>7.5%</td>
</tr>
<tr>
<td>Hungary</td>
<td>6%</td>
</tr>
<tr>
<td>Greece</td>
<td>5.1%</td>
</tr>
<tr>
<td>Italy</td>
<td>4.8%</td>
</tr>
<tr>
<td>Romania</td>
<td>0.7%</td>
</tr>
</tbody>
</table>

35.7% of Dutch workers can work from home, above the EU average of 15%.

Source: Eurostat
Some landlords are pushing ahead with office transactions with the intention to refinance debt once lender caution abates.

European office investment transactions reached €23.3 billion during the first quarter of 2020, 16% above the five year average of €20.1 billion (Chart 5). Much of this activity was down to a shift back to core, illustrated by the resilience of the UK, France and Germany, accounting for a combined 73% of total transactions, up from 63% during Q1 2019.

Germany recorded €7.4bn of transactions, 49% above the level recorded during Q1 2019 whilst the UK observed €4.6bn of office investment, 60% above what was a weaker first quarter last year. French office investment reached €4.9bn, 58% up year on year. The flight to core markets is a theme we expect to gather pace over the course of this year as markets adjust to uncertainty, although given the weight of office transactions we have experienced in recent years, investor sensitivity to pricing will increase as new buying opportunities emerge.

**Capital Markets**

**Will core become ultra-core?**

European office investment transactions reached €23.3 billion during the first quarter of 2020, 16% above the five year average of €20.1 billion (Chart 5). Much of this activity was down to a shift back to core, illustrated by the resilience of the UK, France and Germany, accounting for a combined 73% of total transactions, up from 63% during Q1 2019.

Germany recorded €7.4bn of transactions, 49% above the level recorded during Q1 2019 whilst the UK observed €4.6bn of office investment, 60% above what was a weaker first quarter last year. French office investment reached €4.9bn, 58% up year on year. The flight to core markets is a theme we expect to gather pace over the course of this year as markets adjust to uncertainty, although given the weight of office transactions we have experienced in recent years, investor sensitivity to pricing will increase as new buying opportunities emerge.

**Chart 5: First Quarter European Office Investment (€bn)**

![Chart 5: First Quarter European Office Investment (€bn)](image-url)

15% of EU workers are able to work from home.

€23.3bn European office investment transactions recorded during Q1 2020.
Polarised Investor Demand

A mismatch in pricing expectations will hamper transaction volumes.

With equity still committed and ready to deploy across Europe’s office sector, there appears to be a mismatch in pricing expectations for core product. Vendors are in no need to sell and redeploy capital, whilst buyers are seeking 5-10% “COVID chips” on price—a shortage of investment transactions is making repricing difficult. Given the deterioration in market sentiment and need to deploy capital, this could drive some core cities pricing even sharper.

Much of this stems from lenders’ caution on office pricing of prime assets, with lending rates moving out as much as double for some core German offices, and doubts rising over the speed of return to pre COVID levels. Likewise, loan-to-value ratios (LTV) on offer for core deals are reducing from c65% to what could tend to a new-normal of 55%, limiting debt-backed buyers’ purchasing power. More focus will applied to existing tenant covenant strengths, particularly for insurance companies and banks. Some landlords are pushing ahead with office transactions with the intention to refinance debt once lender caution abates. This will present more core buying opportunities for cash-rich institutions who previously had not been able to compete with leveraged buyers.

As part of a shift to core, we expect the proportion of cross border activity to decline compared to previous years, particularly from Asia-Pacific capital where we have observed unprecedented levels of investment in recent years. We expect that this will affect the Southern European and Central and Eastern European (CEE) markets which are more heavily dependent on cross border capital, relatively more than those in Western Europe.

Core-plus and value-add investors are viewing the pandemic as a chance to count stock on their existing portfolios. Part of this stems from the fact that pricing in these risk profiles is usually more heavily influenced by strong macro fundamentals. At the other end of the scale, we can expect to see US private equity investors seek distressed Southern European opportunities offering price chips of c50 bps.

Chart 6: European Prime Office Yields, Q1 2020 (%)
Savills Commercial Research

We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

Offices
Jeremy Bates
Head of Occupational Markets - EMEA
+44 (0) 207 409 8813
jbates@savills.com

Tris Larder
RIA EMEA
+44 (0) 207 409 8014
tjlarder@savills.com

Investment
Mike Barnes
European Commercial Research
+44 (0) 207 075 2864
mike.barnes@savills.com

Research

Savills plc: Savills plc is a global real estate services provider listed on the London Stock Exchange. We have an international network of more than 600 offices and associates throughout the Americas, the UK, continental Europe, Asia Pacific, Africa and the Middle East, offering a broad range of specialist advisory, management and transactional services to clients all over the world. This report is for general informative purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. While every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.