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Briefing Note

European offices - Half of the development pipeline is pre-let

October 2018

Development activity has picked up

■ Economic expansion, employment creation and occupier demand for well-designed and well-located office space have been the main drivers for the pick-up of office construction over the last couple of years. Office completions increased by 21% yoy in 2017 to over 3.3m sqm in our survey area of 17 European cities. The amount of office completions is expected to reach a similar level in 2018 and to increase by 28% in 2019. This equals about 32% and 41% of last year's annual take-up respectively, which was in the region of 10m sq m.

Vacancy rate at historic low

■ This is a welcome development in the office market as overall it is restrained by high demand and very tight supply of good quality office accommodation. The average vacancy rate in our survey area is at a historic low of 5.9%. According to our projections, availability of space will reduce further to an average vacancy rate of 5.6% by the end of the year. The most undersupplied markets will be Berlin (1.4% vacancy), Paris CBD (2.1%) and Munich (2.5%).

Occupier demand cannot be satisfied

■ We believe that this situation, has constrained occupier activity over the past two years, as occupiers have failed to find the right buildings to accommodate an increasingly demanding labour force. Take-up has been rising by an average of 5% pa since 2013, as a result of economic growth and therefore business expansion, reaching about 10m sq m last year. Nevertheless, the pace of growth has been slowing since 2016 and according to our projections occupier activity could fall below 9m sq m in 2018 due to lack of supply.

■ Although GDP growth has also become more moderate across Europe this year, it remains positive along with positive employment creation, particularly in the service sectors. Moreover, beyond enquiries related to expansion, there are significant outstanding occupier needs for relocation to more attractive and efficient buildings. Lack of choices do not only delay their plans, but also limit the possibility of an existing stock uplift, through refurbishments and redevelopments.

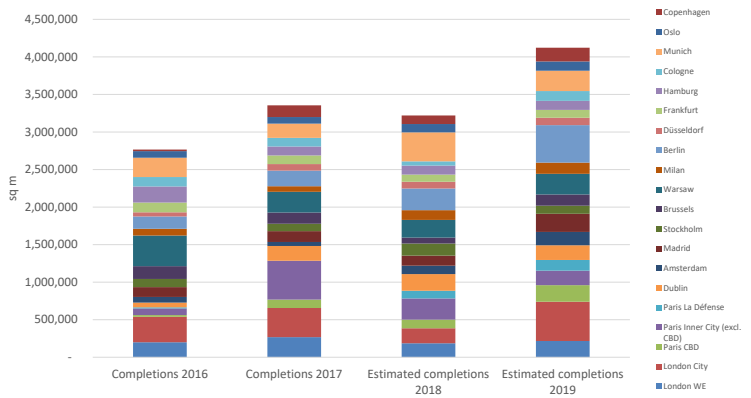
No risk of oversupply

■ The volume of development completions is forecast to exceed 4.1m sq m in 2019. Nevertheless we believe that this is in line with the current market status for the following reasons:

• About half (51%) of the space under construction (H2 2018 and 2019 completions) is already committed to specific occupiers, 58% of this year's completions and 40% of next year's completions. The markets with the highest level of speculative space in the pipeline for next year are Madrid (80% of estimated 2019 completions), Copenhagen (75%), London City (70%) and Dublin (70%). The ones with the lowest level of speculative development are Munich (27%), Dusseldorf (34%) and Hamburg (36%).

GRAPH 1

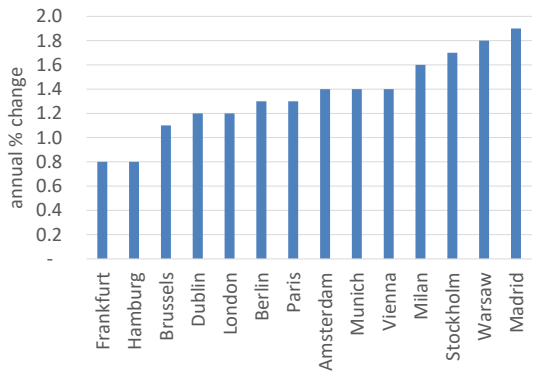
Office development activity will increase by 28% in 2019



Graph source: Savills

GRAPH 2

Office based employment growth 2018-2022 demand for offices will rise



Graph source: Oxford Economics

. • As a result, existing availability and new available supply (vacant space end 2018 and speculative completions 2019) is going to account for about 7% of stock on average, offering slightly more choice to occupiers, but far from threatening the market with oversupply. The markets where tenants should be able to find more easily options to satisfy their needs are Warsaw (13% availability), Dublin (12%) and Madrid (11%).

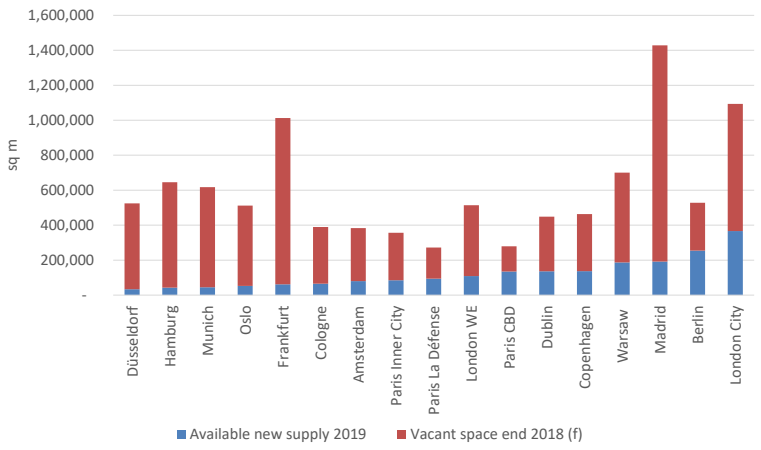
• An additional reason that justifies the need for this new office supply in the market is the fact that office based employment is forecast to continue to grow. According to Oxford economics projections, office based employment will expand by 1.4% pa on average between this year and 2022. Top performers amongst the cities we analyse will be Madrid (1.9%), Warsaw (1.8%) and Stockholm (1.7%).

• One of the key performance measures for the European cities is, the quality of the human capital in terms of skills and qualifications, productivity and availability. The cities which are strongest in that respect, according to our economists, are London, Stockholm, Amsterdam and Dublin.

• Oxford Economics projects the creation of more than 180,000 office based jobs next year across the 17 markets of our survey area. This would correspond to over 2m sq m of traditional office space and would theoretically absorb all the non-committed new supply that is expected to come on to the market next year, which we estimate at about 2m sq m. Of course, as companies plan ahead some of the current pre-lets would have already accounted for this anticipated growth. Additionally some of these jobs may be performed on flexible terms in flexible workspaces leading to reduced space requirements. Nevertheless, the fact that total speculative supply does not exceed the estimated needs for business expansion is a sign of balanced demand and supply conditions.

GRAPH 3

Vacant space and new speculative office supply 51% of next year's completions are pre-let



Graph source: Savills

Outlook

■ Based on the above we expect another year of competitive occupier markets resulting in rising rents for prime stock and delays in the implementation of property strategies, which are fully aligned with the business strategies of companies. We believe that pre-commitments in planned new space will continue to be high and flexible office space will remain a popular immediate solution to satisfy new business needs. As tenants move in the newly developed buildings that come on to the market, there will be opportunities for refurbishments and redevelopments of existing second hand stock. .

■ In the meantime, we project that prime rents will continue to rise next year, albeit at a slower pace. Last year the average growth of the markets we analyse was 5.8% yoy, slowing down to 3.3% in 2018 and 1.9% in 2019. The markets that we forecast to show the highest increase next year are Berlin (5%), Amsterdam (4.9%), Milan (4.3%) and Madrid (3.1%).

Please contact us for further information

Eri Mitsostergiou
European Research
+30 (0) 6946 500 104
emitso@savills.com

Matthew Fitzgerald
International Tenant Representation
+44 (0) 207 299 3082
mfitzgerald@savills.com