European Commercial - November 2022

SPOTLIGHT
Savills Research

European Office Outlook

• Economy • Occupational • Indexation

Resilient occupier demand

2022 take-up remains solid despite weakening Eurozone economy.

Eurozone inflation continued to exceed market expectations in October, reaching 10.7% yoy, which has applied further pressure on the European Central Bank (ECB) to raise interest rates. The ECB's latest base rate rise of 75 bps to 1.50% is expected to be followed by an additional 50 bps rise by the end of 2022.

Consensus forecasts indicate Eurozone inflation is expected to peak during Q4 2022, but concerningly for the ECB, the current core inflation rate of 5% is likely to remain above the ECB's target for some time. Eurozone countries that tend to rely on Russian energy exports are observing some of the highest headline rates of inflation, led by the Netherlands (16.8%), Belgium (12.3%), Italy (11.9%) and Germany (10.4%), whilst Central and Eastern European markets continue to see rising prices well above 15%. Eurozone wage growth is expected to reach 4.2% during 2022, and 4.4% in 2023, although given there still remains space capacity in the employment markets, any fears of an inflationary spiral remain unlikely.

Capital Economics anticipates Eurozone base rates will reach 3% by mid-2023 in an attempt to control inflation, although policymakers will be aware of the negative impact on economic growth across the Eurozone- GDP is already forecast to contract by 0.4% during Q4 2022. Weaker economic growth forecasts are beginning to have an impact on hiring sentiment among employers, although employer hiring expectations still remain above the long term average, according to the European Commission, whilst the Eurozone unemployment rate hovers at only 6.6%, which should help position the economy for a "soft landing".

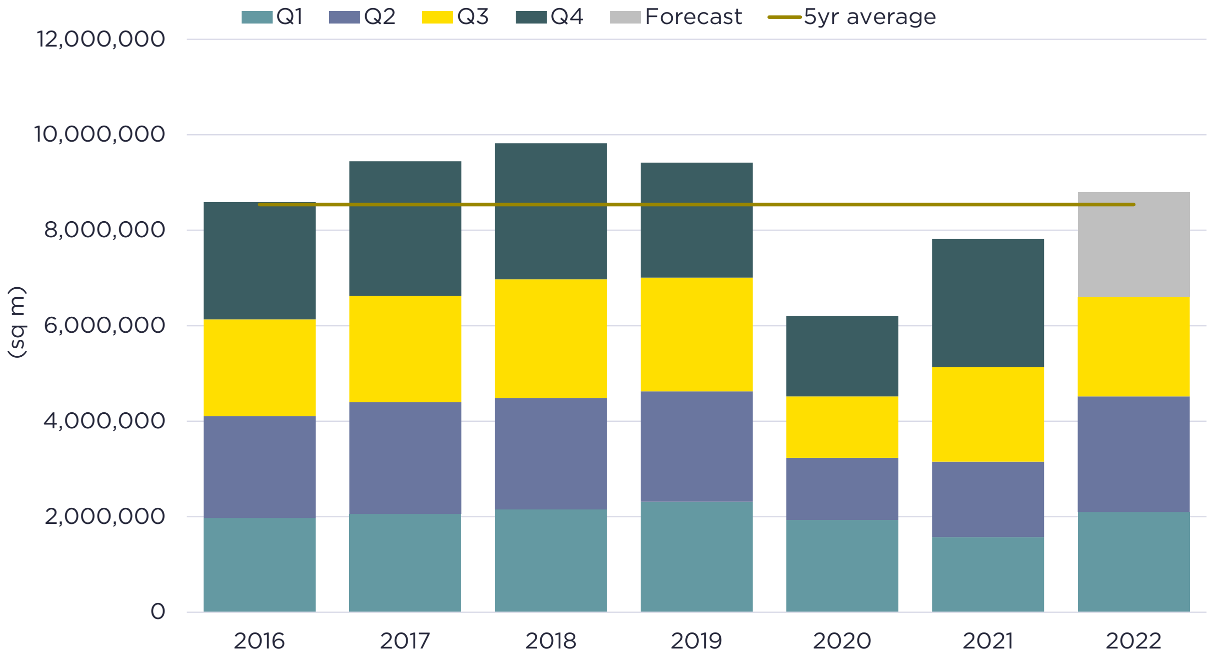
Occupational markets

European office take-up reached 2.1m sq m during Q3, in line with the five-year Q3 average, following a slowdown against the previous quarter. For the year to date (YTD), office take-up is 9% above the five-year Q1-Q3 average following a strong first half of activity. Among the strongest performing markets have been Lisbon (+111% against five-year YTD average), Cologne (+41%) and Prague (+30%).

One concern for the tech sector is the slowdown in venture capital funding, which is likely to impact demand. Companies that were previously operating at a loss are now quickly reducing costs and in some cases, headcount, in order to break even. We are likely to see some tech companies sub-lease or consolidate office space to tackle cost challenges in 2023.

However, given the drive for prime CBD office space, we expect a fairly busy final quarter of deals and expect total take-up for 2022 to reach circa 9m sq m, with a steady flow of deals into 2023.

Chart 1: European office take-up (sq m)



Source: Savills

Vacancy rate stable at 7.5%

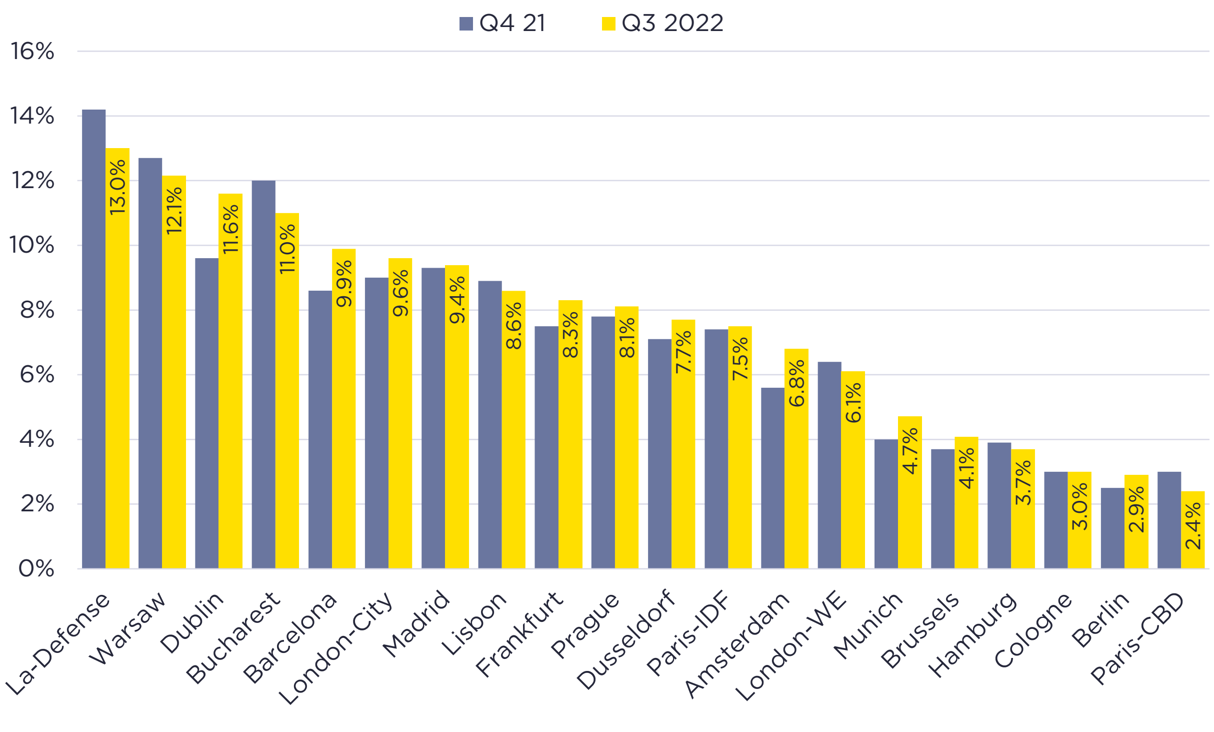
Potential for increase in subleasing.

Office vacancy rates have increased marginally from 7.3% to 7.5% during the third quarter of 2022. Core markets' vacancy rates generally remain below 5%, including Paris CBD (2.4%), Berlin (2.9%) and Cologne (3.0%). We have observed a minor increase in tenant controlled supply in Dublin during 2022, whilst in Amsterdam, there are a number of new office deliveries scheduled for the next six months, although the South Axis submarket's availability remains undersupplied with a 5% vacancy rate. Despite a higher overall vacancy rate in Madrid, there remains a shortage of larger units available within the M-30 ring road as we observe tenant requirements intensify for city centre stock. Developer sentiment remains cautious as we approach 2023, with construction starts delayed. Those occupiers seeking high-quality space in 2025/26 will ultimately need to start their search earlier.

Average prime European office rents rose by 5.5% following a shortage of best in class stock available across the core markets as rents begin to diverge between prime and secondary stock. Amsterdam (+16%), Munich (+14%) and Berlin (+13%) are recording some of the strongest increases, supported by undersupplied prime stock and rising construction costs, and we expect further rental growth into 2023 as occupiers compete for the best space. A further concern for occupiers is the rising energy costs filtering through into service charge increases, as observed in Amsterdam (+50%), London City (+20%) and Dublin (+7%) over the last 12 months.

Rising commodity prices, ongoing supply chain issues and increasing construction and labour costs continue to add upward pressure on fit-out costs, as outlined in Savills Prime Office Costs (SPOC) report Q3 2022. Fit-out costs have subsequently risen by 21% on average across Europe, led by Frankfurt (+30%), London City (+30%) and Madrid (+26%)- above the global average of 10%. Fit-out costs are generally paid for by the landlord in Germany and Poland, although tenants tend to cover the costs in London City, Madrid and Paris CBD.

Chart 2: European office vacancy rates, Q3 2022



Source: Savills

Chart 3: European office rental growth Q3 2022 (% yoy)

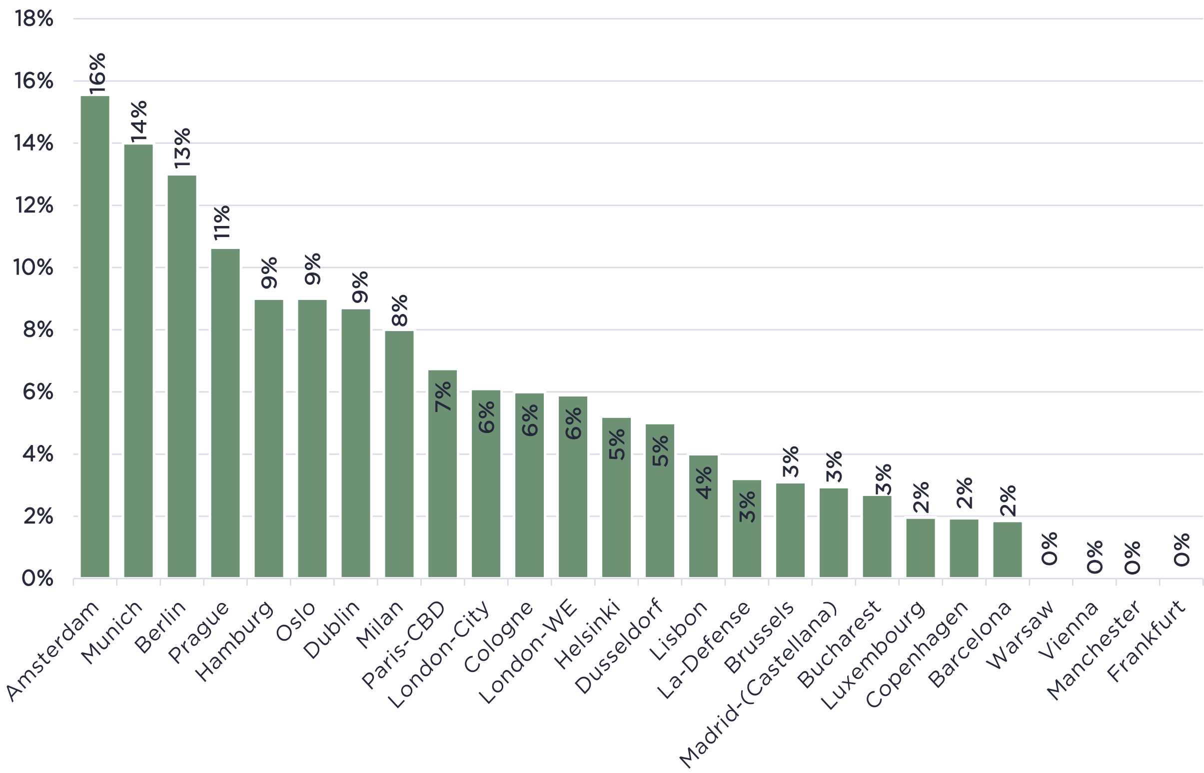


Chart 4: Annual fit-out cost growth (% yoy)

Source Savills

Feature: rental indexation

In which EME office markets are occupiers most exposed to rising inflation?

Savills has benchmarked European office markets where occupiers have the highest rental exposure to inflation through their office leases. The UK and Ireland have a more formal rent review process because of longer leases, sheltering occupiers from higher inflation.

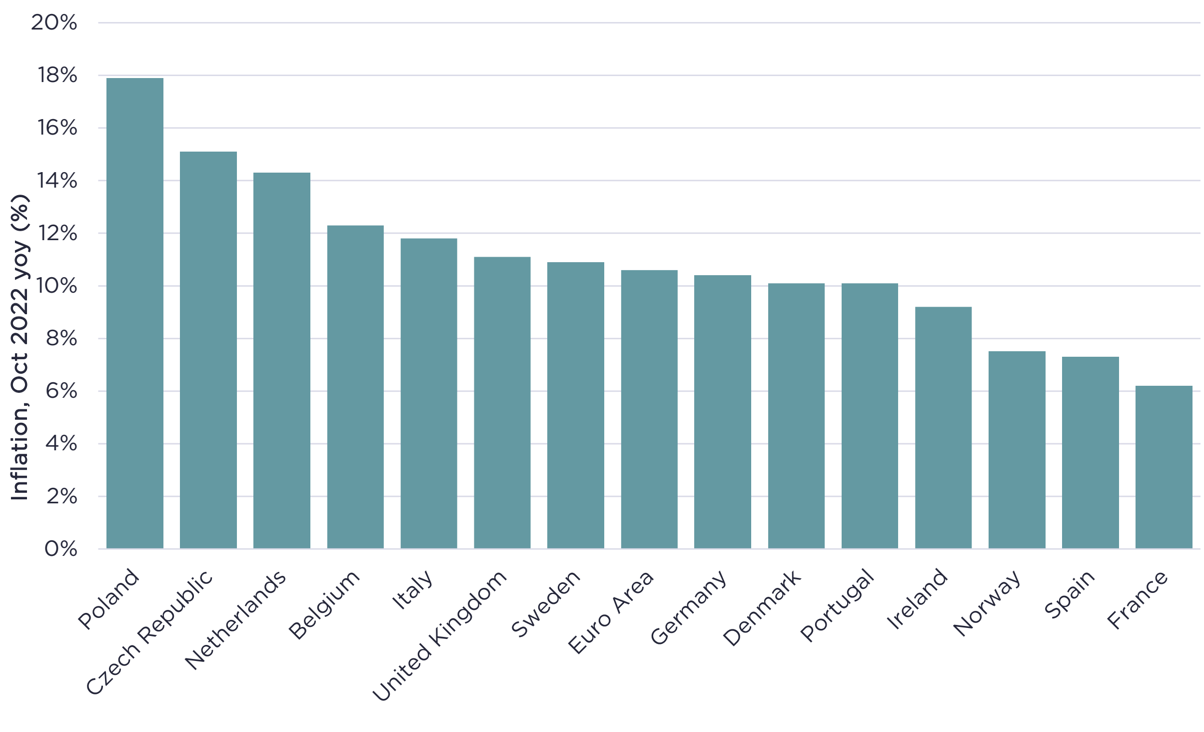
However, mainland European leases tend to include annual rent indexation, many of which do not include a rental cap or collar clause in their contracts, which exposes tenants to higher inflation. Given Eurozone inflation had not exceeded 4% until the current energy crisis, occupiers had not traditionally negotiated rental caps in their lease agreements, with the exception of Portugal's cap of 2% per annum. With Eurozone inflation now above 10%, and reaching 15-20% across Central and Eastern Europe (CEE) occupiers are finding themselves more heavily exposed to rental increases.

However, should inflation continue at current high levels and we begin to see office rents decline following weaker employer sentiment and cost reduction strategies, we may begin to see over rented, reversionary leases. If estimated rental value (ERVs) growth falls significantly behind inflation, then landlords may be faced with tenants vacating their premises at their next lease event, should a compromise not be met.

The British Council for Offices indicates that office-related costs generally account for only around 10% of total business costs. As global occupiers continue to seek best in class office space in order to attract the workforce back, rental indexation is therefore, only likely to have a limited impact on occupier decision-making.

We now expect to see tenants signing new leases to require indexation clauses to mitigate higher inflation risks over the short-medium term. Landlords, however, have sought European offices as a favourable inflation hedge and will be reluctant to offer open market rent reviews. Occupiers in search of new, high-quality office space will therefore need to start their search earlier to account for extended negotiation periods.

Chart 5: Inflation rate, October 2022 % yoy



Source Trading Economics

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.

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