European Commercial - March 2023

SPOTLIGHT
Savills Research

European Office Outlook

• Economy • Occupational • Incentives

Office demand recovery

2022 take-up reached 2% above the pre-pandemic average.

Economic overview
Recent European economic indicators are pointing to an improvement in sentiment since end 2022. Eurozone GDP flatlined in 2022, against the consensus view for a recession, and February 2023's PMI activity points to an expansion in economic output, particularly across Southern European economies and driven by the service sector. However, growth prospects still remain weak, with Capital Economics forecasting -0.5% growth during 2023, followed by 0.8% growth in 2024. On a more positive note for the office sector, employer sentiment is less subdued, with Oxford Economics forecasting a total of 3% office-based employment growth over the next five years.

Inflation appears to have peaked, amid signs that Europe's gas storage levels are higher than were anticipated. Headline inflation is expected to average 5.5% in 2023, and ease back to 2.5% in 2024 according to Capital Economics, nevertheless, there are concerns around the core rate of inflation which is expected to remain around the 5% mark as workers collectively campaign for higher wages.

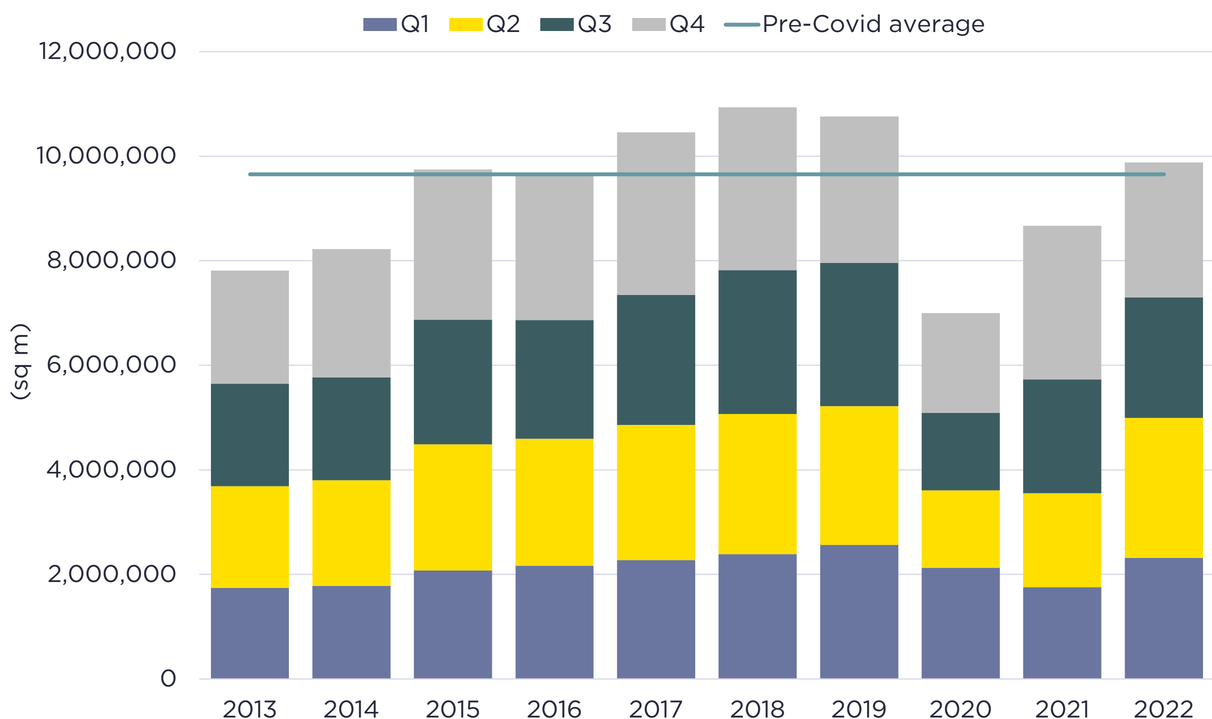
Further rate hikes to 3% are expected by end April, with several economists now expecting interest rates to move out further to 3.5%. There remains a high level of volatility in the bond markets which is likely to remain until rate hikes are finished, which will support investor decision-making.

Demand
European office take-up reached 9.9m sq m during 2022, 2% above the pre-pandemic average. Post-Covid, leasing activity continued to recover, rising by 14% YoY, as business confidence rose and occupiers resumed activity.

Southern Europe leasing activity performed strongly against the pre-pandemic average, led by Lisbon (+80%) following a number of pre-lets from professional services companies and Milan (+51%). Conversely, Amsterdam's take-up fell by 44% against the pre pandemic average. Strong pre-pandemic performance was caused by the completion of various new developments, whereas post-pandemic, demand has been concentrated in South-Axis and the city centre, where stock remains limited.

Looking to 2023, some occupiers are holding off on decision-making, prudently not committing capital at a time of geographical uncertainty but occupancy levels are rising and there is still a demand for skilled talent. Rising costs are shifting companies into cost-control mode, as observed in Deloitte's European CFO survey Autumn 2022, where the net balance of expectations for hiring employees has declined steeply, from 28% in Spring 2022 to −2%. However, skilled talent remains in European CFOs' top three challenges over the next 12 months, and occupiers will use real estate to differentiate themselves as a key draw for talent.

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



Source: Savills

Vacancy rate nudges up to 8%

Rental growth still positive amid shift to prime.

Vacancy and rents
Vacancy rates increased by an average of 50 bps from 7.5% to 8% during 2022, most apparent in Dublin (+290 bps to 12.5%), La Défense, (+250 bps to 16.7%), Budapest (+210 bps to 11.3%), and Amsterdam (+220 bps to 7.8%).

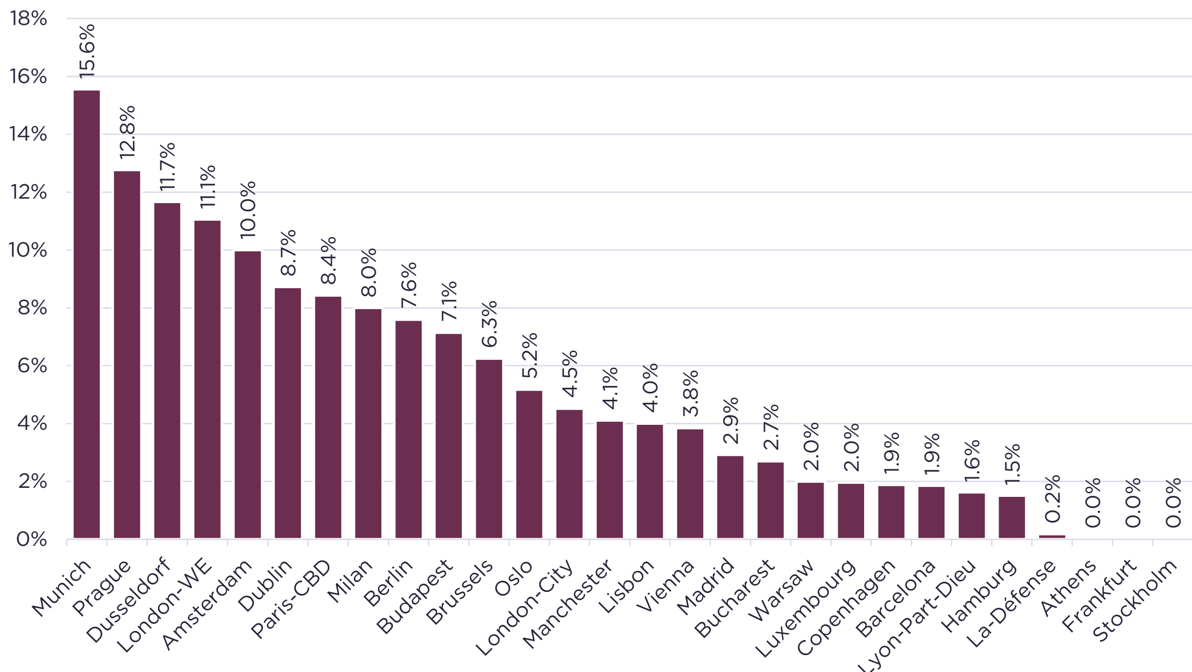
Most of the increase in vacancy rates is reflected in an increase in secondary office stock, or in non-CBD locations following an occupier shift towards best-in-class, CBD located stock. Some of this increase was recorded during the second half of the year, with a number of companies seeking to sub-lease space in order to reduce overall costs.

Core vacancy rates remain very low however, with Paris CBD (2.3%), Cologne (3.0%), Berlin (3.1%) and Stockholm (3.6%) significantly undersupplied, with some prime rental growth likely to be achieved. Development pipelines have also become more modest in many markets, and those occupiers with lease expiries in 2025/26 will begin their occupational searches early, or be forced to regear.

Prime European office rents rose by an average of 5.1% over the past 12 months. Munich (+16%), Prague (+13%), Dusseldorf (+12%), London West End (+11%) and Amsterdam (+10%) prime rents rose at the fastest rate, driven by an undersupply of prime stock and a more limited development pipeline.

Occupier preferences for higher quality, energy efficient space in prime CBD locations, and new regulations on minimum energy performance certificate (EPC) ratings are also supporting rental tone. As a comparison, secondary CBD rents only rose by 3.7% over the same period.

Chart 2: European office rental growth (% YoY)



Source: Savills

Feature: lease incentives

How do lease incentives compare across European office markets?

Following a strong year in office leasing, lease incentives in prime CBD markets stabilised, although with varying trends across the continent.

European office lease incentives remained stable between Q1 2022 and Q4 2022, at 10.3% of total lease value. In 2019 the average rent-free period was 7% of total lease value, indicating that lease incentives are still some way from pre-pandemic levels.

Among many markets, lease incentives fell as vacancy rates stabilised, and a shift to prime locations is taking place. London WE and City lease incentives both fell, reflecting both a shortage of best-in-class supply and a regulatory cliff edge of minimum EPC B by 2030 as ESG remains a key focus for both landlords and tenants. Low vacancy rates in Munich and Paris CBD also reduced lease incentives.

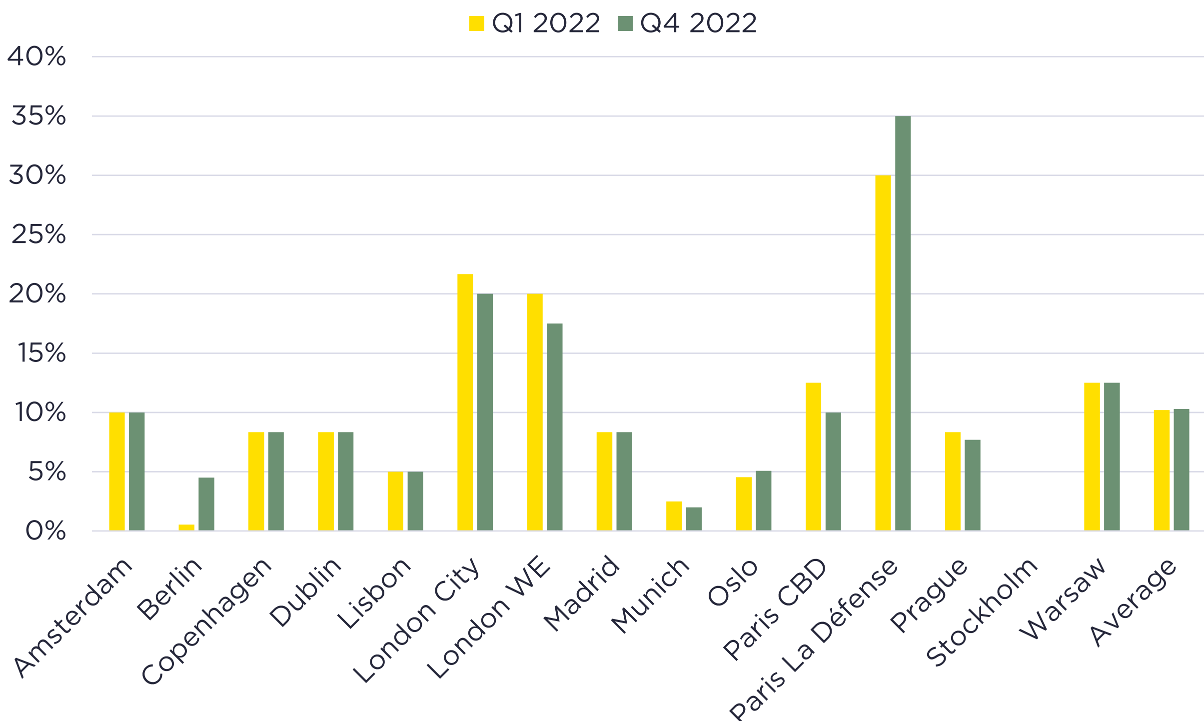
Conversely, Paris La Défense is an interesting outlier, standing out from the European trend as lease incentives increased from 30% to 35% of lease value, reflecting an occupier shift to more mixed-use, well-connected locations, such as Paris CBD. Whilst in Berlin, lease incentives increased from 0.6% to 4.5% of lease value, reflecting a more active development pipeline during 2023/24.

Dublin still maintains a lease incentive of 8%, unchanged from Q1 2022, as vacancy rates rose to 12.5% in Q4 2022. Amsterdam's lease incentives were also stable, at 10% of lease value, whilst in Stockholm, there is now no lease incentive on prime stock for standard three-year leases.

Average conventional lease lengths remain largely in line, although do vary across the board, with three to five year leases more commonplace in mainland Europe and ten-year leases in the UK and Ireland.

Landlords are also offering alternative solutions to incentive tenants looking to sign new leases. According to Savills' latest prime office costs survey, European fitout costs have increased by an average 14% over the last year due to increasing material and labour costs. Occupiers are holding off on committing to fitouts costs. As a result, the level of fitout contribution from landlords is rising in Prague, for example, although local market practices vary depending on whether the fitout is usually paid for by tenant or landlord.

Chart 3: Lease incentives as a percentage of total lease value



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