European Commercial - August 2023

SPOTLIGHT
Savills Research

European Office Outlook

• Economy • Occupational • Business Sectors

Leasing activity slows

Take up falls 15% below the five year H1 average

Economic overview

Headline inflation in the euro area declined from 5.5% to 5.3% in July 2023, the lowest level recorded since January 2022. Though core inflation remained unchanged at 5.5% in July, driven in part by wage growth and a tight labour market.

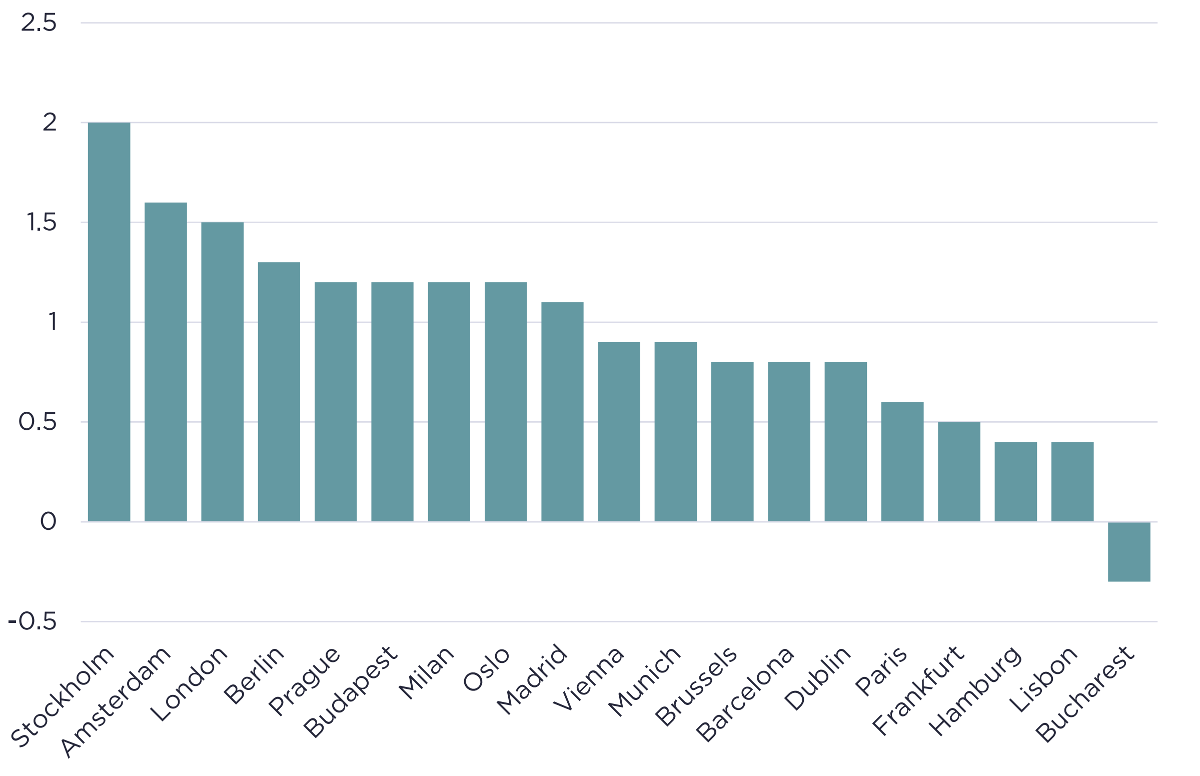
The European Central Bank (ECB) raised the interest rate 25 bps in July 2023 to 3.75% in an effort to keep inflation under control, and Capital Economics forecast that rates will be raised 25 bps further to 4.00% in September. As a result, the euro area is expected to see zero growth in 2023, as it enters a recession in Q3 and Q4 2023. The employment expectations indicator (EEI) has been steadily declining since January 2023 in the euro area, though remains in expansionary territory as companies show signs of "labour hoarding". Consequently, office-based employment is expected to increase by an average of 1% pa over the next five years, with Stockholm (+2.0% pa), Amsterdam (+1.6% pa) and London (+1.5% pa) forecast to see the highest growth.

Take up

European office take-up fell 15% below the five-year H1 average in H1 2023 and is 21% down YoY. The markets reporting the largest increase in take-up in H1 against the previous five-year average were Luxembourg (+137%), Oslo (+22%) and Prague (+13%). In Luxembourg, the large increase in take up is the result of new space delivered to the market that has been occupied. At the other end, Lisbon (-62%), Cologne (-51%) and Dusseldorf (-44%) reported the largest decreases.

The fall in take up can be attributed to both cyclical and structural factors. With increased economic uncertainty, occupiers are firstly concerned with reducing their operational expenditure, before having to resort to any headcount cuts. Businesses are subsequently taking longer to complete leasing transactions as they manage future costs. From a structural perspective, companies are still seeking to optimise their hybrid working strategies and work out what this means for their office footprint. By 2026, Savills estimate the net impact on European office demand will be 10% below the pre pandemic levels.

Chart 1: 2023-27 office based employment growth, (% pa)



Source: Oxford Economics

Chart 2: European office take up (sq m)

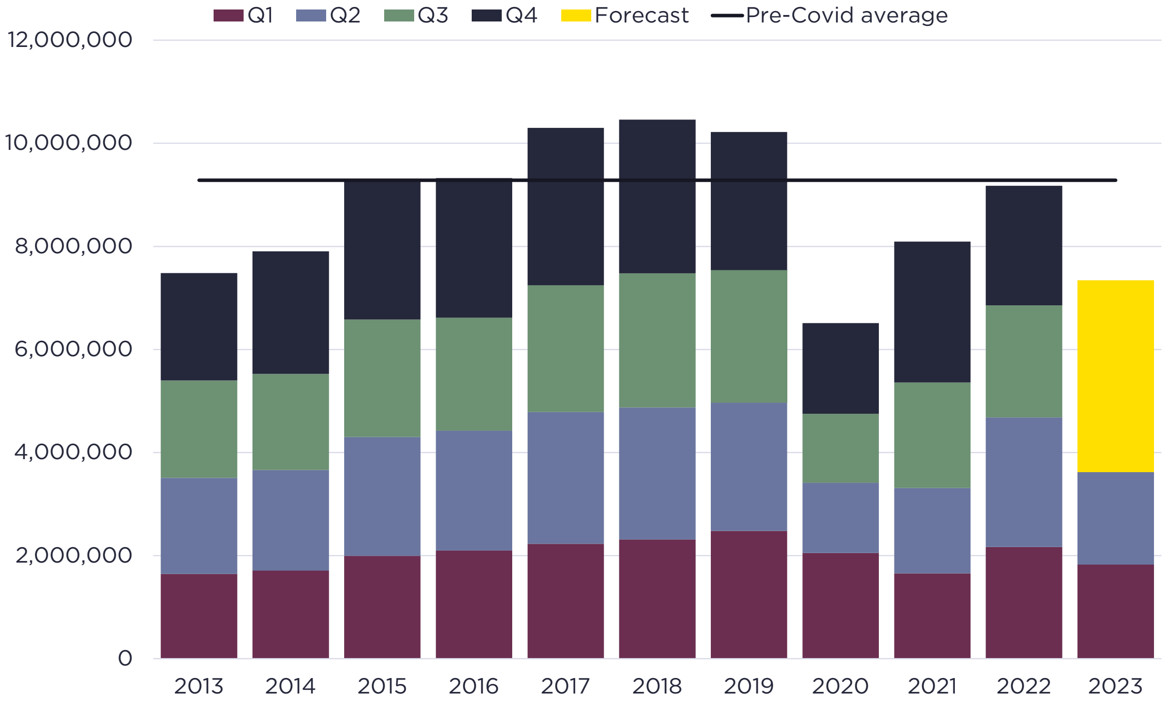
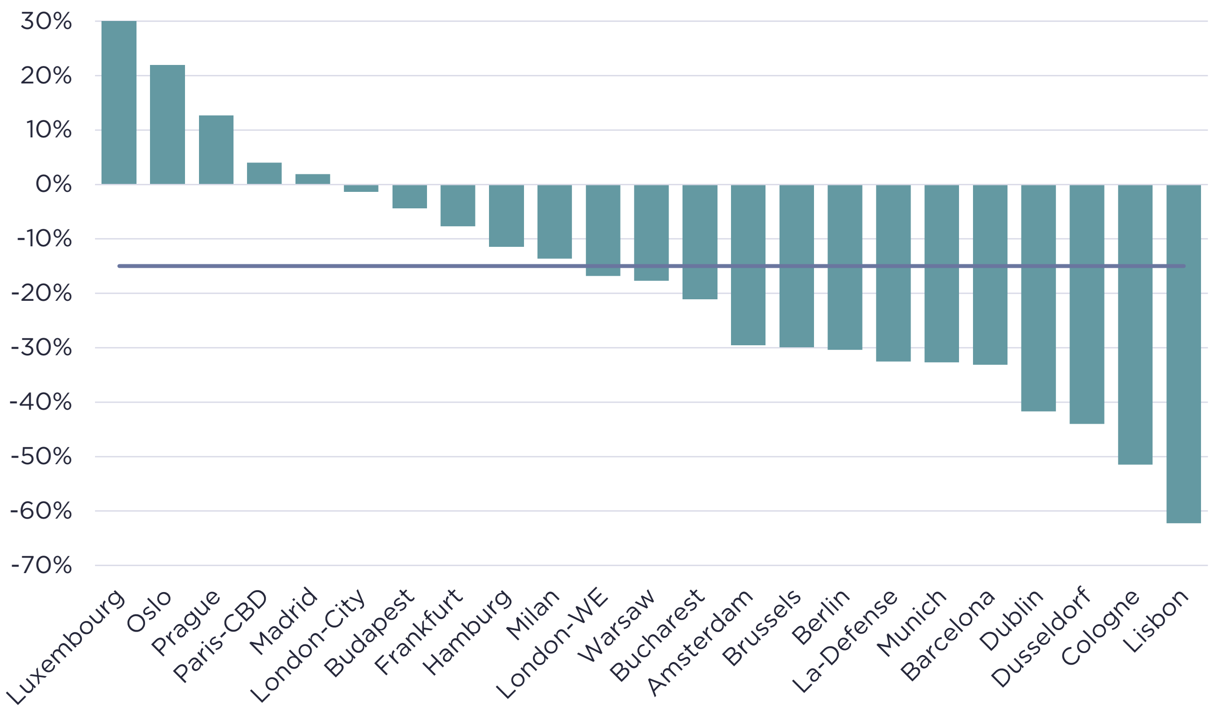


Chart 3: H1 2023 office take up by city vs 5yr average (%)



Source Savills

Feature: business sectors

Professional services support European office demand as tech share drops.

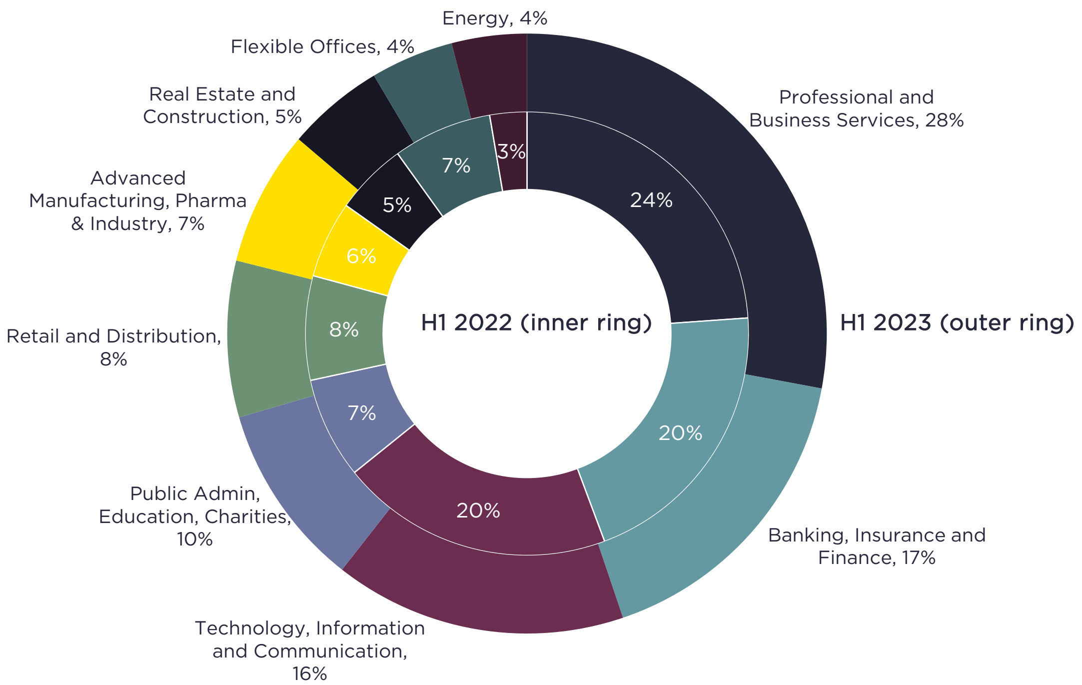
Professional and business services remained the most active sector in H1 2023, taking a 28% share of total take up in Europe, up from 24% during H1 2022. Legal and accountancy firms, for example, are among the most active occupier types given the increased demand for their services during an economic downturn. In London City, law firm Goodwin Proctor signed for 8,300 sqm of space in the city, while in Berlin, professional services firm Boston Consulting Group signed for 19,000 sq m of space in the AP15 building, which will be completed by the end of 2024 and will comprise an in-house fitness studio. At a city level, Madrid and London City have the highest share of professional and business services take up, at 40% and 35% of their total market take up respectively. Given the tight labour market, professional services are clearly using real estate as a way to attract and retain talent in the industry and we expect professional services to be the strongest growth sector over the next 12 months.

The second largest sector, **banking, insurance and finance**, took a 17% share in H1 2023, recording a 4% decrease yoy. Paris CBD reported the highest exposure to banking, insurance and finance firms in Europe, at 30%, reflecting the broader trend of European banks downsizing and relocating away from single-use finance districts to more mixed-use locations, in order to right-size their footprint and retain talent. One of the largest deals signed for in H1 2023 was French private bank Rothschild Martin Maurel, who signed for 21,500 sq m in Paris in Q2 2023.

As a result of recent lay-offs and firms putting space back on the market, the **technology, information and communication** sector saw the largest decrease in share across Europe, declining by four percentage points to 16% of take up between H1 2022 and H1 2023. Markets with a high exposure to the tech sector, for example Lisbon (38%) and Dublin (30%), are reporting some of the largest yoy declines in total take up in H1 2023 (down -77% and -30% respectively). However, tech companies have traditionally grown and contracted their headcount more aggressively than other sectors, given slowing corporate fundraising, resulting in larger fluctuations in take up. Deals in this sector include automotive software firm Cariad SE, who signed for 20,600 sq m in Munich in H1 2023 in the be-blue-be-green building sections of the Parkstadt Office Center, and technology company Bytedance, who signed for 12,500 sq m in London City.

Public admin, education and charities increased their sector share by 3% in H1 2023 to 10% of total take up, as governments and large institutional bodies continued to lease space and maintain their occupational footprint. In Amsterdam, public services accounted for 30% of take up, driven by a renewal by the Dutch Tax Authority who signed for 40,000 sq m.

Chart 4: Take up by business sector (%)



Source: Savills

Prime supply remains scarce

Average European office vacancy rates increase from 7.2% to 8.0% yoy.

Vacancy and rents
Average European office vacancy rates increased by 80 bps from 7.2% to 8.0% over the past twelve months as occupiers held off signing new leases. This is most apparent in Dublin (+400 bps to 14.9%), La Défense (+300 bps to 15.1%) and Budapest (+270 bps to 12.6%).

Vacancy rates remain low in core markets, despite increasing in Berlin (+110 bps to 3.9%) and Cologne (+20 bps to 3.2%), though the development pipeline will affect future vacancy rates as new space is delivered, with cities including Berlin, Bucharest and Barcelona forecast to see the highest proportion of new speculative space enter the market in 2023-2024.

The increase in vacancy rate in La Défense continues to be driven by occupier desire for mixed-use, well-connected locations. This partly explains the decrease in vacancy in Paris-CBD as some banking, insurance and finance firms have started to vacate La Défense.

The increase in vacancy in Dublin can be partly attributed to tech companies returning stock for sublease. In Dublin, the amount of tenant space available for sublet increased by ~200% between Q1 2021 and Q1 2023, highlighting the struggles within the sector.

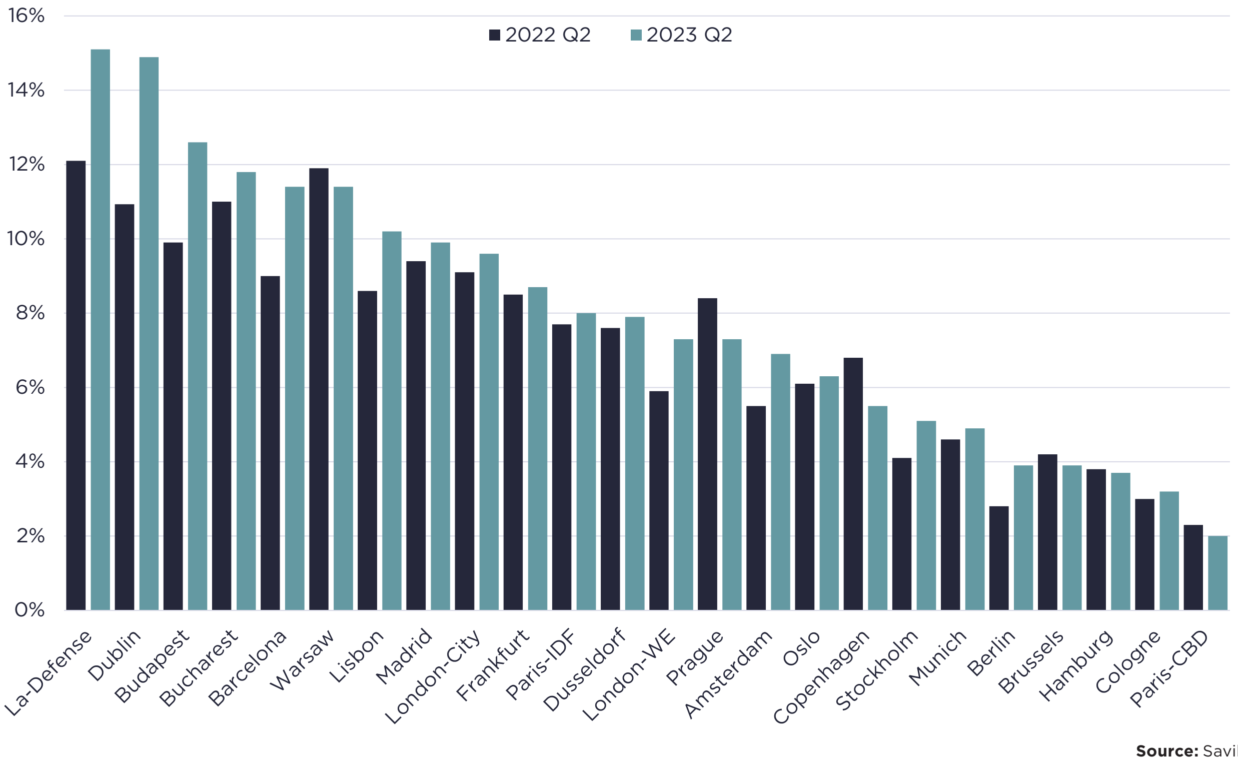
Prime European office rents rose by an average of 5.8% over the past 12 months. Prime rents in Dusseldorf (+27%), Cologne (+24%) and Munich (+17%) rose at the fastest rate, largely due to the demand for high-quality space in central locations.

Rental growth is also the result of increasing headline rents for prime grade A assets that have green accreditations. Prime European Central Business District (CBD) office rents have risen by an average of 7.4% since the pandemic, while secondary CBD rents have risen by only 1.1%. London West End, Amsterdam observe the largest polarisation in prime and secondary rents, supported by EPC regulations in both markets. The CBD in Amsterdam also has some stock from the 1970s-80s which still complies with EPC regulations, but has not seen any large refurbishments, indicating the shortage of prime supply.

Outlook
European firms will be taking steps to mitigate risk and reduce costs over the next 12 months and the following year will continue to be characterised by leasing caution. Nevertheless, a strong labour market and resilient hiring intentions will support underlying demand, especially in the professional and business services sector. Overall, we expect demand to drop off by approximately 15% yoy in 2023 and gradually recover in 2024.

Markets with a well-diversified occupier base will fare the strongest, outperforming traditional financial districts. We expect vacancy rates to increase further during the remainder of the year, but this is mostly going to be reflected in secondary stock following resilient demand for prime offices. As a result, we are forecasting further polarisation in rents between prime and secondary assets.

Chart 5: European office vacancy rates (%)



Source: Savills

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