European Commercial - December 2023

SPOTLIGHT
Savills Research

European Office Outlook

• Occupational • Prime Rents Analysis • 2024 Outlook

Vacancy rates stabilise QoQ

Occupier demand to remain stable in 2024.

Economic overview
Higher interest rates are beginning to have the desired effect on reducing Euro area inflation, which fell to 2.9% in October 2023. Core inflation in the Euro area declined to 4.2% in October, down from 4.5% in September, the lowest level since July 2022. The European Central Bank's (ECB) latest announcement saw interest rates unchanged with the deposit rate held at 4.00% to dampen demand and return inflation to the 2% target. Interest rates are expected to remain stable until H2 2024, with Capital Economics forecasting a 50 bps rate cut by end 2024.

Euro area employer expectations are still positive and remain above the long-term average, reflecting how companies are holding onto staff given previous labour shortages, although overall economic sentiment has significantly weakened since the beginning of the year.

In September 2023, the Euro area unemployment rate rose to 6.5%, up marginally from the record low of 6.4% recorded in August. As the effects of tighter financial conditions take hold, businesses are likely to slow hiring new staff in order to control costs.

Occupational markets
In Q3 2023, European office take-up reached 1.9 million sq m, 11% down on the five-year average, although up 8% QoQ as businesses resume decision making despite higher costs.

European Q1-3 take-up was 15% down on the five year average. The markets reporting the largest increases in take-up in Q1-3 YoY were Amsterdam (+38%), Budapest (+15%) and Brussels (+9%). At the other end, those reporting the largest decreases were Lisbon (-71%), Cologne (-53%) and Dublin (-46%).

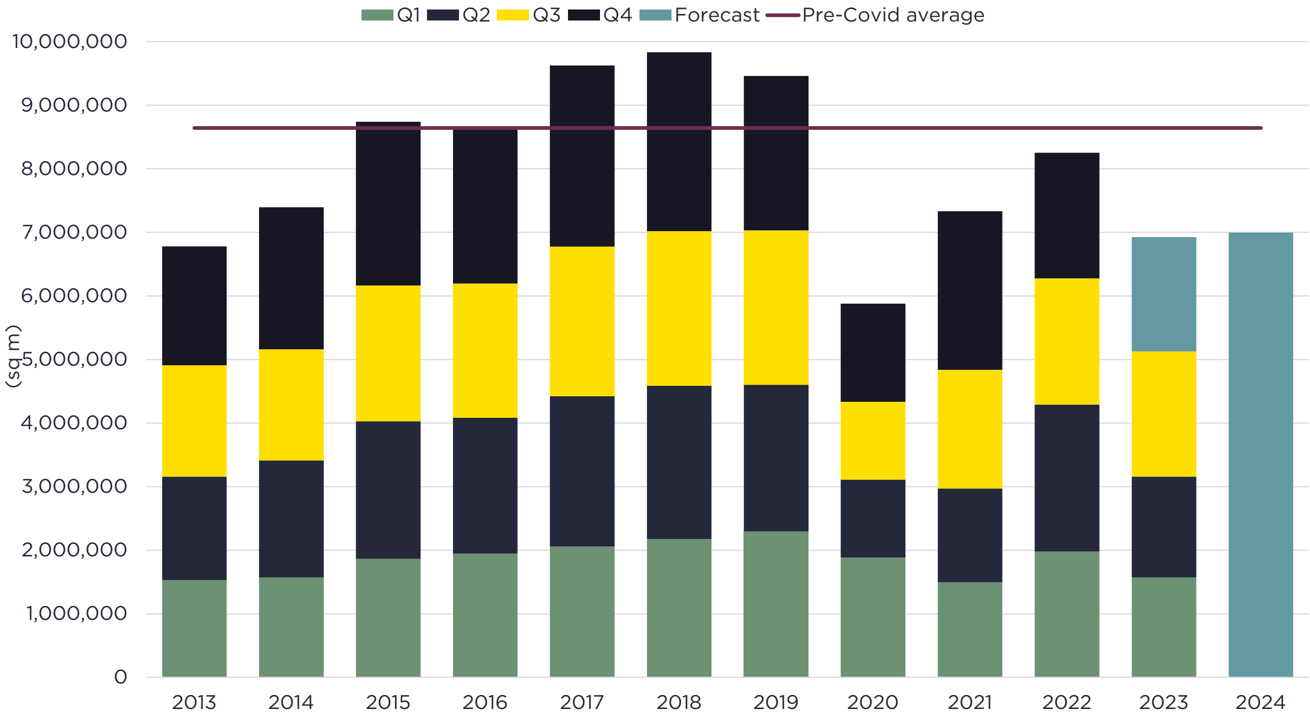
In Amsterdam, new deliveries to the market resulted in an increase in leasing activity. In the Edge Stadium building, which was delivered in Q1, tech company Miro leased 10,500 sqm, whilst in the Pulse of Amsterdam building (which will be delivered in Q1 2024), Boston Consulting Group leased 7,800 sq m.

Savills forecast take-up for full-year 2023 to fall by 18% yoy and remain fairly stable in 2024 as weaker German demand will be balanced out by a modest recovery across other European markets.

European office vacancy rates increased by an average of 60 bps from 7.7% to 8.3% during the past twelve months. This is most apparent in Dublin (+400 bps), La-Défense (+300 bps), Budapest (+200 bps) and Lisbon (+200 bps).

However, the average vacancy rate

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



Source: Savills

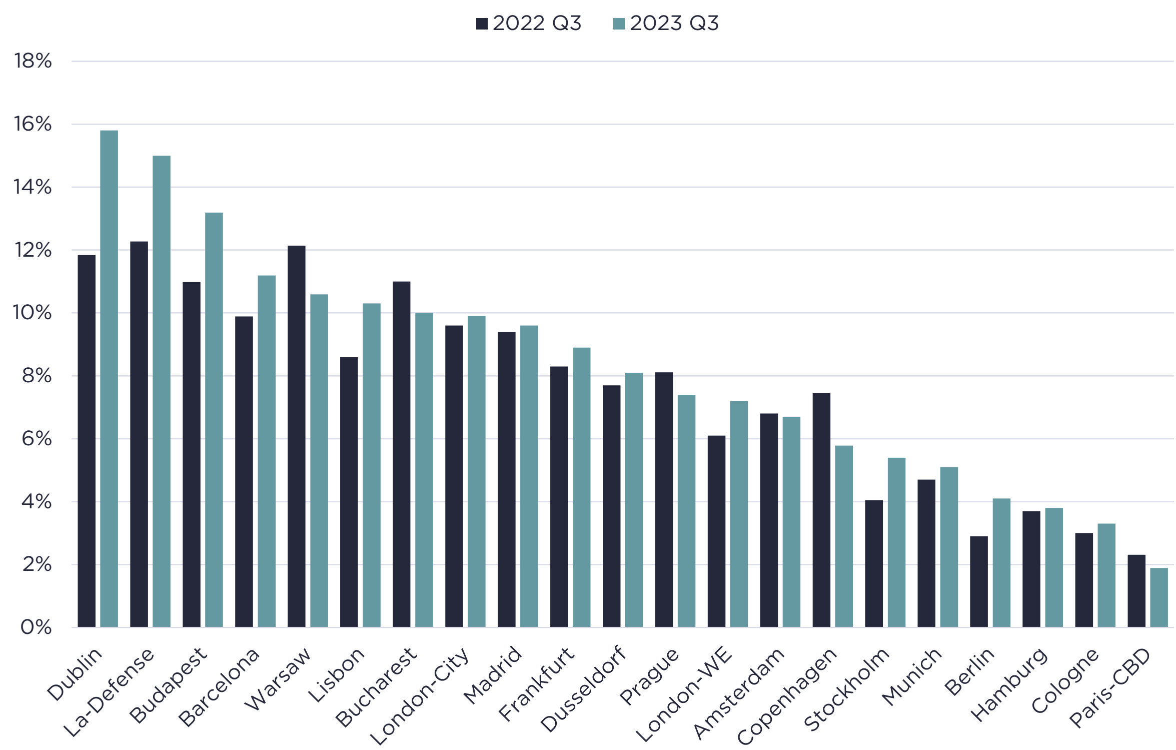
remained stable QoQ, as the vacancy rate fell in five markets in Q3: Copenhagen (-170 bps), Warsaw (-150 bps), Bucharest (-100 bps), Prague (-70 bps) and Paris-CBD (-40 bps).

Vacancy remains low in core markets led by Paris CBD (1.9%), Cologne (3.3%) and Hamburg (3.8%), and with construction delays and many developers unable to secure financing for new schemes, the provision of high quality office space is likely to remain undersupplied.

Prime European office rents rose by an average of 6.3% over the past 12 months. Prime rents in Dusseldorf (+27%), Cologne (+26%) and Munich (+17%) rose at the fastest rate, primarily driven by record rental deals across Germany. Core markets continue to observe the strongest rental increases as occupiers are increasingly looking for quality stock in accessible locations.

Prime space in central locations is becoming increasingly sought after from tenants, supporting CBD office rents. In La-Défense, a 6% increase in rents has been recorded, notably as higher rents in Paris-CBD have forced some occupiers to move back, although incentives remain relatively high.

Chart 2: European office vacancy rates (%)



Source Savills

Feature: prime rents

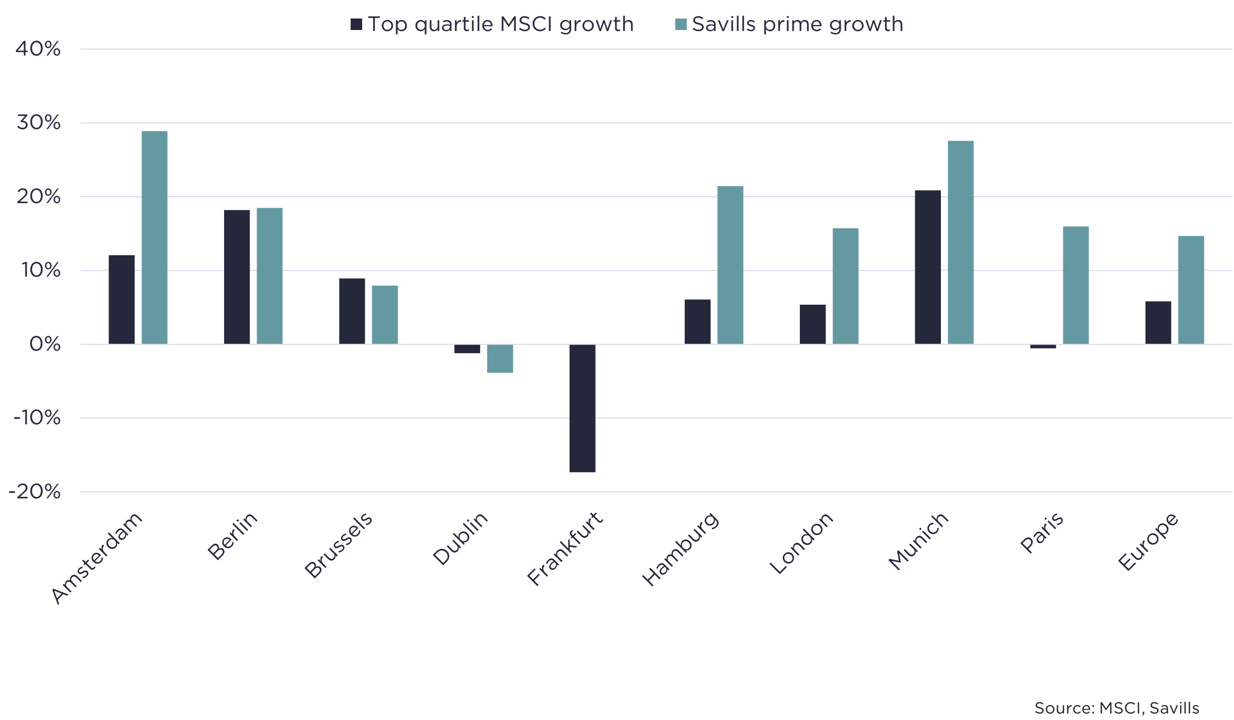
How is the definition of 'prime' changing?

Savills rental growth analysis indicates that Savills prime rents (reflecting highest achievable rents) are outperforming the top quartile of MSCI rents. Comparing 2023 to 2019, the top quartile of MSCI rents have grown by an average of 6%, while Savills average prime rents have grown by an average of 15%. Clearly, the definition of 'prime' is becoming more selective in key European cities as demand intensifies for the very best space.

Paris, Frankfurt and Amsterdam report the largest rental growth differentials between prime and the top quartile, at 17 percentage points. Here, the stronger tenant demand for best-in-class space, coupled with a limited availability is pushing rents up faster for top class assets, while rental growth is happening at a slower pace for the top quartile of rents, reflecting occupiers' flight-to-quality since the pandemic.

In markets where the development pipeline remains scarce, we expect the growth of prime rents to continue at a faster pace as occupiers compete for the best space to appeal to employees and reduce carbon emissions. Rental growth will remain low in markets where office space does not meet corporate and environmental requirements.

Chart 3: Rental growth of MSCI top quartile and Savills prime rents across Europe between 2019 and 2023



Source: MSCI, Savills

Five office themes for 2024

We pick our top five office themes impacting the occupational market.

Occupancy rates- are we reaching the 'new norm'?
Average occupancy levels in Europe increased from 55% in February 2023 to 57% in September 2023, behind the pre-pandemic average of 70%. We expect this to stabilise at around 60% as companies and employees find a balance of remote working that works for them, reflecting occupancy peaks on Tuesday and troughs on Friday throughout the week as many employers want to offer flexible terms to attract and retain staff. Anchor days, where teams have designated days to attend the office may be introduced to help ease high occupancy on certain days where businesses have downsized to adjust for hybrid working.

Demand- who will be taking space?
Savills forecast 2023 office take-up to fall by 18% YoY, with a slight increase of 1% expected in 2024. As economic growth remains weak, demand is expected to remain subdued as occupiers delay corporate decision making and remain in cost-control mode. The weaker economic environment in Germany will drag on overall demand, whilst other Western European markets are anticipating a modest increase in demand. Demand will remain strong for ESG compliant assets as companies seek to reduce their Scope 3 emissions.

Savills latest European business sector analysis showed professional services remained the most active sector, taking a 28% share of total office space. Looking ahead, tenant requirements remain resilient from banking (who are looking to right-size their space and relocate into mixed use districts), and professional who continue to sign for prime offices as a way to attract and retain talent in the industry and will be one of the largest drivers of office demand over the next 12 months.

Vacancy rates to peak in 2024
While vacancy rates rose by an average of 60 bps over the past twelve months, the proportion of vacant offices remained stable QoQ. As the development pipeline is expected to peak in 2023, we expect vacancy rates to stabilise in 2024. Any rise in vacancy rates will be due to the return of older supply coming back to the market which will not meet energy performance requirements with some of these offices that are no longer fit for use repurposed to alternative uses.

Office development starts to ease back
The construction industry has continued to face challenges this year as rising interest rates and more expensive materials has forced many construction companies into liquidation. According to the Financial Times, UK construction companies have ceased trading at the highest rate in a decade as the result of recent economic headwinds.

Rising build costs for high specification improvements required to attract occupiers, coupled with unfavourable yield movements, is making development unviable in many cities. As a result, we can expect projects to be stalled, resulting in a shortage of best-in-class office space. This shortage of stock will therefore have a bearing on the upward trajectory of prime rents.

As markets are increasingly bound by tighter ESG regulations, many landlords will rely on the construction industry to bring assets in line with government mandates. Analysis shows that London WE and Amsterdam, two markets where stricter EPC regulations are in place, have seen the highest differential between prime and secondary CBD office rental growth.

Rental growth- the best versus the rest
The increasing competitiveness for prime stock means many occupiers are willing to pay a higher rental premium, evidenced in the analysis of top quartile versus prime rental growth. We therefore expect rental growth to continue on an upward trajectory for prime offices as new stock delivered to the market remains constrained. We expect lease incentives to increase further for older stock in periphery locations unless they undergo comprehensive refurbishment.

Source: Savills

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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