European Commercial - August 2022

European Office Outlook

• Take-up • Vacancy Rates • Yields

Record inflation to push Europe into recession

Euro area inflation reached 8.9% in July.

The European macroeconomic outlook has weakened as economists' consensus point towards a contraction in economic growth by the end of 2022. Consumer confidence reached as low as -27 in July 2022, below both the global financial crisis and the peak of the pandemic in 2020.

Inflation in the euro area rose further to 8.9% YoY in July 2022, driven by rising energy prices. In July 2022, the European Central Bank (ECB) surprised markets by raising the interest rate by 50 bps to zero in a bid to tackle inflation. High inflation has led to an increase in previously ultra-low interest rates amidst quantitative easing and loose monetary policy, squeezing the yield spread between government bonds and real estate.

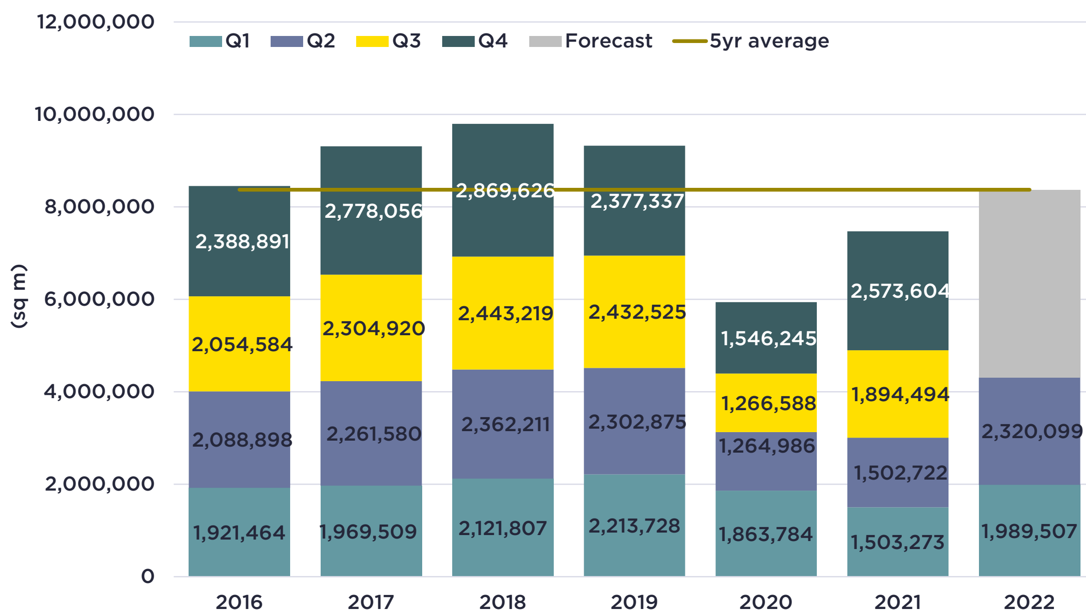
However, the employment market remains buoyant, as the euro area unemployment rate reached a record low of 6.6%. ManPowerGroup latest survey indicates employer hiring intentions remain positive across 20 out of 21 EMEA markets, with Ireland (+42%), Portugal (+37%), Finland (+36%), UK (+35%) and Netherlands (+35%) having the most positive sentiment during Q3 2022, whilst Tech, Sales and Logistics are considered the most in-demand sectors for employers.

The rising cost of materials has been one of the main drivers of construction cost inflation over the last 12 months. Together with higher commodity prices, global supply chain disruptions, higher shipping costs and supply chain shortages, construction costs continue to eat into developer margins.

However, we may now be at a turning point as European markets grapple with signs of a recession. With demand for materials falling as inflationary pressures rise, we have observed a fall in commodity prices. For example, copper prices have fallen to a 19-month low as of July 2022 as indicated by Bloomberg, whilst the European Steel Association (EUROFER) expects steel consumption in Europe to contract by 2% in 2022 as a result of rising energy prices, supply chain disruption and uncertainty around the war in Ukraine.

Europe's construction PMIs have now dipped to 47, below the 50 mark indicating a contraction in future construction activity, driven by price pressures and economic uncertainty. It is likely that construction starts will be delayed until more certainty over input costs arises.

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



Source Savills

Occupier demand is recovering

Professional, technology and banking sectors drive occupier activity.

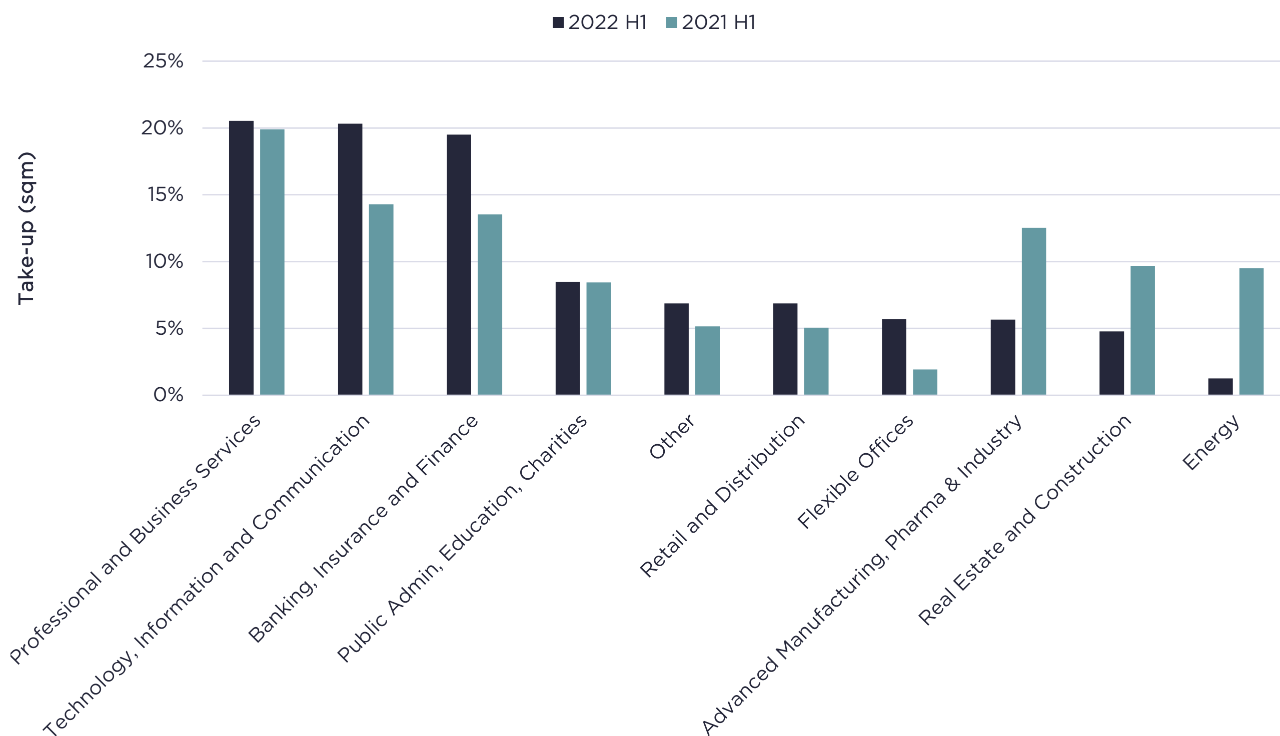
Take up in the European office market continued to recover in H1 2022, reaching 4.3m sq m, 11% above the five-year H1 average (Chart 1). Lisbon (+103%), Cologne (+77%) and Warsaw (+35%) performed the strongest against their respective five-year H1 averages. Despite slowing economic momentum, it is clear that occupiers are still showing an appetite to take more space. Moreover, strong levels of employment across Europe should continue to translate into high levels of activity in the office market.

Professional and business services remained the most active sector in H1 2022, taking a 21% share of total take-up in Europe, in line with H1 2021. This was closely followed by technology, information and communication (20%) and banking, insurance and finance (20%), of which both record a 6% increase in the share of take-up this year. This increase in activity has been driven by the return to the office post-pandemic, coupled with the growth of the traditional tech sector seen across Europe in the first half of the year. Regarding the latter point, this could reveal to be an unsustainable trend given the widespread concerns about the viability of tech start-ups in the current fragile economic environment.

Flexible office space has recorded a four percentage point increase in the share of take-up in the past 12 months, now representing a 6% share in Europe. One such deal in Paris was IWG which signed for 4,296 sq m of space, and similarly in Warsaw, co-working platform Brain Embassy signed for 4,000 sq m of space. Savills latest Landlord Flex Survey finds that flexible office space enquiries were up by 83% from 2019 to 2021, mirroring the sentiment across Europe. Given many occupiers are in search of greater convenience and flexibility as the return to the office is navigated in the short term, the uptake in 'plug and play' offices is no surprise.

Advanced manufacturing, pharma and industry has seen a drop in its share of take-up from 13% to 6% this year, bringing it back to a similar share of take-up that was recorded in 2020 after seeing a noticeable jump in 2021.

Chart 2: Take-up by business sector (%)



Source: Savills

Vacancy rates remain stable

Core markets are observing strong rental increases.

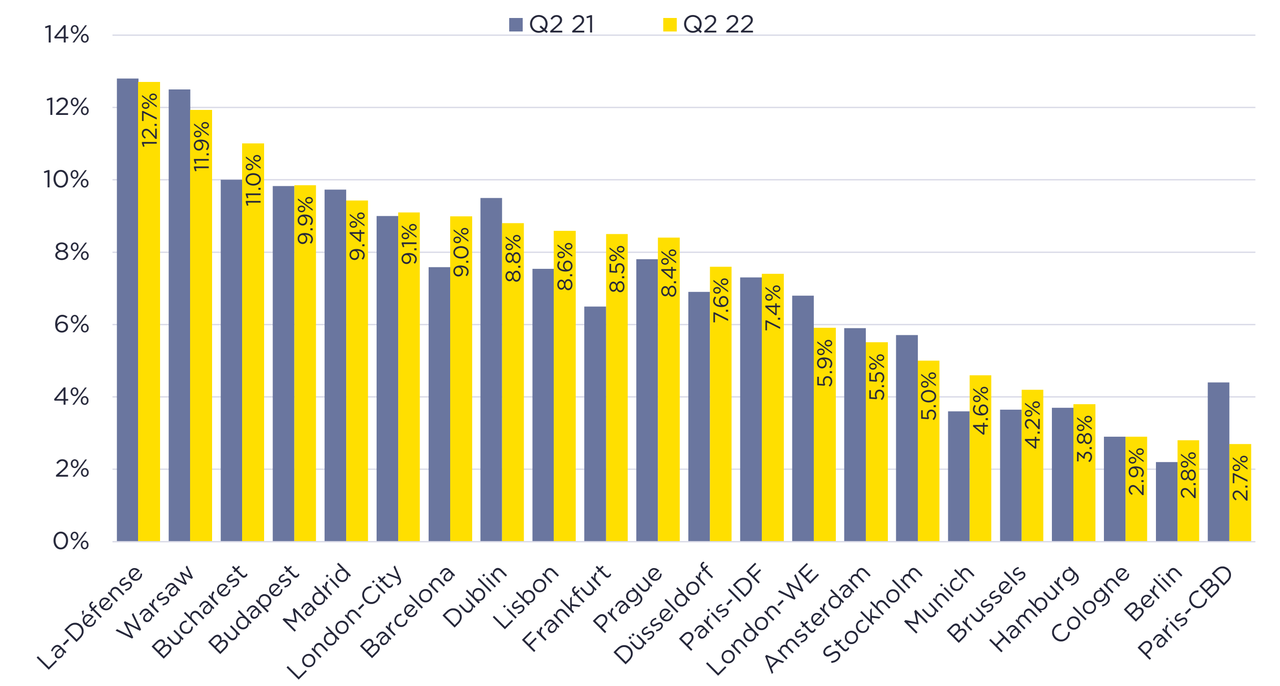
European office vacancy rates have remained at circa 7% over the past 12 months. Those with the highest vacancy rates, La Défense (12.7%), Warsaw (11.9%) and Bucharest (11%), remain unchanged. As the demand for secondary office space diminishes, we expect vacancy rates to rise. Moreover, as ESG restrictions take hold and the economic sentiment weakens, lower-quality office space in secondary locations is at risk of permanent vacancy without redevelopment.

Core markets remain undersupplied, with vacancy rates between the 2% and 5% mark for Paris-CBD, Berlin and Cologne which should continue to support rental growth.

Savills forecasts that 5.7m sq m of new European office stock will complete in 2022, with a further 5.1m sq m scheduled for 2023. In total over the next two years, this marks a 43% increase per annum on the average level of completions over the previous five years. Though, given weaker economic sentiment, it is likely that developers may hold off on new development starts.

Despite the weaker economic outlook, average European prime rents have increased by 4.3% over the past 12 months with core markets observing strong rental increases. German cities recorded strong rental YoY growth, in particular Munich (16%), Cologne (10%) and Düsseldorf (10%), whilst Amsterdam reached 16% growth YoY. Strong rental growth but rising vacancy rates in some locations highlight both how obsolescence risk is rising, and prime office space deals are transacting at higher price points. Rising construction costs will continue to push up the price of prime office space and following the growing supply gap, we expect positive rental growth for the remainder of the year.

Chart 3: European office vacancy rate (%)



Source: Savills

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Investment and outlook

Rising cost of debt adds upward pressure on prime yields.

Previously, there has been a substantial gap between the cost of debt and prime office yields, but that gap is now narrowing as a result of rising rates. This is causing parts of the market to slow down in an expectation of repricing while buyers and sellers recalibrate their expectations in the face of a changing economic landscape.

A multitude of risks have been present in 2022, causing hesitation among investors and thus resulting in lower transaction volumes across Europe; rising interest rates, inflation and the cost of debt are all contributing factors to transactions taking longer to complete. Despite the volume of investment declining in the second quarter of 2022, European office investment reached €43bn during H1 2022, in line with the five-year H1 average. Offices continue to take the largest share of total investment, recording 31% in 2022.

It was not so much the volume of deals contributing to this level of investment but rather deals that closed at higher transaction prices. The number of transactions slowed in July, to the lowest month seen in recent years according to RCA. This is perhaps underpinned by investors being more selective and putting a focus on the quality of product, with a premium placed on prime Grade A offices in sought-after locations.

Ireland has recorded the strongest office investment growth at 71% above the H1 five-year average, followed by Italy (43%). Portugal and the Netherlands have seen the largest decrease, now at 52% below the H1 five-year average. Denmark (-32%) and Hungary (-30%) have also recorded a drop in investment. Core markets UK and Germany are yet to see a drop in investment, 15% and 9% above the five year H1 average respectively.

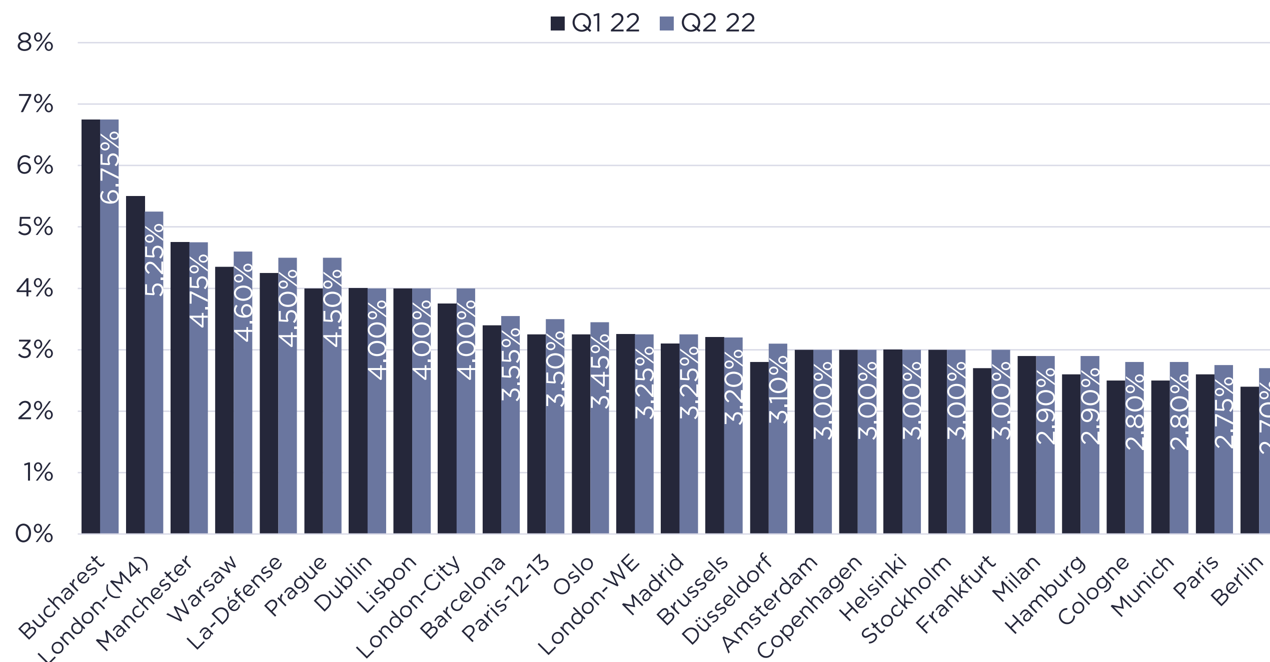
However, the positive H1 headline is perhaps masking the uncertain and deteriorating economic outlook for H2 that many economists are predicting as many of the deals completed in the first half of the year will have started some months earlier. Rising interest rates are driving higher debt costs, in turn pushing yields outwards and stifling investor returns as transaction yields are now frequently below the cost of borrowing.

Prime CBD European office yields moved out by an average of 15 bps to 3.55% during Q2 22. Noticeable outward yield movement can be seen particularly in the German markets, all moving out by 30 bps this quarter, and an average of 17 bps over the past 12 months to 2.88%. The highest movement was recorded in Prague, with outward yield movement of 50 bps during the last quarter.

No inward yield movement has been recorded between Q1 22 and Q2 22, but there has been some inward movement over the past six months for Stockholm (-25 bps), Helsinki (-20 bps) and Milan (-10 bps).

Secondary yields have seen an average 26 bps outward movement during the second quarter, and we anticipate investor demand to weaken over the next six months as debt costs increase quicker.

Chart 4: European prime office yields (%)



Source: Savills

In recent times, investors have reaped the benefits from record low interest rates, attractive yields and a more stable economic environment. Taking into account the current backdrop, a weaker level of activity is expected during the summer as real estate is a slow-moving asset class and there can be a lag in the market before the effects of uncertainty kick in.

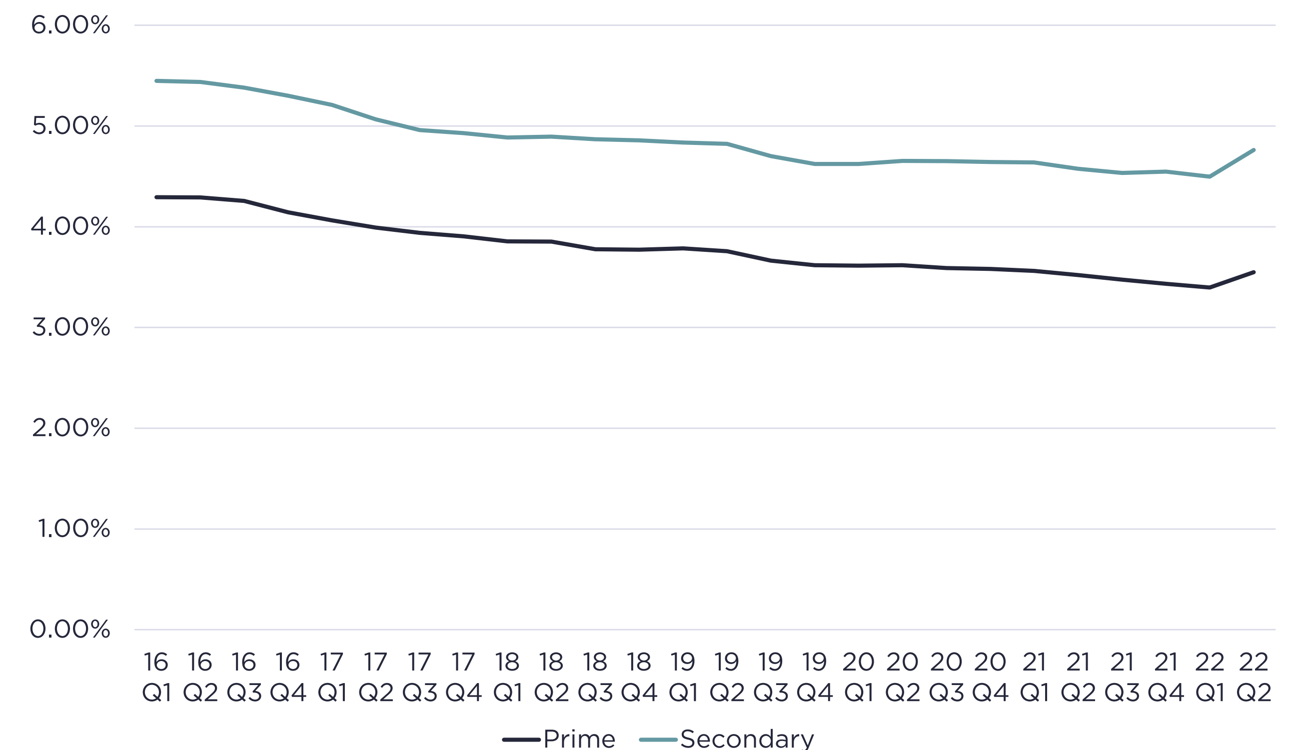
Looking forward, European office yields will depend on a variety of factors:

1) Rising inflation rates - to what extent can landlords pass on rising costs to the tenant in the form of higher rents?

2) The responsiveness of debt costs to rising rates- could this create further refinancing risks in 2023/24?

3) The funding environment - PERE data indicates that dry powder inflows fell by 14% between H1 2021 and H1 2022. However, will multi-asset investors increase their exposure to real estate as an inflationary hedge in the medium term?

Chart 5: Average prime and secondary yields (%)



Source: Savills

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Offices

James Burke
Regional Investment Advisory EMEA
+44 (0) 207 409 8874
JBurke@savills.com

Matthew Fitzgerald
Cross Border Tenant Advisory – EMEA
+44 (0) 207 299 3082
mfitzgerald@savills.com

Research

Mike Barnes
European Commercial Research
+44 (0) 207 075 2864
mike.barnes@savills.com

Georgia Ferris
European Commercial Research
+44 (0) 798 973 3368
georgia.ferris@savills.com

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