European Commercial - Summer 2020

SPOTLIGHT

Savills Research

European Office Outlook

savills

● COVID-19 ● Occupational ● Investment

Emerging from the wreckage

Europe's economic resilience will be dependent on the depths of a second wave.

Few surprises emerge from the Q2 2020 Eurozone GDP growth figures, reflected in a 12.1% qoq fall in output, in line with analysts' expectations. Germany (-10.1%) and Italy (-12.4%) appear the least impacted, whilst France (-13.8%) and Spain (-18.5%) reflect a deeper downturn. The July Eurozone Services PMI reading of 55.1 indicates that the economy has since returned to positive monthly growth, as economies reopen following lockdowns. Attention is now focussed on the likely prospects of a second wave of COVID-19 across Europe and the return of nationwide lockdowns.

July brought good news in that EU leaders struck a deal on a €750bn coronavirus recovery package, split between €390bn in grants and €360bn in low interest loans. The funds will be allocated according to the economic damage caused by the pandemic and therefore more targeted to southern European economies. In order to stimulate demand and avoid a deflationary spiral, the European Central Bank (ECB) maintained its main policy rate at record lows and maintained the size of its emergency quantitative easing programme at €1,350 billion. We have likewise seen government policy introduce temporary tax cuts to boost real incomes, although Eurozone government debt level is expected to increase by 16% of GDP in order to accommodate this.

Savills Research have tracked transit mobility usage using data from Apple, as a short term lead indicator of the speed of return to the workplace across Europe. Chart 1 indicates that at end July 2020, public transport usage in Paris (96%) and Berlin (99%) has recovered to levels in line with pre COVID-19. Sweden's softer lockdown saw a lower nadir of 46% of pre COVID public transport usage in Stockholm, which has recovered gradually to over 75%, whilst in London (64%) and Madrid (57%), workers have been slower to readopt public transport usage. Much of the speed of return to the workplace will depend on government advice on public transport usage and social distancing protocol.

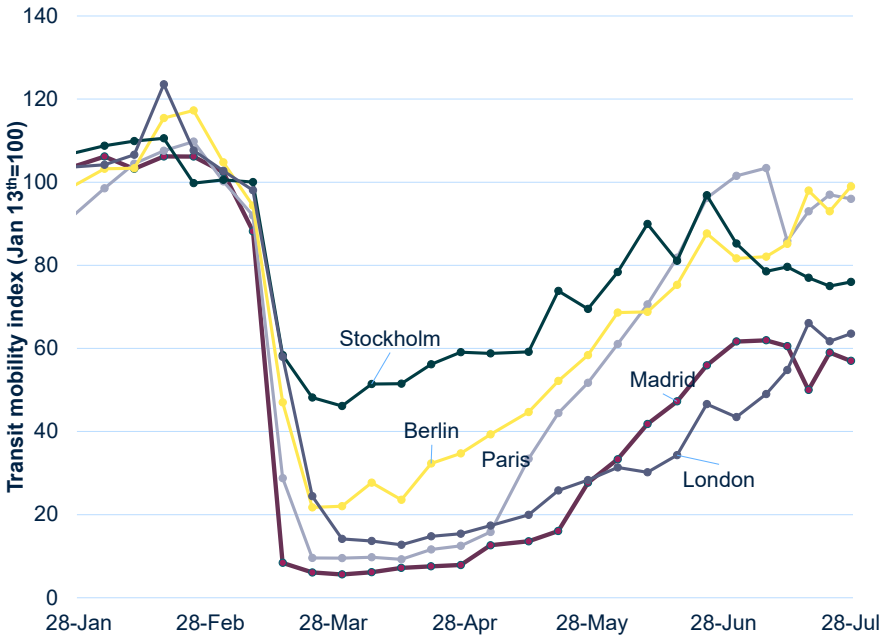
The true health of Europe's economy will however remain a blur until there is more labour market visibility, although Focus Economics indicate GDP growth will fall -8.2% during 2020, above previous months' growth expectations.. The Eurozone's July unemployment rate has increased to 7.8%, although once furlough schemes are gradually removed throughout H2 2020, Capital Economics forecast that the unemployment rate will peak at c10% by the middle of 2021. In Italy's case, a number of unemployed workers have dropped out of the labour force and are now inactive, reducing the number of unemployed workers although we are now observing an increase in the overall rate. Several southern European countries are forecast to see higher levels of unemployment increases due to exposure to the tourism sector and a higher proportion of workers on short term contracts. European office based employment is forecast to rise by 3.1 million over the next five years, reflecting 0.7% growth per annum.

Many questions are still yet to be answered regarding the long term behavioural changes emerging from COVID-19 and how this will affect demand for office space. One thing that we can expect is that the historic relationship between office based employment growth and office demand is likely to change tack as we observe a rise in flexible working post COVID.

Eurozone unemployment is set to reach 10% during 2021.

-8.2% forecast GDP growth for Eurozone during 2020, according to Focus Economics.

Chart 1: European transit mobility index



Source: Apple

Reduced leasing activity

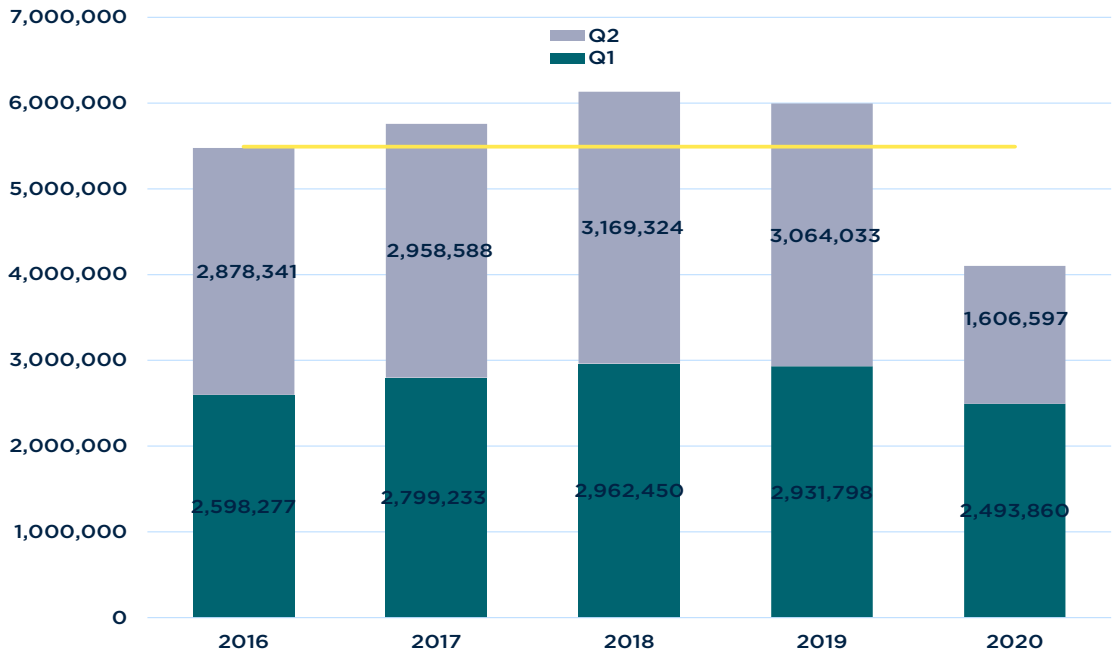
A quarter of limited occupational deals hampered by lockdowns pushed average European vacancy rates up 30 bps during Q2 2020.

European office take up reached 4.1m sq m during H1 2020, down 32% on the first half of 2019 (Chart 2). This was reflected in a 15% yoy fall in Q1 and a 48% yoy fall during Q2 as lockdowns prevented a number of leasing deals from being signed. La Defense (+191% yoy) and Amsterdam (+19%) were the only markets to register an increase, as Paris CBD (-40% yoy), Berlin (-21%), Madrid (-52%) and Warsaw (-17%) all fell. Deals are continuing to take longer to complete as some active requirements are downgraded to potential requirements.

European offices vacancy rates increased by an average of 30bps to 5.8% during Q2 2020, however, vacancy rates remain at historic lows and well below the historic equilibrium of c9%, separating rental growth from decline. More focus will be paid towards the rising level of tenant controlled supply, and how this impacts the "true" vacancy rate. Among the most undersupplied cities remain Berlin (1.2%), Paris CBD (2.0%) and Munich (2.3%) (Chart 3). Speculative development pipelines remain relatively limited and therefore we do not expect any large increases in vacancy rates in core markets.

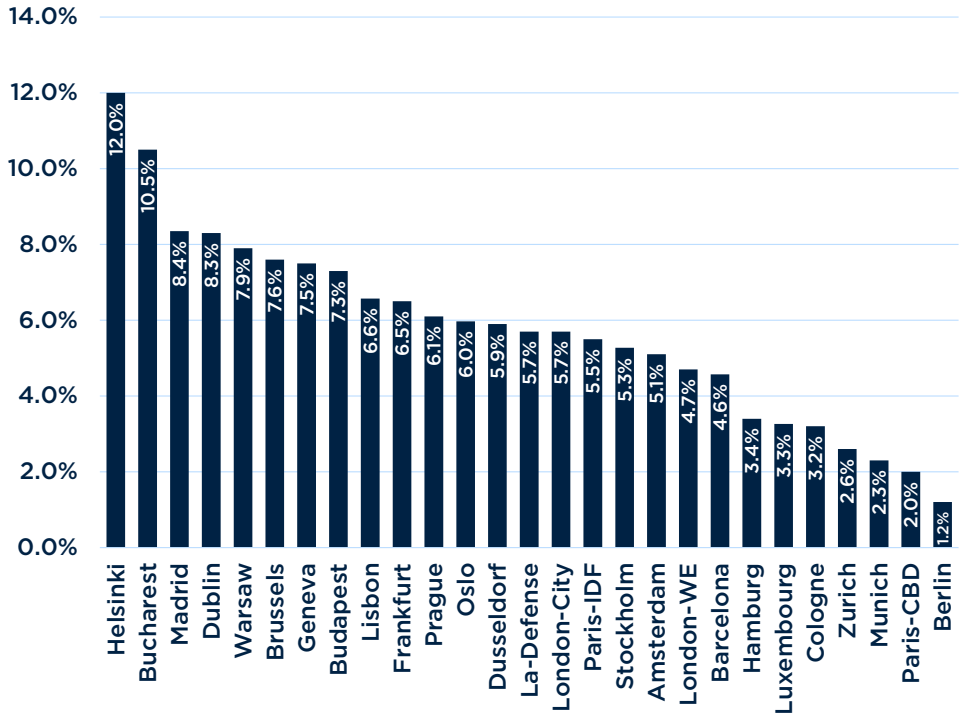
Average European prime rents held firm during the first half of the year, although we have observed rental declines in London West End (-12%) and Geneva (-10%), against growth in headline rents in Paris CBD (+9%), Hamburg (+7%) and Zurich (+6%).

Chart 2: European office take up- H1 (sq m)



Source: Savills Research

Chart 3: European office vacancy rates, Q2 2020 (%)

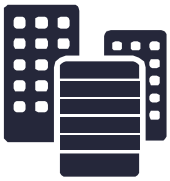


Source Savills Research

Occupier focus

How are Europe's office occupiers responding to COVID-19?

H1 European office leasing volumes fell 32% year on year.



5.8% average European office vacancy rate.

1% fall in lease incentives across Europe over the past 12 months.

€3.2bn of private equity investment into Europe's life sciences sector during as at July 2020.

Cost control has risen to the top of the corporate agenda and companies are acting conservatively in their approach any capex spend. Occupiers are faced with three questions- why do we need an office, what will our business need post COVID and when will rents drop?

Some occupiers are analysing the merits of a "hub and spoke model", which would seem more likely in Europe's largest metropolises of Paris and London, where cross-city transportation takes more time. According to this model companies would downsize in CBDs, but also add a network of smaller offices to access talent and facilitate employee and client needs, although the additional cost burden may prove to be a stumbling point. Flexible office space could facilitate this model, offering a flexible and more cost-effective alternative. Workthere's latest sentiment survey indicates that European flexible office enquiries have increased to 46% of pre COVID levels, compared to 16% in April and 28% in May.

Corporates are strategically reviewing both headcounts and return to workplace strategies over a five year period and these future plans will be impacted by the current uncertainty. We expect the long-term technology based subsectors including fintech and cybersecurity trends to create new office demand.

Some of the multinational tech occupiers have perceived COVID-19 as an opportunity to recruit workers digitally in locations they previously would have had to open an office. However, whilst they are tending to report that productivity has held surprisingly resilient during the lockdown period, creativity levels have waned and initial corporates' remarks surrounding "the end of the office" have since eased down. Virtual meeting platforms including Teams and Zoom has siloed working practices for the younger employees who otherwise would have benefitted from the workplace interaction and Savills Office FiT survey indicates that 89% of respondents expect the office will remain a necessity post COVID.

We expect the life sciences sector to be a source of growth in the aftermath of COVID-19, although these large lot sizes are generally slower moving. As at end July 2020, €3.2bn of private equity has targeted European headquartered life sciences companies, already in line with the previous five year annual average, as Belgium, France, Germany and Switzerland attract increased inward investment. We anticipate the investment into this sector to accelerate driving further lab requirements throughout 2020-21.

Companies with 2021/22 lease events are being forced into regears due to limited alternative options. For companies with leases expiring in 2023/24, companies are actively reviewing when is the right time to strike a deal and are likely to resume activity in September once a price point can be agreed. The direction of rents and level of incentives will be important factors to their strategy.

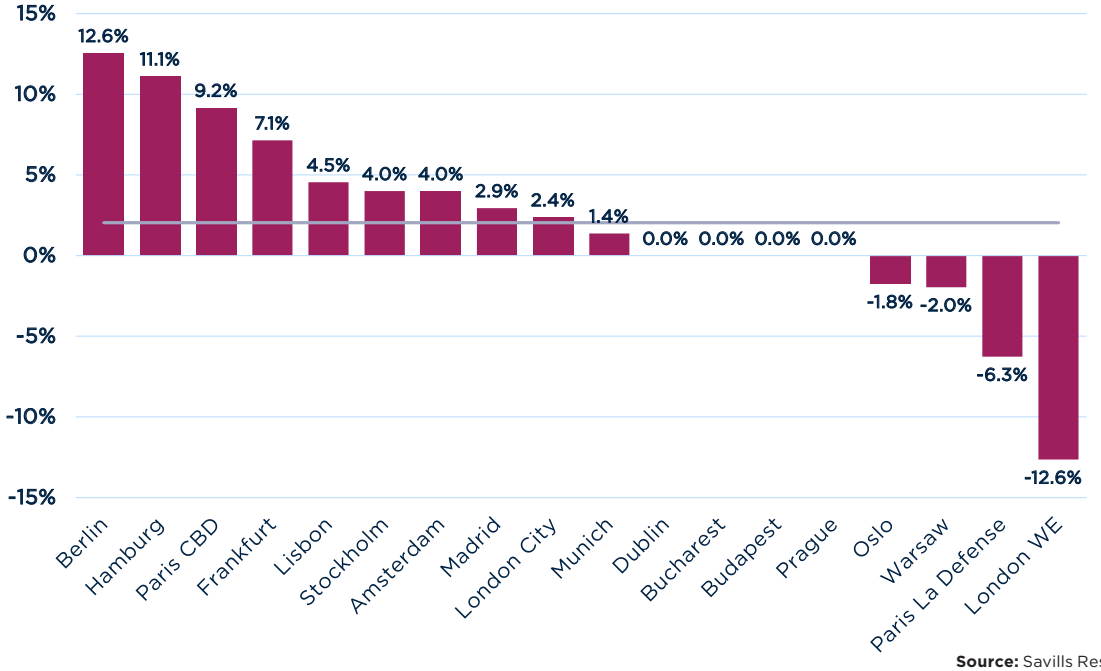
When is the time to strike?

Although rent incentives have traditionally moved out before any movement in headline rents, there appears to be a "stickiness" in rent incentives as at end H1 2020, despite the negative implications of the lockdown on the ability of some tenants to fully meet their leasing obligations. Average European rent free periods currently stand at 9.0% of lease value, increasing marginally from 8.2% at the end of H1 2019. Following the lockdown period, landlords and tenants have been unable to agree on price points- only Amsterdam, London WE, London City and Warsaw have observed any marginal outward movement in incentives over the past 12 months. We anticipate that the weakening economic conditions will lead to further outward movement in incentives.

It is worth noting that lease incentives peaked at 12.8% of lease value during 2009, indicating that incentives have some further room to move out before we can expect any impact on prime headline rents. Savills data indicates that European net effective rents have in fact risen by an average of 2% over the past 12 months (Chart 4), led by Berlin (12.6%), Hamburg (11.1%) and Paris CBD (+9.2%). London WE and La Defense however have observed an increase in rent free periods and decline in headline prime rents.

An undersupply of office space across Europe has continued to apply upward pressure to prime headline rents which have grown by an average of 3% over the 12 months to Q2 2020, despite rent free periods increasing by 1%. However, it should be noted that the majority of this headline rental growth was driven in H2 2019, with rents tending to flatten off during H1 2020.

Chart 4: European office net effective rents Q2 2020 (% change yoy)



Source: Savills Research

Table 1: Office lease incentive levels by city

Market	Office Incentives
London, UK	London WE incentives have increased from 17.5% to 20% over the past 12 months, whilst City rent free periods have increased from 18% to 20%. During 2009, these reached 20% and 30% respectively. We anticipate that rent free periods could rise from 24 months to 26 months rent free by the end of 2020.
Berlin, DE	There are currently no rent free incentives for the low vacancy core German cities including Berlin and Munich, whilst for Frankfurt, this has remained stable at 5% of rent.
Paris, FR	The level of incentive varies from one market sector to another, e.g. 5.8% in Paris CBD vs 29% in La Defense. Due to the shortage of available space in the CBD, a standard lease length has risen from three to six years.
Madrid, ES	There has been no change in Madrid rent free periods which have held stable at one month for each year. Negotiations are ongoing for rental discounts on agreed rents.
Warsaw, PL	We have observed that landlords are willing to spend more on the initial fitout budget to attract tenants to second hand space, and are becoming more flexible with lease incentives for longer lease terms. Incentives have moved out to ten months for a five year lease, but still remain above the 2009 levels, when vacancy rates were significantly lower in Warsaw.
Amsterdam, NL	Rent free periods have increased from 5% to 7.5% from H1 2019 to H1 2020, though these peaked at 20% of rent in 2009.
Dublin, IR	Rent free periods have held firm at six months on a standard five year lease.
Prague, CZ	There has been no change in the lease incentive structure- this may change towards the end of the year but we have only started seeing sublease opportunities on the market which are cheaper than landlord space, so we have yet to see how much flexibility the landlords will show and when.

Source: Savills Research

Investment outlook

Core investors remain split over the impact homeworking will have on office demand.

Despite relatively modest first half yoy falls in office investment volumes, one of the more noticeable trends has been a fall in cross border investment during H1 2020, largely due to a fall from Asian and US investment during travel lockdowns. We see a renewed appetite for European real estate by Korean investors, many of which are now looking to co-invest with European-based asset managers. US capital remained less active during Q2 2020 as French and German retail funds increased cross border activity, however, we expect a return of US investors during H2 2020 as more pricing clarity emerges and there is a return to relative value.

The majority of European office yields ultimately held firm during H1 2020. Only Warsaw (+25 bps), Prague (+20 bps), Manchester (+25 bps), Helsinki (+5 bps) and Amsterdam (+5bps) observed any outward movement, whilst Oslo office compressed by 5 bps (Chart 5).

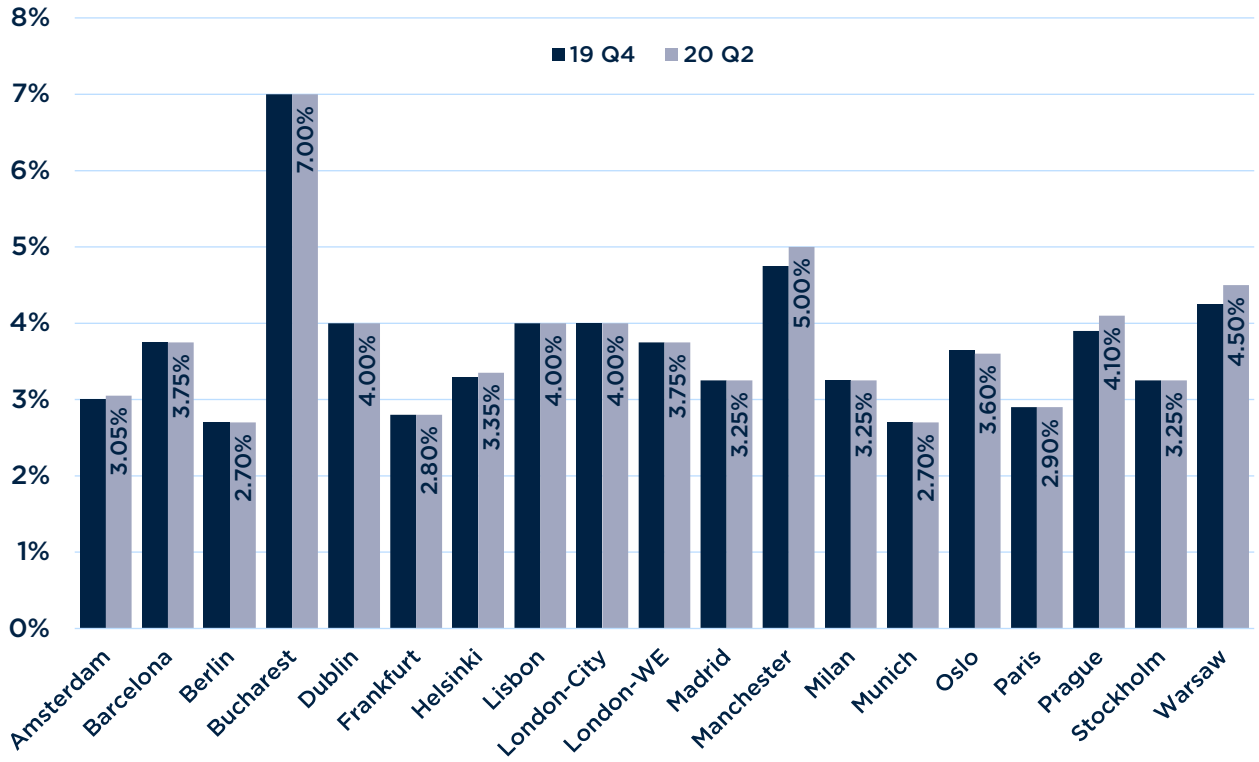
The lull in investment activity is likely to continue through the summer period as landlords take stock, with many waiting until September to launch portfolios which we expect to be reflected in recovering investment transaction volumes towards Q4 2020 and Q1 2021.

There remains a split in sentiment towards homeworking among core investors- some remain cautious over homeworking and are paying close attention to the speed of return to work, although many are seeing this as a buying opportunity at a discount, as the weight of capital is less aggressive than during pre COVID. The perceived lack of availability of debt has reduced the buyer intensity, however most vendors are in no rush to trade up and redeploy capital in an already undersupplied market.

Since the COVID-19 outbreak, we have observed an average c5% price differential on prime offices, with fewer transactions occurring on assets in non-core markets. However, long-leased income to stable covenants has avoided any pricing discounts.

Multi asset managers will continue to see European offices as an attractive income generator despite the muted prospects of rental growth over the next 12 months. The yield spread between Paris CBD offices and French ten year government bonds has reached 310 bps, the highest level on record and almost double the historic average of 163 bps. Similarly, the Big 7 German office-sovereign bond yield spread currently stands at 340bps, maintaining the attraction of CBD offices against alternative assets classes.

Chart 5: European Prime Office Yields, Q2 2020 (%)



Source Savills Research

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.

Offices

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

Investment

Tris Larder
RIA EMEA
+44 (0) 207 409 8014
tjlarder@savills.com

Research

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