European Commercial - Spring 2022

SPOTLIGHT

Savills Research

European Office Development

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● Economy ● Occupational ● Investment

Economic overview

Inflation and construction costs

Record Eurozone inflation continues to surprise investors on the upside into the second quarter of 2022. The March 2022 Eurozone inflation reading reached 7.5%, ahead of consensus projections and now ahead of the UK, despite previous expectations that the Eurozone would be more sheltered to higher prices rises, due to less responsive consumer demand and spare capacity remaining in the employment markets.

Of course, the main contributor to higher inflation in the Eurozone has been the rising energy prices. The EU has announced plans to reduce Russian energy use following the war in Ukraine- of course, the process of replacing Russian oil will be relatively easier than substituting Russian natural gas. However, logistical challenges will still need to be overcome, and rerouting global energy supplies will take time. This is one of the main reasons why oil and natural gas prices are expected to remain historically high for much of 2022-23.

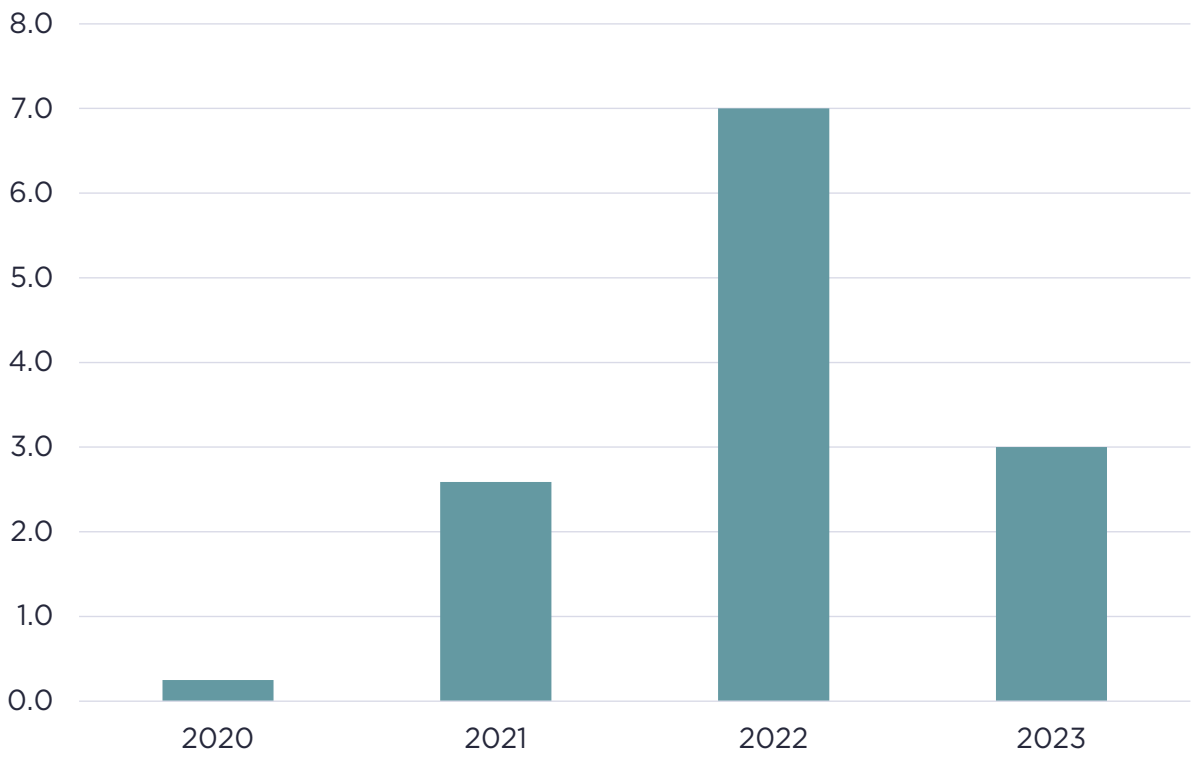
European steel prices (HRC) continue to surge, adding pressure on developer margins, which rose to €1,400/tonne in March 2022, up from €460/tonne in 2020. Surging energy prices and raw materials have forced mills to cut output, although economists expect steel prices will correct lower in H2 2022. Not only are prices increasing, but sourcing materials is becoming increasingly difficult, pushing out project timeframes. Ultimately, developers are finding it difficult to agree fixed input costs for new schemes.

A further factor adding pressure to construction costs is the shortage of available labour. In the UK, there are currently 50,000 job vacancies in the construction sector, according to the ONS, doubling since prior to the pandemic. Similarly, in the eurozone, the total job vacancy rate has reached a record 2.8% from the latest reading as developers are forced to pay higher wages to contractors.

Higher inflation is ultimately applying more pressure on the ECB to raise interest rates. Capital Economics anticipates this will average 7% in 2022 and now expect a total of three interest rate rises in the second half of 2022.

Expectations of rising interest rates have increased 10 year German bund yields to 0.8% in April 2022 (an increase of 120 bps yoy), which has subsequently

Chart 1: Eurozone inflation forecasts (% pa)



Source: Capital Economics

increased debt costs across the real estate lending community, especially on new development.

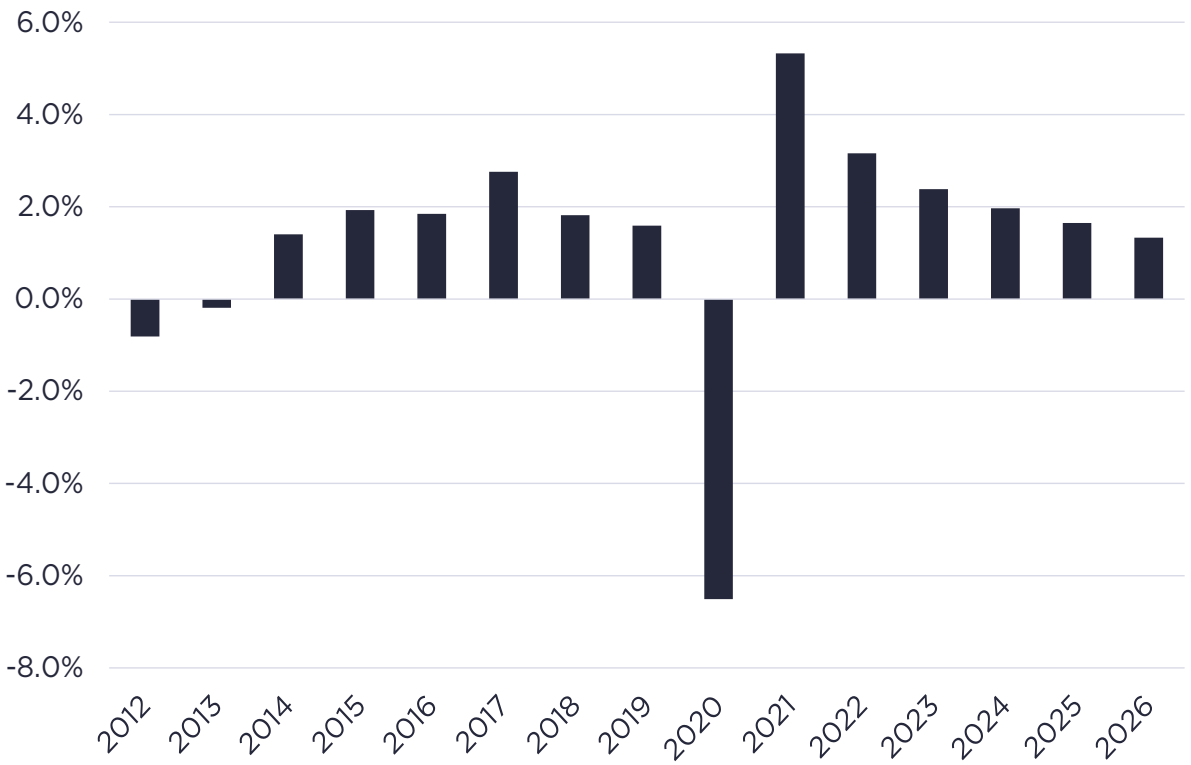
Is Europe heading for a recession?

Business and consumer sentiment is providing a mixed picture over the future economic outlook. The latest Eurozone Composite PMI data reached 54.5, continuing to indicate future economic growth across European markets. However, the impact of rising inflation has impacted business and consumer confidence, which is likely to dampen consumer spending and investment in the short to medium term. For example, the Eurozone Sentix investor confidence indicator reached -18 in April 2022, the lowest since July 2020, whilst Eurozone consumer confidence is now well below the historic average. Given the Eurozone savings ratio has now eased back in line with the level pre pandemic, any interest rate rise is more likely to dampen a consumer bounceback.

Some economic commentators have pointed to the inversion of the US Treasury yield curve (indicating that long term debt is cheaper than short term debt), which has previously resulted in recessions. Should Europe's Russian energy sanctions increase, this is likely to have a negative impact on the economic growth prospects for many of Europe's economies with a higher exposure to the manufacturing sector, including Germany and Central Eastern Europe.

This being said, post pandemic economic momentum still remains favourable, and the Focus Economics consensus forecasts 3.2% GDP growth in 2022 and 2.4% in 2023 for the Eurozone, although we anticipate consensus forecasts will be downgraded in the coming weeks.

Chart 2: Eurozone GDP growth forecasts (% pa)



Source: Focus Economics

Office development pipeline

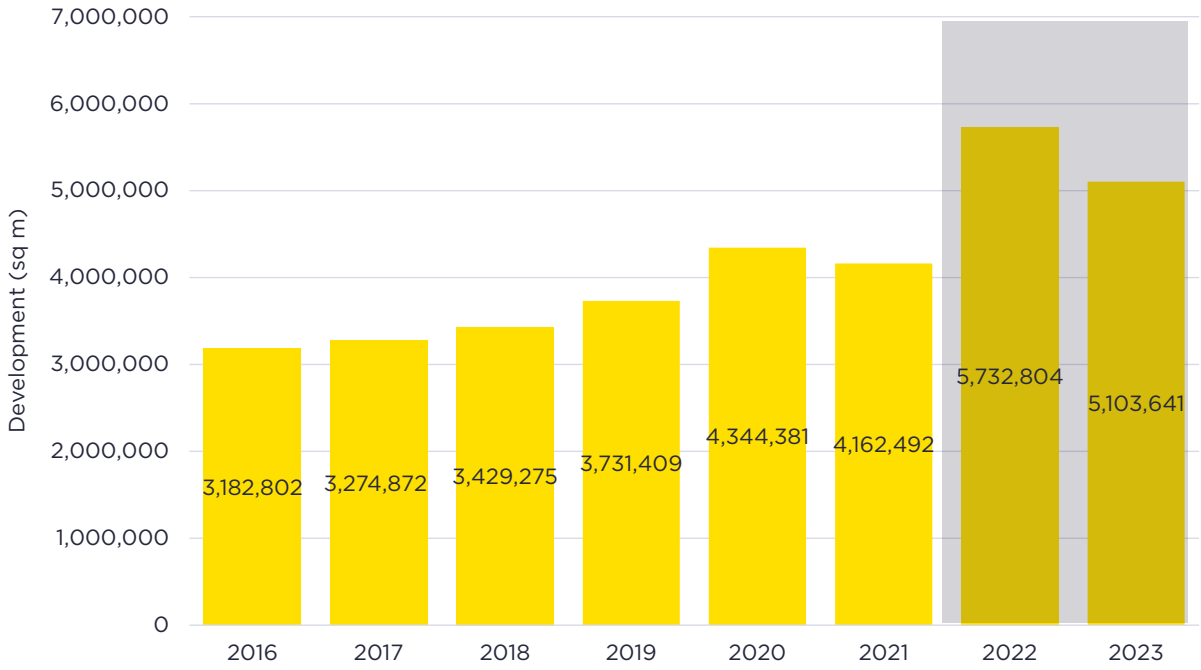
Europe's office development pipelines remain buoyant, amid stabilising office supply and occupier demand resuming following the pandemic. However, rising construction costs and shortages of materials and labour are adding pressure to supply chains and delaying office completions.

In Q2 2021, Savills anticipated a total of 5.2m sq m of new European office stock would complete during 2021, however only 3.8m sq m was delivered, with rising numbers of project timeframes pushed out until 2022/23.

We now anticipate over 5.7m sq m of space will be completed in 2022 (of which 49% is currently prelet), with a further 5.1m sq m of space scheduled for 2023 (of which 23% is prelet). 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.

Looking at a more granular basis, Berlin (1.8m sq m) and Munich (1.0m sq m) have the highest development pipelines by end 2023, in terms of quantum of space. However, Barcelona (8.3%), Dublin (7.7%), Budapest (7.3%) and Berlin (5.6%) are seeing the highest proportions of speculative development as a proportion of existing stock by end 2023.

Chart 3: European office development pipeline (sq m)



Source Savills Research

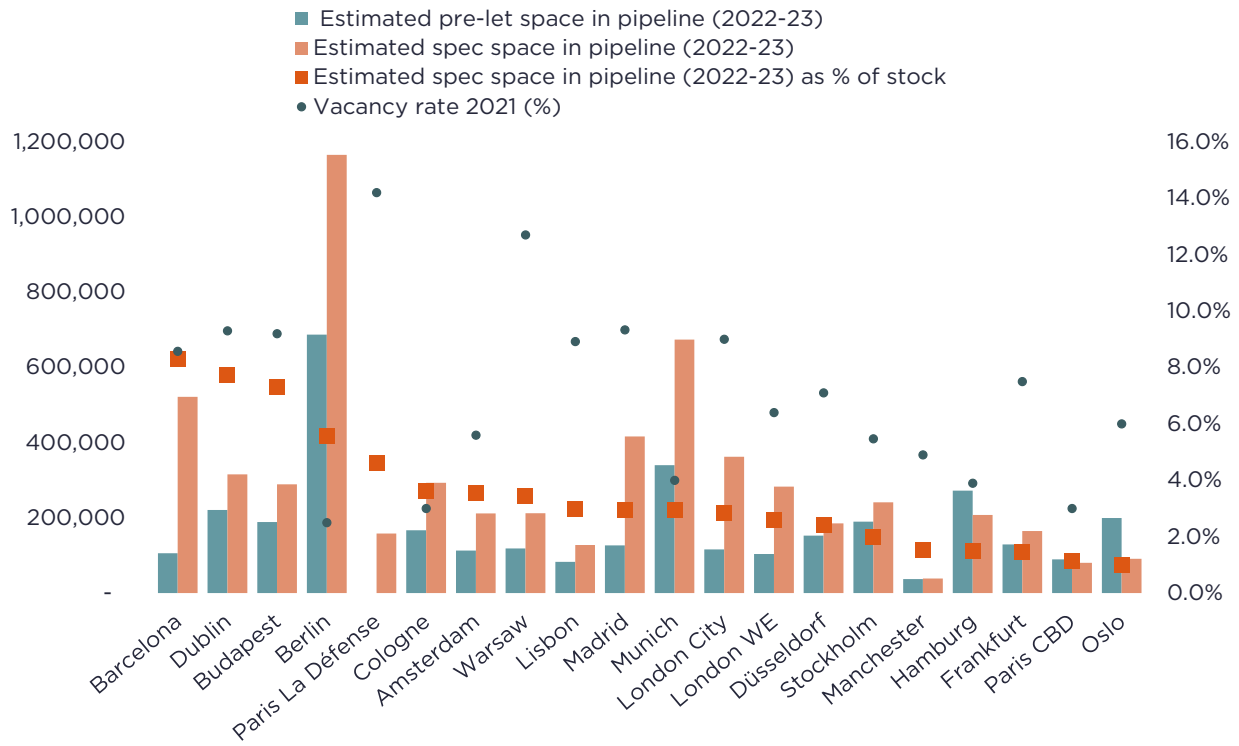
What is the likely impact on rents ?

Although the development pipeline is as large as we have observed in recent years, occupiers' appetite for new, energy efficient space continues to grow in order to meet self-imposed 2030 carbon emissions targets, so we anticipate more of the new schemes will be let before completion. Overall, we anticipate European take up to rise to circa 9m sq m in 2022 and maintain pace in 2023, in line with the previous five year average, as occupiers regain confidence and resume decision making post pandemic. Rising energy prices will further accelerate the demand for more energy efficient office buildings.

What is possible is a slight rise in vacancy rates, although this will be largely accounted for by a rise in the level of secondary office stock as the availability of higher quality stock remains scarce. Our latest data indicates that the overall vacancy rate appears to be stabilising at 7.2%, which Savills classifies as a 'landlord market'. Given the rising costs of construction are supporting rental tone for standing stock, we anticipate landlords will be able to achieve rental uplift on lease renewals for Grade A space. This is particularly the case for the markets where fitouts are usually paid for by the landlord, such as in the Nordics.

The next big question comes with what happens to secondary stock amid obsolescence risk and how much landlords are willing to invest to ensure their buildings are still lettable. Savills estimates the average cost of raising an office's EPC rating from Grade D to Grade B stands at circa €500 per sq m. As a result, we anticipate the gap between prime and secondary rents to increase, creating new opportunities for developers to asset-manage older assets to achieve rental uplift.

Chart 4: Speculative and pre-let development pipelines as a % of total (sq m)



Source Savills Research

Developer acquisitions

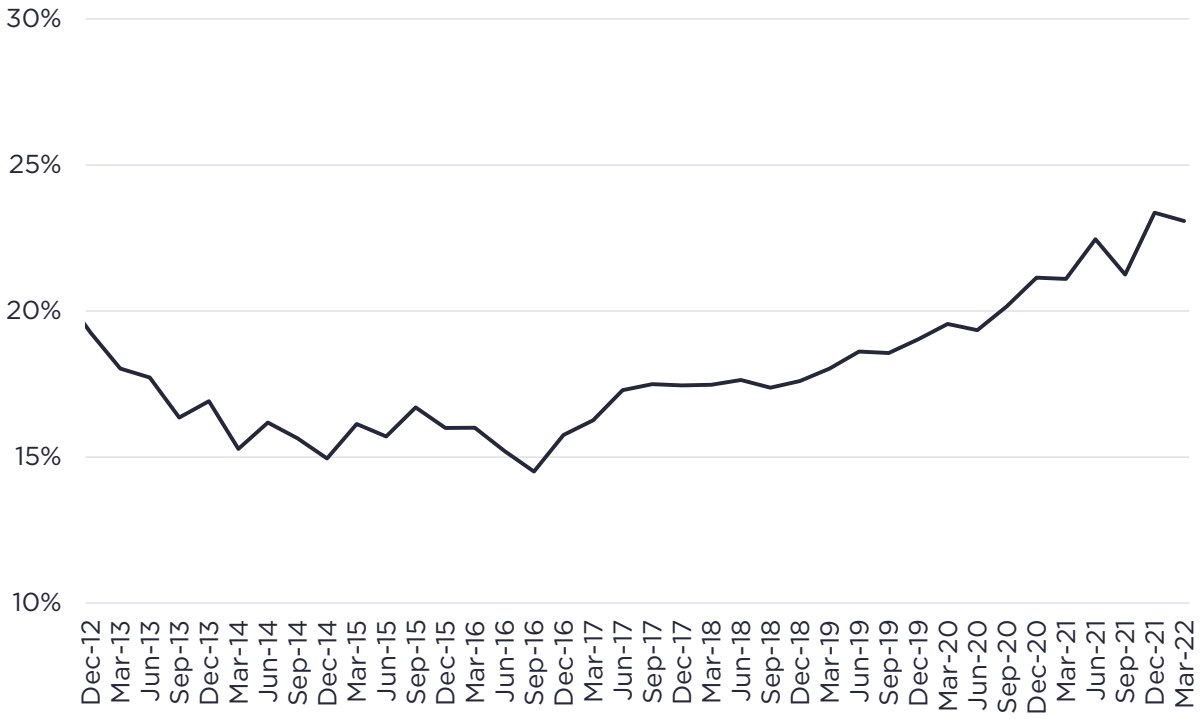
How much are developers investing across Europe?

Given squeezed income yields across core European office markets, the proportion of investment transactions of prime standing stock is falling and developers are now accounting for a larger share of investment transactions. Over the last six months, developers have accounted for 23% of total office investment, up from 19% prior to pandemic according to RCA, as institutional investors hold onto core assets, and developers seek opportunities to turn secondary assets into prime. More landlords are now willing to partner with developers in order to meet their returns targets.

Increasing risk of office stock obsolescence is now creating an opportunity for active asset management of older stock which we expect to gather momentum in the coming years. In our last European office spotlight, we examined how the yield gap between BREEAM certified and total offices had increased by 44 bps over the previous 12 months.

We anticipate development activity will gain further ground once input cost inflation stabilises and developers are able to lock in their input costs. Likewise, as the costs of financing rises, cash on cash returns will fall, encouraging investors to move up the risk curve. Further office completions delays are likely to be on the cards for 2022 as sourcing materials and labour remains a challenge.

Chart 5: Developer share of total office investment (%)



Source: RCA

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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