SPOTLIGHT

Savills Research

European Commercial - August 2021

European Office Outlook

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● Economy ● Occupier ● Investment

Economic recovery

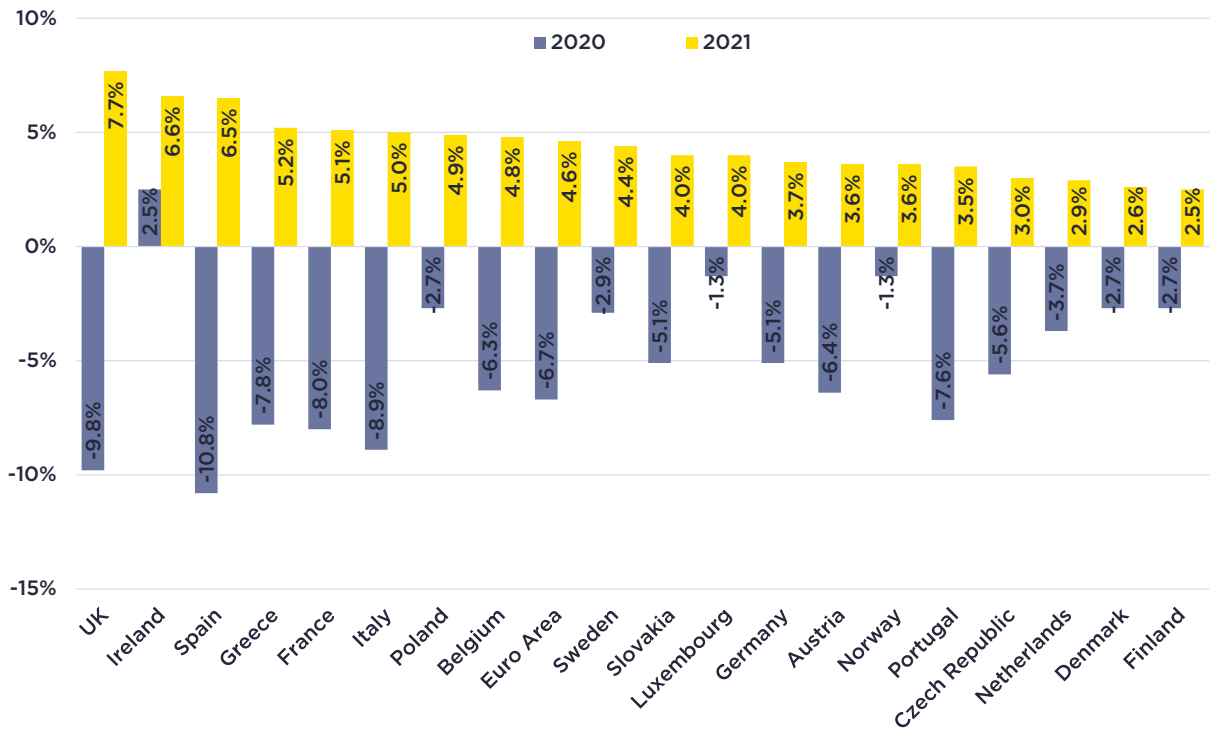
Europe's economies will take until 2022 to fully recover

Economic overview
Europe's economies continue to show a positive recovery, with improving GDP growth forecasts, albeit the Delta variant will continue to pose headwinds to the positive momentum. Overall, the euro area is forecast to see 4.6% growth in 2021, up from -6.7% in 2020. Much of southern Europe will be recovering economic losses in the remainder of the year as international tourism shortfalls continue to drag on domestic economies. Looking forward, service sector PMIs across the eurozone indicate the highest level for 21 years, suggesting resilient economic growth figures to come in the third quarter.

The European Central Bank's forward guidance on interest rates in the July meeting indicates that rates will stay at their present or lower levels until inflation reaches two percent "well ahead of its forecast horizon," suggesting that any near-term interest rate rise is unlikely. Despite that, German bond yields rose to -0.2% during Q2 2021; they have since fallen back to -0.4%, increasing the yield spread against prime CBD offices.

Eurozone unemployment remains supported by furlough schemes, and sits at 7.7% in June 2021. across the majority of European markets, which has risen by 120 bps since end-2019.

Chart 1: European GDP growth forecasts (% per annum)



Source: Oxford Economics

Construction costs

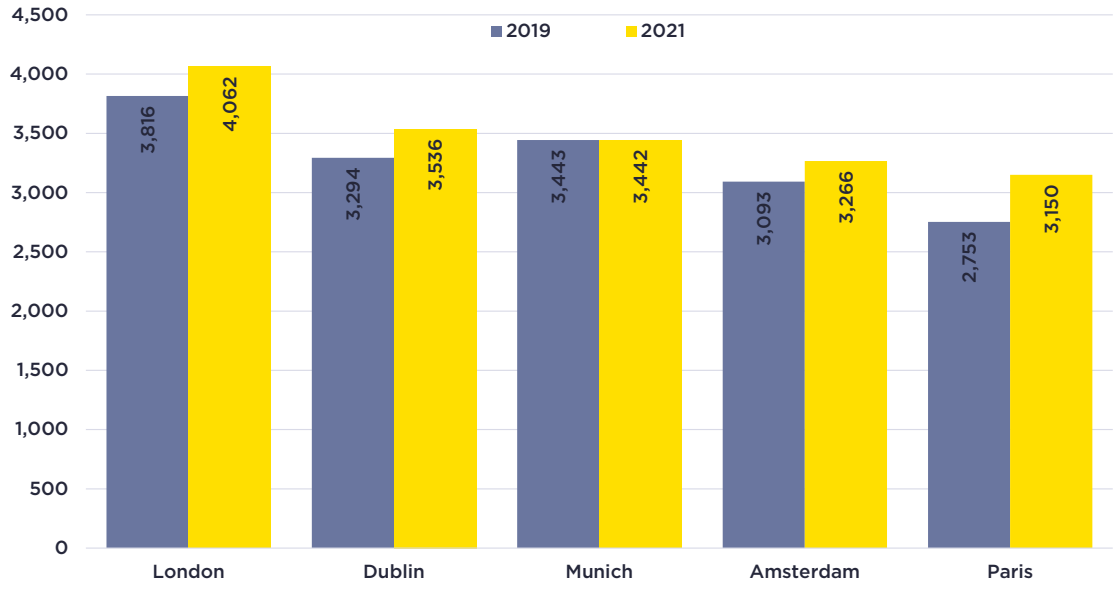
Rising input costs are generating higher rents

Construction cost inflation has come to the forefront for commercial landlords and developers. A shortage of labour, materials and shipping delays are increasing cost pressures across the continent, with Turner & Townsend's latest report factoring a 6.8% increase on average for selected European cities over the past two years. Respondents also claimed that red tape, bureaucracy and delayed approvals had a significant impact on the delivery of construction projects. Once the full effects of the pandemic have been realised, we estimate this will increase again later in the year.

The demand/ supply imbalance has differed for each input cost. For example, the latest evidence in the UK from the Office for National Statistics (ONS) shows a 43% YoY increase in the cost of concrete reinforcing bars. We are observing governments seeking to invest more heavily in infrastructure plans in order to provide an additional fiscal multiplier to economic growth, although we expect private construction activity to cool in the short term.

With occupier trends showing a flight to higher-quality office space and more focus than ever being paid on carbon emission levels ahead of COP26 in November, more emphasis is being placed on balanced, sustainable growth. What's more, the NextGenerationEU funding deal of €750bn in response to the Covid crisis is subject to conditions in that a minimum of 37% must be allocated to climate change and 20% to digital infrastructure to create sustainable growth. Landlords are faced with the question, "Instead of developing new stock, can I reduce my carbon footprint by comprehensively refurbishing stock to a Grade A spec?"

Chart 2: European office construction costs, (€ per sq m)



Source Turner & Townsend

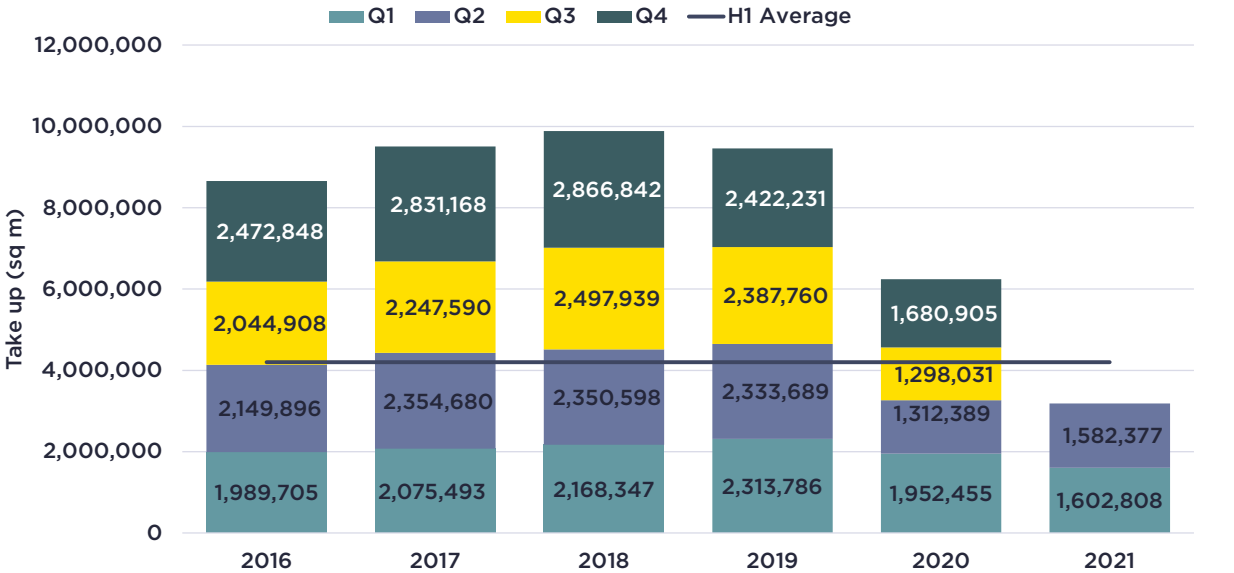
Occupational market

Occupiers will review occupational strategies in H2 2021

European office take-up reached 3.2m sq m during H1 2021, down 24% on the five-year average, and in line with the same period in 2020, despite Q1 2020 being largely unaffected by the pandemic.

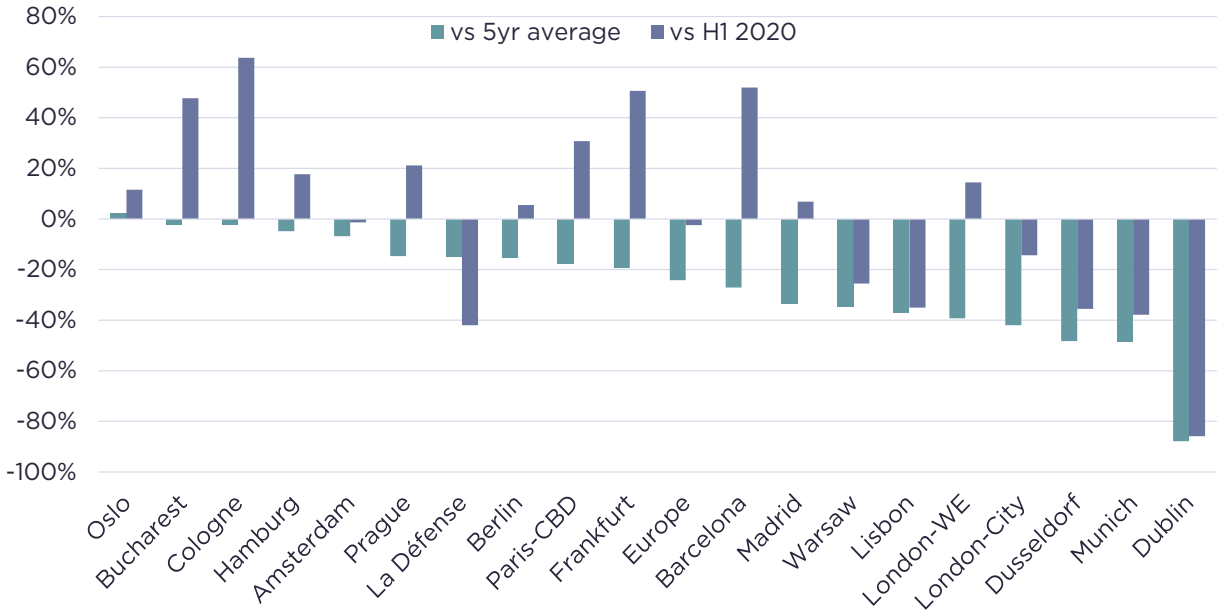
Oslo (+2%) was the only European market to record office leasing volumes above its five-year average during H1 2021. However, demand in the large metropolises of London (West End -39%, and London City -42%) and Paris (-18%) reflects the caution of re-adopting public transit en masse. Dublin (-88%) was most significantly down on the five-year average due to significant lockdowns during the first half, with the CEE and German markets showing the most resilience, potentially due to the relatively higher dependence on office-based working prior to the pandemic. Southern European markets (including Barcelona -27%, Madrid -33% and Lisbon -37%), with a higher exposure to tourism based industry, are also recovering at a slower rate than their European counterparts.

Chart 3: European office take-up (sq m)



Source: Savills Research

Chart 4: European office take-up H1 2021 (% change)



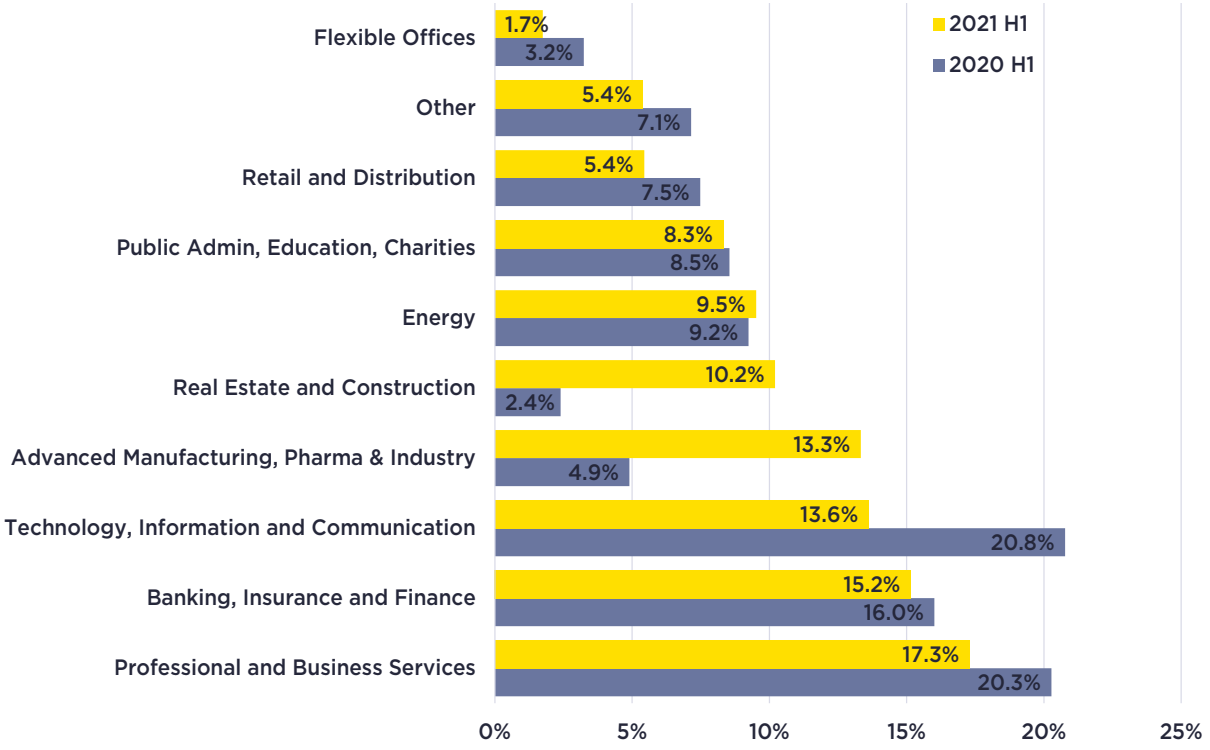
Source: Savills Research

Which sectors have been most resilient?
Although demand volume remained stable year on year, we have observed demand shift away from the tech sector (21% to 14% of take-up) towards the advanced manufacturing and pharmaceutical sector (5% to 13%), as well as real estate (2% to 10%). For example, the 3D design company Dassault Systems has expanded its Campus by 28,000 m² in Vélizy-Villacoublay (Paris region).

The pharmaceutical sector further lifted demand in Prague, accounting for 23% of total space. It should be noted, however, that the European tech sector accounted for around 16% of space during 2019, before peaking at a record share of demand in 2020, so the current proportion is in line with the historical average.

Professional and business services was the most active sector, accounting for 17% of take-up, down from 20% last year. Whereas flex office providers took 9% of space back in 2019, they have accounted for only 2% of space in H1 2021. However, as a service-based element becomes more essential in welcoming staff back to the workspace, we anticipate flex will grow over the next 12 months. We also expect tech companies to be among the fastest to adapt to a hybrid working approach and will increase exposure to flexible offices.

Chart 5: European office take-up by business sector (%)



Source Savills Research

Vacancy rates
European office vacancy rates continue to creep upwards, rising by an average of 150 bps to 7.2% over the past 12 months, where among the fastest risers are La Défense, Warsaw and London City. Markets with a higher exposure to financial services were already observing a tapering of demand prior to the pandemic. Nevertheless, the core markets remain structurally undersupplied, with Paris, Hamburg, Munich, Cologne and Berlin vacancy rates all between two and five percent. Brussels notably recorded a decline in vacancy rate over the 12-month period.

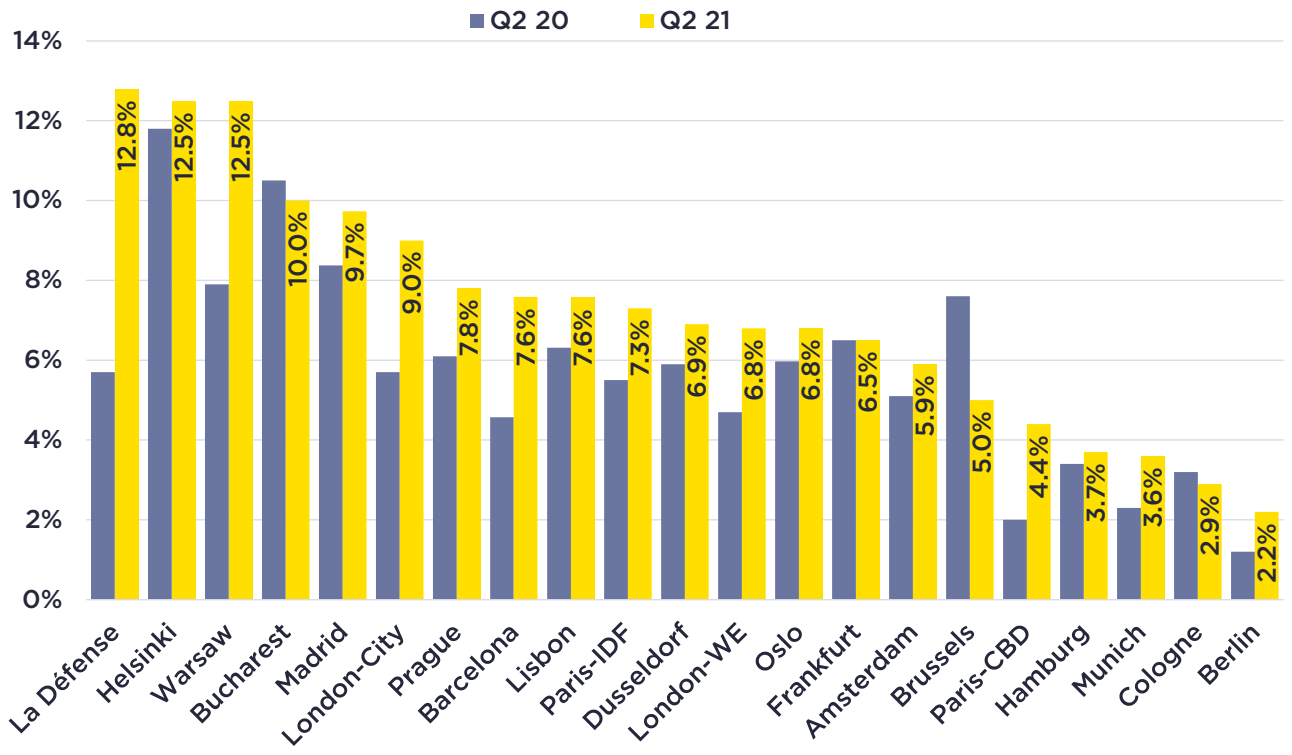
We still anticipate vacancy rate increases before the end of the year; however, much of this reflects the level of secondary space returning to the market, or space available for sublease from tenants locked into leases with circa five years+ remaining.

Savills latest European office development report indicates that 54% of the pipeline in 2021 and 39% of the pipeline in 2022 is already signed for, with 2021 take-up to recover by 7% YoY, which could begin to taper the overall vacancy rate rise. Budapest (11%), Warsaw (10%) and Amsterdam (10%) are all set to see the highest levels of new development between 2021-22.

Prime rents
We have recorded a 1% YoY decrease in the headline prime rent level. Dublin (-12%), Cologne (-8%) and Barcelona (-4%) recorded the more significant falls, although most markets remained stable (+- 2% annual change). Lisbon recorded a 9% increase, whilst Hamburg, Berlin and Munich also recorded modest increases as a result of shortages of space. In general, lease incentives have increased across the major office markets, although we anticipate this may contract again following growing business confidence and occupier activity later in the year.

Despite the rising vacancy indicating rents are falling, the increased CapEx required to upgrade prime office space to meet environmental criteria will begin to raise asking rents over the next couple of years.

Chart 6: European office vacancy rates (%)



Source: Savills Research

Investment and yields

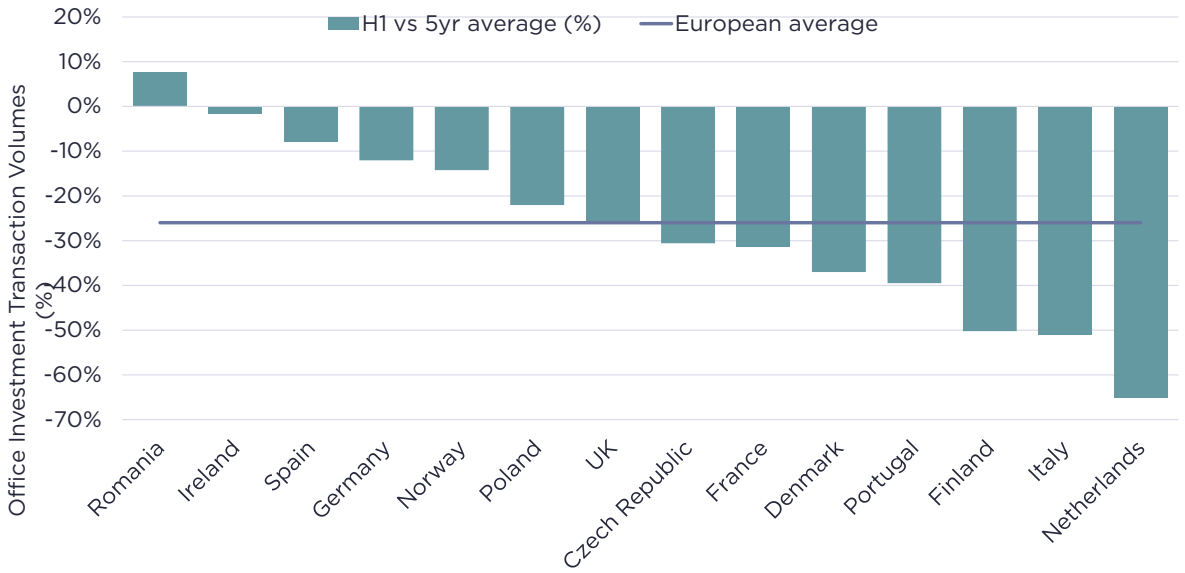
Core markets continue to harden

European office investment reached €30bn during H1 2021, 26% below the five-year H1 average. Among the largest decreases was the Netherlands, representing a 65% fall against the five-year average, partly due to shortage of sellers for core product. Italy (-51%) and Portugal (-39%) also reflected a more cautious investor approach to southern Europe.

Despite a weaker 2020, the UK recovered, but remains 26% below the five-year average. Demand for big-ticket German offices also remains more resilient, with a 12% decline over the same period as a number of the large institutional investors invested closer to home.

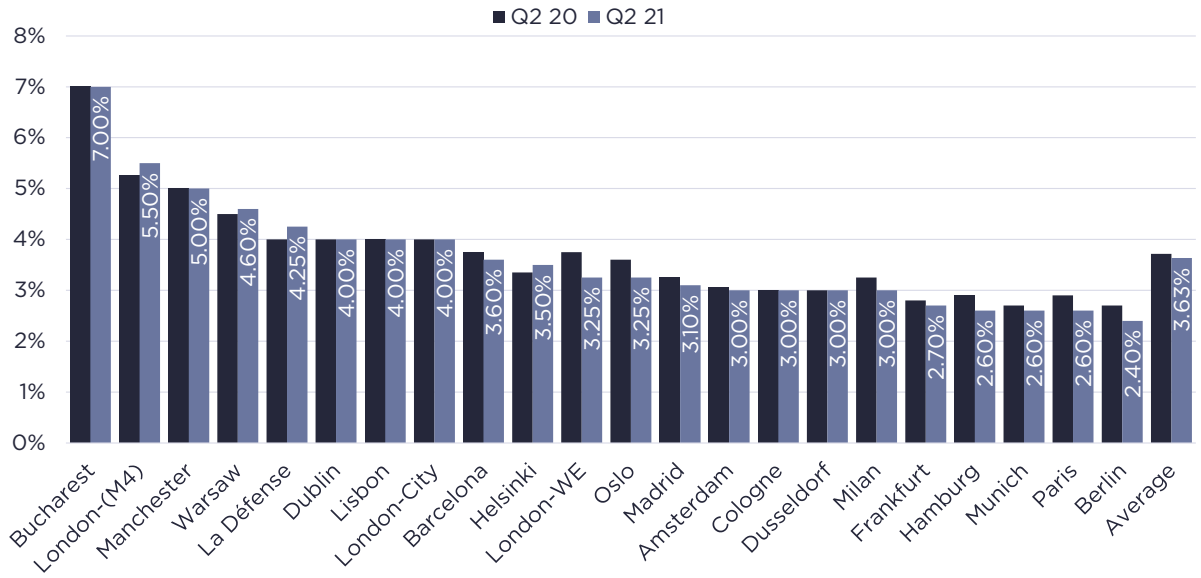
Institutional landlords remain in search of long, secured income, of which there remains a scarcity. Core assets have remained a priority, although sentiment over the workplace continues to split investors and vendors on pricing. Debt terms still remain favourable, although more so on standing stock than new development, particularly in non-core locations.

Chart 7: European office investment volumes (%)



Source: Savills Research

Chart 8: European prime office yields (%)

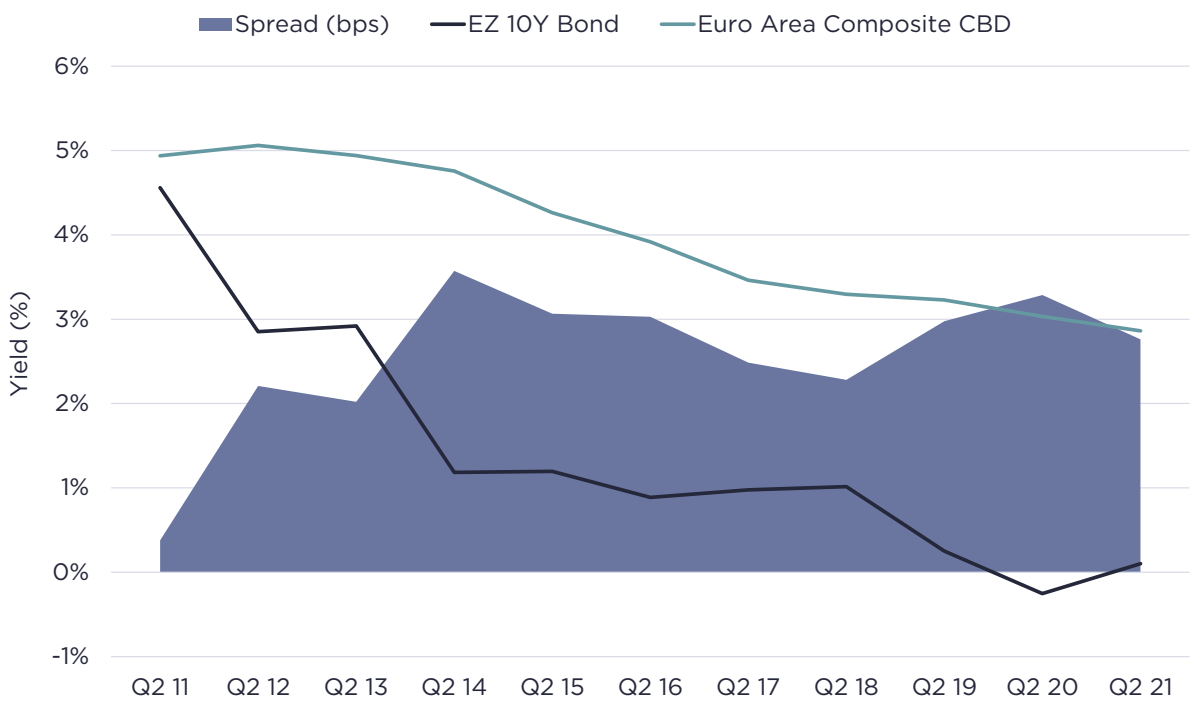


Source: Savills Research

Prime office yields moved in by an average of 9 bps over the past 12 months to 3.62%. Berlin, Paris and Hamburg moved in 30 bps YoY to Q2 2021. London WE in by 50 bps. Some outward yield movement in Warsaw (+10 bps), London M4 (+25 bps), La Défense (+25 bps) since Q2 2020 was recorded, but core markets are generally remaining stable or have hardened.

However, the overall yield spread between prime CBD offices and government bonds remains favourable. Despite a slight increase in government bond rates, and some prime CBD office yield compression, yield spreads continue to position European offices attractively compared to risk-free rates, 20 bps above the long-term average.

Chart 9: Eurozone composite prime yield and government bond yield (%)



Source Savills Research, Oxford Economics

Outlook

What are the three unanswered questions affecting offices?

When will vacancy rates peak?
We anticipate overall vacancy rates will continue to increase to 7.5% by end-2021 (see European Office Development MIM), due to subdued occupier demand and secondhand space returning to the market. As office demand continues to grow on a quarterly basis, grey space is withdrawn from the market and newly developed stock is absorbed, we expect supply to stabilise, particularly within the constrained western European markets.

Flex demand will rise as a result of the pandemic, particularly for private companies that have outgrown traditional co-working space and are unable to plan on a three-year-plus horizon. We expect a bounceback in demand in 2022 as membership agreements are reinstated and a 'service' offering becomes more expected.

What will happen to rents?
Rents for high-quality space are likely to remain stable. Given that the global pandemic has imposed national lockdowns on Europe's major cities, a 1% YoY softening in prime rents would have been expected. The 4% YoY reduction in secondary CBD rents is more concerning for landlords bearing higher risk, and further CapEx will be required to meet ESG criteria and compete for occupiers. Tenant incentives will likely become more favourable in the short term.

Do we expect a correction in capital value pricing?
There remains a high level of dry powder circling prime office assets in core cities. Despite the looming shadow of rising inflation, bond yields remain in negative territory in western European economies, with higher than average yield spreads on offer.

The return of international travel from certain jurisdictions such as North America and the Middle East will also bring a return of extra European capital sources in search of long-term income.

While many Asia-Pacific investors are not currently travelling to Europe, given their vaccination rates and their caution regarding travel to an area with higher case incidence rates, some South Korean investors, for example, are becoming more comfortable transacting without conducting in-person inspections of assets themselves.

Despite prime office yields remaining at record lows, we anticipate yields to remain stable in the medium term.

Savills Commercial Research
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