European Commercial - Autumn 2020

SPOTLIGHT

Savills Research

European Office Outlook

savills

● Vaccine ● Vacancy rates ● Grey space

Vaccine news at last!

A vaccine breakthrough will help tenants plan their occupational decision making.

Europe's major cities remained in the midst of a second lockdown, further denting business confidence as the economic recovery shifts from a 'V' shape to the previous downside scenario of a 'W'. Focus Economics latest November 2020 Euro Area GDP growth forecasts indicate a slump to -7.9% yoy during 2020, with a 5.3% yoy recovery in 2021.

An extension of furlough schemes to Spring 2021 will be welcome news for employers, as 2020 unemployment rates are on course to reach only 8.4%, before peaking at 9.3% in 2021. Of course, this will come at a cost, with average Eurozone public debt rates rising from 84% in 2019 to 102.4% by end 2020. Once public debt exceeds circa 100% of GDP, debt repayment levels begin to show signs of dragging on long term economic growth, although public debt is expected to fall towards the 2023/24 period as taxes are raised in order to pay for furlough measures.

Deloitte's Autumn 2020 European CFO survey illustrates that hiring intensions have improved since Spring 2020 and that the UK's CFO sentiment dampens the European average. We anticipate that more Brexit clarity by end 2020 will gradually improve UK sentiment.

Apple's latest mobility data points to falling public transport usage across Europe's major cities, comparable with levels recorded in early June, led by Paris and London (Chart 1). A second implementation of lockdown measures will further delay occupational decision making throughout end 2020 and into early 2021 as many occupiers opt to extend their working from home policies. Although it is becoming evident that the second lockdown measures are generally less constrained that the first phase, with schools and universities remaining open in many instances.

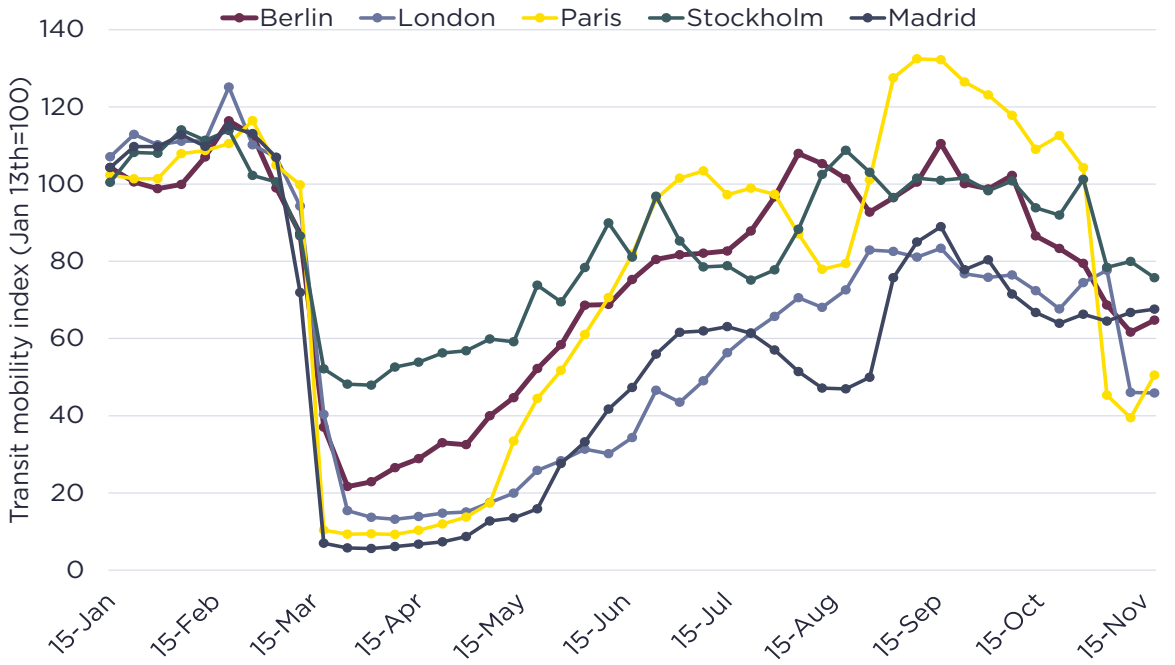
However, employer confidence will be largely boosted by Pfizer's announcement of a vaccine which can be 90% effective in preventing people catching the virus, aswell as Moderna and AstraZenica's vaccines, although there are still many phases of testing before this can be distributed. Several of the major office-focussed REITs observed a marked rebound following the news and we expect more clarity to come for occupiers to be able to draw out timeframes for their next occupational moves. Further announcements are anticipated during Q4 2020-Q1 2021 from major European pharmaceutical companies.

Falling productivity

Employer concerns are emerging regarding the recent drop off in labour productivity. October data from the ONS (Office of National Statistics) indicates that of the employers who have increased homeworking since the virus outbreak, 25% reported that productivity had fallen, whereas only 12% said output has increased.

Employers are also paying particular attention to the impact that working from home is having on employees' mental health as we edge into the winter period. For example, between 28th October to 1st November, 59% of UK workers aged 16-29 reported that they are feeling "lonely", compared with 35% of workers aged 30-59, according to the ONS. The workplace will remain a hub for creativity and wellbeing as we emerge from the pandemic.

Chart 1: Transit mobility index



Source: Apple

Vacancy rate up, but still low

Occupational demand remains 31% down against the five year average.

European office take up reached 1.6m sq m during Q3 2020, reaching a total of 5.7m sq m for Q1-Q3 2020. Year to date, this is -31% against the five year Q1-Q3 average, and -41% on the five year Q3 average (Chart 2).

Among the most resilient markets have been La Defense (+25%), driven by a megadeal early in Q1 2020, although leasing activity in Central Eastern Europe (CEE) and Northern Europe has generally been most resilient compared with previous years (Chart 3).

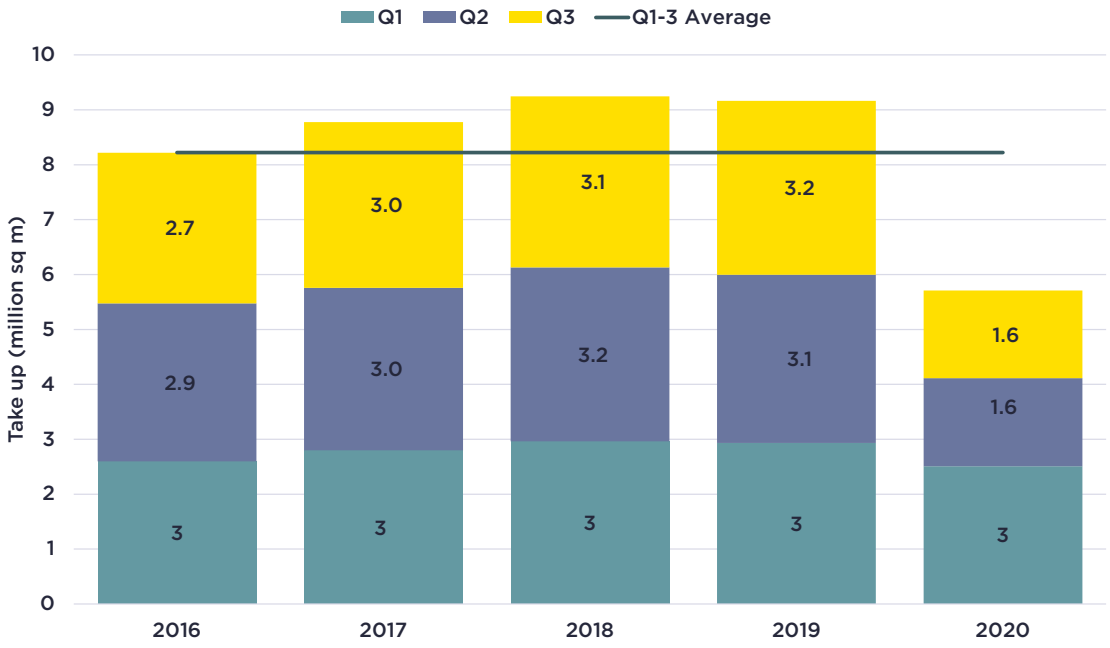
The metropolises of London and Paris have suffered the most in terms of occupier demand during 2020, reflecting the most severe lockdown measures in these cities. However, we anticipate office demand will recover once businesses are allowed to reopen, and office workers are encouraged to use public transport and return to the workplace.

Europe's Q4 office take up has historically recorded a 20% increase in volumes against Q1-Q3. We do anticipate an increased level of take up compared to the last two quarters albeit this will be dampened by the imposed lockdowns.

Vacancy rates

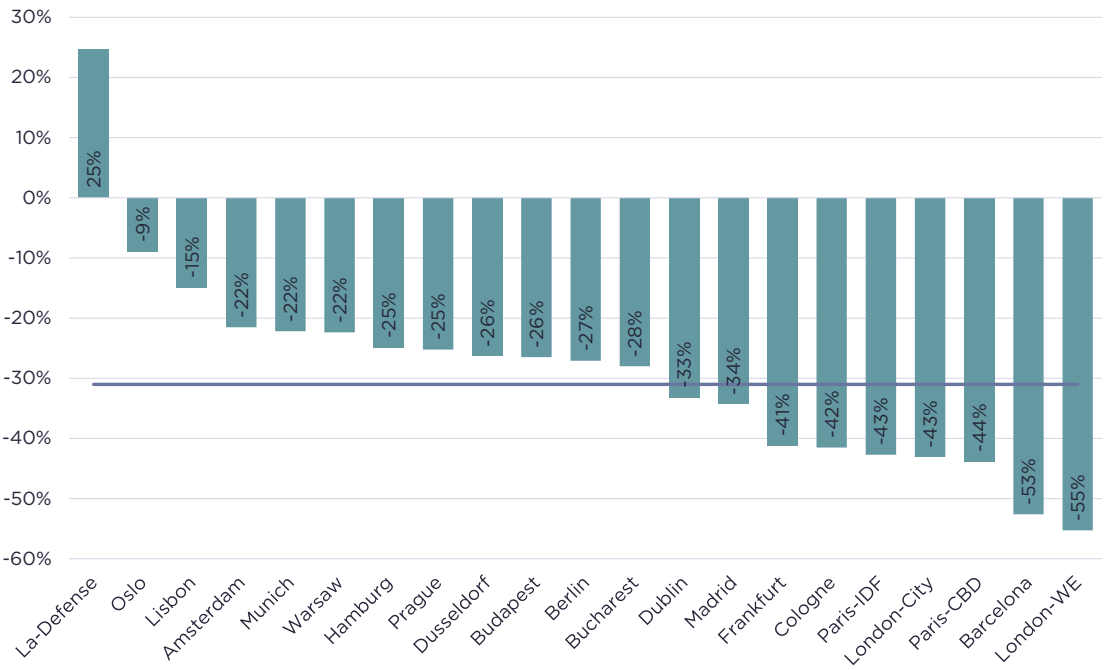
Suppressed occupier activity is weighing in on availability, as European average offices vacancy rates have increased from 5.6% to 6.3% between Q1 2020 and Q3 2020 (Chart 4). The core western European markets of Paris CBD (2.6%) and German top 7 (including Munich 2.4% and Berlin 1.6%) maintain the lowest vacancy rates in Europe, although we have seen the largest increases in vacancy rates across the CEE over the last six months. Warsaw (+2.1 percentage points (pp) to 9.6%, landlord only), Budapest (+1.9 pp to 8.1%) and Prague (+1.8 pp to 7.2%) report among the largest increases in

Chart 2: European office take up (million sq m)



Source: Savills Research

Chart 3: European office take up (Q1-Q3 2020 % change vs 5yr average)



Source Savills Research

vacancy rate across Europe. This is partly down to shorter lease lengths and higher levels of development completions, reflecting a rise in Grade B space returning to the market.

La Defense recorded the largest increase in vacancy rates during the last six months, rising 2.3 pp to 7.8% due to limited occupier activity in the second and third quarters. The German top 7 cities generally avoided any noticeable increases in vacancy rates over the past six months and remain among the most undersupplied markets.

Average European vacancy rates remain significantly below the equilibrium of circa 9% for stable prime rents at end Q3 2020. Lease incentives will continue to increase throughout winter 2020/21 and into spring 2021, reflecting a reduction in net effective rents.

Development pipeline

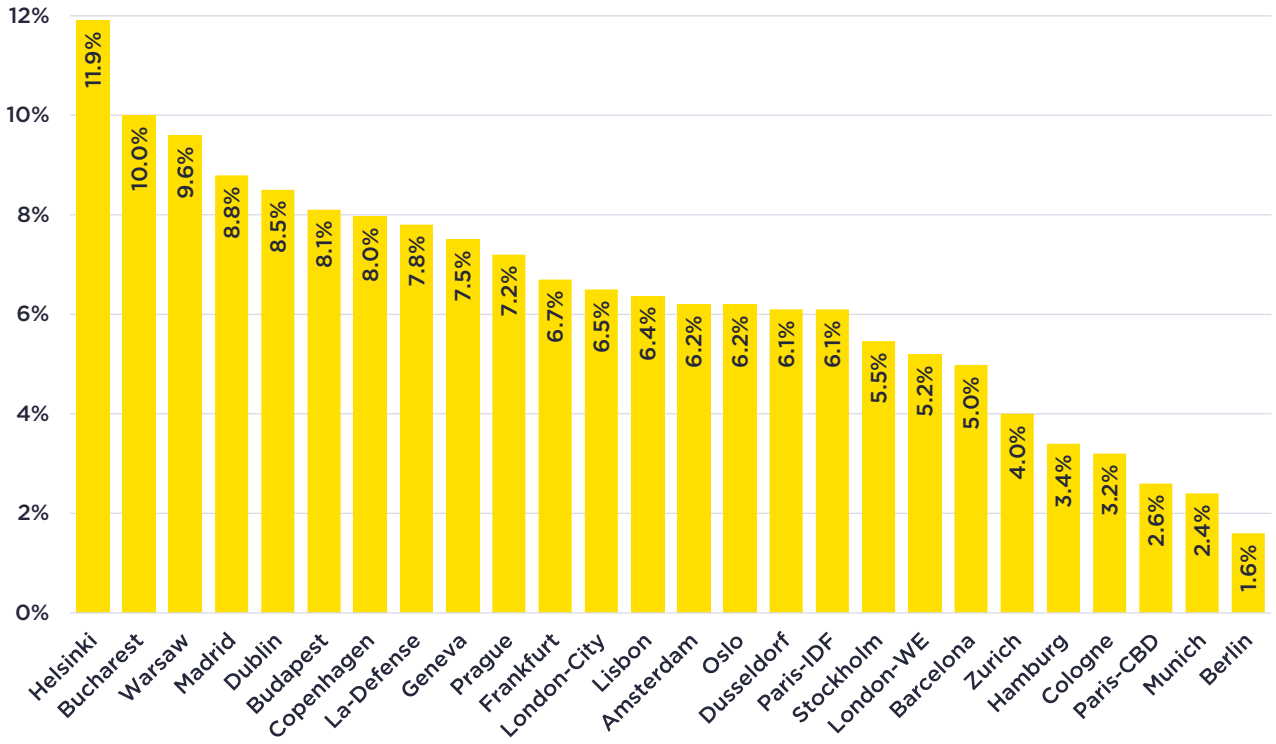
Compared to the Global Financial Crisis (GFC) in 2008/09, the 2021 office development pipeline appears either restricted or majority pre-let across the core markets of Berlin (48% pre-let), Munich (72% pre-let) and Paris CBD (13% pre-let, although only 104,800 sq m in total). Nordics markets, Oslo (63% pre-let) and Stockholm (73% pre-let) vacancy rates will remain low into 2021, with only 100,000 sq m of total space scheduled for completion in Helsinki next year.

With 311,000 sq m of space scheduled for completion in Warsaw next year and 228,000 sq m for completion in Budapest, there is potential for vacancy rates to rise into next year, although generally development pipelines continue to remain modest and we anticipate developer caution going forward. Prague's relatively constrained pipeline should shelter landlords from any significant vacancy rises.

Prime rents

Average prime European office rents remained stable with zero growth over the past six months. Lisbon (8.7%), London WE (7.5%) and Hamburg (5.0%) recorded some of the strongest rental growth over the past six months, although some of the financial centres of Zurich (-5.6%), London City (-4.3%) and Geneva (-4.7%) recorded declines. The majority of core European markets remained flat or a minor increase in headline rents. Rising lease incentives will continue to take their toll on net effective rents, more so in the non-core markets.

Chart 4: European office vacancy rate, Q3 2020 (%)



Source: Savills- as reported locally

Feature: Grey space

How is tenant-controlled supply affecting Europe's office markets?

As a result of working from home during the pandemic, Savills Research have observed an increase in the level of tenant-controlled space available for sublet, or "grey space" across Europe's office markets. Analysing the breakdown of vacant space across a sample of European markets, the average level of tenant-controlled available space has risen from 0.7% to 1.3% of total stock over the course of 2020 (Chart 5).

London City's total office vacancy rate has risen from 5.5% to 6.5% since end 2019. Landlord controlled vacancy has only briefly risen from 4.2% to 4.4% during this period, as tenant-controlled vacancy rose from 1.3% to 2.1% of total stock. A similar trend was observed within the West End office market, rising from 1.3% to 1.8%, despite generally smaller average floorplate sizes and less exposure to financial services occupiers, one of the major contributors to sublet space. London's longer average lease length of course offers more opportunity for tenants to sublet space, so it comes as no surprise that London has seen among the largest rise in grey space across Europe.

We have noticed an increase in grey space in the Dublin market, which has risen from 46,000 sq m at end 2019 to 69,000 sq m at end Q3 2020. Despite total vacancy rate remaining fairly stable during this time, falling from 8.6% to 8.5%, tenant-controlled space has risen from 1.2% to 1.7%. While the majority of the grey space is located in the CBD, this is more due to the fact that the CBD contains the most standing stock rather than an exodus of occupiers from the CBD. In terms of tenant types, the ICT (42%) and Financial Services (32%) sectors are responsible for the majority of tenant-controlled space on the market. 52% of the space on market is "plug and play" space (including furniture and telecoms), and 41% is fully fitted with no furniture, so through the nature of grey space, sub-tenants are able to make savings on fit-out costs.

Tenant demand for more flexible lease terms across the Netherlands has driven Amsterdam's flexible office market in recent years. As a result, this has contributed to a relatively low proportion of tenant sublet space, rising from 30,000 sq m to 39,000 sq m throughout 2020, with overall vacancy rate remaining below 6%, and grey space only 0.6% of total stock.

Whereas Warsaw's tenant-controlled space totalled circa 15,000 sq m at end 2019, representing only 0.3% of total stock, this has now jumped to just under 100,000 sq m of space (1.7% of stock) as tenants have opted to sublet space to the market. Warsaw's total vacancy rate has risen from 8.1% to nearer to 11.3% over the course of the year. Prague's office market provides a similar story- whereas tenant sublet space was close to zero before the pandemic, this has risen to circa 40,000 sq m by end Q3 2020.

"The open marketing of grey space may shift to the form of swing-space over the coming months as occupiers turn their lights back on," Savills Research

Stockholm has observed among the highest levels of tenant controlled space returning to the market in 2020, with tenant vacancy rising from 0.6% to 2.4%. Total vacancy rate has now reached 7.8% at end Q3 2020, up from just 3.5% at end 2019, marking the largest increase in vacancy across the European markets. However, this is largely down to a couple of large tech occupiers returning space before the first wave of the pandemic, rather than being linked to the virus outbreak. We anticipate the vacancy rate to recover despite some occupier caution at leasing sublet space.

Over the border into Norway however, Oslo was the only city to observe a reduction in the level of tenant sublet space over the course of 2020 from 46,500 sq m to 25,000 sq m and now only accounts for 0.3% of total stock. Strong fiscal support has maintained business activity, although an increase in landlord supply has led to total vacancy rate increasing from 5.1% to 6.2%.

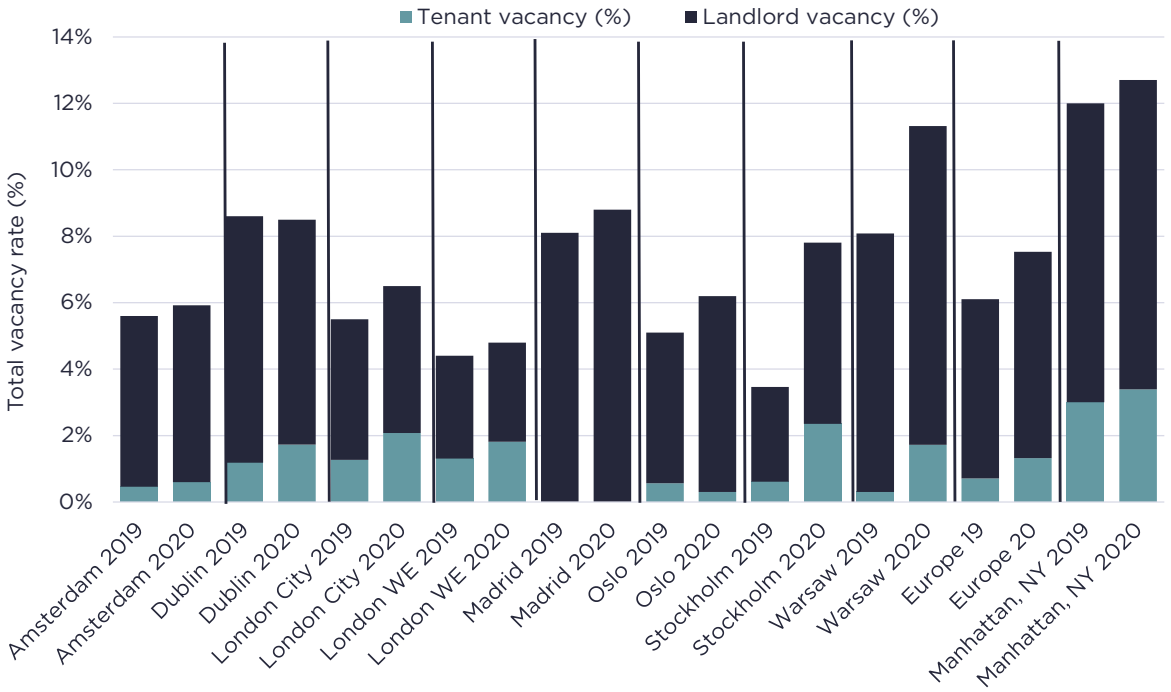
With standard lease terms generally shorter in mainland Europe than in London, we anticipate that the tenant sublet space will remain more of a London theme, and that landlord controlled space will increase more quickly to what is now around 7.2%. In Madrid, for example, only around circa 1% of availability is tenant controlled. Anecdotally, we are observing some minor increases in availability of grey space within Paris and German top 7 cities, although this appears to be below the trend we have observed in London and CEE markets.

We have noticed that while tenants have shown a preference for flexible lease terms and existing fit-out, often the flexible lease terms and fit-out on offer in grey space does not match tenant requirements. They find they do not want to inherit another occupier's lease terms and fit-out- instead, they would prefer their own bespoke office. Although potential occupiers have more choice between landlord, tenant and flex space, we do not expect increased grey space to have a significant impact on achievable rents for flexible offices.

Comparing European key cities with that of Manhattan, New York, tenant controlled space remains relatively low. During Q3 2020, sublet supply accounts for 26.7% of total available space, which has remained fairly stable during 2020, although since Q4 2018, an additional 613,000 sq m (6.6m sq ft) has been added to the market, now totalling 1.5m sq m (16.1m sq ft). It is anticipated that by end 2020, available sublet space will exceed the levels observed during the GFC.

Although it is early days in terms of the vaccine approval, European heads of real estate will now be keeping an eye firstly on return to work strategies and secondly on long term occupational moves. As a result, the open marketing of grey space may shift to the form of swing-space over the coming months as occupiers turn their lights back on.

Chart 5: Vacancy rate split by tenant/landlord controlled space



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.

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