European Commercial - February 2022

SPOTLIGHT
Savills Research

European Office Outlook

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● Economy ● Occupier ● Investment

Economic recovery

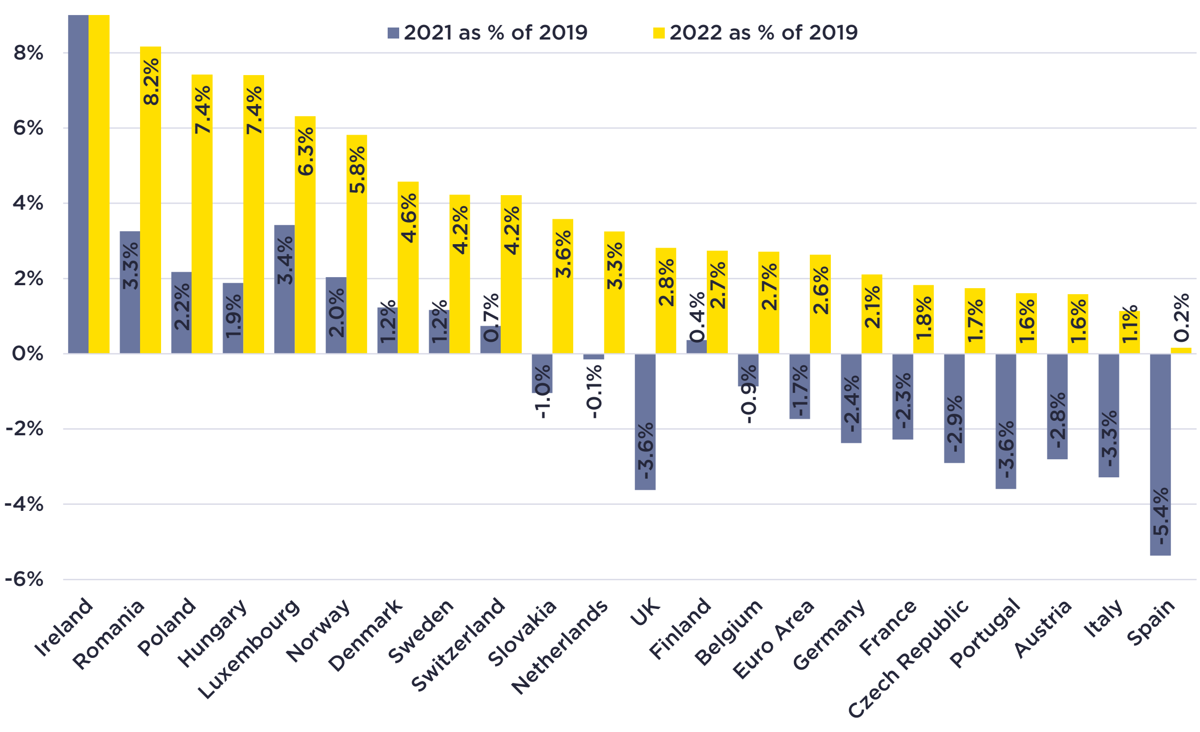
Europe's economies will take until end 2022 to fully recover

A rise in new Covid infections dampened the economic recovery during the final quarter of 2021, however, the Euro Area economy grew by 5.1% for the full year 2021, up from -6.5% during 2020. Southern Europe continues to lag behind the European recovery, although most economies are expected to have registered positive real GDP growth relative to pre pandemic levels by end 2022. Employer hiring intentions remain 13% above the long term average, as indicated by the European Commission's Employment Expectations Indicator (EEI).

Inflation increased to a record high of 5.1% in the Euro zone according to the January 2022 data. Economists expect headline inflation to ease off as energy prices stabilise later in 2022, averaging 4.5% for the year and easing to 2.5% in 2023, as core inflation remains around the 2-2.5% mark. Savills Programme and Cost Sentiment (SPECS) report indicates there has been little in the way of news that would point to a let-up in the pressures currently being faced by the construction sector. As inflation remains fairly supply-driven, economists anticipate the ECB deposit rate will not necessarily have to move above zero, and not to the same extent as is expected for the Federal Reserve or Bank of England.

Following the Bank of England's base rate increase, Capital Economics now forecast the ECB to raise interest rates by 50 bps this year and 50 bps next year. Since the ECB's February press conference, Italian bond yields have risen by 20 bps, whilst German bond yields have risen to their highest level since end 2018. Speculation of an interest rate rise has subsequently increased the EURUSD from \$1.11 to \$1.14, which may impact the level of non-European capital targeting European offices this year.

Chart 1: European real GDP growth forecasts (as a % of pre pandemic)



Source: Oxford Economics

Has office vacancy peaked?

Tenant incentives are being wound back

European office take up reached 8.2m sq m during 2021, down 11% on the previous five year average, but a 25% increase against 2020, as the office market recovery continues to take shape. Q4 2021 recorded the strongest quarterly leasing volume since Q4 2018, driven by pent up occupier demand. Among the most resilient performers were Oslo (+13%), La Defense (+8%), London West End (+4%) and Paris (+1%) marking a reversal of the trend observed in 2020. In Savills recent European Remote Working Impact Analysis, we investigated the potential -10% impact of remote working on office demand and benchmark which cities are likely to be most resilient.

During H2 2021, we observed a relatively low proportion of demand in the 500-1000 sq m size band, with a number of medium sized occupiers opting to sign for flex space during the short/ medium term as they plan around a return to the workplace. Workthere's latest data indicates UK enquiries for flexible office space are up 82% on pre-pandemic levels, and 20% of demand in 2021 has come from companies previously working from home looking for flexible space.

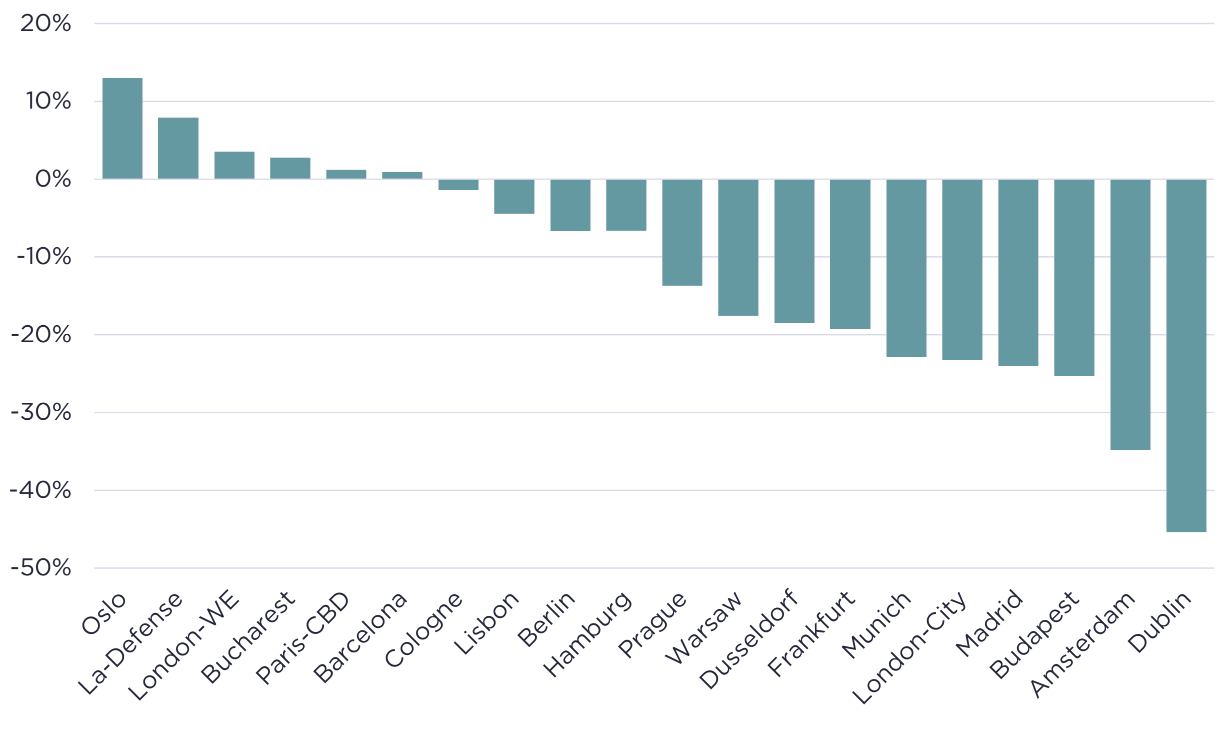
Savills Research forecast in the region of 9m sq m of take up for the full year 2022 as occupiers shift to more prime locations and seeking to densify their floorspace, although much of this will depend on the level of quality available space.

European office vacancy rates: A turning point?

European office vacancy rates rose from 7.1% to 7.2% between Q2 and Q4 2021, although on a quarterly basis, average vacancy rates fell by 0.1%, marking the first decrease since the outbreak of the pandemic. This was partly due to a shortage of new deliveries of space and tenants withdrawing stock which was previously openly marketed.

Core Western European markets still remain at vacancy rates of 3-4%, whilst London WE and London City have stabilised after leasing activity picked up in H2 2021.

Chart 2: 2021 take up vs previous five year average (%)



Source: Savills

Rents and incentives

A shortage of prime stock has increased prime rents by an average of 3% over the past 12 months. Munich (+17%), London City (+12%) and Amsterdam (+11%) reported the largest annual increases, whilst Frankfurt (-8%), Cologne (-7%) and Barcelona (-3%) observed falls.

Lease indexation is contributing to upward rental pressure, whilst rising construction costs are helping to support rental levels for standing stock as we observe an occupier shift to quality.

As a result of stabilising vacancy rates, we have seen lease incentives move back in, from 11.1% of average total contracted rent in Q4 2020 to 10.5% of contracted rent in Q1 2022, indicating that rent free periods have peaked. However, there are differing trends across the European markets. In Berlin and Munich, rent free periods have increased by 4 basis points and 6 basis points respectively. In Warsaw, this has contracted by 10 basis points, due to more resilient office demand.

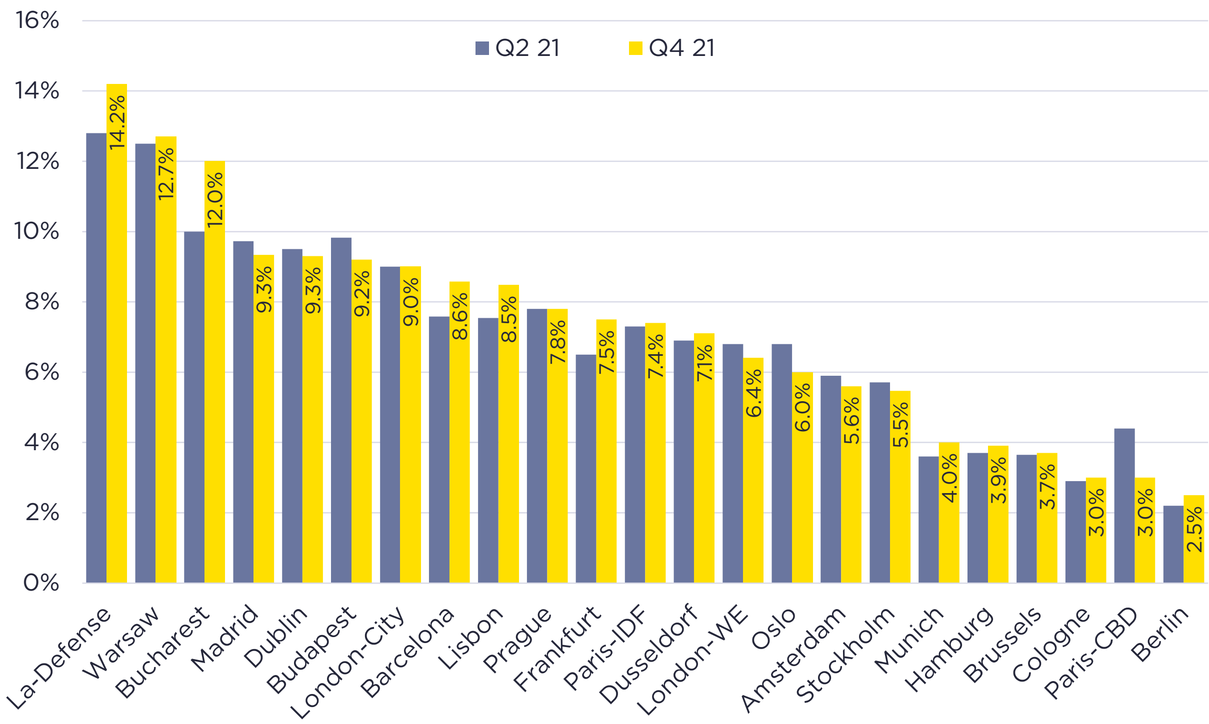
London West End (20% of lease value), London City (22%) and La Defense (25%) remain the markets with the most generous incentives, although this was also the case pre-pandemic.

Of course, lease incentives for secondary product have remained more generous due to changing occupier preferences. Landlords with higher levels of vacancy have offered more generous terms to reduce voids.

Sustainability

Occupiers' main focuses are now shifting towards employee retention and meeting their 2030 sustainability targets. The built environment accounts for approximately 40% of global carbon emissions and some occupiers are seeking to reduce their office footprint in order to reduce their overall environmental impact. However, occupiers are aware that they must ensure they can offer the best in class workplace facilities in order to attract and retain the best talent. As a result, occupiers are shifting towards better quality office stock in prime locations, where we are subsequently seeing the rental premium increase. Landlords are also seeking to offer more green leases to incentivise tenants to actively reduce their buildings' carbon footprint.

Chart 3: European office vacancy rates (%)



Source Savills Research

Investment and yields

Green premium becoming more evident

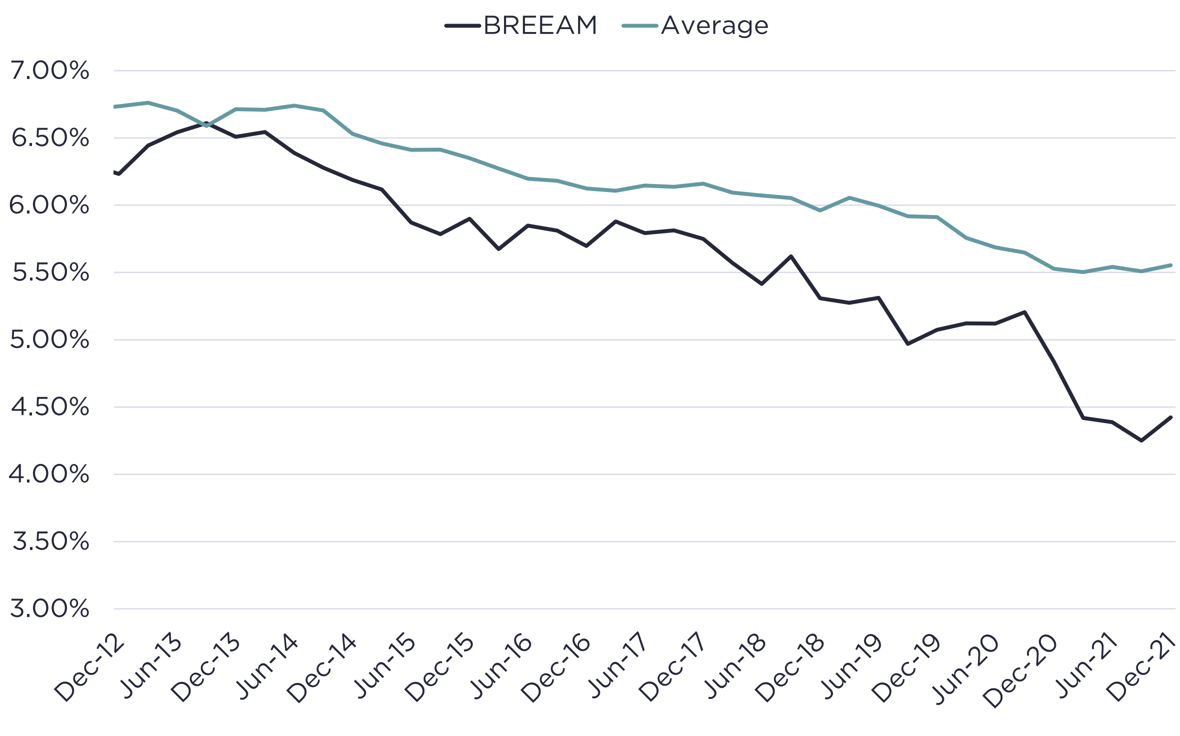
European office transactions reached a total of €99bn during 2021, 8% down on the previous five year average. In the final quarter alone, €38bn of transactions took place, in line with the final quarter average over the same period. Among the most resilient investment markets were Sweden (+91% vs five year average), Norway (+66%) and Hungary (+62%), whereas CEE markets observed relatively lower transaction volumes.

In terms of total share, Germany (27% of 2021 office investment volumes), the UK (21%) and France (15%) remained the most active markets, reflecting a year dominated by core investor appetite, although in the final quarter, Sweden and Norway became more active markets, accounting for a combined 18% of transactions, driven by domestic investment.

Whilst government bond yields have continued to rise since the start of the year, dry powder targeting real estate continues to maintain pricing in the office sector. Resilient investment performance throughout the pandemic has resulted in capital allocations to property rising from 11.7% in 2021 to 12.3% in 2022 across EMEA, according to Cornell University's allocation survey, with income-producing real estate remaining attractive. Lenders continue to be most comfortable around the 50-55% LTV range, although lender appetite for higher LTV deals is on the rise.

Indeed, we have observed a shift towards high quality, ESG compliant office assets. As such, the spread between BREEAM-certified and all offices has widened by 44 bps over the last 12 months, according to data from RCA.

Chart 4: BREEAM certified vs average office yields (%)



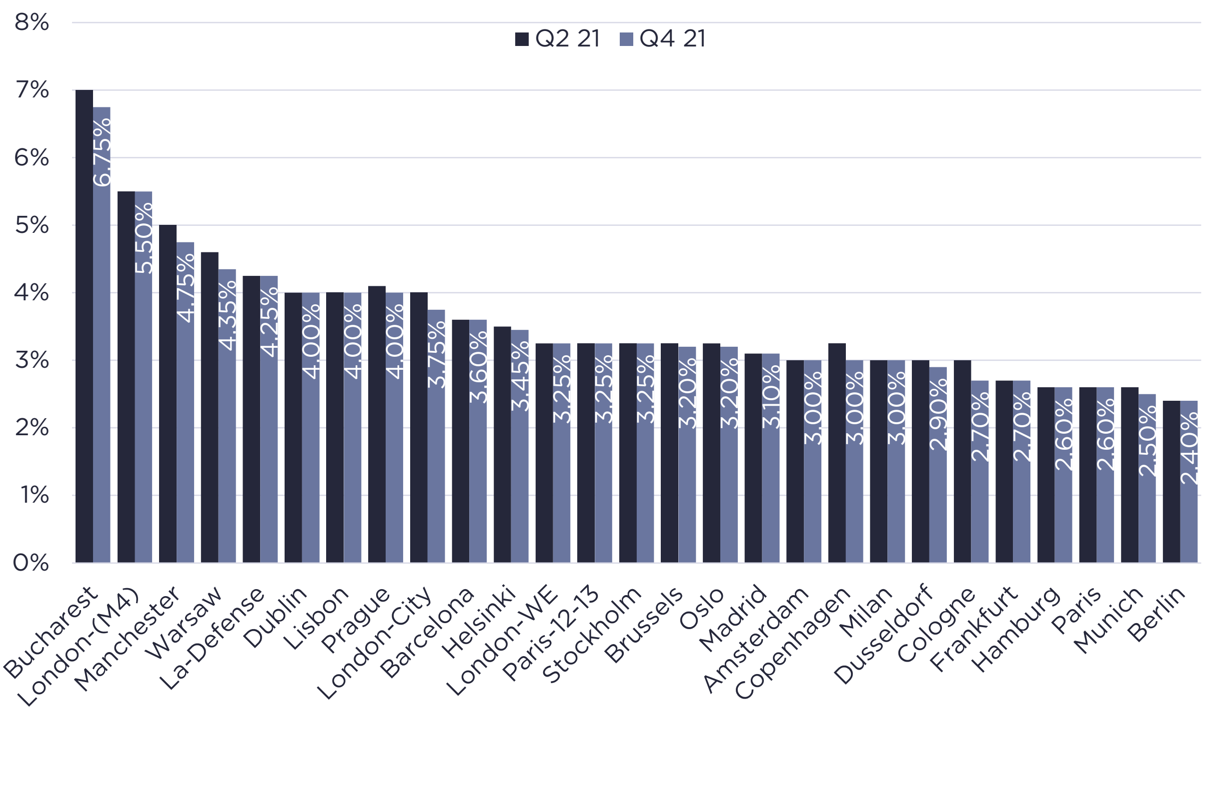
Source: RCA

Landlord sentiment remains mixed on the return to the office, creating a wider gap between buyers' and sellers' expectations. The latest evidence from INREV's Investor Intentions Survey shows a large shift from core to value-add strategies during 2022 as investors become increasingly willing to step up the risk curve in search of higher returns. This could pave the way from a more active approach to asset management in order to boost sustainability ratings in the office sector.

Prime yields compressed by an average of 7bps to 3.52% during the six months to end Q4 2021. Manchester, Bucharest, London City and Copenhagen all compressed by 25 bps, whilst Cologne compressed by 30bps.

Office yield spreads to risk free rates continue to illustrate the sector's attraction despite some more recent increases in bond yields. Given this, we believe the potential for further yield compression is less likely, and we forecast a stable outlook on pricing throughout 2022.

Chart 5: European prime office yields (%)



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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