European Commercial - February 2021

SPOTLIGHT
Savills Research

European Office Outlook

savills

● Economy ● Vacancy Rates ● Lease Incentives

Economic recovery

Eurozone GDP growth to rebound 4.6% in 2021.

Economic Overview

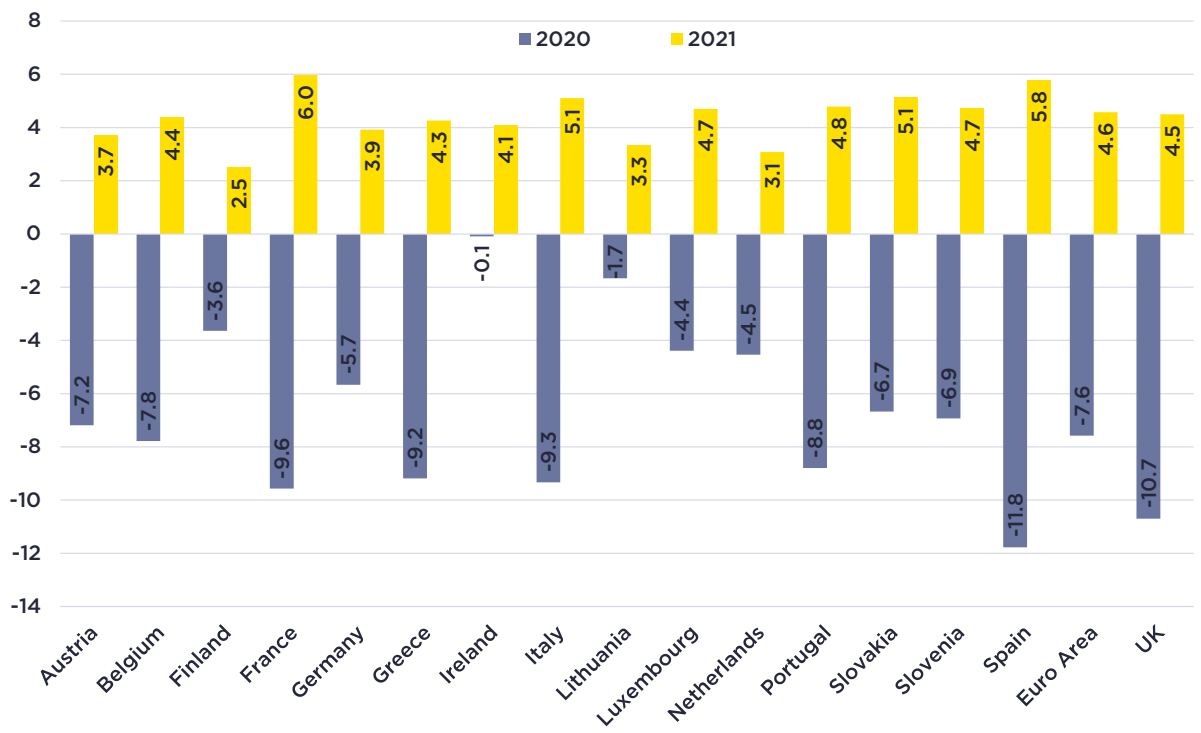
As Europe makes its way through the first quarter of 2021, much focus remains on the speed of the vaccine rollout across the EU. However, supply chain challenges with distributing the vaccines have begun to stagger momentum. The European Commission's plan to inoculate 70% of all adults in the EU by the summer would involve the bloc increasing vaccination rate by a factor of five times in order to meet this target.

2021 will look to consolidate some of economic losses observed during 2020, with Eurozone GDP growth anticipated to grow by 4.6% during 2021 (Chart 1). However, most economies will not fully recover their economic losses until end 2022, according to Focus Economics. It is likely that southern European economies most exposed to the tourism sector are expected to lag behind as weaker sentiment filters through the rest of the services sector, whilst CEE and Nordics countries are anticipated to witness among the most resilient economic recoveries.

The UK's extension agreement from the EU has provided some additional clarity for occupational decision-makers. However, employers remain cautious with respect to committing to new hires and Focus Economics anticipates that Eurozone unemployment rates will not recover to pre-pandemic levels until 2025 as the economy gradually rebuilds.

Apple's transit mobility data indicates that mainland Europe's key cities tended to operate at 60-70% of pre-pandemic levels during January 2021, lagging behind the key Asian cities, although remaining ahead of London and the key US cities.

Chart 1: European GDP growth rate (% per annum 2020, 2021)



Source: Focus Economics

Rising vacancy rates

2020 European office take up was down 32% on the five year average.

Enforced lockdowns and working from home continue to delay occupational deals from progressing as businesses review their operational strategies.

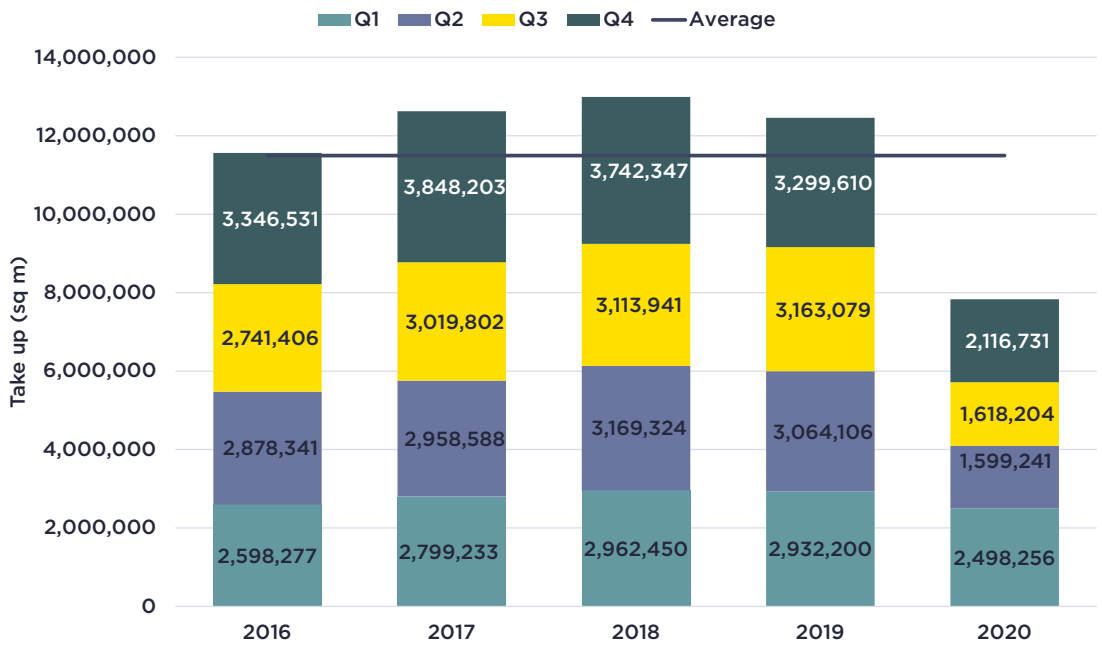
European office take up reached 7.8m sq m during 2020, down 32% on the five year average (Chart 2). Most markets observed a marked fall in demand as a result of the coronavirus pandemic, with London West End (-57%), London City (-52%), Barcelona (-48%) and Paris CBD (-44%) most significantly down on their respective five year averages. La Defense (+3%) was the only market to record an increase due to a megadeal which completed in the first quarter of 2020.

In an otherwise challenging year for the office occupational market, the Q4 2020 deal volume picked up by 31% against Q3 2020, which is above the 20% increase usually recorded in the final quarter's figures, suggesting occupiers are beginning to show some signs of resuming decision-making.

Delving deeper into the analysis shows that Q4 2020 take up was down 35% against the Q4 five year average, an improvement from the equivalent levels for Q2 2020 (-42%) and Q3 2020 (-41%), as some occupiers are seeking to agree lease terms now in order to lock in incentives.

As a result of waning demand however, we have observed a rise in office vacancy rates across the continent (Chart 3). Over the past 12 months, average European office vacancy rates have risen from record lows of 5.5% to 6.8% at end Q4 2020. La Defense observed the largest increase in vacancy rate on a percentage point basis, rising 580 bps to 11.3%, due to new development completions. However, Budapest (+2.9% to 9.1%), Warsaw (+2.1% to 9.9%) and London City (+2.3% to 7.6%) were the only other cities to observe vacancy rate increases by more than two percentage points over this time period. Indeed, Paris CBD and Berlin observed minor increases to 3.5% and 2.0% respectively.

Chart 2: European office take up (sq m)



Source Savills Research

We have observed more examples of tenant controlled supply increasing across European cities. London West End's tenant controlled supply has risen from 1.3% to 2.4% of total stock over the past 12 months, a similar pattern to Stockholm (0.6% to 2.4%) and Warsaw (0.3% to 1.9%). However, an increasing number of Europe's largest banks have reiterated the need for the office as they report of declining productivity levels relative to the first lockdown of 2020. We anticipate some of this "grey" space to adjust to "swing" space over the rest of the year.

Rising levels of availability have been fairly broad-based across each market, with the average core market vacancy rate rising from 3.0% to 4.5%. It should be noted that the equilibrium for stable rental growth across core European markets is a vacancy rate of circa 9%, suggesting the core markets still have some headroom for vacancy rates to increase before we see any real impact on prime headline rents. This is particularly the case with 2021 office pipelines already majority pre-let in Paris CBD (69%), London West End (60%), Munich (65%) and Berlin (50%). Given the flight to quality among occupiers, we anticipate the increase in vacancy rates to be more apparent across secondary stock where rents may begin to soften.

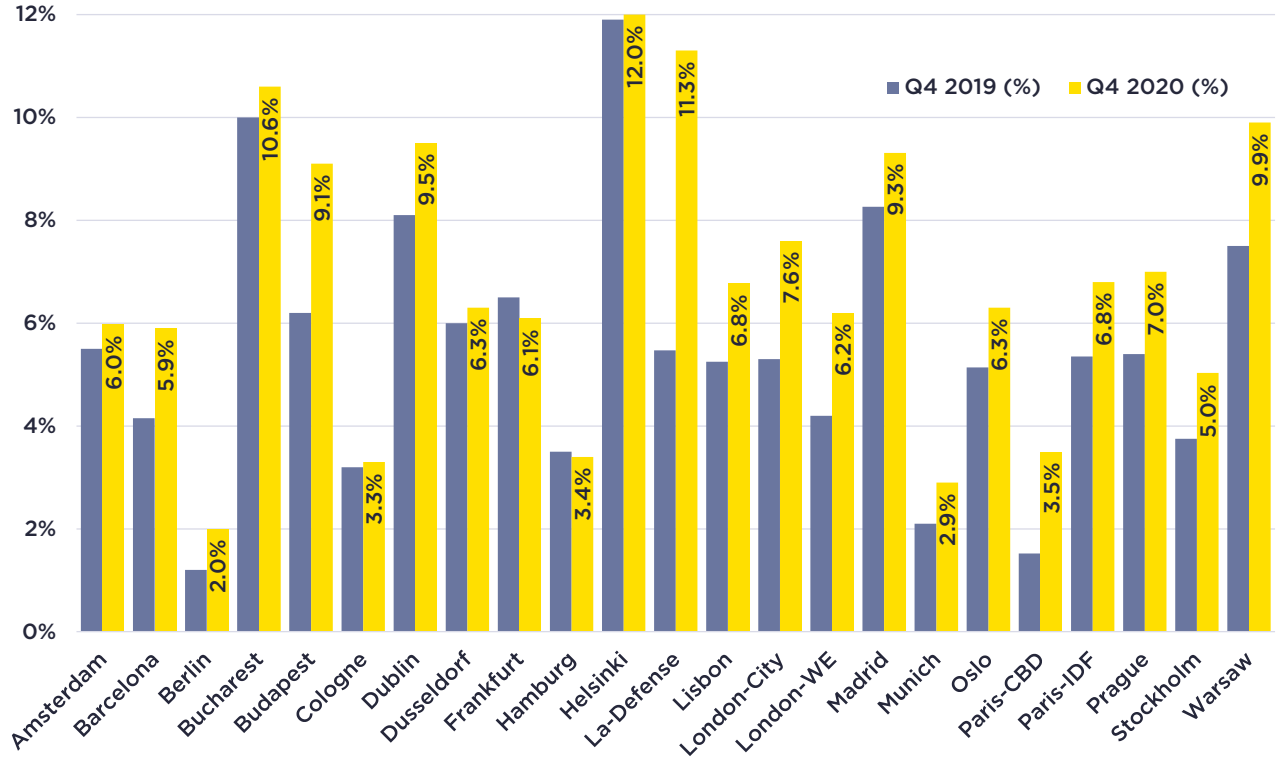
Average prime headline rents held stable across the majority of markets over the past six month period to Q4 2020, with London WE rising by 8%, outperforming the European average, as Dublin rents fell by 8%.

Oxford Economics forecast European office based employment to rise by 5.2% over the next five years (1.0% pa), whilst the major European cities are forecast to observe an average increase of 8.8% (1.7% pa), suggesting urban-based employment is still expected to grow faster than the national averages. As such, CBD occupiers may seek to retain existing levels of city centre office footprint.

Company surveys are indicating that workers would like to work remotely one to two days per week and companies are redesigning their existing space to respond to post-Covid behavioural changes. However, capex restrictions and ongoing uncertainty has meant that plans continue to be delayed.

Over the five year period 2021-25, Capital Economics forecast the strongest office rental growth across the core European cities of Frankfurt (1.8% pa) Paris CBD (1.6%), Munich (1.6% pa), Amsterdam (1.6% pa), Stockholm (1.6% pa) and Oslo (1.5% pa).

Chart 3: European office vacancy rate (%)



Source: Savills- as reported locally

Feature: office rent incentives

How have net effective rents changed during the pandemic?

As a result of occupational market uncertainty, Savills Research has observed an increase in incentives offered by landlords during H2 2020. The average office rent free period as a percentage of lease value has risen from 9.1% to 11.2% between Q2 2020 and Q4 2020. Paris CBD, Dublin and Amsterdam observed the largest proportional increases in rent free periods, whilst landlords for the key German cities including Berlin, Munich and Hamburg have resumed offering rent free periods.

In London, rent free periods remained fairly stable at 20% and 19% of lease value in West End and City markets following initial increases during H1 2020. However, Manchester's rent free period increased from 12 months to 15 months on a five year lease during H2 2020. However, we anticipate a level of circa 20-25% of lease value where rent free period stabilises and prime headline rent softens.

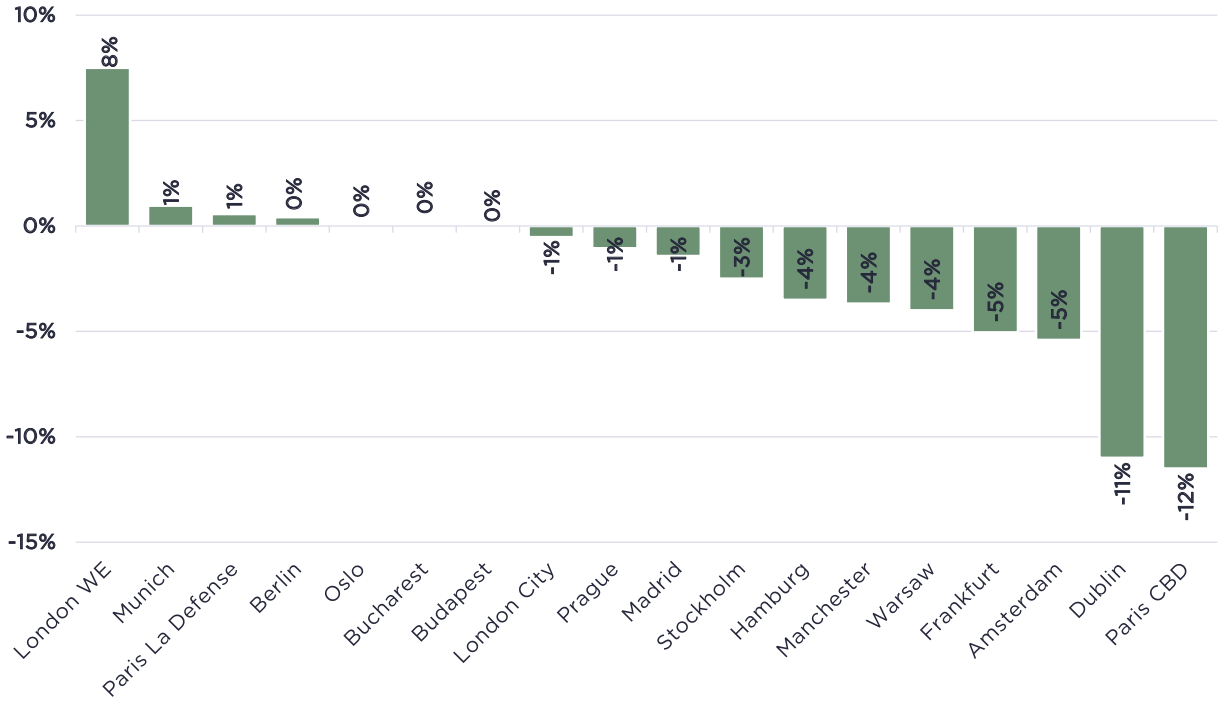
In essence, net effective rents are beginning to decrease across European markets (Chart 4) and have fallen by an average of 2% over the last six months. Net effective rents have fallen most significantly across Paris CBD (-12%), Dublin (-11%) and Amsterdam (-5%) over this period. By contrast, low vacancy rates across Munich and Berlin have continued to apply upward pressure on headline rents, despite additional landlord incentives.

We are observing landlords offering more flexible leasing proposals as a result on the market uncertainty. In Madrid, for example, landlords are able to offer leases with two fixed years plus three optional years, with more generous contributions to fit-outs, although rent free periods have remained fairly stable over the six month period. In Stockholm, landlords remain resistant to offer incentives, although we have observed some instances of rent free periods reaching 1-3 months on a five year lease and more commonly, increased tenant improvements have been agreed.

Office occupiers are also seeking to reduce costs by challenging the level of business rates or property taxes payable on their premises, particularly given that the UK's retail, leisure and hospitality sectors have received government aid as a result of the pandemic.

We anticipate average lease incentives will continue to rise throughout 2021 as lockdowns persist, although once certainty returns, businesses will seek a long-awaited return to the workplace. Looking forward, tenants who are able to lock in improved incentives this year will be the main beneficiaries.

Chart 4: European office net effective rental growth (%)



Source: Savills

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

Jeremy Bates
Head of Occupational Markets - EMEA
+44 (0) 20 7499 8644
jbates@savills.com

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

Research

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