Briefing note
Three reasons why office rents will continue to rise

July 2016

Office rents in the top six cities have risen continuously since 2004 with the exception of 2009, the year following the financial crisis. We believe this rental growth will continue over the coming years, regardless of the consequences of the Brexit vote, and put forward three arguments in favour of this assertion.

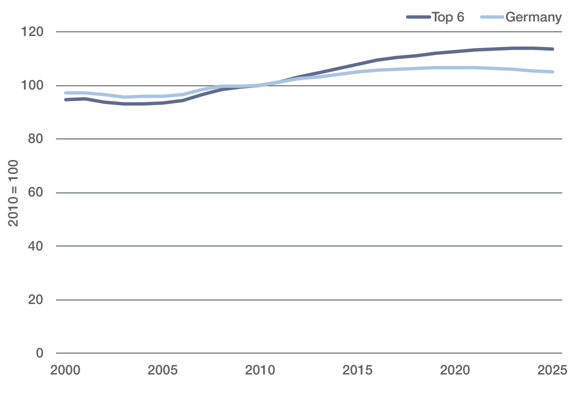
Trends in office rents are dependent on three influencing factors: demand for, supply of and development costs of office space. Consequently, we will look at these three aspects more closely below. In brief, however, all three criteria point towards office rents continuing (and accelerating) their growth over the coming years.

1. Demand will rise
While the German population has more or less stagnated for a number of years despite the current high levels of immigration and will soon begin to decline, the major cities are on a growth trajectory. Consequently, the number of employees in the top six markets is expected to increase until as far out as the middle of the next century (Graph 1). Assuming that the proportion of office employees in the overall workforce does not change materially during this time, and it has not done so for almost 20 years, then the number of office employees will continue to rise for another 10 years. While the amount of office space per employee is likely to decrease over the long term due to the increased adoption of co-working, desk sharing and home office, this will only occur very slowly owing to various hurdles to implementation (such as existing leases or status quo bias). The establishment of new office concepts could even lead to an increase in office space per capita in the short term. Providers of co-working space, for example, are currently expanding rapidly and taking up correspondingly large amounts of office space but have yet to replace traditional office space to a notable degree. At some stage they will do so, as companies cover temporary office requirements in co-working spaces rather than leasing their own premises. Until then, however, demand for office space in the major cities will rise and possibly even more quickly than the number of office employees.

2. Supply will contract
With new-build and refurbishment activity unable to keep pace with the rising demand for space in recent years, availability is increasingly diminishing. Since 2010, the vacancy rate in the top six office markets has fallen from more than 10% to just above 6% (Graph 2). This trend is set to continue over the coming years. Firstly, some vacant office buildings will be withdrawn from the market and converted to another use, normally residential. Secondly, development activity will remain relatively modest. Even the approximately 1.5 million sq m of office space scheduled for completion in 2018 will not be sufficient to maintain prevailing stock levels. Assuming an average (economic) life of 50 years for an office building, this would require a completion volume of almost 1.7 million sq m per year to at least maintain the current stock of 83 million sq m. Such a volume was last achieved in 2003. Consequently, the average age of the existing office stock is increasing year by year. Against a background of rapidly changing requirements for contemporary office space, this will lead to further contraction of the de facto usable office supply. Many older office buildings no longer meet current requirements, particularly in terms of layout. Such properties may be offered on the market and are, therefore, included in the vacancy statistics. However, they only represent actual office availability for a very limited group of occupiers if they do so at all.

3. Costs will rise
The increasing requirements placed on office buildings, particularly with regard to energy, are inevitably resulting in rising construction costs.

GRAPH 1
Development of number of emloyees

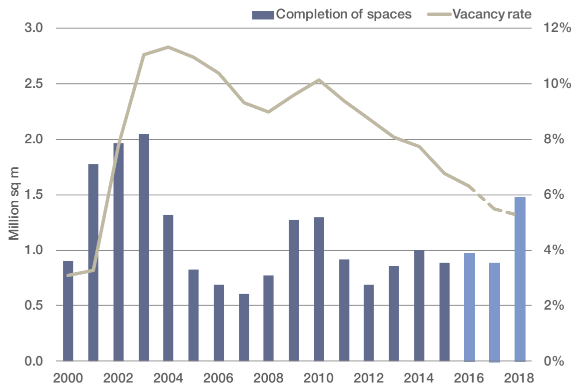


Source: Oxford Economics

Since 2006, net construction costs for office buildings have risen by more than 22%. In the 10 prior years, costs rose by only around 2% (Graph 3). Prices for commercial development land have risen to a similar degree. These rose by almost 5% between 1996 and 2005 before gaining nearly 14% over the 10 years that followed. In both cases, the inflation is likely to continue over the coming years. In the case of construction costs, one contributing factor will be the amendment of the German Energy Saving Ordinance, which recently came into effect. In addition, capacity utilisation in the construction industry is likely to remain very high for some time yet owing to the significant new-build housing requirements. The increasing housing requirements and general ongoing urban growth will also increasingly drive land prices higher.

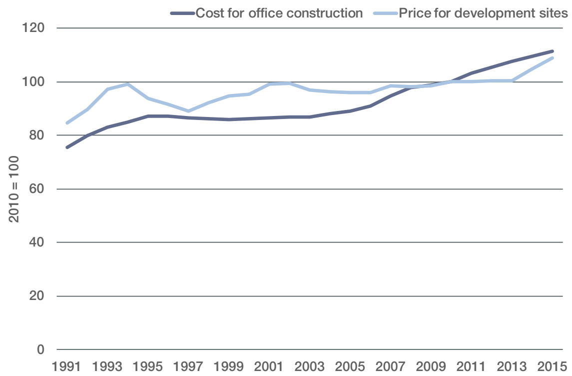
In conclusion, all three aspects discussed point towards a continuation or even acceleration of the rental growth witnessed in recent years in the office sector in the medium term, i.e. the next three to five years. The extent of this growth will vary from one city to another according to local characteristics and changes in conditions. In Frankfurt, for example, owing to the sustained relatively high vacancy rate, comparatively high completion volume and low projected growth in the number of employees, we expect rental growth to be below average compared with other cities. In Berlin, on the other hand, the conditions (low vacancy rate, low completion volume, powerful employee growth) suggest above-average rental growth. Irrespective of this, however, we expect rents in all six cities to show stronger growth over the next three years than their respective averages over the previous three years.

GRAPH 2
Completions and vacancy in top 6



Source: Savills / * forecast from 2016 on

GRAPH 3
Costs for construction and sites



Source: Federal Statistical Office

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