SPOTLIGHT
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Savills Prime Office Costs

Rising costs remain key but green shoots appear

Global uncertainty has dominated the narrative through 2022, producing inflation, volatility, and rising costs for occupiers. Inflation has been the key story for the year, both for individuals and also for firms looking to take up office space. Supply chain disruption and rising costs for materials and labour are leading to higher fit-out costs and longer construction times, at a time when occupiers are looking to create dynamic spaces to attract and retain the best and brightest talent. The role and function of office spaces continues to be challenged and reimagined by real estate teams and business management, something that persists in creating uncertainty in office markets around the globe.

Against this background of global uncertainty and general caution, in the coming quarter the world looks to Egypt for the annual COP meeting in Sharm-el-Sheik. With the global consciousness once again turning to sustainability, questions such as how the built environment contribute positively to the cause once again come to the fore. The global property sector contributes nearly 40% to global carbon emissions, with significant untapped potential to increase sustainable outcomes across all sectors. For office occupiers, increased use of technology, monitoring and achieving energy savings, encouraging employees to use more environmentally friendly commuting methods, and occupying green-certified spaces can all help to lower carbon emissions and is an important and necessary step in achieving sustainability targets. The increasing focus on sustainability, particularly sustainable office spaces, is helping to contribute to the emergence of a green rental premium for environmentally friendly offices in key markets.

Each quarter, the Savills team of expert local tenant representation professionals and researchers present a snapshot of occupancy costs for prime office space across the global markets critical to our clients.

For this issue of Savills Prime Office Cost (SPOC) insights, we spoke with local tenant agents and sustainability professionals to gather market insights and understand how the drive towards sustainability and a greener economy is affecting occupier behaviour, and whether key locations are seeing a rise in green rental premiums from increased occupier demand.

Focal points

Inflation, supply chain issues, and ongoing uncertainty are driving rising costs for occupiers in many markets, particularly fit-out costs

Some key markets are seeing face rent costs increase, while others are only seeing increases in fit-out costs

Green offices – those which help occupiers meet ESG and sustainability targets – are seeing rising demand globally, driving rising rents for these spaces

City	Net Effective Cost to Occupier (Annual PSF)	Trend from previous quarter
Hong Kong	$248.41	-1% ↓
London (West End)	$218.35	0% ↓
New York (Midtown)	$168.54	0% →
London (City)	$138.17	5% ↓
Tokyo	$136.96	2% ↓
Singapore	$131.89	0% ↓
Beijing	$130.20	0% ↓
Shanghai	$117.54	0% ↓
San Francisco	$114.13	0% →
Dubai	$108.66	3% ↑
New York (Downtown)	$105.91	0% →
Paris	$98.66	2% ↓
Delhi	$95.50	0% ↓
Los Angeles (Westside)	$89.88	0% →
Sydney	$87.72	3% →
Shenzhen	$86.13	2% ↓
Seoul	$82.18	2% ↓
Mumbai	$81.27	0% ↓
Dublin	$80.34	7% ↑
Washington DC	$79.42	0% →
Ho Chi Minh City	$77.51	2% ↑
Chicago	$75.67	0% →
Toronto	$72.37	0% →
Guangzhou	$63.96	-2% ↓
Madrid	$62.18	2% ↓
Houston	$59.80	0% →
Amsterdam	$56.93	1% ↓
Berlin	$54.73	3% ↓
Frankfurt	$53.63	-1% ↓
Kuala Lumpur	$42.51	0% ↓

Source: Savills Research

Note: Net effective cost to occupier includes the gross rent (inclusive of property taxes and service charges) plus fit-out costs, less any concessions for rent-free periods

Quarterly highlights

Global uncertainty – both economic and political – is continuing to contribute to volatility and rising prices in the office markets. Rising fit-out costs resulting from inflation in commodity prices, ongoing supply chain issues, and increasing construction and labour costs continue to be a key focal point for occupiers looking to take up space in prime CBD assets. Year to date, fit-out costs have increased across the SPOC markets by an average of 10%, broadly aligning with headline inflation figures. While uncertainty in the markets remains, it is likely that rising costs will persist through the near term.

Through the third quarter of the year, most markets in Asia Pacific haven't seen large changes in rental costs. However, they are not insulated from global supply chain issues contributing to rising fit-out costs. For the region, rental movements are flat on the quarter and down 1% on the year. Locations which have each seen increases in the third quarter include Shenzhen (+2%), Seoul (+1%), Singapore (+1%), and Ho Chi Minh City (+2%). Rental costs are overshadowed by rising fit-out costs, which have risen an average of 3% from Q2 and 9% from Q3 2021 across Asia Pacific.

European and Middle Eastern office markets are more varied, seeing an increase in average gross rent across the region of 2% from Q2 and 6% over the past year. These higher rates can be attributed to both index-linked rental increases, rentalised fit-out costs in some markets, and the fact that energy costs, which are rising precipitously, are often factored into service charges. Fit-out costs are also continuing to rise, increasing by an average of 14% on the year as materials and labour inflation continues to have an effect.

The United States and other North American markets have seen less movement of rental figures, although fit-out costs have seen increases of 7% on the year: lower than the average headline inflation figure but still a sharp increase. Across the region in many major cities, workers have been notoriously slow in returning to offices post-pandemic, leading many firms to seriously reassess their space needs. Savills teams in North America note that there is an increase in subleasing activity, which indicates longer term space and cost reductions from occupiers.

Markets which have seen the largest increases in net effective costs over the quarter are largely clustered in the EMEA region, locations such as Dublin (+7%), London City (+5%), Dubai (+3%), and Berlin (+3%). European market costs have been largely driven by the increasing face-rents as well as rising fit-out costs in many cities, in addition to all time low vacancy rates in many locations. As demand continues to rise in Asia Pacific markets and key North American cities, occupiers will likely continue to pay rising costs as fit-out increases lead to higher net costs for occupiers in the near term.

Rising costs are slowing down development and retrofitting activity creating shortages of prime, sustainable office spaces. This shortage is partially driving the emergence of a green rental premium of between 4%-15% in Asia Pacific markets, 10% in European markets such as the Netherlands, and between 5% and 10% in the US office markets as occupiers look to increase their sustainability in line with corporate and national targets.

Market insights – The rise of the green premium

Global differences in what constitutes ‘green’ and varying levels of environmental legislation can make selection and reporting on space extremely complex. World Research spoke to four regional leaders in the office markets and sustainability research to understand regional differences and trends in sustainable office spaces.

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What constitutes ‘green’ in your market?

MS: In Australia the most broadly applied environmental rating scheme is called NABERS (National Australian Built Environment Rating System). Ratings in this system are issued for Energy, Water, Waste and Indoor Environment. The ratings range from one (lowest) to six (market leading). In addition, we have the Green Building Council of Australia’s GreenStar rating system which operates in a similar manner to the US based LEED building rating scheme. The understanding and use of these rating schemes has steadily increased over many years with developers, owners, occupiers and more generally across the real estate industry.

EW: In the Dutch market BREEAM is most common certification for green office space. We’re also seeing a growth in the WELL certification which is more focused on health and wellbeing from a user perspective. From 1 January 2023, offices in the Netherlands will need to have as a minimum energy label C, which is leading to a lot of focus on energy labels and implementing energy improvements from both an occupier and landlord perspective. This creates added complexity when considering long term options.

WFB: I think it is fair to say LEED would be what constitutes green. For the most part, it is common to have buildings with some level of LEED. However, it’s important to distinguish between the perception of being “green” and actual performance of the building. For example, a lot of LEED Platinum buildings in NYC were rated B or C and not an A based on the new building performance rating requirement for commercial buildings of certain size.

HR: The term “green” is not a well-defined one, which made this question tricky to answer. There are two components to being “green” – environmental sustainability (measured by energy and water efficiency, waste management, carbon footprint reduction) and occupants’ health and safety (measured by air, water, acoustics, and lighting quality, and non-toxic materials and finishes). As CRE professionals and clients become better versed on what constitutes sustainability, we are seeing a trend towards certifications and frameworks that measure the performance of buildings that benefit environmental outcomes and occupants’ experience, beyond looking for LEED certifications (which is not a performance-based certification). For cities in the US with stringent building performance requirements (namely NYC, Washington DC, Boston, and Denver), the key basis is Energy Star score which needs to be re-evaluated every year. We are also seeing preference for performance measurement over certification for the sake of having one.

Are tenants willing to pay a premium for green office spaces? What sort of premium can they command?

MS: Yes most tenants certainly have an environmental conscience when making their real estate decisions. We don’t see that tenants want to pay a premium; however, it generally goes that the better for the environment buildings are, the higher the quality of building and as such these offices come with a higher rent exposure.

EW: Yes, indeed. We see an approximate 10% premium on the rent for a ‘green’ building. However, this premium would only be the case if the asset is a comprehensive business case. Meaning it has to make sense on all elements: high quality amenities, attention to health and wellbeing, big floor plates, high delivery level and attention to green in terms of BREEAM, biophilic and/or WELL certifications.

WFB: We are seeing a flight to quality and quality buildings typically are more “sustainable” - including wellness whether through certification or just modelling the ABC (all but certified). And quality buildings typically have higher rents. We don’t tend to see landlords marketing their buildings as “green” but do see more focus on overall sustainability in general and wellness in particular, including air quality and other elements.

Are you seeing the emergence of a brown discount? Are rents for non-green office spaces dropping and what sorts of price falls are you seeing?

MS: The buildings that offer less environmental amenity are generally lower in quality and older and as such you expect the rents to be lower. Which ties in well with the trend of the better and higher quality buildings being generally more environmentally friendly.

EW: We don’t see any sort of brown discount yet, but we would expect to see one emerging especially now that energy costs are rising in the Netherlands. The pool of occupiers who could accept a lower quality building is dwindling.

WFB: There’s a disconnect between supply (abundant) and demand (tepid) for buildings that are older and less forward thinking on things, which might in fact create a “brown discount”. The biggest problem that “brown” buildings may have is occupancy in the future. It will involve larger concessions to entice a tenant to go there. Also, it is worth noting that landlords already stretch hard to secure a tenant – DC has the highest concessions in the country both for higher end product and commodity buildings.

HR: These sorts of concessions for the more ‘brown’ buildings could include accommodations or allowances for sustainability-related features and infrastructure for ESG data collection (e.g. submetering). These are based on a recent transaction that was completed in DC. Having brokers who understand the long-term and strategic importance of ESG and actively bring in experts to advocate for their clients’ interests on this level is also really important.

Outlook

Office utilisation continues to slowly increase, though it appears to have plateaued across the SPOC markets with utilisation rates standing at 62% compared to 61% in Q2 and remaining lower than the pre-pandemic average of approximately 70%. Office utilisation in the US has ticked up in recent weeks (46% in Q3 compared to 42% in Q2) as many firms used Labor Day in September as a date to encourage workers back to the office. However, uncertainty, cost pressures from rising utility costs, sustainability requirements, and the desire to attract talent and improve company culture means occupiers are willing to downsize and locate in prime buildings.

Uncertainty remains around risks from inflation rates, geopolitics, and the ongoing energy crises facing many economies this winter. Occupiers face rising costs from energy, although many who are locked in to their leases will be insulated from the largest sources of volatility: potential rent increases and the costs for fitting out a new space.

Sustainability scores points for occupiers looking to attract new workers in the war for talent and for bringing current staff back to the office. Several SPOC markets will also face stricter EPC certification requirements over the coming year, which will also affect where occupiers choose to take up space.

Currency crunches could lead to some markets looking more attractive for US headquartered firms and other US dollar-denominated businesses that may be looking to expand. The ongoing strength of the dollar has the potential to offset any local currency price increases.

Methodology

The Savills Prime Office Cost (SPOC) Index presents a quarterly snapshot of occupancy costs for prime office space throughout the world, as provided by our expert, local tenant representation professionals and researchers.

The adjusted annual all-in occupancy cost represents real-time transaction terms for 20,000 sq ft (2,000 sq m) of usable space based on a basket of top 5 most expensive properties to calculate ultra-prime average. The North American markets use a sample of very high rent threshold buildings (leasing occurring at the highest end of market).

All costs are reported in a standardised format of USD per sq ft of usable space per annum to account for variations in currency, reflect local payment protocols, and adjust for measurement practices across the globe. We have also factored in the credit value to the tenant generated from abated rent and the cost associated with fitting out the premises in order to provide an 'all in' total occupancy cost in USD per usable square foot.

The fit-out costs were gathered from local Savills teams assuming the leasing scenario described above, plus the following: i) 30% cellularisation with the remainder of space open plan, ii) construction and cabling only (no furniture or professional fees).

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