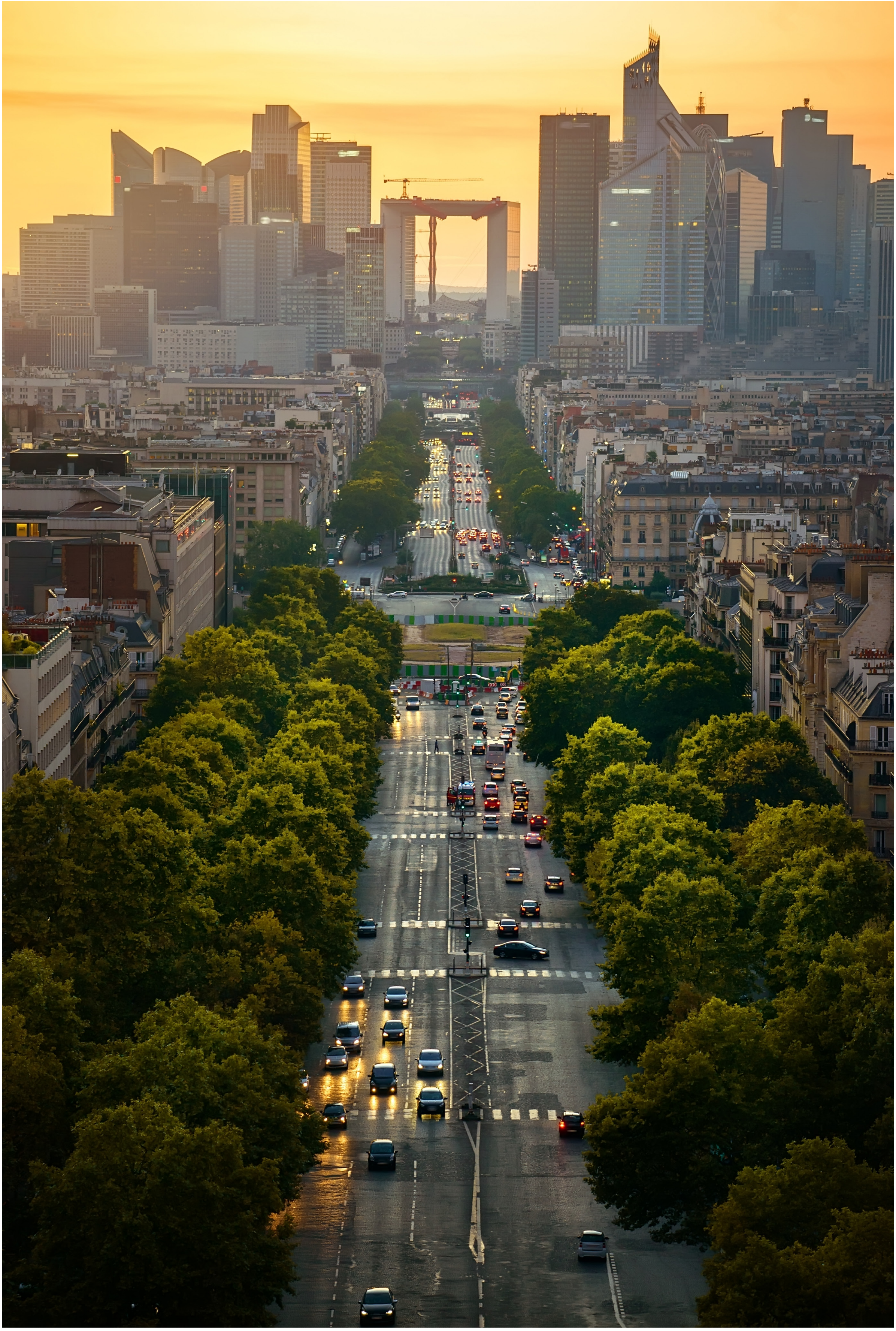
European Commercial – Winter 2018/19

SPOTLIGHT
Savills Research

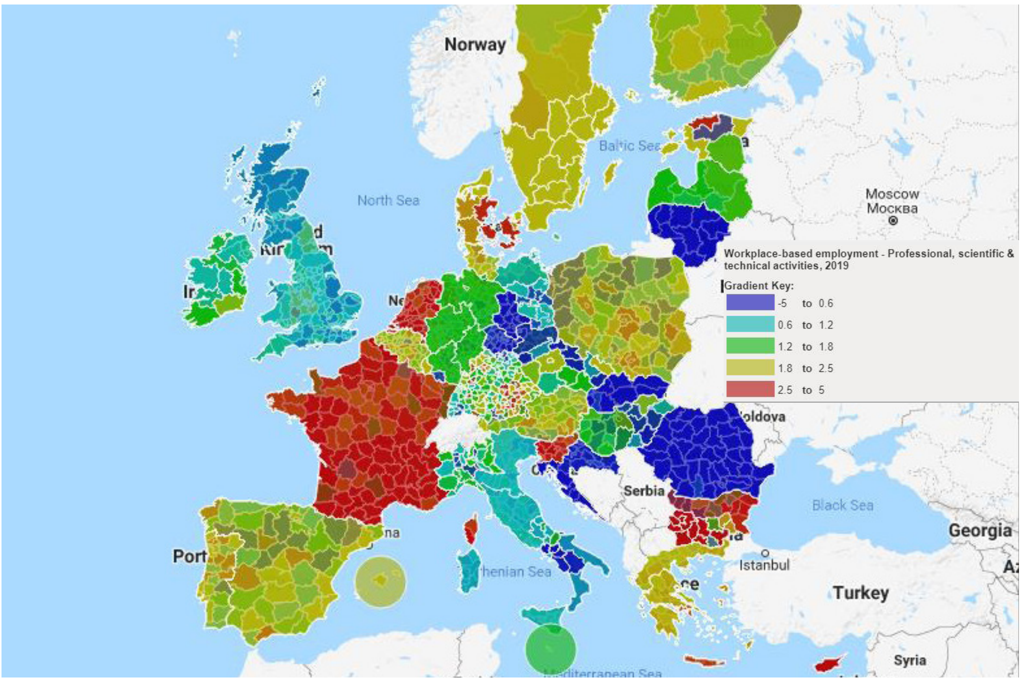
European Offices



● Rental Growth Prospects ● Scarce CBD Supply ● Record Venture Capital Investment

> “Several occupiers have been forced to choose fringe locations or secondary properties to satisfy their needs, while others have postponed their decisions until more options become available.”

Map 1: France, Netherlands and Bulgaria will see Professional, Scientific and Technical Activities employment growth in excess of 2.5% in 2019.



Source: Savills Research, Oxford Economics

Economic Overview

The European Union economy showed modest growth in the third quarter of 2018, with GDP growth reaching 0.3%. However, with PMIs remaining above 50, indicating expansion, and unemployment continuing its downwards trend to 6.7%, we believe that the economy remains in strong health moving into 2019. We expect this to filter through into real wage growth in 2019, as inflation hovers around the 2% mark, and business confidence solidifies.

Forecasts from Oxford Economics indicate that across the European Union member states, Professional Science and Tech will be the fastest growing office based employment sector in 2019, with employment growth expected of circa 1.8%. This indicates in the region of 280,000 net additional jobs will be created in this sector over the next twelve months, which will add upwards pressure to rents, as competition for prime stock intensifies. France, Netherlands and Bulgaria will among the beneficiaries, with forecast employment growth in this sector in excess of 2.5% (see Map 1).

Supply constraints

Occupational activity restricted by scarcity of supply, heaping upward pressure on rents.

Persistent Demand

Office take-up is on track to reach 8.6 million sq metres in the European markets that Savills monitor in 2018. This has been partly bolstered by several of the smaller markets in Europe experiencing higher activity levels compared to the same period last year, such as Vienna (55%), Dublin (19%) and Barcelona (16%). Some of the larger markets such as Ile-de-France (IDF) (19%) and Munich (22%) also performed well. Employment creation and demand for well-designed and well-located offices are driving the activity.

Nevertheless, our end year projections indicate a potential drop of 6.7% yoy in total office leasing activity, with all markets except Dusseldorf (+8% yoy), Dublin (+8% yoy) and Warsaw (+2% yoy), anticipating a drop in take-up volumes by 5-15%. This can be explained by a common theme that characterises most European markets: occupiers are not able to find the type of space they are looking for. Modern premises are scarce in most cities, as vacancy rates are at historic lows and new supply does not keep up with demand.

Falling Vacancy

The average vacancy rate was at 6.1% in Q3 2018 down from 6.9% in the end of 2017 and we anticipate that it will edge slightly lower by the end of this year to 5.9%. Paris CBD (1.5%) and Berlin (1.6%) have almost no available office space, Munich follows with 2.6% vacancy rate and Cologne and London WE are also amongst five cities with the lowest availability at 4.2%.

Under these conditions several occupiers have been forced to choose fringe locations or secondary properties to satisfy their needs, while others have postponed their decisions until more options become available. Committing to space in buildings under construction is another possibility for companies that can plan in advance, with the level of pre-lets at 58% of the expected development completions in H2 2018 and at 40% of next year's pipeline.

Flight to Flexibility

A number of occupiers have chosen to temporarily cover their needs through flexible office space arrangements, either in order to deal with the lack of immediate availability or with political uncertainty – especially in relation to Brexit. Flexible office space take-up accounted for about 8% of the total in Q3, up from 7.2%

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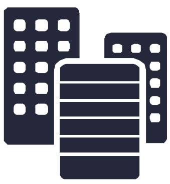
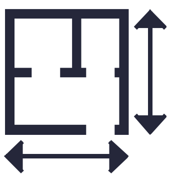
0.3% GDP growth recorded in the European Union during Q3 2018.

8.6 million sq metres of office take-up forecast for 2018 European cities.



6.1% average office vacancy rate across European cities, down from 6.9% at end 2017.

4.0% average annual prime office rental growth recorded across European cities during Q3 2018.



58% of H2 2018 European development completions are pre-let.

at the end of 2017. Flexible office space operators have been quite acquisitive, accommodating not only small scale needs but also larger occupier requirements.

City Analysis

-Rents in the top six **German** office markets continue to show strong growth. This is a reflection of the increasingly acute supply shortage. The average vacancy rate across the top six cities currently stands at 4.6% and falling, with **Berlin** and **Munich** showing the lowest vacancy rates of 1.6% and 2.6% respectively. Occupiers that cannot, or refuse, to pay the currently very high rents are forced to make compromises in terms of quality of space or location. However, such compromises could come at the expense of employee satisfaction. Owing to the increasing supply shortage, take-up declined by 5% yoy to 2.6 million sq m and is unlikely to reach last year's record level in 2018. 1.2 million sq m of office space is due to come to the market in 2019, the largest amount since 2010.

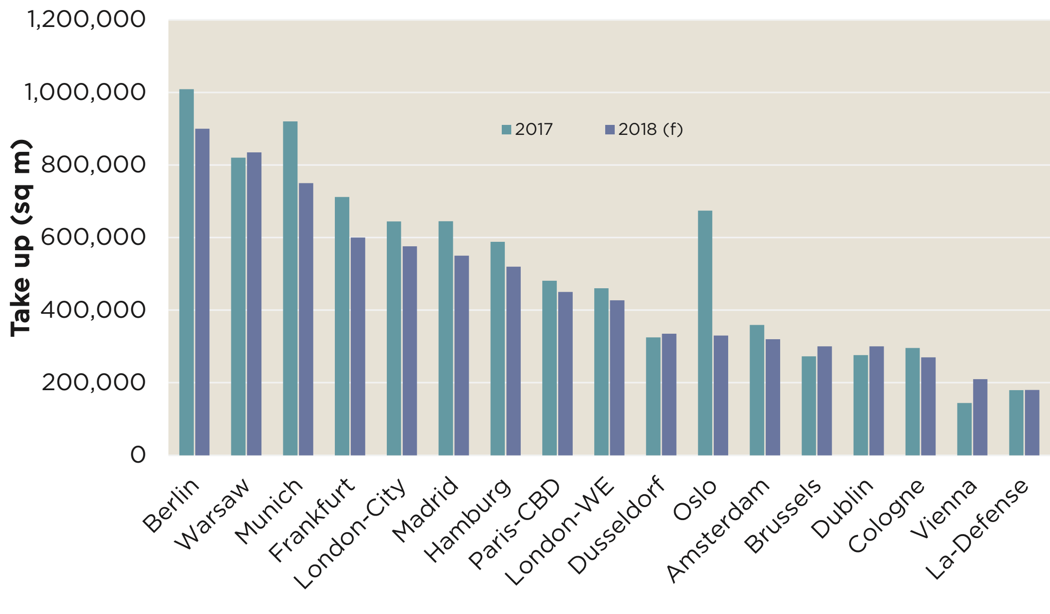
-Despite a weaker Q3, office demand in Ile de France remained upbeat. Take-up in the first nine months of 2018 was up 6% (1,9 m sq m) compared to 2017, which was itself a strong year. Strong demand for central **Paris** and La Defense persists, but lack of options has pushed occupiers in the suburbs as well (Inner Suburbs +11%, Outer Suburbs 25% yoy). Flexible office space operators are particularly expansive leasing more than 70,000 sqm since the beginning of the year, both in the CBD and other locations such as Paris 3-4-10-11 and 12-13 Districts. As a consequence of strong letting activity, the average vacancy rate for IDF has dropped to 5.5%, with Grade A supply representing barely 16% of the available stock. This scarcity is likely to disrupt lettings activity and to put upward pressure on rents, not just in central Paris but other submarkets offering good accessibility and quality stock. Around 30 developments over 5,000 sq m which are in the pipeline for the CBD over the next two years, should help rebalance demand and supply. Some occupiers may even delay their decisions until more options are available in the market.

-**Dublin** has witnessed 17 deals of over 5,000 sq m this year, a rarity for the market. This reflects the changing occupier base with large ICT firms favouring a city campus model that facilitates recruitment and retention of talent. Nearly 73% of these bigger transactions were pre-lets. Brexit uncertainty, new lease accounting standards and the pace of technological change are pushing occupiers towards flexible office model. In the first three quarters of the year this accounted for 13.5% of total take-up.

-Healthy take-up volumes in **Warsaw** (632,000 sq m in Q1-Q3 2018) have pushed the overall vacancy rate to a five year low of 10% and can be as low as 2.4% in the North zone of the city. New supply has slowed down in Q3 and the next substantial deliveries are expected in H2 2019. As a result incentives are decreasing, also due to rising labour and construction costs.

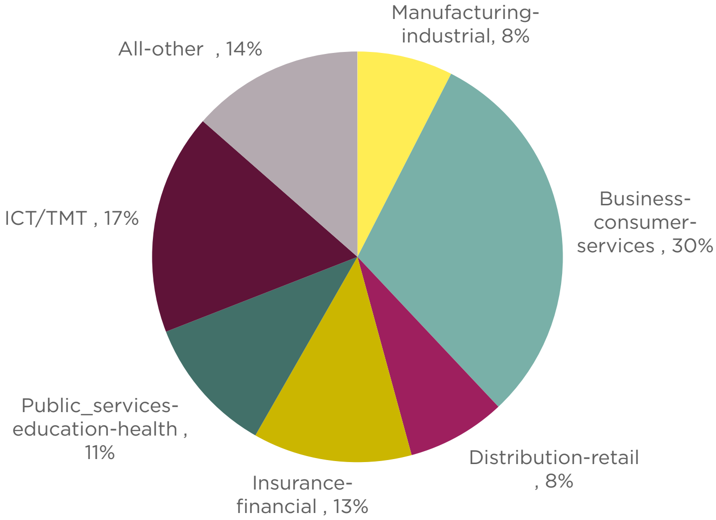
-**Stockholm** remains a landlords market, with rising rents across most submarkets. In the CBD, the sharp rise in rental values that

Chart 1: Berlin and Warsaw on course for the strongest take-up volumes across Europe in 2018.



Source Savills Research

Chart 2: European office take-up by sector: Between Q1-Q3 2018, Business and Consumer services and Technology, Media and Telecoms accounted for nearly half of total take-up.



Source Savills Research

began in 2016 has continued in 2018. The overall vacancy rate is at historically low levels, with the CBD rate at 4.7%.

-In **Oslo** there is a shift of demand towards fringe locations, as occupiers become more realistic about availability of space and more sensitive to high rents commanded in central locations. However, proximity to public transport is of paramount importance to users. Construction activity has picked up to meet demand, however, net new supply is not going to increase substantially before 2020, as there is a significant amount of demolitions and conversions. Positive employment growth outlook will sustain low vacancies and rental growth.

-In **Vienna** rising demand has driven the dynamic development of office clusters across the city, which have been commanding high rents due to good connectivity and outstanding architecture. Micro-locations south and north of Vienna, the AirportCity and others where large projects are underway will be focal points for growth over the coming years.

-Q3 has confirmed the strong take-up of flexible office space in **Brussels**, with over 16,000 sq m during the quarter or 29% of total letting activity, with Spaces, Regus and Multiburo as protagonists. Despite a weak Q3 for the public sector, it still accounted for 30% of total activity since the beginning of the year. 68% of all transactions are led by small requirements up-to 500 sq m, a market characteristic that may support the expansion of flexible office space.

-In **Barcelona,** the market continues to experience a downward trend in supply. Prime and CBD areas have almost reached 100% occupancy, which diverts the search for spaces to new business areas and the periphery. As a result prime rental values were 9.3% higher in Q3 2018 compared to last year. Development activity has picked up and 74% of this year's pipeline has been pre-let.

-In **Madrid,** the third quarter showed a boost after a discreet first half of the year (162,000 sq m). This is the best data of the historical series since the pre-crisis era. Asking rents continue to increase in the best buildings in the CBD area (8.3% yoy). The supply of quality buildings in prime locations has risen thanks to the entry of new and refurbished products. Many occupiers seeking large spaces in quality buildings have found the solution in pre-letting contracts during 2018, 45% of the pipeline.

-In **Amsterdam,** the scarcity of office space has resulted in a fall in take-up over the past two years. Total take-up for the year can be expected to be in line with the 10-year average (> 300,000 sq m). Amsterdam has seen steady rent rises in recent years. This has been a consequence of the increasing shortage across the whole of Amsterdam's office market. As a result, prime rents have risen to above €400 per sq m, with some outliers even exceeding €500. The combination of low vacancy, sustained demand and limited new-build will create additional rental price pressure on central Amsterdam's office market.

-**City of London** take up at end Q3 2018 stands 18% up on

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RECORD €69BN OF TECH VENTURE CAPITAL INVESTMENT BOOSTS TAKE-UP IN 2018

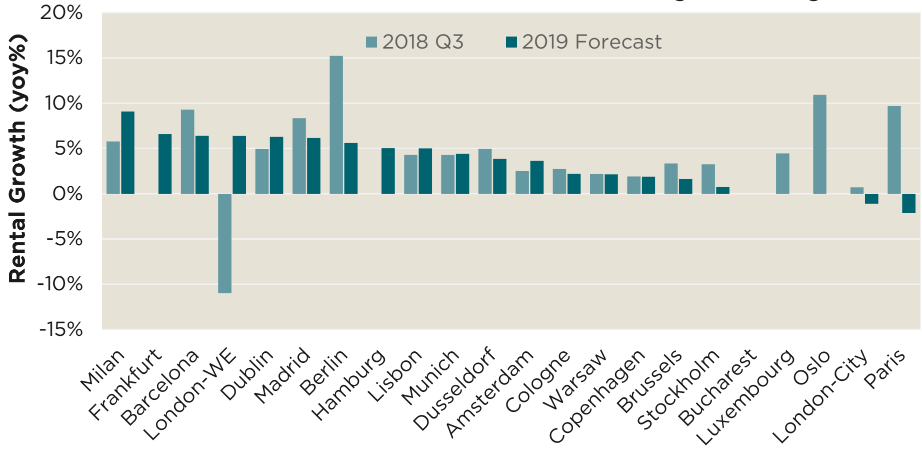
A total of €69bn of tech venture capital has been invested across Europe during 2018, up 129% on 2017's level of €30bn.

Savills Research tracks venture capital flows across Europe as a key indicator of latent office demand. Once venture capital funding has been secured, this can create a new office space requirement from tenants who are looking to expand in the following c.12-18 months. We expect European office markets to benefit from new requirements off the back of this unprecendented level of corporate investment.

2018 has been another strong year for the Technology, Media and Telecoms (TMT) sector across the European office market. TMT has accounted for c.17% of the office market so far this year, up from 15% during 2017. Dublin has been one of the key drivers of this, with 90,000 sq m taken by tech based firms, accounting for 45% of the city's total take up. Interestingly, the proportion of insurance & financial services take-up across Europe fell from 18% to 13% between 2017 and Q3 2018.

17%
of European office take-up during Q1-Q3 2018 was accounted for by the ICT/TMT sector.

Chart 3: Rental Growth Berlin and Oslo recorded rental growth of over 10% in 2018, with Milan and Frankfurt on course for the strongest 2019 growth.



Source Savills Research

the 10-year average for this stage of the year. The insurance & financial sector has accounted for around 20% of take up, with serviced office providers appetite remaining strong, at around 12%. This has boosted average prime rents to £80 per sq ft (€955 per sq m), 6.5% above the 2017 level.

London West End office demand has been largely boosted by the tech and media sector during 2018, which accounted for 45% of total activity. 75% of these transactions have been below 10,000 sq ft (929 sq m). Vacancy rate now stands at only 4.2%, with over two thirds of 2019's office developments already pre-let.

Lisbon office take up is on course to exceed 200,000 sq m by end 2018, over 24% above the level recorded in 2017. Due to the shortage of new office deliveries over the next 2-3 years, rents could reach €280 per sq m by end 2019, which could see some demand filter out to the Western Corridor/ Zone 7 markets.

Vacancy in the **Prague** office market fell to 6.1% in Q3 2018, with 55% of the space under construction currently pre-let. Take-up is forecast to reach between 270,000 sq m and 290,000 sq m for the full year, in line with the long term average.

Outlook

According to Oxford Economics there will be 2.8 million additional office based jobs created over the next five years within the European Union. We expect this to sustain demand for office space, particularly high quality premises in good locations. Property strategies are core to the attraction and retention of talent for most companies and competition for the best buildings is set to continue. As a result we expect another year of market fundamentals in favour of landlords, with rising rents and reduced incentives.

On the other hand, occupier expectations for service, amenities and flexibility will put pressure on office owners to offer space under these terms in order to compete with the expanding flexible office operators. The share of flexible office space in take-up is likely to continue to rise, especially in markets with limited immediate availability (Berlin, Paris), where the uncertainty of Brexit impacts business decisions (London, Dublin) and where ICT sectors are growing more rapidly (Madrid, Stockholm).

At the same time, as economic growth stabilises and even slows down in some cases and quantitative easing comes to an end, developers may become more cautious and focus on well-connected locations in mixed use environments for launching new projects. Next year occupiers will have slightly more choice as development activity has also picked up along with growing demand for offices. However, as we explained in our recent Briefing Note (European offices - Half of the development pipeline is pre-let, October 2018) all the expected new supply can be absorbed based on employment creation forecasts (Oxford Economics).

We predict that prime rents in the desirable locations will rise for another year, albeit at a slower rate than in 2018. By the end of 2019, we expect prime rents to be on average 3.4% higher than last year. We forecast that the markets with the highest increases will be Milan (9.1%), Frankfurt (6.6%), Barcelona (6.4%) and Dublin (6.3%).

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2.8 MILLION ADDITIONAL OFFICE BASED JOBS TO BE CREATED IN THE EU OVER THE NEXT FIVE YEARS

An improving economic backdrop across Europe will create more office based jobs and increased demand for new office space. A net additional 2.8 million office based jobs are forecast to be created in the EU28 countries over the next five years, reflecting 4.4% growth, according to Oxford Economics.

1.2 million jobs will be created in the professional, science and tech sector, with a further 1.2 million jobs in the administrative sector, reflecting a 7.5% increase in headcount in each sector.

Sweden (8.5%) and Denmark (8.2%) are forecast to see the strongest employment growth over the next five years, supported by professional and tech employment growth.

By total headcount, despite Brexit concerns, the UK is forecast to see the strongest office based employment growth of 609,000 net additional jobs over the next five years. Around half of these will be delivered in the administrative and support sector.

We generally expect city level employment growth to outperform country level growth as increasing urbanisation draws talent to key cities, adding upward pressure to CBD rents.

6.6%

Forecast increase in Frankfurt office rents for full year 2019.

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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