European Commercial - June 2024

SPOTLIGHT
Savills Research

European Office Development

● Pipeline ● Conversions ● Viability

Vacancy rates stable

Office take up rose 2% YoY during Q1 2024.

European office take up rose by 2% YoY to 1.7m sq m during Q1 2024, however, this remains 11% below the pre-pandemic five-year Q1 average. Southern Europe performed strongly, with Lisbon (+82%), Barcelona (+20%), Milan (+9%) and Madrid (+6%) all above the pre pandemic five-year Q1 average. For the full year 2024, we expect take up to remain in line with 2023 at circa 7m sq m.

Office vacancy rates remained stable at 8.4% during Q1 2024, with Paris CBD (2.3%), Cologne (3.6%) and Hamburg (4.0%) all undersupplied. Prime rents continue to rise, increasingly by an average of 3.6% over the last 12 months to Q1 2024. London City (+15%), Dusseldorf (+11%) and Munich (+10%) observed the largest increases over the past 12 months.

Chart 1: European office take up (sq m)

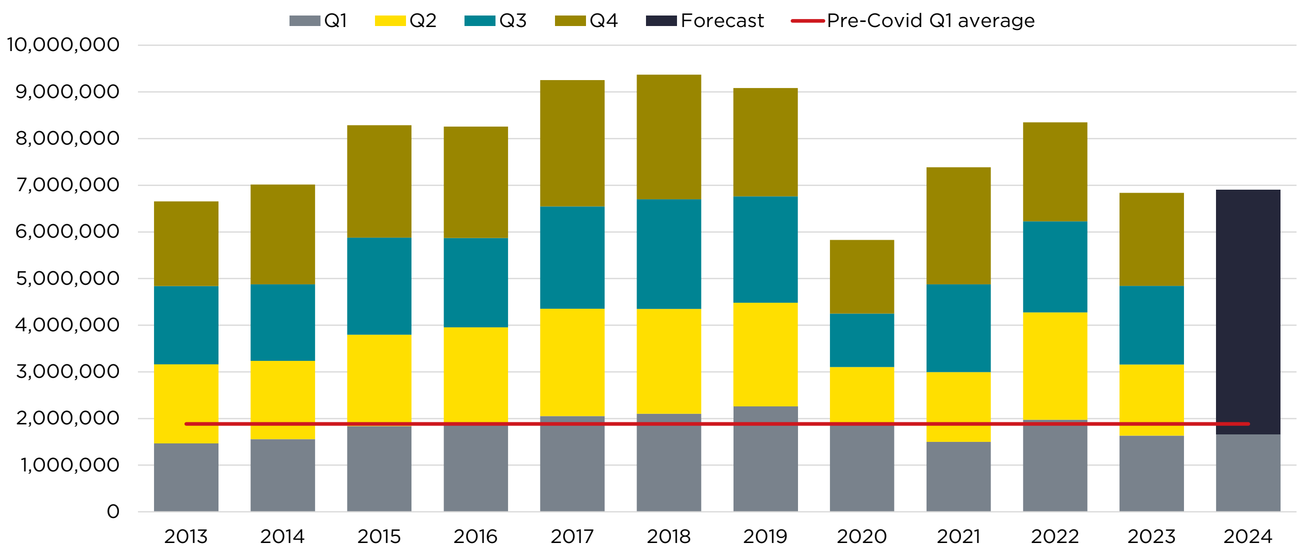
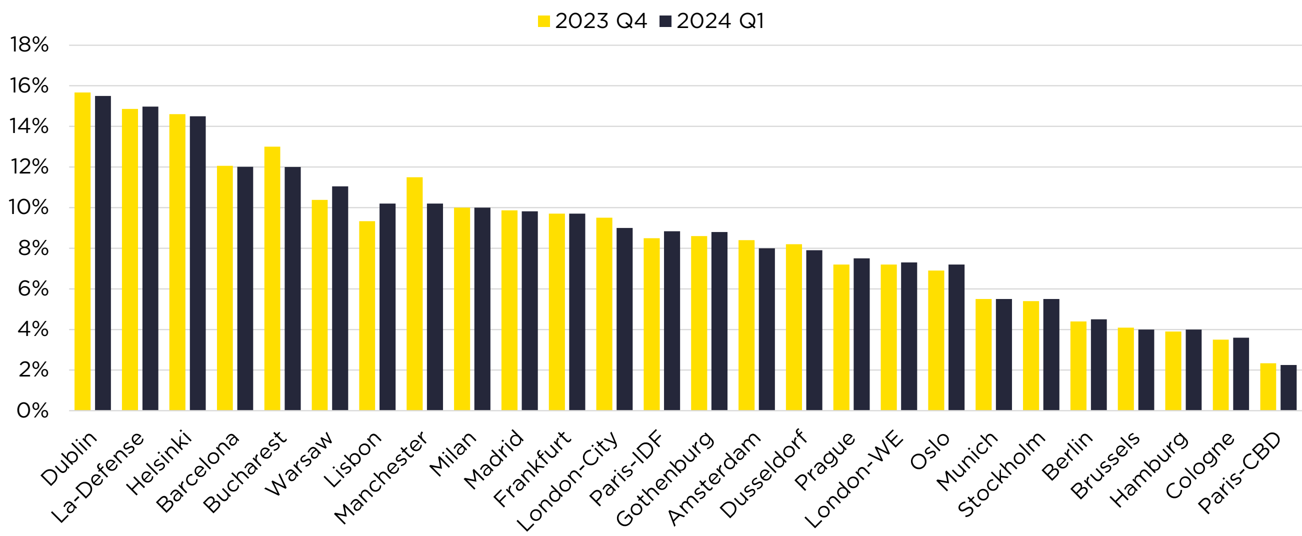


Chart 2: European office vacancy rates (%)



Source Savills

Development activity

Speculative announcements postponed as developer caution rises.

Development challenges
Despite a solid occupational market, Eurozone construction output has been in decline since April 2022, according to S&P's PMI (Purchasing Managers Index) data. The contraction in construction activity has been particularly significant in Germany and France, whilst Italy recorded a modest decline in April 2024 as new orders have fallen and staffing levels and material purchases have been cut back. On a brighter note, UK construction activity has returned to growth for the first time in nine months, buoyed by an increase in refurbishment projects and improved sentiment regarding the UK economic outlook.

European office construction costs have risen by circa 50% since 2019, whilst a shortage of construction labour has pushed out completion dates. 33% of office space scheduled for completion in 2023 did not complete and has been pushed out to 2024/25, with a number of German developers reporting insolvencies.

Lender caution has also risen with only non-bank lenders more willing to lend on speculative developments. Many banks who have lent against speculative office development are now more cautious on leasing risk and are waiting to see their current loan book become fully let before committing to new loans.

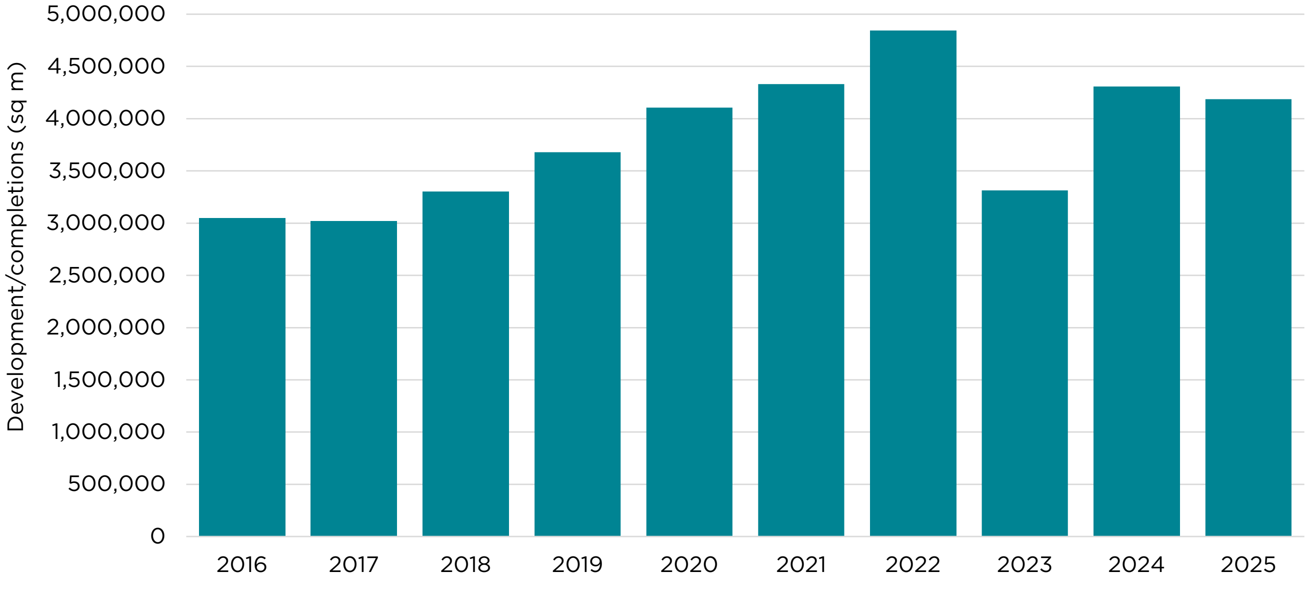
Development pipeline
European office completions fell by 32% YoY to 3.3m sq m during 2023, the lowest level for five years. In 2024, we expect a 30% YoY increase to 4.3m sq m (although this is still 11% below the 2022 peak), followed by a 3% YoY decrease to 4.2m sq m in 2025.

However, more importantly for vacancy rates, the total volume of speculative office space in the pipeline has fallen by 21% YoY, from 5.7m sq m to 4.5m sq m, dampening any potential increase in vacancy rates. Over the last two years, the speculative development pipeline as a percentage of existing stock has fallen from 3.1% to 2.1%. As occupier demand gradually recovers over the next 12 months, we expect the supply of Grade A space to gradually decline and prime rents to continue growing.

Budapest (4.8%), Lisbon (4.5%) and Barcelona (3.9%) have the highest proportion of speculative space set to complete by end 2025, as a percentage of total stock, although we expect much of this space will be absorbed as leasing markets remain buoyant and occupiers compete for best-in-class office stock to reduce their Scope 3 emissions. On the other hand, speculative development pipelines in Munich, Stockholm, Hamburg and Copenhagen account for less than 1% of stock in each market.

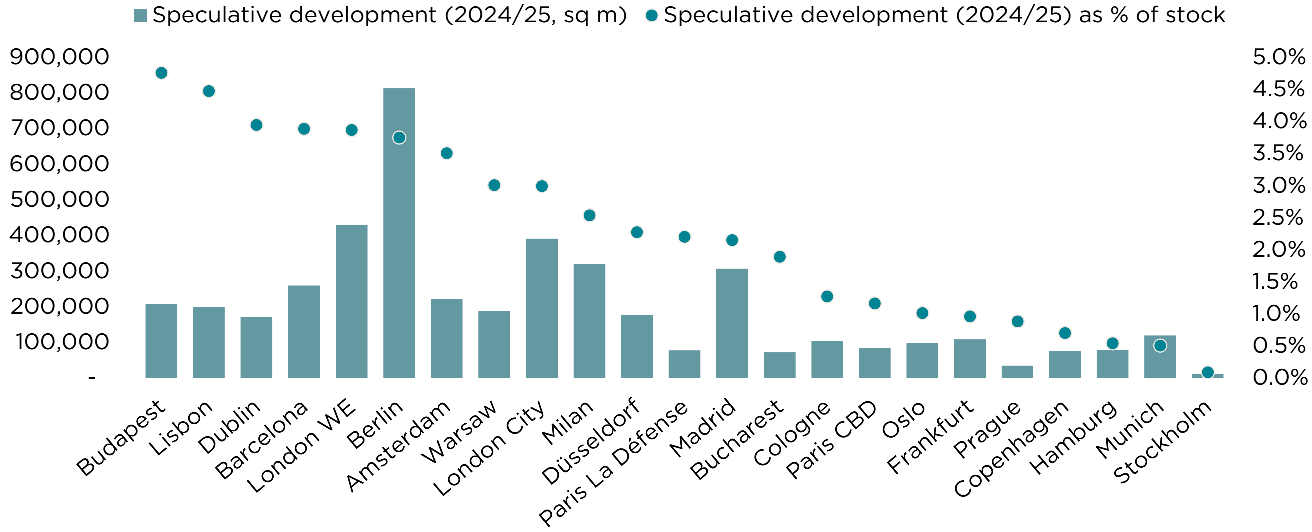
Given tighter planning policies implemented around reducing whole-life carbon, we are also beginning to observe an increase in comprehensively refurbished stock delivered to the market. In London West End, 59% of the development pipeline is from refurbished stock, above the historic average of 32%. Likewise, in Lisbon and Milan, 32% and 47% of the current pipeline respectively is comprehensively refurbished.

Chart 3: European office completions/ development pipeline



Source: Savills

Chart 4: Speculative development pipeline as a percentage of total stock



Why deliver best in class space?

Savills leasing comparables data indicates that in the City of London over the last five years, office developments achieving BREEAM Outstanding/Excellent certifications are three times as quickly to let prior to practical completion than BREEAM Very Good developments. Occupiers are seeking better quality office stock and there is a rising leasing risk on office stock which does not meet the environmental criteria.

Chart 5: City leasing velocity by BREEAM rating for developments (2018-2023)

Source Savills

Office conversions

What is happening to older office stock across European cities?

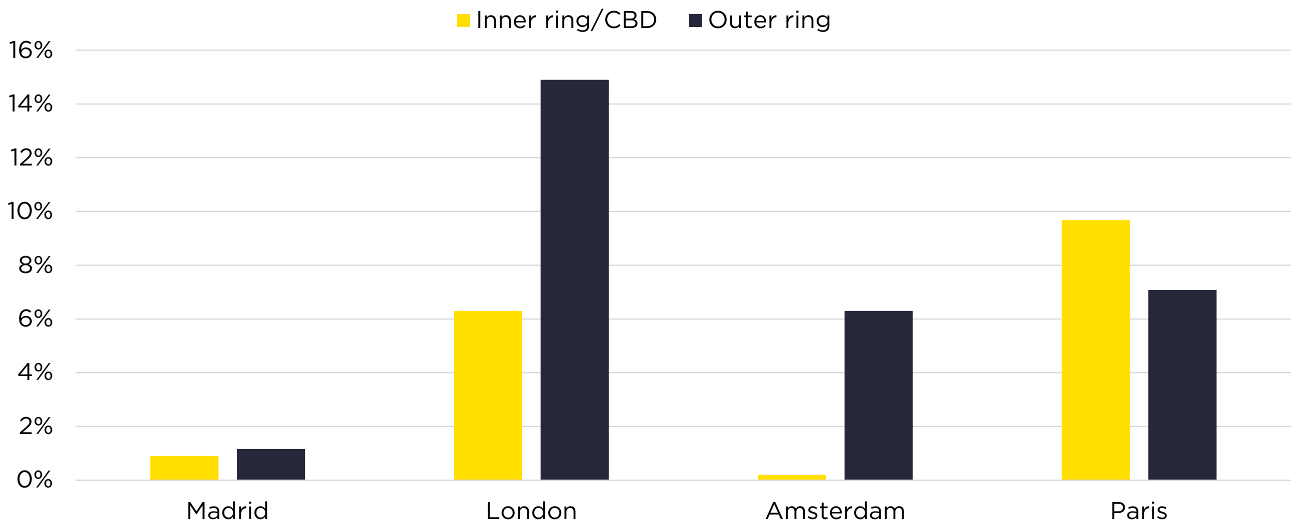
Savills has recorded a higher proportion of office space being removed from cities' outer rings since the pandemic. However, CBD office stock levels have remained more resilient, supported by occupier demand. Focussing on Amsterdam, London, Madrid and Paris, an average of 3.9% of office stock has been converted or removed from the inner ring/CBDs since 2020, whilst 7.1% of stock has been converted or removed from the outer ring.

Outer London has had the highest proportion of office stock converted/removed from the market at 15%, with much of this space converted to residential. Inner London, on the other hand, has seen 6% of office stock removed/converted. Less than 1% of office stock in Madrid and Amsterdam's city centres have been removed/converted, although a relatively higher proportion of stock has been converted in the outer ring. On the other hand, nearly 10% of Inner Paris' office stock has been converted to alternative uses, mostly hotels and residential.

In city centres, conversions to residential/hotels have been more popular, whilst in the outer rings of cities, student housing has become more common. Planning authorities want to maintain a strong business presence in city centres and are reluctant to grant permission to convert office space unless there is a strong case.

By 2026, we anticipate a 10-15% reduction in office demand as a result of remote working, although this is already beginning to have a larger impact on non-CBD locations than in CBD locations.

Chart 6: Proportion of office stock removed/ converted to alternative uses since 2020



Source: Savills

Development viability

Higher construction costs, and outward yield movement have squeezed developer profit margins.

London office development: what has changed since 2021?
Since Q4 2021, new build construction costs have risen by circa 50%, prime London City office yields have moved out from 3.75% to 5.25%, whilst financing costs have risen as swap rates increase.

On a brighter note for developers, prime rents have risen from €868 per sq m to €1000 per sq m, supporting capital values. Overall there has been an impact on land values over the period, with an increased delta between good quality schemes in strong locations, and the rest.

Is it the same case in mainland European markets?
Eurozone core markets have averaged a -40% yield impact on capital values, whilst the City of London has recorded a -29% yield impact, and with weaker rental growth, Eurozone development margins have been squeezed further.

Outside core mainland European markets, prime capital values are not high enough to justify new office development given the outward yield movement since end 2021. Across Northern Europe, yields have seen less outward movement, although rents have grown at a slower pace, and any evidence of prime transactions remains scarce. In Southern Europe, yields have moved out further, although rents have shown stronger growth.

What will it take for development to resume?
Development starts have fallen significantly, given that the risk associated with securing a tenant to a headline rent has heightened and the risk buffer is no longer present. However, the pre-let market has remained resilient.

A 5% fall in construction costs would not significantly tip developers to proceed on a speculative basis- any improvement in sentiment will be down to rising capital values, supported by a broader buyer pool at exit.

Rental growth, yield compression and debt finance will be the larger drivers of development viability. Office rents would need to rise by at least 10%, or yields will need to compress by 25-50 bps to provide developers with a sufficient profit margin, all else being equal.

Will we see an increase in rents?
Given European office vacancy rates are stable and prime product remains limited, the case for further rental growth is compelling. Indeed, average prime European office rents have actually fallen by 10% in real terms over the last three years, and are therefore accounting for a lower proportion of a company's total operational costs. Thus, there is headroom for companies to pay higher rents.

We expect the fall in development starts will result in an undersupply of Grade A space by 2027/2028, supporting prime rental growth to recover its inflationary losses.

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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