European Commercial - June 2023

European Office Outlook

● Take-up ● Vacancy Rates ● Sublease

Employer sentiment remains resilient

Lowest unemployment rate on record in the euro area

After a turbulent 2022 characterized by weak growth due to inflationary pressures, supply chain bottlenecks and rising interest rates, expectations are now for inflation to stabilise and bond yields to peak by year-end 2023 means a rebound for CRE will most likely take place in 2024.

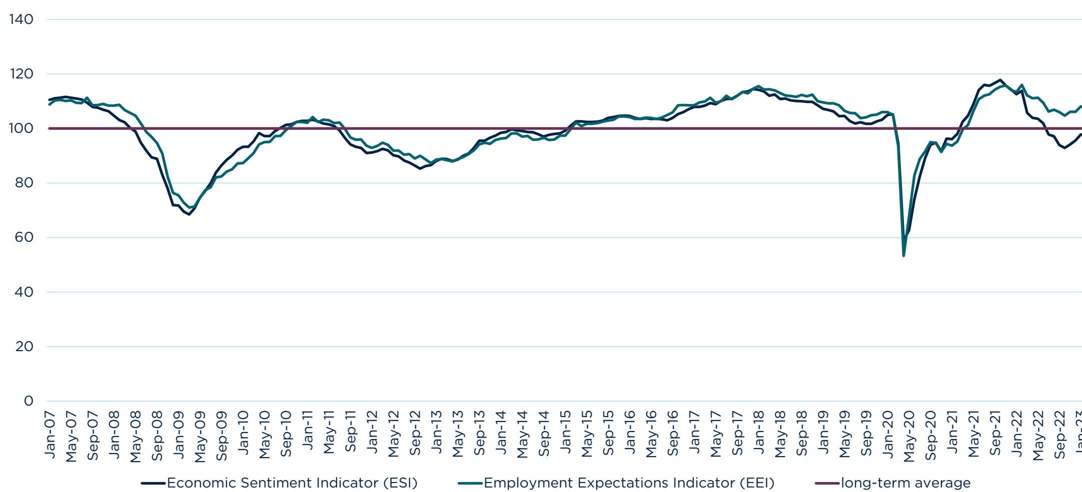
The inflation rate in the euro area increased slightly to 7% in April 2023, up slightly from the eleven month low of 6.9% in March. Given the sticky inflation, it was necessary for the European Central Bank (ECB) to raise the interest rate to 3.25% in May, in line with market expectations. Consensus forecasts are for interest rates to rise a further 50 bps and stabilise at 3.75% in July 2023.

In the euro zone, a 0.1% increase in GDP was recorded in Q1 2023, a better than expected result as the region avoids a recession. Expectations are that the euro zone economy will avoid a recession in Q2, albeit with GDP growth still to remain weak.

The unemployment rate in the euro area decreased to 6.5% in March 2023, the lowest on record as job postings remain high and firms report staff shortages.

Despite economic sentiment and employment expectations being marginally lower in the EU and the euro area in March 2023, employment intentions appear to be resilient when compared to the long term average (chart 1).

Chart 1: Economic sentiment and employment expectations in the EU and Euro Area



Source European Commission

Lack of prime stock affecting take-up

Development pipeline should help ease the drop in take-up

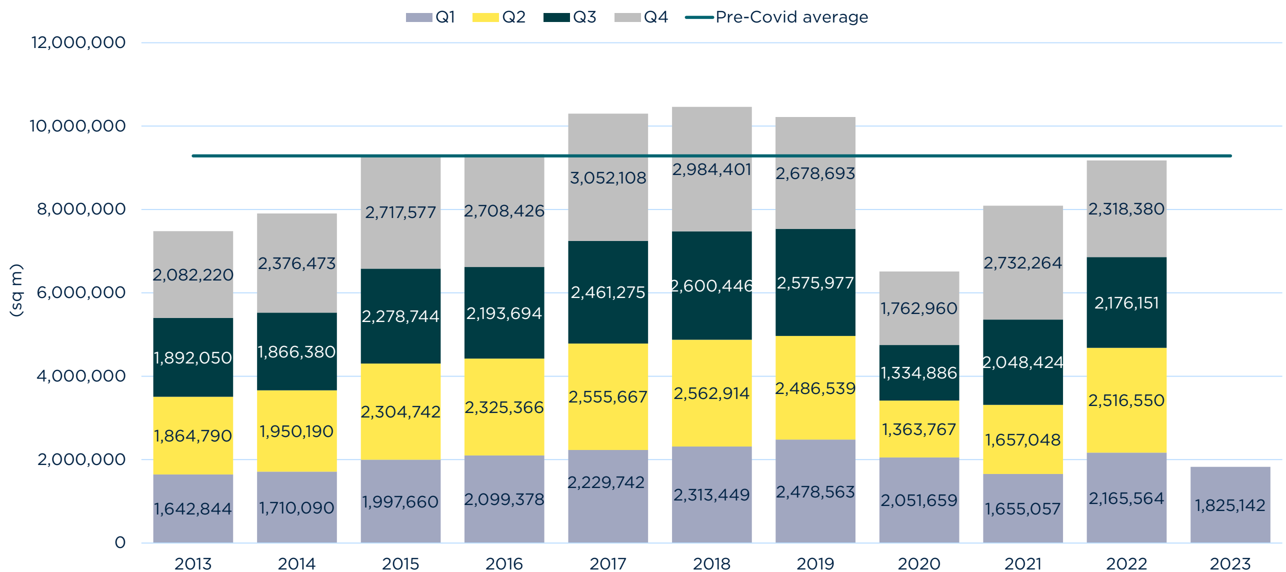
European office take-up fell 14% below the five-year Q1 average during Q1 2023. The markets reporting the largest increase in take-up in Q1 were Oslo (+50%), Prague (+19%) and Madrid (+5%). At the other end, Dublin (-62%), Bucharest (-57%) and Lisbon (-55%) reported the largest decreases.

In Lisbon, the drop in take-up is largely due to the lack of stock available. 2022 was a record year for take-up in Lisbon with the highest 272,000 sq m recorded, but now faces the challenge, much like other markets, of not having enough quality stock for occupiers where there is pressure to let Grade A space.

Certainly, we are observing a flight to quality with a large portion of existing stock not suitable or qualify to be occupied, especially in non-CBD areas made up of older stock lacking in green credentials. This demonstrates the need for investment in new and redeveloped office space where competition for quality stock will remain high as secondary stock is increasingly ruled out by occupiers.

With 4.6 million sq m of new European office space to be delivered in 2023 alone, the delivery of new space will enable occupiers seeking prime stock. With the return of business confidence and a more stable economic landscape, we can expect demand to recover in 2024. In Portugal for example, between 2023 and 2025 approximately 265,000 sq m of new office space is expected to be delivered, of which 59% is already pre-let or occupied, reinforcing the strong demand and competition for space.

Chart 2: European office take-up (sq m)



Source: Savills

High vacancy rates outside of CBD

Occupier desire for prime CBD locations is driving vacancy up

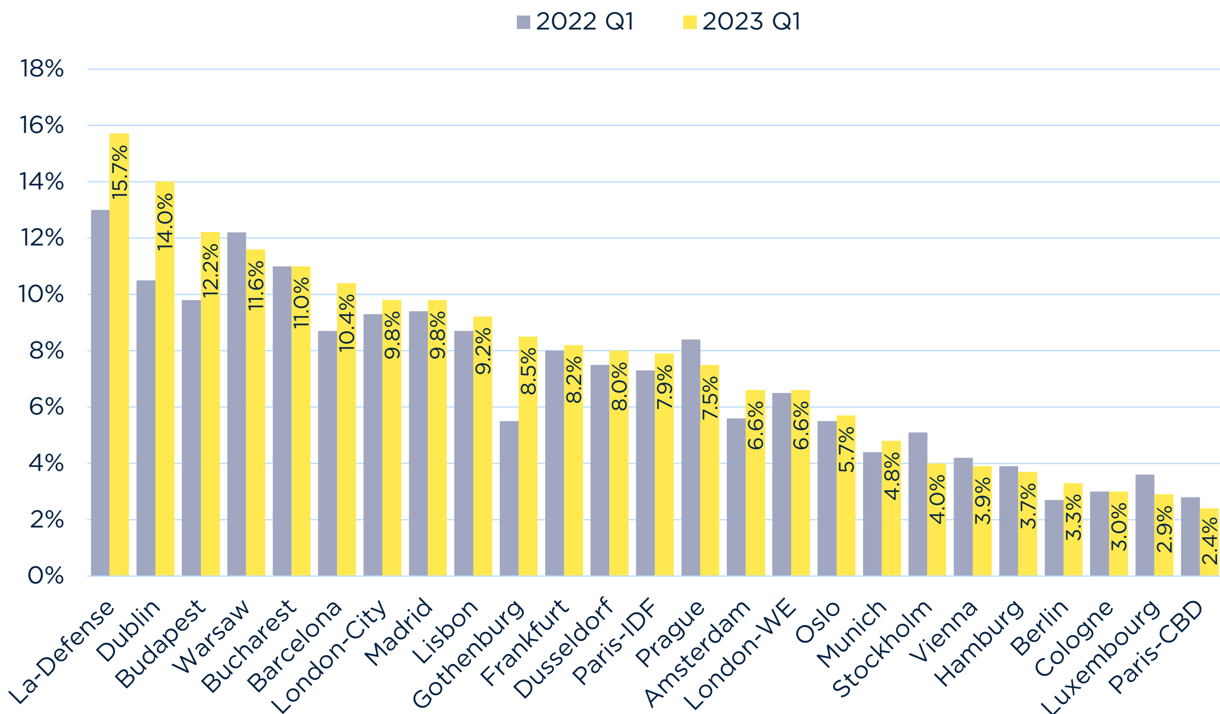
Vacancy rates increased by an average of 50 bps from 7.1% to 7.6% over the past twelve months as occupiers hold off signing new leases. This is most apparent in Dublin (+350 bps to 14.0%), La Défense, (+270 bps to 15.7%) and Budapest (+240 bps to 12.2%). Vacancy increased by 20 bps QoQ.

Indeed, negative office sentiment is partly based on high level of vacancies, though when compared to the US, Europe appears more shielded as supply of new space is limited. Core vacancy rates remain very low, with Paris CBD (2.4%), Cologne (3.0%), Berlin (3.3%) and Stockholm (4.0%) undersupplied of prime CBD stock.

The occupier shift that we are observing towards more central locations is reflected in the increase in vacancy in La Défense (+270 bps), a predominantly single-use financial hub, and the decrease in vacancy in Paris CBD (-40 bps), a more mixed-use, well connected location. MSCI analysis shows French offices were the top transacted segment in Q1 2023, with Paris CBD prime yields remaining amongst the lowest in Europe.

The increase in vacancy in Dublin reached a high of 14.0%, a level not seen since 2014, as a result of tech occupiers reducing the amount of space they lease.

Chart 3: European office vacancy rate (%)



Source: Savills

Further bifurcation of rents expected

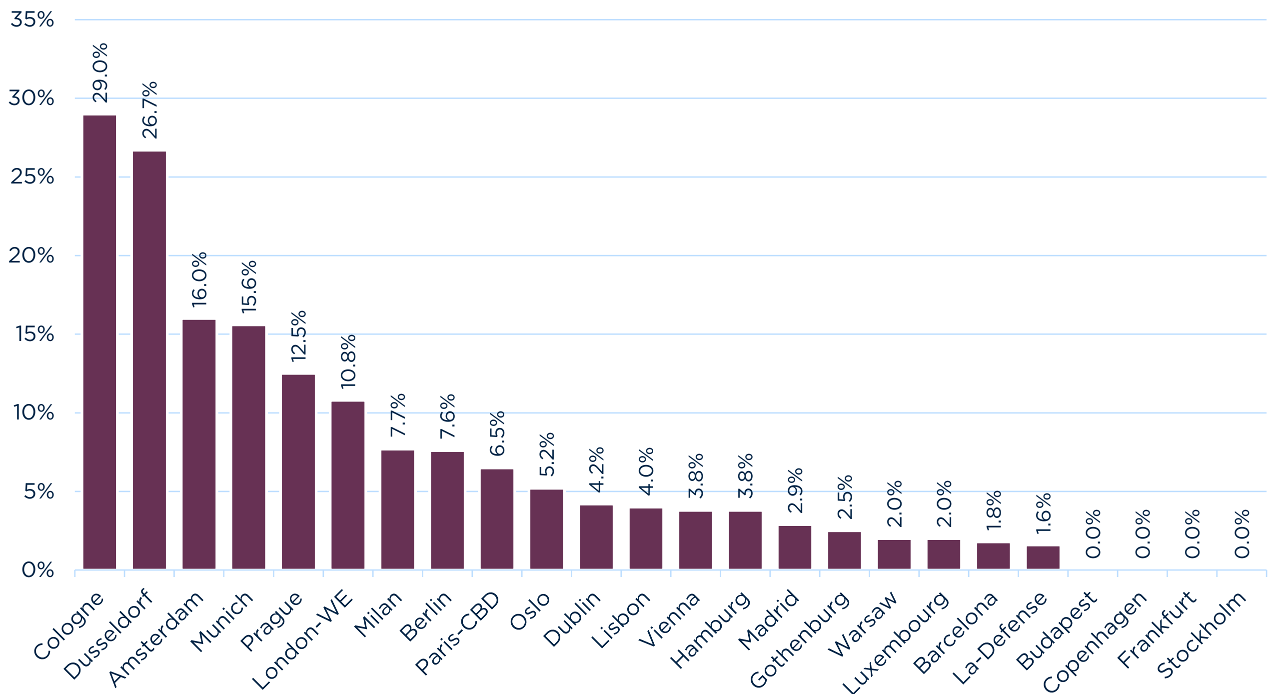
Challenges for secondary stock, ultra-prime assets set to be the most resilient

Prime European office rents rose by an average of 6.3% over the past 12 months. Prime rents in Cologne (+29%), Dusseldorf (+26%), Amsterdam (+16%), Munich (+16%) and Prague (+13%) rose at the fastest rate, primarily driven by new headline rents across Germany.

The ongoing strong occupier emphasis on higher-quality space in prime CBD locations and an undersupply of suitable stock where corporations are enforcing tighter regulation is driving rental growth in these markets. In Prague, a thinning construction pipeline is also pushing headline rents.

We can expect to see further bifurcation between prime and non-prime rents, as occupiers opt for more modern offices with appropriate EPC ratings and ESG related regulation that will be more difficult to meet for lower quality buildings.

Chart 4: Prime rental growth over the past twelve months (achievable rents)



Source: Savills

Feature: Tenant controlled space

Analysing the breakdown of vacant space across a sample of European markets, the average level of tenant space available for sublet has remained stable between Q1 2021 and Q1 2023 at 1.2% of total stock. While some markets have seen a reduction in the amount of space on the market for sublease, previously tight markets have seen an increase in tenant vacancy.

Tech

In the past six months we have seen a significant number of tech companies making redundancies in the face of growing costs and a weaker growth outlook, in turn, causing them to re-evaluate their office space requirements. This is predominantly reflected in cities with a higher tech occupier exposure, including Dublin and Berlin, which have reported increases in tenant space available for sublet. This has not been the case in markets with a more diverse occupier base within the CBD.

In Dublin, the amount of tenant space available for sublet has risen by ~200% between Q1 2021 and Q1 2023, while the level of stock only increased by 7% during the same time period. This trend is mostly attributable to space being returned to the market by big tech firms who may have pre-committed to office space but subsequently have made space available for sublease after announcing job cuts.

A similar story is reported in Berlin, where space available for sublet increased by ~300%, and total stock by only 4%. A significant proportion of the space that is available for subletting comes from tech start-ups that have committed to now surplus space that is not fully needed. In an environment that was previously extremely tight with limited space on offer, the increase in space available for sublease provides an opportunity for other occupiers to enter the market.

In Amsterdam, approximately 20,000 sq. m of office space is available for sublet, roughly 0.6% of the total office stock in the region. 65% of the tenant-controlled available space offered for sublease is currently leased by companies in the tech sector.

In Paris, only 9,000 sq m of space is on the market for sublease, reflecting ultra-low vacancy rates and stickier labour markets. In La Défense on the other hand, subleasing is becoming more common due to a higher presence of tech firms located here, large corporations implementing working from home policies and typically signing longer leases.

London-City has the highest tenant vacancy rate out of the European cities we have analysed, at 2.5% of total stock. The stock on the market for sublease is largely of poorer quality and for a shorter lease period, and with the current vacancy rate at 9.8% and an occupier focus on prime stock, this space is more difficult to let with occupiers having choice of better quality space elsewhere in the city. 56% of tenant controlled stock is available on a term of five years or less, where typical lease lengths significantly exceed this. We expect small to medium sized, businesses operating on short to medium time frame will be one of the main subleasing groups.

In comparison, London-WE has a lower tenant vacancy rate of 1.3% due to the shortage of prime space where good quality tenant controlled space is successfully let when put on the market. Here, lots of tenant space was withdrawn after the pandemic, pushing the tenant vacancy rate down from 2.4%.

Shorter lease terms

Standard lease terms are generally shorter in mainland Europe than in London, which helps explain why London City recorded a higher proportion of tenant space for sublease. In general, leases in mainland Europe are five years, with a three year break option and is more common therefore to find a new tenant to replace the contract. Compared to cities in the US, generally Europe has a much lower rate of tenant space available for sublet. San Francisco and Manhattan, two cities more exposed to tech occupiers reducing space, have tenant vacancy rates of 10.3% and 4.8% respectively.

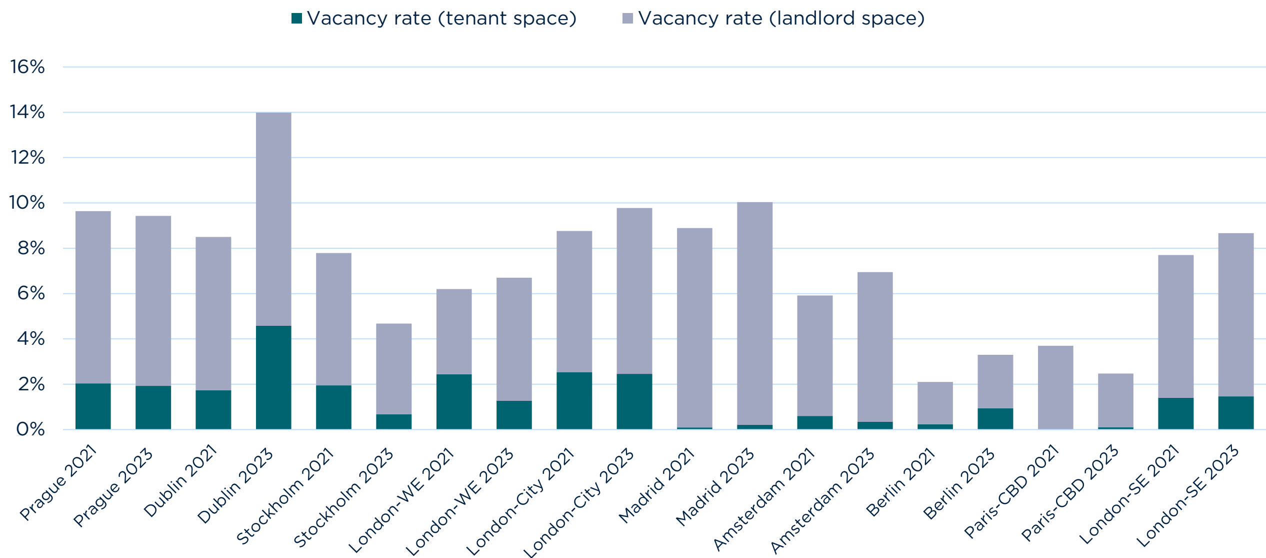
However, in non CBD locations, tenant space for sublease has not significantly increased as a proportion of stock. This is partly due to withdrawal/ conversion of secondary stock; in the London/ South East office market, total stock has fallen by 9% over the last five years, indicating a number of older office schemes have been converted to alternative use, or withdrawn from the market. Looking forward however, in non CBD markets where there is a higher proportion of Grade B/C stock, we expect to see higher levels of subleasing.

Inflexible lease terms and an existing style of fit-out on offer in tenant sublet space that does not match prospective tenant requirements is another reason grey space does not make up a dominant part of the office leasing market. With the increase in flex office space across Europe, this may be a more attractive option than inheriting another occupier's lease terms and fit-out.

Overall, we expect to see an increase in the level of sublease space over the next 12-18 months and expect non-CBD markets to see a larger increase in tenant available space as companies shift to well connected, CBD locations.

Given still-rising office occupancy rates, we can expect the impact on CBD offices to be more limited in markets with a diverse occupier base.

Chart 5: Vacancy rate split by tenant- / landlord-controlled space



Source: Savills

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