European Commercial – June 2021

European Office Development

savills

Office development completions are at a five-year high. How does this affect the demand and supply equilibrium?

What is driving developers' confidence in the office sector?

In 2020, new development completions reached the highest point of the past five years across the 25 European markets that we analyse in this report. At almost 4.2m sq m, they were 23% above 2019 levels and 26% above the five-year average. Experience from previous market cycles shows that development activity usually lags demand by at least two years, which is the typical construction timeline. Indeed, in the current cycle, take-up peaked in 2018 (12m sq m), pushing the average European vacancy rate at the historic low level of 5.2% in 2019. Some cities saw their vacancy rates dropping below 3% (Berlin, Stockholm, Munich, Paris CBD), with companies struggling to identify high specification space, which was often required to attract and retain talent.

The pandemic has put a temporary halt to these trends. People have been forced to work from home for more than a year due to strict lockdown measures imposed to contain the spread of the virus. In 2020, office take-up dropped by 35% YoY to 7.8m sq m. Companies adopted a "wait and see" approach focusing mainly on lease renewals rather than expansion and relocation. The amount of grey space in the market increased and vacancy rates rose to an average of 6.7% by the end of last year.

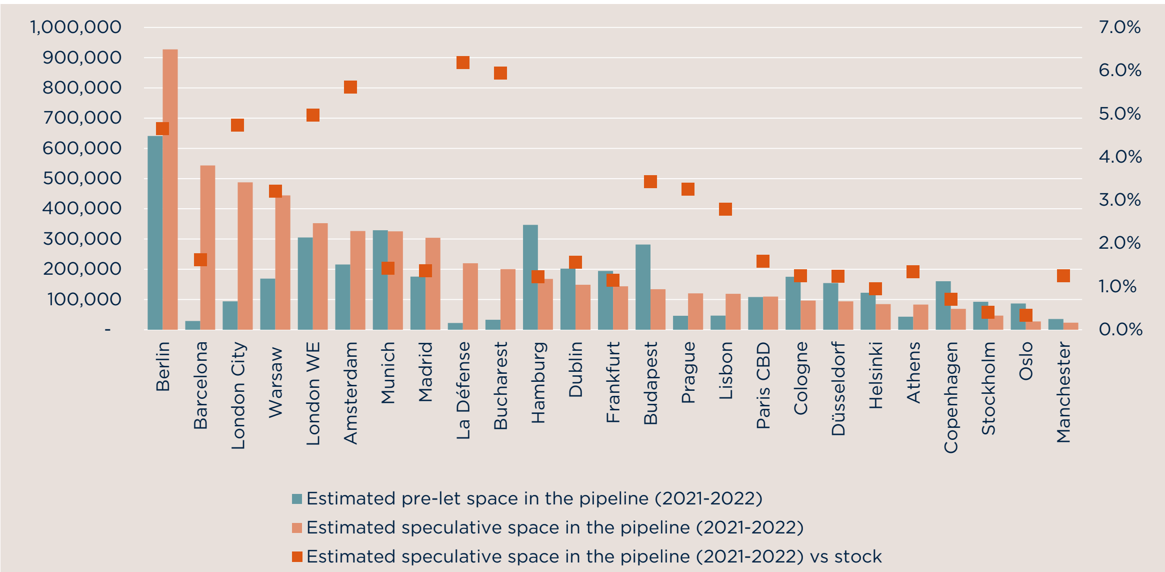
The roll-out of the vaccination program across Europe has allowed the gradual return to the office. However, the question about the future of work and the future of the office remains. To what extent will a hybrid working model be adopted? What does this mean for companies' office space requirements? Early indications demonstrate that there is definitely an intention to redesign office spaces in order to adapt to the current priorities of their employees for safety and wellness. With the majority of the workforce requesting to continue to work flexibly, some companies have already announced a reduction of their overall space requirements. Others are adopting the "hub and spoke" model, a combination of CBD located headquarters and complementary, on-demand flexible office space closer to residential areas. Overall most employers are expected to request a minimum amount of time spent in the office in order to maintain the creative collaboration amongst employees, to sustain their corporate culture and to satisfy client demand for face-to-face interaction. In some cases, this may even lead to higher space requirements, especially in client interfacing sectors.

Are we at risk of oversupply?

Previous cycles have taught us that during post-crisis periods, development activity drops. Based on current estimates of 2021 and 2022 office deliveries, this is not going to be the case yet for Europe. The development pipeline this year is expected to deliver 26% more space than 2020, at over 5.2m sq m, the highest level of the past five years. Next year, another 5.1m sq m of offices is planned. The total space under construction (2021 and 2022) corresponds to about 4% of stock and to about a year's take-up based on past five-year average. But how does the level of new supply compare to the current reduced levels of demand?

Firstly, we need to take into account that about 47% of the space in the pipeline is already committed; 54% in 2021 and

2021-2022 development pipeline corresponds to about 4% of stock



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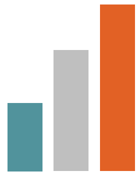
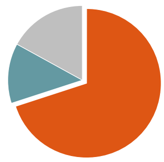


5.23m sq m
Office space is expected to be delivered this year. This will be 26% up from last year's completions



54%
Of the space in the pipeline for 2021 is already committed. Pre-lets are at 39% for 2022.

7 months

Speculative new supply of 2021 and 2022 corresponds to about 7 months of annual take-up (2020-2021f) levels

7%

We project that total take-up will recover by about 7% yoy in 2021, nonetheless remaining about 33% below the five-year average

> "We believe that all new supply is likely to be absorbed; however we expect to witness a slight increase in the average vacancy rate"

39% in 2022. Although this is slightly below previous years' levels (which were between 55% and 60%), this still reflects that quality workspace is a priority for occupiers and its supply remains tight.

Secondly, we anticipate that leasing activity will strengthen in the second half of the year, and we project that total take-up will recover by about 7% YoY, nonetheless remaining about one-third below the five-year average. Based on these lower levels of letting activity, speculative new supply in 2021 and 2022 corresponds to about seven months of annual take-up. Besides, it is still uncertain how much of this space will be actually completed. Indicatively, 2019-2020 deliveries were about 24% below our estimates in Q1 2019. Supply chain disruptions and rising construction and retrofitting costs may lead to delays and postponements of projects next year.

Higher levels of new supply (2021-2022 new supply as a percentage of stock) are anticipated in Budapest (11%), Warsaw (10%) and Amsterdam (9%). The highest level of pre-lets in 2021 are noted in Budapest (97%), Hamburg (80%) and Oslo (77%). Most of the speculative development in 2021 is expected in Bucharest (86%), Paris La Défense (83%) and London City (72%).

The economy is expected to bounce back

Healthy levels of business activity are expected to be supported by economic recovery. According to Focus Economics, a bounce-back in consumer and capital spending is expected. The gradual easing of restrictions, expansionary fiscal and monetary policies and the disbursement of EU recovery funds, should translate into a GDP growth of 4.2% this year. That said, rising public debt stocks and banks' bad loans pose downside risks.

Demand and supply in balance

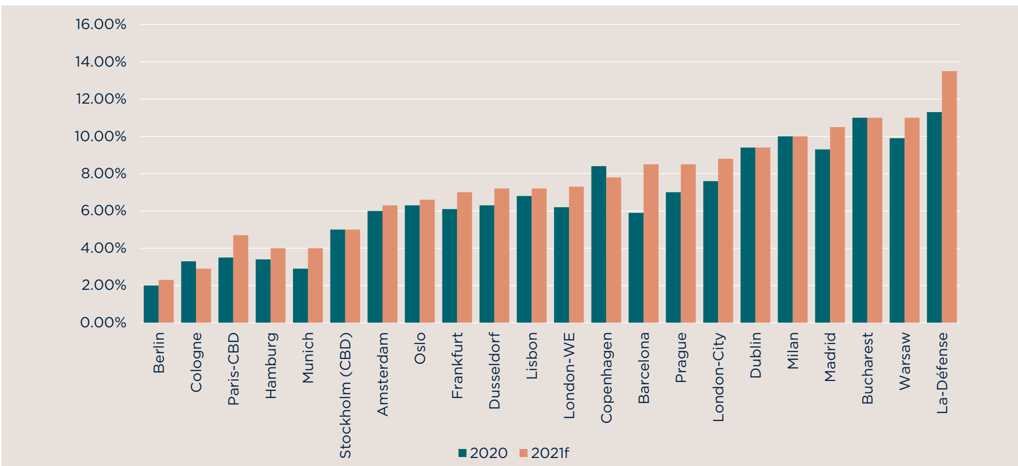
All in all, we do not see a risk of oversupply, due to heightened occupier demand for Grade A space. We believe that all new supply is likely to be absorbed; however, we expect to witness a slight increase in the average vacancy rate of about 80 bps to an average of 7.5% across our survey area. The markets with the highest vacancy rates in 2021 are expected to be Paris La Defense (13.5%), Warsaw (11%), Bucharest (11%) and Madrid (10.5%) and the ones with the lowest Berlin (2.3%), Munich (4.0%) and Paris CBD (4.7%). Available space is likely to be concentrated in secondary stock, which does not meet current occupier requirements for space, natural lighting, air quality, acoustics, outdoor space, and green credentials, to name a few. This is likely to lead to more redevelopment projects in the coming years. As the lines between personal and work time become more blurry, flexibility and the mix of uses, even at building level, are becoming factors of choice for occupiers. Competition amongst landlords will increase, while operational efficiency and quality of services may become even more important than location.

Prime rents will remain stable

This year we do not expect to see any major movements in prime asking rents in the best locations. We predict that prime CBD headline rents will remain overall stable, with the exception of London, where we expect a correction of -6.5% YoY on average, Barcelona (-2.7%) and Warsaw (-1.0%). Secondary rents may also remain stable in the short term, but they run the risk of experiencing corrections in the future if landlords do not address current occupier needs.

We believe that prime rents may increase in the future under the pressure of rising construction costs and the need to upgrade the energy ratings of buildings. Higher occupancy costs will be counterbalanced by the reduction of operational costs in the long run and the improvement of the resilience of buildings.

Office vacancy rates will rise further in 2021



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