Briefing Note

Why European office rents will continue to rise

Feb 2018

It's a landlord's market…

We are going through the fifth consecutive year of upward average rental growth for prime CBD offices in Europe (6.0% yoy in 2017), while if we exclude the Peripheral markets rents have been rising constantly in Core (2.4% pa) and Nordic markets (5.4% pa) since 2010.

At the same time the average vacancy rate is also at historic lows, and has been falling since 2010 reaching its lowest point of 6.6% in Q3 2017. Q4 2017 was the first quarter that we saw a slight rise in the overall vacancy rate from 5.3% (Q3) to 5.6% in the Core markets and from 7.7% (Q3) to 8% in the Nordics.

These conditions have been good news for landlords of good quality buildings and bad news for occupiers who are competing for the limited stock and are dealing with rising costs.

Economy: from 'recovery' to 'expansion'

The positive rental growth in the prime office sector has been sustained by positive economic activity and business expansion. The European economy has been enjoying steady economic growth over the past four years and in 2017 outpaced the US once again as it recorded its strongest growth in a decade at 2.5% pa.

The outlook for the European and the world economies is positive for 2018, with the ECB confident that the Eurozone economy is no longer in 'recovery' but 'expansion'. The Focus Economics Consensus Forecast for 2018 GDP is at 2.1% pa and 1.5% pa on average for the following four years.

Are prime CBD office rents too expensive?

In absolute terms the most expensive market remains London, which is two (City €956/sq m per year) to three (WE €1,556/sq m per year) times more expensive than the average. Paris (€780), Stockholm (€689) and Dublin (€678) follow.

Compared to the past peak there is a higher discrepancy between the highest and lowest rents. There are a number of cities where prime office rents are considerably higher compared to their past peak: Stockholm (49%), Berlin (35%), Oslo (26%), Munich (16%) and London WE (14%) while others where prime rents have not fully recovered yet: Paris (-6%), Madrid -26%, Barcelona (-15%), Athens (-33%) and Warsaw (-34%).

In two thirds of the cities analysed prime office rents are on average 15% higher compared to their past peak (2007 or 2008). At the same time the service sector output of all the cities has been expanding over the past decade and in 2020 is forecast to be 35% higher on average than just before the GFC. This implies that overall office occupiers can afford the rising property costs, since their sector has been enjoying rising revenues.

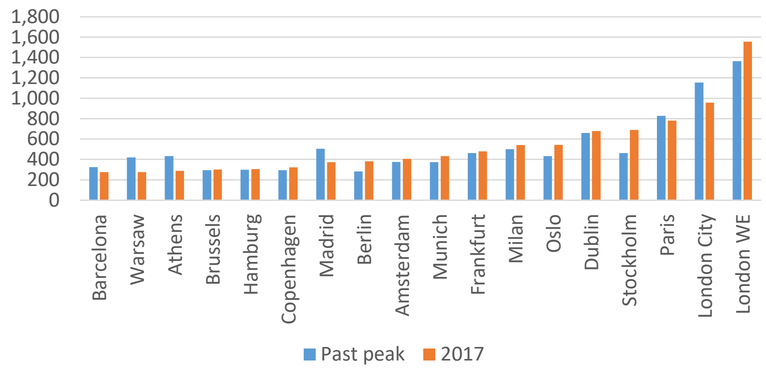
Based on this analysis we have grouped the cities in the following categories:

■ Highly competitive: These cities have been the most dynamic economically and office space has repriced in line with strong business expansion, climbing above the previous peak. In this category fall Stockholm, Oslo, London WE, Berlin, Munich, Copenhagen, Amsterdam, Milan and Dublin.

■ Value for money: In these cities prime office rents are still below pre GFC peak level, despite the fact that their economies have recovered and that their service sectors are larger than 10 years ago. This group includes the Spanish cities, which are on a fast recovery path, Paris and Brussels where lack of quality space can hold back business expansion, London City which is in a cyclical downturn and Warsaw where rents have gone through a correction phase due to high level of new supply.

GRAPH 1

Current prime office rents vs past peak most markets have become more expensive



Graph source: Savills

■ Recovering: Athens is the only city where the service sector has not fully recovered yet. Nevertheless as the economy returns to growth (1.2% in 2017 and 2% pa on average for the next four years), demand for quality business space grows and prime rents rise (4.3% yoy in 2017).

Prime office rents will continue to rise for three reasons

Based on the economic trends and the demand and supply conditions, we believe that all the markets are in an upswing phase of the rental cycle. We forecast that prime office rents will continue to rise (or remain stable in markets with higher levels of future supply) for at least another three years for the following reasons:

■ Rising demand
The outlook of the European economy is positive and growth dynamics are expected to remain unchanged from last year, underpinned by accommodative monetary policy, improving labour market and positive sentiment. This should continue to support business expansion and demand for office space. In the cities we analyse the service sector will keep growing by 2.6%pa on average till 2020.

■ Restricted supply
Following at least four years of rising demand and cautious lending conditions for new construction, the availability of office space has been shrinking. In 8 out of the 18 markets we analysed the average vacancy rate is below 6%, practically meaning that there is no choice of high quality space for occupiers.

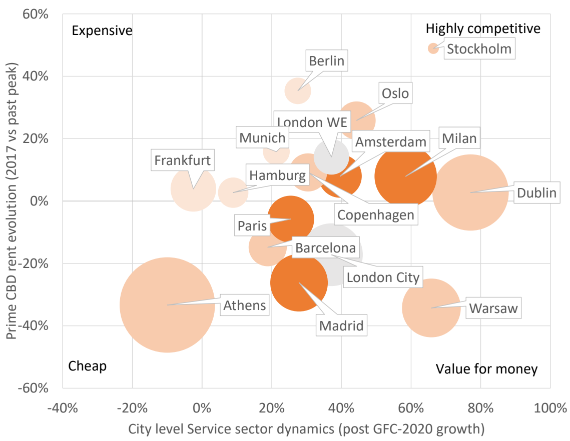
There is about 10.5m sq m of office space under construction (2018-2019) in the 18 markets that we analysed, which is about 4.7% of the total stock. This share is higher in Dublin (16%), Warsaw (12%) and London City (8%). Overall the amount of space in the pipeline for 2018 and 2019 across the markets corresponds to about one year's take-up (long term average). As it should take some time before demand and supply rebalance, upward pressure on prime CBD rents will be sustained.

For 2018 we forecast an annual increase of 2.5% pa on average across the markets: Oslo, Madrid, Barcelona and Copenhagen stand out with over 4%pa annual growth rates.

■ Space is not only a cost
Attracting and maintaining talent has become a challenge for employers. In order to remain competitive companies need to choose buildings which are flexible, attractive, located in trendy areas, close to amenities and public transport. For occupiers property is not a mere cost, but reflects the company culture and contributes to the productivity of its employees and companies are prepared to pay for it. This has intensified the competition for the best accommodation, especially in hubs of talent, where the best companies of similar sectors tend to cluster. Despite the fact that new ways of working may reduce the overall office requirements, companies aim to create engaging and inspiring work environment that will bring younger employees in the office to work and collaborate. This type of space differs from the traditional corporate office and is in limited availability in most markets. New space that comes on the market has to meet these prerequisites.

GRAPH 2

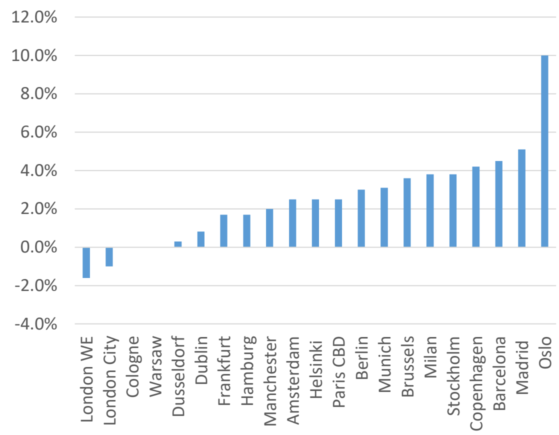
Are prime office rents too expensive? some markets still offer value for money



Graph source: Savills - Note: Size of bubbe is total supply as a % of stock

GRAPH 3

Prime CBD office rents will continue to rise



Graph source: Savills

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