European Commercial - Q3 2021

SPOTLIGHT
Savills Research

Emerging European Office Themes

● Mobility ● Occupier ● Investment

Mobility recovery

Positive timely data on the return to workplaces continues to boost Europe's office markets. Savills Research has analysed four key trends impacting the occupational and investment markets across the continent

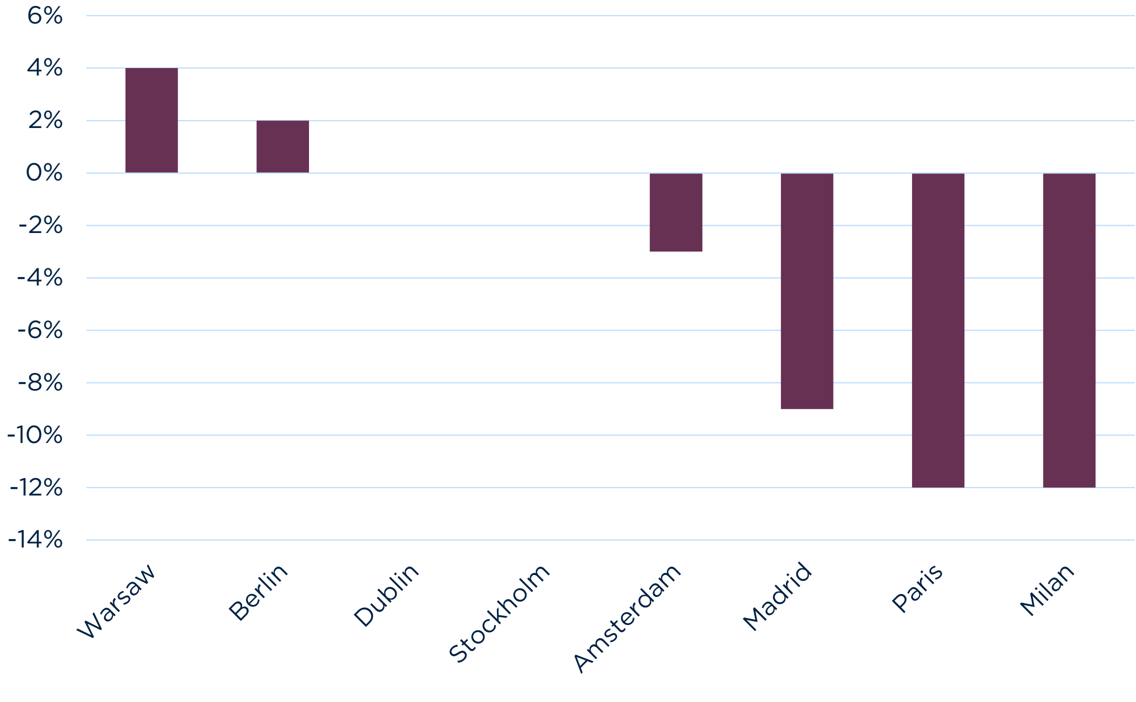
Europe's gateway cities are observing encouraging signs of workers returning to the workplace. Google's mobility data indicates that mainland Europe's workplace occupancy in October 2021 is on average 4% below pre-pandemic levels (cited on the 13th January 2020).

Amsterdam (-3%) Île-de-France (-12%), Madrid (-9%), Berlin (+2%), Dublin (+0%), Stockholm (+0%), Milan (-12%), Warsaw (+4%) all compare favourably with the lockdown occupancy levels of as low as -80% across a number of cities as restrictions are lifted and workplaces reopen.

Larger metropolises and cities most impacted by the pandemic have been slower to respond, although successful vaccination rollouts are leading to further restrictions being lifted. However, health authorities are now paying closer focus on the Delta 'Plus' variant and the level of infections during the winter period.

Rising mobility has ultimately resulted in recovering office demand. Into the third quarter of the year, preliminary data for the European office markets continues to show a recovery in leasing activity - up 15% YoY as at end Q3 2021, although still down 17% on the five-year average.

Chart 1: Workplace mobility levels - October 2021, relative to pre-pandemic (%)



Source: Google

Sector resilience

Professional services continues to support office leasing volumes

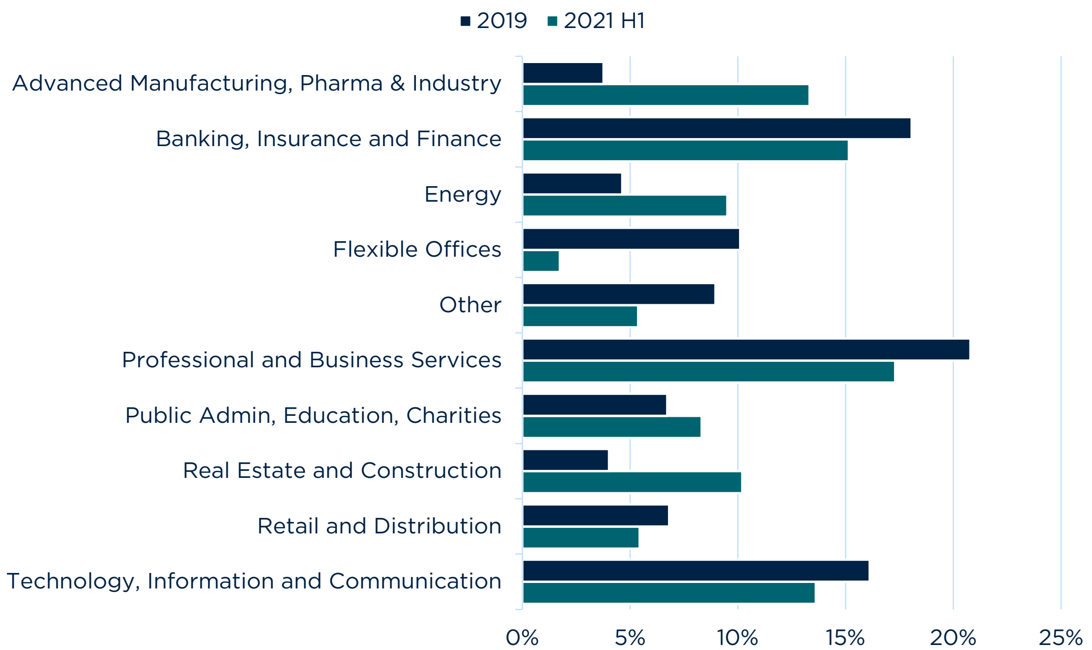
Looking more closely at the drivers of office demand, Professional & Business Services (21%) and Banking, Insurance & Finance (18%) remain the most dominant occupier sectors across the European markets in H1 2021. However, the advanced manufacturing and pharmaceutical sector has surged in 2021 to reach 13% of total take-up (previously 4%), following growth in venture capital funding into the life science sector. Into Q4 2021, occupier sentiment has improved and we anticipate rising levels of new requirements to result in further increased take-up in H1 2022.

Central London focus

Throughout the pandemic and accompanying subdued activity in Central London, some industries have remained relatively resistant to Covid-19's fallout. Three resilient sectors include the Banking, Insurance & Financial Services sector, which accounted for a fifth of central London take-up since the Covid-19 outbreak; this is not too far from the five-year average of 22%. The same applies for the Tech & Media sector, which equally accounted for 20% of take-up during the pandemic, compared to the five-year average of 22%. However, it was the Professional & Business Services sector that increased dramatically, accounting for 24% of take-up since the pandemic began, compared to the five-year average of 15%.

This sharp increase can be attributed to a handful of large pre-lets from legal firms over the last 18 months. Some notable deals include the largest pre-let in the last two years, where Linklaters took the majority of 20 Ropemaker Street, EC2 totalling 307,195 sq ft. In January 2021, Latham & Watkins pre-let 200,000 sq ft across the bottom 15 floors at 1 Leadenhall, EC3 and anticipates moving into the tower in 2025, whilst more recently, Travers Smith signed for 70% of Stonecutter Court, 1 Stonecutter Street, EC4. This can partially be attributed to such firms coming to the end of long 10-, 15- and 20-year leases in which a large scale move to new, premium office space is required with regards to attracting and retaining employees, as well as companies pushing to increase sustainability reform. Savills office take-up data for the City of London shows that 45% of occupiers who have acquired 15,000 sq ft or more since the start of 2020 and were increasing their office footprint were from the Professional & Business Services sector.

Chart 2: European office take-up by sector (%)



Source: Savills

Prime office yields

The prospect of rising interest rates has reduced the yield spread between prime offices and risk-free rates

Savills European Office Value Analysis Q3 2021 indicates that 12 of Europe's office markets appear fairly priced, eight markets appear fully priced, whilst London City and West End both remain underpriced.

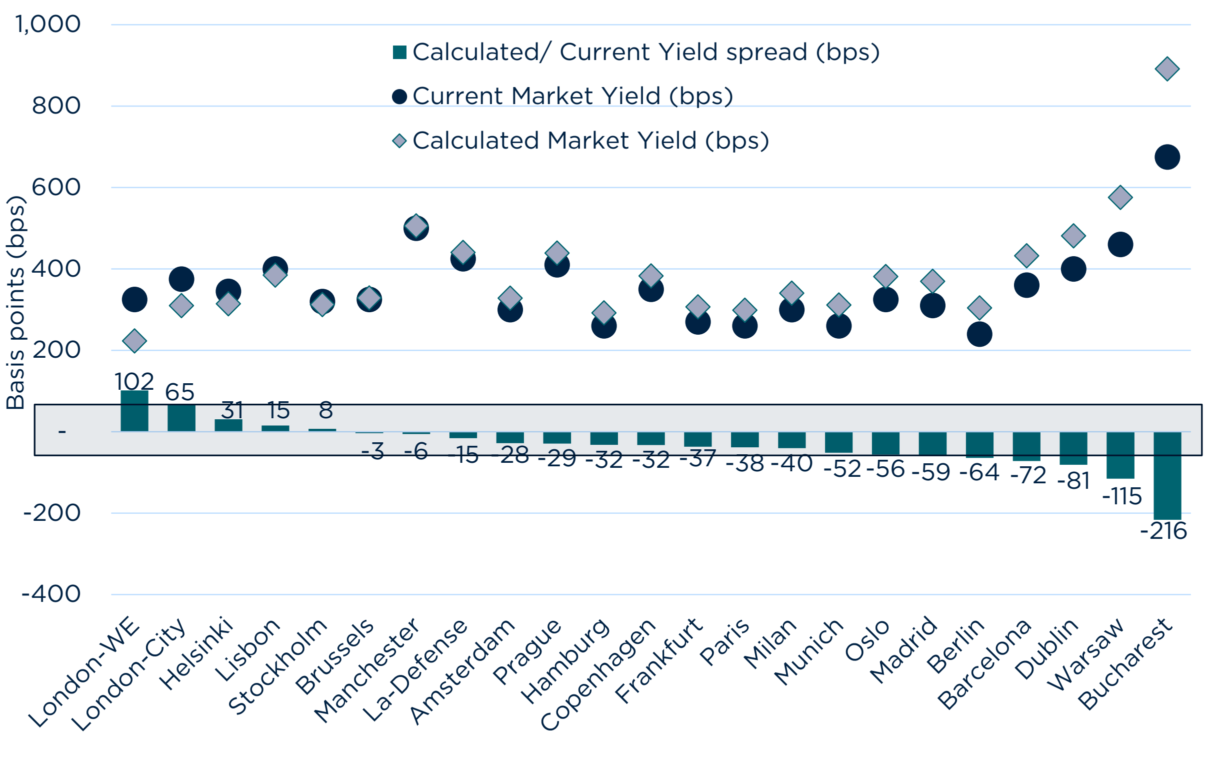
Rising capital allocations towards real estate have continued to support valuations, indeed with some yield compression, as we have seen in the ultra-core European cities of Paris, Berlin and Munich over the past 12 months. London's relatively higher rental growth prospects and current yield discount against the five-year average indicates an opportunity for further yield compression in the future. Given the rising importance of sustainability, we have increased the office depreciation rate from 1.0% pa to 1.5% pa since Q2 2021.

However, the big shift over the last quarter has been the rising government bond yields impacting relative pricing, given the potential for rising debt prices and a narrower yield spread against risk-free rates. Supply shortages, particularly labour and fuel, are increasing price levels, which landlords will try to offset in rental growth. However, we anticipate that an interest rate hike is more likely to be observed in the APAC or US markets, where the consumer bounce-back from the pandemic has been relatively strong, rather than the eurozone market, where inflation is expected to be short term, or transitory, and interest rates are not anticipated to rise before 2024/25. As bond markets settle, we expect yield spreads to recover to previous levels across eurozone markets.

Should the eurozone observe a sustained increase in inflation, we also expect European landlords to be more sheltered to any real rental declines due to the nature of lease indexation in mainland Europe.

Given the rising level of eurozone government debt since the pandemic, any rate rise would likely be very marginal. An interest rate rise in non-European markets would, ceteris paribus, increase demand in non-euro denominated currencies, making European real estate appear cheaper, which could pave the way for a return of APAC investment in 2022, once travel restrictions are fully lifted.

Chart 3: Savills European Office Value Analysis, Q3 2021



Source: Savills Research, Oxford Economics

Sustainability and lettability

Rising regulation on carbon emissions and a flight to quality is driving occupier demand for sustainable office buildings

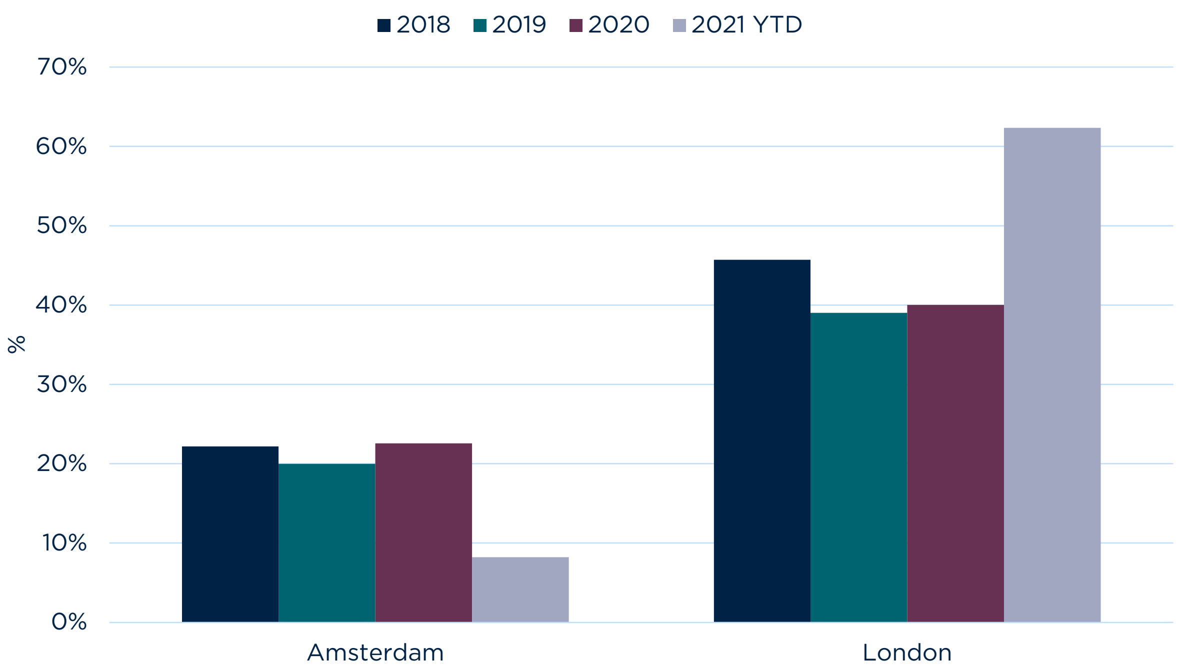
Tightening government regulation and businesses' self-imposed sustainability targets are driving tenants to lease offices with higher environmental credentials. The IEA calculates that the built environment accounts for 38% of global carbon emissions. The UK has been relatively early in the adoption and utilisation of environmental accreditation of buildings, and since 2020, all UK commercial leases must now be at least EPC level E.

Our analysis shows that more than 70% of the office properties that achieved the top 10% of rents in central London in 2018 and 2019 had a BREEAM rating of 'Very Good' or better. The strong preference for 'Very Good' and higher BREEAM-accredited space has accounted for 60% of total take-up from 2019 to present. In 2021, 64% of take-up in the City of London was rated BREEAM 'Very Good' or higher.

In Amsterdam, the proportion of BREEAM leases achieving Very Good or higher reached between 20-25% in recent years; although below 10% of office leases so far in 2021 have been BREEAM Outstanding, due to the scarcity of high-quality supply remaining in the market.

The demand for sustainable offices will increase in the coming years, partly because of increasingly stringent government sustainability criteria. As of 1st January 2023 in the Netherlands, it will be prohibited by law to occupy an office building with an energy label D or worse. In 2030, this will be stepped up to energy label A. Landlords will have to act now by asset-managing their schemes in order to meet sustainability criteria across Europe and ensure their offices do not become obsolescent.

Chart 4: Proportion of office leases achieving BREEAM "Very Good" or higher (%)



Source Savills Research

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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