European Office Market

Q3 2020

ECONOMIC OVERVIEW

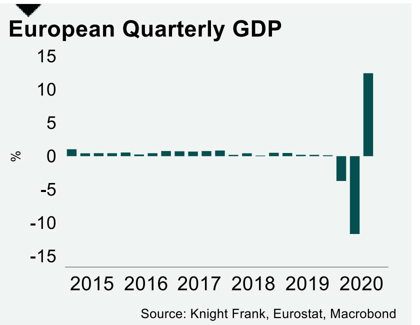
Positive third quarter GDP growth for the eurozone

Eurozone GDP increased +12.6% over the quarter, its highest quarterly gain on record and recouping 75% of its H1 loss, according to Oxford Economics. GDP in the eurozone's four largest economies, France (+18.2%), Spain (+16.7%), Italy (+16.1%) and Germany (+8.2%) all recorded their largest quarterly growth in Q3 2020 since the time series began.

As COVID-19 cases rise, Oxford Economics forecast an economic slowdown in Q4, albeit not to the level seen earlier this year. As a result, they predict an overall decline in eurozone GDP of -7.9% for this year, before increasing by +5.7% in 2021. Of the eurozone's largest economies, GDP projections for 2021 are forecast to be greatest in France (+7.0%), followed by Spain (+6.6%), Italy (+6.1%) and Germany (+5.3%).

Unprecedented monetary and fiscal support...

To counteract the economic dislocation that has occurred over



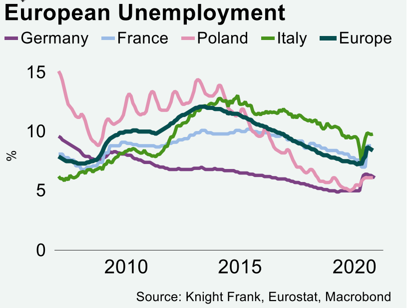
Source: Knight Frank, Eurostat, Macrobond

the first three quarters of the year, governments and central banks have delivered significant fiscal and monetary support. Indeed, the European Union has agreed a €750 billion recovery package, which includes €390 billion in grants to countries worst affected by the virus. Additionally, individual governments have been providing support. For example, to date Italy has provided fiscal and monetary support worth 77% of GDP, Germany has provided 65%, France 44% and Spain 36%, according to C.Elgin.

...with effects on unemployment tempered thus far

The aims of this support include preserving the economy as much as possible and minimising unemployment. The eurozone was in a relatively robust position going into the pandemic, with unemployment at the lowest level on record in February 2020 at 7.3% (seasonally adjusted). While unemployment has since increased to 8.4% in October, in line with expectations, this remains well below the long term average of 9.5%.

Further pressure on unemployment has been mitigated, at least in part, through furlough schemes. According to Capital Economics, up to 5.4% of the workforce across the eurozone are currently in some form of wage subsidy scheme. Capital Economics forecast eurozone unemployment to rise in the coming quarters as these schemes are scaled back in some countries. The jobless rate is expected to rise to 10% by mid-2021, before falling back to just below 9% by the end of 2022. The relatively swift return of unemployment to below the long term average means that it is less likely to have an impact on the office sector than a more structural, longer term change.



Source: Knight Frank, Eurostat, Macrobond

INVESTMENT HEADLINES

Prime office yields remained broadly stable over Q3, with an average prime office yield of 4.06%. This is a compression of -5bps compared to Q3 2019.

European office investment volumes saw improvement over the quarter to Q3 2020, up +14% to €16.2 billion. However, volumes remain tempered when compared to Q3 2019, down -47%.

France and Germany received 23% of total European office investment each in Q3 2020, with France improving its share of investment from 13% in the quarter prior. Further recovery in office markets has been noted in Romania (+238%), Spain (+199%) and Finland (+136%) who all recorded quarterly increase in investment over Q3 2020 albeit large individual deals have a significant impact on these numbers.

Cross border investment into the European office sector has remained relatively resilient. Despite YTD volumes declining by one third year-on-year, this compares favourably to a global decline over the same period of -42%. Q3 cross border investment into Europe totalled €8.1 billion, a +47% increase on the quarter prior.

Institutional investors also rotated back into the European office market, increasing investment +43% over the quarter to €11.2 billion in Q3 2020.

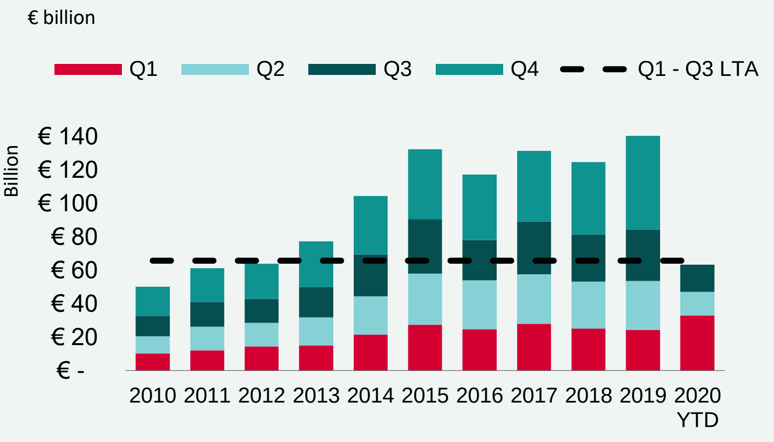
Non-European cross border investment has slowed due to COVID-19. As 70% of cross border European office investment is now intra-regional, +19% higher than in 2019 and above the long term average of 51%.

German (+54%), Austrian (42%) and French (+38%) investors have all increased their year to date cross border investment into European offices compared to 2019.

Prime European Office Yields

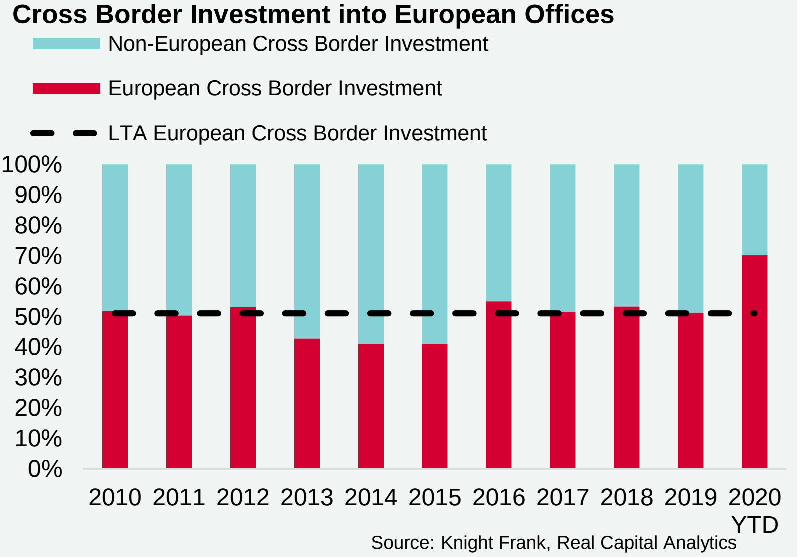
Source: Knight Frank

European Office Investment Volumes



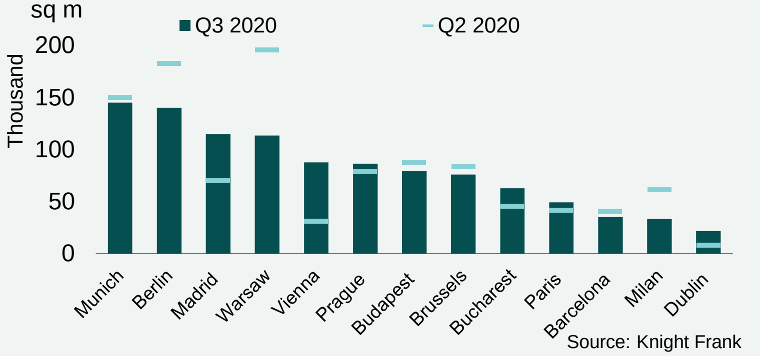
Source: Knight Frank, Real Capital Analytics

Cross Border Investment into European Offices

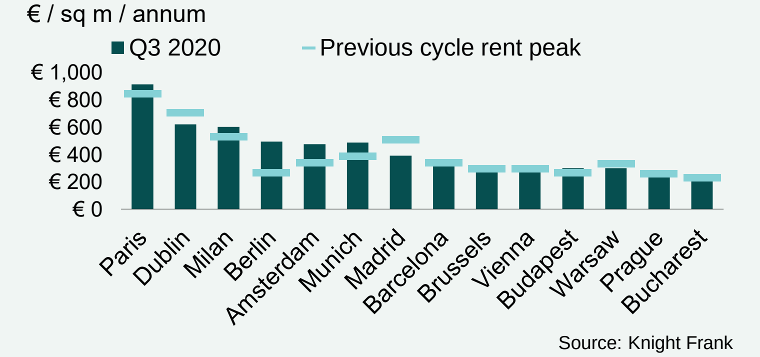


Source: Knight Frank, Real Capital Analytics

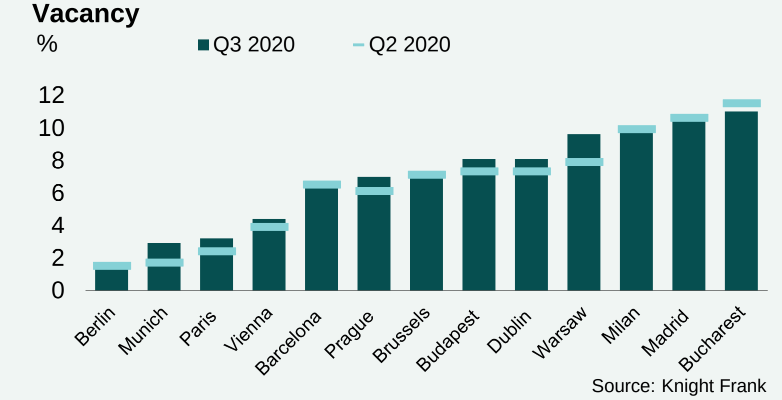
Take-Up



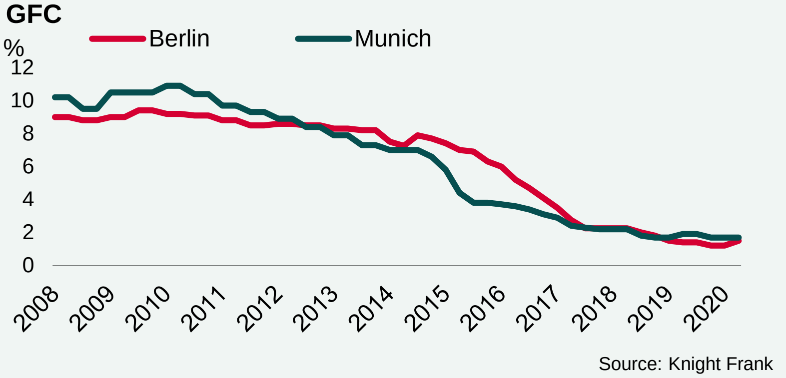
Rent



Vacancy



Vacancy remains below levels seen during the GFC



LEASING HEADLINES

Office take-up in Europe for Q3 2020 was on average down by almost one third compared to Q3 2019. However, Q3 did see some improvement over the quarter, with take-up recovering by +2% compared to Q2.

There have been some stand-out performers this quarter. Office take-up in Vienna was the second highest third quarter on record, increasing +186% over the quarter to Q3 2020 and was +65% higher than in Q3 2019. Some cities in Europe have still seen significant increases in take-up over Q3 including Dublin (+179%), Madrid (+64%), Bucharest (+38%) and Paris (+9%).

Despite the pandemic, Berlin (+4%) and Munich (+1%) have seen rental growth over the quarter to Q3, with the majority of the remaining markets remaining stable this quarter. However, Dublin (-8%), London West End (-4%) and London City (-3%) saw declines in rental growth in Q3 2020 compared to Q2.

While average prime office vacancy increased by +0.5% q-q across the European survey area in Q3 2020, to 7.3%, this remains -1% below the long-term average Q3 vacancy of 8.3%.

In the three years prior to and during the GFC, vacancy in the core was higher than today. For example, in 2008, Munich had a 10.2% vacancy rate compared to 2.9% today. Berlin is similar having a 9% vacancy rate in 2008, which has since declined to 1.5%.

This time around the development pipeline in most core locations is heavily pre-let. In Berlin, 60% of all office completions in 2021 are pre-let. In Paris, 94% of the new supply coming to market in 2021 is pre-let.

BUILDING RESILIENCE IN OCCUPIER MARKETS

Claims alluding to the death of the office have steadily given way to a more balanced position in the last few months of the year. It is now more widely understood that the way we work and where we work is subject to change, meaning that the form and function of the office will have to adapt accordingly.

It is therefore not the death of the office that must be considered, but its evolution in light of changing occupier – aka customer - demands. Our experience over the last nine months points to a clear future for offices, but also towards a different way in which users interact with them.

To the benefit of both business occupiers and their staff, the office becomes less of a centre for administration and more a setting for innovation, collaboration, socialisation and education.

COVID-19 changes the context in which occupiers commit to offices, and with that in mind, we've identified those dynamics which will shape the post COVID-19 office at both the corporate level and the asset or office level.

In reviewing these dynamics, we forecast four key trends that will shape the European office market going forward:

1.

There will be a rise in on-shoring or near-shoring of activity to the benefit of European markets as many occupiers rethink their office portfolios as they seek greater operational resilience in light of the pandemic.

2.

With that comes a greater desire for flexibility in both lease terms and the space committed to. True co-working will be challenged by the legacy of social distancing, but managed or serviced space will grow, and simply become part of conventional landlord's product offering.

3.

More fundamentally, offices will need to present compelling reasons for people to invest in their commutes, and offer an experience that can't be replicated digitally or at home. The result is a flight to quality, and to office space that offers a first-class experience as well as a first-class environment.

4.

And the focus on sustainability is here to stay. Most occupiers now have ambitious plans to reduce their carbon footprints, and real estate will be key to achieving that ambition. Occupiers will place great emphasis on sustainable real estate over the next cycle.

Dynamics of a post COVID-19 Office

CORPORATE LEVEL	Survival instinct vs sense of purpose	Rethinking globalisation & the global footprint	Reducing the carbon footprint	A new contract between employer & employee
OFFICE BUILDING LEVEL	Better but more dispersed space	Office as a choice not an obligation	Emphasis on experience not environment	Health, safety & wellbeing key to the experience

In the next cycle, prime offices will absolutely remain in demand, but that demand will become more sophisticated, and ever more strategic.

Prime offices will be a more complex product and a more specialist consideration, and this has clear implications for the investor and the resilience of returns.

Investors will have to take a more active role in creating the workplace experience, with more intensive management, and sometimes partnership with operators, but in doing so, they will be better positioned to secure tenants and ultimately to drive out-performance and resilience.

We will also see a specialisation of the customers driving European take-up over the next cycle.

One example is the life sciences sector, which will be a dominant occupier group and growing source of occupational demand across Europe, not just as a response to the pandemic but also due to wider concerns about health, wellbeing and Europe's aging demography.

Another example is the tech sector – particularly the tech titans – who have also grown significantly during the pandemic. Indeed, the rise of digital B2C and B2B services in particular will drive demand for more sophisticated offices as well as more specialist real estate, including data centres.

BY DR LEE ELLIOTT
PARTNER, COMMERCIAL RESEARCH

Greater Specialisation in the Office Sector

AS HUB OFFICES:	Become amenity rich	Have a strong service layer	Offer flexibility	Are an experience as well as an environment
INVESTORS MUST CONSIDER:	Shorter income streams	Premium performance	Operational platform & partners	Active & intensive management

Please get in touch with us

If you are looking to buy, sell or would like some property advice, we would love to hear from you

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