RESEARCH

Knight Frank

EUROPEAN OFFICE OUTLOOK

AUTUMN 2019

European Outlook

Despite global headwinds, there are still local growth stories and opportunities in new sectors

Amid global economic and geopolitical headwinds, Europe continues to enjoy a record low unemployment rate, positive employment growth and increased service sector output for Q2 2019. However, with a continuation of the US-China trade war, many export-led countries around the world have encountered its negative implications and Europe has not fully escaped this. GDP growth for the European Union moderated to 0.2% in Q2 and industrial production saw a slight contraction of -0.6%. We expect global headwinds to continue for now, albeit tempered by an expansionary European Central Bank, which announced in July its intention to release further policy stimulus in the coming months.

While take-up across Europe was mixed over Q2 2019, there were some particularly positive local growth stories. Take-up in Warsaw increased by 73.8% q-o-q and 9.3% y-o-y, while in Vienna, take-up increased by 59.4% q-o-q and 15.2% y-o-y. Take-up in the Budapest Office market also rebounded over the quarter, with an increase of 104.3%. Bucharest (+40.3%), Brussels (+11.5%) and Milan (+2.9%) also saw notable increases.

Across Europe as a whole, the average Office vacancy rate reduced by 0.2% over the quarter to 6.0%. The largest cities in Germany enjoy some of the lowest vacancy rates across the continent and all are at 10-year lows. Correspondingly, these cities also saw positive rental growth in the year to Q2 2019, including Berlin (+15.6%), Frankfurt (+12.5%) and Munich (+5.8%).

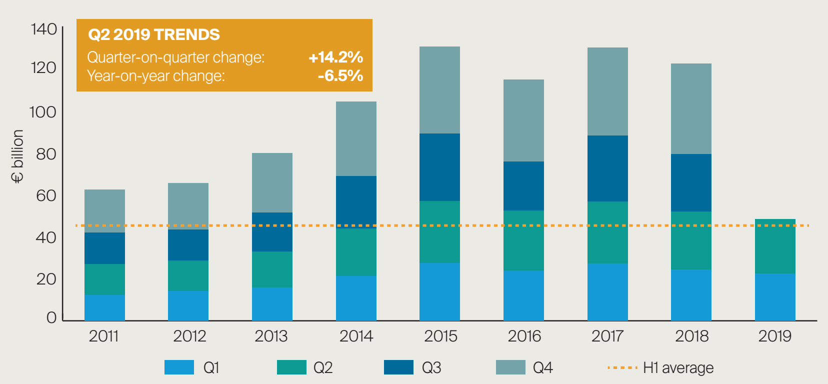
In fact, resilient European labour markets and an overall tight level of supply across the survey area, meant that 71% of the European cities surveyed saw rental growth over the year to Q2 2019. While some cities have now surpassed rents achieved at the peak of the previous cycle, multiple markets still have scope for rental growth relative to their previous cycle peak rents. These include London West End, Madrid and Moscow. Looking ahead, we expect 65% of cities surveyed to experience further growth in prime Office rents in H2 2019.

Cross border investors have also sustained their interest in the European Office market, contributing 55% of the total investment year to date (YTD). This overseas demand has driven investment volumes to increase by 14% over the quarter, to €25.9 billion. Office remains the most active sector for investment, contributing to 40% of total volumes in Q2 2019.

Overall investment volumes were up in two thirds of the countries surveyed in Q2 2019. In particular, CEE countries saw activity increase by 91% q-o-q and 14% y-o-y. Foreign investment continues to dominate in the CEE, driving 82% of all purchases year to date. Despite transaction numbers being similar to that previously recorded, the size of the deals surpassed volumes recorded since Q4 2016. Belgium also enjoyed its best second quarter since Q2 2014. Indeed, after a slower start in Q1 2019, Belgium's investment volumes recovered by 200% q-o-q, with interest from South Korean investors.

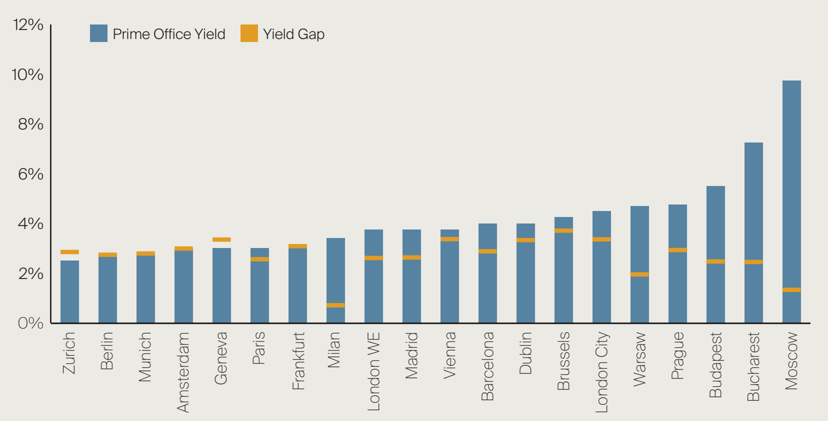
Prime Office yields in Europe averaged 4.2% in Q2 2019, a fall of 2bps from the previous quarter, or 6bps y-o-y. 63% of the survey area are experiencing yields at 10-year lows and in many cities, yields have reached and fallen below where they were at the previous cycle. However, the gap between prime Office yields and 10-year gilts remains wider than the previous cycle. With this in mind, we anticipate yields to remain stable in most locations, highlighting three cities: Berlin, Brussels and Bucharest, which could experience further yield compression in the second half of 2019.

FIGURE 1
European Office investment volumes



Source: Real Capital Analytics / Knight Frank

FIGURE 2
European prime Office yields vs 10 year government bond rate
Q2 2019



Source: Knight Frank Research, Eurostat, Macrobond, Swiss National Bank

"Cross-border activity into the European Office sector continues to prevail, with South Korean investors having a dominating presence across the continent in H1 2019. As well as the traditional gateway markets, international investors are also increasingly looking to southern and eastern European locations, which we expect to continue over H2 2019."

MIKE BOWDEN, CO-HEAD EUROPEAN CAPITAL MARKETS

Spotlight on Spain

Standout performers in the investment and occupier markets in H1 2019, both Madrid and Barcelona are being acknowledged as new gateway cities.

ECONOMIC GROWTH PERSISTS

Spain is less far through its economic cycle than some other European countries and as a result continues to enjoy above Eurozone average GDP growth. While growth is expected to moderate, it is set to remain above the European average for the next few years. This should drive favourable employment conditions and sustain demand for Office space. Reflecting this, Madrid recorded a 41% increase in take-up year-on-year in Q2.

Positive conditions are also enticing cross-border investment, particularly into Madrid and Barcelona as investors look for growth and liquidity. Due to supply constraints in the CBD, these cities are seeing a rise in investor demand in well-connected emerging-core locations, such as the 22@ district in Barcelona.

SCOPE FOR RENTAL GROWTH

Despite strong rental growth, rents are currently below the previous cycle peak for Madrid and Barcelona. When overlaid with supportive economic conditions, this provides scope for further rental growth over H2 2019. Vacancy rates in Madrid and Barcelona are below their 10-year averages, leading occupiers to consider emerging-core locations. Indeed, ING Bank recently occupied approximately 35,000 sq m of Office space in the Campo de las Naciones periphery of Madrid, choosing to move its head quarters from the popular area of Las Rozas in the CBD.

CROSS BORDER ACTIVITY DOMINATES

In Madrid, H1 Office investment reached €1.3 billion in 2019, a 106% increase y-o-y. In Barcelona, H1 2019 investment volumes increased to €599 million. Foreign demand remains strong in both cities. In H1 2019, 94% of Office investment in Barcelona and 72% in Madrid were from overseas investors. Germany, the UK and the Philippines were significant sources of investment in both cities in Q2 2019. In terms of investor type, over 60% of transactions were by pooled funds in Barcelona over the quarter, while in Madrid, they accounted for 43% of transactions.

YIELDS SET TO REMAIN STABLE

We forecast Office yields for H2 2019 in Madrid and Barcelona to remain stable. Despite yields being at multi-year lows, the yield gap with the risk free rate is wider than at the peak of the previous cycle. Certain investors, including dollar denominated ones have also been able to benefit from favourable currency hedging.

European market indicators

The average European Office yield fell 6bps y-o-y in Q2 2019. The majority of yields are expected to remain stable in the second half of 2019.

Commercial property prime rents, yields and outlooks

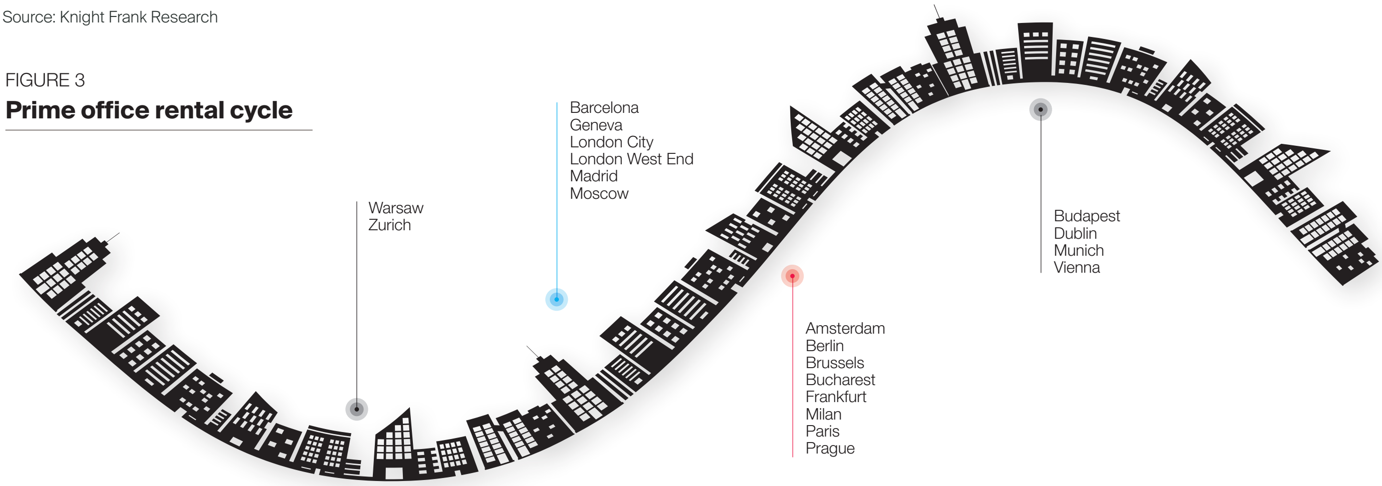
City	OFFICES Prime rents (€/sq m/yr)	OFFICES Prime yields (%)	LOGISTICS Prime rents (€/sq m/yr)	LOGISTICS Prime yields (%)	SHOPPING CENTRES Prime rents (€/sq m/yr)	SHOPPING CENTRES Prime yields (%)	HIGH STREET Prime rents (€/sq m/yr)	HIGH STREET Prime yields (%)
Amsterdam	475 ▶	3.00 ▶	85 ▶	4.25 ▶	N/A	N/A	3,000 ▶	3.00 ▶
Barcelona	276 ▲	4.00 ▶	82 ▶	5.00 ▼	600 ▶	4.50 ▲	3,480 ▶	3.50 ▶
Berlin	444 ▲	2.75 ▼	84 ▶	4.50 ▶	1,380 ▶	3.75 ▶	3,900 ▶	2.50 ▶
Brussels	320 ▲	4.25 ▶	55 ▲	5.25 ▼	1,650 ▶	4.25 ▶	1,800 ▶	3.75 ▶
Bucharest	216 ▶	7.25 ▼	48 ▶	8.25 ▼	N/A	N/A	840 ▶	7.25 ▶
Budapest	294 ▲	5.50 ▼	51 ▲	7.00 ▲	120 ▲	5.50 ▶	1,350 ▲	5.50 ▲
Dublin	673 ▶	4.00 ▶	105 ▲	5.25 ▼	3,500 ▶	4.50 ▶	7,000 ▶	3.50 ▶
Frankfurt	540 ▲	3.00 ▶	80 ▲	4.00 ▶	N/A	N/A	N/A	N/A
Geneva	630 ▶	3.00 ▶	180 ▶	5.00 ▶	1,027 ▶	4.00 ▶	3,602 ▶	3.75 ▶
London	1,287 (WE) ▲ 872 (City) ▲	3.75 (WE) ▶ 4.50 (City) ▶	192 ▶	4.00 ▶	N/A	N/A	10,827 ▶	2.75 ▶
Madrid	372 ▲	3.75 ▶	66 ▶	5.00 ▼	600 ▶	4.50 ▲	3,600 ▶	3.25 ▲
Milan	580 ▲	3.40 ▶	55 ▶	5.25 ▶	900 ▶	5.00 ▶	11,500 ▶	2.75 ▶
Moscow	704 ▲	9.75 ▶	66 ▲	11.00 ▶	3,099 ▶	10.25 ▶	N/A	N/A
Munich	456 ▶	2.80 ▶	84 ▶	3.90 ▼	N/A	N/A	4,400 ▶	2.90 ▶
Paris	845 ▲	3.00 ▶	58 ▲	4.50 ▼	1,800 ▶	4.25 ▲	20,000 ▶	2.90 ▶
Prague	270 ▲	4.25 ▼	51 ▲	5.25 ▼	N/A	N/A	2,760 ▲	3.75 ▶
Vienna	312 ▶	3.75 ▶	72 ▶	5.20 ▶	1,920 ▶	4.10 ▶	7,200 ▶	3.30 ▶
Warsaw	288 ▶	4.50 ▶	60 ▶	6.00 ▶	1,200 ▶	4.75 ▶	N/A	N/A
Zurich	743 ▶	2.50 ▶	225 ▶	5.25 ▶	1,351 ▶	4.00 ▶	8,105 ▶	2.50 ▶

Indicative prime yields, as quoted locally, based upon a hypothetical Grade A unit. Office rents are for prime city area Grade A space, 2,000 sq m. Shopping Centre rents are based on prime covered shopping malls, quoted on best position, 100 sq m units. Retail Warehouse rents are for units of 1-5,000 sq m located in purpose built parks. Typical Retail Warehouse schemes vary between countries. Logistics rents are for prime industrial space of units over 5,000 sq m. The data above is provided for general reference purposes only. Local market conditions will vary. *Zoned/weighted figure. Arrows provide a broad indication of recent movements and the short-term outlook for prime rents and yields. London office data is quoted for the West End (WE) and City (C) submarkets. All yields are in local convention, net yields are in red.

Source: Knight Frank Research

FIGURE 3

Prime office rental cycle



The above diagram is intended to provide a comparative guide to the current positions of European prime office markets in their rental cycles. Markets will move through their cycles at different speeds and, sometimes, in different directions. The positions indicated in the diagram do not constitute formal forecasts of future rental trends.

EUROPEAN RESEARCH

Victoria Ormond
Partner, Capital Markets Research
+44 20 7861 5009
victoria.ormond@knightfrank.com

Antonia Haralambous
European Research Analyst
+44 20 3866 8033
antonia.haralambous@knightfrank.com

EUROPE

Richard Laird
Partner, Capital Markets
+44 20 7861 1663
richard.laird@knightfrank.com

Mike Bowden
Partner, Capital Markets
+44 20 7861 1546
mike.bowden@knightfrank.com

Caroline Bathgate
Head of European Valuations
+44 20 7861 1287
caroline.bathgate@knightfrank.com

Colin Fitzgerald
Head of International Occupier Services
+44 20 7629 8171
colin.fitzgerald@knightfrank.com