Investment, Development &
Occupational Markets

Knight Frank

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European Office Market

Summer 2021

ECONOMIC OVERVIEW

Local instances of economic positivity amidst mixed results.
Of the Eurozone's largest economies, France (0.4%) and Italy (0.1%) recorded positive GDP growth over the quarter. Meanwhile, Germany (-1.8%) and Spain (-0.5%) saw declines.

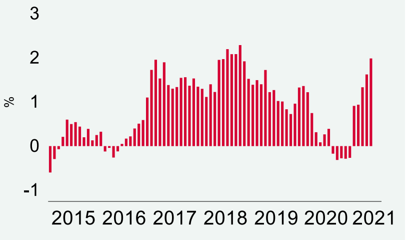
However, for Europe as a whole, the Eurozone entered into a double dip recession in Q1 2021. Following a 0.7% decline q-q in Q4 2020, Eurozone GDP contracted a further 0.3% in Q1 2021, albeit beating forecasts of a 0.6% decrease.

Forecasts project positive growth for the remainder of the year
Oxford Economics forecast Eurozone GDP to grow by 1.7% in Q22021, 2.2% in Q3 and 1.2% in Q4, leading to an overall growth of 4.3% in 2021.

...as inflation pushes higher
Eurozone inflation increased from 1.6% in April to 2.0% in May, above expectations of 1.9%. This was the first time inflation surpassed 2% since 2018 and in response, the ECB adjusted its inflation target from 'just below' 2% to 2%. Inflationary pressures have largely been driven by oil prices.

However, pressure on prices is expected to be transitory with the ECB forecasting inflation of 1.9% overall this year, before pairing back further to 1.5% in 2022.

European Inflation
CPI, y-y



Source: Knight Frank, Eurostat, Macrobond

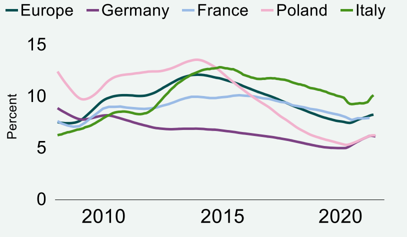
... while interest rates are expected to remain at record lows
Despite the higher levels of inflation in 2021, the ECB are not expected to increase interest rates in the near future.

... and property yields are unlikely to be impacted
Even if above target inflation was to persist long enough to prompt a rate increase, it is currently unlikely that any uplift would be significant enough to impact property yields.

While unemployment stays below average
Eurozone unemployment was 8.0% in April, down from 8.1% in March. While, employment has increased from 7.3% recorded pre-pandemic in February 2020, it remains below the 9.5% long term average.

Low levels of unemployment have been supported by wage subsidy schemes. Latest figures for Germany and Italy show that 5.5% and 5.7% of the national workforce are on furlough, which is down from peaks of 12% and 17%, respectively. However, Italy's unemployment rate has increased from 7.4% in March 2020 to 10.5% in May 2021, thus not wholly absorbing the impact of the pandemic on unemployment.

European Unemployment
Rolling 12-month average



Source: Knight Frank, Macrobond

INVESTMENT HEADLINES

European office investment volumes totalled €14.7 billion in Q1 2021, a 54% contraction over the quarter and 56% lower than the €33.7 billion recorded in Q1 2020. However, Q1 2020 was the best first quarter on record for European office investment and it is typical for activity to ease in Q1 following a busy final quarter.

While investment was down overall and 30% below the Q1 long term average, there were some markets that recorded growth compared to Q1 2020. This includes Switzerland (762%), Greece (195%), Ireland (79%), Austria (40%) and Denmark (11%).

France overtook Germany as the largest recipient of European office investment in Q1 2021, the first time since Q2 2019. **French offices received a quarter of total European office investment in Q1 2021, at €3.6 billion**, albeit down 24% on Q1 2020. Germany with €2.9 billion and the UK with €2.0 billion, were second and third for investment, albeit both saw declines of 66% and 61%, respectively.

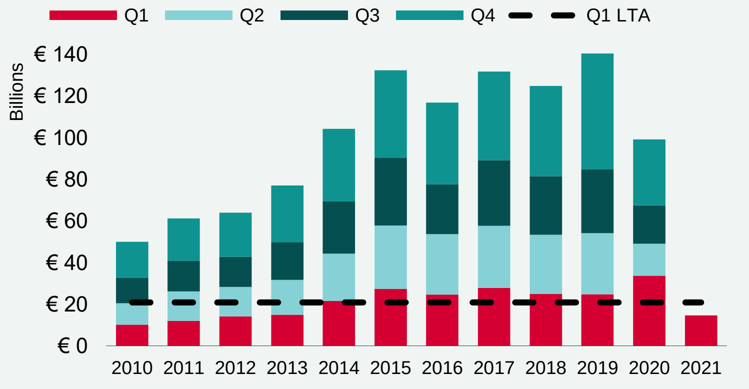
The strengthening of containment measures across most of Europe proved an obstacle for cross border investors in Q1 2021. Cross border investment totalled €5.7 billion in Q1 2021 and equated to 39% of all European office investment. This compares to the record €15.9 billion in Q1 2020 which was 47% of total investment.

Despite the more tempered investment activity in Q1 2021, prime office yields compressed both over Q1 2021 and relative to Q1 2020.

Prime office yields were down 8bps q-q and 3bps y-y, with an average prime office yield of 3.90%. This highlights the weight of capital allocated to European Offices, despite headwinds.

European Office Investment Volumes

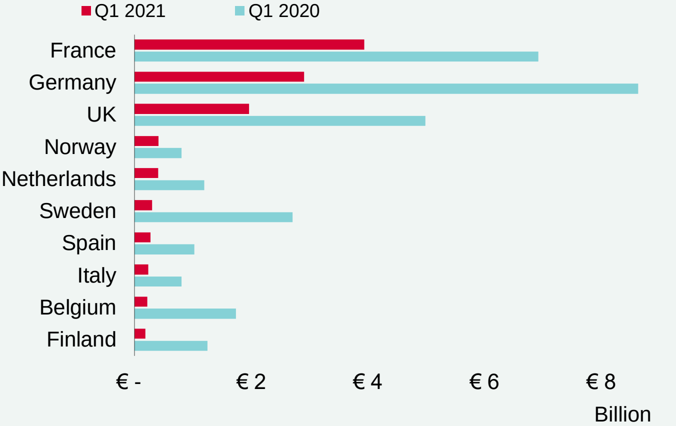
€ billion



Source: Knight Frank, Real Capital Analytics

Top 10 Destinations of European Office Investment

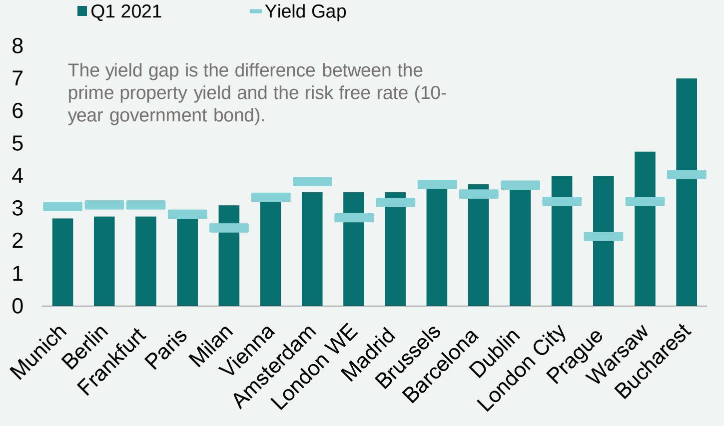
€ billion



Source: Knight Frank, Real Capital Analytics

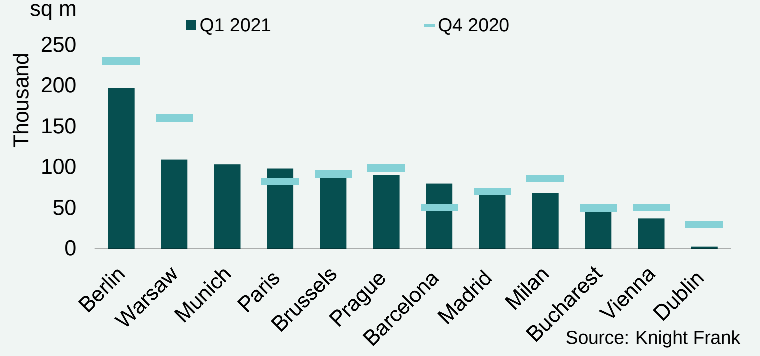
Prime European Office Yields

%

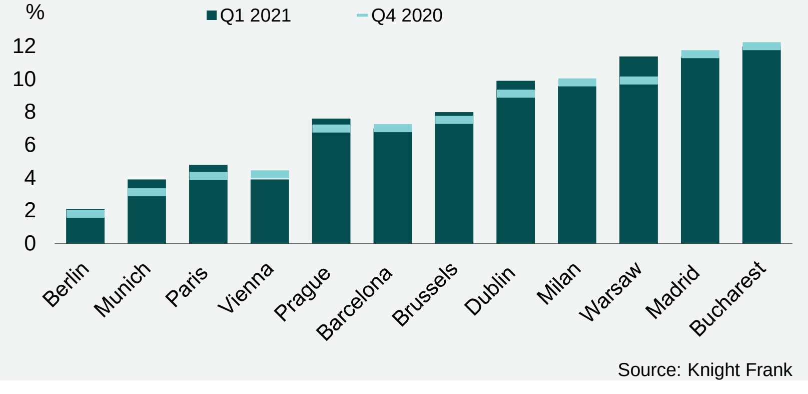


Source: Knight Frank

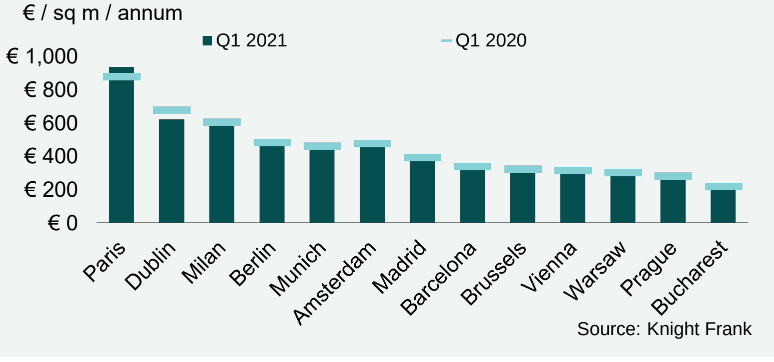
European Office Take-Up



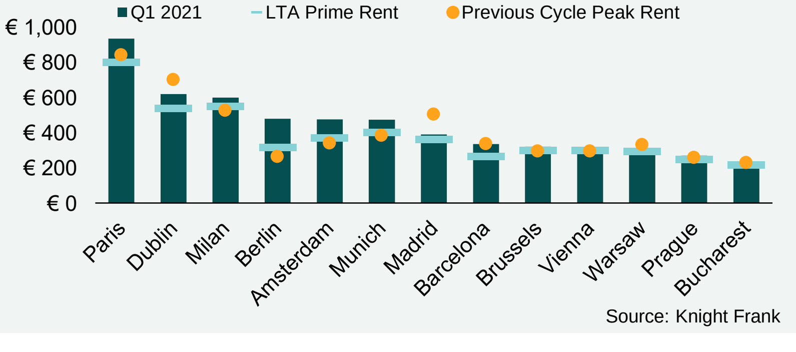
Vacancy



European office market rents



Prime office rents remain higher than the long term average in most markets



LEASING HEADLINES

In Q1 2021, average office take-up amassed to 92,420 sq m, down 20% over the quarter, but just 7% below the long term average for Q1. This is a relatively modest impact given the disruption seen across Europe and more widely, due to the pandemic.

On a city level, there were some markets which outperformed. Compared to Q1 2020, take up in Vienna (186%), Barcelona (78%), Moscow (46%), Brussels (44%), Prague (30%) and Berlin (14%) all saw improvement in Q1 2021. Moscow (208%), Barcelona (60%), Paris (20%), London City and Brussels (both 6%) also saw take-up recover over the quarter.

Vacancy for Q4 2020 was 7.4%, which was 1.0% below the long term Q1 average of 8.4%. This is despite the vacancy rate increasing by 1.5% over the quarter and 3.9% compared to Q1 2020. While vacancy was higher overall in Q1 across Europe, Vienna and Milan were the only markets to record declines in vacancy, both over the quarter and over the year to Q1 2021. Vacancy for Vienna and Milan fell 0.2% and 0.3% q-q and 0.3% and 0.1% compared to Q1 2020, respectively.

Prime office rents remained mostly stable over the quarter, further highlighting the sector's resilience, despite the pandemic. However, Paris (7%) and Munich (4%) saw rents increase compared to Q1 2020.

Prime office rents across all European markets in the survey area were above their long term averages (LTA) in Q1 2021. Indeed, Berlin (52%), Amsterdam (29%), Barcelona (28%) and Munich (19%) were notably higher than their LTA's.

Meanwhile, Bucharest, Dublin, Madrid and Warsaw remain the only markets with room for prime rental growth, compared to their previous cycle peaks.

Cross border investment within Europe bolsters demand

Last quarter we forecast that intra-regional, near neighbour investing in Europe would rise over 2021. This was primarily due to advantages offered to local investors, including fewer issues with travel disruptions.

This forecast is already coming into fruition. In Q1 2021, 68% of all European office cross border investment was from within Europe itself, which was up from 64% in both Q1 2020 and Q4 2020. Furthermore, this is notably higher than the 50% long term Q1 average share of cross border investment from Europe into European offices.

Another prediction made last quarter was that safe havens, in relatively liquid, transparent locations would be the greatest beneficiary of intra European cross border investment. This has also transpired in the first quarter, with France receiving the most European near neighbour investment, with €902m. This equated to 66% of all cross border investment into France, up from 57% in Q1 2020.

Switzerland was the second largest destination of investment from within Europe in Q1 2021 with €566m, an increase of 277% compared to Q1 2021. However, this €566m was the result of one large transaction acquired by Deka Immobilien. Germany also received a significant amount of intra-regional cross border office investment from within Europe in Q1 2021, totalling €530m or a 58% share of total cross border investment into German offices.

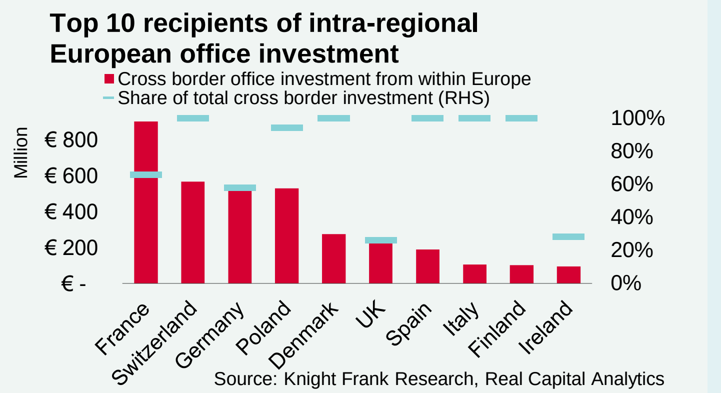
A number of countries only saw intra-regional inbound investment over the first quarter of the year. Countries across the Nordics and Iberia, as well as Austria, Bulgaria, Hungary, Italy, Luxembourg, Romania, Slovakia, and Switzerland all received 100% of their cross border office investment from within Europe itself in Q1 2021.

The greatest sources of this within-Europe cross border office investment were from Germany, the UK and Switzerland. €1.4bn was spent by German investors, which equated to 37% of all intra-regional European office investment. Cross border investors from the UK and Switzerland invested €528m (14%) and €480m (12%), respectively.

Cross border investors from Spain and the Netherlands rotated back into the European office market in Q1 2021, increasing their investment by 334% and 112%, when compared to Q1 2020.

With this renewed focus of cross border investors on European office assets, we are starting to see transactions with larger lot sizes recover. For example, the €620m sale of Shift, Nestlé's head quarters in France to Primonial REIM, La Francaise and EDF Energy. The aforementioned Acacias 60

Intra-European cross border office investment dominates in Q1 2021



Source: Knight Frank Research, Real Capital Analytics office building in Geneva was acquired by Deka Immobilien for €566m and the Focus Teleport II office in Berlin was bought by Asia Pacific Land for €280m.

We anticipate a further recovery of cross border office investment in H2 2020, especially if lockdowns ease further and international travel restrictions lessen. We expect this recovery will largely be supported by these larger transactions, as investors continue to look to deploy capital into prime assets with strong covenants and increasingly, sustainability credentials. In terms of location, due to the larger lot sizes demanded, the focus is likely to be on liquid, safe haven locations, particularly across Germany, France and the UK.

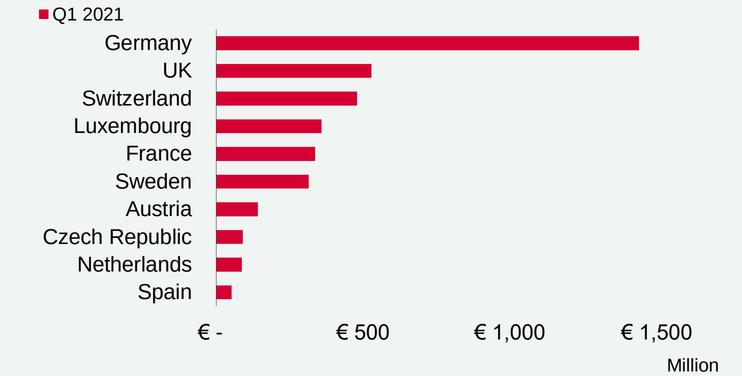
"Despite volumes moderating due to the pandemic, there is no shortage of capital seeking to be deployed in Europe. Twinned with the low interest rate environment showing no signs of change, we expect the core sector to remain particularly active with further yield compression for best in class product in key European locations.

As travel restrictions start to ease and Europe opens up to overseas capital, sellers are becoming more confident in the depth and transactional capability of their investor audience. As such, an increase of product to the market in Europe is anticipated in September. We are working up a number of assets for launch and also tracking others that are being prepared for sale."

Mike Bowden, Co Head of European Capital Markets

Germany remains the greatest source of intra-European cross border office investment

Top 10 sources of cross border intra-European office investment



Source: Knight Frank Research, Real Capital Analytics

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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