Research Blast

COVID-19 European Office Markets Series, Edition 2 – May 2020

Limited current and future supply levels will limit the decline in prime office rents in the short term.

But the economic challenges are likely to lead to headcount reductions, with corporates vacating unutilized space.

This trend could be accelerated, if as we expect, corporates adopt higher levels of flexible working in a post COVID-19 world.

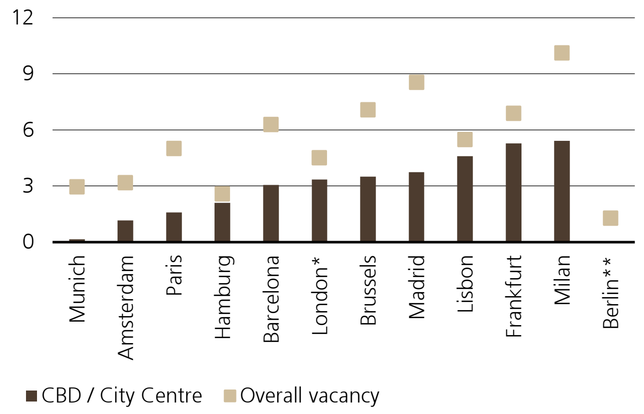
Some cause for comfort

Office rental levels are ultimately a product of the balance between occupational demand, and office supply in a market. In the first edition we discussed some of the inevitable challenges COVID-19 will place on the demand side. In this paper, we examine the current situation and future supply of office space in Europe, and how COVID-19 may impact the balance between supply and demand, and rental growth prospects, over the coming years.

The good news is, markets are entering this downturn from a position of relative strength on the supply side. Chart 1 illustrates that vacancy rates in most European markets are at, or are close to, historic lows. And when we dissect the numbers on a submarket level, there is even less space available in the more core, central districts.

But it is common for office markets to enter downturns from a position of low vacancy – these come off several years of strong economic, and jobs growth, which new supply typically lags. Once an economic downturn hits, vacancy rises from two sources. Initially, new office schemes which started during the strong economic growth years complete. Against a weak demand backdrop these take longer to be leased, and add to vacancy levels. And then as the economic slowdown starts to bite, second-hand space starts to be released from occupiers through both full scale insolvencies and more commonly, job consolidations. We will examine where the markets currently sit in light of these drivers and what the implications might be for rents, compared to previous downturns.

Chart 1: Vacancy rates (%)



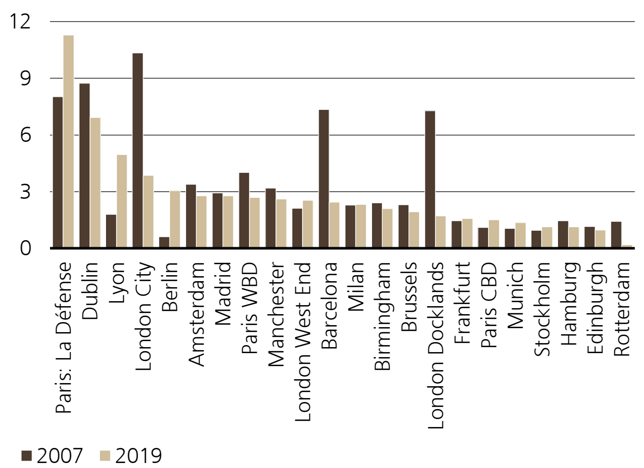
Source: CBRE ; 1Q20

Although there is a clear variation between markets, vacancy rates across Europe have come down markedly over recent years. And with vacancy levels particularly tight in CBD locations, we have also seen several years of widespread prime rental growth.

Future supply

What is more relevant when we consider the outlook for rental growth, however, is the future supply coming through. One of the main reasons behind the relatively low vacancy rates in Europe is the lack of construction activity moving forward since the global financial crisis (GFC). This is partly due to a reluctance of banks to lend to speculative construction schemes. In more recent years, there has been a bit of tick-up in schemes as alternative lenders such as debt funds have stepped into the void left by bank lenders, but as Chart 2 below shows, there are far fewer markets with a sizeable development pipeline coming through than in 2007.

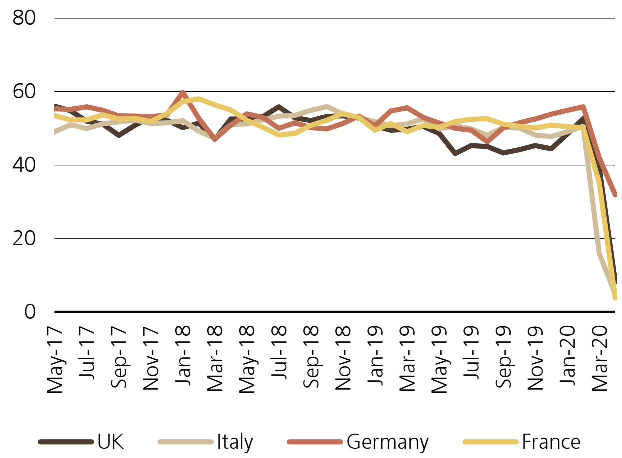
Chart 2: Speculative space u/c as % of office stock



Source: PMA ; Spring 2020

That is not to say there are no markets which are going to see a considerable amount of newly built available space coming through over the next few years. There are some major towers under construction in La Défense in Paris, development in Dublin has begun again in earnest and London City has some significant schemes due to complete this year, although significantly less than prior to the GFC. But for the majority of markets, speculative space under construction remains around 2%, or less, of stock. And these numbers do not take into account any impact that COVID-19 may have on existing, and future developments.

Chart 3: Construction PMI Surveys



Source: Datastream; May 2020

Chart 3 shows that construction PMIs across the major markets have unsurprisingly collapsed to record lows. Even though sites have started to open up, with social distancing measures remaining in place there are likely to be significant delays to any of the schemes currently under construction in Europe. And many of the schemes which were due to start in the short-term will see the pause button being hit, and potentially be cancelled completely. With the timescales involved, we're likely to see a significant reduction in the number of schemes moving forward over the next two years, which translates into a limited amount of new supply coming through for at least the next three to five years.

Second hand vacancy

A bigger challenge on the supply side will come from space being released back onto the market by existing occupiers. This impact is likely to be felt in stages. Initially, there is the potential for space to be vacated through insolvencies if companies are unable to withstand the short-term pressures of the economic crisis. However, with huge amounts of fiscal stimulus and monetary easing implemented across Europe, we are hopeful that the level of insolvencies affecting office occupiers is lower than in the GFC, and dot-com crisis. But we are in uncharted territory here.

We don't know how long restrictions on economic activity will remain on place, how effective the government interventions will be in saving businesses, or how many companies may fail further down the line as result of the weaker economic environment created by the pandemic. And one sector which clearly is exposed to the short-term impacts of the virus, is serviced offices. This has been discussed at length already, but clearly there is the capacity for a significant amount of space to come back to the market in a relatively short amount of time, if the operators are unable to remain solvent as their income streams dry up.

Even if widespread insolvencies are avoided, it's difficult to see how there will not be significant consolidations in the aftermath of COVID-19. And there are two issues facing the occupational market here. One is the natural reduction in office-based headcount as a result of an economic slowdown and lower revenues leading to cost cutting. This would seem to be an inevitable consequence of the current crisis, although the scale of those job losses remains to be seen.

But there is an additional challenge this time around. The relative success of what has been dubbed the greatest "working from home experiment", has unsurprisingly led to expectations that even after the virus is contained, that a much higher proportion of staff will be working from home in the future. To us this seems inevitable. If productivity can be relatively well maintained with virtually 100% of staff working from home all the time, the resistance to allowing staff to work remotely for one or two days a week will be harder to justify. And corporate real estate teams will be seeing this as an easy opportunity to reduce their floorspace, and costs, at a time when they are likely to be coming under pressure.

A counter argument to this, is that with COVID-19 and social distancing companies are likely to need more space. This is a valid point, but only for the very short-term. We do not expect these measures to need to remain in place, once an effective treatment or a vaccination is found.

And the structural changes we are expecting would generally be part of a longer term strategy, rather than short-term solution. Lease events need to come up before corporates are able to realign their real estate strategies, which can be anything up to five years in Europe, and even longer in the UK. So we expect any impact from this to take a gradual effect on vacancy rates over the next few years, and many of these decisions to be taken in a post-COVID environment, when hopefully the current social distancing measures won't be a factor.

It's important to note here that we are not talking about the death of the office. We still expect corporates to maintain a city-center presence post COVID-19 for collaboration, client meetings etc. We also expect to see suburban co-working hubs emerge, to facilitate work within an office environment without the need for commuting. But we expect significant challenges to be faced in the secondary locations where offices fulfill a more functional "work" environment, with limited value-add for travelling into the office.

Impact on rents

Putting precise numbers on expected rental movements for the coming years is a somewhat futile exercise in the current environment. But we can consider some of the factors which differentiate the current situation from previous downturns and estimate a scale of severity, and the parts of the market which are likely to feel the most stress.

Part of the challenge is we still don't know what shape this downturn will look like. The "V" shaped recovery is already looking somewhat optimistic, certainly for the recovery to come through in 2020. A more realistic (but still optimistic) view would be something like a "Nike swoosh" shaped downturn, with the sharp contraction but a more gradual recovery coming through starting next year. If we take this as a baseline, we would still be expecting prime rents to fall across the vast majority of European markets this year.

There will be exceptions – such as Munich where there is only 2,400 sq m of available space in the City Center – but generally the negative impact on sentiment and demand will force landlords to be more accommodative, even on the better quality space in tight markets. But the extent of the declines should be lower than in the GFC and dot-com crash, where aggregate euro zone prime rents fell by 8% and 15% respectively. And this is the result of the modest level of existing supply, weak future supply pipeline coming through and the assumption that we avoid mass scale insolvencies and the worst of the potential job losses in the coming years.

However, outside of the more core locations, even under this scenario we think there could be a more severe impact on rental levels. Vacancy rates are coming from a much higher level, and ultimately these locations are set to be far more defensive if we do, as we expect, see an increasing shift towards remote working in the coming years. As the retail sector found out several years ago, it will no longer be enough to provide a functional environment, if employees are going to go back into their offices there will need to be some value-add offerings in the locations to make it worthwhile.

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