



SHIFTING SUPPLY PATTERNS IN EUROPEAN OFFICE MARKETS

By Bruno Berretta, Analyst, EMEA Research & Consulting

OVERVIEW

Recent data show that vacancy rates have begun to retreat in several office markets as new supply hits cyclical lows. Almost everywhere, this has been accompanied by notable shifts in the quality and geographical distribution of vacant space as occupiers continue to upgrade or move to better located (and still relatively cheaper) premises. These factors have highlighted substantial variations in rental performance and vacancy levels at the micro level. As a result, investors need to be even more rigorous and precise in the selection of areas for investment.

INTRODUCTION

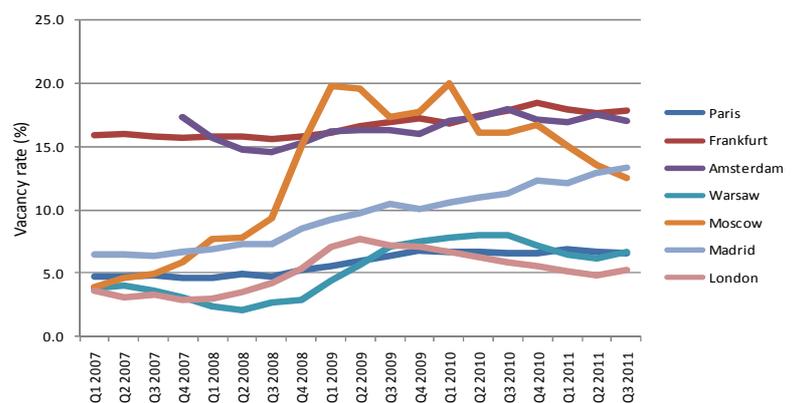
The economic crisis has brought a sharp increase in vacancy levels across major European office markets, fuelled by the combined effect of lower leasing volumes and the delivery of several schemes started during the stronger 2006-2007 markets. As a result, the CBRE EU-27 Vacancy Index has climbed by nearly 350 bps between Q1 2008 and Q4 2010 and it has only been since the beginning of 2011 that this trend has shown signs of reversing, with the index edging down from 10.5% to 10.2% over the first six months of the year. The third quarter saw vacancy levels rising marginally, but increases were mostly confined to a limited number of markets.

The extent to which supply has already declined (and how far it can decline further) varies across cities reflecting differences in individual pipelines, strength of occupier demand as well as other structural variations. London is one of the places that has experienced one of the largest and earliest declines in vacancy levels, with the vacancy rate having fallen by approximately 2.5% to 5.2% in Q3 2011 from 7.7% in mid-2009. Warsaw and Moscow have also recorded noteworthy reductions in vacancy. By contrast, supply is continuing to trend upward in cities like Madrid. Even in these cases, the pace at which vacancy has increased seems to have slowed and, with little development to come, supply could soon start to stabilise despite the fact that demand remains subdued.

Recent CBRE research on office development activity in Europe revealed that development completions will decline by over 30% in 2011 and by nearly 50% in 2012 compared with the levels observed in 2010 and should stay low in 2013 as well.

The decline will be particularly marked in those markets where falling rents or a weak rental outlook have deterred any resumption in speculative development. Even where market fundamentals look healthier, the current low level of starts indicate that stock additions will be extremely subdued for some time. London is one of the few cities where there appears to be a higher level of interest in new development, but this has yet to translate into more starts. In addition, there are indications that increased financial stress and renewed economic uncertainty following the summer turmoil may delay an actual recovery in speculative construction activity.

Vacancy rates for selected European office markets, Q1 2007-Q3 2011



Source: CBRE

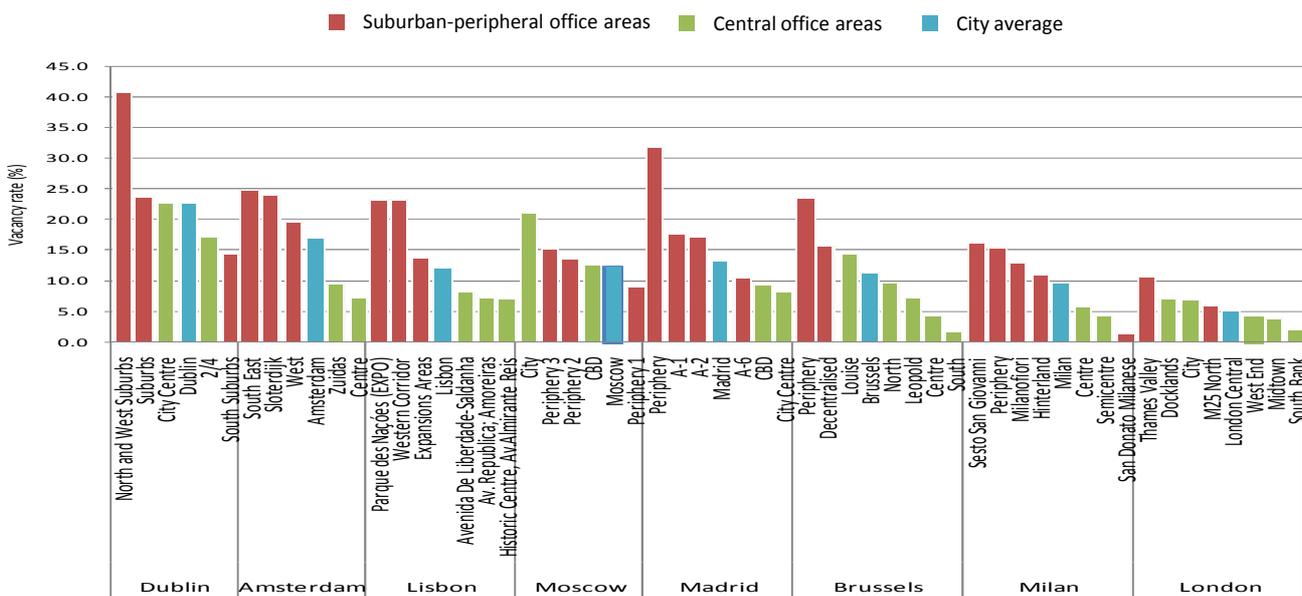
INCREASINGLY POLARISED SUPPLY PATTERNS

The slowdown in office development not only is enabling the absorption of part of the existing stock, but, in combination with other factors, is also driving substantial changes in the quality profile and geographical distribution of vacant space.

A manifestation of this is the growing shortage of modern office accommodation that is beginning to emerge in some cities, particularly in core office locations. This has been partly fuelled by occupiers taking advantage of the current rental weakness to secure modern or better located office premises. There is evidence of this in **Madrid**, where, for example, a number of prominent IT companies based in the immediate outskirts of the city have recently decided to move to the city centre attracted by the relatively low differential between central and suburban office rents.

In some cities, the bias towards core office areas has filtered through into lower vacancy rates. In **Stockholm** prime CBD office area, for example, the vacancy rate has dropped sharply from 8.7% in Q1 2010 to 5.7% in Q3 2011. In **Amsterdam** Zuidas office district vacancy declined by roughly 3.9% from 13.6% to nearly 9.7% during the first nine months of this year. Likewise, **Moscow** CBD vacancy rate has fallen by 170 bps over the last 12 months to 12.6%. Also in other markets where total vacancy remains relatively high in absolute terms, such as Dublin (22.5%), Frankfurt (17.8%) or Madrid (13.3%), prime/CBD locations typically continue to display lower vacancy rates than suburban or less central office districts as illustrated by the chart below.

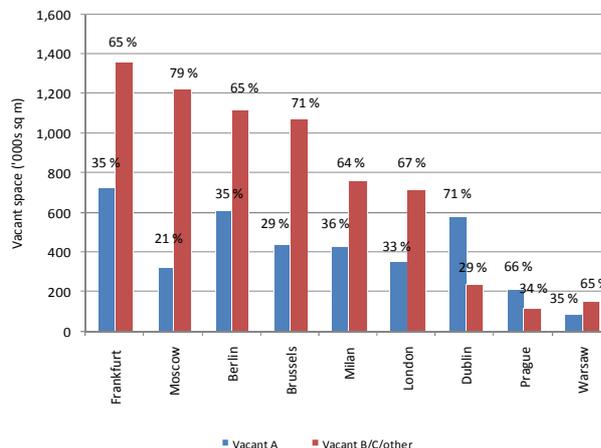
Vacancy is higher in the periphery



Source: CBRE

A consequence of the ongoing upgrading and consolidation process is that a rising proportion of vacant space is concentrated in second-hand accommodation or poorly-located space. As an example, in **Milan** some large companies like Unicredit will soon vacate part of their current buildings to consolidate their space requirements into new (and more cost-efficient) office premises.

Composition of vacant space, selected cities, Q3 2011



Source: CBRE

According to preliminary estimates, supply of inferior quality space (B, C) there has increased by 13.5% since the beginning of the year, while grade A availability actually fell by over 4% over the same period. This trend is also apparent in **Brussels** where the availability of grade A space has contracted by 10% between Q1 and Q3, while supply of inferior quality grade C space has increased by a similar extent throughout.

Likewise, in **Paris** the share of new supply in the total has shrunk by nearly 5% since the end of 2009 to 23% and it is even tighter in core locations. In **Dublin**, although most of the space currently being marketed is grade A space, there is only a very small number of buildings able to accommodate tenants with large requirements (7,000 sq m or above). With no more space under construction, supply of this type of accommodation could contract further when demand picks up.

The growing polarisation of vacancy between modern and secondary space is a distinct feature of the current phase of the cycle. As clearly illustrated by the chart for the Central London office market,

Rental cycle and second-hand/new supply gap, Central London



Source: CBRE

the gap between the quantum of secondary and modern vacant space tends to widen when the market falls and completions are generally lower (e.g. during the period 2002-2004 and in conjunction with the recent economic crisis) and, conversely, to narrow in period of rental growth.

The increase of voids and lengthening of vacancy periods in older and more obsolete buildings have led some landlords to consider the conversion of their properties into other use such as residential, retail or hospitality. This trend is particularly evident in more central locations that typically benefit from better accessibility and larger consumer catchment areas compared with suburban locations and are hence more suitable for these purposes. Brussels and Amsterdam provide some interesting examples of this trend.

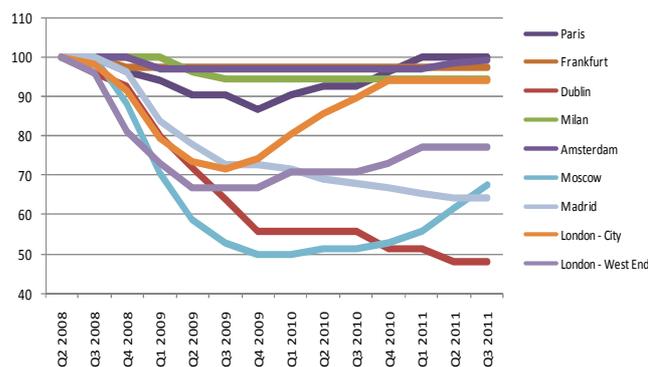
PRIME RENTS STILL WAY OFF THEIR PEAK

The attractive pricing of prime space has been a major catalyst for the migration towards better-quality accommodation that has been apparent in some cities. Although prime rents have begun to move ahead in many markets, rental growth remains uneven across Europe (and actually stalled in Q3) and in most instances it has been insufficient

to bring back nominal rental values to their pre-crisis levels. One direct consequence of this is that prime CBD offices remain relatively cheap by historic standards. This implies that those occupiers who were reluctant (or could not afford) to commit to prime buildings at peak rents may now be in a better position to do so (or have already done so), where budget is available.

As clearly shown by the chart below, prime rent trajectories vary substantially across different markets. In a number of cities like Frankfurt, Milan and Paris the rental correction has been relatively limited and prime rents have bounced back or are close to their pre-downturn levels. Prime rates in London dropped much more significantly during the same period but despite the strong positive rental momentum in 2010, they are still approximately 15% and 23% off their 2007 peak in the City and West End respectively. In some cities, mostly in Southern Europe, the gap between peak and current rents is even greater and, in some cases, further widening.

Prime Rent Index, selected cities, Q2 2008=100



Source: CBRE

In Moscow, despite the strong growth recorded recently, prime rents are over 30% lower than before the outbreak of the financial crisis in 2008.

Likewise, while falling vacancy rates have gradually started to erode the levels of incentives for prime space in markets like London, Warsaw and Moscow, elsewhere rent-free periods have showed little change of late and in many instances remain relatively high. In addition, there are actually places like Lisbon, Athens, Amsterdam and Milan where terms on offer appear to have loosened further. This means that even where prime headline rents have hit a floor, net effective rents continue to remain under downward pressure. Occupiers' ability to secure incentives - and the levels achievable - is also dependent on the specificity of their property requirements. In an increasingly supply-constrained environment, companies with strong building/location preferences are generally in a weaker negotiating position than those with less stringent and more flexible site-selection criteria.

WILL THE FLIGHT TO QUALITY CONTINUE?

The “flight to quality” in the occupier markets had been to some extent indicative of a relaxation of cost constraints across businesses, as suggested by the annual occupier survey carried out by CBRE earlier this year.

Most corporates entered 2011 with healthier balance sheets and looked to leverage their stronger position to pursue business growth. Also, many had already implemented the bulk of their cost control programmes during the downturn, hence limiting the scope for further rounds of cost reductions across different areas of business, including real estate.

However, since the summer the economic backdrop has sharply deteriorated and most corporate occupiers face renewed pressure to keep a lid on costs. With real estate budgets likely to come under greater scrutiny and tenants to become more sensitive about rental costs as a result, we can perhaps expect the trend towards prime to weaken.

The increasingly limited choice of high-quality supply in central areas could also put off some prospective movers. In Frankfurt, this has started to generate higher interest among certain occupiers in more decentralised office locations.

IMPLICATIONS

The ongoing supply/demand-side changes are having a significant impact on the relative rental performances of different type of properties. In particular, they are accentuating the divergence between rents for prime and secondary properties that has been a key feature of the initial stages of the rental recovery.

Investment selection

Data for various European markets shows that secondary buildings/locations have only marginally benefited from the rental growth seen at the prime end of the market.

In some cities, the stream of grade C space released by occupiers has further inflated the levels of available second-hand space, placing rents for this type of accommodation under greater downward pressure. With rental performance becoming increasingly polarised across different locations and type of assets, investors need to be even more rigorous and precise in investment selection.

In particular, the fact that within the same city, areas with relatively high vacancy rates coexist with low vacancy ones means that investors need to be pay even greater attention, not only to the market,

but also to the exact locations they want to put their money in. This is particularly true of markets with relatively high total vacancy rates where recent rental growth has been highly localised and predominantly confined to the core office districts.

Impact on values and development

The diverging rental trajectories coupled with investors’ strong preference for the best properties, have been equally echoed in capital value growth, with prime properties significantly outperforming secondary over the last year. This is in line with historical data showing that prime properties tend to hold values better than secondary at the end of the cycle.

However, recent weak economic data combined with concomitant signs of weakening occupier sentiment suggest that demand side pressure on rents could remain subdued and that prime rental growth could lose momentum, despite the low level of new supply coming through. In confirmation of that, the CBRE EU-27 Office Rent Index has remained flat over the last six months, highlighting the shallowness of the current rental cycle, especially compared with previous ones.

With rental growth faltering and yields now starting to stabilise in the current weaker economic environment, prime capital value growth could also stagnate as a result. This means that performance will be increasingly tied to the rental income component of return, emphasising the importance of the security of rental stream and, possibly, further enhancing investors’ preferences for prime space with lower vacancy risks at the expense of properties with poorer rental prospects.

In the same vein, the absence of clear rental momentum and still expensive cost of development funding, could shift back further the beginning of the next development cycle. Pre-letting could provide some stimulus to a recovery, but corporates are generally finding it increasingly difficult to forward plan their office requirements. This, in turn, could potentially reduce the number of pre-let candidates.

CONTACTS

For further information contact:

Bruno Berretta
Analyst, EMEA Research
CBRE
St Martin's Court
10 Paternoster Row
London EC4M 7HP
t: +44 20 7182 3101
e: bruno.berretta@cbre.com

Disclaimer 2011 CBRE

Information herein has been obtained from sources believed to be reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty or representation about it. It is your responsibility to confirm independently its accuracy and completeness. Any projections, opinions, assumptions or estimates used are for example only and do not represent the current or future performance of the market. This information is designed exclusively for use by CBRE clients, and cannot be reproduced without prior written permission of CBRE. © Copyright 2011 CBRE Group, Inc.

About CBRE Group, Inc. CBRE Group, Inc. (NYSE:CBG), a Fortune 500 and S&P 500 company headquartered in Los Angeles, is the world's largest commercial real estate services firm (in terms of 2010 revenue). The Company has approximately 31,000 employees (excluding affiliates), and serves real estate owners, investors and occupiers through more than 300 offices (excluding affiliates) worldwide. CBRE offers strategic advice and execution for property sales and leasing; corporate services; property, facilities and project management; mortgage banking; appraisal and valuation; development services; investment management; and research and consulting. Please visit our website at www.cbre.com.