European Commercial - Q4 2024

SPOTLIGHT
Savills Research

European Office Outlook 2025

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● Economy ● Occupational ● Investment

Occupational resilience

European office take-up to rise by 4% YoY in 2025.

Much of the geopolitical uncertainty investors had hoped would be resolved in 2024 continues to dampen Europe's economic growth prospects as we head into 2025. Germany's 2025 election and France's budget deficit and recent parliamentary no-confidence vote have injected new uncertainty into the short-term outlook for the eurozone's two largest economies. However, a recovery in Central and Eastern Europe (CEE), Nordics and Irish economies, alongside an already outperforming Southern Europe will provide brighter prospects.

Despite multiple headwinds facing the office sector, Savills forecasts that take-up will rise by 4% in 2025, on top of the 5% rise in 2024. This means that by the end of 2025, take-up will only be 10% below the pre-pandemic average, exactly in line with our forecast back in 2022.

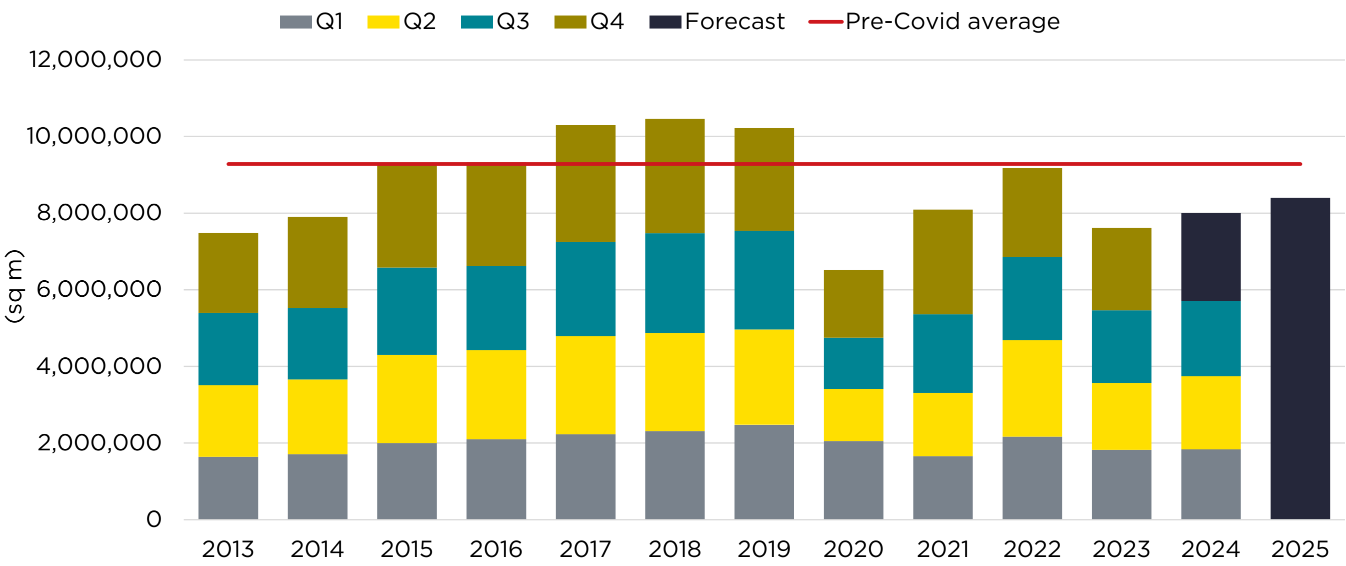
So what's driving the increase? A resilient Southern European market and a recovering tech sector have supported take-up during the second half of 2024. Part of the increase for 2025 will be supported by increased business confidence in a period of more stable inflation, as fewer companies extend their existing leases, and opt to upgrade their premises, both to attract and retain talent, and reduce their overall Scope 3 emissions.

It has also become clearer that following the surge in agile working hype, companies are becoming more committed to the office sector over the longer term and some occupiers are applying more pressure on employees to increase office attendance. Occupier preferences have gone 'full circle' and tenants are now opting to increase the provision of desks, on top of a marked increase in demand for meeting rooms and breakout areas to meet employee requirements. In 2024, average weekly European office occupancy rates reached the 60% mark (compared against a pre-Covid average of 70%), led by Madrid, London and Prague, and we expect occupancy rates to remain around this level moving forward.

Hybrid working is here to stay, but many companies are still working out what hybrid means for their business. We are tracking strong requirements for flex space, particularly with modern designs, collaborative areas and enhanced amenities, which can be vital for attracting and retaining talent.

Vacancy rates have stabilised in Europe, and tenants are now beginning to withdraw 'grey' space from the market, with a view to reutilising the space with new hires. With a muted development pipeline over the next couple of years, Savills anticipates average prime rental growth of 2.7% in 2025, marking the return of real rental growth. After all, in real terms, office occupiers are still paying 10% less for prime rents than in 2019, indicating they are able to pay more for the best space.

Chart 1: European office take-up (sq m)



Source Savills

Investment recovery

2025 to record this cycle's fastest period of yield compression for prime offices.

Average European prime office yields have been stable at 4.9% for the last three quarters and falling interest rates are presenting a green light for investors to resume acquisition activity. In many senses, it remains the buying opportunity of a generation, the issue is the lack of vendors returning prime stock to the market given very limited distress. As at end Q3 2024, Savills analysis indicated that Madrid, Oslo and Amsterdam remained the most underpriced European office markets. The stage is now set for 2025 to record this cycle's strongest period of yield compression for prime offices.

Investor sentiment towards the office sector appears to be improving too. Offices fell down the investment wishlist in 2024, accounting for only 22% of total European transaction volumes during Q1-Q3, down from 37% five years ago. However, we are tracking an increase in the number of underbidders for prime Central London and CBD Paris office stock, reflecting an increased pool of buyers.

The price expectation gap is closing, but still remains, as buyers are gradually moving closer to sellers' expectations. However, we are still observing a higher-than-normal number of terminated deals, as vendors increase their price expectations amid falling interest rates.

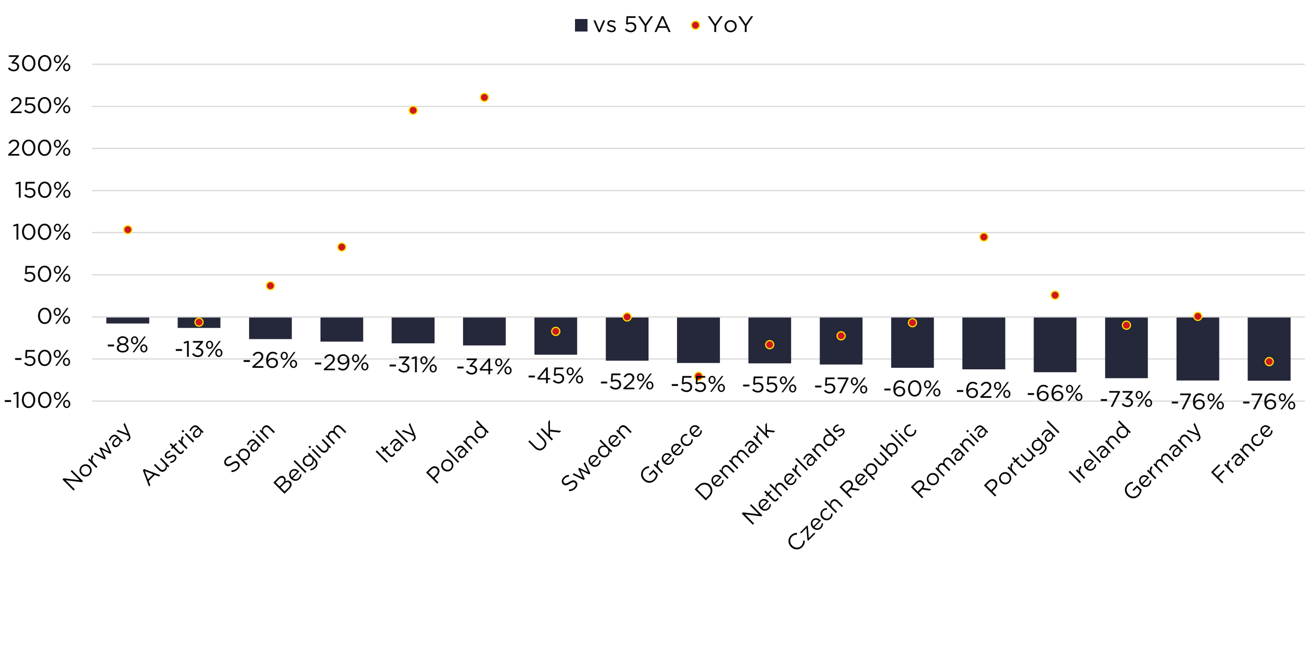
Distress is not as visible as many had expected by this point in the cycle, with banks opting to extend existing terms. In fact, lender sentiment has improved in recent months as their margins are reducing, which should support an increase in demand for larger lot sizes. Whilst we have seen more non-bank lenders plug the refinancing gap in 2024, we will see the recovery of bank lending in 2025, supporting core transactions.

Grade B quality stock in a Grade A location will remain a top pick for value-add investors to asset manage across Western European cities - not all occupiers are seeking to pay the top headline rents. What is clear is that older office stock in non-CBD locations will remain difficult to transact in 2025 given increased scrutiny on ESG criteria and leasing risk from investment committees, and prices will need to adjust further before investors re-enter the market. In some instances, we expect developers will seek to reposition older office stock to student accommodation.

German, Spanish and Middle Eastern family offices will continue to seek core stock, and as debt costs fall, we will see insurance companies become more acquisitive for the €100m+ lot sizes in Western European markets. SCPIs will continue to seek higher-yielding returns within smaller lot sizes across Europe, whilst it is probable we will see a greater presence in the sector from North American private equity, as has been order of the day in London and Dublin during the course of 2024.

Whilst the office sector is not out of the woods, much of the negative sentiment towards offices feels overplayed. Recovering demand, scarce Grade A stock and a limited development pipeline will deliver real rental growth for prime stock in 2025. Core investors will maximise their returns by securing new CBD stock before their competitors return to the market, whilst value-add investors who can redevelop well-located space to the market will see returns outperform.

Chart 2: European office investment volumes Q1-Q3 2024



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Savills Commercial Research
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