



EUROPEAN OFFICE DEVELOPMENT: NO SIGNS OF A RESUMPTION

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OVERVIEW

It is now increasingly evident that the two coming years will see a sharp contraction in new office completions, at a time when most of the schemes started before the market peak have already completed. Latest available figures show that new supply in major European office markets could potentially fall by over 30% in 2011 compared with 2010 and decline further in 2012 as the low level of starts during the crisis feeds through into lower completions. In most instances, completions will likely remain subdued in 2013, reflecting continued risk-aversion on the part of developers and the lack of development finance. London is one of the few major European markets where the recovery has created conditions for the start of a new development cycle, as illustrated by the expected pick-up in the volume of new delivery in 2013 and 2014. Across all geographies, development loans are still the hardest segment to gain terms for and this is unlikely to change in the short term as lending capacity is restricted by the need to address legacy loans, and interest rates appear increasingly likely to rise.

INTRODUCTION

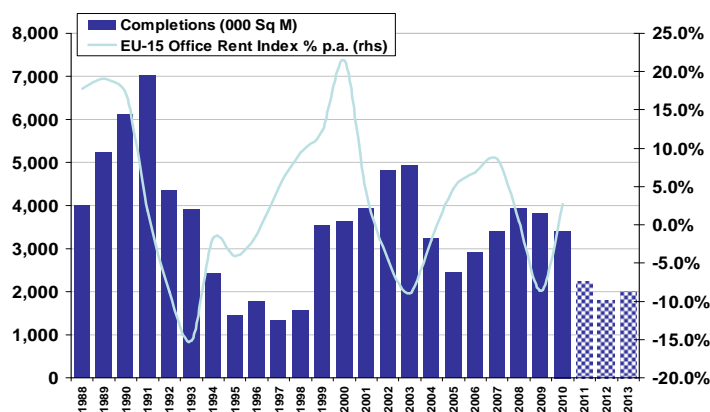
The credit crunch and ensuing economic crisis have had a major impact on office development activity and reshaped development pipelines across Europe. The shortage of available debt and uncertain economic environment have in many instances prompted developers to downscale or delay planned projects in the expectation of market recovery. It is now evident that the resultant reduction in the levels of starts during the crisis will produce a sharp fall in office completions across Europe over the next two years, now that virtually all the schemes started before the market peak have delivered.

Based on current data, aggregate completions in major Western European markets in 2011 are predicted to dip by one third compared with 2010 and by over 40% on the peak recorded in 2008. Some cities are expected to see particularly sharp y-o-y reductions in the scale of completions, including Barcelona (-69%), Amsterdam (-66%) and Madrid (-50%). In Dublin, the last schemes due for completion in 2011 just completed and there is no more space in the pipeline for the remainder of the year.

The correction will be particularly pronounced in 2012, which now represents the low point of the development cycle. Completions in the main Western Europe cities are expected to decline to 1.8 million sq m, down by a further 21% on 2011 levels.

Only a handful markets such as Milan may see some increases in completions, but even in these instances the absolute volume of stock additions remains below market norms.

Office development completions, Western Europe, 1988-2013



Source: CB Richard Ellis

LITTLE IMPROVEMENT IN 2013

While the longer term pipeline is still difficult to measure from this point, preliminary forecasts for 2013 point to only a modest pick-up in office completions in major European office markets (+12% on 2012 levels). This will still leave new supply nearly 50% lower than the peak year for completions (2008).

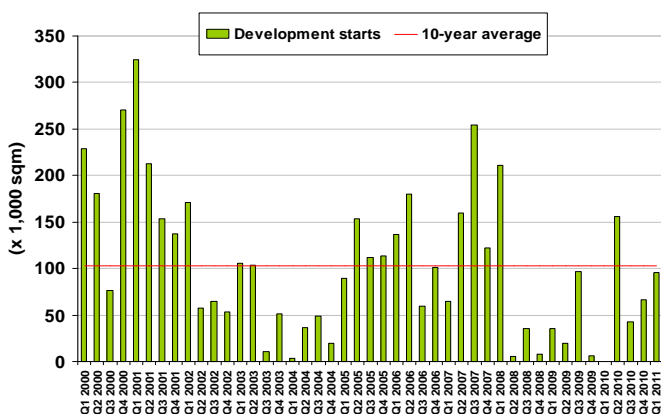
1. Based on figures for London, Paris, Brussels, Frankfurt, Madrid, Berlin, Hamburg, Munich, Milan, Amsterdam and Barcelona

Clearly, new schemes may enter the pipeline in the coming months to boost the total, but generally there is not yet evidence of a turnaround in office development as current starts remain subdued and caution prevails among developers and banks, especially in oversupplied markets. In markets with stronger fundamentals there is generally more interest in reconsidering or launching new schemes, although, with few exceptions, this has not yet translated into a clear pick in new construction. In many instances, pre-letting remains a key condition for securing financing and commencing development.

London is one of the few major European markets where the rally in property values and rents has reignited substantial interest in new development and conditions are in place for a relatively quick recovery in new development. Forecast completions for 2013 in Central London are set to more than triple the trough in 2011 and could rise further in 2014 when a number of tower office schemes are due to complete in the City market. Construction starts haven't yet returned to pre-crisis levels but last year they were nonetheless nearly 70% higher than in 2009 and are expected to pick-up as the year progresses. With funding still an issue, the noticeable increase in pre-letting activity seen in London recently (most recently, AON in British Land's "Cheesegrater") bodes well for developers seeking to secure bank finance.

Paris is also beginning to see signs of a revival in office development, with a number of speculative schemes recently commenced in the Western Crescent, Inner Rim and La Défense areas. Construction of the Majunga tower (63,000 sq m) just started in La Défense, with delivery expected by the end of 2013.

Quarterly office development starts, Central London, Q1 2000-Q1 2011



Source: CB Richard Ellis

This project is part of a series of high-rise buildings which could get off the ground in the area in the coming years. Despite the uptick in starts, it will require new construction to increase more sharply for completions to return to pre-recession levels, with forecast completions for 2013 still two-thirds lower than the long term average. New speculative schemes are mainly financed by equity and the proportion of debt used in funding is often limited.

In **Warsaw**, developers have recently re-announced a number of projects that had been on standby, including the Grzybowska 81 Office (10,560 sqm) and the Get-In Building (35,000 sqm). Construction of the Warsaw Spire (100,000 sqm) could also start soon in the city centre, with delivery expected to boost 2013 completions. Despite this upturn in development activity, only a few buildings are being started without pre-commitment.

In **Milan**, a number of projects that stopped during the crisis are back on developers' agendas. However, developers' cautious stance coupled with a series of authorization problems is slowing the start of works. As a result, it's unlikely that some of those schemes deliver before 2015. In the meanwhile, the Hines development in the area between Garibaldi and Centrale stations is attracting increasing interest from the real estate community. Some landlords whose offices will soon be vacated in the area are increasingly concerned with this, and may start considering refurbishment to make their properties more attractive to prospective tenants.

In **Copenhagen**, there has been some increase in overall development starts since mid-2010, including a 30,000 sq m speculative office building launched in Q1 2011. However, generally construction commences only when at least 50% of the building is pre-let.

In some others markets, interest in new speculative development remains weak, such as in **Amsterdam** where high vacancy and the continuing market weakness are delaying any recovery in new construction. Also in **Vienna**, interest in this sort of scheme is limited, as the letting market remains extremely competitive and incentives substantial.

In **Madrid**, construction of new buildings has stopped and just 400,000 sqm would be available during the next 3-4 years. Developers are waiting for the economy to recover and for some of the unlet new stock to be absorbed before launching new schemes. A number of office projects currently planned or under construction are part of larger regeneration schemes, such as Valdebebas and Chamartin.

FUNDING STILL AN ISSUE

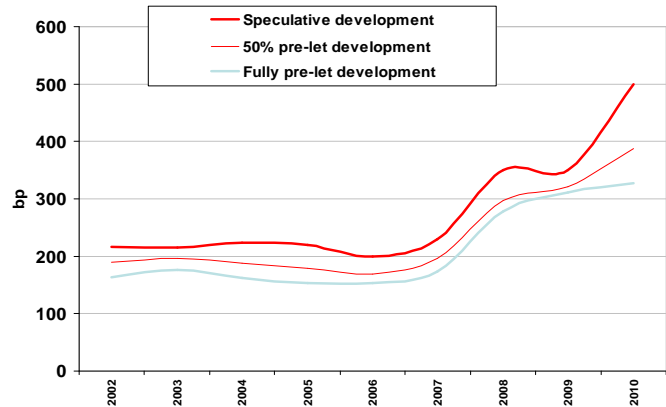
In many instances, the lack of funding available on reasonable terms remains one of the main factors hindering a pick-up in new construction. Despite the improvement seen in the occupier market recently, the supply of development finance remains restricted, as banks focus on reducing their overall exposure to troubled property loans and repairing their balance sheets. According to a recent study by De Montfort University, the value of outstanding debt allocated to development projects in the UK for example fell uninterruptedly from 11% before the outbreak of the crisis to 4.75% last year.

Lending terms on development loans also remain tight, with banks requiring a substantial risk-premium to incur the additional risks associated with development. Anecdotal evidence suggests that at the end of Q1 2011 margins charged on development loans for high quality schemes in Central London where lender has good relationships with developer, would be approximately 100-125 bps higher than the 215 bps currently required for a loan on a top-quality standing investment and tenant.

Banks' willingness to lend and terms on offer are increasingly a function of developers' ability to secure tenants in advance of construction. In many instances, indeed, lending organisations are still reluctant to offer terms on fully speculative development, unless the project is located in a particularly desirable location with good letting and rental growth prospects. For fully or partly pre-let schemes, finance is more widely available but margins, after having eased in the first part of 2010, tightened again towards the end of last year. LTC ratios, which are equally a good measure of the degree of lenders' risk-aversion, also showed a similar trend, declining between 2009 and 2010 for every type of projects.

Clearly, margins applied and pre-letting requirements vary from country to country depending on market practices and local market conditions, but generally in the current environment the flow of finance into development remains restricted.

Average interest rate margins for different types of projects in the UK, 2002-2010



Source: De Montfort University

This appears unlikely to change in the short term. Generally, the fact that a high proportion of outstanding commercial debt will come to maturity in the next three years, may limit banks' ability to finance new transactions, as part of lending capacity is absorbed in refinancing existing loans. Over the longer-term, the availability of debt finance for development may be equally affected by the implementation of Basel III, which will impose higher capital allocation requirements for property loans.

All of these factors may potentially lead banks to reduce their overall exposure to office development loans and further heighten their preference for less risky projects i.e. high-visibility schemes with strong covenants in core locations.

Interestingly, the high margins charged for development loans have led a growing number of smaller and non-traditional lenders to consider development finance, which could ultimately bring some improvement in debt availability. This however raises the question as to whether it would be still viable for developers to borrow at all at this kind of cost, or to consider other forms of financing instead such as joint ventures or partnerships with equity-rich investors. Notable is the growing prominence of overseas equity involved in development transactions in markets such as Central London.

IMPLICATIONS

The next two years will see a very limited amount of new supply coming through, as markets approach the end of the current development cycle. However, evidence from local development pipelines suggests that this period of low completions may well continue beyond 2012, reflecting the current reduced levels of starts and the shortage of available development finance. London stands out as one of the few major office markets where developers' interest in new construction is growing and conditions are in place for a quick recovery in office development.

In some other markets, high vacancy rates, often combined with the absence of a clear rental momentum, have the potential to delay further the start of a new development cycle, which in some cases is unlikely to occur before 2015-2016. Understanding future supply dynamics and their impact on market balance is crucial for occupiers in formulating and implementing their real estate strategies.

As European economies improve, we expect new demand to increase across a number of markets as companies reactivate or reassess their property requirements. In some instances, this may more simply be the result of a concentration of upcoming leases expiries. As the flow of new supply dries up and the choice of new space becomes scarcer, such additional needs however may prove increasingly hard to satisfy, with some markets already reporting a shortage of modern, well-located buildings. This means that occupiers with large or specific requirements would need to assess local supply patterns closely to make sure that they have access to a sufficiently large choice of space when needed. Pre-let is increasingly seen as a solution to this, as illustrated by the pick-up in pre-letting activity noticeable in some cities such as London and Warsaw.

With development finance still restricted, the emerging lack of prime space in some markets is generating growing interest in refurbishment activity. This represents an effective alternative to redevelopment or new construction, which typically tends to be more costly and involve longer administrative procedures.

There is evidence of such a growing interest in a number of cities including Paris, where the volume of renovated space rose by 36% over Q1 2011.

In a context characterised by limited new stock additions, the renovation of existing stock is particularly welcomed by investors as it replenishes the market with exactly the type of products they are particularly keen to invest in, i.e. modern buildings with stronger letting and rental growth prospects.

Generally, with European capital still highly selective and supply of prime stock set to tighten, in some markets there is scope for further yield compression to reflect this mismatch. Although there is limited investor appetite for secondary products, the increasing shortage of prime investment opportunities may lead some buyers to move further along the risk-return spectrum and consider buildings other than prime. So far, however there are only isolated examples of such a shift, as the security of income remains a primary concern to most investors. This also reflects the continuing dominance of institutional investors, traditionally more risk adverse, in the pool of active buyers.

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