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# THE CHANGING EUROPEAN DEVELOPMENT CYCLE

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## OVERVIEW

One of the ways in which the credit crunch and recession have affected the real estate sector has been to cause a sharp reduction in the scale of development activity in most of the main European office markets. Severe restrictions in the availability of development finance, coupled with weak tenant demand and falling values, have resulted in a 4.5% drop since the end of last year in expected office completions over the two years 2009-10. With some development schemes being delayed or deferred, the pattern of completions has also shifted towards the end of this two-year period, such that 2010 now represents the peak year for completions. In terms of the total volume of development activity, this peak is significantly lower than the previous single-year peaks of 2003 and 1991, which demonstrates how sharply development has eased in this cycle. Most markets have seen a reduction in the scale of expected completions over this two-year period, although the distribution of completions within the two years varies significantly: London and Paris in particular will see substantial reductions in 2010. A larger and much more widespread reduction is likely in 2011, with the current lack of new starts producing a possible fall in completions of around 40%, which would take them close to the levels that followed the early 1990s recession.


## INTRODUCTION

A recent report from CB Richard Ellis focusing on the London market* noted that Central London is experiencing high development completion rates but very low levels of new starts, and identified the scope for low levels of future development completions to support medium-term rental recovery. Other European markets are also seeing a contraction in the scale of expected future development and changes in its timing. This also reflects the situation in the USA, where projects which could potentially enter the pipeline are being abandoned or deferred at an increasing rate.

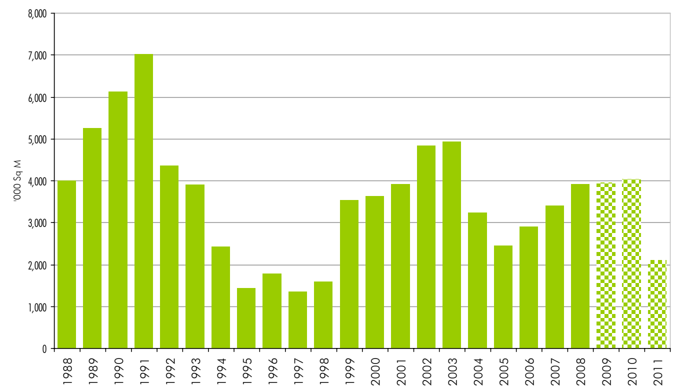
This is therefore a global phenomenon, driven by similar influences in all regions of the world. Across the major Western European markets**, several key changes in the anticipated development pipeline for the two years 2009-10 are notable. Firstly, the overall scale of development expected over this period is 4.5% lower than was expected at the end of 2008.

*The Development Cycle: A Catalyst for Rental Recovery in London (Available at www.cbre.eu)

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

There has also been significant redistribution of activity, with some schemes previously scheduled to complete this year now deferred until 2010. Anticipated 2009 completions are 11% lower than they were at the end of last year, while completions scheduled for 2010 are 4% higher. As a result 2010 now represents the peak year for completions, but the difference in the scale of completions expected in the two individual years is now negligible.

### Office development completions, Western Europe, 1988-2011




Source: CB Richard Ellis

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### A SUBDUED DEVELOPMENT CYCLE

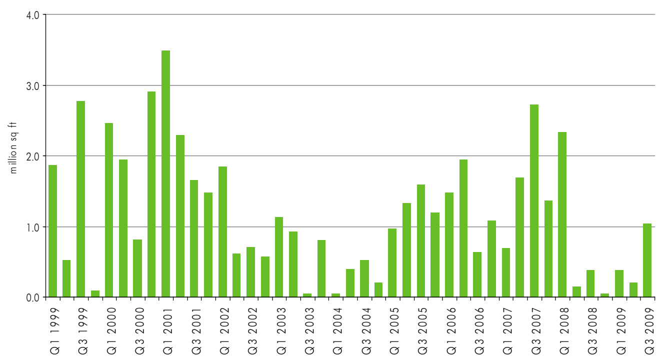
Despite the overall contraction in the size of the pipeline, in the short term completions will accelerate. To date, aggregate completions in the first three quarters of this year have run at levels only slightly higher than those recorded in the second half of 2008, but completions in the final quarter of this year will account for about a third of the full-year total.

Taken together, this would leave office completions in Western Europe over the five years 2006-10 around 12.5% lower than in the previous development boom of 1999-2003, and 30% lower than in the 1988-92 period. The individual peak year for completions (2010) is around 18% lower than the previous peak (2003), and 42% lower than 1991.

While the longer-term pipeline for 2011 is more difficult to measure at this point, there are strong indications that completion levels will drop sharply relative to 2010, possibly by 40% or more. Clearly some schemes not yet under construction could deliver within this timeframe to boost the total, but schemes currently notified indicate a marked reduction in development levels.

In any case the current state of the development finance market suggests that the chances of a near-term revival in new starts are remote. Lenders generally remain more discerning on the standing of the prospective borrower, and more demanding on loan-to-value ratios, lending margins and pre-let requirements. As a result new speculative starts have fallen to such low levels that stock additions will be very constrained once the remaining schemes under construction have completed. For instance, in Central London less than 2.2m sq ft has commenced construction in the past year and a half.

#### Central London construction starts, 1999-2009




Source: CB Richard Ellis

### SIGNIFICANT LOCAL VARIATIONS

At individual market level, downward adjustments in the expected level of completions over the 2009-10 period have been seen in most markets, notably Barcelona, Frankfurt and Hamburg. Of those that have seen an increase, the changes in Berlin and Madrid are relatively modest, while that in Milan is much more pronounced.

#### Expected office development completions ('000 Sq M), 2009-10

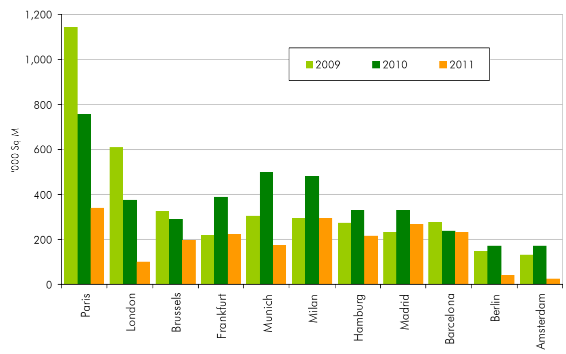
| | As at Dec 2008 | As at Sept 2009 | % Difference |
|---|---|---|---|
| Brussels | 688 | 616 | -10.5% |
| Paris | 1954 | 1905 | -2.5% |
| Berlin | 309 | 320 | 3.7% |
| Frankfurt | 858 | 607 | -29.2% |
| Hamburg | 782 | 604 | -22.8% |
| Munich | 819 | 808 | -1.4% |
| Milan | 367 | 772 | 110.4% |
| Amsterdam | 320 | 303 | -5.3% |
| Barcelona | 754 | 516 | -31.5% |
| Madrid | 520 | 564 | 8.3% |
| London | 996 | 988 | -0.8% |
| Total | 8367 | 8003 | -4.4% |

The distribution of completions across the two years also varies significantly. Among the largest markets, London and Paris (both of which are well advanced in the development cycle) are expected to see much reduced levels of completion in 2010, as are Barcelona and Brussels. Examples exist in several markets of development schemes being reviewed, delayed or scaled down. In Madrid, for instance, Reyal Urbis have announced that work is to stop on a major mixed-use scheme that is in construction on the Castellana. Despite this, Madrid is among the markets expected to see an increase in completions next year – a list that also includes Milan, Amsterdam and Frankfurt. As a result, across the entire group of markets analysed next year's completion levels are expected to be slightly higher than this year's.

The almost complete absence of new speculative starts indicates that a much larger and more general reduction is likely in 2011. In part this is because the initial value stimulus for this development cycle was yields rather than rents, making it slower to gain momentum and easier for developers to defer schemes late in the cycle. Based on current data, overall completions are set to be around 40% lower than the 2010 total, and close to the sorts of levels that followed the early 1990s recession.

At individual city level, some markets are expected to see particularly sharp reductions in the scale of completions, notably Amsterdam, Berlin, London, Munich and Paris.

### Office development completions, 2009-11




Source: CB Richard Ellis

## IMPLICATIONS

The scale and pattern of future office development has significant implications for occupiers and investors alike.

While new requirements remain subdued in many European markets, some cities are seeing the beginnings of a pick-up in activity reflecting a growing view among occupiers that, from their perspective, market conditions are about as favourable as they are likely to get in this cycle. This is most apparent in markets that are furthest advanced in the cycle and where rents, values and, in many cases, tenant incentives have adjusted most. London in particular is at the forefront of this shift.

As European economies recover, we are likely to see growth in the number of large-volume requirements across a broader range of markets. In an environment where new completions will be running at very low levels, occupiers will need to assess individual city pipelines to ensure they have access to a sufficient choice of space on acceptable terms.

Many large organisations have emerged from "survival mode" and are aware that they will need large new buildings in the next few years. Landlords remain focussed on securing income, particularly for large developments that remain unlet. Tenants are therefore taking advantage of current market conditions to secure their long-term needs on attractive terms, as exemplified by Nomura's acquisition of 500,000 sq ft at Watermark Place in the City of London.

With the speed and strength of economic recovery still uncertain, however, a more widespread recovery in tenant demand across different markets and grades of space could be a very gradual process. Some major European economies - including France and Germany - have emerged from recession in a technical sense, but so far without an accompanying resurgence in corporate investment or property demand. Selecting investments on the basis of demand prospects alone is therefore problematic.

However, the reduction in development activity will act as a general cushion against the worst effects of subdued demand. Over the past ten years, average annual take-up for the group of markets analysed has run at around 7.2m sq m per year, which is more than three times the expected level of completions in 2011. With tenant demand increasingly focussed on higher quality space, there is clear potential for shortages of prime space to emerge, particularly in markets with strong recovery prospects. In a still uncertain economic environment, understanding future supply patterns may provide investors with a clearer basis for investment selection. This is particularly the case while landlords remain at least as concerned with protecting against downsides as with identifying growth prospects.

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