Theme 2) Will office vacancy rates recover in 2022?

The World Health Organisation's stark reminder that Europe is "once again at the epicentre of the pandemic" is likely to have a more modest impact on occupier demand than during 2020/21, as occupiers have already had their first taste of work-life post pandemic and begin to plan longer term. The recent re-introduction of curfews and work from home advice across several countries following the outbreak of the Omicron variant will continue to cloud the outlook for European office occupier demand in 2022.

Historical data shows a strong relationship between GDP growth and demand for office space as companies hire employees at a faster rate during recovery periods. Malaga, Toulouse, Bratislava, Seville and Valencia are expected to observe the strongest office based employment growth over the next five years according to Oxford Economics. We may begin to see some companies seek to expand across secondary cities where talent availability remains strong and cost of living is lower, and city-based employment growth will continue to outstrip national averages.

Workers have shown encouraging signs of returning to the workplace and occupiers are now removing some of their previously marketed "grey space" from the market. In Prague, for example, space available for sublease fell by 25% to 48,700 sq m during Q3 2021 which will feed into vacancy rates levelling out in 2022.

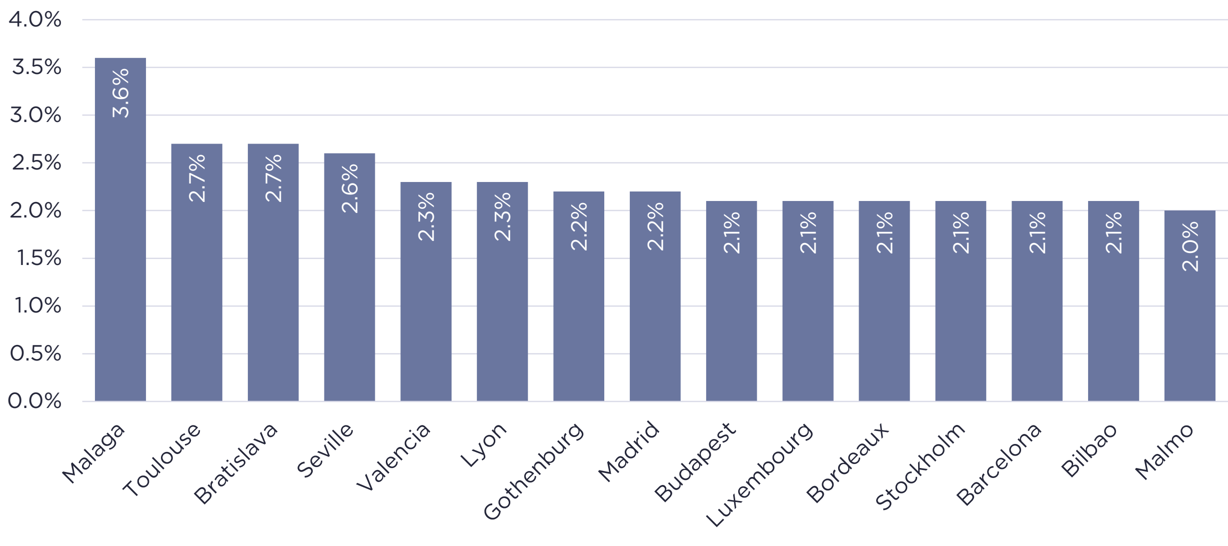
Countries may also begin to introduce new laws to attract talent intending to work remotely. New Portuguese work from home laws have banned employers from contacting staff outside working hours and the legislation is also aimed at attracting inflows of skilled 'digital nomads' to Portugal. We anticipate this will boost occupier demand in these locations on the basis that office-based workers expect a return of 2/3 days per week as employers factor remote working into their operations.

Offices in prime locations with good transport links and strong EPC ratings will be essential to attract and retain workers, where we will see the strongest occupier demand. Although some tenants may look to downsize their footprint, demand for high quality space will remain strong and we may begin to see office densities reduce as employers increase their focus on the social aspect of the workplace, which will keep prime vacancy rates low. For older office buildings in fringe locations, we expect landlords to spend more on refurbishments to avoid obsolescence, although an increase in secondary vacancy rates is to be expected in 2022 as prime/secondary rents will begin to diverge.

Flexibility will become more essential for occupiers' return to work strategies, centred around collaboration, creativity, and engagement. Many companies will remain unable to plan for longer lease periods and we expect more larger corporates to be increasing their exposure to the flex office market. Flex accounted for a record 9% of Europe's office demand in 2019, falling to 2-3% during 20/21 and we anticipate a recovery towards the pre-pandemic level in 2022.

A shortage of new supply will help to stabilise vacancy rates and rents. Germany's development pipeline appears majority pre-let in 2022, whilst only 260,000 sq m of new space is expected to be delivered in Madrid in 2022, of which 33% is committed. Indexation and rising construction costs will maintain modest rental growth across the core markets in 2022, although we expect incentives to remain generous, at least during the first half of the year. Developers have absorbed much of the increase in construction costs thus far, which we anticipate may begin to be reversed once occupier markets stabilise.

Chart 4: European office based employment growth forecasts (five year, % pa, top 15)



Source: Oxford Economics