European offices - Future Rental Growth Hotspots

2018
Identifying rental growth hotspots

Against a background of record pricing, identifying income driven returns and rental growth has become paramount. With a modest development cycle across many European office markets, office supply levels are playing an important role in current rental growth. We can see this demonstrated in markets such as Dublin, Stockholm, Berlin and Amsterdam where a sudden pinch in availability has triggered exceptional rental growth in recent years.

Supply - or lack of it - is therefore likely to play an increasingly important role in driving rental growth over the next 2-3 years. To help investors factor this in, JLL has developed a Supply Sensitivity Index that explores the relationship between vacancy rates and net effective rents to help provide new insights into market performance. This is a forward-looking indicator, complementing traditional forecasts to help investors identify possible office (supply-led) hotspots of the future - cities where we see potential rental growth upside in the next couple of years.

This report showcases some of the insights resulting from the development of our Supply Sensitivity Index. Please contact us for further information or to request a presentation by our team of the full Rental Growth Hotspots results and what they might mean for your future investment strategies.

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2018 Growth Hotspots
Identifying supply-led growth

New development expected to remain cautious
2017 marked the start of a new development cycle and at 5 million sq m, 2018 will see the highest office completions since 2010. However, more than 60% of this is already pre-let and most of the cities that have had, or will see, a rise in development, are currently severely supply squeezed and will therefore often not be able to accommodate all future demand.

The current view of the development pipeline for 2019-20 looks stronger but not exceptional. In the past two years, development estimates have tended to the upside as forecasts have included not yet commenced plans, which means in reality completions could well be lower than anticipated. Historic patterns suggest that actual completions may even remain below 6 - 7 million sq m per annum. Compared with previous development cycles (1999-2003 and 2007-2010) most cities are currently showing much lower development levels than in the past, highlighting the relatively modest supply reaction this time around.

Limited late cycle development exuberance
Shortages in Grade A space are even more acute. At this point in the cycle, when Grade A vacancy rates have reached record lows, a pinch in availability often strongly influences rental growth across Europe. Stockholm is a prime example of where a significant and sudden supply-demand imbalance significantly pushed up rents (+17% in 2017), comfortably outperforming the European average and the city’s historic performance (as we predicted in JLL’s 2017 Rental Growth Hotspots report).

Grade A space shortage continues
"Paris CBD, Paris LDF & Luxembourg based on New Stock
**Stockholm & Madrid – Estimated from the Grade A vacant stock %"
Supply-led growth

Intuitively, the lower the supply or vacancy rate, the more rents will tend to rise as occupiers are increasingly willing to pay extra for scarce space. In thinking about how supply may affect rents in the future, we analysed the available data for 35 European cities, calculating an average vacancy rate below which we have seen rents begin to rise in each city.

This stable rate varies widely across markets. Office vacancy in Dublin, for instance, has historically been relatively high and volatile. On the other side of the spectrum, London West End records one of the lowest and most stable rates over a period of many years.

Note: Please contact us for the percentages data for each city
Source: JLL
Supply Sensitivity Index

On its own, the stable rate offers limited predictive value. Our Supply Sensitivity Index however, provides a broader measure to explore the relationship between supply and net effective rental growth. It offers a complement to our traditional macro-econometric forecasts that can add valuable insight to the decision making process. Linked to net effective rents rather than headline rents, it offers a broader perspective on market performance, pinpointing potential hotspots for availability-driven growth across Europe.

From its stable rate, the index looks at future movements and assesses what this means for rental prospects in key European markets.

The Index is based on a 20-year time series across data from 35 European cities - where available - and incorporates seven metrics ranging from current and future supply, to sensitivity of rents and supply absorption. The final Sensitivity Supply Index provides a combined score which indicates the potential for supply driven rental growth for each city.

In this report, we offer a top line look at three of our seven metrics, ranking the top 10 cities for each, as well as providing a summary of our overall final ranking. For a deeper look at the results and to get the fuller picture by city, please contact the team for a presentation.

### 1. Future supply
Where will vacancy be in 5 years?

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<tr>
<td>Amsterdam</td>
<td>Munich</td>
<td>Dublin</td>
<td>Bucharest</td>
<td>Utrecht</td>
<td>Stuttgart</td>
<td>Stockholm</td>
<td>Manchester</td>
<td>Dusseldorf</td>
<td>Hamburg</td>
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**Top 10 cities 2021 vacancy v stable rate**

Looking ahead, limited development and strong absorption will push vacancy across Europe below previous lows. In many cities, this implies supply is well below the stable rate.

In Amsterdam, this effect is most severe. Historically defined by high rates (double digits rates since 2002), vacancy is forecast to move 1100bp below the stable rate. Germany is also well represented with five of the big seven markets expected to see vacancy rates well below the stable rate by 2021.

Frankfurt doesn’t quite make the top 10 but also stands out. The development pipeline has picked up significantly in the last 18 months. Nevertheless, vacancy is predicted to remain around 250 – 300bp below the market stable rate.
2. **Rental sensitivity**

How sensitive are office rents to vacancy changes?

1. Leeds
2. Budapest
3. Prague
4. Stockholm
5. Stuttgart
6. Moscow
7. Warsaw
8. Berlin
9. The Hague
10. Dublin

**Top 10 cities - Rental response to vacancy changes**

As each market is balanced differently, rents will react in a different way to changes in vacancy. The rental sensitivity to vacancy changes is therefore important when highlighting potential hotspots.

Budapest for instance has historically recorded substantial rental changes on the back of relatively modest vacancy rate fluctuations. Prime rents jumped by 10% when vacancy dropped 230 bp to 11.3% between Q3 2016 to Q1 2017.

In Warsaw, high levels of supply in recent years (2013-2016) have muted rental growth. However, supply constraints in 2006-2008 and again in 2012 were followed by a sudden and significant rental surge.

3. **Sense check**

Are we missing any other major barriers for rental growth?

1. Madrid
2. Barcelona
3. Utrecht
4. Amsterdam
5. Lyon
6. Moscow
7. Stuttgart
8. Edinburgh
9. Birmingham
10. Manchester

**Top 10 cities - 2018-2021 Annual rental growth forecast**

Overlaying the supply side analysis with the traditional macro-econometric forecasts provides a sense check. It also highlights if there are any significant barriers for rental growth that the supply analysis does not account for.

Unsurprisingly, the majority of markets that we expect to provide supply driven rental growth upside are also listed high up the macro-economic forecast. These are accompanied by markets still in recovery mode, where rents are expected to move up from their cyclical low (e.g. Madrid, Barcelona and Moscow).

Three regional UK cities are listed in the top-10 European rental growth stories, with Glasgow just outside at number 11. These are underwritten by strong demand for high quality space despite the potential geo-political headwinds.
Amsterdam, Stuttgart and Stockholm look to outperform

Amsterdam, Stuttgart and Stockholm are the clear top 3 in our overall ranking, with limited supply in these cities likely to play an important role in driving further growth.

Amsterdam leads the ranking. While headline rents have seen little movement in the last 20 years, net effective rents show a different story as incentives play a significant role in lease negotiations. Net effective rents have historically stabilised at a relatively high vacancy rate of around 15%. While rental sensitivity to vacancy changes falls in the mid-range, supply is forecast to drop dramatically (more than 1000bp below the stable rate) to 4.7% by 2021 as development has all but dried up. Prime space will become increasingly valuable across Amsterdam.

In Germany, Stuttgart’s relatively small market (comparable to the London West End submarket), also offers upside rental growth potential. Riding on the coat-tails of strong growth in the manufacturing sector, availability has dropped to a record low. A strong sensitivity to availability and a vacancy rate which is likely to drop to around 1.5% should provide plenty of opportunity in different submarkets across Stuttgart.

Following a 17% per annum prime net effective rental growth in 2015-17, Stockholm still offers opportunity for further rental growth. Stockholm prime rents record one of the strongest reactions in Europe to decreases in vacancy. Although vacancy is not expected to decrease much further by 2021, a vacancy rate of around 7.5% - 8% should continue to push up net effective rents.

Munich and Prague round out the top 5, with tight supply in these markets expected to drive strong rental growth. In Munich, vacancy is below 4% and is forecast to tighten further beyond the stable rate (-750bp). In Prague, vacancy declined by 320 bps in 2017 alone and is now at its lowest level since 2008 (-400 bps below the stable rate).

Beyond the Top 5

There are a number of other cities outside the top five that offer significant supply driven rental upside. These include markets such as Warsaw. Only recently bottoming out after a prolonged period of oversupply, Warsaw represents one of the strongest leasing markets in Europe. While supply is significant, large pre-lettings quickly absorb the remaining quality space on offer. Vacancy is likely to fall sharply in the short term and rental growth should accelerate on the back of this.

Against the backdrop of tight supply and low speculative development, UK regional office markets also offer substantial potential for further supply-led rental growth. Edinburgh, Manchester, Leeds and Birmingham are all ranked in the top 15 of our final growth potential ranking.

Across the Big 6 markets, high-quality space is in increasingly short supply, with total Grade A vacancy at just 1.7%. The pressure is most pronounced in Bristol (0.5%) and Edinburgh (1.4%), which last year saw annual rental growth of 14% and 3.2% respectively. Despite potential geo-political headwinds, the outlook remains positive for the UK regions, with tight supply, modest development and active pre-letting expected to drive rental growth in cities such as Bristol, Edinburgh and Manchester.
Submarket outperformance to continue

The Supply Sensitivity Index highlights the potential upside net effective rental growth in some of Europe’s prime office districts. This does not mean rental growth is constrained to just the prime office districts. Indeed, the lack of modern, efficient, office supply in traditional CBD will drive occupiers to second-best submarkets offering high quality space. In some markets this supply-constrained environment is creating ‘a tide that raises all boats’. It will be crucial to clearly identify which markets will be a short-lived bounce and which are supported by structural improvements, differentiators, solid property fundamentals, and strong occupier demand.

Below we look at the top 5 markets from the Sensitivity Index which benefit from these drivers of growth and where investors can expect above average rental growth in 2018-2019.

Amsterdam
Netherlands
South East and Sloterdijk/Teleport

Extremely low vacancy in the Zuidas (3.5%) and City Centre (2.0%), as well as a modest pipeline, will push demand into more peripheral areas, with occupiers increasingly targeting South East and Sloterdijk/Teleport. These submarkets offer large floorplates at a discount to prime locations, plus good transport connections to Schiphol Airport and other cities across the Randstad (i.e. Utrecht, Rotterdam & The Hague). These factors, plus ongoing retail/residential development in these areas, combine to attract a diverse occupier base, ranging from tech and media companies to more established tenants in the financial services sector (e.g. ABN Amro and Deutsche Bank). As the supply-demand imbalance intensifies, rental growth is expected to accelerate in South-East and Sloterdijk/Teleport in 2018.

<table>
<thead>
<tr>
<th></th>
<th>Annual Rental Growth 2017</th>
<th>2017 Take-Up (000 sq m)</th>
<th>Vacancy Rate Q4 2017 (%)</th>
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<tbody>
<tr>
<td></td>
<td>2017 v 5Y Avg</td>
<td>2017 v 5Y Avg</td>
<td>2017 v 5Y Avg</td>
</tr>
<tr>
<td>Amsterdam</td>
<td>8.1% +6.1pp</td>
<td>389 +42%</td>
<td>7.1% -640 bp</td>
</tr>
<tr>
<td>Zuidas</td>
<td>8.1% +6.1pp</td>
<td>97 +128%</td>
<td>3.5% -400 bp</td>
</tr>
<tr>
<td>South-East</td>
<td>0.0% +0.0pp</td>
<td>81 +52%</td>
<td>5.5% -1380 bp</td>
</tr>
<tr>
<td>Sloterdijk/Teleport</td>
<td>2.8% +1.6pp</td>
<td>56 +11.2%</td>
<td>11.2% -870 bp</td>
</tr>
</tbody>
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Key reasons for rental growth
- Demand spillover from core submarkets
- Large, cost-effective floorplates
- Good transport connections
Robust demand and modest development has pushed vacancy down to long-term lows in the City Centre (1.8%) and Vaihingen-Möhringen (2.5%) submarkets. This intense supply shortage is unlikely to be addressed in the near term as development remains muted. In the City Centre, floorplates greater than 1,000 sq m remain scarce and will continue to demand a premium. This will force occupiers to more peripheral locations such as Vaihingen-Möhringen. Here, Daimler AG is building a 90,000 sq m office campus, which has in turn attracted a cluster of other tech-related businesses. Already, a local developer is achieving rents well-above the current prime rent. This submarket’s accessibility via the S-Bahn and proximity to Stuttgart Airport will also support rental growth.

### Stuttgart

**Germany**

City Centre & Vaihingen-Möhringen

**Key reasons for rental growth**

- Vacancy amongst lowest in Europe
- Subdued development pipeline
- Demand from diverse occupier base

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<th>Vacancy Rate Q4 2017 (%)</th>
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<tr>
<td>Stuttgart</td>
<td>4.7%</td>
<td>+1.0pp</td>
<td>255</td>
</tr>
<tr>
<td>City Centre</td>
<td>4.7%</td>
<td>+1.0pp</td>
<td>61</td>
</tr>
<tr>
<td>Vaihingen-Möhringen</td>
<td>7.1%</td>
<td>+5.6pp</td>
<td>53</td>
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Over a 1-2 year horizon, the Solna/Sundbyberg submarket is expected to outperform in terms of rental growth. This submarket is popular due to its relative affordability and the lack of available space in the Stockholm CBD. A number of schemes have also recently been completed in Solna/Sundbyberg, boosting the submarket’s offering of modern space across large, efficient floorplates. The area’s ongoing transformation, with new infrastructure improvements (e.g. subway extension) and mixed-use schemes (e.g. Mall of Scandinavia) will also play an increasingly important role in boosting the area’s attractiveness, particularly around Arenastaden. Elsewhere, the Kista submarket is more opportunistic and a longer-term play. While currently oversupplied with older stock, conversions/refurbs and the expansion of the tech cluster centred around Microsoft, Lenovo and other firms, could provide some longer-term upside.

### Stockholm

**Sweden**

Solna/Sundbyberg (Arenastaden)

**Key reasons for rental growth**

- Relative affordability vs CBD
- Infrastructure improvements
- Tech cluster in Kista

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<th>Vacancy Rate Q4 2017 (%)</th>
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<tbody>
<tr>
<td>Stockholm</td>
<td>12.9%</td>
<td>+4.5pp</td>
<td>355</td>
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<tr>
<td>CBD</td>
<td>12.9%</td>
<td>+4.5pp</td>
<td>41</td>
</tr>
<tr>
<td>Solna/Sundbyberg</td>
<td>14.3%</td>
<td>+6.3pp</td>
<td>81</td>
</tr>
<tr>
<td>Kista</td>
<td>0.0%</td>
<td>-1.9pp</td>
<td>20</td>
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**Munich**

**Germany**
East (Wierksviertel)

Key reasons for rental growth
- Strong demand for Werksviertel area
- Affordability - 43% discount to CBD
- Vibrant mixed-use precinct

The Munich East submarket continues to see high levels of development (refurbs and new builds) on the back of ongoing urban renewal. Despite this, vacancy remains well below the long-term trend (-430 bps). Werksviertel, adjacent to the München Ost train station, has benefitted from a tight CBD (1.1%) and become particularly popular with occupiers. Indeed, 7 of the top 10 largest deals recorded in the East submarket in 2017 were in this microlocation. While rents in East have increased by circa 40% over the last 5 years, affordability remains a key driver of demand, with prime space currently transacting at a 43% discount to the CBD. 2017 annual rental growth in East outperformed the 5-year average by 9.1% and we expect this trend to continue over the next 12 months.

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<tr>
<td>City Centre</td>
<td>4.2%</td>
<td>+0.8pp</td>
<td>177</td>
<td>+13%</td>
<td>8.0%</td>
<td>-150 bp</td>
</tr>
<tr>
<td>East</td>
<td>13.5%</td>
<td>+9.1pp</td>
<td>64</td>
<td>+10%</td>
<td>5.1%</td>
<td>-430 bp</td>
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**Prague**

**Czech Republic**
Prague 1

Key reasons for rental growth
- Vacancy below 5Y avg (-700 bp)
- Lack of sites restricting development
- Strongest demand on record in 2017

2017 was an exceptional year for the Prague office market, with vacancy falling to its lowest level since 2008 and annual take-up the strongest on record. In the Prague 1 submarket, completions were relatively modest last year, with only two buildings delivered totalling circa 14,300 sq m. This subdued supply response is in part due to a lack of sites, and is expected to persist over the next year. As a result of the limited available prime office product in the city centre, robust demand and strong economic growth, we expect prime rents to continue to increase in Prague 1 over the next 12 months.

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<tbody>
<tr>
<td>Prague 1 (CBD)</td>
<td>5.0%</td>
<td>+5.0pp</td>
<td>44</td>
<td>+19%</td>
<td>8.0%</td>
<td>-700 bp</td>
</tr>
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Want to know more?

Our research clearly underlines the increasing importance of office space availability in driving future rental growth in the next three to four years. Understanding the relationship between vacancy rates and net effective rents therefore provides a valuable tool in the armoury of investors looking to identify rental growth prospects.

For more information or to request a presentation of our full ranking and analysis please contact one of the team.

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