MARKET PULSE

EDITION N°2, JANUARY 2025

SIOR | EUROPEAN REGIONAL CHAPTER

SIOR EUROPEAN ROUNDTABLE ON THE FUTURE REAL ESTATE TRENDS

As part of our interest to exploring the future of the European Commercial Real Estate, the SIOR European Chapter hosted a virtual roundtable discussion bringing together insights from a select group of SIOR members, representing diverse markets across Europe.

The discussion focused on key trends shaping the industry, opportunities and challenges ahead, and how the real estate landscape may evolve over the next decade. By gathering expert perspectives, we aimed to provide valuable insights into the future of European real estate, career opportunities in the industry, and the sector's long-term outlook.

Below, we present the key takeaways from this engaging and forward-thinking conversation.

INTRODUCTION

It's easy to write off the office sector. The risk of economic obsolescence has increased due to the remote working revolution, with the potential impact of artificial intelligence adding further to the uncertainty over future demand levels.

On top of this, an ever-increasing focus by occupiers on high quality, energy-efficient space, as well as higher regulatory requirements for sustainability, have heightened the risk around the functional obsolescence of office buildings.

Given lower overall occupier demand post pandemic, a steady stream of office assets across Europe are effectively becoming obsolete as they do not meet today's occupier requirements or regulatory standards.

Against this backdrop, a round table of senior SIOR property practitioners from across Europe discussed the opportunities and risks in the office sector, as it transitions to a smaller, higher quality market.

THE FOCUS ON PRIME

Corporate occupiers are increasingly using high quality, sustainable buildings to assist their recruitment, retention and productivity strategies, as well as provide broader employee wellness benefits. In addition, occupying highly sustainable buildings helps them to meet sustainability targets and is increasingly used to create a positive corporate image.

However, many key markets across Europe have a lack of high-quality supply, as relatively little development has come through in recent years. The Vienna office market provides a good example, as Frank Bruen SIOR, FRICS points out:

"In Vienna there is a significant undersupply of office space, with a vacancy rate of only 3.3%, and almost no supply of larger units. If firms want to occupy more than about 3-4,000 square meters, there is simply no supply at all."

For large corporate occupiers, it's all about quality not quantity, and most will only consider best-in-class buildings.
Tobias Schultheiss SIOR, FRICS sums, it up

"Obsolete means you can no longer rent the building because a tenant won't look at it, even if you offered it for one euro."

As a result, the rental gap is widening between best-in-class buildings and secondary assets, and also between prime and secondary locations - a good example being central Paris rents compared with those in La Défense.

The evolving nature of office use will only serve to increase the importance of sustainability and broader quality factors. For example, the rise of AI-related jobs will mean higher quality, higher paid functions will be undertaken in offices, and occupiers are therefore likely to invest more in them.

HIGH QUALITY SECONDARY

With corporate demand focussed ever more towards best-in-class offices, fears over owning 'stranded assets' have understandably come to the fore. However, all is not lost for landlords of secondary office property.

It is important to remember that there is still demand secondary buildings from smaller, local occupiers. Indeed, the 'Grade B+' market still has a very important role to play outside of core office locations.
As James P. Mulhall SIOR, MSCSI, MRICS explains

"In Dublin, it tends to be a local market, which is reasonably substantial. So, I wouldn't be too critical of the Grade B plus market."

Indeed, this is a vital part of the market, as economic growth is highly dependent on small and medium-sized businesses being able to grow whilst keeping their cost base under control. The main proviso is that buildings must adhere to minimum regulatory standards (or be upgradable to meet them in a cost-effective way).

ENHANCING THE SPACE - REFURBISHMENT VERSUS NEW BUILD

Despite ongoing demand for good quality secondary space, many buildings are unlikely to find an occupier. Here, the first obvious option is to refurbish the building to a best-in-class specification, particularly if it sits in a prime location. It must be remembered that refurbishments are not always cheaper than new builds, depending on the specific challenges associated with the work. Indeed, in some cases it may simply not be possible to refurbish an older building to the quality or specification required.

There are many potential advantages to undertaking a refurbishment. For example, the timescale is likely to be quicker, and the environmental impact / carbon footprint is likely to be lower.

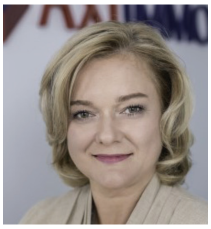
In some cases, it may also be easier to obtain planning consent for a refurbishment. Indeed, there have been instances across Europe where local authorities have refused consent for demolition in favour of retaining and refurbishing the existing structure to reduce carbon emissions from the development process.

On the other hand, new builds have the advantage of 'starting with a blank sheet of paper', and may be more compliant with current building regulations. For some buildings, refurbishment may be the preferred option for the developer anyway, but for others, there may be an unarguable case for demolition.

To some extent, planning policy is now pulling in two different directions - demanding more energy-efficient office space but constraining the ability of developers to provide this by requiring the retention of outdated core infrastructure from the 1960s and 1970s. In addition, sustainability measures have added considerably to the costs of refurbishment.
In Charles Tatham's SIOR view

"governments really need to resolve this by considering which regulations can be removed or watered down, without throwing the baby out with the bathwater".

There is a clear conflict between the regulation promoting sustainability and governments' desire to stimulate economic growth and development. This also has implications for Europe's global competitiveness. The US, for example, already has less regulation, and with the new administration in now in place, it is fair to assume that the gap between the US and Europe will widen further.
Renata Osiecka SIOR, MRICS believes that



"with the Trump presidency, Europe could be forced to create more competitiveness. So investing in real estate sustainability may slow in favour of investing in innovation".

There are other regulatory implications, as Michael Pain MRICS SIOR points out - "The EU's Corporate Sustainability Reporting Directive is likely to have an impact on those countries like the UK that are not a part of the EU, because companies within the EU will have to report who they're trading with and whether their trading partners meet the European directive."

There is bound to be an impact on values.
Iain C.M. Finnegan SIOR, FSCSI, FRICS sums up the problem –

"You have to get the base cost down so far before you can actually make the figures stack up. The fact that we won't be able to demolish buildings because of embedded carbon is a definite problem and repurposing is a good thing, but we will need to readjust the base value values to a new starting point."

Solly GUBBAY SIOR, MRICS agrees -

"it is first and foremost a valuation problem, which is going to knock billions of portfolios if those assets cannot be repurposed and you're basically looking at a new build."

In some cases, specific funding may also be available. For example, the Bank of Ireland has introduced Green Business Loans that can provide discounted finance for implementing sustainability initiatives.

THE REPURPOSING OPPORTUNITY

The phrase 'stranded asset' is increasingly being used to describe buildings that no longer meet today's requirements and are not easily upgradable. Whilst a building might be stranded as an office asset, the repositioning of office buildings is becoming commonplace, particularly conversions to residential, BTR or hotels.
As James Mulhall put it -

"I think we need to be careful about catastrophising the phrase 'stranded assets'".

Indeed, demand for a wide range of property types including residential, student accommodation and hotels is being accelerated by demographic, social, and technological change.

Of course, repurposing presents a variety of challenges, the most obvious of which is the viability of converting an office to a new use, particularly given the high level of building cost inflation in recent years. Viability is highly dependent on local supply and demand conditions, and the prevailing level of rents and capital values. However, there is perhaps a more fundamental reason why the numbers don't add up. In many cases, the core base cost of repurposing is too high simply because the original owner of the asset (and their lender) may not be prepared to accept a lower, more realistic valuation.

Iain Finnegan explains

"We've all seen over the years that it's not the first guy who makes money, it's not the second guy who makes the money, it's usually the third guy because he buys it cheap enough and he can make it work."

Obtaining planning consent for a change of use is also becoming an increasing challenge, and appears to be becoming less predictable, even countries such as France which have a clear zoning system.

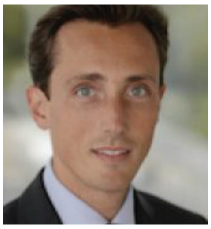
There are good reasons why planners are concerned over change of use. An unintended consequence of the reduction in office occupancy is the impact on the vibrancy of city centres, as lower footfall means fewer retail and food & beverage. The good news is that the design of office buildings does naturally lean towards uses such as education, student accommodation, primary health car, hotels and hospitality – uses that encourage people to come into the city centre.

IMPLICATIONS FOR THE INVESTMENT MARKET

Futureproofing will become increasingly important as investors will look at what alternatives uses could suit the asset in five or ten years' time.

With higher vacancy rates and obsolescence, together with - shrinking stock as outdated offices are converted to other uses, the investable office investment market is declining. This clearly has implications for the large funds, which are increasingly turning to a wide variety of other asset types.

Guillaume Turcas FRICS observes that



"Back in the day, you just had to throw 65% of your money at offices - one single asset with one tenant worth €500 million – easy! Now you have to deal with local operators across hotels, logistics, last mile, beds, and so on. So I think the way most of the funds are looking at the investment market now is totally different."

An additional issue is that a significant amount of refinancing will need to take place this year and next for loans taken out in 2018/2019. This could prove problematic for vacant assets, or those likely to become vacant with little prospect of being relet. This is only likely to accelerate the trend towards repurposing.

WHO WE ARE

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The SIOR European Chapter extends its deep appreciation to Andrew Smith FRICS SIOR, Partner and Dan Francis, Head of Research at Carter Jonas, who led this report.

We are also grateful to all the members across Europe who contributed their valuable time and insights. A special thanks to Frank Bruen SIOR FRICS, Daniel Cautis SIOR, Eiliv Christensen SIOR, Paul Danks SIOR FRICS, Iain Finnegan SIOR FSCSI FRICS, Solly Gubbay SIOR MRICS, James Mulhall SIOR MSCSI MRICS, Renata Osiecka SIOR MRICS, Tobias Schultheiss SIOR FRICS, Charles Tatham SIOR, Guillaume Turcas FRICS, Christophe Wuyts SIOR MRICS and Piotr Sutkowski.

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This report was sponsored by Carter Jonas,
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