HAS THE OFFICE MARKET PEAKED?

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Office letting activity and demand is stronger than ever in Copenhagen. The market seems insatiable, with rents now exceeding pre-crisis levels. There are no indications that the market is heading for a major correction if (when) the market turns. In the short term, we even see a potential for further rent increases. Nevertheless, investors have started to fear that the office market has peaked, lacking the depth required to retain momentum.

Full steam ahead in the office market

The fact that the current Copenhagen office letting market is riding on a high the scale of which has not been seen since before the financial crisis is clearly reflected in key market indicators: Rent levels are record-high, vacancy rates are downtrending and the number of speculative office developments is growing.

All in all, this paints a picture of a market going full steam ahead. The strong market momentum is driven mainly by the economic upturn and the resulting favourable effect on employment levels, which have seen a steady increase since the crisis in the late 2000s.

However, the exceptional momentum has made some investors doubt the sustainability of the favourable developments. As such, it is only natural that a market upturn should raise the awareness of underlying market structures and how changes in fundamentals have contributed to the developments.

For instance, several fairly central Copenhagen districts have seen prime office market rent hikes in the 10-15% range since 2015, relative to 4.0%[1] overall price growth in the same period.

Surging demand driving up rental prices

Rent level increases have been driven mainly by a surge in the demand for office premises in combination with an only moderate increase in the supply of such premises. If applying the increase in the number of full-time equivalent employees as an approximation of demand in the occupational market, demand has increased by approx 8.4% since end-2014[2]. In the same period, aggregate office supply has increased by only approx 1.0%[3].

Although office vacancy rates have been downtrending in the period, the decline has far from matched the increase in demand. This indicates that several current office vacancies are not even taken into consideration by the businesses looking for premises.

FIGURE 2:

SHARP INCREASE IN OFFICE MARKET RENTS SINCE 2015

Increase in prime and secondary office market rents in selected Copenhagen districts

Source: Colliers International

Notes: [1]Net price index (NPI), key figures (index 100 = 2015): 2015M1 = 98.7 and 2019M1 = 102.6.
[2]Movements between Q3 2014 and Q3 2018. [3]Ejendomstorvet.dk

In the short term, this kind of scenario will therefore put rent levels under pressure as supply is slow to adjust. At the same time, the demand for office space will grow in the business community, unless businesses are prepared to reduce office area requirements per employee.

Although certain surveys suggest that an increasing number of businesses have in fact become better at space utilisation, the businesses carrying out space-per-employee reductions are mainly businesses that have taken a lease in new, flexible and up-to-date office premises.

Prospects of short-term rent increases

Seen in isolation, this could lead to the misconception that rent increases in Copenhagen have been driven by a supply and demand imbalance, and that a demand shock (say, an economic downturn) may trigger a correction to market rent level. However, an in-depth analysis of e.g. vacancies and the current pipeline of new office premises shows that the market is deeper than apparently indicated. Current rent levels are therefore relatively robust even in the event of a major demand shock.

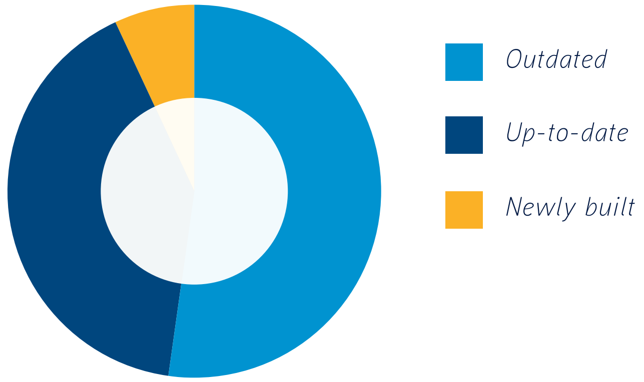
In fact, the present market structure supports the possibility of short-term rent increases.

Since 2010, Copenhagen office vacancies have come down from a level above the 10% mark to approx 6% today. Although the current vacancy rate marks a 10-year low, it still greatly exceeds the pre-crisis level. For instance, the office vacancy rate was 3.1% at the beginning of Q4 2007, in some areas driving up rents by 30-35% from start-2005 to start-2009. In subsequent years, ending in 2013, market rent levels dropped due to the crisis – in some areas by as much as 15%. Precisely the fear that market

FIGURE 3:

ACTUAL OFFICE VACANCY RATES LOWER THAN FIRST ASSUMED

Vacancy, office, Copenhagen CBD

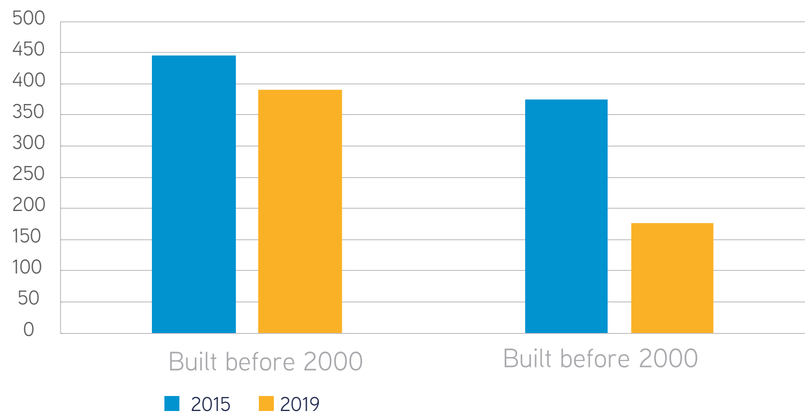


Sources: Ejendomstorvet.dk and Colliers International
Note: Based on analysis of sample units offered in the market.

FIGURE 4:

LETTABILITY OF OLD-STOCK OFFICE PREMISES CONTINUES TO BE POOR

Days on market for analysed sample units as at 28 February in 2015 and 2019, respectively, according to construction year



Sources: Ejendomstorvet.dk and Colliers International

> ***In fact, the present market structure supports the possibility of short-term rent increases.***

rent levels may have peaked is now making several investors increasingly attentive to the pricing of risk associated with a possible downtrend in rent levels.

Actual office supply may be lower than indicated

A closer look at the composition of current office vacancies[4], however, paints a different and more nuanced picture of the underlying risk. About 50% of existing office vacancies are in old, often functionally obsolete buildings constructed before the millennium. The remaining vacancies are found in new or relatively new buildings[5], which are better equipped to meet today's tenant demands.

This situation is confirmed by the average number of laydays registered for office units currently offered to let. Available office units in newer buildings have been on the market approx 175 days on average, whereas units in older buildings have been on the market for approx 390 days. The actual supply may therefore be considered lower than the overall volume of vacancies.

Does the market have an A-team and a B-team?

Basically, vacancy rates and the underlying supply of lease units represent two independent markets: A market for newly constructed and up-to-date properties that have seen mounting demand in recent years, and a market for older and outdated properties that have not reaped the same benefits from the economic upturn.

In addition, an only slight decline in re-letting periods in the old building stock since 2015 indicates a market increasingly failing to meet tenant requirements.

This tallies with the indications that we see and hear in today's market.

An increasing number of businesses find it difficult to find premises that match their requirements in terms of unit size, location and flexibility. Requirements of installations, including in particular air conditioning and ventilation systems, have become weighty parameters for choice of office premises – typically installations which are offered in newer and up-to-date buildings.

Office pipeline

Although a substantial pipeline of new offices is available to meet the strong demand, most of these offices will be completed two or three years from today, and a large proportion will already be pre-let. At the same time, an increasing volume of vacated space is converted for other uses[6].

Market depth is therefore greater than you might be led to believe from looking solely at vacancy rates. In fact, it turns out that not only is the current market rent level relatively robust, the composition of the existing supply and the mounting demand even provides a basis for potential short-term rent increases.

This notion is supported by one of our previous analyses[7], describing how recent years' decline in vacancies has failed to match the surge in employment levels. Accordingly, a certain demand has yet to register in vacancy statistics, mainly because of a shortage of up-to-date premises.

It is difficult to assess how big a demand shock it will take to trigger a renewed downtrend in Copenhagen rent levels. We believe that today's market is sufficiently robust to weather a downturn without any significant decline in rent levels.

However, when evaluating investment or development opportunities, investors are advised to focus increasingly on picking the right product, given the ever-widening range of localisation criteria on which businesses and industries base their choice of premises.

If you fail to realise the importance of choosing the right concept, you may well end up facing a dramatically higher risk of vacancy and lower achievable rental income.

Notes: [4]The composition has been approximated by means of an analysis of office units of 1,000+ sqm currently offered to let. This method is therefore associated with a certain element of uncertainty as not all office vacancies are included. Office developments are not taken into account. [5]Constructed post-2000. [6]For instance, Nordea's former Copenhagen head office, dubbed "The Desert Fort" ("Ørkenfortet"), is being converted into a new Hilton hotel, and similarly, Danske Bank's Copenhagen head office is expected to be converted for mixed-use residential/retail, when the bank relocates to new premises at Posthusgrunden on completion of the ongoing development headed by Danica. [7]"Is speculative office building returning to the Copenhagen market?". READ ARTICLE