GLOBAL CAPITAL MARKETS | JUNE 2023

Insights & Outlook: **Offices**

Global Overview | North America | EMEA | APAC | Outlook | Summary

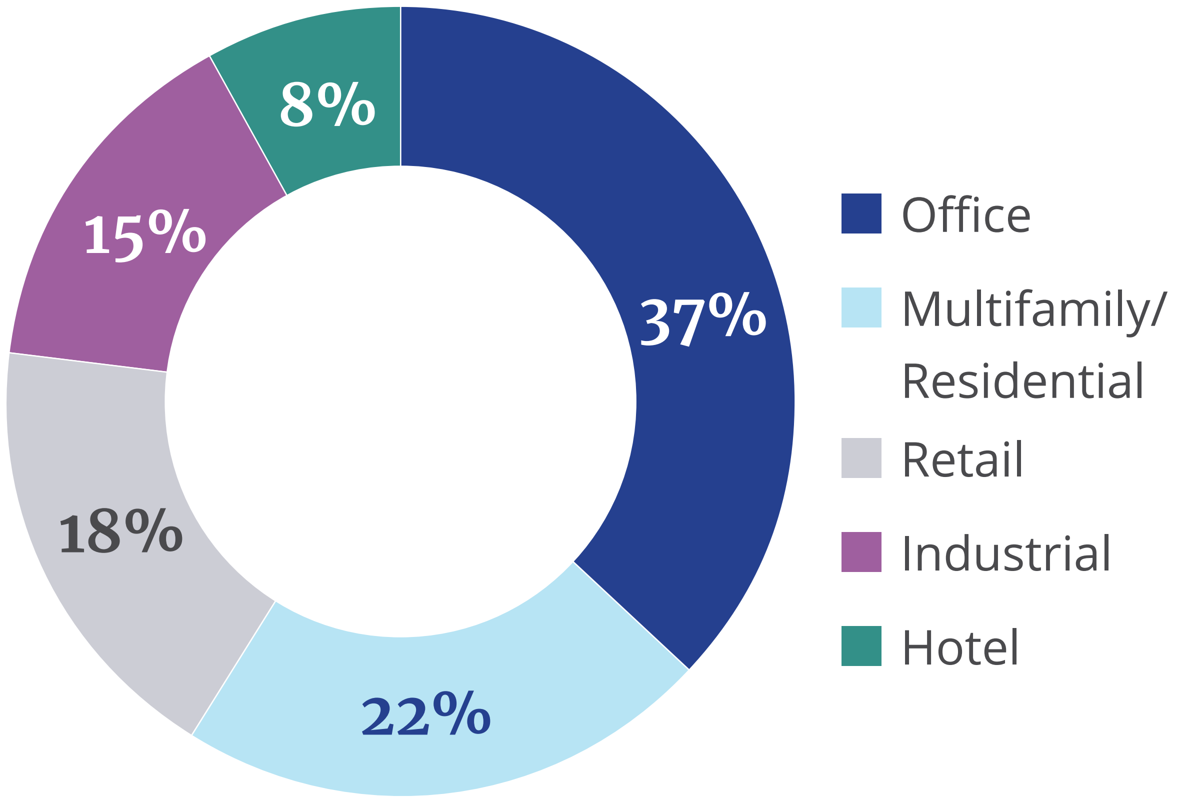
Global Overview

Global office markets bifurcate on fundamentals and pricing.

Office sales as a share of total investment volume is still declining in North America.

The office sector has been the largest recipient of real estate investment capital globally over the last 15 years. Accounting for 37% of all activity over this period means it is almost double the size of the next biggest sector, and based on Colliers Global Investor Outlook survey it was the joint top pick for investors in the APAC and EMEA regions in 2023.

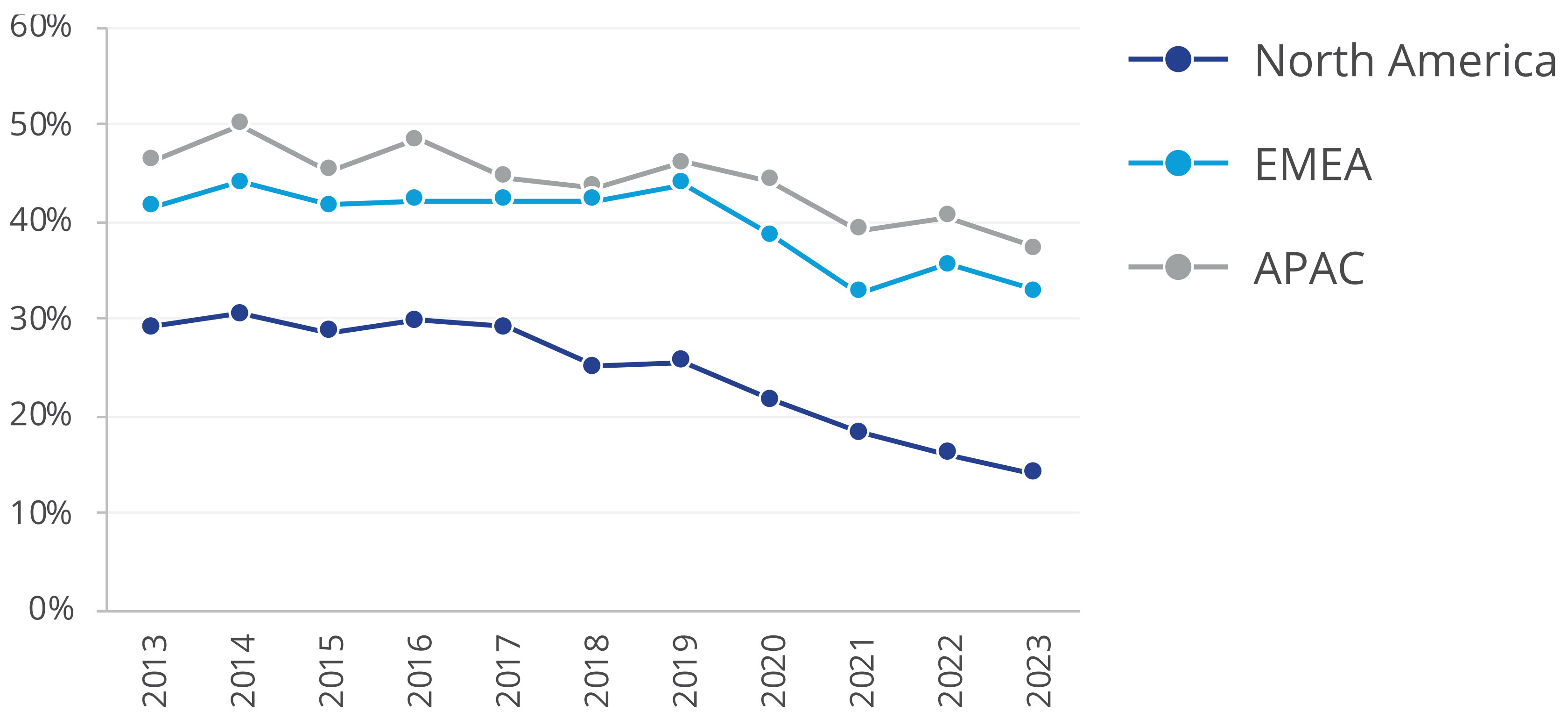
Figure 1. Global Investment by Sector: 2007 - Q1 2023



So when news around the sector turns negative, primarily emanating from issues regarding return to the office trends post-COVID, particularly in North America (the world's largest office investment market), we need to take note. Investment into the North American office sector has been on the decline for several years, falling to 15% of all activity.

Whilst activity has been on the decline in EMEA and APAC, volumes are holding out at much higher proportionate rates (circa 35% and 38% of all activity, respectively).

Figure 2. Global Office Investment Volumes



Sources: Colliers, MSCI Real Capital Analytics

In light of this, it is important to document the differences in each region regarding the fundamentals impacting office demand, supply, pricing, and appetite/sentiment. **Within each region, there is also great diversity in performance and fundamentals across city markets and their sub-markets.** In our opinion, tarring all markets with the same brush is not warranted.

Some conditions are similar – yields/cap rates are expected to drift out further in the sector in most major global city office markets in the next 12 months, but the rate of change will be much lower than in the last 12 months.

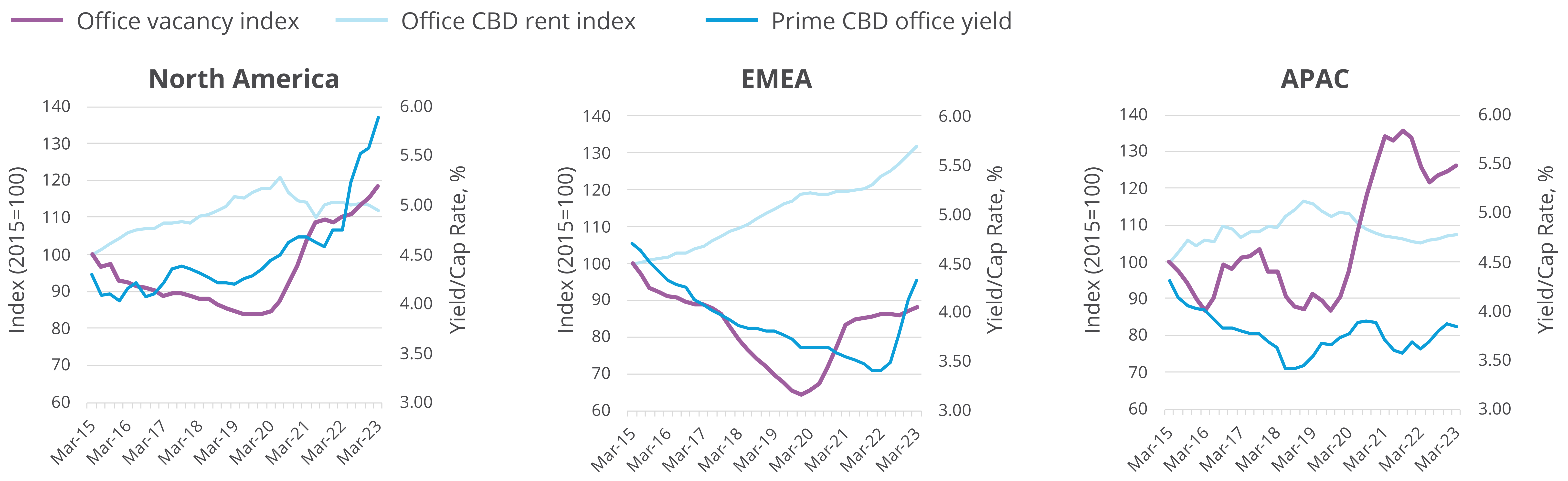
Pricing is not only moving in sync with the key macro-factors of inflation and interest rates, it is also adjusting to market fundamentals, where there is huge divergence in the factors at play. In North America, underlying market fundamentals are 'out of sync', illustrated by vacancy at 16% on average, predicated by weak demand. There is limited immediate scope for positive net absorption amidst challenges in improving return to office occupancy rates.

In Europe and APAC, vacancy is quite steady, at circa 8% and 10% respectively, and occupancy rates are largely back to pre-COVID levels. Office assets in these regions are densely populated on the whole, so the potential for 'space efficiency-led' vacancy is limited.

The better utilisation of office space in North America in recent years has been a contributing factor in creating such a large over-hang of older, vacant space.

Additionally, the shift towards **demands for higher quality office space is playing out differently, particularly when it comes to ESG compliance.** This is now a key factor in driving both occupancy and higher prime rents in European cities, especially CBD locations. Bar the very best space in markets in North American cities, net effective rents (and thus values) are under much greater downward pressure, leaving investors in those markets feeling spooked about the sector.

Figure 3. Global Offices: Vacancy, Rents, Weighted Yields/Cap Rates by Region



**All aggregate figures are based on values from key regional city markets. Yields/Cap rates are calculated on a net initial basis, and weighted according to office transaction volumes per market.*

Source: Colliers, MSCI Real Capital Analytics

The challenge for the investment market generally, is that the U.S. is the world's largest office investment market (circa $113bn in 2022), despite a gradual drop-off in activity. If activity comes to a halt, it will act as a drag on the market globally. **North American investors comprised one third of all global cross-border investment into offices in 2022, so investors looking to sell offices in EMEA and APAC will need to re-orient to other sources of capital.**

While broader pricing continues to adjust, it could take time for appetite in offices to re-balance. Understanding and processing the nuances and considerations of each market has become more complex. For those willing to invest ahead of the curve, many global office markets present a positive story and outlook.

Figure 4. Top 10 Global Cross-border (XB) Originators of Capital into Offices: US$ bn, 2022

	Country	XB	XB Global	XB Continent
1	U.S.	14.23	13.23	1.00
2	Canada	9.56	8.70	0.86
3	Singapore	9.09	3.42	5.67
4	Germany	6.20	2.40	3.80
5	Hong Kong	5.50	1.18	4.32
6	UK	5.34	1.26	4.08
7	South Korea	4.76	4.16	0.60
8	France	4.11	0.00	4.11
9	Luxembourg	3.08	0.03	3.06
10	Australia	2.96	2.26	0.69

XB total is the total amount of capital deployed into office assets outside of the home market. XB global is capital deployed outside the country's respective region. XB continent is capital deployed within the country's respective region. For example, Singapore distributed $9.09 bn globally of which $5.67 bn was distributed across APAC.

Sources: Colliers, MSCI Real Capital Analytics

North American capital has been the primary cross-border source for acquiring office assets.

Regional Overview: **North America**

The softening of key U.S. office market fundamentals accelerated in the first quarter of 2023. Net absorption remained negative, occupancy losses increased, vacancy rose at a faster pace, and available sublease space hit a new record high.

The U.S. office vacancy rate stands at 16.1%, an increase of 40 basis points in the first quarter.

Vacancy is still slightly below the prior peak of 16.3%, seen at the height of the Global Financial Crisis, but looks set to equal or exceed this level by mid-2023, with further upward pressure to follow. Net absorption, which measures the change in occupied office inventory, was positive in only 24% of the metro office markets tracked in our national survey, down from 43% in the fourth quarter. National office absorption totalled -25.4 million square feet. Seventeen metro markets posted negative absorption above 500,000 square feet in Q1 2023, up from 12 in Q4 2022, reflecting this shift in fortunes.

Asking rates are, by and large, showing little change. However, **the gap between asking and effective rents remains significant, with generous concessions on offer.** Tenant improvement allowances of $100 per square foot or more are available in 10 of the 15 leading U.S. office markets when a tenant signs a new 10-year lease on Class A space. Similarly, two-thirds of the leading markets offer 10 months or more of rent abatement on such transactions.

Key Office Factors

Working from home

Low — High

Commuting journey to office

Short — Long

Office density *(sqm/sq ft)**

Low — High

ESG considerations

Low — High

**Low density reflects high amount of space per person. High density reflects low amount of space per person.*

50%

Average Office Occupancy

Estimated office occupancy as of May 2023.

North America

Cap rates continue to face upward pressure, and investors are generally down on the asset class, making it challenging to price the market accurately today.

As a result, risk capital is circling office, looking for bargains. It is not uncommon for offers to come in 20%-40% short of guidance. Meanwhile, debt maturities are beginning to create distress as investors default on assets. Central bankers are signalling flexibility in their phrasing, suggesting that the rate hike cycle could, or soon will be, at its end.

Return to office in Canada is on a par with the United States, especially in the downtown cores of major cities, although Toronto has seen office occupancy rise to 60% by the end of Q1. Vacancy has risen into double-digits across most of the country, and after subsiding in 2022, subletting has re-emerged as an issue for the office leasing market in 2023. In several cities, more than 20% of vacant space is sublet space, and that number is rising.

Transaction volume has been extremely low for office, preventing price discovery in an era of much higher borrowing costs. Many major institutional players, traditionally the largest owners of high-quality office assets, have opted to sit on the sidelines, pursue development strategies, or diversify abroad.

> Toronto has seen office occupancy rise to 60% by the end of Q1.

Regional Overview: **EMEA**

In Europe, office take-up and absorption rebounded very strongly in 2021 post-COVID, but started to flatten out during 2022 and this trend has continued in 2023.

New development activity has been declining for a year in light of higher construction costs and a weakening economic outlook, so vacancy overall has only marginally crept up at the end of 2021 to 8.1% by the end of Q1 2023 – the European aggregate. This masks differences in performance across markets.

> **London City has seen vacancy rise up to 11.4% from 9.7%; in Dublin, vacancy jumped from 10.6% to 13% - a market very oriented to the tech sector.**

Vacancy rates in Paris overall have risen from 7.4% to 8% while Berlin has seen rates creep up to 3.7% from 3.1% at the beginning of 2022. Meanwhile vacancy in Brussels has dropped from 8.3% to 7.7%, Amsterdam rates are down to 6.1% from 6.5% and London's West-end has held steady at 6.8%.

European vacancy rates

London City
11.4%

Dublin
13%

Paris
8%

Berlin
3.7%

Brussels
7.7%

Amsterdam
6.1%

London West-end
6.8%

Key Office Factors

Working from home
Low — High

Commuting journey to office
Short — Long

Office density *(sqm/sq ft)**
Low — *EMEA has a larger office density range.* — High

ESG considerations
Low — High

**Low density reflects high amount of space per person. High density reflects low amount of space per person.*

65%

Average Office Occupancy

Estimated office occupancy as of May 2023.

EMEA

Overall, markets may be largely neutral or tenant friendly, but we're not seeing a picture of over-supply.

A significant element of vacant space comprises older, obsolete stock and there is a real scarcity factor of high quality, energy efficient space which is pushing higher prime rental values up. **There will be pressure on markets to re-purpose secondary space that don't meet contemporary demands**, but that is nothing new, markets constantly re-purpose, down cycles simply trigger these decisions.

A bigger challenge for European pricing is the extent to which inflation is proving to be sticky due to consistent core inflation, wage rises, imported energy and food prices. While wholesale food and energy prices are rescinding, there is a significant lag effect to when these prices diminish for businesses and households. Interest rates will likely rise further in 2023 - putting pressure on office yields to move out further - but we are now at, or very close to, peak rates. Some 75% of key European markets expect office pricing to adjust further in Q2 to compensate (another 25-50 basis points on the cards), although 25% of markets believe office yield pricing has now stabilised – notably in Spain and Denmark.

25% of markets believe office yield pricing has now stabilised - notably in Spain and Denmark.

In earnest, **we are looking at the end of 2023 before there is much greater certainty around inflation and interest rates, to support a clearer path on pricing levels across multiple markets.** It really comes down to when pricing hits the right level to match future exit yields. CAPEX also must be factored in to allow for assets to be upgraded to meet higher energy/operational carbon and ESG requirements.

Regional Overview: **APAC**

The APAC region has experienced resilience overall throughout the last 12 months compared to North America and EMEA, but the change in sentiment due to inflationary driven interest rate increases will continue to create some headwinds for the region over the remainder of 2023.

Occupancy levels across the region are above those of EMEA and North America and are currently averaging around 80%.

> **Average vacancy across major APAC markets currently sits around 10% - although the divergence is vast with Seoul vacancy at 2.3% and Beijing 16.9%.**

Despite a stronger rebound in occupancy levels compared to other regions, global uncertainty is weighing on occupier demand and supply/demand side fundamentals are shaping different recovery profiles across major APAC office markets. **Both Seoul and Singapore recorded net absorption 30% above historical averages with both markets recording falling vacancy rates over 2022**, **contrary to most major markets globally.** However, like most markets demand is wavering in Singapore as occupiers remain wary of economic conditions, but low supply over the last 12 months in Seoul has driven vacancy to just 2.3%, down from 6.4%, keeping market conditions strongly in favour of the landlord contrary to global trends.

Key Office Factors

Working from home

Low — High

Commuting journey to office

Short — Long

Office density *(sqm/sq ft)**

Low — High

ESG considerations

Low — High

Importance of ESG varies markedly across the region.

**Low density reflects high amount of space per person. High density reflects low amount of space per person.*

80%

Average Office Occupancy

Estimated office occupancy as of May 2023.

APAC

Over the remainder of 2023, underlying demand is in a net neutral state as expansionary tenant activity within some markets and sub-markets is being offset by contractionary moves, particularly within the tech-sector and across amenity/infrastructure lacking locales.

As a result, **vacancy levels are expected to increase across major APAC markets over 2023**, although not to the same extent as we witnessed through 2020/21.

Stability or the initial recovery of face rents have been apparent over the last 12 months. Hong Kong, Mumbai and Melbourne are expected to be at, or close to, bottoming rents, and some rental growth is likely to be achieved by year end. Whereas Tokyo (overall market) although seeing the rate of rental decline slow, is expected to see some further downward pressure on rents over 2023 as vacancy remains above historical averages. Higher vacancy levels and weak demand will drive rents lower in Beijing and Shanghai, whereas strong rental growth over the last 12 months within Seoul and Sydney is expected to taper but remain positive.

Overall **office investment volumes across the region declined by 13% over 2022 to record US$85.9 billion**, with consistent declines across capital sources (domestic, regional, and global cross border) as investors take a more cautious approach amidst changing conditions. APAC has historically lagged EMEA and North America and has now started to see a sustained tapering off of transaction activity at the start of 2023. This is similar to the slowdown in transaction activity that occurred over H2 2022 across EMEA and North America.

Although limited sales transactions occurred over Q1 2023, **we anticipate market sentiment will recover as an expected peak of the interest rate cycle comes to fruition over H2 2023** and equips investors and vendors with clarity and confidence regarding asset values and the cost of borrowing across the region.

> We expect to see some rental growth in Hong Kong, Mumbai and Melbourne by year end.

Outlook

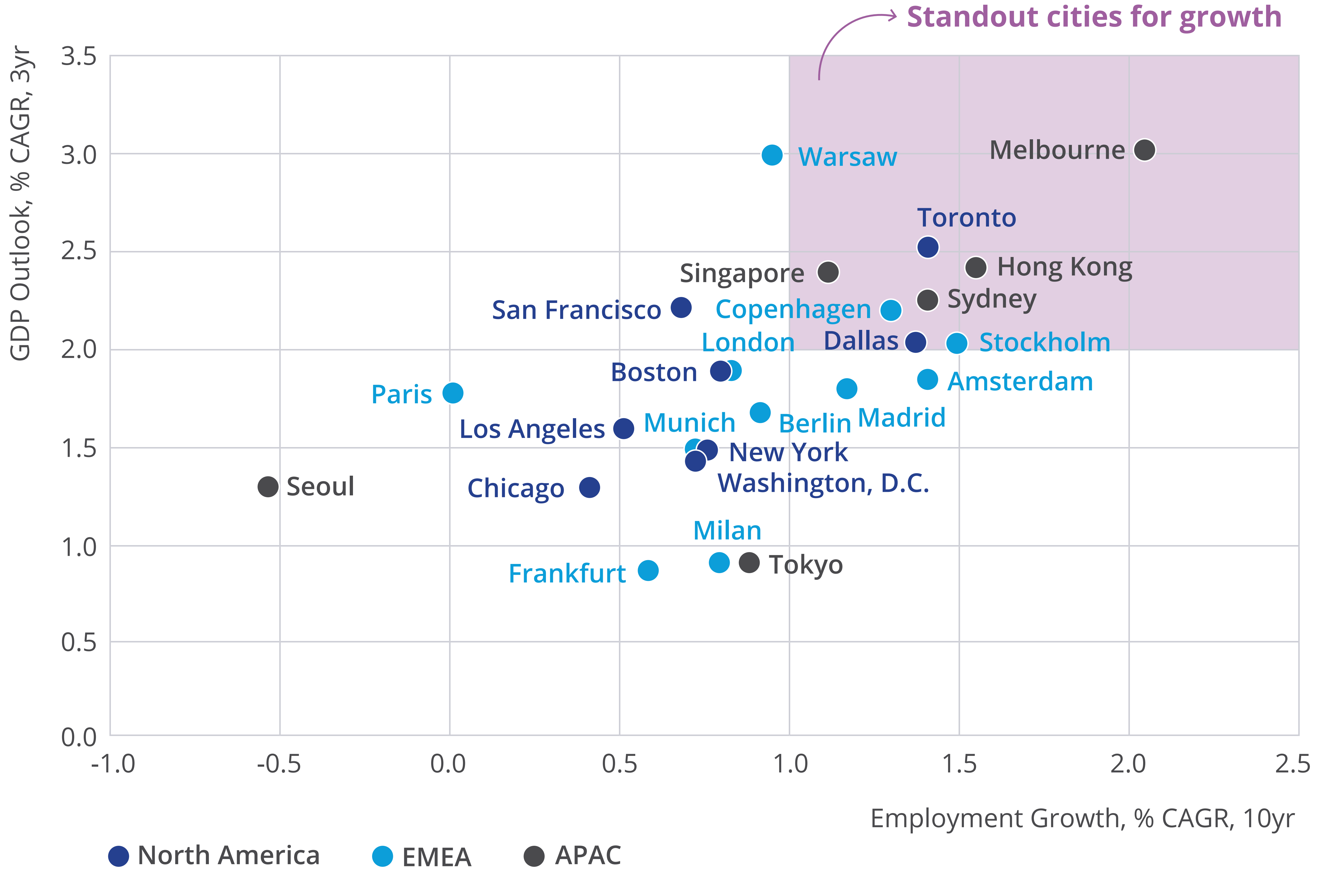
Looking beyond the factors immediately at play across regions, we can also see differentiation in the longer-term factors impacting global cities.

Figure 5 illustrates current forecasts for economic growth (three-year outlook), **and employment growth** (10-year outlook), **across major global cities.** These growth projections will clearly be subject to change by multiple global and regional events, but they give a good indication of underlying demand growth for offices and other forms of real estate going forwards.

Overall, there is annual economic and/or employment growth forecast for each city, but at varying rates of growth.

Seoul and Paris stand out as having weak employment growth prospects (0% or less). Melbourne is expected to see 2% annual growth in employment over the next 10 years. This goes hand-in-hand with strong economic growth of 3% per year, and makes it the standout market.

Figure 5. City Demand Drivers: Economic/Employment Growth



Source: Colliers, Oxford Economics

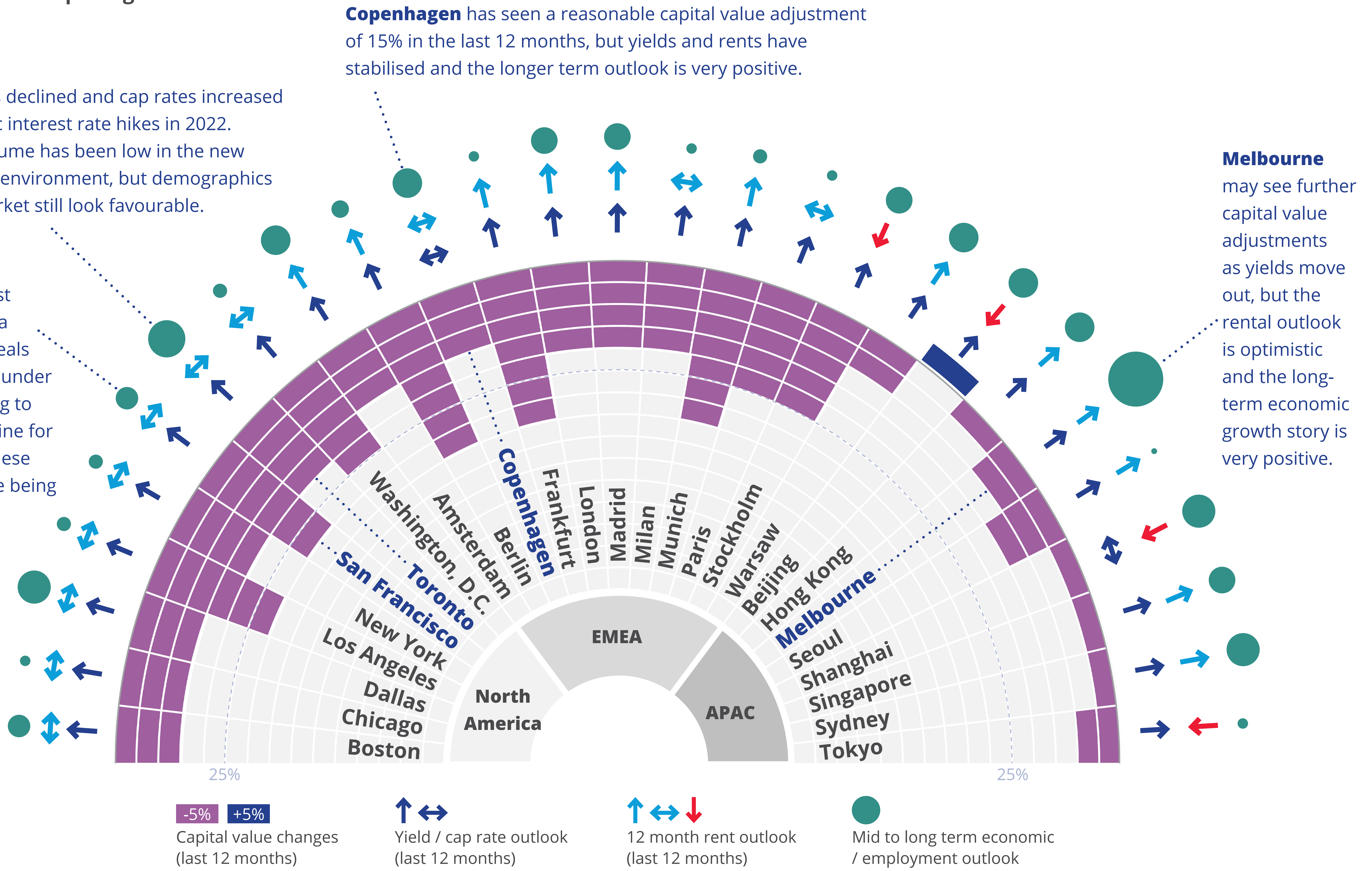
It is interesting to note how the APAC cities 'top and tail' the chart, with **Australian cities leading the growth charts along with Hong Kong and Singapore**, while Seoul and Tokyo are at the back of the pack. North American cities are spread across the middle although **Toronto and Dallas stand out as the top economic-led growth markets.** The European cities are also well distributed, with **Warsaw, Stockholm, Copenhagen and Amsterdam leading the growth charts for the region.**

Outlook

If we map the growth forecasts alongside the recent impact to office capital values and prospects for further change in values over the next 12 months via rental and yield/cap rate movements, we get a view of how global office markets stack-up against each other.

The city office pricing outlook illustrates the key factors including capital value impacts over the past 12 months (%), prospects for further capital value change (via rents and yield/cap rate change) and the longer term economic outlook per city.

Figure 6. City office pricing outlook



Sources: Colliers, OxfordEconomics, Macrobond

Summary

These metrics, plus all the other factors mentioned in this report, are being taken into account when investing across markets. **This underpins how complex investing into office real estate has become, as the factors influencing global city markets are so diverse in range and application.**

> **All markets have their own story, and picking out the right markets for investment will depend on multiple factors: appetite for risk, use of leverage, return targets. But some markets do stand out on the path to value stability and recovery.**

Key takeaways

Demand

- U.S./Canadian office demand continues to weaken, but there is bigger upside if occupancy rates comes back. **Toronto occupancy is now back up to 65%.**
- European challenges are selective by sub-market, with a similar situation in APAC, but overall **demand is robust even though the future economic/jobs growth outlook differs markedly.**

Range of factors impacting city office markets

- The huge range of factors impacting city office markets means **you cannot treat all markets on the same basis.** Natural vacancy rates differ across cities. The exposure to - and balance across - business sectors also differs and can skew demand/growth prospects.
- **ESG is an increasingly significant factor and driver of higher prices, but not universally.** It is significant in Europe, particularly in the UK and Netherlands where asset energy performance targets are set in stone. This is driving value-add investment, given the dearth of modern assets that are energy efficient and meet low operational carbon targets.

Capital flows

- **North American investors are spooked about offices generally**, even though the fundamentals differ globally. **EMEA and APAC will need to consider alternative sources of capital for offices. This also presents a great timing opportunity for capital willing to invest today.** Values are likely to drift further in the majority of markets, but the biggest value hits look to be behind us.

For more information, please contact:

CAPITAL MARKETS RESEARCH LEADS

Damian Harrington
Head of Research,
Global Capital Markets & EMEA
+44 7867 360489
damian.harrington@colliers.com

Aaron Jodka
Director of Research,
U.S. Capital Markets
+1 617 330 8059
aaron.jodka@colliers.com

Adam Jacobs
Senior National Director Research,
Canada
+1 437 836 0491
adam.jacobs@colliers.com

Joanne Henderson
National Director Research,
Australia
+61 2 9257 0286
joanne.henderson@colliers.com

GLOBAL CAPITAL MARKETS LEADERS

Luke Dawson
Head of Global & EMEA Capital Markets
+44 7821 636148
luke.dawson@colliers.com

David Amsterdam
President,
U.S. Capital Markets & Northeast Region
+1 212 716 3556
david.amsterdam@colliers.com

Lucas Atkins
President, Capital Markets,
Canada
+1 416 643 3424
lucas.atkins@colliers.com

Chris Pilgrim
Managing Director, Global Capital Markets,
Asia Pacific
+65 8952 6064
chris.pilgrim@colliers.com