Real Estate Research

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The Transformation of European Offices

Identifying optimal locations for best-in-class office refurbishment

IN A NUTSHELL

— Structural changes to the way we work, alongside environmental pressures, present a clear opportunity to transform well-located, Grade B offices into Sustainable Next Generation Office space.
— A value-add office refurbishment strategy will prove most successful in dynamic, fast-growing and sought-after cities. In order to identify target markets, we analysed and scored 30 major European cities on four key metrics.
— Seven European cities were identified as strategic primary targets for an office refurbishment strategy. A further seven cities were classified as tactical target markets, where a value-add strategy would be feasible depending upon pricing and micro-location.

The European office market is in a period of transition. We foresee lower aggregate demand for office space in the years ahead but believe offices will remain a key part of corporate strategy to facilitate collaboration, as well as attract and retain talent. Climate change, decarbonisation of the economy and ESG considerations are increasingly at the forefront of both occupier and investor decisions, and increasingly driving demand for highly sustainable office buildings. The definition and drivers of a Sustainable Next Generation Office (SNGO) is addressed in our "Sustainable Next Generation Office" paper.

With the above in mind, alongside the notable repricing evident in secondary office stock, transforming old, but centrally located office assets into best-in-class SNGO assets presents an attractive value-add investment opportunity. This report highlights the European office markets in which our analysis suggests such a redevelopment strategy would be most attractive.

1.1 Scoring methodology

DWS framework to rank office markets based on four key indicators

To identify target office markets, we analysed, scored, and ranked 30 of Europe's largest investible office markets. We separated both London and Paris into clearly definable submarkets, given the often-contrasting dynamics within these large cities. Central Paris, by which we are referring to Paris Central Business District and the adjacent neighbourhoods, operates very differently from La Défense, while London's West End and Docklands have very different market fundamentals. Each of the chosen 30 (sub)markets were then scored on four key indicators: investment appeal, office market fundamentals, office-related city characteristics, and macro-economic outlook. Within these four overarching themes, a total of fifteen variables were analysed, incorporating both quantitative and qualitative factors.

Table 1: Market Scoring Methodology

Investment Appeal (30%)	Office Market Fundamentals (30%)	City Characteristics (20%)	Macro-economic Outlook (20%)
Certified Buildings	Vacancy	Business Friendliness	Office Employment Growth
Grade A vs. B Rent Premium	Supply Barriers	Productivity	GDP Growth
Liquidity	Net Additions	Climate Event Risk	Workforce Growth
		Desirability	Fiscal Health
		Public Transportation	

Source: DWS, Oxford Economics, Green Street, April 2023

Investment appeal

The ranking of the investment appeal aimed to identify the markets most suitable for an office refurbishment strategy. Firstly, the current percentage of certified buildings relative to the total office stock indicates the scarcity of such offices. For example, markets such as Warsaw have a high share of certified buildings, which makes a refurbishment strategy less impactful. Secondly, a value-add refurbishment strategy also requires a sufficient rental premium between Grade A and Grade B office to justify the required capital expenditure. Lastly, liquidity is a key consideration when selling a fully refurbished best-in-class office asset.

Office market fundamentals

The scoring of the office market fundamentals largely involved analysis of supply metrics and the evidence of absorbing net additions over time. Those markets with low vacancy and/or high barriers to future supply, such as Munich, scored the highest.

City characteristics

Non-property city characteristics were incorporated into the scoring; factors such as business friendliness were considered to identify those markets that have the greatest competitive advantage in attracting and retaining businesses. Dublin, for example, scored highly given Ireland's favourable corporate tax laws. Importantly from an ESG angle, climate event risk was analysed to assess the likelihood of environmental risks such as flooding and extreme heat. Characteristics such as desirability and public transportation connection identified those cities that are most desirable to and accessible to a large workforce.

Macro-economic outlook

The macro-economic outlook of each city was examined to gauge future office demand by identifying cities with strong economic, employment and workforce growth rates. Nordic cities, such as Stockholm, ranked highest here.

The overall score was determined by weighting the respective indicators, with investment appeal and office market fundamentals considered the most important features for determining key target markets. In some cases, an adjustment was incorporated to reflect the feasibility of executing a refurbishment strategy. For example, Copenhagen's overall score was adjusted downwards given structural factors such as rent regulation and a predominance of out-of-town business park office stock. As such, weaker rental growth prospects make office investment less viable, a feature that would not have been accounted for in the framework.

1.2 The results

What office markets should we be targeting?

Based on our scoring methodology, the analysis highlighted seven (sub)markets seen as the most attractive for an office refurbishment strategy. We have therefore identified these markets as our 'primary strategic' target markets:

- **London West End & City:** A dynamic and highly integrated global city. Despite Brexit, London's vibrant culture and abundant employment opportunities continue to attract migrants from both Europe and further afield. Unrivalled access to talent makes London an attractive location for high-productivity firms most able to afford best-in-class office space.
- **Central Paris:** A truly cosmopolitan city, Paris attracts workers from around the world. Low structural office vacancy and a high supply barrier market, Central Paris continues to attract office occupiers from less central locations as many are choosing to upgrade in terms of location and quality, while reducing their footprint.
- **Munich:** An established location for a magnitude of large domestic and international companies, investment into high-tech infrastructure is increasingly attracting fast-growing and high-productivity sectors. Munich's liquid office market is supported by low vacancy and high barriers to future new supply.
- **Berlin:** Renowned for its diversity, rich history and social scene, Berlin's position as a cultural 'hot spot' improves the attractiveness to international workers and firms. A relatively low proportion of existing certified buildings should support greater green premiums for best-in-class sustainable office stock.
- **Amsterdam:** A vibrant and desirable city that attracts young and educated workers, the city is proving a key beneficiary of Brexit. Amsterdam benefits from world class international connections and a strong inner-city transportation system. Strict current and future energy efficiency regulations require a high standard of office buildings.
- **Stockholm:** Well-regarded for its high quality of life, Stockholm is supported by strong urbanisation and a young demographic. A highly qualified workforce attracts innovative firms from fast-growing sectors such as life sciences. Environmental sustainability is top of the agenda from both a public and policy perspective, driving demand for best-in-class, certified offices.
- **Madrid:** A high proportion of city-centre living means employees are more willing to commute easy distances to the office and Madrid continues to see some of the strongest office occupancy post-Covid. A positive outlook for office employment growth will continue to drive demand for office space over the coming years.

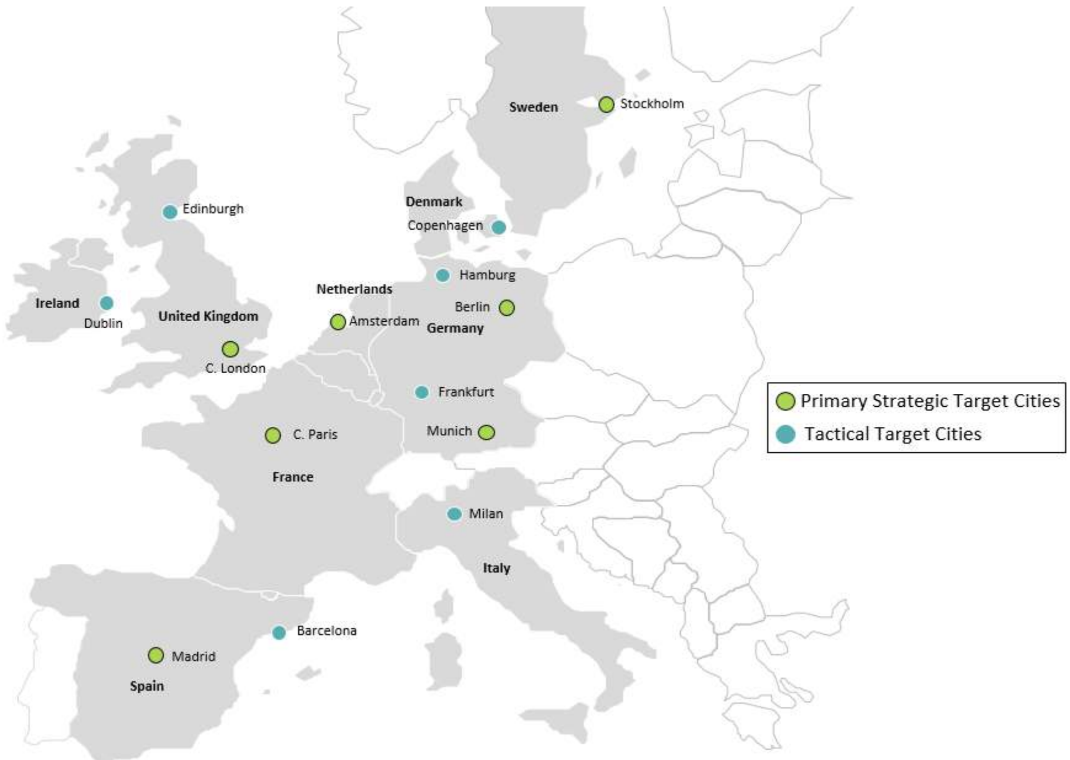
We do anticipate that across Europe Grade B office stock will continue to see capital value decline over the coming years. Construction costs, the potential for rental uplift and exit price at stabilisation are also important factors when determining the profit margin.

With that in mind, a further seven 'Tactical Target' cities have been identified as potential target markets, where given an adequate correction in pricing, an office refurbishment strategy would also be viable.

Strong tactical target markets include:

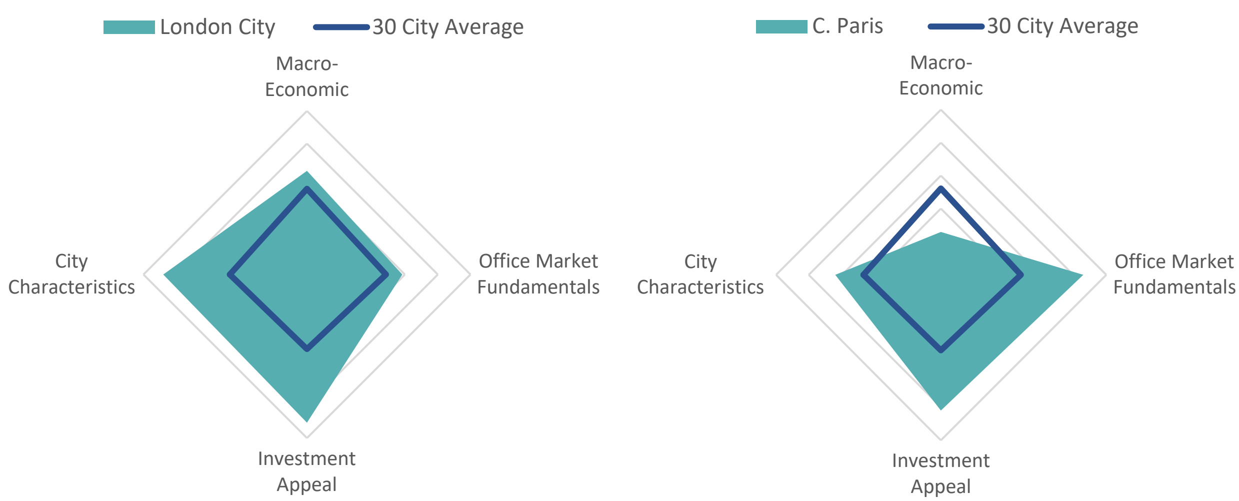
- **Milan:** A desirable location for both employers and employees, supported by strong inward migration. The notable rent premium between Grade A and secondary office stock makes a refurbishment strategy viable.
- **Dublin:** Despite immediate challenges facing the tech sector, longer-term fundamentals continue to look supportive. The city scores highly on business friendliness and Dublin has become increasingly important for US firms post-Brexit.
- **Frankfurt:** Although the macro-economic outlook is somewhat weaker than other target cities, Frankfurt remains a high productivity city and global hub for business. A highly liquid office market provides further comfort.

Figure 1: European Real Estate Transformational Office Markets



Source: DWS, April 2023

Figure 2: Scoring Methodology Examples



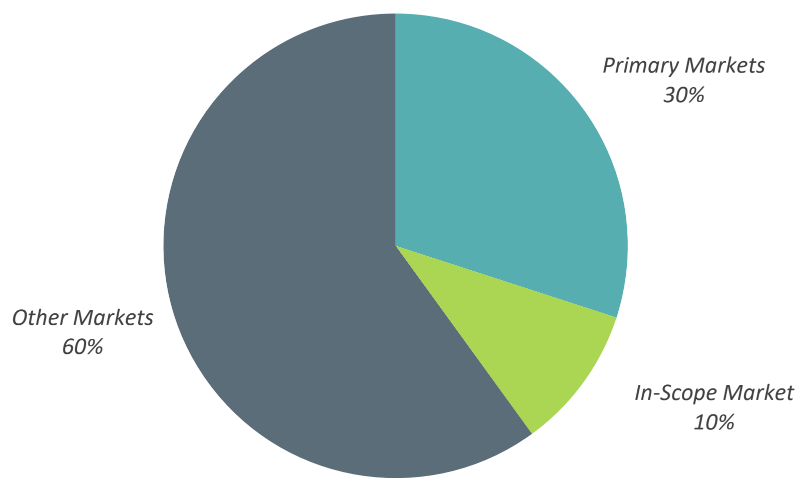
Source: DWS, Oxford Economics, Broker Sources, April 2023

The micro-location within these markets is also exceptionally important. Centrally located and well-connected assets with strong live-work-play amenities are expected to outperform. Different submarkets within cities also perform differently. For example, the Central London submarkets of West End and City of London scored the highest overall, but London's Docklands submarket ranked much lower given lower employment growth prospects and concerns around current and future supply. Similarly, Central Paris is a clear target market, whereas, for several reasons, particularly around supply, the Paris Western Business District would not be considered a target market for an office redevelopment play.

It is worth noting, that the successful execution of such a value-add office strategy in these strategic and tactical markets does depend on the availability of suitably priced grade B assets and overall liquidity of the office market for disposals to crystalise investment gains. As such, it is important that over the last ten years the seven primary target markets in our analysis accounted for circa 30% of all European office transactions by volume (Figure 2). Together with the seven tactical target markets, the share of transaction volumes increases to roughly 40%.

Furthermore, research commissioned by the Urban Land Institute (ULI) and New Climate Economy (NCE) concluded that larger and more dense cities are associated with higher returns for real estate investment[1], further supporting our investment call to target Europe's key gateway cities.

Figure 3: Total European Office Investment Volumes (2013-2022)



Source: DWS, RCA April 2023

1.3 Summary and conclusion

Through this detailed analysis we have identified seven primary target markets, that we expect to provide the best opportunities to successfully execute this strategy in terms of both access to stock and outperformance in rental and value growth over a five year hold period. We believe investing in these cities provide a strong basis for this sort of strategy, taking advantage of current repricing, market fundamentals, and long-term structural changes.

Seven further European cities have been identified where a value-add, office refurbishment strategy would also be viable, although further a repricing in secondary office stock values may need to be evident before required returns could be met.

[1] Urban Land Institute, 'Supporting Smart Urban Growth: Successful Investing in Density', 2018

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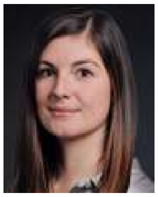

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Important information