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Prof. Dr. Michael Voigtländer
Head of Research Unit Real Estate Economics
Institut der deutschen Wirtschaft Köln

Property Industry must take action on office vacancies

Most of the leading real estate agent groups would agree that 2011 was a successful year for the office market, by any measure. Transaction volumes soared compared to 2010, as did prime rents. Nonetheless, vacancy rates saw only slight reductions - while actually increasing in cities such as Düsseldorf and Frankfurt, according to brokers BNP Real Estate and the DIP-Partner network, to cite just two sources.

The year just passed reinforces a long-term characteristic of the German office market. And that is that, when the market is in an upswing, vacancy rates either stagnate or fall only slightly, while they increase significantly in downswings. As a result, the stock of empty offices increases with each cycle.

According to data provided by researcher BulwienGesa, the average vacancy rate across 125 German cities climbed from 1% in 1990 to 7.5% in 2010. In the Big Seven largest urban centres, the average vacancy rate is now actually above 10%.

The laws of supply and demand clearly do not hold absolutely for the office market. An extreme example is Frankfurt. The dotcom bubble boosted the construction of new office space, but the subsequent bust of the 'new economy' saw a lot of office workers losing their jobs. Consequently, over the period 2000-2005, the stock of available office space rose by 17% while office employment decreased by roughly 2%. Between 2005 and 2010, office supply and employment levels increased quite synchronically by 5-6%, but taking the decade as a whole, the overall growth in office supply was 23% while employment levels remained static. Although less pronounced elsewhere, this development was fairly characteristic of all Germany's major office markets.

The crucial question, therefore, is this. Why do developers build new offices, although the stock of empty offices is so high? The reason is simple: demand. Tenants prefer high-quality and energy-efficient offices in the best locations. These requirements can be met more easily by the provision of new buildings. And since staff costs far outweigh rental costs, tenants are willing to pay for new buildings as long as the high-quality offices contribute to a reduction in employee turnover and absenteeism.

In addition, high energy-efficient standards comply with the code of corporate social responsibility strategies most big companies now employ as a matter of course. As a result of these preferences, buildings no older than 20 or even 10 years old can now be difficult to let.

Given Germany's demographic profile, the situation can only be expected to worsen in the near future. By 2025, the working population in Germany will have shrunk by 8%, compared to today's level. Fortunately though, the major office markets are expected to fare better than the national average. In Munich and Hamburg, for example, the amount of people aged between 20 and 65 years will actually increase by a few percent. In Düsseldorf and Frankfurt, however – the two major markets with the highest office vacancy rates – the work force will, at best, stagnate. But with developers putting up new buildings no matter how the overall employment figures evolve, a further increase in office vacancy rates seems inevitable.

At this point, some market participants will argue that office vacancy is only a problem for the relevant landlord. But this is patently not true, for at least two good reasons. Firstly, at some point in time, the ever-increasing vacancy rates will give rise to a backlash effect for the whole office market. Higher vacancy rates imply higher risks for landlords. That's because investors sooner or later take into account the shorter economic life of office properties, resulting in a lower price they are willing to pay. Hence, prices for the office market as a whole will fall.

Secondly, and perhaps even more importantly, rising vacancy rates also dramatically increase the risk of unwanted political intervention.

In all major cities we face a shortage of residential properties in central districts. The older 'silver-agers', in particular, increasingly want to live in urban locations, and hence - according to most projections - housing demand is expected to increase until at least 2030, even while the overall population is shrinking. The larger cities, in particular, are a major focus for this demand. But the preponderance of vacant offices act to stifle this demand and hinder a better use of the land. It is then only a question of time until politicians bring the issue to the fore on their agenda. If this happens, the industry will face new regulations, new restrictions on developments and even new local taxes. The industry, then, would be well advised to act voluntarily before it is forced to act by law.

What should be done? A first step would be to increase market transparency so that market participants are fully aware of actual high vacancy levels. For a major office market like Frankfurt, you will hear nearly 20 different vacancy rates depending on whom you talk to. These rates often differ not only in the level, but also in the trend. As a consequence, investors and developers tend to make use of the data that best fits their needs. Even worse, the statistics on vacancies as a rule only include buildings that would be available for let within a period of three months. The real stock of vacant offices is therefore MUCH higher than frequently assumed.

Developers also need to design offices that are more flexible. For instance, by directly assembling water installations, delinquent offices can be more easily converted to residential use or for use as hotels. These considerations may well increase construction costs, but on the beneficial side may significantly increase the economic life of the building.

Finally, members of the property industry need to cooperate more closely with each other to actually prevent further increases in real vacancy rates. In Amsterdam, for example, investors, developers, real estate agents and mortgage lenders are now agreeing to construct new buildings only when vacant buildings are demolished at the same or at another site. As a consequence, the demand is directed to existing buildings. In the Netherlands, this cooperation is moderated by the government Ministry of Construction. A further positive effect of the this new cooperation is heightened market transparency, since the partners develop a common view on the supply and demand sides of the office market. Given the high vacancy rates and the dark shadows of demographic change, Frankfurt and Düsseldorf would do well to learn from the Dutch approach.