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Savills Research
Ireland

Market in Minutes
Dublin Offices

Q3 2017

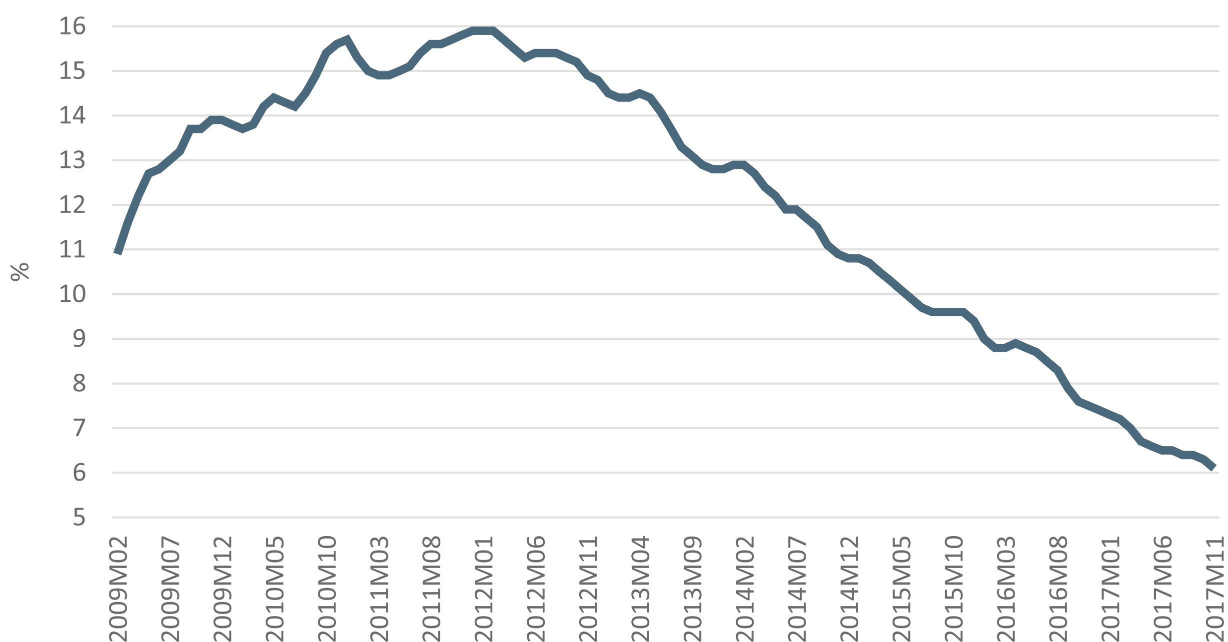
Introduction

Ireland's economy continues to perform exceptionally well with output now rising at a rate of 5.8% per annum (compared with 2.0% across the EU as a whole). Jobs growth is the engine behind this continued expansion. At national level employment has risen by 2.4% in the last 12 months, while Dublin's labour market has been even stronger - office-based employment in the capital has grown by 2.8%. This jobs creation is the fundamental driver of increased demand for office space in Dublin.

As a result of sustained jobs growth unemployment fell to 6.1% in November and the economy is getting closer to full employment.

This has led to intensified competition between organisations seeking to recruit talent. Naturally, pay and benefits play a critical role in attracting staff, but the location and quality of an organisation's office buildings are increasingly becoming part of the HR 'pitch'. As new office supply continues to come onstream occupiers will have a greater choice of buildings. Therefore location, design and the internal functionality of space will exert a greater influence on occupancy levels and the pricing of leased office space in the coming years.

FIGURE 1:
Unemployment Rate



Source: CSO

Ireland's strong economic momentum is set to continue with consensus GDP growth forecasts of 3.7% for 2018 and 3.1% for 2019. The uncertainties that have been hanging over the global economy for some time still persist and, in our view, neither Brexit nor the US Tax Cuts and Jobs Act are necessarily positive for Ireland. At least, however, we are likely to get greater clarity about both issues in the near future and this in itself is a positive.

Market Demand

Lettings

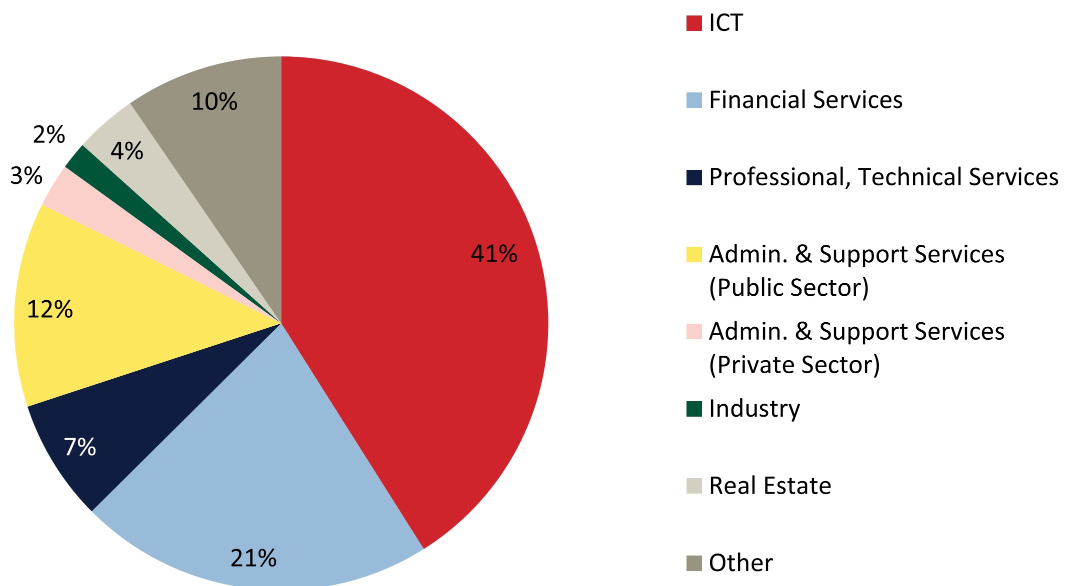
After a very strong first half of 2017, letting activity fell to just 29,628 sq m in Q3. Although this represents the lowest quarterly lettings total for three years it reflects a quirk of timing more than anything else. A large amount of space is currently committed and will be contracted in Q4. Therefore we still expect total take-up for the year to approach the record levels set in 2015.

Lettings by Sector

Figure 2 shows that the Information and Communications Technology (ICT) sector continues to be a big driver of the demand for Dublin office space – ICT occupiers accounted for 73,762 sq m (41%) of total take-up in the first three quarters of 2017. However a strength of the Dublin market is its diverse occupier base and take-up has been broadly distributed across a range of sectors. In previous reports we noted that the public sector is now back in play as a taker of Dublin office space. This remains the case and public sector bodies have accounted for just over 12% of the space that has been let, both in Q3 and on a year-to-date basis.

5 School House Lane

FIGURE 2:
Dublin Office Take-Up By Sector Q1-Q3 2017

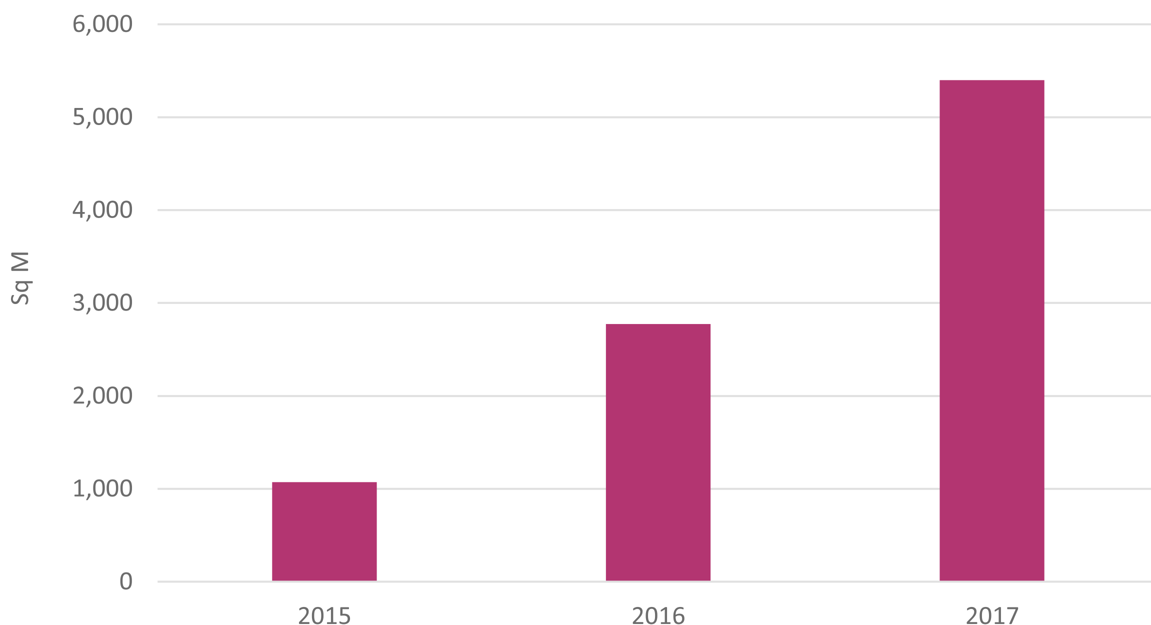


Source: Savills Research

Brexit Effect

Since Brexit was announced in June 2016 there has been speculation that Dublin would see an upsurge in office demand from London-based legal and financial services companies seeking to maintain passporting rights into the EU. While there have been some Brexit-related deals the dramatic upsurge that some people anticipated has not yet materialised. In our view this is not surprising. With Article 50 only being triggered in late March, and with the withdrawal process set to continue until March 2019, companies affected by Brexit were always more likely to play a waiting game – at least until a clearer picture of the final Brexit deal began to emerge. Of course this does not mean that they have been inactive. But instead of committing to long leases on big quantities of space in Dublin, companies that might be affected by Brexit have been more likely to dip their toes into the water by seeking out relatively small parcels of space on flexible terms. One side effect of this has been a marked increase in demand from serviced office providers. These operators typically lease office space on long contracts and then sub-let smaller lots on flexible terms at a mark-up. While they still only account for a small proportion of lettings, the amount of space being taken by these serviced office suppliers has risen exponentially since the announcement of Brexit – see Figure 3.

FIGURE 3:
Space Taken By Serviced Office Providers – Q1-Q3



Source: Savills Research

Lettings by Sector

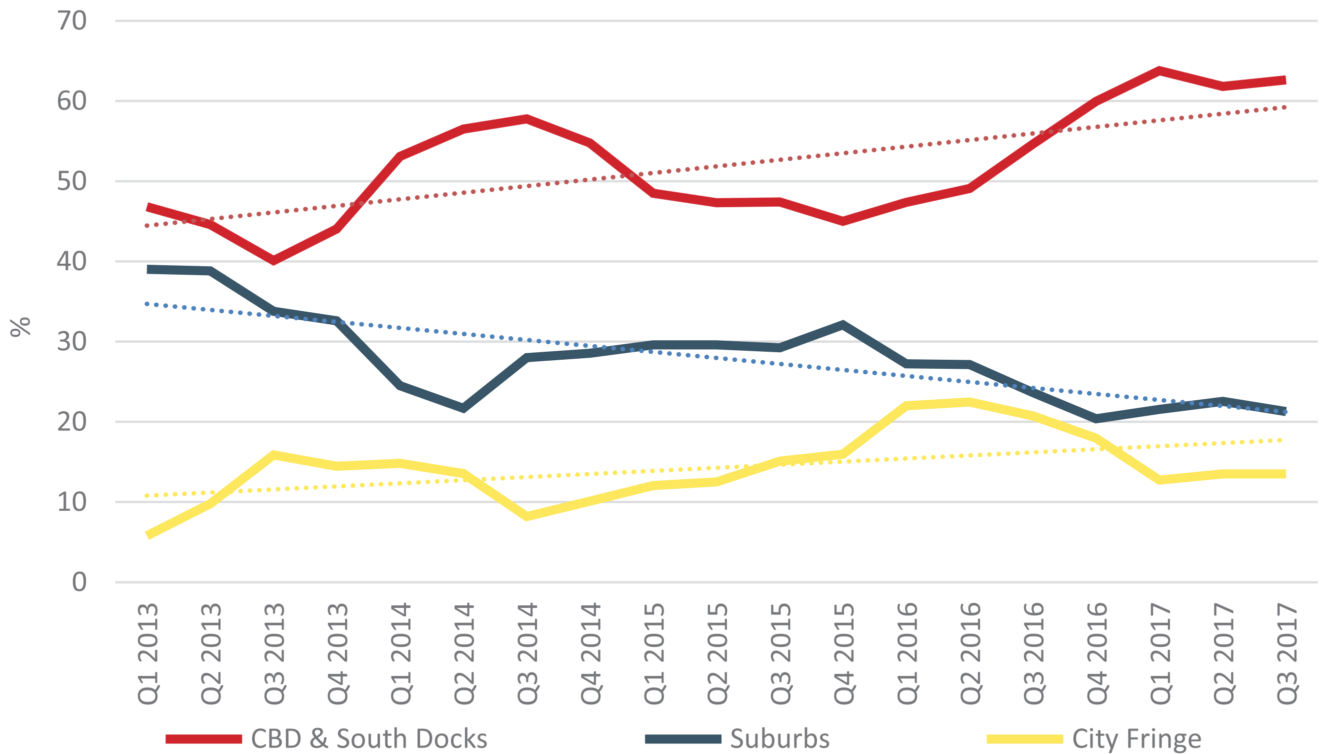
The traditional 'core' Central Business District (CBD), and the South Docks area which has *de facto* become incorporated into the CBD, remain the dominant locations for market activity. Together they accounted for just under 100,000 sq m of take-up in the first nine months of 2017 – 56% of total let space. These locations appeal to a variety of occupiers because they are well serviced by all modes of public transport, and because they offer an array of attractive cultural amenities – restaurants, shopping, entertainment etc.. As outlined above these factors have become an increasingly important means of attracting and retaining staff in a competitive labour market. Typical takers of space here include large tech firms, financial and professional services companies that benefit from clustering effects and, to an extent, public sector bodies. While the latter tend to be cost-sensitive some have negotiated attractive rents on the basis of their strong covenants and willingness to sign longer leases.

A notable trend in the current cycle is the increased demand for city fringe space. Eighteen percent of all the space taken in Dublin since 2011 has been in the city fringe which incorporates parts of Dublin 3, 4, 7 and 8. Moreover, as shown in Figure 4, this area is accounting for an increased share of lettings over time. Particularly in locations close to good public transport links fringe areas offer some of the convenience of CBD locations. But, because rents are considerably lower, they appeal to more cost sensitive operators including start-ups, public sector bodies and mature ICT companies.

While the stronger suburban locations are still doing well, activity and pricing has largely been flat in locations that are further out of town or more difficult to get to via public transport.

FIGURE 4 :

Share of Total Dublin Lettings By Location (4 Quarter Moving Average)



Source: Savills Research

Net Absorption

While take-up provides insights into market activity, net absorption - the period-on-period change in occupied space - gives a better understanding of how quickly the economy is consuming office accommodation. Other than in exceptional circumstances net absorption should be lower than gross take-up. This is because of 'churn' – occupiers moving within the market vacate space which nets against the quantum of space that they are taking-up. In a growing economy one might expect new entrants and expansions to increase relative to movers in the share of market lettings. As such the gap between take-up and absorption should narrow.

Paradoxically, despite Ireland's continued economic outperformance, only 51,972 sq m of Dublin office space has been absorbed in the first nine months of 2017 – equivalent to just 29% of take-up. This is because of pre-lets on buildings which are not yet completed. Such transactions are counted in take-up immediately when the lease is signed. However they cannot be counted in occupied space until the building completes. Therefore there is a lag between the recording of take-up and net absorption.

Pre-lets have traditionally represented a small share of Dublin office lettings, but they have featured much more prominently in the current cycle. Twelve percent of all the space that has been let since Q4 2014 has been pre-let and this figure rises to almost 30% in the prime postcodes of Dublin 2 and 4. At this point in the cycle many of the pre-let buildings remain under construction. Consequently absorption is lagging take-up. However when these buildings reach practical completion over the coming quarters they will immediately be counted in occupied space. This unwinding effect will lead to a period of quite rapid net absorption in the coming year.

Office Supply

Four new office blocks, totalling 20,359 sq m, were completed in Q3 2017. This brings year-to-date completions to 122,645 sq m while completions since the current cycle began have now reached 199,567 sq m.

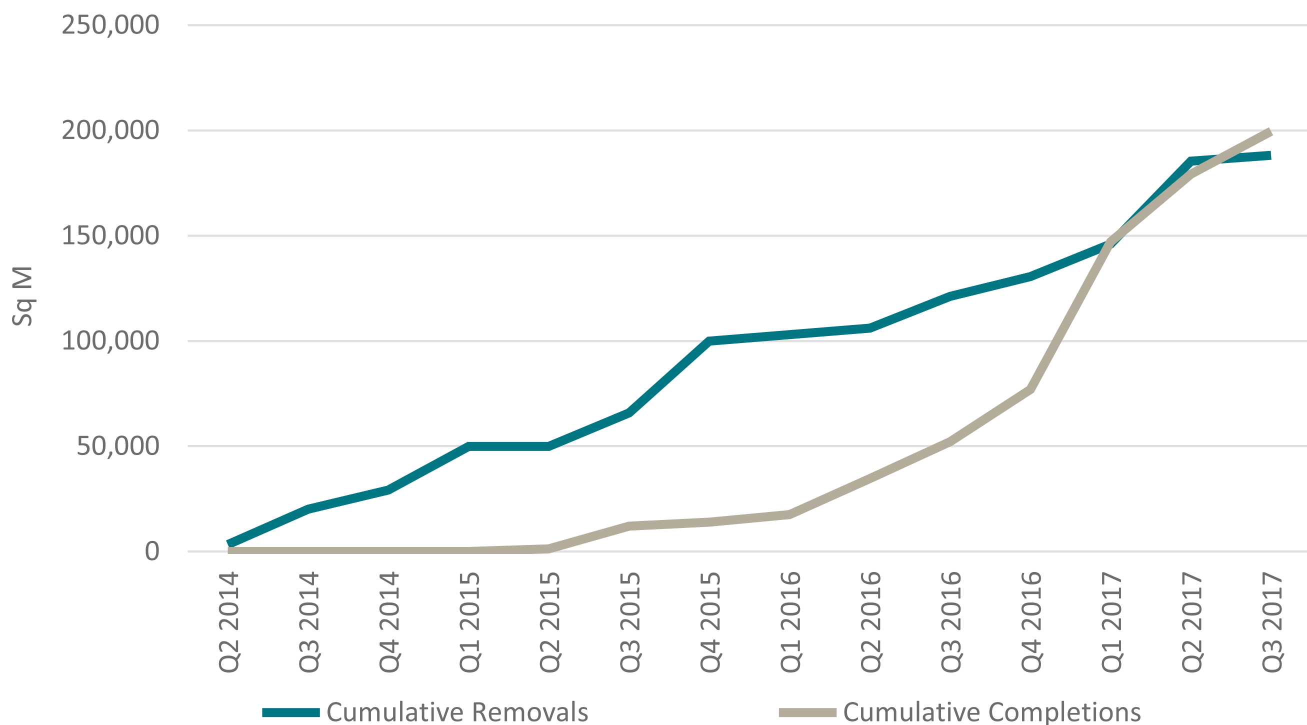
In addition to the space that has already been completed a further 393,000 sq m is presently under construction. Therefore the combined total of completions in the current cycle plus work-in-progress comes to almost 600,000 sq m. This seems like quite a sizeable figure but two factors need to be borne in mind when evaluating it. Firstly, the current development cycle is considerably smaller than the two that preceded it. Between 1996 and 2003 1.29 million square metres of new office space were constructed, almost doubling Dublin's stock of modern buildings. And a further 854,000 sq m were developed between 2006–2009 adding nearly one third to the pre-existing stock. By comparison the 593,000 sq m of space completed and underway in the current cycle only represents 16.3% of the existing stock.

A second point is that the above numbers refer to gross development. The current cycle differs from previous rounds in that it involves significant redevelopment – for the first time we are knocking down buildings on a large scale to make way for new ones. This trend reflects several factors;

- A strong preference among occupiers, developers and investors for city centre and city fringe locations
- A scarcity of vacant sites due to such locations being heavily built-up by previous office development and competing land uses e.g. hotels and residential
- An ageing stock because centrally located sites were the first to be colonised in Dublin's earliest wave of office development in the 1960s.

The upshot is that almost as much stock has been withdrawn for redevelopment (188,360 sq m) as has been added through new completions (199,567 sq m) – see Figure 5. The offsetting effect of these demolitions, in combination with ongoing net absorption due to economic growth, has prevented any major rise in vacancy despite increased construction activity.

FIGURE 5:
Cumulative Withdrawals and Completions in the Current Cycle



Source: Savills Research

[1] The average ages of purpose built offices in Dublin 2 and 4 are 28.2 and 25.2 years respectively. For comparison, the average age of office buildings in all other parts of Dublin is 19.7 years.

Building Bigger and Better

A Before-And-After Comparison of Dublin's New Office Buildings

As outlined above almost as much office space has been demolished as constructed since 2014. This exercise looks at how Dublin's office landscape is changing by examining the subset of buildings that have been knocked-down and rebuilt in the current cycle.

- **How Many?** - 26 office blocks in Dublin have been demolished and replaced since 2014.
- **Older Buildings Being Targeted** - The average age of the demolished blocks was 40.5 years. This compares with an average age of 22.4 years for all office buildings in Dublin.
- **City Centre Focus** - Redevelopment has focused almost exclusively on the city centre. Twenty-one projects (81%) have been in Dublin 2, four have been in Dublin 4 (15%), and one has been at Dublin Airport. The city centre focus reflects a concentration of public transport and social infrastructure in this location. Tenant demand for such amenities underpins the value of redeveloped assets in central locations.
- **Bigger and Better** - The average size of the demolished buildings was 3,643 sq m. The average size of the properties that replaced them is 4,968 sq m - 36.4% bigger
- **Net Gain In Space** - The net gain from knocking and redeveloping these buildings has been 34,449 sq m – enough space for approximately 2,850 aditional employees
- **Change of Use** - Two city centre offices have been converted to hotel use and fallen out of the office stock – Findlater House on O'Connell St. and Pinebrook House on Harcourt St.. Oisin House on Pearse St. has also been removed for redevelopment as student accomodation. Two further buildings – Creation House on Grafton St. and 10-12 Trinity Street – have had their first floor offices converted to retail use.

Vacancy

The increase in vacant space between time periods is dictated by two factors;

- Net completions – the additive total of gross completions (+) and demolitions (-)
- Net absorption – the sum of gross lettings (+), pre-lets (-) and churn (-)

Table 1 summarises how these factors have contributed to a modest 15,605 sq m increase in vacant space over the first nine months of 2017. As a proportion of total stock this has caused the vacancy rate to rise from 9.0% last December to 9.3% currently.

North Wall Quay

TABLE 1:

Table 1. Analysis of Vacancy Movement Q1-Q3 2017

ACTION	SUPPLY	DEMAND	NET
Completion	122,645		
Withdrawals	-57,630		
Revisions	2,562		
Net Movement in Stock	67,577		
Lettings		179,744	
Pre-lets and Churn		-127,772	
Net Absorption		51,972	
Movement in Vacant Space			15,605

Outlook

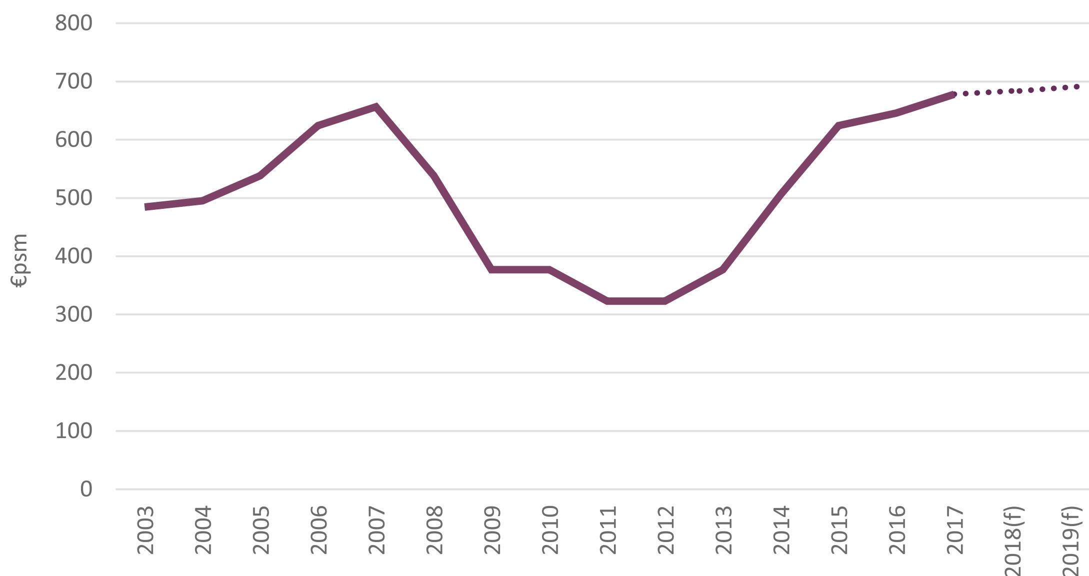
Last year our econometric model forecast that prime headline rents would rise from €646 per sq m per annum in December 2016 to just over €678 by December 2017. From there headline values were predicted to reach €721psm by December 2018.

As we approach year-end it looks like the 2017 forecast has been very accurate and, factoring in Q4 deals that we are aware of, the tone of rents is likely to be in or around €678 per sq m by 31st December.

Looking ahead we are reducing our 2018 forecast from €721 per sq m to €685. This is because the December 2017 vacancy rate – which determines rental growth in 2018 – will be higher than we foresaw 12 months ago. This is not down to weaker market demand than anticipated - net absorption has been closely in line with what was fed into our forecasting model last year. Instead it reflects stronger net completions on the supply side. Gross completions have come through as expected during the year. However, although there have been significant withdrawals of old stock as discussed above, considerably less space has been decommissioned than we allowed for. This is due to the deferral of projects that were scheduled to happen later in the cycle. The upshot is that the end-2017 vacancy rate will be higher than we anticipated a year ago, resulting in lower rental growth forecasts for 2018.

Looking further ahead, if the economy performs in line with consensus macro-economic forecasts, 2019 will be the peak of the cycle with the tone of rents in prime locations tipping above €690 per sq m per annum.

FIGURE 6:
Prime Dublin Office Rents Forecast 2018-2019



Source: Savills Research

The Hamstead Building

Dublin Landings

Ireland Office and Research teams

Please contact us for further information

John McCartney
Director
Research
+353 (1) 618 1427
john.mccartney@savills.ie

Andrew Cunningham
Director
Head of Offices
+353 (1) 618 1720
andrew.cunningham@savills.ie

Roland O'Connell
Chairman and Director
Office Agency
+353 (1) 618 1315
roland.oconnell@savills.ie

Michael Healy
Divisional Director
Office Agency
+353 (1) 618 1367
michael.healy@savills.ie

David O'Malley
Associate
Office Agency
+353 (1) 618 1458
david.omalley@savills.ie

Peter Owens
Senior Surveyor
Office Agency
+353 (1) 618 1466
peter.owens@savills.ie

Kellie O'Brien
Senior Surveyor
Office Agency
+353 (1) 618 1348
kelly.obrien@savills.ie

Christopher Boyce
Senior Surveyor
Office Agency
+353 (1) 618 1310
christopher.boyce@savills.ie

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