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What can city number 2 do better than the largest city?

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Overtaking in the fast lane – or eternal second place?

The city with the largest population in each country, which will here be referred to as the first city, and the second-largest city (second city)[1], often show striking differences in their development because of indicators such as the quality of the infrastructure, economic dynamism or location factors. In times of crisis, investors mainly look for the security of high-quality real estate in central locations in the top cities (flight to quality). But it is also worth looking at the second cities, which may offer interesting potential in the rental and investment market. In the following, various market indicators will be compared for first and second cities in Germany (Berlin vs. Hamburg), France (Paris vs. Lyon), the Netherlands (Amsterdam vs. Rotterdam), Spain (Madrid vs. Barcelona) and Ireland (Dublin vs. Cork), in order to identify the location-specific potential of the different office markets.

The second cities at a glance: Hamburg, Lyon, Rotterdam, Barcelona and Cork

Various studies have shown that the second cities are becoming increasingly attractive as locations. For example, the magazine *France Attractive* selected **Lyon** as the most popular city in France, a city which is distinguished by progressive industries – such as chemicals, biotechnology and medicine – and by a large and highly qualified potential workforce.

The second city in Ireland, **Cork**, is also marked by economic and demographic growth. With leading global companies such as Apple and Pfizer, the city has developed over the last few years into a business centre with sectoral clusters in global industries which offer great prospects for the future, as for example pharmaceuticals, life sciences, information communications technology (ICT), energy, and shipping. This potential arises from a number of factors such as renowned universities and research centres, the city's location and the quality of life. Cork has Tier 1 connectivity, good transport infrastructure and a port with national importance.

[1] Ranking the cities by their population only goes part of the way to recognizing their importance in the hierarchy of cities in the country (e.g. Dublin vs. Cork; Berlin vs. Hamburg).

The city has additional location factors such as a healthy climate, a low level of environmental pollution and low commuter travel times, which are increasingly important for the rentability of office space as an attractive alternative to remote working at home.

Hamburg, as the most important port in Germany, offers an important trading location and a vibrant maritime industry. Rotterdam, one of the largest seaports in the world, is a logistical hub of global importance and is economically interesting as an affordable residential location and an attractive tourist destination with a wide range of hotels. Barcelona impresses with its Mediterranean way of life and is an emergent location for technology and the creative sector. These second cities are therefore not overshadowed by the largest cities in their countries. On the contrary, they offer equally attractive location conditions for personnel and business enterprises.

Comparison of the key figures of cities

Table 1 gives an overview of economic and market-specific data such as population, unemployment rate and office market size of the ten analysed cities.

Table: Differentiation between first and second cities according to population, unemployment rate and office market size

City	Population 2022	Unemployment rate 2022	Office market size 2022 (sqm)
Berlin	3,760,000	8.8%	19,669,000
Paris	2,130,000	7.3%	18,678,000
Amsterdam	918,000	4.8%	6,068,000
Madrid	3,300,000	10.8%	8,782,000
Dublin	593,000	8.9%	3,977,000
Hamburg	1,892,000	6.8%	13,924,000
Lyon	522,000	6.9%	5,774,000
Rotterdam	664,000	4.7%	3,487,000
Barcelona	1,630,000	9.1%	4,590,000
Cork	222,000	8.0%	657,000

Source: Statista, cso.ie, PMA, Lisney (Cork); Chart: Real I.S.

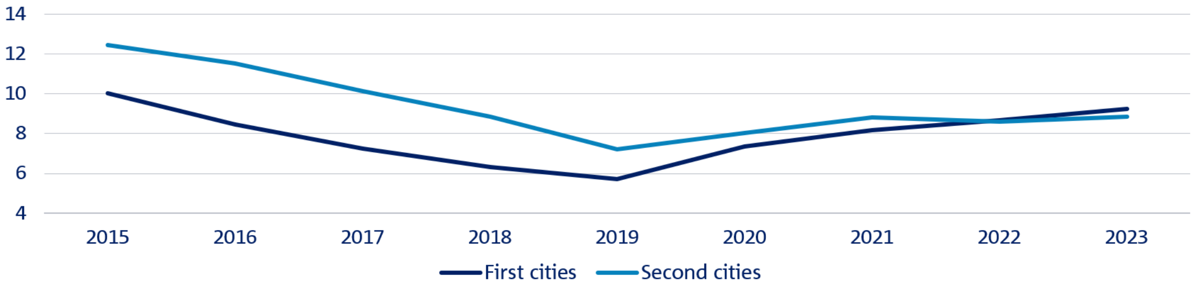
Berlin has a population of 3,760, 000 and is thus the biggest city. Paris, Hamburg and Lyon, however, have larger office markets in relation to their population (Paris: 18,678,000 sqm; Hamburg: 13,924,000 sqm; Lyon: 5,774,000 sqm).

The lowest unemployment rates by a long way are found in the Netherlands, with a rate of 4.8% in Amsterdam and 4.7% in Rotterdam. It is noticeable that the unemployment rates are always lower in the second cities than in the first city of each country.

Reversal of trend in vacancy rates

Whereas the average vacancy rates in the first and second cities in this study initially saw a parallel development up to 2021, in 2022 the vacancy rate in the second cities fell to the same level as the first cities. Since 2022, the vacancy rates in the first cities have been higher than in the second largest cities. This development was due to the high rate of completed office construction in the first cities from 2019/2020, combined with a decline in the demand for space because of the trend of working from home, which led to a reduction in market activities. In comparison, the second cities have seen a more moderate level of completed construction in the last few years, and because of the lower rents they have also seen an increase in the demand for space, which has reduced any additional growth in the vacancy rate. At the end of 2023, in the first cities (Berlin, Paris, Amsterdam, Madrid and Dublin) the average vacancy rate of office real estate stood at 9.3% and in the second cities (Hamburg, Lyon, Rotterdam, Barcelona and Cork) at 8.8% (see figure 1).

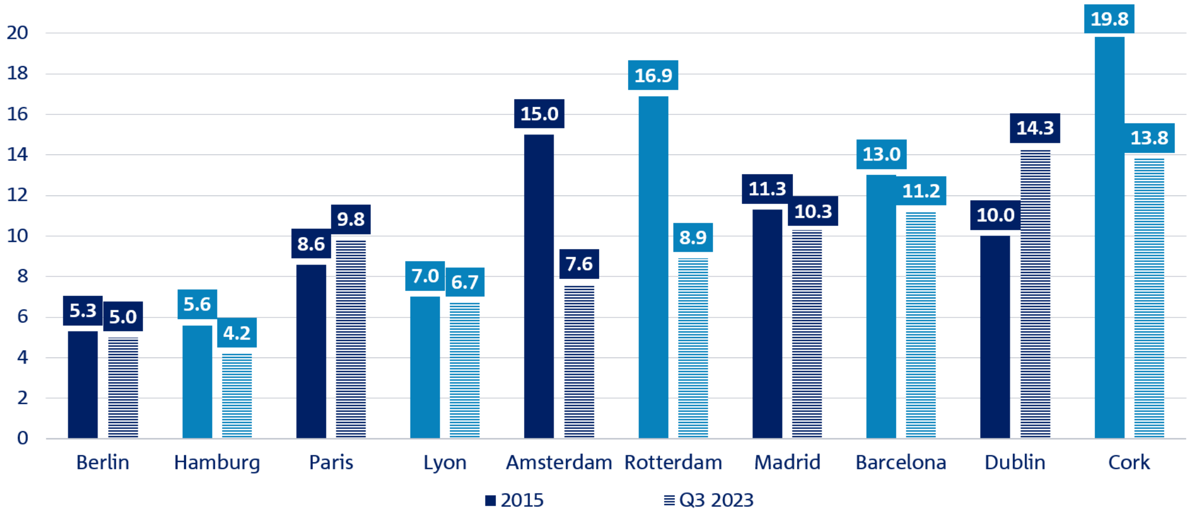
Figure 1 : Development of average vacancy rates 2015-2023 (%)



Source: PMA, Lisney (Cork); Chart: Real I.S.

The graph shows the vacancy rates in the cities in 2015 and in the third quarter of 2023:

Figure 2: Comparison of vacancy rates 2015 versus Q3 2023 (%)



Source: PMA, Lisney (Cork); Chart: Real I.S.

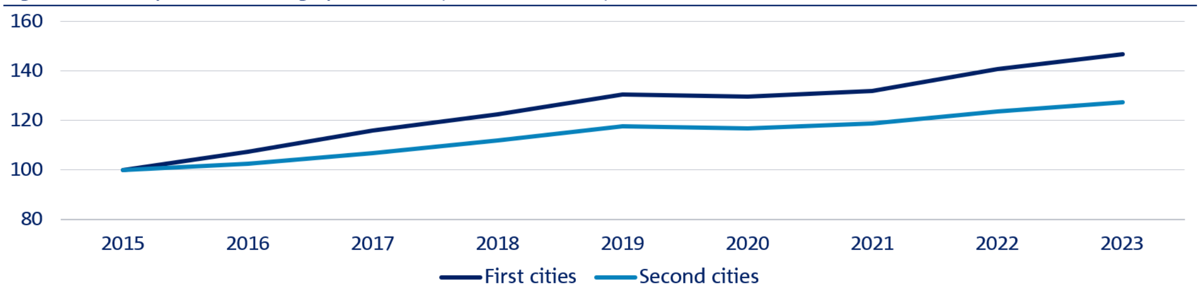
Vacancy rates in the German cities (Berlin and Hamburg) were low in 2015 and in the third quarter of 2023 (~ 5.0%). At 7.0% and 6.7%, the vacancy rate in Lyon was moderate too. Amsterdam und Rotterdam managed to reduce their vacancy rates by approximately 50%.

Rental market trend shows a simultaneous development

Prime rents of office property markedly increased between 2015 and 2023 in both city categories. In the third quarter 2023, the average prices were 51.10 EUR/sqm (first cities) and 26.10 EUR/sqm (second cities) – see figure 3.

The growing attractiveness of the second cities and the moderate current rents even offer potential for rent increases. This should positively impact the performance of the real estate markets in the coming years.

Figure 3: Development of average prime rents (index 2015 = 100)



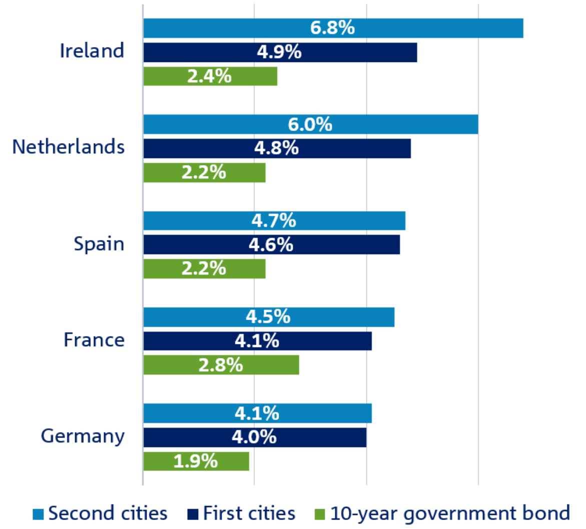
Source: PMA; Chart: Real I.S.

High yields are reflected by investment volumes

On the investment market, initial yields in first cities are clearly different from those in second cities. The city of Cork is at the top of the city comparison list. The prime yield for office properties in Cork is 6.8% and the yield on 10-year Irish government bonds is 2.4%. So there is an attractive risk premium of 4.4 percentage points. For office properties in Dublin with a prime yield of 4.9% the spread is 2.5 percentage points only, and thus decisively narrower. On the whole, the analysis across borders shows that yields in second cities are always higher: the average prime yield for office real estate in first cities is 4.5% and 5.2% in second cities (see figure 4).

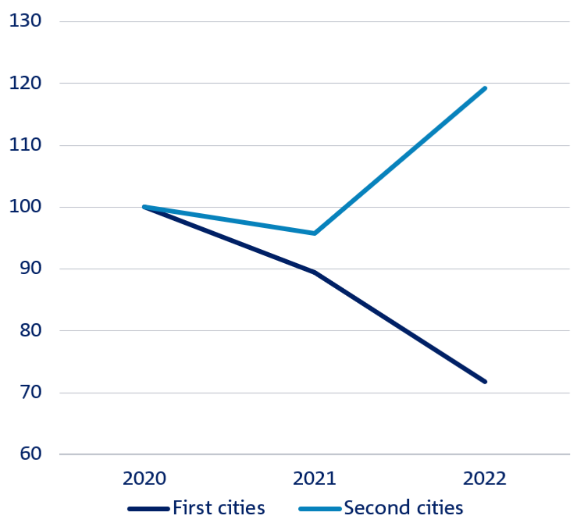
An interesting development can also be seen in the investment volume for office properties. Whereas there was a decreasing investment trend in the first cities in the three-year period from 2020 to 2022, there was an opposite development in the average investment in the second cities from 2021 onwards. The largest driving force for this growth in the investment volume in the second cities was Rotterdam, where the investment volume was almost quadrupled. An important factor for this increase was Rotterdam harbour. It is one of the largest seaports in Europe and an important transport hub for cargo handling, which led numerous business companies to establish a presence there. In a comparison of the figures without Rotterdam, the investment volume in the second cities nevertheless increased slightly, whereas the first cities (without the city of Amsterdam) saw a major decline, as can be seen in figure 5.

Figure 4: Comparison of yields Q3 2023



Source: PMA, Lisney (Irland), World Government Bonds; Chart: Real I.S

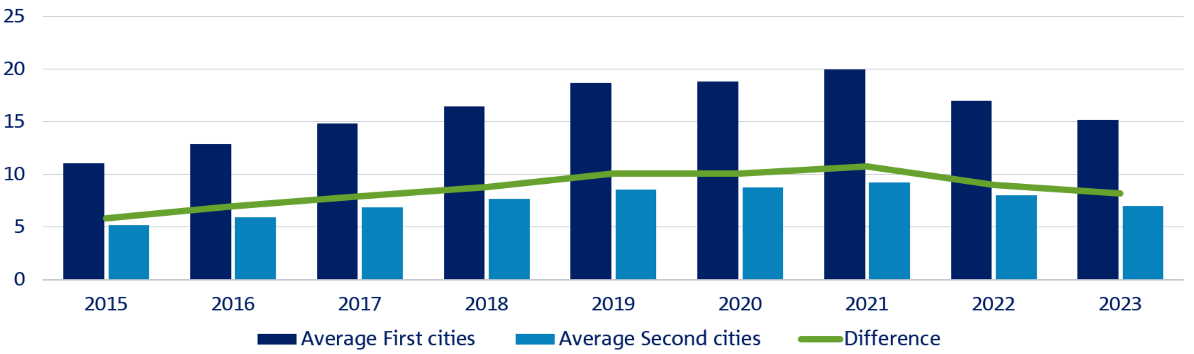
Figure 5: Development of investment volumes of the first and second cities (index 2020 = 100)



Source: PMA; Chart: Real I.S.

A consideration of the peak purchase prices also underlines the development described above. Purchase prices of office properties in first cities went up by 81.1% between 2015 and 2021 (second cities: +77.1%), but decreased stronger than in second cities in the years 2021 to 2023 (-25.0% vs. -22.6%). In relation to the years 2021 to 2023, it can be seen that the purchase prices in the first and second cities came closer together. This trend can be seen in the extent to which the line showing the difference in average purchase prices declines from 2021 onwards (see figure 6).

Figure 6: Average purchase prices and their difference (000 EUR per sqm)*



*Source: PMA; Chart: Real I.S. * Ireland is neglected in this analysis as no values are available for Cork*

Conclusion: second cities offer opportunities

From an investor perspective, office premises in second cities offer a promising potential in view of the growth in rents, the lower vacancy rates and the higher yield. These positive market indicators are also enhanced by soft factors such as a higher quality of life. On the whole, second cities thus offer an attractive mixture of yield and risk, which represents a sensible supplement to the markets of the first cities.

Cork convinces with a high initial yield of 6.8%, Hamburg gains points with a low vacancy rate of just 4.2%, and Rotterdam was able to almost quadruple office property investment volumes in the period from 2020 to 2022. Lyon was selected by the magazine *France Attractive* as the most popular city in France, a city which is distinguished by a dynamic labour market and progressive industries. Barcelona is an emergent location for technology and the creative sector.

It could even be said that the 'number 2 cities' of the five countries considered here could to some extent take first place for market attractiveness.

Kind regards

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