Briefing note
Berlin - a hotspot for TMT start-ups

October 2013

Courtesy of Hub:Raum, Aline Lefield

SUMMARY

Berlin is a young but growing start up hub offering opportunities for landlords and developers

■ TMT is one of the main economic sectors in Berlin, with 5,800 businesses registered in the city, employing about 83,000 workers and generating an annual turnover of €10bn.

■ Within TMT, there is a buzzing start up scene, which has been named among the top 20 hubs globally and is forecast to grow a further 5% by 2018.

■ One of the major obstacles so far has been the patchy funding infrastructure and the lack of venture capital, which is gradually improving.

■ Start ups have increased their take up from 22.2% in 2010 to 54.8% in 2012 within the TMT sector. They mainly cluster around northern Mitte, Prenzlauer Berg and northern Kreuzberg, and pay on average €142 per sq m/year with lease length at 3.1 years.

■ Landlords and developers are to benefit from this increasing demand if they acknowledge the specific requirements of young TMT businesses. They are looking for small scale but central accomodation with a high technology fit out and flexible lease terms.

"Berlin is a growing start up hub with a wide range of options for developing the kind of space occupiers are looking for, and could significantly compete on pricing with more established hubs ." Julia Maurer, Savills Research

Since the 1990s Berlin has been developing as a diverse and vibrant hub for innovation and creativity. Together with a relatively low cost of living, this has attracted a young, well-educated, and increasingly international community, interested in new ideas and new technology.

The TMT (technology, media, telecommunications) sector was able to become one of the main clusters in the economic mix of Berlin. Boosted by new technological developments over the past years, there are now 5,800 TMT businesses registered in the city, employing about 83,000 workers and generating a turnover of €10bn each year (Graph 1).

This note will look at the financial and property related conditions of the cluster to assess if Berlin could follow London's example of becoming an international hotspot for TMT, with the potential to drive the office market.

The Berlin tech start up scene

Start ups are defined by the German association for start ups as businesses which are less than ten years old, and are characterised by a distinct growth in number of employees, turnover or customers as well as a high level of innovation.

Within the Berlin TMT sector a lively start up scene has developed over the past five years, which in a recent, widely regarded study by Telefonica, was named among the top 20 start up hubs globally. The exact number of start ups is difficult to determine as no public survey yet exists. A study by Hascore.com quotes a number of 285, the German association for start ups has 61 members in Berlin and the Silicon Allee blog counts100 Berlin start ups on its website. In comparison, the London TechCity organisation has 1,250 start ups on its map.

Berlin start ups specialise in internet technology, social media, gaming and mobile applications. They have largely focussed on targeting the general consumer but a recent shift towards more B2B has been noted.

The start up scene cannot yet compete with more established ecosystems like the Silicon Valley as it is simply too young in age. The Telefonica ranking acknowledges the ambition, educational standard and high technology adoption of Berlin tech entrepreneurs, but cites the prevalent funding gap and generally patchy support infrastructure to be the main obstacles for why the city has not yet lived up to the hype around it. On the other hand, London, which is the leading European hub offers much better funding and support conditions, including geographic closeness to both clients and investors and a more flexible tax system.

Finance and the start up lifecycle

In this first phase of the lifecycle, start ups depend on seed capital (up to about €1m). According to the German startup monitor, the most important sources of seed funding are family/friends (77%), public funding (50%) and business angels (46%). Generally speaking, the public authorities are supporting individual businesses via several funding programmes (e.g. EXIST, German Silicon Valley Accelerator) but there has not been any major policy initiative comparable to the TechCity campaign in London which has an annual budget of £1.7m.

One successful funding scheme, though, is the High Tech Founder Fund, created in 2005 by public and private investors including the German ministry for economic affairs and Bosch, which offers €500,000 in seed funding to young tech companies. The fund currently holds a portfolio of 254 companies and in the past has helped the likes of 6Wunderkinder and TradeMob in the seed financing stage. An important source of private funding at this stage are business angels who provide capital usually in exchange for convertible debt or ownership equity. Among these are, for example, the SoundCloud founders and Amen CEO. After the seeding phase, and in particular for start ups which require series A financing rounds of more than €1m, venture capital (VC) becomes essential. The concept of VC is relatively alien to German investors which is one of the reasons why this funding stage is not well covered in Berlin. Although Berlin attracts the highest amount of VC in Germany and the total volume received has quadrupled over the past three years, from €34.2m in 2009 to €133.3m in 2012, 70% of start ups have claimed that they still find it difficult to obtain VC.

Case study: start-up

Edition Lingerie

Edition lingerie is an ecommerce start up still in the early stages of the business cycle. It was founded by an US-German/French entrepreneur duo who met and developed the first business plan when studying for an MBA course in New York. With initial seed funding coming from family/friends, they decided to develop their start up in Berlin, attracted by the city’s relatively cheap office and housing costs and lower competition for resources than in bigger tech hubs such as New York or London. The size of Germany's domestic market as well as the stability of its economy were also important pull factors. They came to Berlin in September 2012, starting up in a friend’s office loft in Kreuzberg. They found their current office (approx. 50 sq m, rent €1000/month, three year contract) near Rosenthaler Platz in Mitte by using online property website immoscout, subleasing from another entrepreneur who had moved to Asia before the original lease had expired. It took them about two months to find this space, longer than expected as office rents and occupational costs were higher than they had thought. The sublease was a rare opportunity considering the quality of space and it being in their idela location. They started their business with two employees, having now grown to five and are looking to hire again, in accordance with their growth plans.

Most of the venture capitalists are still foreign (US, British) with only a handful being actually present in Berlin. According to the Startup Monitor, over half of the start ups in Berlin (54%) which received VC have had foreign investors.
Berlin/Germany also lag behind the Anglo-Saxon tech hubs in the volume of series A financing rounds, which are only about a third of the US ones

GRAPH 1

TMT sector in Berlin

Graph source: Oxford Economics/*forecast

($0.9m vs. $7.1m in the US and $2.6m in the UK). According to the Telefonica study, Berlin start ups raise 80% less capital in all stages than their counterparts in the Silicon Valley, with a specific funding gap before and after market fit.

The capital supply demand gap has implications for the ability to create big exits (i.e. the purchase of a start up by another company), which are essential for reaching the later stages in the business cycle where companies are able to create most employment. On the other hand, exits also create business angels which then help to launch more start ups. Berlin also has not seen any technology IPO since 2006 although according to Index Ventures, there should be six tech companies in Germany ready to list, including Berlin based Wooga. This compares to ten companies ready to list in the UK, and three tech IPOs counted in London in 2012.

However, there are also positive signs indicating a catch-up process: according to a recent study on subsequent financing rounds for start ups in the first half of 2013 (by DFJ Esprit and Go4Venture), London remains the number one in terms of total funding raised, but France (28) has actually overtaken the UK (25) when looking at the number of investments >$5m, and Germany is closely following up (18).

Property and the start up lifecycle

The majority of entrepreneurs will start their business in a low-cost office environment, such as a university, a privately funded incubator, or a shared working space.

Incubators provide start ups with inexpensive office space during the initital growth phase. There are a couple of privately funded incubators in Berlin, which other than co-working spaces also offer an additional, extensive training programme. This normally includes a capital injection (e.g. start-up bootcamp: €15,000), a specific, experienced tutor, and contacts to investors. Examples include Startupbootcamp backed by Mercedes Benz, Bosch and HDI, Immobilienscout's incubator You Is Now and Deutsche Telekom's Hubraum (see box). More recently, Microsoft joined the club with plans to open its venture accelerator programme in Berlin this September. Co-working projects offer workspaces for rent, on a daily/weekly/monthly basis. Berlin offers about 48 co-working spaces where desks start at €100 per month.

Start-ups only enter the commercial office market when they generate the necessary income or investment capital to pay rents and guarantees associated with leasing a commercial office unit. Indeed, as the start up scene has grown in Berlin, they also have become more visible on the leasing market with their share of all TMT take up increasing from 22.2% in 2010 to 54.8% in 2012. In comparison, the whole sector accounted for 18% of total take-up in 2012.

Leasing transactions from that period show these businesses want to cluster around the existing TMT axes, around the Rosenthaler Platz and northern Mitte district, northern Kreuzberg and Prenzlauer Berg (Graph 2) which matches the registrations of new tech businesses in the same period (Mitte 23%, Friedrichshain-Kreuzberg 17%, Pankow/Prenzlauer Berg 13%). Compared to more established TMT businesses they take about 18% less space, and also pay lower rents. The average rent TMT businesses

Case study: Incubator

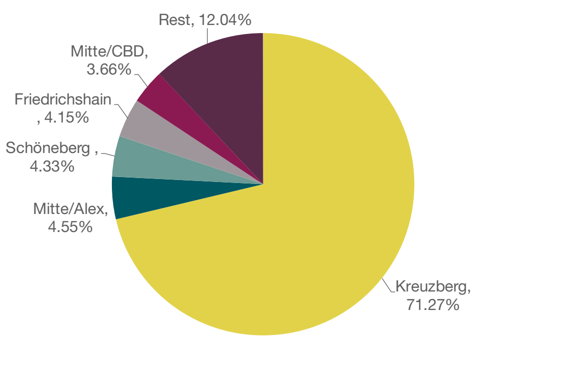
Hub:raum Berlin

The Deutsche Telekom funded hub:raum was launched in May 2012. Currently located in Deutsche Telekom's offices, they are due to move to their own, 7,000 sq m space in Schöneberg this October. Hub:raum, a seed stage initiative, offers an accelerator and incubator programme to currently six teams of start ups which are part of the Berlin cluster for consumer and software technologies. The start ups are each assigned an investment manager and receive training in marketing and programme management. They usually stay for about 9-12 months before building and launching their product. Normally they start with teams of 3-5 which over the course of the programme grow to teams of 8-10. 70% of the start ups which apply for the programme are from Berlin, although they usually are composed of international teams. Over the past 12 months about 100 start ups have applied.

Deutsche Telekom‘s motivation behind the initiative is to open up the innovation process to external sources, expecting a transfer of know-how, scouting partnering and at a later stage the joint development of new technologies. In additional they also hold shares in the participating start ups. For the start ups the major benefits lie in getting access to Deutsche Telekom's customers, as well as a general marketing boost. According to Hub:raum's assesment, once the start ups finish the accelerator programme they can find it difficult to find office space outside this more protected environment with a 1 out of 10 success rate. Essential for future success is the ability to access VC, which in the majority of cases comes from overseas, mostly US and UK investors. In their experience, the start-ups usually relocate to the US, or at least open an office there, if the capital is American.

GRAPH 2

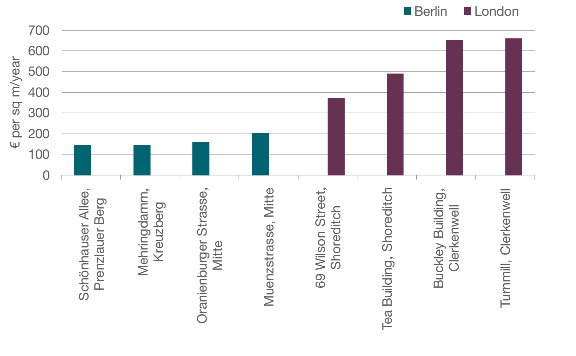
TMT take up by location in Berlin



Graph source: Savills

GRAPH 3

Top TMT rents Berlin vs. London



Graph source: Savills

paid in H1 2013 was €156 per sq m/year, while start ups pay about €142 per sq m/year. Costs in Berlin - even in very central locations - are therefore considerably cheaper than in equivalent London locations (e.g. Shoreditch, Clerkenwell) (Graph 3).

Start ups usually find it difficult to commit to longer lease terms given the financial insecurity during the initial growth phase. The lease terms for Berlin tech start ups shows that on average they have signed leasing contracts for 3.1 years, compared to 3.5 years for established TMT businesses and a five year typical lease length in Berlin.

Will Berlin follow London?

Given the increasing demand from tech companies for suitable office space, boosted by the 70,000 sq m letting to online retailer Zalando in 2012, office developers are becoming increasingly aware of this potential client group.

S+P Real Estate, backed by Berlin based seed investor JMES Investments, opened the "Factory" earlier this year, a 12,000 sq m tech hub located at the intersection of Mitte and Prenzlauer Berg. The tenants include some of the stars of the Berlin scene, SoundCloud and 6Wunderkinder, but also global business Mozilla. A similar project aimed specifically at tech companies is a converted former cigarette factory in Prenzlauer Berg. The rents here are above the Berlin average at €180 per sq m/year, but 80% of the 6,000 sq m office space were pre-let.

The comparison with London as the more mature hub shows what could lie further ahead: TMT start ups there have been clustering around the Silicon Roundabout in the north-eastern City fringe since the late 1990s, attracted by the introduction of the necessary bandwith and low rents. Together with a major government funding initiative, TechCity, this has been a huge success. Around 15,700 new tech businesses were created in this postcode area over the past year with TMT accounting for 22% of all London take-up in 2012 (158,000 sq m).

One of the first investors to capitalise on this trend was Derwent, with the conversion of the Tea Building, a former tea factory, into a hub for creative companies in 2003. Rents at that time started at €125 per sq m/year but have now reached a level of around €481 per sq m/year (+285%).

The presence of an abundance of young tech businesses has helped to transform this former secondary location into a submarket which now also attracts major players including PushButton. Apart from Derwent there are several other investors (e.g. Helical Bar, Resolution) which are either acquiring, or developing space with the intention of marketing it to TMT companies, backed by a continuous demand coming from the sector.

Outlook

TMT will become a staple source of demand

■ TMT in Berlin will continue to grow, with employment forecast to increase by 5% until 2018 (compared to a 0.1% decline in total employment).

■ Based on these employment figures, we estimate that the sector currently occupies 2m sq m (10%) of the office stock in Berlin, this is expected to increase by at least 5% (=100,000 sq m) over the next five years.

■ Also ecommerce which has seen sales rising by 66% over the past 5 years in Germany, will grow further, generating more demand for business space.

■ Improved funding conditions and governmental support (including higher R&D spending) will make it easier for young entrepreneurs to capitalise, and thus stay and develop their business in Berlin.

■ Over the medium term, the start up ecosystem will mature further and with it the requirements coming from the sector in the commercial leasing market, including the ability to pay higher rents. Landlords and developers will benefit from this if they acknowledge the specific property requirements that can be different to those of more traditional occupiers.

■ In accordance with the lifecycle, their space requirements are relatively small scale (only about 30% lease more than 1,000 sq m). However, they require flexible lease terms and a high technology fit out. While start ups want to take advantage of the lower property costs in Berlin, once they make it beyond the seeding phase they will seek good quality accomodation in central locations.

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