Briefing note
German real estate market: Four themes for 2014

Issue 1/2013

There are already a number of identifiable trends that will shape the German real estate market in 2014. Here, we summarise our expectations in four themes; namely rising office take-up, yield compression and wider investment market activity with a loss of momentum in the residential segment.

The initial scenario

In the briefing note, we look at identifiable trends for the German real estate market in 2014. Our outlook comprises four key themes, which are based upon the following financial and economic scenario:

- The global economy will grow at a moderate rate in 2014 and the European crisis nations will slowly return to economic growth.

- The stabilisation of the financial and economic environment will slowly diminish the risk aversion of investors in the eurozone. However, risk aversion remains still high in view of the persistent shortcomings (such as a lack of common financial policy) and the associated downside risk.

- The modest economic recovery combined with continued extremely high levels of sovereign debt will force the European Central Bank (ECB) to continue its accommodating monetary policy. Interest rates will remain correspondingly low and the flight to tangible assets will continue.

- Germany will remain the economic driving force of the eurozone with gross domestic product (GDP) growth of almost 2% next year. This growth will be around double that of the remainder of the eurozone.

We regard this as the most likely scenario at the present time. On that basis, the following four theses represent our assessment of how these developments will be reflected in the German real estate market.

Theme 1: Office take-up to increase – particularly in the second half year

The last two years can be most accurately described as a period of consolidation with regard to the major German office markets. Take-up has been in decline and rents have largely stagnated. This has been not least attributable to the weakness of the financial sector and the reticence of major occupiers faced with the challenging economic climate. However, with completion volumes falling by half as a result of highly restrictive development financing between 2009 and 2012, vacancy rates have continued to decline despite the below average take-up. Indeed, in view of the persistently high vacancy rates, this phase of extremely low completion figures was entirely salutary. However, it has resulted in a drastic shortage of high quality space

Conclusions in brief

Our four themes for 2014

■ Theme 1: Office take-up to increase
Driven by increasing economic activity, office take-up will exceed the previous year's figures in 2014.

■ Theme 2: Prime yields to tighten further
The low interest rate environment will ensure that players in the capital markets continue to shift funds into property from other asset classes. Due to the excess demand in the core segment, yields for prime assets will continue to fall.

■ Theme 3: The commercial investment market will maintain its tempo but sales of residential portfolios will decline
Lack of supply and of large portfolios in particular will negatively impact the transaction volume in the residential investment market. 2013 was the cyclical peak. In contrast, the commercial investment market will again approach a transaction volume of €30bn in 2014.

■ Theme 4: The gap between core and non-core will narrow – more so in terms of transaction volume than yields
Supply of and demand for non-core real estate will increase. Consequently, non-core assets will account for a higher proportion of the overall transaction volume in 2014. The willingness of investors to climb up the risk curve will lead to hardening yields in terms of non-core properties.

in central locations. Consequently, prime rents have risen to a 10-year high and large requirements in particular can still only be satisfied by new developments. While the completion volume in the top six markets is expected to reach approx. 1.15m sq m (2013: 1.04m sq m), with an assumed life cycle of 50 years for office properties and a resulting annual rate of depreciation of 2%, this is still too little even to maintain the existing level of office stock. To do so would require a completion volume of approx. 1.6m sq m per annum.

Thus, the supply side alone is expected to provide for a further modest increase in prime rents and a slight decline in vacancy rates in 2014. This will be supported by an increase in activity on the demand side with the anticipated rise in economic activity precipitating an increase in take-up. Graph 1 illustrates the close correlation. The rates of change of German gross domestic product and office take-up in the top six markets have behaved very similarly over the last 21 years (coefficient of determination = 0.58) and have moved almost in parallel over the last ten years (coefficient of determination = 0.73). It is interesting to note the divergence of the curves in the last two years. This is likely to have been caused by the negative economic development in the eurozone as well as the somewhat weak growth in the global economy. Both are important parameters for international corporate groups who, therefore, contributed a relatively lower proportion to overall take-up in the years 2012/13.

A similar trend could be observed in 2001/02 when the bursting of the dotcom bubble affected the major German office markets more than it did the German economy as a whole. For 2014, this initial situation means that, in the event of an economic recovery in the eurozone and more favourable development of the global economy, office take-up could rise more sharply than German GDP growth would suggest. With that in mind, we expect a double-digit increase in take-up. Since the office market lags the real economy by a few months, leasing activity should particularly increase in the second half of 2014.

Theme 2: Prime yields to tighten further

By the end of 2013, yields on prime assets had returned to their 2007 lows and were even lower in the case of prime high street properties. However, this yield compression is likely to continue in 2014. This is supported by a number of factors:

1. Not for the first time, with its latest key interest rate cut to 0.25%, the ECB has indicated that it will continue its accommodating monetary policy for as long as necessary. Indeed, in view of the slow pace of economic recovery in the peripheral European nations and continued high levels of sovereign debt, benchmark interest rates in the eurozone should remain at very low levels for several years. Thus, financial repression, whereby real returns in the money markets and on bonds regarded as secure are negative will become the "new norm". The longer this status quo persists, the more investors will shift towards assets offering an income yield greater than the rate of inflation. Against this background, property will come into investors' focus more than before.

2. The spread between long-term German government bonds and prime yields in the German property market is not only historically high, it is also higher than in most other countries (Graph 2). Although this figure should be interpreted with caution, since running yields are being compared with initial yields, many multi-asset investors use it as a decision-making tool in allocating their capital across the various asset classes. A (continued) shift in allocations from bonds to the real estate market is, therefore, highly probable. The core segment will particularly benefit from this shift since prime properties with long leases are most comparable with bonds.

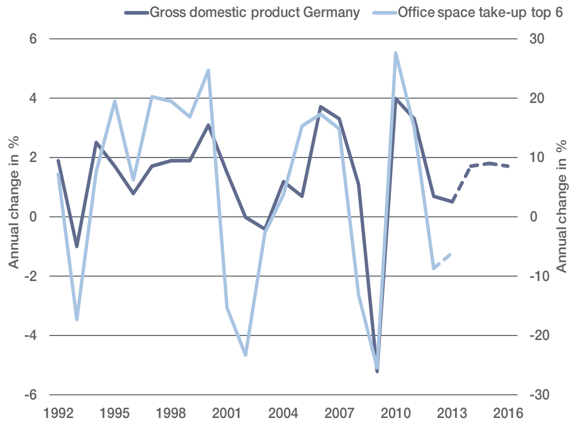
3. Although inflation is not an issue in the eurozone at present, in the medium to long term the extremely accommodating monetary policy of the ECB poses a considerable inflation risk. Therefore, particularly those capital investors with a longer time horizon are likely to prefer asset classes offering a certain level of protection against inflation. Core properties with long-term, indexed (!) leases fall into this category.

4. For many investors focused on core property assets, generating returns is not (or no longer) the dominant motive for investment. Particularly for private investors and other very defensive groups of investors (e.g. foundations), preservation of capital is the priority in the current capital market environment and income return is of less importance. Furthermore, foreign investors, such as those from Asia, are more accustomed to significantly lower yields both in their domestic markets and in their preferred European destination markets of London and Paris than those prevalent in Germany. Both groups of investors will therefore accept lower yields than the prime yields to date.

All four reasons stated are directly related to the capital markets and are particularly associated with the current low interest environment. In other words, the current low yields and another year of rising capital values are principally induced by interest rates and are not primarily attributable to expectations of rental growth. Core investors should be aware of this paradigm since prime yields will react very sensitively to interest rate changes, if rental growth expectations have not improved by then (theme 4).

GRAPH 1

Office space take-up and gross domestic product



Source: Statistisches Bundesamt, Focus Economics, Savills

Theme 3: The commercial investment market will maintain its tempo but transactions in the residential investment market will decline due to scarcity of supply

In terms of transaction volume, the German residential investment market reached its cyclical peak in 2013. There is one essential reason for a decline in sales going forward: a lack of supply, particularly in terms of large portfolios. In the last two years, large transactions (e.g. LBBW, TLG, DKB, GBW) have contributed significantly to overall volumes. Owing to lack of supply, transactions of this magnitude will be very scarce in future. Therefore, the transaction volume will decline year-on-year in 2014, although investor interest in German residential property will remain high.

The transaction volume in the commercial investment market is also limited on the supply side, particularly in the core segment. However, the lack of product should not be notably higher over the coming months than in recent times.

In the office segment, the completion volume will even increase slightly (theme 1), creating additional supply. The retail investment market is more focused on existing stock in any case and further rises in capital values in the prime segment (theme 2) could result in current owners being more inclined to sell. However, in view of the lack of alternative investment opportunities, this is not highly likely. Nevertheless, rising price levels will have the effect of increasing transaction volumes in the commercial investment market. While higher prices may reduce the pool of potential purchasers, the enormous surplus demand in the core segment will ensure that transactions take place. And since higher prices will be paid, the transaction volume will increase.

Transaction levels will also be buoyed by the low interest rate environment created by monetary policy, with increasing capital flows into the real estate market (theme 2) and increasing activity in the non-core segment (theme 4). Conversely, however, highly positive economic development could reduce transaction levels. If the nascent economic recovery in some of the peripheral eurozone countries proves stable, risk-averse investors for whom the eurozone has been principally limited to Paris and the top five German markets in recent years will once again expand their investment universe to markets such as Barcelona, Madrid and Milan. Germany would then receive a smaller slice of the cake. However, in this scenario, the cake would also increase in size since a potential break-up of the eurozone would be off the table and investors who have avoided the single currency area to date for fear of such a break-up would return.

The net effect of a smaller slice of a larger cake is likely to be moderately negative but at least counter-balanced by the factors mentioned that would have a positive effect on transactions. For that reason, an investment volume of approx. €30bn is likely to be achieved in the commercial property market in 2014.

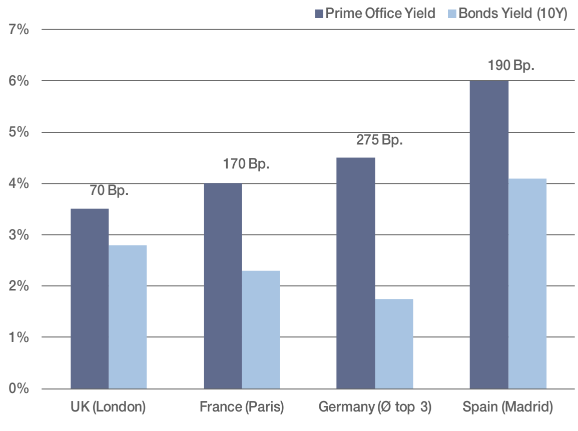
Theme 4: The gap between core and non-core will narrow – more so in terms of transaction volume than yields

As explained in the previous theme, (German) core property will continue to come into the focus of investors next year. However, in view of the lack of appropriate supply, a notable increase in the transaction volume in this market segment is extremely unlikely. This is in contrast with the non-core segment, where both supply and demand should support an increase in the transaction volume. On the supply side, maturing loans and banks' increasing willingness to dispose of assets in particular should bring more products onto market. However, the greater impetus will come from the demand side, as higher capital values in the prime segment and short supply will lead even risk-averse investors to seek investment opportunities outside the pure core segment. By way of example, 45% of insurance companies surveyed in the Ernst & Young "Trend Barometer of Real Estate Assets of the Insurance Industry 2013" indicated that they were planning acquisitions in the value-added segment. Indeed, 18% were planning investments in the opportunistic segment. However, it is not only traditional core investors who are looking for alternative investments outside the core segment. Opportunistic investors from English-speaking countries are also expected to increase their acquisition volumes next year. The recent significant increase in investment in property loans is occupying the interest of these players in European real estate. However, there is also several billion euros available for direct investment. Private equity funds listed in euros with a value-added or opportunistic investment approach account for a target volume of more than €7bn alone. This will particularly result in a rise in portfolio transactions. A number of larger retail portfolios are likely to change hands in the coming months and office portfolios are also likely to increasingly come into the focus of investors.

Both traditional core purchasers and opportunistic investors are therefore likely to be more active outside of the core segment and will ensure that non-core assets account for a larger proportion of the transaction volume. A stronger orientation towards non-core properties even makes sense for risk-averse investors in view of the now very high risk premiums on non-core assets – or in other words the very high safety margins on core property (Graph 3). Even core investments are not without risk and the lower the initial yield, the greater the probability that yields will be higher upon disposal. In order for a property not not lose value owing to market forces in such a scenario, the yield increase must be

GRAPH 2

Spreads between office prime yields and government bonds yields



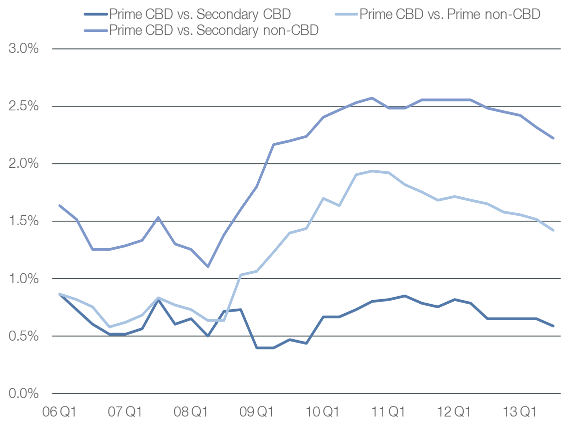
Source: ThomsonReuters, Savills

counter-balanced by corresponding rental growth. In addition, there is the long-term risk of interest rate rises and associated yield increases in the bond market. In the event of such a turnaround in interest rates, the yields on core property, which investors often regard as an alternative to bonds, would react particularly sensitively. Faced with such "collective risks", investors must ask themselves whether non-core property, despite its higher individual asset risk, actually has a lower overall risk or at least a more attractive risk-return ratio.

Whether risk premiums for non-core assets reduce significantly against this background remains to be seen. In view of increasing demand, yields will certainly compress. However, with significantly higher financing costs for non-core assets compared with the previous boom and continued high levels of risk aversion, the extent of this is likely to be very limited. For investors, this makes it worthwhile to pursue 'manage-to-core' strategies, whereas an investment approach targeting further yield compression between core and non-core property is speculative in character.

GRAPH 3

Risk premiums on prime CBD office



Source: Savills

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