Market report
Germany residential portfolio market

H1 2013

Summary

Residential portfolio market at a glance

■ High demand for residential portfolios continued in the first half of 2013. Investment totalled €5.66bn; a similar volume to that in the corresponding period last year (-0.7%).

■ The number of units transacted fell by 18% to around 89,000, with just one transaction of more than 20,000 units in the GBW deal.

■ The market did become on the whole wider, however, with the total number of transactions rising by 40% to 89.

■ Berlin continues to top the list of most popular investment locations. The German capital accounted for some 13% of all units transacted. Munich and Dortmund were some way behind, each accounting for 7%, followed by Duisburg (5%) and Düsseldorf (3%).

■ With a number of larger portfolios of over €100m still being marketed, the €10bn mark would appear realistic for the year as a whole. Transaction volumes should also remain above average in the long term.

"Since alternative types of investment are still rare residential properties in Germany remain on top of many investors' wishlists." Draženko Grahovac, Savills Corporate Finance - Valuation

Real economy and financial environment

German economy weakens in H1 - greater activity expected in H2

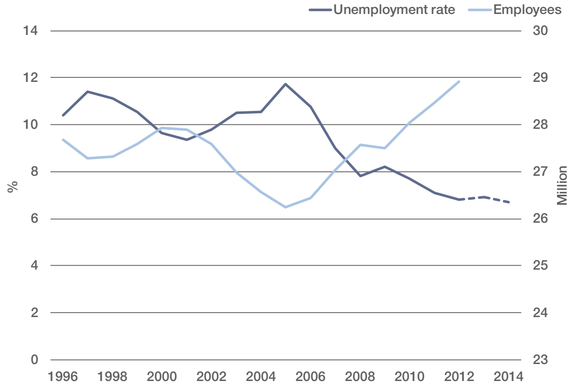
The longer the eurozone crisis persists, the more Germany proves itself an economic linchpin of the single currency. While the eurozone remained in recession during the first half of the year, the German economy returned to growth during the first two quarters of 2013 following a setback in the final quarter of 2012. However, upon closer inspection, it is clear that Germany cannot continue to escape the downward trend in the eurozone, particularly in view of the lack of noteworthy stimulus in the global economy thus far to compensate for European challenges. While the German economy grew during the first half of the year, the growth was modest. Economic output in the first quarter increased by a mere 0.1% on the previous quarter. Although figures for the second quarter are not yet available, several indicators point to the growth being only marginally higher than in the first three months of the year. This would once again mean significantly weaker growth than anticipated during the first half of the year. Besides the challenging economic environment in Europe and the rest of the world, this is primarily attributable to two factors. Unusually low temperatures in the first quarter particularly impacted construction, retail and hospitality, preventing higher growth figures. At the end of the second quarter, large parts of eastern and southern Germany were covered by floods, which also affected local businesses. However, in both cases, the expected recovery effects should provide impetus to the economy in the second half of the year.

Employment in Germany remains largely unaffected by the weakening economy. The unemployment rate remains stable at 6.8%; almost half that in the eurozone, where unemployment rose to 12.2% in April to set a new record. Private consumption remains an important pillar of the economy this year. The positive employment situation and marked salary increases prompted the GfK Consumer Confidence Index to reach 6.5 points; its highest level since 2007.

Other components of GDP (net exports, investment and government expenditure) that contracted overall in the first half of the year showed recent improvements and should gain further momentum in the second half of the year. This is supported by the ifo Index and, in particular, the sub-indicator for future expectations of companies. The Business Climate Index rose by 0.2 to 105.9 points in June while the Business Expectations Index gained by 0.9 points. Such figures provide justified reason to hope that companies will expand their investment activities in the months ahead. Businesses have been rather reluctant in their actions to date against a backdrop of high uncertainty with regard to the economic outlook for Europe and other world regions.

GRAPH 1

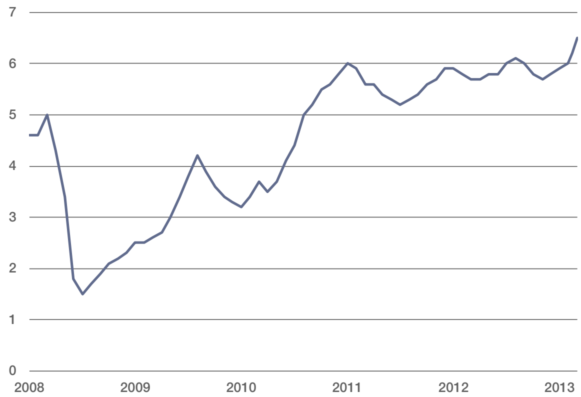
Labour market Not a bit of weakening growth



Source: Bundesagentur für Arbeit, Focus Economics

GRAPH 2

Consumer climate Wage increases stimulate domestic economic activity



Source: GfK

TABLE 1

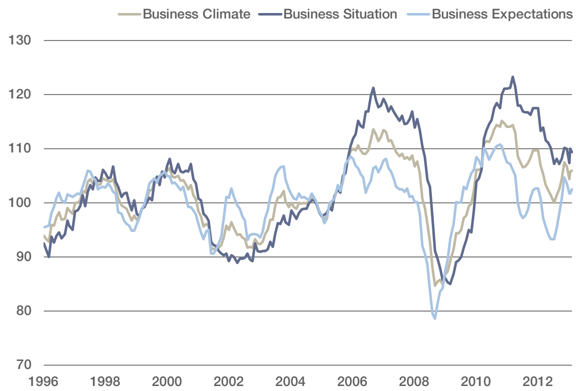
Macro-economic key figures at a glance* Significant brightening in 2014 expected

Figure (y-o-y change in %)	2013	2014	2015	2016	Ø 08-12
Gross domestic product	0.5	1.6	1.7	1.7	0.8
Private consumption	0.7	1.1	1.3	1.3	0.9
Industrial production	-0.4	2.4	2.0	2.0	0.2
Consumer prices	1.6	1.9	2.0	2.0	1.7
Exports	2.1	4.8	5.1	5.0	3.1
Imports	2.5	5.3	5.4	5.3	3.2

Source: Statistisches Bundesamt, Focus Economics / * 2013-16 forecast values

GRAPH 3

Business climate Future expectations became far more optimistic recently



Source: cesifo

The expected rise in global economic activity should produce an increase in exports. However, this will be insufficient to create noteworthy overall economic growth this year. The current consensus forecast is +0.5%, and this is more likely to be revised downwards rather than upwards in the months ahead. Nevertheless, the medium-term outlook for the German economy remains good.

USA hints at interest rate turnaround - consequences felt in eurozone

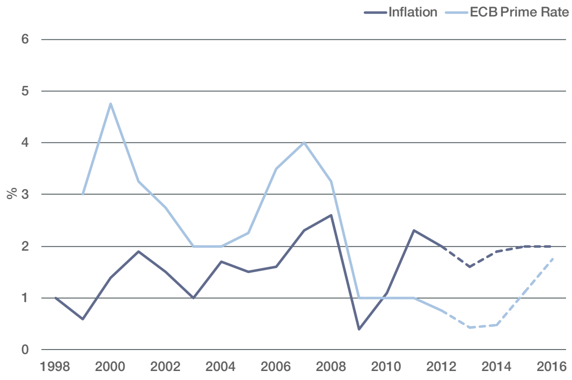
The weak economic activity in Germany and particularly in the remainder of the eurozone also has a positive flipside. Despite the historically low interest rates, which have now persisted for several years (the ECB lowered its key interest rate in May by a further 25 basis points to 0.5% and reserved itself the right to take further interest rate action), the inflation rate in the eurozone has only briefly risen significantly above the 2% mark and has been back below this level since the start of the year. The (hyper)inflation and associated massive devaluation of private savings feared by some as a consequence of the extremely expansive global financial policy is not, therefore, expected to materialise. Even in Germany, where the relatively sound economic performance has been most likely to produce above average inflation rates, inflation has recently remained below 2% and will remain there for the next three years according to current forecasts. This gives the ECB scope to hold interest rates at their low levels and even to reduce them further, where necessary, in order to stimulate investment activity in the eurozone and, above all, to maintain interest charges for those nations with excessive debt at manageable levels.

However, it is unlikely that such countries have much longer to bring their debts under control and, ideally, to convince investors via structural reforms that their solvency is guaranteed for the long term. For it appears that bond yields have bottomed out. The recent upward shift was prompted by the US Federal Reserve and their increasingly clear hints that they will soon taper their bond purchasing programme against a backdrop of economic recovery in the USA. While an interest rate hike may still be some way in the future, these announcements can be regarded as a departure from their ultra-loose economic policy. Consequently, yields rose on both US treasuries and government bonds of other nations. Yields on 10-year bunds, for example, rose by 50 basis points over the last two months, recently reaching their highest levels for more than a year at approx. 1.75%. While such developments may be largely unproblematic for Germany, their consequences are somewhat more serious for the peripheral nations. Bond yields in these countries rose more sharply, with those in Spain recently reaching approx. 4.9%. This is detrimental to refinancing conditions for these nations and makes it more difficult for them to reduce their debt burden to tolerable levels.

Further moderate increases in bond yields, and hence declining prices, are also expected over the coming months. Together with the continued very low yields on bonds of creditworthy issuers, despite the recent increases, this creates an extremely unfavourable environment for investors. In the bond market, they are presented with a choice between purchasing securities with a low risk of default but a very low yield in return, or accepting a significantly higher risk of default. In either eventuality, they must also expect prices to fall. Faced with this dilemma, investors will divert even more capital than before to other asset classes and a portion of this "diverted" demand will find its way into the property market. Property in Germany in particular will continue to enjoy high demand in view of Germany's relatively sound fundamental economic data compared with most other European nations as well as its manageable levels of public debt.

GRAPH 4

ECB prime rate and inflation No significant price increases ahead



Source: Statistisches Bundesamt, Deutsche Bundesbank, Focus Economics

Outlook

Continued financial repression?

At the beginning of July, Mario Draghi, President of the European Central Bank, announced that the ECB would continue its loose or, in ECB-speak, "accommodating" monetary policy for as long as necessary. At the same time, he expressed the expectations of the ECB Governing Council that its key interest rate would remain at its current level, or even lower, for a long time. In view of economic developments in peripheral eurozone countries, it can be assumed that "a long time" could easily mean several years. The objective of these measures is clear. The low interest rates should stimulate lending and, thus, the economy in eurozone countries, while keeping bond yields at low levels so that servicing of national debt remains manageable for countries in the single currency. At the same time, moderate rates of inflation should serve to devalue sovereign debt burdens.

Whether the ECB's strategy is working will only be able to be properly assessed in a few years time. However, it is beyond doubt that this financial repression means investment options that at least promise to preserve capital for investors remain rare. In such a climate, real assets are among the best performers. This has already been observed in the equity and real estate markets in recent years and it can be assumed that above average levels of capital will continue to flow into these asset classes going forward.

Residential portfolio market

Continued strong demand for German residential property

The rally in the German residential property market continues against the backdrop of continued low prevailing interest rates and low achievable yields in the bond markets. Residential portfolio transactions in the first half of 2013 totalled €5.66bn; a similarly high level to that achieved in the first half of last year.

Fewer "big tickets" – but more deals

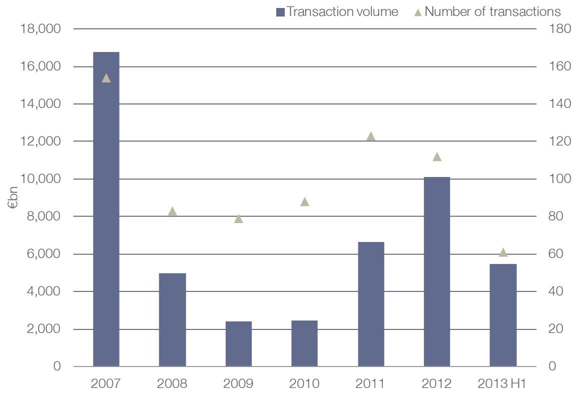
The market in recent months has been broader than in the first half of 2012, when volumes were largely dominated by four major deals, each for more than 10,000 residential units. There was just one transaction in the order of over 10,000 units in the disposal of the GBW portfolio. Overall, however, the number of residential portfolio deals rose by 40% to 89. The number of sales in the segment for portfolios of more than 1,000 units almost doubled, with 16 completions in the last six months compared with nine transactions in the first half of 2012. Conversely, the number of units transacted fell by some 18% to just over 89,000 following a shift from a small number of large deals to more small deals. As a result, the average transaction size was also lower. At just over 1,000 units, this was some 40% smaller than in the first half of last year.

Berlin remains the most popular investment location

Berlin remained the most popular investment location in the first six months of 2013, continuing the trend of recent years. More than 17,500 residential units changed hands in portfolio deals in the capital, accounting for 13% of all residential units transacted in Germany. With initial yields in Berlin scarcely any different from those in the other A cities (with the exception of Munich), the run of investors into Berlin residential property is largely predicated on expectations of further above-average rental growth. Indeed, the average residential rent in the capital has risen by 19% over the last three years; more than in Hamburg (10%) and Munich (6%). However, it is also clear that this catch-up process will complete at some point, and before Berlin's rental levels reach those of the other two cities since income levels in the capital are significantly lower. Consequently, many investors are already shifting their focus to other cities, with Munich (approx. 9,500 units), Dortmund (approx. 9,000) and Duisburg (approx. 6,500) among the top investment locations in the first half of the year.

GRAPH 5

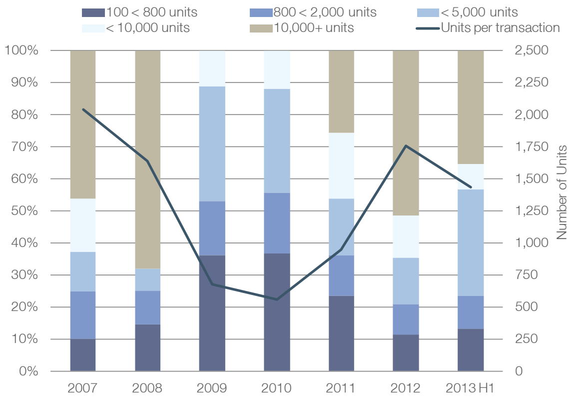
Transaction volume and number of deals* Last year's volume achievable



Source: Savills / * portfolios with at least 100 units each

GRAPH 6

Size of portfolios transacted* Portfolio size decreases for the first time since 2009



Source: Savills / * portfolios with at least 100 units each

TABLE 2

Largest transactions in H1 2013 at a glance Contrary to H1 2012 only one "big ticket" comprising more than 10,000 units

Portfolio name	Number of units	Volume*	Purchaser	Vendor
GBW	ca. 31,000	€2,367m	Patrizia led consortium	BayernLB
Berlin	ca. 6,900	€369m	Deutsche Wohnen	Blackstone
NRW	ca. 3,700	€250m	Corestate	DKB
Duisburg	ca. 4,290	€210m	Adler	Immeo
Rhine-Main, Berlin, Munich, Hamburg	1,923	€200m	DeWAG	German insurance company

Source: Savills / * purchase price or estimated value

"Private-equity funds in particular take advantage of the high level of prices and the considerable demand to realise disposals." Matthias Pink, Savills Research

Rise in number of developments sold

The high demand over several years both in the rental market and from investors has significantly stimulated developer activity. This has resulted in a steep rise in the number of developments and, in turn, an increase in development sales. Developers raised some €450m from 13 disposals in the first half of the year. This compares with just three forward sales of developments to end investors in the corresponding period last year with a combined volume of some €115m.

High price levels favour domestic purchasers

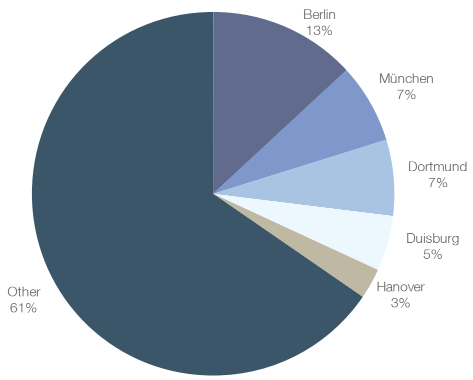
The higher proportion of development transactions also contributed to a further increase in prices. The average price paid for a residential unit in the first half of 2013 stood at €63,400; a fifth higher than in the corresponding period last year. This represents a five-year high, favouring equity-rich purchasers and those with access to low-cost finance when it comes to bidding processes. Since this primarily applies to German investors, domestic purchasers significantly dominated market activity in the first half of the year. Domestic investors accounted for more than 80% of the transaction volume compared with 72% in the corresponding period last year and 77% for the whole of 2012. Foreign investors who acquired residential portfolios in the last six months came almost exclusively from other European countries. Swiss investors alone accounted for 8% of the transaction volume, driven by a number of large acquisitions by Corestate AG. Other European purchasers came from Austria, Luxembourg, Italy and Sweden among other nations. Overall, European investors accounted for 16% of the transaction volume, equating to more than €900m. This represents a significant increase compared with the corresponding period last year, when the rest of Europe accounted for 10% or just below €600m. This trend underlines that Germany continues to be seen as a safe haven for investment in the eurozone and that investors are purposefully adding a "German allocation" to their portfolios. In contrast with last year, investors from North America did not appear on the purchaser side in the last six months. Instead, the more opportunistic American investors took advantage of the increased price levels to make disposals, selling residential portfolios for a combined total of approx. €370m in the first half of the year.

Equity-rich investors dominate on the purchaser side

The geographical composition of investors was also mirrored in the structure of purchaser and vendor types. Insurance companies, pension funds and property companies were by far the largest net purchasers in the first half of 2013. These groups of purchasers accounted for a net investment in German residential portfolios of just under €900m. However, insurance companies and pension funds invested not only directly in property but also via open-ended special funds. Their net investment volume over the last six months totalled almost €450m. All of these investors benefit from large equity reserves and access to low-cost financing, meaning that they were and are in a position to pay very high prices. Private-equity investors took advantage of the high demand from such investors and the generally favourable market conditions to make disposals. After banks and developers, these were the third largest net vendors with a volume of just under €300m. The high sales volume from banks is almost exclusively attributable to the largest deal of the first half of the year; the disposal of GBW, which was owned by Bayerische Landesbank. The net sales volume from developers totalled almost €450m.

GRAPH 7

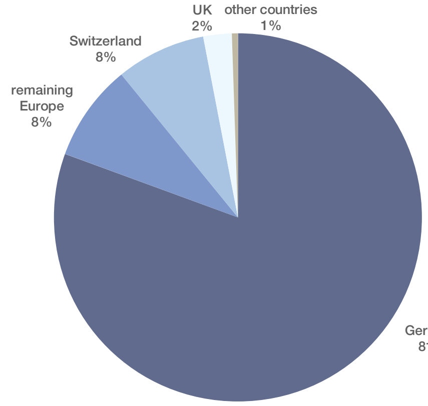
Transacted units by location Berlin remains on top



Source: Savills

GRAPH 8

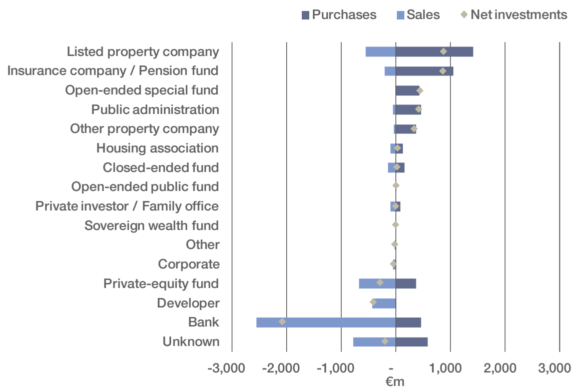
Transaction volume by origin of buyer Domestic buyers dominate



Source: Savills

GRAPH 9

Transaction volume by type of investor Insurance companies are very active



Source: Savills

Public sector disposals increase market liquidity

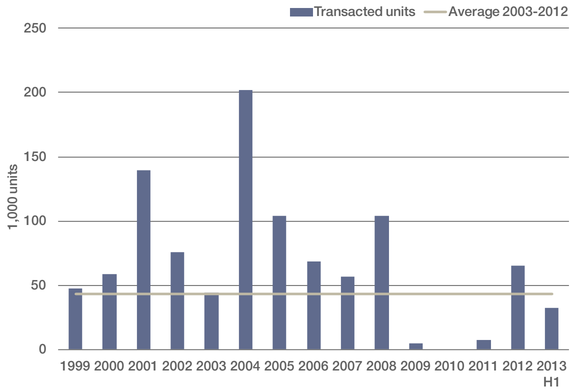
Analysis of the vendor structure reveals another important factor. For the first time since 2008, there have been significant disposals by the public sector over the last 18 months. Portfolio sales by LBBW, DKB and TLG saw more than 60,000 residential units pass from public to private ownership in 2012. The GBW disposal added more than 30,000 units to this tally in the first half of 2013. Such disposals, therefore, represented a significant portion of market activity, just as they did in the years up to 2008. This transfer of residential portfolios from the public sector to private ownership also means that the units concerned will now be transacted regularly going forward. This will increase liquidity in the German residential market and, consequently, potential transaction volumes in the coming years.

Outlook - €10bn ahead

With private-equity funds also preparing numerous disposals, the transaction volume in the German residential portfolio market should remain high both in this year and the coming years. The rally is currently expected to continue in the second half of 2013, making the €10bn mark realistically achievable in terms of sales.

GRAPH 10

Public sector disposals Sales activity is increasing again



Source: BBSR, Savills

Latest news: Rental cap

...and the consequences for the residential investment

The debate surrounding more restrictive regulation of residential rental increases during the German parliamentary election campaign has recently intensified further. All major parties, with the exception of the FDP, are in favour of amending rental laws in one form or another to place greater restrictions on rental increases for existing tenants. There is also a desire for the measures to cover new tenancy agreements. It is self-evident that such moves would impact the yield calculations of residential investors. Some investors are likely to act with restraint for the time being until there is clarity regarding the precise structure of the anticipated regulatory conditions. This will have a corresponding dampening effect on the transaction volume.

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