

Market report Germany residential portfolio market

H1 2012



Summary

Residential portfolio market at a glance

■ The transaction volume for residential portfolios amounted to approximately €6.13bn in the first half of 2012. This represents an increase of 75 % compared with the same period last year and already exceeds the total volumes for the years 2008 to 2011.

■ While the number of units transacted has doubled, the number of transactions has reduced by a third. These opposing trends reflect the fact that the market has been dominated by four large transactions.

■ Berlin continues to top the list of most popular investment locations. The German capital accounts for around a fifth of all units transacted. Next in line, and by some margin, are Gera and Stuttgart (6% each), Erfurt (5%) and Hamburg (4%).

■ The transaction volume in the second half of the year is unlikely to match that of the first six months. However, if some of the pending large transactions can be completed this year, the €10bn mark can still be reached.

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 "The very high demand for German residential property will create a 5-year high in transaction volumes this year." Karsten Nemecek, Savills Corporate Finance - Valuation

Real economy: Healthy but with significant downside risk

Making an accurate assessment of the state of the German national economy is certainly no easy task at the moment. On the one hand, a glance at the macro-economic fundamentals provides every reason for optimism. On the other hand, events concerning the future of the eurozone hold tremendous risks, particularly for the German economy.

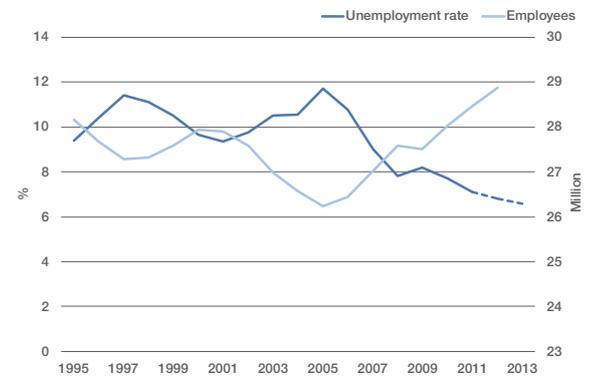
The start to 2012 appeared highly promising with gross domestic product growth of 0.5% in the first quarter. Since then, however, economic activity has noticeably declined, meaning that lower growth rates are anticipated for the subsequent three quarters. Nevertheless, the German economy remains in good health. Employment has reached an all-time high with almost 29 million employees subject to social insurance contributions while the unemployment rate currently stands at its lowest in decades at 6.6%. In addition, significant increases in some wages and salaries mean that a large proportion of the German population is enjoying higher income.

With positive reports from the labour market supporting domestic consumption, the sentiment among German consumers is also as good as it hasn't been for a long time. The monthly Consumer Confidence Index calculated by market research company GfK has now been above the five-point mark for almost two

years. This positive sentiment is also appreciably reflected in the composition of the gross domestic product. An increase in private consumer spending of 1% is anticipated for the current year. Thus, consumption will contribute markedly towards GDP growth, as it did last year, which is quite remarkable in export-dominated Germany.

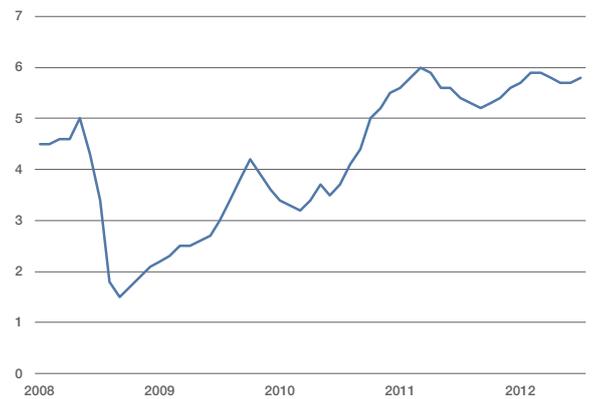
However, a closer look at the most recent data reveals that both sentiment and real economic trends may have already peaked. Unemployment declined only negligibly and less strongly than expected in June while recent consumer sentiment has seen only marginal improvement and the business climate has remained continually cloudy for more than a year - interrupted only by a ridge of high pressure in spring. The business expectations of companies determined by the Ifo Institute have since fallen below the important 100-point mark and point towards a deterioration in economic conditions in Germany. This picture is underlined by recent decreases in industrial production as well as a slowdown in export performance. Against this background, it comes as little surprise that the gross domestic product forecasts for the current year published by banks and economic research institutes have been increasingly revised downwards in recent weeks. According to the consensus forecast from July, the German economy will grow by 0.8% this year. In view of the expected growth rates of other national

GRAPH 1 **Labour market** Employment reaches historic high



Source: Bundesagentur für Arbeit, Focus Economics

GRAPH 2 **Consumer climate** Customers are rather optimistic



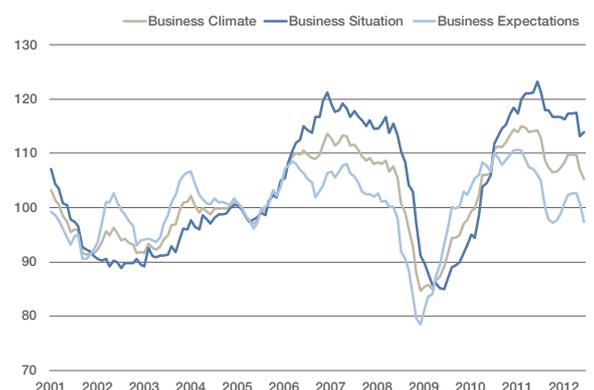
Source: GfK

TABLE 1 **Forecast of macro-economic key figures**
Consumption promotes the economic growth

Figure (y-o-y change in %)	2012	2013	2014	2015	Ø 07-11
Gross domestic product	0.8	1.4	1.5	1.6	1.2
Private consumption	1.0	1.3	1.2	1.3	0.5
Industrial production	0.6	3.0	4.1	3.8	1.7
Consumer prices	2.1	1.8	1.9	1.9	1.7
Exports	2.8	4.6	5.1	5.4	3.8
Imports	2.9	5.3	5.5	5.4	3.7

Source: Statistisches Bundesamt, Focus Economics

GRAPH 3 **Business climate** Enterprises become more sceptical



Source: cesifo

economies in Europe, this is quite solid. However, it equates to just 50% of the growth rate forecast at the same point last year.

Financial environment: Source of downside risk

The negative momentum is not least attributable to the euro crisis, which has now dominated the financial markets for more than two years. While the problem was originally confined to Greece, a number of eurozone countries are now in difficulties and dependent on financial assistance from the economically strong member states of the single currency area. Germany is playing a central role in this scenario and the problems in the eurozone and associated rescue measures are negatively impacting the German economy in two principal ways.

Firstly, the German government has already provided, or promised in the form of guarantees, several hundred billion euros via the EFSF bailout fund and ESM stability mechanism. This money is, therefore, no longer available for domestic investment, which also reduces the likelihood of reductions in taxes and social security contributions originally intended by the parties in power in order to relieve the burden on individuals. Recent debates have even seen calls for tax increases from some politicians in opposition.

Secondly, the problems are long since no longer confined to the national budgets of the states in crisis. They have now caused substantial consequences for the real economy, which are particularly affecting Germany. Discounting Germany, economic performance in the single currency area is expected to contract this year as well as next year. For Germany, this means a decrease in exports to partner nations. Since the eurozone accounts for some 40% of German exports, this deterioration has a significant weighting, and correspondingly negative consequences, on economic growth.

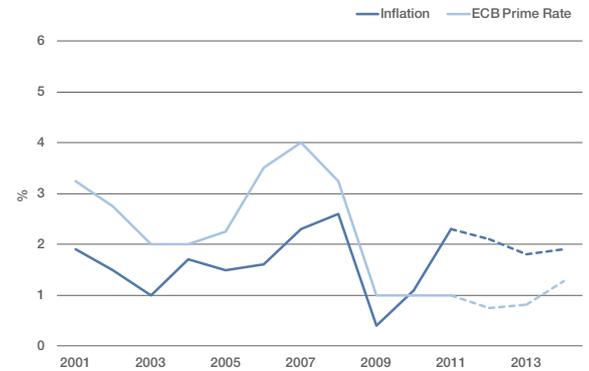
Besides Germany, the European Central Bank is one of the key figures in resolving the euro crisis. In recent months, it has agreed a range of measures to appease players in the financial markets and to relieve the burden on states in crisis. One such

measure has seen the ECB lend banks in the eurozone a total of over a trillion euros for three years in two tranches. This should stabilise the banks in the southern European states in particular. To further relieve pressure on the states in crisis, the ECB also reduced its key interest rate by 25 basis points in July to a historic low of 0.75%.

The consequences of the low interest rate are not entirely positive for Germany. While there is greater incentive for growth-stimulating investments, the risk of misallocation is high. There is also a significant increase in the risk of inflation, which creates uncertainty for consumers in particular. Fear of currency devaluation is driving people to increasingly invest in assets, which are supposed to be inflation-proof, such as gold and property. Some significant price increases can currently be observed in the residential market in particular. At the moment, this trend is supported by the good fundamentals. However, in the long term, there is the risk of a (local) bubble developing.

Overall, the currently prevailing financial conditions pose significant risks for the German economy. Although it has cultivated an outstanding competitive position in recent years, even Germany cannot permanently escape a sustained eurozone crisis.

GRAPH 4 **ECB prime rate and inflation** Low interest rates lead to higher inflation risk



Source: ECB, Statistisches Bundesamt, Focus Economics

Outlook

Euro crisis - How much longer?

Hopes of a swift end to the euro crisis and the associated problems appear to be without foundation. All attempted solutions thus far have sought to create time for the affected nations to consolidate their budgets and to implement structural reforms. However, experiences to date show that such reforms have only been partially addressed and that their implementation is taking more time than the German government in particular would like. Furthermore, as much as it may be the right answer, structural reform takes several years to bear fruit. Often cited as a prime example, Agenda 2010 in Germany provides evidence for this assertion. The reform of the German social system and labour market was introduced between 2003 and 2005, yet its successes are only just becoming clearly apparent today.

However, since the other proposals brought to the table are either scarcely politically viable or only tackle the symptoms of the problems, it is highly probable that we will continue to pursue the current course of action. Whether it will be successful and the affected states can gradually resolve their problems with the help of the partner nations or whether the challenge is too great a burden for the eurozone remains to be seen. However, it is already apparent today that the consequences of the crisis will continue to be felt in the years and possibly decades to come.

Transaction volume of residential portfolios reaches 5-year high

The economic stability and currently robust economy, particularly compared with most other eurozone countries, is reflected quite clearly in the German investment market for residential portfolios. In the first half year, a total of approx. €6.13bn was invested in residential portfolios. This represents an increase of 75% on the first six months of last year and the highest half-year volume for five years. The current figure also exceeds the total annual volumes for the years 2008 to 2011.

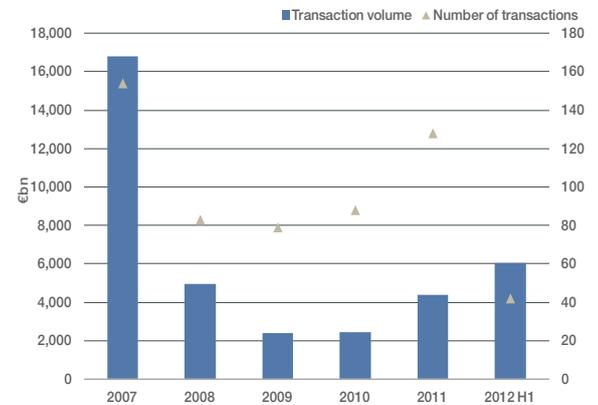
Mega deals dominate the market

Behind this trend lie two completely opposing developments. While the number of residential units transacted has almost doubled to 119,500 compared with the same period from the previous year, the number of transactions has reduced by around a third. This reflects the fact that recent months have been characterised by a small number of large transactions. The four largest portfolio disposals of the first half year account for around three quarters of both the total transaction volume and number of units transacted. It is the first time since 2007 that such transactions, e.g. the disposal of some 25,000 units from DKB Immobilien to TAG or the disposal of the 23,000-unit-plus Baubecon portfolio to Deutsche Wohnen AG, have actually been seen in numbers again. That such transactions (can)

currently occur in these numbers is explained by the conducive conditions. Large residential portfolios are being offered for sale, investor demand is high and financing for such large transactions is also possible. In recent years, these criteria have not always been fulfilled - at least not simultaneously.

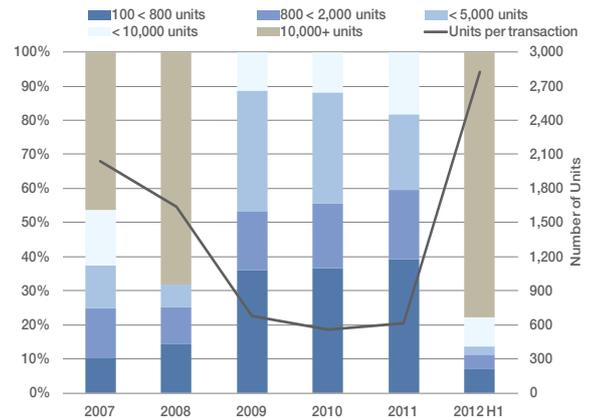
Yet, while transactions of packages of more than 1,000 units have increased, the number of smaller portfolios transacted has significantly declined. A total of 60 residential portfolios changed ownership in the first half of 2012 compared with more than 90 packages transacted in the same period last year. However, rather than a consequence of insufficient demand, this is primarily attributable to a lack of supply. Particularly in the core segment, the strong buying interest of recent years means that there is scarcely any product remaining on the market. Consequently, price levels have also markedly increased. It has not been uncommon to see multiples of more than 15 times the annual net rent paid for portfolios in the prospering conurbations. However, the scarce supply in the high-quality segment and consequent low number of high-value transactions has seen average prices decrease to just below €800 per square metre. Average prices achieved last year were some 5% higher.

GRAPH 5 Transaction volume and number of deals* Large turnover, little transactions



Source: Savills / * Pakete ab 100 Einheiten

GRAPH 6 Size of portfolios transacted* Average portfolio size jumps up



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

TABLE 2 Selected transactions in H1 2012 Four deals with more than 20,000 units each

Portfolio name	Number of units	Volume*	Purchaser	Vendor
LBBW	ca. 21,500	€1.44bn	Consortium (Patrizia et al.)	Landesbank BW
Baubecon	ca. 23,500	€1.24bn	Deutsche Wohnen	Barclays
DKBI	ca. 25,000	€0.96bn	TAG	DKB
Speymill	ca. 22,500	€0.90bn	Cerberus	Speymill / creditor banks
GSW (20% share)	ca. 9,900	€0.56bn	Cerberus / Whitehall	institutional investors

Source: Savills / * purchase price or estimated value

„Regarding core assets supply is rather scarce as demand for these properties has been strong for years.” Matthias Pink, Savills Research

Domestic investors dominate deals

Just as in previous years, purchasers in the first half year were predominantly based in Germany. Domestic purchasers accounted for more than 70% of the total transaction volume in the first six months of 2012. However, it would be erroneous to conclude from this that foreign investors have no interest in German residential property. On the contrary, the German residential market is exceptionally attractive from the perspective of international investors and interest in residential portfolios in Germany is correspondingly high. There are two principal reasons for the proportion of foreign purchasers being so low. Firstly, such purchasers are primarily interested in opportunistic investments, or at least portfolios with upside potential. However, such investment opportunities are (still) relatively few and far between owing, among other reasons, to the high price expectations of current owners. Secondly, German purchasers often have access to more favourable financing structures either because they bring more equity capital or they can obtain debt capital at good conditions. Ideally, they can even do both. As a result, they can submit higher offers during competitive bidding than foreign investors and the latter, despite their interest, do not always come to the fore.

Listed property companies and insurance companies the largest purchasers

The dominance of German purchasers is also reflected in the distribution of the transaction volume according to investor type. Listed property companies or REITs were the largest purchaser group with a 43% share of the transaction volume. While they also made disposals of residential property in Germany totalling more than a billion euros, their net total invested stood at €1.5bn. Pension funds also invested a net amount of some €1.5bn to claim second place in the rankings. Other purchaser groups with significant

positive net investments were private-equity funds (€640m), open-ended funds (€250m) and other real estate companies (€200m). The largest net vendors by far were banks, to which some portfolios had reverted from insolvent owners. Their net balance from portfolio disposals stood at almost €3.9bn. Closed-ended real estate funds (- €200m) and developers (- €110m) were also among the net vendors.

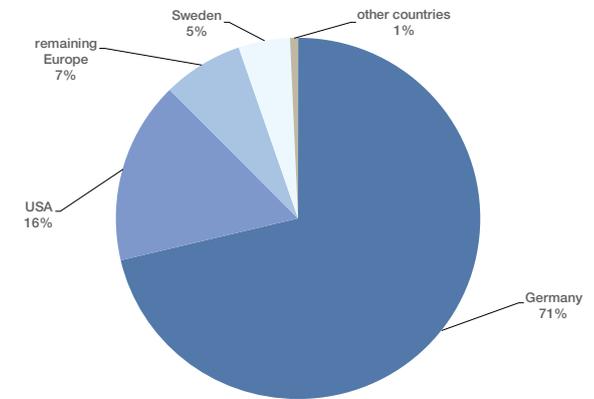
Berlin the favourite for investors

As per the previous one and a half years, Berlin remains the favourite investment location this year. More than 24,000 residential units were transacted in portfolios in the capital in the first half year. This represents 20% of all units transacted in Germany. Berlin is followed, some way behind, by Stuttgart (6%) and the Thuringian cities of Gera (6%) and Erfurt (5%). Stuttgart accounts for a large proportion of the LBBW portfolio while the other two cities were heavily represented in the DKB portfolio. Hamburg ranks fifth with just less than 4,200 units transacted.

Barely any project disposals

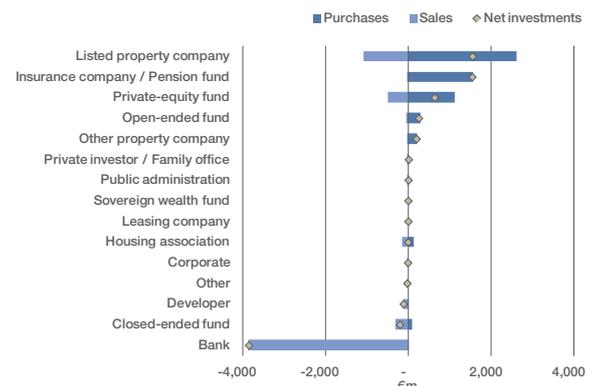
That only three of the major German cities in Berlin, Stuttgart and Hamburg recorded noteworthy shares of the overall market is also explained by the scarcity of product in these markets. On the one hand, there is relatively little willingness to sell and, on the other hand, there is scarcely any new supply on the market. The latter is primarily reflected in the low number of developments transacted. Just four project disposals have been recorded in the current year. In view of the immense purchasing interest in the core segment in particular, this figure is barely worthy of mention.

GRAPH 7 Transaction volume by origin of buyer Domestic investors account for 70%



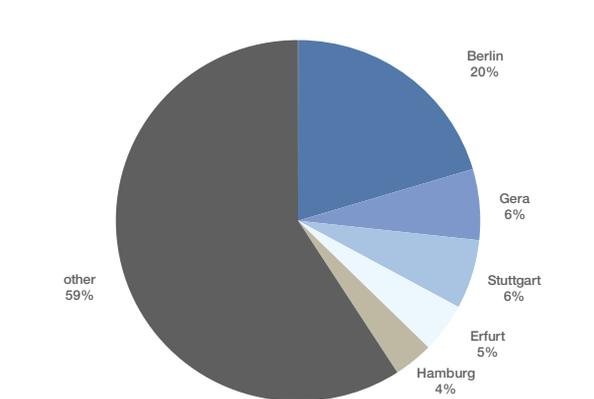
Source: Savills

GRAPH 8 Transaction volume by type of investor Listed property companies most active



Source: Savills

GRAPH 9 Transacted units by location Berlin remains top of the list



Source: Savills

Developers becoming noticeably more active

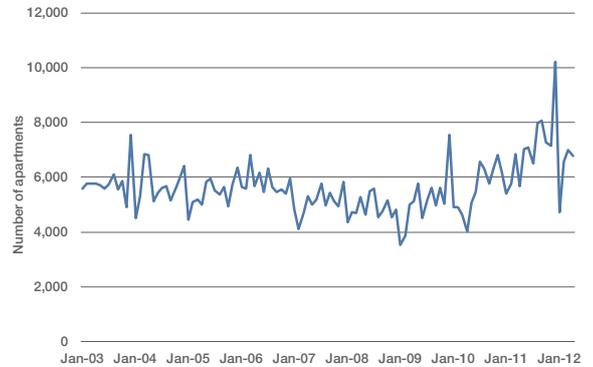
A glance at the planning permission statistics shows that this supply shortage may be relieved in the medium term. The number of units approved per month in the apartment segment has shown a clearly upward trend since the turn of the year 2009/10. While some 4,000 to 6,000 units per month were approved in the years 2003 to 2009 this figure moved towards 8,000 units during the course of 2011 and, at its peak, exceeded the 10,000 mark. This trend also indicates that the price rises in recent months have increased the profitability of residential projects and stimulated developers to take more projects forward.

Sustained high price levels and a shift to B-locations expected

The price levels now reached leave scarcely any upward room for manoeuvre. However, with demand likely to remain high and supply short, stable price trends are anticipated. Owing to the high prices in the large metropolises, it is also expected that investors will increasingly shift their attention to smaller B-locations. Price increases in the major conurbations mean that these locations now offer more attractive risk-return ratios in some instances (see our report "Residential Markets in Germany").

Several recently published studies rightly suggest that established university locations in particular are worthy of attention. Corresponding capital flows into the residential markets in these locations will surely be seen in the near future. ■

GRAPH 10 **Planning permissions for new apartments*** Strong increase since 2010



Source: Statistisches Bundesamt / * in buildings with at least 3 apartments

Outlook

Transaction volume of €10bn realistic

The question of how the current year will fare compared with recent years is already largely answered. At the mid-point of the year, the transaction volume has already exceeded annual volumes achieved since 2008. Therefore, 2012 will see the highest transaction volume since 2007. However, it is also clear that the volume of 2007 - when residential portfolios totalling more than €15bn changed hands - will not be reached this year. A double-digit total is still quite realistic, even if the transaction volume in the second half of the year is likely to be lower than that of the first six months. Much depends on whether any additional major transactions (e.g. the disposal of GBW, Woba or TLG) will be completed this year, for there is no indication of a significant upturn in transactions of smaller portfolios at present.

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