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Briefing note
German real estate market in 2015: an outlook

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The surplus demand in the investment market will continue. Yields will tighten owing to higher risk tolerance from investors, particularly in the non-core segment. Demand will stagnate in the office lettings market. However, the scarcity of Grade A offices will cause prime rents (only) to rise. Consequently, the investment and lettings markets will diverge further in 2015.

The base scenario

Our outlook for the real estate market in 2015 is based upon the following financial and real economic scenario.

■ Although the recession has been overcome, the economic recovery in the eurozone will remain sluggish. Positive economic impetus from the USA, for example, will be offset by adverse factors such as the ongoing crisis in Ukraine. The gross domestic product of the eurozone will only grow by approx. 1% again in 2015. As a result, inflation will remain low while sovereign debt will continue to rise.

■ Even in Germany, economic activity will remain somewhat subdued. The gross domestic product will grow in line with the eurozone as a whole by approx. 1%. While consumption will continue to contribute positive growth, investment will remain weak. The increasingly rigid yet erratic conditions imposed by the government (change in energy policy, retirement age, minimum wage) will create uncertainty, dampening appetite for investment. Since investment is the basis for future growth, medium-term growth prospects will also weaken.

■ The expansionary monetary policy of the major central banks will also continue in 2015. However, while the European Central Bank will loosen the reins further, the US Federal Reserve will begin tightening. Consequently, interest rates in the European money market will remain near zero, while yields on long-term German government bonds will rise moderately over the course of the year. In view of the overall economy and the associated low inflation, an increase in the ECB's key interest rate will be pushed back even further and is not expected before 2018.

Against a background of these financial and real economic conditions, we expect the German real estate market to develop as follows in 2015.

2015 will be another strong year for the investment market with yield compression in the non-core segment in particular

One thing is clear. The assumptions in our initial scenario would keep the floodgates open for the German investment market. Interest rates will remain extremely low for another year, making it scarcely possible to achieve positive real returns in the money or bond market. Even 10-year corporate bonds with a BBB rating, whose default risk makes them just eligible as an investment option for many regulated investor groups such as insurance companies and pension funds, currently yield around a mere 2%. Since this 2% is likely, in most cases, to be below the required rate

Summary

Our theses for 2015

■ Thesis 1: Another strong year for the investment market - yield compression on non-core property
The surplus demand in the investment market will persist. Non-core yields will tighten further than core yields for two reasons: Firstly, the risk tolerance of investors will increase further. Secondly, the tightening of US monetary policy will result in slower yield compression in the prime segment.

■ Thesis 2: In the office market, supply and demand will stagnate - prime rents will rise
Demand for space will stagnate owing to a lack of impetus in the economy. Scarce development activity will result in reduced available space and a rise in prime rents. Rents for lower quality space will remain under pressure.

■ Thesis 3: Capital values and rents will continue to diverge - this will extend to non-core property
Significantly tighter initial yields and only modest rental growth will cause prime rents and capital values to drift considerably apart. This trend will also become increasingly apparent in the non-core sector.

■ Thesis 4: Rising loan-to-values in the financing market - return on equity to fall less than overall yields
Positive developments in the financing market from an investor perspective (rising LTVs, falling margins), will mean initial yield compression only impacts partially on returns on equity.

of return, more capital will inevitably (have to) be shifted into real asset classes, including property. In brief, even more capital will be available for real estate investments in 2015 than in the previous year. As a result, demand for property will remain higher than the available supply and the transaction volume is likely to exceed the level seen in 2014.

This scenario initially sounds like a repeat of the previous year. However, upon further analysis, 2014 and 2015 are likely to be quite different. One such difference is likely to be that prime yields will no longer tighten to the same degree. The reason for this is that the tightening of US monetary policy will cause bond yields in America to rise. Consequently, prices of long-term European bonds will also come under pressure. Since yields on such bonds, e.g. 10-year German government bonds, are a key benchmark for many core investors, a rise in these will curb yield compression on prime property. Furthermore, at 4% to 4.5%, prime yields have now reached a level that represents the lower limit many investors are prepared to accept. Only Asian investors, whose involvement is likely to increase significantly further in 2015, might be prepared to accept lower yields as they are often accustomed to even lower levels in their domestic markets.

However, since prime yields have largely bottomed out, even the more conservative investors have recently been increasingly shifting their focus to B cities, B locations and use types other than offices and retail. This trend will continue in 2015 and possibly even accelerate, particularly against a background of increased risk tolerance among both investors and lenders. As a result, a disproportionately high amount of the additional funds that will be available for investment in German real estate in 2015 will be allocated to non-core strategies. This, in turn, will lead to initial yield compression in the non-core segment. As a consequence of both trends (slowing yield compression in the prime segment and accelerated yield compression in the non-core segment), the yield differential between core and non-core property will fall (Graph 1).

"Great stagnation" in the office lettings market - price differential between prime and secondary to widen

Demand in the office lettings market will continue to lack positive impetus in 2015. Economic activity will remain subdued and a number of risk factors (Ukraine crisis, eurozone crisis, etc.) will prevent companies from making large investments, including agreeing new leases. Against this background, it can be assumed that office tenants will show an even greater tendency than in recent years to extend existing leases and, in case of doubt, to avoid risk-laden and costly relocations. Nevertheless, modest growth is expected in the number of office employees in German cities in 2015, meaning that take-up should be broadly in line with that of the previous year.

However, stagnation will impact supply as well as demand. The general reticence to invest will also mean that, following a brief rise, the completion volume will return to a low level. Around 900,000 sq m of new office space will come to the market in the top six German cities in 2015 (2014: approx. 1.2 million sq m), of which more than half is already let.

The combination of both stagnating demand and stagnating supply is very similar to that seen in 2014, meaning that current trends in vacancies and rents should continue in 2015. More specifically, this means that the office vacancy rate should decline slightly further, particularly since older stock will continue to be withdrawn from the market for conversion into apartments. Vacancies are particularly expected to fall in the modern office segment, where there is already excess demand. The low development activity in recent years means that the proportion of new-build space has continuously fallen in relation to the overall office stock and that the average age of office buildings has risen accordingly. This in turn is supporting rental growth, particularly in the prime segment. The upward trend in this segment since 2010 is, therefore, expected to continue and prime rents across the top six cities are projected to rise by an average of 2% to 3% (2014: approx. 1.5%). At the opposite end of the market, however, rents will

Our theses from last year

Three hits, one off target

✖ Thesis 1: Office take-up to increase

While we predicted a rise in take-up, but in fact the figure is approx. 5% lower than for the previous year. Our optimistic projection was based upon expected GDP growth of 2% for 2014. In the event, the German economy has only grown by little more than half of that amount, which is a significant reason for the lower office take-up.

✔ Thesis 2: Prime yields to tighten further

Indeed, prime yields have tightened somewhat further. Over the first three quarters, yields were down by an average of 14 basis points on offices and 10 basis points on high street property across the top six German markets.

✔ Thesis 3: The commercial investment market will maintain its momentum but sales of residential portfolios will decline

By the end of November 2014, approx. €11.3bn had been invested in German residential portfolios compared with €12.9bn at the same point in the previous year. The prediction of a drop in tempo was also accurate. The commercial investment market has not only maintained its momentum. This has increased significantly further. By the end of November, €32bn had already been invested; more than during the entire year in 2013 (approx. €30.4bn).

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

Yields in the non-core segment have tightened slightly further than those on core property. Over the first three quarters, yields on office property of average quality tightened by an average of 14 basis points in central locations and 27 basis points in secondary locations. That the gap in volume closed more strongly is illustrated by the following analysis. The transaction volume for commercial single assets with a price per square metre below €2,000 (= non-core property) rose by 17% year on year to the end of November compared with an increase of just 13% for properties with a price greater than €2,000 per sq m. In addition, the portfolio transaction volume rose by 76%, which primarily comprises non-core assets.

remain under pressure, particularly in cities such as Düsseldorf and Frankfurt, where vacancy rates remain in the double digits. As a result, the differential between rents achievable in the prime segment and those in secondary locations and on secondary property will widen further (Graph 2).

Investment and lettings markets will drift further apart

The inevitable consequence of the two trends outlined above is that the office lettings and investment markets will drift further apart. This has already been occurring in recent years but, owing to the high risk aversion of investors, has been largely limited to the prime segment. In this case, modest rental growth combined with significant initial yield compression meant that capital values rose significantly faster than rents. The same trend has unfolded in the secondary segment since around the end of 2013. Until that point, rents and capital values moved almost in tandem. Now, capital values are almost 4% above their level at the start of 2009, while rents remain 5% below the corresponding figure. In view of the anticipated yield compression, this divergence of rents and capital values will accelerate further during 2015. In the prime segment too, capital values will continue to drift apart from rents as a result of solid rental growth and continued modest yield compression, albeit to a far lesser extent than in the non-core segment (Graph 3).

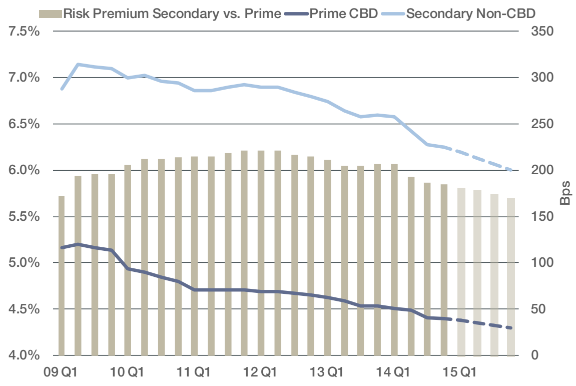
Opportunities and risks for investors

This scenario poses risks for investors and, of course, opportunities. In the short-term, investors in all market segments could take advantage of further tightening of yields and, provided that rents at least remain stable, the associated capital growth. Owing to the higher initial yields and anticipated stronger yield compression, the non-core segment would appear most suited to this approach. For those with a somewhat longer investment horizon, the current environment offers prospects in new-build office property. An investment in or the acquisition of speculative developments will allow investors to profit from the scarcity of high-quality office properties that is likely to persist in both the lettings and investment markets. The same is true for value-add investors pursuing refurbishment strategies in good locations.

The greatest risk lies in the differential between rents and capital values. These have not drifted apart to such an extent in the near 25 years since German reunification. Indexed capital values have only once remained above the rental index for a prolonged period, in 2006-07, before subsequent dropping back below the latter level. It is quite possible that the current situation is part of the "new normal" in the context of long-term low interest rates. However, it is also conceivable that the ECB will start to increase their key interest rate in a few years' time. This would mean a significant fall for investors. Based upon current values, a 50-basis-point increase in the prime yield would mean a decrease in capital value of more than 10%. The 11% rental growth necessary to offset this loss currently appears quite unrealistic.

GRAPH 1

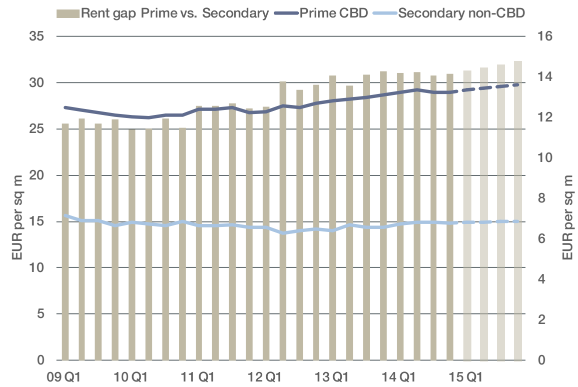
Yield compression between core and non-core is accelerating*



Source: Savills / * average yields for offices in top 5

GRAPH 2

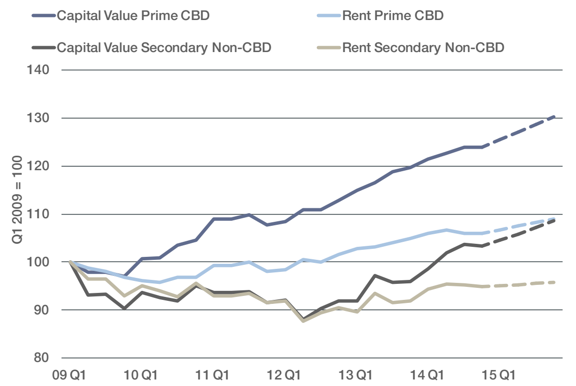
Prime and secondary office rents are diverging*



Source: Savills / * average rents for offices in top 5

GRAPH 3

Capital values and rents are drifting apart - in the non-core segment too*



Source: Savills / * average values for offices in top 5

Outlook for the financing market in 2015

Guest commentary by Curth-C. Flatow, Flatow AdvisoryPartners

The German financing market for commercial property will see positive developments over the coming year. Stability in commercial property financing will be supported by sustained high demand. Institutional investors will also be very active in the German market over the coming year. We expect to see more financing involving insurance companies, pension schemes and loan funds. In addition, new international finance providers will seek to enter the German market. Owing to the high demand, margins will remain low and even fall further in some segments such as residential.

Another trend for 2015 will be that loan-to-values (LTVs) will rise further on average by around three basis points. While the average LTV across all sectors stood at 72% in 2014, this will rise to an average of 75% in 2015. In this regard, it will also be fascinating to follow the discussion raised by the Bundesbank regarding 100% financing. Driven by a fear of price decreases and loan defaults in heavily financed property markets, the Bundesbank believes financial stability is at risk. To guarantee stable price levels, the central bank has to contend with potential bubbles and financial market risks. Bundesbank Vice President Claudia Buch has concluded that, despite rising residential property prices in the German real estate market, there are no excessive risks in terms of financial market stability. The Bundesbank's bank survey showed that the loan volume has recently risen only moderately at 2% per year. Should stabilisation measures be necessary, one of its proposals is to restrict LTVs in an emergency.

Another financing trend in 2015 will be the reinvigoration of CMBS-financed acquisitions. We expect an increase in mortgage-backed securities in Europe and Germany, not only for refinancing but also increasingly for financing purchases. One such example is the securitisation of IVG's refinancing for approx. €680m by Deutsche Bank. While there were ten deals in 2013, seven deals had already been completed by the start of November 2014 totalling €2.57bn. According to our observations, there are a further twelve in the pipeline, which will be on the market at the start of 2015.

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