Briefing note
Outlook: German real estate market in 2016

The demand surplus in the property market will increase further in 2016! Office occupiers with larger requirements will be limited to pre-lets in developments, while logistics and residential will get scarcer too. For investors, it will nevertheless be more difficult to invest their capital sensibly, particularly since they should now be preparing for the time after the boom.

The initial scenario

Our outlook for the real estate year 2016 is based upon the following financial and real economic scenario:

■ The economic recovery in the eurozone will continue in 2016, albeit at a very slow tempo. The economy will grow by 1.5% with predominant downside risks.

■ Economic activity will be greater in Germany than in the eurozone overall. The domestic economy will gain further ground compared with the export sector. Contributing factors will include falling unemployment and rising incomes as well as sustained high immigration, resulting in increased government and private consumption. GDP growth in 2016 will stand at almost 2%.

■ The world will remain trapped in a low interest rate environment. While the US Federal Reserve will start to increase interest rates, the ECB will loosen its monetary policy further. Overall, interest rates will remain very low and yields on bonds from creditworthy issuers will remain negative (in real terms) out to medium-term maturities.

Office rents to rise further - high-quality space only available in developments

The favourable economic conditions, particularly in terms of high employment and income levels, will have a positive impact on occupier demand in the residential and commercial property markets. In the larger office markets, this will be reflected in further growth in take-up figures. Even more so than in recent years, companies seeking suitable office space will realise that high-quality supply is very scarce, at least in central locations. Although completion volumes in the top six markets will show a modest increase to a projected 1.2 million sq m, space completed in 2016 will once again be less than is required to maintain current levels of office stock. Assuming an economic life of 50 years for an office building, this would require a completion volume of almost 1.7 million sq m. Consequently, vacancy rates will fall further, causing rental growth to continue in the prime segment and even to probably accelerate in (good) secondary locations. Occupiers seeking suitable office space will, therefore, be faced with increasingly fewer alternatives to choose from, which will also be increasingly expensive. Larger companies seeking high-quality space upwards of around 5,000 sq m will be practically limited to pre-lets in developments.

Results at a glance

Our theses for 2016

■ **Thesis 1:** Take-up in the **office** markets will rise. Since the completion volume will only be slightly higher than in 2015, vacancy rates will fall further and rents in prime and good secondary locations in particular will rise.

■ **Thesis 2: Retail** growth will be skewed towards the online segment, causing overall demand for space to stagnate. However, retail space in high-end locations will remain scarce while consumer locations will increasingly witness declining rents.

■ **Thesis 3:** Demand for **logistics** space will rise owing to positive impetus in the (domestic) economy and structural effects (e-commerce). Consequently, supply will become even more scarce although rents will not rise.

■ **Thesis 4:** The transaction volume in the **commercial investment market** will exceed €50bn once again. The pressure to invest will result in lower risk premiums across the board. Prime yields starting with a three will become the norm on office properties and high-street properties.

■ **Thesis 5:** The wave of consolidation in the **residential investment market** will end in 2016. The transaction volume will again be above average (> €10bn), which will be not least attributable to a rising number of acquisitions of development schemes.

Demand for logistics property to grow at an above-average rate

Like the office market, the logistics property market will also be characterised by continued growth in demand. Besides the positive impetus in the (domestic) economy, demand for space in this segment will also be driven by structural effects, particularly the growth in e-commerce. The latter has already manifested itself in recent years in a growing share of take-up attributable to wholesale and retail. Since there is an increasing shortage of suitable sites for logistics properties, supply will come under growing pressure. In contrast with the office market, however, rents on logistics properties are subject to tight limits, not least due to the relatively low margins in retail and in the logistics sector itself, and are not expected to increase in the short term. Furthermore, owing to the lower initial yields, developers can continue to offer favourable rents without eroding their profits.

Retail rents have reached their peak

Like the logistics sector, retail is also benefiting decisively from Germany's strong domestic economy. Rising employment figures and incomes are likely to be reflected in higher retail sales in 2016. However, since this growth will again be primarily concentrated in the online segment, demand for retail space is likely to diverge from that in the other two sectors discussed by showing no overall increase. Nevertheless, surplus demand will persist in selected markets, such as high-end locations of some major cities. In consumer locations, on the other hand, the likely best case scenario is that rents will stagnate while the number of cities whose prime highstreet locations witness declining rents is likely to increase. This is already true for secondary locations.

Seven-year itch in the investment market? No!

The favourable financial and real economic conditions are just one reason why the boom in the German real estate investment market is expected to continue into its seventh year in 2016. Another reason is that capital allocations to real estate investment have reached unprecedented levels and, in view of the lack of alternatives, are unlikely to have reached their peak. Despite the expected reversal of interest rate policy in the USA, bonds from creditworthy issuers remain unattractive for the time being while equities are subject to increasing downside risks in view of the low global economic growth; upside potential is limited at least. The sheer volume of capital chasing real estate, particularly from abroad, combined with the strength of the German economy, will also result in an extremely high investment transaction volume in 2016. On the vendor side, there will be an increasing number of investors who bought at the start of the boom and will now want to realise gains. In the commercial investment market, the €50bn mark can be assumed as a lower limit. At the same time, this means that pressure on yields will remain high. Prime yields starting with a three will become the norm on office and retail properties in the top locations. These can be expected to harden by around 20 basis points over the course of the year. There will be even stronger yield compression in all non-core segments, such as all secondary and tertiary locations, markets outside of the the top locations and less liquid market segments, such as hotels or care homes. Consequently, risk premiums will contract further. However, since debt financing remains relatively scarce in the non-core segment and investors must, therefore, contribute sufficient capital, risk premiums are unlikely to return to 2006/07 levels.

Consolidation in the residential market to reach its conclusion

The transaction volume in the residential investment market is also expected to exceed the 10-year average (> €10bn) once again. The supply shortage will remain the prevailing theme in the sector. In the larger size segment, company mergers and acquisitions are likely to continue to dominate activity although, with the benefit of hindsight, it is likely that 2016 will be looked back on as the end of the wave of consolidation in the German residential market. Furthermore, development projects will account for a larger proportion of the transaction volume. This will be

Our theses from last year

Correct on the trend, but ...

Thesis 1: Another strong year for the investment market - yield compression on non-core property

The 2015 investment year was strong - very strong! More than €50bn was invested in commercial property and more than €20bn in residential property. Non-core yields hardened significantly, by more than 30 bps on offices. However, prime yields also tightened somewhat further, albeit less strongly (approx. 20 bps on offices).

Thesis 2: In the office market, supply and demand will stagnate - prime rents will rise

The completion volume declined moderately compared with the previous year while take-up in the top six markets rose by almost 10% according to preliminary figures. Consequently, the vacancy rate fell significantly (by approx. 0.8 percentage points) and prime rents rose by approx. 3%.

Thesis 3: Capital values and rents will continue to diverge - this will extend to non-core property

The divergence continued both in the core and non-core segments. Capital values on offices rose by 9% in the prime segment, which was six percentage points higher than the increase in rents. Grade B properties in secondary locations also showed a differential of 6 percentage points, with rents falling by 2% and capital values rising by 4%.

Thesis 4: Rising loan-to-values in the financing market - returns on equity to fall less than overall yields

According to the BF quarterly barometer, LTVs fell only modestly during the course of the year to 71% (previous year: 72%). Over the same period, however, margins fell by 45 bps to 131 bps. Consequently, debt financing costs fell overall.

Conclusion: Significantly higher dynamics than expected

Contrary to our expectations, office take-up rose sharply. In all other respects, we correctly predicted actual developments even though we significantly under-estimated activity. In the investment market in particular, the boom not only continued but accelerated yet again. A significant reason for this is the deferral of interest rate hikes in the USA, which we expected to take place in the first half of 2015 in our baseline scenario.

attributable, on the one hand, to a rising number of developments and, on the other hand, to the fact that a larger proportion of these projects is likely to be sold to institutional investors in the form of whole properties rather than being sold to private purchasers as freehold apartments. Owing to the sharp rise in prices, outright sales have become significantly more attractive for developers.

Regional markets to remain attractive for long-term investors

Whether they invest in residential or commercial property, the greatest challenge for investors will be to find suitable product for their capital. While it is becoming increasingly easy to accumulate capital for real estate investments, it is becoming increasingly difficult to invest this capital sensibly. In their search for acceptable (portfolio) yields, investors will be forced to venture even further from their traditional path than previously. Particularly for long-term investors who do not operate in the €100m-plus segment, prime locations in the regional markets remain a good choice owing to the relatively high initial yields. While liquidity risks are also increasing in such locations, since the large amounts of capital currently flowing into these relatively small markets will one day flow out again, these risks will diminish over the long term.

The time is right for cycle-defensive investment strategies

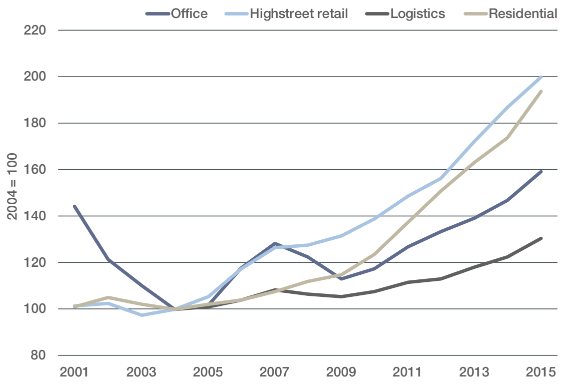
For counter-cyclical investors, the current investment cycle in Germany is already too far advanced. While it may be true that nobody can call the top of the market with any certainty, capital values in all major sectors are already above their long-term averages (see Graph 1). Counter-cyclical opportunities are, therefore, rare if they still exist at all. Owing to the advanced stage of the investment cycle, the time is right for all investors to adopt cycle-defensive investment strategies. Specifically, this means focusing on properties that are either mostly or completely unaffected by fluctuations in the economy or that benefit from long-term trends. Ideally, they would fulfil both criteria. Such long-term trends include, for example, the advancing urbanisation, the ageing population and the burgeoning education sector (see Graph 2). Against this background, investments in university buildings, care homes, sheltered accommodation and student accommodation, preferably in the centre of major conurbations, appear sensible. In terms of independence of the economic cycle, office properties occupied by the public sector or car parks are attractive options. From this perspective, the residential market also remains attractive for defensive investors despite the record high prices. Compared with the rest of Europe, residential property in Germany remains inexpensive while the fundamentals are extraordinarily positive. In the large metropolises and conurbations in particular, vacancy rates have fallen to almost zero per cent. This should ensure that rents at least remain stable while there is essentially no re-letting risk, particularly since strong immigration will further increase the pressure on residential markets.

Property to become increasingly scarce - both for occupiers and investors

To summarise, the real estate year 2016 can be characterised as follows: Property owners will generally enjoy solid to rising demand, from both occupiers and investors. The latter will require patience in order to identify suitable potential investments and to examine these in terms of opportunities and risks. However, despite the rising costs, it will be impossible to look beyond real estate as an asset class.

GRAPH 1

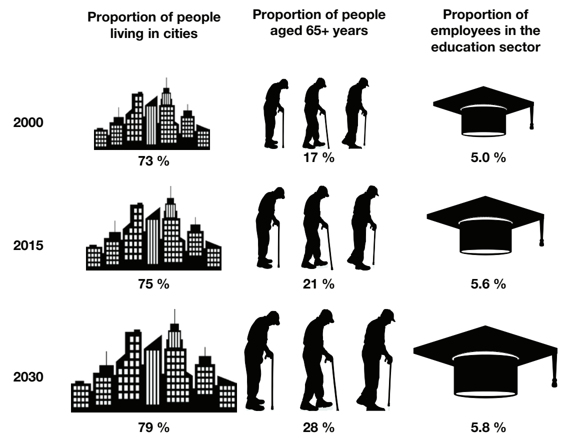
Capital values are above their long-term average in all sectors*



Source: Bulwiengesa, Savills / * Average for top 7 markets

GRAPH 2

Three long-term trends: Urbanisation, ageing, education*



Source: BBSR, Oxford Economics / * all figures are related to Germany

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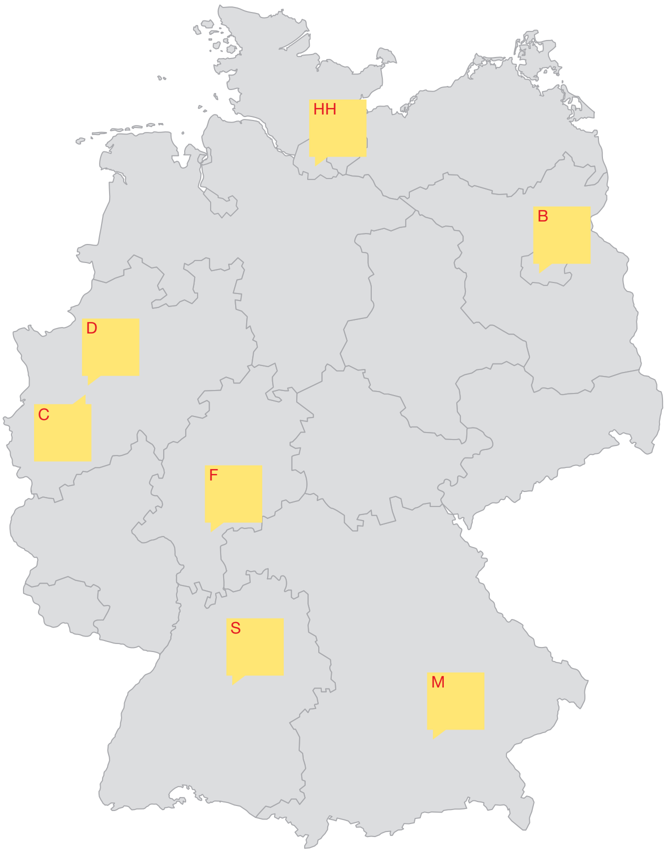

Savills Germany

Please contact us for further information

Marcus Lemli
CEO Germany
+49 (0) 69 273 000 12
mlemli@savills.de

Andreas Wende
Investment
+49 (0) 40 309 977 110
awende@savills.de

Marcus Mornhart
Office Agency
+49 (0) 69 273 000 70
mmornhart@savills.de

Karsten Nemecek
Corp. Finance - Valuation
+49 (0) 30 726 165 138
knemecek@savills.de

Draženko Grahovac
Corp. Finance - Valuation
+49 (0) 30 726 165 140
dgrahovac@savills.de

Matthias Pink
Research
+49 (0) 30 726 165 134
mpink@savills.de

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