savills

Analysis

Outlook for the German real estate market in 2017

Finding property will be even more challenging for investors and occupiers alike in 2017. With further initial yield compression likely to be no more than marginal, investors will be targeting rental growth potential. The latter will be found in more and more office locations as well as on inner-city logistics assets, though no longer on retail property.

The initial scenario

Our expectations for developments in the German real estate market in 2017 are based upon the following financial and real economic scenario.

■ The era of perennially lower interest rates and bond yields is coming to an end. However, the road out of the low interest rate trap will be long and is starting from an extremely low base. Consequently, nothing will change in the general interest rate environment. Bonds will remain correspondingly unattractive as an asset class. It is impossible to overlook equities and real estate although valuations of these assets are also very high.

■ Global economic growth will remain moderate at just 3% with predominant downside risk in view of the apparent trends towards deglobalisation (examples in Europe: Brexit, TTIP/CETA). Growth in the eurozone will be around half that of the global economy.

■ The German economy will grow at around the same rate as the eurozone as a whole in 2017, namely around 1.5%, which is somewhat slower than in 2016. Domestic consumption will remain the principal driver of growth. This will be supported by population and employment growth among other factors. Inflation will rise to approximately 1.5%.

Acute growing pains in the office markets

While growth prospects may be deteriorating, Germany has enjoyed a significant economic upturn in recent years. The provisional result of this is an unprecedented number of people in work. The same is true of office personnel and, consequently, demand for office space has never been greater. However, construction has been and remains relatively modest, causing vacancy rates in the top six office markets to almost half since 2010. The recent moderate increase in (speculative) development activity will not be sufficient to reverse this trend in 2017. Rather, the average vacancy rate across the top six markets will fall to approximately 5%. As a result, office occupiers will have to adjust to an even greater supply shortage and further increases in rents. This will be particularly true of Berlin and Munich. Companies seeking to open an (additional) office in a major German city in 2017 can strike these two cities off their list of potential locations even before commencing their search for a suitable property. Beyond a certain size, there is simply no modern office space available in these cities. Even if this statement proves to be a slight exaggeration, it nevertheless highlights the issue that the shortage of office space is becoming a hindrance to growth both for companies and for the cities concerned. This also means an almost inevitable decline in take-up

Results in Brief

Our theses for 2017

■ **Thesis 1:** Take-up in the **office** markets will decline owing to a supply shortage. Companies will be increasingly forced to turn to peripheral locations and urban hinterlands. Consequently, rental growth will continue.

■ **Thesis 2:** The **retail** sector will see increasing demand for smaller units and a decline in requirements for retail space. The number of locations affected by declining rents and vacancies will increase with rental growth expected in only a small number of prime highstreet locations at best.

■ **Thesis 3:** Expansion of **logistics** space will continue and will increasingly penetrate into cities as the "last mile" becomes a decisive factor. Inner-city rents will therefore rise while, outside cities, the upper limit will remain approximately €6.50 per sq m/month.

■ **Thesis 4:** Although total returns in the **commercial investment market** will fall, demand will remain at least in line with the previous year. Consequently, yields will harden moderately further while B locations and niche sectors will move even higher on investors' agendas.

■ **Thesis 5:** In the **residential market**, construction activity will accelerate significantly, creating investment opportunities. Supply across the existing building stock will remain extremely scarce. However, with more stringent regulation on the horizon, initial yields will not harden.

since no deals can be completed where there is no available office space. This particularly applies to central business districts, meaning that a larger proportion of take-up will shift to peripheral locations within the city boundaries or even to surrounding areas.

Fewer and smaller stores required in the retail sector

Such growing pains are a remote possibility for most retailers. The structural change in retail is in full swing yet far from complete. A principal feature of this change continues to be a shift in sales from in-store to online retail. The consequence of this is reduced requirements for retail space, which will manifest itself in higher vacancies across all retail formats outside of the prime shopping locations. With online retail delivery times becoming ever shorter (hence the terms: 'same day' and 'one hour delivery') and individual delivery time windows becoming standard, in-store retail must also move closer to its customers. Consequently, requirements in the retail sector will concentrate on those locations with optimal footfall and proximity to residential areas. In addition, such locations will also be used to connect the online and offline worlds via click-and-collect facilities (order online, collect in-store) or greater use of showroom formats (shop in-store with home delivery). On prime shopping streets in major cities and attractive retail parks, therefore, demand will continue to exceed supply although the trend towards smaller stores will continue. Thus, rental growth is expected in only a small number of prime highstreet locations if at all. Declining rents will be witnessed primarily in B and C locations as well as on retail formats and properties with a high proportion of revenues from textiles.

Rapid growth in logistics demand

Retail has one thing in common with the logistics sector. There is increasing demand for small units. However, while this comes at the expense of demand for larger units in the retail sector, the same is not true for logistics. Demand in this sector is far from satiated and the rising demand for small units is primarily attributable to the fact that logistics operators are increasingly

Our theses from last year

2016 was the year we expected

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 A and good B locations in particular will rise.*

Take-up in the top six markets exceeded the previous year's figure by an estimated 10%. The completion volume is likely to total around 0.9 million sq m, which is only approximately 5% higher than in 2015. The average vacancy rate across the top six cities fell by around 2 percentage points during the year to less than 6%. There is scarcely any available office space in the city centres. Consequently, there was an increase in both prime rents (approx. +4%) and average rents (approx. +5%). Rents on top-quality properties in B locations rose by more than 7%.

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.*

German retail association Handelsverband Deutschland expects retail sales for 2016 to show a nominal rise of 2.5%, with growth in online retail significantly higher at +11%. Lettings on the shopping streets of major cities were down by 5-10% compared with the previous year, which is principally attributable to the fact that preferred store sizes are contracting. Rents even stagnated in the 1a locations of the top six cities (sole exception: Berlin). Many other cities and locations beyond the main shopping streets witnessed 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.*

Take-up of logistics space reached record levels in 2016. This was substantially driven by the continued dynamic growth of online retail. Pure e-commerce companies were responsible for more than 10% of take-up. A much larger proportion was attributable to rising demand from logistics service providers and retailers due to online retail. Sites have become extremely scarce, particularly in the major conurbations, and prices have risen accordingly. However, with further significant yield compression on logistics property during the course of the year (-30 basis points in the prime segment), developers were able to keep rents stable.

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.*

Despite the extremely low willingness of property owners to dispose of their assets, which we did not anticipate to such an extent, the transaction volume did indeed surpass the €50bn mark again. The supply shortage forced prime yields on offices and high-street properties in the top seven markets below 4% almost without exception. Risk premiums also fell slightly further, e.g. on office properties of average quality in B locations, by 10 to 15 basis points compared with prime yields.

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

Despite the small number of additional mergers and acquisitions completed or initiated during the year, the major wave of consolidation is essentially over. That the transaction volume once again exceeded €10bn is attributable to the doubling of capital invested in development projects.

penetrating into cities to ensure adequate goods distribution over the "last mile".

It remains to be seen what typical inner-city logistics properties will look like. However, they will not be viable at current prime rents. Outside of the cities, rents of approximately €6.50 per sq m/month will remain the upper limit. However, inner-city rents will establish themselves at a significantly higher level. Like in the inner cities, expansion in the commuter belts of the major conurbations will also be restricted by a shortage of suitable sites. Nevertheless, more than 4 million sq m of new logistics space will be completed again in 2017.

Challenging balance of risk and return in the commercial investment market

On the surface, little will change for commercial real estate investors in 2017. The greatest challenges will remain on the acquisition side with demand focusing on the core and core+ risk categories and competition among investors remaining correspondingly fierce for these scarce properties. Consequently, investors will move cautiously away from the core segment while also increasing their willingness to pay somewhat in order to secure assets for their portfolios. Thus, initial yields will harden moderately. However, the exact same or a similar description could have been applied to 2016. And 2015. And even 2014. The key difference is that we have now evidently seen the top of the market in terms of transaction volume and, even more importantly, the air for capital growth through further yield compression has become thin. Rental growth will, therefore, be all the more important with realistic appraisals of rental growth potential requiring both an understanding of the relevant sector and local market knowledge. In other words, finding the right balance between adequate yield and acceptable risk will become more challenging for investors. In the office sector, they will be aided by favourable conditions in the lettings market, leading us to predict a continued shift to B properties, B locations and B cities. Even at this late stage of the current investment cycle, there are still cities where acquisitions can be made at relatively high initial yields with favourable long-term prospects as illustrated in Graph 1. Of the 127 relevant office markets in Germany, 24 cities still have a net prime yield of at least 6% combined with positive population projections out to 2030. Besides small markets, such as Ravensburg and Trier, these also include larger cities such as Braunschweig, Erfurt and Rostock. Of course, investment risk cannot be adequately determined using population projections alone. However, over the long term and in the less volatile B cities, rental growth is closely correlated with population growth and, in this regard, population projections are a helpful initial indicator for market selection.

While the high occupier demand for office and logistics properties will lead investors to add one or two B cities to their search profiles, their criteria for the retail sector will be somewhat more stringent. As a result, we expect office property not only to remain the preferred sector among investors but to extend its lead over retail assets. Logistics property will also grow in favour with investors, as will hotels, while niche sectors offering stable returns, such as car parks and nursing homes will move even higher on investors' agendas. We therefore expect greater yield compression in these sectors than in the established sectors. Yields on retail property are likely to have bottomed.

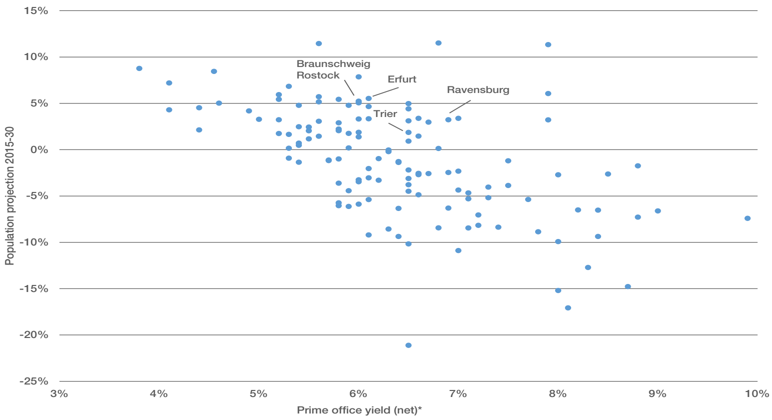
Despite the overall decline in total returns achievable on real estate in Germany, demand is expected to at least remain at current levels. Firstly, property continues to promise significantly higher returns than bonds and, secondly, Germany will move even higher on the agendas of international investors following the 'Leave' vote in the UK. This is particularly true of risk-averse investors, whereas opportunistic players are likely to turn their backs on Germany. All things considered, we expect a transaction volume of between €40bn and €50bn.

Housing market to remain strained despite increased construction activity - policy to create additional tension

Supply in the housing market also remains extremely scarce for occupiers and investors alike. However, the

GRAPH 1

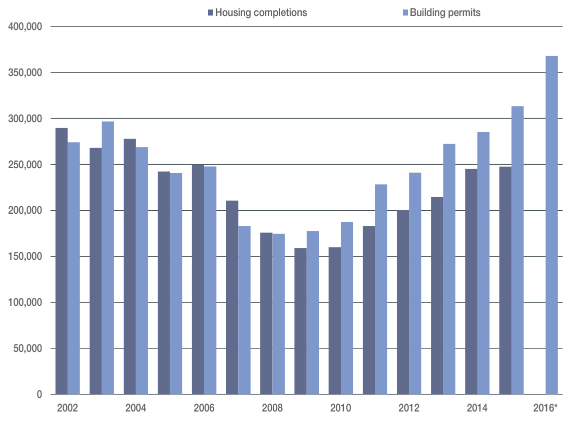
Some regional locations offer above-average yields with favourable long-term prospects



Source: Bulwiengesa, Federal Statistical Office / * Data as of 2015

GRAPH 2

Significant increase in residential construction



Source: Federal Statistical Office, Savills / * Extrapolated based upon Jan-Aug buoyant construction activity will relieve the situation for both groups of market participants. Over the last year, monthly housing completions stood at more than 20,000 while more than 30,000 building permits were granted per month (Graph 2). In terms of permits at least, this represents a level deemed adequate by most demand projections. On the one hand, the rising number of new-build projects creates investment opportunities for investors in an otherwise exhausted market. On the other hand, however, this dampens rental growth. Furthermore, with even more stringent regulation of the German residential rental market expected, the forthcoming federal election could see housing policy playing a prominent role. Against a background of this latent risk, initial yields are not expected to harden further. The double-digit annual total returns achievable on German apartments since around 2010 may, therefore, be consigned to the past for the time being. Nevertheless, the German residential market remains a good choice for risk-averse investors. Scarcely any other property market worldwide offers such high liquidity combined with such low volatility. The easiest way to gain exposure to this attractive combination is to invest in one of the listed residential property companies. These in turn will be striving for further growth, firstly by examining their few remaining competitors with a view to a merger or acquisition, secondly by purchasing smaller portfolios if the opportunity presents itself and thirdly by generally consolidating their own portfolios wherever possible. Thus, since no land costs are incurred, they can add residential space relatively economically and cater specifically for the demand segment that cannot be addressed via new-build projects owing to the excessive costs. Investors who value the stability of the German residential market but for whom rental yields in the apartment building sector have become too low should look to the student apartment market. Such assets offer relatively high running yields combined with the opportunity to benefit from further yield compression as the sector becomes increasingly institutional. The same is true of the micro-apartment sector excluding student accommodation, although this is still very modest in size. Here too, however, development activity is rising in line with that across the residential market as a whole, meaning that the transaction volume in the German residential investment market should once again exceed €10bn in 2017.

Savills Germany

For further information, please contact

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

Marcus Mornhart
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

Savills, a leading global real estate services provider, has its head office in London where it is also listed on the stock exchange. The company was formed in 1855 and can look back on a long history characterised by formidable growth. Savills sets trends rather than following them and, today, has more than 700 offices and associates throughout the Americas, Europe, Africa, Asia Pacific and the Middle East, employing more than 30,000 personnel. In Germany, Savills is represented by some 200 personnel across seven offices in the major real estate markets of Berlin, Düsseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart.

This publication is for information only. We accept no liability for losses, costs or other damages resulting from the use of the information published. The information is based upon sources we consider reliable. However, we cannot give any warranty as to the correctness or completeness of the information. Neither this publication nor parts thereof may be reproduced without prior written consent from Savills.
© Savills December 2016