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Savills World Research
Germany

Market report
Residential market Germany

March 2017

Summary

Proposed political regulations are a sword of Damocles for investors

■ Fundamentals in the German residential market remain positive from an investor's perspective. Population numbers have risen once again, there is continued rental growth and the supply shortage in the rental market is set to continue in many cities in the medium term.

■ However, the currently sound market data should not obscure the fact that even some cities that are still growing at present are likely to contract going forward. We see opportunities in the areas surrounding major cities.

■ Even growth regions, where one might reasonably expect rents to increase, may be unable to keep this promise. This is attributable to conflict over regulatory proposals in the federal election. Many of these proposals would significantly restrict rental increases on existing property.

■ The extensive political risks associated with existing properties are likely to increase the attractiveness of acquiring development projects and new-build assets. Since new-build is exempt from regulations such as the rental cap, significantly higher rents can be achieved.

"The fundamentals on the residential market remain favourable for investors. However, the main topic of the year will be the political conditions."

Karsten Nemecek, Savills Corporate Finance - Valuation

Germany is growing faster than expected

The German population is currently at an all-time high. According to estimates from the Federal Statistical Office, there were 82.8 million people living in Germany at the end of 2016, which was 300,000 more than in the previous year. A principal driver of this growth was further net migration of 750,000 people. Consequently, the number of people requiring housing has risen yet again.

Construction activity is increasing but remains insufficient

The supply side has been slow to respond to the sustained population growth witnessed since 2012. However, new-build activity has recently increased significantly. Annual housing completions totalled almost 250,000 last year, having risen by 35% between 2011 and 2015. In the same period, building permits gained over 37% to more than 310,000. However, this increased activity remains insufficient to cover the additional demand. While the number of households, and hence those seeking housing, has risen by almost 1.5 million since 2011, housing completions in the same period stand at just 1.1 million (see Graph 1). As a result of this trend, vacancies in many cities have been largely exhausted. Vacancy rates of 0.5% or lower in cities such as Munich and Frankfurt may already be preventing people from moving to the city of their choice. Particularly in the major cities, new-build activity cannot keep pace with the growth in household figures. Between 2011 and 2015, housing completions lagged growth in the number of households in 72 out of 79 major cities. Berlin added just 28,000 new residential units compared with approximately 132,000 additional households. New-build volume in 2015 was only sufficient to at least cover household growth in twelve major cities that year. Since the trend towards urbanisation is expected to persist and even intensify, many residential markets are likely to remain strained in the medium term.

Residential markets remain strained

The sustained influx into cities combined with inadequate new-build activity resulted in further widespread increases in rents and multipliers last year. Average rental growth across A, B, C and D cities (based upon Bulwiengesa classifications) accelerated compared with 2015 once again both on first-time lettings and re-lets. The A cities witnessed the strongest growth yet again, with rents on first-time lettings rising by 4.2% and those on re-lets increasing by 5.1%. The price rally in the investment markets also continued. Gross multipliers rose at their fastest pace in the last five years. Only in D cities did the rally in sale prices moderate slightly. In view of the high demand, rents will continue to rise in the current year unless the State intervenes with significant regulations.

The investment market continues to be inundated with capital

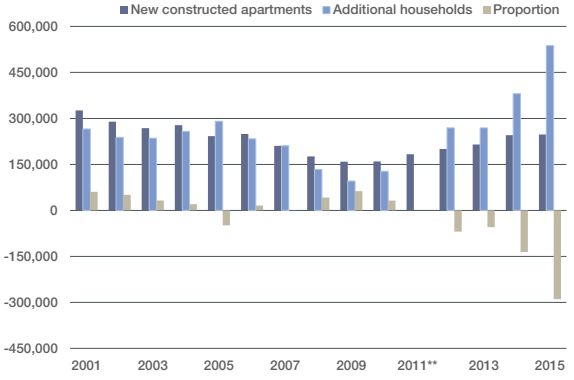
The positive fundamentals continue to attract enormous inflows of capital seeking investment opportunities in the residential market. However, in an era of Brexit, Trump and uncertain election outcomes in the Netherlands and France, the stability of Germany is likely to mean sustained investment pressure in the German residential investment market. Furthermore, there is no significant increase in interest rates on the horizon, at least in Europe. Consequently, German residential property will remain the anchor in the safe haven in the eyes of many investors. Investment deals completed last year totalled around €12.1bn, representing a 54% decrease compared with the previous year (see Graph 2). With scarcely any further large portfolios of existing property available, investors will be increasingly forced to acquire development projects this year. Moreover, the rising new-build volume offers an increasing number of options in this sector.

Areas surrounding the major cities provide opportunities but many growing cities warrant caution

Despite the excellent present fundamentals, however, caution is advised with regard to many cities that are still currently growing. According to regional planning forecasts from the Federal Institute for Research on Building, Urban Affairs and Spatial Development (BBSR), household numbers in more than half (52%) of all administrative districts (Landkreis) and cities with district status (kreisfreie

GRAPH 1

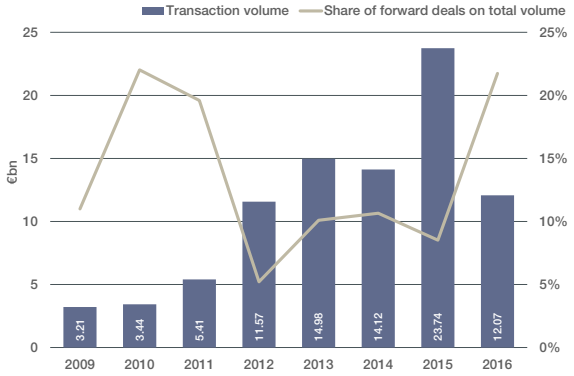
Increasing gap between construction activity and growth of households*



Source: Bulwiengesa / * in Germany total / ** Census, no data for 2011

GRAPH 2

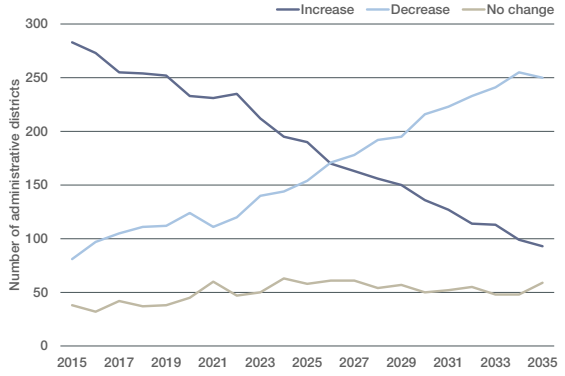
Decreasing transaction volume and increasing share of foreward deals*



Source: Savills / * only transactions with at least 50 residential units

GRAPH 3

Forecast of number of households*: The tide is turning on the long-term



Source: BBSR / * in each case against the previous year

Stadt) are expected to decline or stagnate by 2035 (see Graph 3). These include 72 cities with district status, the majority of which fall into city categories C and D. Hence, even cities that are currently still growing, such as Kiel and Kassel, are likely to contract in the long term. However, such cities and even smaller municipalities have accounted for an average of 40% of the transaction volume over the last five years. Cities that are currently growing due to migration from their immediate catchment areas are particularly likely to contract again in the future as demographic change significantly curtails their sources of population growth. Hence, the current positive fundamentals in such locations should not obscure the long-term risks.

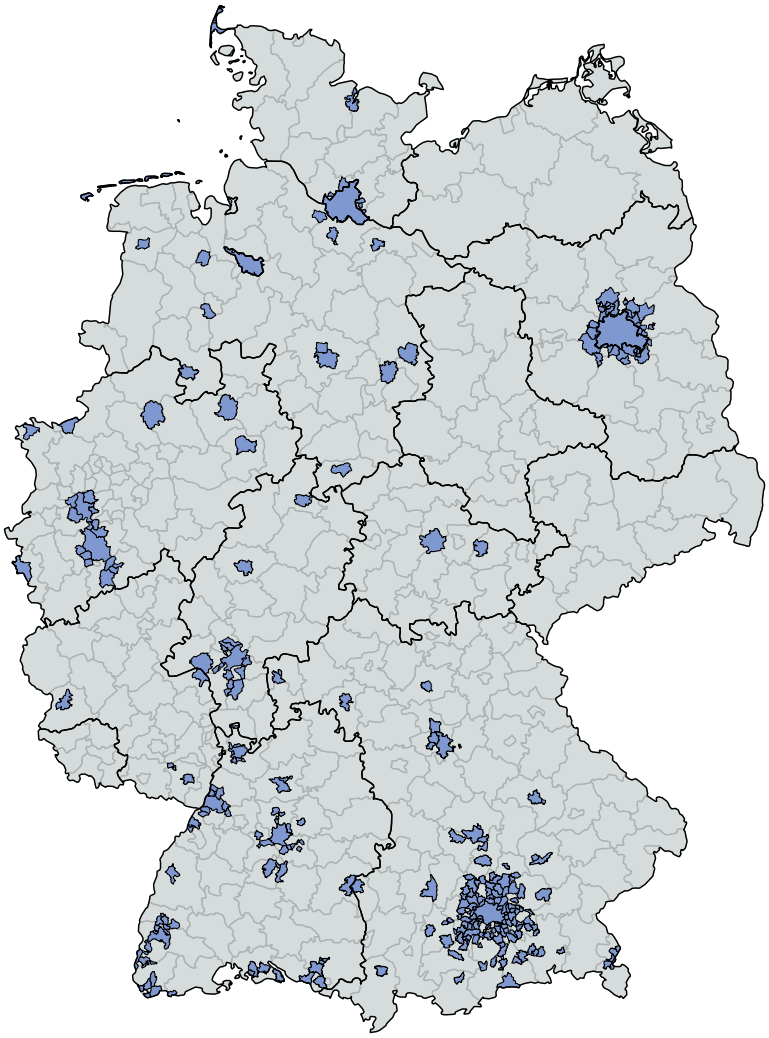
In contrast, the large metropolitan regions continue to promise long-term positive growth prospects. However, investors should not only monitor those core cities characterised by intense competition among bidders, they should also keep the surrounding locations on their radar. Surrounding districts such as Erding near Munich, Harburg near Hamburg and Barnim near Berlin also show a long-term increase in household numbers.

HOWEVER, the supply shortage in the rental market has alerted the attention of politicians

Yet the growth regions also pose considerable investment risks to investors despite the fact that their long-term increase in housing requirements would suggest further rental growth. These risks are primarily of a political nature since the significant increases in rental levels in many areas has triggered a widespread social debate, often associated with calls for stricter regulation of the housing market. As a consequence, some anticipated rental increases may fail to materialise. The most significant newly introduced regulation from a landlord's perspective was the rental cap (Mietpreisbremse). This came into effect at the end of 2016 in more than 310 cities and municipalities, which account for around 31% of inhabitants in Germany. For investors, the geographical scope of this restriction on rental increases alone is of major relevance, even if this housing policy

GRAPH 4

In these cities and municipalities the rent control (Mietpreisbremse) is effective: Potential for rent increase for existing properties is considerably limited here



Source: Savills / map source: BKG

"The risk, that rent increases for existing properties will be more restricted, is growing. Purchases of project developments will become even more attractive." Matthias Pink, Savills Research

instrument has yet to produce any noteworthy decline in rental growth. However, further tightening in the application of the rental cap and the introduction of additional regulatory measures could tip the balance in terms of the financial models and calculations for many investments. The increases in sale price multipliers witnessed in recent years are a result of investors pricing in future rental growth and the risk that this expected growth could be effectively thwarted by legislation continues to rise.

Regulatory conflict looms in the federal election

The closer the 2017 federal election approaches, the more proposed regulations or catalogues of measures to mitigate rental increases or to promote new-build activity are discussed. In any event, it appears clear that housing market policy will be one of the most important themes of the election. For real estate investors, therefore, the political landscape is likely to supplant socio-economic trends and traditional property market data as the key focus of 2017. To date, the majority of proposals have targeted further tightening of tenancy law to the potential detriment of landlords. We have summarised some prominent proposals and their potential consequences for investors below.

■ Statutory duty to disclose the previous rent

This proposal is aimed at improving the effectiveness of the rental cap by obliging landlords to disclose the previous rent received on a property. This increased transparency is likely to allow more new tenants to take action against legally prohibited rental increases, thus improving the effectiveness of the rental cap. In the medium term, a more effective rental cap will result in a further reduction in potential rental growth since the new rents entering the rent index are likely to be lower. Hence, future rental increases will be significantly limited for all holders of existing property in the affected areas.

■ Extended reference period for the rent index

The rental cap as an instrument is principally based on existing rents shown in verified rent indexes. The reference period for the rent indexes is currently four years. One proposal currently being discussed is the expansion of the reference period to eight years. It is not yet clear whether the implementation of this proposal would result in a gradual expansion of the reference period or whether the new period would be applied immediately. While leases already agreed are likely to be subject to grandfathering, index rents adjusted on the new basis would significantly reduce achievable rents on new lettings. Cities with significant recent rental growth would see a particularly sharp decline in reference rents should the reference period be expanded. Assuming an immediate expansion and based upon re-let rents, for example Berlin and Wolfsburg would be affected as follows. Instead of the four-year average of €8.38 per sq m/month, the reference rent in Berlin would be just €7.59 per sq m/month with an expanded eight-year period, representing a decrease of 9.4%. In Wolfsburg, the reference rent would fall from €7.00 per sq m/month to €6.30 per sq m/month, a decline of 10.0%. With a gradual expansion, the decreases would be lower but still significant. In cities where rents are falling, on the other hand, an expansion of the reference period would result in an increase or a slower decline in index rents. However, such cities currently remain the exception and, in any case, are rarely likely to satisfy investors' profiles. Ultimately, the intensity of the impact of this measure is largely dependent on the nature of its implementation and the actual degree of expansion. In any event, holders of existing property in the particularly strained housing markets would be most affected.

Commentary

Housing redefined?

Until now, housing has varied in size, quality and location but has otherwise remained broadly similar despite being aimed at a wide-ranging target group. This housing has been available to families, senior citizens, young professionals and students in equal measure. As a result, all of these target groups have been competing for the same product.

However, the increasing number of residential concepts aimed at specific target groups appear to be redefining the very notion of housing. The student accommodation market in Germany has now established itself as a sector in its own right, both on the demand side and from an investor's perspective. With almost 60,000 beds in the 30 largest university cities alone, the stock of private student accommodation is soon likely to have risen more than five-fold since 2010. The micro-apartment market targeting young professionals represents another rapidly growing segment while other prospective growth markets include senior citizens' apartment complexes and affordable housing. The subdivision of the housing market into several sub-segments and the associated focus on specific target groups makes it essential for developers and investors to understand their end customers, the tenants, and their specific requirements. Students and senior citizens, for example, have entirely different preferences in terms of location that must be respected. Requirements for communal areas and services in a property, such as the presence of a property manager, also vary from one target group to another. Going forward, we expect occupiers to demand such services with increasing regularity, meaning that niche product must offer more than simply providing an apartment.

As a consequence, the boundaries between living and lodging are likely to become increasingly blurred. However, what appears certain is that the residential market is becoming more multi-faceted and granular, reflecting a changing society.

■ Reduced apportionment of modernisation costs

A further proposal to reduce the rental burden on households targets the apportionment of modernisation costs to tenants. The SPD party has tabled a reduction of the current limit on apportionment from 11% to 8%. A cap threshold would also be introduced. Accordingly, rents could only be increased as a result of modernisation by a maximum of €3.00 per sq m/month within an eight-year period. Another party, "Die Linke", would like to completely abolish the apportionment of modernisation costs. Regardless of the specific regulatory proposals, any restriction in the apportionment of modernisation costs would make investment in existing properties less attractive owing to the significantly limited opportunity to increase value-add potential. This is likely to make investment in development projects and new-build assets even more attractive from an investor's perspective.

■ Clients to pay agents' fees on sale contracts

To make home ownership more accessible, another proposal being discussed is the extension of the principle that the client pays the agent's fees (Bestellerprinzip) to sale contracts. In such case, fees would be paid by the party who instructed the agent. This would also reduce ancillary acquisition costs by a small percentage in the institutional segment. Furthermore, such legislation could also indirectly produce cost savings for investors since the logging of information and particulars hitherto required for the purpose of clarifying commission claims would no longer be necessary.

■ Assistance to increase home ownership

Another theme in the discussion of housing market policy is the question of how to enable more households to build or purchase their own home or apartment. Proposals on this issue include introducing of an exemption from real estate transfer tax or even direct financial support. In the event of extensive financial assistance with building or buying a home, development activity may once again turn increasingly in favour of constructing condominiums. Such a move might also restrict the availability of product for institutional investors.

■ Greater use of pre-emptive rights

Other discussions focus on an increasingly active role for local authorities in the housing market, particularly in major cities such as Berlin. The coalition agreement of Berlin's state government, for example, includes stipulations regarding the increased use of pre-emptive rights. Accordingly, directives on pre-emptive rights should be enacted with the objective of giving priority of acquisition to local housing associations. For private-sector investors, this is likely to further heighten the already intense competition for development sites. In the long term, a shift in development activity towards municipal companies would also reduce the new-build stock available to end investors.

■ Obligation to provide subsidised housing with tenant controls

The award of municipal sites for residential development in major cities is increasingly subject to the obligation to provide a specific proportion of subsidised housing. According to the coalition agreement of Berlin's state government, for example, state-owned sites should only be awarded to developers who will deliver 30% to 50% of the residential space under rent and tenant controls. This is likely to significantly hinder investment from private-sector developers in such sites while also potentially reducing availability of product for end investors.

The political climate is shifting to the detriment of residential investors

On the whole, it is reasonable to state that the political climate appears to be shifting significantly to the detriment of investors in residential property. Depending on the outcome of the federal election, the potential to impose rental increases may be materially limited. Furthermore, a number of measures may contribute to a further scaling back of new-build activity. Of the proposals being discussed, only the re-introduction of the home ownership subsidy would stimulate construction, although a potential shift towards building condominiums may even reduce availability of product for institutional investors. Overall, investment scenarios that consist of acquiring properties with below-average passing rents with the objective of increasing these significantly are likely to be far more difficult to implement. Against this background, properties with an above-average or market rental level will become even more attractive. Hence, the sound fundamentals of the German residential market are opposed with significant political risks. The political landscape following the federal election in September could, therefore, have material implications for the profitability of many existing investments as well as the viability of planned investments. Further investments in the residential market may be generally hindered or even prevented, thus removing competition from the market.

Savills Germany

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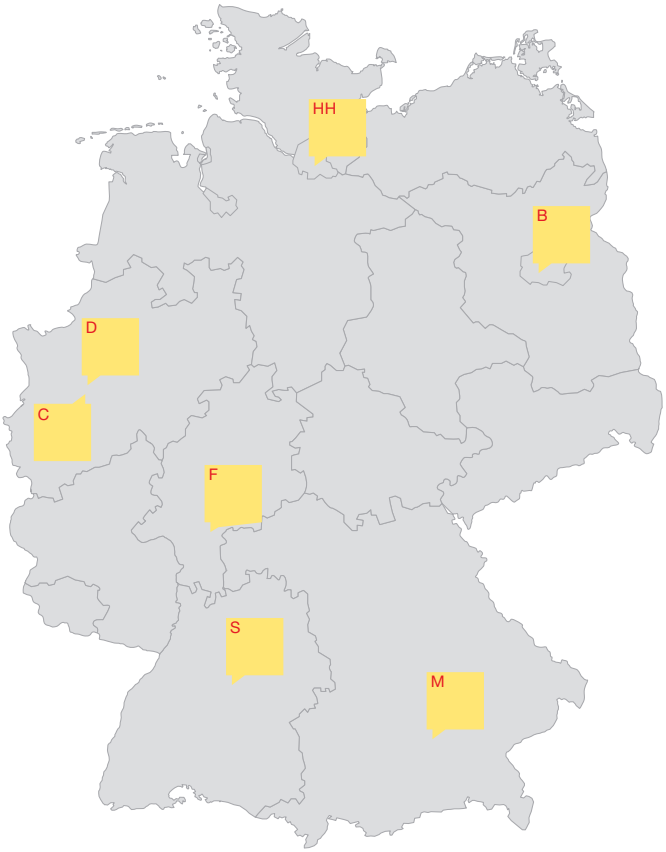

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