savills

Savills World Research
Germany

Analysis
Outlook for the German real estate market

December 2017

An increasing number of end-of-cycle phenomena are causing widening concerns although, based upon the facts, there is still no end to the cycle in sight. However, a closer examination of the superficial case for "onward and upward" reveals details that could precipitate major changes in the mid-term.

Waiting for the black swan

As 2017 draws to a close, sentiment in the real estate sector appears strangely ambivalent. On the one hand, most market participants looking at the facts reach the conclusion that the German market will remain strong for the time being and, consequently, there is no cause for concern. On the other hand, they do not appear to genuinely believe in the case for "onward and upward" and are looking for indications of an imminent reversal. For the most part, they do not find anything and then start to seek out the "black swan", one of those improbable events that occurs unexpectedly and suddenly topples the uptrend. In our opinion, however, a sober analysis of the facts suggests that the overarching trends of recent years will continue and, from a current perspective, "onward and upward" represents the scenario with the highest probability of occurence. Hence, our first key message of this analysis is: **while concerns may increase, little will change fundamentally.** Consequently, the fact-based overall picture that can be mapped out for the real estate sector in 2018 looks confusingly similar to that of the previous years. We believe that looking for a black swan in this picture is a fruitless exercise. Instead, we will focus on the details of the picture that we consider interesting. However, we cannot rule out that one of these details will subsequently prove to be a black swan.

Competition for talent is just one factor in favour of co-working spaces

In the office lettings markets, even higher rents and an even scarcer supply will further strengthen the negotiating position of landlords, posing genuine challenges to companies seeking office space. Existing tenants with expiring leases will also be faced with significantly higher rents when negotiating lease extensions. Companies that cannot meet these higher costs of accommodation will then be forced to lease offices of lesser quality or in poorer locations. This, in turn, will weaken their position in competing for the best personnel. In the worst-case scenario, this may even threaten a company's existence since the shortage of skilled personnel is a more pressing problem than the shortage of office space for many companies. Hence, despite the higher property costs, their location strategy is tailored towards the availability of skilled personnel rather than the availability of inexpensive office space provided that the former option is within their budget. Nevertheless, to limit property costs, this strategy often involves dividing personnel across several locations for larger companies. Unlike in the past, however, this multi-location strategy will not mean shifting back-office activities to peripheral locations but rather leasing high-quality space in optimal locations for the knowledge workers. This increasingly involves co-working spaces and serviced offices (in the following, we will refer only to co-working spaces, by which we mean both). While these were once aimed solely at freelancers and startups, large companies have long been a significant client group for their providers. One fifth of WeWork members, for example, are employed by a company with at least 500 personnel. **Co-working space providers will capitalise on the shortage of office space to become major players in the office markets.** We are noticing rapid growth in both supply and demand and this growth cannot fail to have consequences for providers of traditional office space. Users of co-working spaces, whether they work for a startup or a major company, are accustomed to the amenities they offer, which is bound to raise their expectations of all other forms of office space. Their employers, in turn, are learning to appreciate the flexibility of co-working spaces both spatially and with regard to contractual terms and will make corresponding demands of their landlords in the traditional office segment. What this means in concrete terms is that office space without bicycle parking, showers and perhaps even a fitness

area could become significantly more difficult to let going forward while leases may trend towards shorter terms. However, the latter will only become an issue once occupiers are in a stronger negotiating position again, which we expect to be no earlier than 2020.

The sole risk for office investors is over-optimism

In view of the worsening supply shortage in the near future and the resulting rental growth potential, office property will remain extremely attractive to investors. Competition for office assets will also remain correspondingly strong. As a result, the pressure on initial yields will continue, particularly in the core-plus segment. However, the high multipliers are justifiable with reference to the sustained low interest rates in the money and bond markets and the good prospects of rental growth. **Yet the combination of extremely high pressure to invest and the growing supply shortage in the office lettings markets could lead investors to set excessive rental growth expectations.** In the short term, we are in no doubt that the strong rental growth will continue. Over the longer term, however, there are four factors that could at least curb this growth. *Firstly*, and most obviously, development activity is set to increase. In 2019 already, completion volumes in the top six cities will be significantly higher than in previous years and are unlikely to fall below this level in the subsequent years. *Secondly*, and conversely, growth in the number of office employees in these top six markets is highly likely to be much slower than in the recent past since the cities concerned and their surrounding areas are running out of (affordable) housing. Faster growth in supply and slower growth in demand cannot produce any other outcome than lower rental growth. For the remaining two factors, we will adopt the conditional tense. The *third* would be the growth in co-working spaces, which we have already discussed. If their workstations could be more fully utilised than is the case in the "old" office world (and this is one of the pillars of their business model), then each co-working space workstation would replace 1 plus X traditional office workstations over the

Our theses from last year

Too cautious in some instances but accurate overall

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.*

The supply shortage did not prevent take-up. While the average vacancy rate across the top six cities fell to approximately 5% as predicted, take-up rose by almost 10% (estimated) compared with the previous year. One reason for this is that the proportion of pre-lets rose significantly. Prime rents rose by approximately 3% while the average rent rose by almost 5%, a reflection of occupiers shifting to B and C-locations.

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.*

Rents only rose in selected areas and were stagnant at best even in most prime highstreet locations of major cities. A number of development projects, such as the Mall of Ku'damm, were withdrawn indicating declining demand for space that was reflected in lower take-up. Many retailers rolled out smaller store concepts or announced these (Ikea, Decathlon). Some retailers did expand their stores but this was normally associated with a reduction in store numbers (e.g. Zara in Cologne or the food retail segment).

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.*

'City logistics' has become the buzzword in the debate around logistics properties. However, while the number of delivery vehicles has predominantly risen, this has not been generally true of logistics properties to date. Nevertheless, there are some examples, with the most prominent being occupied by Amazon Fresh and Prime Now in Berlin and Munich. The overall stock of German logistics space rose by more than 5 million sq m in 2017, the strongest growth on record.

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.*

Rising demand + growing willingness to sell = €60bn transaction volume. Such was the equation in the commercial investment market in 2017. The rise in investment essentially benefited all categories of city and location, with third and fourth-tier cities and the areas surrounding A-cities benefiting disproportionately. Initial yields across the various segments hardened by an astounding 20 to 50 basis points during the year with the highest yield compression in the core-plus segment.

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.*

Sales of residential developments totalled more than €3bn in 2017, an increase of more than 20% compared with the previous year and four times the five-year average. Conversely, the transaction volume for existing stock stagnated at approximately €10bn. Initial yields showed little movement in the prime segment but moved in significantly across the market as a whole. While there were numerous housing policy proposals on the table during the federal election, their probability of implementation is considered low.

long term. Then, it would require less supply to satisfy the same demand, which would exert pressure on office rents. *Fourthly*, in the event of declining office vacancies combined with sustained high demand, the period between a lease being agreed and lease commencement is likely to become increasingly long, simply because the amount of pre-lets as a proportion of overall office take-up would increase in view of the lack of availability. Even today, companies seeking at least 3,000 sq m of contiguous office space must allow a lead time of 30 to 36 months. If such a long waiting time became the norm, this would mean that an increasingly large proportion of take-up counted today would relate to the business plans of yesterday and would not manifest itself in actual absorption of space until the day after tomorrow. Overly optimistic investors should then ask themselves: what would actually happen if the economy no longer grows as strongly tomorrow as we expected yesterday?

Retail: pop-up stores instead of 10-year leases

Downside risk is far easier to identify when it comes to retail rents. With a few exceptions, the market for retail space is now a tenant's market. This shift in power is exemplified, for example, by the fact that H&M has publicly declared its interest in leases of no longer than three years. In addition to lease lengths, we also expect demand for space to decline. On the one hand, multiples will significantly roll back their expansion drives and, on the other hand, their store concepts will shrink in size. Exceptions here will confirm the rule. **We only anticipate stable demand for retail units in the best locations, i.e. those with the highest footfall, and at an international level.** Indeed, there will be more and more new players on the demand side in these hot spots, including brand manufacturers such as Tesla and Dyson. Outside of these prime locations, we expect retail space to contract. The planned letting of WeWork in the Kaufhof property on the Zeil in Frankfurt, for instance, illustrates two things in this regard. Firstly, almost all locations are "outside of these prime locations". Secondly, the fact that such locations are less in demand from retail occupiers does not mean that they are unattractive for other uses. Moreover, fewer and fewer retailers will initiate searches for attractive retail locations based upon a 10-year lease or even a three-year lease. Instead, they will start with a pop-up store and test whether operation of a long-term outlet is viable in the location.

Falling demand for retail space poses a challenge to investors

If department stores transform into XXL high-street properties and 10-year leases give way to pop-up stores, landlords will require a high degree of adaptability. For investors that once included retail properties in their portfolio to achieve stable long-term rental income, this is a significant departure. Combined with the generally unfavourable outlook for capital values, this is likely to increase investors' willingness to sell, which we expect to produce rising initial yields from as early as 2018. Prices could only rise further in individual, limited market segments (e.g. high-street properties in prime locations or established local supply stores with no competition in their catchment area). When such a rare prime property comes to the market, bidders form an orderly queue. It is not only investors in retail property that will feel the effects of declining demand, however. Developers and owners of office property, for example, are increasingly confronted with this situation since the ground floors of their properties can now only be let as retail space in selected locations and even the demand for restaurant space is finite.

Logistics will move into cities but not into new buildings

Judging by the intensity with which the issue of city logistics is being discussed, logistics space could not only fill vacant ground floors but entire cities. And with demand for urban logistics space from Amazon, Kaufland and Zalando increasing, blueprints for ideal city logistics properties are being drawn up. **However, a new type of urban logistics property could prove to be a mirage.** Even with today's structures, goods orders in major cities can often be fulfilled seamlessly the following day. For same-day or even same-hour deliveries, the logistics network in cities is without doubt still insufficiently dense but the hubs in this network are logistics properties of up to a few thousand square metres. We therefore believe that the rising demand for logistics space in inner-city locations will probably be satisfied, for the most part, in the existing building stock rather than in a new form of urban logistics property, which would also require some high hurdles (planning law, noise protection, etc.) to be overcome. Hence, urban logistics will not be an issue for logistics developers and investors but for everybody else

As residential investors shift to B and C-cities, the population will migrate to the areas surrounding A-cities

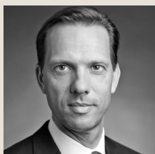
The most acute shortage of space will remain that faced by inhabitants of major cities, where the supply of (affordable) housing is running out. And where do these people move to instead? To Mittelmark, Harburg or Straubing. Such suburban districts in particular show the highest relative net migration. And investors? They are acquiring apartment buildings in Duisburg, Halle (Saale) and Oberhausen, i.e. shifting their attention to second and third-tier cities in view of the lack of supply in the A-cities. The three afore-mentioned cities are all on the list of the top 10 markets in terms of the number of residential units transacted in 2017. This is all the more remarkable since, in the twenty years prior to the peak of the wave of refugees, all three cities shrank almost continuously and the same is also projected for the next twenty years. One possible interpretation of this phenomenon: **the high pressure to invest is causing investors to place greater importance on the market size than the fundamental conditions.** It may be easier to invest 50 million euros in Duisburg than in Teltow. However, migration flows suggest that the latter town in Brandenburg offers significantly more favourable rental growth prospects

More and more end-of-cycle phenomena but no end to the cycle

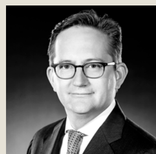
The gradual increase in residential investors' appetite for risk can also be witnessed in other sectors and is manifesting itself in a variety of ways. Compromises on macro-location and micro-location, shifting to (former) niches such as logistics and student accommodation and rising willingness to acquire developments, etc. In other words, the number of end-of-cycle phenomena is increasing, which is surely among the causes of many players' concerns outlined in the introduction**. However, these very concerns may actually be restraining a self-accelerating, euphoria-driven momentum that is driving market participants almost unnoticed into high-risk areas and will culminate in an abrupt change of sentiment.** In addition, from an international investor's perspective, Germany represents a safe haven for capital, possibly more than ever in view of the disruption in many other locations, and is therefore predominantly attracting risk-averse investors for whom stability is more important than growth. So, a cycle without end? Surely not, but we still do not believe that the end is in sight. Unless there is a black swan...

Savills Germany

Please contact us for further information

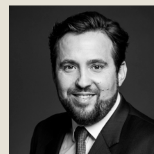


Marcus Lemli
CEO / Investment
+49 (0) 69 273 000 12
mlemli@savills.de



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 is a leading global real estate service provider listed on the London Stock Exchange. The company, established in 1855, has a rich heritage with unrivalled growth. It is a company that leads rather than follows and now has over 700 offices and associates throughout the Americas, Europe, Asia Pacific, Africa and the Middle East with more than 31,500 employees worldwide. Savills is present in Germany with around 200 employees with seven offices in the most important estate sites Berlin, Dusseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart.

This bulletin is for general informative purposes only. Whilst every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The bulletin is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.
© Savills December 2017