

Briefing note  
**Outlook for the German  
real estate market**

December 2018



The German real estate market ten years on from the Lehman crash  
and how the journey might continue

# First a crisis, then a boom

*Texts: Matthias Pink*

Hand on heart, if somebody had told you ten years ago that property prices in Germany would at least double over the coming decade, would you have believed them? On 15 September 2008, investment bank Lehman Brothers filed for insolvency, marking the nadir of the global financial crisis. The crisis would lay the foundations for a perhaps unparalleled real estate boom, not least in Germany. Over the last ten years, purchases of residential and commercial property by institutional investors have totalled half a trillion euros (€120bn for residential property and €380bn for commercial

property). Such inflows of capital are unprecedented in the German real estate market. This surge in demand has driven prices to an extent that nobody would have truly expected. Capital values have doubled across practically all property sectors during this period, reaching new record levels across the board.

Indeed, the past decade has produced a number of records, initially on the negative side, before setting numerous positive benchmarks. In that respect, the last ten years will leave many entries in the history books. They have

also given us plenty of tales to tell, such as Berlin's promotion into the league of world-leading investment locations and the renaissance of residential property as an institutional asset class. Here, we recount both of these stories and map out how the narratives might continue. In a third story, we discuss how the German real estate market could unfold going forward and give our medium-term outlook. The story so far: there was a crash and then a boom and there are still no signs of a 'bang' on the horizon.

## 10 years since the Lehman crash – a chronology



# From “poor but sexy” to boomtown Berlin

A glance at the trends in several indicators underlines that **the Berlin real estate market has written a quite unique story over the last ten years** (Graph 1). When the global financial crisis materialised, the German capital was still known as “poor but sexy”, a soundbite coined by then Mayor of Berlin Klaus Wowereit five years earlier that became arguably the most powerful slogan of any city in history. Certainly, “poor but sexy” is not an image that appeals to real estate investors. It did, however, attract young creative people in their droves. Net migration in Berlin has been consistently positive since 2001, with a net balance of around 400,000 people relocating to the German capital. The number of students alone has increased by 50,000 during this period. **Berlin became the ultimate place to be.** The dawning of the knowledge-based society in which human capital appears to supersede financial capital as the key resource created a launchpad for economic growth. Yet, while the Berlin Institute claimed that Berlin had the greatest potential for growth of any German city in a study published in 2007, making reference to the knowledge economy, property market participants remained sceptical. In March 2008, German property newspaper “Immobilien Zeitung” ran the headline: “Berlin

real estate market only moderately attractive” while a year later in the [Urban Land Institute’s annual ranking of European cities](#), Berlin placed just 9th out of 27 cities in terms of its investment prospects. The ranking is still produced today and Berlin has occupied first place for the last four years.

**Over the last ten years, the scepticism of real estate investors towards Berlin has given way to a euphoria that is manifested in their willingness to pay.** Prime office yields, for instance, are on a par with those in Frankfurt and Munich. Since the capital continues to lag behind the other top seven cities significantly in terms of economic output, the low yields surely reflect high expectations of future growth in Berlin, among other factors. In fact, Berlin has closed the gap in economic performance over the last ten years and the ongoing vibrant start-up scene, combined with the sustained influx of creative minds into the city, promises further growth. One notable product of this phenomenon is Zalando. Formed in the same year that Lehman Brothers filed for insolvency, the online retailer is now among the fifteen largest companies in Berlin and has accounted for one of the largest requirements in the office lettings market in recent years. Today,

Berlin still produces more than 500 start-ups per year. Most will certainly fail but many will establish themselves and some may even become the next Zalando. With such a vast number of new businesses, randomness alone dictates that it will also produce success stories. In addition, more and more established companies are moving into the capital to be close to Berlin’s technology and start-up scene. **In this regard, the prospects that Berlin’s catching-up process will continue over the coming decade are good.** Real estate investors are certainly betting on this. However, they should also be mindful of the fact that the new economy emerging in Berlin is more vulnerable to economic fluctuations than its public-sector-led predecessor. **Hence, short-term setbacks on the long-term growth trajectory should also be expected in the real estate market.**

GRAPH 1 Selected indicators for Berlin over the past decade

	2008	Top 7 rank	2018	Top 7 rank	2008-18	Top 7 rank
Prime office rent	22.80 €/sq m	5	34.80 €/sq m	3	+53%	1
Prime retail rent	230 €/sq m	5	310 €/sq m	2	+35%	1
Average residential rent	6.30 €/sq m	7	10.90 €/sq m	6	+73%	1
Prime office yield	5.2%	3	2.9%	1	-44%	1
Commercial transaction volume*	€16bn	2	€31bn	1	+94%	1
GDP per capita**	€28,900	7	€36,800	7	+27%	1

Source: Bulwiengesa, Empirica-Systeme, Federal Statistical Office, Savills / \*last five years respectively / \*\*2016 instead of 2018 since more recent data is unavailable

### March 2009

The ECB lowers its main refinancing rate for the eurozone to 1.5%, breaching the 2% mark for the first time in its history

### July 2009

The DAX closes at 4,573 on 8 July, having dropped more than 40% in two years

### June 2009

The transaction volume in the German commercial property market for the first six months is down 75% year on year

### December 2009

The German economy contracts by 5.6% compared with the previous year – the strongest economic slump in German post-war history

# An old flame rekindled. The return of residential property in institutional investors' portfolios

**Once upon a time, residential property was an integral component of the portfolio mix for German institutional investors.** In the 1970s, for example, asset allocations to residential property by life insurance companies and pension funds were constantly above 5%. In the decades that followed, apartments represented an increasingly smaller proportion of the portfolios of both these and other investor groups. By the dawn of the financial crisis, residential property accounted for just 0.3% of the portfolios of direct insurers in Germany. Even the portfolios of the German open-ended real estate funds included scarcely any residential property anymore. What had happened? **In view of the low initial yields and greater protection for tenants, institutional investors increasingly avoided residential property from the 1980s onwards.** Instead, they devoted their attention to commercial property.

**Today, initial yields are lower than ever and the state is increasingly intervening in the apartment market. However, apartments continue to enjoy levels of demand from institutional investors that have not been seen for a long time.** The strong risk aversion among institutions following the shock of the financial crisis smoothed the path for residential property to make a comeback into investment portfolios. To this day, limiting risk remains the utmost priority and stable returns are sought first and foremost. The German rental apartment market is tailor-made for this requirement profile. In fact, it always has been. However, the majority of investors simply preferred other investments in previous decades. The high levels of letting activity in recent

years have certainly contributed to the rediscovery of the apartment market by investors.

The comeback is also perhaps best illustrated with reference to German insurance companies and pension funds. Over the last ten years, these have been responsible for net investment of €1.9bn in the German apartment market. Their directly-held apartment stock, which totalled €3.4bn at the end of 2008, has grown accordingly (although concrete figures are no longer available owing to changes in reporting obligations). Together with their foreign counterparts, these have invested a good €3bn, representing the fourth largest purchaser group of the post-Lehman era.

However, apartments have not only found their way back into the portfolios of insurance companies, pension schemes and pension funds by way of direct investment. These and other institutional investors have also increased their exposure to apartments indirectly. One way they have done so is via special funds, which have accounted for net investment of a good €13bn in the German apartment market over the last ten years and whose main source of capital is insurance companies, etc. Another way, which has only occurred in Germany over the last few years, is via the stock exchange. **Prior to the financial crisis, listed residential property companies scarcely came into the equation. Today, they include five of the ten largest apartment owners in Germany.** These five companies combined hold more than 800,000 apartments and have a total market capitalisation of around €50bn.

**Among their largest shareholders are insurance companies, pension funds and sovereign wealth funds.** The Norwegian sovereign wealth fund, for example, holds shares in the three

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## Top 5 net investor groups since 2009

1. Property companies/REITs €19.3bn
  2. Special funds €13.1bn
  3. Housing associations €6.8bn
  4. Insurance companies/pension funds €3bn
  5. Retail funds €0.8bn
- .....

largest companies. Mathematically speaking, therefore, the fund “owns” more than 40,000 German apartments.

In brief, this can all be summarised as follows: institutional investors have rekindled their passion for residential property. The risk aversion of investors, which peaked during the financial crisis, has brought the two back together. Will the romance be short lived? The characteristics of residential property alone, namely stable income and hence modest prospects of short-term capital growth, favour a longer-term relationship. Moreover, such stable returns that are independent of economic conditions are particularly valued by investors in this late stage of the cycle (see the following page). Evidently, however, investors' preferences are no match for the income from apartments when it comes to stability. From time to time, their eyes will wander.

### April 2010

Greece requests a pre-prepared aid package from the IMF and EU as the global financial crisis culminates in a euro crisis

### September 2013

The Federal Republic of Germany has more than 30m employees subject to statutory social security contributions for the first time

### July 2012

ECB President Mario Draghi delivers his famous “Whatever it takes” speech to dispel doubts surrounding the future of the euro

### September 2014

Prime office yields in the top seven cities harden to 4.5%, returning to pre-crisis levels for the first time

# Thus far, a boom – and now? An outlook

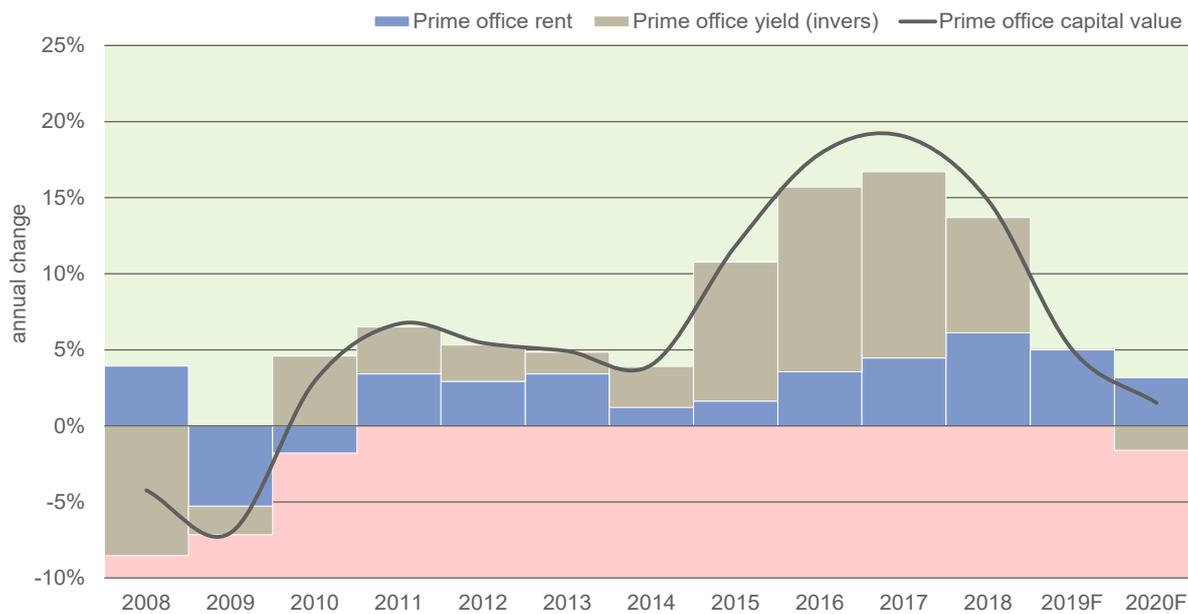
Today, ten years on from Lehman, players in the German real estate market are no longer staring into an abyss; they are enjoying the views from previously unscaled heights. The brief downturn associated with the financial crisis, which in terms of the apartment market was actually only a small dent, has been followed by an upturn spanning many years (Graphs 2 and 3) and the longest to date since German reunification. Since 2015, at the latest, the pace of rental growth and yield compression has been so great that the upturn can be confidently referred to as a boom. **We are also almost certain that this boom is now coming to an end. However, that is not to say that the market is immediately about to go downhill.** Rather, that the boom is

set to revert to an upturn since the stimuli of monetary policy that created the boom are becoming weaker. The US Federal Reserve has now hiked its key interest rate eight times and has signalled its intent to continue on this path. The European Central Bank (ECB) has also begun to unwind its ultra-accommodative monetary policy albeit without hiking interest rates to date.

The normalisation of monetary policy will take much of the momentum out of the supercycle but will not bring it to an end. This is explained by the fact that, *firstly*, normalisation has long been factored into investors' expectations and, as such, is already reflected in investment decisions and prices. *Secondly*, unlike the previous

debt-driven cycle, the current cycle is driven by equity, which is why the braking effect imposed by interest rate increases via financing channels is likely to be relatively modest. In any case, the ECB appears to have limited room for manoeuvre in terms of interest rate hikes. The consensus estimate of analysts is that the key interest rate will remain below 2% up to and including 2023. The same applies to 10-year German government bonds. **Hence, while the reversal in interest rate policy is not necessarily a threatening scenario, (the prospect of) more restrictive monetary policy will not pass by without consequence.** We expect three consequences, which are as follows. *Firstly*, inflows of capital into the real estate markets will be reduced.

GRAPH 2 Office market cycle in the Top 7 since 2008



Source: Bulwiengesa, Dekabank, Savills

**March 2015**

The ECB begins purchasing securities

**December 2015**

The US Federal Reserve raises its key interest rate to a range of 0.25% to 0.5% - its first interest rate hike since June 2006

**December 2015**

Investor acquisitions of German residential portfolios total more than €23bn – a new record

**March 2016**

The ECB lowers its main refinancing rate to 0%

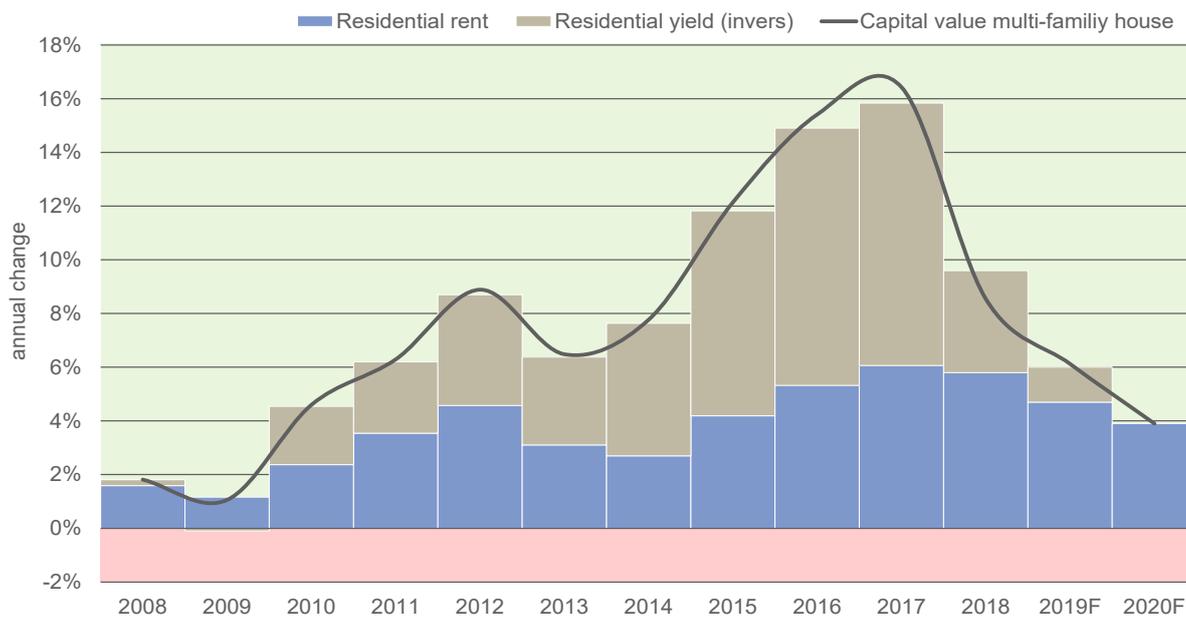
Secondly, there will be no further yield compression driven by interest rates. This will culminate, thirdly, in initial yields only hardening further in those sectors and regional submarkets in which rental growth prospects are enhanced by strong fundamentals.

In the office markets, the continued economic growth is likely to produce rising demand for space. However, the outlook has recently become clouded and the list of actual and potential stress factors is long (trade conflicts, Brexit negotiations, EU budget dispute with Italy, etc.). The economic upswing remains intact but it is on shaky ground. At the same time, completions of office space in the top seven cities are on the rise again, particularly in Berlin. Even in

the German capital, however, the expected new-build volume for 2019 is only sufficient to cover projected requirements and supply is only expected to grow somewhat faster than demand from 2020. We expect rents in the top seven cities as a whole to show similarly strong growth in 2019 to that witnessed in 2018 before the pace of growth subsequently slows (Graph 2). However, should the economy lose momentum quicker than expected, the period of rental growth could well come to an end sooner. **In any event, we consider a reversal in the economy to be a far greater risk than a reversal in interest rate policy.** Market participants are prepared for the latter but are probably not ready for a recession.

In the apartment market, only stringent regulation could prevent further rental growth (and even then, only ostensibly). Building permits for apartments continue to lag behind demand, not to mention completion figures. And since this appears extremely unlikely to change in view of the numerous shortages (including development sites and personnel in both planning authorities and construction companies), there is fundamentally only one realistic scenario. **Rental growth on apartments is likely to continue to outstrip the inflation rate over the coming years** (Graph 3).

GRAPH 3 Apartment market cycle in Germany since 2008\*



Source: Bulwiengesa, Savills / \*basis: average values for 127 Riwis cities

**June 2016**

The vacancy rate in the top six office markets falls below the 5% mark for the first time in 16 years

**November 2018**

The transaction volume in the commercial property investment market exceeds €50bn, making 2018 the fourth year in succession and only the fifth year in history to break the threshold

**December 2017**

Residential rents in German cities increase by 7% year on year, marking a 13th successive year of rising rents

# The German real estate market from 2009 to 2018 in figures

## Commercial property market



**18,000**  
transactions



**€380bn**  
transaction volume



**2,500**  
purchasers

Increase in  
prime rents ...



**+21%**  
office

### Top five cities by transaction volume

1.	Berlin	€46bn
2.	Frankfurt	€41bn
3.	Munich	€37bn
4.	Hamburg	€30bn
5.	Düsseldorf	€19bn

### Top five purchaser nations by net acquisition volume

1.	Germany	€25.3bn
2.	France	€11.0bn
3.	Singapore	€4.3bn
4.	China	€2.6bn
5.	South Korea	€2.3bn



**+29%**  
high street retail



**+11%**  
logistics

## Residential property market



**2,500**  
transactions



**€120bn**  
transaction volume



**500**  
purchasers



**1.6m**  
apartments transacted

### Top five cities by number of apartments transacted

1.	Berlin	366,000
2.	Dresden	67,000
3.	Hamburg	40,000
4.	Leipzig	39,000
5.	Munich	31,000

### Top five purchaser nations by net acquisition volume

1.	Germany	€24.0bn
2.	Luxembourg	€2.5bn
3.	France	€1.9bn
4.	Israel	€0.8bn
5.	Sweden	€0.4bn

### Increase in average rents

A-cities  
**+62%**

B-cities  
**+52%**

C-cities  
**+55%**

D-cities  
**+44%**

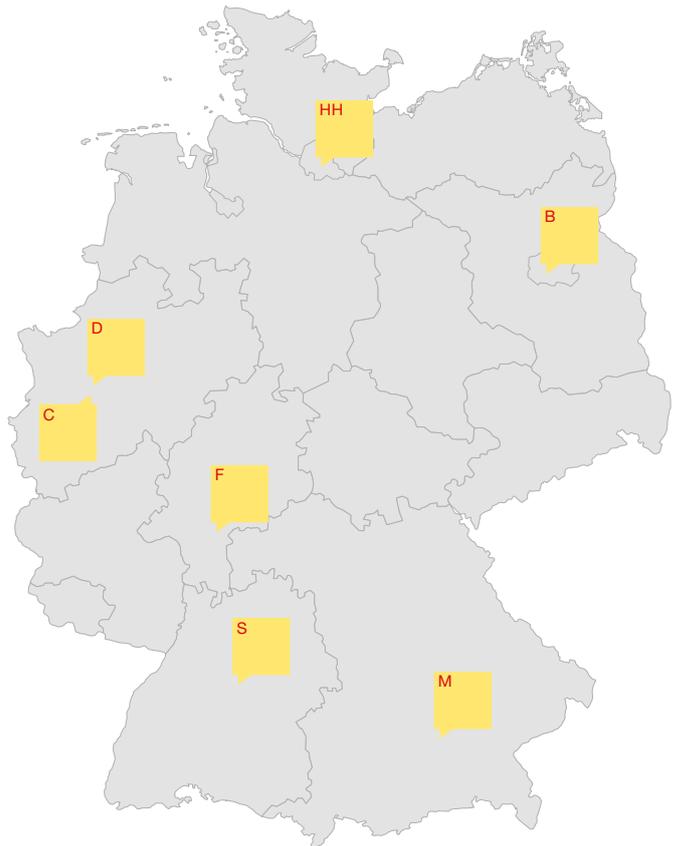
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