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Savills World Research
Germany

Market report

Commercial property market Germany

March 2018

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The best of times

Germany in 2018: the population has been rising consistently for years and the economy is growing sustainably and more strongly than in recent memory. Unemployment is at record lows and incomes of most employees are rising appreciably. Saving is unattractive owing to the low interest rates, producing higher consumer spending than ever before even when price-adjusted.

In the commercial real estate markets, all of this is manifesting itself in high demand for space and rents that, in some cases, far exceed their previous highs (see Graph 1). With supply having been unable to keep pace with the growth in demand in most sectors, vacant properties are now a rarity in many major cities.

Owing to the extremely accommodative monetary policy that continues to be pursued in Europe and beyond, these outstanding conditions from an investor's perspective are complemented by an interest rate environment unique in history (see Graph 2). Consequently, capital is inexpensive but cannot generate interest in the money markets or significant yields in the bond markets. Instead, it is flowing into equities and real estate.

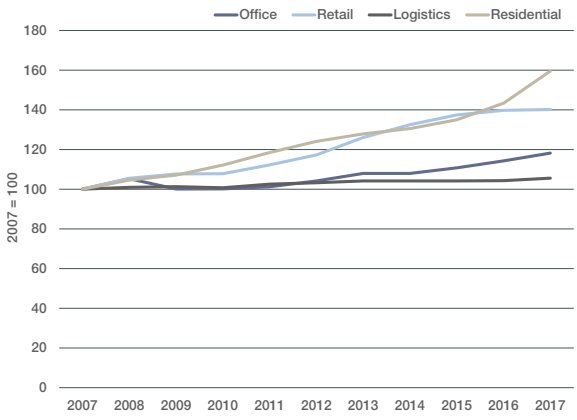
Another phenomenon in Germany in 2018 is that it has never taken so long to form a federal government. However, the fact that the associated noise has been predominantly limited to the press while the nation has otherwise carried on regardless can be reliably interpreted as a major sign of social stability. On the whole, therefore, the conditions for the German real estate market are excellent and, for many market participants, it must be difficult to imagine a better time.

The only problem in the best of times: things will never be better

Even the best of times brings its worries. For a long time, investors worldwide have been saying that the German real estate market is bursting with strength and investor demand for property in Germany remains

GRAPH 1

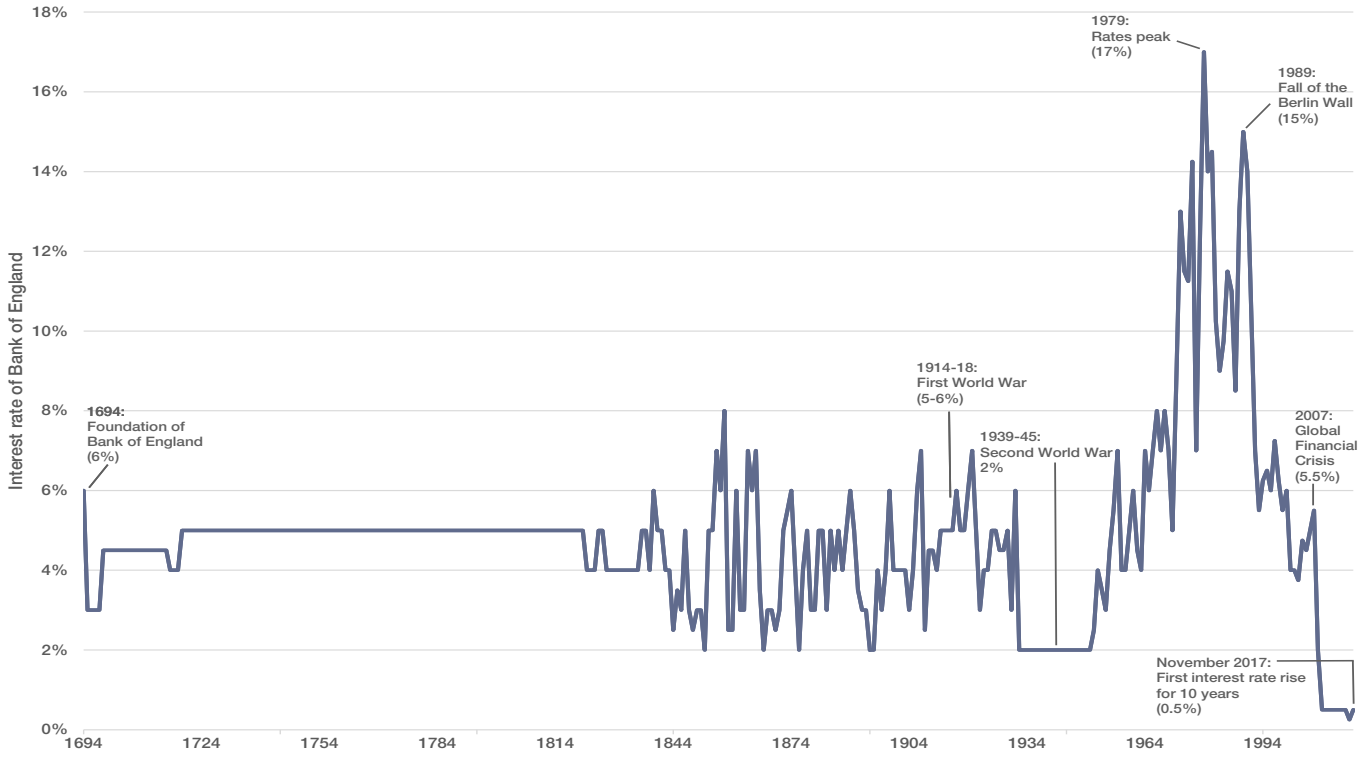
Rents* much higher than last peak



Source: Bulwiengesa, Savills / * each case prime rent for top 7 locations

GRAPH 2

A history of key interest rates - the example of England



Source: Bank of England

correspondingly high. Never has so much capital flowed into German commercial real estate and never has the latter been so expensive as it is today. This is a concern insofar as, in the best of times, downside risks are obviously greater than the prospects of further upside. This situation is particularly challenging for the risk-averse majority of investors. It could also be said that the environment for real estate investments in Germany could scarcely be better but could also scarcely be worse.

In an environment with almost perfect conditions, risks cannot be avoided even in the core segment. However, to not take risks today is also costly, not only in terms of forgone returns but also in the form of penalty interest from the banks or negative yields (in real terms) from investments in German government bonds. Waiting, therefore, is an extremely unattractive option, especially as the cycle could last even longer than most consider possible. However, a macro strategy targeting prime office properties in central locations in the top seven cities, for instance, only promises relatively low total returns (see Graph 3) since prime yields are not expected to harden significantly further. For investors aiming to be invested until the next cycle or longer and for whom the current low initial yields are adequate, this medium-term outlook is unimportant. As one of the largest and most stable national economies in the world, Germany offers these investors outstanding fundamentals with correspondingly favourable potential returns. For all others, it is impossible to look beyond a micro strategy that delves intensively into the details of individual use types, locations or properties. The potential starting points for such an approach in our estimation are outlined below.

Yield compression will be limited to logistics properties and retail parks

Even if we no longer expect significant yield compression across the board, there may be exceptions (see Graph 4). Logistics properties, for example, are expected to show further yield compression at least in the short term and it is conceivable that the perception of risk regarding this sector is changing for the long term. Yields on retail parks are also likely to harden somewhat further since these are attracting an increasing proportion of demand for retail property.

The attraction of short-term office leases

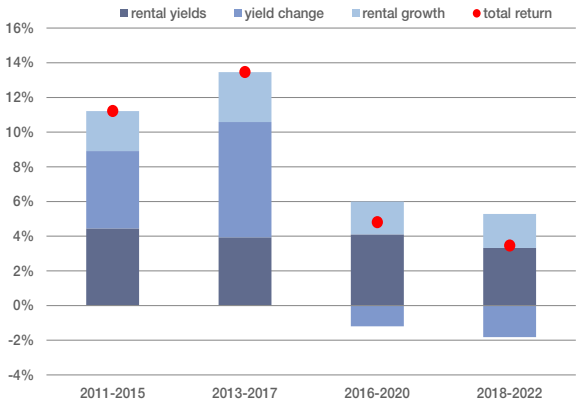
Office properties are and remain the undisputed favourites of most investors. Consequently, they are currently also the most expensive in terms of initial yields, just ahead of high-street properties. However, the low initial yields reflect not only the high demand but also the potential rental growth over the coming years (see also our current office market report). With long-term rental growth uncertain against a background of digitalisation and demographic change, investors could target investments in properties with short unexpired lease terms with a view to both fully capitalising on rental growth over the coming years and securing long-term leases. In view of rising inflation, indexed leases would make sense (see Graph 5).

Second-tier cities offer good risk-return profiles for long-term investors

For those investors seeking higher income returns from the outset than those currently available in the central locations of A-cities and whose focus is on stable, long-term cash flow, we believe many B-cities and C-cities represent an attractive alternative. In many cases, the fundamentals in these cities (e.g. unemployment rate, economic growth, vacancy rate) are in no way inferior or are even superior to those in the A-cities. They also offer the advantage over A-cities of lower volatility in terms of rents and particularly yields. However, this is offset by lower market liquidity. Not only is the investable stock significantly smaller than in the top seven cities, the individual properties are also smaller on average. Furthermore, there is even less transparency than in the A-cities, making the construction of a diversified portfolio somewhat labour-intensive. For long-term cash flow investors in particular, however, such endeavour is likely to pay dividends. Graph 6 provides a simple representation of all A, B and C-cities with regard to prime office yields and employee projections to 2035. This can serve as a starting point for identifying attractive

GRAPH 3

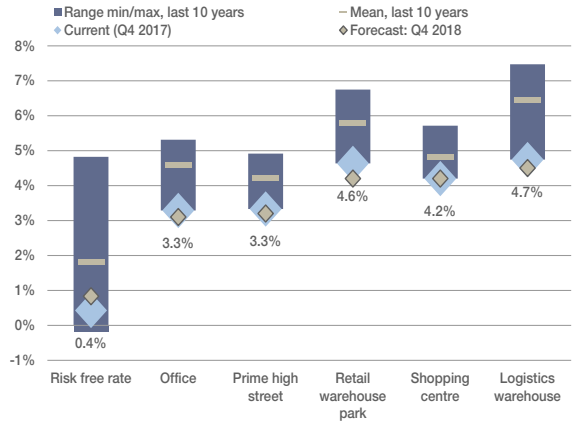
Total returns in the office segment is likely to decline



Source: Dekabank

GRAPH 4

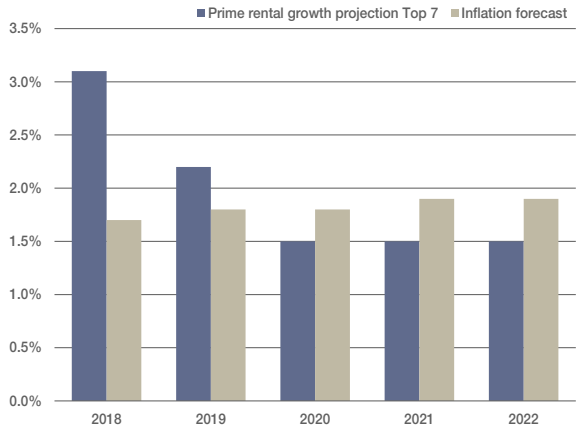
Yield compression will be limited to logistics properties and retail parks



Source: Focus Economics, Savills

GRAPH 5

Inflation overtakes rental growth



Source: Dekabank, Focus Economics

investment destinations. Leipzig, for example, appears to provide an extremely favourable risk-return ratio as well a couple of other cities such as Offenbach, which offer investors rather high initial yields relative to employee projections.

Small also beats large when it comes to volume

Not only smaller cities but also smaller properties could provide room for manoeuvre in the current highly competitive investment climate. Owing to the high pressure to invest, the preferred acquisition volume of investors has increased continuously in recent years. If we look, for example, at the average transaction size for office properties in the institutional segment (in this case, from €10m excluding portfolio transactions), there has been constant growth since 2012 (see Graph 7). The average transaction size over this period has risen from €42m to significantly more than €50m today. If we assume that this average figure reflects the preferences of investors, then competition among investors must be at its most intensive around this figure. Hence, investors wishing to avoid this competition at least to a certain degree can either focus on properties with significantly higher or lower investment volumes. While the room for manoeuvre upwards is theoretically unlimited, the actual supply diminishes rapidly from around €75m to €100m as there are simply very few properties of this value. Furthermore, properties of such volume would entail excessive cluster risk for many investors. The actual usable room for manoeuvre above the average volume of €50m, therefore, is rather limited. Conversely, were the focal point of demand to shift upwards, the "room" below would be greater. The range from €20m to €40m appears promising at present. There is sufficiently large volume for most investors and yet probably less intensive competition than in the size categories above.

Leveraging value-add potential with manage-to-core-plus strategies

Should investors wish to distance themselves even further from the competition, it is practically impossible to avoid taking higher risk. Very few investors remain active in the value-add segment and, although prices have also risen significantly in this segment in recent years, the risk-return ratio is likely to be more favourable than in the core/core plus segment. The A, B and C locations of major cities, such as Frankfurt's City West or Düsseldorf's Seestern, for example, are worthy of investigation. Unlike central locations, these submarkets still offer properties with value-add or re-positioning potential. Exploiting this potential promises significant increases in value since, in view of the high risk aversion of most investors, the difference in capital values between prime properties and those of average quality in B locations is very large (see Graph 8).

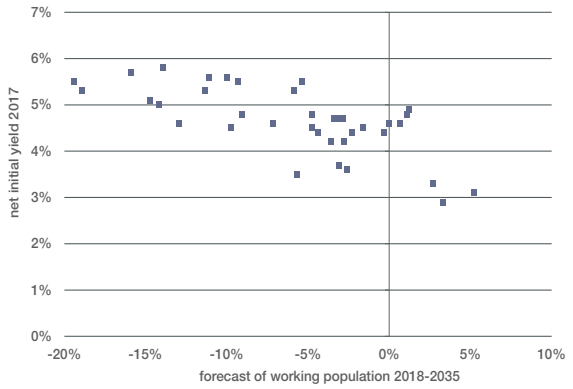
Many value-add strategies in the retail sector

While the office market offers a number of starting points for value-add strategies, retail properties offer significantly more. Many retail formats are facing stagnating or declining revenues with department stores merely the most prominent examples. As a long-term trend, we therefore expect demand for space to decline even in good locations (see our "Outlook for the German real estate market"). Should our expectations prove accurate, many properties occupied by retailers to date will no longer be in demand for retail use going forward. However, with surplus demand from practically all other uses, at least in the larger cities and particularly in central locations, there are numerous potential alternative uses for these former retail stores. In view of increasing consumer spending on eating out, food serving industry is an obvious option. However, this does not work everywhere and is most successful when it complements the neighbouring uses and their target groups (see our analysis "Restaurant expansion in shopping centres: path to success or a wrong turn?"). In addition to restaurants, there are numerous other potential alternative uses, particularly in central locations and those with good public transport links.

Essentially, all uses are conceivable in these locations, from offices/co-working and warehousing/logistics to residential. Which use actually makes

GRAPH 6

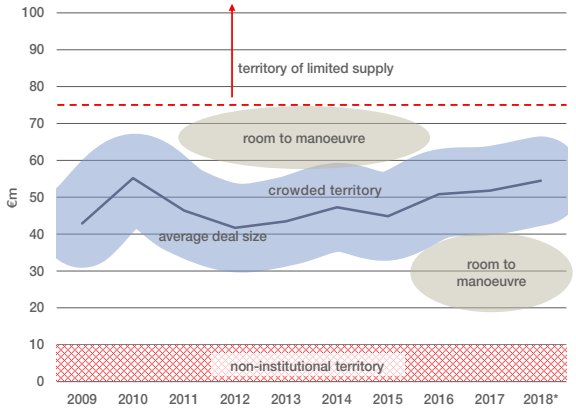
A-cities all highly rated, Leipzig appears low-priced



Source: Bulwiengesa, Oxford Economics, Savills

GRAPH 7

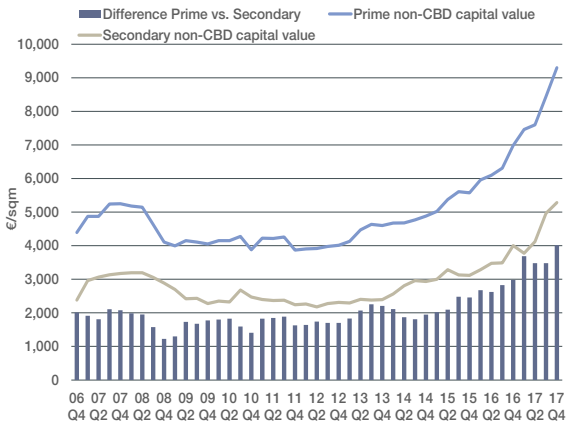
Traded office properties are getting bigger



Source: Bulwiengesa, Oxford Economics, Savills / *January und February

GRAPH 8

Increasing capital value difference between A and B objects in B-locations*



Source: Savills / * average for Berlin, Frankfurt und Munich

sense can only be assessed in each individual case taking into account factors such as the location and number of floors of a property.
In general, however, there is an observable overarching trend: single-use retail concepts are increasingly less successful (see the Habona Report on local amenities). A similar phenomenon can be observed in the office sector (see our research "Office of the Future?"). Consequently, value-add strategies are increasingly likely to involve combining complementary uses. Investors and asset managers who do not equate asset classes with usage categories will be at an advantage.

Do not lose sight of the big picture when focusing on the details

In the current environment, it is essential for many investors to look at the details, whether it be the characteristics of second and third-tier cities, locations outside city centres or individual properties, in order to achieve adequate returns while limiting risk. Such a "micro over macro" approach promises to be even more successful if this focus on the details is aligned with overarching trends in the economy, society and technology, all of which impact the nature and type of use of properties.

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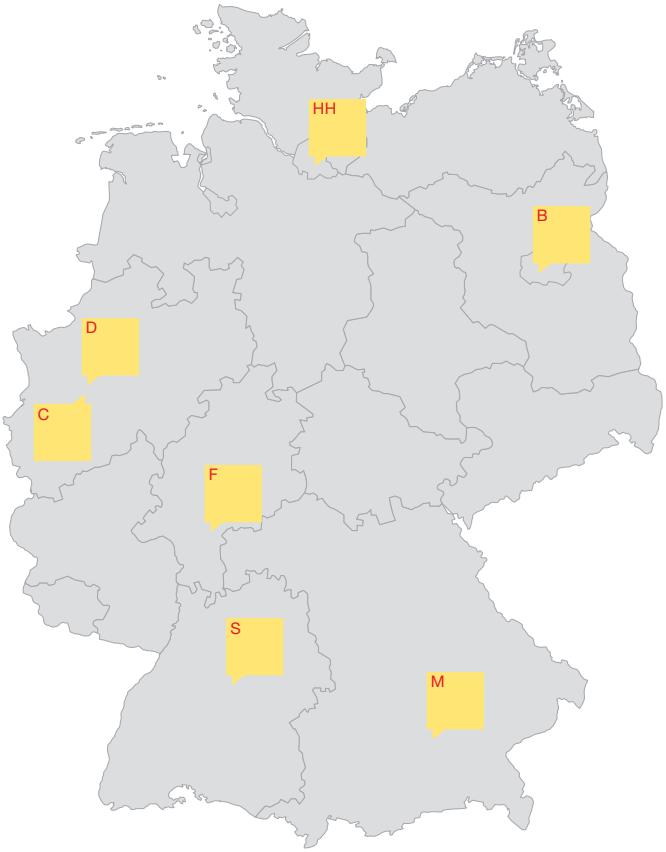

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