Cross-sector Germany - December 2020

SPOTLIGHT
Savills Research

German property market outlook

Everything *stays* different

COVID-19 as a catalyst for structural change in the property markets

The COVID-19 pandemic has clearly left its mark on the German property markets. But it is not only in the short term that it is causing a huge spread in the occupier markets. We expect that even after the pandemic the space requirements will be substantially different from those in spring 2020, both quantitatively and qualitatively. For investors, this initially means increasing risks - but also a multitude of investment opportunities.

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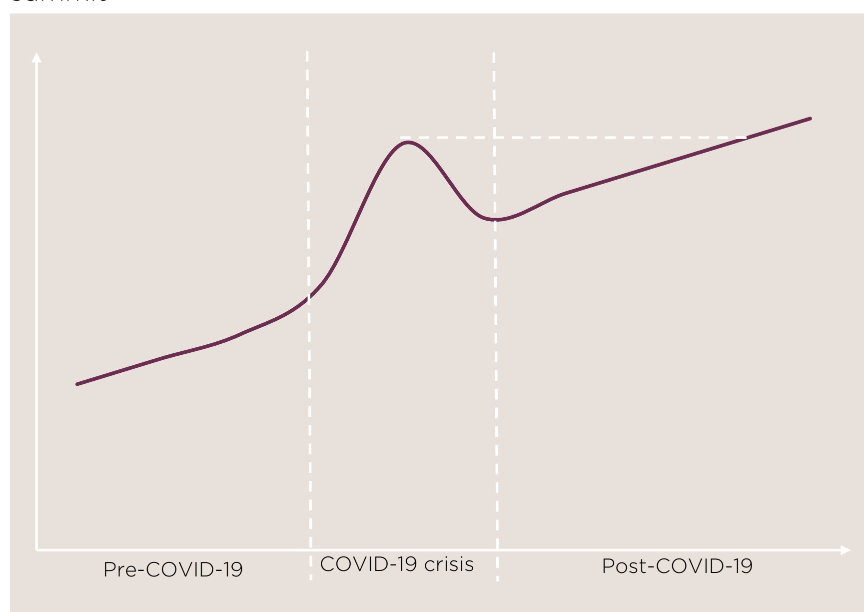
Round trip to the future

Lenin is quoted as saying: "There are decades where nothing happens; and there are weeks where decades happen." The past decade was by no means uneventful in the real estate markets. However, it does rather feel that way compared with the events since the outbreak of the COVID-19 pandemic. Accordingly, for many years, we have written in this report: the supercycle continues. Nuances have changed but the principal message has remained the same. Ironically, last year's Outlook was even entitled: "An eternal supercycle". In terms of capital market performance, we were perhaps not too far wrong (see the section "Higher risk aversion and increasing risks in the investment markets"). In the lettings markets, however, the pandemic has undoubtedly introduced a new cycle (see the section "The great divide: occupier markets"). Furthermore, it has also catapulted us into a new era to which we must all become accustomed in the first instance. The World Uncertainty Index, which soared to unprecedented highs following the outbreak of the pandemic, is an expression of this disorientation. Questions that would have appeared ridiculous to most only a few months ago are now being discussed by the general public in complete earnest. Whether the office has a future (and of what nature) is but one such question.

Graph 1 Idealised progression of a rising trend with COVID-19 summit



Source Savills

This trend-accelerating aspect of the crisis that is being so widely discussed today can be observed and measured in many areas. Many indicators, such as online retail sales or the number of people not working in traditional offices, are following a progression illustrated in Graph 1. These trends were showing growth even prior to the crisis but soared to almost unthinkable highs upon the outbreak of the pandemic and we are still at this apex of COVID-19. What this does is to offer us a view into the future and, in a sense, a unique opportunity to live in the future (visualised by the horizontal line in Graph 1), albeit for a relatively short time. For, once the virus is under control, our descent from this summit will be as rapid as the ascent. The number of people working from home will swiftly decline, as will online retail sales. At this stage, it will feel as though we have returned to the pre-crisis normality we were all familiar with. However, while we will all approach this scenario to a greater or lesser extent, we will never actually return to it. Even after the descent from the summit, more people will continue to work from home at least some of the time and more will shop online than prior to the crisis. These numbers will subsequently rise further, perhaps faster than in the pre-COVID-19 world or perhaps slower. At some point, however, perhaps within five years or possibly in 50 years, these number may return to the levels we are witnessing today. The wise option is to use this brief trip to the future to draw lessons for the present rather than to await a return to normality.

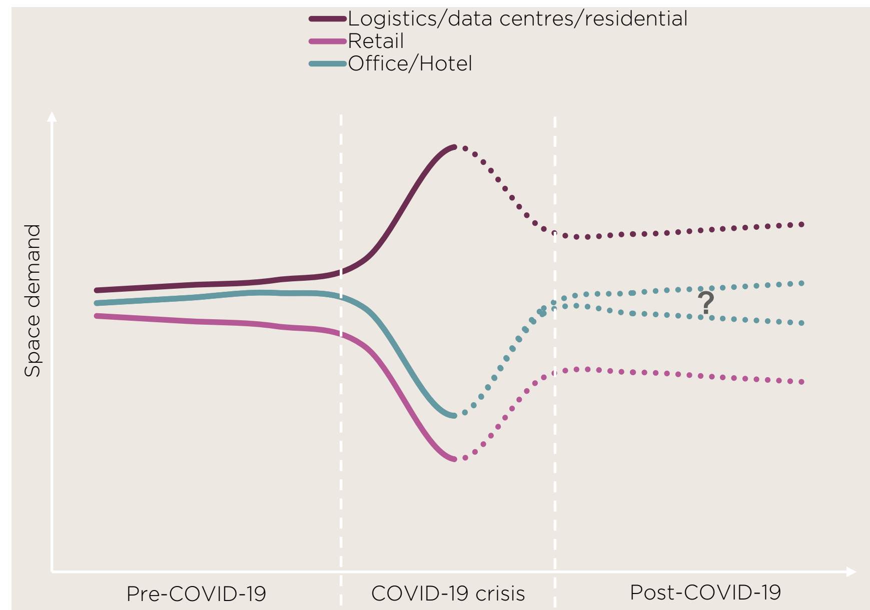
Admittedly, it is not true that we only have to look closely enough today to foresee the future. The fact that far from all trends are following the progression illustrated in Graph 1 is sufficient to dismiss this alone. Global tourism, also in a rising trend, is showing a deep trough rather than a COVID-19 peak. In this instance, the crisis has not transported us into the future but rather many years into the past. Yesterday, we were closer to tomorrow than we are today. We can also observe falling trends combined with a peak or trough. The ability to reliably differentiate the different progressions is essential not only for real estate decisions. Even if we could decipher all of these trends, however, it ultimately remains to be seen how the coronavirus crisis will change the world. That it is changing the world is certain. Ahead of us lies not a pre-crisis normality but a post-crisis reality. Below, we will discuss how this might look in the German property markets.

> "Many of us are pondering when things will return to normal. The short response is: never
> (Klaus Schwab, Founder of the World Economic Forum)"

The great divide: occupier markets

"The novel coronavirus does not discriminate" was a frequently heard narrative at the outset of the pandemic. While this may be true in a very abstract sense, the reality of life is quite different. The consequences of the virus and their prevalence have been distributed extremely unevenly. This applies to both the impact on health of an infection and the economic consequences associated with the pandemic and the measures introduced to contain it. This can be very clearly observed at sector level. While some sectors have been subject to government-imposed lockdowns (e.g. restaurants and hotels), others have benefited from pandemic-related increases in demand (e.g. telecommunications). While such divergences are not inherently out of the ordinary as concomitant effects of a crisis, the extent of these divergences is.

Graph 2 Schematic progression of demand in selected sectors*



Source Savills / * neither absolute values nor relations are shown

This same is true of the property markets. Demand for space in the individual sectors has diverged massively, with the peaks and troughs of COVID-19 overlapping. Interim lettings of logistics space on the one hand and losses of rent in the retail sector on the other are just one example. The extent of this spread is so great that compensatory measures were implemented immediately following the onset of the crisis. Examples include hotels letting rooms as home office alternatives, Airbnb apartments returning to use as standard apartments and event space being converted into film studios to host virtual events. The example of film studios in particular illustrates that the true extent of the peaks and troughs remains a mystery. And the standard market indicators no longer adequately reflect the state of the markets. A complete picture of events could only be created by taking into account incentives, losses of rent and many other similar phenomena. These elements are scarcely measurable, however, and so the picture remains incomplete.

In this extreme form, the divergence of demand for space in the individual sectors is undoubtedly due to the acute pandemic situation and is, therefore, of a temporary nature. By around mid-2021, this situation is likely to have been resolved and the COVID-19 peaks and troughs will disappear. In our opinion, however, the structure of demand in the property markets will still differ fundamentally from that at the beginning of 2020 (see Graph 2). Some uses will have substantially higher demand than prior to the crisis while demand for other uses will be substantially lower. Demand for logistics space is one example of the former scenario while demand for brick-and-mortar retail space is an example of the latter. These two sectors have already been diverging for years owing to the expansion of online retail. COVID-19 is merely acting as a catalyst. All other sectors are also subject to such structural change, the extent of which is expected to be in direct proportion to the duration of the acute crisis.

How strongly demand for space will change can be scarcely estimated and will only be slowly revealed. The effects may be particularly pronounced in instances where COVID-19 is acting against the previous trend in demand, such as the office sector. Demand for office space has risen for years, driven by growth in the number of office employees, and this trend is now at least overlaid with a COVID-19 trough. Moreover, the depth of the trough cannot be adequately reflected with traditional market indicators, as a glance at the vacancy rate demonstrates. Vacancy rates have a delayed reaction to changes in demand in any case and that is also true on this occasion. The vacancy rate began to rise several months after the onset of the crisis and, to date, only the number after the decimal point has changed. Actual office utilisation has reacted much more strongly and, here too, it is the extent of this divergence that makes this crisis particularly powerful. We estimate that, on average, more than half of the office stock has been unused since the pandemic began (see Graph 3). As a trend, office utilisation appears to decline as company size increases and our observations indicate that utilisation is typically no more than 20% among international corporations. Going forward, the vacancy rate and percentage of unused office space will surely begin to converge. It is also certain that the percentage of unused office space will move more strongly towards the vacancy rate than vice versa. Many people currently do not need and do not want to go into the office in order to protect their own health and the health of those around them and will only return to the office once the pandemic is over. Until then, we expect the vacancy rate to increase. The extent of this increase, however, is largely uncertain. In our view, nobody can seriously estimate how many people will return to the office and to what extent. Neither can most companies answer this question with regard to their own personnel according to our observations. Some are pre-empting this response with appropriate provisions, confronting us with every permutation from 100% home-office solutions to compulsory full attendance. What this means for office demand overall remains to be seen. We believe post-pandemic office utilisation will be meaningfully lower than prior to the crisis,

> "The year 2020 can be interpreted as the first year of the 21st century (Peter Thiel, Founder of Paypal)"

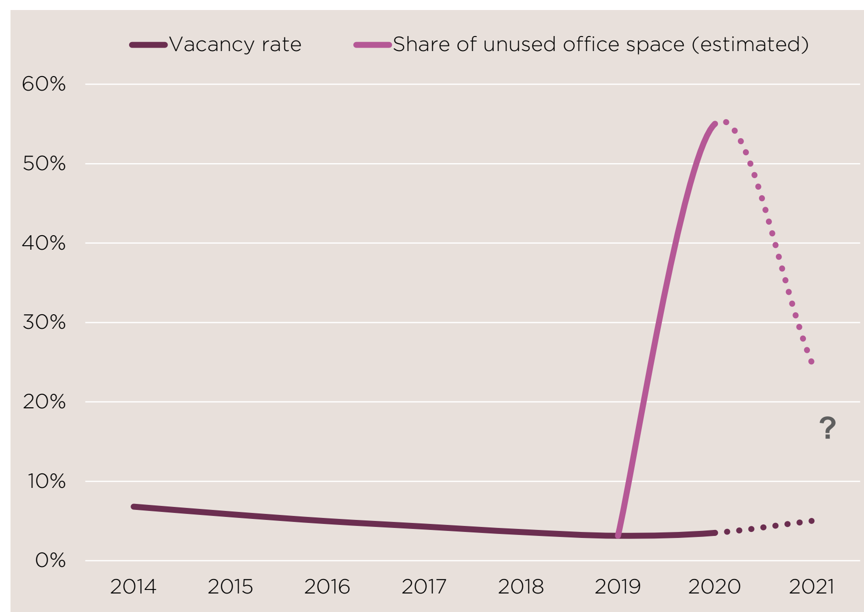
leading companies to dispose of space while maintaining the same number of personnel. We particularly expect this from large occupiers and, accordingly, in the large size category. This would produce a structural contraction in office demand.

However, offices are not only subject to uncertainty surrounding the depth of the trough and the extent of the rebound. In that respect, offices are no different from retail space. However, the progression of post-pandemic demand is much less clear in the office market than in the retail sector. The number of office employees, the driver of growth in demand to date, may well continue its upward trend once the crisis is over. Conversely, however, the average time people spend in the office may also steadily decline after the pandemic. The net impact of these and other potentially still unknown effects remains uncertain. At a minimum, however, it is questionable whether COVID-19 has not just interrupted the increasing trend in office demand but ended it (we believe the same applies to hotels but have not explored this sector in detail here).

Nevertheless, even if COVID-19 results in lower office demand, it could simultaneously create significant demand for modernisation and new build. We assume the breakthrough in geographically flexible working will also firstly change the space requirements of occupiers and secondly raise their expectations. Essentially, the central role of offices is shifting from being places to work to being places to collaborate. The rising expectations are a result of the fact that the company office is faced with far greater competition from other places as locations to work from than prior to COVID-19. While some new requirements will be capable of being accommodated within the existing building stock, some will not. This will particularly apply when new workplace concepts also entail new location models. There is much to suggest, for example, that office space near residential locations will gain in popularity. This would produce demand for new build and changes of use in such locations and potentially result in surplus space in other locations.

In any case, it would be insufficient to reduce the transformation of the office environment to its consequences for office demand. It could have effects far beyond this. Demand for restaurants and local supplies could rise in residential areas, for example, if people are working from home to a greater extent going forward. Conversely, such demand could decrease in central office locations. Retail locations along commuter routes could also be faced with reduced demand. Ultimately, geographically flexible working will mean a greater decoupling of working and residential locations. This will challenge traditional location models and all the more since it remains completely unclear how people's preferences in terms of residential locations will change in this context.

Graph 3 Office vacancy rate versus office utilisation



Source Savills

Many of these trends would have played out over the coming years in any case. COVID-19 has massively accelerated them, however, and demand after the acute crisis will differ from that in early 2020 in terms of quality and quantity, and in some cases substantially. This change in demand will meet with an unchanged building stock. Unless we are completely mistaken, the consequences of COVID-19 for the property markets will continue to unfold for many years.

Higher risk aversion and increasing risks in the investment markets

If there were any doubts prior to the COVID-19 crisis that interest rates would remain low over the coming years, they are now likely to have evaporated. Around 80% of all bonds in circulation worldwide have a yield below 1% and a quarter of bonds even have yields below 0%. It appears unlikely that this will change notably in the 2020s. Against this background, we expect allocations to real estate in the portfolios of institutional investors to continue to rise, producing sustained high pressure to invest. This particularly applies to Germany, which has withstood the pandemic relatively well to date, consolidating its status as a safe haven. In view of the further increase in risk aversion, Germany is likely to benefit from this status to an even greater extent going forward. We would point to the fact that prime yields in the lowest-risk real estate sectors have not softened despite the deepest recession in German post-war history as an expression of the sustained very high pressure on capital in the core segment.

This capital is meeting with significantly increased risks in the occupier markets which, in our view, will to some extent continue beyond the end of the acute crisis (see the section: "The great divide: occupier markets"). In any case, the investment universe for risk-averse investors has contracted at least temporarily. Large sections of the hotel and retail property markets have lost their core status in the eyes of many investors, who have also become

“In 50 years, people won’t remember the epidemic itself so much. Instead, they will say: This was the moment when the digital revolution became reality (Yuval Noah Harari, Historian)”

more selective when it comes to office property. Demands is likely to be even more concentrated on those properties that offer stable cash flow during the crisis and promise the same once the pandemic is over. These primarily include logistics and residential property, food retail property, offices let on long-term leases to public-sector occupiers or similarly strong covenants, as well as niches such as data centres and other infrastructure-related properties. In all of the above segments, we therefore expect initial yields to harden further and transaction volumes to rise again by no later than the end of the pandemic.

Outside of this now smaller core segment, we expect yields to soften by the end of the pandemic. However, the extent to which yields will increase will only be capable of being assessed once there are sufficient transactions taking place in the non-core segment again. In the office sector, where COVID-19 has posed structural questions, particularly for offices in secondary and tertiary locations or in the case of business hotels, the price correction phase could last longer.

Foreseeable developments in the investment markets could, like those in the occupier markets, therefore be accurately described with the word ‘spread’. This applies not only to prices and transaction volumes but also to the balancing act facing investors. On the one hand, they are likely to receive even more investor capital seeking adequate and stable income. On the other hand, in view of trends in the occupier markets, income that combines these properties could be even more scarce. Against this background, we believe the investment strategies of individual investors beyond the lowest common denominator of ‘logistics, residential and AAA offices‘ will become more differentiated. Many investors, for example, are likely to view any downturn in the capital values of offices in secondary locations as a counter-cyclical opportunity for acquisitions, while others will may regard the same offices as having excessive structural risk and be active on the vendor side. This would firstly keep the transaction volume at a high level and secondly suggest relatively stable capital values in those segments that are neither undeniably core nor non-core.

Unlike the risk-averse investors, those investors with a higher risk tolerance are likely to see an environment with many investment opportunities. By that, we do not mean forced sales. In view of the continued low interest rates and good capital resources of most owners, we only expect to see these in low number. Nevertheless, the qualitative and quantitative changes in demand we have outlined for the coming year, which will be massive in some cases, (see the section “The great divide: occupier markets”), are likely to offer significant potential for value-add strategies and even greater opportunities for development strategies. The re-positioning of hotels, shopping centres and department stores or construction of new local supply and urban logistics properties are just a few examples. Since banks have largely withdrawn from development financing, this offers opportunities for alternative capital providers.

In recent years, it has been primarily the defensive components that made real estate popular with investors as an asset class. In our opinion, nothing will change in that regard in principle, particularly in comparison to other asset classes. However, COVID-19 could now add a certain offensive component to real estate. Should the pandemic prove to be the catalyst for structural change in the occupier markets that we expect, the risk capital requirements in the real estate sector are likely to remain high for years.

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