German real estate market - June 2020

SPOTLIGHT
Savills Research

COVID-19 pandemic

LONG-TERM IMPLICATIONS FOR REAL ESTATE MARKETS

"We will be living in a different world when this crisis is over", according to Yuval Noah Harari, one of the best known historians of our time, in a recent interview. Nobody knows what this world will look like. It will certainly not be substantially different from our world today, only very slightly. However, in the real estate industry, a sector characterized by decisions that are effective in the long term, these nuances can mean the difference between success and failure, between profit and loss. It is therefore particularly important for real estate market players to address the long-term implications of the COVID-19 pandemic in order to track down those nuances.

Our five authors have also gone in search of evidence, each formulating a personal hypothesis about what the post-COVID-19 real estate world might look like. We would like to give them a forum here. Not because we believe that their version of the future hits the mark, but we are convinced that only an intensive and often contradictory debate will produce the best arguments and help us all to sharpen our vision of the future. Contradiction is therefore not only allowed, but desired.

However, first and foremost, we wish you an inspiring reading. Our authors are looking forward to discussing with you afterwards.

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Hypothesis 1: Real estate as an asset class - more attractive than ever, especially in Germany

"Flight-to-safety" is the order of the day in uncertain times like these. Together with a lack of investment alternatives, this will increase investor demand and push initial rates of return to new record levels in the long term. But first, one step backwards: The difficulties for companies unleashed by the COVID-19 pandemic and the associated upheaval on the labour market are likely to cause a dip on the real estate markets in the short term. Although the instrument of reducing working hours (german: Kurzarbeit) is likely to prevent large-scale redundancies, it is nevertheless a burden on social security funds on an unprecedented scale. In addition, the German government is responding to the looming wave of insolvencies in the corporate landscape with a series of tax breaks and bail-out packages. All these measures are likely to lead to a massive increase in national debt - not only in Germany, but on a global scale. When the burden of debt rises, the the risk of sovereign default also increases. This can currently be seen in the increased risk premiums for government bonds. However, not only the states, but also the central banks have adopted support programmes worth billions. For instance, the ECB balance sheet has risen to the highest level in its history and with it the long-term inflation risk.

It is precisely these dark clouds over the economy and financial markets that could make the real estate asset class shine all the brighter. Its main rival, bonds, have become less attractive. The default risk has increased not only for government bonds, but also for corporate bonds, as is shown, for example, by Standard & Poor's downgrade of the German automotive industry's credit rating. In the case of bonds classified as largely default-safe, coupon rates remain close to zero. In view of the prolonged zero interest rate policy and the increased risk of inflation, there is little hope of adequate returns. It is precisely those yields that can still be achieved with real estate. They are also inherently considered to be more resilient to inflation and low volatility. The German real estate market in particular is considered stable. Not least because of its polycentric system, which makes diversification easier, and its strategically key location in the heart of Europe, Germany has in the past always been able to benefit from its status as a safe investment haven as the pathway of goods will always flow to a certain extent through Germany. Since the COVID-19 pandemic is likely to have intensified many investors' need for security in the long term, it can be assumed that Germany's favourable fundamentals, its legal and planning security, will help the local real estate market to achieve an unprecedented upswing internationally as soon as the short-term disruptions caused by the crisis are overcome. This upswing is likely to spread through all asset classes, some of which could benefit disproportionately (see hypothesis 2).

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Hypothesis 2: Residential real estate will be even more attractive for investors

Having a roof over our heads is one of our basic existential needs. Residential real estate offers us exactly that and is therefore a non-substitutable good. Therefore it is considered to be relatively safe by investors. This security is manifested in relatively stable rental income. For instance, statistically speaking since 1976, average rents for existing apartments in West German A-cities have fluctuated only about half as much as office rents in the same cities[1]. Even during the COVID-19 pandemic and the envisaged recession, residential rents are expected to remain relatively stable.

In times of crisis, risk mitigation is the top priority for many investors. This quest for security has resulted in yields on low-risk investments, such as government bonds of countries with strong credit ratings, falling to an all-time low. The ECB's purchase programme, with an additional volume of around €750bn, will not only keep securities yields low, it will also crowd out private investors. These in turn will be obliged to look for alternatives, which is likely to further increase the investment pressure on the real estate market (see hypothesis 1).
As residential real estate is particularly stable in terms of revenue compared with other types of real estate, it is likely to benefit particularly from these circumstances and from investors' high risk aversion. The character of residential real estate - low fluctuation of income, but also little chance of short-term increases in value - also speaks for longer-term investor commitment.

In addition, the COVID-19 pandemic and its side effects could even strengthen the status of housing as an existential, non-substitutable commodity. The lockdown experience could result in homes becoming increasingly important in people's lives and, together with other effects such as the increasing acceptance of working from home, could lead to a higher demand for living space (see hypothesis 5). As such effects become apparent, this would make the housing sector even more attractive for investors.

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[1] *The coefficient of variation of the annual rate of change in residential rents is 1.18 for the period 1976 to 2019. For office properties, it was 2.08 over the same period.*

Hypothesis 3: Flexible workspaces become increasingly important, especially when close to residential areas

Due to the outbreak of the COVID-19 pandemic and the subsequent social distancing regulation by the German government, an extraordinary home office experiment was initiated. This experiment has triggered significant behavioural changes among employees and employers, which could drastically change the office market in the long term in Germany.

According to an Immowelt survey, around one-third of those working from home during the Corona crisis are doing so for the first time. If positive experiences with virtual working methods are gained from this situation, it is very likely that working and communicating via virtual platforms will outlive the pandemic. This should not only favour the trend towards home office, but also towards flexible workspaces. For when working from home, there is no physical and mental separation between work and private life. Especially in larger cities, where living space is limited, it may be difficult for employees to work and live in the same environment.

Flexible workspaces in close proximity to residential areas enable a spatial and mental separation between home and office, without sacrificing the advantage of short commuting times. They also provide a productive working environment and allow offline exchange with others. If there are people who consider flexible workspaces to be the better working environment than traditional company offices or home office, flexible workspaces will become a tool for attracting and retaining employees, which creates an incentive for companies to at least partially allow employees to work in a flexible workspace. Additionally, the legal requirements regarding the safety and protection of employees in the working environment can be easier satisfied in flexible workspaces than at home.

A hybrid model, which allows working both in the company office and in flexible workspaces close to home, could be attractive for many companies and employees. The supply of flexible workspaces could quickly follow such a demand. After all, flexible workspaces are characterized by low barriers to market entry. Apart from a suitable location, office desks and an internet connection, not much is needed to offer people a flexible workplace. During the Corona crisis, some players have tried to provide flexible workspaces for the first time. Since the beginning of the pandemic, for example, more and more hotels, including the Dorint Group, have tried to make a virtue out of necessity and offered empty hotel rooms as workplaces. In addition to hotels, unused retail and restaurant space offers further potential for a subsequent use as flexible workspace.

It is possible that in the long term, large flexible workspace players will establish themselves on the market and broker their business concept within the framework of an operational partnership or award a right-of-use to investors but also to restaurants and hotels in order to be able to offer users a standardised and functioning service across a wide network. In the long term, providers who have a large network or those who are connected to one should be the ones to survive. After all, the larger a provider's network is, the more attractive it becomes for users.

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Hypothesis 4: Online food sales are on the verge of a breakthrough

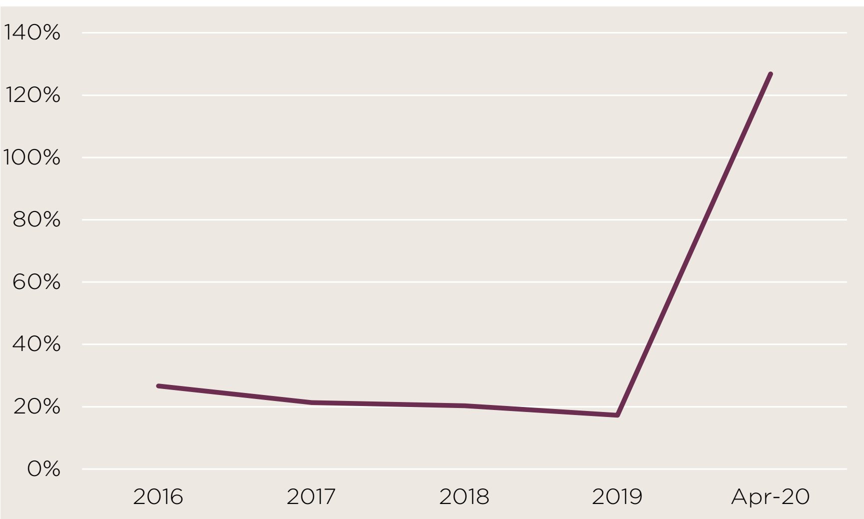
For years, the online share in the food trade in this country was only 1%. Then COVID-19 came and online food sales have grown strongly across national borders. In China, for example, Carrefour's deliveries for the New Year, which took place a few weeks after the outbreak of the epidemic, increased by 600%. Chinese online retailer JD.com reported a 215% increase in online food sales in the first ten days of February alone. The situation in Europe is no different: In Italy or Spain, the number of e-food users doubled and in Germany, too, sales in online food retailing in April rose by 127% compared to last year (see Graph 1).

According to a survey by Bitkom in April, 19% of consumers in this country have now switched to online food shopping. Detail Online assumes that up to 60% of customers will change their behaviour in the long term. The longer the pandemic lasts, the greater the effect of this new habit is likely to be, especially since online trading seems even more convenient than it already is in view of the distance and hygiene rules that will probably still apply in offline retailing for a long time to come.

The decisive factor will be how quickly the providers can increase their capacities and serve new customers. After all, initial entry is considered as the biggest hurdle and currently, many eager online shoppers are experiencing that retailers have reached their capacity limits and can no longer offer delivery slots. However, it is just a matter of time, until they will be able to expand their capacities to the required extent. While the provider picnic hires 50 new employees every week, some retailers are taking creative approaches: in the UK, for example, Aldi is testing food delivery in cooperation with Deliveroo. In Germany Netto is trying out a pick-up service and Rewe is opening hundreds of Click & Collect pop-up stations.

Not only food retailers, but also real estate players should adapt to these developments. Thus, supermarkets are in part becoming city storage areas, pick-up stations are needed and even drive-in counters like those of fast-food providers are likely to become the norm, especially in the city outskirts on busy streets.

Graph 1 Annual growth rate of online food trade in Germany



Source: German E-Commerce Association

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Hypothesis 5: More space, less costs, and far greener: revitalizing city outskirts

The lockdown measures in the wake of the corona pandemic have not only led to a conscious shift in consumption to online offers (see hypothesis 4), but also triggered the largest home office project of our times. From service companies to educational establishments, numerous institutions have introduced new concepts of virtual collaboration and communication.

Now it remains to be proved and tested whether these measures can withstand conventional working methods in terms of their effectiveness. However, depending on these results and the duration of the pandemic, it is quite reasonable to expect that the crisis has already brought lasting changes in the behaviour of private households and companies and has definitely accelerated digitalization. So partially retaining the virtual working method even after the pandemic is very likely, as working from home has proved to be a real alternative for many professionals (see hypothesis 3). A recent study has found that for the American labour market around 37% of all occupations could also just as well be done from home. A similar pattern is likely to emerge in Germany due to the comparable share of service industry companies at around 70% of gross value added.

If more companies stay with mobile work opportunities even after the pandemic, this will mean more freedom of choice for the affected employees to find an appropriate place to live. Since the costs of commuting between home and work will be reduced if the employee is required to be only partially present at the employer's company location. At the same time, the relevance of having one's own office and working space and the need for additional living space are increasing, if more people decide to work from home. Both effects could boost the attractiveness of city outskirts and peripheral city locations due to the lower cost of land. Increasing online trade would also favour this development if supply and demand for more and more consumer products were no longer dependent on the location.

In addition to the city outskirts, smaller towns could also experience an upswing if the choice of location is less dependent on commuting costs for more and more professionals. A good example of this is the small town of Montabaur which has experienced an economic and demographic renaissance due to an ICE (high-speed train service) connection, built in 2002. Since then, the city observes net increases in migration and attracts new companies to settle there. What triggered the ICE connection for Montabaur could now also be a new pattern of work and consumption elsewhere.

Moreover, the current crisis is also likely to create an increased awareness of security, environment and housing needs. A relatively high population density, more travel, overcrowded underground and suburban trains, smaller residential units and a lack of green spaces represent a fundamental challenge and psychological test in the current situation, especially for the inhabitants of metropolitan areas. In less densely populated peripheral areas or small towns, on the other hands, the desire for more distance, nature and open space can usually be fulfilled much more easily and, in the long term, also with less costs involved. Therefore, reassessing household needs and the associated location factors seems very plausible.

To summarize: The current corona crisis could lead to permanent changes in behaviour and increased implementation of digital concepts, especially in the areas of consumption and work. In addition, an increasing preference for more security, open space and living space in the wake of the current pandemic is highly conceivable. In the long term, this would strengthen urban peripheries and decentralize urban development. Even a revitalization of smaller towns and cities does not seem out of the question if this means less time and money spent on commuting, as the example of Montabaur shows. This could open up many new opportunities for the real estate market, especially in the residential section. A good start would be to follow the motto "More space, less costs and far greener".

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