Cross- sector Germany - December 2021

SPOTLIGHT
Savills Research

German property market outlook

ESG and the consequences • Housing market developments • Inflation environment

> “While the short-term effects of the pandemic are fading, the medium- and long-term effects on real estate markets will increasingly shine through.”

As COVID-19 continues, other issues are coming to the fore

Text: Matthias Pink

Last year, there was only one subject to discuss in a real estate market outlook: the COVID-19 pandemic and its consequences. This year, we have not escaped the pandemic as hoped and, in terms of infections, we have reached new peak levels. Nevertheless, the subject is drifting into the background of the real estate debate as other issues take its place. This is no doubt due on the one hand to an element of pandemic fatigue. On the other hand, however, the most extreme side effects for the real estate markets have subsided. Hotels are hotels again, and no longer alternatives to working from home, and event spaces are no longer merely film studios, to give just two examples.

Such phenomena were an expression of the extraordinary distribution of space requirements that we described in last year's outlook as the peaks and troughs of COVID-19. These have now been left behind at least to some extent. As the short-term consequences of the pandemic fade, the medium and long-term effects will now become increasingly apparent in the real estate markets going forward. We also described these in last year's outlook. And, since we feel validated in our statements in view of developments to date and have, therefore, not added to these substantially for the time being, we would once again refer you to them here.

In this year's outlook, therefore, we turn to some other specific issues that we believe are particularly worthy of consideration. The first of these issues is the potential consequences of ESG regulation on the investment markets, which we discuss under the title “Flight into new buildings?”. In our second piece, titled “Yields are temporary, security is permanent”, we provide a medium-term outlook for the German residential market and, last but not least, our article “Portfolio optimisation in times of high inflation” deals with the issue of what owners and investors can do to brace themselves against higher inflation.

The topics of our outlook:

ESG and the consequences
Flight into new buildings?

Residential market outlook
Yields are temporary, security is permanent

Inflation environment
Portfolio optimisation in times of high inflation

"A climate-ideal implementation of the E in ESG would have to favour the purchase and subsequent refurbishment of existing buildings over the acquisition of new buildings."

ESG and the consequences: Flight into new buildings?

Text: Matti Schenk

ESG: not only on everyone's lips but now in every portfolio

The EU sustainability taxonomy, better known under the abbreviation ESG ("Environmental, Social, and Corporate Governance") is intended to contribute to the implementation of the European Green Deal. The objective of this Green Deal is to make the European Union climate-neutral by 2050. Against this background, ESG directives should result in capital flows in the financial markets being redirected into sustainable investments in order to provide sufficient capital for the pending transformation.

As an asset class, real estate is also affected by these regulations. The incremental implementation of the EU sustainability taxonomy is already creating shifts in the real estate investment markets. In March 2021, the Disclosure Regulation came into force, requiring investors affected by the taxonomy to disclose how they intend to respond to the sustainability objectives. Since then, the number of Article 8 funds has risen constantly and some Article 9 funds have already been launched. While Article 8 funds are aimed at taking sustainability objectives into account, Article 9 vehicles strive to make a direct contribution to greater sustainability with their investments. In October 2021, 32% of European fund assets were classified according to Article 8 or 9 and a further increase is foreseeable.

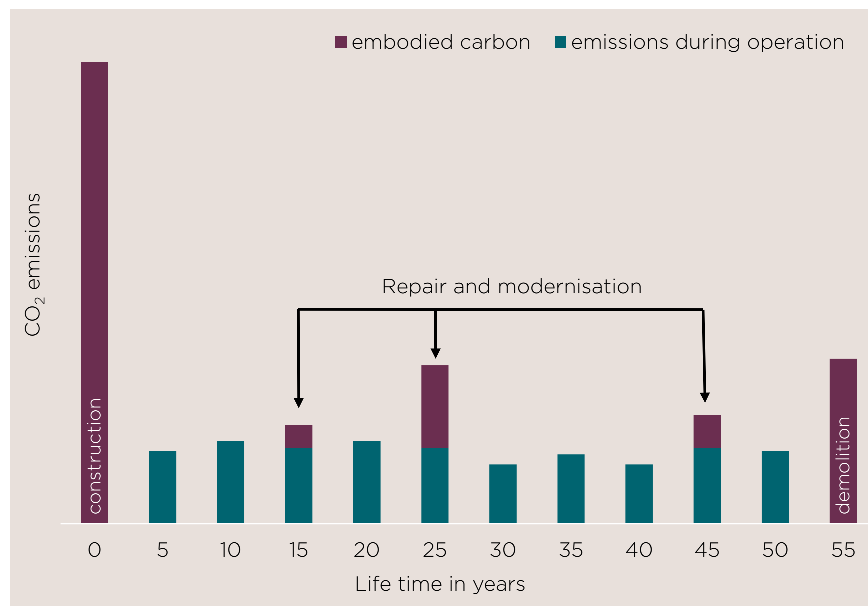
While an increasing number of funds and investors are making themselves ESG-compliant, the final structuring of ESG criteria is not even known yet. Indeed, this is not expected to be the case before July 2022. The ongoing absence of a binding regulatory framework for ESG criteria is ensuring that many market participants are drafting their own ESG property ratings and sustainability strategies. Consequently, how sustainability objectives are reflected in investment strategies and which points are emphasised can vary.

The most climate-friendly implementation of the E in ESG

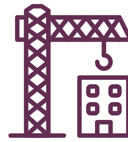
In view of advancing climate change and the scientific consensus that the world must become climate-neutral within a few decades, the avoidance of greenhouse gas emissions should play a leading role on the issue of sustainability. Ecological sustainability objectives, the E in ESG, are likely to be a focal point for many investors. But what would their ideal implementation in the real estate market look like? Most researchers, the German Federal Environment Agency and the German Energy Agency are agreed that climate neutrality in the German built environment is only possible via extensive refurbishments of the existing building stock. This is attributable, on the one hand, to the relatively low new-build rate in Germany and, on the other hand, to the massive potential savings from energy-efficient refurbishments.

Particularly when it comes to the least energy-efficient existing buildings the ratio of refurbishment costs to CO2 savings is especially advantageous. The refurbishment of existing buildings is almost without exception more sustainable than demolition and replacement with a new build. This is because the CO2 emissions produced during construction and the production of the building materials represent a significant proportion of all emissions across the life cycle of a property (Graph 1). These emissions are described as grey energy, grey emissions or **embodied carbon**. According to calculations from the Federal Environment Agency, for instance, embodied carbon account for around 80% of all emissions across the entire life cycle of a new build completed to Effizienzhaus standards. In addition, embodied carbon is released practically all at once and therefore immediately impact the climate in their entirety. These are only offset by savings during the operation of the building after several decades. From a climate perspective, therefore, it would make the most

Graph 1 Schematic distribution of CO2 emissions in the life cycle of a property



Source Savills in reference to London Energy Transformation Initiative



1 %
The rate of new construction in the German office markets has been only 1% per year over the last ten years.

sense if capital were directed into precisely such upgrades of existing property. An ideal implementation of the E in ESG should favour the acquisition and subsequent refurbishment of existing buildings over the acquisition of new builds.

The actual implementation of the E in ESG

In practice, however, ESG regulations are directing capital into new builds rather than refurbishments of existing buildings. The reasons for this are multi-faceted. Firstly, it is highly probable that grey emissions are not reflected in the taxonomy. Instead, the reduction of CO_2 emissions is focused on the operational phase. We do not foresee embodied carbon being included in regulations over the coming years. This is also attributable to the highly complex calculation of these emissions, which is further complicated on existing buildings by a lack of data. Since new-build properties generally perform better than existing buildings during the operational phase, it is little wonder that new builds better fulfil regulatory requirements.

A further reason for the focus on new build is the fact that ESG criteria for new builds are significantly more straightforward owing to the better availability of data and are, therefore, easier to fulfil. This idea is supported by a study from the German Sustainable Building Council (DGNB). Furthermore, many new builds offer various amenities for occupiers that count towards the S in ESG. Finally, many major occupiers prefer new builds in order to fulfil their own sustainability and ESG objectives. The issue of embodied carbon is either overlooked by most occupiers or is completely unknown to them according to our observations. Hence, in view of how the EU sustainability taxonomy appears to be taking shape, institutional investors appear to be on the safe side by acquiring new builds. For owners of existing buildings, ESG regulations and their focus on the operational phase doubtlessly incentivise energy-efficient refurbishments. This could contribute to achieving refurbishment objectives. However, ESG compliance could also be achieved by owners by disposing of older existing properties or demolishing these and replacing them with new builds. This would counteract refurbishment objectives.

Potential consequences for the markets

As long as ESG compliance is predominantly achieved via new builds, capital in the investment market will be redirected into this segment. Since new-build availability is also limited, the shift in demand in the investment market is likely to result in an appreciable rise in sale prices on new builds. This, and no doubt also changing occupier requirements, is also likely to encourage development activity. It is already apparent that new-build activity remains buoyant. Developers were the third most active purchaser group in the commercial property market over the last twelve months, which is a novelty. The consequences of this trend for existing property would be significant. If institutional investors, in the first instance, predominantly acquire new builds and owners increasingly dispose of their non-ESG-compliant existing properties, this will result in a devaluation of existing stock. This, in turn, will create opportunities for value-add investors, who will be able to acquire existing buildings at a lower price and subsequently refurbish these properties to ESG-compliant standards.

Over time, ESG-compliant end investors will also have to turn their attention towards existing property. One explanation for this is that the supply of new builds will only be able to respond slowly to the further increase in demand in the investment market owing to the lead times involved. This is exacerbated by the fact that the construction industry is already largely working to its full capacity. A glance at new-build volumes in Germany illustrates that demand in the investment market cannot be satisfied by new property in any case. The new-build rate in the office markets in the 127 RIWIS cities over the last ten years stands at just 1% per year. On the other hand, the increasing price differential between new builds and existing properties will make taking on refurbishments of existing properties increasingly attractive. Building an ESG-compliant portfolio by acquiring and refurbishing existing buildings may well take longer than doing so by acquiring new builds. However, the cost of such a strategy will probably be significantly lower and the yields higher.

Hence, following a phase of intensive focus on new build and a withdrawal from existing property, we could witness a phase of differentiation in the acquisition profiles of ESG-compliant investors in the markets. In the long term, therefore, market mechanisms may contribute to a reorientation in the real estate investment markets towards the most climate-friendly implementation of the E in ESG. Should the road ahead include the introduction of a comprehensive CO_2 tax, refurbishments of existing property would immediately become more attractive. Such a tax would price in the external costs of embodied carbon and make new builds significantly more expensive. This, too, would create an incentive for capital to be redirected back into existing properties and to refurbish these to ESG-compliant standards. The new German government has also announced in its coalition agreement that it wants to create the basis for being able to take a closer look at the use of embodied carbon. This is to be done, among other things, via a digital building resource passport. Should such an instrument be introduced, it could facilitate the recording and pricing of grey emissions and accelerate the redirection of capital into the existing building stock.

50 billion Euros
The transaction volume on the German residential market will amount to more than 50 billion euros in 2021. For the first time, residential real estate will be the type of use with the highest turnover, far ahead of offices and the other commercial real estate segments.

Residential market outlook: yields are temporary, security is permanent

Text: Matthias Pink

2021 was a "year of housing". Not only did many people spend an unusually high proportion of their time between their own four walls owing to the pandemic, but investors were also more focused than ever on residential property. The transaction volume in the German residential market has exceeded €50bn in the second year of the pandemic. This is double the previous record total from 2015. For the first time, residential property is also the leading sector for investment, way ahead of offices and the other commercial property sectors. This is the, perhaps only provisional, pinnacle of an extraordinary comeback for residential property as a defensive asset class, which began following the global financial crisis (see "An old flame rekindled. The return of residential property in institutional investors' portfolios").

The residential market has been a perfect investment environment since the financial crisis

In our estimation, the rising popularity of residential property among investors is essentially attributable to its bond-like characteristics: stable income and very low default risk combined with low fluctuations in value and high liquidity. With these qualities, residential property has become all the more a substitute for bonds for many risk-averse investors the lower that bond yields have fallen. And bond yields have been in constant decline since the financial crisis. Furthermore, falling bond yields have been accompanied by relatively strong growth in the population and household income as well as very low housing completions. All in all, the German residential market has offered investors almost perfect conditions that are unrivalled in historical comparison (see Table 1). The only "stain" on this picture is the increasing intensity of regulation since 2015 at the latest. However, that too has a positive side for risk-averse investors since it tends to increase the scarcity of product in the regulated segments of the market, stabilising rental growth and further reinforcing the bond-like character of residential property.

Hence, if we disregard the regulation, all fundamental factors have been extremely favourable from an owner's perspective. This has resulted in predominantly double-digit annual total returns, even in the sector with the lowest risk in the German real estate market.

The pandemic has fuelled the attractiveness of residential property

The COVID-19 pandemic has only had an enduring effect on one of the aforementioned four fundamental factors: bond yields, which will now remain low for an even longer period. The pandemic has only had a short-term negative impact on population growth since immigration has been lower. This has had practically no effect on housing development and the negative consequences on household income have been largely compensated via government measures such as short-time working benefits. The bottom line is that the COVID-19 pandemic has increased the attractiveness of residential property as an asset class overall and, in that respect, it is only logical that it has not slowed the residential investment market but rather fuelled it. Besides the record transaction volume, another manifestation of this is that we registered more than thirty first-time purchasers in the German residential market between January and October 2021.

Table 1: Fundamental conditions on the German residential market

Fundamental indicator	1996-2009	2010-2019	2020-2025*
Population growth p.a.	0.0%	0.4%	0.1%
Household income growth p.a.	1.7%	2.4%	2.5%
Housing completions p.a.	337,057	232,106	>300,000
Yield change on 10-year German government bonds p.a.	-26 bps	-39 bps	+18 bps

Data sources Bundesbank, Focus Economics, Federal Statistical Office / * forecast

> "The bottom line is that residential real estate remains a safe asset class."

Regardless of the pandemic, the phase of perfect conditions is over

While the pandemic has attracted new investors to the German residential market, the phase of perfect fundamental conditions is ending. We consider it extremely improbable that the investment environment will remain as favourable over the coming years as it has been to date. An essential indicator for this is the strong increase in the number of housing completions per year. Since the nadir of less than 160,000 in 2009, this figure has increased to some 300,000. This is at least at the bottom end of the range most experts consider necessary to cover demand. Both the building permit figures and the attempts of politicians to stimulate housing development suggest further growth over the coming years.

While the supply is growing at an increasing rate, however, the opposite is true of demand. Since 2015, population growth has decreased consistently and the Federal Statistical Office is predicting annual population growth of around just 0.1% by 2025. Growth in the number on inhabitants in Germany between 2009 and 2019 was almost four times this amount. Against this background, it is increasingly likely that housing vacancy rates, which have fallen almost without exception over the last 15 years, will increase again over the coming years. When and to what extent this will happen also depends on how much pent-up demand for housing there has been over recent years. It is known that around 8.5 million people are living in over-occupied housing (according to the definition of the European Statistical Office). In addition, there is likely to be a large number of other people who have decided against finding their own home, or a larger one, in recent years owing to the lack of available supply. However, even if resolving this surplus demand pushes back the advent of an increase in vacancies, the supply/demand relationship in the housing market will already change to the detriment of investors ahead of this time.

There could also be a reversal in bond yields looming. In fact, it may have already happened. Yields on 10-year German government bonds reached their lowest level to date on a monthly basis in August 2019 and have not returned to these levels despite some interim declines since the outbreak of the pandemic. Current consensus projections expect yields to rise to approximately 0.8% by 2025. Such a yield projection undoubtedly comes with a high degree of uncertainty. Nevertheless, in view of the expected higher levels of inflation (see also our article "Portfolio optimisation in times of high inflation") it appears extremely improbable that yields will continue to fall at the same rate as in recent years.

In summary, one of the four fundamental factors, supply growth via housing completions, will almost certainly no longer be as favourable from an investor's perspective over the coming years as it has been in the years since the financial crisis. The same is also probably true of two other factors, namely population growth and bond yields. Only projected growth in household incomes, the fourth fundamental factor, will remain at the same level as in previous years (see Table 1).

The environment no longer guarantees rising rents and capital values but security remains

We still interpret these conditions as a favourable environment for risk-averse investors. The quasi-guarantee of nationwide rising rents and capital values may well be expiring. However, at least in the growth regions, we expect rents to rise further albeit at a slower rate than previously. The foreseeable more stringent regulation may cap this rental growth but will also remove volatility from the market. Unlike with rents, we see relevant downside risks for capital values. Both lower rental growth expectations and the probable flattening or reversal of the interest rate curve should themselves produce higher initial yields. However, this upward pressure could be offset by a lowering of the risk premium on residential property compared with bonds and, in view of ever-increasing investor interest, we also consider this highly probable at least in the short term. Between now and 2025, we expect initial yields to move in a narrow range from their current level, with breakouts from this range to the upside being more likely than those to the downside. Even in view of these downside risks for capital values residential property will remain an equally secure asset class. However, it may no longer produce the extraordinarily high total returns witnessed in recent years.

> “An indexed lease only provides good protection against inflation if the tenant concerned can actually pay the rising rent in times of high inflation.”

Portfolio optimisation in times of high inflation

Text: Matthias Pink

Inflation in Germany and other parts of the world has reached its highest level for decades. While this may be partially attributable to temporary effects, the probability of a sustained period of higher inflation appears sufficiently high to us to prepare for such a scenario. On a macro level, the first important question is whether there is actually a causal relationship between inflation and rents or property prices. In our estimation, most (scientific) studies come to a clear conclusion on this: there is no robustly demonstrable causal relationship when looking at typical holding periods of real estate investors. Consequently, total returns from property are also not dependent on inflation. In other words, whether property acts as protection against inflation for a specific holding period can only be determined in hindsight and, even if it appears to do so, this can actually be attributed to other favourable conditions (e.g. strong population, employment or economic growth) and not to inflation itself.

Real estate as an asset class does not protect against inflation but protective measures can be taken at portfolio and property level

As an asset class, then, real estate does not offer inherent protection against inflation. At portfolio level or at an individual property level, however, it is possible to apply at least partial protection. Both in terms of portfolio management and when making acquisitions, investors can take measures to brace themselves against a period of higher inflation (summarised in Table 2).

Indexed leases are surely the best instrument for owners to hedge their income against inflation. A portfolio comprising exclusively indexed leases would be perfect and ideally with indexation clauses that provided for annual and complete adjustment of rents in line with the consumer price index. The fact that inflation rates may exceed rental growth rates over the coming years also favours longer lease terms. Conversely, non-indexed leases should have the shortest possible lease terms since, with long-term leases, inflation may mean that the increasing costs actually exceed rental income in the worst-case scenario. The risk of rising costs can be reduced with triple-net leases, whereby tenants bear the cost of repairs.

An indexed lease only provides good protection against inflation if the tenant concerned can actually pay the rising rent in times of high inflation. This is most likely to be the case with tenants whose costs are either not increasing to the same extent as general consumer prices or those who can pass on their own increased costs due to inflation on to their customers in the form of higher prices. Owners are always on the safe side with public-sector tenants in this regard (rising prices also mean rising tax revenues). Consumer goods manufacturers with strong brands are also likely to be a good choice owing to their typically high level of pricing power.

Table 2: Portfolio optimisation measures in an inflationary environment

Hedging income via ...	Hedging costs via ...
Indexed leases	Triple-net leases
Long lease terms on indexed leases	New-build or refurbished properties with low operating and maintenance costs
Short lease terms on non-indexed leases	
Turnover rents	
Tenants with low inflation-related cost risks (e.g., consultants)	
Tenants with strong pricing power (e.g., food manufacturers and retailers, luxury brands)	
Preference for (high) income in the present rather than (high) future income (e.g., over-rented rather than under-rented properties)	

Source Savills

> “Should expectations of inflation strengthen, even more capital than to date is likely to flow into real estate.”

Turnover leases, which are commonplace in the retail sector, also offer a certain level of protection against inflation since rising prices translate into rising turnover and, in turn, into higher rents. However, this is only the case if this positive effect on price is not offset by a negative effect on volume, i.e., customers buy less of the product owing to the increase in prices. The fast moving consumer goods segment (food, drug stores, etc.) is very robust in this regard, as is the luxury segment.

Properties offering better inflation protection will become more expensive

Since properties fulfilling the specified criteria are more attractive from an investor's perspective in times of rising inflation expectations, these are also likely to become relatively more expensive. As some of these advantageous characteristics appear more frequently in certain property market segments more than others, there would then be price shifts on a macro level. In contrast with the commercial sector, for instance, leases on apartments are not indexed for the most part. This in itself suggests a declining price differential between commercial and residential property. As another example, the entire local supply property segment is likely to hedge cash flows relatively well against inflation owing to the stronger pricing power of tenants and could, therefore, become (even) more expensive.

New builds or completely refurbished properties also become more attractive than older stock in an inflationary environment owing to their lower operating and maintenance costs both in absolute terms and relative to the rent. Hence, existing properties generally become less attractive, particularly if the contractual rent is below the market rent. The longer the leases on such properties, the further into the future the associated income potential lies and hence the lower the present value of the cash flow in an inflationary environment.

Regardless of the characteristics of the property being acquired, the high inflation rate and sustained low interest rates support higher loan-to-value ratios upon acquisition or refinancing. In any case, it is completely rational to take on loans in such an environment. This brings us back to the macro level. In no other asset class can investments be financed via borrowing to such a high degree and on such favourable terms. Should expectations of inflation strengthen, even more capital than to date is likely to flow into real estate.

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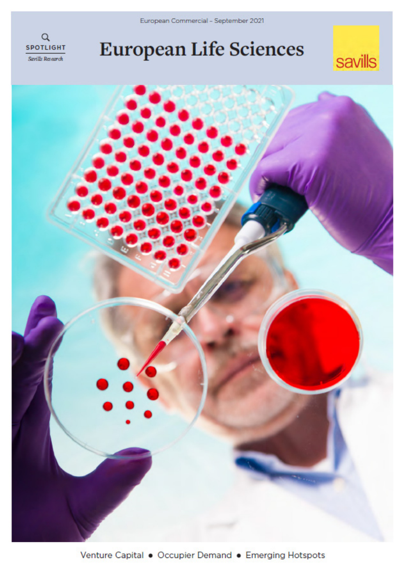

European Life Sciences

Savills Team

Please contact us for further information

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

Panajotis Aspiotis
Agency
+49 (0) 221 22 962 220
paspiotis@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

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