Germany Residential - October 2022

Residential Market Germany

savills

Struggle between rising interest rates and housing shortage

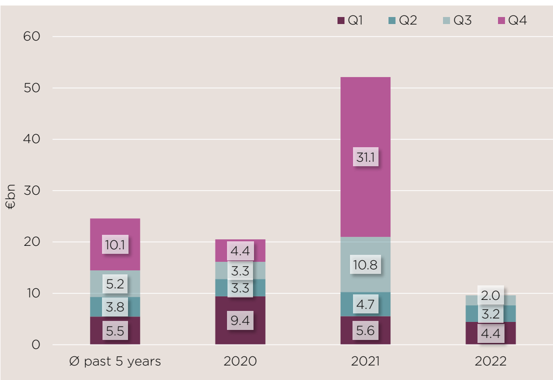
The situation on the German residential market is currently very ambivalent. On the investment market, the changed financial conditions have led to great restraint among investors. On the residential letting markets, on the other hand, supply has become even scarcer, which is why the long-term incomes outlook has improved further from an investor's point of view.

The transaction volume (transactions of 50 units or more) was only €1.96bn in the third quarter (Graph 1). It was the weakest quarter in terms of turnover since the first quarter of 2016. The number of transactions (Graph 3) was as low as it had last been in 2010. In the year to date, the transaction volume adds up to around €9.6bn – approx. 54% less than in the same period of the previous year (Table 1).

Price adjustment in progress

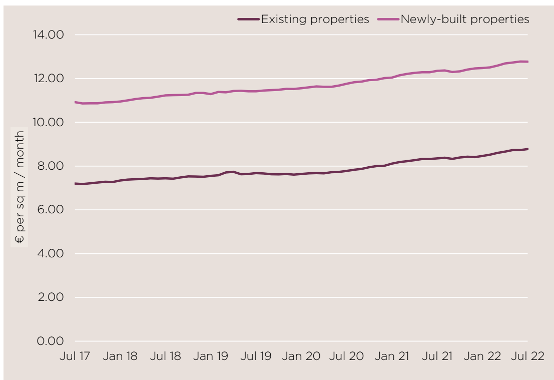
The low transaction activity reflects the current often protracted negotiations between vendors and investors. Due to the initiated interest rate turnaround, most market participants have to recalculate their investments. Since the end of 2021, not only interest rates for debt capital have increased, but also German bond yields. For example, the ten-year SWAP rate has risen by about 270 basis points within nine months to now around 3%. The yield on ten-year German government bond rose by about 230 basis points over the same period and currently stands at about 2.1%. Meanwhile, the prime yields for multi-family properties were still at 2.2% at the end of the first half of the year. Due to this constellation, the leverage effect has turned negative within a very short time. At the same time, the risk-free interest rate is now at the same level as the prime yields for residential property were a few months ago. These developments are causing yields on residential property to rise. Some investors, including internationally active private equity companies, assume in their calculations that the previous increases in SWAP and bond yields will be fully

Graph 1: Transaction volume*



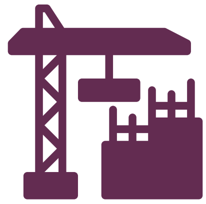
Source Savills / * only transactions with at least 50 units

Graph 2: Average asking rents*



Source VALUE Marktdaten / * nationwide average

Focus on selected figures



24%
In the third quarter of 2022, 24% of the volume was attributable to forward deals. This is less than in the two previous quarters, but still more than the five-year average (22%).

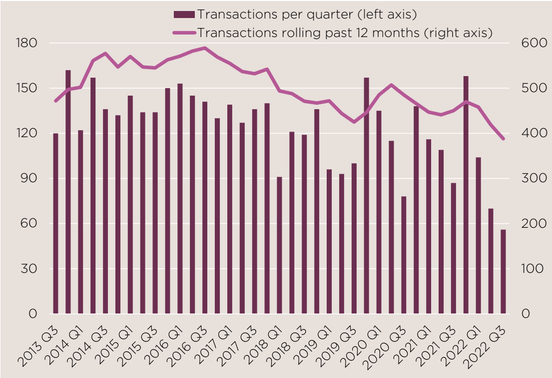
€961m
In the first three quarters of 2022, student and micro-living properties were traded for approx. €961m. This is 11% more than in the same period of the previous year.

Table 1: Transaction volume and number of traded units at a glance*

	Transaction volume (€m)		Number of traded units	
	Q1 - Q3 2022	y-o-y change	Q1 - Q3 2022	y-o-y change
A cities	3,969	-68%	12,910	-75%
B cities	1,462	-11%	8,712	-19%
C cities	931	-12%	4,466	-19%
D cities	1,076	+18%	10,369	+69%
Other	2,179	-58%	15,745	-55%
Germany	9,617	-54%	52,202	-52%

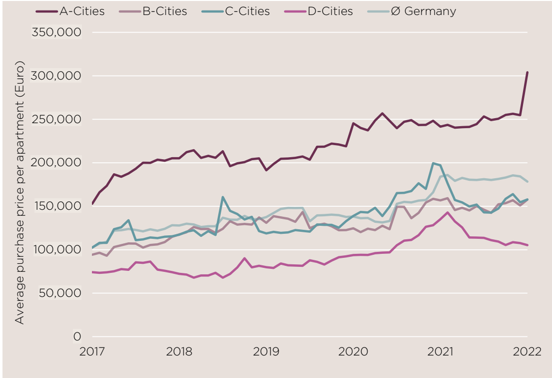
Source Savills / * only residential transactions with at least 50 units; city categories based on the Bulwiengesa classification

Graph 3: Number of transactions*



Source Savills / * only transactions with at least 50 units

Graph 4: Prices of traded units



Source Savills / Note: always past 12 months rolling; based on the Bulwiengesa classification

reflected in residential yields. Should this be the case, prime yields of around 4.5% could be expected in the medium term. However, almost no property owner is currently responding to such purchase price offers. The landlords have good arguments against such a strong rise in yields. On the one hand, the fundamental conditions on the occupier markets continue to be extraordinarily positive and, on the other, the residential property market has become much more institutionalised and liquid since the great financial crisis. In times of high uncertainty, the fact that residential property promises an unparalleled stability in rental income could stabilise demand on the investment market and dampen the rise in yields. For the coming months, it is to be expected that the consequences of the rise in interest rates and the positive long-term fundamentals will be brought into play against each other in the purchase price negotiations and priced in respectively. It is therefore still unclear at which yield level the market will settle, especially as volatility on the financial markets remains high.

Supply shortage in letting markets intensifies

The fundamentals still speak in favour of a long-term commitment to German residential real estate, and probably even more so than ever, because rental apartments will remain scarce in the coming years, promising secure long-term returns. The combination of rising construction and financing costs, the termination of subsidies in new construction and a lower willingness to pay on the part of investors will lead to fewer housing completions. According to a study by the ifo Institute, 11.6 % of construction companies were affected by order cancellations in August, which is an exceptionally high figure by long-term standards. This indicates that the federal government's target of 400,000 completed residential units per year will be missed by a wide margin in the next few years. While there is hardly any relief to be expected on the supply side of the letting markets, demand is likely to be higher than expected at the beginning of the year. In a recent study, for example, Deutsche Bank assumes that almost 86 million people will be living in Germany in 2030. This long-term increase in demand is accompanied by a short-term increase in demand because the purchase of residential property has become unaffordable for more and more households due to the rise in interest rates and these households are becoming active in the letting market instead. For owners of rental apartments, this means that in many locations there is virtually no risk of vacancies for the foreseeable future and rental income can be expected to remain stable at least.

In the current high-inflation phase, however, the considerably rising ancillary costs are likely to mean that the ability of many households to pay will reach its limits, making rising cold rents (Graph 2) less likely. Because the rising ancillary costs disproportionately affect households with lower incomes, owners of properties of simple quality could be particularly affected.

Listed companies switch to sell side - opportunity for new investors

In the coming months, the tug-of-war between greater housing shortages on the one hand and rising interest rates on the other is likely to continue. This will create many opportunities for investors in the coming months. For example, significantly more supply in the portfolio segment can be expected in the fourth quarter. At the same time, the listed residential companies, which were responsible for 41% of the acquisition volume in the last five years, are now on the sell side. The de facto disappearance of this group of buyers increases the chances for all other investors to obtain larger residential portfolios. In view of the positive long-term prospects on the occupier markets, there is an opportunity to enter a market with hardly any vacancy risk, long-term rent increase potential and high long-term stability of capital values with less competition and at lower prices. The large product pipeline could lead to the market regaining momentum faster than other real estate segments. The transaction volume could rise to up to €15bn by the end of the current year. This would mean about as much volume being turned over this year as at the peak before the great financial crisis.

Download the charts and raw data here

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