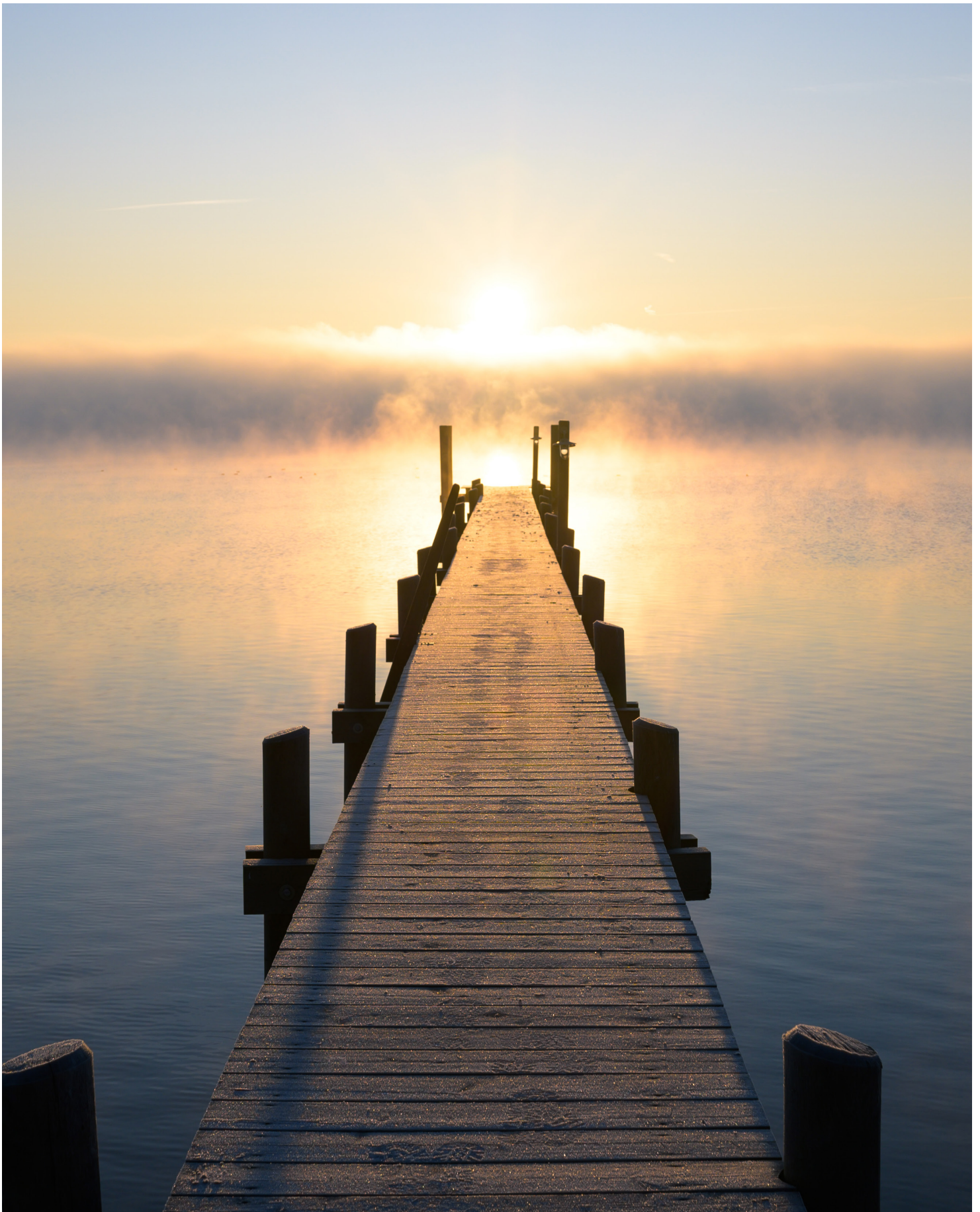


Cross-sector Germany - December 2022

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SPOTLIGHT
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German property market outlook

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While 2022 was dominated by the interest rate shock, 2023 is likely to be dominated by occupier themes. The economic dip will dampen demand for space in the commercial property markets and vacancy rates will mostly rise. Consequently, downward pressure on rents will increase. Due to increased demands and high inflation, space will nevertheless remain scarce and expensive for occupiers. This is even more true for flats.

*Text: Matthias Pink und Matti Schenk
(Housing markets section)*

Introduction

“We have to be prepared to live in a future where everything is different than before”. You can’t get more uncertain than that. This sentence was uttered by the Egyptologist Jan Assmann, someone who has spent his life studying human history. His “before” spans millennia, not just one or two real estate cycles, and that gives his statement all the more weight. So, the future seems extraordinarily open, perhaps more open than ever. For long-term decisions, and that includes real estate decisions, this is the worst possible environment. However open the future may be, such decisions require an outlook that goes beyond “everything could

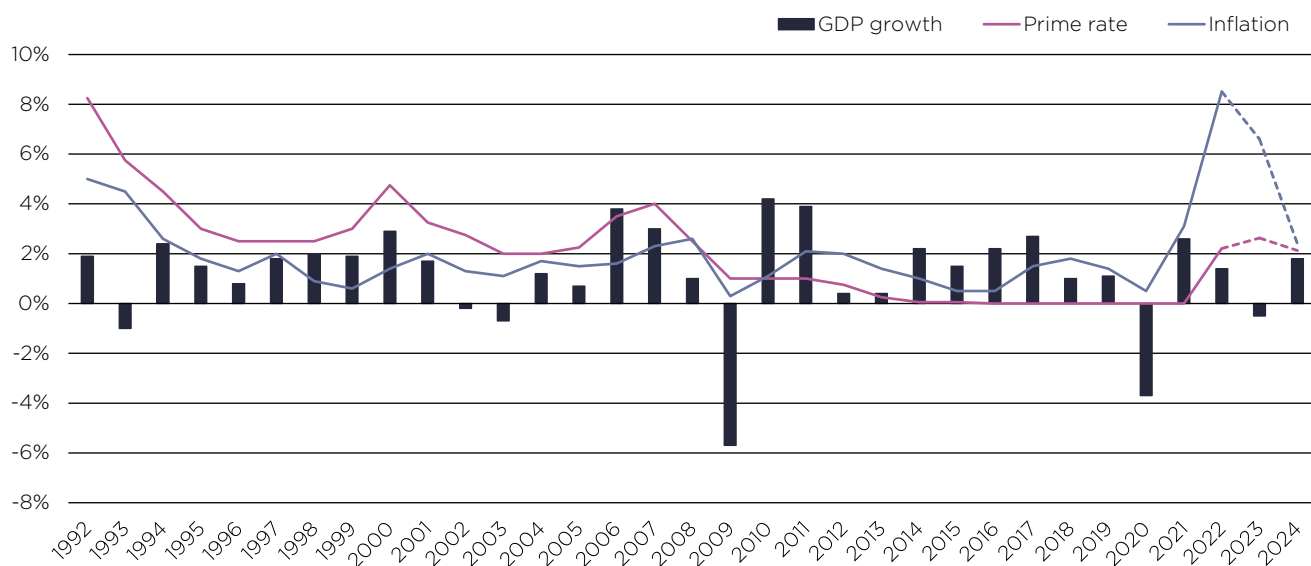
be different”. But what is the value of such an outlook if the present - shaken by pandemic, war and other catastrophes - is already barely comprehensible? Well, **precisely because the future is unusually open, it requires a sharp look at recent developments to be able to limit this openness.** The fact that everything could be different than before does not mean that everything is possible. With this in mind, we would like to share our observations on the German real estate market here and, based on them, set out a frame of reference for what we think market players might expect in the coming years.

Macro environment

The omnipresent uncertainty among real estate market players is no coincidence.

The markets are confronted with a macro environment that is unique in this constellation. This starts with inflation, which has not been as high as it is at present since the 1970s. But above all, weakening economic momentum coincides with rising interest rates (see Figure 1). **Two stimuli that have a negative impact on property values and that normally offset each other are thus now acting in parallel.** In a sense, this is the reversal of the post-financial crisis environment,

Graph 1: Macroeconomic environment



Source Bundesbank, Focus Economics, National Statistics Office

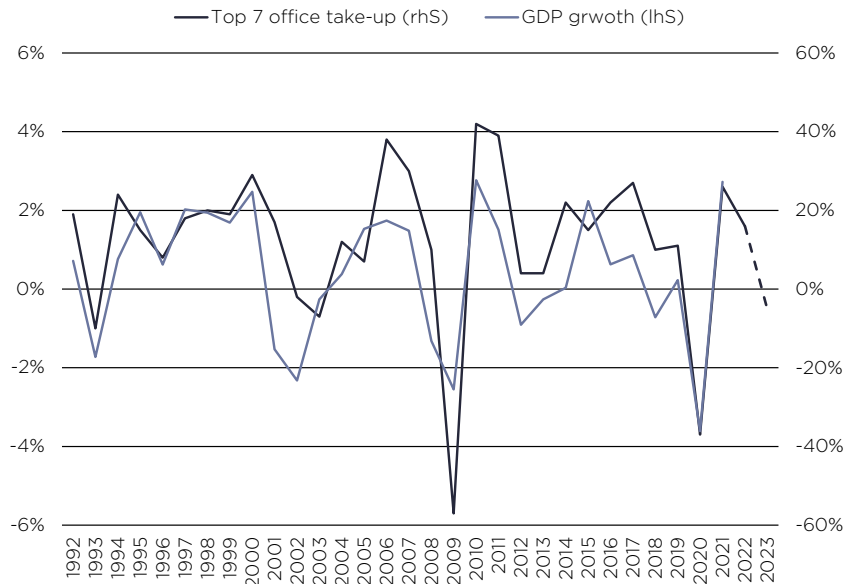
“Deglobalisation and decarbonisation could keep inflation above target for a longer period.”

which was characterised by low inflation, falling interest rates and mostly high economic momentum. **The good news is that such a mixed situation is, by its nature, limited in duration.** In our baseline scenario, which forms the basis for all our subsequent comments on the property markets, we assume that Germany will go through a mild recession in the winter and then grow moderately again. The employment level remains high and unemployment increases only slightly. However, in our assessment, the downside risks outweigh the upside risks in this scenario, not least with a view to the winter of 2023/24, when another gas shortage could loom. The inflation forecast is also subject to this uncertainty because it is predominantly driven by energy prices. We assume here that the inflation momentum will already slow down significantly next year and that the European Central Bank's inflation target of 2% will at least come into sight again in 2024. This goes hand in hand with the fact that the interest rate peak has almost been reached and the prime rate will be around 2% in the medium term. Here too, in our view, a less favourable course is much more likely than a more favourable development path. For example, it is conceivable that the deglobalisation tendencies that can be observed as well as the decarbonisation of the economy that has begun will ensure that inflation remains above the target level for a longer period of time. Either way, **Germany is not a winner of the crisis this time.** On the contrary: because of its dependence on exports and energy, the German economy is suffering particularly from the current macro environment and it could even be that the previous business model of the industrial and exporting nation is fundamentally threatened and in need of transformation.

Office markets

Without exception, all recessions of the last thirty years have been accompanied by a decline in take-up on the major office markets (see Figure 2). We expect this to be the case in 2023, too. **We are already observing unmistakable indications of falling demand for space**, for example in the form of an increasing supply of sublet space and a lower number of rental enquiries. **As a consequence, the increase in vacancies of recent years will continue** and possibly even accelerate.

Graph 2: Economic cycles and office space take-up

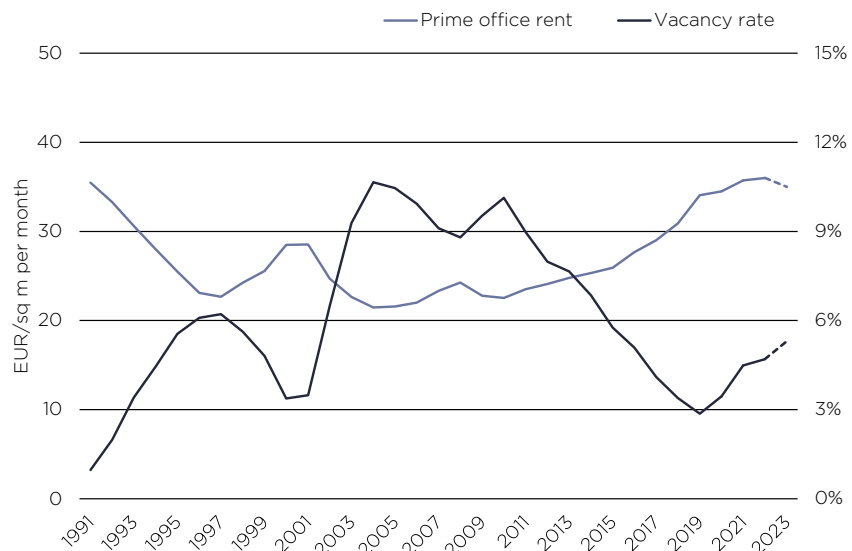


Source Bulwiengesa, Focus Economics, National Statistics Office

Until the beginning of the pandemic, rising vacancies were synonymous with falling rents. Since then, this correlation no longer holds and rents have continued to rise despite increasing vacancies (see Figure 3). We believe this is mainly due to the sudden shift in demand preferences towards higher quality office space. This qualitative change in

demand has met and continues to meet a rigid supply in the short term. As a result, some of the space that was previously still marketable no longer meets user needs and has fallen vacant. All other spaces have become scarcer and thus more expensive because the entire demand now hits them.

Graph 3: Prime office rents and vacancy rate in the Top 7



Source Bulwiengesa, Savills (forecast)

**43 %**

Almost half of the European logistics occupiers we surveyed expect to need more logistics space in the next three years.

This process is not yet over, but it is likely to weaken and become increasingly overlaid. In our view, three aspects come into play here. Firstly, the volume of completed space will be comparatively high, at least in the next two years, and will ensure a greater supply of modern office space. Secondly, the economic downturn will, at least temporarily, bring the cost side back into sharper focus for companies - this will also influence their willingness to pay for office space. Thirdly, and this is presumably the strongest effect, the increased demands on office space quality are offset by a lower quantitative demand. According to our impression, at least most large users want to significantly reduce their per capita office space footprint against the backdrop of the hybrid working world that is becoming established. We think it is unlikely that this will be compensated by a rising number of office employees. In the short term the economic development stands in the way and in the long term demographics.

In view of this mix, downward pressure on rents is likely to increase. Away from the top segment, we expect rents to fall in the coming year. **The top segment may be able to escape this development against the backdrop of the ESG issue.** Since some occupiers only rent space that is ESG-compliant, it is not in competition with other space. Consequently, the rents of modern spaces could decouple from the rest of the market. For such a development, the number of occupiers who rely exclusively on ESG-compliant space seems too small to us. In our main scenario, we therefore also assume slightly falling prime rents for the coming year.

In 2024, too, the downside risk outweighs the growth opportunities for rents in view of further rising vacancy rates. This could change from 2025 onwards, because the current environment of high financing and construction costs will lead to significantly fewer project developments being started. There could then be a lack of new construction space, at least, and this could lead to rising rents in the prime segment.

Logistics markets

Private households and the manufacturing sector are suffering particularly from the current and foreseeable macroeconomic environment. The former are facing a massive real loss of purchasing power due to high inflation and will have to reduce their consumption. The latter will be squeezed by

rising energy costs and lower global demand. If fewer goods are bought as well as produced, this puts a double burden on the demand for logistics space. **After rising to record levels until recently, take-up is expected to fall in 2023. A rising number of insolvencies, especially among small and medium-sized enterprises, could also lead to higher vacancy rates in the small-space segment.**

In addition, online retail, which was a massive demand driver especially in the last two years, is experiencing a setback. This was to be expected anyway after the pandemic-related boom. It is now being exacerbated by high inflation. Such an effect could also be observed with regard to inventories. In response to the disrupted supply chains caused by the pandemic and the war, the majority of manufacturing companies have significantly increased their inventories and also rented additional space for this purpose. 'Just in time' has become 'just in case'. Many retailers have also acted in this way - partly also as a measure against supply problems, partly in anticipation of a post-pandemic consumption boom. Because of the weak demand, inventories are now likely to last much longer than expected in many cases and further storage space is not needed for the time being.

In our view, there is much to suggest that demand for logistics space in the coming year and perhaps beyond will be lower than in recent years. **However, we assume that demand will continue to exceed the supply of modern space and that vacancy rates will remain in the restrictive range. At the very least, prime rents are likely to continue to rise, albeit at a slower pace initially.** This is all the more true after the economic downturn will have been overcome. Almost half of the European logistics users we surveyed [expect to need more logistics space](#) in the next three years and Germany is their number two expansion target. Only one in ten users is planning to reduce space. Sooner or later, online retail will also switch back into growth mode, although it will probably not be able to match the pace of earlier years. Nevertheless, a rising online share of retail sales increases the need for warehouse space. We expect these structural demand drivers to gain the upper hand over demand-dampening effects again in the medium term. As the supply-side 'bottleneck' is the availability of suitable land and this neck is likely to narrow, the shortage of space will remain. **Should vacancy actually increase in the short term, opportunities**

will open up for owners and investors to refurbish these spaces and then bring them to the market when demand picks up again.

“While city centres can no longer be fully occupied by retail, neighbourhood locations are increasingly coming into focus.”

Retail markets

Even more than two and a half years after the start of the COVID-19 pandemic, sales in the brick-and-mortar retail trade are still below the previously achieved level. In view of the massive loss of real purchasing power of private households, this is not likely to change in 2023. The lower sales are accompanied by higher costs, so that the already high pressure on retailers has increased even more. The number of insolvencies has already risen recently and this development is likely to continue in the coming year. Rising vacancy and rent default risks are the result. **Against this background, we expect rents to continue to fall except for the local supply retail.** Only the prime highstreet locations in the metropolises could escape this development. However, such locations have shrunk considerably and the rent differential to adjacent locations is becoming steeper.

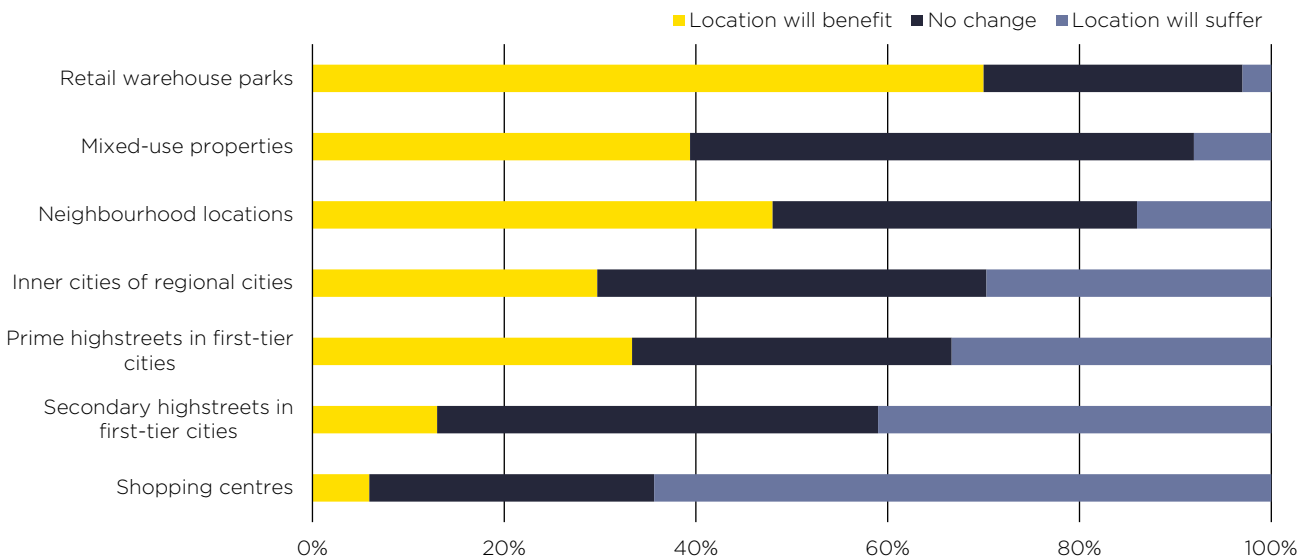
Even beyond the coming year, the non-neighbourhood-oriented retail sector will continue to be characterised by consolidation. This is helped by the fact that some of the increased costs, especially for staff, are of a structural nature. As a result, the demand for space is likely to

continue to shrink. **Exceptions prove the rule, and there are many of them.** They include the already crisis-proof luxury segment, but also many sneaker and young fashion brands as well as the still expanding e-car manufacturers. In the sought-after locations, new occupiers will continue to be found for spaces that are falling vacant. In some cases, the rent on a new lease can even be significantly higher than before. A prerequisite, however, is often a modernisation of the space, because retailers' demands on the space are increasing.

Food retailing and other local suppliers remain an anchor of stability, especially as they benefit disproportionately from the high immigration. There are even opportunities for expansion here, because the increase in working from home has led to a migration of purchasing power from office locations to residential areas. **In any case, mobile working, changed mobility behaviour and also demographic change argue for a more decentralised retail structure.** While city centres can no longer be fully occupied by retailers, neighbourhood locations are increasingly coming into focus (see Figure 4). **Conversions are thus becoming the order**

of the day. In locations with a surplus of retail space - including an increasing number of shopping centres - alternative uses are needed, and in other locations suitable space must be created for retail. In most cases, both require structural interventions, but in any case investments. Stable cash flows may be becoming rarer on the retail property market, but the playing field is large for project developers and other value-added investors.

Graph 4: Retailers' assessments for different location/property types



Source EHI, Hahn



84 million

For the first time, more than 84 million people live in Germany and this number is likely to increase in the coming years.

Housing markets

In the housing markets, the new macro environment has probably changed the outlook most seriously. The demand for rental housing has by no means weakened, as seemed to be foreseeable at the beginning of the year. Due to the influx of Ukrainian refugees, Germany's population has risen to over 84 million people for the first time. In addition, current population forecasts, such as the one by Deutsche Bank, assume a high immigration rate in the future and thus a continued increase in demand for housing. Due to the sharp rise in financing costs, many households can no longer afford to buy their own home and remain tenants.

While demand for rental housing is unexpectedly high, conversely, construction completion figures must be assumed to be falling instead of rising.

Higher interest rates and construction costs have made projects massively more expensive. Expected sales prices, on the other hand, have fallen. This has led to a halt in many construction projects. Instead of 400,000 completed flats per year, as targeted by the federal government, a figure 200,000 new flats in 2023 seems much more likely. In 2024, it is likely to be even lower. **The supply-demand relationship is thus out of balance as rarely before** (see Figure 5). In the next few years, we therefore expect the already very low vacancy rates in most rental housing markets to fall further and

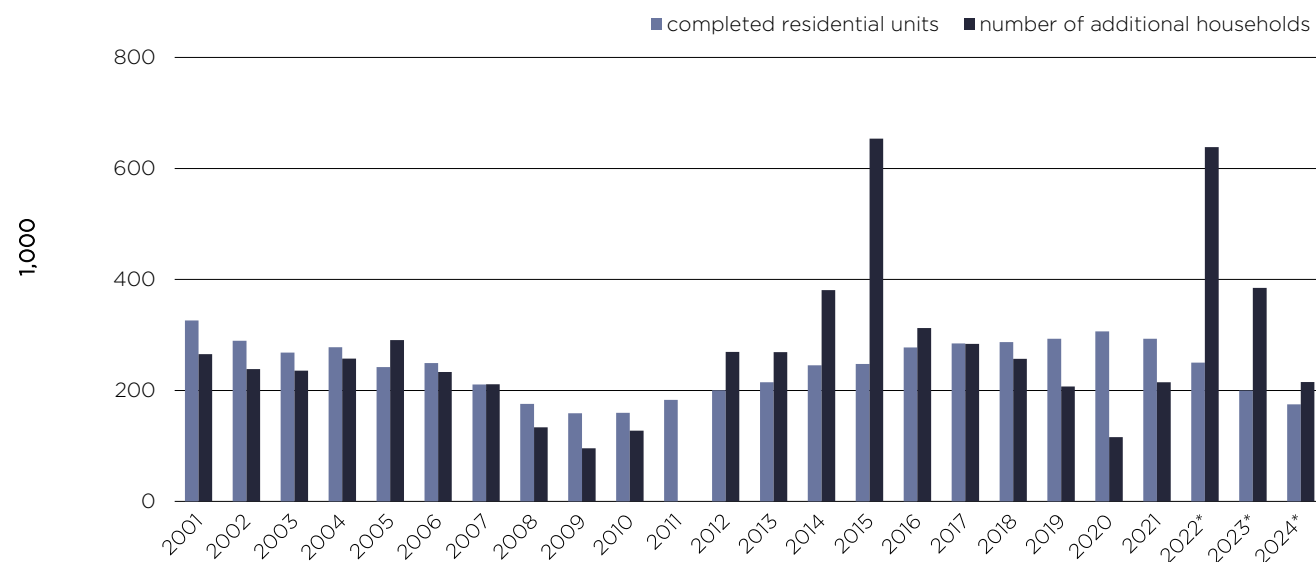
rents to rise. **From the landlords' point of view, the fundamental framework conditions not only remain favourable, the outlook has even improved compared to last year.**

However, the socially explosive nature of these developments is likely to call government onto the scene. Recently, it was decided to increase the linear depreciation from 2% to 3%. For new rental housing that meets the EH-40 standard and the requirements of the Quality Seal for Sustainable Buildings (QNG), it will even be possible to write off 5% of the construction costs over four years. Although these and possibly upcoming decisions will not have an effect on the number of completions in the short term, in the medium term they could significantly boost construction activity in rental housing. **We think it is conceivable that 400,000 flats per year will actually be completed in the next legislative period.** But even then it would still take years to reduce the accumulated surplus demand. In the short term, therefore, policymakers could further tighten rent regulation to at least alleviate the symptoms of the housing shortage. For example, at the end of November Hamburg proposed legislation to introduce a cap on index-linked rents. Because more landlords are currently relying on such index-linked rents, we believe that their tighter regulation is a scenario that

landlords should prepare for.

As stronger regulation acts as a barrier to market entry, such and similar regulatory interventions reinforce the defensive investment character of residential real estate. They cap the potential for rental growth, but precisely because of this they have the effect of tightening supply and thus ensure very secure and stable returns. **For risk-averse investors, the market thus remains attractive in principle.** Against the backdrop of the climate targets for the German building stock, which have so far been missed by a wide margin, regulatory pressure could also increase here. A range of measures is conceivable, from renovation incentives to usage bans, as already exists in other European countries. These no longer only affect the income side, but also the cost side and thus represent a completely different kind of risk. This risk can only be eliminated with the purchase of new buildings or energy-efficient renovated existing buildings, so risk-averse investors are likely to focus even more on this part of the market. **Should regulatory interventions actually take place that force the owners of older stock to refurbish, the bureaucratic and financial effort involved would presumably be too much for smaller landlords in particular. Many of them could then withdraw from the market in favour of larger landlords and initiate a consolidation process.**

Graph 5: Number of additional households and construction activity



Source Deutsche Bank, GdW, National Statistics Office, Savills / * forecast

“Assuming stable interest rates, a reliable price level should emerge in the course of 2023.”

Investment markets

Looking back at the year 2022, the real estate investment market was primarily characterised by the interest rate shock. The steep turnaround in interest rates triggered a price correction on the real estate markets from the spring onwards, whereby the uncertainty about the extent and duration of the correction led to many investors temporarily withdrawing from the market. **The turnaround in interest rates now appears to be largely complete and on this basis, we believe that a reliable price level should re-emerge on the real estate markets in the course of 2023, possibly as early as the spring.**

At what level buyers and sellers will come together remains to be seen. **We are convinced that the 200 to 250 basis point rise in interest rates will not translate one-to-one into initial property yields.** If one looks at the difference between the yield on 10-year Bunds and the prime yield on office property over a very long period of time (office property is representative of real estate as an asset class), the last few years stand out clearly (see Figure 6). On average, the office yield was more than 300 basis points above the bond yield between 2008 and 2021. It then melted down to around 100 basis points by the end of 2022. Looking at the last ten years, this buffer may

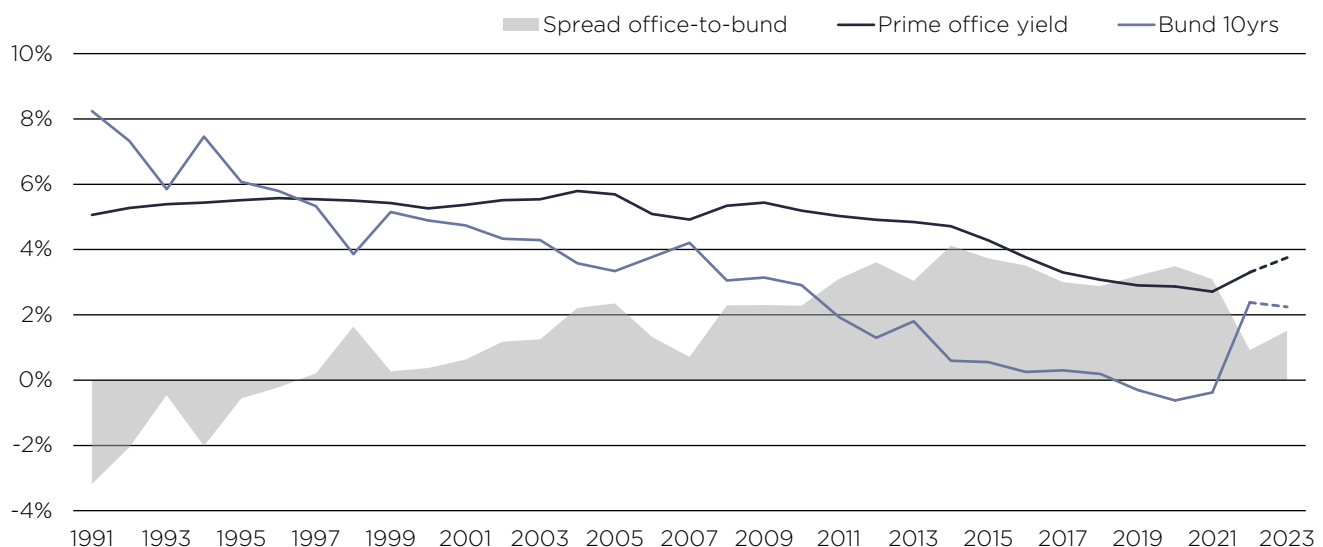
seem small, but not compared to the decades before the financial crisis. Between 1991 and 2007, it averaged only about 20 basis points. Against this background, **we interpret the high difference between real estate yields and the risk-free interest rate, which developed after the financial crisis, as a historical anomaly.** In our view, it is mainly explained by the ultra-loose monetary policy of the European Central Bank and in particular its active intervention in the bond markets. At the latest from 2015, when the ECB began extensive government bond purchases, the Bund yield was kept artificially low. The difference to initial property yields was distorted as a result. With the normalisation of monetary policy that has now begun, this situation should dissolve and the rise in real estate yields should be flatter than that of the risk-free interest rate.

As a look at the early 1990s shows, prime real estate yields can even be below bond yields. Such a constellation presupposes high rental growth expectations. Given the current macro environment, we believe that investor expectations of rental growth are not sufficiently high for this in any sector. The logistics market and the less regulated part of the residential market might be an exception. But here, too, the uncertainty about further developments is likely to be too great, at least temporarily.

Another relevant “lower edge” for property yields is financing costs. At the end of the third quarter of 2022, prime yields in all major market segments were below the cost of debt capital (see Figure 7). This situation could only persist if the number of equity buyers is sufficiently large. Indeed, such investors are currently quite active and are taking advantage of the lower prices for purchases. **However, we think it unlikely that the existing equity volume will be sufficient to anchor prices below the cost of financing.**

The fact that the increase in initial yields is nevertheless likely to be comparatively flat is also due to the mostly comfortable financing situation on the part of the landlords. **Apart from the project development segment, we expect few forced sales. We rule out a wave of non-performing loans like after the financial crisis.** Nevertheless, the steep rise in interest rates is likely to put individual landlords under stress, especially in the value-add and opportunistic segments, where financing durations are typically short. Lower demand for space and rents due to the recession could jeopardise the implementation of the business plan and thus also refinancing. **In our view, it should be borne in mind that, unlike after the financial crisis, the banks are unlikely to have any incentive to postpone the**

Graph 6: Risk-free rate and property yield



Source: Bulwiegese, Bundesbank, Focus Economics, Savills

“In addition to refinancing issues, there are other reasons for an increasing number of sales.”

workout of non-performing loans. Two factors play a role here: Firstly, loan-to-value ratios are only rarely likely to exceed 100%, even after value adjustments have been taken into account. In this case, a bank would not suffer any (balance sheet) damage from a workout. Secondly, in an environment of rising interest rates, lenders can use the equity released from repaid loans to grant new, higher-interest loans. In this respect, it could be that lenders in many cases are aiming for a speedy redemption of loans.

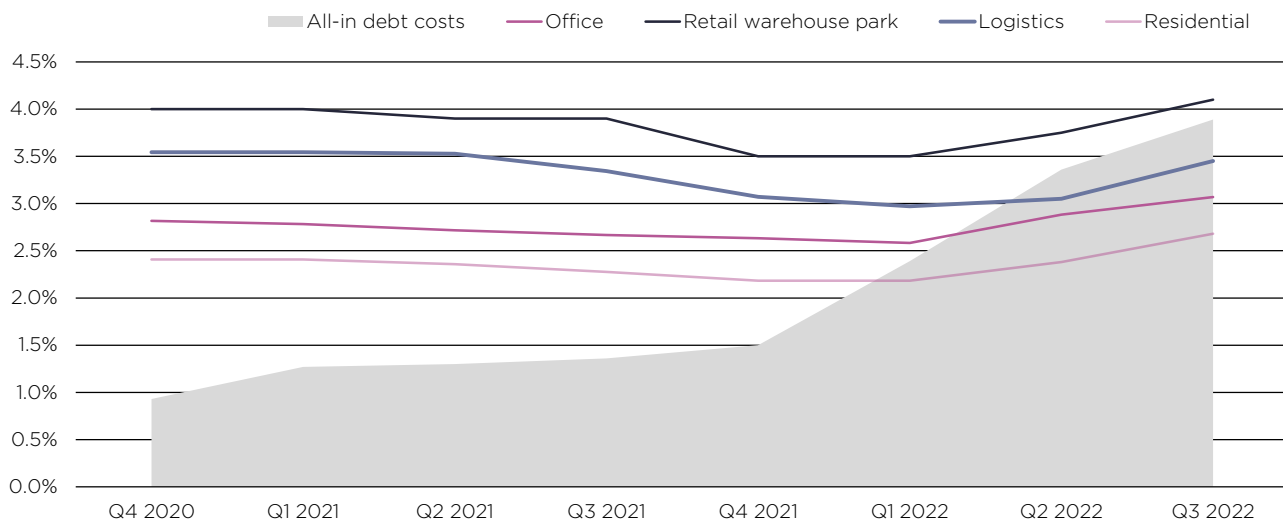
In addition to refinancing issues, there are other reasons for an increasing number of sales. For example, the devaluation of equities and bonds may have led to real estate quotas above target in some portfolios. This could trigger sales. Liquidity bottlenecks in open-end funds due to cash outflows could also make sales necessary. Against this backdrop and based on our observation that the number of sales processes started has already risen in recent weeks, we expect more supply again in perspective than recently. The big unknown is how much demand this supply will be matched by. In principle, many investment managers and other capital collection agencies still have plenty of money to invest, and capital sources such as insurance companies and pension institutions are continuously receiving more money to invest.

However, the trend in recent years of more and more of this money flowing into the real estate markets may have been broken with the turnaround in interest rates. The artificially low interest rates have made the money and bond market unattractive for many years. In addition, central banks have squeezed private investors out of the market with their securities purchase programmes and forced them to invest their money elsewhere, including in real estate. If this period now comes to an end, it could result in a countervailing reallocation process. In combination with monetary tightening, there would then be less money available for real estate investments than before until the long-term growth trend (driven by growing population and income) gains the upper hand again.

From a German perspective, there is another question: how safe is Germany still perceived as an investment haven? For the moment, we believe we can observe that overseas investors at least have become more cautious. The economic weakness plays a role here, as does the war in Ukraine. On the other hand, the euro has depreciated and the interest rate differential of the euro area against most other currencies has increased significantly. Both make the euro area and thus also Germany more attractive for investors from non-euro countries. The net effect of

these aspects cannot be determined, but the negative factors clearly outweigh the positive ones. **We expect more and more buyers to return to the market in the coming months, especially after a resilient price level has been established. Nevertheless, the volume of demand will remain considerably lower than during the 2021/22 turn-of-the-year summit.**

Graph 7: Debt costs and prime property yields



Source investing.com, Savills / * 10-year Swap rate plus 120bps margin

“Especially in terms of the occupier markets for office and retail spaces, the structural changes can be summarised in the formula ‘size down and grade up’.”

Conclusion

Despite all the uncertainty, one thing seems certain in our view for the real estate year 2023: **it will remain challenging for all market players.** Investors will be busy digesting the interest rate turnaround for at least the first few months. And many occupiers will increasingly feel the effects of the economic downturn. **Letting-related issues will thus also come more to the fore for landlords in the course of the year.** However, not only cyclical but also structural changes will keep the market in motion. Especially in terms of the occupier markets for office and retail spaces, this can be summed up in the formula “size down and grade up”. This creates both abundance and scarcity: abundance of space that no longer meets the increased demands and scarcity of those spaces that do. In many cases, however, even the surplus areas are not fundamentally obsolete. Often it is only a matter of identifying a suitable subsequent use and preparing the land for it. There are numerous opportunities for this, because supply remains scarce in many other market

segments. Logistics and housing are among them. **From the point of view of most occupiers, space will therefore remain scarce and expensive,** especially since the initially still high inflation will eat up any savings in cold rent through higher costs elsewhere. In view of this dynamic, risk-taking investors and those for whom real estate is an investment that needs to be actively managed are likely to get their money’s worth in 2023. **Asset management could become the buzzword of the year.**

In view of the major trends of digitalisation and decarbonisation, it could well be not just a year, but an era of asset management. But that is a topic for another outlook.



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