SPOTLIGHT
Savills Research

Outlook 2020

An eternal supercycle?

Yields continue to fall • Rents grow slower • Apartments remain scarce

Amid the conflicting forces of the cancelled reversal in interest rate policy and dampening of the economy, we are bullish on the German real estate investment market and cautiously optimistic on the lettings markets. In the apartment market, regulation is casting a shadow over the favourable fundamentals. The supercycle will continue to clear the hurdles in its path in 2020 – and may run on for much longer.

Investment market – the cancelled reversal in interest rate policy will give fresh impetus to the supercycle

Text: Matthias Pink

The event that will most influence the real estate investment market next year in our opinion is actually a non-event. The long-awaited reversal in interest rate policy has not materialised. And not only that. The European Central Bank and other central banks have even eased their monetary policy again and an interest rate hike in the eurozone before 2022 is practically out of the question. Interest rate expectations have never been lower since the global financial crisis.

Hence, the low interest rates that have prevailed for almost a decade will continue for an indeterminate period. Consequently, bonds are transforming from fixed-interest securities into non-interest-bearing securities as can be seen from the coupons of 10-year Bunds currently in circulation (Graph 1). Meanwhile, the secondary market yields of many investment grade bonds worldwide are already negative. Against this background, investors focused on regular income are unlikely to be able to avoid reducing their exposure to bonds in favour of real estate and other higher yielding asset classes. **Consequently, we assume that more capital will be available worldwide for real estate investments going forward.**

Since risk aversion remains high, this capital will continue to flow primarily into Germany and other established markets. **While the German economy may be growing more slowly than in recent years, the promise of stability remains. As a result, the supercycle will also continue in 2020.** Only a deep recession could end it but there is no such recession on the horizon (see 'Commercial lettings markets' section). **We even consider it possible that the supercycle is far from over, at least in the financial markets.** A reversal in interest rate policy has receded into the far distance and it appears realistic that the world could be shaped for decades to come by interest rates far below the norm prior to the global financial crisis. A substantial increase in the importance of real estate in investors' portfolios would then not be behind us but would be yet to come. In view of the global bond market volume of around USD 100 trillion, even a modest reallocation from bonds to property would create vast additional liquidity in the real estate markets.

However, the prospect of long-term low interest rates and yields will not only increase investor demand for real estate, it will also lessen the incentive for property

Graph 1: The decline of coupons on 10-year Bunds

Coupon rate: 3.5%, 3.0%, 2.5%, 2.0%, 1.5%, 1.0%, 0.5%, 0.0%

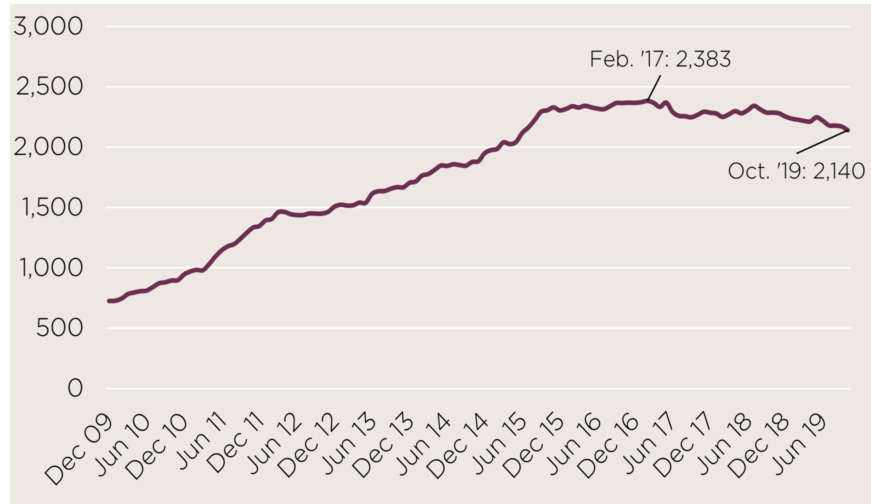
Year of maturity: 2020, 2025, 2030

Data Source: Finance Agency Germany

115 **In 2020 alone, Bunds will be worth about 115 billion euros. Part of this money is likely to flow into the German real estate market.**

owners to part with their assets. More and more properties are falling into the hands of long-term investors already. Consequently, the average holding period is increasing, which is inevitably resulting in a falling number of transactions. This trend has been in progress since the start of 2017 (Graph 2) and we expect it to continue. **Since rising demand will be opposed by lower willingness to sell, initial yields will remain under pressure. In markets with favourable fundamental data, we consider similar yield compression to that seen in recent years as realistic**. The risk premium compared with bonds remains at historically very high levels (Graph 3). This may be the case because investors have repeatedly expected a reversal in interest rate policy in recent years. Now this scenario is off the table, the premium could begin to melt, which could even open a window of entry into the German market for opportunistic investors.

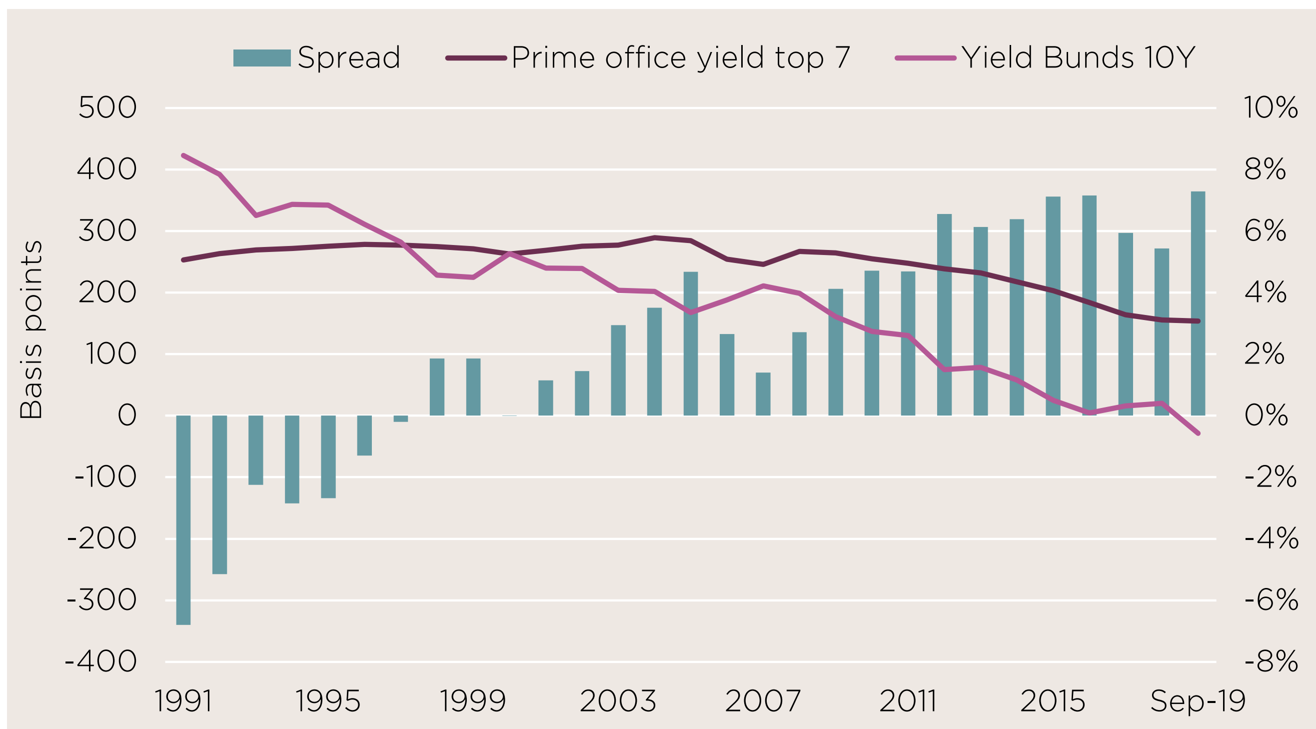
Graph 2: The number of transactions* in the commercial real estate investment market is steadily declining



Data source: Savills / * twelve-months rolling

Germany primarily remains a core nation, however, and risk-averse investors will continue to dominate transaction activity during the coming year. The trend for these investors is: lower (initial) yield for the same risk. In view of the strong risk aversion, which could intensify even further in view of the weakening rental growth (see 'Commercial lettings markets' section), top properties in prime and up-and-coming locations in the top markets will remain in the spotlight. Office properties will continue to be the preferred choice going forward. We also expect continued diversification into anything that promises stable cash flows.

Graph 3: Risk premium for real estate still at historic high



Data Source: Bulwiengesa, Deutsche Bundesbank

Commercial lettings markets – growth in demand for space to slow in a weaker economic environment

The German economy has enjoyed an incredible prolonged boom, which has also benefited the lettings markets in the form of sustained high demand for space. Economic growth has dramatically lost momentum in recent times, however, and there is no fresh impetus in sight. GDP growth is expected to come in at around 0.5% both this year and next year, while the average growth over the last three years was 2%. **The economic dip is primarily attributable to an industrial recession and is consequently likely to dampen demand for space firstly and most noticeably in Germany's industrial regions and particularly in production and industry-related logistics property markets dominated by owner-occupiers.**

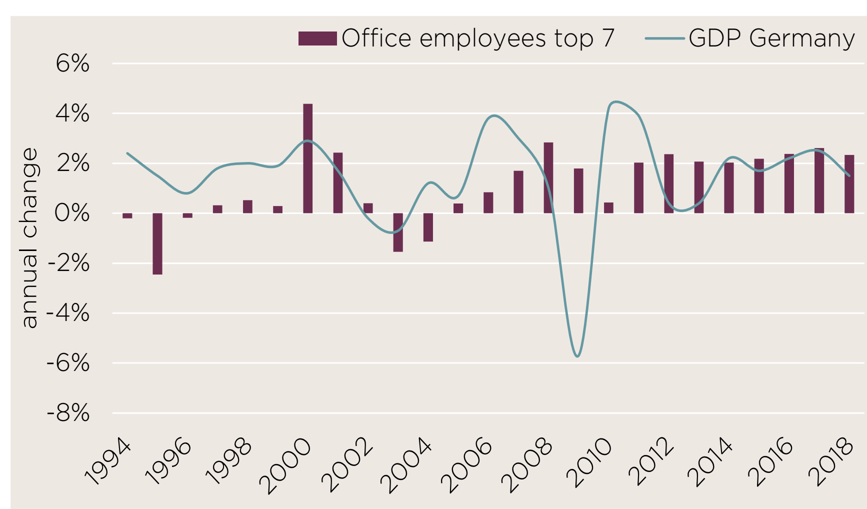
The top seven office lettings markets will also be unable to escape the weaker economic environment and cities where a high proportion of gross value added is generated by industry are likely to be more strongly affected. This is true of Stuttgart (30%) and Munich (20%), while all other cities generate between 9% and 13% from the industrial sector. **We expect lower growth in demand for space in all seven office markets compared with recent years. At the same time, we assume that the number of office employees and hence demand for office space will increase again next year**. We see three reasons for this:

1. The German economy will grow less strongly than in recent years going forward but is highly unlikely to contract.

2. In view of the shortage of qualified personnel, companies have a great incentive to retain their personnel even if they are not working at full capacity for a time.

3. Even in the depths of the recession after the financial crisis, the number of office employees in the top seven markets continued to grow (Graph 4).

Graph 4: Growing office employment in the Top 7 since 2005



Data Source: Bulwiengesa, Federal Statistical Office

Hence, demand for office space is growing more slowly but not contracting. Next year, this slower growth in demand will be met with faster growth in supply. Overall, we expect growth in the number of employees of approximately 1.5% in the top seven cities (2019: 2%), while the office stock is likely to grow by around 2% (2019: 1.1%). For the first time since 2010, therefore, the completion volume next year will cover demand. A similar scenario is expected in 2021 (Graph 5). The only exception is Cologne, where the expected new-build volume will also be below anticipated additional demand during the next two years. In Berlin, on the other hand, the extremely low vacancy rate of around 1% is likely to increase moderately since the office stock is expected to grow twice as strongly as the number of office employees.

Hence, the individual markets are at different stages of the cycle but are all heading towards lower rental growth. The specific degree is dependent on both local conditions and parameters that are difficult to quantify. We assume that a backlog in demand has built up in recent years in the form of over-occupied office space, which will dissipate with an increasing supply. Other buffer effects are expected from longer-term developments, which will counteract cyclical effects. These include the sustained expansion of flexible workspaces.

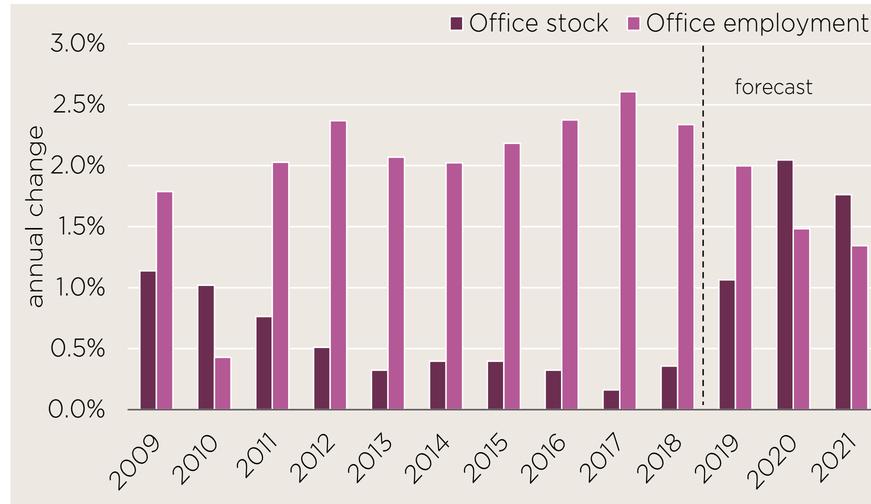
Still no sign of lower rental growth in the logistics market. The supply shortage will particularly increase in the major conurbations, where demand is rising in view of the continued rapid growth in online retail. While we assume that demand from

1.9 **Next year are expected in the top 7 markets 1.9 million m² of office space completed. That was the last time in 2003.**

production logistics will decline for economic reasons, this is likely to be more than offset by demand from online retail. In any case, the growing importance of e-commerce means that demand for logistics space is less and less dependent on growth in the overall economy and foreign trade and far more influenced by growth in retail sales and e-commerce in particular. The latter in particular is continuing to show strongly above-average growth (Graph 6).

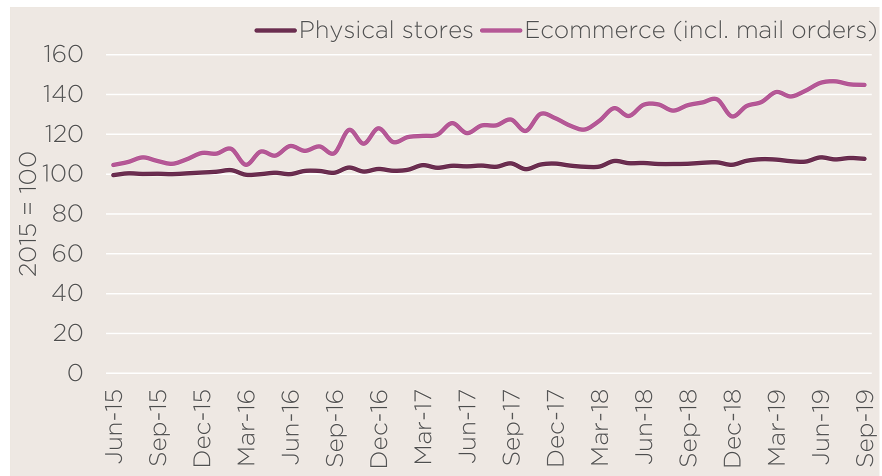
Sales achieved by brick-and-mortar retail have proven robust to date (Graph 6) and this is likely to remain the case despite a weaker economic environment. Firstly, current projections suggest a sustained high level of employment and, secondly, fiscal measures such as a higher income threshold for parental maintenance from January 2020 and the partial removal of the solidarity contribution from 2021 will stimulate consumption. **Hence, the market for retail space is also likely to be relatively unaffected by the weaker economic growth**. The structural growth of online retail will continue to dominate, which will result in an overall decline in demand for space and a focus on demand in the best locations. With the exception of a few prime locations and local supplies, therefore, rents will remain under pressure.

Graph 5: Growth in supply to cover demand in the Top 7 from 2020?



Data Source: Oxford Economics and Savills

Graph 6: Retail sales are increasing – brick-and-mortar steadily, online rapidly



Data Source: Federal Statistical Office

Apartment market – regulatory measures will further intensify the supply shortage

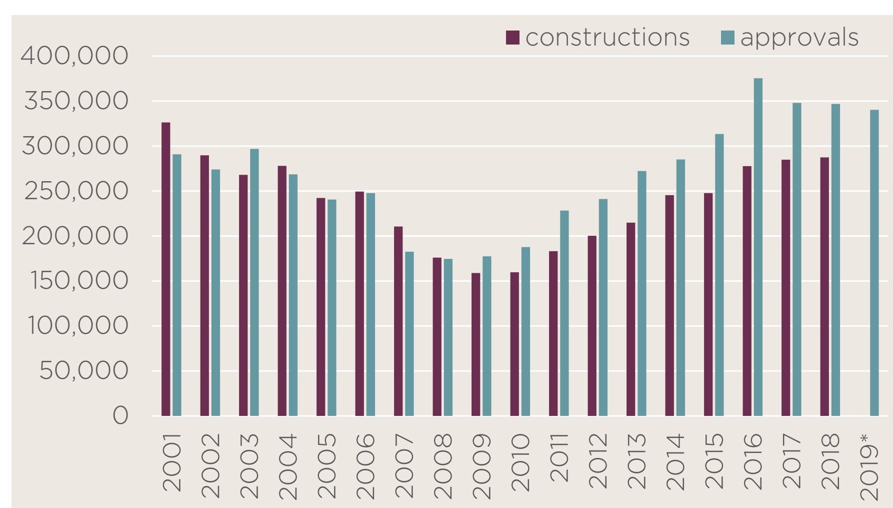
If the supercycle is the hot topic in the commercial real estate market, the term is all the more relevant to the apartment market. Apartment rents will increase for the fifteenth time in succession this year and there is no reversal of this trend in sight. While the number of apartments approved will be in the range of 300,000 to 400,000 for the fifth year in succession, a level that will cover demand according to most estimations, the completion figures have yet to reach this level (Graph 7). It could be the case this year that, as the negative momentum in approvals since 2017 suggest, the peak has already been reached. In any case, with the construction sector working at full capacity, a further increase appears unlikely. **Apartment rents are likely to increase further, therefore, albeit less strongly than in recent years.**

The objective specified by politicians of building more affordable housing will also be missed. To achieve this would require apartment completions to exceed demand for a number of years. The reality is particularly far removed from this in the fastest growing cities and their commuter belts. Against this background, the intensity of regulation in the German apartment market, which has already increased sharply in recent years, can be expected to increase going forward. However, there is little to suggest that the measures taken to date are having the desired effect. These are essentially addressing the symptoms of the housing shortage but not its causes (including a lack of building land and rising construction costs). Some measures, such as the family housing grant, are even stimulating demand rather than supply and are only increasing housing costs. **On the whole, current housing policy is having the effect of prolonging the cycle.**

This means two things for investors. Firstly, the fundamental data favours (further) investments in the German apartment market. Secondly, the increasing volume of regulatory measures is causing increases in cost and complexity. Consequently, at a time when the portfolios of institutional investors around the world are increasing their exposure to apartment buildings, Germany is likely to vanish from many investor profiles. This is likely to be particularly true of investors who still have no expertise of the German apartment market However, this does not inevitably mean that less capital will be available for investments going forward. **Many investors active in the market are likely to adjust to the regulatory conditions and expand their holdings in view of the stable income achievable despite or even because of the growing intensity of regulation.**

The situation in Berlin looks somewhat different. The long-term investment capital will, in all likelihood, lose this status in view of the impending introduction of a rental cap. However, this rigid intervention of Berlin's politicians in the apartment market could result in a new group of apartment investors entering the scene: major companies already based in Berlin or those seeking to locate themselves in Berlin. The supply shortage in the rental apartment market will only intensify further with a rental cap, particularly for newcomers. For companies seeking to expand, of which there are many in Berlin, this would be an additional and, in some cases, even an existential hurdle in the competition for qualified personnel. If they do not want to relocate, such companies could overcome this hurdle by acting as (company) homebuilders themselves. This is undoubtedly only a consideration for very large companies and even these would require several years to implement such plans. Until then, they could increasingly rent serviced apartments, which could even be the ideal long-term solution for smaller companies. **In this respect, the more intense regulation of the apartment market could contribute to a rapid expansion in the serviced apartment market including, in some cases, in locations where apartments should originally have been built in the first instance.**

Graph 7: Peak in approvals already passed



Data Source: Federal Statistical Office / * Extrapolation based upon Jan to Sep

You can also read from us:

Temporary living - short-term, small and expensive?

The Evolution of Retail Destinations

Impacts - the future of global real estate

European Office Outlook 2020

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

Savills is a leading global real estate service provider listed on the London Stock Exchange. The company, established in 1855, has a rich heritage with unrivalled growth. It is a company that leads rather than follows and now has over 600 offices and associates throughout the Americas, Europe, Asia Pacific, Africa and the Middle East with more than 39,000 employees worldwide.. Savills is present in Germany with around 200 employees with seven offices in the most important estate sites Berlin, Dusseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart. This bulletin is for general informative purposes only. Whilst every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The bulletin is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.
© Savills December 2019