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Market report
Commercial property market Germany

April 2017

Summary

Never ending boom? Favourable conditions are attracting investors

■ Interest for German property from domestic and international investors alike may well continue for some time. With bonds still relatively unprofitable, there remains a vast amount of global capital seeking investment in real estate. Moreover, Germany's role as a safe haven is being further strengthened by unpredictable developments elsewhere in the world.

■ The logical consequence is that competition among investors for German property will further intensify, maintaining significant pressure on yields. However, in view of the reversal in interest rate policy, at least in the USA, the era of yield compression is coming to an end.

■ Investors seeking stable rental income continue to focus on office and logistics properties as well as hotels and other 'alternatives'. In the office sector, there is a noticeable trend of "suburbanisation", whereas B-cities are struggling to gain any traction.

■ While investors are expanding their search profiles for offices and certain other sectors, they are becoming more cautious when it comes to retail property.

„Yield compression is slowly coming to an end. The fundamentals in the lettings markets are now, therefore, all the more important for investors."
Marcus Lemli, CEO Germany / Head of Investment Europe

German property is becoming even more attractive

The perpetual loosening of global monetary policy may have come to an end but the era of extremely low interest rates is far from over. This particularly applies to the eurozone where, unlike in the USA, the central bank has yet to start raising interest rates. The yield on 10-year German government bonds, for instance, recently stood at 0.4% (end of March 2017), which was only moderately higher than a year earlier. Hence, returns in the bond market remain equally unfavourable. Particularly for those investors with ongoing distribution obligations (e.g. insurance companies and pension funds), it is therefore almost impossible to overlook investment in property and, consequently, many of these investors remain anxious to increase their portfolio allocations to real estate. Global demand for property will, therefore, remain equally strong over the coming months.

The risk-averse profile of most of these investors dictates that they are focused on mature property markets. Last year, just three countries, the USA, Great Britain and Germany, accounted for almost two thirds of the global transaction volume. The fact that Germany was almost on a par with its European partner and even attracted more capital in the second half of the year is a likely pointer for the current year. The Brexit negotiations and their open outcome represent a scarcely calculable risk for investors. The same applies in the USA, where President Trump's election victory is fuelling concerns that populists will also gain further ground in Europe. Evidently, this is particularly true of France and presidential candidate Le Pen. Since the election of Donald Trump as US President, the differential between French and German 10-year bonds has approximately doubled.

The logical consequence of sustained high demand for real estate and an even more prominent role for Germany is that competition for German property will become even more intensive than it has been to date. Although the number of active purchasers in Germany declined moderately last year, this remained several times higher than between 2009 and 2013 (see Graph 1).

Furthermore, there is an indeterminable number of investors that would like to acquire property in Germany but have not succeeded in doing so to date. Moreover, their prospects of success show no sign of increasing in the short term, with holders unlikely to become significantly more willing to sell in the current environment and the number of developments showing very little growth.

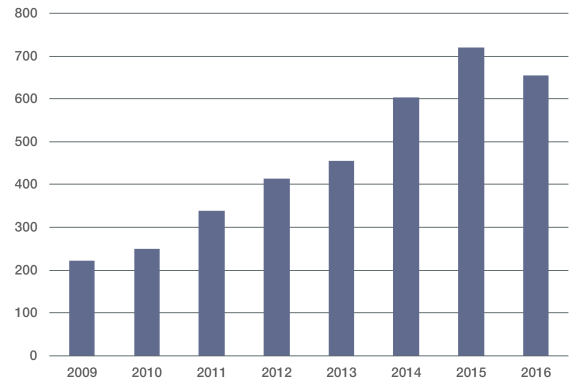
The era of yield compression is coming to an end

Even if purchase opportunities present themselves, they are very expensive. In view of the sustained excess demand, pressure on yields will inevitably remain high. This is particularly true of the prime segment in the top cities. Demand in these locations has risen at an above-average rate since general risk aversion remains high and the numerous investors that have made their first acquisitions in the (German) real estate market in recent years have initially been restricting their activities to the most transparent and liquid markets. Nevertheless, this period of unprecedented yield compression is likely to be over (see Graph 2). Interest rates may not have changed significantly compared with a year earlier but trends and expectations have reversed. This also means that property yields are likely to bottom out. Whether the absolute bottom will be reached this year or in 2018 is immaterial for long-term investors. The more decisive fact is that, at the end of a typical investment horizon of five to ten years, initial yields are extremely unlikely to be below today's levels. Consequently, total returns from property investments will be practically completely determined by rent and rental growth over the coming years.

While the reversal in interest rate policy has commenced, there is much to suggest that interest rates will remain at very low levels for a long time to come. In a world characterised by high levels of debt, low economic growth and correspondingly low inflation, central banks have very limited room for manoeuvre with regard to raising interest rates. Thus, bond yields may also remain at low levels for the long term. Indeed, when looking at the long-term trend, any alternative scenario requires a certain amount of imagination (see Graph 3). What this

GRAPH 1

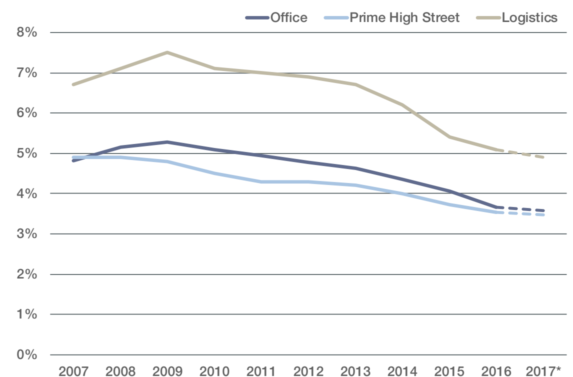
Number of purchasers Increasing number of investors



Source: Savills

GRAPH 2

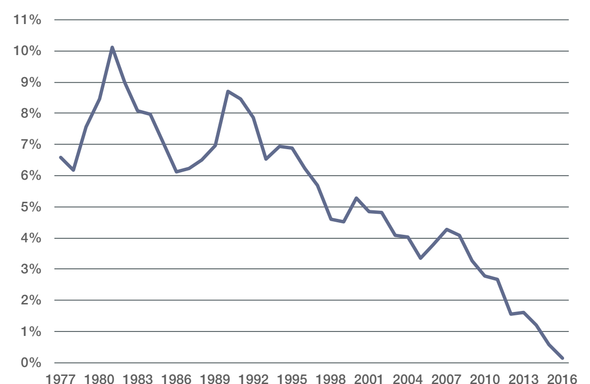
Prime yields top 7 Unprecedented yield compressions



Source: Savills / * forecast

GRAPH 3

Bond yields* Long term trend is only descending



Source: Bundesbank / * bonds of public authorities (residual term of 9-10 years)

means for initial yields in the real estate market is that, while the bottom may (soon) have been reached, a return to levels that were the norm prior to the financial crisis is out of the question. It appears entirely plausible, therefore, that prime yields with a five before the decimal point have been consigned to history.

Office suburbanisation with risks

The low initial yields and consequent search for rental growth potential is driving more and more investors into the office sector. Since 2013, office property has consistently accounted for more than 40% of the total commercial transaction volume. In approximately the same period, the top six office markets have witnessed relatively strong rental growth that continues to this day and has even accelerated in recent times. With vacancy rates low and, in view of the continued rather low levels of development activity, likely to fall further, rents are also expected to rise over the coming years. However, since the lack of office availability in central locations is leading (or forcing) companies to move to peripheral submarkets and even surrounding areas, rents are rising here too and often at a faster rate than in the prime locations. This is also attracting investors to the peripheral areas. This “suburbanisation” is progressing particularly rapidly in the Frankfurt and Munich regions (Graph 4). In both cases, the proportion of office transactions in surrounding areas of the cities has risen significantly. In the Frankfurt region, almost every other transaction last year was completed outside the city boundaries. In Munich, it was almost a quarter of transactions. With rents rising sharply, low vacancy rates and significantly higher initial yields than in the city centres, it is easy for investors to acquire such suburban properties for their portfolios. However, they should be mindful of the fact that B and C locations are so called because they are not the first choice for many occupiers. If, in the event of an economic downturn (which is not currently foreseeable), there is less demand for the same office stock and rental levels consequently fall, occupiers will return to more central locations. Hence, the general risk of vacancy remains higher in the peripheral locations than in the city centres even if the current trend invites an alternative interpretation.

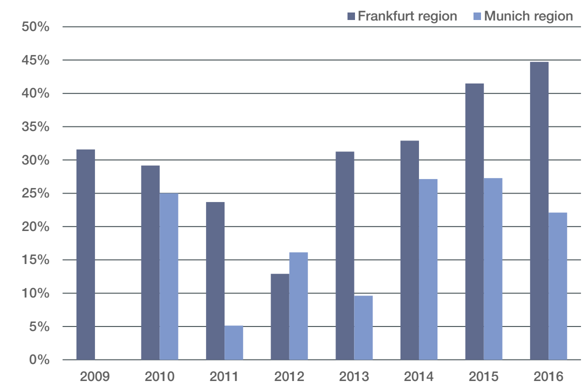
Unlike the surrounding boroughs of the A-cities, second and third-tier cities have not enjoyed disproportionately high involvement in the growth in office investment. In terms of the number of office properties changing hands in individual transactions, B-cities accounted for 16% of all deals between 2013 and 2016, which was even moderately lower than in the previous four years. The same applies to C and D-cities, whereas the remaining cities and municipalities (which also include the surrounding boroughs of A-cities mentioned above) were able to increase their proportion from 10% to 13% (see Graph 5). This may also be attributable to the fact that suburban boroughs of the A-cities are benefiting from strong rental growth while rents in the B to D-cities are growing consistently but at a relatively slow rate. This data tells a more impressive story for Unterschleißheim than it does for Hanover. However, Graph 6 also illustrates the other side of the coin. During downturns, rents in A-cities decline equally as quickly as they rise during upturns. This volatility is likely to be even more pronounced in the peripheral locations since they are primarily considered when there is no longer any space available in central submarkets or rents are too high. In other words, the potential for above-average rental growth for investors is contrasted with the risk of above-average rental declines. Investors who value long-term income stability ahead of capital growth prospects would be best advised to acquire office property in B and C-cities rather than making investments in areas surrounding A-cities. The latter, on the other hand, are suitable as portfolio diversification for such investors or as acquisitions for opportunity-driven investors with a shorter investment horizon since, in the short to medium term, properties in peripheral locations surely still offer significant potential for appreciation.

Boom in alternatives

Investors’ search for adequate initial yields is also benefiting the so-called “alternatives” (everything outside of offices, retail and mixed-use). For the first time in the current cycle, alternatives increased their share of the overall commercial transaction volume last year to more than 22%.

GRAPH 4

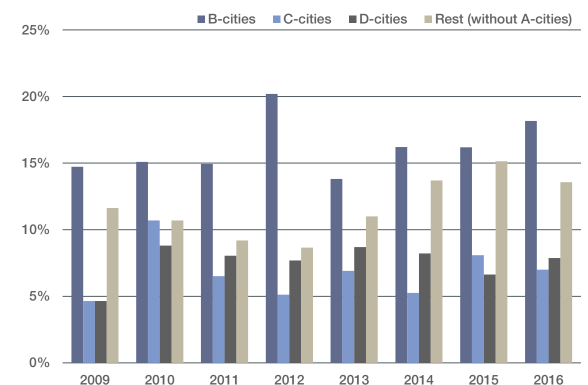
Office transactions in the hinterland* Strong "suburbanisation" in Munich



Source: Savills / * transactions outside the city within 20 km

GRAPH 5

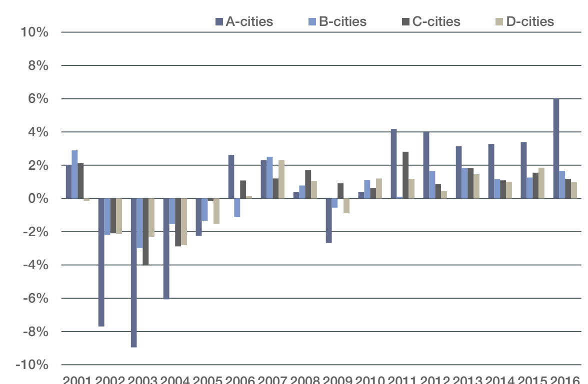
Office transactions by city category* Little increase in B-cities



Source: Savills / * Bulwiengesa classifikation

GRAPH 6

Office rents by city category* Highest volatility in A-cities



Source: Bulwiengesa / * change of secondary CBD rents year-on-year

„The permanent decline in yields may come to an end, but a significant increase is very unlikely. It is infact conceivable that prime yields with a five before the decimal point are history." Matthias Pink, Head of Research Germany

Three sectors also achieved new all-time highs in terms of transaction volume: hotels with almost €4.3bn, care properties with almost €2.7bn and industrial and logistics properties with around €4bn.

In all three cases, however, the momentum is explained not only by a cyclical outward movement from investors but also by long-term trends and favourable fundamental data. The hotel market is benefiting from the fact that, despite the terrorist attacks in Europe, the number of overnight stays in Germany has risen consistently in recent years. Germany registered more than 447 million overnight stays in 2016, which was 2.5% more than in the previous year and 27% higher than ten years earlier. According to projections, global travel will rise significantly over the coming years, with Germany benefiting disproportionately.

In the logistics sector, the rapid growth in online retail remains the central driver of demand for space. This requires not only large central warehouses but, with individual delivery time windows currently becoming the norm and delivery times becoming ever shorter, also an increasing number of smaller warehouses as close as possible to end customers. The latter is being accelerated by online food retail, which is still in its infancy, since the perishability of the goods dictates that delivery routes must be particularly short. Against this background, logistics property is likely to remain the fastest growing sector over the coming years even if it remains to be seen how the protectionist trade policy of many nations will impact German industry, which is the second highest source of demand for logistics space after retail.

In the care property sector, the ever increasing number of old people will drive demand for such properties for the foreseeable future. According to projections from the Federal Statistical Office, the number of people aged 70 and above in Germany will increase by 19%, or approximately 2.5 million people, by 2030 alone. It is self-evident that this will entail rising demand for care and hospital facilities. We therefore expect even more investors to consider properties in this sector going forward.

Despite the overall extremely positive conditions for many of the alternative sectors, we do not expect the total transaction volume for these sectors to increase notably further. The run on these categories has caused significant yield compression to date. Indeed, this has been even more significant than in the "traditional" sectors of offices and retail. Prime yields on logistics property, for instance, have fallen by 240 basis points from their previous high in 2009. Meanwhile, the various segments of retail property have witnessed declines ranging from 140 basis points (high-street properties) to 190 basis points (retail parks). In the same period, prime yields on office property have fallen by around 160 basis points. Hence, the 'alternatives' have seen stronger capital growth than the traditional sectors. This reduces the former's attractiveness to investors and, conversely, makes office and retail property appear more attractive from a yield perspective.

Saturation of in-store retail

In contrast with the alternative sectors, the transaction volume for retail property fell by 35% last year compared with 2015. Accordingly, the retail transaction volume fell as a proportion of the overall market from 36% to 25%. When interpreting this trend, it is important to consider that more than €5.5bn was invested in retail portfolios priced from €500m in 2015. Last year, on the other hand, there were no transactions of this magnitude whatsoever. However, even when individual transactions are considered in isolation, the transaction volume fell by more than 20%.

The reticence of investors is also a reflection of the structural change in retail and the associated uncertainty. The significant increase in delivery vehicles and bicycle couriers in cities and the disappearance of traditional retailers, such as Praktiker and Schlecker, are only the most visible manifestations of this change. Many owners of retail property are likely to see the change reflected in their cash flow. While the desire of many store retailers to expand has maintained rental levels to date and even driven rental growth in the better locations, natural selection is starting to gain the upper hand. It is now apparent, even in 1a locations in major cities, that rents have reached their peak. While the prime locations continue to benefit from the fact that even many online retailers are ambitious to gain a foothold in such locations with their own stores, which will sustain the excess demand, all other locations are fundamentally faced with declining demand. In brief, retail property investors are operating in a shrinking market.

Against a background of rising vacancy risk combined with at best stagnating rents, retail property is increasingly losing the advantage that had previously set it apart from office property: long-term cash flow stability. The 10 or 15-year leases that remain the norm in retail offer little security if the tenant's business model is in jeopardy. In this regard, the increase in the transaction volume for office property and the declining investment in retail property go entirely hand in hand.

A number of shopping centres currently illustrate how ephemeral retail properties can be today. The MyZeil shopping centre in Frankfurt's pedestrianised zone, for example, opened in 2009. Owners ECE are planning to convert sections of the property for an amount in the mid-double digit millions of euros. There is a similar scenario at the Lilien-Carré in Wiesbaden. The shopping centre

which opened in 2007 directly adjacent to Wiesbaden's main train station is scheduled to be converted and re-positioned by autumn 2018 for €34m. Such examples may be the first of many.

In view of the trends described, unlike in the office sector, we expect core investors not to continually expand their search profiles but rather to increasingly narrow their criteria and focus on prime locations as well as properties in affluent catchment areas and with lower intensity of competition. This assessment of competition includes both store retailers and online operators. Shopping centres or retail parks with a high proportion of (low-priced) fashion and/or electrical retail warehouses, for example, could quite plausibly find themselves in an intensive competitive environment even if they are the only centre in the catchment area.

The structural change presents as many opportunities as it does risks for investors. However, in a time of high risk aversion, this will inevitably result in risks being weighted disproportionately highly and a tendency to refrain from investment. Hence, it can be assumed that the transaction volume for retail property will trend below average relative to the overall market going forward.

Macro-level conditions remain favourable

When taking a holistic view across all real estate sectors, there is much to suggest that the run on office property will continue. Many of the niche segments are becoming mainstream, at least temporarily, and are enjoying continued high demand. This is particularly true of logistics property since the investable stock is growing rapidly. To a certain extent, this growth will also manifest itself in retail property. On the one hand, there is an amalgamation taking place between online and offline retail and, thus, between retail and logistics space. On the other hand, lower in-store retail requirements are resulting in vacant space which, in view of its location, is ideal for goods distribution to consumers and could therefore be used as logistics space. Faced with such upheaval, investors will assess retail property very critically and risk-averse players will primarily focus on high-street properties and successful shopping centres and retail parks.

The macro-economic conditions for real estate investment in Germany are likely to remain generally excellent. Combined with the stable political environment, which is expected to remain in tact after the federal election, this will mean continued high demand for property from domestic and international investors alike and that the transaction volume will be limited only by the available supply.

Future cities

A look at the three Ts

In the age of digitisation, in which more and more routine activities are being automated, access to knowledge workers is becoming a key resource for companies. Such knowledge workers are so sought-after and, at the same time, so mobile that they can choose where they want to live. Even national boundaries are of little importance to them. And those who can decide where they want to live will gravitate to where it is most beautiful. According to Richard Florida's theory of the creative class, the 'beauty' of a region in this context can be measured primarily by reference to three factors:

1. Technology, which is understood as a region's innovative capacity and the concentration of high-tech and knowledge sectors.

2. Talent, which Florida defines as the knowledge workers already living in the region.

3. Tolerance, which means the openness of a society towards the new and unfamiliar, which in turn promotes creative exchange and generates new ideas.

Regions that satisfy these criteria to a high degree attract particularly large numbers of knowledge workers and, consequently, companies and will therefore prosper compared with those regions that perform poorly according to these factors. All such growth regions include either one (e.g. Berlin) or several (e.g. Silicon Valley) core cities and their surrounding areas.

If the thesis is correct that knowledge workers are conglomerating in the world's most attractive regions and that these will become the world's growth engines of future, then there is every reason for real estate investors to align their investment strategies with this trend. One consequence, for example, would be to allocate capital not by countries but by regions. Another would be a change in the location factors used to select cities and regions. Thus, when evaluating the future growth potential of a city in Germany, more weight may be given to whether the city has an elite university than whether it is home to the corporate headquarters of a Dax-listed company. The Savills publications 'Tech Cities', 'European Cities' and 'Cities of the future' consider which other factors play an important role for knowledge workers when deciding where to locate themselves as well as which cities perform particularly well in this regard and, consequently, promise above-average growth potential.

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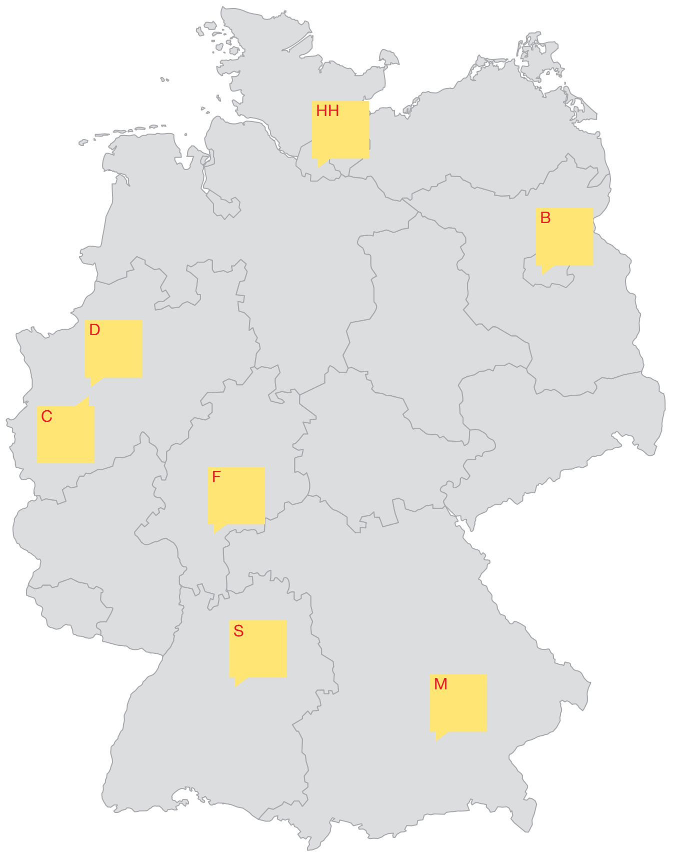

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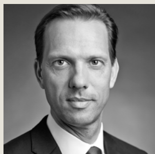

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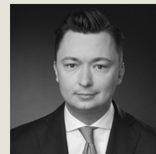

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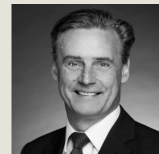

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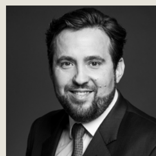

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