Savills World Research
Germany

Market Report
Germany Offices

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Once upon a time...

The German economy has scarcely grown for years and is heading towards a recession. At the same time, the population has reached record levels and will now decline at an increasing rate every year. In the major office markets, the oversupply is growing rapidly and the vacancy rate is making large strides towards the 10% mark. The unanimous conclusion from this confluence of factors is that Germany is completely built.

Germany is anything but completely built

However, what sounds absurd today was reality around fifteen years ago. Germany was the "sick man of Europe" and all indicators were pointing towards contraction. Of course, we now know that things turned out differently. Ultimately, the German economy has been growing for years, interrupted only by the global financial crisis, and at times with impressive rates of growth. Meanwhile, the population is larger today than at the start of the millennium. However, because we have since become accustomed to growth, this mental time travel is useful for explaining the situation we currently face in the major office markets. For, although demand for office space has grown strongly every year, culminating in record take-up in 2017 (see Graph 1), and is likely to grow further, development activity remains rather modest. These pieces of the puzzle only fit together if the discrepancy between expectations at the beginning of the millennium and actual events is understood as the missing piece. This discrepancy can be illustrated, for example, by comparing population projections from that time with actual population growth or current projections (see Graph 2).

Office space is a rare commodity

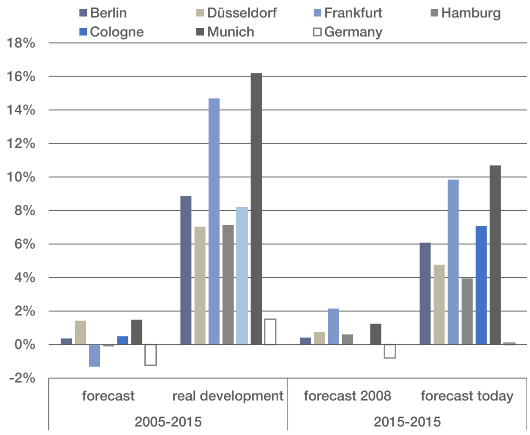
While construction volumes have been low, demand has remained high. Consequently, office vacancies in the top six markets have approximately halved since 2010 to just above 3.7 million sq m. To put this figure into context, in case this initially sounds like adequate market reserves, recent annual take-up has consistently significantly exceeded 3 million sq m. At little more than 5%, the vacancy rate has also reached its lowest level for more than 15 years and is below this figure (in some cases significantly) in four of the six cities. Conversely, in view of the acute supply shortage, rents have reached multi-year highs (see Graph 3).

A period of extraordinary rental growth

On a five-year rolling basis, the typical length of a lease, rents have increased by around a fifth in three successive years. This is unprecedented since German reunification, even during the boom years of the new economy. In fact, you would have to delve far into the past to find such a sustained period of rental growth (see Graph 4). These observations underline the fact that many office occupiers are faced with a completely extraordinary and, in many cases, completely unfamiliar

GRAPH 2

Population forecast in comparison to reality



Source: BBSR, Bulwiengesa, Savills

GRAPH 3

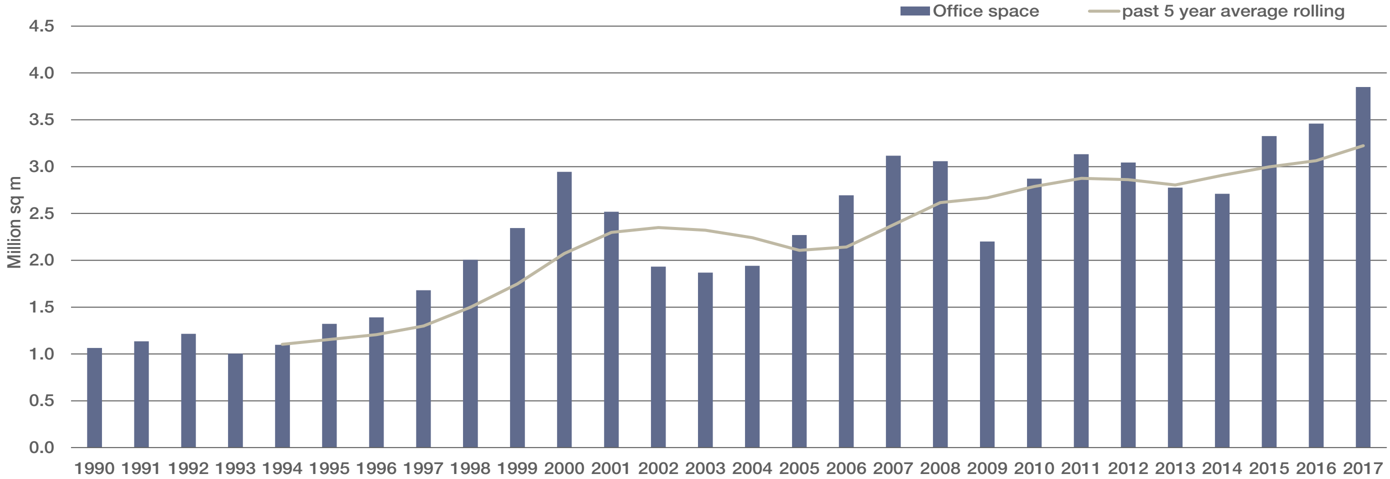
Top 6 office market figures 2017 vs. 10 years average

	2017	10 years average
prime rent	€30.28 per sq m	€27.42 per sq m
average rent	€16.59 per sq m	€14.62 per sq m
take-up	3.85m sq m	3.04m sq m
vacancy rate	5.1%	8.0%
completions	834,000 sq m	947,000 sq m

Source: Savills

GRAPH 1

Office space take-up in the top 6 markets



Source: Bulwiengesa, Savills

situation. In addition, focusing on the average figures evidently overlooks the extreme scenarios. In Berlin-Kreuzberg, for example, average office rents have risen by almost two thirds over the last five years. Conversely, there are very few office submarkets in which rents have not risen during this period, Düsseldorf's Seestern being one example. Hence, almost all office tenants are faced with rising property costs, including and especially those that previously agreed long-term leases.

Rising property costs are forcing some companies to relocate

For larger companies, the significant increases in office rents may be painful. However, in view of the strong economic growth in recent years, such companies have typically generated sufficient profits to absorb the higher property costs. For many small and medium-sized businesses, however, the higher costs pose a much greater challenge, even if these occupiers are also generating higher revenues. The two examples in Box 1 illustrate the situation for two office tenants that agreed leases five years ago in an office location typical for such companies and, faced with increased space requirements, are now seeking equivalent larger offices. While the management consultancy used in the example can more than absorb the higher property costs thanks to revenue growth, this is not the case for the less profitable PR agency. While their revenues have increased by 20% over the five years, the

Case studies: Impacts of rising property costs on corporate profits

Case study 1: International consulting company - Berlin Potsdamer Platz

Figures	Feb 2013	Feb 2018
employees	40	50
area	1.000 sq m	1,250 sq m
rent (incl. additional costs)	€21.50 per sq m/month	€29.50 per sq m/month
rent p. a.	€258,000	€442,500
turnover	€8.0m	€10.0m
profit before rent	€1.2m	€1.5m
profit after rent	€942,000	€1,057,500
share of rent in turnover	3.2%	4.4%

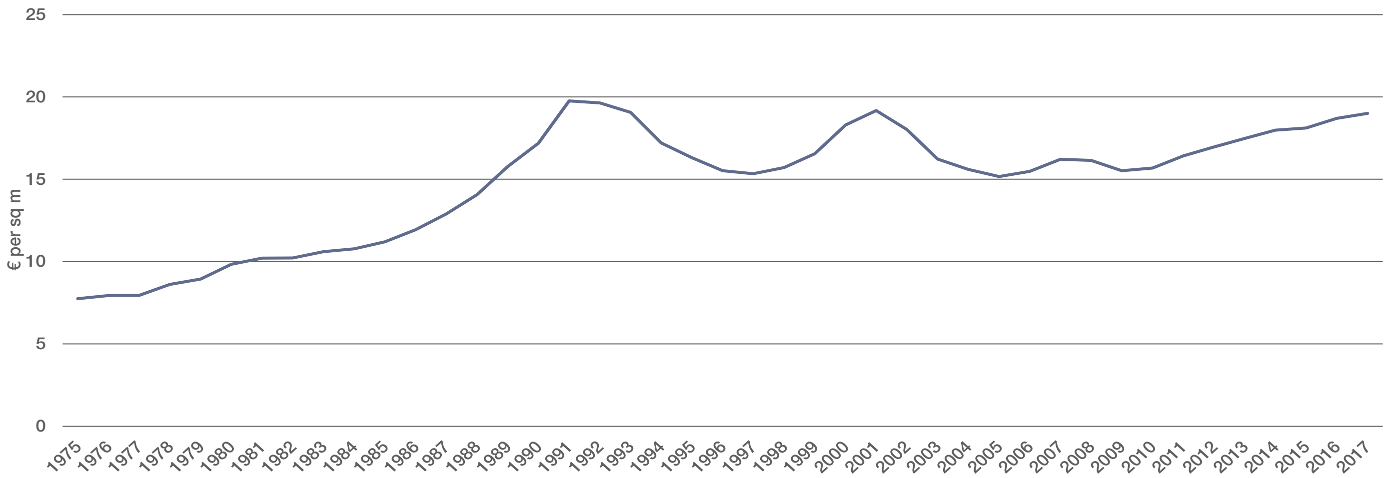
Case study 2: Owner-operated PR agency - Berlin Kreuzberg

Figures	Feb 2013	Feb 2018
employees	10	12
area	250 sq m	300 sq m
rent (incl. additional costs)	€3.00 per sq m/month	€19.00 per sq m/month
rent p. a.	€39,000	€68,400
turnover	€1.0m	€1.2m
profit before rent	€100,000	€120,000
profit after rent	€61,000	€51,600
share of rent in turnover	3.9%	5.7%

Explanation: Both cases, these are fictional examples with hypothetical numbers. However, they are intended to give a realistic picture of the actual situation.

GRAPH 4

Development of average city rents in the Top 5*



Source: Bulwiengesa / * Düsseldorf, Frankfurt, Hamburg, Cologne, Munich (Berlin has no corresponding data due to the German division) materially higher property costs mean that residual profits are lower than previously assuming that all other costs remain unchanged. This is also explained by the fact that many small and medium-sized companies, including the PR agency, have their offices not in prime locations but in B and C locations. Rents in such areas have risen particularly strongly in recent years. Companies that have been unable to grow their revenues in recent years would be even worse affected. Such companies will not even have greater space requirements and yet their property costs are likely to increase materially in many cases when extending their leases. In certain circumstances, this is forcing such companies to relocate involuntarily.

No relief in sight until at least 2020

Office occupiers hoping for rapid relief of the strained market situation are destined for disappointment. The uptrend in rental levels is highly likely to continue for a few more years for two principal reasons. Firstly, investor demand for office property has exceeded supply for several years and initial yields are already significantly below their previous record lows. Investors purchasing an office property today, therefore, are generally already pricing in rental growth, meaning that their initially low income return will increase over time. Consequently, they should take even more advantage than usual of every expiring lease to increase rents to market level. Secondly, the indicators for Germany point towards continued growth. Hence, demand for office space is likely to rise further while development activity slowly gains momentum. Only in 2020 is the office completion volume expected to be sufficient to cover demand. Until then, the supply shortage will worsen and rents will continue to rise.

Massive growth in co-working spaces

An increasing contributing factor to this shortage is a sector that previously played a very minor role. Co-working spaces were, until a few years ago, a niche and somewhat amateur offering that provided a place to work for freelancers and the self-employed. Temporary office space in the traditional sense was only offered by business centres, with Regus enjoying by far the largest market share. Today, the boundaries between business centres or serviced offices and co-working spaces have become so blurred as to be indiscernible. What is clearly apparent, however, is that the professional offering of these two types of office space has grown massively. In 2017 alone, national providers leased more than 200,000 sq m of office space in the top six markets, representing almost 6% of overall take-up. The majority of these lettings were in prime locations and the better B locations, i.e. the areas where office space is particularly scarce.

Further expansion likely

The professionalisation of the sector has coincided with a fundamental change in the occupier structure of co-working spaces. The days when solopreneurs, freelancers and start-ups were the only occupiers to appreciate what these new spaces have to offer are long gone. Customers now include international companies, which place individual teams or departments in co-working spaces. In some cases, they also operate entire satellite offices from such addresses. As a result, providers of co-working spaces are not only absorbing a remarkable amount of space in the office market, they are also now absorbing much of the demand that would otherwise manifest itself in requirements for traditional office space. In brief, they have become a defining influence in the office market. That WeWork, now the largest office provider in London with a reported company value of around $20bn, is the mostly highly valued start-up worldwide and that investment firms Onex and Brookfield indicated an interest in acquiring Regus operator IWG at the end of 2017 point towards further expansion of the segment.

Efficiency of space is integral to the business model

Even if the percentage of solopreneurs and freelancers is likely to decrease significantly across all co-working spaces, they continue to represent a significant proportion of the clientele. In absolute terms they are probably even increasing in number. In all likelihood, many such occupiers previously worked in coffee shops or at a desk in their own home and so did not generate any demand for office space. That changed the moment they began working in co-working spaces rather than in coffee shops or at home. By attracting such people as members, therefore, co-working spaces are generating demand for office space that did not previously exist, thus contributing to the shortage of office space at least in the short term. In the long term, however, the expansion of co-working spaces is likely to dampen demand for office space. On the one hand, operators of co-working spaces can use their space more efficiently than many companies. They do not, for instance, have to reserve a separate conference area for each occupier, which is deserted most of the time. Instead, all occupiers share the conference rooms provided as well as kitchens, break rooms and similar resources. Even the workstations in hot-desking areas can probably be filled more effectively by such operators than many companies could in their own offices, even if they use desk-sharing. In the long term, therefore, a desk at WeWork or a similar space is highly likely to replace 1 plus X desks in a traditional office, particularly since such operators' profit margins will increase the more efficiently they can use their offices in terms of both space and time.

Growth in demand for office space will slow going forward

Owners and investors should bear this trend in mind since, if office space is used more efficiently then, all other conditions remaining equal, some office space will become obsolete. Furthermore, two additional factors will ensure that demand for office space does not increase at the same pace over the coming years that we have seen in recent times. Firstly, the major cities are virtually out of space, both with regard to offices and particularly housing. There are practically no vacant apartments in Berlin, Hamburg or similar cities. Consequently, such cities can only absorb new inhabitants to the extent that new homes are built. And, for various reasons (shortage of sites and personnel, overloading of planning authorities, etc.), the German housebuilding sector is evidently unable to deliver new homes at the rate required for "unbridled" urban growth. If the slower rate of population growth is not offset by an increase in commuter volumes then growth in the number of office employees will be impacted. Secondly, the same applies in respect of the ageing of the German population. This could even result in a decline in employees in its own right since, in the future, there will be more older people retiring from working life than there will be young people entering the workforce. In the major cities, this could be offset by an influx of young people. However, this will only be possible if there is sufficient housing to accommodate these newcomers.

The big unknown: per capita floor space usage

In conclusion, almost all of the evidence suggests that, for the next two to three years, office space will become even more scarce and correspondingly more expensive. Office occupiers would be well advised to prepare accordingly and develop strategies to deal with an even more acute supply shortage. Going forward, from 2020/21 the outlook is more unclear simply because we do not currently know how strong the growth in supply will be at that point. In addition, the influencing factors described above (greater efficiency of space via co-working, slower urban growth and the ageing population) are highly likely to result in slower growth in demand for office space, albeit this is almost impossible to quantify specifically owing to the complexity of the circumstances. While the demographic factors can still be projected relatively reliably (see the research "The Impact of the Demographic Transition on the Office Real Estate Market in Germany" from the German Economic Institute; in German language) and suggest slower yet continued growth in demand for office space in the top five cities, predicting future changes in office space usage per employee is far more challenging. Digitisation and co-working have the potential to cause significant disruption in this regard. Owners and investors should, therefore, pay particularly attention to these factors, since they could materially influence demand for space both in terms of quantity and quality.

Savills Germany

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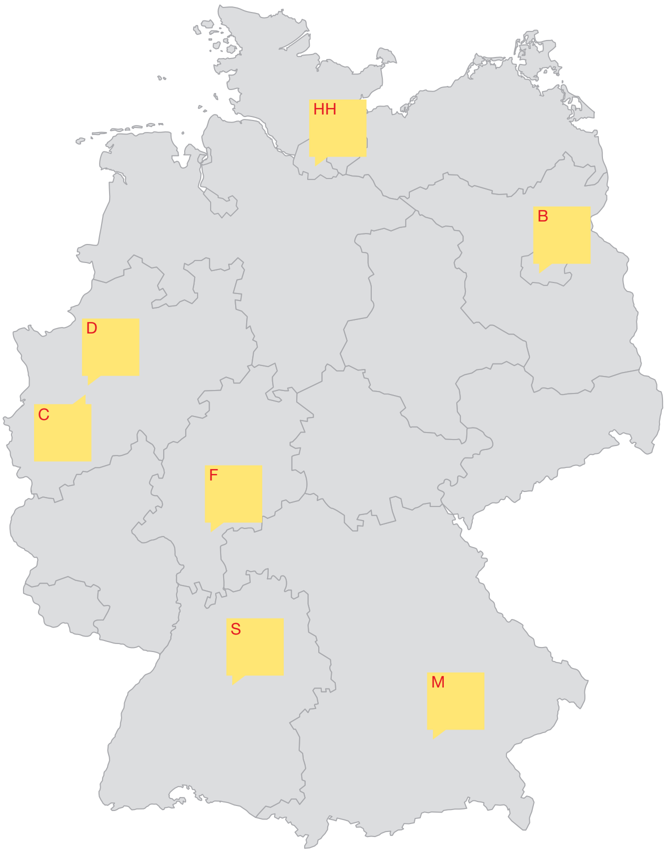

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