Real Estate House View

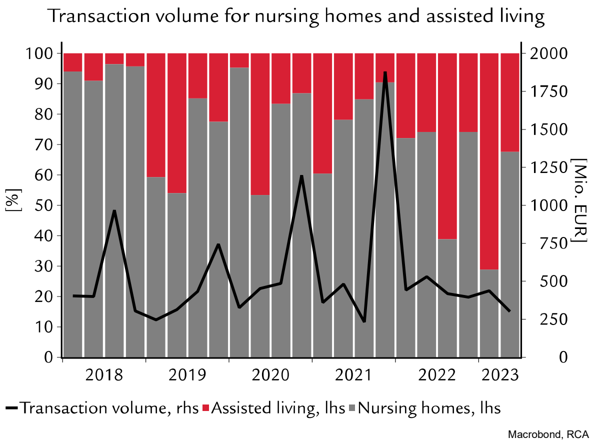
Germany

Second half-year 2023

Key takeaways

- **Investment opportunities at a new price level:** Following a significant correction in transaction prices, buying opportunities will open up in some segments during the second half of 2023 – but only if the quality of the property and location is sufficient.
- **Avoiding second-rate properties:** The gap between high-quality products in attractive locations and the rest is becoming increasingly apparent on the rental market for commercial real estate. Investment volumes reflect this, and the future viability of existing stock should be critically questioned.
- **Growth in logistics is slowing:** Lower momentum in e-commerce and the fading boom relating to securing supply chains are hovering over the logistics market. However, space remains scarce, offering further potential for rental growth.
- **Office markets overshadowed by falling demand for space:** Could flexible working and artificial intelligence (AI) be reducing office-based work? Demand for office space is decreasing and puts large portions of the existing stock at risk. Only prime properties are holding their own.
- **Residential market provides a stable anchor:** The supply deficit will lead to rising rents in metropolitan regions and large cities over the long term. New regulations may be introduced, but without prohibiting new construction and renovations.

Chart in focus



The market for retirement and nursing homes has been under pressure following the recent sharp rises in labour, energy and other costs, and the resulting insolvencies of some operators (even the larger ones). In the investment market, this is reflected in a significant shift in transactions from nursing homes to assisted living – not a new trend, but one that has been intensifying in recent quarters. The situation should improve as soon as homes receive sufficient financing from social security funds again. However, healthcare financing will remain a permanent issue – as will the need for nursing homes in an ageing society.

In mid-2023, Germany is still experiencing a mild recession. The manufacturing sector in particular is facing a decline in demand, which will be reflected in falling production figures in the second half of the year. In addition to higher financing costs resulting directly from the key interest rate hikes by the ECB, the lower-than-expected tailwind from China is also a factor. An interesting observation in the current cycle is that companies are still creating jobs, even in manufacturing. This is bolstering household incomes and the demand for services.

Time to take the plunge?

It is said that you can't time the market, but, following recent price corrections, opportunities in high-quality assets are there for the taking. The focus is on sectors with fundamentally strong prospects, such as residential or logistics/ industrial. Until mid-2023, however, most investors remained on the sidelines, as evidenced by quarterly transaction volumes of EUR 6 to 7 billion. A recovery of the overall market is therefore going to take time, as many sellers have still not sufficiently reduced their price expectations. But the process is under way. Sectors with comparatively high acquisition yields, such as light industrial, are generally expected to pick up faster than low-yielding residential or office property, as required yields of 4% (or even 5%) are easier to meet in competition with bonds.

Economy dampens demand for commercial space…

The weak economy of recent months is reflected by falling take-up on the rental markets for commercial real estate, as underlined by a decline of around 30% in the top seven office markets in the first half of 2023, and a decline of 40% on the nationwide logistics market compared to the same period in the previous year. As there is no sign that the economic environment will improve before year-end, this weakness is likely to persist and will be especially challenging for assets that do not offer first-rate property and location quality. Our outlook for high-quality space remains positive, and we expect further rental growth potential given the current shortage.

…but rents for modern premises continue to rise

Compared to the marked increase in prime office and logistics rents in recent years, expectations are now more moderate. In the logistics sector, while the strengthening of supply chains is generating additional demand for space, the current weakness in the e-commerce market is dampening momentum. The key factor remains the shortage of rental and building space, especially in the established logistics regions, where rental growth of 5% to 6% is expected for 2023. In the medium term, e-commerce is expected to pick back up again; however, the additional demand for space should not be overestimated. We expect rental growth in the main logistics regions to be around 2% p.a. in the medium and long-term. In the office sector, the trend towards higher-quality but smaller space has solidified and will reduce overall portfolios on the markets in the long-term. Flexible working and the possible impact of AI on office employment are likely to weigh on demand for space and rents, particularly outside of "A" locations. Modern spaces in trendy locations remain scarce, however, and the high cost of construction will restrict new supply; this is expected to provide scope for a 2% to 4% increase in prime rents in the top seven markets in 2023/24.

Residential staying power

By the end of May, high construction and financing costs had squeezed the number of building permits granted by 27% compared to the previous year, making forecasts for the construction of 250 000 new apartments more realistic than the 400 000 target. In the first half of the year, this lack of supply pushed headline rents up by around 5% in the top seven cities and by an average of 2% nationwide, which means our forecast of around 6% growth in the metropolitan regions and large cities in 2023 is realistic. New discussions surrounding stricter tenancy laws for furnished housing reminds us that the risk of market intervention remains. However, we do not expect any over-regulation as this would slow down vital new construction and renovations supporting the energy transition.

Chart 1: Prime rents in the top seven cities

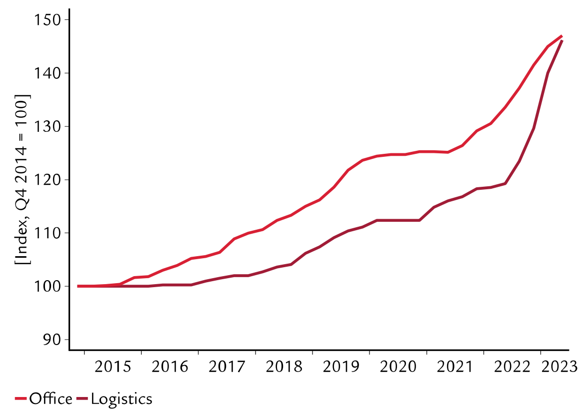


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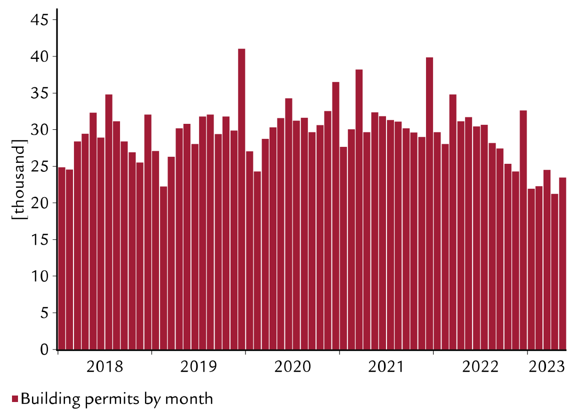
Chart 2: Building permits by month



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