Real Estate House View

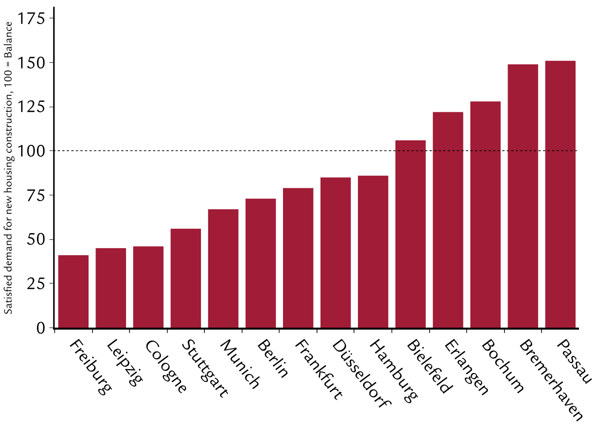
Germany

First half-year 2020

Key takeaways

- **Solid framework for the real estate markets:** the German economy suffers from a weak industrial sector, but moderate positive growth is likely to continue.
- **Initial yields likely to remain at low levels or even fall with fundamentals of rental markets remaining favourable:** prolongation of the easing monetary policy fuelling investment markets for the foreseeable future.
- **Room for modest rental growth in office markets:** despite headwinds from economic weakness and increasing completions, remaining backlog of tenants' demand and low availability of space.
- **Remaining challenges in large parts of inner-city retail probably longer than expected:** landlords have to accept changes in tenants' needs and a reduced ability to pay rents potentially resulting in value depreciation.
- **Logistics markets continue to rely on transport and distribution for e-commerce:** availability of space, in particular in metropolitan areas, major constraint on the rental market – potential for rents to rise.
- **Increasing regulations take away dynamics from residential markets:** nevertheless investments still attractive due to fundamental imbalance between demand and supply in many regions.

Chart in focus



Source: German Economic Institute

The insufficient supply of dwellings and rising rents remain hot topics in Germany's residential market. The spatial dimension, however, is often neglected. If current completion figures and demand for housing are compared on a regional basis, there is a lack of construction activity especially in major cities and surrounding areas. Yet, there are also numerous cities and districts with exceeding demand. This applies above all to economically weaker, and more frequently to rural regions. Nevertheless, the analyses also demonstrate exaggerated levels of new-build activity in some cities with favourable socio-economic conditions – all in all a mixed picture.

In the absence of any meaningful stimuli from either monetary or fiscal policy for the domestic economy in the short term, Germany depends on foreign demand to reanimate economic dynamics in its industrial sector. Yet, in contrast to the last three acceleration periods, emerging markets are unlikely to act again as the global economy's growth engine. Thus, the ongoing adjustment process in Germany's manufacturing sector will continue to weigh on growth. Meanwhile, business sentiment indicators have started to hint superficially at stabilising conditions. A closer look at the details in the latest ifo survey reveals that net balance of manufacturing firms which intend to reduce their labour force in the next three months reached its highest level since January 2010.

Office markets still buoyant

The economic slowdown and job cuts in manufacturing have not yet been apparent in the office market. On the contrary – higher take-up figures were reported in the first quarters of 2019 compared to the previous year in the top seven letting markets. At very low vacancy rates, it is difficult for occupiers to get access to space, allowing landlords to enforce higher rents. Tenants extend contracts to secure space in advance. However, experience shows that letting markets lag the economy by almost a year. Completions will increase in the coming years – thus a call for caution. We remain cautious but positive in our outlook. A large proportion of new buildings has already been pre-let, and a backlog of demand has been built up intending to prevent the market from slumping even in a downturn in demand. However, the era of strong rental growth is likely to end and growth will be moderate in the coming years.

Re-pricing of retail assets ahead

The contrast between the weakening, textile-based inner-city retail and the robustness of retail formats for daily needs has often been raised and is unlikely to change in the foreseeable future. The priority for small-scale retail space in top locations seems to be becoming more acute. At the same time, new demand is still upcoming, e.g. from restaurants and food services. Nevertheless, they may not be able to pay the high rent of previous tenants. Many landlords will have to accept a devaluation in their property sooner or later. On the basis of adjusted rent and price levels, rents may subsequently even rise again. Top locations in inner cities will always attract customers, either for shopping or leisure purposes.

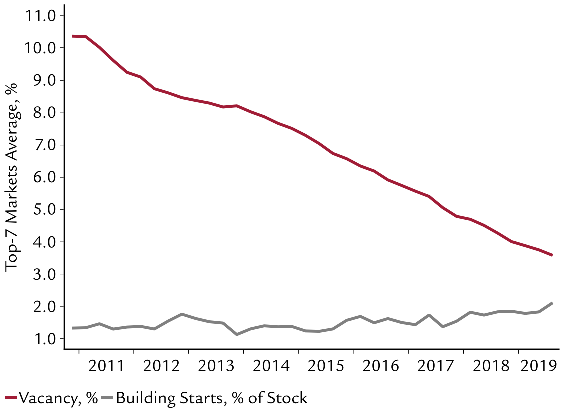
Limited supply dampens logistics

The requirement for logistics space remains consistently high. E-commerce keeps growing and even the struggling manufacturing sector is expanding at least in some industries. For example, the automotive industry needs capacities for both conventional as well as electrically powered vehicles. Letting activities declined in 2019, particularly in metropolitan areas with a relocation to other regions boosting take-up outside the conurbations. The unequal availability of space is a limiting factor since the number of sites for logistical use is decreasing. This scarcity is leading to rising rents, especially in conurbations. Facilities for distribution in urban areas are of particular importance. Rents are still in upswing.

The ongoing investment boom

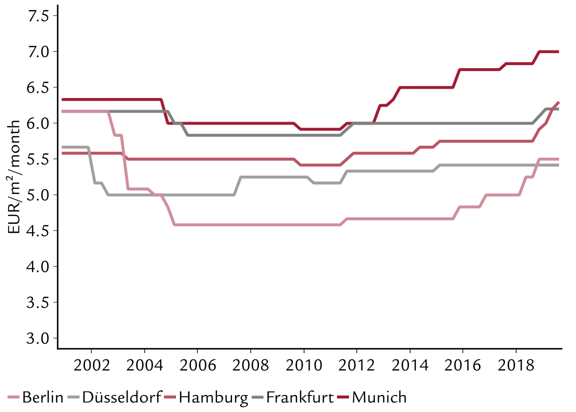
The boom in investment markets continued in 2019 and there is still no indication that it will end soon. The low interest rate environment still outweighs the economic slowdown and potential impacts on letting markets. As a result, the transaction volume remained high in 2019, even though a fall of around 10% in the first three quarters indicates a decline in liquidity due to insufficient supply. However, we see some signs that market actors are trying to reduce risks as the market cycle is anticipated to be at a late stage. For example, developers of new buildings are trying to shift the risk of vacant space to a greater extent towards investors. On the one hand the strong competition for assets may allow this procedure, on the other hand this is a sign of developers' concerns about an upcoming clouding of the market. Overall, investment activities are increasingly focusing on the top markets with high liquidity. As a result, a further contraction in initial yields was recorded in 2019. In the top seven markets, prime office yields decreased by about 20 basis points to an average of 3% in the third quarter, while yields for logistics properties fell below the 4% level. In general, the trend towards falling or stable, low yields is likely to continue in most real estate segments over the next couple of years.

Chart 1: Offices – Vacancy and building starts



Source: PMA

Chart 2: Logistics rents



Source: PMA

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