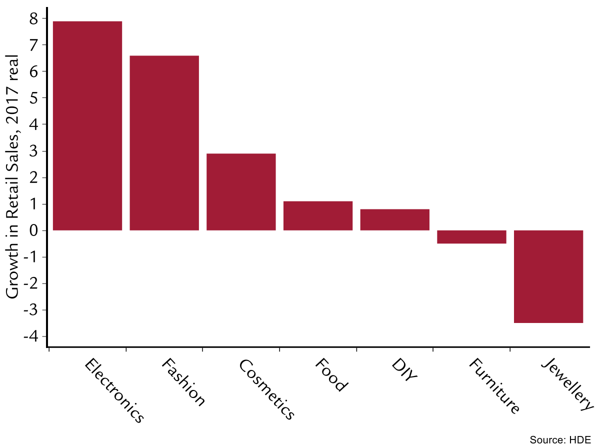
Real Estate House View
Germany

First half-year 2019

Key takeaways

- The German real estate market is in good shape, and this is likely to continue for the foreseeable future despite the rise in political, economic and financial risks.
- The office markets continue to benefit from the scarcity of available space and sustained buoyant demand. There are good prospects for further rental growth, although the momentum will slow in the medium term.
- The residential markets in the metropolitan areas and large cities benefit from the shortage of housing due to insufficient construction activity and the growing number of households. The upward trend in rents continues.
- Given the healthy economy and the booming e-commerce sector, demand for logistics properties from tenants and investors has increased. Additional rental growth can be expected in metropolitan regions with a shortage of land, but less so in logistics hot spots outside these centres.
- The low interest rate environment and lack of attractive investment alternatives should keep transaction volumes high in 2019.
- The shortage of existing properties is increasingly prompting investors to buy into developments, mainly in the residential sector.
- Initial yields for the main sectors have stabilised at a low level and are likely to remain on a sideways path in the medium term.

Chart in focus



The fashion industry is considered a critical component of the retail landscape in Germany. This may apply to store-based retail in many key shopping locations but the industry also continues to grow from a macroeconomic perspective. In 2017, fashion industry sales increased by 6.6% in real terms. However, due to expanded supply from textile discounters or supermarkets, but above all to e-commerce, the distribution channels have shifted noticeably away from traditional store-based retailers.

Germany's economic expansion experienced a noteworthy moderation in the second half of 2018 with industrial output almost stagnating compared with levels a year ago. Details of the negative GDP growth rate in the third quarter reveal that this slowdown is explained to a large degree by problems in the car manufacturing sector. As domestic activity remains firm, a strong rise in imports resulted in the unusual instance of a negative net trade contribution in Germany's national account data. As car production improved in the final quarter of 2018 and the labour market tightens further, we expect the economy to continue to grow above its potential in 2019. Among the sectors continuing to contribute firmly to growth is the construction sector, supported not least by favourable financial conditions.

Investments on top of cycle

Even though the economy is showing some signs of weakening, German real estate remains very popular with investors. Up to the end of Q3 2018, total transaction volume in commercial and residential property reached about EUR 58 billion, i.e. 15% above the equivalent period in 2017 according to JLL analysis. Initial yields are bottoming out. In markets and sectors with very low yields, such as the office markets in Berlin or Munich, prices remained unchanged in the course of 2018. At the same time higher-yielding investment opportunities continued to be exposed to modest yield compression. We expect yields to remain stable in the short to medium term.

Offices still offer rental growth

In the first half of 2018, institutional investors once again had the strongest appetite for office properties, accounting for 35% of total volume. There are good fundamental reasons for this as office space has become scarce in Germany's major cities. This also explains the slight decline in take-up in the first quarters of 2018. Accordingly, companies have postponed relocations and restructured their existing premises in order to meet demand. The number of renewals is increasing compared to a market that exhibits balanced demand and supply. Thus, rents continue to rise – not only in the prime segment, but in the broader market. Completions will increase noticeably in the coming years but demand should absorb the additional supply pretty well. As a result, vacancy rates are likely to remain at low levels over the next few years and rents are set to increase considerably in 2019 before momentum slows in the medium term.

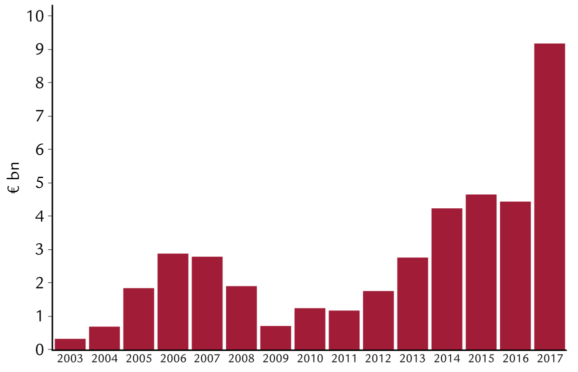
Logistics on the rise

The good economic environment, ongoing outsourcing of logistics services and, as a major driver, rapidly growing e-commerce are pushing up investor demand for logistics property. However, according to CBRE, the transaction volume in the first nine months of the year fell by around 20% to a still respectable EUR 5 billion compared with the same period in the previous year. At the same time, however, the competition for high-quality products has reduced the initial yield for prime properties to close to 4%. Even if there is still pressure on yields, we do not see much scope for further compression, but letting market fundamentals support investor demand. According to JLL, take-up in Germany was approximately 4.8 million sqm in the first nine months of 2018 – 30% above the 10-year average. At the same time, rents are on an upward trend, especially in metropolitan regions with a corresponding shortage of land and rental space. We see further rental growth in these areas, aided by urban logistics serving e-commerce (though this should not be overestimated on a national level).

Forward purchases dominate residential investments

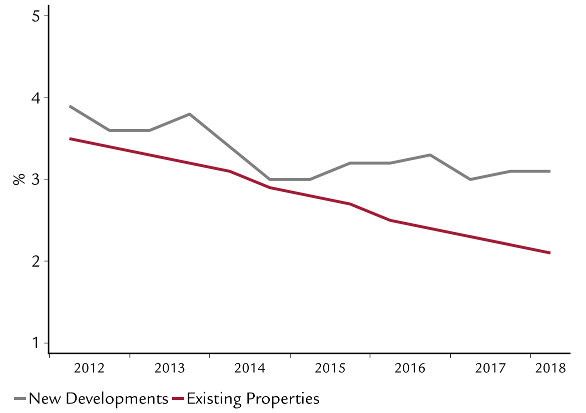
The residential sector is a key driver of the investment market in Germany. According to JLL, transaction volumes of around EUR 15 billion was recorded in the first three quarters of 2018. Even when large portfolio deals, such as the takeover of Buwog by Vonovia, are excluded, the strong appetite of institutional investors is evident. The intense competition for a scarce product range is increasingly encouraging investors to purchase developments well before the properties are completed through forward deals. More than 50% of the market supply is accounted for by such assets. In addition, the pricing favours development projects. In a market with very low initial yields, it is still possible to achieve more than 3% with new-builds. Thus the spread to existing properties widened to almost one hundred basis points in the course of the year.

Chart 1: Logistics transaction volume



Source: PMA

Chart 2: Net initial yield in the residential sector in Germany's top 7 markets



Source: Empirica Analyst

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