Real Estate House View

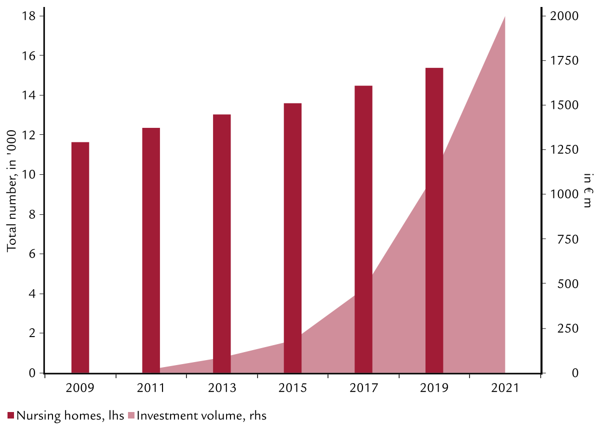
Germany

Second half-year 2021

Key takeaways

- **Top dog:** The German real estate market constitutes the largest and most liquid real estate market in Europe offering broad occupier markets that are spread all over the country.
- **Residential – top of the top:** Positive development of capital values and rents characterises the residential market. In the short term, the momentum is expected to continue. However, investors should not underestimate the effect of affordability issues and potential regulations in the medium to long term.
- **Retail is upside down:** Multiple lockdowns and consumers opting for increased online spending are pressuring high street retail and shopping centres and respective rents. Retail parks and grocery-anchored stores remain strong and offer potential for slight rent increases.
- **Industrial and logistics – a hyped sector?** A healthy occupier market in need of floorspace is meeting an investment market in need of certainty. In the short term that is a good match and the positive development of rents and capital values is expected to continue. In the medium term, the momentum might cool down and stabilise rental growth and yields.
- **Binary offices:** While occupiers seek smaller floorspace, shorter rent periods and rent incentives, investors seek core properties – under the assumption that core properties in prime locations will sustainably withstand the structural changes in office requirements or even emerge as profiteers from those changes.

Chart in focus



Source: destatis, RCA

Germany's aging population is triggering demand for healthcare properties. Although the number of nursing homes rose by 32% to 15 380 from 2009 to 2019, a further 3400 nursing homes at least are needed by 2025 to fill the supply gap. An occupier market showing pronounced demand will always attract investors; an occupier market that pays stable cash flow during economic downturns is even more attractive for investors. Consequently, investment volumes in German nursing homes peaked during the current crisis: in H1 2021, the rolling 4-quarter investment volume totalled EUR 2.1 bn, compressing prime yields to 4.0%.

Recently, there have been increasing signs of broader economic confidence in smaller companies and especially service providers. According to the ifo Institute, among the ten sectors with the most optimistic outlook for the next six months, there is a strikingly large number that have suffered particularly badly from the containment measures. These include catering, accommodation, the entire passenger transport sector and travel agencies. According to the same source, the employment intentions of service providers also increased sharply. This development is the result of accelerated vaccination progress and rapidly falling incidence levels. Easing measures are now being implemented in rapid succession. These in turn are already having a positive impact on the dynamics of the domestic economy and consumer sentiment. According to GfK, the latter rose for the second consecutive time in June. The marked improvement in employment prospects and the prospect of wage increases should further boost economic sentiment in the second half of the year.

Second-tier residential first?

With roughly 22.5 million households renting, Germany constitutes Europe's largest private rental market that additionally exhibits a housing shortage, which in turn supports positive rental growth both in tier one and second-tier cities. Given that even average yields in tier one cities are touching levels close to 2% (Munich: 2.1% as of Q1 2021), second-tier cities, where prime yields are still above 3% while rental prospects are positive, are becoming more attractive for investors. Also, suburban areas are becoming more attractive as people migrate into the suburbs. The ongoing trend of extending catchment areas is further fueled by new home office dynamics. An ongoing debate in the German residential market is affordability of rents – especially in tier one cities, i.e. A-cities. Despite the constant regulation debates, best depicted by Berlin's rent cap that was ruled null and void in April 2021, investors should monitor future regulatory developments.

Office towards core

The future of office will embrace elements of working from home and office locations that provide the required office space and working atmosphere. For the time being, take-up volumes are still subdued. In Q1 2021, take-up volumes averaged across the top seven German real estate markets are down by 17% compared to the 5-year average. It is noticeable that many contracts are signed by the public sector, whereas the private sector is still relatively reluctant to rent new office space. This hesitance is causing an increase of vacancy rates, albeit still at low levels, among the top seven markets (average: 4.3%). Those private corporations that are active in the letting market show a preference for smaller office locations and shorter lease contracts. We expect the stable pattern of headline rents of 2020 to continue in 2021, though the use of incentives is effectively decreasing rents. A polarisation in the investment market towards core properties is stabilising prime yields at low levels – 2.65%. Berlin is the most expensive office market for investors.

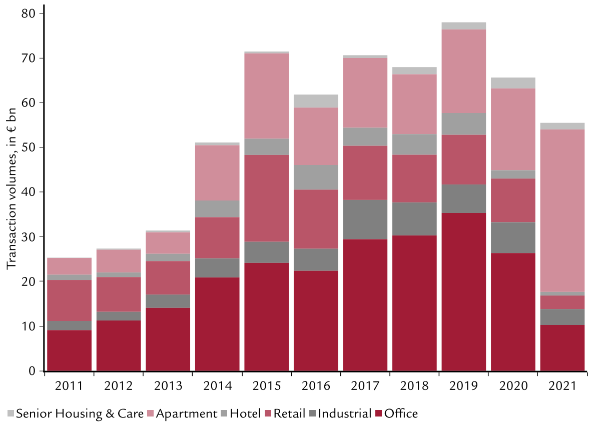
Retail divided

While high street retail and shopping centres are still under pressure – with further rent declines and increasing risk premia expected in 2021, even for prime locations – retail parks and grocery stores on the other hand offer stable cash flows and thus attract investors. As of Q1 2021, prime yields for grocery stores stood at 3.9% (-10 bps y-o-y), retail parks were even more in demand (3.8%, -30 bps y-o-y). Declining rents and increasing floorspace in inner-city locations offer opportunities for new occupiers to enter the market at attractive rent levels and with adjusted concepts that incorporate hybrid in-store/offline aspects as a response to shifts in spending behaviour. As these schemes require a lower quantum of physical retail floorspace, there will be a reduction of floorspace, even in prime locations.

Logistics with momentum

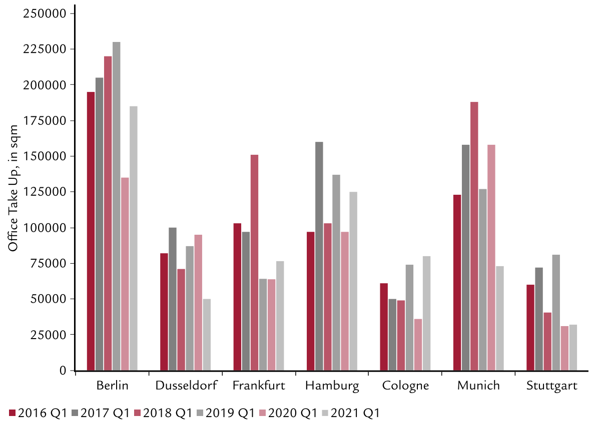
Driven by e-commerce, higher inventories and supply chains that remained intact during the second and third lockdowns, the occupier market is booming and demanding floorspace. With a take-up volume of 1.77 million sqm, Q1 2021 set a record in first quarter take-up volumes. Demand is not only concentrated on the top markets but is spread across the country. Though completions are rising, they cannot fulfil demand for modern properties. Thus, prime rents are rising, just like capital values, leading to a compression of prime yields. With a prime yield of 3.45% (-45 bps y-o-y) Berlin – again – constitutes the most expensive market.

Chart 1: Transaction volumes over time until H1 2021



Source: RCA, 2021 data as represented by H1 2021

Chart 2: First quarter office take-up volume over time in the top seven markets



Source: RIWIS

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