savills

Market report
Germany investment

2014

Summary

Investment market at a glance

- Solid fundamental economic data combined with interest rates that have been at extremely low levels for several years are acting as a catalyst for Germany's commercial investment market. Investment in Germany totalled €39.8bn in 2014, which represents a 27% increase on the previous year.

- The proportion of the transaction volume attributable to areas outside of the top six markets increased, as did activity in B locations of the A cities. In other words, ABBA strategies have re-emerged after years of absence.

- Last year, investors' increased appetite for risk caused yields in the non-core segment to harden more than those on prime property for the first time. Nevertheless, non-core investments remain attractive.

- Foreign investors accounted for more than half of the transaction volume, with those from Asia particularly increasing their market share. This trend is likely to continue, producing a transaction volume of more than €40bn this year.

"The persistently low interest rates and the solid economic fundamentals will ensure that the boom in the German investment market continues in 2015 too." Andreas Wende, COO Savills Germany, Head of Investment Germany

Real economy and financial environment

German economy remained below expectations in 2014

In December 2013, growth projections for the German economy in 2014 stood at 2%. Actually, the growth rate of the German national economy was at only 1.5%; lower than projected at the end of 2013. There are many reasons for the unexpected low growth, including the sustained weak growth in the eurozone. The positive side is that the single currency area has been able to leave the two-year recession behind and achieve provisional economic growth of almost 1% last year. However, the return to a solid growth trajectory is proving sluggish and continues to suffer with setbacks. The Italian economy, for example, contracted last year for the third year in succession while France, the second largest national economy in the single currency area, effectively stagnated (provisionally +0.4%). The weakness of two such important trading partners alone was a significant burden to the German economy last year. Exports were also negatively impacted by geopolitical crises; notably the conflict in Ukraine. Additional stresses included the floods in the early part of the year and rail strikes in the autumn.

Weak investment, strong consumption

These negative influences caused the German economy to significantly lose its driving force over the course of last year. Investment in particular was once again weak owing to the continued uncertainty of the eurozone crisis, the crisis in Ukraine as well as the increasingly rigid and erratic national and regional economic policy from the federal government. In contrast, consumption was a significant positive growth factor, rising by a provisional 1.1% year on year in 2014. This above-average growth is based not only on real growth in wages and salaries but also on further improvements in the employment market. At the end of December, the (seasonally-adjusted) unemployment rate was just 6.5%; the lowest since German reunification (Graph 1). Both factors have produced an extremely positive consumer climate. The consumer climate index calculated by GfK recently stood at 9 points; the highest level since December 2006 (Graph 2).

Spectre of deflation forces ECB to act

However, for many nations in the eurozone, there are no signs of a healthy employment market or the associated rise in wages and salaries. On average, 11.5% of those capable of work in the eurozone were unemployed at the end of last year. In many countries, as many as one in four or five people is unemployed. This, in turn, is one of the reasons for the consistent decline in the rate of inflation over the course of the year. Inflation stood at 0.3% in November; equal with the lowest level in five years. Consequently, the European Central Bank (ECB) maintained its extremely

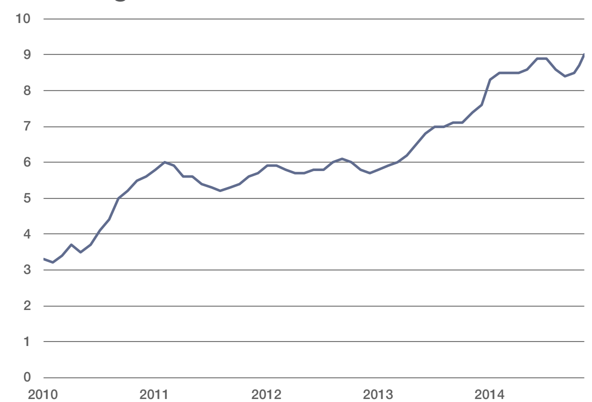
GRAPH 1

Labour market Employment jumps over 30 million mark

Source: Bundesagentur für Arbeit, Focus Economics

GRAPH 2

Consumer climate Private households remain generous



Source: GfK

TABLE 1

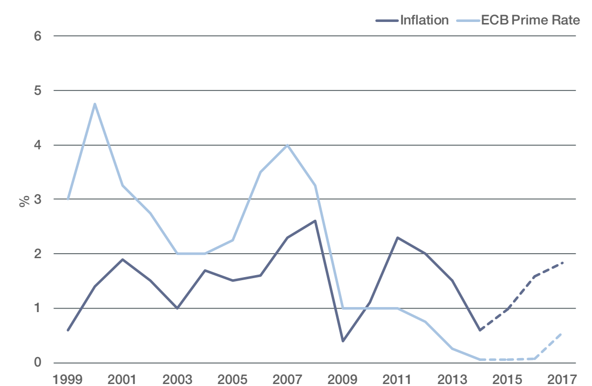
Macro-economic key figures at a glance*
Consumption is driving economic growth

Figure (y-o-y change in %)	2014	2015	2016	2017	Ø 09-13
Gross domestic product	1.5	1.7	1.9	1.7	0.8
Private consumption	1.1	1.3	1.5	1.5	0.9
Industrial production	-0.2	2.3	2.4	2.5	0.2
Consumer prices	1.6	1.6	1.8	2.1	1.7
Exports	0.6	4.6	5.1	4.6	3.1
Imports	1.2	5.0	5.7	5.0	3.2

Source: Statistisches Bundesamt, Focus Economics / * 2013 preliminary figures; 2015-17 forecasts

GRAPH 3

ECB prime rate and inflation Inflation decreases despite interest rates of zero



Source: Statistisches Bundesamt, Bundesbank, Focus Economics

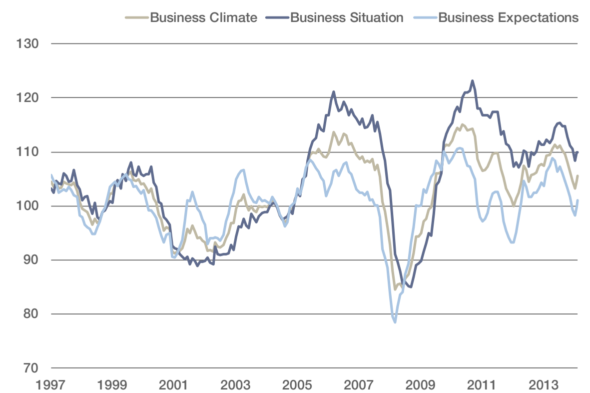
expansionary monetary policy last year and even loosened the reins further. In two stages, the ECB lowered the main refinancing rate from an already record low of 0.25% to 0.05% (Graph 3). It even lowered the deposit rate to a negative value for the first time in its history. However, despite these measures, the rate of consumer price increases in the eurozone continued to move away from the ECB target (just below 2%), partly due to the recent drop in oil prices and the associated lower energy costs for consumers. As long as the rate of inflation remains in what ECB President Mario Draghi refers to as the "danger zone" of below 1%, the ECB is highly likely to take further measures in monetary policy to dispel the "spectre of deflation". As a start of such a package of measures, although extremely contentious from a legal perspective, they decided in favour of an extensive purchasing of government bonds to increase the ECB's balance sheet.

Low external value of the euro and cheap oil are the economic drivers for 2015

The extraordinary measures in monetary policy and economic weakness have caused the euro to significantly lose value against other major currencies, particularly the US dollar. At the start of 2014, one euro would buy 1.35 dollars. At the start of 2015, this had fallen to less than 1.20 dollars. Many experts believe this trend towards currency parity is likely to continue. However, this devaluation combined with the low oil price is likely to provide significant impetus to the economy in the eurozone. The German economy, which is heavily dependent on exports, should particularly benefit. Indeed, some recent indicators have pointed to an increase in economic activity. At the end of the year, the ifo Business Climate Index halted its decline that commenced in the spring, rising slightly in November and December. Both the current business situation and business outlook of companies surveyed showed improvements (Graph 4). German industrial orders also recently resumed an upward trend following a prolonged period of weakness, providing cause for optimism with regard to trends in production activity over the coming months. However, this year too, it is private consumption that is likely to prove the most significant driver of economic growth. Owing to their opposing effects, it remains to be seen what impact legal amendments to pensions and the minimum wage will have in the long term. Indeed, many factors point towards a sustained weakening of the German economy. However, for this year at least, both developments should fundamentally provide further stimulus to the consumer climate. Despite the sustained risks, including the recently resumed talk of a "Grexit" (Greece leaving the eurozone), all of this could bring about a reversal of the situation last year and economic growth may actually exceed the current projections of 1.3%.

GRAPH 4

Business climate Mood amongst enterprises seems to swing up again



Source: cesifo

Spectre of deflation

Effects on property

The inflation rate in Europe has been constantly falling in recent years. Despite massive interventions from the European Central Bank, the downward trend has continued to date. Against a background of continuing weak economic growth, a sustained period of deflation is a quite possible scenario. For real estate markets, such a development would entail some serious consequences, three of which are outlined below:

■ Indexed leases would be highly attractive from a tenant's perspective owing to nominally falling rents. Investors and landlords, on the other hand, would prefer leases without indexing.

■ While nominal interest rates would fall further, the negative inflation rate would result in higher real interest rates than nominal interest rates. Furthermore, since liabilities would increase in real terms, the use of debt capital would make little sense. Consequently, the amount of capital available for property investments would decrease and property prices would fall.

■ Since a deflationary scenario would go hand in hand with a world of stagnating or even contracting economies, real estate investors would once again become much more risk averse and focus more strongly on the core segment than in recent times in order to minimise their risk of tenant default, for example. Property values in the core segment would, therefore, react less strongly than those in the non-core segment.

Investment market

German economic strength + low interest rates = boom in the investment market

Germany's continued strong economic position in Europe combined with interest rates that have been at extremely low levels for several years are acting as a catalyst for Germany's commercial investment market. Investment in German commercial property totalled some €39.8bn last year; a further 27% rise on a strong previous year. The final quarter was particularly noteworthy. During the three months from October to December 2014, commercial property transactions totalled more than €14bn (Graph 5), suggesting that the rally will continue this year.

Wider market activity - ABBA strategies re-emerge

Last year was characterised not only by increased investment but also by more differentiated market activity compared with previous years. This is apparent by looking at activity by sector, the regional distribution of transactions and the structure of purchasers and vendors. Some 45% of the overall transaction volume last year was attributable to the office sector (Graph 6; 2013: 42%). However, this high proportion is more a reflection of available supply rather than demand. In the retail sector in particular, the lack of properties available for sale limited the transaction volume. Taking shopping centres, for example, the transaction volume rose ten-fold between 2009 and 2011 to almost €4.5bn but has since fallen significantly. Last year, only slightly more than €1.6bn was invested in shopping centres. However, this decrease is not due to falling demand but a lack of supply. Between 2009 and 2011, around 90 shopping centres changed hands, equivalent to almost a quarter of the entire stock in Germany. Since most purchasers were strategic investors with a long-term investment horizon, these properties are off the market for a correspondingly long period of time. However, the other sectors are also afflicted with excess demand, particularly in terms of well-let properties in good locations in the top markets. Against this background, investors continued to shift their attention to cities outside of the major metropolises last year. Cities and municipalities outside of the top six markets accounted for precisely half of the transaction volume (Graph 7; 2013: 46%). In turn, in the top six markets, transaction activity increasingly shifted to areas on the periphery of city centres owing to the extremely intensive competition for properties in the central submarkets. This demonstrates that ABBA strategies, i.e. targeted acquisition of properties in A locations of B cities or B locations of A cities, re-established themselves last year following five years of extreme focus on the core segment.

More yield compression on non-core than core property for the first time

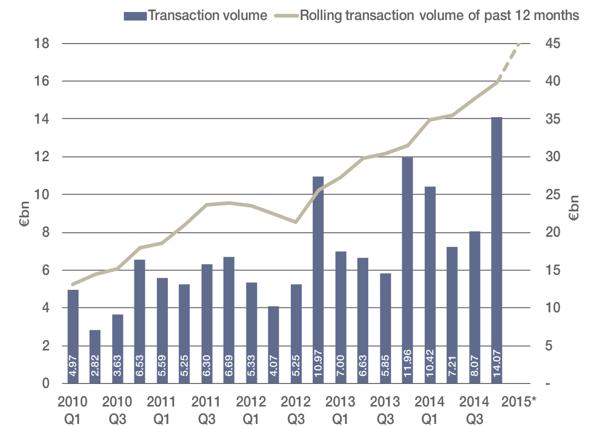
Most investors continued to prefer purchasing core properties. However, the demand surplus is now so great that they are forced, at least in isolated cases, to divert to other risk categories in order to make any acquisitions at all. Furthermore, investors must be prepared to pay record prices in order to secure one of the highly sought-after core properties. Prime yields have now significantly surpassed their previous record lows from 2007 (Graph 8). Average prime CBD yields across the top six markets stood at 4.3% on offices at the end of 2014 (2013: 4.6%) and at 3.9% on high-street properties (2013: 4.1%). However, the rising risk tolerance of investors is also impacting price trends. For the first time in this cycle, yields hardened further in the non-core segment than on prime property last year. Secondary non-CBD office yields in the top six markets tightened by 40 basis points to 6.2% during the year. In contrast with the core segment, however, the record lows are far from having been reached. Nevertheless, it can be assumed that non-core yields will harden further than prime yields once again this year and that yield compression will continue.

Almost all investor groups active on the purchaser side

As mentioned previously, market activity has also widened in terms of the participants involved. Graph 9 illustrates that almost all major investor groups were notably active on both the purchaser and vendor sides. In keeping with the previous year, the most active purchaser group was special funds, which made property

GRAPH 5

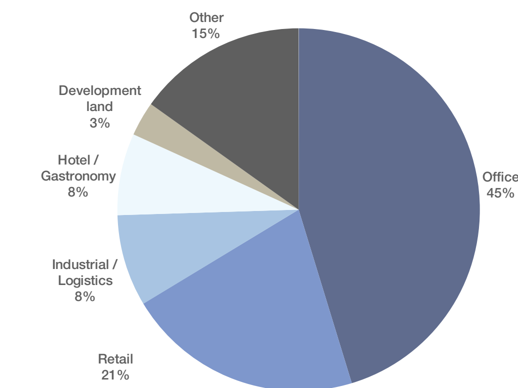
Transaction volume The €40bn mark is expected to break soon



Source: Savills / * forecast

GRAPH 6

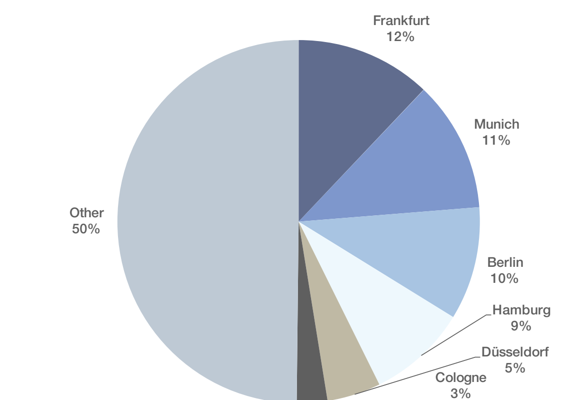
Transaction volume by type of use Office proportion increased again



Source: Savills

GRAPH 7

Transaction volume by location Three cities with at least €4bn



Source: Savills

"Asian investors increasingly establish in the German market. Last year they reached a market share of 6% and we expect it to rise further this year." Marcus Lemli, CEO Savills Germany, Head of Investment Europe

acquisitions totalling almost €7bn. This group also recorded the highest net investment volume (acquisitions minus disposals) of more than €3.1bn last year. Listed property companies / REITs came second (€2.3bn), followed by insurance companies / pension funds (€2.1bn) and private equity funds (€1.5bn). These four groups each made a net investment of at least €1bn in German commercial property last year while also covering the entire risk spectrum from conservative (insurance companies) to opportunistic (private equity funds).

Corporates use low interest rate environment for strategic purchases

The attractiveness of property as an asset class in the current capital market environment is also demonstrated by the high investment volume from corporates and private investors / family offices. While neither group are typical property investors, each invested significantly more than €2.5bn, which was more than in any of the five previous years. The high investment volume from corporates is particularly noteworthy and demonstrates that companies with large cash reserves would rather invest these in (owner-occupied) property than holding liquid assets in a low interest rate environment or even investing in their core business in view of the continued economic uncertainty in Europe. Retail chains in particular, such as Metro and Edeka, used excess reserves for strategic (re)purchases of owner-occupied property last year. The latter retailer also acquired an office property in Hamburg, which is still currently let to PwC, for its own subsequent use.

Open-ended funds now scarcely significant

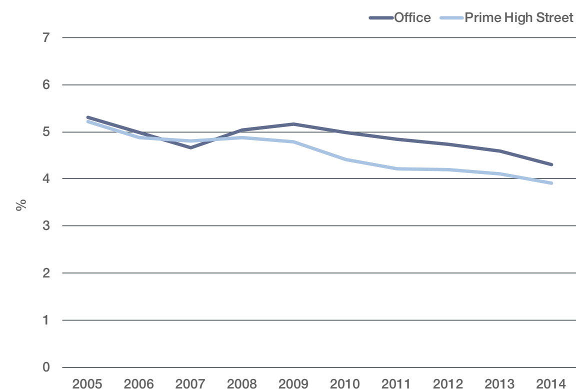
In sharp contrast to the investor groups discussed above were open-ended funds. These were once dominant players in the German investment market and materially influenced its cycle. Last year, however, they played scarcely any role as an investor group in the German market and were also predominantly active on the vendor side. These funds still have assets under management of approx. €80bn. However, almost one fifth of this overall volume is attributable to funds that are frozen or in liquidation and two thirds of the remaining volume is managed by four funds. Accordingly, few such funds were active on the purchaser side last year, particularly since they primarily made acquisitions outside Germany. The dominant role of open-ended funds has now been overtaken by special funds, which have invested more than €21bn in German commercial property over the last five years; far more than any other investor group.

Increased activity among foreign investors

The low engagement of open-ended funds meant that domestic purchasers' share of the overall market declined significantly last year. German investors accounted for just 48% of the transaction volume last year compared with 66% in 2013. This also means that domestic investors reduced their purchase volume compared with the previous year, from approx. €20.6bn in 2013 to around just €18.9bn in 2014. This decline is almost entirely attributable to open-ended funds, whose purchase volume was more than €1.5bn lower than in the previous year. However, foreign investors more than compensated for this decrease, investing almost €21bn in 2014; some €10bn more than in the previous year. The most active were investors from the USA with a 15% share of the overall transaction volume, followed by British investors (9%) and French purchasers (6%). However, the largest increase in purchase volume was registered by investors from Asia. This group increased their share of the overall transaction volume from 1.5%

GRAPH 8

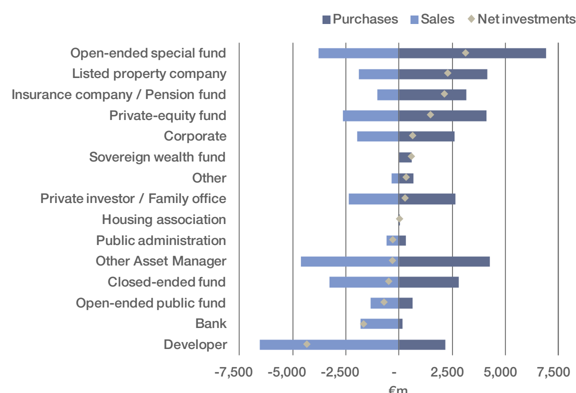
Yields* Prime yields achieved new all-time lows



Source: Savills / * average of Top 6 - until 2011 without Cologne

GRAPH 9

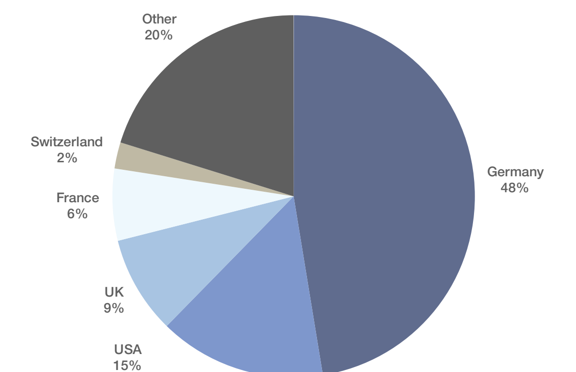
Transaction volume by type of investor Very broad activity



Source: Savills

GRAPH 10

Transaction volume by origin of investor Foreigners on top



Source: Savills

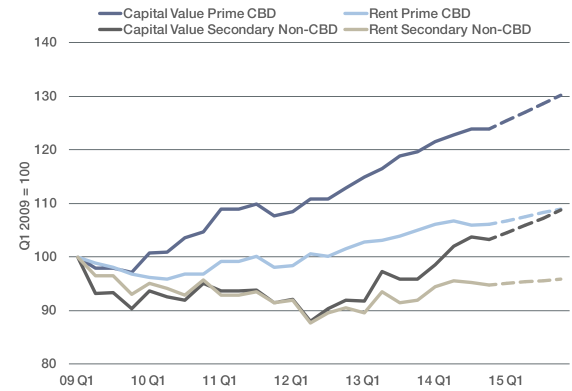
in 2013 to almost 6% last year. It is also noteworthy that these purchasers are increasingly investing directly and sometimes without local partners. This, and the overall increase in interest from Asian investors in the German market is likely to ensure that they will increase their purchase volume further in the current year.

Excess demand to rise further in 2015

Since investors from other regions are also likely to increase their engagement further this year, there will be even more funds available for real estate investment than last year. Consequently, the transaction volume will in all likelihood significantly exceed last year's level and, thus the €40bn mark. At the same time, this will mean that the excess demand not only persists but will increase yet further. This will place further pressure on yields, particularly in the non-core segment owing to the increased appetite for risk of investors. Nevertheless, non-core investments are likely in many cases to continue to offer a more attractive risk-return ratio than core properties. For while capital values in the prime segment have risen far ahead of rents, this trend is not yet quite so pronounced in the non-core segment (Graph 11). Accordingly, the risk in the event of an interest rate rise is lower, although this is not currently foreseeable.

GRAPH 11

Capital values and rents of prime CBD vs. secondary Non-CBD*



Source: Savills / * average for offices in the top five markets

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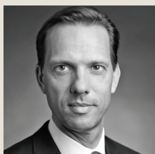

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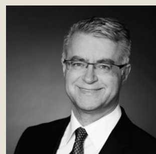

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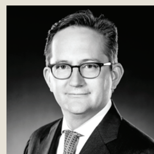

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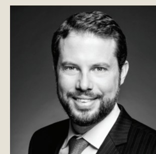

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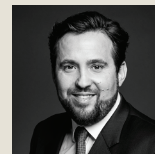

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