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The Office Property Market in Germany

Rents, returns and latest trends in financing volume

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When examining the latest developments in the office property market in Germany, it is necessary first to make a distinction between the leasing market and the investment market. The leasing market, which is where offices are offered by their owners for rent and are in demand among firms, is currently in good shape. The future prospects, too, appear to be more positive than they have been for a considerable time.

This is true of the investment market only up to a point, however. In this market, it is not rights to use office space that are offered and are in demand: this is where ownership rights to existing office properties are bought and sold. There is no doubt that the investment market is booming at present. Yet boom phases are often linked to inflationary developments. Against this background, the question is whether the growth seen in recent years – without leading to price exaggerations – can go on.

This article describes office market developments in both the leasing and the investment market. In connection with the leasing market we will, moreover, turn our attention to new construction activity and look at how much own capital and borrowed capital were spent in recent years to purchase and to build office properties.

Office leasing market

The office leasing market is in good shape. The reasons for this are to be found, above all, on the demand side. In the light of stable macroeconomic developments, which mean rising job figures, the demand for office space has been growing for years. One good indicator of this development is the time series on letting performance in six major office property markets in Germany,[1)] which the Gesellschaft für Immobilienmarktforschung (gif e.V., Society of Property Research in Germany) compiles each year. Since 2010, this time series has followed an upward trajectory – interrupted by slight annual fluctuations – that has gained considerably in momentum over the last three years. In 2016, more office space was let in the top markets than in 2000, the year with the hitherto highest office space take-up.

What is more, the supply of office space is rising only moderately. Unlike in the first half of the 1990s and again around the turn of the century, comparatively little is currently being invested in erecting new office buildings, despite the positive economic framework conditions (see Figure 1). Since 2004, newly completed floor space has averaged around 2.5 million m² a year, whereas more than 5 million m² were offered on the market each year in the 1990s. The low completion figures of the past years are largely attributable to the overcapacities and legacy assets from the boom phase at the beginning of this century.[2)] Between 1999 and 2004, the vacancy rate in office properties in the top markets surged from less than 3% to over 10%. This was mainly due to new construction activity triggered by the “dot.com euphoria” that prevailed at the end of the 1990s. These new buildings were planned and projected, and then came onto the market, ready for use, in the first half of the 2000s, when the boom had long since peaked and demand was weakening accordingly. These years were marked by what is colorfully referred to as a “cattle cycle”.

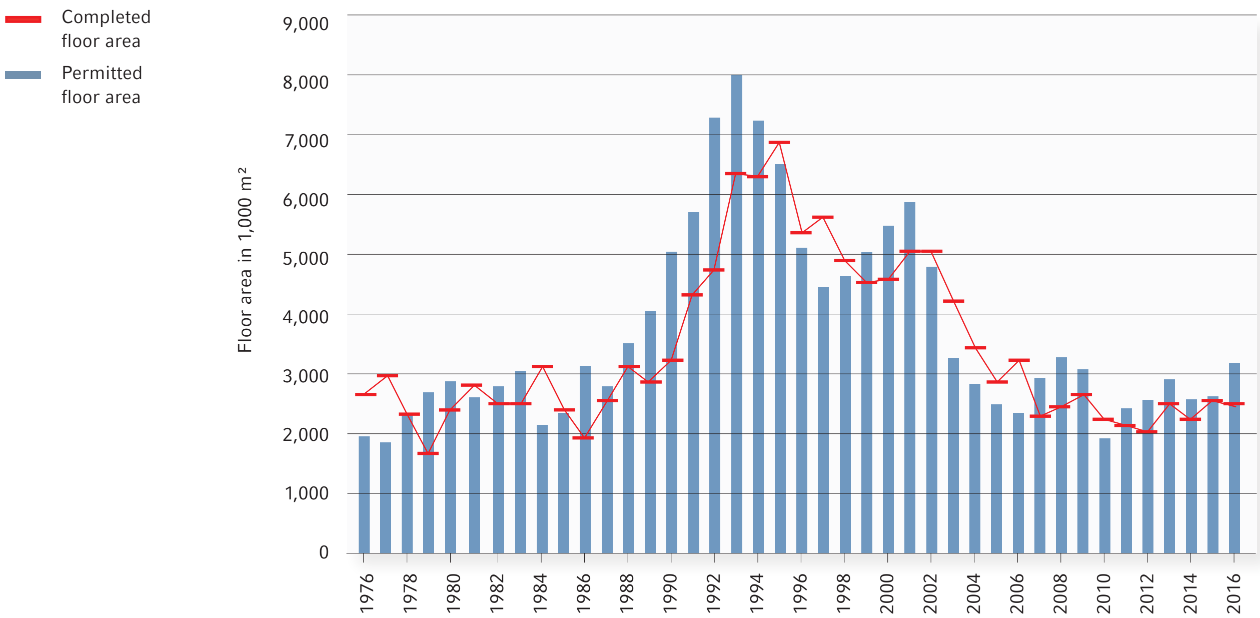
Today – in mid-2017 – less than 5% of office space in the large German office property markets is vacant. It may be assumed that the vacancy rate for Germany as a whole is even lower. This leads us to the conclusion that the situation on the office leasing markets will remain favor-

1) These are the office markets in Berlin, Hamburg, Munich, Cologne, Frankfurt and Stuttgart. The top seven markets are these plus Düsseldorf.

2) In addition, relatively cautious bank lending practices are likely to have played a part in the moderate new construction activity, in line with market conditions.

FIGURE 1

New construction of office buildings in Germany

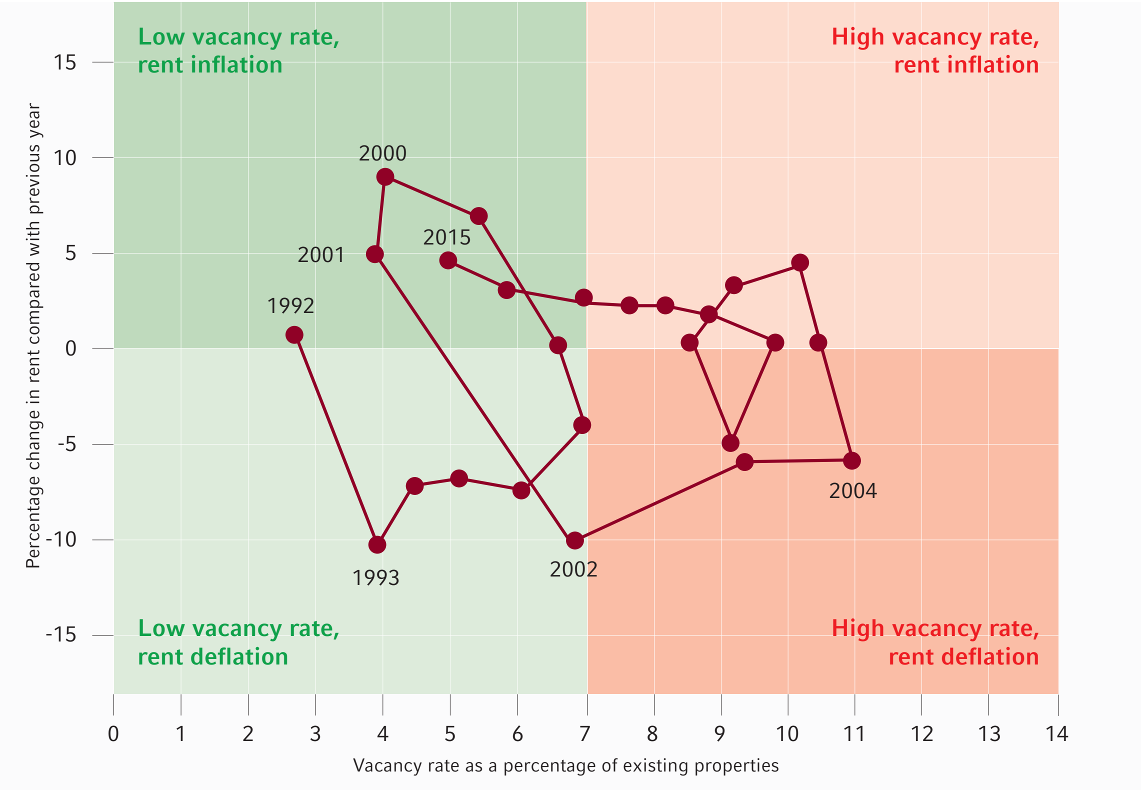


Permits: from 1991 Germany; previously old Federal states
Completions: from 1993 Germany; previously old Federal states

Source: Federal Statistical Office

FIGURE 2

Office vacancy rate and change in office rents



Source: vdpResearch

able for the time being. This is because the low vacancy rate is set, first, against stable demand for offices to let and, second, against subdued new construction activity. The Deutsche Bundesbank, the OECD, the IMF and other institutions estimate that the economic upturn in Germany will continue in the next few years. Moreover, the upturn is sufficient to go on fueling a favorable trend in the labor market. This bolsters demand for office premises, all the more as the upswing is expected to go on beyond the next year or two. At the same time, building permit figures for the next two years point to only moderate new construction activity. In the current year, 2017, the volume of completed floor space will increase slightly, yet not strongly enough to satisfy the additional demand for office space to let. In the near future, therefore, there is only a slight risk that vacancy rates on the German office markets will rise.

The decrease in vacancies over the past years was accompanied by a moderate increase in rents. Figure 2 combines these two developments and illustrates that a relationship exists between vacancy level and rental growth, the idea being: the less floor space that is vacant (i.e. the greater the demand pressure on the office leasing markets is), the more sharply office rents rise. Indeed, the chart shows such an inverse relationship between the level of vacancies (cause) and increases in rent (effect). For 2016, the chart reveals a combination of vacancy rate and rental growth that was last witnessed in 1992, 2000 and 2001. On closer inspection, the current situation is even better than in those years: unlike in 1992 and in 2000/2001 – as mentioned above – new construction activity in the office and administration building sector is extremely moderate and is not characterized by special effects such as German reunification or a wave of speculative investments prompted by the internet boom. In other words, this development, too, suggests that the office leasing markets will remain stable in the years ahead. ■

Investment market

The same cannot be said of the investment market. Since 2010, capital values for office premises in Germany have been rising at a considerably faster pace than new lease rentals. This is demonstrated by both the data of vdpResearch for Germany as a whole and the data of Jones Lang LaSalle (JLL) on trends at Germany's top seven office locations (see Figure 3). A divergence of this kind is not a new phenomenon. Measured against the growth in rents, the investment market tends, time and again, to follow striking or exuberant price cycles. Particularly at the major international office locations, pronounced waves of speculative investments repeatedly led to excessive valuations that were corrected some time later. The difference that has built up in recent years in the German office property markets between developments in rents and values is exceptionally large; it is greater than ever before. What will the consequence be? Can Germany expect to see a correction in the foreseeable future?

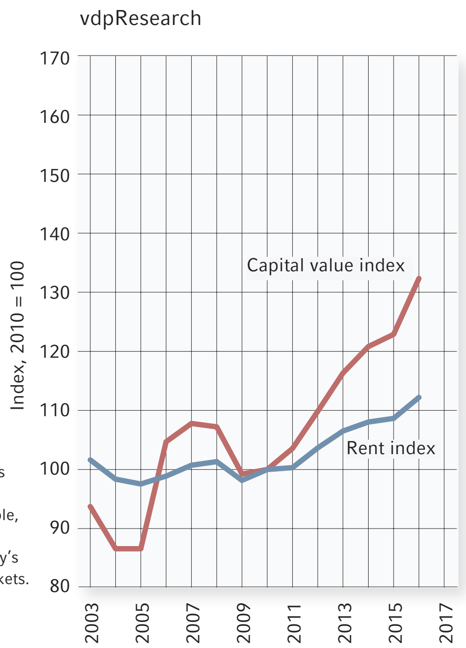
Regarding the current causes of the disproportionately strong rise in capital values (in relation to rental growth), we should first consider a trivial calculation that is based on the definition of capital value used here, whereby the capital value (KW) is equal to the quotient of net income (RE) and cap rate (LZ):

$$KW = \frac{RE}{LZ} = \frac{(M + BEK) - BWK}{LZ}.$$

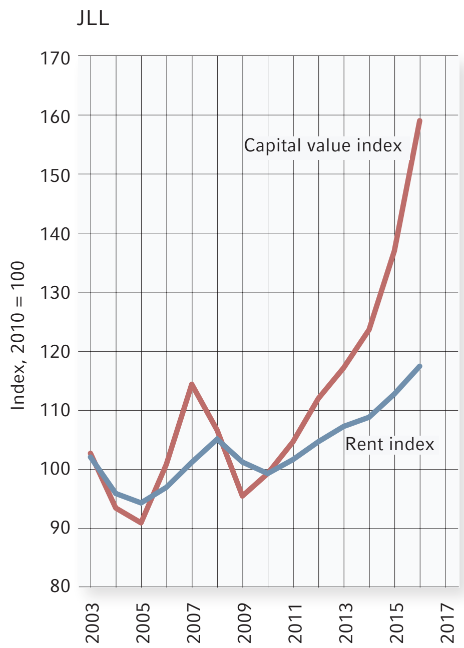
Essentially, net income is equivalent to gross income less management costs (BWK), whereby the gross income is determined by the rent (M) and the operating costs (BEK). If we assume, for simplicity's sake, operating and management costs to be constant, the development of net income is derived solely from rental growth. According to the formula, the capital value goes up as the rent rises and/or the cap rate falls. Bearing in mind, moreover, that the rate of change of a quotient is equal to the difference between the growth rates of the numerator

FIGURE 3

Rental and capital value indices for office properties calculated by vdpResearch and JLL



Remarks: The indices of vdpResearch refer to Germany as a whole, whereas the indices of JLL cover Germany's top seven office markets.



Source: vdpResearch

Source: JLL

and the denominator, i.e.

$$\widehat{KW} = \widehat{M} - \widehat{LZ},$$

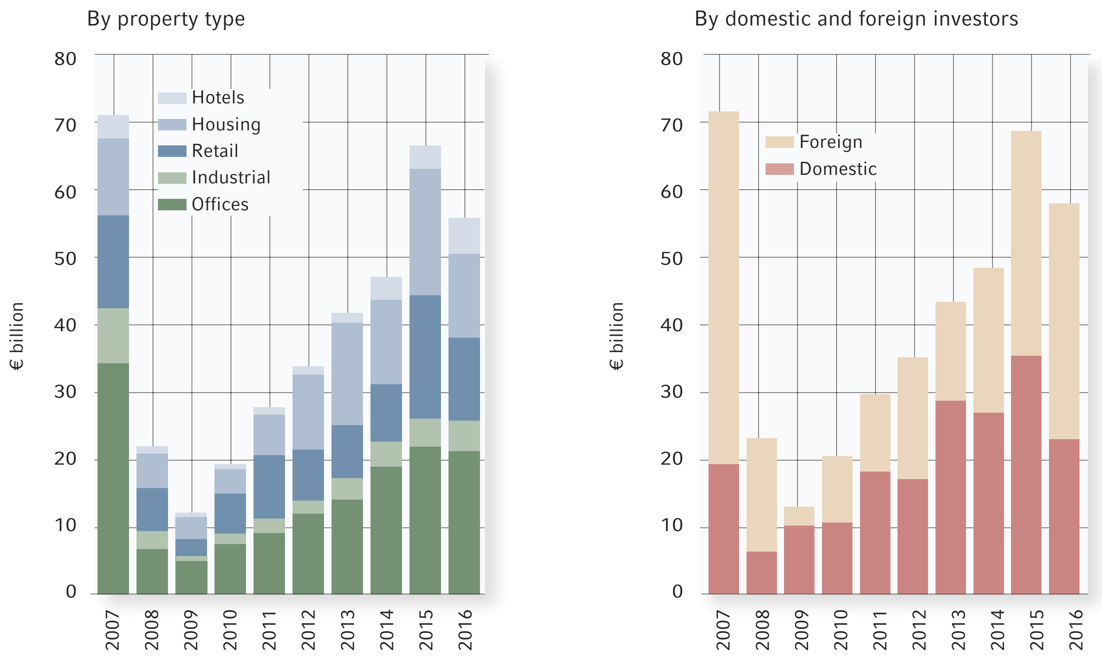
then we see that capital values can only rise more strongly than rents if the cap rate goes down. With regard to current office market developments in Germany as shown in Figure 3, it therefore follows that capital values and rents will only continue to diverge if cap rates in Germany continue to fall. How likely is this, given the very low levels that cap rates have reached in the meantime?

The decline in cap rates in recent years is primarily due to the search for profitable investment opportunities. Against the backdrop of the low-interest-rate environment and the lack of alternatives, real estate is one of the most attractive options for investors. This is illustrated in Figure 4, which shows the property investment volume in billions of euro by property type and broken down according to German and foreign investors. From it, we see that the purchase of investment properties located in Germany was obviously very attractive for many private and institutional investors in recent years. And indeed, decreasing vacancy rates, rising rents and favorable economic prospects do lead to comparatively high cash flows.

But what the above two charts also show is a drop in effective demand in 2016. However, this point and the expected gradual phasing-out of the low-interest-rate policy suggest that cap rates will not continue to fall. This means that the scope for short-lived, disproportionately strong rises in capital values has (largely) been exhausted. In the long term, capital values will, at best, rise with growth in rents. Anything else must mean that cap rates would follow a downward trajectory, which is economically implausible. From this it follows that the question we asked earlier, i.e. whether the growth in capital values can go on over the coming years, must be answered with "no". Rather, capital values can be expected to move sideways, so that a slight increase in rents will gradually close the gap between the rental and the capital value index. ■

FIGURE 4

Property investment volume in Germany



Source: Real Capital Analytics (RCA)

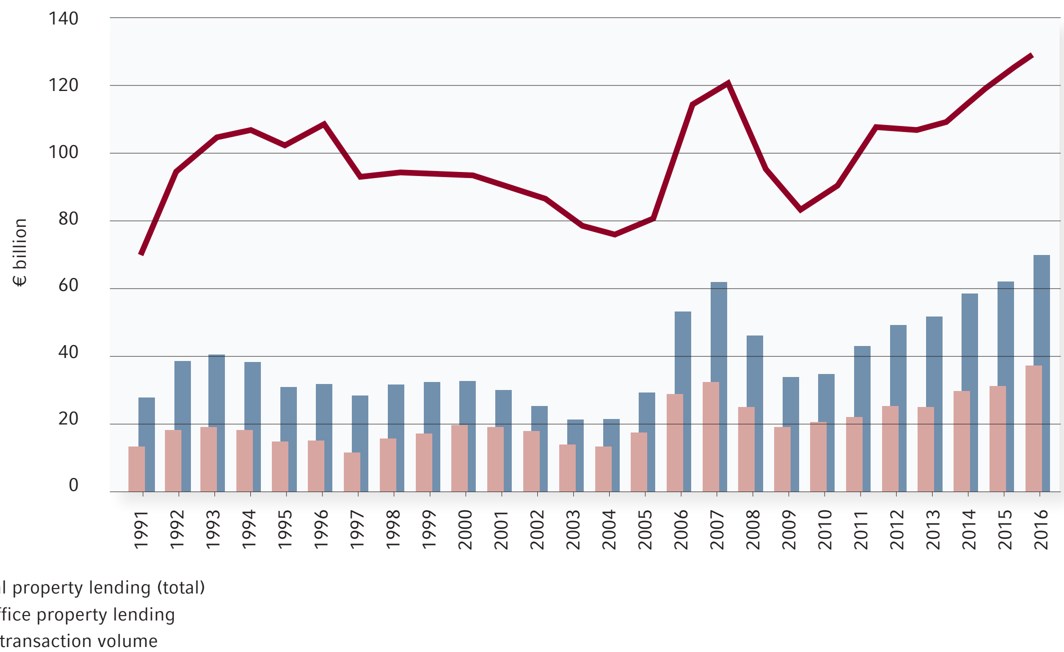
Financing volume

A close relationship generally exists between the real estate and the banking sector. Mortgage-secured bank loans are the most important source of funds for building new or purchasing existing office properties. Figure 5 traces the development of the volume of investments and transactions in the commercial property market as well as the development in new lending to finance commercial properties, both for the market as a whole and for the office property segment in Germany. The chart covers new mortgages granted (i.e. excluding existing loans that were prolonged) by German banks to domestic firms and individuals

The course of the time series on lending reveals a high correlation with the development of the volume of construction and transactions.[3] This suggests that the average share of borrowed capital used to finance commercial properties is rather stable and is subject to fairly low fluctuation. A similar picture is presented by a study conducted by the International Real Estate Business School, IREBS (the German Debt Project 2017), which found that the share of borrowed funds averaged between 64% and 68% in new loan activity for the construction and purchase of office, retail and operator properties over the period 2010 to 2016. Based on the data available here, debt finance accounted on average for around 50% of the financing over the same period. It should be taken into account, however, that this calculation also includes segments such as modernization and maintenance, which require less borrowed capital.

In the course both of the reunification boom in the early 1990s and of the bouts of New Economy euphoria towards the end of the same decade, there were multi-year phases of growth in new loan activity. Com-

FIGURE 5
Financing of commercial properties in Germany 1991-2016



Sources: vdpResearch, Gutachterausschüsse für Grundstückswerte, DIW

[3] Commercial and industrial construction (DIW – German Institute for Economic Research) plus turnover of money on the market for existing properties (vdpResearch based on Regional expert committees for property valuation)

mercial property finance – and with it, office property finance – saw the strongest increase on the eve of the financial market crisis: between 2003 and 2007, the volume of new lending was almost tripled. After dropping sharply in 2008 and 2009, loan disbursements have proceeded on a clear upward path since 2010. Between 2011 and 2016, disbursements rose at an average rate of 10.2% per year. In total, loans of around €70 billion were granted to finance the construction and purchase of commercial properties in 2016. This is the highest volume of new lending in this business area since statistical recording began.

Growth in commercial property finance is largely driven by developments in the largest market segment: office properties. Lending for this property type has likewise risen continuously since the financial market crisis, advancing from around €18 billion (2009) to around €36 billion (2016). ■

Conclusion

In view of the up-beat economic framework conditions and the moderate new construction activity seen in the office property market in recent years, there is little risk that vacancy levels in the German office property market will rise in the near future. The leasing market may be considered to be in a very good state of health.

The situation is somewhat different in the investment market. In the last years, capital values have risen considerably more strongly than new lease rentals where office properties are concerned, which is attributable to a correspondingly strong decline in cap rates. This, in turn, is largely due to the search for profitable investments. However, cap rates cannot be expected to keep falling in the quarters ahead. At best, therefore, it will only be possible for capital values to rise with rental growth in the medium to long term.

Price corrections in the commercial property market can impact negatively on the market for commercial property finance. This is particularly true when commercial properties are financed with very little or no own capital. Although the granting of commercial property credit has risen sharply in recent years, the financing structures have seen only little change; own capital continues to play an important part in financing.

This development is unlikely to entail any unusual uncertainties for banks provided they continue to pursue a safety-oriented financing policy. However, a risk does exist for investors that capital values for office premises could fall back to the current level if the framework conditions deteriorate. ■

The member institutions of the Association of German Pfandbrief Banks (Verband deutscher Pfandbriefbanken, vdp) have been the market leaders in commercial real estate finance in Germany and hold sizeable market shares in residential real estate finance as well. As the representative of its member banks, the vdp performs this function vis-à-vis all executive bodies of politics on both the national and the European stage and a wider public.

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Figures provided by vdpResearch are regarded by numerous banks as a crucial tool for valuing and assessing property and market risks. The Germany-wide real estate price indices which it prepares for the Association of German Pfandbrief Banks are also directed at interested members of the public. These provide an overview of general trends in real estate prices in Germany.

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