SPOTLIGHT

Real Estate Market

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Real Estate Market in Germany in early 2019

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The German
Pfandbrief Banks

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A year ago, I began this report by writing that residential and office properties were expensive and in short supply, especially in Germany's flourishing urban concentrations. Nothing has changed in this respect in the past 12 months – except that rents, prices and capital values are now even higher than at the beginning of 2018.

There are good reasons why inflation on the housing and office markets has persisted and will probably continue for the time being, at least to some extent:

1. Residential and office space is still difficult to secure, there are a lot of prospective customers and supply is scarce. The construction of new residential and office properties barely provided any relief last year. As a result, vacancy rates remain low on both the housing and office markets, not everywhere, but particularly where rental space is currently in demand and needed.

2. Residential and office properties were also very much sought-after last year as investment properties. Fuelled by persistently low interest rates and a lack of investment alternatives, a propensity to buy continued. Although there was a reduction in the number of property transactions, this was not due to a lack of buying interest but rather because fewer owners were prepared to liquidate their properties despite higher prices. Interest rates are unlikely to make an upward leap, although macroeconomic developments could dampen demand and the willingness to invest somewhat.

By focusing on selected indicators, the following pages provide an up-to-date overview of movements in the housing and office property markets in Germany. Given how sensitive real estate markets are to the economic situation, this overview is preceded by a summary of macroeconomic conditions. As can be seen, economic growth as well as the trends in consumer prices, incomes, employment and interest rates are key factors behind the current boom in the real estate market.

Macroeconomic developments

> All in all, the economic background is solid and the interest-rate setting remains expansionary.

Last year, the German economy performed below expectations. Exceptional factors in the automotive industry and less favourable foreign trade conditions caused economic growth to lose momentum. Over the year as a whole, real gross domestic product (GDP) rose by only 1.5% in 2018, following a gain of more than 2% in each of the previous two years. Nevertheless, there were some positive trends: employment rose strongly again and the unemployment rate fell to its lowest level since 1989.

In all probability, the German economy will continue to expand moderately in 2019 and 2020. The German Council of Economic Experts forecasts GDP growth of 1.5%. The Deutsche Bundesbank is forecasting an increase in real GDP of 1.6% this year and next. Others, such as the Federal Ministry for Economic Affairs and Energy, predict GDP growth of only 1% (2019). They all expect domestic demand to provide positive impetus, while net exports (balance of exports and imports) are seen as a factor putting the brakes on growth due to a significant increase in imports. It should also be emphasised that all of the forecasts predict that the positive trend in employment will continue.

From the beginning of 2010 until the end of 2018, the number of people in employment rose by a total of 4.1 million, while the unemployment rate fell from just under 8% to below 5%. Migration was one of the main factors fuelling job creation during this period. According to the Council of Economic Experts, the number of foreigners in employment subject to social security contributions rose by almost 2 million to the present level of 3.5 million. Without labour migration, the sharp rise in employment would not have been possible. In the current and coming year, the number of people in employment will rise by 0.8% and 0.5% respectively, according to forecasts by the Deutsche Bundesbank. The result could indeed turn out to be better, as bottlenecks in the labour market are increasingly limiting growth opportunities. This is becoming particularly evident in the construction industry.

The current yield on long-dated German sovereign bonds was already close to zero in 2016: this was as low as it could possibly go. 2017 saw a slight rise, while there was a marginal increase in 2018 looking at the year on average. At the end of 2018, public-sector bonds with a residual maturity of between nine and ten years were again yielding 0.2%. This low figure does not constitute a normalisation of interest rates, especially since inflation is around the 2% mark.

All in all, the economic background is solid and the interest-rate setting remains expansionary. This will be a contributing factor in sustaining demand for housing and offices. Economic growth and low interest rates have already been the main driving forces over the past few years.

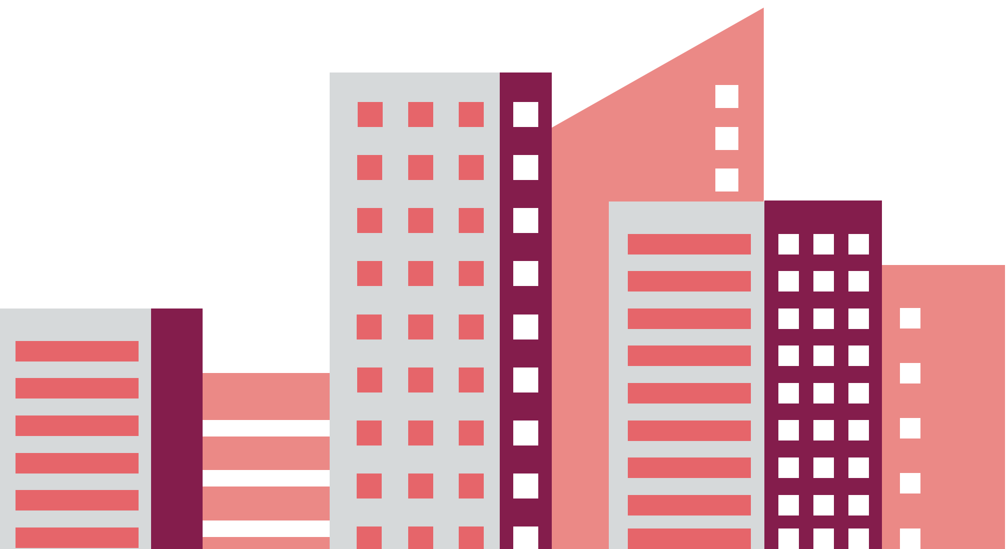
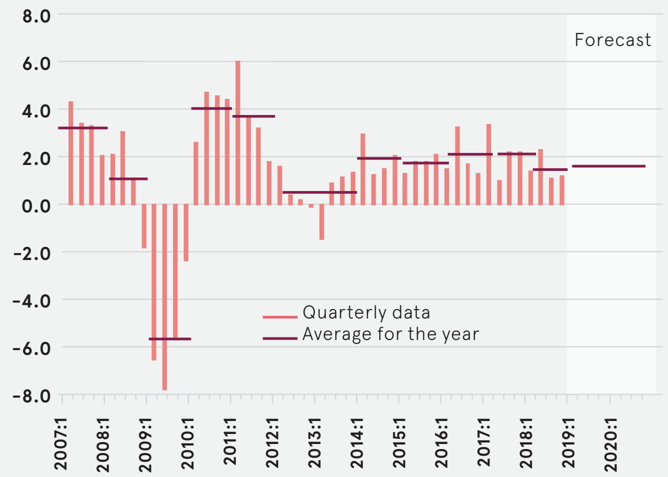


Figure 1: Indicators of macroeconomic development

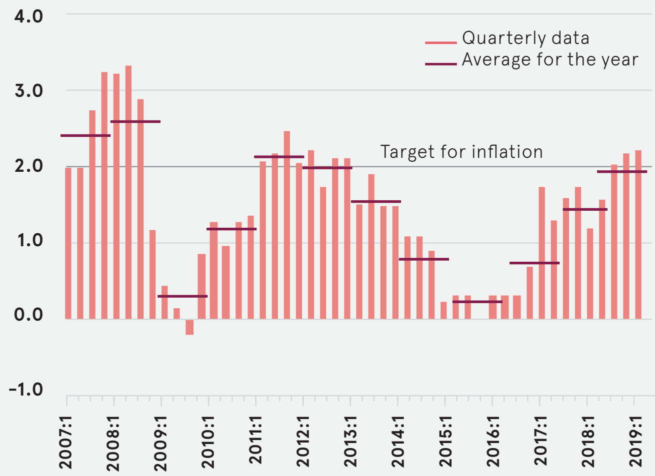
Real gross domestic product

Percentage change compared with corresponding period one year earlier



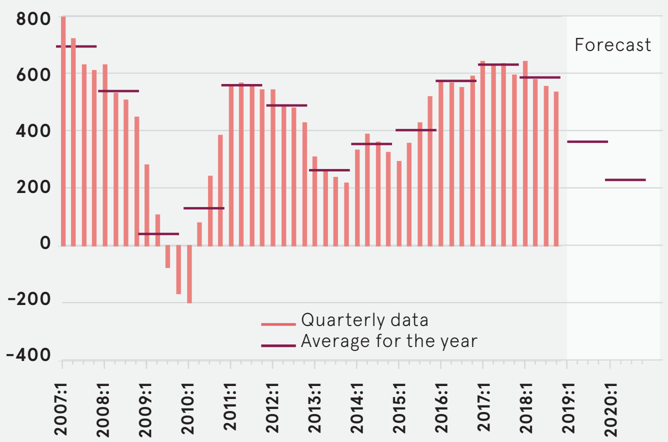
Consumer prices

Percentage change compared with corresponding period one year earlier



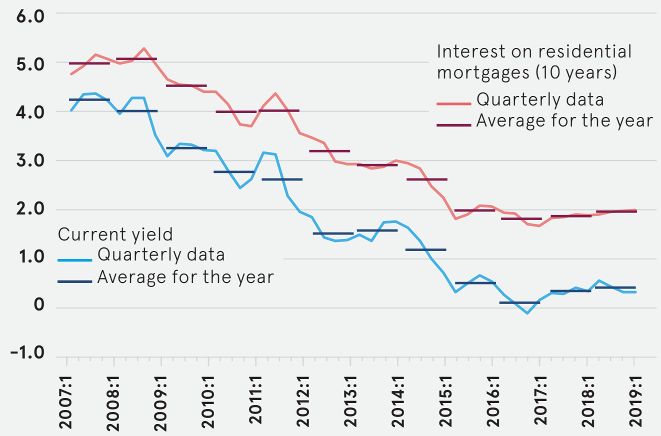
Working population

Change compared to same period in previous year, in thousands



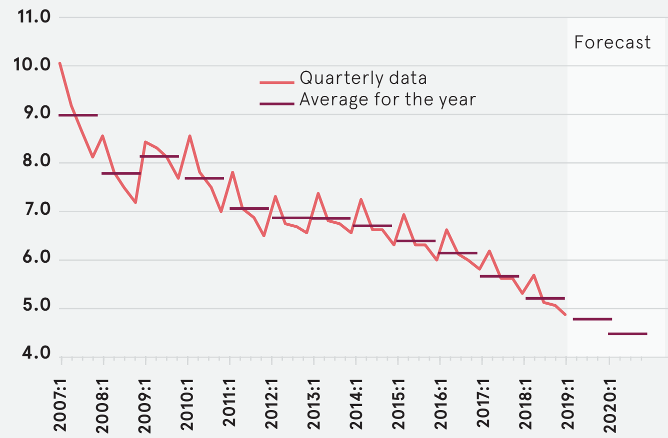
Current yield on sovereign bonds and interest on residential mortgages

As a percentage



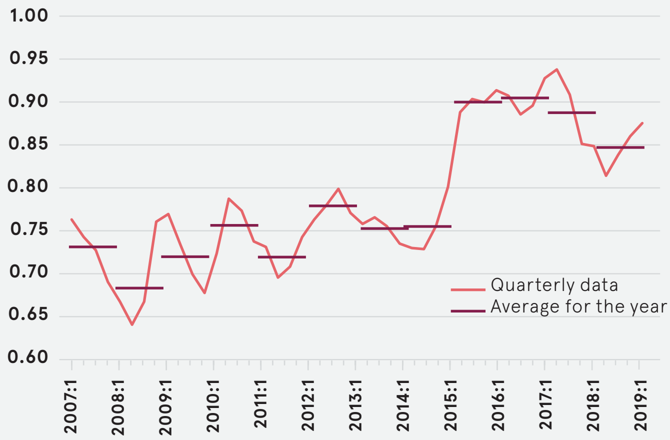
Unemployment rate

As a percentage



Exchange rates

Euro per dollar



For explanations and sources, see annex, pages 10 and 11.

Housing market

Prices for residential properties rose significantly again in 2018. The vdp property price index for single-family and two-family houses rose by 8.2% and for condominiums by 5.8% on average for the year. In addition, capital values for rental multi-family houses increased by 9%. Yet index figures for Germany's top seven cities (Berlin, Hamburg, Munich, Cologne, Frankfurt, Stuttgart and Düsseldorf) rank far above these nationwide figures. Prices for condominiums in these locations rose by 8%, with capital values for multi-family houses climbing by 10.4%.

How can the sharp rise in prices last year be explained, and how can further trends be estimated against the background of the current rent and price levels? While rents for new tenancy agreements are mainly determined by supply and demand for rental apartments, the trend in purchase prices results from conditions on the markets for "second-hand" residential properties. In these markets, the number of purchases has been stagnating for several years, with only the amount of money being transacted increasing significantly in line with rising prices. Although the owners of residential real estate in and around the "popular" cities are much richer on paper today than they were a few years ago due to the rise in prices, the potential profits are not being taken. There is a lack of willingness to sell, or the other way around: despite the high prices, the efforts of potential buyers to acquire residential property are not finding much favour.

The reasons for this reluctance to sell are not clear. As a rule, owner-occupiers have no choice but to remain living within their own four walls; because it is precisely where apartments are scarce and expensive that supply is low, both on the rental market and on the property ownership market. In the case of those for whom the apartment or house is primarily an investment, there are also good reasons for keeping the property in their portfolio: a) There is a lack of alternative investment opportunities. The acquisition of other properties only leads to high transaction costs; b) If it is expected that the sustained demand will trigger further price increases, selling is not a very attractive option, even with rising prices and stable demand. This is because the money generated by a sale must in turn be re-invested.

Germany's top seven cities:

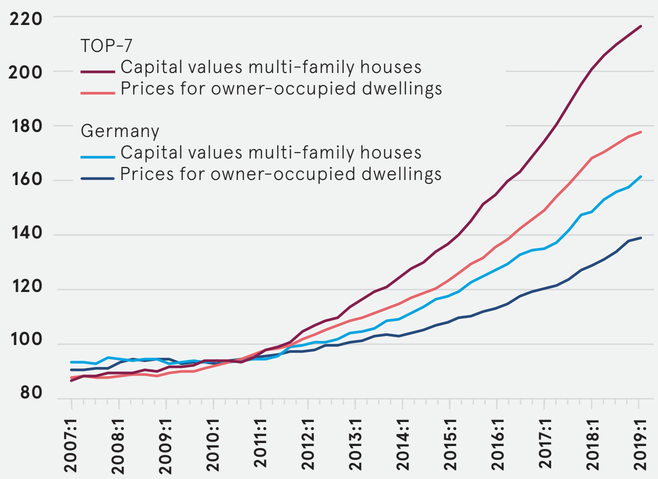
> Prices for condominiums in these locations rose by 8 %, with capital values for multi-family houses climbing by 10.4 %.

The rise in prices is largely attributable to two factors, tight regional housing markets and low interest rates. The tense housing markets are leading to rising rents, while low interest rates are driving the strong demand for residential property, for use both as a home and for investment purposes. If we want to slow down the dynamic rent development in the prospering regions by addressing the root causes, it will be necessary to ease the chronically strained housing markets in the main cities of these regions. Since there are only limited options available for redistributing demand for housing in a market that is tighter in some regions than in others, the only other approach to ease the situation is to address housing supply. This requires a significant increase in supply through the construction of new apartments. Despite the marked increase seen since 2010, building permits and completions have so far not been sufficient to meet demand. This is clearly evident from the housing vacancy rate, which is very low in many cities. The Federal Association of German Housing and Real Estate Companies (GdW)'s latest market description for the city states of Hamburg, Bremen and Berlin shows vacancy rates of 0.9%, 1.4% and 1.6% respectively. New construction reaching the market this year will not change this situation. Although various cities now have a considerable volume of dwellings not yet started or already under construction, the high degree of capacity utilisation in the construction industry alone means that it is currently not possible to construct new buildings at a rate that some fear will be excessive.

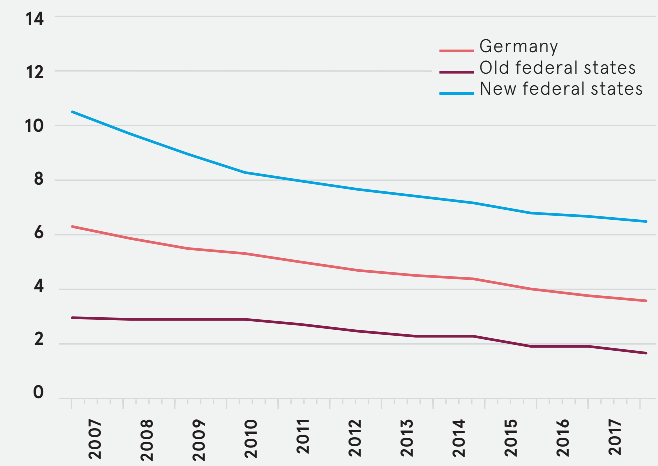
So what options remain? It is expected that the rental markets will remain tight in the current year, despite an

Figure 2: Housing market indicators

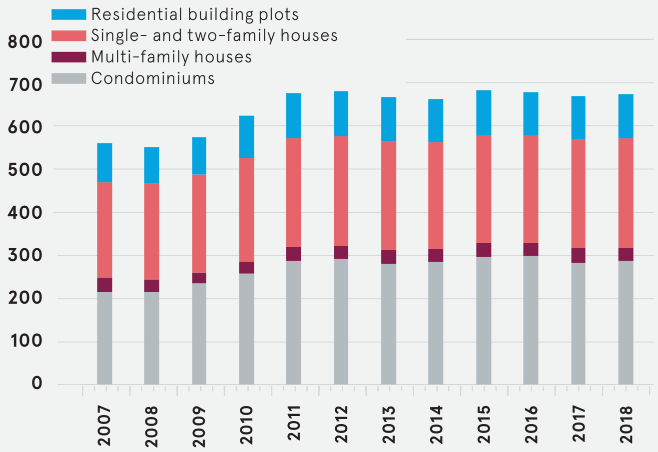
Prices and capital values residential properties
Index, 2010 =100



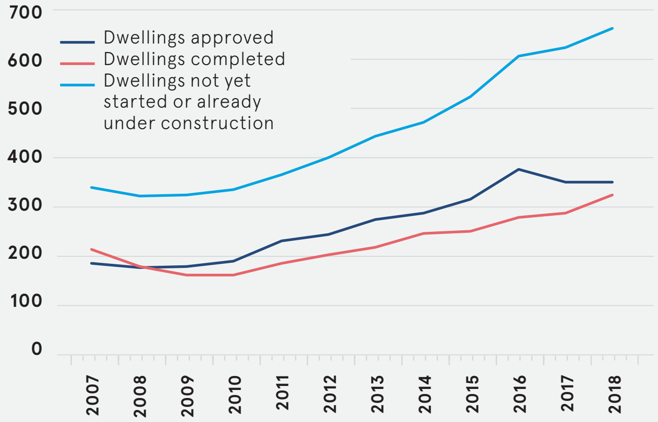
Vacancies in % of housing stock



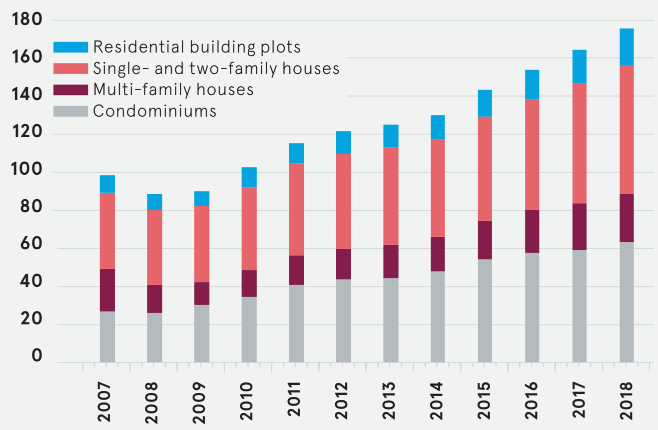
Sales volume in the market for existing properties
in thousands



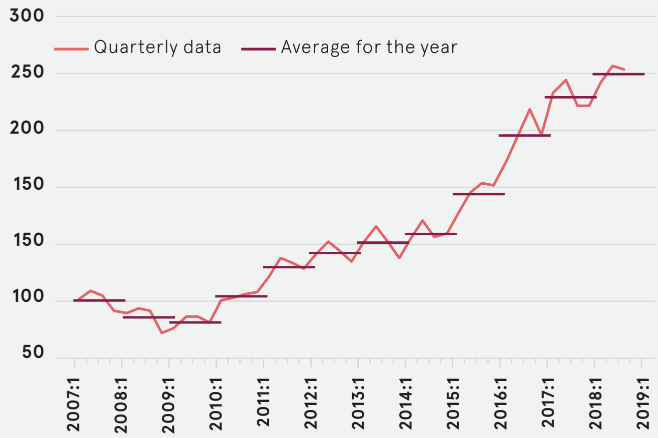
Dwellings not yet started or already under construction, approved and completed,
in thousands



Sales volume in the market for existing properties
In € bn



Orders on hand residential construction
Volume index, 2010 = 100



For explanations and sources, see annex, pages 10 and 11.

> In view of low interest rates, residential real estate is highly attractive as an asset for both investors and private households.

increase in new construction activity. On the one hand, this will mean that the frequency at which people move house will remain at the current low level; relocation leads to new tenancy agreements, which generally result in a higher rent. On the other hand, rents under new tenancy agreements will continue to rise and, with a time lag, lead to higher rents for ongoing tenancy agreements. From a social perspective, it is hoped that the rise in rents will remain moderate. A decline in rents under new tenancy agreements is not expected.

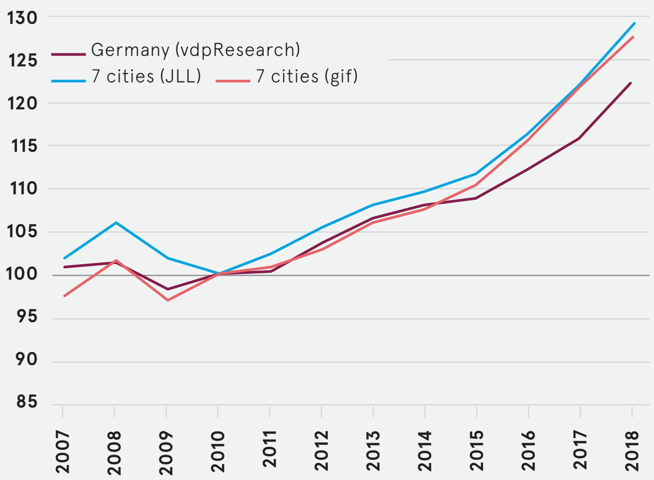
This brings us to the second main reason for the sharp rise in prices: low interest rates. Firstly, they make residential property ownership more affordable and thus indirectly reinforce the price trend via demand for property. Secondly, interest rates have a direct price effect. For owner-occupiers, the price of an apartment can be understood as the present value of the rental payments saved in the future. The discount factor used to determine the net present value of saved rental payments is influenced by current interest rates. Low interest rates go hand in hand with a low discount factor under otherwise identical conditions. A low discount factor leads to high prices for given rents, a falling discount factor to rising prices. Thirdly: home ownership serving as an investment is compared with investment alternatives. In view of low interest rates, residential real estate is highly attractive as an asset for both investors and private households if it promises higher returns than, for example, bank deposits or securities such as government bonds and equity investments. This is clearly the case at the moment if we consider the housing market as a whole.

= Conclusion

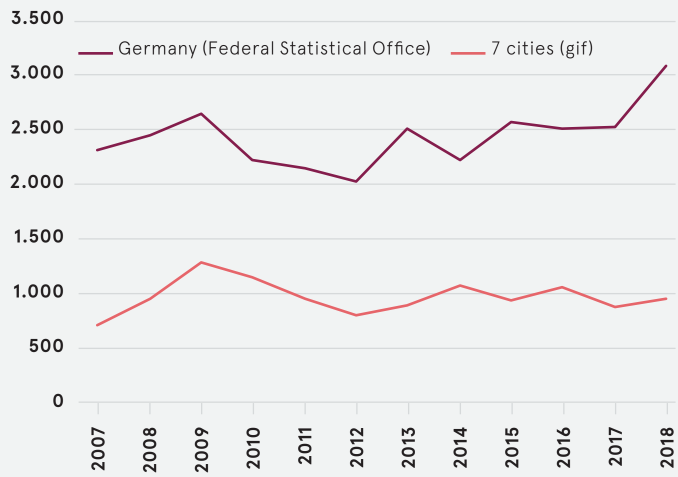
It is not possible at present to predict whether credit and capital market interest rates will rise in 2019. Current trends suggest the opposite. Interest rates having started to rise very slightly in the course of 2017 and 2018, they have edged downward again since the end of 2018/beginning of 2019. A turnaround in interest rates is evidently not imminent in one direction or the other. This means that the purchase of residential real estate should remain attractive for the time being, without any additional impetus or restraining influences from the interest rate side. Should interest rates remain at roughly the current level in the near future, we therefore assume, bearing in mind expected economic growth, that the rise in prices will lose momentum. We expect prices to rise in line with the increase in rents.

Figure 3: Office market indicators

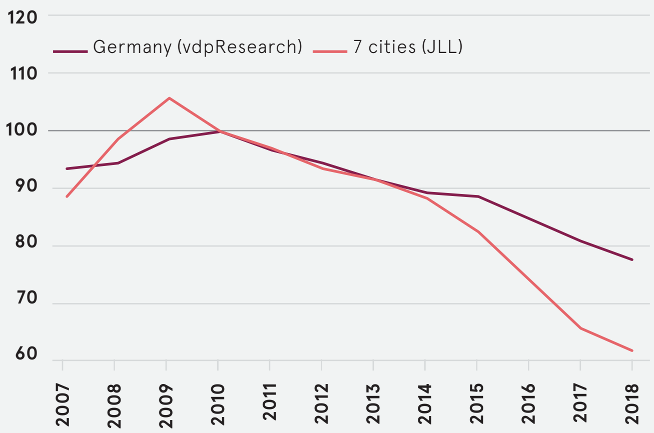
Office rents
Index, 2010 =100



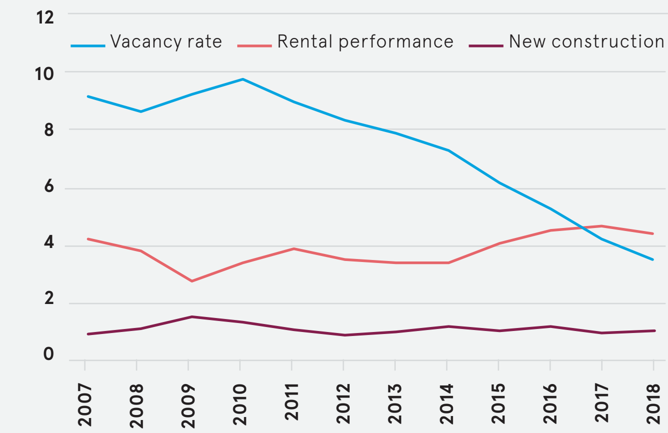
New construction
In 1,000 m²



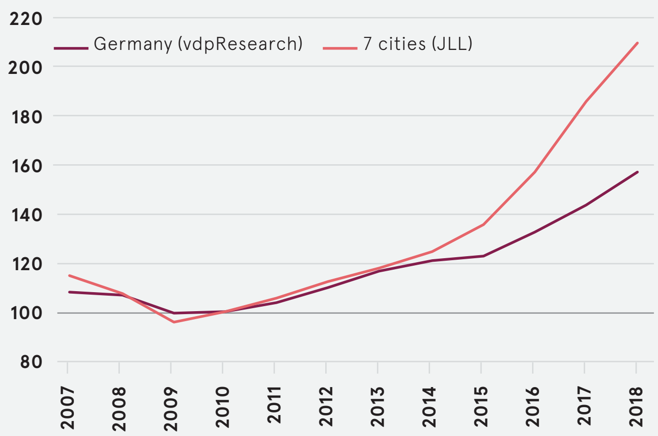
Cap rates
2010 = 100



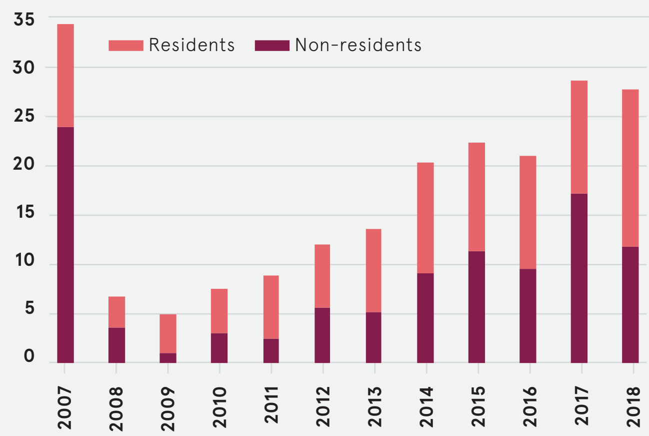
New construction, rental performance and vacancy rate
As % of existing properties



Capital values
2010 = 100



Investment volume
In € bn



For explanations and sources, see annex, pages 10 and 11.

Office property market

The demand for office space is essentially determined by trends in service sector jobs. As indicated at the start of this report, this trend is unequivocally expansive. When looking at the office market, this can be clearly seen from the indicators "Rental performance" and "Vacancy rate". Last year, strong employment once again resulted in comparatively high rental performance. Since at the same time, creation of new office space has been below demand, vacancy rates have fallen once again. At the end of 2018, less than 5% of office space in Germany was vacant; in the seven largest German office markets, the weighted average vacancy rate in 2018 was only around 3 %. In other words, availability on the office space market has dried up in the prospering conurbations.

This situation is increasingly having an impact on the level and development of office rents. Various sources indicate that office rents have recently risen sharply as momentum has picked up. The prime rent indices of Gesellschaft für Immobilienwirtschaftliche Forschung (gif) and of JLL and the much broader vdpResearch index all show substantial growth rates. According to gif, rents rose by 5.1 % in the course of 2018 and JLL puts growth at 7% for the period from the end of 2017 to the end of 2018. The vdpResearch results, which indicate an increase in rents of 5.5%, are similar, albeit not quite as high.

Office rents will continue to rise in 2019. Although a generally weaker macroeconomic performance will slow the pace of employment growth and reduce the need for additional new office space, overall demand for space and the relevant occupancy rates remain high. The upturn in new construction activity, which is reflected in the current plans and building permits, will not be sufficient to provide any general market relief for the time being. Firstly, much of the space that is planned or under construction already has a high level of preletting. Secondly, the overall completion volume is not high enough, especially since capacity bottlenecks in the building trade are slowing the pace of new construction.

As far as the investment market is concerned, it should be noted first and foremost that capital values of office properties located in Germany again rose at a faster pace than rents in 2018. This ongoing divergence is due to falling initial yields (cap rates, net initial yields). Two factors are crucial in this respect, ongoing low interest rates and the associated quest by institutional investors to find real estate investments offering higher returns. Last year there was hardly any movement in interest rates, as mentioned above, while total investment in the office market, which had risen sharply in previous years, fell only slightly from a very high level.

= Conclusion

So what will investment markets look like in the future? Firstly, vacancy rates on office space markets are and will remain low, and rents will, in all probability, rise further. This means that the total cash flow that office properties will generate in the current year will be higher than in the previous year. In addition, there are no indications that interest rate levels will rise. Taken together, this suggests stable demand over the short term for investment properties on the office markets, even though purchase prices are already very high. This could, in turn, mean that initial yields will drop slightly again, further widening the gap between rents and capital values.

In view of the gap that already exists, however, the question that is increasingly being posed is: can this gap remain as it is, or will there be a correction in the foreseeable future? It is virtually impossible to answer this question. Firstly, it is impossible to estimate how long the low interest rate level will last. Secondly, up until now, there is no experience of the impact of persistently low interest rates on the (risk) behaviour of real estate investors in office markets. As a result, it is essential to keep a close eye on further developments. Generally speaking, there are signs of more cautious investor behaviour. The pace of decline in initial yields has slowed of late.

Indicators	Sources
Figure 1	
Real gross domestic product (year-on-year-change in %)	
▪ Historical development	Federal Statistical Office
▪ Forecast for 2019 and 2020	Deutsche Bundesbank
Working population (year-on-year change in thousands)	
▪ Historical development	Federal Statistical Office
▪ Forecast for 2019 and 2020	Deutsche Bundesbank
Unemployment rate (unemployed persons as % of civilian labour force)	
▪ Historical development	Federal Employment Agency
▪ Forecast for 2019 and 2020	Deutsche Bundesbank
Consumer prices (year-on-year change in %)	Federal Statistical Office
Current yield in sovereign bonds and interest on residential mortgages (in %)	
Interest on residential mortgages (10 years)	Deutsche Bundesbank
Current yield on public-sector bonds (residual term 9 to 10 years)	OECD
Exchange rate (Euro per dollar)	OECD
Figure 2	
Prices and capital values for residential properties	
▪ Owner-occupied dwellings, Germany (index, 2010=100)	vdpResearch
▪ Owner-occupied dwellings, top 7 (index, 2010 =100)	vdpResearch
▪ Multi-family houses, Germany (index, 2010=100)	vdpResearch
▪ Multi-family houses, top 7 (index, 2010 =100)	vdpResearch
Sales volume in the market for existing properties (in thousands) Number of sales in at arm's length transactions which were calculated on the basis of data provided by local expert committees for property values and vdpResearch projections.	vdpResearch
Sales volume in the market for existing properties (in € bn) Sales volume in at arm's length transactions which were calculated on the basis of data provided by local expert committees for property values and vdpResearch projections.	vdpResearch
Vacancies in % of housing stock	
▪ Old federal states	GdW
▪ New federal states	GdW
▪ Germany	GdW
Dwellings not yet started or already under construction, approved and completed (in thousands) The data for 2018 were estimated by vdpResearch.	Federal Statistical Office
Orders on hand residential construction (2010 =100)	Federal Statistical Office

Indicators	Sources
Figure 3	
Office rents (2010 = 100)	
■ Germany Index for new lease rentals in a good location for office properties in Germany as a whole (average for the year).	vdpResearch
■ 7 cities Stock-weighted index for prime rents in the cities Berlin, Hamburg, Munich, Cologne, Frankfurt, Düsseldorf and Stuttgart.	JLL
■ 7 cities Stock-weighted index for prime rents in the cities Berlin, Hamburg, Munich, Cologne, Frankfurt, Düsseldorf and Stuttgart.	gif
Initial yields (2010 = 100)	
■ Germany Cap rate index for office properties in Germany in a good location (average for the year).	vdpResearch
■ 7 cities Aggregate index of net initial yields for office properties in prime locations (prime rents) in the cities Berlin, Hamburg, Munich, Cologne, Frankfurt, Düsseldorf and Stuttgart.	JLL
Capital values (2010 = 100)	
■ Germany Ratio of rent index (Germany) to cap rate index (Germany).	vdpResearch
■ 7 cities Ratio of rent index (7 cities) to index of net initial yields (7 cities).	JLL, vdpResearch calculations
New construction (in 1,000 qm)	
■ Germany Completed office and administrative buildings in Germany (total) in 1,000m² floor space. The data for 2018 were estimated by vdpResearch on the basis of building permits using a realisation function. The realisation function shows the relationship between building permits and completed buildings.	Federal Statistical Office
■ 7 cities Completions of office space in 1,000m² rental space in the cities Berlin, Hamburg, Munich, Cologne, Frankfurt, Düsseldorf and Stuttgart. The figure for 2015 is based on the results of a survey conducted by gif.	gif
New construction, rental performance and vacancy rate (in %) ■ New construction, rental performance and vacancy rate in % of stock of office space in the cities Berlin, Hamburg, Munich, Cologne, Frankfurt, Düsseldorf and Stuttgart.	gif, vdpResearch calculations
Investment volume (in € bn) Purchases of properties and property portfolios equal to or greater than € 5 million. Only office properties are included in the purchases.	RCA

Association of German Pfandbrief Banks

The member institutions which together make up the Association of German Pfandbrief Banks (vdp) have for years now led the market in commercial property financing in Germany and also hold considerable market shares in the financing of residential properties. As their representative, the vdp looks after the Pfandbrief banks' interests in dealings with national and European decision-making bodies as well as with a broad professional public.

The vdp's expertise is geared to the specific requirements of Pfandbrief issuers in terms of the Pfandbrief itself and loans which are eligible as cover assets. Moreover, the vdp promotes the concerns of its members in regulatory matters and represents them vis-à-vis national and European supervisory authorities. Member banks' Pfandbrief-related information and experiences are exchanged within the vdp's respective bodies with a view to developing market standards. Additionally, the vdp provides its members with business solutions to support the Pfandbrief banks in their specific lending and issuing activities.

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vdpResearch GmbH

vdpResearch GmbH, a subsidiary of the Association of German Pfandbrief Banks (vdp), works intensively on compiling, analyzing and forecasting property prices in the context of real estate financing. To this end, vdpResearch examines not only individual properties but also entire property markets. Thus, its remit covers providing comparative prices, comparative rents and other valuation criteria for property markets as well as recording and forecasting market prices by key property types at the regional and national level. In its activities, vdpResearch makes use of specially developed analysis tools and comprehensive models designed to study aggregate market trends.

The figures compiled by vdpResearch are today a vital component for many credit institutions in evaluating and assessing property and market risk. The nationwide property price indices that vdpResearch prepares for the vdp are geared to an interested public and offer an overview of general price trends in Germany's real estate markets.

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