Alternatives Research
Real Estate

February 2022

DWS

GERMANY REAL ESTATE STRATEGIC OUTLOOK

First Quarter 2022

IN A NUTSHELL

- Supply chain disruption, rising inflation and the spread of the Omicron variant pose short-term risks for the economy, but we remain positive on the longer-term outlook for real estate, backed by strong market fundamentals and a sustained yield premium over other fixed income assets.
- Our main investment focus remains on regional and life-long residential assets, which we believe will provide the highest risk-adjusted returns.
- ESG dynamics should accelerate office portfolio adjustments towards sustainable and future-proof stock, and we favour creating these assets through refurbishment. Current investment sentiment could allow for divestment of ageing logistic assets at record low yields.

We maintain our positive view on the German economy despite short-term headwinds from the spread of the Omicron variant, supply issues and rising inflation, which reached 5.3% year-on-year in December 2021[1]. However, pent-up demand, accommodative fiscal policy, an advanced vaccination rate (which now stands at 71.4%[2]) and an expectation of easing supply bottlenecks mean the outlook is likely to brighten later this year, resulting in an expected real GDP growth rate of 4.8% in 2022.[3]

In the real estate market, a gradual recovery is already setting in. There is still some uncertainty over the exact future path of the office market, but with polarisation between prime and secondary stock likely to intensify, we expect strong outperformance from future-proof office assets in the best locations. In addition, the residential sector remains our top performer, driven by strong letting markets, while the logistics sector remains in high demand, putting significant upwards pressure on pricing. The full recovery of the German hotel market was once again postponed due to yet another wave of Covid-19 infections, although domestic tourism continues to drive demand.

Next Generation Offices to benefit from ESG dynamics

Investors remain confident in the German office market. Vacancy rates in the top-seven office markets edged up during 2021, but take-up and rent growth both started to recover – albeit from a low base. However, polarisation within the largest office markets continued during the second half of the year, reflected in a widening price gap between prime and secondary locations.[4] Rising demand for high-quality office assets in major cities is being fuelled by factors such as ESG considerations and a stronger tenant focus on location.

[1] Destatis, January 2022.
[2] Bundesministerium für Gesundheit, 12/2021 (full vaccination).
[3] DWS, November 2021.
[4] RCA, September 2021.

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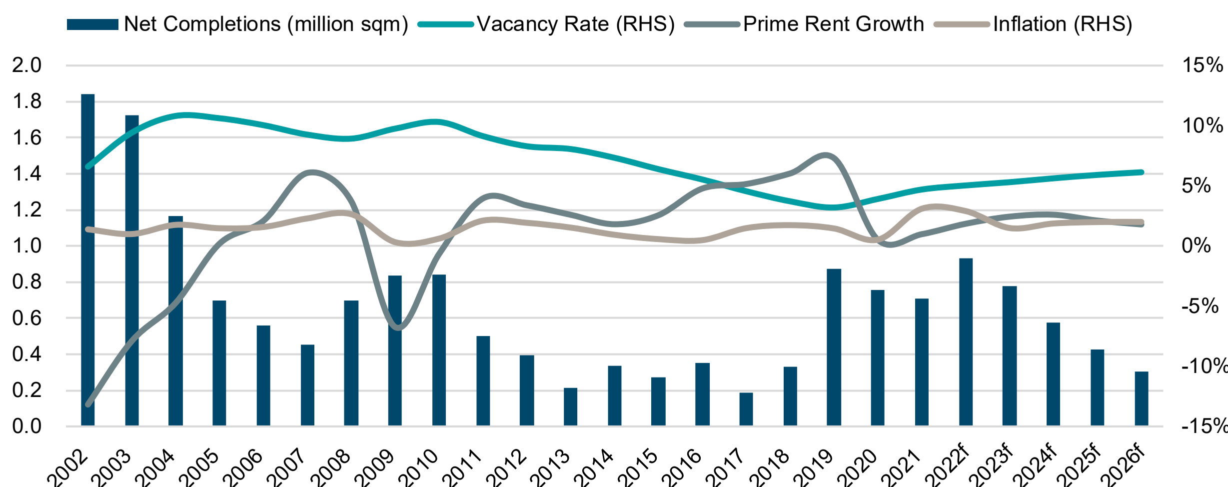
More selective occupier demand is underlined by mainly stable grade A vacancy rates in prime locations, while availability is generally increasing in inferior locations, although remaining low in a historical context.[5] With lower overall demand we expect average vacancy rates to trend upwards in the coming years, although inflationary pressure could have a dampening effect on supply here, with net completions expected to peak in 2022 – driven largely by Berlin. As such, at the prime end of the market we are forecasting rental growth of 2.2% p.a. over the next five years, significantly outperforming weaker assets and locations.

German Top-Seven Office Occupier Market



Source: DWS, Oxford Economics, January 2022. F = Forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not indicative of future returns.

In this regard, our investment focus rests on creating Next Generation offices in tech hubs and high-productivity markets such as Berlin, Munich and Frankfurt. Reducing carbon output by upgrading existing stock to ESG-compliant, best-in-class buildings could provide additional return as demand for high quality assets increases, as shown by high pre-letting rates of around 50% among the top-seven markets.[6] With more low-quality stock likely to become obsolete due to fading tenant demand, this should reduce overall supply and support rents from mid-market through to the prime segment. As such, portfolio optimisation, asset rotation and divestments should become increasingly important in the coming years.

Strong investor sentiment towards German offices and high levels of dry powder looks likely to lead to further capital inflows. Despite ECB tapering, with inflation still forecast to be somewhat transitory, monetary policy tightening is expected to be gradual. And while we see rising bond yields over the medium-to-long-term leading to some outward real estate yield shift, this should be cushioned in part by today's large yield spread.

Residential investments remain on the agenda; logistics running hot

Residential and logistics investments currently rank highly on investor wish lists and are both experiencing significant demand as resilience in these sectors during the crisis attracted new investors. This has weighed on yields already during the pandemic, and we expect this trend to continue in medium term as more capital flows into the market.

We forecast residential rents for new build stock to increase by more than 3.0% p.a. over the next decade and prime logistics rents to grow at 1.9% p.a. However, with residential yields heading towards 2.00% in some markets and prime corridor logistics close to 3.00%, this requires an increasingly selective approach to investment.

[5] PMA, October 2022.
[6] JLL, January 2022.

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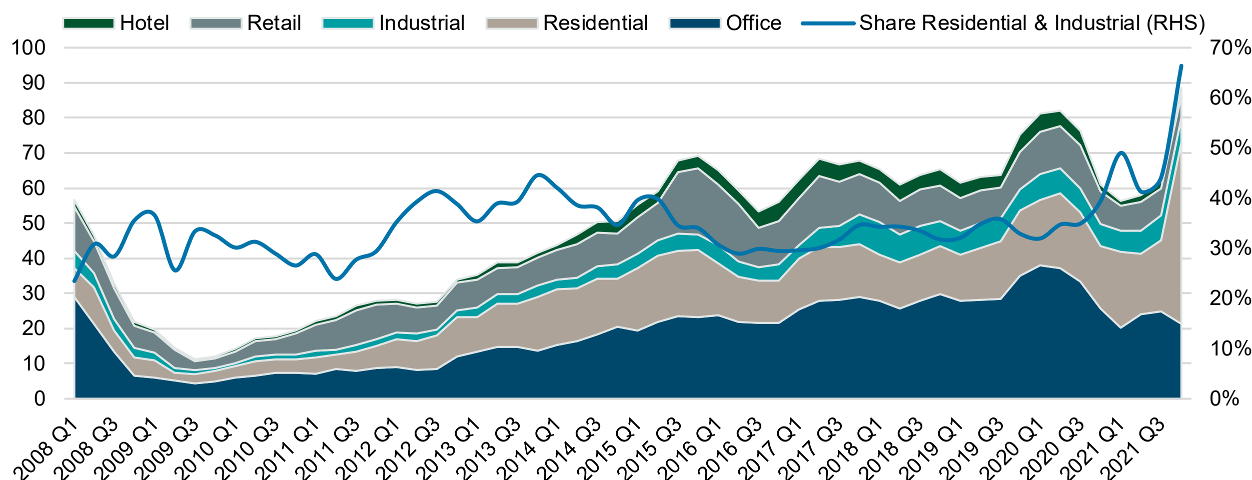
In the case of residential, our focus is on strong regional markets and more operational assets such as student housing and senior living. Key targets include economically sound regions outside major metropolitan areas, such as Leipzig, Karlsruhe or Ingolstadt. These markets offer a yield premium over large city hubs and have strong underlying market fundamentals and attractive growth prospects. An ageing population and low homeownership rates support an emphasis on assisted living investments in Germany, while suburban commuter locations in major agglomerations like Berlin, Frankfurt or Munich also remain key targets.

Transaction Volumes by Sector (€ bn)



Source: RCA, January 2022. Preliminary and annualised data.

Rising investor demand for German real estate

The investment market reflects a significant divergence between sectors, although sentiment is generally broadening beyond the prime segment. Overall, we see a gradual shift in investors' risk appetite as preferences shift towards value-add strategies.[7]

Residential investment accounted for the largest market share of around 40% in 2021, a greater proportion than in any year before the pandemic.[8] This was followed by the office sector with 35%, but investor demand remains divided between prime, future-proof assets and inferior stock. Logistics on the other hand is showing signs of overheating as yields have compressed to a level that requires a high level of confidence in the letting market and future rent increases. As a consequence, we suggest taking a more tactical investment approach to logistics, focusing on prime hubs and last mile assets, while taking advantage of strong investor sentiment to consider the divestment of older stock, in unconstrained corridor locations.

The hotel sector is still undergoing a gradual recovery, as suggested by improving occupancy rates during the summer. Domestic demand is supporting the sector, focusing on tourist destinations, and the investment market is showing signs of increasing liquidity.

Despite some improvement in market fundamentals, the retail sector continues to perform poorly, showing limited signs of recovery beyond the grocery and retail park segments, as rents remain under downward pressure. Conversion of older assets into mixed use schemes could be a viable option going forward, although this is generally not happening yet. For now, we expect ongoing rental decline and higher yields, but at a slower pace, supporting the case for selective asset sales.

[7] INREV Investment Intension Survey 2022.
[8] RCA, January 2022. Excluding Vonovia / Deutsche Wohnen entity-level deal.

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