Real Estate Research

September 2022

Germany Real Estate Strategic Outlook

Third Quarter 2022

IN A NUTSHELL

- The German economy is facing continued high inflation, and with increasing risk of an energy crisis, which could weigh heavily on consumer sentiment and disrupt industrial production, there is an elevated risk that growth may stagnate. There is mounting evidence that the real estate market has entered a period of price correction, driven by higher financing costs and economic uncertainty.
- Our German investment strategy focuses on resilient assets with low vacancy and solid through-the-cycle demand drivers. Operational residential should provide additional income protection against inflation, particularly given persistent supply shortages, while we also expect urban logistics to see strong rental growth, driven by robust demand and competition for alternative land use.
- Potential price dislocations in the office and retail sectors could offer good opportunities for value-add focused strategies, such as ESG-related office refurbishments or retail repositioning.

Market outlook

The German economy stagnated in the second quarter of 2022, with a growing risk of an inflation-induced recession, driven by rising energy prices, gas rationing and ongoing supply chain disruptions. Inflation hit a peak of 8.5% in July this year, and in June retail sales dropped by 8.8% year-on-year in real terms, the largest decrease since 1994. In July, the manufacturing PMI dropped to 49.3, pointing to the first contraction in manufacturing activity since June 2020, while consumer sentiment reached an all-time low of -27.4 points. Looking ahead, the German economy is set to grow at a modest pace as the labour market is expected to hold up well, but the outlook remains fragile.[1]

The cycle of real estate yield compression and subsequent capital growth, fuelled by decreasing long-term interest rates and strong fundamentals, has come to a halt. Market momentum slowed significantly in the second quarter after a strong start to the year as higher inflation, increased borrowing costs and a slowing economy led investors to become more cautious.

An increased cost of finance will likely lead to higher target levered returns for many investors. At present, yields have started to move out moderately, but we anticipate outward yield shift to sharply reduce values in certain sectors over the next 12-18 months, although partially compensated by stronger rental growth. This expected repricing should provide good opportunities in core markets and also allow for attractive repositioning strategies in the value-add space.

[1] Destatis, June 2022; PMI Markit, August 2022; GfK, July 2022

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Focus on resilient residential

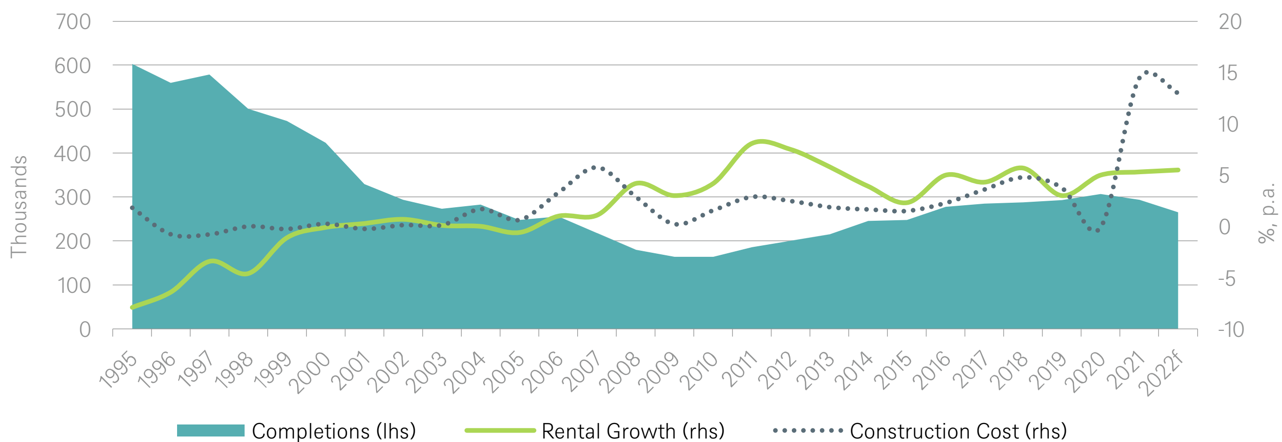
We believe that residential could be among the most resilient sectors in Germany. Generally, the sector offers good inflation protection as comparatively short leases provide the opportunity to adjust rent levels more often and vacancy is exceptionally low. The balance of fundamentals could also tighten further as rising financing costs put pressure on developers. Rising construction costs are starting to impact the already modest development pipeline, with construction output prices up by 17.6% year-on-year in the second quarter, leading to a wave of cancelled developments.[2] The delivery of new-build housing is likely to continue to fall short of the government's annual target of 400,000 new units, exacerbating the current shortfall.

Financing conditions for mortgages have tightened strongly, with monetary policy becoming less accommodative,[3] while stronger financial regulation is set to persist as BaFin introduced the sectoral systemic risk buffer of 2% for housing loans in April.[4] If this translates into lower demand for owner-occupied homes, this would likely lead to stronger demand for the private rental sector.

The wave of refugees from Ukraine is likely to further exacerbate the fundamental supply shortage. An influx of almost 1.6 million people to is expected in total over 2022 and 2023, in addition to immigration from other countries. We expect vacancy to remain at a very low level and anticipate strong prime rental growth in the unregulated market, reaching 3.4% per annum over the next decade.

Market fundamentals remain supportive, but expected levered returns in traditional multi-family residential appear too low based on current pricing and borrowing costs. With slowing economic growth and prime net initial yields often still below current financing rates, we believe the residential sector will see some repricing to meet previous levered return expectations. As such, we expect prime residential yields to expand over the next 18 months, before compressing slightly in 2024.

German Residential: Construction Costs May Slow Supply



Source: Destatis, DWS, July 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.

Energy efficiency is becoming increasingly important as rising energy prices are impacting housing affordability. Energy costs had limited effects on rent levels in the past, but this is expected to change. This issue is intensified by the limited energy

[2] Destatis, July 2022; ifo institute, July 2022
[3] ECB Bank Lending Survey, July 2022
[4] Bafin, March 2022

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efficiency of the current housing stock, which has only gradually improved in recent years. As such, we believe that rents of poorly insulated and inefficient housing come under pressure, highlighting the significance of energy efficiency for institutional investors from both a performance and ESG-perspective.

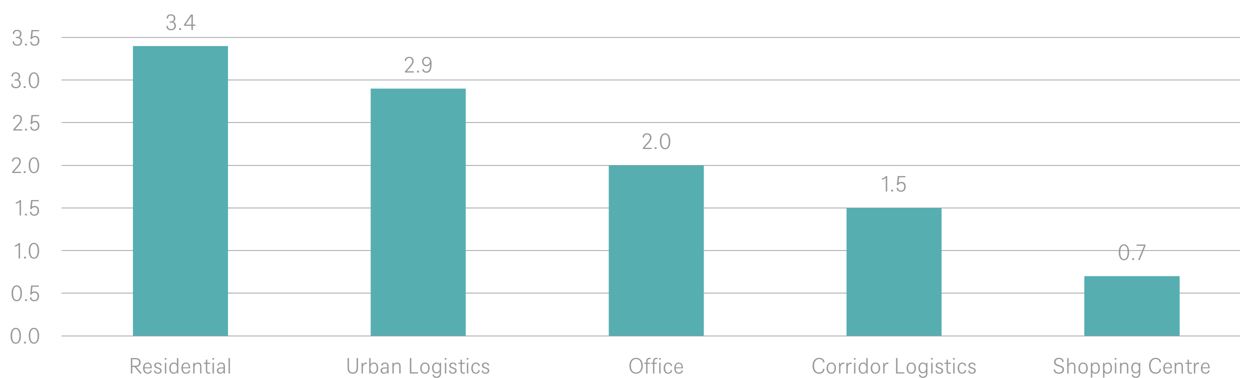
We prefer regional residential and commuter locations over prime city centre stock, given current pricing levels. In particular, commuter locations in Berlin and the regional city of Leipzig look likely to perform well based on strong growth drivers and well-balanced fundamentals. An attractive yield spread over multi-family and recession-resilient demand trends are also shifting our interest towards assisted living and student housing, where a lack of good quality stock is creating a clear supply-demand imbalance in both sectors.

Urban and niche logistics to outperform

Supply shortages, higher construction costs and rising land prices, together with strong occupier demand, have resulted in accelerating rental growth across the German logistics sector. Last-mile and urban logistics assets are seeing the strongest demand as e-commerce penetration continues to rise and occupiers seek to be nearer the end consumer. Looking ahead, we expect rent growth in supply-constrained urban locations to outperform corridor logistics, where we see an increasing risk from speculative development projects, with peripheral locations in particular looking at risk. We continue to focus on urban and last-mile assets, and expect cities such as Berlin, Munich, and Frankfurt to record the strongest rental growth.
Pricing in some parts of the logistics sector looks unsustainable given record low yields and current borrowing costs. We anticipate that weaker consumer spending and slowing economic growth will put upward pressure on logistics yields, although keen investor interest in urban logistics will likely offer greater protection against falling values. However, for much of the sector, strong expected rental growth over the coming few years, based on favourable supply-demand fundamentals should, to some extent, offset any rise in entry yields.

The niche segment of self-storage has proven to be a successful business model in U.S. and is poised to grow in Europe, with the potential for strong total returns. While the sector is well established in the U.S., self-storage penetration rates in Europe – and particularly Germany – are still very low, but are expected to increase as people and businesses adopt self-storage for temporary and long-term needs. A self-storage strategy is likely to require a development programme and partnership with a specialised operator.[5]

Prime Rent Growth Forecast (2022-2031f, % p.a.)



Source: DWS, July 2022. Note: 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.

[5] Source: JLL/FEDESSA, 2021

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Office and retail repositioning strategies

The office sector is often more susceptible to economic downturns, with GDP and employment growth being significant drivers of performance, and we expect that rental value growth will tail off next year as output growth fades. We also anticipate a repricing within in the sector. Prime net yields, which are still well below 3%, could move out by up to 60 basis points over the next 18 months.

Take-up figures remain strong in Germany's top locations, but the market is becoming increasingly polarised as tenants focus on flexible workplace strategies, targeting modern properties with good ESG credentials in central locations at the expense of secondary locations and grade B stock. As such, the increase in available stock is likely to be greater in out-of-town locations, while portfolio adjustments away from low energy-rated stock should result in stronger price corrections there. With tightening regulation and changing occupier demand, we therefore see attractive core plus and value-add opportunities in transforming weaker assets in CBD locations into Next Generation office space.

In the retail sector, sentiment towards grocery-anchored retail, supermarkets and fashion outlets continues to hold up well. However, given weak consumer confidence and lower discretionary spending due to the increased cost of living, we could see even larger price dislocations in other parts of the market. Repositioning strategies, including conversions to other uses, could be considered if pricing moves out far enough.

As well as the effects of ongoing structural shifts, shopping centres suffered most severely from lockdowns and restrictions during the worst of the Covid-19 pandemic. And rent levels are now under pressure again due to inflation and record-low consumer confidence in view of real income losses. We don't expect a turnaround yet, and both rents and values are forecast to continue their downward trajectory this year and next. However, while we are still highly cautious for now, prime shopping centre values could potentially bottom out next year more than 40% below their 2017 peak, which could eventually begin to provide repositioning opportunities within the sector.

The hotel sector is another that saw significant disruption from Covid-19. Investment volumes in the first half of this year remained weak, although occupier fundamentals have recovered relatively well. Hotel performance indicators such as occupancy rates, ADR and RevPAR are all almost back to pre-crisis levels, and demand should be supported by increasing tourism activity from pent-up demand. Hotel room prices are extremely flexible and can adapt very quickly to inflation trends, yet falling disposable incomes and rising costs for businesses pose short-term challenges. We would suggest a focus on modern hotels in central locations that attract a well-balanced mix of both leisure and business travellers.

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