

The background of the cover is a blue map of Germany. Overlaid on the map are various numerical values in a light blue, semi-transparent font, representing real estate data. These numbers are scattered across the map, with some appearing in larger, bolder fonts than others. A red circular badge with the word 'Summary' is positioned in the upper right corner.

Summary

Spring Real Estate Industry Report 2018

by the Immobilienweisen Expert Panel

Prof. Dr. Dr. h.c. Lars P. Feld

Andreas Schulten (bulwiengesa)

Sebastian Müller (GfK)

Prof. Dr. Harald Simons (empirica)

Carolin Wandzik (GEWOS) – Special Chapter

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Die Immobilienwirtschaft

About the Publisher

The **ZIA German Property Federation** is the leading professional association and the regulatory-policy and economic-policy interest group for Germany's entire real estate industry, and is based in Berlin. It represents over 280 direct members, including numerous renowned companies of the real estate and financial sector, and more than 25 industry associations. This makes it the mouthpiece of 37,000 businesses in the industry. On the European level, the ZIA maintains a liaison office in Brussels, operating under the name "German Property Federation."

The interest group represents the interests of the real estate economy in a comprehensive single-voice approach that reflects its significance for Germany's national economy. The Federation promotes and facilitates measures that help to preserve and improve the economic, legal, fiscal and political parameters within the industry.

In the context of building public, political and administrative consensus, the ZIA represents the diverse objectives of its members in the form of unified, integrative positions. Representing both corporate players and industry associations, it lends its voice to the entire German real estate industry both on the national and on the European level – and in the BDI Federal Association of the German Industry.

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Immobilien Zeitung (Thomas Hilsheimer, Simone Scheurer)

ZIA Zentraler Immobilien Ausschuss e.V., Unter den Linden 42, D-10117 Berlin

Dear Reader,

The real estate markets of the popular major cities and university towns remain strained – and this has long ceased to be an issue of the residential segment. The sustained low-interest policy of the ECB has pushed international demand for German real estate to a new peak level. The progressive digitisation is changing the existing processes and is creating new professions and businesses. The quest for well-trained young professionals has been noticeably exacerbated by the intense recruitment efforts of competing business sectors.



In addition to the growing challenges, our industry has also had to address regulatory changes in the recent past. This has caused the investment environment to deteriorate in some places, and noticeably so. The “rent freeze” rent control measure, for instance, has made investors uneasy – both private and professional ones. The tightening of equity and debt capital requirements among financing banks has led to credit crunches here and there. The real estate industry, being a capital-intensive sector, is particularly hard hit by the tightened rules. Construction and refurbishment costs have been driven up by tighter building and development regulations, in some cases considerably so, while the tax depreciation options have maintained the same low level. In parallel development, the ongoing surge in real estate transfer tax hikes has pushed up the incidental acquisition costs. These are only a few examples of recent political interventions to the detriment of the real estate industry.

The real estate sector’s role is to ensure holistic, liveable and affordable growth in our cities and communities, and it will continue to play that role in the future. But to be able to do so, a flexible environment is needed that encourages investments. Accordingly, we as top-level professional association are lobbying the body politic to speed up planning permit procedures and the allocation of property, to zone more building land and to improve the financing terms for lenders and borrowers. Specifically in order to attain the climate targets and to boost the liveability of our cities and communities we need sustainable investments into existing property stock. And these need to become financially more attractive. Which is why we are calling for a raise in straight-line depreciation from currently 2% to 3% at the least. In addition, we are advocating higher tax concessions for the energy conservation upgrades of buildings.

In this year’s as in previous Spring Report by the Immobilienweisen panel of real estate experts, the political environment plays a key role. And as usual, our job as top-level industry association is to rub salt into this political wound, using the basis of the report now before you.

I hope you will find it a fascinating read.

A handwritten signature in black ink, appearing to read 'A. Mattner', written in a cursive style.

Dr. Andreas Mattner, President of the ZIA German Property Federation

Spring Real Estate Industry Report 2018 – Summary

1. Macroeconomic Development

The growth of the German economy continues at a brisk pace. The German Council of Economic Experts (SVR) has predicted an increase in **real gross domestic product** by 2.0% for 2017 as a whole. When adjusted for calendar effects, the growth rate would actually be 2.3%. It would imply a continuation of the economic upturn that started in 2014, with the German economy gradually entering a boom cycle.

The country's **labour market** is in exceptionally sound shape. According to the employment accounts of the Federal Statistical Office (Destatis), 44.62 million people were gainfully employed by October 2017. It is the highest employment level since reunification of Germany in 1990. The fastest job growth was registered in the sectors public services, education, healthcare, trade, transportation, hospitality and food service activities. Conversely, the jobless figure relative to the entire civilian labour force dropped to 3.6%. It marks the lowest level in 25 years.

The **disposable income** has experienced growth over prior-year quarter in every spring quarter since 2013. Following a brisk start to the year 2017 with an increase by 4.17% since the first quarter of 2016, the disposable income grew by just 1.7% over prior-year quarter during the second quarter of 2017. By contrast, the third quarter registered a 5.2% growth rate, which is the third-fastest rate since the stagnation phase in the wake of the European debt crisis.

It is true that the energy sector saw substantial one-year price hikes during the winter months of 2017, and that the growth in **consumer prices** crossed back across the 2% mark for the first time since 2012. However, they returned to a dampening role during the summer months. The brisk increase in consumer prices in April 2017 (2%) year on year was explained not just by higher energy prices, but also by an exceptionally steep price hike for package tours (10.5%). The latter was attributable to a calendar effect, as Easter was earlier than usual in spring of the previous year. Lately, consumer prices have pointed back down but remain close to the ECB's 2% target benchmark at just over 1.5%.

The **lending market** remains relaxed. While the ifo Institute for Economic Research identified no credit hurdle for 2017 due to a switch in survey methodology, it assumes with a view to the persistently favourable terms of financing that lending will remain as accommodative as it was the previous year. In its 2017 Bank Lending Survey, Deutsche Bundesbank noted that banks have largely relaxed their lending policies in all business areas (loans to companies, private housing construction, and consumers).

In March 2016, the ECB entered uncharted territory in monetary policy terms when it lowered the **key lending rate** to 0%. Although the pressure to exit the zero-interest policy is rising in tandem with the resurgence of the inflation rate in the eurozone since late in 2016, the ECB failed to adjust its key lending rate in its communiqué of 14 December 2017.

Evidence on the ground at year-end 2017 suggests that **Germany's real estate economy** will be operating at capacity in 2018 in terms of production. At the moment, the building sector has a particularly high production output, reflecting the heavy use of equipment and a high volume of orders on hand. In addition to these challenges, companies in the building trade report an increasing lack of skilled labour. These circumstances on the supply side are matched by a demand that is particularly keen in

conurbations, and that is stimulated by the permanently favourable terms of financing as well as by the auspicious economic development.

Slow building activity in the German metro areas is driving up property rents and prices. Whenever expanding demand is paired with a supply growing at a slower pace, prices will go up. With all of this in mind, it is high time that the **fiscal and regulatory encumbrances** of the real estate industry be discussed.

2. Office, Corporate, Logistics, and Hospitality Real Estate

A historically low level of interest rates, favourable terms of financing, and strong liquidity positions once again ensured extensive **investments in commercial real estate**. Provisional figures suggest that 58.1 billion euros were invested last year. This mid-year result implies a significant year-on-year increase by 9.8%. As usual the bulk of the invested capital (42%) was earmarked for office real estate. Investments in commercial real estate were dominated by Germany's "Big Seven" cities Berlin, Hamburg, Cologne, Düsseldorf, Frankfurt, Munich and Stuttgart, which alone accounted for 52%.

Office Real Estate

For the time being, the economic parameters are having a favourable impact on the 127 largest **office real estate markets** in Germany: Robust economic figures and employment gains have successively increased the office space requirements, and not just in 2017, but successively over the past few years. Against this background, the inclination among employers to keep hiring is likely to persist throughout 2018. Job growth remains subject to an upward trend, and there is every reason to assume that the demand for office accommodation will show a lively development without turning into a rally.

Like in previous years, office real estate was a sought **investment** target among private and institutional investors from inside and outside Germany. 42.0% of all real estate investments targeted this type of use – slightly less than the five-year average (45.6%) and more than in any other real estate asset class. In absolute terms, the investment volume more or less matched the prior-year level at c. 24.4 billion euros and thus roughly 3.0 billion euros above the five-year average. The share of single-property deals was unusually high in 2017 at around 80.1%.

Rents (prime rents) rose for the seventh consecutive time in the 127 largest office markets. The weighted average prime rents in the seven "Class A" cities equalled c. 29 euros/sqm RAC¹ of office space. This implies an increase by 4.8% year on year, and by an actual 12.0% since 2015. The prime rents quoted in Class B cities averaged 13.70 euros/sqm RAC, topping the prior-year figure by around 1.3%. The price growth in the Class C cities was faster compared to 2016 at 2.4%. The weighted average prime rent level reached 12.50 euros/sqm RAC by the end of 2017. The weighted average prime rent in the Class D cities gained by 1.6% compared to 2016, having climbed to 9.90 euros/sqm RAC.

¹ Since June 2017, the German Society of Property Researchers (gif) has used the acronym "RAC" to designate "rental area of commercial use" in buildings rented or occupied for commercial purposes. It is derived from the DIN 277 standard re-enacted in January 2016, and takes the place of the "RA-C" acronym used since 2012.

At the same time, **selling prices** kept making significant gains in 2017. Capital values in Class A cities increased by an average of 19.2% to 9,871 euros/sqm. This means they have nearly doubled in these cities since 2011, growing by 48.6% between 2015 and 2017 alone. The most expensive city is still Munich with a capital value of nearly 12,900 euros/sqm RAC (+10.7%). Runner up is Frankfurt am Main with 12,500 euros/sqm RAC (+35%), while the capital value in Berlin was nearly 11,100 euros/sqm RAC (+21.9%). Hamburg represents the midfield among the “Big Seven” cities with 9,160 euros/sqm RAC (+18.4%). More affordable are Düsseldorf at c. 7,100 euros/sqm RAC and Cologne at 6,250 euros/sqm RAC, both of which move at a slower growth pace (+12.2% and +13.9%, respectively). The capital value in Stuttgart jumped the threshold of 6,000 euros/sqm RAC (+21.0%). Class B cities attained an average of 3,200 euros/sqm RAC (+12.4%), Class C city office markets 2,580 euros/sqm RAC (+11.6%) and Class D cities 1,700 euros (+8.8%).

The **net initial yields** continued to harden for the eighth consecutive year since 2009. In Class A cities, the weighted average for the net initial yields of core property was down to 3.6% by the end of 2017 (40 basis points below the prior-year figure) – the steepest drop since 1990. For the first time on record, net initial yields dropped below the mark of 4.0% in all of the Class A cities at the same time. Meanwhile, Berlin has taken Munich’s place as the priciest city. The yield rate in the German capital went down to 2.9%. Munich trails it closely at 3.0%, followed by Hamburg (3.1%), Frankfurt am Main (3.3%), Stuttgart (3.5%), Cologne (3.6%) and Düsseldorf (3.7%). Yields in the Class B, C and D cities dropped by around 50 basis points each in 2017 – outpacing the Class A cities on average – to 4.6%, 5.2% and 6.3%, respectively.

Vacancies in the 127 German office markets went down for the seventh time in a row. By the end of 2017, the vacancy rate across all 127 cities stood at 4.9% (down by 60 basis points year on year). The vacancy rate dropped to 4.1% in the Class A cities, to 4.7% in the Class B cities, to 4.9% in the Class C cities and to 6.0% in the Class D cities.

The **demand** for office accommodation is likely to remain strong in 2018. Vacancies will keep going down while rents and prices will continue their ascent. Yields are already under tremendous pressure, raising the spectre of speculative exaggerations in certain markets. On the tenant side, the manifest trend toward more flexibility and thus short lease terms persists.

Unternehmensimmobilien

Unternehmensimmobilien is the German term for a type of commercial real estate that resembles “light industrial” assets more than anything else. The distinct characteristics that set them apart from logistics real estate include a certain size, their locational and structural parameters, as well as their tenant and occupier line-up. While the properties owned by large industrial firms are similar in structure, they tend to be labelled “corporate real estate” unless they are heavy industry assets (e. g. steel mills, refineries).

The term “**Unternehmensimmobilien**” refers to mixed-use commercial properties with alternative use potential, and typically with a tenant structure comprising mid-market companies. The mixed use format normally includes offices, warehouses, research, service, and/or wholesale trade and open areas. Unternehmensimmobilien formats include converted properties, business parks, warehouse/logistics properties, and light manufacturing properties.

Although the final year-end stats were not available yet by the editorial deadline for this Spring Report, the evidence suggests that 2017 set a new record in terms of **transactions**. Well over 2.6 billion euros are expected to have been invested in Unternehmensimmobilien. Year after year, the transactions market has kept setting new records. Whenever a minor dip is registered, as was the case in 2016, it is explained less by flagging demand than by short product availability. As often as not, the kind of property stock the market craves belongs in the inventory of industrial firms (corporate real estate), which are often very reluctant to part with their real estate holdings.

The risen demand for Unternehmensimmobilien has put **yields** under pressure, but not as much as is the case in other real estate asset classes, and subject to a moderate delay. This is a less than transparent segment, and the management of this property type requires specialist know-how and decentralised asset management. The yield compression can develop in any number of ways. For instance, converted properties (revitalised commercial property) and business parks were considered less than attractive products until just a few years ago, and returned rather tidy yields of up to 12%. Today, the yield rate for converted properties ranges between 4.5% and 6.7%, and that for business parks between 6.0% and 8.2%.

Prime rents for Unternehmensimmobilien vary from one accommodation type to the next. Between the second half-years of 2016 and 2017, the rents for office and social areas rose from 13.05 to 13.81 euros/sqm, and flex spaces registered a rent hike from 12.24 to 14.82 euros/sqm, whereas rents for light manufacturing units remained virtually stable, rising from 8.06 to 8.07 euros/sqm.

Logistics Real Estate

Supply and demand on Germany's **logistics real estate** market set new high-water marks in 2017. Last year's market action was again defined by a robust transaction volume, fuelled by a number of portfolio deals and a continuously strong building activity on the supply side. Now, as then, the logistics industry gravitates toward the development of large-scale assets. Most of these logistics properties are located on the urban periphery or within integrated conurbations, and ideally have easy access to the motorway network. However, the logistics real estate sector shows a supply gap created by the lack of adequate city logistics properties that could reduce the delivery traffic into town centres by employing new means of distribution.

Logistics properties claim a growing share of the **investment market** in commercial-use real estate. Between 2012 and 2016, a total of c. 12.6 billion euros was invested in logistics real estate. The investment volume of 2017 came close to 5.7 billion euros, which is 76.6% more than the previous year (3.2 billion euros). At the moment, its share in the investment total is nearly 10%. Historically, it used to range between 5% and 6%.

As in the preceding years, the **demand for floor space** was excessive in 2017. Existing properties proved insufficient to meet demand, and a substantial share of the property stock is already obsolete and/or fails to meet modern requirements, specifically those of the still fast-growing e-commerce sector.

There is a high level of **building activity**. Like in 2016, more than 4.5 million sqm of logistics space were completed in 2017. This is considerably more than the medium volume of new construction seen between 2012 and 2016, which was barely 3.8 million sqm. It was also the first year in which the volume of logistics space completed

in Germany topped 1 million sqm in every quarter. Judging by the floor area in the pipeline for 2018 and 2019, the construction activity will maintain in brisk momentum in 2018.

Hotel Real Estate

The number of **overnight stays** in Germany increased for the eighth time in as many years. Provisional figures suggest that the number of arrivals in the German hospitality industry rose by 4.2% to around 178.8 million, and the number of overnight stays by 2.7% to around 459.5 million.

Despite the high completion and project planning figures, the year-end **transaction volume** will probably fall short of the prior-year figure of 5.2 billion euros because no major portfolio transactions were expected to go ahead in the fourth quarter. Then again, c. 3.1 billion euros worth of hotels (including forward deals) changed hands during the first three quarters of 2017. The total breaks down into 61 single-property transactions and 13 portfolio deals, roughly two thirds of which were acquired by German investors.

As demand remained on a rather high level, the **prices** for hotels continued to go up in the course of last year. In spring of 2017, Motel One bought up an asset next to Nikolaikirche from Lloyd Fonds at a multiple of 22.2 times the annual net rent. Prime yields in Germany's "Big Seven" cities are nearing the mark of 4%. But compared to other countries, the value of a hotel room in Germany is still modestly priced, and the hotel valuation index which is published by HVS in London (covering the upscale segment only) is quite explicit in saying so. Out of the 33 international cities mapped by HVS in 2016, Munich ranked tenth with 297,400 euros per room (previous year: 8th place), while Hamburg and Frankfurt ranked 16th and 17th (previous year: 17th and 15th) and Berlin ranked 20th (previous year: 18th). Paris once again took the lead with c. 643,700 euros, although the value dropped by around 8% year on year.

3. Retail Real Estate

Consumer sentiment in Germany has remained more or less immune to the many negative headlines and uncertainties that presented themselves in the course of 2017. The GfK Consumer Climate Index experienced only minimal fluctuations in 2017, and generally maintained a much higher level than the previous year. At the turn of the year, the consumer climate therefore showed a handsome year-on-year increase and has maintained its record level.

This means that the parameters in the retail sector remain auspicious. Indeed, the GfK consumer research society has projected a nominal 2.8% increase in **per-capita purchasing power** for 2018. This would bring the average purchasing power per resident up to 22,992 euros, meaning the disposable amount the average German can spend on consumer goods, housing and leisure, or save. Against the background of a growing population, the total disposable income has also increased, outpacing the per-capita purchasing power at a growth rate of 3.6%.

Distance selling continued to expand its market share last year, and currently accounts for 12.3% of German retail sales. That being said, the growth dynamic of this channel or operating type has lost some of its steam, and is growing slower than was predicted as recently as last year. It is nonetheless expected to keep expanding its share of the market in 2018.

Inversely, the **brick-and-mortar retail business** has become increasingly flexible in regard to the distribution channels it employs. The options to shop online, offline or via Click & Collect have already become well established, especially among **non-food multiples**. Cases in point include retail multiples of any kind typically found in high-street pitches, district locations or shopping centres. Setting up and expanding online services is an important subject of development for them because it presents an opportunity to compensate for their loss in market share, which is now down to 12.2%.

As in previous year, the majority of owner-operated **traditional specialist stores** are losing market shares, and have lately dropped down to just 17% of in-store sales. But although this trend will continue, many specialist stores are firmly entrenched in their local markets and boast a superior competitive position, actually consolidating it steadily by expanding their range of goods and services. The market share of mid-size to large-scale **retail warehouses** also declined slightly to 16.5% of in-store sales. The trends here are heterogeneous: Drugstores and retail warehouses in the low-price segment (e. g. Tedi, KiK, Takko) are seeking to expand. All of the DIY store chains except toom now operate online shops, and are intensifying their focus on the expansion of their personal customer service. **Department stores** maintained their market share of 2.1%. **Food retailing** managed to retain its market shares or even expand them in the case of certain operating types. Meanwhile, all types of retail operation are undergoing modernisation. With the market entry of Amazon Fresh in Germany, the food segment has moved into the focus of e-commerce. The sales share of **superstores** remained unchanged at 8.4%, but the experts expect to see it lose some of its market share next year. Conversely, **full-line suppliers** have continued to expand their market share to 11%, subject to an upward trend, as they keep riding the modernisation wave and to expand supermarkets into full-line retail venues. **Discount supermarkets**, after years of consolidation, are reporting the fastest gain in market share among the various retail types, and now account for 17% of all German retail sales.

Demand for **investment-grade** German retail real estate remains strong among national and international investors, and this goes not just for assets in the Class A cities but for assets outside of them, too. Year on year, the investment market in the retail segment saw sales increase by around 11% to a total transaction volume of 14.1 billion euros nationwide, the second-best year-end result since 2010. Single-asset deals and portfolio transactions contributed in nearly equal measure to bring about this tidy year-end result.

The investor side was dominated by three **types of buyers**, which together accounted for two thirds of the sales volume. Once again, open-ended real estate/institutional funds were particularly active, and yet their market share of 24.6% saw a steep year-on-year drop (2016: 38.9%). Next in line were asset managers and fund managers with a slightly increased share of 23.4%, so that buyers of this type retained their position from last year. A single portfolio acquisition sufficed to put private investors in third place because it pushed their sales revenue share up to 18.1%. The shares of the other investor types remained in the single-digit range.

Strong demand for retail real estate caused the **net initial yields** to harden in all of the “Big Seven” cities. Among them, Munich remains the most expensive one. Here, the yield rate dropped to 2.70%, well below the mark of 3%. Net initial yields in Hamburg are at 3.00%, while Frankfurt ranks third (3.10%) and is trailed by Berlin (3.25%). At 3.30%, Stuttgart passed both Düsseldorf and Cologne (3.40% each). The net initial yield rate across all seven Class A cities averages 3.16% (previous year: 3.47%).

The Seven Leading Retail Property Markets

Berlin continues to develop at break-neck speed, and registered another increase in population and tourist figures. The brick-and-mortar retail business benefited from the trend in 2017, reporting a revenue growth of 1.9% year on year. While this implies a year-on-year drop in top line sales growth, it contrasts favourably with the performance of the other German retail metropolises. The retail-space-per-capita ratio citywide showed a similar percentage growth as sales did, so that the floor space productivity of Berlin's retailers maintained its average of 3,800 euros/sqm. Prime high-street rents remained unchanged at 180 euros/sqm/month for stores between 300 and 500 sqm, whereas the monthly rates for smaller units of 80 to 120 sqm rose by 2.9% from 350 to 360 euros/sqm.

Hamburg analogously maintained its place among Germany's cities in 2017 with retail revenues of c. 11.2 billion euros, the second-highest total after Berlin. Drivers behind the trend include demographic growth, an increasing integration of the metro region, and a rise in tourist figures. Combined with a slight drop in retail-space-per-capita the retail space productivity rose to now 4,200 euros/sqm. Top line sales growth also outpaced the growth in retail floor space in the inner city, so that the retail space productivity of high-street retailers climbed to an average of nearly 5,900 euros/sqm. Rents are also under pressure in downtown Hamburg. The target prime rents stagnate at 310 euros/sqm for smaller stores (80 to 120 sqm) and at 200 euros/sqm for larger ones (300 to 500 sqm). Some locations are actually bracing themselves for rent discounts. High-street locations such as the southern section of Neuer Wall, which has positioned itself as luxury pitch, compete with nearby projects such as Stadthöfe, Alter Wall and, going forward, the Burstah Ensemble which are already in the letting stage.

In **Munich**, the permanently superior demographic and economic parameters ensured that the retail revenues continued to climb, totalling 10.9 billion euros by the end of 2017 (previous year: 10.7 billion euros). The footfall in the town centre, which is very high compared to other European cities (according to BNP, Kaufingerstrasse is one of the busiest high streets in Europe, second only to Oxford Street), generates the highest retail space productivity of any of the analysed cities. The productivity is also explained by the retail-space-per-capita ratio here, which remains comparatively low. International retail multiples continue to focus on Munich, and so its contested retail property market with its sale-price-to-rent ratio of 31 counts among the priciest anywhere in Germany. Last year, the sale of a commercial building on Weinstrasse for a price-to-rent ratio of 60 set a new record. The rent ceiling for the prime high street pitch remained unchanged at 370 euros/sqm for small retail units of 80 to 120 sqm, and at 240 euros/sqm for larger units of 300 to 500 sqm, a level that has been in place for the past two years.

Cologne reported the fourth highest retail revenues in Germany in 2017 at 7.1 billion euros, which implies a modest gain year on year. But the city's total retail area actually declined slightly after several stores went out of business. This did nothing, however, to change the pro-rata share of high street retail areas in the city's total retail area, which remains at roughly 20%. The centrality rating of 121 underlines the inter-regional attractive pull of Cologne, which is something no other German city boasts on the same scale. Retailers in downtown Cologne achieve an average floor-space productivity of c. 5,200 euros/sqm. Prime rents in the city's premium high-street pitches have softened slightly year on year. The passing rent for a store between 80 and 120 sqm equals 270 euros/sqm (-3.6%), whereas larger stores (300 to 500 sqm) are currently let at a rent of 145 euros/sqm, which implies a -3.3% drop on the prior-year level.

Düsseldorf saw its population continue to grow in 2017. At 117.8, the city's purchasing power index is among the highest of any major German city, second only to Munich. Nonetheless, retail revenues manifested a modest downtrend. The fashion market has shown a sluggish performance lately, and the retail area contracted slightly. The completion of ongoing projects will expand the total retail area in the longer term. The growth in prime rents confirms the persistently keen demand for retail units in Grade A locations. For small to midsize stores on Königsallee, Düsseldorf's prime high-street pitch, 285 euros/sqm were quoted, and 150 euros/sqm for larger units between 300 and 500 sqm. Retailers in the inner city raised their average retail space productivity to an average of over 4,600 euros/sqm. This puts Düsseldorf in the midfield among the "Big Seven" cities.

Frankfurt registered another population increase in 2017 along with a large number of incoming commuters. Fuelled by a high purchasing power, Frankfurt's retail sector achieved a positive year-end sales total. While the total retail area did not significantly increase, the average space productivity of the city's retailers rose to more than 3,800 euros/sqm. In response to the general trend of shifting customer expectations in regard to distribution channels and shop concepts, Frankfurt's retail sector stepped up its restructuring and modernisation efforts last year. The prime rent declined slightly to 290 euros/sqm for small stores of 80 and 120 sqm. Analogously, larger stores were available at a top rate of 165 euros/sqm and thus somewhat more affordable than the previous year.

Stuttgart, being at the heart of one of the country's economically strongest and most innovative metro regions, has benefited from a positive economic dynamic while also registering sustained demographic growth in 2017. With a retail trade centrality of 117.3, Stuttgart stayed in second place among Germany's leading retail cities. The retail revenues suffered a minor setback last year, whereas the floor-space productivity actually increased to over 4,250 euros/sqm as certain unproductive retail areas were taken off the market. The regressive growth in prime rents observed in 2016 has slowed noticeably since. Prime rents for smaller stores of 80 to 120 sqm rented out at 250 euros/sqm, while larger units between 300 and 500 sqm commanded a rent of 135 euros/sqm.

4. Residential Real Estate

Residential rent rates (asking rents, hedonic, any year of construction) in Germany continued to follow the upward trend of previous years by climbing +4.3% last year and thus slightly faster than the previous year (+3.1%). With the general inflation taken into account, it implies an increase by 2.5% in real-money terms. The median rent across Germany was 7.46 euros/sqm in 2017, up from 7.15 euros/sqm the year before.

Asking rents experienced nominal upward growth in virtually all counties of Germany (392 out of 400). Despite the widespread trend, however, the growth rate differs from one county to the next. Annual rent increases of 3% or more in the years since 2009 were registered in 137 districts, which together account for over one third of the German population (39%). But drastic rent hikes can also be the consequence of a low baseline level. Out of the 30% of the population who live in the districts with substantial rent growth of 3% p.a. or more, 18% reside in districts with average rent rates despite the rent growth. Accordingly, steep rent hikes and high rents on new leases in the wake of the rent growth affect 20% of the German population. At present, 29.9% of the population live in districts where the rent on new leases is 8.00 euros/sqm or

higher, whereas 50.4% are at home in districts with a rental level of less than 7.00 euros/sqm. Another way to put things in perspective: Even today, no less than 41% of the population live in districts where the average rent undercuts the national average rent of 2009 in real money terms.

Selling prices for condominiums also continued to go up across Germany in the course of 2017. Having gone up by 7.9% since 2016, the one-year growth was slightly slower than it had been the previous year: Between 2015 and 2016, selling prices were still rising at an annual rate of 8.8%. The nationwide price average for existing condominiums currently stands at 2,120 euros/sqm, up from 1,970 euros/sqm in 2016.

The modest slowing of the price growth is noticeably across all types of regions, although the fastest price growth is still reported from the corporate cities of West Germany with a rate of 8.2% (previous year: 9.8%). At 7.9%, selling prices were also slower to rise in West German districts than the year before (8.3%). A look at the situation nationwide suggests that the price cycle has slowed down a little, and this should come as no surprise after a boom cycle of eight years. Since 2009, selling prices have risen by a total of 61% nationwide, and by 78% in the corporate cities of West Germany, 52% in the West German rural districts, and 53% in the corporate cities of East Germany (not including Berlin). In real money terms, the growth is 10 to 15 percentage points less. Principally speaking, brisk price growth does not necessarily imply that the resulting prices are particularly high. As with rents, there are districts in Germany where prices have been fast to rise from a low level. However, the number of districts with price hikes from sub-average levels is lower than that of districts with rents soaring from a low baseline level. Statistically, the situation breaks down as follows: 38.6% of the population live in districts with an annual price growth of 6%, yet 7.6% thereof in districts where the price level remains below the national average even after the price hikes.

But with now eight years of upward movement behind us, prices are likely to level out soon, and again the situation will differ from one region to the next. By analogy, the same will be true for rents. Demand for residential accommodation is currently growing slower than it did until recently, because the incoming migration from abroad (refugees, other EU member states) has plummeted. At the same time, the number of flats coming on-stream is rising faster than it used to. It is expected that more than 300,000 new-build flats were completed in 2017, and the number is likely to increase again in 2018. As a result, the housing market is moving toward a balanced development, easing the pressure on residential rents. Since another drop in interest rates can be ruled out, the price-driving effect on the buyer market will cease as well.

In the **seven Class A cities**, rents on new leases continued to rise in 2017 at rates between 2.4% in Düsseldorf and 7.6% in Berlin. Selling prices once again outpaced rents, rising by anywhere between 5.3% in Stuttgart and 16.9% in Frankfurt. The selling price inflation, derived from the relative performance of rents to prices, kept accelerating year on year, and currently equals around 30%. That being said, the trend will not continue. In Munich, Berlin and Stuttgart, the times of runaway demand for residential accommodation are over. While this is not yet the case in Hamburg, Frankfurt, Cologne and Düsseldorf, the trend here might well level out in the future. The pace of incoming migration has noticeably slowed, especially in Munich, Berlin and Stuttgart. At the same time, the housing supply has expanded quickly as the planning permits issued in recent years have started translating into elevated completions figures. Especially Berlin is facing a veritable wave of completions, compared to the way things used to be. Roughly 18,700 flats are likely to be completed in 2018, which would more or less match the rise in demand. This is up from 13,700 in 2016, and from just 8,700 in 2014.

At least in Munich, Berlin and probably in Stuttgart, the current **rent cycle** is drawing to a close with what is likely to be a more or less balanced development of supply and demand. This will impact the yield calculation of investors who are currently accepting net initial yields below (Munich), on a level with (Berlin) or barely above (Stuttgart, Hamburg, Frankfurt) the interest level for housing construction, which means it will cease to be possible to repay the loans out of the cash flow and that subsequent contributions will become necessary on a regular basis. In effect, the **selling price inflation** of up to 30% will be corrected. In last year's issue of this report, we predicted a drop in selling prices – particularly in Munich and Berlin and possibly in Stuttgart – by somewhere between a quarter or a third in real money terms, and we hereby reaffirm that prediction. The outlook for Hamburg, Cologne and Düsseldorf is mixed, whereas for Frankfurt the ramifications of the Brexit will play a key role.

5. Special Chapter: Investment Opportunities in Large Mid-Size Cities

If you move beyond Germany's metropolises, you will find the many of the **mid-size cities** offer chances for profitable real estate investments, too. Below, we take a closer look at ten of the large mid-size cities that manifest the best development dynamic to analyse their investment opportunities in residential and commercial real estate.

These include the **university cities** of Konstanz, Tübingen, Flensburg, Fulda and Bayreuth where the inflow of young education migrants more than makes up for the relocation of family households into the surrounding region, and indeed causes these cities to grow. This differs from cities like Norderstedt, Meerbusch and Speyer that benefit from their **location within a fast-growing metro region**, especially through the inflow of families. By contrast, the cities of Rheine and Nordhorn have an anchoring function for their surrounding area inside prospering regions.

As far as the **housing market** goes, the analysed mid-size cities – with the exception of Konstanz – offer attractive investment and yield opportunities. The net initial yield that an investor may realise when acquiring a **condominium** as buy-to-let investment in one of the mid-size cities (not including Konstanz) ranges from 3.1% to 4.3%. The net initial yield to be achieved in the seven Class A cities at the moment averages 2.8% only. The forecast for the projected number of households through 2030 shows that all of the selected mid-size cities will experience a growing demand for housing in the future, and with it a serious demand for new housing construction. With their high net initial yields and their strong demand for new construction in the segment of **multi-family dwellings**, the cities of Flensburg and Fulda stand out as particularly interesting investment destinations.

A closer look at the **commercial real estate** in the mid-size cities reveals that the situation differs from one market to the next. As far as retail markets go, Konstanz and Flensburg, for instance, strongly benefit from cross-border trade, whereas the **retail sector** in Meerbusch and Norderstedt are slightly underdeveloped because of their suburban location within the metro areas of Düsseldorf and Hamburg, respectively. Cities that serve as centre of a region (cases in point being Nordhorn, Fulda, Bayreuth and Speyer) report robust retail revenues and a high retail centrality. The transaction activity in the examined cities is generally low and concentrates mainly on (combination residential and) **commercial buildings**. Predictably, rents are strongly dependent on the location and fit-out of a given retail unit. The analysis identified auspicious investment opportunities in retail real estate in the mid-size cities Speyer, Konstanz, Flensburg, Nordhorn and Fulda above all.

The trend toward a service and knowledge economy with positive effects for **office real estate markets** extends to the analysed mid-size cities, too. However, the office real estate markets of the analysed cities are characterised by relatively low take-up figures that are explained by the modest size of these business locations. For the same reason, the investment activity is also rather low-scale, and focuses on commercial buildings with offices and doctors' offices. The office markets of Meerbusch and Norderstedt are part of the office markets of Düsseldorf and Hamburg, respectively, and benefit mainly from their proximity to the airports of these metropolises. Due to the relatively low rent level, attractive risk/reward ratios for property developments in the analysed cities are realistic only in the prime locations and/or via property developments defined by a high value in use. The identified investment opportunities are particularly positive in Konstanz, Tübingen, Flensburg and Norderstedt.

The **hospitality markets** in the examined cities differ in terms of their baseline situations. Konstanz, Fulda, Bayreuth and Speyer are established tourist destinations with a relatively high number of overnight stays and considerable upside potential. Norderstedt benefits from the booming hospitality market in neighbouring Hamburg whereas the hospitality markets of other cities are predominantly paced by the endogenous demand for accommodation generated by local business. In these cities, the number of overnight stays falls short of 50,000 per year (cases in point being Nordhorn and Rheine). The average revenues per available room (RevPAR) match the national average of c. 64.00 euros in some of these cities (Norderstedt, Flensburg and Tübingen), whereas Konstanz actually exceeds it and substantially so. The chances for investments on the hospitality markets of the examined cities are usually created by supply-driven trends in demand. Particularly positive investment opportunities were identified in the cities Konstanz, Tübingen, Flensburg, Norderstedt and Bayreuth.

The “Immobilienweisen” Council of Real Estate Experts

Prof. Dr. Dr. h.c. Lars P. Feld, author of the “Macroeconomic Development” chapter, is tenured professor of macroeconomics specialising in economic policy and regulatory policy at the University of Freiburg, and Director of the Walter Eucken Institute. He is also a Member of the Council of Experts for the Evaluation of Macroeconomic Development, a Member of the Scientific Advisory Council of the Federal German Ministry of Finance, and a Member of the Independent Advisory Board to the German Stability Council. The chapter was co-authored by **Julia Wolfinger**, research fellow at the Walter Eucken Institute in Freiburg and research assistant at the University of Freiburg.



Andreas Schulten, author of the “Office, Corporate, Logistics, and Hospitality Real Estate” chapter, has served as CEO of bulwiengesa AG since 2005, his sphere of ownership including the office and residential real estate market. He also teaches at the Real Estate Management Institute of the European Business School in Oestrich-Winkel, at the International Real Estate Business School in Regensburg, at the VÖB Association of Public Banks in Bonn and Berlin, and for the REM degree program at the University of Technology in Berlin. This chapter was co-authored by **Dierk Freitag**, **Ralf Fröba**, **Tobias Kassner**, and **Martin Steininger** of bulwiengesa AG.



Sebastian Müller, author of the chapter “Retail Real Estate,” is in charge of the retail and real estate consultancy at the GfK consumer research society. In this role, he advises investors, banks, property developers and retailers on investment issues concerning locations, retail properties and retail concepts. For instance, he counsels retailers on the development and implementation of expansion strategies, and investors and banks in the context of pre-acquisition audits. The chapter was co-authored by **Luisa Linek** and **Cornelia Bellersheim** who are both retail & real estate consultants at GfK.



Prof. Dr. Harald Simons, author of the “Residential Real Estate” chapter, has been with empirica AG since 1993, and joined the Management Board in 2002. He read national economics at universities in Bamberg, Colchester (UK) and Bonn, and obtained a doctorate from the University of Magdeburg in 2008. Since 2010, he has moreover been tenured professor of microeconomics at the University of Technology, Economics and Culture in Leipzig. Co-author **Eliza McGownd** is a research assistant at empirica ag.



Carolyn Wandzik, who wrote the special chapter “Investment Opportunities in Large Mid-Size Cities” holds a degree in economic geography from the University of Osnabrück. After working as a research assistant at the Dresden University of Technology, she transferred to the GEWOS Institute for Urban, Regional and Housing Research in 2005. In 2013, she assumed a senior position at the urban planning firm BIG Städtebau GmbH. In 2017, she returned to GEWOS as its Managing Director. It was co-authored by **Dr. Flemming Giesel** (GEWOS) and **Ulrike Biermann** (Georg Consulting).



