Real Estate Research

March 2023

DWS

Germany Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

- The German real estate market has been hit by a sharp rise in financing costs and a weakening economic outlook. Transaction volumes fell significantly, and property yields saw strong outward movement towards the end of last year.
- But 2023 may provide opportunities as the main part of the correction seems now to be complete and interest rates are expected to stabilise. Occupier market fundamentals also remain supportive and weaker construction activity should eventually boost rental growth and thus support total returns.
- Price corrections across sectors should support core investments, as well as value-add strategies such as office refurbishments. The residential market remains attractive on a selective basis, with service-oriented subsegments gaining in importance.

Mild winter to prevent a severe recession

The German economy proved more resilient than expected in the second half of 2022, despite a gloomy outlook. The country will most likely head into a mild recession this year, with a modest increase in the unemployment rate, but we don't expect a severe downturn.[1] China's easing of its zero-Covid strategy, a slowing of the monetary policy tightening cycle, and an easing of the energy crisis should support aggregate demand. Major economic indicators such as the ifo Business Climate Index and the ZEW Economic Sentiment Index have also come off their recent lows,[2] while fiscal packages worth €200 billion – or 5% of GDP – will provide support for real incomes and boost consumption in 2023.

CPI inflation averaged close to 8% in 2022, the highest annual figure for around 70 years. However, monthly figures show that inflation came down from a peak of 10.4% year-on-year in October to 8.6% in December, backed by federal one-off payments for gas and heat. Nevertheless, core inflation is expected to remain significantly above target in the short term, maintaining pressure on monetary policy actions.[3]

Yield adjustments and price corrections provide opportunities

Commercial property investment volumes collapsed in the second half of 2022, while prime yields have expanded rapidly across the board, driven by the surge in financing costs and limited liquidity in the market. Financing sentiment declined for the fourth quarter in a row to an all-time low at the end of 2022,[4] as both the current situation and the outlook for financing deteriorated.

[1] DWS, December 2022
[2] Ifo, ZEW, December 2022
[3] Destatis, January 2023
[4] ZEW, JLL (DIFI), January 2023

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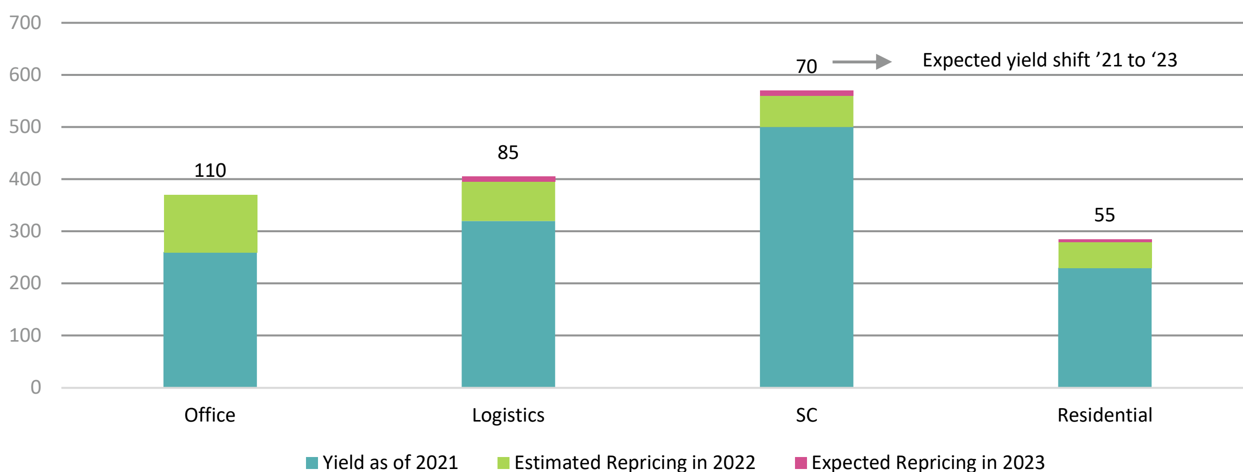
Prime market yields have moved out faster than expected but we have most likely now seen most of the adjustment in the office sector. Residential and logistics prices are also expected to stabilise in 2023 and any further modest yield expansion should be offset by rental growth. Price corrections across segments should provide attractive opportunities and allow for repositioning strategies in the value-add space, which could support the EU digital and sustainable transformation by reducing net greenhouse gas emissions. Moreover, we also see opportunities in repriced core assets across segments. Looking forward, we expect a slow market recovery in the second half of this year, while total returns should turn significantly positive again from 2024 onwards, driven by yield compression and stronger rental growth.

Occupier markets remain in a relatively strong position, with prime rents reaching record levels in many places last year. In the medium term, a slight weakening in the office rental market is likely as weaker economic sentiment is reflected in lower output and employment growth. Changing occupier requirements, driven by ESG regulation, energy costs and the war for talent, mean that we expect the diverging trend between peripheral, non-core properties and centrally located, best-in-class buildings to continue.

Prime Yield Shift by Sector Since December 2021 (basis points)



Source: DWS, January 2023. 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.

A positive outlook for best-in-class office properties

Prime net office yields moved out by more than 100 basis points in 2022, leading to an estimated capital value decline of up to 25%. However, we believe that the sector is close to fully repriced now, with yields expected to remain broadly flat in 2023. In the longer term we anticipate some modest yield compression as inflation normalises and bond yields find a new balance.

Current repricing, which is likely to be even greater for lower quality assets than for the prime segment, provides opportunities in transforming weaker assets into Next Generation properties. New requirements for modern office buildings are increasingly driven by hybrid working, digitalisation, sustainability and new flexible work models, and call for resilient properties to avoid the risk of obsolescence. To create such buildings, we focus on factors such as flexibility, micro location, asset specification, energy efficiency and corporate branding in cities with high productivity growth and strong fundamentals like Berlin and Munich.

We have a positive outlook for the prime office letting market, with best-in-class properties expected to maintain very low vacancy rates, but we see restrained demand in peripheral locations or for older stock. For the office market as a whole we foresee slightly decreasing tenant demand and a moderate increase in vacancy, as post-pandemic catch-up effects begin to fade and the letting market lags the wider economic trend.

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Overall, we expect the office vacancy rate in Germany to peak slightly below the historical average at around 6%. However, a limited supply pipeline and low availability of centrally located space in cities such as Frankfurt should support healthy prime rental growth in the coming years. The shortage of central grade A space is already visible in the top seven German cities, with grade A vacancy standing at 2.5%, compared to a total market average of 4.9%.[5]

Residential remains attractive as supply constraints lead to further rent growth

Given a sizeable repricing late last year, the residential market looks increasingly attractive and is expected to outperform. Demand fundamentals remain supportive, with positive city-level demographics, while the development pipeline has eased due to rising financing and construction costs, as well as high land prices. And with the number of permits for new dwellings continuing to trend downwards in recent months, the number of completions is likely to have been far below the annual target of 400,000 units last year, with a similar trend continuing this year.[6] This should result in further rental growth, particularly given the estimated net inward migration of one million people into an already tight market in 2022.[7]

Affordability is becoming increasingly important due to the surge in living costs. Initial concerns about rent indexation have already emerged and the discourse could intensify depending on the extent of further inflationary pressures. We expect energy efficiency to become more visible within pricing, through green premiums for efficient stock and brown discounts for older stock, as new regulations like the Carbon Dioxide Cost Allocation Act and the German Buildings Energy Act (GEG 2023) are applied.

Within the multifamily segment, we continue to focus on the slightly higher yielding commuter locations and regional markets, while micro living and senior housing also still offer an attractive yield premium. The maturing subsegment of co-living is particularly attractive, as we expect positive spillover from the tight residential market into this unregulated segment, given the widening supply gap. Demand from international occupiers, young professionals and business travellers in cities with wide appeal and a strong economy, such as Berlin and Munich, should push up rent growth.

Strong demand and limited supply in the logistics market; retail remains muted

The German logistics market saw a strong correction in yields and capital values in the second half of 2022. But healthy occupier demand and limited supply resulted in rents growing at their fastest rate for over 20 years.[8] In the short term, we anticipate lower but still comfortably positive rent growth, driven by supply shortages, nearshoring, and growth in the courier, express and parcel segment. We see new opportunities in repriced core assets across the main logistics clusters, while our focus is still on urban logistics and last mile properties, which are expected to outperform in terms of rental growth.

The retail market has already seen a significant correction in recent years and is now suffering additional stress from high inflation and a loss in private household spending power. Real wages dropped sharply in 2022, leading to more pressure on footfall and retail turnover. Consumer confidence in Germany hit a record low in September last year,[9] but has since recovered slightly and is expected to increase further in 2023 as the economic outlook improves. Nevertheless, we still expect some further decline in both rents and capital values over the next 12-18 months, before a gradual recovery sets in.

[5] JLL, DWS, October 2022
[6] Destatis, January 2023
[7] Destatis, September 2022
[8] DWS, CBRE, PMA, January 2023
[9] Macrobond, January 2023

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