Real Estate House View
Germany

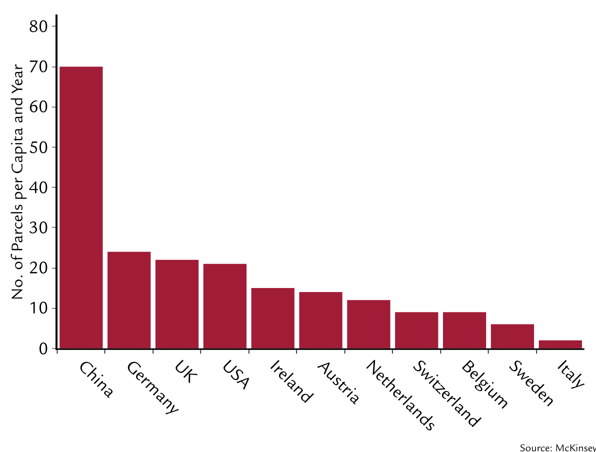
SwissLife
Asset Managers

Second half-year 2019

Key takeaways

- Growing economic uncertainties and insufficient product availability are dampening the investment market. On the other hand, it is possible that central banks will keep interest rates low for a longer period of time.
- Office markets benefit from robust demand and low supply. However, increasing completions and a possible stronger downturn in the economy will reduce the potential for rental growth in the medium term.
- The polarisation of retail between high-quality locations and event-driven shopping formats, as well as growth in the value segment, continues to put mid-market retail under pressure. At present, we consider the value segment to be the favourable store-based format.
- E-commerce continues its success story and leads to strong competition for commercial space by logistics hubs in urban areas in the pursuit of shorter delivery times.
- In the residential sector, construction activity in the cities remains inadequate. Political interventions to control rental growth are intensifying and may reduce the attractiveness of investments, at least locally.
- In the low-interest environment, a stabilisation of initial yields at a low level can be assumed for the short and medium term. Additional measures by central banks could even further enhance the attractiveness of real estate and lead to an ongoing yield compression.

Chart in focus



Private consumers continue to boost the logistics sector through e-commerce. According to a survey by McKinsey, a disproportionately large number of parcels is shipped in Germany: 24 parcels per capita in 2017, ahead of the UK with 22 parcels, even though e-commerce accounts for a larger share of retail sales there. A global look also indicates that the Chinese enjoy online shopping. In the metropolises of Shanghai and Beijing the number of parcels per capita and year exceeds 70. The US has 21 items, with India at less than 1 parcel - not so far away from Italy at the bottom of the list in Europe with 2 items. High parcel volumes indicate further demand for urban logistics properties.

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Germany's Bundesbank expects real GDP to grow by just 0.6% from the previous year in 2019 and by 1.2% next year. Last December, the Bundesbank still expected 1.6% growth for both years. Capacity utilisation in the car industry has not regained traction so far this year, and the job market tightening has run its course. Global headwinds are weighing on the important export sectors, and risks of a shallow, temporary recession have re-emerged in our view. Nevertheless, our own assumptions on growth dynamics differ from the Bundesbank's in the assessment of domestic demand. Wage growth and low interest rates remain supportive for service industries and residential construction activity. Private households continue to spend, and construction is expected to be a strong contributor to growth. The fiscal impulse as a share of nominal GDP will be the strongest since 2010.

Is the investment market tiring?

The investment market in Germany calmed in the first months of 2019. Some investors may be cautious in view of the looming tougher economic picture, but demand for core assets or properties with upside potential remains high. However, the corresponding supply is lacking. Particularly in the core segment, it is hardly surprising that institutional investors, who invested in real estate in recent years due to the low interest rates, are not willing to sell their assets again. Additionally, premium supply is largely driven by new-builds, while other owners try to get rid of difficult properties or activist investors continue to turn single assets and portfolios. In the first half-year, the transaction volume across all sectors fell by roughly 15%, but the figure of approximately EUR 30 bn is still strong in a long-term perspective. Slightly weaker dynamics on the investment market were already reflected in the performance in 2018. According to MSCI, the total return for all property eased from 10.9% in 2017 to 10.2% – a very good result although it shows that capital growth weakened last year due to the high price levels already achieved – especially in the residential sector – whereas logistics has seen new record levels.

Office markets remain tight

An imbalance of supply and demand continues to shape the office market, and the situation worsened in the first quarters of 2019 as vacancies continued to decline. Despite the shortage of space in the top 7 markets, take-up remained at the previous year's level on average. Nevertheless, several requests, especially for the preferred central areas, cannot be fulfilled, meaning that tenants have to prolong their leases or relocate to decentralised areas. Not surprisingly, pre-letting is an essential element for the market. Rising completions should thus provide relief for the markets, despite high pre-letting rates, and there is currently considerable evidence that completions will be properly absorbed. However, it is important to keep an eye on the economic and employment situation. A sharper economic dip should nevertheless result in a setback for the office markets. In our baseline scenario, however, we assume that rental momentum will remain positive, but is likely to ease in the medium term.

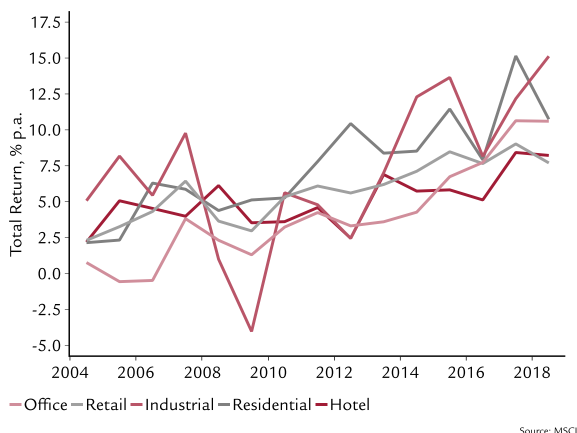
Rising yields in the retail sector

The crisis in the fashion industry as well as ongoing competition from e-commerce is causing concern among store-based retailers and their landlords. Apparent signals include declining demand for retail space and concentration in very good locations, but also the scepticism of investors, which is reflected in rising yields for shopping centres and secondary locations. However, there are still promising segments in retail: retailers of food and daily goods as well as the value segment can compete with e-commerce, making retail centres and supermarkets a good choice. High investment volumes and continued yield compression in this segment underline this assessment.

Regulation may affect housing

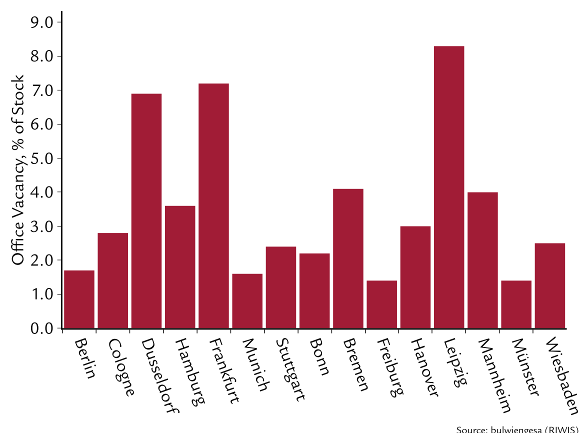
The residential sector has established itself as the main investment category after offices, and once again recorded an attractive return of 10% in 2018. The fundamentals remain consistent: the migration to the cities is not backed by appropriate homebuilding activity. Thus, the completions in 2018 scarcely exceeded the previous year's figure of around 286,000 apartments built (instead of 350,000 p.a. required). For investors, inadequate supply and high prices are challenging. In addition, government regulation seems to be another aspect that is intensifying. The Berlin Senate wants to freeze rents for 5 years from 2020. It is possible that such measures could also spread to other cities.

Chart 1: Total return by sector



Source: MSCI

Chart 2: Office vacancies in selected cities (Q4 2018)



Source: bulwiengesa (RIWIS)

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