Pending rate rises fail to dent German property appeal

Germany’s reputation for solid economic performance and political stability is drawing investment, as rising global geopolitical and economic risks and the prospect of higher European interest rates weigh on investors’ decisions, panellists said.

“There has been a wave of fear of protectionism so there has been a redirection of global capital towards safe haven markets, including Germany,” said Muscarà. As investors have moved out of riskier assets, they have flocked to German fixed income, pushing down 10-year bund yields to 0.49% from 0.65% over the last month, she explained.

Similarly, the German real estate market is benefiting from strong fundamentals and macro trends. The tight supply of new property, combined with rising rents in key cities such as Munich and Berlin, is driving up values and compressing yields, Muscarà said. At the same time, the economy remains healthy and is expected to grow by 2.4% in 2018, according to German government data, although Düsseldorf-based Macroeconomic Policy Institute issued a recent warning about increased recession risk due to falls in retail sales, industrial production and factory orders in the first quarter.

The broadly positive outlook is helping pull in investors. “What we are seeing is that German institutional investors in particular have increased their real estate exposure in direct real estate investment, indirect investment and, in the last two or three years, have increased their real estate debt exposure as well,” Flatow said. He believes that investors will retain that focus on real estate and not be lured away to other assets, such as fixed income.

Indeed, the expectation of rising interest rates as the European Central Bank gradually removes monetary support is not dampening demand. Muscarà said that a hike in interest rates is already priced in, while Mühlen said that real estate yields would likely remain well ahead of any potential fixed income return. “It seems common consensus that interest rates will rise within the next year or two,” he said, also drawing attention to German property yields in the range of 3%-5% depending on the investment sector. “Does anyone in this room honestly believe that within the next three, four or five years we will get back to these kinds of interest rates? Or we will have a slight increase [in yields] and continue to have a gap between real estate and interest rates?”

Despite yields at historically low levels, others argue that prices are not high in relative terms –
particularly in Eastern German cities. “I slightly disagree with Germany being overpriced. Compared with London, I find it very possible to build stuff in Berlin,” said Reynolds, whose company Lobe is building a new business block for creative businesses in the centre of the capital. She added that sites for development are still available in cities including Dresden and Leipzig. “I think the prices are really good in those parts of Eastern Germany, and that it’s a developing market and a strong market,” Reynolds said.

**Asian investors flood in**

The stability of Germany is drawing both domestic and international investors, with the country registering record commercial property investment of €57bn in 2017, according to JLL figures. Flatow has recently talked to institutional investors from Lebanon and Korea who have bought commercial portfolios in B and C locations across the country as they look to access higher yields. At the same time, FAP is fielding demand for its maiden mezzanine debt fund – a roughly €250m vehicle that the firm expects to launch later in the spring. “We strongly believe that there will be so much demand from German institutional investors that there may be no need for us to go abroad,” Flatow said, although he added that the firm had received interest from a Korean investor for the fund.

The interest from Korea reflects the country’s high level of activity in Germany, as well as more broadly across Europe. Foreign investment has accounted for about 45% of the total over the last three years, Muscarà said. “The big trend if you look through the numbers is the rise of the Asian investors,” she said, adding that their presence in Germany is at a record high, accounting for around 10% of the investment total. “It’s the South Korean investors who have been knocking on people’s doors – they have certainly knocked on ours,” Muscarà added.

But while appetite for investment is high, supply of new properties is low. “We see family offices sitting on offers for super-prime properties at 2% entry yield but not wanting to sell,” Flatow said. Although the sale prices are clearly attractive, they see limited options to invest their capital elsewhere, he explained.

For those who do decide to dispose of their assets, it’s a sellers’ market which allows them to call the shots. Mühlen said co-exclusivity is increasingly common, highlighting one extreme example in which a seller selected three parties for final negotiations, all conducting financial due diligence at the same time. The seller then organised three separate meetings for the bidders with three separate notaries on the same day. “The one party that was willing to enter the highest purchase price on the SPA would have the transaction notarised, whereas the other two were sent home and couldn’t buy the property,” he said.

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The signs of fierce competition and boom-era deals are also returning to the lending market. Flatow said that in some instances, lenders are providing senior loans of up to 80-85% loan-to-value topped up with mezzanine, while developers can secure loans of 95-98% loan-to-cost.

**Rents soar in top cities**

While investor competition and prices are high, rents are rising in key locations. According to Cushman & Wakefield’s Germany Office Market Snapshot for the fourth quarter of 2017, prime office rents in Frankfurt’s CBD increased by 13.5% over the year, while they rose in central Berlin by 11.5% and in Munich’s peripheries by 10.1%. “Frankfurt office rents have gone up very significantly, which is possibly due to Brexit,” Mühlen said.

Meanwhile in Berlin, commercial rents have doubled over the past eight years, Reynolds said. There the more avant-garde projects with higher architectural appeal are generating the most interest. “The projects that are experimental are accidentally making more money,” she said.

Across the major cities, it is the low supply of new properties – one of the drivers for higher asset prices...
Tariff war could tarnish German economy

Despite Germany’s reputation as an outperformer on the global stage, as risks to the global economy increase once more in 2018, so do other risks. The most significant issue is the prospect of a global trade war, started by the US’s recent decision to put tariffs of 25% on some €60bn of Chinese imports, a move which provoked retaliatory measures from China. As a result of growing concerns, German auto manufacturers Daimler and BMW, which together export over 100,000 vehicles annually to China, have seen their shares slide 14% and 6% respectively from January highs.

“The most significant threat from our point of view is that the increase in protectionism would lead to an economic downturn in Germany. We are an exporting nation, we are basically the world’s champion when it comes to exporting goods,” Mühlen said, highlighting the country’s strong trading links with both China and the US. “We have been incredibly successful in the past few years because of a lack of customs and an absence of protectionism. And if this turns into a spiral where the Germany economy is impacted, then yes, possibly this will have an impact on real estate too,” he added.

Flatow agreed that protective tariffs posed a threat to the German economy and also pointed to the risk of new or extended real estate tax measures following the formation of Germany’s new government in March.

Other potential issues stem from the conservative nature of the German consumer, who prefers renting over home ownership. “It worries me a bit that Germans are not investing in their own property. It could be that Koreans and Chinese people do take over some areas of big cities and then these properties are not culturally entwined with the city, and that would anger fractions,” Reynolds explained.

Still the risks remain relatively low and the market is on a sounder footing than the past, the panel argued. “Compared to 2007, it’s just not the same market,” Muscarà said, indicating low supply, solid economic factors and broadly cautious financing levels. “It’s a pretty risk-averse environment, particularly in Germany,” she said.