Overview of 2018

Germany, the EU’s largest economy faced increasing headwinds over 2018. The US-China trade war dominated global geopolitics, while in Europe, Brexit, the Turkish currency crisis and tensions surrounding the Italian budget began to encumber sentiment and exports.

Domestically, 2018 also saw an upset in the German political order, with the formation of a grand coalition and the announcement that the Merkel era is to end. In the automotive sector, new emission standards weighed down on production, while shipping saw disruption due to record low river levels. This and an influenza outbreak all contributed to domestic challenges.

Despite these headwinds, Germany remained resilient over the year. High workloads resulting from production struggling to keep up with demand, spurred businesses to invest in increasing their productive capacities. This is particularly the case in the construction sector, where activity is trending upwards, albeit, surging prices hint at labour shortages. Unemployment declined by 0.5 percentage points over 2018 to 5.2% and employment rose 1.3% over the year, reaching a post-unification high. The export of goods and services also grew 2.4% per annum (p.a.) over 2018 and imports by 3.4% p.a.

These factors suggest a solid domestic demand, driven by burgeoning private and public consumption, collectively supporting German gross domestic product (GDP) growth of 1.4% over the next five years, a G1 percentage point upward revision from their previous forecast. Prosperity, as measured by GDP per capita, is forecast to grow by an average 1.3% p.a. over the same period.

In terms of sentiment, the manufacturing PMI by IHS Markit fell in March to the lowest level in 79 months, indicating a contraction. However, the service sector PMI, while also experiencing a marginal decline for March, was better than expected on the basis of solid employment growth and new work in the sector. The ZEW economic index, traditionally the most forward-looking indicator, also increased significantly over the end of Q1 2019 to well above expectation. This suggests that the overall gloomy sentiment may lift over 2019, particularly as there are indications that US-China trade relations could thaw.

On the monetary policy side, the European Central Bank currently remains on an expansive course, which could keep the Euro low. In this environment, investors from outside the Eurozone may find German real estate a relatively attractive destination for their capital.

Economy

Robust activity amid global headwinds

Overview of 2018

German economy at a glance

<table>
<thead>
<tr>
<th>Economic growth</th>
<th>Unemployment rate</th>
<th>Inflation</th>
<th>Nominal wage growth</th>
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<tr>
<td>2017</td>
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Sources: Ifo, German Federal Ministry for Economic Affairs and Energy, German Central Bank, German Statistics Department, German Council of Economic Experts, Trading Economics
Capital markets – liquidity continues

According to Knight Frank’s 2018 European investor sentiment survey, 36.1% of property investors expect dampened investment conditions across Europe for 2019 while 40.2% expect an improvement. Amid this mixed outlook, Germany remains a favoured location for investment by the respondents.

An additional sentiment poll by Union Investment found that 70% of institutional investors surveyed stated their preference for acquisitions in Germany compared to the rest of Europe, providing a continued demand driver into 2019.

Supporting this sentiment, Germany’s overall real estate market turned over €78 billion in 2018, according to EY. However, EY’s trend barometer indicates a potential top of the cycle, with forecasted transaction volumes of €72-75 billion for 2019. This is still significant, but expected to be slightly down on last year.

Office investment contributed 56% of total German CRE transactions in 2018, according to Real Capital Analytics (RCA), of which circa 43% were cross border. Germany was the dominant European destination in 2018, taking 25% of total European office investment, followed by the United Kingdom (24%), and France (20%).

By value, the Frankfurt area was the most active in 2018, with almost double the volumes seen in the next most investible locations of Berlin-Brandenburg, the Rhine-Ruhr and Munich, reflecting the transacting of larger lot sizes.

By number of properties, the Rhine-Ruhr, saw a significantly higher number of office properties transacted over the year however, reflecting a larger number of smaller assets. Given elevated pricing and late position in the cycle, we expect that some current owners are increasingly looking to sell, while purchasing investors are becoming increasingly selective, amid tight yields. In defence of current pricing, demand drivers should continue to support stable or increasing office rents in the main cities over the coming year. Yields are expected to remain stable, supported by continued investment demand and a general theme of limited stock availability.

Defensive late cycle investors could find multi-let prime office buildings in the core attractive. Prime office assets in liquid, well-connected tier two cities, as well as assets in well-connected fringe-of-core in top tier cities such as Berlin, Frankfurt, and Munich, with potential for active asset management, could also see scope for further capital growth over 2019.

We also see evidence of increasing investor interest in digitalised real estate, for example offices, serviced apartments and micro-apartment living, that are integrated with “smart infrastructure”. Investors are increasingly identifying value in the data generated through the consumption of real estate, as well as the value inherent in the asset itself.

Linked to changing habits and digitalisation, logistics continues to grow in demand, particularly, the last mile deliveries, while retail is increasingly considered challenging as a sector, albeit returns are to be found here too.

Germany was the dominant European destination in 2018, taking 25% of the total European office investment.”
Attitudes towards real estate costs are changing. The focus has shifted from cheap fixes to effective real estate solutions. Businesses are utilising their property portfolios as a strategic device to encourage and increase productivity within their workforce. The creation of, and investment in, a positive, serviced and well-supported workplace environment has been integral to this process.

In Berlin, the Karl-Marx Straße 101, previously a department store, has incorporated multiple amenities to boost productivity. Included in the building’s approximate 37,400 sq m total area are retail units, an on-site gym, a six floor parking garage, bicycle parking and a food court. These facilities are tailored to the young and vibrant workforce that businesses are trying to attract and retain.

Further to this, Artificial Intelligence (AI), robotics and automation have the capacity to instigate rapid organisational and process re-engineering. This might update the future form, function and location of workplaces. Specifically, it could reset the quantum and quality of staff required by a business, whilst enabling the closer interactions of humans and technology to increase productivity. For example, in its office in Berlin, B:HUB is building an app that automates the lighting, air conditioning, booking of shared rooms, and sports classes in the internal gym.

The workplace has become a flexible business service that can actively support growth, rather than acting as, especially for the occupier, a physically onerous product. Traditional landlords who want to remain competitive need to extend their innovation beyond the design of the physical product and towards soft-services, community and well-being.

In a period where M&A activity is beginning to flourish, and the search for talent intensifies, portfolios should engage with both core and submarkets. The growing mobility of occupiers indicates businesses prioritising workplaces close to talent pools that also have access to amenities, services and infrastructure.

Technology is a critical factor driving the seemingly constant revision of business models. As organisations refocus their core competencies or seek skills outside of their traditional orbit, corporate supply chains are becoming broader and deeper. Simultaneously, corporate diversity initiatives and increasingly multi-generational workforces have altered company demographics. The effect of these changes is the greater need for flexible and collaborative workspaces that facilitate interaction between staff. However, such approaches have been slower to be administered and utilised in Frankfurt office spaces, due to company and government workplace regulations and workers councils. This has meant that many corporate real estate departments act as an internal service provider instead. Companies including Lufthansa have had to provide each department with a specific amount of space, where they individually design its layout according to the department’s own requirements.

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Space-as-a-service becomes the demand default. The workplace has become a flexible business service that can actively support growth, rather than acting as, especially for the occupier, a physically onerous product. Traditional landlords who want to remain competitive need to extend their innovation beyond the design of the physical product and towards soft-services, community and well-being. Berlin has become increasingly attractive to start-ups. These young companies have high standards regarding their technical infrastructure and community engagement. Here, the desire for flexible offices with break-out areas, co-working spaces and a less restrictive work environment is paramount.

In a period where M&A activity is beginning to flourish, and the search for talent intensifies, portfolios should engage with both core and submarkets. The growing mobility of occupiers indicates businesses prioritising workplaces close to talent pools that also have access to amenities, services and infrastructure. Increasingly, the location, the style, image of the location and a company’s image all influence real estate strategy. Indeed, the Frankfurt market has been heavily driven by re-locations from outside the city. Companies including Capgemini and Sage Software moved into Frankfurt to benefit from the city’s accessibility.

Changing Corporate Constitutions
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Office investment volumes in Germany amounted to €29.7bn in 2018, according to RCA. The big seven cities accounted for the majority of volume, with €24.1bn of office transactions. Frankfurt continued to dominate with 29% of office investment, up from 25% the prior year.
Berlin – the go to location for business of any size

Germany’s capital has evolved into a globally competitive hotspot, offering a highly qualified skill pool, diverse science and research sector and modern infrastructure. Berlin is the most populous cultural centre in Germany. With a catchment area of some six million people, the city benefits from a supply of highly skilled national and international labour. It has the highest density of researchers and academics per capita in Germany, while its universities graduate some 19,000 students annually. International conglomerates, small-to-medium sized businesses, and young start-ups alike are all drawn to the capital, which has established itself as the go-to location for businesses of any size. The likes of Google, Facebook, Amazon, Expedia but also Daimler Benz, Universal, Siemens and IBM have chosen to locate themselves in the city.

Europe’s number two for venture capital attracts many start-ups and innovative businesses, such as e-commerce firms Zalando and Rocket Internet. As well as a cultural, tech and business centre, the city is also home to the German parliament. The above are all positive for office demand. Reflecting this, office take-up in 2018 totalled 960,000 sq m, the third highest level ever registered, across segments of all sizes. This number would potentially be even larger if more space was available. With growing demand from local and international companies, we expect take-up in 2019 to reach 1,000,000 sq m. Existing available space and anticipated completions may still not suffice to satisfy the demand.

Due to strong demand drivers, prime rents have surged in the last 24 months. Secondary product and locations are now shifting into the spotlight. Vacancy rates are at an all-time low and one of the lowest levels across Europe. We expect further declines on the 1.8% vacancy rate over 2019, which could lead to challenges for corporate newcomers, relocations and expansions.

Office stock levels are currently at circa 18.9 million sq m with 500,000 sq m expected to complete in 2019, of which 70% is already pre-let. Additionally, we also see 50% of 2020 completions and 40% of 2021 completions being pre-let. The city is into its sixth year of growth in investment volumes. 2018 transaction volumes for commercial real estate in Berlin totalled €70 billion, of which 60% were in the office sector. Over 20 single asset transactions were above €100 million. Offices were the most popular asset class in Berlin (60% of investments), with 47% of capital inflow originating from international investors.

2019 has kicked off with a flurry of activity: Office block Oberbaum City in Berlin’s Friedrichshain district, a mixed-use complex on a historic factory site, was purchased by Blackstone and QuinCap for €500 million and offers 79,000 sq m of office, 5,200 sq m warehouse, along with 4,200 sq m retail space. Meanwhile, the former Steinbeis College, also in Friedrichshain, was sold in February 2019 to a subsidiary of the Steinbeis Group to be converted into 8,600 sq m of office space. Italian insurer Generali bought 6,500 sq m in Spindlershof, which will be refurbished and customised for co-working, ready for serviced office space provider Regus to take occupation in 2020.

Prime office yields have compressed by 10-20bps over 2018 to 2.75%, which combined with rising rents and decreasing vacancy rates means that Berlin continues to be attractive.

Fast forecast 2019

Office
employment
767,021

Vacancy rate
1.5%

Prime office rent
504 €/SQ M (PER ANNUM)

Take-up
1m

Prime office yield
2.5%

Working population
3.0m

Source: Oxford Economics, Knight Frank

“Berlin has the highest density of researchers and academics per capita in Germany, while its universities graduate some 19,000 students annually.”
Frankfurt – the global market place

Frankfurt is a key European finance and trade hub, housing over 300 international banks according to information portal Teleauskunft, as well as the world’s fifth largest stock exchange and two central banks – the European Central Bank and Germany’s Bundesbank.

36% of the gross value added (GVA) for the city was generated by the financial and services sector in 2018, according to Oxford Economics and employment here is expected to continue expanding. Despite continued growth in this sector, this represents a 6% reduction in contribution to overall GVA over the last decade, reflecting diversification of the city. Over the same period, employment in the public sector has increased by 23%, representing a shift to a lower beta segment. This potentially helps insulate Frankfurt against large market swings – a positive impact on the office sector.

Frankfurt acts as a transportation hub for Germany and Europe. The city benefits from its central location, airport and high-speed trains that connect to almost all European capitals within two hours. This infrastructure is supportive of future growth.

Despite strong demand drivers, take-up totalled 533,800 sq m over 2018, largely due to lack of availability. The CBD continues to be the most sought after area; Bankenviertel was the most popular sub-market, but the increasing lack of available central floorspace is also moving sub-markets like City West and Niederrad into the spotlight. This is evidenced by Commerzbank taking 36,000 sq m in City West and Nintendo leasing 16,000 sq m in Niederrad over the year. Financial services providers continue to make up the metropole’s largest lease-takers with the Technology, Media and Telecoms sector in second place.

Frankfurt continues to register rising rents, with rental growth of 4.0% over 2018. Vacancy reduced by 0.6% over 2018 to 7.2%. For 2019, we expect this to drop further to 7.0%. Office availability has been on the decline, while the development pipeline offers little in the way of speculative contributions, given the high rate of pre-lets. New developments, especially for larger floorplates, would be welcome by occupiers.

In terms of investment, Frankfurt took the top spot in Germany for office transactions over 2018 with €8.5 billion in volume. Compared to the year before, the number of transactions reduced, but the magnitude of transactions increased, evidenced by the number of high-rise office buildings that changed hands. The Bankenviertel district, for example, registered ten office tower transactions in 2018, the largest of which was the €700 million Omniturm purchased by Commerzbank Real Estate; a mixed-use office and residential block with over 54,100 sq m of floorspace.

Frankfurt saw a healthy presence of capital from Asia. South Korean consortium IGIS and Hana Financial Investment purchased the €650 million Trianon, a mixed-use office and residential block totalling 68,000 sq m, of which 61,000 sq m comprises office space. Taiwanese insurer Fubon Life purchased the Eurotower, the former headquarters for the European Central Bank, for a reported €575 million.

In terms of investment, Frankfurt took the top spot in Germany for office transactions over 2018 with €8.5 billion in volume.

**Fast forecast 2019**

- **Office employment**: 661,483
- **GVA (€ million)**: 143,954
- **Vacancy rate**: 7.0%
- **Working population**: 1.8m
- **Prime office rent**: €652 (PER ANNUM)
- **Prime office yield**: 3.25%

**Source**: Oxford Economics, Knight Frank
Munich – the knowledge led city

Munich enjoys the highest purchasing power per capita in Germany, according to market research think tank GfK. The service-driven economy is fuelled by small and medium sized companies (SMEs) as much as it is by Germany’s industrial heavyweights like BMW and Siemens. Munich is also home to Linde AG, Allianz, MAN, Munich Re, Wirecard and Infineon.

The multitude of universities in Munich helps generate qualified and entrepreneurial minds, who often remain in the city to take advantage of its technology centres, incubators and accelerators. Munich therefore provides structural diversity which, combined with a population of 1.5 million, expected to increase to 1.7 million by 2030, job growth of 25,000 per annum and the lowest unemployment rate among the big German cities, offers strong demand drivers.

Just under one million sq m office space was let in 2018; much of this take-up measured above 5,000 sq m. The IT sector remains the most active tenant group, accounting for circa 25% of take-up, followed by the manufacturing and advisory industries. Fintech firm Wirecard (39,500 sq m in Aschheim-Dornach), and Europé’s largest integrated agency group Serviceplan (38,500 sq m in Wehrenberg), signed Munich’s two largest leasing deals of the last ten years.

Prime rents grew by 0.2% to €434 in 2018. We expect prime rents to remain at this level in 2019. Strong demand and supply challenges in the city centre are pushing average rents in secondary locations towards inner-city prime rent levels.

Vacancy rates in 2018 were down 0.5% over 2018 and are expected to drop another 0.2% this year. At the time of writing, we are seeing a vacancy rate of 1.7%-2.0% between prime and secondary locations.

The supply scarcity is reflected by a high level of pre-lets, 80% of the 810,000 sq m development pipeline under way in 2018, was already pre-let. We expect similar pre-let levels for 2019, which has 830,000 sq m due to complete. Construction activity is increasingly moving away from the CBD into secondary locations and delivering office space in business park formats owing to a lack of developable space in prime locations.

The shortfall of top-spec product means that occupiers, especially those with large floorspace requirements, have to renew or secure new contracts long before lease expiry. Serviceplan for example have already signed on 40,000 sq m of space that is due to complete in 2020.

Flexibility needs and rising rents are pushing up the demand for co-working space as not only self-employed, digital nomads and creatives, but also corporate occupiers are discovering the benefits for themselves. The likes of Design Offices, Mates, Smartvillage, Mindspace and WeWork contributed to some eight percent of take-up.

In terms of investment volumes, 2018 saw a new office transaction record for the Bavarian capital of €3.7 billion. We expect this to marginally reduce over 2019 due to a lack of prime investment assets. The sale of Oskar for €380 million to a consortium including the asset manager, BKV and the insurer, Swiss life, was one of the largest transactions in Munich in 2018. The Corona Quarter at the main train station, sold by the Postbank to Credit Suisse for €275 million, also contributed to the top deals list.

Foreign capital is drawn to Munich, where 66% of office transactions in 2018 were cross-border investments. South-Korean Samsung Asset Management for example procured the 44,000 sq m Atrium, for a reported €180 million. The main tenant, IT firm Oracle, will contribute to 45% of the rental income.

Munich is running out of buildable sites and as such, we see little new availability coming to the market. There could be opportunity for investors from office conversions and refurbishments of current stock in prime locations.

Fast forecast 2019

Office employment 854,796
GVA (€ million) 224,006
Working population 2.8m
Prime office rent 434 €/K2 M PER ANNUM
Prime office yield DOWN TO 3.0%
Take-up 800k
Vacancy rate AT A RECORD LOW OF 1.5%

Source: Oxford Economics, Knight Frank
At times like these, with growing global headwinds, it is easy to overlook that there are upside opportunities to be found. Here we consider two risks to be aware of and three areas of opportunity for Germany.

Energy reform

While Europe is introducing competition in the energy markets, global oil and gas reserves are increasingly controlled by a handful of state enterprises. Phasing out nuclear and fossil fuels in favour of renewable energy resources could transform Germany’s economy. The country’s aim to reduce CO2 emissions by 80-95% in the six decades to 2050, requires investments of over €200 billion by 2022.

Existing buildings will need to be retrofitted, new-builds will be subject to new energy guidelines, current coal mining districts such as those outside Berlin and Frankfurt, and the Rhinisch coal field close to Cologne, may face redundancies and complete restructuring. Labour markets and business landscapes in these areas will need to reinvent themselves once the mines and power plants are shut down. Still, opportunities arise from new economic hubs that require new types of buildings, and energy real estate investments such as geothermal generation resources and energy storage.

Automotive industry

Circa 1.8 million job roles are derived directly and indirectly from the car manufacturing sector, according to the German Association of the Automotive Industry. They found that three quarters of automotive products manufactured in Stuttgart, Wolfsburg and Munich are exported. A combination of the Dieselgate scandal, new regulatory requirements, geopolitics and the knock-on effects of protectionism, led to a fall in the automotive market by almost one third over Q4 2018. Impacts from the adoption of the new worldwide harmonised light vehicles test procedure, are expected to only be temporary, however.

Germany also remains the frontrunner in patent registrations according to the European Patent Office. In terms of autonomous driving patents, Germany is the leading innovator behind the United States, with 14% of global self-driving inventions registered since 2011.

Urban densification

Urbanisation is driving strong growth in German metropolitan areas, particularly in the Big 7 real estate locations of Berlin, Cologne, Düsseldorf, Frankfurt, Hamburg, Munich and Stuttgart. For example, Munich is expected to see a 12% increase in total population and a 4% rise in working age population over the period to 2030, according to Oxford Economics. The Eurozone total population is expected to remain broadly stable, in terms of number, over the same timeframe. Berlin and Frankfurt should also see growth in the total population, although not as high as seen in Munich.

This trend of urbanisation should drive returns across sectors, including mixed-use developments, as the silhouettes of professional and personal life enlace.

Record employment

Record employment rates and notably low unemployment levels continue to create demand in the office sector, especially considering continued tight supply. The employment trend contrasts the challenging economic conditions. Continuously increasing wages due to a labour shortage and growing staffing demand in the service sector, should elevate income expectations and purchasing power. This, coupled with low interest rates, is expected to drive consumption propensity. The resultant increase in wholesale and retail sales volumes could propel the demand for storage and logistic assets.

Internet of Things (IoT)

The IoT could see a quadrupling of networked devices to 125 billion by 2030 according to IHS Markit. This will create versatile potential opportunities for the manufacturing and service sectors such as individualised products, resource efficient logistics, new service provisions, or more flexible working. The blurring of boundaries between residential and commercial space is fundamentally transforming how value is delivered – office and retail space need to become compelling destinations.

Investors can look to optimise existing and new space to meet occupier demands for flexibility, and alternative investments like datacentres. The Prime-Main region around Frankfurt is a case in point. It has the world’s largest internet exchange point DE-CIX and is struggling to meet the demand for datacentres according to datacentre operator Telehouse CEOs Béla Waldhauser, creating opportunities for growth in this sector.
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