FOLLOW THE MONEY?

While other parts of Europe have been hit hard by the financial crisis, Germany's biggest cities have prospered. Office and residential space is especially hard to find, and investors seem confident the economy will continue to thrive

MICHAEL WEBER/IMAGEBROKER/REX/SHUTTERSTOCK

In Düsseldorf, office investment increased by 280% in Q1 2017

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Strong, stable, stoic. When the global financial crisis hit, many looked to Germany for leadership and guidance. It is not hard to see why. Left comparably unscathed following the 2008 downturn, the country's economy has seen nearly a decade of growth while others – including Greece and Spain – have suffered crippling recessions.

That growth shows no sign of slowing down. In April this year, the International Monetary Fund (IMF) raised its forecast for German economic growth to 2.5%. Off the back of a 2.2% jump last year, this signals the strongest growth the country has seen since 2011.

The knock-on effect for the German real estate market has been just as positive. "It has been a pretty solid market throughout the crisis," says Toby Baines, chairman of Citygrove, which has entered the German market with a play in the branded business hotels sector.

"Back in 2012, when people thought Greece was going to knock the euro into touch, the rush was to own real estate in Germany. It makes sense because if there had been a return to local currencies and you owned assets in Germany, you would probably get around a 30% uplift compared with owning property in places such as Italy or Spain as the Deutschmark would be regarded as undervalued, whereas the lira and peseta would be considered overvalued."

Continued growth?

While the return to local currency never happened, this rush to snap up German assets further buoyed Europe's already largest economy during the crisis. Now people are asking whether it can continue to grow and what role the country's real estate market will play.

With increasingly tight supply in the office and residential sectors across most of the country, escalating rents are starting to raise questions over how long is left in the current cycle. For many looking to develop and invest in Europe's strongest economy, the trick will come down to targeting the right sectors in the right cities.

Scarce space

Office space in the top office markets in the country (Berlin, Frankfurt, Munich, Hamburg, Düsseldorf and Cologne) is scarce and the average vacancy rate across all six cities fell to an average of 5% in Q1 this year, according to Savills. Development activity is expected to increase over the next three years, with particularly strong growth in supply in Berlin and Munich. The completion volume for the top six cities this year will total 840,000 sq m (10-year average: 950,000 sq m), which will increase to around 1.3m sq m and 1.5m sq m in 2019 and 2020 respectively.

Transaction volumes in the German office investment market in the first quarter of the year were up 32% to €6bn with the top seven cities – the six mentioned above plus Stuttgart – attracting 90% of the funds. Savills expects a total investment volume of around €25bn in 2018. "Investors will remain focused on the top seven cities in Germany this year," says Marcus Lemli, chief executive Germany and head of investment Europe for Savills. "This indicates that market liquidity is an extremely important factor in investment decisions."

Düsseldorf and Hamburg showed the highest relative increases of investment, up 280% and 240% compared with the corresponding quarter last year. "The primary driver of this focus on the largest cities is the relatively high short- to medium-term rental growth potential," says Matthias Pink, director and head of research Germany for Savills. "Current office rents are expected to increase by an average of 3% to 4% this year alone."

In addition to the overall volume, the size of individual transactions has also increased. A number of deals in excess of €100m were completed, including 11 individual sales, all of which were in the top seven cities. This also included the largest deal, the sale of Frankfurt's administrative centre by WealthCap to Aroundtown. A further three large deals were completed in Munich: the Correo Quartier, the Aviva Munich and the SZ Tower.

Special funds and asset managers were the most active investors in the first quarter of the year, with acquisition volumes of €1.2bn and €700m respectively, according to Savills. An analysis of purchasers' countries of origin shows that invested capital is divided equally between domestic and foreign investors. Europeans were the most active among foreign investors, with 65% of the volume, followed by Asian (20%) and North American investors (15%).

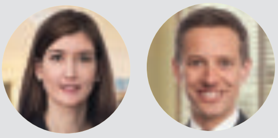
Co-working expansion

There has also been a surge in flexible working in the major cities: co-working companies have become some of Germany's most prolific occupiers, making up 35% of Munich's office sector, and 23% of Berlin's, according to CBRE. In Hamburg, Düsseldorf and Frankfurt, co-working companies make up 16%, 14% and 12% of the office markets respectively.

Beyond the office sector, transaction volume in Q1 2018 for German commercial real estate was €12.2bn. While offices accounted for just under half of that figure, the retail sector attracted €1.9bn (16% of the total volume) followed by logistics and industrial, which attracted €1.5bn (13%). "There are good reasons there is so much capital seeking investment opportunities in the German real estate market," says Savills' Lemli. "The conditions for investors are almost perfect. The population and the economy are growing and demand for space and rents are rising in many sectors."

The flip side is that this has resulted in record lows in initial yields. "The low yields are also an expression of investors'

Citygrove is developing a 450-bedroom hotel in Düsseldorf, due to open next year



Stefanie Kern and Christian Herweg, partners, Hogan Lovells, Munich

'Hot topics in the German real estate market'

The German real estate market remains highly attractive to investors. While office investment remains the largest sector in commercial real estate, there has been a growth in the volume of logistics and retail investments.

In the legal environment, the following are the most discussed topics:

Uncertainty about share deal structures

Many buyers in German real estate use share deal structures to avoid paying real estate transfer tax ("RETT") which is levied at between 3.5% and 6.5% of the purchase price. The new German coalition government has announced that it will "implement an effective and legally secure legal regulation to end abusive tax arrangements in real estate transfer tax by means of share deals".

At the moment, it is still unclear when and how legislation will change share deal structures and how this will affect future and even current deals. The current standard structures to avoid RETT are: If the property owning company ("PropCo") is a partnership, a maximum of 94.9% of the partnership interest can be transferred within a period of five years. If the PropCo is a limited company, 100% of the shares can be transferred but only 94.9% can be purchased by one purchaser or several purchasers who are legally or economically connected.

We would expect that either the required 5.1% minority share will be increased and/or the period of five years will be extended. If you plan to invest in German real estate via a share deal structure, you should consider the effect of these possible changes.

Limitation clauses

There have been some changes regarding limitation clauses in financing agreements. These clauses aim to protect the managing directors of a German limited liability company ("GmbH") against the directors' potential personal liability in case of upstream or cross-stream guarantees. In March 2017, the German Supreme Court decided a case on a GmbH's upstream/cross-stream guarantees in relation to capital maintenance regulations and the personal liability of the management. The market is currently developing a new standard on how to deal with this

Hamburg: short-term potential

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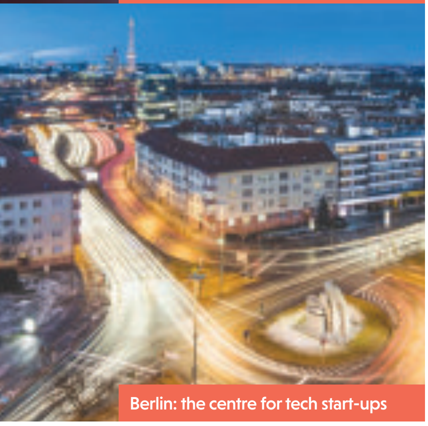

Berlin: the centre for tech start-ups

RONNY BEHNERT/IMAGEBROKER/REX/SHUTTERSTOCK

expectations of rental growth," insists Lemli. "Despite the record-low initial yields, rental growth expectations allow long-term investors to achieve attractive total returns on their capital."

On the residential side, transaction volumes increased by 7% to €13.7bn in 2017, average prices rose by 27% while the number of apartments sold fell by 16%. Investment in developments increased to 28% of the transaction volume and investment in student apartments and micro-apartments exceeded €1bn for the first time. Supply is exceptionally tight in Germany's major cities: in Berlin, apartment vacancy rates fell to just 1.2%.

Alternatives

For those who want to avoid the tight supply and low yields in the German offices and residential markets, there are other options. Germany has lots of alternative investment and development opportunities.

"We were very focused when we went into Germany," says Citygrove's Baines, following the announcement in 2017 that it would be developing a 450-bedroom hotel in Düsseldorf. "What we noticed was that there was a significant under-provision of branded business hotels in the country. The advantage we have always found with this sort of asset is the creation of a product that the institutional investment market likes to buy – assets with 20-plus leases and strong financial backed covenants. We saw that Whitbread, through the Premier Inn brand, was moving out to Germany in a big way.

"We picked up the original site in Düsseldorf at €1.41 to the pound in 2015 before Brexit vote. In hindsight, that made life much easier. We have bought another site in Hanover for a 250-bed hotel and we are looking at further opportunities, but land prices have continued to inflate and with no exchange rate to benefit from, we are being very selective now."

Baines adds that this is not putting developers and investors off this sector as it effectively created "an institutional product" in a market where lack of supply and huge demand makes these schemes very viable. "More people are definitely waking up to the opportunities in the hotel market," he says. "Not least because the demand from occupiers is phenomenal. We are looking at another site in Düsseldorf that got 23 bids."

Secondary choices

Thomas Herr, CBRE's head of digital innovation for EMEA, is a big advocate of German's secondary cities as investment options – the likes of Hanover and Bremen – and Baines could not agree more. "There is a great list of German cities with populations of between 500,000 and a million and we are looking increasingly at these markets."

He adds that, when it comes to the product, the German market is after something very specific. A straightforward room with fast internet but nothing too flash. And there is declining interest in the restaurant or spa as the hotel market shifts towards "glorified B&B" to cater for a largely domestic market. "People don't travel to Germany for the sun," says Baines. "So it is popular with Germans looking for weekends away to avoid the long waits at the airport that are part of overseas trips."

Challenging elements

For developers and investors, Germany is a relatively straightforward market, with some challenging elements. One pitfall to avoid is pitching the product wrong. The German culture means that people think long and hard about how they spend their money. This has resulted in the downfall of some retailers who underestimated just how frugal the market and consumer base can be.

"There is a ceiling," says Baines. "You have to deliver the right product for the market and a lot of people have been caught out by that."

Then there are the vast differences between the major commercial hubs – Hamburg in the North feels very different from Munich in the South, for example. Each of the major six cities has different fundamentals. Looking at tech in Frankfurt, for example, makes little sense when the digital start-up scene is almost entirely in Berlin.

Ultimately, though, Germany is a country with a strong economy open for business where overseas investment is welcomed and encouraged. "We have experienced a very positive, open door here," says Baines.

"Germans say what they think. The knowledge that a company such as ours, which has worked in real estate in a major world city such as London, can bring adds a lot of value here. That is even after Brexit. I have to say I am relieved the reaction here tends to be more "Well, that was a mental decision wasn't it?", which is much better than "Get out of my office."

new approach in financing agreements and how to protect the managing directors properly.

W&I Insurance

A relatively new trend in the market is the emerging popularity of W&I insurance – insurance of the warranties and indemnities agreed in a purchase agreement. Most W&I insurance policies are "buy-side" but often the seller initiates the inclusion of the W&I insurance. Generally, it is possible to insure the usual warranty and indemnity catalogue. However, you should be aware that W&I insurance usually excludes certain risks, such as environmental risks, hidden building defects, defective formal requirements. Further, insurance coverage is always subject to the underwriting and diligence requirements of the insurer. Therefore, although W&I insurance provides protection, you should be aware that there may be risks that cannot be fully covered. Finally, you should allow enough time for the underwriting process to be completed.

Formal requirements

For long leases, special written formalities apply. If these requirements are not met, the lease is not invalid but can be terminated at any time within the statutory termination period. Most leases contain a special clause according to which the parties agree not to terminate the lease if there is a breach of the written formalities. Although the validity of such clauses was uncertain, they were still seen as offering some protection. In October 2017, the German Supreme Court held that such clauses were invalid. This has led to further uncertainty for long leases and we strongly recommend a careful review of the written formal requirements when acquiring a long lease as an investment.