

GERMAN PROPERTY MARKET

FROM UNDERACHIEVER TO STAR PERFORMER



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Anyone looking at the property markets over the past 10 years could be forgiven for thinking the whole of Europe has experienced one long boom. In most countries prices have risen at exceptional rates and returns have been strong. However, in Germany the market has remained flat.

During the excitement of the early 1990s, it looked as though Germany would go from strength to strength. However, a combination of reduced exports, stagnating wages, low consumer confidence and the costs of reunification created economic conditions that were in sharp contrast to those of the previous decade. While these conditions impacted across the country, Eastern Germany was hit the hardest as people moved to the West and consumption slowed. Although economic analysts are reporting a rise in confidence in Germany, this can be partly assigned to the economic boost created by the World Cup. In August, the Bundesbank reported that "The German economy still has not moved beyond the opening phase of a cyclical recovery". In actual terms, growth is still slow and there are concerns that the reported strengthening of the property market may purely be due to speculation.

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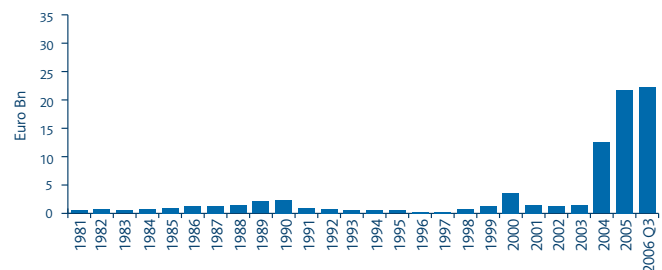
For many years, the German property market has been the poor cousin of the real estate investment world. Weak demand combined with extensive construction activity, especially in the East, has led to soaring vacancy rates in most cities, with the office availability rate in Frankfurt, for example, rising from just 2% in 2000 to around 18% currently. As a result, rents have fallen - in the case of Frankfurt they halved during the five years to the end of 2005. Despite this, German office property delivers among the lowest yields in Europe. Liquidity remains low but is undoubtedly growing rapidly. In 2004, the percentage of cross-border transactions into Germany was only 5%, rising to 13% in 2005 and further increasing in 2006, as last year's levels have already been exceeded.

Interest in Residential Sector

In addition to German open-ended funds increasing their purchasing abroad, foreigners are buying into the German property market. And while the last two years have seen large residential portfolio deals, many of which have been effectively "privatisations" of state owned housing associations, foreign investors are now increasingly focusing on commercial property. After the US, the UK is currently the largest foreign investor in German property. A number of weighty deals have grabbed the headlines in recent months and made investors wonder whether there might not, after all, be value in German markets. But

some people in the property world, above all Germans, are rather sceptical. Unlike their foreign counterparts German investors are not active in the residential market. One of the reasons foreign investors are attracted to residential property in Germany is that it appears to be cheap compared to their home markets.

Foreign Investment Volumes in Germany



Source: BulwienGesa AG, PMA

As residential prices have remained stagnant for a number of years – unlike in the US, UK and other European markets – a dramatic slump in house prices is very unlikely. There is also the prospect of stable cash flows and rent rises on the back of active asset management – as rents are believed to be below market rate. Another factor that could lead to an increase in demand for residential property, and therefore to higher prices, is the uncertainty surrounding the state pension in Germany. With the value of pensions expected to fall in real terms, it may be assumed that an increasingly large proportion of the population would have to invest in housing in order to safeguard their pensions.

Apart from the motives of these investors, it is principally the "exit strategy" – such as the sale of sub-portfolios or individual flats and IPOs or the conversion into REITs – and the effects of such volumes on the German residential market that create opportunities. However, high management costs could render these investments less lucrative and the opportunities for rent increases appear to be limited within many existing rental contracts. Also the demographics are less favourable than in many other countries, as the German population is getting older.

Retail Mismatch

These demographic factors also have significant implications for the retail sector. At present there is a clear disparity between the supply of



Paul McNamara
DIRECTOR, HEAD OF RESEARCH

retail space and spending potential. Purchasing power is much lower in the former Eastern states, while shopping centre stock is much higher than in the West. This is the result of heavily subsidised construction by the German government in the former Eastern states after reunification, which soon led to oversupply and high vacancy rates as people moved to the wealthier West where they could find jobs and get higher wages.

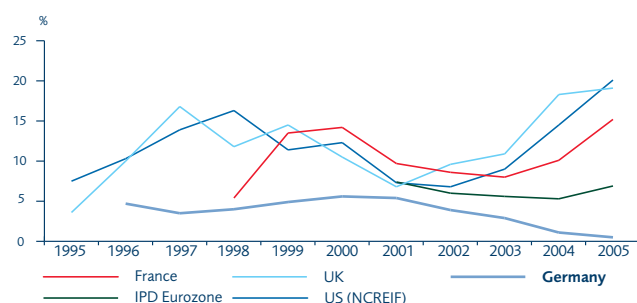
Looking forward, retail supply does not match future demographics. In general, population growth is concentrated in the former West Germany with the South and North West seeing the highest growth rates. According to forecasts from the statistical office, the population will peak in 2012; then an accelerated decline is expected to set in. Moreover, the labour force will start to shrink earlier and faster and, in order to keep the working population constant, Germans will have to work longer, start younger and increase the share of women in the working force. Potential investors in German retail need to be aware of these trends.

Performance

When looking at the performance of the commercial market, the picture is not too dissimilar from the residential sector. Germany has consistently underperformed the other European property markets over the short, medium and longer term. Yields have moved in during the last two years though, reaching record lows.

The retail sector has historically not been popular in Germany. According to IPD, domestic investors have just 19% of their portfolios in the retail sector - compared to 50% in the UK. Although, the most recent foreign investor flows have been into the retail sector, partly driven by a perception that a structural change is about to take place

International Real Estate Returns



Source: IPD, NCREIF

in retail. For example, Germany has a lower stock of shopping centre and retail warehouse space per capita than most other Western European countries partly because German planning law seeks to protect town centres. However, the amount of retail space per capita

is now rising as shopping centres spring up in numerous city centres and development activity is increasing in secondary and tertiary towns. For example, there are currently more than 60 projects with a volume of around 2 million square metres of space in the pipeline for the next three years.

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Investors however should bear in mind that there are reasons for this relative undersupply and ask if the increase in investor interest and space is in line with market fundamentals. The characteristics of the current situation in the German retail property market are falling sales figures, an increasing supply of space, lower space productivity, historically low yields and a high level of demand – particularly from overseas investors.

Investors are now increasingly looking away from the office markets which have proved very volatile and have underperformed historically. With rents at or below construction costs there is little incentive to develop new space at present – although over-capacity remains a characteristic of the German property industry. In contrast, the retail sector has both historically outperformed and could well benefit from the favourable restricted supply position. The German market has been re-pricing for the past two years and this is the factor which is driving transactions. It seems the attraction is not the prospect of a rental or economic recovery in German markets, but pricing.

The balance of risks has clearly changed for the better in Germany. The economy is on the road to recovery and interest rates are still at a very low level. Restructuring progress, wage control and productivity growth have improved competitiveness and boosted exports. Most German markets are now considered to have reached their trough, while most other European markets are close to or have passed their peak. There are currently numerous opportunities as German investors dispose of a large number of their assets. In addition, municipalities and local authorities will be attracted into selling their commercial and residential assets to REITs. However, despite the many opportunities for investors, a differentiated analysis and comprehensive knowledge of the market are crucial in order to identify favourable business opportunities. Most market commentators agree that German property markets will rise once more – they are just not sure exactly when. ■

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PRUPIM is one of the leading real estate investment managers in the United Kingdom. We form part of the M&G Group of Companies which is the asset management arm of Prudential plc in the UK and Europe. We manage around US\$37 billion of real estate assets, of which US\$6 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 1,000 properties with approximately 6,000 property occupiers. We manage real estate investments for a wide variety of clients, providing core services and expertise in fund management, asset management and property management. These services are offered individually, or on a fully integrated basis.

Our major activities are driven by powerful research, managed by the Global Property Research Team. Our considerable scale and diversified activities allow us to draw on our own multi-dimensional inputs which give us an unrivalled information advantage. We evaluate the macro-economic environment working as part of the global research capability of Prudential. We receive detailed property related data generated by our on-the-ground surveyors. This is fed into proprietary modelling systems which form the basis of our analysis. The 10-strong Global Property Research Team was formed in 1987 and is comprised of property economists and performance measurement analysts who work together to provide leading property analysis and commentary on the UK and international property markets.

— PROPERTY RESEARCH TEAM —



Paul McNamara

DIRECTOR, HEAD OF RESEARCH

Paul is responsible for the overall direction of property research within PRUPIM. He is also a member of the PRUPIM Board. Paul joined Prudential in 1987.

Paul McNamara, Director, Head of Research, BSc (Hons) PhD ASIP OBE

Scott Girard, Director, Research and Strategy, PRUPIM Singapore, B.Commm MAF

Will Robson, Analyst, BA (Hons.) MSc

Richard Gwilliam, Analyst, BSc (Hons)

Henri Vuong, Analyst, BSc (Hons.) MSc

Cuong Nguyen, Analyst, BSc (Hons.) MSc PhD

Weijia Wang, Analyst, BSc (Hons.) MSc

Nick Blakemore, Director, Performance Measurement

Katie Smith, Performance Analyst

Sarah Chan, Team Secretary, BA (Hons)

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