

German Residential Property Markets: Interesting or too much Interest?



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Overview

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German Real Estate: Biggest Market in Europe

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Residential Property: Short-term developments

3

Portfolio investments: Why and how?

4

The Demographic Challenge

5

Concluding Remarks

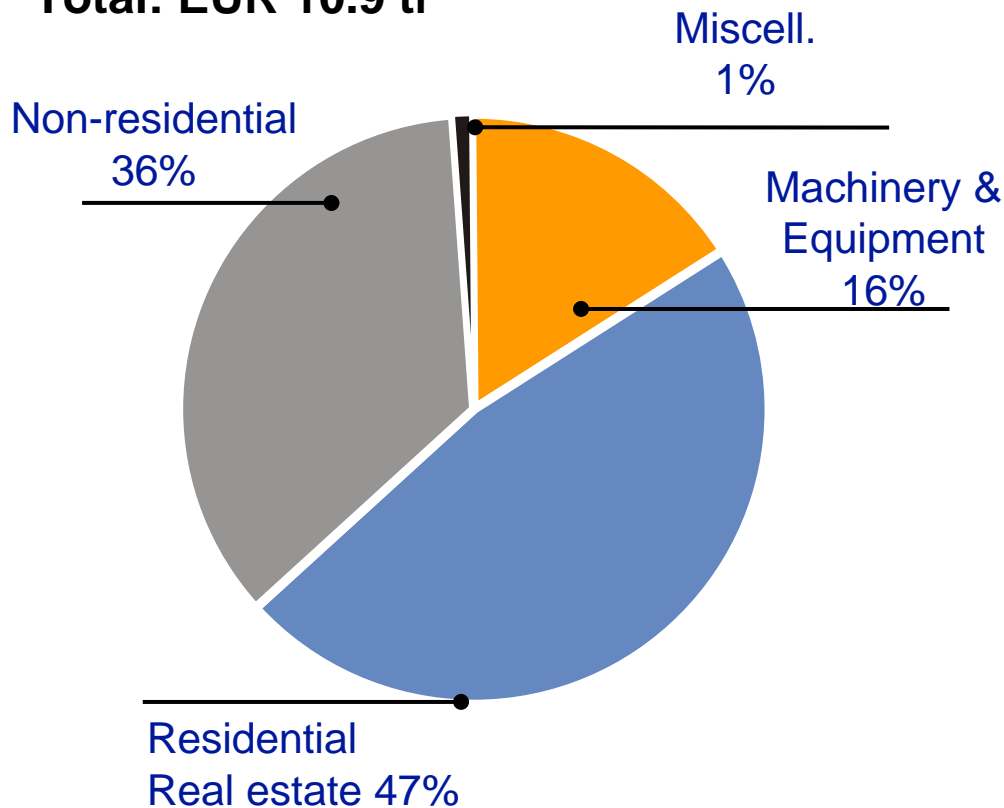




Gross fixed assets in Germany

- 2005 -

Total: EUR 10.9 tr

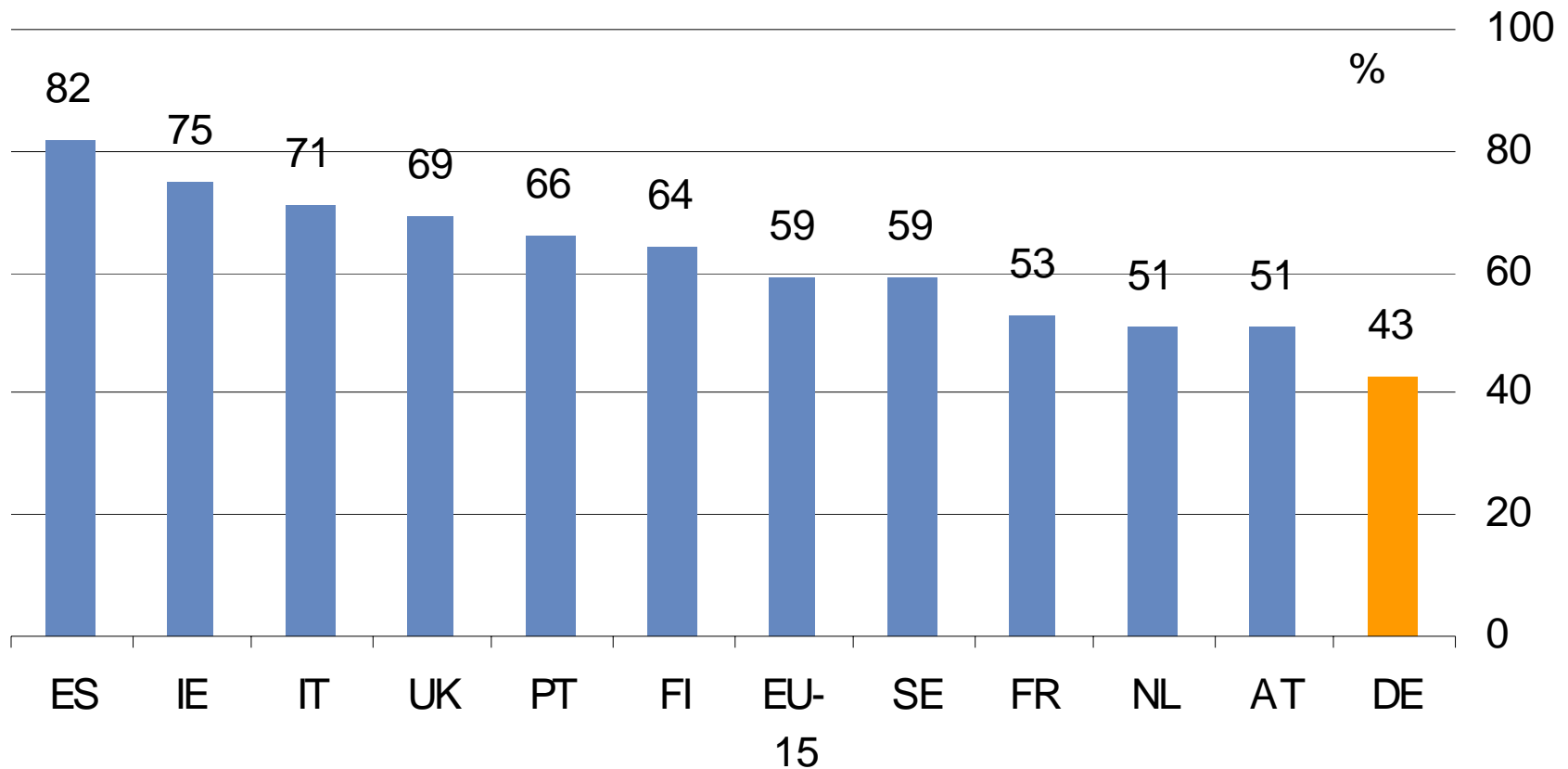


- Real estate assets account for more than 80% of all fixed assets in Germany – that is more than EUR 9 tr
- Roughly 40m dwellings are estimated at gross asset values of more than EUR 5 tr
- More than 40% of private households' assets are invested in residential real estate (EUR 3.2 tr)

Source: Fed. Stat. Office



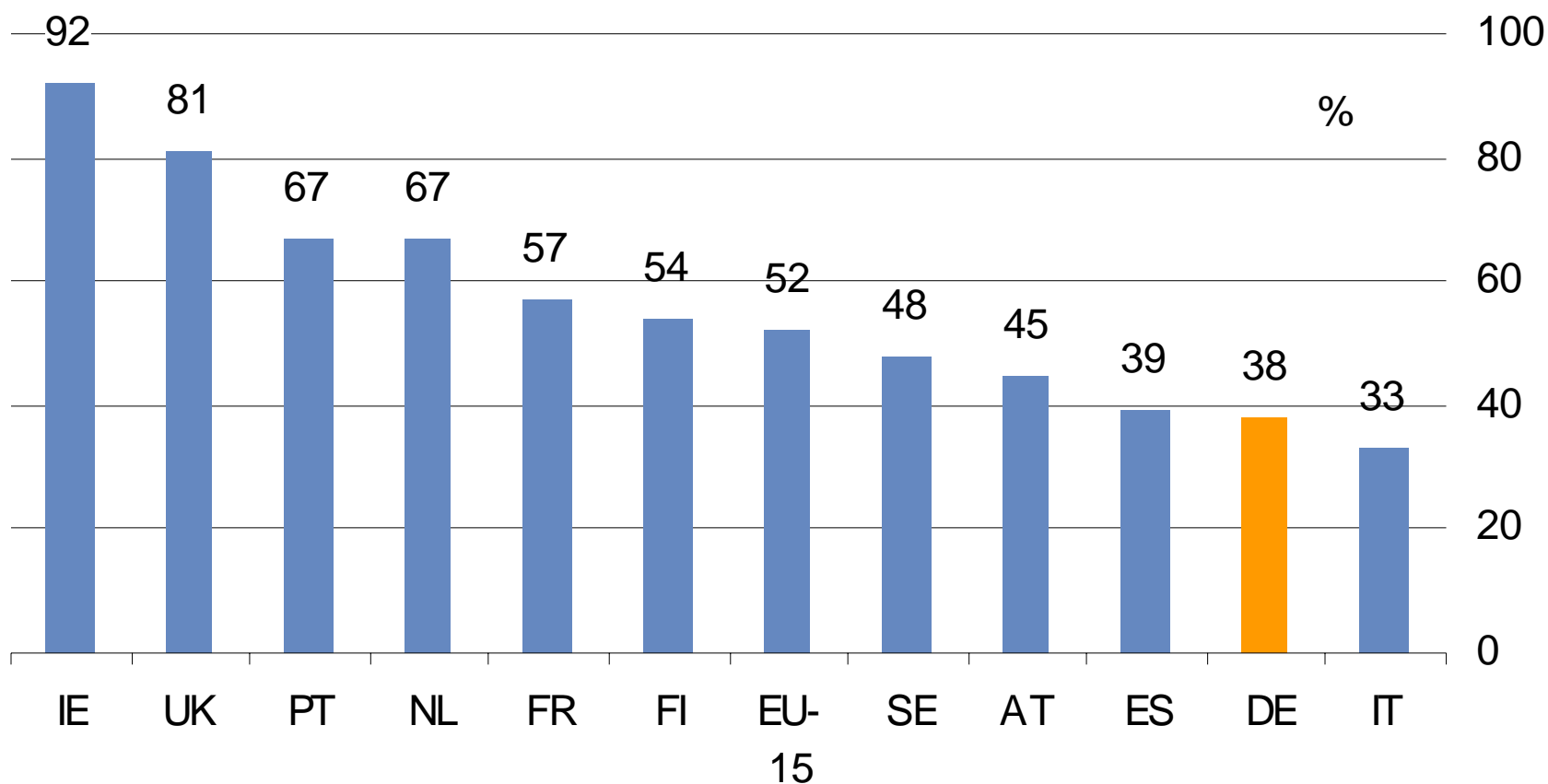
Owner occupancy rate is still very low



Source: Eurostat



Households in single-family houses *)

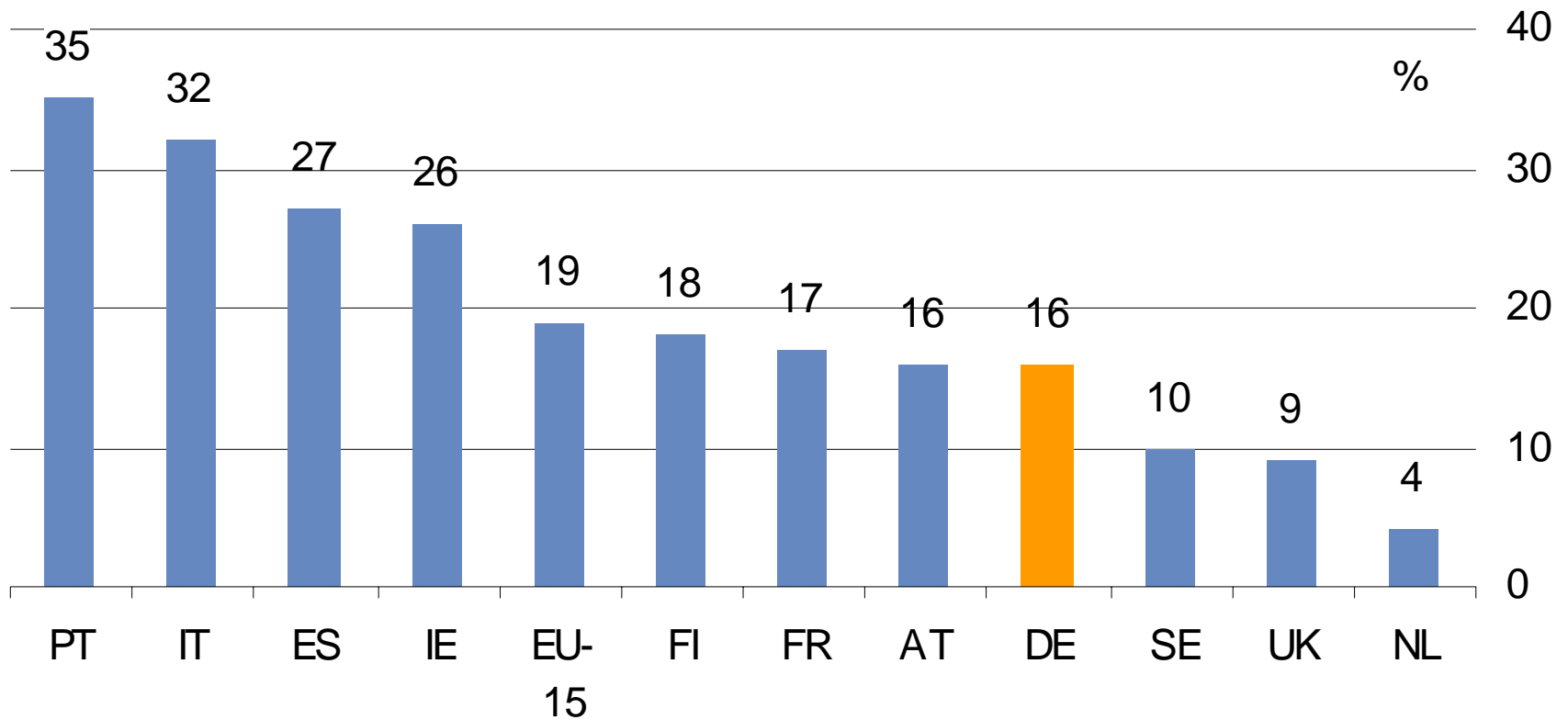


*) Households not living in apartments, 1998

Source: Eurostat



Population in cramped housing conditions*)

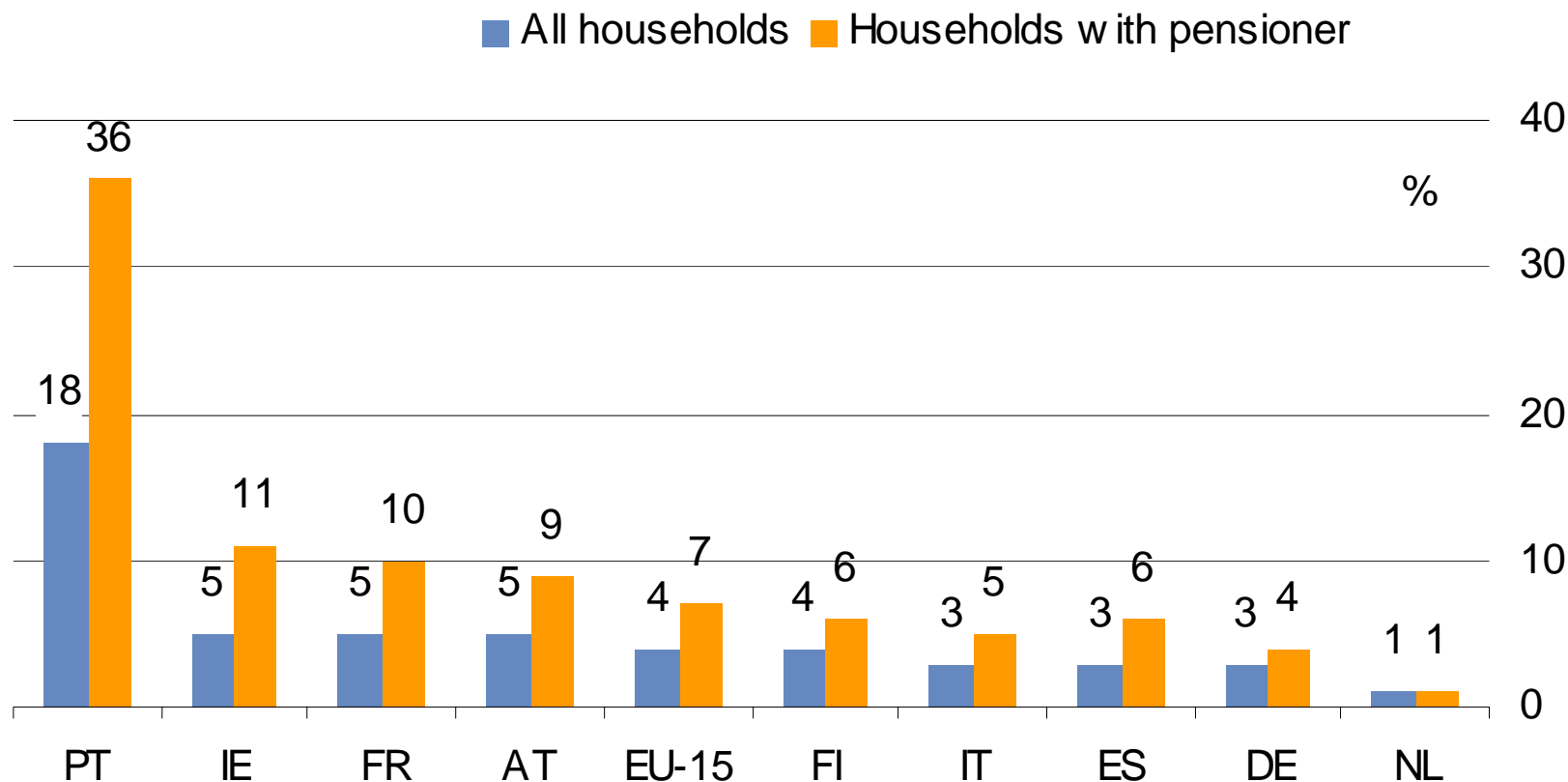


*) more than 1 person per room, 1998

Source: Eurostat



Houses with low standards*)



*) Houses where at least one of the following basic elements (bath/shower, indoor WC, hot running water) is missing, 1998

Source: Eurostat





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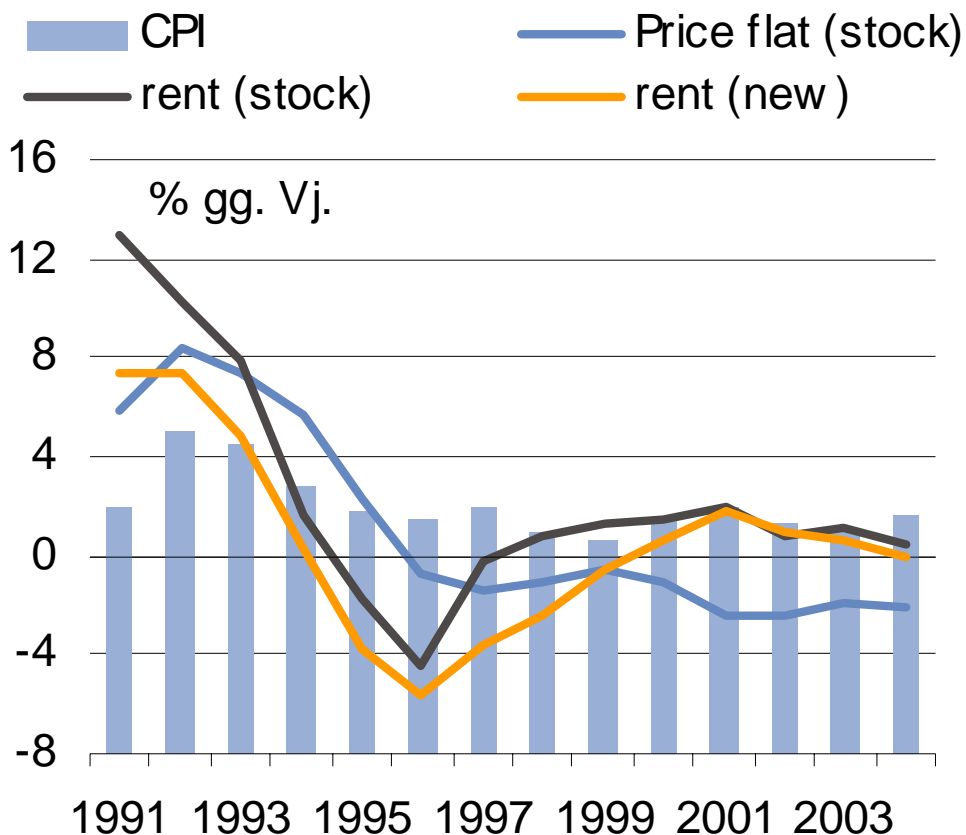
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The buyers' perspective: Is this market attractive?



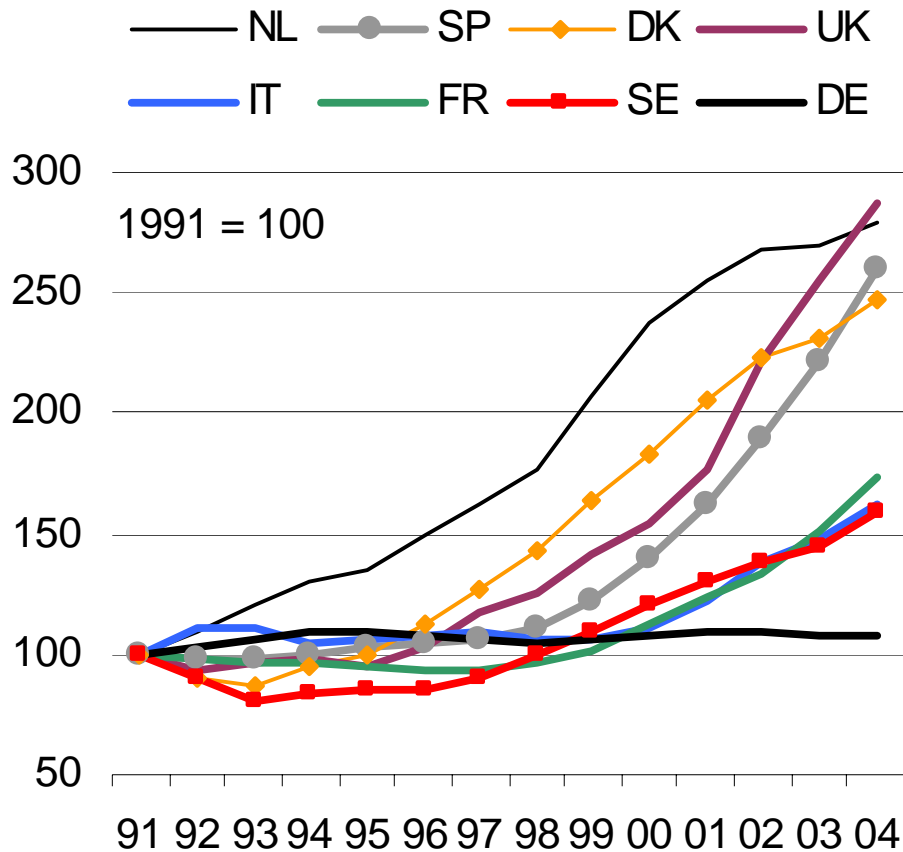
- Prices for owner-occupied flats have been falling for years
- Rents for new-builds stagnate, after strong declines in the second half of the 90s
- Rents for secondary flats are increasing only marginally – less than overall inflation

Average of 50 / 100 German cities in East and West Germany

Sources: BulwienGesa, Stat. BA, DB Research



House prices in Europe: Germany is different

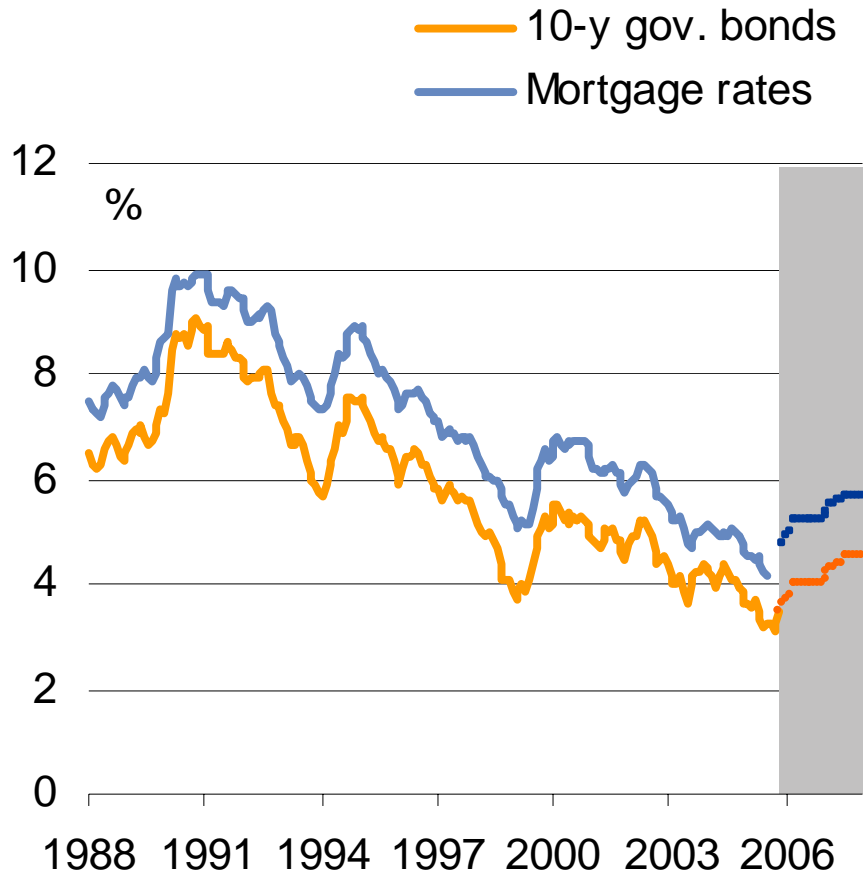


- While German house prices are not much above their level of 1991,...
- ... most European countries experienced strong house price growth in the last years
- That implies a rising risk of strong price corrections outside Germany
- Stable house prices in Germany might turn out as a merit in the near future

Sources: Nationwide, Nat. stat. offices, BulwienGesa, NVM



Long-term interest rates are still very low



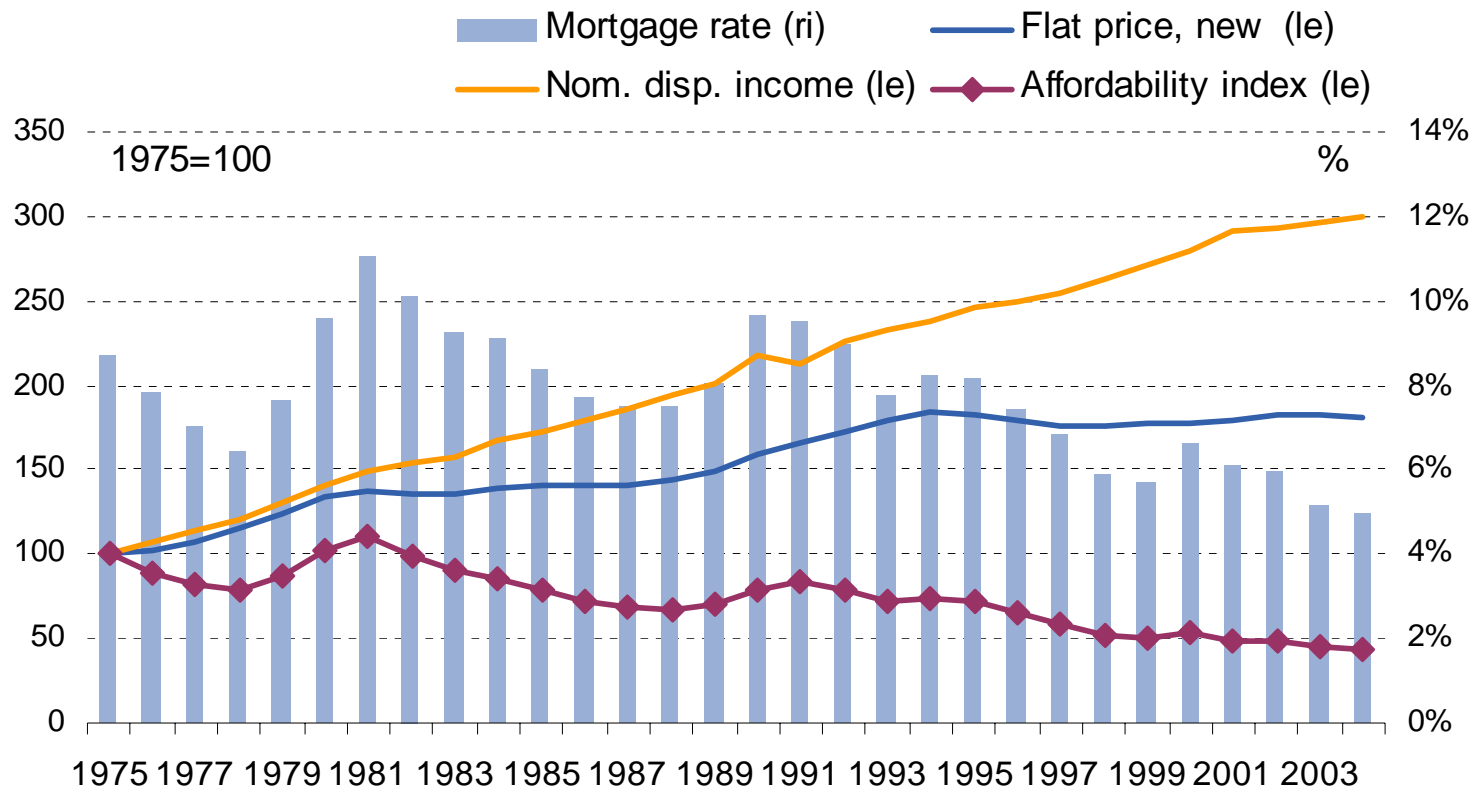
- Long term interest rates are still very low and only in the last month picked up slightly
- Facing the weak economic outlook for 2006 a strong rise is not very likely
- Low interest rates make real estate affordable

Sources: Bundesbank, EZB, Deutsche Bank



Houses in Germany are relatively cheap

- Deutsche Bank's affordability index; All Germany -



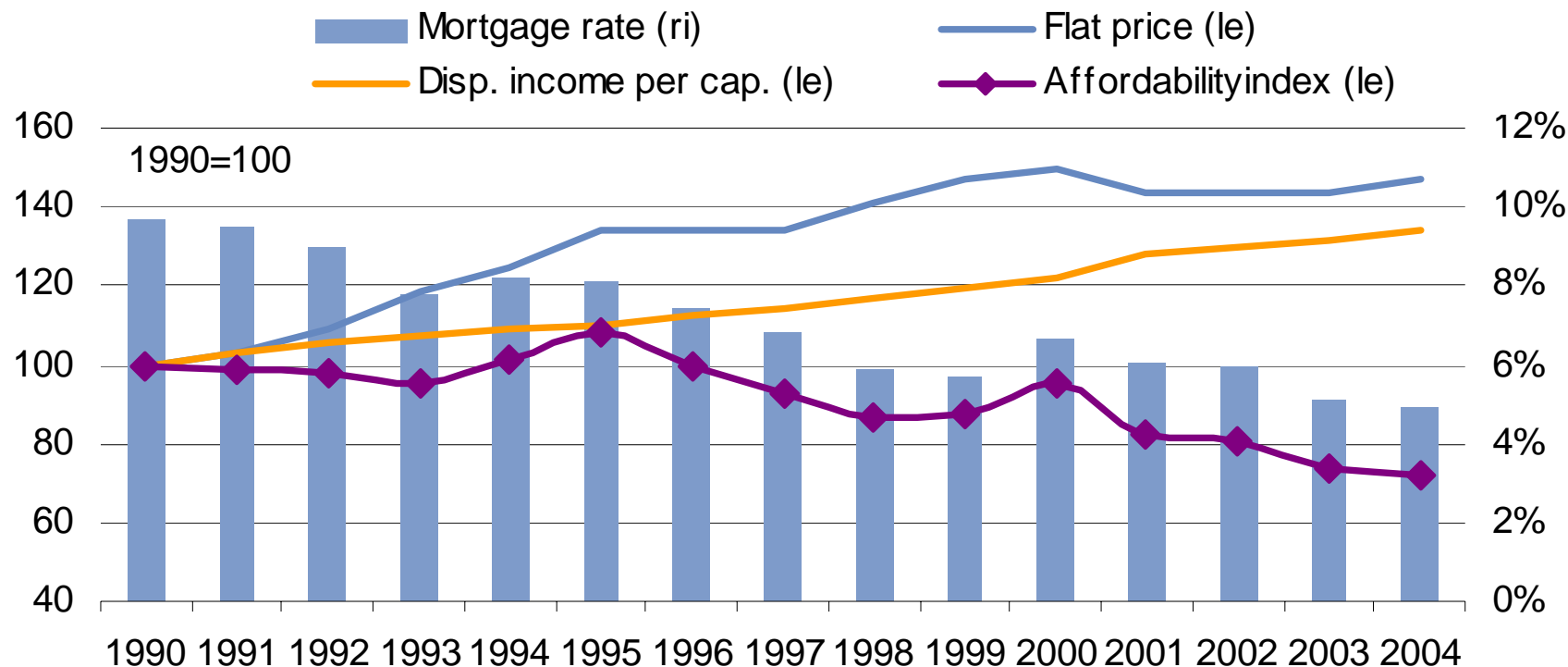
Sources: BulwienGesa, Bundesbank, OECD, DB Research

The affordability index is calculated as the average mortgage payments for an average sized flat (80 m²) and a mortgage with 25 yr maturity in relation to Germany's disposable income per capita



That holds even for the conurbations

- Affordability index, example Frankfurt/M -



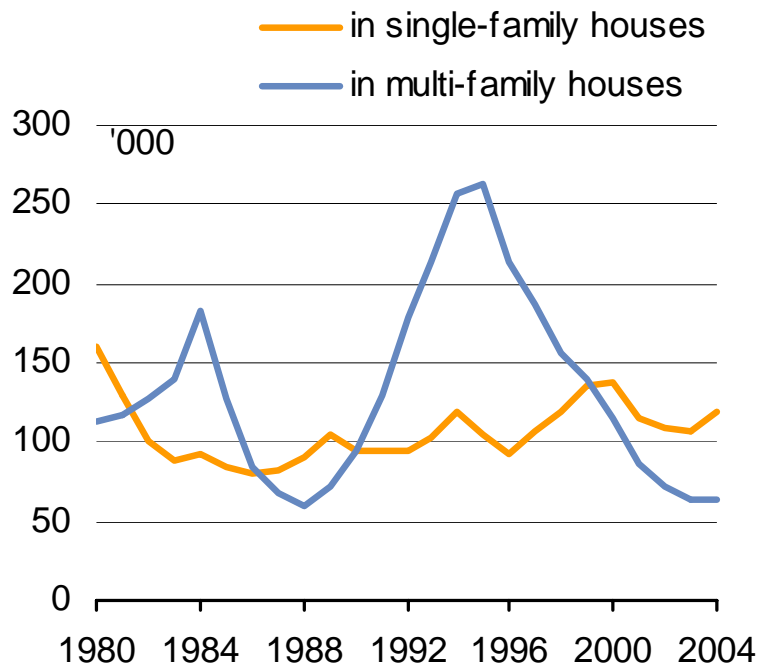
Sources: BulwienGesa, Bundesbank, OECD, DB Research

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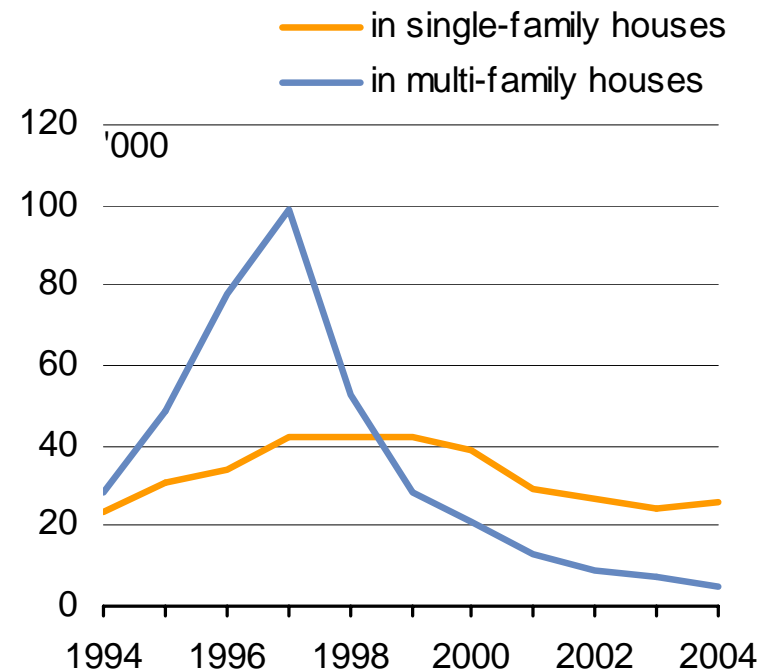
Housing completions below medium term requirements

West Germany



Source: Fed. Stat. Office

East Germany





Important changes ahead

- new government, new coalition contract -

- Home ownership subsidy will be ended by 2006. This will have a negative price effect on housing. However, overall effect is not very big, to our view
- Discussion of taxation of value gains within 10-year period. So far, privates could realize tax-free capital gains, if they held their property more than 10 years. This will have strong effects on the markets – however, technical problems will postpone enactment
- REITs have been positively mentioned in the contract. This is an important sign. However, it is not more than the signal of political will
- House ownership is planned to be strengthened within the new (subsidised) capital-based pension system (Riester-Rente). This is a strong argument for holding direct property. However, it has proven to be difficult to translate the good idea into a workable system





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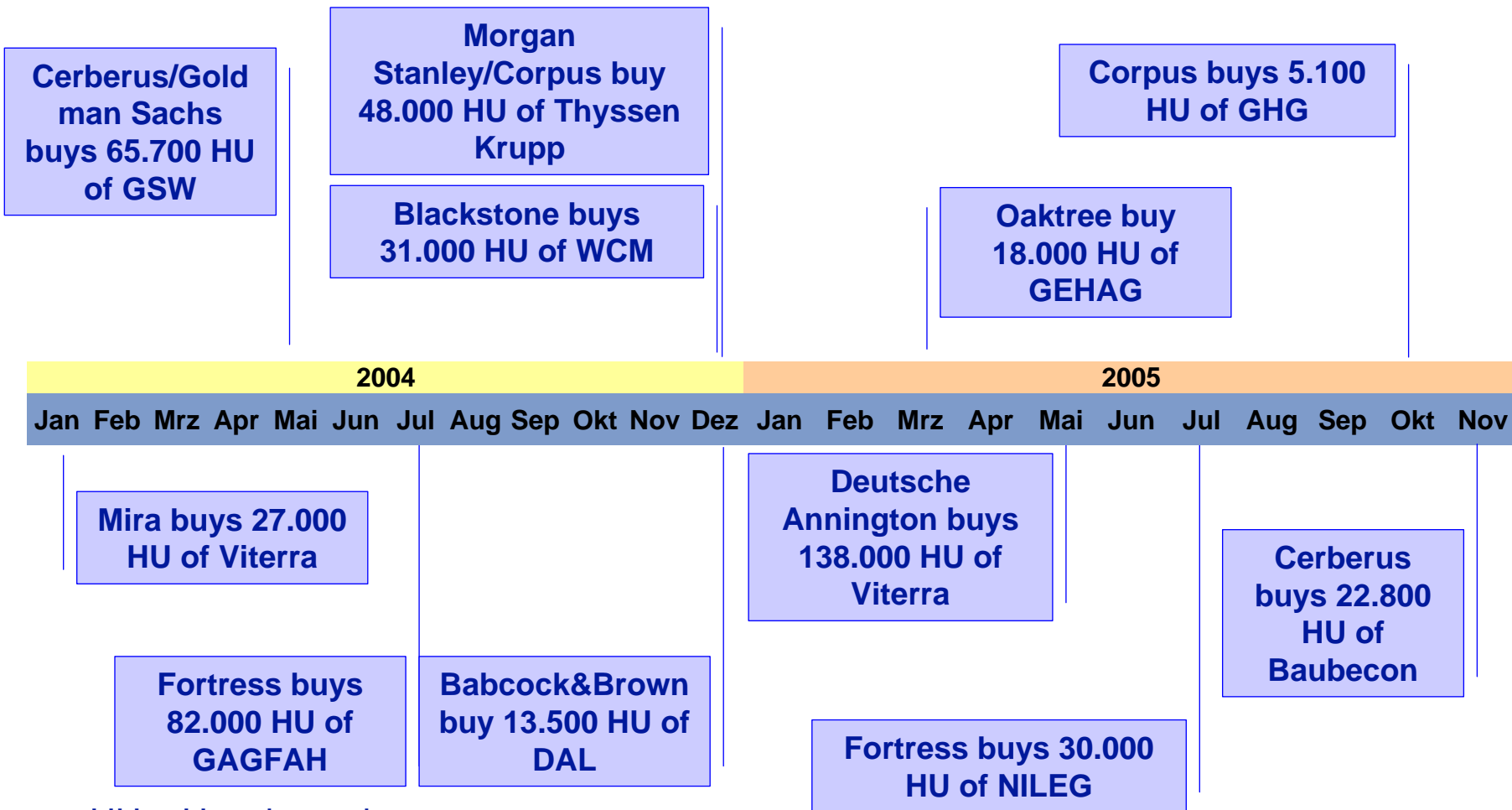
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German Housing portfolio transactions

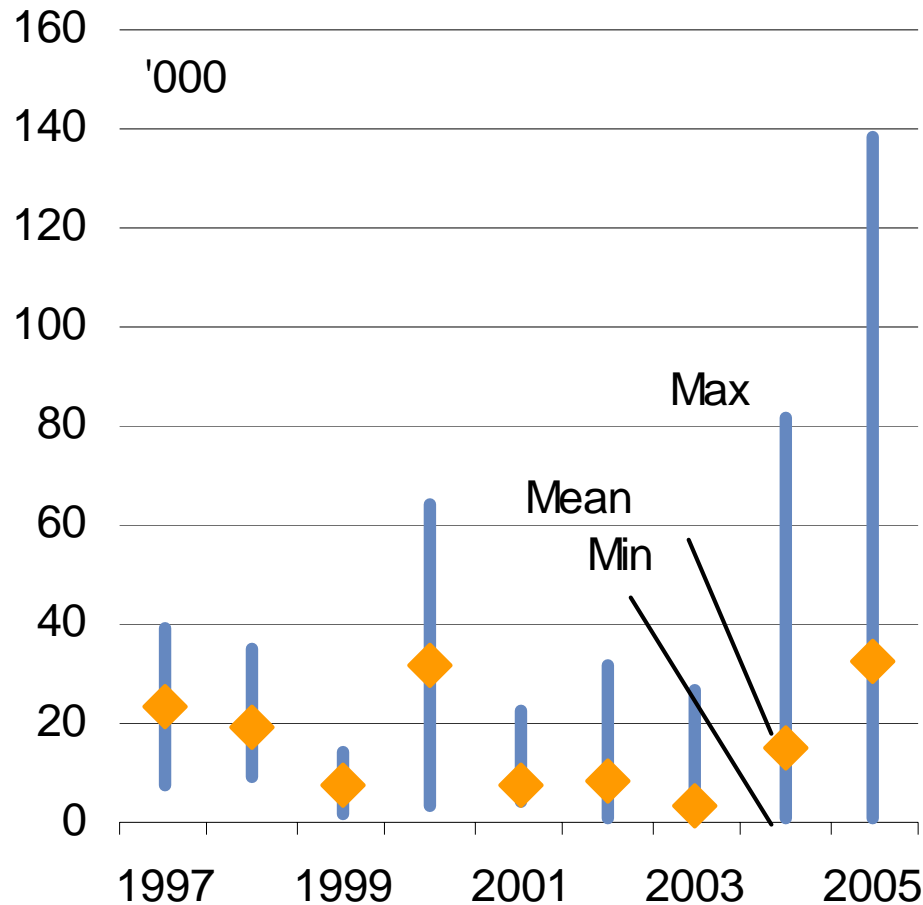
- Most important deals since early 2004 -



HU = Housing unit



Development of portfolio transactions since 1997



Source: Deutsche Bank

- More transactions than in the late 90s
- Average portfolio sizes have been moving up since 2003
- But also smaller portfolios are turned. We expect this to happen more often in the future
- Average prices have moved up markedly in the course of the last bidding-rounds (calculated as average price per flat or average price per m²)





Modular business models for housing privatisation

Operative plans	Tenant privatisation	Active management	Repositioning
	<p>Direct sale to tenant</p> <ul style="list-style-type: none"> - relatively high returns <p>But: often limited market size, and the problem of remaining lots lowers the value of the residual portfolio</p>	<p>Increasing efficiency</p> <ul style="list-style-type: none"> - vacancy management - cost reduction (facility mngt) - exploiting synergies - tenant management - preparing exit <p>But: Politically sensitive</p>	<p>Upgrading properties</p> <ul style="list-style-type: none"> - refurbishment - special properties, freedom from barriers <p>But: the costs can be recouped through higher prices only if there is enough demand</p>
	Refinancing	En bloc sales	Real estate funds/REITs
Financing plans	<p>Debt financing (leverage)</p> <ul style="list-style-type: none"> - securitisation - mazzanine financing <p>But: still not a final exit Flexibility is also reduced</p>	<p>Sales of partial portfolios</p> <ul style="list-style-type: none"> - quicker and often easier than tenant privatisation <p>But: added value is then shifted to the next stage and the returns fall</p>	<p>Indirect investments</p> <ul style="list-style-type: none"> - exit strategy on a grand scale - attractive returns - management can be retained <p>But: high requirements of investors; limited market depth</p>

Source: Deutsche Bank



Investor Friendliness (extract)

	FR	DE	PL	SP	UK
Market liquidity					
Size of market					
Volatility (rents)					
Rental structure					
Transaction costs					
Total score 20 countries	10	5	20	11	1

Very good Good Average Sufficient Not good

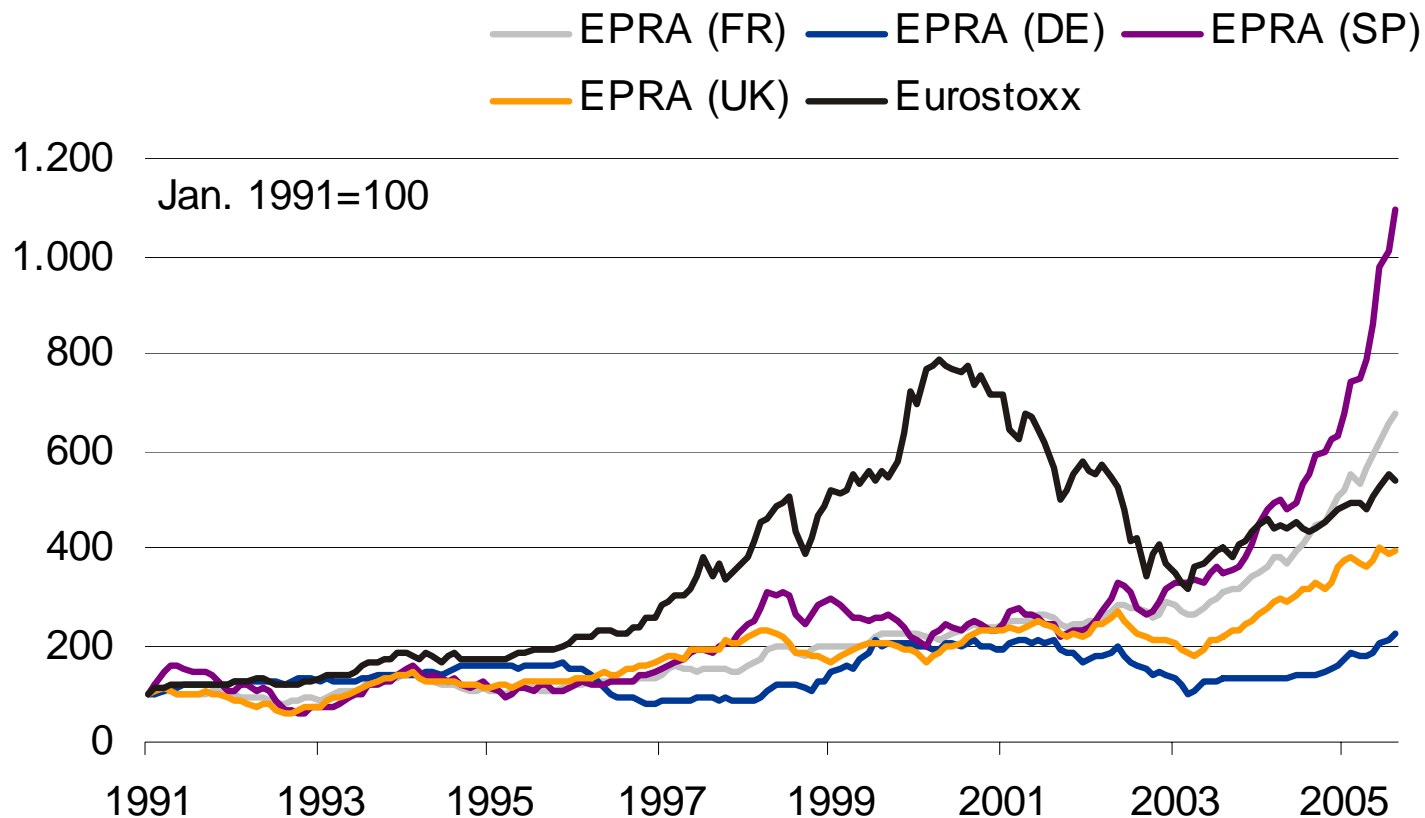
Source: DTZ





Development of Real estate stocks

- Compared to Eurostoxx -

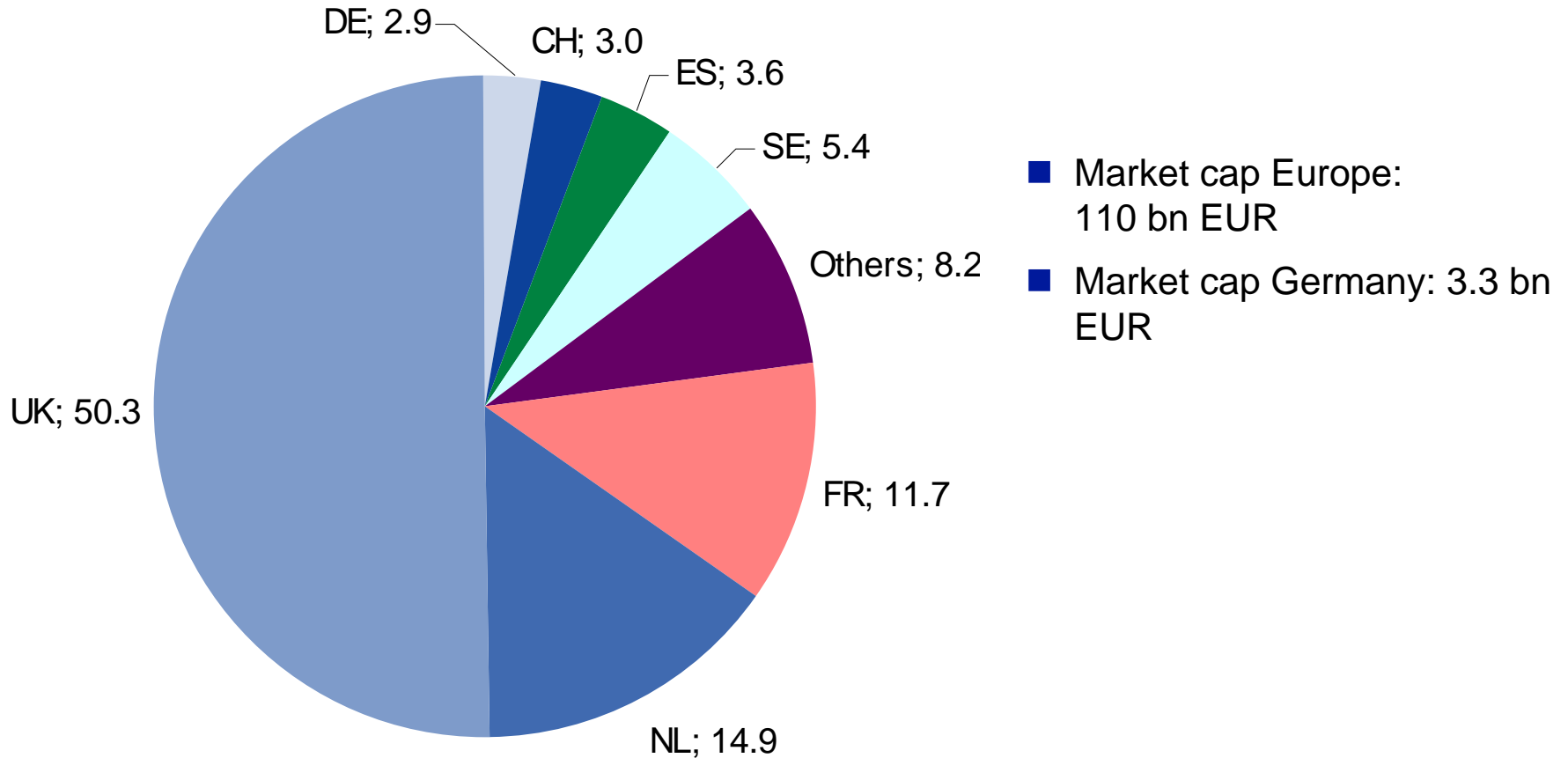


Source: DJ, EPRA



European market for Real estate stocks

- Country weights FTSE EPRA Europe -



Source: Bloomberg, February 2005

Europe's long walk to REITs (part I)

**REIT-like structures exist in NL, BE and FR.
In UK, DE, SP, FI and IT the introduction is discussed**

Advantages

- REITs facilitate an easy comparison of indirect real estate investments – also with other asset classes
- REITs are internationally well-known and well-received (US; AUS; JP). This can work as catalyst for the introduction of a stronger real estate stock market
- A more professional indirect real estate market enables investors to more efficiently diversify their real estate portfolios
- Empirically the discount to NAV (net asset values) is lower in countries that have established REIT structures compared to countries that lag the development. Even the announcement of REITs has reduced the discount (e.g. France)



Europe's long walk to REITs (part II)

Risks / Challenges

- Tax authorities fear tax losses (double tax agreements). Only if this issue can be resolved, REITs will be introduced in Germany
- Mobilisation as additional measure is important. As REITs are new vehicle on the demand side, no increase of new supply would yield rising prices only
- European REIT as final goal. National legislations as important first step
- Beauty contest has just started. Countries that introduced REITs successfully can attract the expert jobs (first-mover advantages)
- Some real estate stock markets look overvalued (Spain). A cooling of these markets might have negative political impact



German residential portfolios have come into focus of foreign investors

- Foreign investors have increasingly been buying residential property portfolios: In 2004 foreign Private Equity investors bought about 300,000 German flats – 2005 will not be far below that value.
- We do not expect this enthusiasm for German portfolios to ease in the near future
- House prices today are not much above their level of the early 90s. This promises stable cash-flows
- As new-builds are close to historical minimum, and the number of households is still increasing, there is some upward potential for the medium term
- But, for 2006 and 2007 the consolidation process of the new government does not promise much economic growth – and low growth will not allow for strong price rises
- The low interest rates combined with the slight decreases in house prices imply that houses and especially flats are more affordable than in the mid-90s. However, this can be partly explained by the special situation of reunification





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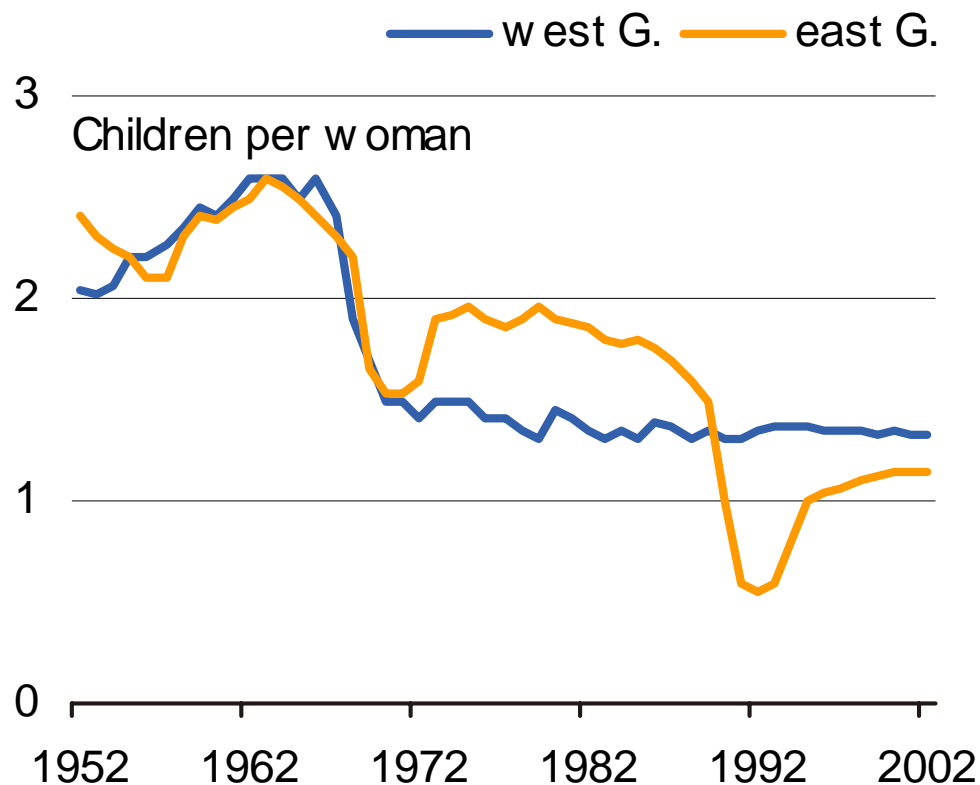
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Room to manoeuvre?

- The case of the two Germanys -



- While West Germany's fertility rate has been stagnant for more than 30 years...
- ... efforts in East Germany have led to a temporary rise in fertility rates („Honecker-hump“)
- These efforts, however, can neither be financed nor are they adequate in a liberal society

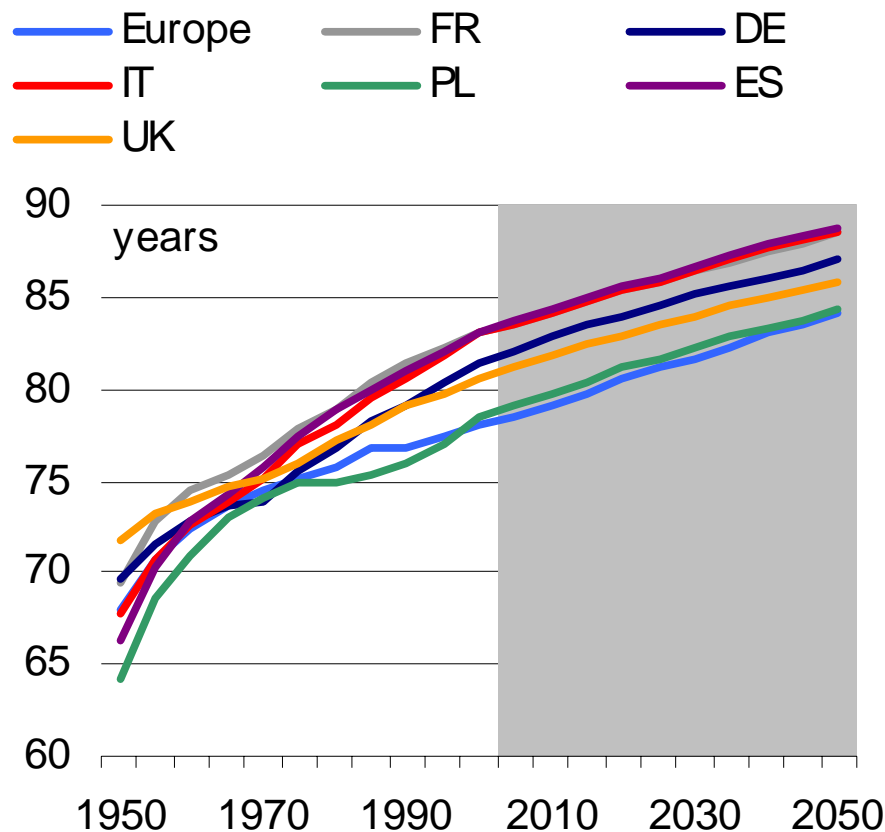
Source: Federal Statistical Office





Long live Europe!

- life expectancy at birth of European women -



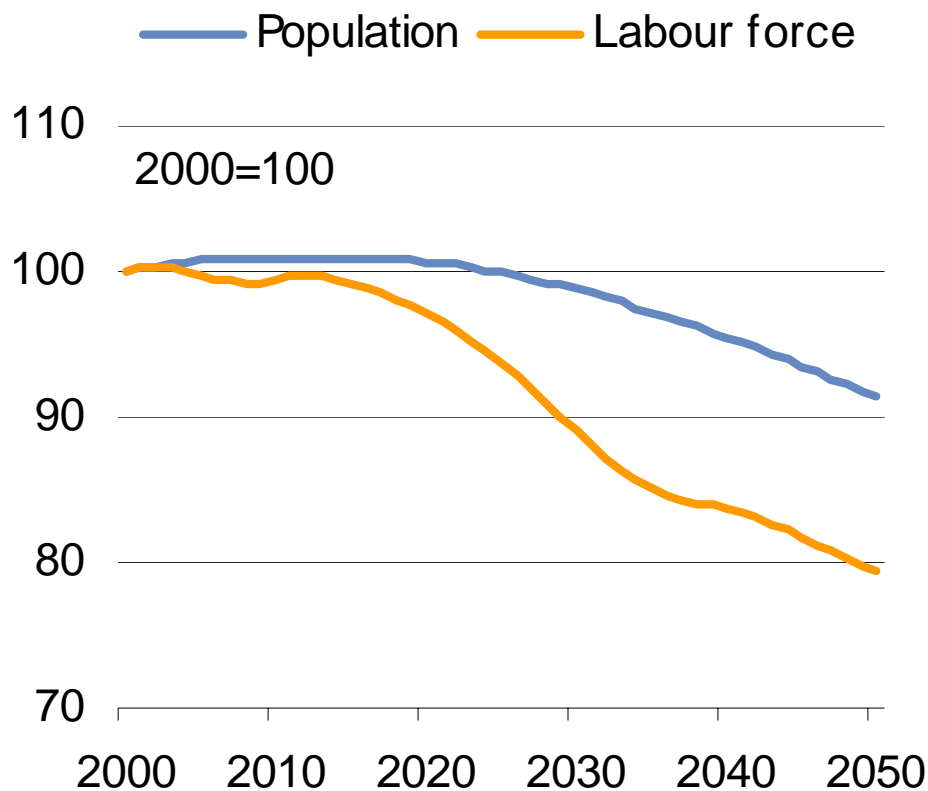
- Life expectancy has risen since we started to record data
- Some argue that there exists a biological end to this process...
- ...others say that medical progress will even allow linear increases in life expectancy
- Here, we assume a weak log-function
- But, some nutritionists warn, that „lifestyle diseases“ are progressing rapidly in Europe („Supersize me“)

Source: UN Population Division





Population Decline is on the Cards



- According to forecasts of the Federal Statistical Office, the population will peak in 2012
- Then, an accelerated decline sets in
- In 2003 and 2004 the number of inhabitants shrank slightly, due to a sharp fall in inward migration
- The labour force starts to shrink earlier and stronger – to keep working population constant, we have to work longer, start earlier and increase the share of women in the working population

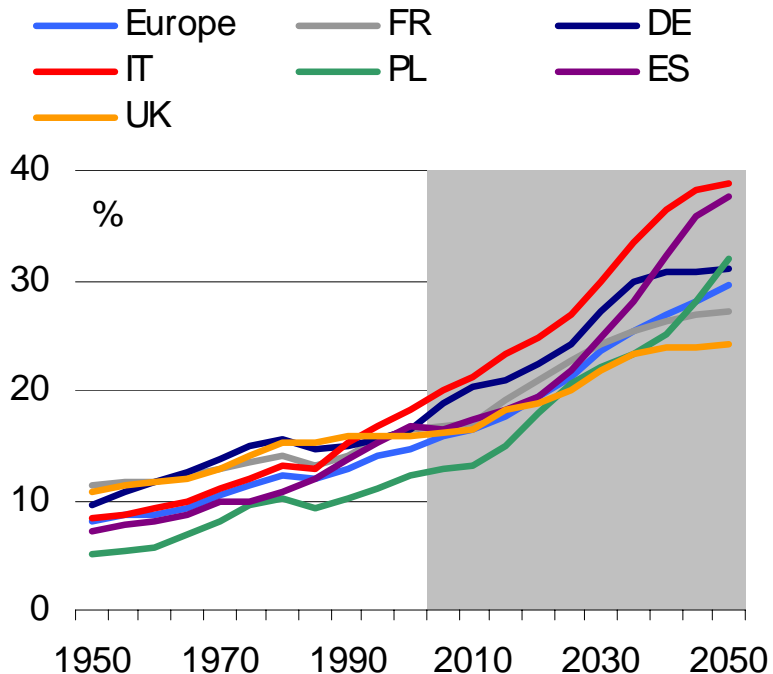
Sources: Fed. Stat. Office (medium variant), DB Research





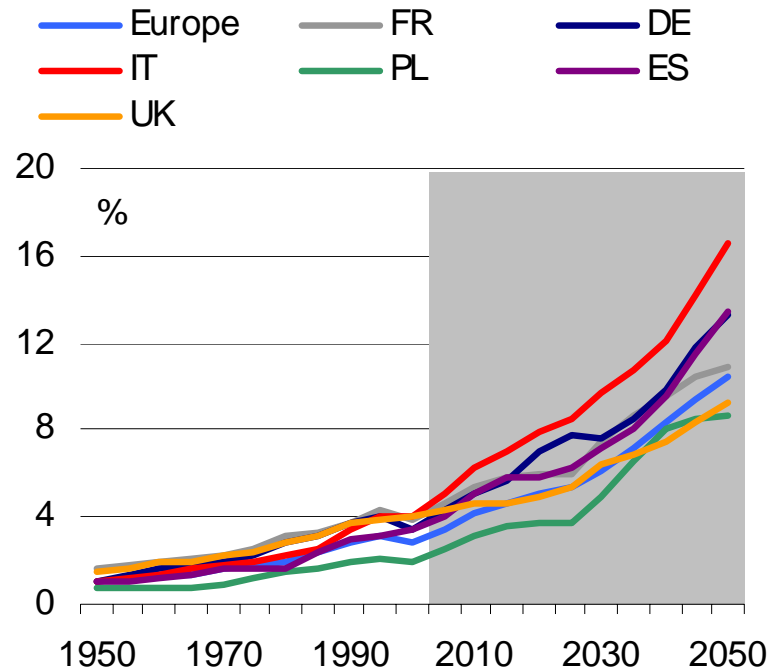
We will be all “old Europe” tomorrow

Share of pensioners (>65 years) of total population



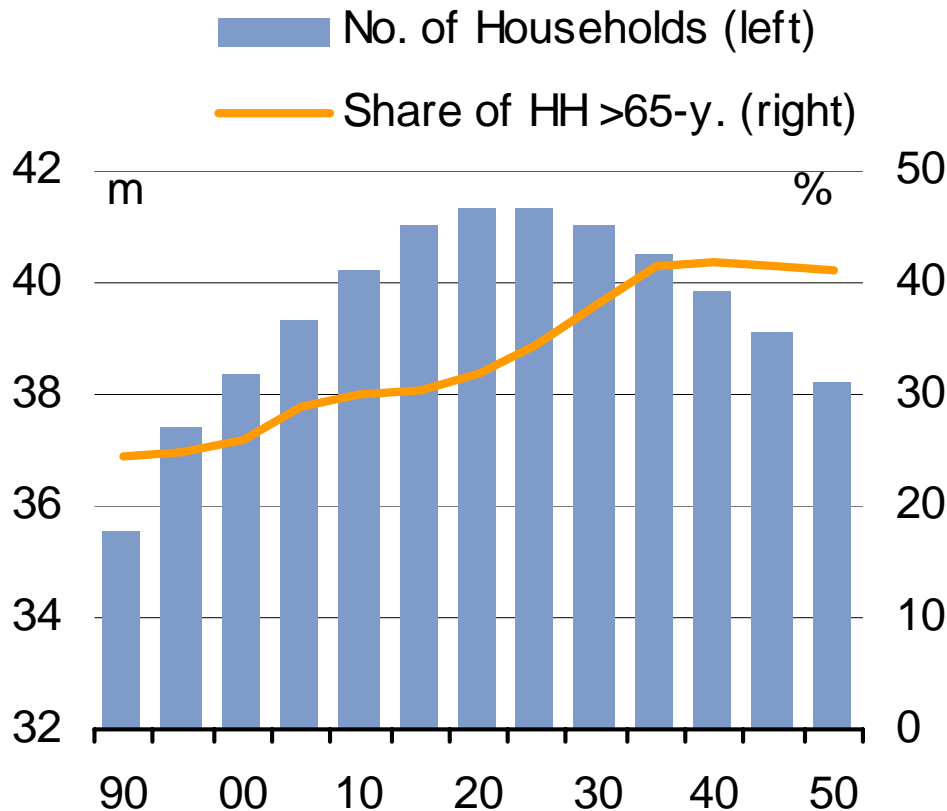
Source: UN Population Division

Share of >80-year-olds of total population





Number of Households will continue to rise

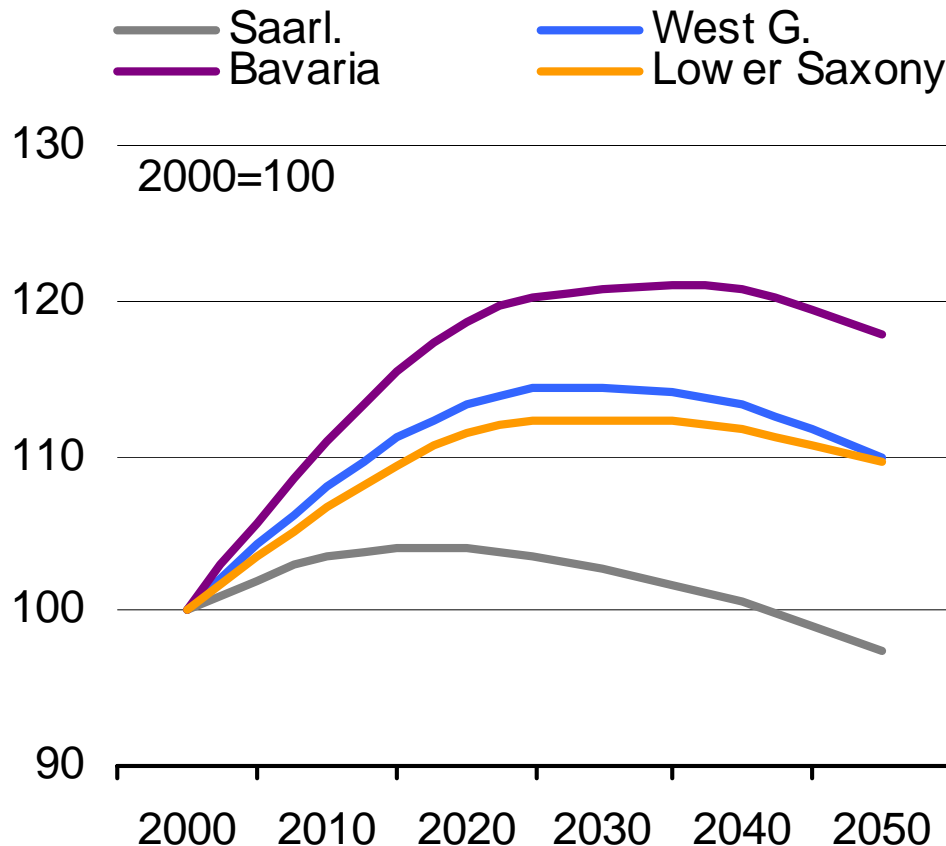


Sources: Fed. Stat. Office, DB Research

- Average household size is smaller in older households
- In the age cohort 35-45 the average household size is 2.7 persons, in the age cohort 75+, the average household size is 1.5 persons
- Therefore the trend to smaller household size in an ageing society can offset the demographic trend of a shrinking population for some time



Demand for living space in West Germany



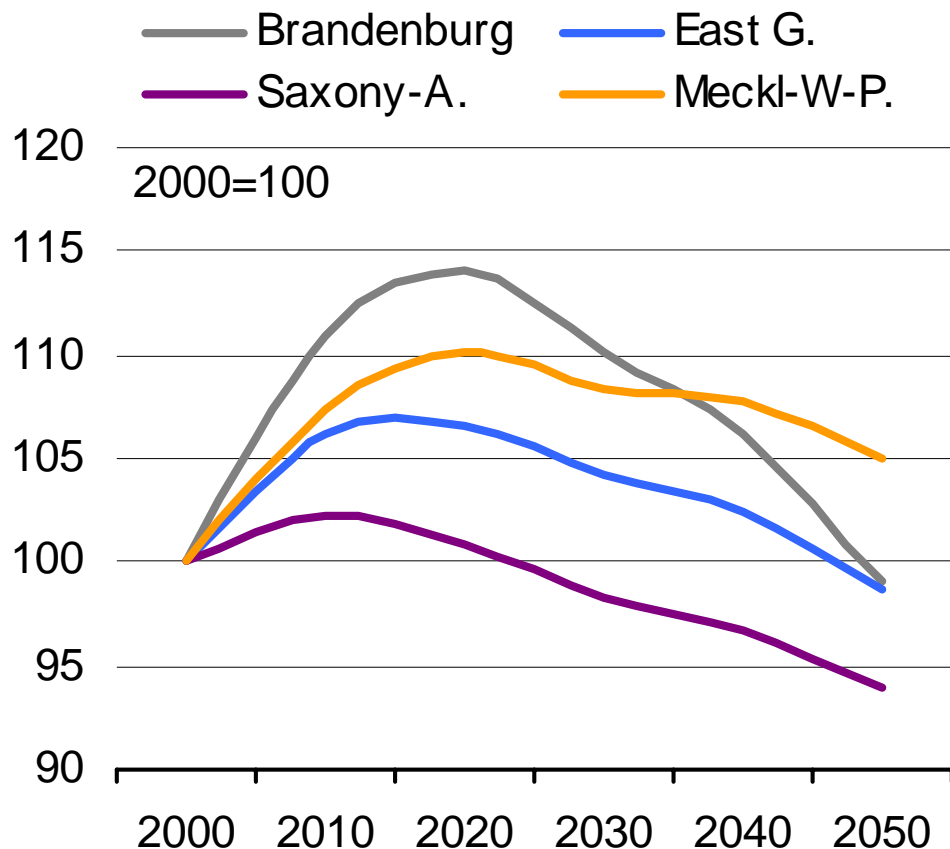
Source: DB Research

- Until 2020 the demand for living space will increase strongly
- Demand will not start to erode before 2030
- West Germany is not homogenous – strong differences between in- and outmigration regions





Demand for living space in East Germany



- Muted development – despite immense backlog demand
- Brandenburg profits from its vicinity to Berlin – but that is only true for a small belt in Brandenburg
- Mecklenburg-Western Pomerania is offering coast line and Germany's largest lake district for recreation

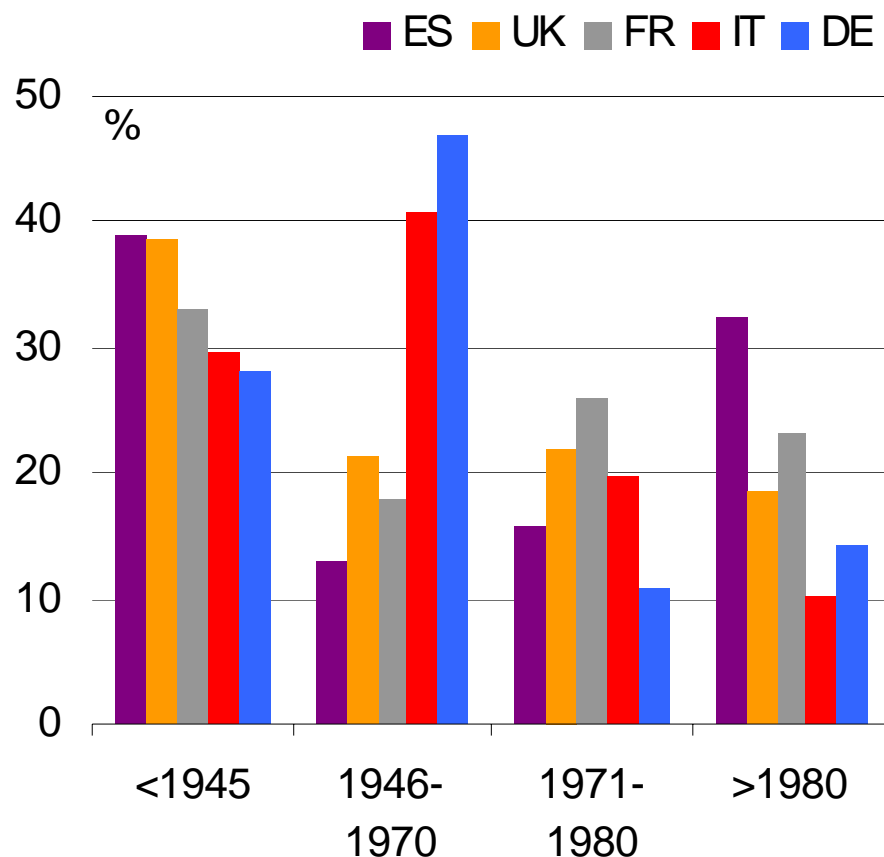
Source: DB Research





Age of dwelling stock

- varying need to renovate -



Sources: Eurostat

- Age of dwellings implicitly hints at the need to refurbish and renovate
- In Spain and the UK almost 40% of all dwellings are more than 60 years old
- In Germany the reconstruction phase after World War II led to very intensive construction activity
- Spain has profited strongly from EU-funds

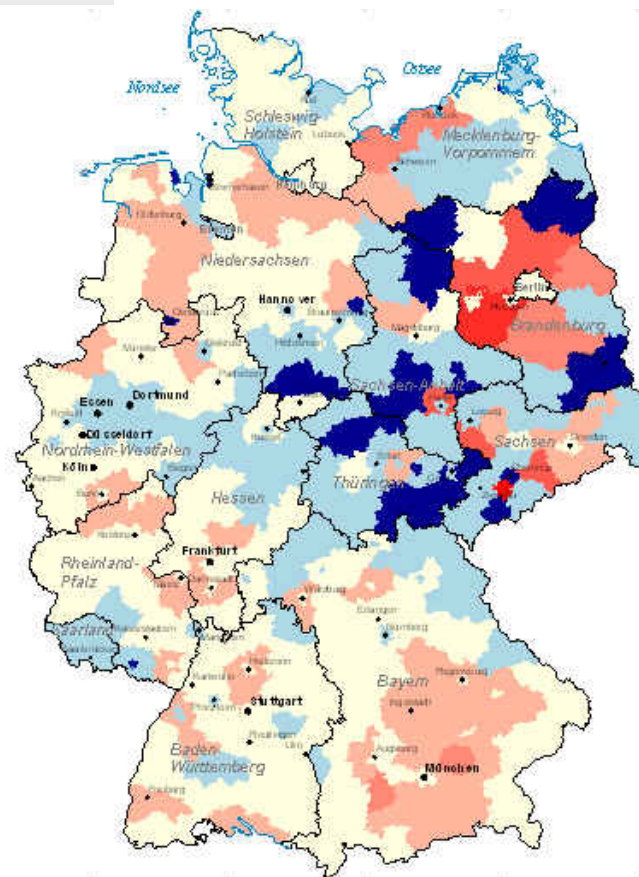
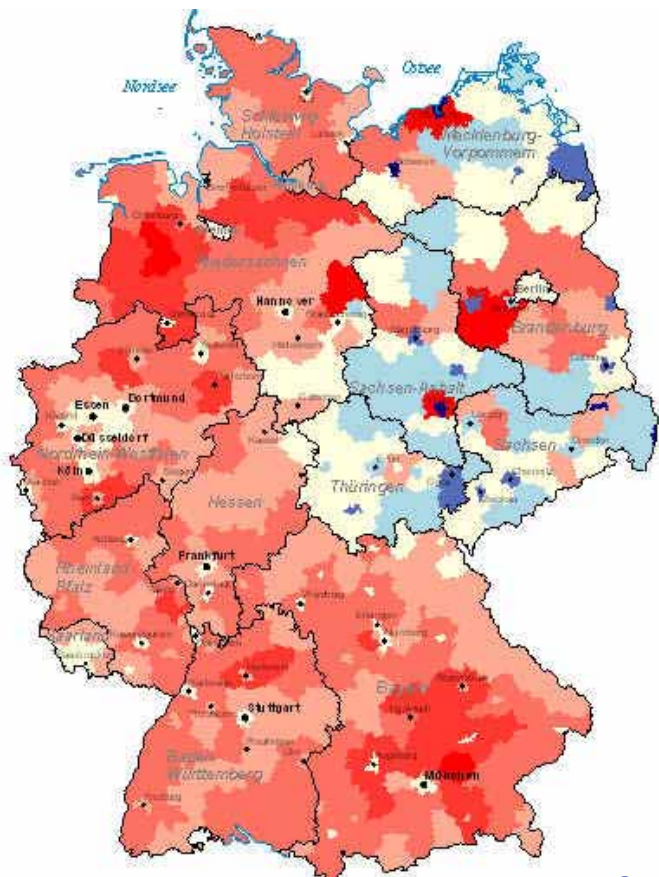


Regional Differences are aggravated

1990-2000 in %

Population growth

2000-2020 in %



Red = Growth
Blue = Shrinkage

Source: BBR





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All in a nutshell: price trends

- how do the major factors contribute to price developments -

	Growth regions			Regions with outward migration		
	1 Y	2-10 Y	10-50 Y	1 Y	2-10 Y	10-50 Y
Demographics	↗	↗	→	↘	↘	↘
Economic growth	→	↗	↗	→	→	→
Interest rates	↗	→	↗	↗	→	↗
Alternative invest.	→	→	↘	→	→	↘
Gov. subsidies	↘	→	→	↘	↘	→
Prod. costs	→	↘	↘	→	↘	↘
Total	→	↗	→	→	↘	↘





So, is German real estate attractive? It depends!

PROS

CONS

- Stable markets – most other European markets have reached or are close to their peak
- Many companies and communities feel that they have to sell – this offers opportunities
- German investors still avoid the German market
- New-builds close to historic low – in some west German centres this will lead to shortage
- Still very low interest rates

- Income growth has been very muted in recent years; labour markets have not yet improved. (BUT is it likely that Europe's biggest country will lag forever?)
- Regionally very heterogeneous; regional knowledge is essential
- Demographics are less favourable than in many other countries
- Interest rates have started to move up
- In east Germany, 1.3 m flats are already vacant (16% of stock)

