

RESEARCH



THE
GERMANY
REPORT
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THE ECONOMY AND POLITICS

GERMAN ECONOMY POWERS ON

The German economy continues to gather momentum.

Despite the political standoff, the German economy grew sharply in the third and fourth quarters of 2017, exceeding the strong pace of growth seen over the same period in 2016. GDP rose by 2.20% in 2017 – the highest since 2011. Underpinned by elevated foreign demand, the value added by the manufacturing sector increased sharply and service sector activity saw a steep increase.

The German economy's high underlying pace of economic growth is set to continue in 2018. The Ifo Institute raised its growth forecast for the country's economy to 2.60% for 2018, up from 2.00% predicted previously. As the manufacturing sector benefits from an improved economic outlook, industrial export and investment activity will continue to rise robustly throughout 2018.

German inflation accelerated to its highest level in five years. Consumer prices increased to 1.70% on average for 2017, owing to markedly higher food costs. Inflation is likely to remain high until 2019 after which time it could rise further. Even Germany's large publicly listed companies experienced a record 2017. These figures have sparked

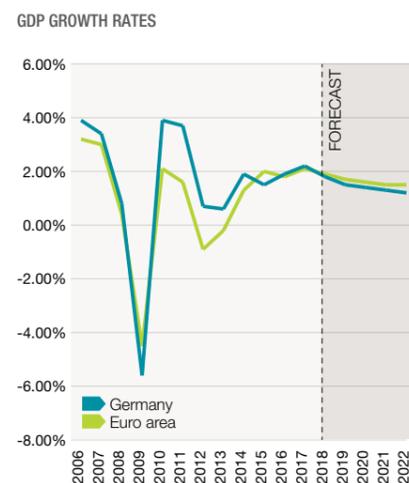
debates about whether or not the European Central Bank should cease injecting money into the Eurozone.

In January this year, the European Central Bank began to scale back its quantitative easing program by pledging a gradual withdrawal in order to mitigate any adverse impacts on the financial markets. This decision comes a decade after the global financial crisis and signals the ECB's intention to normalise monetary policy in the eurozone. The eurozone saw solid growth that was particularly pronounced in the second half of 2017. Notwithstanding this positive economic momentum, the ECB is expected to keep interest rates on hold throughout 2018 as expansion in the eurozone remains contingent on significant support.

Labour market tension has also amplified. Yet, despite skills shortages and record low unemployment since German reunification, wage rises are only marginally above the long-term averages. This lack of wage growth is creating challenges for the ECB as it tries to unwind its stimulus measures.

In September, the elections returned an unusually fragmented parliament representing more parties than usual. The Social Democratic Party's (SPD) refusal to continue the coalition with the Christian Democratic Union (CDU) and its Christian Social Union (CSU) sister party left Germany without a ruling government for four months. However, German chancellor Angela Merkel nailed down an agreement with her former partners to enter into the third coalition following the drawn-out negotiations. The strong performance suggests the economy shrugged off the absence of a new government.

The rapid rate of expansion is fuelling fears among some experts of an overheating economy. For now though, Germany's economy is burgeoning and this has been the impetus for the strong momentum seen in the property market. The same market fundamentals that supported growth in 2016 and 2017 will be in place in 2018. The key question must be how effective additional stimulus; low interest rates and strong domestic demand can be as the German economy enters a mature part of its cycle.



Source: IMF 2017

GERMANY KEY STATS 2017



GERMANY GDP PER CAPITA



KEY

GDP per capita

- <€25,000
- €25,001-€30,000
- €30,001-€40,000
- €40,001-€50,000
- >€50,001

Source: Federal Statistical Office of Germany, 2016

CAPITAL MARKETS OVERVIEW

GERMANY – A PREMIER DESTINATION FOR INVESTMENT

The German property market seems to have emerged unscathed from the German parliamentary election.

Despite the uncertainty in the lead up to and following the election, this had little impact on the decisions of property investors. Instead, demand for Germany's real estate continued on an upward trajectory against the backdrop of low interest rates, a robust economy and strong occupier market fundamentals across the German property markets.

German property investment volumes soared in 2017 and reached €67.54 billion exceeding the record set in 2015. Compared to 2016, volumes were up 8%. The major uptick in property prices has been a key trend underlying this new record. In particular, the office sector saw the largest increase in prices due to a scarcity of product. As a result, investors have turned their focus to markets outside of the Big 7. Indeed transactions outside of these markets accounted for over half of total investment volumes in 2017.

Berlin was on top of the leader board with a total transaction volume of €11.92 billion. The Sony Center represented a record transaction at €1.10 billion. Frankfurt followed in second place, with strong growth in office investment volumes, as foreign investors made record transactions. Stuttgart and Düsseldorf also registered significant growth year-on-year, at 45% and 38% respectively.

Foreign property investment in Germany reached a new peak in 2017. Cross-border investors accounted for 60% of the commercial transactional volume. US investors remained the largest source of foreign capital into Germany, although appetite from Asian investors continued to grow considerably. Chinese, South Korean

and Singaporean capital accounted for a rising share of investment in Germany's property market.

Germany's property markets have become increasingly expensive, buoyed

by the country's economic boom, and an exceptionally strong letting markets. In comparison to Europe's major office markets, Germany has been facing a dearth of core assets. This led to further yield compression across Germany's office markets in 2017. Frankfurt had the largest compression, with prime office yields falling by 75bps to 3.25%. In Munich and Berlin, prime office yields are at 3.00% and 3.10% respectively, and have now caught up with Paris and are below London, with investors taking on riskier propositions in order to achieve target returns.

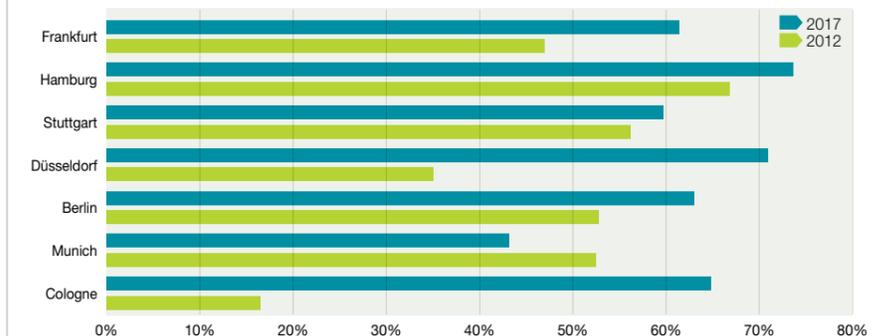
There is little sign of capital flows into Germany ebbing. With the pressure to invest, investors will continue to default to real estate while bond yields remain low. Although the spread between property yields and bond yields will narrow, this will be a result of rising government bonds. Scope for further yield compression is likely to be limited. With four of the top ten cities for commercial investment, Germany has consolidated its position as Europe's safe haven for capital.

LARGEST OFFICE TRANSACTIONS, 2017

PROPERTY	LOCATION	SALE PRICE (€ million)	BUYER	SELLER
Sony Center	Berlin	1,110	Oxford Properties JV Madison International	Hines on behalf of National Pension Service (NPS)
Tower 185	Frankfurt	775	Deka Immobilien	CA Immo Deutschland JV
Kap West	Munich	242	Allianz RE Germany	OFB

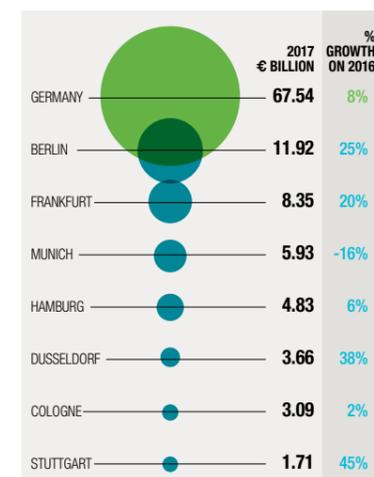
Source: Knight Frank Research

SHARE OF CROSS BORDER CAPITAL



Source: Knight Frank Research / Real Capital Analytics

TOTAL INVESTMENT VOLUMES (€ BILLION)



Source: Knight Frank Research / Real Capital Analytics



SONY CENTER IN BERLIN, THE LARGEST OFFICE TRANSACTION IN 2017.

BERLIN

BERLIN IS BUZZING. UNEMPLOYMENT IS AT A RECORD LOW AND THE POPULATION HAS BEEN INCREASING BY 50,000 PEOPLE PER YEAR.



"New office developments are required in Berlin to provide sufficient opportunities for companies to expand, with extremely low availability one of the reasons behind significant rental growth. We expect commercial and residential rents and capital values to continue rising".

OLE SAUER, MANAGING PARTNER

BERLIN KEY STATS



950,000 SQ M

TAKE-UP IN 2017, UP 17% ON 2016



YIELDS COMPRESSED TO

3.10%



RENTAL GROWTH OF
37.50%
SINCE 2016



VACANCY RATE AT A RECORD LOW OF
2.25%

Although Berlin's economy has lagged Frankfurt, Munich and Hamburg, the city may one day end up becoming Germany's economic growth engine.

Berlin has developed a reputation for being one of the coolest cities in Europe. The thriving city attracts investors, corporates and talent from across the world. It has become a hub for fast-growing tech companies. From tech giants like Google, Apple and Facebook, to local successes such as SoundCloud and Zalando, Berlin spawns a diverse mix of technology firms. This perhaps explains the significant wage

growth seen over the past year. According to a report from Ernst & Young, Berlin offers the highest post-graduate tech salary in Europe (an average of €3,100 per month).

The city's dynamic entrepreneurial culture has been appealing to a raft of corporates. Deutsche Bank has relocated part of its risk management branch from London to Berlin. Google is also planning to open its own campus for startups in Kreuzberg but has met with opposition. This illustrates the rapid process of gentrification in Berlin. Due to its particular and turbulent history, Berlin's planning framework is dissimilar to

other European cities. The large number of abandoned spaces inherited from the Cold War frontier enabled the occupation of buildings and the formation of an alternative culture. Today there is little left of the old city.

Instead, Berlin's property market is burgeoning. Office leasing activity has been soaring, setting a new record. During the course of 2017, co-working providers became increasingly active, taking on large-scale leases. WeWork was the most dynamic operator. Since opening its first German campus in the Sony Center in 2016, the flexible office space provider has committed to a further three sites. The Sony Center also happened to be the largest investment transaction in Berlin. Acquired by Oxford Properties, the real estate arm of a Canadian pension fund, for €1.10 billion, the trophy asset achieved an uplift of about €500 million over a period of seven years. This is a reflection of how tight market conditions are.

Core office assets are scarce, and this has underpinned phenomenal growth in property values over recent times. To add to the market challenges, Berlin's office development pipeline has been in short supply. Supply has not kept a pace with demand, leading to extremely low availability across the city. Completion volumes will however increase in 2018 and provide some welcome relief to the market.

Berlin is a maturing market, with property prices on an upward trajectory. Five years ago, it was an emerging market but it has now become a core market for investors and corporate occupiers alike. Berlin has been booming, with rents increasing by 37.50% to €33 per sq metre per month over the last two years. Compared to cities like London and Paris, Berlin still has a lot of catching up to do. Although yields are at historic lows of 3.10%, there is room for further movement. Berlin's rental growth prospects are compelling and this is fuelling investor appetite.



FRANKFURT

FRANKFURT'S OCCUPATIONAL MARKET HAD AN OUTSTANDING 2017, ACHIEVING RECORD TAKE-UP OF 715,100 SQ M. THIS EXCEEDED THE LONG-TERM AVERAGE BY MORE THAN 50%.



"Frankfurt's office lettings market set a new benchmark in 2017. We expect to see continued momentum throughout 2018."

ELVIN DURAKOVIC, MANAGING PARTNER

The most active tenant was Deutsche Bahn AG, which leased over 80,000 sq m of space, spread across nine deals, and corresponding to 12% of the total take-up volume. In view of this, the banking and finance sector became the most active occupier in 2017.

Despite Brexit, Frankfurt is yet to see an increase in new leases signed by international banks. Many existing occupiers have, however, been proactive in the market, renegotiating their lease terms. This has been in order to secure space for their future business requirements, should Brexit bare any significant impacts on the occupational market. Frankfurt also benefited from

growth by flexible workspace providers, who accounted for around 7% of the total take-up volume in 2017. As the trend toward flexible workspaces is set to increase, these operators will remain an important source of demand over the short and medium term.

Due to strong demand and low completion volumes, Frankfurt's availability has been decreasing over the past several years. Following the financial crisis, the vacancy rate peaked at 15.00% in 2010 but has been falling ever since and is now below 8.00%. Consolidation in the financial services sector and the increasing trend toward redevelopment and reconversions has

also contributed to declining availability. Niederrad is one example illustrating this trend toward redevelopment. In the 1970s, it was predominantly an office precinct occupied by IT companies. However, as stock became older and obsolete, occupiers relocated, leading to underutilisation of office space. To alleviate this problem, Frankfurt's City Planning Department devised a masterplan to transform the area into a mixed-use precinct. Upon completion, Niederrad will accommodate some 3,000 households, addressing the city's looming housing shortages.

Despite a period of muted office development activity, Frankfurt's development pipeline has begun to improve. Three significant schemes are under construction in Bankenviertel, including Four Frankfurt, Omnium and Marienturm, collectively comprising over 160,000 sq m of office space. One of Europe's largest district development projects is also underway in Frankfurt, Gateway Gardens, situated on a 35 ha site adjacent to the airport. It has a planned gross external area of 700,000 sq m and on completion, is expected to accommodate a workforce of 18,000.

Frankfurt was the second most active German city for property investment behind Berlin. New benchmarks for the current cycle have been witnessed, with prime yields in Frankfurt hardening by 75 bps over the past year to a record low of 3.25%. The restricted availability of investment stock in central locations has prompted investors to turn to non-core stock and forward deals.

Major infrastructure investment in Frankfurt has been a catalyst for strong investor and occupier activity in the city's commercial real estate. The largest project underway is Terminal 3 to the south of Frankfurt Airport. The new terminal will have 24 aircraft docking positions, handling up to 14 million passengers per year. Two of Frankfurt's transport networks are also undergoing significant capital expenditure. The light rail network is undergoing a 2.70 km extension from Frankfurt Central Station to Europaviertel and will have four new stations, scheduled to be in operation by the end of 2022. The extension to the rapid transit system is also under construction and will link the Gateway Gardens precinct to Frankfurt's inner city and airport terminals.



FRANKFURT KEY STATS



715,100 SQ M
TAKE-UP IN 2017, UP 35% ON 2016



YIELDS COMPRESSED TO
3.25%



RENTS INCREASED TO
€40.00 PER SQ M



VACANCY RATE CONTINUES TO FALL TO
7.80%

MUNICH

KNOWN FOR ITS ELECTRONICS AND ADVANCED MANUFACTURING, MUNICH IS ONE OF GERMANY'S LEADING MANUFACTURING REGIONS.



"As more companies move their headquarters to Munich and local firms continue to expand, job opportunities will increase significantly. Sufficient development sites, office developments and office availability is needed to address the burgeoning office demand".

DANIEL CZIBULAS, MANAGING DIRECTOR, AGENCY

Munich's population has been increasing at a much faster rate than the other major German cities. By 2030, an additional 200,000 inhabitants will be residing in Munich. Unemployment at 3.80% has fallen to be among the lowest in Germany.

Munich benefits from a broad based economy. With a diverse mix of occupiers, the market has sustained consistently high demand for office space. In 2017, office take-up fell just shy of 1 million square metres, setting a new record.

Large corporates and global firms have been undergoing expansionary activity.

With virtually no large office space available in the city centre, occupiers have expanded their search criteria to the city outskirts and suburban areas. These secondary locations have, however, seen limited new office development, and new supply is often purpose-built for owner occupation, making it unsuitable for other occupiers.

Availability has fallen to an alarmingly low level in Munich's city area. Occupiers have been forced to defer their expansion plans, or alternatively move to unpopular suburban locations far from the city centre. Co-working providers have been

increasingly active, focusing on the inner city, to address the gap between supply and demand. This has, however, provided only temporary relief for occupiers, as opportunities for growth are constrained.

Munich's occupier market has become extremely competitive over recent years. With the market facing a dearth of available office space, occupiers approaching the end of their lease agreements are obligated to extend their new leases at a higher market rent, or otherwise lose out to competitors. Despite the shortcomings, the office development pipeline is showing signs of improvement on recent years.

Stock levels will be augmented through a mix of new schemes and refurbishment, with around half a million square metres of office space under construction. The Werksviertel district continues to provide considerable potential for new development, with ATLAS currently under construction. The 25,000 sq m property is over 90% pre-let a year before its completion date, reflecting the tight market conditions.

Based on recent demand trends and future supply, Munich's office market may reach full occupancy in 2020. As development activity continues to favour residential, lateral thinking is required to address the supply-demand imbalance. Vacant buildings should favour redevelopment and reconversion into office uses that maximise space efficiency. In the interim, the vacant space could provide occupiers with temporary relief as a business location. Munich's north-eastern suburbs have the highest availability and potential for redevelopment and these areas may become a focus for activity.

Munich's office market has not been exposed to the degree of yield compression seen in other German cities because of its already low yields. Yet it remains the most expensive market. Gross initial yields for prime office buildings have fallen to 3.00%. As strong appetite continues to prevail, intense competition for prime assets in Munich will lead to further yield compression.



MUNICH KEY STATS



986,000 SQ M

TAKE-UP IN 2017, UP 26% ON 2016



YIELDS TIGHTEST OF THE GERMAN MARKETS AT

3.00%



RENTS INCREASED TO
€36.30
PER SQ M



VACANCY RATE CONTINUES TO FALL TO

2.20%

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