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2020 Germany roundtable

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Germany stays resilient, but future worries persist

German real estate has ridden out the pandemic, so far. But managers are keeping a wary eye on the impact of economic distress still to come. Stuart Watson reports

While other European real estate markets have foundered in the wake of the pandemic, covid-19 appears only to have sharpened investor appetite for Germany. Real Capital Analytics calculates that the German market accounted for more than a quarter of European dealflow in June, and the country outperformed in absolute as well as relative terms. Deal volumes for both the first half of 2020, at €35 billion, and the second quarter, at €16.2 billion, exceeded those for the same periods last year.

RCA explains this as a consequence of three factors: the size, scale and sophistication of Germany's domestic investor base, which accounted for more than half the activity in H1 2020; a more successful response to the pandemic than rival nations; and strong public finances that have increased the scope for an effective fiscal stimulus – six months into 2020, Germany's response amounted to 13.3 percent of the country's GDP, compared with 8 percent in the UK and 4.4 percent in France.

But government support will not continue indefinitely, and the economic consequences of the pandemic, in Germany, as elsewhere, are likely to be far-reaching. One of the most pressing questions facing the four managers participating in *PERE*'s 2020 Germany Roundtable is how long, and to what extent, will the hitherto relatively robust performance of German real estate assets be maintained?

Low visibility of virus impact

"That is a difficult question to answer because at the moment it is a bit of a black box," muses Florian Geistmann, head of asset management at Munich-headquartered manager GLL. "Warren Buffet said it is only when the tide goes out that you see who was

Christoper Garbe

Managing partner, GARBE

Hamburg-based GARBE Group is best known as a developer, owner and operator of industrial and logistics buildings. But it also comprises property management business Fontenay, a development arm focused on constructing residential and office properties in Germany, and investment manager GARBE Institutional Capital. The group employs around 230 people, manages around €5.5 billion of real estate assets and is currently carrying out €1.5 billion of development.

Bernd Haggenmüller

Managing director, Ardian

Frankfurt-based Haggenmüller, who has more than 20 years' experience in the real estate industry, joined Ardian in 2016. The firm is the largest European private equity house with total assets under management of around €100 billion. Its 30-strong real estate division was formed five years ago and manages around €2 billion in core-plus and value-add funds.

Andy Watson

Fund manager, Europa Capital

Paris-based Watson is a partner at manager Europa Capital and fund manager of its core Europa Diversified Income Fund. The firm, which is 75 percent owned by Japanese institutional giant Mitsubishi Estates, manages around €4 billion of European real estate assets. The firm employs 65 staff and mainly raises capital for value-add investment strategies.

Florian Geistmann

Head of asset management and regional DACH and the Nordics, GLL (a Macquarie Group company)

Geistmann joined Munich-headquartered manager GLL four years ago. The firm was acquired by Macquarie Infrastructure and Real Assets (MIRA) in 2018 to act as its European real estate equity platform in Europe and the Americas. GLL manages around €8 billion of assets and employs more than 150 people globally.

swimming naked, and at the moment the government is holding the water back."

The participants' assessments of their success in collecting rents since the onset of the virus appears to vindicate the government response and speak to the relative health of the German economy. Bernd Haggenmüller, managing director at private equity firm Ardian, pegs the collection rate across its office portfolio at 96 percent, with the delayed 4 percent expected to be repaid with interest. Geistmann says GLL's figures are similar in the office segment, while 100 percent of logistics rents have been paid.

Christoper Garbe, managing partner of GARBE Industrial Real Estate, which oversees a €3.5 billion portfolio in the segment, adds that in a survey of its tenants only 18 percent said it was possible that they might ask for a rent reduction. "About 10 percent did ask if they could reduce the rent. But only half of them actually did it. So, 3-5 percent took the opportunity of reducing the rent under the government restriction. But most of them were SMEs and start-ups. Not one of our larger established tenants have done it," he says.

Andy Watson, fund manager at Europa Capital, has been favorably surprised by the resilience of the German market. "There were some real worries about tailspin in March that have not come to pass. The resilience of our core fund, in particular, has been pleasing, with tenants paying over 99 percent of the rent," he says.

However, he concedes that gauging the impact of the pandemic on occupier stability over the longer run is difficult. "We have no visibility. So we adopt the common sense asset management approach of talking to the tenants."

He reveals that Europa has also adopted a proptech tool designed to provide an early warning when tenants default on payments to their suppliers.

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> **Ardian**

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>
> **CHRISTOPER GARBE**
> **GARBE**

Buy sheds, or hold fire?

Your last euro – would the participants invest theirs now, and if so, where?

Geistmann: City logistics.

Garbe: Logistics development.

Watson: Last-mile logistics is a good 10-year bet.

Haggenmüller: I would wait for opportunities in the next 12-18 months in value-add offices.

Haggenmüller says that while Germany's short-time work scheme, under which the state tops up the wages of workers whose hours have been reduced, has functioned very well so far, the economic impact of the pandemic will be significant nonetheless. "We will still be affected by this in all aspects of our economy, just as we were in the financial crisis. We hope this crisis will not go on too long and the impact will not be too hard. But if you look at what is happening in the US, there is reason to be pessimistic."

A major economic downturn could even impact the popular logistics sector, says Garbe. "At the moment, we do not see it. But the next 12-18 months will show what the reality is. Car industry suppliers are under scrutiny. Everybody expects manufacturing to suffer most. But, in reality, manufacturing tenants are still signing leases at the moment. There is no clear picture of what is happening. We will observe the market closely and talk to our tenants, keeping a close watch on rental collection rates."

Demand for office space has already diminished, says Haggenmüller. "Take-up in the first half of 2020 was about one-third below the 2019 figure. But, if you look at the second quarter in isolation it was 50 percent down on 2019. We have had a bull ride in German offices over the last 10 years with tenants catering for their expansion programs. That is coming to an end now. Occupiers are asking themselves twice if they want to expand or not."

Domestic capital winning the day

Reflecting on continued demand for German real estate, Geistmann says: "With only low interest available on fixed-income, we are still seeing investors expanding their real estate portfolios. Return spreads have been maintained through the crisis, and, as such, there is a lot of equity chasing deals, particularly on the core and core-plus side."

He notes that demand in Germany and France has been more resilient than in central and eastern Europe. "That is driven by markets which have lots of domestic capital being stronger through the crisis than markets that do not have as much," he says. "We currently see less international capital looking at those markets."

Travel restrictions have played a role in dampening overseas demand, suggests Watson. "There is often a need for a certain group of decision makers to visit the real estate and, for the moment, they cannot always do that. There is an obvious trend of domestic capital winning the day at the moment."

Value-add transactions falling

While Germany is attractive compared with other European markets, strong capital demand is not evenly replicated across all segments and strategies. The participants agree that although logistics and low-risk office investments retain their popularity, retail and value-add office strategies are a much harder sell to investors.

"For logistics in Germany we are inundated with money at the moment," says Garbe. "We see a real run on the asset class, with multipliers we have not seen before and record pricing because logistics has been seen as a safe haven among asset classes, while Germany is seen as robust, too. The rental growth in logistics in the last two years has been low compared with offices, so I still believe there is some potential for increases and therefore some justification for higher pricing.

"We also raised a discount food retail fund, and those assets have been very robust in the Covid crisis. Fundraising for that was a bit more difficult, however, because investors were reluctant to back something labeled as retail."

The pandemic has created sharply contrasting demand dynamics between core and value-add office investments, observes Haggenmüller: "Core offices in Germany are extremely resilient. So far, the few transactions we have seen are at similar yields to before the crisis, and if you have exceptionally good tenants you can even command higher prices now because everyone is looking for that kind of product. On the value-add side, the impact of weaker leasing markets is beginning to show. That will eventually have a price impact. But sellers and buyers have not yet adjusted to that new dynamic and, therefore, we see value-add transaction volumes dropping. I wouldn't say the value-add market has come to a standstill. But it has slowed significantly."

The office debate

While the participants agree that slowing economic growth means short-term pain for office markets, there is less consensus over whether structural trends accelerated by the pandemic will cause permanent disruption and reduce the need for space.

Geistmann notes that the tech industry was driving a "voracious" hunger for offices before the pandemic. But, since then, examples from the US present a mixed picture, with app Pinterest paying to relinquish a lease in San Francisco, while Facebook has taken a huge new building near New York's Penn Station. "More people may work from home. But you could argue that, to have more flexibility, tenants will need more space so that the need will reach a sustainable level. After six months of working from home, we think people are really seeking the social element that is enabled by offices. As a result, we still believe there are strong fundamentals underpinning office as an investment class."

Haggenmüller also takes a bullish

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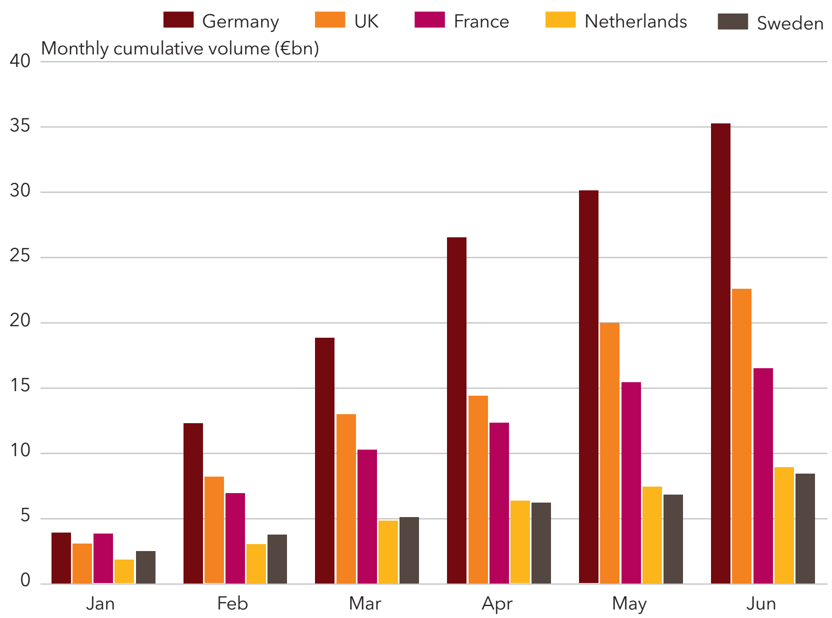
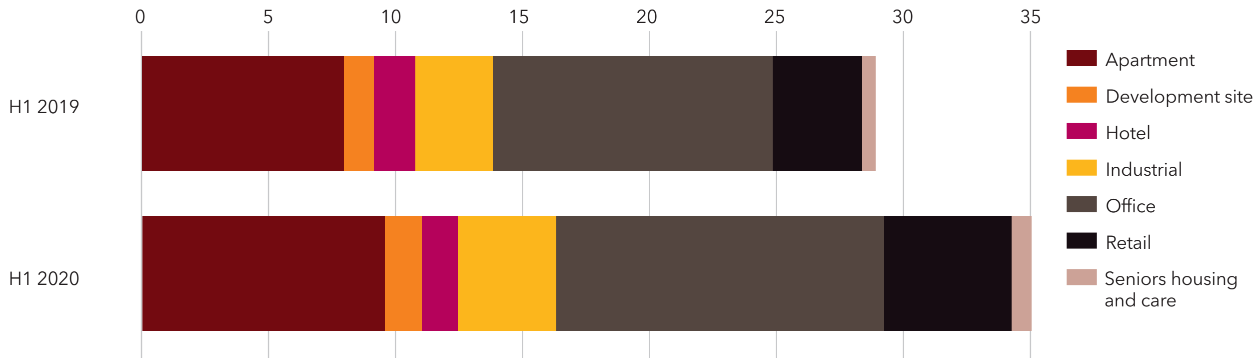
>
> **FLORIAN GEISTMANN**
> **GLL**

Germany outstripped other major European markets in H1 2020

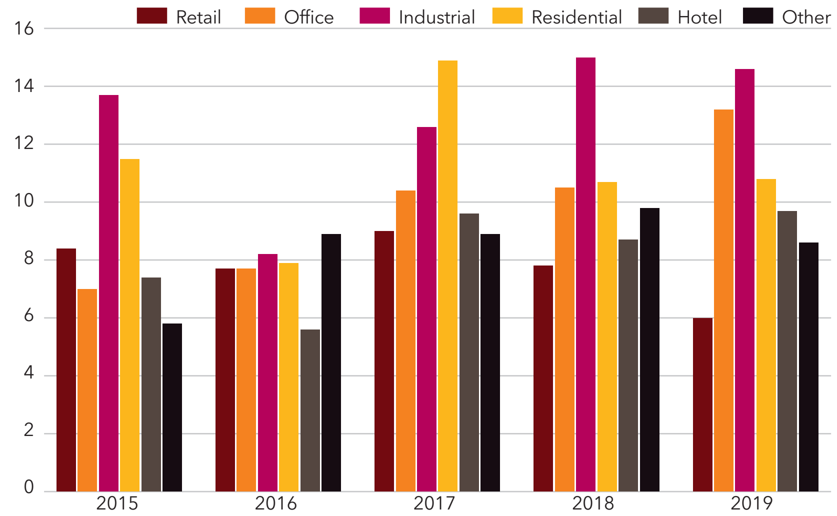


Monthly cumulative volume by sector (€bn)



Source for both charts: Real Capital Analytics

Pre-covid returns in Germany were highest in the office and industrial sectors, while retail returns were already falling away (%)



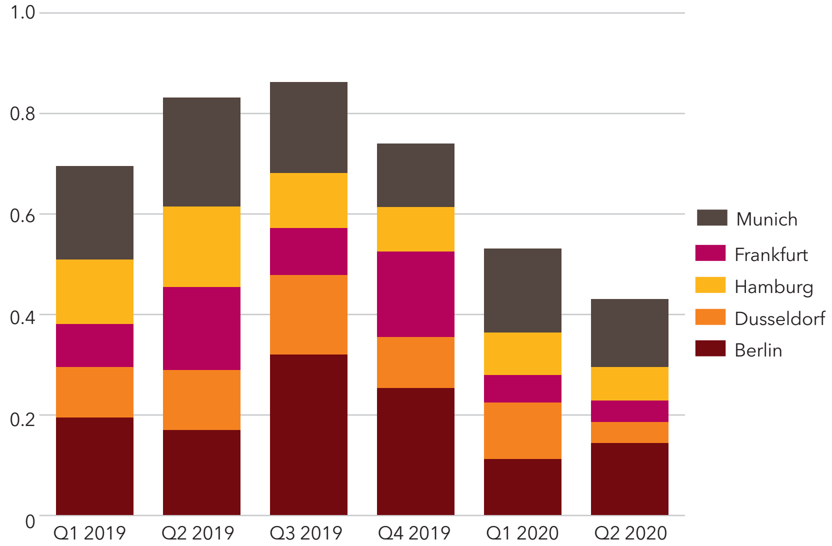
Source: MSCI

stance on offices. "This reminds me somehow of the situation after 9-11 when there was a big debate over whether companies would still want to locate to high rises. Humans tend to exaggerate from their current very significant and dramatic experience how the future will evolve. It is clear that office use will have to respond to new needs. But the need to bring people together for a creative process will not go away. Whether there will be a shift in the proportion of flexible space and long-term space that big corporations occupy I do not know. But nothing will make office buildings obsolete," he argues.

However, Garbe offers a dissenting perspective. "The true question is not, 'Do we need offices or not,' but, 'How much office space do we need?' We did a survey of our employees and the clear result was that they do want to come into the office two or three times a week to meet their peers. But they also want one or two days at home. In Germany, that will not have as much impact as it will in cities like London where you have packed open-plan offices and long commuting times. But it will have an impact. When economic growth returns, it may not have as great a positive impact on office take up as it would have done before, so we need to think about the office in a new way."

Some analysts have suggested that increased home working will provide a boost to suburban office and residential locations. However, Watson dismisses that as a "fashionable" idea. "Right now, and perhaps for the next year or two until we get a medical solution, the de-urbanization discussion will continue. But the long-term trend is to continue with urbanization," he argues. "It is expensive for governments to put infrastructure out of town, and the other factor that speaks in favor of the downtown office is that there will be a

The pandemic led to falling office take up in the top five German markets in Q1 and Q2 2020 (square meters)

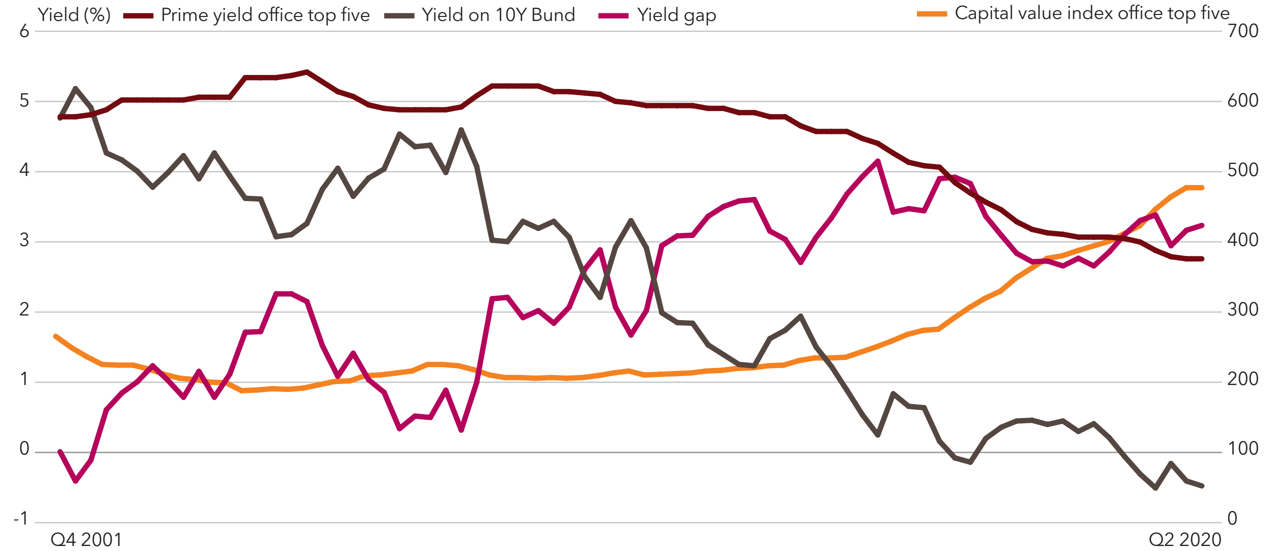


Source for both charts: CBRE

"We are in no hurry to get that dry powder out of the door. Sticking around for another six months is not going to hurt"

ANDY WATSON
Europa Capital

Prime yields in the German top five office locations maintained their Q1 levels in Q2, while the yield gap with bonds remains attractive



Lenders favor core offices, logistics development

In some segments, real estate finance remains plentiful and the rates low. But German banks are wary of higher-risk investments, say the roundtable participants

Geistmann: At the beginning of the lockdown, we saw the risk margin on lenders' interest rates expand. But that was just a blip and they have compressed again already for assets with strong income.

Haggenmüller: Banks are fighting for the few core transactions that you see. But value-add is difficult to finance at the moment. We have seen margins increase by at least 100 basis points in Germany for the speculative repositioning of offices with no income, and more in other countries.

Watson: We are going to take modest leverage of 25 percent on the seed portfolio for our core fund and the margins for that are probably 50 basis points higher right now than they were six months ago. We expect that to compress a little, so we are in no massive hurry. On the value-add side some assets are unfinanceable and that is translating into a repricing of secondary deals in that space.

Garbe: In the logistics market banks are quite concerned about the steep increase in capital values because 60 percent LTV at the new values would have been 90 percent at the values of three years ago, so they are reluctant to lever up to rates of over 50 percent LTV on market values as they stand. However, and this is a specifically German trend, for development we are getting extremely aggressive offers from lenders, sometimes 80-90 percent LTV, even for speculative development, at highly competitive rates.

deeper pool of potential occupiers, and not just for offices, but for residential and restaurants as well."

Will economic pain create investment opportunities in Germany? "Not yet," is the response from the panelists. "In the sectors we are actively targeting, beds and sheds, both for value-add and core, we see very little distress," says Watson. "Europa has raised €600 million of equity for our latest value-add fund. But we are in no hurry to get that dry powder out of the door. Sticking around for another six months is not going to hurt. There is still plenty of time on the clock."

"It is still early days," agrees Haggenmüller. "Price adjustments have not yet happened to the extent necessary to make investments attractive again. It will be interesting to see how much price adjustment has to happen before we and our peers are back in the market, because there is a lot of liquidity."

With German real estate still at the top of many investor wish lists, there are likely to be plenty of buyers waiting to pounce upon any re-priced opportunities that emerge. Meanwhile, existing owners will undoubtedly keep a sharp eye on the stability of their income as a fuller picture of the economic damage wreaked by the virus begins to emerge. ■