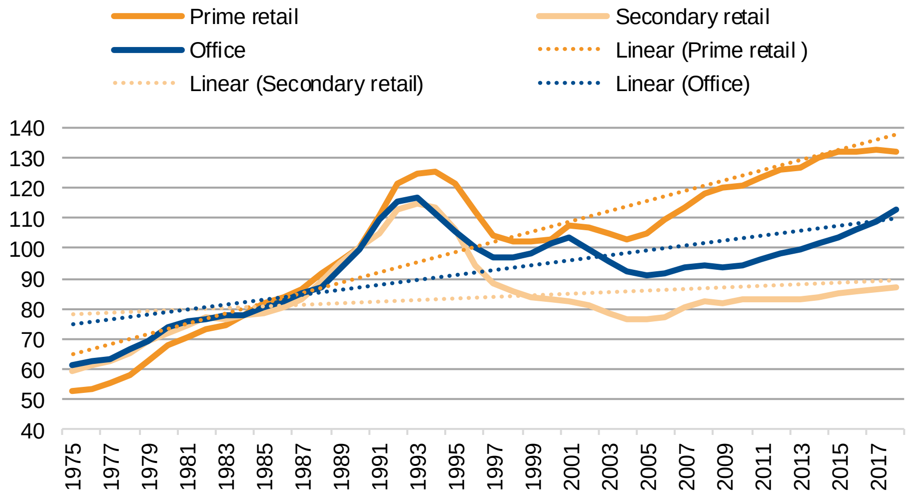
Rent dispersion driven by structural elements
Five observations on German CRE

German office and secondary retail commercial real estate rents are catching up with past stagnation. The picture does not break down equally, however, and volatility between sub-asset classes and location differs. Office rents in Germany are generally around their long-term levels, but rental levels in the big cities are much higher, potentially implying that unsustainable levels have been reached regionally. However, the short-term trend is likely to be reinforced by construction backlogs and further pressure on vacancy rates. Current rents for retail are below the long-term average. Structural elements, however, will prevent further growth.

First Observation: On average, German commercial rents are not inflated but…

German office and commercial real estate rents are, on average, around their-long term mean, supported by strong growth in the last decade for office and prime retail following long-term stagnation or even declining rents in earlier years. Secondary retail, however, remains below its long-term growth.

Nominal rent index & long-term trend (since 1975)



Source: Bulwiengesa, Scope

Commercial rents are driven by multiple factors impacting supply and demand. Rental returns are driven primarily by micro location and the specific local environment. However, on a macro level the long-term trend can be a useful tool for assessing the sustainability of rents, with the caveat that structural elements can drastically change the nature of any market over the medium term. Retail is a prime example of this, given its vulnerability to e-commerce and changes in customer behaviour that are structurally changing the market.

Second Observation: …rental growth is not equally distributed across German CRE

Growth is not distributed equally across CRE segments. In line with the general trend in market values, office space shows the strongest rental level, at 2.9% above the long-term average. While this is moderate, office rents in the Big Seven cities (Berlin, Hamburg, Munich, Cologne, Frankfurt, Stuttgart, Duesseldorf) are 8.4% above average levels, albeit with strong heterogeneity between locations. On the other hand, cities and towns are around their long-term average (0.4% above).

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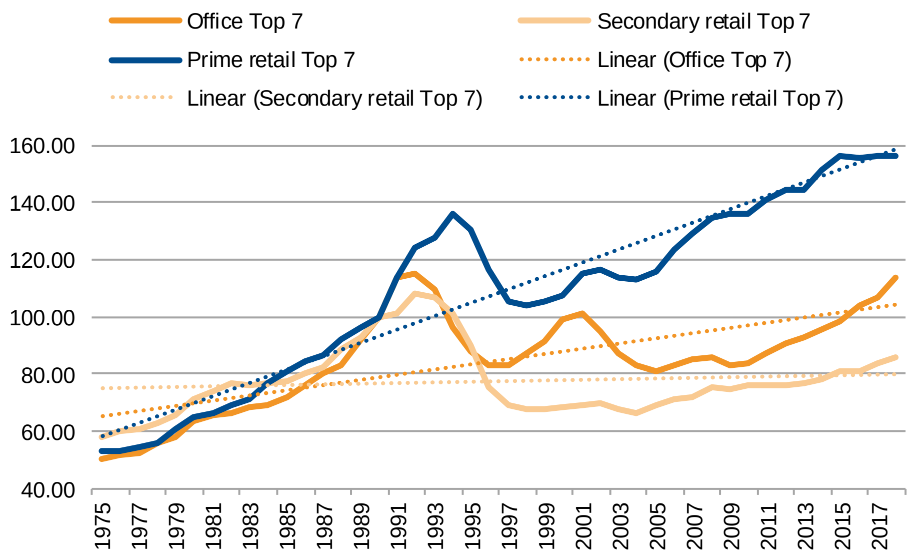
Prime high-street retail locations, on the other hand, show rents 4.4% below their long-term average with two different trends: Top 7 city rents are close to average levels while retail rents in cities and towns remain low (around 6% below average).

For secondary retail, the respective trends diverge even more strongly: 7% above their average for big cities; 6.9% and 5.8% below their respective long-term average for cities and towns.

Top 7 German cities: nominal rent index & long-term trend (since 1975)



Source: Bulwiengesa, Scope

The difference in rental levels between urban and rural areas is also comparable to Scope analysis published in October 2018 which highlighted that market values for commercial properties are above our sustainable averages, especially in the largest cities (German commercial real estate – refinancing risk surging).

Third Observation: Retail rents driven by structural elements; the long-term trend will not persist

The squeeze on profitability for retailers vulnerable to changes in consumer behaviour and the growth in e-commerce limits demand for prime retail space, putting rents under pressure. Accordingly, the retail segment is not expected to close the gap to its long-run trend over the foreseeable horizon[1].

The strong long-term growth of retail of up to 2.8% p.a. (since 1975) for high-street locations in the Big Seven cities is not seen as sustainable due to structural economic changes as well as changes in consumer behaviour crystallised by online growth that is driving the market. Scope has a negative view on retail rental growth and does not expect further growth over the medium term.

A correction is most likely for high-street retail more exposed to e-commerce competition, as rental costs would not be offset by adequate revenues in a low-margin business model environment. We foresee shopping malls in the largest cities (secondary locations) still showing smooth rental increases and stability, however.

[1] Corporates Outlook 2019/Retailing: Profitability expected to be under pressure. January 2019

Fourth Observation: Despite strong levels, office rents are not expected to drop in big cities

German offices may have reached a stage of elevated and potentially unsustainable rental levels indicated by the distance to its long-term average of +8.4%. Constant growth in office rents in the Big Seven cities has been 3.5% p.a. since 2010, but just 0.85% p.a. between 2000 and today. However, over the short term, we expect the momentum in rent increases in the Big Seven cities to continue due to structural effects such as construction shortages[2], further pressure on vacancy rates and Brexit-driven demand.

Fifth Observation: Rent growth volatility differs among sub-asset class and location.

Observed volatility differs within the commercial real estate sub-asset classes. The highest volatility in rental growth was observed for office. Further, within office we see the strongest dispersion between Top Seven and cities/towns.

On the other hand, volatility for retail is relatively balanced, though interestingly less pronounced in cities than in towns.

Observed rent growth volatility

Observed rent growth volatility	Office	Prime retail	Secondary retail
Top 7	5.3%	4.4%	4.6%
Cities	2.9%	3.5%	3.6%
Towns	3.1%	4.3%	4.3%

Long term trend remains vital element in Scopes credit analysis

Scope's forward-looking approach to CRE considers long-term trends and volatility for rents and property prices. It also embeds macro and micro structural changes impacting sub-asset classes or specific locations which promote further credit differentiation between property portfolio.

[2] Bundesbank: Building permits for and completions of commercial real estate in Germany. November 2018

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