LINK WEALTH

Impact of Inflation
on the German Real Estate Industry

Market Report

2024

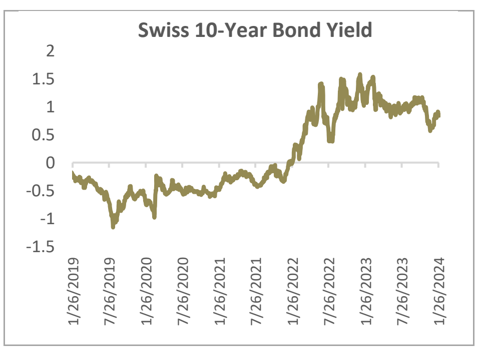
Germany	2021	2022	2023	2024e	2025e	2026e
Real GDP (YOY %)	2.6	1.8	-0.1	**0.4**	**1.2**	**1.3**
Inflation (YOY%)	5.8	9.8	6.1	**2.7**	**2.5**	**2.2**
Unemployment	3.6	3.1	3.0	**3.2**	**3.1**	**3.0**

Source: Federal Statistical Office

Eurozone	2021	2022	2023	2024e	2025e	2026e
Real GDP (YOY %)	5.4	3.5	0.7	**1.2**	**1.8**	**1.7**
Inflation (YOY%)	2.6	8.4	5.6	**3.3**	**2.2**	**2.0**
Unemployment	7.7	6.7	6.6	**6.5**	**6.4**	**6.3**

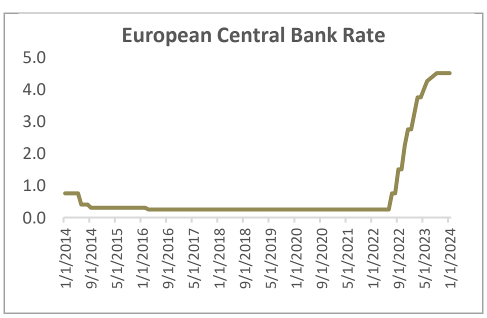
Source: IMF

Source: Bloomberg



Source: Bloomberg

Note: Swiss 10-year bond yield is used as a benchmark due to stability in rates



Source: Bloomberg

Introduction

Following the reopening phase after the COVID-19 pandemic, supply-side limitations precipitated inflationary pressures in the developed world, notably in Germany, surpassing thresholds not observed in the previous two decades. In 2023, Germany's annual average inflation rate was +6.1%, well above the European Central Bank's (ECB) medium term average inflation target of 2.0%. Although there was a moderation in inflation in January 2024, with the average rate falling to 2.9%, it is important to note that several factors have contributed to Germany's high inflation over the past two years:

1. High energy cost

Russia's invasion of Ukraine in February 2022 led to a surge in energy prices, significantly impacting inflation in Germany, which heavily depended on Russian energy supplies. To mitigate this, Germany swiftly sought alternative sources, decreasing reliance on Russian oil and gas, which helped alleviate inflationary pressure in the latter half of 2023.

2. Ukrainian imports and high energy costs propel food prices

Reliance on Ukrainian goods and rising energy costs drove a notable spike in food prices in 2023, a key factor in Germany's inflation. This prompted increased spending on food production, transportation, and storage, further fuelling inflation. As energy prices stabilised, food inflation significantly decreased.

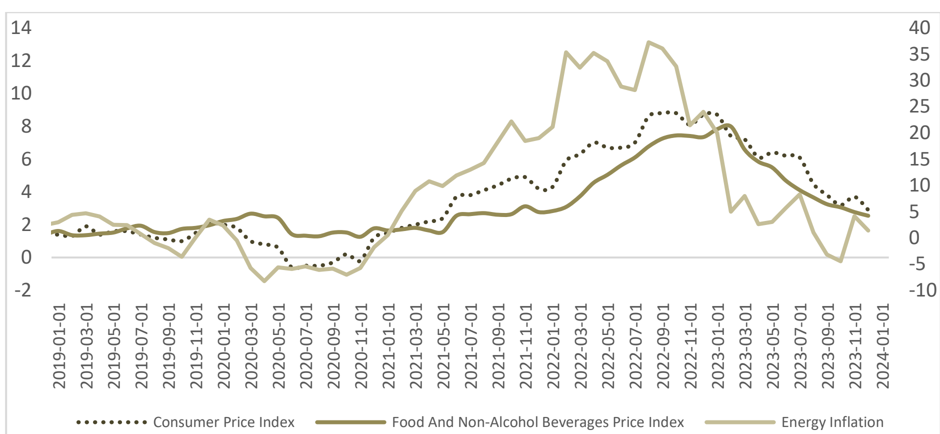
3. High construction cost and rental yields

After the Russian-Ukraine conflict, Germany witnessed an influx of Ukrainian refugees, making up approximately 1.3% of the population. This influx posed challenges, including a 14.0% to 16.0% increase in housing rentals, particularly in cities like Munich and Berlin. The conflict also disrupted supply chains, especially for construction materials, as it affected significant producers of steel and timber.

4. Tight labour market and soaring vacancy rate

The constricted labour markets in Germany, characterised by elevated job vacancy rates and minimal unemployment, are compelling employers, including entities within the food industry, to escalate wage levels to secure a workforce. This, subsequently, contributes to an augmentation of operational costs for businesses, particularly within the food sector, driving higher inflation.

Five Year Inflation



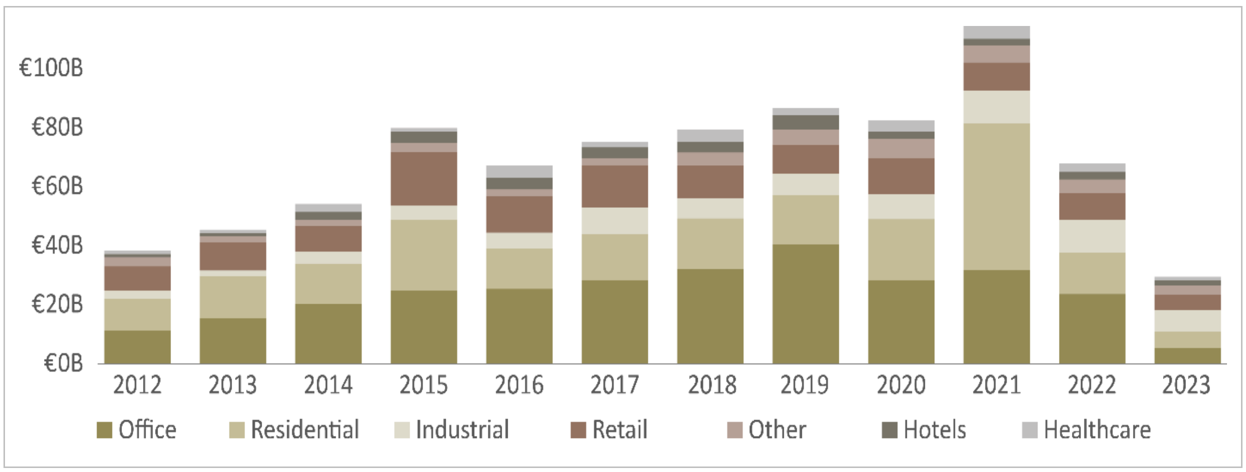
Source: Statistisches Bundesamt (Destatis)

Germany's Investment Market Landscape

During 2023, Europe's real estate sector faced considerable challenges due to liquidity pressure, weakened investment metrics, and reduced profitability. Increased interest rates impacted housing affordability and market outlook, particularly in Germany. As expected, the German investment market entered 2023 with notable fragility due to persistent inflation concerns and rising interest rates since the previous year. In 2023, the transaction volume in the German investment market totalled €29.0 billion, marking a 56% year-on-year (YoY) decline compared to 2022 and below the 5-year average of €55.6 billion. The 4Q23 contributed €7.5 billion, the second strongest result of the year. The contribution from the Top 7 investment locations, which include Berlin, Düsseldorf, Frankfurt am Main, Hamburg, Cologne, Munich, and Stuttgart, dropped to 39.0% in 2023 from 50.0% in 2022. Moreover, contrary to previous years, the anticipated year-end rally did not materialise in the last quarter of 2023.

In January 2024, the inflation rate declined to 2.9% after reporting slight increase in inflation in December 2023 (3.7%). Despite this, there is no indication of a significant reduction in the key interest rate as the ECB aims to balance controlling inflation and promoting economic growth amid geopolitical uncertainties and ongoing supply chain challenges. The average yield on 10-year German government bonds was 2.17% at the year-end of January 2024, maintaining a relatively high level. Likewise, in December 2023, 10-year mortgage rates declined to 2.86% after experiencing a consistent increase.

Investment Volume by Sector



Source: CBRE

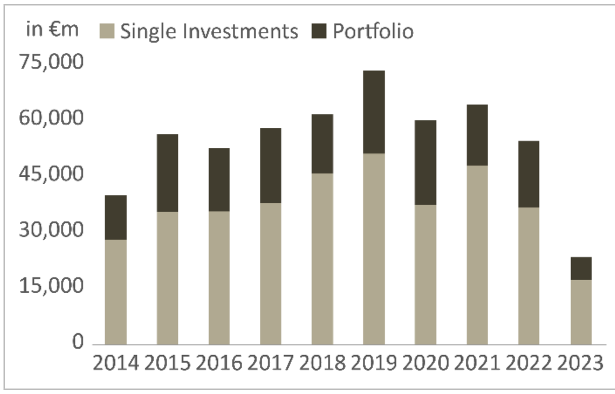
Commercial Real Estate (CRE)

As anticipated, turnover experiences significant decline

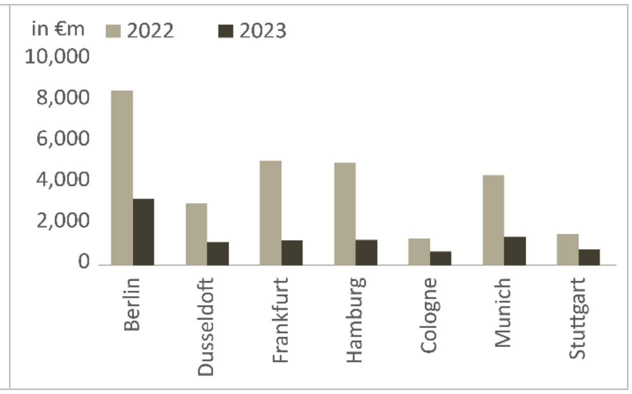
Germany's commercial real estate investment market saw a transaction volume of around €21.50 billion in 2023, marking a YoY decline of 57.0%. This is the lowest level observed since 2010, when it was €18.8 billion. The fall is mainly attributed to challenging conditions throughout the year, characterised by high financing costs, prolonged price corrections, elevated inflation, and a weakening economy, which instilled caution and hesitation among institutional investors. However, with indications suggesting that the market has reached a trough, the international real estate advisor anticipates a resurgence in activity during the latter part of the year 2024. Misaligned price expectations between buyers and sellers have contributed to the low transaction volume, although there is a gradual alignment as prices have already decreased significantly. Institutional investors remain cautious of the core office properties in the investor class.

The Top 7 investment locations witnessed 67.0% lower investment volume in 2023 than the previous year. The total investment volume was around €9.26 billion, the weakest result in the last ten years.

Transaction Volume Commercial Portfolio



Investments in Top 7-Locations



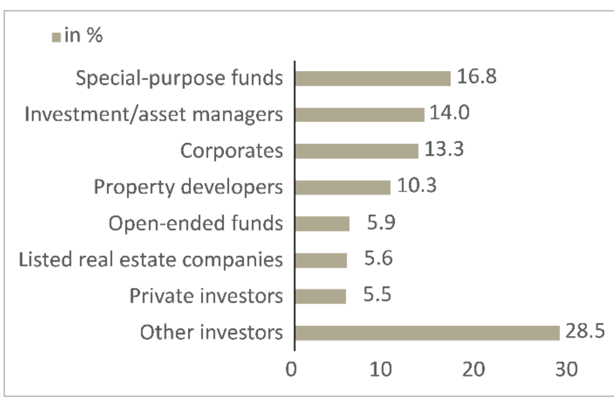
Source: Cushman & Wakefield, BNP Paribas

Amid disagreements on pricing, commercial property markets experience a standstill

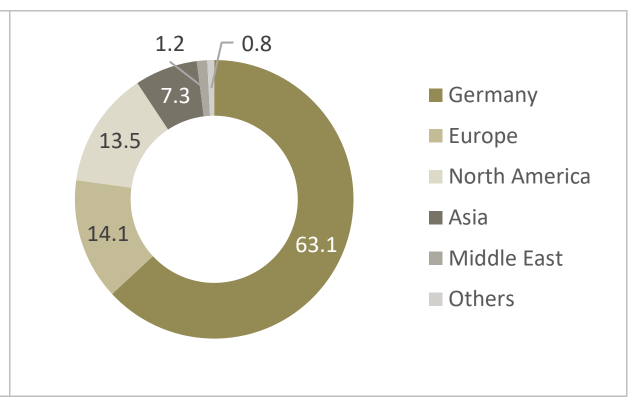
2023 witnessed a significant decline in retail and overall commercial investment market activity due to financing challenges and pricing negotiations, resulting in subdued dynamics. In 2023, logistics and industrial properties led the CRE investment market with €5.82 billion in transactions despite a 37% yoy decline. Retail properties transaction volume was €5.12 billion, down by around 35.0%; however, it was the second-strongest category in CRE after logistics properties, mainly due to a significant portfolio transaction involving 188 grocery stores. Office properties faced significant challenges, with only €4.40 billion invested, marking a substantial 78.0% decrease, primarily attributed to shifting interest rates and value retention factors like desk-sharing, remote work, and ESG compliance. Most individual deals (about 90%) were below €50.0 million, aligning with current financial conditions. Notable high-value investments were mainly limited to a few share deals rather than individual assets. The halt in Germany reflects similar trends in European nations like Sweden, Ireland, and the UK.

Many buyers are delaying purchase decisions; Domestic investors, especially those with solid financial backing, were notably active. However, international investors, who made up 50.0% of the volume in 2022, only accounted for 20.0% of the total commercial property volume in 2023. Despite initially announcing their intention to increase investments in Germany following the interest rate shift, major foreign players such as Blackstone have not yet followed through, signalling waning interest in German real estate by foreign investors.

Investments by Buyer Group (in %)



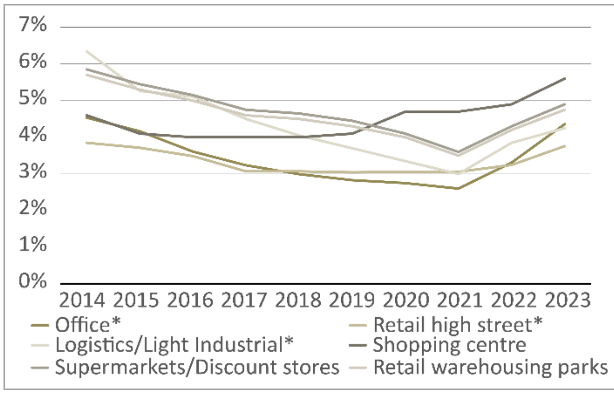
Investments by Buyer Nationality (in %)



Source: Data for 2023, BNP Paribas

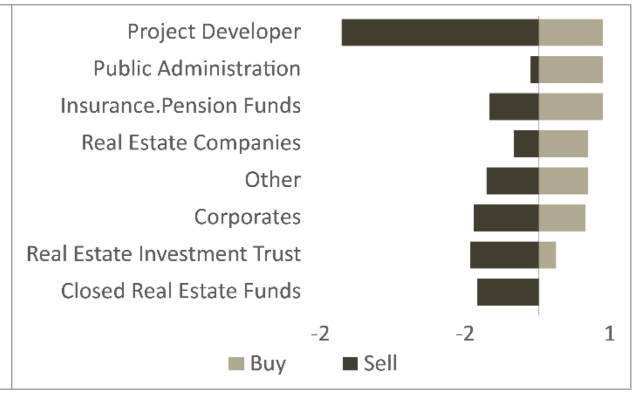
Source: Data for 2023, BNP Paribas

Development of Net Prime Yields



Source: BNP Paribas
* Top 7 locations

Investment Volume by Buyer/Seller Types (in bn €)**



Source: BNP Paribas
** Office properties

Is the hesitance of investors stifling inventory movement?

Pricing disputes between buyers and sellers have brought commercial property markets to a standstill. Rising interest rates have raised borrowing costs, prompting potential property investors to aim for higher yields. As a result, offer prices have declined. As prices remain low, investors retain inventory, but the escalating interest rates are increasing their borrowing expenses and making debt servicing challenging. At present, a prevailing sense of prudence is evident. The investment trend in CRE in 2023 was closely aligned with that observed in 2012. During 4Q23, domestic and international investors collectively allocated approximately €5.9 billion toward the CRE properties.

The investment market might see a boost as selling pressure rises due to higher refinancing expenses and portfolio devaluations, particularly in project developments. With the rise in interest costs and the necessity to bolster their financial positions, sellers could find themselves compelled to provide discounts shortly. This adjustment comes as the prevailing environment shifts toward a "new normal" with elevated interest rates and yields. As these factors put increased pressure on sellers, they might be more inclined to make concessions to navigate the evolving landscape.

A downward price trend: Catalyst for increased transaction activity?

Investors remain in a state of heightened caution, primarily due to the uncertainties surrounding economic trajectories and interest rate shifts. The acceleration of transaction activity is contingent upon achieving a certain level of stability, at which point investors might ease their restraint. The long-lasting price corrections are nearing their peak, and there are indications of stabilising yields in the future. Capital availability remains high, and the importance of real estate in investment portfolios remains unchanged. With a stable financing environment, confidence in an upcoming market recovery will increase, along with transaction volume.

Riding the waves: overcoming the currents of financial challenges

ECB raises rates to combat inflation, and the economy feels the effect

In 2023, persistent inflation and rising interest rates posed significant challenges for households and businesses, making it harder to access credit and mortgages. To combat and reduce inflation back to the target, the ECB has significantly increased main refinancing operations rate (MRO) reaching 4.5% by January 2024—an overall increase of 1.75 percentage points yoy. Furthermore, the ECB's tightening of monetary policy, including rate hikes and quantitative tightening, resulted in a contraction of its balance sheet, affecting sovereign bond markets. Specifically, the decrease in holdings of German federal bonds is anticipated to be the main factor behind the reduction in banks' excess reserves during the year.

In early 2024, inflation was cooling due to lower energy prices, with January's rate dropping to 2.9% from its peak of 10.6% in October 2022. Additionally, the Core CPI held steady at 3.4% in January 2024. The ECB is expected to wrap up its restrictive monetary policy in 2024, following the fastest and most substantial interest rate hike cycle in EURO history, likely leading to a gradual reduction in key interest rates.

Could rising interest rates and inflation lead to a German banking crisis?

The Bundesbank, Germany's central bank, faces pressure from a €1.07 trillion debt acquired through ECB's bond-buying programs. The extensive purchases and negative interest rates led to bonds with negative yields, straining Bundesbank's financials. Due to sluggish demand, German banks are pressured to raise deposit rates but can't transfer this to loan customers. Many banks hold long-term low-rate mortgages, devalued by a 4.0% ECB rate increase. Two-thirds of German banks faced additional capital requisites, increasing minimum capital requirements by almost €12.0 billion. The Bundesbank reserved some funds to cover losses, but projected future losses are expected to surpass its remaining provisions (~€19.2 billion) and capital (€2.5 billion). Non-performing loans might rise in energy-intensive sectors, while real estate faces pressure due to interest rate strain. Germany's federal audit office suggested a future bailout might be needed to cover losses from the ECB's bond-buying scheme.

Moreover, the German government aims to enhance company liquidity and promote investment by implementing an annual tax relief of €7.0 billion from 2024 to 2028. This Growth Opportunity Act is anticipated to bolster the economy in the upcoming years.

Crunching the numbers: Is higher CRE exposure a risk for banks?

In November 2023, the ECB warned about European commercial property companies facing significant losses on higher interest rates and inflation. In the past, when interest rates were meagre, many investors and banks put their money into commercial real estate. However high interest rates can present difficulties for individuals and investors seeking to purchase properties, particularly because they frequently depend on loans for financing. As interest rates increased in the last two years, the real estate deals slowed down because not as many people were interested in buying. This has been tough for the sector, and banks that lent much money to commercial real estate might face problems as the values of these properties are expected to drop. Many owners now have properties worth less than what they paid for them. While the commercial real estate sector represents about 10.0% of banks' lending, it could still impact the financial system. The insolvency of Signa Holdings also intensifies the troubles in Germany’s CRE property market, further curtailing banks' appetite to lend to commercial real estate.

Outlook

In the German economic landscape, there is a discernible decline in inflation, yet caution is warranted due to the persistently high core inflation. The annual average inflation rate in 2023 stood at approximately 6.1% and is anticipated to decrease to 2.7% in 2024, primarily driven by notable reductions in energy and food price inflation. Core inflation, elevated at 5.1% in 2023, is expected to recede to 3.1% in 2024. Noteworthy revisions in inflation rates for 2024, and to a lesser extent for 2025, have been observed compared to projections made in June 2023, fortifying hopes amongst private investors.

On the other hand, the real estate investment market remains challenged, given the subdued growth outlook for the economy, higher interest rates and rising construction costs. The GDP forecast for 2024 hovers between 0.5% and 1.0%, indicating continued sluggishness that is likely to impede investor activities. The future interest rate development plays a vital role in shaping the direction of Germany’s real estate investment market. If a moderate increase in interest rates is assumed, Germany is anticipated to be a ‘safe heaven’ with stable rents and prices; however, in the event of substantial upward movement in interest rates, a correction in the property market is anticipated, potentially ranging between 20.0%-30.0% or more.

On a positive note, the gap between sellers’ and buyers’ price expectations is closing, and the market participants are slowly reaching a consensus on a mutually acceptable price level, indicating a recuperative phase for property markets. Nevertheless, this recovery is expected to unfold gradually, attributed to restricted credit availability for commercial real estate, financial instability, and the persistence of elevated interest rates. Under the assumption that interest rates have plateaued, investor confidence is anticipated to drive demand higher during the latter part of 2024.

Link Wealth SA
Rue du Rhone 114
1204 Geneve
Switzerland

Tel: +41 22 552 25 03