REFIRE
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## Inside REFIRE

REFIRE is a specialised report focused on providing market intelligence and background analysis to finance professionals in German and continental European real estate investment.

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# Supply demand imbalance in traditional German assets sees rise of new hybrids

**As 2018 gets underway, one thing is clear: demand for real estate in Germany is radically outpacing supply. For investors with deep pockets, the problem is exacerbated because there simply aren't enough traditional assets in which to invest. As core assets become harder and harder to source, canny investors are turning to new income streams to boost their portfolios.The disconnect between current pricing and risk is propelling Germany's real estate market in a new direction as investors increasingly seek out more diverse opportunities.**

**New hybrids shake up market**

'The demand for real estate is still very high but the current pricing of real estate doesn´t always reflect existing risk,' **Olaf Janßen**, head of research at **Union Investment Real Estate**, told REFIRE.

Hence the need to find new ways in which to invest, says **Dr. Esfandiar Khorrami**, a partner at law firm **Bottermann Khorrami**. Budget food retailer Aldi is shaking up the residential space with plans to build apartments above its existing stores, creating a new food retail/resi hybrid, much like **Tesco** is doing in the UK. (**Sainsbury** and Morrisons are also building on-site housing).

Discount grocer **Aldi** is planning to build more than 2,000 rental apartments above its stores in Berlin. The mixed-use developments will be rolled out in at least 30 locations across the city. First up will be 200 apartments in the hipster district of Neukölln; and Lichtenberg, home to the former headquarters of the Stasi. **Jörg Michalek**, managing director of Aldi, has described the developments as a 'future-oriented solution'. The Berlin apartments are due to be ready by mid-2019 and will be rented for between €6.5 and €10 per sqm.

Understandably, the new schemes are already attracting investor interest: 'We'd be very interested in that sort of product,' **Florian Mundt**, managing partner of open-ended fund manager **Deutsche Investment**, told REFIRE. 'Everyone shops at Aldi and Aldi is always looking

## Logistics in Frankfurt and Berlin are best bets for 2018

Logistics in cities such as Frankfurt and Berlin offer the best investment opportunities in 2018, Peter Salostowitz, CEO of German data provider IndustrialPort told REFIRE this week see page 6

## GroKo agreement 'boosts stability' of German real estate market

Germany's Christian Democratic Union and the centre-left Social Democrats have reached an agreement regarding the terms of a coalition deal, in a move that will boost stability in the market, Dr. Esfandiar Khorrami, a partner at law firm Bottermann Khorrami, told REFIRE. see page 8

## Treatment of share deals likely to come under coalition focus

As Germany's coalition partners the SPD and the CDU/CSU union look set to finally agree on a new programme for government, there may finally be some movement in attempts to address the issue of share deals when buying property. Companies have long avoided the local Grunderwerbsteuer see page 14

## Foreign investors dominate care home market

Foreign investors have muscled in on Germany's care home market in a big way, accounting for 64% of deals last year, according to CBRE's analysis for the fourth quarter 2017, published this month. Care home transactions .see page 18

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to find the right location. We have some land upon which to develop, so we would be very interested in collaborating with Aldi on projects like this.'

Another investor open to food retail/resi hybrids is New York-based real estate group **Madison International Realty**, which acquired Berlin's *Sony Center* in partnership with Canada's **Oxford Properties** for €1.1bn last October. 'We would certainly look at this,' **Ron Dickerman**, president and founder of Madison, told REFIRE. 'Grocery stores tend to be a draw, so adding apartments is not crazy. Also, Europe is in a pretty solid growth mode and Germany is leading the pack. We're looking for larger opportunities to invest capital there.'

***"'It can be slow to get building permits, though, which makes it hard for retailers to expand aggressively. Hence Aldi building apartments in Berlin"***

Aldi's move into the residential space highlights 'the lengths they will go to in order to get the sites they want', said **John Wilkinson**, CEO of fund manager **Greenman Investments**. 'We're already buying retail in C and D cities,' he said. 'We look at local demographics and what the population is expected to be in 10 years' time. 'It can be slow to get building permits, though, which makes it hard for retailers to expand aggressively. As a result, they are becoming more creative, hence Aldi building apartments in Berlin.'

However, how successful Aldi is will depend on the group's exit strategy, according to **Gunnar Herm**, head of real estate research and strategy – Europe at **UBS Real Estate**. 'Will they pull down existing stores and replace them with more modern ones with apartments? It would make sense for traditional food retailers to do this, too, given that they tend to be in strong urban locations, and local councils would be supportive of the new housing opportunities. I think there would be immediate interest if they started making these available to investors – it's definitely a type of product that institutional investors like us would be interested in.'

German fund manager **Arbireo Capital** is also eyeing Aldi's development plans with interest: 'This could mark the beginning of a new product in the market,' the group's CEO, **Dr. Martin Leinemann**, told REFIRE. 'This would appeal to us as investors. Equally, given the relative lack of affordable hospitality in Germany, we could see supermarkets with a hospitality component above.' Another option would be to tear down older supermarkets and to rebuild them with a residential or hospitality element, according to Leinemann. 'I think this product will become more popular. **McDreams** is doing this in the 'Big 7' and elsewhere, with food retail on the ground floor and hospitality above. We and our investors would like to get a chance to do this.'

### Competition for co-working spaces on the up

Another option is to invest is in offices – 'not classic offices but exotic co-working spaces', Khorrami told REFIRE. 'Companies want more flexibility and services, without having to be tied into 10-year contracts. There's a lot of competition for co-working spaces because you can transform an office property with a 3% yield into one with a 10% yield. Some companies will cease to do business if they don't want to take on more risk. The market is changing.'

Cities such as London may be leading the way when it comes to shared workspaces but Berlin is busy playing catch up. Last year, around 75,000 sqm of co-working space were leased there, more than a five-fold increase on the 14,000 sqm leased the previous year, according to **C&W**. The city's popularity with start-ups - which thrive on low cost, low risk flexible spaces – is also boosting interest. **WeWork** is also expected to significantly increase the space it takes in Berlin.

Ultimately, 'investors have to go to non-core assets or invest more broadly if they want better returns', according to **Dr. Jan Linsin**, head of research at **CBRE Germany**. 'They also need to look more at secondary and tertiary markets – your typical ABBA story,' he told REFIRE.

Linsin also expects investment in co-working spaces to be a trend in the occupier/leasing market this year. 'It now accounts for 7% of the office market in the 'Top 5' markets from virtually zero a couple of years ago.'

Not all investors are swayed by co-working, though. 'Co-working spaces continue to garner a lot of interest from both occupiers and investors,' said **Justin Curlow**, global head of research and strategy at **AXA IM - Real Assets**. 'I think we'll probably see a market evolution whereby more cities have a greater degree of these spaces. However, they also create an asset liability mismatch if you have a long lease on a building let to short-term tenants.'

**Complex deals gaining ground**

For other investors, flying under the radar to home in on complex deals is the key to sourcing good opportunities. 'We can fly under the radar of the bigger institutional players to land smaller deals,' **Dr. Matthias Mittermeier**, managing partner at **Commodus Real Estate Capital**, told REFIRE. 'The beauty of our structure is that we have an agnostic mandate. We focus on offices and have just acquired a property where we've managed to increase the rental income by 35% in just one month. We like the value-add segment: you mustn't shy away from complexity.'

Commodus still sees good opportunities in the market especially below the €30m mark, according to Mittermeier. 'Irrespective of market conditions, finding good deals is never easy. We're prepared to take on more risk but not to lower our return expectations. The combination of being really asset-focused against a strong macro backdrop allows you to



generate risk-adjusted returns in Germany that are difficult to find today in other European markets.'

In particular, Commodus is targeting units in excess of 1,000 sqm per floor, which can command a premium of 15% compared to smaller units in today's market, Mittermeier said.

Another investor not afraid of complexity is AXA IM – Real Assets. 'Germany is the poster child for growth following the global financial crisis,' said Curlow. 'Even secondary and tertiary cities have benefitted. The supply side is starting to respond and cheap debt is plentiful, which is driving investors into new types of investment. For example, we are considering mixed use schemes which add an added layer of complexity, but as always it would depend on the asset and location.'

Core assets, however, have lost their shine. 'Given the interest rate outlook globally, we are not currently interested in investing on behalf of our clients in core assets offering wafer-thin yields, because our focus is on growing our income stream,' Curlow said. 'We wouldn't categorically rule out moving up the risk curve, but we would expect adequate compensation for that risk. Too many investors are deploying capital just for the sake of it.'

For investors willing to take on more risk, there are development opportunities in offices, resi and hotels. 'Ultra-core money from *Spezialfonds*, which is backed by pension funds and insurers, is also investing more in development projects because they have to – especially in this low interest rate environment where bond yields are very low,' Linsin said.

**Low returns trump high risk for many investors**

Nonetheless, lower returns continue to trump additional risk for many investors. In the latest investment climate study by **Union Investment**, published this month, 56% of those surveyed are not willing to recalibrate their risk strategy, choosing instead to accept lower returns. However, 37% of investors said they would be willing to take on more risk for the same returns. Also, two thirds of the 151 property investors surveyed in Germany, France and the UK expected the turning point in the cycle to be reached in 2020 or later. And 36% of the investors surveyed estimate that it will be at least three years before initial returns on real estate in Europe start to rise again.

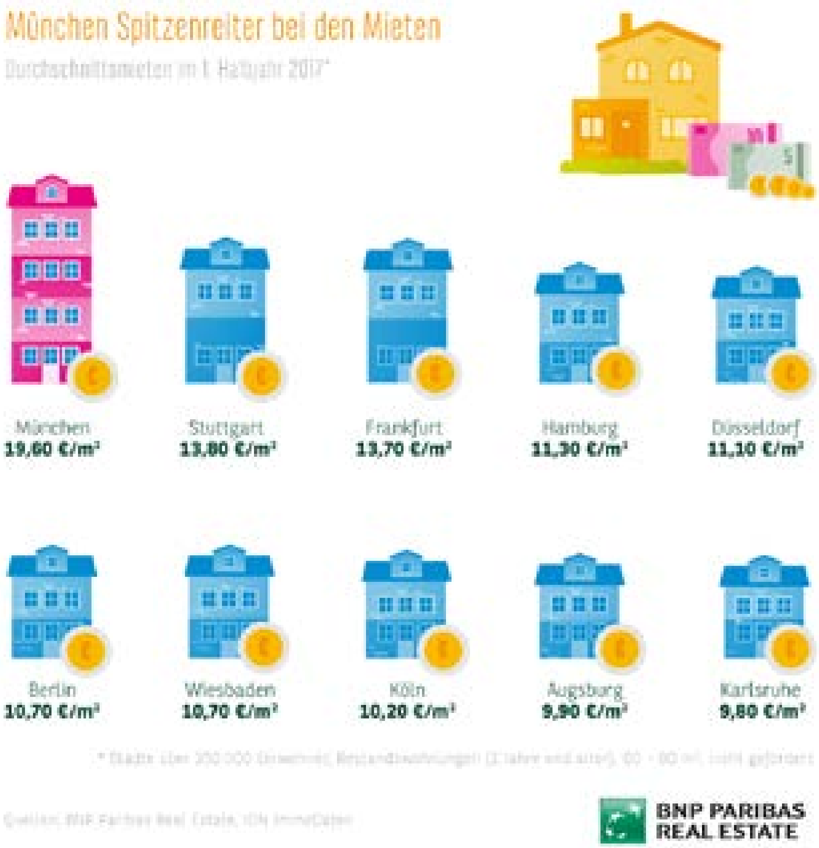
While many investors don't want to go too far up the risk curve, taking on 'selective' risk is becoming more commonplace. 'Similarly to the majority of investors, we are reluctant to take on excessive risks,' said **Monika Sujkowska**, an analyst, real estate investment strategy and research, at **Aviva Investors**. 'We are, however, prepared to take selective occupier, asset management and development risks in markets with strong occupier fundamentals. We aim to only invest in markets where we have deep local expertise and close relationships with developers, policymakers and occupiers on the ground. Being embedded in a market allows us to spot mispricing opportunities and make high conviction calls about opportunities that may not be on the radar of other market players.'

Around half of the investors taking part in the survey said that they do not expect to achieve their own yield targets, within a timeframe of three-to-five years. This is supported by the consistently high value placed on security by professional investors, as reflected in the results of the survey. Security remains the most important aspect of investment decisions for 30% of the interviewed investors. For 15%, liquidity is the most important factor, while return on investments heads the list for 54%, as in the previous year's survey.

'These findings indicate the most common ways out of the investor's dilemma,' said Janßen. 'A third option between a wait-and-see attitude and excessive risk, although still a much less common choice, involves more innovation with calculable risks.'

Mega trends are also feeding into investment patterns, according to Herm: 'Mega trends are influencing how we invest,' he said. 'Technology has had a huge impact on how we work and live, making data centres and urban logistics attractive.'

Whatever investors end up investing in, 2018 is expected to be another strong year for Germany's real estate market. CBRE is forecasting around €50bn in commercial real estate deals in Germany this year and another €15bn in institutional grade residential transactions. Investors clamouring for deals will just have to hope that enough comes to market to satisfy their appetite. This year, it's not just about playing the game: successful players will need to take it to a whole new level.




Germany/Logistics

## Logistics in Frankfurt and Berlin are best bets for 2018

Logistics in cities such as Frankfurt and Berlin offer the best investment opportunities in 2018, **Peter Salostowitz**, CEO of German data provider **IndustrialPort** told REFIRE this week.

'We've created a logistics 'heat map' (with **Savills**),' Salostowitz said. ''For investors looking to invest in German logistics this year, one option could be to invest in logistics spaces close to big cities. In our 'heat map',, we think it's safe to invest in any of the 'green' areas, which includes Frankfurt, Berlin, Leipzig, Munich, Stuttgart, Hamburg and Dortmund.'

There is a need for more logistics space near big cities, especially given that more and more people are moving there, he added. Part of the problem is that apartments are being built along Germany's rivers or former industrial areas where previously there were a lot of warehouses. Those warehouses are being lost.

'It's hard to gauge the logistics development pipeline going forward – a property could be built this year or in 10 years' time. However, what we do know is that