Guest Column: George Salden (5)

The German Property Market: If You Want Good Returns, You Must See the Big Picture

In the last article, we put real estate under the microscope: The tenant cycle is well-known; the structure of rents is transparent; the dynamics were revealed; and the decision for a certain style of investment was made. The next step is to analyse the property environment over time since tenant dynamics are closely connected to the rent index and market rents. It is necessary to take a differentiated approach in considering how the rent level will develop, which in turn depends upon the cycle of the location – on a large and small scale, i.e. the city, district, street.

This macro-cycle is defined by four successive phases that repeat each other cyclically. At the beginning of the cycle, the supply is low, and investors look for rising rental prices and high returns. This phase is followed by overbuilding: Many buildings are finished in a short time and the supply is greater than the demand. Since the macro-cycle of the overall economy often follows with a slight lag, demand falls in this phase of the cycle due to the economy. The supply of space outstrips demand and meets with the already limited purchasing power of the population. To put it briefly: vacancies increase, and rents and purchase prices fall. When the market consolidates, the oversupply and the falling demand reinforce each other, causing rents to drop to a low level. The market stabilises when this phase reaches its nadir: The low price level stimulates demand for affordable real estate which is also supported by a recovering economy. Demand gains traction and reinforces itself, and there is a rise in rents from new tenancy agreements.

It is not possible to react directly to this rise in demand since the production of new space lags behind demand. At this point, the cycle has been completed once and begins again with the market shakeout phase. The main cause of the macro-cycle is the time lag that is a part of the property asset. Due to the long production periods for real estate, new space can only service the strong excess demand with a time lag. Most construction projects are completed in a phase of the macro-cycle that exhibits a completely different relationship between supply and demand than when the projects were begun.

However, it is necessary to consider that the value of a property at the beginning and the end of a cycle is usually different. In the following, we will consider what happens when there is a long-term change along with a cyclical fluctuation, i.e. when a trend is integrated into the analysis. The model is expanded for this: Besides the cyclical fluctuation, the market rents only change by an additional constant percentage. While the market is always subject to the same fluctuations, the absolute performance of the market rents is now constantly rising. Important: Only a forecast that also takes into account the trends makes it possible to anticipate the development of the rents and thus the returns on investments.

The previous analyses of the macro-cycle are based on the assumption that the market cycle changes like a sinusoidal wave. However, this form of the cycle is often pure theory since the macro-market is influenced by a number of factors that were insufficiently considered in the previous analysis. Let us take a very current example for a “player” that can have tremendous consequences: the statutory limits on rental prices. Such intervention in the existing system has a major influence – which is very easy to understand – on the future development of market rents. This example shows that it is insufficient to also include the status quo and its direct forecast change in analyses. Rather, potential influential factors must always be monitored since they can have a serious influence on the cycle and thus can also be an important basis for deciding for or against an investment.

Let us begin with an analysis and description of a macro-location in order to gain a feel for its development. I must stress again that the macro-cycle in its pure form solely provides a theoretical explanatory model in order to approach the peculiarities of the property market. In reality, the property market is much more complex than the approach with this model suggests. It consists of various sub-markets that are all interwoven and mutually influence each other.

The factors that should be considered at a location can be divided into hard and soft ones. The hard ones certainly include the infrastructure: How do the streets or roads run, how accessible is the location and how do you reach it, what is the parking situation and how far are the connections to the local and national public transport system. It is also necessary to consider how easy it is to reach the city by car, underground, railway or plane, and what the overall structure of the networks for the public local transport system is.

The geographical location – another hard location factor – consists of parameters such as the location of the city, the distance to the neighbouring cities, the urban development plans – like the zoning plan or the regional planning programme – as well as factors such as the development of the city. The hard location factors that have the greatest influence on the market are labour and demographics: The social and economic structure is the key to a sustainable description of the current condition of a macro-market and its future development. Among the most important demographic developments are the population structure, the age structure, the social structure, the number of households, the current migration trends and the level of education. These structural circumstances are not a static snapshot, however; rather, they must be recognised as trends in development. Only then is it possible to take the important step from market analysis to cycle forecast.

Besides the hard location factors, soft location factors are also an important part in an evaluation of the macro-cycle. The soft location factors primarily include the image of a city or a part of a city that results from a combination of hard and soft factors and has immense significance for the attractiveness of a market. An impressive example here is the Berlin district of Kreuzberg, which enjoys the reputation of a being a hip neighbourhood thanks to its cultural diversity and attracts above all young people. This in turn has a demographic impact.

In a comparison of the hard and soft location factors, we can see that the hard ones are easier to influence and their significance is easier to describe for the macro-market than the soft location factors. The construction of a new street can eliminate infrastructure flaws or harm the quality of a neighbourhood due to the increase in traffic. On the other hand, soft location factors are interesting for the development of the macro-cycle due to their longevity. They prove to be significantly more stable than hard criteria: For example, the number of unemployed people can change quickly, but a location's image needs much more time.

The dramatic extent to which the economic performance can affect the property market is evident, for example, by taking a glimpse at the east of Germany: While companies have moved to Berlin and Leipzig, entire villages in the greater metropolitan areas are dying out. There are already ghost towns in Saxony and Brandenburg. An example of this is Heuersdorf, which lost its entire population due to the decline in the lignite industry. This trend shall continue in the future.

A demographic analysis shows that the age structure also plays an important role. Retirees use the largest amount of space because they fear a move for emotional and financial reasons. For this reason, retirees have higher consumption expenses for home ownership on average. But new family and labour structures shall also cause an increase in the demand for individual use concepts. The traditional family is increasingly losing importance and the tendency to work in a "home office" plays a major role here. Consequently, if the housing stock wants to generate high returns over the long term, it will be necessary to adjust it to the new needs of a changing population. In hardly any other place is it as clear that property investments must focus on the tenant and not the property. Anticipating the long-term development of the population structure is essential for an investment in real estate since such an investment will be exposed to the consequences of demographic change due to the long holding periods. Many developments cannot be predicted with any degree of certainty – but close monitoring is absolutely essential. Only in this way is it possible to react to the problem of asset meltdown.

While some experts assume that the ageing population will use real estate as security for retirement, others hold the view that people will terminate their investments in order to cover the costs of retirement. The latter would mean more real estate on the market and would lead to a loss in value for individual properties in future. In the next article, we will look at how the micro- and macro-analyses come together since if you want good returns, you have to match.

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