



# German residential property

## Back in fashion – with good reason?

September 3, 2010

40 million dwellings in Germany. Germany's population of just under 82 million people live in approximately 40 million dwellings. Nearly half of these are single and two-family homes. At slightly over 42%, the home ownership ratio is still below the European average. In itself, this ratio represents neither a call for politicians to approve new incentives nor an implicit invitation for investors to tap into the market.

Prices are unchanged on average. Unlike in many other European countries, residential markets in Germany did not go on rollercoaster rides in the last ten years. Prices had neither soared up until 2007 nor did they drop in the course of the recession.

Average fails to reflect major regional differences. However, price trends also differed substantially between the attractive regions with high in-migration and the economically weak regions with high out-migration. While house prices in the weakest regions fell by more than 30% in the last ten years, they rose by up to 20% in the best regions.

Slight price increases to be expected in the next few years. The low number of completions, Germany's quick economic recovery, low interest rates and the fact that many investors are looking for low-risk investment products have led to a small boom in some subsegments of the residential property market. Prices are on the rise for prime inner-city locations especially in the major conurbations. But bargains can be found outside these few major conurbations as well. There are numerous attractive medium-sized towns and cities such as well-established university towns. On average, house prices in Germany look set to rise by roughly 1.5% p.a. over the next two years.

Beware of the risks. The positive outlook should not, however, render investors blind to the specific investment risks: real estate is always an investment in a particular region or area, making it vulnerable to changes in regional economic structures and the related demographic changes.

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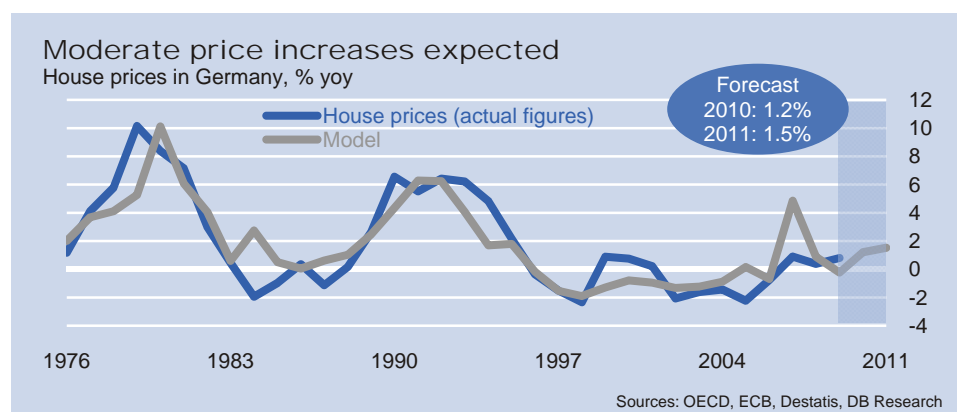
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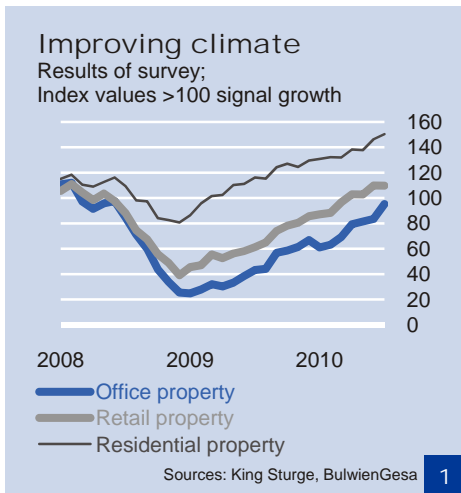
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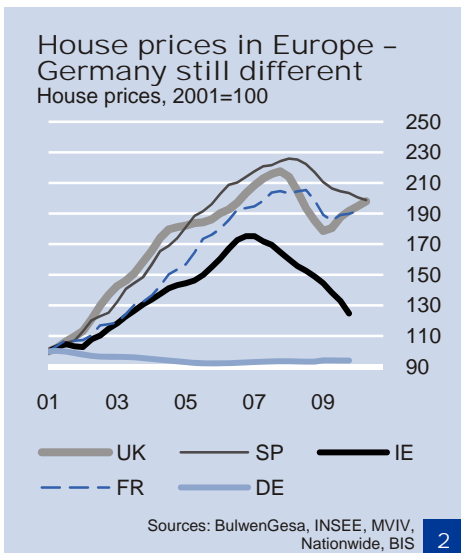


## Introduction



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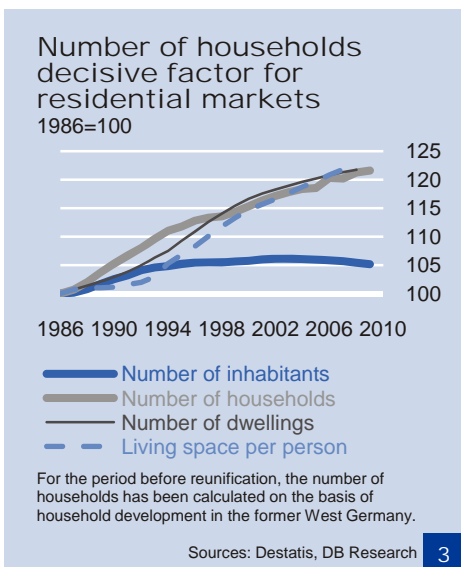
In its German edition the Financial Times on July 5, 2010 published an article on Germany's residential property market entitled "Summer fairy tale in German real estate market" and in May even reported a "run on residential property". This enthusiasm is also reflected in the King Sturge Real Estate Climate Index: in July 2010 the subindex for the German residential market reached the highest level since the inception of the survey and remains considerably higher than the commercial property subindex. But not only sentiment among market participants is picking up. Transaction volumes are also rising noticeably: according to BNP Paribas Real Estate, turnover of residential portfolios was up 35% in the first half of 2010 – albeit from a very low level. The fact that demand for property picks up at the end of a recession is nothing out of the ordinary, as incomes are the most important determining factor in the demand for property.



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Nonetheless, two important questions arise in light of this dynamic. First, what are the reasons for this development? After all, Germany's residential market was hardly considered particularly attractive by many domestic investors prior to the crisis. While property prices soared in most OECD countries, prices in Germany stagnated for years. German residential markets were not overvalued before the crisis and thus did not collapse when the recession hit. Secondly, there is the question of the short and medium-term outlook for German residential property.

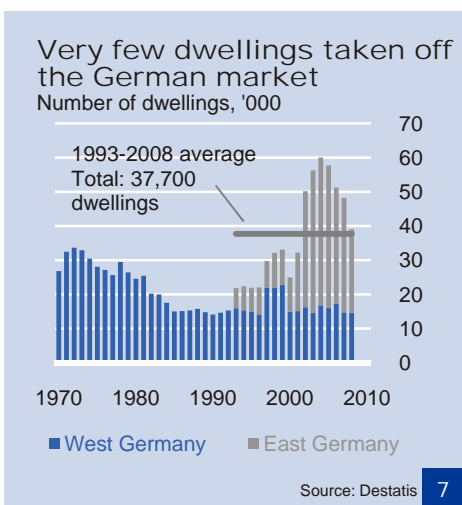
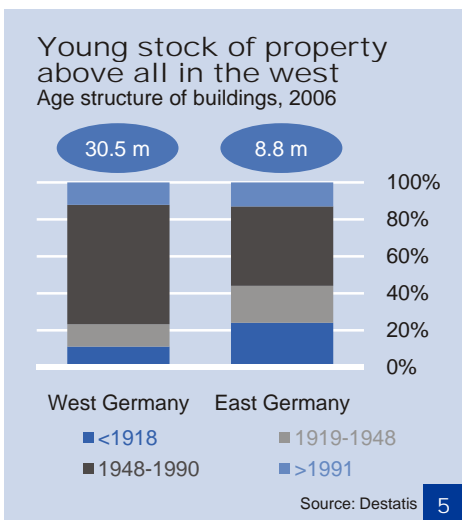
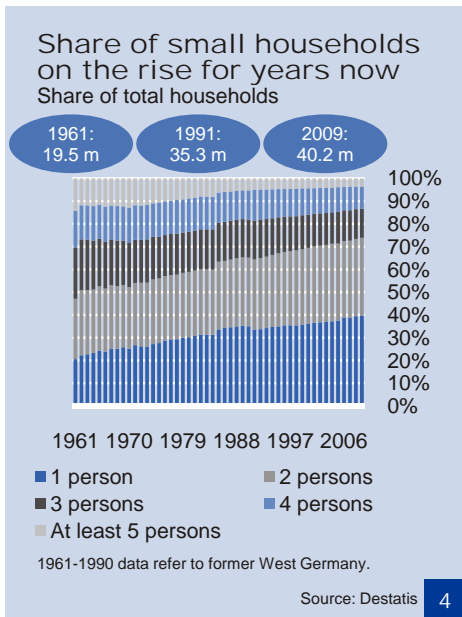
## Structure of Germany's residential market



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At the end of 2009, approximately 81.8 million people lived in Germany – roughly 700,000 less than in 2002, when the population had reached a record high. Nonetheless, demand for housing also grew in the past few years, mainly because the average number of persons per household fell as in earlier decades. So despite declining population figures, the number of households rose: at 40.2 million currently, the number of households in Germany has risen by about 5 million since the time of German reunification. The figures reflect the societal trend towards singularisation, population ageing and the continuously low fertility rate. Nearly three-quarters of all households currently comprise no more than one or two persons; in 1960 it was less than one-half of total households. In particular, large households with at least 5 persons are steadily losing in importance: in 1960, one in seven households comprised 5 or more persons while today the figure is just under one in thirty. Even in the old federal states there were twice as many large households in 1960 as in all of Germany today.

Also, the amount of living space per person has been rising for years now. This reflects rising incomes and considerable construction activity in the post-war decades as well as in the first ten years after German reunification. Overall, the supply of housing has developed more or less in line with the number of households since reunification: the pent-up demand registered up until the mid-1990s was met quickly thanks to large-scale building activity. Since then, supply and demand have been in equilibrium. The newly created housing limited the scope for price hikes, allowing for more space to be used per person.



In fact the two major disruptions of the last 70 years – WWII and the break-up and subsequent reunification of Germany – have resulted in a stock of housing stemming from two distinct eras. 60% of Germany’s residential real estate was built in the forty years after WWII, with the share of dwellings from this period being larger in the west than in the east of the country. By contrast there are considerably more houses in east Germany that are at least 90 years old.<sup>1</sup> A substantial part of this stock of old houses has been refurbished and modernised in the course of reunification. The relatively young housing stock and large-scale refurbishment imply that only very few houses are being withdrawn from the market: an average of below 40,000 dwellings or 0.1% of the entire housing stock has been demolished in each of the last ten years.<sup>2</sup>

### Big differences between east and west Germany

Even twenty years after Germany’s reunification notable differences remain between the east and the west of the country. This holds true for both the stock of housing and household formation. Some of these differences can be attributed to differences in income. It is also a fact that structural changes in real estate markets take a long time. Living space (per person) is 20% larger on average in west Germany than in east Germany. Moreover, the share of single and two-family homes in the total housing stock is markedly higher in the west than in the east. This is the legacy of 40 years of socialism.

### Residential property market: Differences between east and west

Latest available annual data

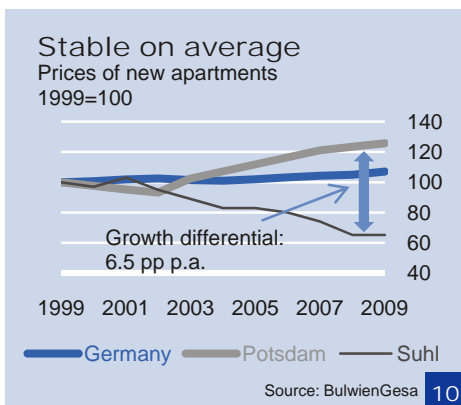
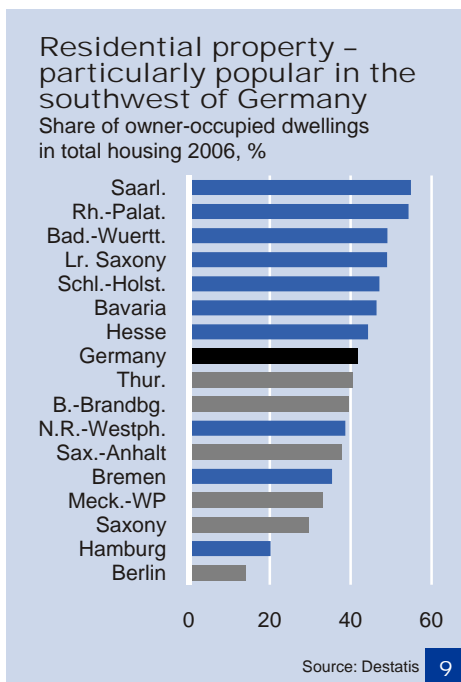
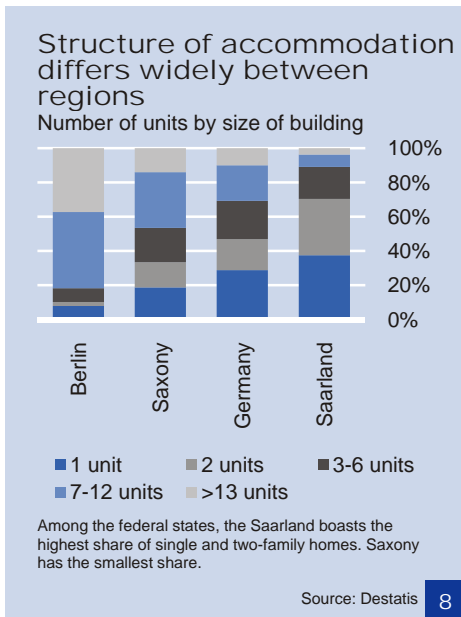
	West Germany	East Germany
Number of dwellings per 1,000 inhabitants	473	535
Living space per dwelling (m <sup>2</sup> )	90.1	73.0
Living space per inhabitant (m <sup>2</sup> )	42.6	39.1
Share of single and two-family homes (%)	50.6	34.0
Ownership ratio (%)	45.7	32.5
Share of single households (%)	38.9	42.8
Average household size	2.08	1.89
Vacancy ratio, according to microcensus (%)	6.7	12.3

Source: Destatis **6**

Some divergences, however, can be put into perspective by pointing out other structural differences: the smaller size of dwellings, for instance, can be explained at least in part by the smaller number of persons per household in the east. In addition, the lower ownership ratio in the new federal states is largely the result of the specific structure of properties in this part of the country: People in Germany tend to prefer buying single-family dwellings rather than flats in multi-family houses. While more than 85% of all single-family houses are owner-occupied, the ratio is just under 15% for apartments in multi-family buildings. In fact, the ownership ratio for single-family houses is even higher in the east than in the west of

<sup>1</sup> Berlin is considered to belong to east Germany.

<sup>2</sup> Even though there are good reasons to assume that official statistics underestimate the number of properties taken off the market, the actual ratio is likely to be markedly below the hypothetical 1% ratio frequently applied in rough calculations. The natural process of ageing also implies of course that the number of demolished properties will rise gradually over the coming decades.



Germany. There are, after all, more multi-family buildings as a share of total housing in the new federal states than in the old. In the western state of Saarland, for instance, roughly 70% of all dwellings are single or two-family homes, while the figure is only about one-third in the eastern state of Saxony. The reason, then, for the low ownership ratio in east Germany is the fact that there are considerably fewer properties that are attractive to buy. This indirectly confirms the theory that many people regard their home not only as an investment but also as a consumer good.

Especially as east Germany has excess supply of living space in multi-family houses, the demand for single and two-family housing cannot be met easily. Every newly built single-family home in east Germany exacerbates the problem of vacant dwellings in multi-family buildings. Both the microcensus and the Techem-empirica index show at least twice the number of vacancies in the east as in the west.<sup>3</sup>

Moreover, the simple dichotomy between east and west no longer captures the situation entirely as there are also major structural differences between the west German states and between rural and urban regions within individual federal states. The supply of living space, for instance, is more generous in east German territorial states than in the west German city states. We will have to take a closer look at this aspect when considering possible investment opportunities.

## Price trends

The price signals coming from German residential property markets in the last ten years were totally different from the signals sent by other European residential markets. By and large, rents and prices moved sideways in Germany. However, we have noted some remarkable developments in individual subsegments.

Residential rents in Germany rose by a mere 1% p.a. over the past ten years, i.e. by approximately 50 basis points less than consumer prices. However, this average calls for differentiation in two respects: first, over the last three years rents in the major cities rose about twice as much as in the whole of Germany. And secondly, there are notable differences even between these larger cities. While rents generally increased more strongly in the western cities than in the big cities in the east, this division is much too coarse: especially over the last three years good locations in east Germany registered strong increases in rents even by west German standards. At the same time, poor locations in the east also suffered most in all of Germany over the last three years. Another important aspect in west Germany is the fact that among the ten cities with the highest rent increases the usual suspects like Hamburg and Munich have been joined by smaller places such as Trier, Karlsruhe, Würzburg, Braunschweig and Osnabrück.<sup>4</sup> This goes for both the short and the longer term. A striking aspect is that in both top-ten rankings, medium-sized university towns fared particularly well.

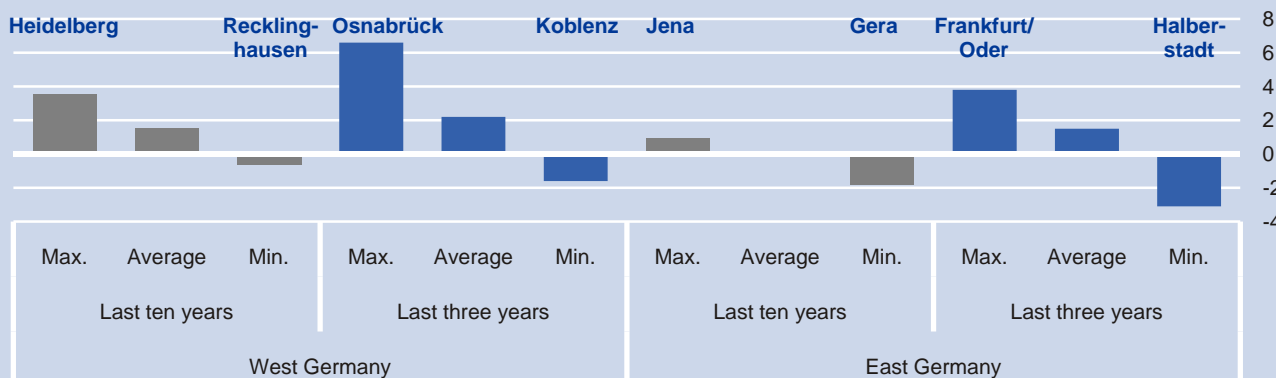
<sup>3</sup> There are interesting differences between the two measures. According to Techem-empirica, the level of vacancies is considerably lower than that reported by the microcensus.

<sup>4</sup> This top-10 list applies to average rent increases over the last three years.

### Rental trends in German cities

Rents for newly built dwellings, % p.a.

Max. = highest level in subsegment; Min. = lowest level in subsegment



Sources: BulwienGesa, DB Research

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### Only slow increase in rents in Germany

Rents and consumer prices, % yoy



Sources: Bundesbank, Destatis

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### Prices unchanged on average

Prices for apartments have been stable in the past ten years throughout Germany. Prices for newly built flats – as for detached single-family homes – only rose very marginally, while prices for existing apartments even fell by an average 0.5% per year. But these averages fail to reveal major regional differences: prices for newly built dwellings diverged by 6.5 percentage points of growth p.a. between the best location (Potsdam) and the poorest location (Suhl). And the ten-year period in question does not take account of the dramatic adjustments in the years following reunification, either.

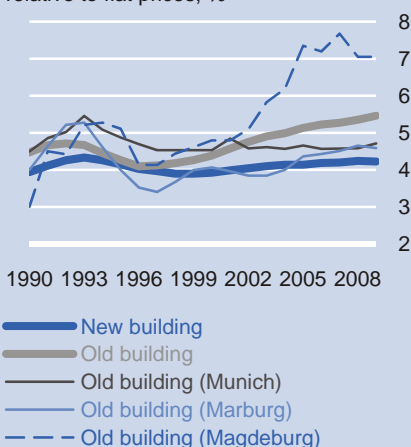
When comparing residential rents and prices, one arrives at a simple rental yield measure. This yield for new buildings has risen marginally over the past few years, reflecting the slightly stronger rent growth compared with the growth of prices in the past few years. By contrast, yields for old buildings have increased substantially. In many places prices for old buildings have fallen more steeply than rents. Especially in the out-migration regions of east Germany, this probably reflects the expectation of shrinking population figures.<sup>5</sup>

### Look beyond the typical big cities

Particularly regarding yields, there are interesting regional differences. In Munich, e.g., yields have been relatively stable while prices have risen in line with rents. There are also towns like Marburg or Karlsruhe which have seen prices rise but failed to keep up with the rise in rents over the last ten years. This is an important message for cashflow-oriented investors, especially as the greater cyclical nature of yields in Marburg suggests potential capital gains. However, these markets are less liquid and call for better regional market knowledge. Finally, the exciting developments in some east German cities with above-average economic growth such as Magdeburg, Dresden, Jena and Leipzig must also be taken into account. Yields there had risen markedly up until 2005, as prices frequently fell faster than rents. Since then, both prices and rents have stabilised. The higher risk of vacancies is now better reflected in higher yields than ten years ago. And there is good news even for places like Chemnitz and Gera, where yields recently picked up markedly (to approx. 8%), as rents have lately stabilised there too.

### Rental yields: Huge differences

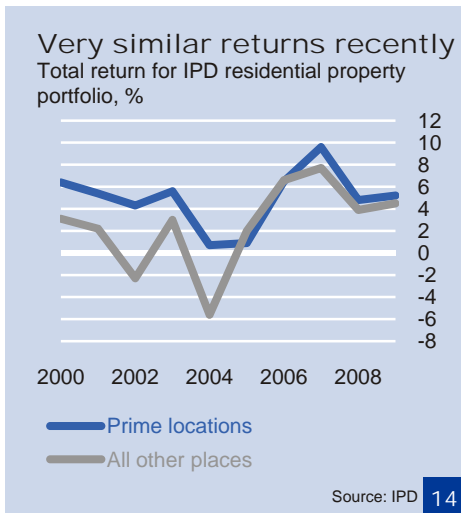
Rents (excl. electricity and heating) relative to flat prices, %



Sources: BulwienGesa, DB Research

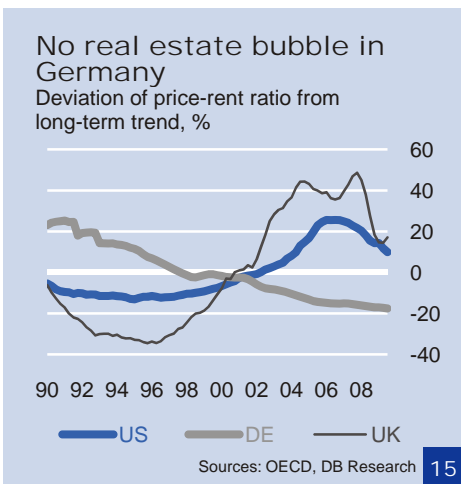
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<sup>5</sup> The yields used here only provide a broad orientation as costs incurred by the landlord that cannot be passed on to the tenants have not yet been subtracted.



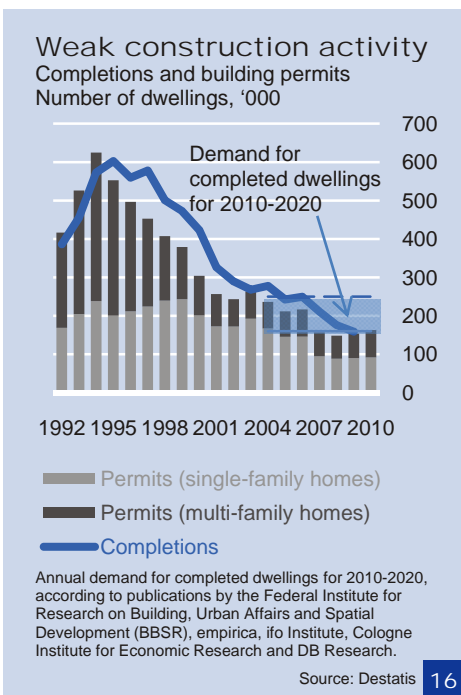
Opportunistic investors will thus be able to find bargains also in the new federal states.

IPD Deutschland recently reported that total returns (rental yields plus the capital gains/losses) in selected conurbations<sup>6</sup> were more than 200 bp higher per annum over the last ten years than in all other (peripheral) locations. This result unexpectedly confirms our recommendation to keep an eye on selected small cities, too. For one thing, the yield difference was the result of developments prior to 2004. In the years following 2004, the yield gap was less than 50 bp. For another, it makes sense that peripheral locations differ more strongly than the few conurbations. This would suggest that within the portfolio of smaller cities there are places that fare better than the conurbations portfolio. This could hold true for university towns, selected industrial locations and some east German urban centres.



## Outlook for prices and completions

Looking ahead, the fact that there was no real estate bubble and hence no necessary adjustment is a very important message for Germany's residential property markets. Moreover, supported by an effective fiscal and monetary impetus and a strong export boom, the German economy has quickly returned to job-creating growth. Construction activity has been very slow over the past years, too. In 2009, less than 160,000 units were completed. Housing starts had dropped to a record low in 2008. Especially multi-family dwellings saw a massive drop in construction activity after the boom in the 1990s. Since 2008 the number of building permits for both single and two-family homes as well as for multi-family buildings have been rising slightly again. The first few months of 2010 also seem to show a moderate increase in building permits. All in all, the number of residential permits still hovers around the lower limits of what researchers consider to be the necessary completion volume over the next ten years. We expect completion figures to rise slowly over the coming years, with construction activity to continue to concentrate on regions with strong growth and high in-migration.<sup>7</sup>



### Higher prices expected for residential property

We expect house prices in Germany to rise by slightly over 1% in 2010 and by more than 1.5% in 2011. This is the result of an econometric model based on changes in disposable income and the cost of construction as well as the level of long-term interest rates as explanatory variables. As the model is based solely on so-called hard economic variables, it could even underestimate actual developments if soft factors influencing investors' decisions play a larger role than in the last few years. One of these soft factors could be concern regarding new turmoil in the capital markets or fears of rising inflation (combined with expectations that property is an inflation-proof investment). Risk-averse investors harbouring such concerns will then look for less risky residential market segments. This would probably benefit good and very good central locations in the major business cities. Of course, these are not necessarily the segments which will create the strongest additional rental demand over the coming years.

<sup>6</sup> The top regions were Hamburg, Berlin, the Rhineland, the Rhine-Main region, Stuttgart and Munich. Peripheral locations thus include all other cities, i.e. also Ingolstadt, Freiburg, Oldenburg, Regensburg and Magdeburg.

<sup>7</sup> For a regional distribution of completions see appendix.



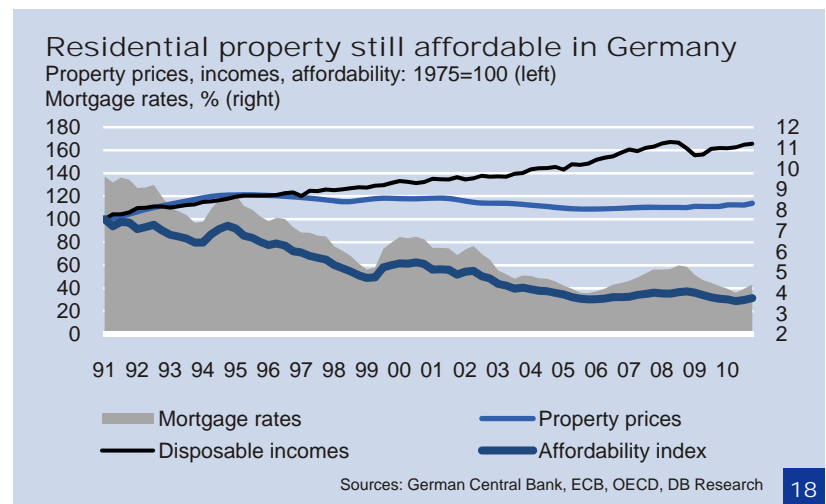
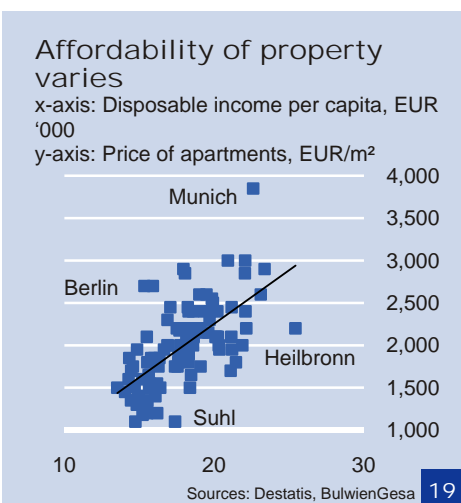
### Look beyond the prime locations

If one compares price developments for new apartments in German cities in the last three years, an interesting division into two groups emerges: in about two-thirds of all cities, the price of property in prime locations has grown more strongly than in peripheral locations. In the following, we will refer to these cities as cities with a positive growth difference. In the remaining one-third of the cities monitored the opposite, i.e. a negative growth difference, was the case. But to avoid the hasty conclusion that especially the prime locations harbour good investment opportunities, a second look is merited for two reasons: first, the larger group includes some east German towns which only boast a positive growth difference because prices for prime locations are falling more slowly than for smaller cities (Gera, Suhl). Secondly and above all, though, the second group of places with negative growth difference includes many cities currently favoured by risk-averse investors (e.g. Munich, Hamburg, Frankfurt and other cities in the Rhine-Main region as well as Berlin). The fact that too few apartments in multi-family houses in peripheral locations were completed in these high-growth regions is the reason why prices for lower quality property rose more strongly than in very good locations.<sup>8</sup>

Hence, these opportunities in peripheral residential locations within the bigger agglomerations should not be overlooked (and not only by moderately risk-averse investors), especially as many investors are currently focusing on the core locations.

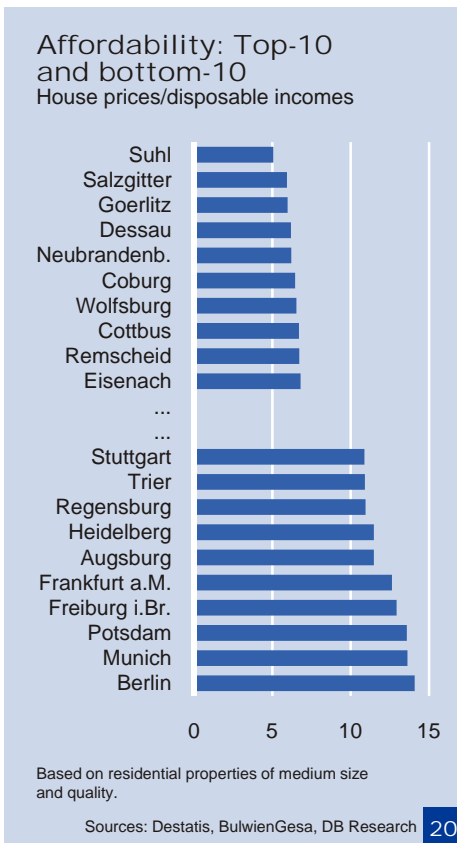
### Residential property remains affordable

Thanks to historically low mortgage rates, residential property in Germany continues to be affordable. Our affordability index, which sets mortgage payments for fully financed property against disposable income, is still hovering around its historic low in 2010. Even if mortgage rates rose by 100 bp, which is conceivable over the coming 18 months, the affordability index would still be 30% below the long-term average.



But regional differences also play an important part: if one sets average prices of apartments against disposable per-capita income (see chart 19), one does not only see the upward slope of the regression line, which represents a positive correlation between

<sup>8</sup> In Düsseldorf and Cologne prices were up more strongly in prime locations than in peripheral locations.



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property prices and incomes. In addition, deviations from the regression line illustrate relatively cheap and expensive locations: all points above the line are relatively expensive for the current working population, while all points below the line are relatively attractive. Calculating the ratio of property prices and disposable incomes will provide an indication of relative affordability in a town or city. In Frankfurt and Munich this relation is more than 40% higher than the all-German average and in many other west German cities (e.g. Düsseldorf, Stuttgart, Regensburg) it is also a double-digit figure above the German average. Another remarkable aspect is the fact that – measured against disposable incomes – prices in Potsdam and Berlin are also about 50% above the all-German average (nearly 20% in Jena and Erfurt). At the other end of the scale there are many medium-sized east German towns as well as some west German industrial locations (Wolfsburg, Salzgitter, Heilbronn). In these places, residential property is particularly affordable compared with all of Germany. Despite these patterns, it is also true that very coarse rules no longer apply.

## Wrap-up: Beware of the risks

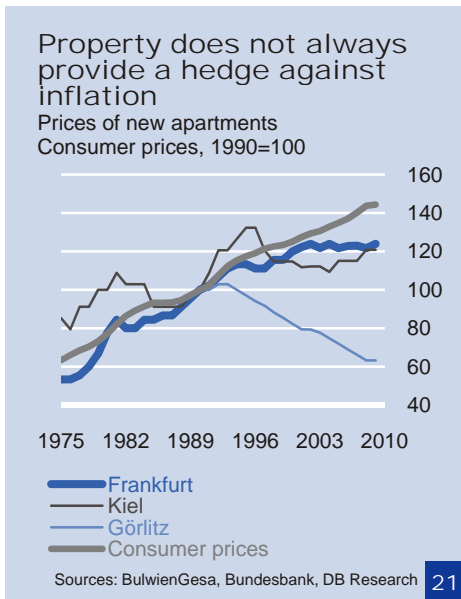
Investing in residential property in Germany is becoming increasingly popular again. This applies not only to private buyers but also to institutional investors.

In fact, there are good reasons why such an investment is worth considering: interest rates are low, there has been no price bubble, completion figures have been very low for years and the German economy has recovered quickly from the recession. But besides highlighting the positive points, this article has also pointed out that in-depth knowledge of the regional market is very important. There isn't one single German market for residential property, but very many regional sub-segments which sometimes show very different dynamics.

Besides the specific regional risks of investing in German residential property, investors should also consider the specific institutional risks, which include Germany's restrictive tenancy law. Also, many state incentives have been abolished or at least cut noticeably. And serious efforts are being made at present to tap into energy-efficiency reserves in both newly built and older dwellings. Investment risks could emerge, however, if these related costs had to be borne unilaterally by landlords. If this led to restraint in new construction, tenants would have to shoulder the cost of this alleged benefit by means of rising rents.

One of the greatest risks for the next decades, however, is the demographic trend. It will exacerbate regional differences: the number of Germany's inhabitants has been on the decline since 2003 already and will shrink further by a projected 10-16% by the middle of the century. This will not put similar pressure on housing demand as the number of households and the average living space per inhabitant looks set to rise for another few years. But only in regions with strong economic growth will this also lead to rising demand. In structurally weak regions, the out-migration of the younger population will weigh heavily on property markets.<sup>9</sup>

<sup>9</sup> Just, Tobias (2009). Demografie und Immobilien. Oldenbourg-Verlag, Munich. See also the chart on domestic migration of the workforce in the appendix.



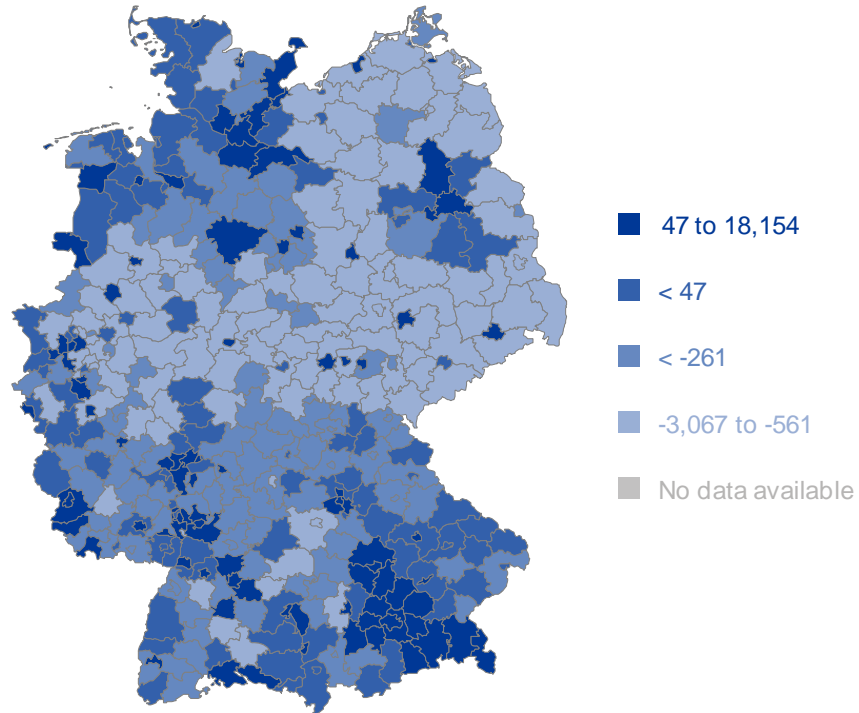
Investors with a long investment horizon must take this into account already today.

Finally, the large regional differences within Germany's residential markets also imply that caution is advised when counting on the conventional wisdom that property ownership is a hedge against inflation. Quite obviously this is not the case everywhere. The following would be more appropriate: Property *can* provide a hedge against inflation. It is also true that the more people rely on this simple inflation-protection rule, the more likely it is to hold true. It's the old self-fulfilling prophecy. But unfortunately it applies only to the early (investor) bird. For investors who come later the traditional long-term test of the market applies: rising house prices must also be covered by income and potential alternative rental income.

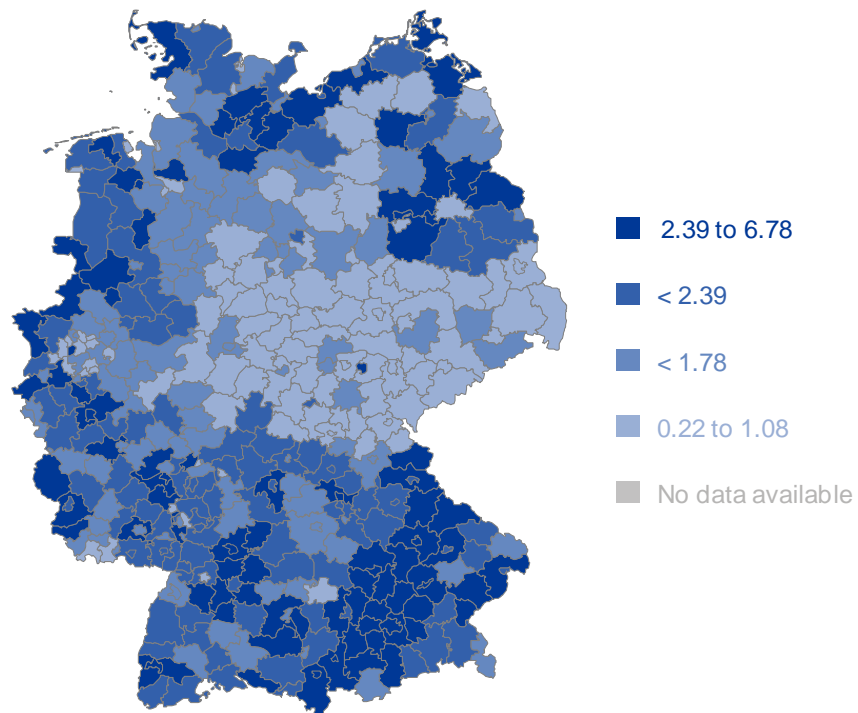
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## Appendix

### Net migration in Germany Net migration of 18 to 65-year-olds



### Building completions in Germany Completions per 1,000 inhabitants, 2007



Source: DB Research

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