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The COVID-19 crisis and the German real estate market

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Due to the COVID-19 pandemic, uncertainties about the future development of German real estate prices have increased considerably.

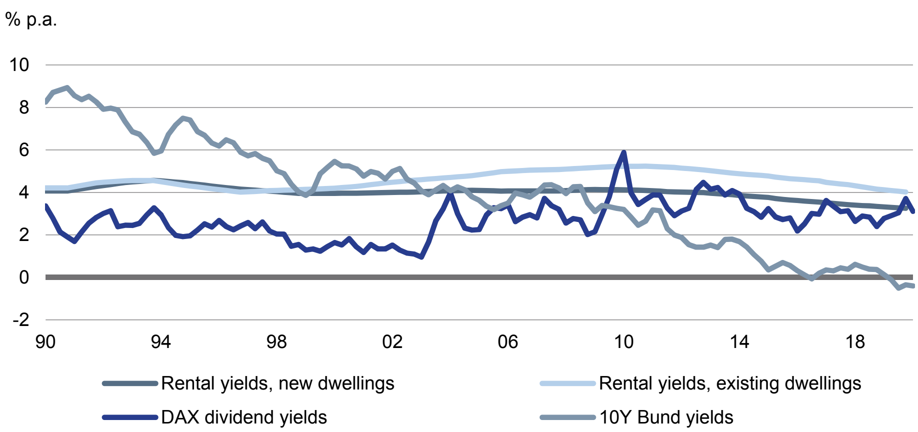
A global flight to safety should drive prices for residential properties up. In the short-run, the downturn in economic activity, particularly during the first half of 2020, and considerable uncertainty about the future as well as the psychological burden are likely to result in price declines.

The expected economic downswing leads to particular uncertainty about the demand for office space. Prices for office buildings may temporarily decline in metropolitan areas. Still, they will probably continue to be regarded as relatively secure investments, as they have been in the last few years, and should also benefit from the flight to safe havens.

In the event of a more severe, protracted corona crisis, rents for residential and office space will probably stagnate in 2020. They may even decline in individual regions, cities or markets where contagion is particularly high.

According to our risk scenario, the COVID-19 crisis has the potential to trigger a structural break in the office property market. As the crisis has increased the number of people who work from home, a structural decline in the demand for office space is possible. In that case, higher vacancies might trigger the end of the cycle, with property prices and rents starting to decline.

Investment returns 1

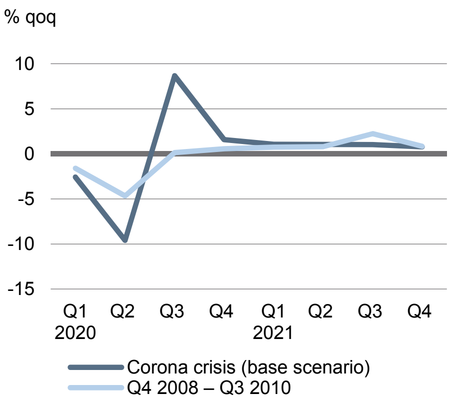


Definition: Rental yields = Rents to prices (ex transaction costs, ex maintenance, ex taxes and ex credit)

Sources: Bloomberg Finance LP, bulwiengesa, Deutsche Bank Research

Our baseline scenario: COVID-19 is contained by the middle of the second quarter

Germany: GDP growth 2



Sources: Deutsche Bank Research, Federal Statistical Office

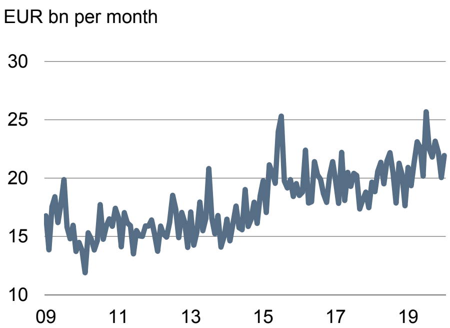
Contact bans and lockdowns are the main measures taken by the German government to try to reduce the contagion and in order to prevent the health system from being overrun. In the short term, these restrictions will considerably increase the burden on the economy. We forecast the deepest recession since World War II. In our baseline scenario, real GDP will shrink by about 12% during the first half of 2020 (compared to end-2019). The economy is likely to recover from the second half of 2020, but the pre-crisis level will probably not be reached again before the end of 2021.[1] These developments will have considerable implications for the German residential and office property market.

Residential properties: New construction is likely to take a blow,…

Completion figures are likely to experience an unprecedented decline during the first half of the year. Bottlenecks at building authorities will probably increase due to contact bans, lockdowns, illness or fear of contagion. Urban planning procedures, the allotment of new construction plots and the issuance of construction permits will be delayed. In addition, the construction process itself will probably become more difficult, as the number of available qualified workers is declining due to the crisis and supply chain disruptions may lead to a shortage of replacement and wearing parts, which means that equipment and vehicles cannot be used to capacity. This may hamper new construction even after the start of the economic recovery.

... and demand for residential space looks set to dip as well

New business: Mortgages 3



Sources: Deutsche Bundesbank, Deutsche Bank Research

Uncertainty will cause many households move into “crisis mode” and focus on securing their jobs and livelihood. That means that they will be less willing to move or to buy a home, which is why overall demand for residential space will probably shrink considerably in the short term. Demand for mortgages is likely to slide as well. In January, new loans summed up to almost EUR 22 bn. Starting from this figure, we expect new mortgage lending to decrease by about EUR 3 bn in each crisis month. A further decline in 5-10-year mortgage interest rates to new lows will stimulate demand only marginally. Both monetary and fiscal policy measures will have a fairly negligible impact on the mortgage market – not least because many clients still prefer to discuss the financing conditions for their new home in a personal meeting with their bank advisor. This is not possible right now as banks are temporarily closing their local offices and customers are restricted in their movements. The lack of notarial attestations of real estate purchases will also contribute to the decline in mortgage lending. Still, once the pandemic is over, we may see a partial catch-up.

Residential property market: Possibly significant discrepancies for some time

During the coming months, we may see a price correction due to uncertainty and the almost unique expected economic downturn. Many people have to cope with unusual psychological difficulties in the current situation. Moreover, the future economic development is highly unclear. Uncertainty might cause some

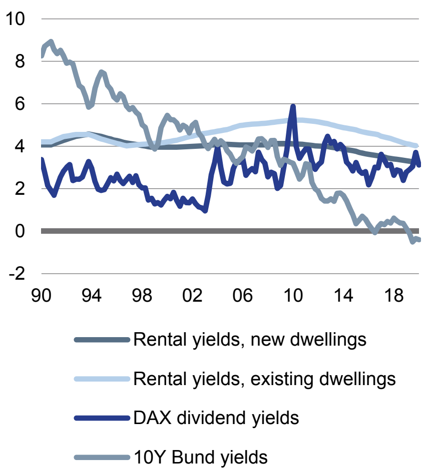
[1] David Folkerts-Landau et al. (2020): Impact of Covid-19 on the global economy: Beyond the abyss. Deutsche Bank Research.

overreactions among both sellers and buyers, which is why market prices might be spread across an unusually wide range. At the same time, the number of transactions is likely to decline considerably due to the lockdown, so the major price discrepancies will probably have only a limited direct economic effect. We believe that the short-term decline in demand for residential space will be more important than the decline in supply. While price pressure will be lower, a flight to safety may tend to push prices up. As a rule, relatively risk-free assets, such as bonds and many properties, become more expensive during crises. With government bond yields having reached new lows and equity prices sliding, German residential properties, which offer average rent yields of roughly 4% p.a. across the country, will appear even more attractive than before the corona virus crisis. Moreover, crises in other countries (remember the euro crisis or Brexit) have caused immigration to Germany to increase during the past decade. As Germany's household and government debt is relatively low in an international comparison, other countries have no provisions similar to German short-time work and the German healthcare system is relatively robust compared to other countries, immigration may rise further in the coming years. This should prop up structural demand for residential space.

Residential properties to become even more attractive in the medium term – will this lead to massive government intervention?

Investment returns 4

% p.a.



Definition: Rental yields = Rents to prices (ex transaction costs, ex maintenance, ex taxes and ex credit)

Sources: Bloomberg Finance LP, bulwiengesa, Deutsche Bank Research

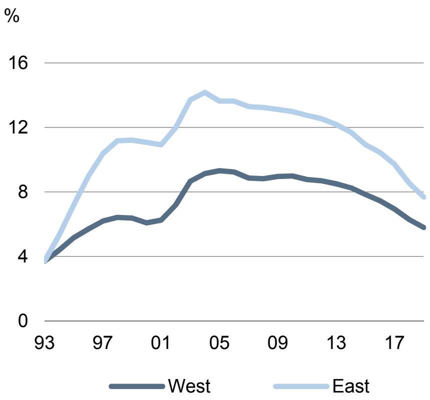
Once the end of the pandemic is in sight, the monetary and fiscal policy environment will shape the future price path. Considerable infringements of personal liberties, significant economic interventions and the huge support packages during the crisis months may result in unorthodox measures during the normalisation phase. There are significant political incentives for allowing higher inflation; after all, higher inflation would reduce crisis-related debt in real terms and prevent rates from staying at their low pre-crisis level for years to come. The ECB and the member states are currently funding their crisis support measures from traditional sources. If, however, other currency areas took unconventional funding measures and boosted global inflation, the euro area would probably be unable to escape the general trend. Either the euro would appreciate or inflation would accelerate in Germany, too. These developments would boost demand for real estate from non-euro or euro-area investors, respectively. Even though the government has banned rent increases for now, real estate will provide some protection against inflation. Market interventions which appeared to have an almost socialist character were popular even before the corona virus crisis. Ultimately, the government might put additional burdens on property owners. Higher wealth taxes or a tax on increased land value, which was already discussed before the crisis, might seem attractive to policymakers. Compulsory mortgages, similar to those introduced after World War II, cannot be excluded in the current emergency situation either. Property owners had to pay back these mortgages over 30 years.

Rents may decline in hard-hit areas

Rents for existing homes are unlikely to be increased this year. Regardless of temporary restrictions on terminating rent contracts, many small landlords may be particularly interested in the personal circumstances of their tenants and stable payments. The same applies to commercial landlords. Moreover, rent increases in the midst of the crisis may be a considerable reputational risk for large investors. Still, long-term, regular rent increases and contractual provisions, such as index-linked rents, will remain in force. Such contracts are relatively rare in Germany, however. New tenancy contracts are unlikely to provide for significant rent hikes either. Lockdowns and contact bans will keep demand very low for now. In fact, landlords in some regions, cities or markets may be happy to find reliable tenants at all in the current situation. This is particularly true for regions which are hard hit by the disease; in fact, rents may decline significantly for some time to come in such areas. In addition, some landlords may leave newly built apartments vacant and opt to take advantage of the planned provisions on the deferral of loan payments. This provides for the possibility of suspending interest and redemption payments for existing loans for three months. In other words, payment obligations due by 30 June 2020 are to be deferred for three months – until 30 September 2020, if the debtors' livelihood or the economic basis of their businesses are at risk.

Office property market: Considerable uncertainty about price developments, stagnating rents

Office market: Vacancy rates 5



Sources: bulwiengesa, Deutsche Bank Research

Due to the deep economic crisis, prices for office space may temporarily decline. However, the price range may be wide, similar to that on the residential property market, as the forecasts for local markets will vary. Generally speaking, however, many office properties may become more expensive due to a flight to safe havens, similar to residential properties. This applies above all to office buildings in metropolitan areas, which have been increasingly regarded as a "safe haven" asset in the last few years. In contrast, office rents are likely to stagnate and the number of sales and new tenancy contracts might dip. This statement applies both to sales and to new rental agreements. Moreover, the coronavirus crisis raises the question of whether the increased shift towards working from home will permanently reduce demand for office space. The longer the crisis continues, the more people will get used to long-distance cooperation – and the more efficient will communication become. If there is a structural break to demand for office space (which is not our baseline scenario), rents and prices are likely to decline. In that case, the coronavirus crisis might trigger the end of the office market cycle. Overall, uncertainty about the future is considerably higher in the office than in the residential segment.

Conclusion and outlook

After a serious crisis, we usually experience a strong upswing. However, in the case of the corona crisis, the upswing itself might increase contagion rates and thus trigger a W-shaped, protracted recovery. In any case, the good piece of news for real estate investors is that, for as long as the crisis continues, investors will flee to safe haven assets. That means that demand for real estate will likely exceed that for other asset classes. However, the deeper and more protracted the crisis becomes, the larger the redistribution burdens might be in the longer run.

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