



## Shaping Germany's Future

### Honing Market Economy Instruments Preferable to Regulatory Zeal

The outlook for those looking to buy a condominium or home this year represents a mixed bag. The bad news first: Property prices and rents increased in 2013, and will continue to push up. Now for the good news: At least the pace of the price growth is likely to slow. The key reason for the rise in rents and prices in many cities is that construction has not kept up with the growth in incoming migration. Notwithstanding the number of condominium transactions, which stagnate or even decline in many places, this observation does not imply that the market strain is easing, but rather that the anyway short supply continues to contract: The situation suggests that poten-

tial sellers are keeping their apartments off the market in the hope of selling them at higher prices later on. Outside the prospering metropolises and campus towns, the demographic trend is less auspicious. Rather than showing signs of bottlenecking, remote rural locations are dominated by ample supply, with stagnant or falling prices the predictable result.

Price growth is driven by short supply that coincides with a steady demand in agglomerations. Since the 1980s, mortgage interest has declined along with the share taken out of disposable incomes by interest and repayments. Moreover, borrowers benefited not only from the declining level of interest rates but also from the growth in disposable income, which has outpaced residential property prices. So you would actually expect the high affordability of real estate to precipitate an upward price trend. While there is admittedly a risk that low or declining interest rates could prepare the ground for debt-fuelled price bubbles, Germany is still a far cry from such a scenario because of the country's historically low price-to-income and price-to-rent ratios. The conservative lending policy in housing construction that is applied by German banks has also served as a bulwark against price exaggerations.

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Dear Readers,

The wind on Germany's property markets is shifting. While our models shows that prices and rents continue to go up, their momentum has slowed. Price levels especially in highly coveted locations and building types have reached the limit of what is reasonable. As a result, investment styles based on Class B locations and a value-added approach are more readily embraced than they were a year ago or two. That said, the investment focus will remain on Germany for some time to come.

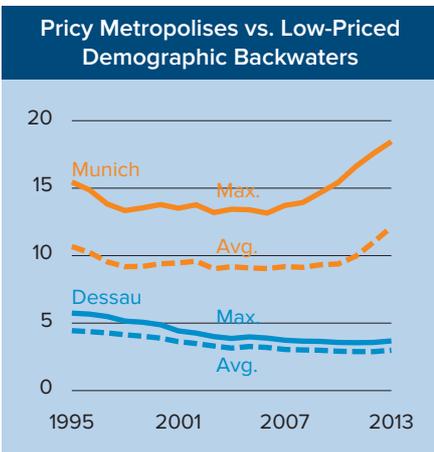
Taking a long-term perspective, there are two ways to respond: One is to wait for the next cycle in a conservative countercyclical approach. The other would be to fine-tune your approach in terms of locations, asset classes, financing, and portfolio structure. Equity and finance partners are currently rather open to progressive policies of this sort. Does this, in and of itself, imply greater exposure? As so often in life: It all depends! In times like these, it might be a good idea not to focus on risk-adequate returns alone, but to collaborate with partners who have demonstrated in previous cycles that they are capable of handling change, and who are here to stay as a result. Indeed, there has always been a "creative class" that matches this specific profile – why don't you call us to learn more?

Sincerely Yours,

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Affordability of homeownership (costs in multiples of disposable annual income, average/maximum prices)

The numerous upheavals on the world's capital and real estate markets have made German lawmakers and regulators particularly wary. In its monthly report for February 2014, for instance, the Bundesbank commented the findings of a price trend analysis for residential property by saying that prices for condominiums, though not for houses, in Germany's "Big Seven" cities are overrated by up to 25 % compared to levels in 2004 when put in relation to fundamental values that are backed by demographic and economic factors. While our own analyses have confirmed these findings, a drilldown to the sub-area level delivers much more fascinating analytic results as shortages can be put in context with quality aspects of construction projects.

With a view to the residential property market in Germany as a whole, the Bundesbank analysis concluded that we are still not seeing any serious price deviations from the long-term fundamental values, and moreover that there are currently no indications for a destabilising interaction between property price hikes and lending on the macro-economic level.

The run-up to the most recent general elections in Germany demonstrated impressively how the demand for property, which was already very high in some regions, can unleash a lively public debate about the need for government intervention on the housing market. Virtually no political party managed to steer clear of the subject: The term "rent freeze" became the buzzword of the day. Any intervention in the price mechanism of the market – however well-intended – must answer to the fact that prices serve an important signal function in a market economy. A region's gain in attractiveness due to rising economic prosperity is almost inevitably matched by a rise in incoming migration. The signal effect of price growth helps the market to restore the equilibrium of supply and demand when temporarily dislodged by incoming

migration. On the one hand, it creates an incentive for investors to step up their activities in affected cities, while the attractiveness of moving to those cities is diminished for the demand side, on the other hand. If the intention is to intervene in the market mechanism by imposing statutory rent caps on new leases, there is every reason to expect the following short- and medium-term developments:

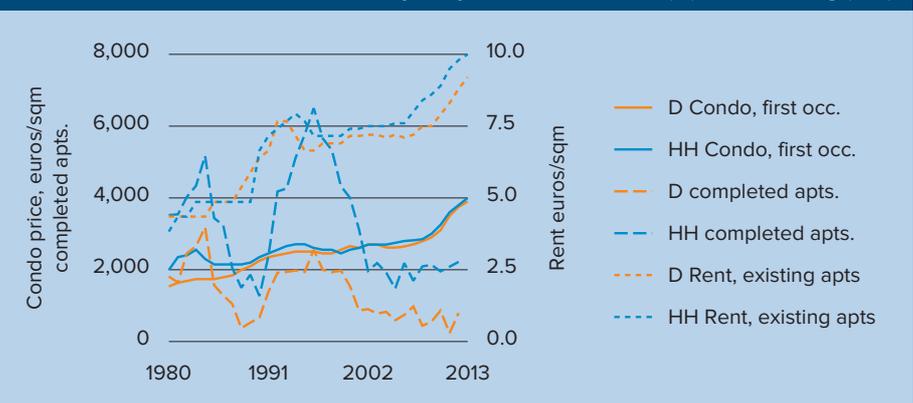
- Far from eliminating the imbalance, its only effect is to deactivate pricing as an allocation process. So we are likely to see an alternative mechanism of good connections or indirect payments such as high redemptions paid for furnishings come into play – but is this truly a step forward?
- If, from an investor's point of view, the incentives for investing in residential real estate as rental property are dismantled, and if intensification of owner occupation in (existing) properties becomes the one option left, rent caps will actually exacerbate the imbalance on the market. For the situation will put regulated rents in juxtaposition to freely negotiated purchase prices, and the resulting insider / outsider issue will turn homeownership into the only viable alternative for incoming residents.

It will be exciting to see how the political parties will position themselves for the

next general election in the fall of 2017. If the market is left to government regulation, then the anyway considerable regional disparities on Germany's housing market are likely to keep widening. Demographic trends and construction volumes inadequate to satisfy market demand can already be identified as underlying cause. The need to step up housing construction is most pronounced in metropolises and campus towns. Here, low vacancy rates and rising household numbers, on the one hand, coincide with a lack of investments in multi-family residential construction, on the other hand. The latest trends in the number of planning permissions do suggest that we might be seeing a shift, but private investors will obviously base their decisions on future government regulation of the real estate market. More incentives for private and government investments in housing construction could offer a better way out of the current imbalance. Considering the fact, however, that both the incentives mentioned and the steady increase in real estate transfer tax fall into the responsibility of the German states, it makes you wonder whether the political stakeholders are working toward a common goal or whether diverging interests may be at work here.

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Price Trend and Construction Activity – Cycles in Düsseldorf (D) vs. Hamburg (HH)



Condominiums in first occupation (average, euros/sqm), rents for existing apartments (average, euros/sqm), completed apartments in residential buildings with 3 or more dwelling units

# The "Creative Class" in Berlin

## The role of creative quarters for the city's office market

### Creativity: the Driving Force of Urban Development?

Some say that Google has become more important than Deutsche Bank in Germany. Differently put:

The ongoing societal change, and the increasing differentiation of society, have accelerated the disintegration of traditional forms of living and working. As a result, certain challenges are emerging for cities and their residents.

The creative class is seen as one of the most dynamic influencing factors for the urban development going forward, and this has been the case well before they started getting increased media exposure due to investments by numerous celebrity sponsors, and became less dependent on commercial success. Seen from this angle, they play a pioneering role and thus act as drivers in the district renewal process. Although many creative professionals occupy properties only as temporary users, there is a close and demonstrable link between their place of business and residential urban renewal processes.

This industry is therefore closely scrutinised by city hall, because from an urban development and real estate economy perspective it lends itself to forecasts regarding up-and-coming locations in town.

### But Who Are these Creative Minds?

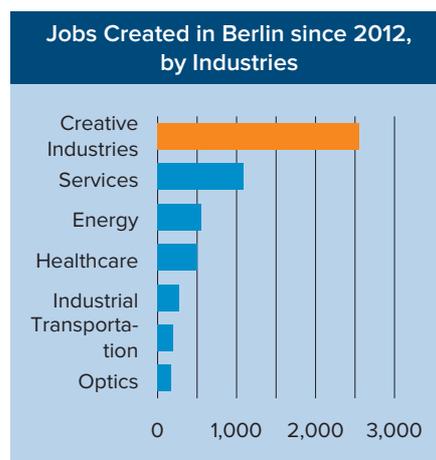
Creativity is hard to define in this context. Scientific papers use the term "creative class" to cover a wide occupational area that includes artists and designers along with attorneys. Berlin focuses on the cluster "ICT, media, and creative industries" as a sector that represents a cross-section of several sub-segments.

### Creativity as Economic Factor in Berlin

In recent years, Berlin has positioned itself as the nation's capital of start-ups. In fact, the city is aiming to become the creative centre of Europe. Creative minds from the four corners of the earth have flocked to Berlin for years, because they fancy the city's infrastructure and quality of life as well as its image and big city ambience.

Statistically speaking, the fact translates into demographic growth and rising tax revenues. More than 32,000 companies, most of them small and medium-sized enterprises in the "ICT, media, and creative industries" cluster accounted for 240,000 jobs and generated approx. 25.8 billion euros in revenue in 2011.

Berlin Partner, the capital city's marketing firm, reported that 5,313 jobs had been created in 2012. Nearly half of them, or 2,554 to be exact, were created in the "ICT, media, and creative industries" cluster."



Source: Berlin Partner GmbH

The associated investment volume, including in the form of venture capital, will noticeably boost the gross domestic product and public revenues in the coming years.

### Focus on Trendy Quarters

Unlike the classic drivers of housing demand, the migration pattern of the creative class is increasingly paced by soft locational factors. Especially the creative milieus of the trendy districts are appreciated as inspirational, and actively sought.

### Is This Relevant for the Office Market?

With more than 240,000 employees, the "ICT, media, and creative industries" cluster certainly represents a relevant factor for the office market.

When assuming a hypothetical floor area of 20 sqm RA-C per employee, this would translate into a potential floor area demand of 4.8 million sqm RA-C, or the equivalent of nearly 25 % of Berlin's current office stock. At first glance, this suggests that of the "ICT, media, and creative industries" cluster will exert enormous influence on Berlin's office market in the years ahead.

But is the cluster's assumed floor area ratio of 20 sqm RA-C even realistic? And are the companies in this cluster part of the creative class in the narrow sense, or should they rather be grouped with the office market's classic demand side?

It should be taken into account that the creative sector is experiencing a rising demand for flexible, often short-term, rental space. Concepts such as co-working spaces, of which "betahaus" would be a good example, are particularly relevant here.

These are just some of the questions that show how difficult it is to venture any prediction regarding the future significance of the creative set just based on statistics.

**Current and Future Hot Spots**

To what extent, though, can the creative class actually play an active part in shaping the market development?

To answer this question, bulwiengesa compiled a scoring that ranks the attractiveness of Berlin's office sub-markets for the purposes of the creative class.

Aside from ranking the attractiveness of each area in recent years, some of its indicators also permit forward-looking predictions. Shares in turnover, business registrations, and the situation of business incubators also entered into the evaluation.

For the purposes of this screening, the term "creative class" was not applied collectively to all companies of certain industries. Rather, the leases were individually checked in regard to the user. The outcome of the detailed lease contract analysis suggests that a share of around 40,000 to 80,000 sqm RA-C was registered between 2009 and 2013.

With an average annual take-up of 550,000 sqm RA-C over the past five years, the creative class had a market

share of 11.25 %. It is subject to a steep upward trend, and had climbed to nearly 14 % by 2013.

And yet the level remain well below the hypothetically determined potential of the cluster as a whole. In addition, each sub-market differs radically from the next in terms of market share and total volume. With additional indicators taken into account, clear differences in location attractiveness come to light.

The boroughs of Mitte and Kreuzberg position themselves as by far the most appealing top locations. While both are on the fringe of downtown, they are still part of the inner city and benefit both from this fact and from the readily availability of office space. Less established locations within the markets, such as Wedding in the Borough of Mitte, are precisely the ones that the creative class clientèle is interested in.

The locations next in line include peripheral sub-markets in the northern and southern part of the city that are more remote from the typical office districts. Their appeal is specifically attributable to

the pull of trendy quarters in Prenzlauer Berg and Neukölln, respectively.

Since even well-known incubators like Rocket Internet or hubraum have relocated here as starting point of future start-ups, it is safe to rate this as a sustainable trend.

Friedrichshain and Charlottenburg are another two districts on the edge of downtown that position themselves in the lead group of the ranking. While Friedrichshain draws on its hip image, Charlottenburg benefits from its proximity to the University of Technology in Berlin and the research-related labs from various industries.

Going forward, it is reasonable to expect the creative class to consolidate its position and indeed to expand its market share. In addition to those locations dominating the current scoring, the rising price pressure will cause the focus to shift increasingly to peripheral locations.

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