SHORT STUDY

Office Market: Investment Opportunities in German Secondary Cities

Client: DEMIRE – Deutsche Mittelstand Real Estate AG

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Source cover picture: DEMIRE (Dresden, Nossener Brücke)

Preliminary Remark

Most studies of the German market for office real estate tend to focus on the seven well-known Class A-cities commonly called the Big 7. Accordingly, topics like the declining transaction volumes in office real estate in the Class A-cities in 2020 and the general willingness to work from home during the coronavirus pandemic were the ones dominating the debate about the future of regular offices. Comparatively little attention, by contrast, has been paid to office locations in second-tier cities. This is odd insofar as second-tier or secondary cities have predominantly proven resilient, because they are not as dependent on international demand groups as the Class A cities are, but mainly meet the needs of public-sector occupiers or small and medium companies from the mid-market sector which tend to maintain strong ties within a given region.

To enhance the recognition and transparency of so-called secondary cities, DEMIRE (Deutsche Mittelstand Real Estate AG) asked bulwiengesa to conduct an analysis of selected cities in Germany, this being the fourth edition of the survey. DEMIRE owns a diversified portfolio of commercial real estate in Germany, and sees itself as an expert for secondary cities, or „secondaries“ for short, and here for the office real estate asset class in particular. In its investment decisions, DEMIRE consistently follows a so-called ABBA strategy, concentrating on investments in Grade A locations in Class B-cities and, inversely, Grade B locations in Class A-cities. As a result, the company’s property holdings are not clustered in the Big 7 cities but include pinpoint investments in secondary cities. It is an approach that once again proved successful during the coronavirus pandemic.

» Survey structure

The survey examines a total of 35 cities. In addition to smaller towns like Aschheim in Upper Bavaria, it looks at major cities like Leipzig and Dortmund. The survey divides into six chapters: The objective is to study and understand the typical interaction between supply and demand on the office real estate market.

The preliminary remarks will be followed by an Executive Summary presenting the key insights of the survey. The next section will provide a risk/return profile of the secondary cities and compare it to the seven Class A-cities. The subsequent chapter will discuss the structure of the office real estate market – comparing it to those in the United Kingdom and France to put things in perspective. It will touch upon the parameters of gross value added, vacancy rate (supply situation), office take-up and prime rents (demand situation).

Next, selected secondary cities will be studied in detail on the basis of supply and demand parameters. On the supply side, the trend in office vacancies and new office accommodation coming on-stream will be analysed. The focus on the demand side will be on trends in office employment, average rent and office take-up.

In order to highlight the ramifications of the interaction between supply and demand, the chapter after that will be dedicated to Germany’s office investment market. The survey will conclude with a clearly structured look at the development of the key office market indicators.

Overview secondary cities

Source: DDS Digital Data Services GmbH

» Source of the data

The data used in this study come from the information system RIWIS (bulwiengesa´s proprietary regional information system for Germany´s real estate industry). Data from PMA (Property Market Analysis) is used for the comparison with the United Kingdom and France.

Executive Summary

Unlike the United Kingdom and France, where the bulk of the market action takes place in the nations' capitals (London and Paris, respectively), the German (office) market has a polycentric structure. This becomes obvious, for instance, when you study the economic output, which in the case of Germany is generated in many different cities. In addition to the Class A-cities, the survey looks at secondary cities, whose markets tend to be dominated by companies of the mid-market sector (the backbone of the German economy) and public-sector occupiers.

» Vacancy rates declining in virtually alss secondary cities

The robust economic development of recent years and the formation of new occupational areas as a result of digitisation have fuelled a brisk growth in office jobs. Naturally, the new office jobs require office accommodation. Combined with a building activity that is virtually devoid of a speculative angle, the development has led to a decrease in office vacancies in almost all secondary cities (during the period between 2011 and 2020). However (and despite the drop in vacant space), it should be remembered before investing in any secondary city that the exit of a major occupier can be hard to compensate on short notice

» Building activity paced by demand

Unlike in the Class A-cities, the building activity in the overwhelming majority of secondary cities is dictated by demand. This means that office units are developed only after having been pre-let and rarely on speculation. The advantage of such an approach is that it reduces the probability of market upheavals.

» Office job growth not ubiquitous

The trend in office employment is considered the main determining factor when seeking to quantify future office space requirements. Due to the sound economic parameters (and the progressing digitisation), municipalities experienced an inflow of high-skilled professionals – as a result of which the number of office workers has increased in almost all secondary cities since 2011. That being said, longer-term forecasts do not project a continuation of the upward trend for all secondary cities, not least because of the demographic trend.

» Take-up

The letting performance (including the start of construction for owner-occupied units) reflects the activity and vitality of a given office market. It is therefore the actual growth in office jobs over the past years that prompted the noted increase in office take-up. But despite the robust take-up figures, anyone seeking to invest in secondary cities should ensure that the size of the investment property is consistent with the respective market.

» Rental growth almost everywhere

The sound demand situation of recent years has caused both prime rents and average rents to follow an upward trend. The fastest rental growth at +60 % has been recorded in the Class A cities. But brisk growth was also registered in most of the secondary cities – Leipzig standing out here with a +50 % rent hike.

» Yield rates maintaining low level

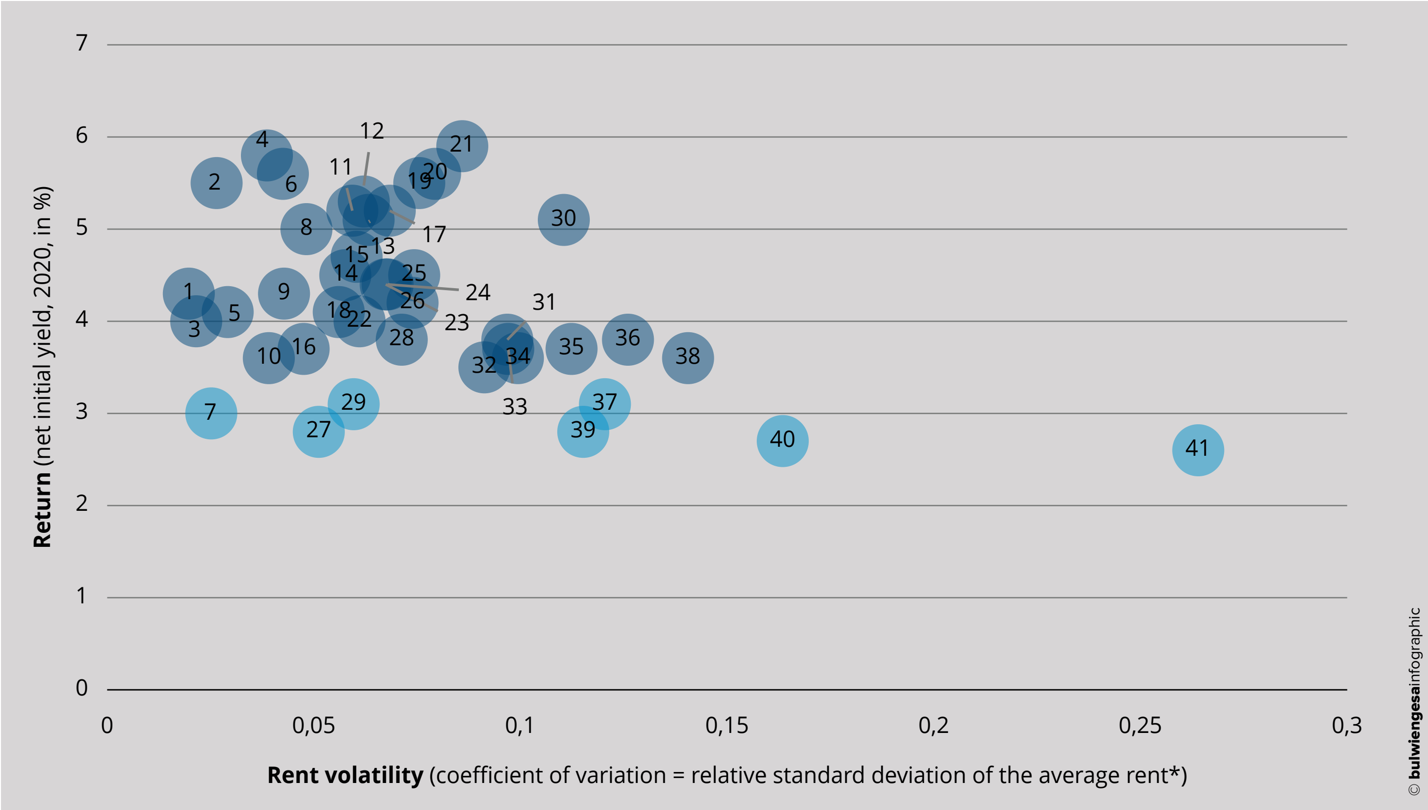
As demand for properties with attractive characteristics (location, covenants, etc.) remains extremely high despite the pandemic, prices have maintained their high level. This has in turn caused net initial yield rates to stay at the level they achieved in 2019. In this context, the secondary cities offer a (slightly) higher return potential than Class A cities.

» Risk/return profile

The secondary cities studied (and the Class A markets included as benchmarks) were examined in regard to their stability of income and the achievable rate of return, as shown on the next page. The evidence shows that all of the secondary cities have a higher return potential than the Class A markets, even if the spread has narrowed. The bracket of achievable net initial yields extends from 3.5 % in Freiburg im Breisgau to 5.9 % in Chemnitz. For the sake of comparison: The current yield level in the Class A cities ranges from 2.6 % (Berlin) to 3.1 % (Cologne and Stuttgart).

To put the return potential and the earnings risk in relation, a quotient of yield and volatility was created. It is listed in the table on page 5. Due to rapid rent hikes, Class A cities like Berlin, Munich, Hamburg and Cologne as well as the second-tier city of Leipzig bring up the rear. Cities like Dortmund, Trier and Darmstadt, by contrast, show a more favourable r ratio.

Risk/Return Profile



Selection of cities sorted by return-/risk-quotient

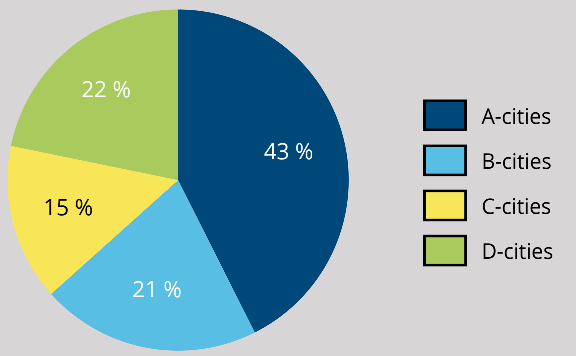
1	Dortmund	secondary city	16	Bonn	secondary city	31	Mainz	secondary city
2	Trier	secondary city	17	Wuppertal	secondary city	32	Freiburg/B.	secondary city
3	Darmstadt	secondary city	18	Essen	secondary city	33	Wiesbaden	secondary city
4	Schwerin	secondary city	19	Bayreuth	secondary city	34	Dresden	secondary city
5	Frankfurt Out of Town	secondary city	20	Flensburg	secondary city	35	Potsdam	secondary city
6	Landkreis Pinneberg (Quickborn)**	secondary city	21	Chemnitz	secondary city	36	Hannover	secondary city
7	Düsseldorf	a city	22	Karlsruhe	secondary city	37	Cologne	a city
8	Erfurt	secondary city	23	Osnabrück	secondary city	38	Leipzig	secondary city
9	Ulm	secondary city	24	München Out of Town	secondary city	39	Hamburg	a city
10	Heidelberg	secondary city	25	Rostock	secondary city	40	Munich	a city
11	Kiel	secondary city	26	Regensburg	secondary city	41	Berlin	a city
12	Leverkusen	secondary city	27	Frankfurt/M.	a city			
13	Kassel	secondary city	28	Münster	secondary city			
14	Bremen	secondary city	29	Stuttgart	a city			
15	Wolfsburg	secondary city	30	Jena	secondary city			

* The relative standard deviation (average rent) refers to the period between 2011 to 2020; ** Average rent for the district of Pinneberg is only available from 2015

Structure of the German Office Market

There are roughly 10,800 municipalities in Germany, of which 80 are categorised as major cities. By definition, these cities have po pulations of at least 100,000 residents. Relevant for the purposes of this survey is the real estate stock of these nearly 11,000 municipalities. They are home to around 324,000 office and administrative buildings.[1] The most important cities in the office real estate market context have been organised into a classification system (classes A, B, C and D) by bulwiengesa.

A- to D-cities: Share of office space inventory (2020)

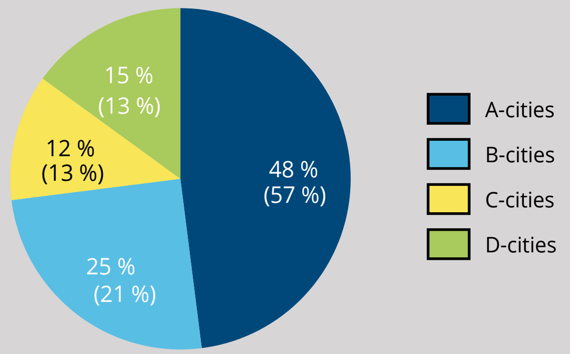


Source: bulwiengesa (base: office space inventory in sqm)

The seven Class A cities account for around 43 % of the total office stock of all categories combined. This class is trailed by the 84 Class D cities (e. g. Bayreuth, Chemnitz, Flensburg), which usually serve a central function within their regional context, and which account for 22 % of the office real estate stock. The 14 Class B cities (e. g. Dortmund, Dresden, Leipzig) weigh in at 21 %, and the 22 Class C cities (e. g. Darmstadt, Freiburg) at 15 %.

The polycentric structure of the German office real estate market is reflected not just in the distribution of the office real estate stock but also in the office take-up. According to the long-term analysis (2011 through 2020), more than half of the take-up (including owner-occupiers) was generated in the Class A cities. But even so, this share of the office take-up is spread across seven cities, not a single centre. Moreover, the Class B cities account for a share of roughly one fifth. Following the onset of the coronavirus pandemic in the spring of 2020, the Class A cities registered a substantial drop in take-up. The Class B cities benefited from the situation, as their share of the 2020 take-up climbed to 25 % of the total. Their outperformance highlights the domestic orientation of the Class B cities, because it makes them less susceptible to slumps in international demand.

A- to D-cities: Share of office take-up (2020)*



Source: bulwiengesa (base: office take-up in sqm)
* In the wake of the Corona pandemic there was a significant slump in demand for office space in the German A-cities. For the sake of completness, the share of the longterm average (2011 to 2020) has therefore also been shown in brackets.

The polycentric structure of Germany contrasts with the monocentric structure of countries like France and the United Kingdom. Although there are more than 80 cities with populations of over 100,000 in the UK and more than 40 in France, the figures below indicate that the economic action in either country is concentrated in and around the respective capital. The survey will start with a closer look at the distribution of the gross value added. This will be followed by an analysis of the office market with focus on the variables vacancy rate, office take-up and prime rent.

» Economic Situation

The first criterion, whose examination will illustrate the concentration on a single centre in France and the UK, is gross value added. In this context, gross value added will serve as measurement for the economic output of a delineated region.

In the case of Germany, it reveals that the country's seven Class A cities account for about 21 % of the gross value added. Berlin, Germany's first city and home to nearly 3.7 million residents, contributes 5 % to the country's economic output. The years since 2015 have witnessed a particularly dynamic development in the German capital (e. g. a 17 % increase in insurable employees), yet the trend was checked, for the time being, by the outbreak of the coronavirus pandemic in the spring of 2020. Berlin is trailed by Munich and Hamburg, each of which account for about 4 % of Germany's gross value added. A total of 13 % of the economic output is produced by

[1] Source: dena-Studie (05/2017): Büroimmobilien. Energetischer Zustand und Anreize zur Steigerung der Energieeffizienz.

the secondary cities investigated, where mid-market players tend to be domiciled. Among these, Hanover claimed the highest gross value added in 2019 with c. 33,100 million euros. The secondary cities next in line are Bremen with 30,068 million euros, Bonn (24,300 million euros), and the cities of Essen (23,631 million euros) and Dortmund (21,546 million euros). Hanover has outperformed Bremen in terms of gross value added since 2016. This is explained by fast-trading companies from the automotive industry and automotive suppliers (Continental AG, WABCO) along with tourist businesses (TUI AG), retailers (AGRAVIS) and banks/insurance companies (NORD/LB, HDI). At the other end of the scale are Schwerin and Flensburg with the lowest gross value added among the examined secondary cities.

In stark contrast to the heterogeneous distribution of gross value added in Germany, the British capital London makes up nearly one quarter of the country's economic output. The other cities contribute only about 1 % each – with the exception of Birmingham (2 %) – to the value creation in the United Kingdom. To be sure, there are economically significant sites such as Trafford Park (one of the largest industrial zones in the country, with relatively low tax rates) in Manchester, yet the capital city clearly dominates the British economy.

France presents a picture similar to the United Kingdom, although the Île-de-France region (which includes the capital Paris) claims a yet larger share of the economic output than London. Nearly one third of the French gross value added is generated here. The country's other regions (Provence-Alpes-Côte d'Azur, Nord-Pas-de-Calais, Auvergne) play but a subordinate role.

The table listing the gross value added illustrate just how heterogeneous the spread of the value creation is in Germany. Rather than being dominated by the capital or any other single region, Germany's economic output is generated by a large number of municipalities. Secondary cities have a special significance in this context because they tend to be the home base of mid-market companies, which form the backbone of the German economy. By contrast, value creation in France is clustered in the Île-de-France region around Paris, the same being true for the United Kingdom in regard to London and the city's greater metro area.

Gross Value Added (GVA)

City/Region	Population*	GVA** (in Mio. €)	in %
Germany (GER)			
Berlin	3,664,088	141,247	5 %
Düsseldorf	644,280	47,807	2 %
Frankfurt	758,847	66,010	2 %
Hamburg	1,904,444	111,307	4 %
Cologne	1,088,040	59,774	2 %
Munich	1,562,096	110,094	4 %
Stuttgart	608,260	52,201	2 %
Analysed Secondary Cities***	8,379,119	409,074	13 %
Rest of germany	64,545,857	2,108,644	68 %
GER in total	**83,155,031**	**3,106,157**	**100 %**
France (FR)			
Provence-Alpes-Côte d'Azur (Marseille)	5,077,582	151,559	7 %
Nord-Pas-de-Calais (Lille)	4,061,166	106,521	5 %
Auvergne (Lyon)	1,371,820	36,134	2 %
Île-de-France (Paris)	12,291,557	659,678	31 %
Rest of France	44,518,091	1,203,219	56 %
FR in total	**67,320,216**	**2,157,111**	**100 %**
United Kingdom (UK)			
Glasgow	626,410	21,804	1 %
Edinburgh	518,500	26,419	1 %
Birmingham	1,141,374	31,031	2 %
Manchester	547,627	24,160	1 %
London	8,908,081	467,013	23 %
Rest of Großbritannien	54,693,608	1,402,192	72 %
UK in total	**66,435,600**	**1,942,619**	**100 %**

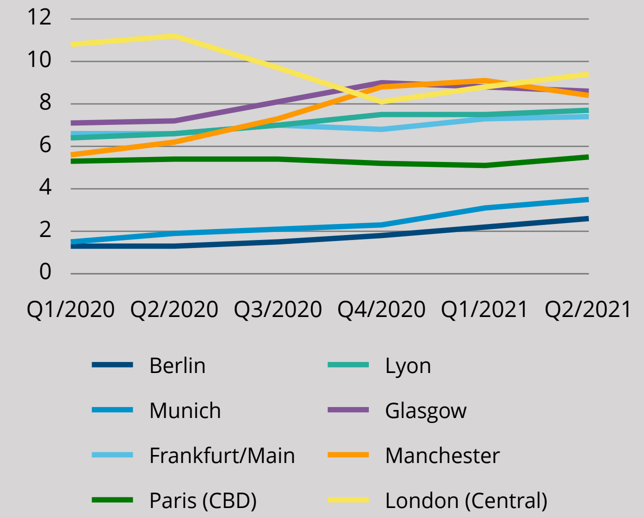
Sources: Eurostat (FR), ONS (UK), bulwiengesa (GER)
* Date GER/FR: End of the year 2020, Date UK: 2018; ** Date GER/FR: 2019, Date UK: 2018; *** GVA without Aschheim, Eschborn, Langen, Quickborn

Office real estate markets in any of these countries is defined by the interplay of supply and demand. The section below will analyse the ways in which things differ in Germany, France and the United Kingdom. It will take a closer look at vacancy rate (supply side) and office take-up and prime rent (demand side) as the key variables.

» Supply situation

The purpose of looking at the supply situation (vacancy rate) is not to highlight the differences between these countries' monocentric or polycentric structure, but is meant to supplement the chapter.

Selected vacancy rate
in %



Sources: PMA (UK/FR), bulwiengesa (Germany)

In Germany (and in the group of cities analysed), Munich (3.5 %) and Berlin (2.6 %) are among the cities with the lowest vacancy rates as a result of the robust demand situation of recent years (as of Q2 2021). Conversely, the banking and financial metropolis of Frankfurt am Main has had the highest vacancy rate among Germany's Class A cities for years. That being said, vacancies have come down even here over the past years because of the sound demand situation in combination with the demolition/conversion of obsolete office schemes. The ramifications of the coronavirus pandemic have lately precipitated a modest increase in vacancies in the three cities mentioned.

Analogously, Paris (CBD) and London (Central) have registered a build-up in vacant floor space over recent months. It should be added that London had already seen its vacancy rate go up to 11 % in the wake of Brexit, when companies chose to move their offices to mainland Europe. Having gone down since, the rate rebounded during the pandemic when employees became wary of commuting to their offices in London, and it currently stands at 9.4 %. The fact that the rise in vacancies in Paris has remained moderate so far (5.5 %) is also attributable to the concept of the 15-minute concept, which seeks to combine living, working and local amenities.

» Demand situation

In some of the office real estate markets analysed, the onset of the coronavirus pandemic caused demand to slump in spring of 2020. In Berlin, for instance, the 2019 office take-up totalled 1.07 million sqm RAC, before declining to 730,000 sqm RAC in 2020, a drop by 30 %. Paris CBD similarly reported a 40 % dip in take-up compared to 2019, while an actual 65 % decline was registered in London Central.

Office Take-up

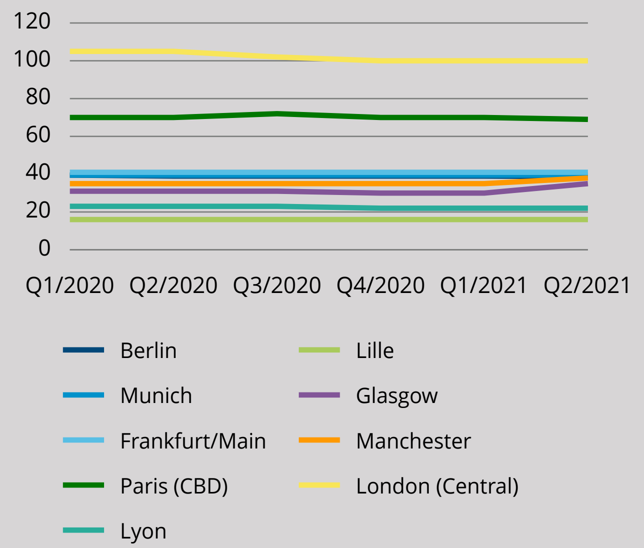
City/Region	2020	2020 in %	ø 5 years in %**
	Germany (GER) in sqm		
Berlin	730,000	20 %	18 %
Düsseldorf	238,000	6 %	7 %
Frankfurt	281,800	8 %	10 %
Hamburg	335,000	9 %	11 %
Cologne	190,000	5 %	6 %
Munich	415,000	11 %	12 %
Stuttgart	135,000	4 %	3 %
Analysed Secondary Cities*	1,355,000	37 %	30 %
GER in total	**3,679,800**	**100 %**	**100 %**
	France (FR) in sqm		
Marseille	126,000	6 %	–
Lille	140,000	7 %	–
Lyon	202,000	10 %	–
Paris (total)	1,513,000	76 %	–
FR in total	**1,980,000**	**100 %**	–
	Unites Kingsdom (UK) in sqm		
Glasgow	57,200	6 %	–
Edinburgh	54,000	6 %	–
Birmingham	64,400	7 %	–
Manchester	130,000	14 %	–
London (total)	618,000	67 %	–
UK in total	**923,600**	**100 %**	**–**

Sources: PMA (UK/FR), bulwiengesa (Germany)
* without Aschheim and Quickborn; ** 2016 until 2020

But the figures still reflect the enormous significance of the respective office real estate market. Berlin accounted for 20 % of the office take-up in the Class A and secondary cities, although it should be added that the take-up total was influenced by the major lease that Deutsche Rentenversicherung signed at the CULE scheme (for 85,000 sqm). In previous years, Berlin had claimed a take-up share of around 18 %. The figure mirrors the city's emergence as the place of choice for start-up businesses in Germany, prompting a significant increase in office employment and with it a strong demand for office accommodation. Unlike Berlin, other Class A cities – except Stuttgart – show a decline when compared to the five-year mean. Secondary cities have proven particularly resilient in the context of the coronavirus pandemic. The decline in take-up was not nearly as drastic as it was in the Class A cities – while their share in the take-up total actually increased.

Paris and London also had to cope with declining take-up volumes compared to 2019, and this despite the fact that 126,000 sqm RAC at the Paris office scheme The Link were pre-let to Total in 2020. That the centre of gravity remains in the capitals of the two countries is nonetheless reflected in their share of the national take-up total. Paris, for one, accounts for nearly three quarters of the take-up achieved. The take-up share of London is two thirds, a ratio not much lower.

Selected prime rent
in Euro/sqm/month



Sources: PMA (UK/FR), bulwiengesa (GER)

The monocentric structure of the United Kingdom and France also becomes apparent when you analyse the prime rents in the two countries. By far the highest prime rents in either country are paid in the inner city of the respective capital, averaging 100 euros/sqm/month in Central London and 69 euros/sqm/month in Paris CBD (as of Q2 2021). In Germany, by contrast, the highest prime rents paid in Q2 2021 were reported from Frankfurt (41.00 euros/sqm RAC) and Munich (39.50 euros/sqm RAC), and are not all that far apart.

The, in some cities dramatic, downturn in office take-up triggered by the pandemic – and by Brexit in case of the UK – has so far had only limited repercussions for the prime rent level in the cities selected in Germany, the United Kingdom and France. Flatlining prime rents were reported from Munich, Frankfurt and Lille. Prime rents were slow to soften in the cities of Berlin (-2 %), Paris CBD (-1 %), Lyon (-4 %) and London Central (-5 %). Conversely, they actually increased in Glasgow (+13 %) and Manchester (+9 %). Overall, it is reasonable to say that properties in central locations remain subject to strong demand while the supply shortage persists. Motivated by certain location characteristics (e. g. easy accessibility), enterprises still prefer to rent accommodation in central locations because the competition for skilled workers has not eased in the wake of the pandemic.

Conclusion

In contradistinction to France and the United Kingdom, Germany's market structure is polycentric. This becomes obvious, for instance, when you study the economic output, which in the case of Germany is generated by many different cities. In addition to the Class A cities, the survey looks at secondary cities, whose markets tend to be dominated by companies of the mid-market sector (the backbone of the German economy). That the market structure in Germany is much more decentralised than in the United Kingdom and France also becomes apparent when you start analysing variables from the office segment.

Naturally, each city has its specific characteristics, and calls for a differentiated approach – which is exactly what the subsequent section will do (esp. for the secondary cities in Germany).

Performance of the Office Markets in Secondary Cities

As already discussed in the foregoing chapter, the detailed analysis of the secondary cities will concentrate on the supply and demand angles.

» Supply situation

The robust economic development of recent years and the formation of new occupational areas in the wake of digitisation have generated a brisk growth in office jobs. Naturally, the new office jobs require office accommodation. Combined with the virtual absence of speculative building activity, the situation has prompted a reduction in office vacancies in all of the secondary cities with the exception of Bayreuth, Heidelberg and Freiburg im Breisgau. It should be mentioned in this context that Bayreuth had a vacancy rate as low as 2.8 % in 2011. The increase by 2.2 percentage points is mainly attributable to the fact that Telekom moved out of its premises on Wilhelm-Pitz-Strasse. So, another thing the example illustrates is the difficulty to compensate for the removal of large-scale occupier on short notice and the probability of fluctuations in vacancies. By contrast, Freiburg im Breisgau has always shown a vacancy rate below the mark of two percent.

Overview – vacancy rate in selected second-tier cities

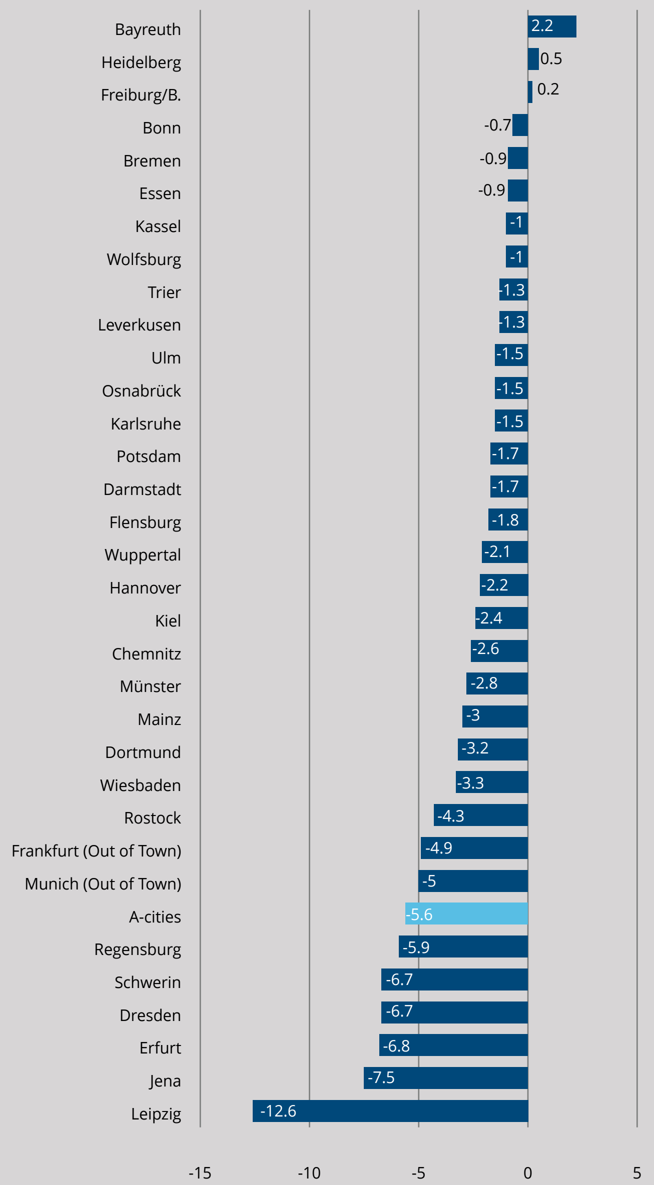
Secondary cities	Vacancy rate (2020)*	Trend (2021)
Frankfurt (Out of Town)	15.3%	↗
Chemnitz	10.6%	→
Erfurt	10.4%	→
Munich (Out of Town)	6.5%	↗
Leipzig	6.1%	↘
	⋮	
Wolfsburg	1.7%	→
Jena	1.6%	→
Regensburg	1.6%	→
Münster	1.5%	→
Freiburg/B.	1.4%	↗

Source: bulwiengesa (without Quickborn)
* Note: The high vacancy rates in F-OOT, Chemnitz, etc. are mostly due to older buildings that no longer meet technical requirements.

Accordingly, the modest increase that was registered has no impact on the office real estate market.The fastest reduction in vacancies during the observation period was registered in Leipzig. Although the 6 % vacancy level in Saxony's largest metropolis remains well above the average among the other Class B cities (3.5 %), it has steadily declined from its peak level of 33 % in 1997. The vacancy rate in the inner city is even lower. The trend is driven primarily by sluggish construction volumes and very keen demand (with annual take-up averaging 110,000 sqm RAC between 2011 and 2020).

Another city with a low vacancy rate is Wolfsburg where the main demander, Volkswagen, often absorbs modern office accommodation as soon as it comes onto the market. Combined with a demand-driven building activity, this has resulted in a vacancy rate of 1.7 %.

Development of vacancy rate
in % (2011 to 2020)



Source: bulwiengesa (without Quickborn)

Overview – new office space added*

Secondary cities	New added (Ø 5 years)**	New added (Ø 10 years)***
Karlsruhe	49,500	35,400
Essen	39,700	31,500
Bremen	36,000	27,800
Dortmund	31,100	26,100
Bonn	31,000	27,200
M-OOT (u. a. Aschheim)	30,000	37,000
Hannover	25,800	32,600
Wolfsburg	24,600	21,000
Freiburg/B.	24,600	19,200
Leipzig	23,300	18,000
Heidelberg	21,700	20,100
Potsdam	21,700	17,900
Dresden	21,200	18,300
Münster	20,400	21,800
Mainz	19,000	15,400
Wiesbaden	17,100	14,200
Darmstadt	14,600	14,900
Regensburg	14,000	14,600
Osnabrück	12,000	11,300
Leverkusen	11,600	7,400
Ulm	9,400	13,600
Erfurt	8,500	8,500
Rostock	8,300	8,300
Kassel	8,200	10,500
Jena	7,200	7,900
Chemnitz	7,000	5,600
Wuppertal	6,800	5,800
Kiel	6,100	5,400
Bayreuth	5,700	3,600
Eschborn	5,000	4,000
Trier	2,800	2,500
Flensburg	2,100	2,800
Langen (Hessen)	1,300	800
Schwerin	1,000	1,600

Source: bulwiengesa (without Quickborn)
* without redevelopment; ** 2016 to 2020; *** 2011 to 2020

Unlike in the Class A cities, the building activity in the overwhelming majority of secondary cities is dictated by demand. This means that office units are developed only after having been pre-let and rarely on speculation. The long-term observation (2011 through 2020) returns the highest average completions volumes among the secondary cities for the Class B cities of Karlsruhe, Essen, Bremen, Dortmund and Bonn. Especially in Karlsruhe, the construction activity picked up further momentum, and significantly so, during the past five years. The high level of building activity – with nearly 100,000 sqm RAC completed in the peak year of 2020 – indicates robust demand for modern office units. Even in the longer term, there is no reason to expect vacancies in Karlsruhe to rise, despite the brisk building activity. The Class B cities are trailed by the suburban market of Munich (M-OOT), which is dominated by the market action in the town of Garching. At the other end of the scale within this market is Aschheim, another Munich suburb, where construction has been very low-key in recent years. The construction activities are exclusively pursued by owner-occupiers like the Fogra research institute who only develop small-scale office units. The Hammerschmidt and Campus One (extension) developments currently under way will create roughly another 26,000 sqm by 2022, and these premises have yet to be let.

Overview – new built (2011 to 2020) in relation floor space stock (2020)

Secondary cities	Share of new office space inventory
Munich-OOT (u. a. Aschheim)	29.0%
Heidelberg	19.0%
Wolfsburg	18.0%
Ulm	15.0%
Karlsruhe	14.0%
⋮	
Trier	5.0%
Chemnitz	4.0%
Kiel	4.0%
Wuppertal	4.0%
Schwerin	2.0%

Source: bulwiengesa (without Eschborn, Langen, Quickborn)

When putting the new-build construction activity in relation to the existing stock, the list is topped not by Class B Cities but by the suburban market of Munich as well as by Heidelberg and Wolfsburg. The building activity in Heidelberg is basically of a non-speculative and small-scale nature. Rather, completions peaks such as the one seen in 2020 are triggered by owner-occupiers like HeidelbergCement, who moved into its new head office of 40,000 sqm that year. The market action in Heidelberg has been, and will continue to be, augmented by large one-off measures likes the development of the new Bahnstadt district or the revitalisation of former US military areas.

Wolfsburg (a Class D city) similarly experienced a high level of building activity – compared to its existing floor space stock – over the past ten years, averaging 21,000 sqm RAC annually. In this case, new-build construction is dominated by owner-occupiers from the automotive industry. Completions peaked in 2017, when the Nordkopftower and Volkswagen IT-City were finished, delivering a combined total of about 45,000 sqm.

Quite the opposite is the case in Schwerin, a Class D city whose sluggish construction activity has resulted in very low completions volumes of around 1,600 sqm annually.

» Demand situation

The trend in office employment is considered the most important parameter when trying to determine future office space requirements. Before taking a look at the prospective trend in office employment through 2030, this section will undertake an ex-post-facto study.

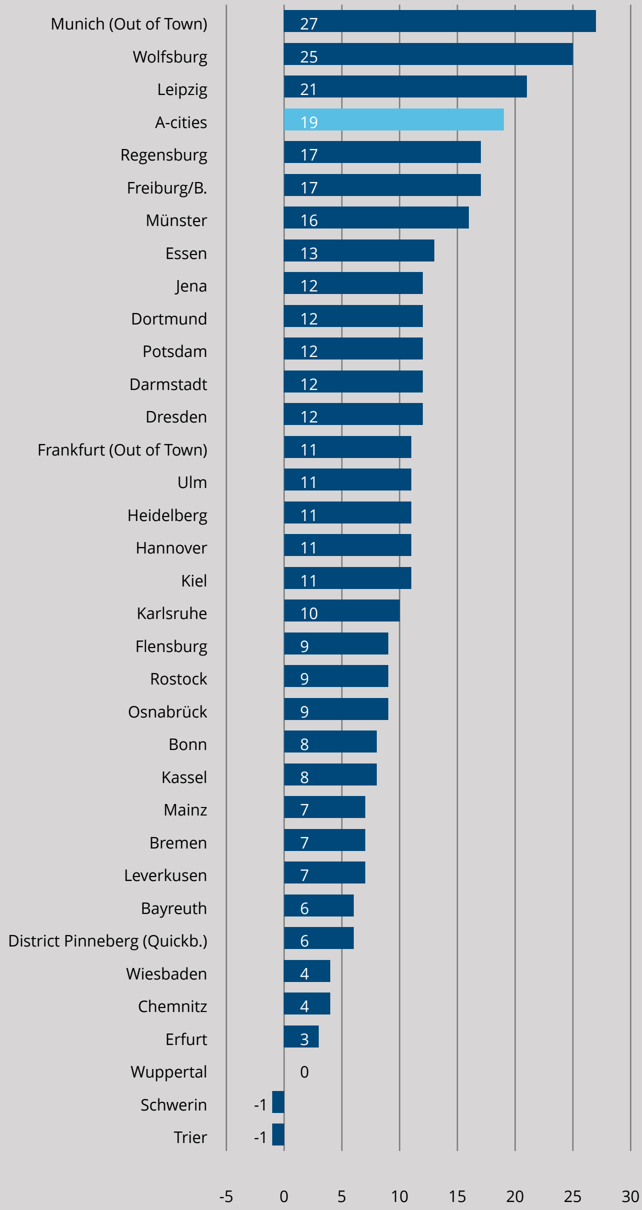
Principally speaking, the profiled secondary cities experienced an inflow of qualified professionals who were attracted by the sound economic parameters – and the number of office workers has grown accordingly since 2011. During this time, 18 (out of 34) cities recorded growth rates in excess of 10 %. Overall, the spectrum ranges from 3 % in Erfurt, state capital of Thuringia, to 27 % in the suburban market of Munich. Wuppertal, Schwerin and Trier were the only cities registering no growth in office workers.

As mentioned above, the market with the fastest growth in office employment during the period of 2011 through 2020 is suburban Munich. The total of about 137,000 employees worked here by 2020. The suburbs of Munich benefit from the land shortage within the city proper, and from the resulting spillover trend as companies relocate beyond the city limits.

The growth leaders next in line after suburban Munich are Wolfsburg (+25 %) and Leipzig (+21 %), whose growth rates top the level of any Class A city. The rapid increase in office jobs in Leipzig is attributable primarily to massive investments in infrastructure and in the university, which in turn has improved the demand generated by companies from the automobile industry (BMW, Porsche).

Trend in office employment

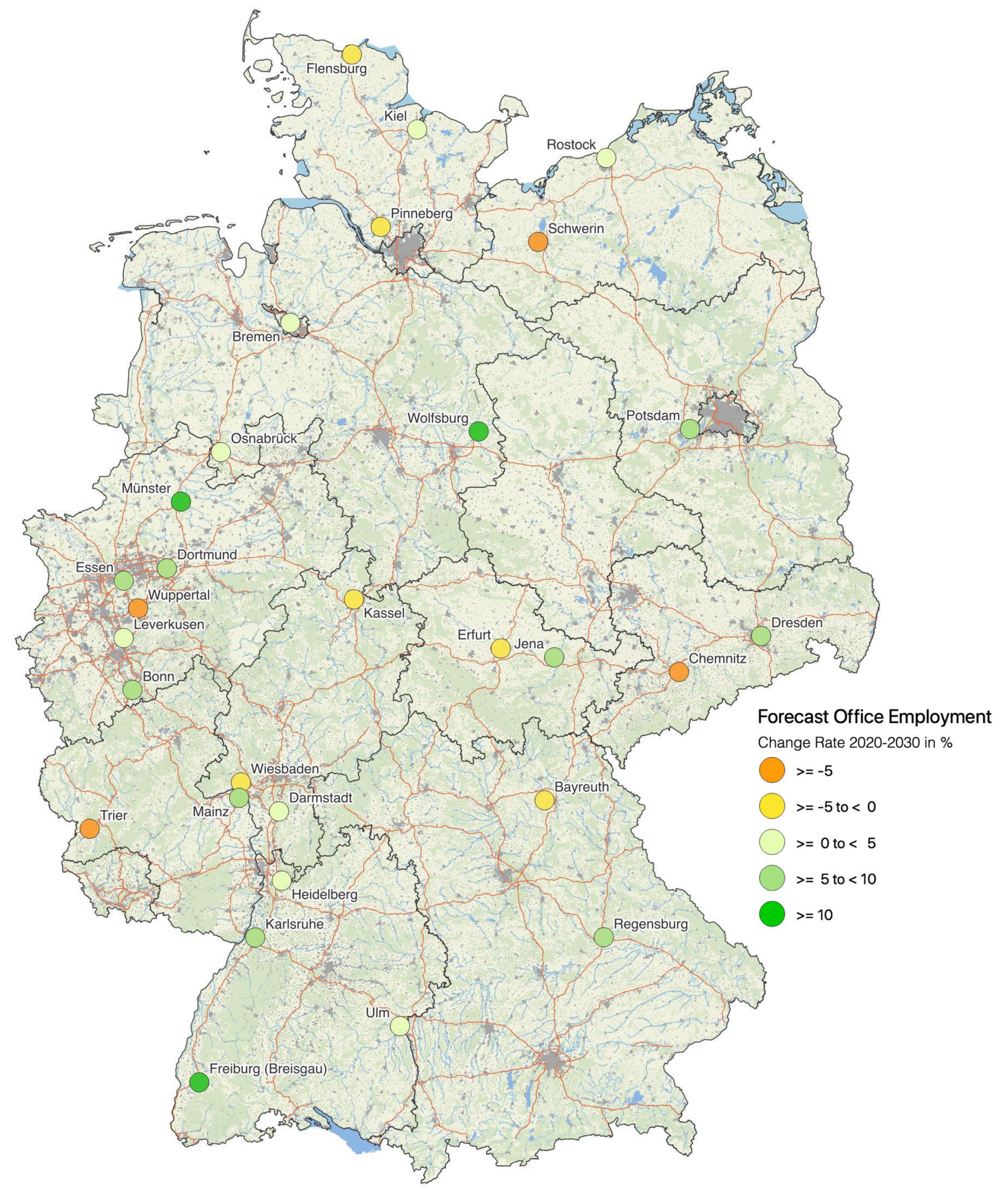
in % (2011 to 2020)*



Source: bulwiengesa
* 2020 preliminary figures

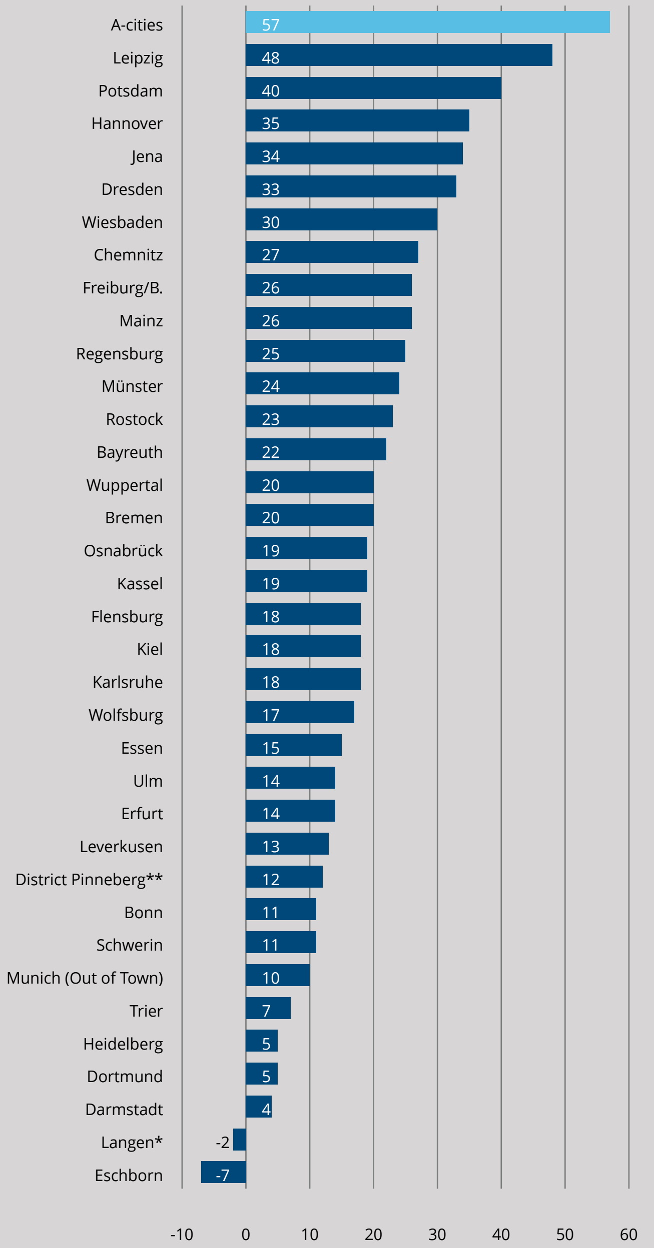
Further growth in office jobs (through 2030) is predicted for 22 of the 32 secondary cities (not including the suburban markets of Frankfurt and Munich). The fastest rates of growth are projected for Wolfsburg (+16 %), Münster (+12 %) and Freiburg im Breisgau (+11 %). However, the demographic trend will also increase the number of cities with a regressive growth in office employment.

Trend in office employment in % (2020 to 2030)*



* without Frankfurt Out of Town und Munich Out of Town (Eschborn, Langen und Aschheim)

Trend in average rent (office city)
in % (2011 to 2020)*



Source: bulwiengesa
* Langen inclusive Dreieich; ** District Pinneberg since 2015

The robust demand situation of recent years is reflected in the trend in average rents as well. The chart illustrates that all of the secondary cities – with the exception of Langen and Eschborn – followed an upward trend. The growth spectrum ranged from around 4 % in Darmstadt to nearly 50 % in Leipzig.

Next in line in terms of growth came Potsdam (+40 %), Hanover (+35 %), Jena (+34 %), Dresden (+33 %) and Wiesbaden (+30 %).

But Leipzig clearly took the lead in recent years with its brisk market dynamics. The substantial increase in office employment (+21 %) and a subsequent take-up of nearly 130,000 sqm RAC annually (2016 through 2020) helped to bring down the comparatively high vacancy rate (2016: 11 %), as did demolitions and conversions. At the same time, the supply side was defined by low-key building activities and rising rent rates as a result. On the whole, the office market of Leipzig has developed more dynamically than that of the state capital Dresden, even though the latter experienced rapid rental growth in its own right (+33 %).

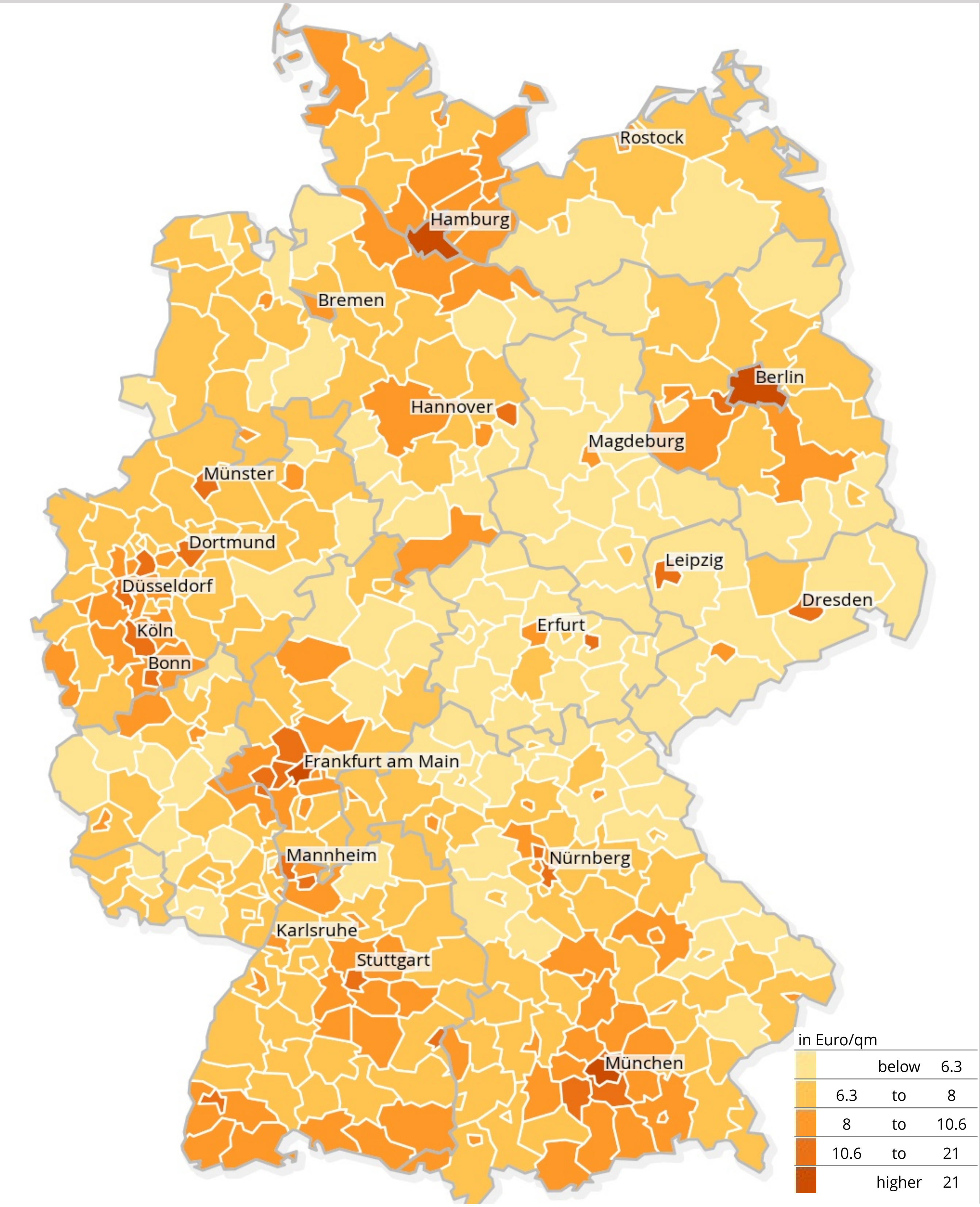
A positive market development was also reported from Potsdam, the state capital of Brandenburg, which benefits from its geographic proximity to Berlin. Potsdam is also one of the most important office markets among the Class C cities, and has positioned itself as an administrative hub and a services-dominated city. The upward trend is visible moreover in the growth in office jobs (+12 % between 2011 and 2020). This in turn has increased the office space requirements, rolling back vacancies and driving up rents as a result.

Another city boasting a positive performance during the past decade is Chemnitz, whose office real estate market saw rental income climb by 27 %. The upward trend is also reflected in declining vacancies (-2.6 percentage points since 2011) and rising rent rates. However, the trend was checked in 2020 as the take-up fell short of the average, and vacancies rebounded slowly (compared to 2019). Only the rent level was spared by the consolidation cycle as it continued to follow the upward trend of recent years even in 2020.

In Regensburg, the trend in office jobs has pointed upward since 2011. By the end of 2020, about 54,000 employees worked in the office sector (+17 % since 2011). The robust demand situation in sync with the growing supply contraction has driven up rents here, too (+25 %).

By contrast, Bonn only made the lower third of the list in terms of rental income growth. It should be noted, though, that the rent level here in the former West German capital has always exceeded the average of the other Class B cities. Another thing worth noting is that the highest rent average is paid not downtown but in the office district. Trier and Schwerin are also among the cities in the bottom third, albeit due to their scores in the other ratios.

Overview average office rent (2020)



Overview – Office take-up

Secondary cities	Turnover (Ø 5 years)* in sqm	Turnover last 5 years measured against stock
A-cities	3,414,000	21 %
Munich (Out of Town)	205,000	23 %
Hannover	143,000	16 %
Leipzig	129,000	23 %
Essen	124,000	20 %
Bonn	117,000	18 %
Bremen	101,000	18 %
Dresden	89,000	15 %
Dortmund	86,000	16 %
Wiesbaden	72,000	16 %
Karlsruhe	70,000	14 %
Heidelberg	50,000	24 %
Münster	47,000	10 %
Eschborn	41,000	–**
Darmstadt	39,000	12 %
Mainz	39,000	12 %
Potsdam	35,000	12 %
Regensburg	32,000	15 %
Freiburg/B.	31,000	11 %
Kassel	30,000	13 %
Kiel	22,000	8 %
Erfurt	21,000	6 %
Leverkusen	19,000	13 %
Rostock	19,000	9 %
Jena	18,000	15 %
Ulm	18,000	10 %
Wolfsburg	18,000	8 %
Chemnitz	16,000	6 %
Osnabrück	16,000	8 %
Wuppertal	13,000	4 %
Bayreuth	12,000	13 %
Langen*	11,000	–**
Flensburg	8,000	10 %
Trier	7,000	7 %
Schwerin	5,000	4 %

Source: bulwiengesa (without Quickborn)
* Langen inkl. Dreieich; ** no stock numbers available

The largely positive trend in office employment over the past years is also reflected in the office take-up figures. Aside from the suburban market of Munich, the Class B cities (Hanover, Leipzig, Essen, Bonn, Bremen, Dresden, Dortmund, Wiesbaden and Karlsruhe) reported the highest take-up figures over the past five years among the secondary cities selected.

The highest-scoring "non-Class-B" city in the survey is Heidelberg. If you view its take-up relative to its existing floor space, the city would actually top the ranking. Lettings during the past five years equalled nearly 50,000 sqm RAC per year. The largest lettings seen in recent years include the start of construction for the owner-occupied premises of Heidelberg-Cement (40,000 sqm RAC), the lease signed by Stadtwerke Heidelberg for 20,000 sqm RAC, and the 17,000 sqm RAC pre-let to Sparkasse in the Bahnstadt locality.

Eschborn is part of Frankfurt's suburbs, an office market that is dominated by the cities of Bad Homburg, Neu-Isenburg, Offenbach and Eschborn itself. In addition to the low trade tax multiplier, benefits of Eschborn's office market include the easy access to Frankfurt proper and Frankfurt Airport. Eschborn gained in appeal over the past few years as spill-over location, and the fact is reflected in a take-up of around 41,000 sqm RAC annually. This contrasts with the performance of Langen (including Dreieich), another Frankfurt suburb included in the survey, which only plays a negligible role within the market structure. The five-year take-up average of 11,000 sqm RAC per year suggests as much.

The lowest take-up – relative to the existing floor space stock – was generated by Schwerin and Wuppertal with 4 % each. In either city, the low level of demand mirrors the trend in office employment.

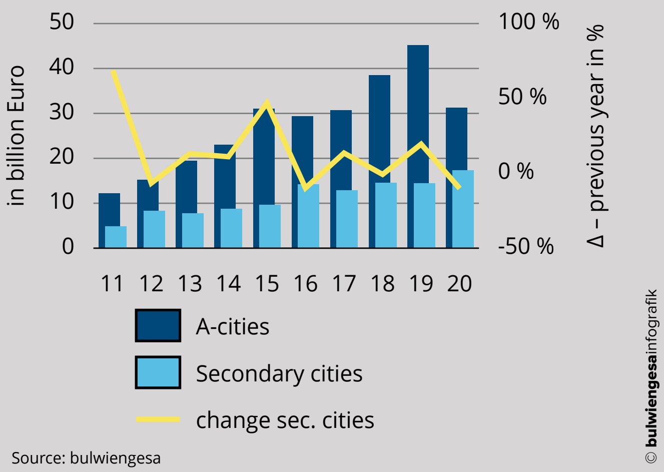
Conclusion

Germany's sound economic parameters have translated into a positive development on the office real estate markets of the secondary cities in recent years. The number of office jobs rose in virtually all of the cities studied, a fact that combined with demand-driven building activities to bring down vacancy rates while driving up rent levels. For many of these cities, the coronavirus pandemic put a damper on the upward market trend, and yet the secondary cities in general had an easier time coping with the crisis than the Class A cities.

Germany´s Investment Market

With transactions worth c. 60 billion euros completed, Germany's commercial real estate investment market[2] proved its vitality even in 2020. The bulk of the sum (about 42 %) represented offices, which underscores the prominent position of this type of use. At the same time, logistics real estate seriously benefited from the growing e-commerce market and continued to expand its footprint on the investment market. Foreign investors, who consider Germany a safe-haven investment destination, accounted for 40 % of the investment total. Worth noting is that the traded transaction volume did not feed on transactions already initiated prior to the outbreak of the pandemic, but is generated by lively new business deals. Specifically, the transaction volume in office real estate amounted to 25.1 billion euros in 2020, implying a year-on-year dip by -37.0 % but still topping the ten-year mean by around 35 %. Secondary cities claimed about 18 % (c. 4.5 billion euros) of the total, which equals a -39 % drop compared to the 2019 figure.

Transactions volume commercial property
(2011 to 2020)



Source: bulwiengesa

Regardless of the coronavirus pandemic, the slowing dynamic of the yield compression already manifested itself both in the Class A cities and in the secondary cities through the fact that prices had already gained an extremely high level that limits any further upside potential.

Currently sought-after assets include properties in the core segment, let to blue-chip occupiers on long-term leases – the focus being on public-sector tenants at the moment.

Overview – net initial yield

Secondary cities	2015 – 2019 (in basis points)	2019 – 2020 (in basis points)
Chemnitz	-240	0
Freiburg (Breisgau)	-190	0
Mainz	-190	10
Dresden	-180	0
Potsdam	-180	-10
Frankfurt (Out of Town)	-170	0
Leipzig	-160	0
Bayreuth	-150	0
Jena	-150	0
Karlsruhe	-150	0
Wiesbaden	-150	-10
Heidelberg	-150	-10
Rostock	-140	-10
Darmstadt	-140	-10
Hannover	-140	0
A-cities*	-140	0
Münster	-140	-10
Wuppertal	-140	0
Wolfsburg	-140	0
Schwerin	-130	0
Osnabrück	-130	-10
Ulm	-120	0
Bonn	-120	0
Erfurt	-110	0
Bremen	-110	0
Essen	-110	-10
Trier	-100	0
Kassel	-100	0
Dortmund	-100	0
Regensburg	-100	-10
Flensburg	-90	0
Kiel	-90	0
Munich (Out of Town)	-90	0
Leverkusen	-70	0
District Pinneberg	-70	0

Source: bulwiengesa/* A-cities: average

Conclusion

As demand for properties with attractive characteristics (location, covenants, property qualities, etc.) remains extremely high despite the pandemic, net initial yields have maintained their level. In this context, the secondary cities offer a higher return potential than Class A-cities.

[2] Commercial real estate: office, retail, logistics and other real estate (hotels, retirement homes etc.)

Summary

Overview Variables

	Vacancy rate (Δ 2011 - 2020 in %-points)	Trend of vacancy rate (2021)	ø-rent (Δ 2011 - 2020)	Trend in ø-rent (2021)	NIY (Δ 2011 - 2020 in %-points)	Trend in NIY 2021
Aschheim Munich-OOT	– -5.0	↗	– +10 %	↗	– -1.5	→
Bayreuth	+2.2	→	+22 %	→	-2.5	→
Bonn	-0.7	↘	+11 %	↗	-1.8	↘**
Bremen	-0.9	→	+20 %	↗	-1.9	→
Chemnitz	-2.6	→	+27 %	→	-3.1	→
Darmstadt	-1.7	↗	+4 %	→	-2.3	→
Dortmund	-3.2	↘	+5 %	↗	-1.9	↘**
Dresden	-6.7	→	+33 %	↗	-2.8	↘**
Erfurt	-6.8	→	+14 %	→	-1.9	→
Eschborn Frankfurt-OOT	– -4.9	↗	-7 % –	→	– -2.0	→
Essen	-0.9	↗	+15 %	→	-1.9	→
Flensburg	-1.8	→	+18 %	→	-1.4	→
Freiburg/B.	+0.2	↗	+26 %	↗	-2.8	→
Hannover	-2.2	↗	+35 %	→	-2.3	→
Heidelberg	+0.5	→	+5 %	→	-2.4	→
Jena	-7.5	→	+34 %	↗	-2.1	→
Karlsruhe	-1.5	→	+18 %	→	-2.3	→
Kassel	-1.0	→	+19 %	→	-1.7	→
Kiel	-2.4	↘	+18 %	→	-1.8	→
Langen* Frankfurt-OOT	– -4.9	↗	-2 % –	→	– -2.0	→
Leipzig	-12.6	↘	+48 %	↗	-2.7	↘**
Leverkusen	-1.3	→	+13 %	→	-1.0	→
Mainz	-3.0	→	+26 %	→	-2.7	→
Münster	-2.8	→	+24 %	↗	-2.6	↘**
Osnabrück	-1.5	→	+19 %	→	-2.2	→
Potsdam	-1.7	↗	+40 %	↗	-3.0	↘**
Quickborn (Dis. Pinneberg)	–	–	– +12 %	→	– -0,7***	→
Regensburg	-5.9	→	+25 %	→	-1.8	→
Rostock	-4.3	→	+23 %	↗	-2.2	→
Schwerin	-6.7	→	+11 %	→	-1.7	→
Trier	-1.3	→	+7 %	→	-1.7	→
Ulm	-1.5	→	+14 %	→	-1.7	→
Wiesbaden	-3.3	→	+30 %	↗	-2.6	→
Wolfsburg	-1.0	→	+17 %	↗	-2.3	→
Wuppertal	-2.1	→	+20 %	→	-1.8	→

Source: research bulwiengesa (Date November 2021); * included Dreieich; ** With a continued favourable interest rate environment and limited supply and investment pressure on the part of investors, slightly declining yields are also to be expected in some locations in 2021.; *** NIY only available from 2015

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