AEW EUROPE

Press release

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AEW Europe sees value in Germany outside the core markets

Paris - Germany will remain a priority destination for real estate investors looking to deploy capital in Europe as the economy's improved prospects and near record pricing for core assets revive interest in secondary and tertiary markets, new research by AEW Europe shows.

Sam Martin, Head of Research at AEW Europe, commented: "The outlook is brightening for the German economy and, as concerns about the Eurozone crisis dissipate. investors are prepared to move up the risk curve by looking at markets that they overlooked during the financial crisis."

Core German real estate has been an attractive asset class for investment throughout the Global Financial Crisis (GFC) and subsequent Eurozone crisis, offering resilient or moderately rising capital values with security of income. Demand has driven net initial yields for prime assets close to record lows, fuelling investor interest in secondary German cities, according to the recent short paper by Holger Zilleken of AEW Europe Research & Strategy. This can be a fruitful strategy for those with experienced stock picking skills and the ability to assess the associated risks, the research concluded.

Investors see little scope for further compression of net initial yields in Germany's seven largest and most liquid markets - Munich, Berlin, Hamburg, Frankfurt, Dusseldorf, Stuttgart and Cologne. Instead, they are attracted to other cities offering higher returns as the economic recovery strengthens occupier markets. Indeed, 48% of the €12.6bn invested in Germany in H1 2013 went to locations outside the top seven cities, according to CBRE, while demand for higher yields is starting to affect pricing. This contrasts with the two other main core European real estate markets of France or the UK, where the bulk of investment activity was concentrated on Paris and London.

Prudent stock picking and portfolio construction matter in secondary locations because the 100-200bps premium to net initial yields in prime cities may not provide a sufficient buffer for the additional risks of reduced liquidity, higher transaction costs, limited market transparency and fewer potential tenants. Capital values often have limited scope to appreciate as new construction activity addresses specific tenant requirements, stifling speculative development. Since single properties in smaller cities usually tie up significantly less capital, investing in secondary cities can diversify a portfolio across a larger number of assets and locations, while their more affordable office rental values can reduce the risk of tenant default.

The AEW Europe Research & Strategy team has developed a framework for actionable investment strategies that combines an analysis of German city macroeconomic and property dynamics with in-house expertise on the country's various markets or submarkets. This approach categorises cities according to size, population, tenant base and investment liquidity.

The seven “Tier 1” cities are the largest, with populations in excess of 600,000, a tenant base of DAX listed companies and demand from more than 30 investors for each institutional grade office property for sale at any one time. Since yields tend to be low, particularly for prime stock, any value creation lies in income generation improvements via asset re-positioning, either by changing the tenant profile or enhancing the quality of the asset. Converting offices to residential use is another strategy, since housing commands higher prices per square metre.

“Tier 2” cities like Nuremberg, Bremen and Karlsruhe are mid-sized with populations of 250,000-600,000 people. The majority of tenants are MDax listed or unlisted SMEs, while properties generally attract fewer than 10 potential buyers. Attractive investment locations are mostly central and have multimodal transportation systems. Affordable rents and long leases on assets in these cities ensure that income is protected over the longer term, making them attractive to investors when put up for sale.

“Tier 3” cities, including Ingolstadt, Heidelberg and Leverkusen, are smaller with populations of 100,000-250,000 people. Tenants are largely SMEs, with assets for sale either coming to the market through sale and leasebacks or disposals by private investors. Typically there are no more than five potential buyers per asset. While Tier 3 cities share some characteristics of Tier 2 cities, liquidity risks are greater and transparency is low. Typically offices in Tier 3 cities do not meet institutional grade standards because they are located close to SME tenants’ factories or grouped in office parks rather than in the city centre. However, dominant local retail parks with extension options or other alternative real estate sectors, such as senior assisted living, offer attractive investment opportunities in these cities.

Rob Wilkinson, CIO at AEW Europe concluded: “Secondary or tertiary cities offer investors plenty of opportunities to generate attractive returns provided they take a disciplined approach in stock selection and combine this with local expertise.”

Ends.

About AEW Europe

AEW Europe is one of the leading European real estate asset and investment managers. Together with AEW Capital Management in the United States and Asia, AEW Europe and its regulated subsidiaries - AEW Europe LLP, NAMI - AEW Europe and AEW Europe SGP - form a global real estate platform with more than €38 billion in assets under management (of which €17.8 billion is in Europe). AEW has over 30 years experience in the management of real estate funds and separate institutional mandates with 500 employees in 13 locations around the world, including head offices in Boston, London, Paris and Singapore. AEW's innovative investment strategies are research-driven and rigorously controlled for risk, with implementation carried out by professional teams in its extensive network of local offices on the ground.

AEW regularly receives industry awards in recognition of its investment performance and adherence to principles of sustainability. AEW Europe is a founding member of the group of leading real estate fund managers applying the Bureau Veritas "Green Rating" standards to its European investment portfolio and is a signatory to the United Nations' Principles for Responsible Investment. The company is also an active member of the European Association for Investors in Non-listed Real Estate Funds (INREV) and its portfolios are benchmarked by the Investment Property Databank (IPD). AEW Europe is a subsidiary of Natixis Global Asset Management, one of the top 15 asset managers in the world.

Contact AEW Europe

Saida Grosvalet
AEW Europe
+33 1 78 40 92 10
saida.grosvalet@aeweurope.com

www.aeweurope.com