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The German Retail Property Market: 2003 to Today

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Recent years have seen the German retail industry undergo considerable structural change. In this edition of the vdp Real Estate Special we examine this topic and summarize the main changes in the structures of the retail business in Germany. For the first time, vdp's new indices for this market segment are used to illustrate the implications of these developments for the retail property market.

The Association of German Pfandbrief Banks (vdp) has created three new indices to complete its real estate index family. The vdp capital value index for retail buildings measures the development of prices and comprises the rent index for rents under a new lease and the empirical cap rate index.

Main Developments over the Last Ten Years

Developments in the German retail industry can be summed up by just a few figures:

- a. Between 2003 and the end of 2013, retail selling space rose by 7% or around 8 million m². Germany has selling space totaling more than 122 million m² at present.¹⁾
- b. According to estimates by the German Retail Federation (Handelsverband Deutschland, HDE), retail sales totaled roughly €433 billion in 2013. Compared with 2003, this means a nominal increase of nearly 8%. However, in real terms – which is to say adjusted for the general increase in prices – this is equivalent to a decline of just over 8%.

These figures are the outcome of deep-seated changes in the German retail landscape, and we will examine them more closely in the following.

Shopping Malls, Specialist Stores and Food Discounters Post Growth in Sales Area

The structural change that has been ongoing in the retail sector for decades now continues, with total selling space rising constantly. The main driver of the steady growth in sales area is the construction of new shopping malls, specialist stores and food discounters. The number of **shopping malls** alone went up from 338 to 453 in the last ten years. This is equivalent to an average of 11 new shopping malls opening every year. Consequently, selling space in this segment has risen by around 34% to a total of roughly 10 million m², so that malls today account for more than 8% of total selling space. This rise in the number of new malls is accompanied by changing location preferences. In the late 1990s, fewer than 50% of malls were built at town center locations, compared with three out of four new shopping malls today. The offering of downtown selling space has expanded noticeably in many towns and cities as a result.

Developments in the case of **specialist stores** – large-area units which specialize in one specific range of items, such as drugstores (i.e. non-dispensing pharmacies), electrical goods retailers, clothes stores and home-improvement centers – have not been uniformly positive in all segments. Drugstores as well as pet and pet supplies stores, for example, are expanding appreciably. In the

last ten years the drugstore chains dm and Rossmann, which together account for over 70% of all drugstore sales, doubled the number of their stores. On the other hand, the Schlecker chain had to file for insolvency, as a result of which a large number of stores with a total sales area of some 1.8 million m² were closed in 2012. In many cases, the location or the layout makes re-letting such properties possible to a certain extent only. Moreover, developments in the home-improvements segment were dampened last year by the insolvency of the Praktiker group. This led to more than 300 stores with a total sales area of some 2 million m² being shut down. Given the size of the individual Praktiker stores (over 6,000 m² on average), it is extremely difficult to find new tenants for many of these properties. By contrast, many of the premises that had been occupied by Praktiker subsidiary Max Bahr have been taken over by other specialist store operators such as the furniture store chains Möbel XXX-Lutz and POCO Einrichtungsmärkte.

Aldi Süd, whose selling space increased by around 27% in the period under review, serves as an example of **food discounters**. This expansion was driven, on the one hand, by an increase in the number of stores (+13%) and, on the other, by a marked rise in sales floor area per store. Today, the average store size is 860 m² (2003: 770 m²). Food discounters currently report sales area totaling some 12 million m², representing a 10% share of all retail selling space.

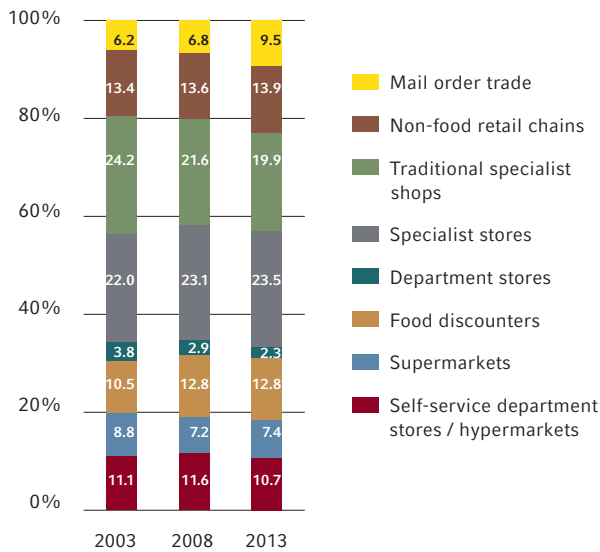
Changes in Sales Floor Space Are Accompanied by Shifts in Sales Generated by Retail Formats

The differences in the degree of expansion in sales floor space are also reflected in the changing market shares of the individual retail formats. Chart 1 shows the respective shares in sales in the years 2003, 2008 and 2013.

The relative winners and losers in the retail industry over the last ten years are easily recognizable here. Besides expanding sales floor space as described above, specialist stores posted an increase in market share and together account for the largest percentage of sales volume (more than 23%). Food discounters likewise increased their share of the market, generating around one-eighth of total retail sales in Germany in 2013. However, food discounters have apparently been unable to make any further market share gains since 2008. By contrast, traditional supermarkets such as Edeka and Rewe, which have also proven to be aggressive market players, have again succeeded in improving their position slightly.

¹⁾ Unless another source is stated, the data were generated from publications by EHI Retail Institute.

CHART 1 Development of shares in sales by retail format



Source: GfK GeoMarketing

Non-food retail chains

Non-food retail chains likewise recorded an – albeit slight – increase. Growth in this segment was dampened by mail order trade in particular, which increased its market share in the last ten years by some three percentage points to almost ten percent today. However, a distinction needs to be made here between traditional, catalog-based mail order business, which recorded a drop in sales, and online mail order business, which more than compensated for this decline. In 2013 alone, online sales represented just over €33 billion of the total sales generated by mail order trade (approx. €43 billion).²⁾

As the above chart shows, the main losers are the traditional (high street) specialist shops, which are predominantly found in downtown and district-center locations. While their market share ten years ago was more than 24%, it is today only somewhat less than 20%. This means that they have lost their position as market leader to the large-area specialist stores. Sales were also down for department stores, which in the last ten years experienced insolvencies and a large number of closures in the case of Hertie, Woolworth, Karstadt and Kaufhof. This led, in some cases, to centrally located large-area vacancies, notably where considerable difficulties were experienced in re-letting the affected properties.

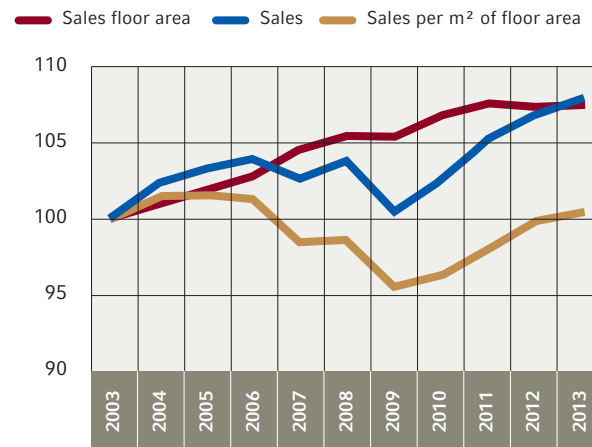
Sales Cannot Keep up with Expansion in Floor Space

The many business closures and insolvencies were due, among other things, to the fact that retail sales rose only moderately in the period under review. In nominal terms, the retail industry achieved an increase in sales of close to 8% in the last ten years. After adjustment for price increases, however, sales were down by 8.2%. The decline in sales was especially pronounced in the years 2006 to 2009 in connection with the financial and economic crisis. This temporary upset affected both the food segment (including beverages and luxury foods) and the non-food sector.

Thus, the above-mentioned expansion in retail sales space in the period under review was not accompanied by a corresponding growth in sales. As a result, from 2007, sales floor productivity (productivity per square meter of sales floor space) was consistently below the baseline level of 2003. Whereas roughly €3,520/m² was generated in 2003, the absolute low of €3,360/m² was reached in 2009. Only as a result of the insolvency of Schlemmer and the associated correction in sales floor area have figures again risen to the level of 2003.

Chart 2 illustrates the development of sales floor area, sales and sales floor productivity, indexed to 2003 levels.

CHART 2 Development of sales floor area, retail sales and sales floor productivity (2003 = 100)



Sources: HDE, Federal Statistical Office, own calculations; development in nominal terms

²⁾ German E-Commerce and Distance Selling Trade Association (Bundesverband des deutschen Versandhandels)

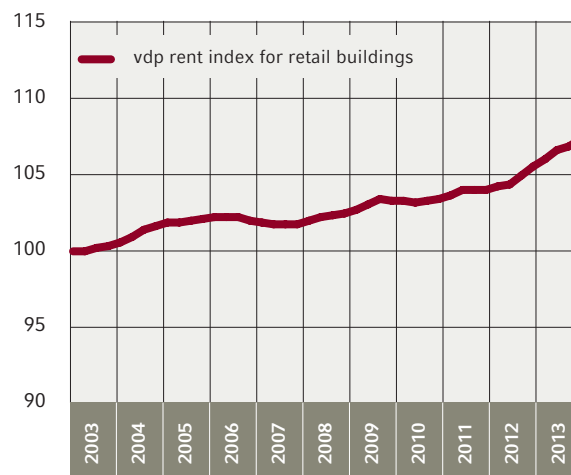
Isolated Cases of Strong Retail Space Demand Lead to Slight Rise in Rents

Despite these occasionally difficult market conditions, demand for retail properties in Germany has remained consistently strong at individual locations. In addition to the strong domestic demand, a recent survey by CBRE shows that Germany is currently also the most attractive market for international retailers wishing to expand. Roughly 40% of the companies questioned stated that they intended to open a store in Germany, with US and Italian retailers in particular indicating above-average interest in German retail premises. The main focus of demand for selling space is on downtown locations and shopping malls in large towns and cities; specialist store centers are also garnering more and more interest from retailers. Particularly since 2011, demand for retail space has picked up substantially, as a result of which there has again been a rise in rents under a new lease.

But how have the rents for retail premises developed during the ten-year period we are looking at? The vdp index for rents under a new lease shows, for Germany as a whole, an increase of around 6% over the entire period under review. At the end of 2013, the index stood at 106.1. As may be seen from Chart 3, the development of the ten-year period can be broken down into five phases.

- 2003 until 3rd quarter of 2006 – rents under a new lease rise by 1.8%. During this period, retail sales grow more strongly than the total sales area. Sales floor productivity is therefore also higher as a result.
- 3rd quarter of 2006 until 4th quarter of 2007 – rents decline by 0.4%. An increase in total sales area combined with a decrease in retail sales pushes sales floor productivity below the 2003 baseline value.
- 4th quarter of 2007 until 3rd quarter of 2009 – rents rise by 1.4% despite a drop in sales floor productivity due to decreasing retail sales.
- 3rd quarter of 2009 until 1st quarter of 2011 – rents are stagnant. Retail sales again rise more strongly than the total sales area. Sales floor productivity picks up again.
- 1st quarter of 2011 until the end of 2013 – rents rise by 3.1% overall, with a sharp increase from the 2nd quarter of 2012 onwards. The expansion of sales space is reined in while retail sales go up. Sales floor productivity in 2013 reaches the level of the base year 2003.

CHART 3 vdp index for rents under a new lease
(2003 = 100)



Source: vdpResearch

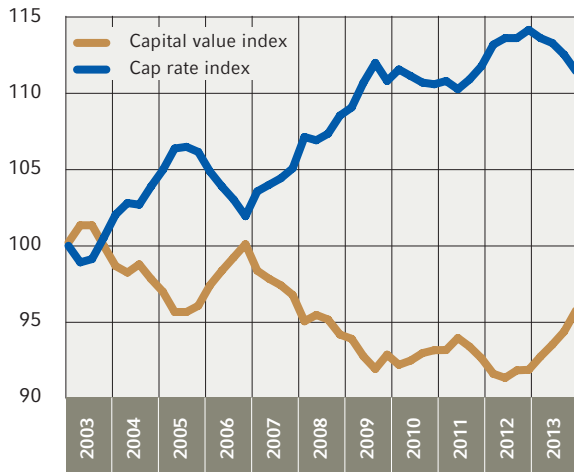
The highly frequented downtown locations of large towns and cities naturally post higher growth rates. It is here that an over-proportionally strong demand coincides with an extremely limited supply. Without question, the most expensive location for retail premises is Munich, followed by Frankfurt am Main, Stuttgart and Hamburg.

Cap Rate Falls, Capital Value Index Rises Again Slightly

As has been mentioned above, the retail market is extremely heterogeneous. On the one hand, the demand for retail space is concentrated mainly on prime locations, where it is usually well in excess of supply. On the other hand, the ongoing structural change in the retail industry and the insolvencies and closures which have occurred, in part, as a result is causing a rise in vacancy rates at locations that are not on the main shopping streets. The unoccupied retail properties range from small premises in secondary locations to large-area units such as vacated food discount markets and specialist stores which no longer meet these users' floor space requirements.

Rising vacancy rates and expectations of rising vacancies produced a trend of rising cap rates in the ten years under review. For more details, see Chart 4, which also shows a decline in cap rates (blue line) at the current end. This is a reflection both of the comparatively favorable economic development overall as well as of the strong demand – at specific locations – for retail premises for investment purposes.

CHART 4 vdp indices for capital values and empirical cap rates for retail buildings
(2003 = 100)



Source: vdpResearch

Consequently, the vdp capital value index for retail buildings, which is calculated as a quotient from two sub-indices (for rents under a new lease and for empirical cap rates), advanced again markedly in 2013. Having gained 3.7% compared with the 4th quarter of 2012, the index as at end-2013 stood at 95.6 percentage points, which was the highest level since the end of 2007.

Outlook

With retail sales space of around 1.5 m² per person, Germany has one of the highest densities of selling space by international standards. In terms of the stock of retail space, therefore, the market in Germany as a whole must be considered saturated. Nevertheless, the stock of retail space is expected to continue to grow slightly. Among other things, this is indicated by the following factors:

- Plans exist to open roughly 50 new shopping malls in the next five to ten years alone. Based on an average size of 30,000 m², this would mean an increase in sales floor space by around 1.5 million m².
- Expansion activities at specialist store centers are far from over. There will be a growing trend away from specialist stores at remote or stand-alone locations towards newly established agglomerations.

Overall, the stock of retail sales space is likely to increase by roughly 6 million m² by the year 2020.

EXCURSION:

Methodology for Calculating the Retail Index

In addition to the development of the capital values for retail properties in Germany, the developments of rents under a new lease and of the empirical cap rates over time are also shown as index series. The vdp transaction database is the empirical basis in calculating the indices. This database contains not only the transaction prices but also the main characteristics which affect the price, such as the floor area, age and micro-location of the properties. It currently comprises around 2.1 million datasets and is updated on a quarterly basis by, at present, over 260 participating banks representing all three pillars of the German banking sector.

Real estate is extremely heterogeneous. For this reason, to be able to measure purely the change in prices, the various characteristics of the respective properties have to be considered when measuring the prices. A number of methods exist today which appropriately take the different characteristics of the individual properties into account, making it possible to measure purely the change in prices. So-called hedonic models are used to calculate the indices for rents under a new lease and empirical cap rates for retail buildings. Such hedonic models are based on the idea that heterogeneous goods can be described in terms of their features. In other words, it is possible to portray a good as the sum of its various qualities and characteristics. With regard to a property, these may include, for example, physical characteristics such as the site area, living area and year of construction or information on a property's location. Each individual quality and characteristic affects the price of a property. However, there is of course no market for individual qualities or characteristics, meaning that they cannot be sold separately, nor can they be considered independently of the others. Yet it is possible to determine implicitly the contribution of each characteristic to a property's price by looking at the supply and demand situation. To this end, multivariate regression models are used with which the marginal contributions of the characteristics can be statistically estimated.

The index for rents under a new lease and the index for cap rates are calculated separately from each other. The capital value index for retail buildings is derived as a quotient from the sub-indices for rents under a new lease and cap rates.

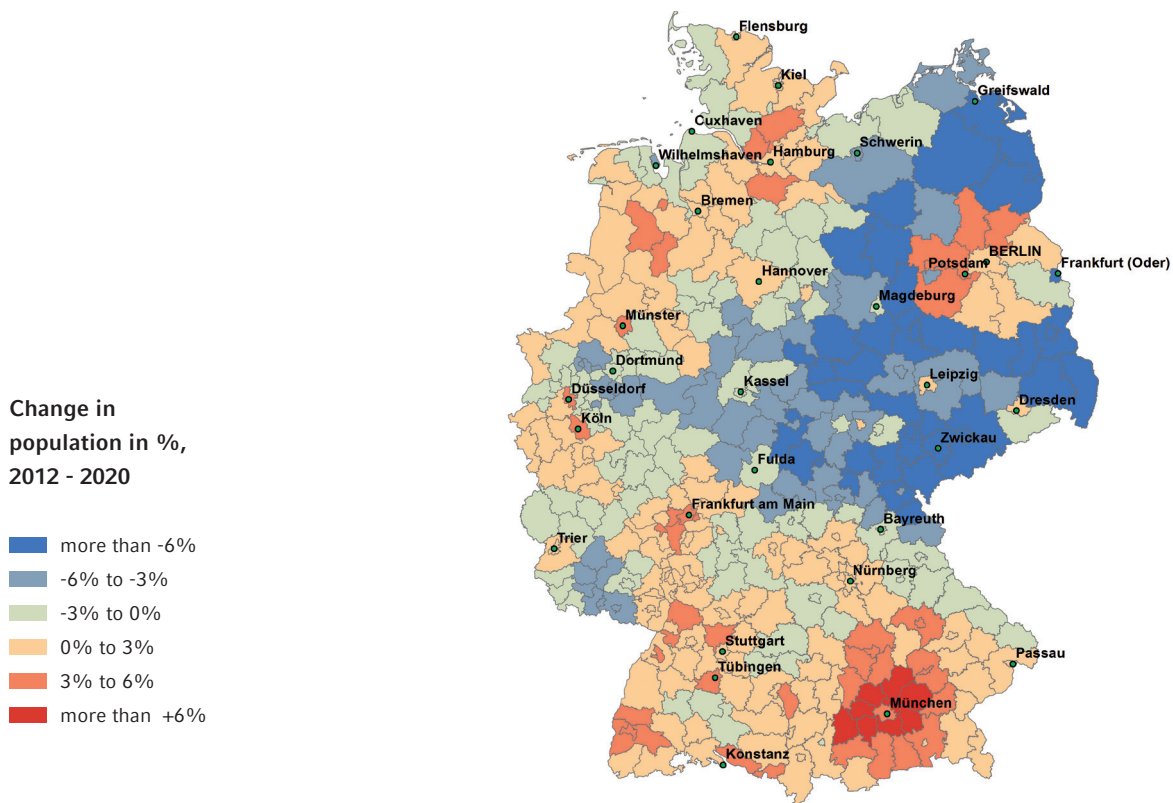
The indices were first published for the 4th quarter of 2013; the individual indices are measured dating back to the 1st quarter of 2013. The base year for all indices is 2003.

The future demand for retail space must be viewed in close relation to regional demographic and economic developments. For retailers, rising population figures tend to mean greater potential purchasing power, whereas purchasing power drops when the population decreases. At individual region level, it therefore only makes sense to increase retail space in regions in which the population will continue to rise. The projected demographic development for Germany at district level up to 2020 is shown in Chart 5. As may be seen, a considerable number of districts are expected to experience a, in some cases marked, decline in population by the end of the current decade. Thus, the risk of retail space vacancies is clearly higher in those regions in the medium to long

term than in regions for which population figures are forecast to go on rising.

The division of the market will also continue in individual towns and cities, where retailers are expected to withdraw increasingly from less desirable and less frequented shopping areas (subsidiary and remote locations). It will probably be difficult to re-let many of these premises, all the more as the importance of online shopping is set to grow further. Forecasts assume that, in 2020, at least 15% of retail sales will be generated through mail order business. Retailers must increasingly face up to this ongoing challenge. The structural change in the retail sector is therefore likely to continue.

CHART 5 Population projections at district area, 2012 - 2020



Source: vdpResearch 2014



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