

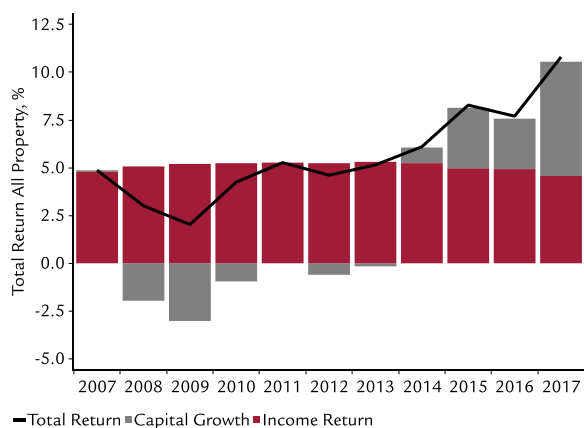
Real Estate House View Germany

Second half-year 2018

Key takeaways

- Despite a slight slowdown in the economy, the German real estate market is likely to continue its upward trajectory in the coming quarters and will be a principal focus of national and international investors.
- The office markets are currently driven by a shortage of available space. Even though completions will increase, there still is potential for rental growth.
- Store-based retail remains challenged due to continued growth in e-commerce. Only top high streets in a few cities and well-established shopping centres offer rental growth potential. Retail formats serving daily needs remain our favoured retail opportunity.
- In 2017, residential investments achieved the highest total return (16.6%) of all sectors. The ongoing scarcity of stock in the metropolitan areas as well as in numerous large and attractive mid-sized cities is pushing up rents and purchasing prices such that we can again assume a good performance in 2018.
- Initial yields for the major sectors are currently bottoming out at levels of about 3% for prime property. We expect flat movement in the short term.
- Transaction volumes are heavily dependent on interest rates. Thus, there are no signs that the high demand will be dampened in the foreseeable future.

Chart in focus



The strength of the German economy and real estate markets has been reflected in the performance of real estate investments in recent years. In 2017, the all-property total return reached a record level of 10.8%. With falling income returns, considerable capital growth has become the main performance driver – a remarkable development for the German market after decades of stagnation in capital gains.

After four years of GDP growth above 1.5%, we expect GDP growth to reach 1.8% in 2018. Yet, business sentiment indicators such as the purchasing managers indices (PMI) or the ifo Business Climate Index hint at slowing dynamics. The main reasons for the fading momentum are the appreciation of the euro, higher commodity prices and more reluctant corporate investment behaviour on the back of rising global trade tensions. Nevertheless, Germany continues to grow above its potential rate. Thus, the positive output gap widens further, resulting in rising wage pressure – a typical late cycle development. In this context the recent increase of inflation to 2.2% must be monitored closely. In our view, much of the increase is due to higher energy prices. Looking through this temporary phenomenon, we expect inflation to average between 1.5% and 2.0% in the medium-term.

Investments remain dynamic

In 2017, the institutional investment market generated a transaction volume of EUR 57 billion in commercial property and just under EUR 16 billion in residential property, confirming the high levels of previous years. Strong transaction activity continued in the first quarter of 2018, with JLL reporting a total of EUR 20 billion. Thus, assuming that the economy and letting markets remain in good shape and interest rates stay low, the transaction volume for full-year 2018 should be similar to previous years. Supply to the market should continue to grow – on the one hand through development projects and on the other hand through properties, which investors return to the market after having purchased them in an earlier stage of the cycle.

Still rental growth in offices

The continuing boom in the letting markets helped the office sector to achieve a total return of 10.3% in 2017, of which 5.9% was capital growth. The strong demand for space reflects ongoing employment growth and occupier relocation to attractive locations in or close to the city centers. The moderate completion figures to date are a key factor which has led to declining vacancy rates and upward pressure on rents in 2017 and early 2018. The increasing construction activity and expected completions in the next years will provide urgently needed additional modern space, especially in Berlin and Munich. It will also pose a certain risk for

rental growth but more likely in the top 7 than the regional markets. We confirm our expectation that rents are likely to increase in the short term, whereas momentum will slow down in the medium term.

Challenges in retail ongoing

A total return of 9.5% in 2017 represents a slightly below-average but historically very good result for the retail sector. However, the retail industry needs a differentiated view. We believe in the creativity and adaptability of store-based formats to compete with e-commerce in the long run, but we remain sceptical in the medium term, based on the challenging situation in current rental markets. Looking at the majority of high-street areas as well as at shopping centres, we assume that rents will stagnate at today's level or decline in less attractive markets and ordinary centres respectively. In contrast, retail parks are still in high demand, pointing to further rental growth.

Residential – thriving again

The residential sector achieved the highest total return of all sectors in 2017 at 16.6%. Even if previous years' returns are unlikely to be repeated, demand will continue to drive rents in the coming years. While completions increased slightly to 285,000 units in 2017 (+2.5%), building permits fell by around 7% at the same time, still far from meeting the needs of 400,000 units per annum. We assume that rents will increase by about 2% p.a. over the next years in the major cities.

Initial yields bottom out

Despite the predominantly good fundamentals, uncertainty about the future development of the investment markets – and above all the initial yields – is growing as the long-lasting market cycle goes on. In our view, current yields (of around 3% for prime office, retail and residential property) seem to have bottomed out, although further compression in individual locations and segments cannot be ruled out. At the same time, we expect stable yields for the coming quarters in our main scenario. In a changing interest rate environment, expected from end of 2019, yields are likely to increase slightly.

Chart 1: Demand and supply in the office segments of the Top 7 markets

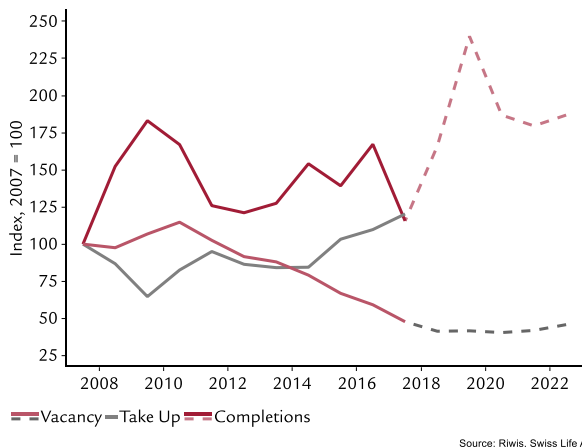
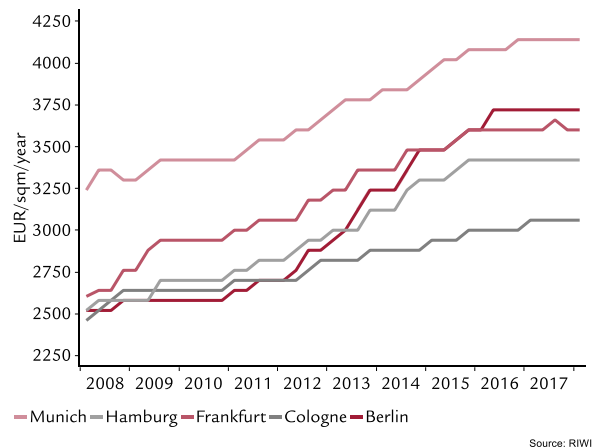


Chart 2: Rise in high-street prime rents turns into a sideways movement



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