

Real Estate House View

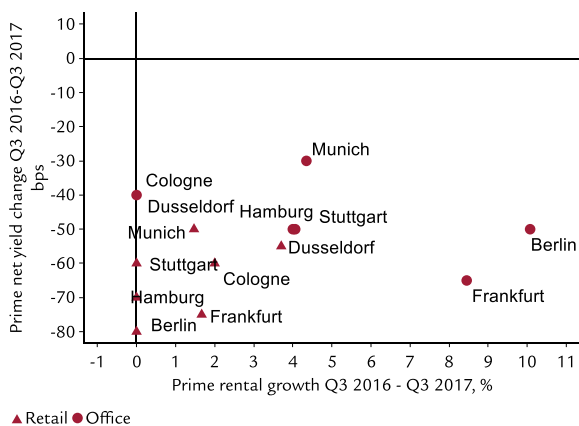
Germany

First half of 2018

Key takeaways

- The German real estate market is expected to continue its upturn in 2018 due to a strong economic tailwind and a persistently low interest rate environment.
- Office markets are benefiting from strong demand for space and moderate construction activity. Our expectations for ongoing rental growth are relatively strong in the short term and moderately positive in the medium run.
- We tend to be cautious about retail: only selected high streets and shopping centres can cope with the negative impact of online shopping thanks to their high quality of shopping and leisure facilities. The situation is more favourable for retail formats for daily needs.
- The residential markets in the major cities are suffering from tight supply, rents and prices continue to trend upwards.
- Investors' appetite plus sufficient but still limited supply raised transaction volumes in 2017 compared to 2016. Supply is unlikely to run out in 2018, as early-stage investors are likely to decrease their exposure.
- Yields are still under pressure, but show signs of bottoming out in some segments. The low interest rate environment is expected to prevent a noticeable increase in initial yields in the short and medium term.

Chart in focus



2017 was characterised by ongoing, strong yield compression as well as noticeable rental growth in the office sector, and by more modest growth in retail. Looking at 2018, yields are expected to bottom out although some markets or segments may exaggerate.

Low interest rates and a competitive export sector are providing a tailwind for Germany's economy. Sentiment indicators like the ifo business climate index reached record levels by the end of 2017. The firm labour market suggests rising wage pressure going forward, resulting in a positive contribution to growth from private consumption. In light of the continued euro appreciation, we expect overall growth dynamics to moderate slightly. The strong Euro, however, is limiting inflationary pressures through lower import prices. A failure in the talks to continue the coalition government poses a certain short-term risk but should not impact the outlook as regards to medium-term economic growth. Regardless of the composition of the next government, we expect a net positive contribution to GDP growth from the fiscal policy.

Effects of economic performance on office segment

Driven by the good economic environment, the demand and take-up in the top 7 and the secondary markets increased in the course of 2017. Despite strong demand and decreasing office vacancies, construction activity is still moderate, and there are currently no indications of any significant changes. Office projects increasingly compete with residential or hotel projects, which are more attractive for developers in many locations. As a result, vacancy rates have fallen again in 2017. The scarcity of space mainly affects the central locations. Market conditions create the basis for further rental growth: Berlin and Munich are currently posting the strongest rental growth and we expect rents there to increase at above-average rates in both the medium and the long term. Frankfurt is likely to benefit from relocations from London. However, the effects on the office market should not be overestimated, especially as the domestic financial sector is facing further cuts in employment.

Cautious optimism in retail

The favourable economic conditions are pushing up sales in Germany's retail sector (+3.3% in H1 2017) but store-based retailing is suffering from competition from online trade, changing consumer habits and the weakness of the fashion sector, which is particularly affecting domestic retail chains. The rental market for

retail space in many high street areas and shopping centres has changed noticeably in the last quarters: it is no longer only the large and mid-size cities but the top 7 markets that have been hit by decreasing demand, causing vacancies and stagnating or even declining rents. Above all, it is larger units that are affected, while smaller premises continue to be well let. For the short and medium term, we expect a stagnation of rents at today's level and some pressure in less attractive markets. However, there are some outliers where rental growth is close to the level of inflation: Munich (due to its economic power) and Berlin (as a major hub of tourism) are a starting point for the market entry of new retailers. In the shopping centres segment, dominant schemes with a high proportion of leisure facilities and a variety of shops offer ongoing slight rental growth. However, the majority of centres weakens, e.g. suffering from the uniform range of goods, resulting in stable or declining rents. The retail warehouse segment is hardly affected by e-commerce and, in our opinion, currently has the best prospects in the retail sector. Food and drug stores continue to expand and are willing to pay higher rents in competition for market shares.

Residential continues to boom

Migration to large cities and to selected large and medium-sized towns will remain the fundamental driver of the local housing markets. New construction (278,000 units in 2016, with about 320,000 estimated for 2017) is far from meeting the requirement of 400,000 units per annum. In 2017, the number of building permits even declined. Over the next few years, rents are expected to rise by circa 2% p.a. in the major cities.

Investments reaching new records

In 2017, transaction volumes for commercial and residential property reached new record levels and are much higher than expected at the beginning of the year. Forward deals gained in importance again, especially in the residential sector. Yields are still under pressure but show signs of bottoming out. Prime yields are expected to stabilise but a further decline cannot be ruled out in some segments in the short term.

Chart 1: Office vacancy levels become a burden for the letting markets

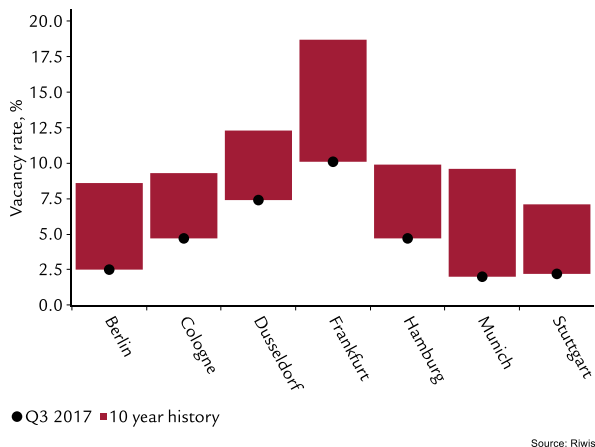
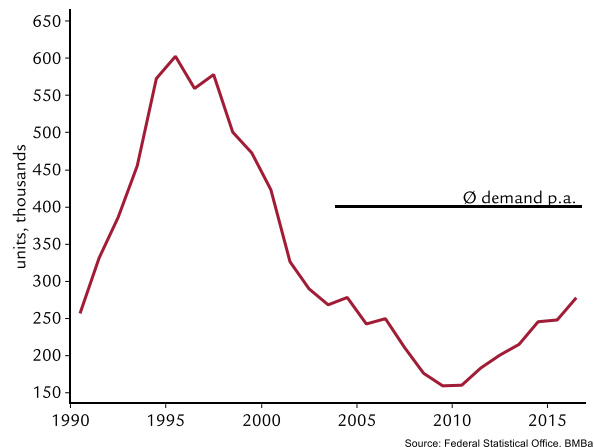


Chart 2: Construction activities in the residential sector: actual completions and demand



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