

No one-way street

As in the past, retail property has proved less volatile in the most recent crisis (see p. 2). The improvement in the real estate markets is proceeding in tandem with the economic recovery. However, this development is not a one-way street: the data from the US shows, for example, that the road out of the deep slump can be a bumpy one (see p. 3). At first the value of high-quality real estate objects in the investment market recovers, with rental markets usually following with some time lag. And given the existing excess supply, it can also be some time before construction activity revives (see p. 4 for Germany).

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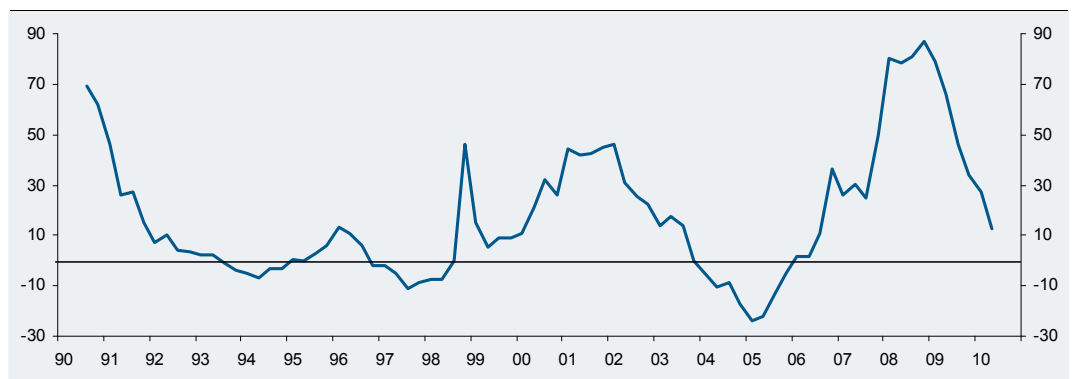
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1	At a glance	1
2	Selected real estate analyses	2
2.1	Real estate returns: retail more attractive than office	2
2.2	Bottom formation in commercial US real estate	3
2.3	German commercial construction will grow only little	4

1 At a glance

Commercial real estate lending less restrictive in the US

Domestic respondents tightening standards for commercial real estate loans, % net



Sources: Senior Loan Officer Survey of the Federal Reserve, Helaba Research

Lending by US banks for commercial real estate has eased noticeably since the height of the financial and economic crisis. While at the peak at the end of 2008 nearly 90 % of loan officers at the banks reported more restrictive lending, that figure had dropped to only 12.5 % in the second quarter of 2010. Likewise, the proportion of those who perceived a declining demand for commercial real estate loans has declined markedly. With that, the lights should slowly switch to green also in the area of real estate financing.

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2 Selected real estate analyses

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2.1 Real estate returns: retail more attractive than office

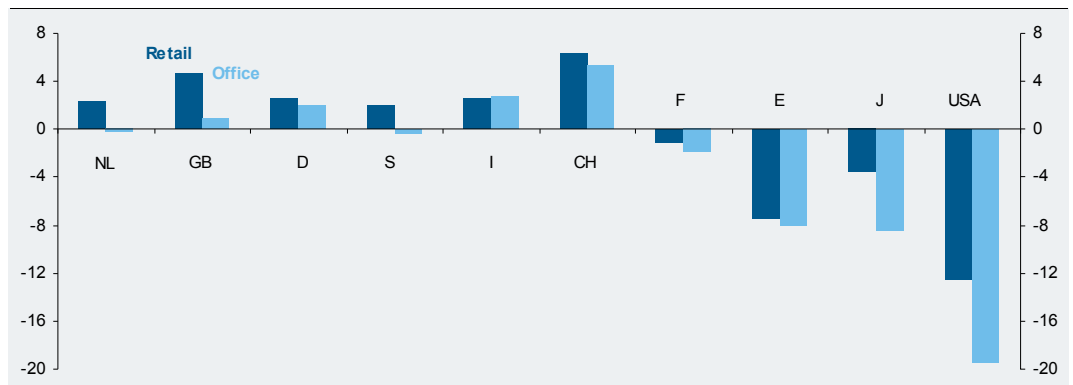
In many countries, retail property did better in 2009 in a difficult environment than office. However, the retail sector has also generated higher total returns on average than office over the last ten years – and it has done so with mostly lower volatility. From the perspective of investors, retail should therefore be given preference.

Clear differences
by sectors

The global index of Investment Property Databank (IPD), which brings together the performance data of institutional real estate investors from a total of 23 countries, posted a decline of 7.3 % in local currency last year. Of interest are especially the results of the various sectors. With 42 %, office constitutes by far the largest component of the global index, followed in second place by retail with 26 %. Last year, the performance by office space, at a total return of -8.5 %, was noticeably worse than retail (-4.2 %). This reflects primarily the stronger cyclicality of the office market, which is surpassed only by that of the industrial sector (performance 2009: -12 %). The outperformance of retail objects is also confirmed by the IPD real estate indexes on the national level. In 17 of 23 countries, the total return on retail real estate was higher than in the office sector.

Shopping centers beat office towers

Total return on real estate investments 2009 in local currency, in %



Sources: IPD, Helaba Research

Retail ahead also
in the long-term

The better performance by retail property is not an isolated phenomenon. Looking at 10-year averages, the sector is also ahead of offices in leading real estate markets. For example, German retail real estate has achieved an average annual performance of 4.3 %, compared to only 2.6 % for office space. This difference is even more pronounced in the US (8.7 % versus 5.9 %). This better performance went hand in hand with a lower volatility. Given the more favorable return-risk profile, retail should thus be given preference from the perspective of investors.

Reasons for the higher attractiveness are likely to be found in the more stable development of the retail trade, while the office sector is determined more strongly by cyclical trends. Moreover, the trend toward modern shopping centers might have contributed to the better performance, as they are found more prominently in the portfolios of the institutional investors included here, while problematic retail real estate, for example objects in bad locations, are likely to be underrepresented. However, the drastic consolidation that is coming and foreseeable restraint by consumers should weigh on consumer spending in some countries, which means that a further above-average development of retail property is not assured everywhere.

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2.2 Bottom formation in commercial US real estate

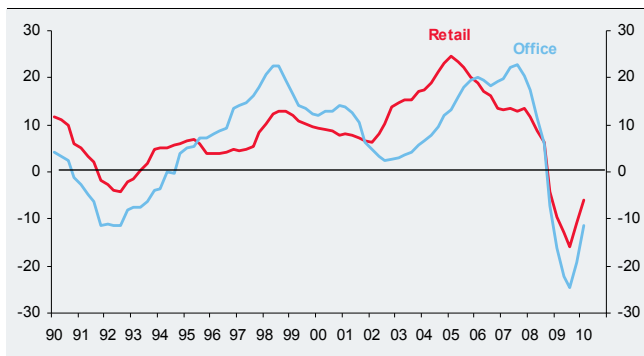
Commercial US real estate lost more than 40 % of its value in the recent crisis. With that, the correction should have been largely carried out. In the coming years, however, risks emanate from the very high refinancing volume.

Decline in real estate values has slowed

The financial crisis, in conjunction with a shrinking economy, has led to a strong decline of commercial real estate values in the US. The total returns on directly held real estate have been negative since the middle of 2008. For 2009, the NCREIF Property Index, which is adjusted for leverage, posted a total return of -16.8 % over the previous year. With a minus of 19 %, the development in the office segment was worse than that of retail real estate (-11 %). On a quarterly basis, the largest percentage decline in the index occurred at the end of 2008, and since then the downtrend has slowed. A slight increase is now being reported for the first time again in the first quarter of 2010 (+0.8 % over the previous quarter). And here one should take into consideration that the index, which is based on appraiser assessments, tends to lag the activity in the market.

The worst is over

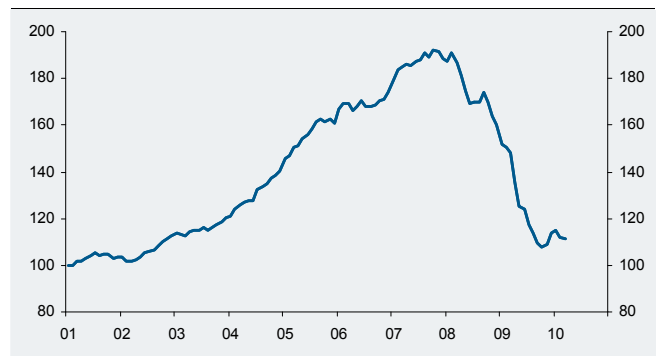
NCREIF Property Index, total return, % yoy



Sources: Datastream, Helaba Research

Bottom formation with transaction-oriented prices

Moody's/REAL CPPI, 12/2000 = 100



Sources: Moody's/REAL, Helaba Research

Transaction-based indicators are also signaling a stabilization of commercial real estate prices, though the market is still a long way from an upswing. Since its high at the end of 2007, the Moody's/REAL Commercial Property Price Index had fallen by nearly 44 % at its lowest point last fall. Increases were seen again on a month-over-month basis between November 2009 and January 2010, which were then followed by a setback in February and March. Overall, the price level was most recently still 42 % below its high. However, one should bear in mind that the evidentiary value of these indexes is fairly limited at this time, given the still rather small number of transactions.

Risks from high volume of refinancing

In the coming quarters, the expiring financing of real estate that was acquired during the phase of high prices could unsettle the market. Many financing arrangements, by which transactions were carried out before the crisis with a very high leverage, are set to expire only this year or in the coming years. Given the sharply lower real estate prices, in many cases the loan volume currently exceeds the actual value of the objects. As a result, a number of refinancing efforts could fail and thus lead to distress sales, which are a burden on the market. Against the background of the still low demand in the real estate investment market and declining rents, we believe that a palpable recovery of commercial real estate values in the US is likely only later in 2010.

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2.3 German commercial construction will grow only little

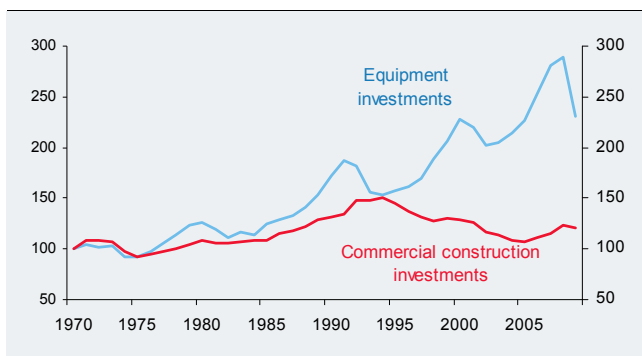
Stabilization in commercial construction in Germany is foreseeable. However, over the medium term, against the backdrop of equipment investments that are rising once again, we expect to see only restrained growth in commercial construction.

Little growth in commercial construction over the medium term

The erection of commercial buildings presupposes an investment decision by businesses. To that extent there should be a close connection between the development of equipment and commercial construction activity. However, over the last two decades, the link between these two components has loosened in Germany. Whereas from the seventies to the middle of the nineties a rise in equipment investments always went hand in hand with a growth – weaker, to be sure – in commercial construction investments, that was no longer the case in the following decade. Evidently it was increasingly possible to use already existing buildings for new equipment. In the office sector, the higher efficiency of space is also likely to have contributed to this development. Since there will be little change in these trends, the expected rise in equipment investments is likely to stimulate commercial construction only below average over the next few years.

De-coupling of equipment and commercial construction

Real investments, Index: 1970 = 100

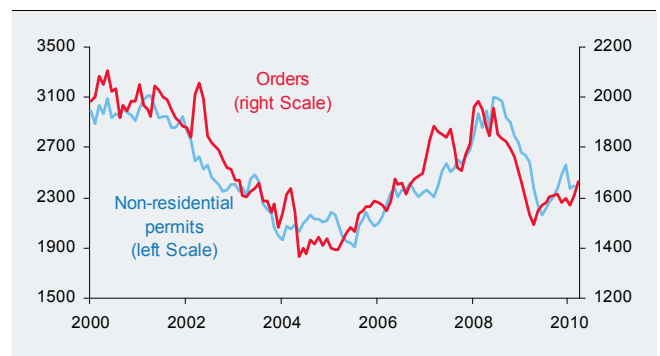


Sources: Federal Statistical Office, Helaba Research

Trend reversal in commercial construction

Floor space in 1,000 square meters

in million €



Sources: Feri, Helaba Research

Commercial construction has come off its low point

Commercial construction investment dropped by a real 2.9 % in 2009. Industry-related construction, in particular, suffered from the sharp decline in investments: for example, permits for factory buildings shrank by nearly 40 %, with retail and warehouse buildings the decline was about a third. Office and administrative buildings more strongly sought after by service providers dropped by “only” 13.5 %. Here the higher vacancy rates that had risen in the face of weak demand had a negative effect. By now, however, the economic situation in commercial construction has stabilized. At least the level of incoming orders in the first quarter of 2010 was more than 10 % above the low level of the previous year. Although permits are still noticeably below last year’s level, the low point was already reached in the middle of 2009. Since then the trend has been upward.

In the first quarter of 2010, the entire construction industry in Germany was impeded by the unusually severe frost. The second quarter is likely to be marked by catch-up processes. The situation in commercial construction should also continue to improve. Capacity utilization in the industry, which had declined sharply in the wake of the serious recession, has risen most recently to around 80 % and is thus only three percentage points below the long-term average. With that, businesses are thus likely to start looking at expansion investments more seriously once again. The improved economy and rising corporate profits will stimulate investments, which contributes to stabilizing commercial construction. After a decline in commercial construction of around 3 % this year, growth is likely to be only moderate over the medium term. ■