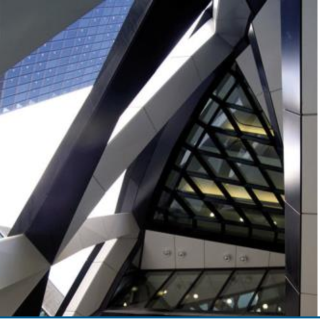

Helaba Research

REAL ESTATE REPORT

13 December 2016

Real estate outlook 2017: more of the same?

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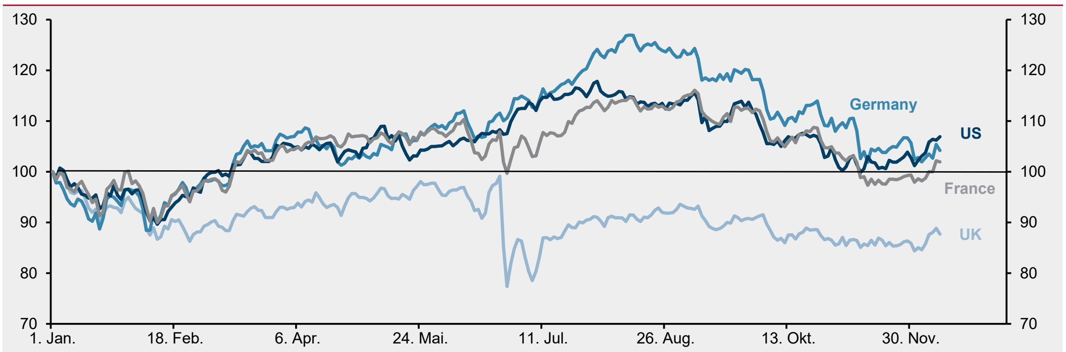
- There should be no fundamental change in the low interest rate environment in 2017, and framework conditions remain positive in most real estate markets. With that, the uptrend is entering its eighth year (p. 2).
- German open-ended real estate funds should post only a marginally higher performance in the new year. The net inflow of funds will not reach the very high level from 2016 (p. 3).
- The election of Donald Trump does not fundamentally change the 2017 outlook for US real estate. We believe that expectations of higher growth are exaggerated (p. 4).

1 At a glance

Fears of rising interest rates and the Brexit weigh on real estate stocks

EPRA FTSE/NAREIT real estate equity indices, total return in local currency, 1 January 2016 = 100



Sources: Datastream, Helaba Research as of 12 Dec. 2016

Real estate stocks in the US and Europe have given back the noticeable price gains from the summer. Rising capital market interest rates and higher inflation expectations, in particular, are weighing on the “brick-and-mortar” stocks that are traditionally sensitive to interest rates. Since the beginning of the year, German and US real estate stocks have posted a plus. By contrast, the weighty real estate sector in the British stock market is lagging behind. After the discussion leading up to the EU referendum already led to a palpable underperformance, the surprising outcome of the vote triggered a price slump that has not been made up so far. In view of the uncertainty about the beginning and the outcome of the Brexit negotiations, British real estate stocks should not be the first choice in 2017, either.

2 Selected real estate analyses

2.1 The hoopla in the real estate market continues

In our recently published outlook for the next year[1], in the base scenario (with a probability of 75 %) we look for interest rates only to rise modest in Germany. The demand for “bricks and mortar” will remain high in the continuing low interest rate environment. Since it is becoming increasingly difficult for investors to acquire attractive properties, the trend of rising real estate values will continue. With that, the market is in the eighth year of an uptrend.

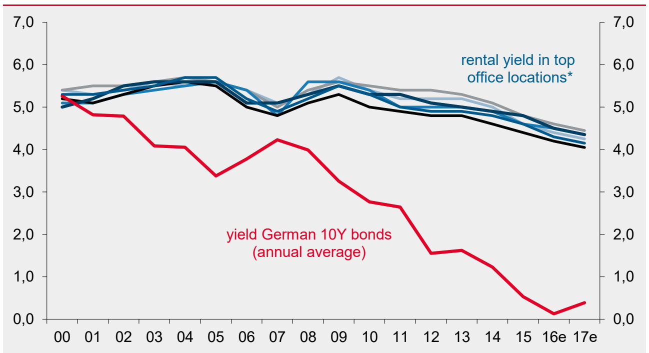
Transaction volumes in the commercial real estate market are likely to be well below the highs of 2015. This is attributable not so much to a waning demand, but primarily to the tight supply of high-quality properties. One exception to the trend of rising real estate prices in Europe is Great Britain, where a correction has begun in the wake of the Brexit referendum. So far this correction has been contained, but it could pick up pace if, once the Brexit negotiations have begun in the spring of 2017, more and more companies announce that they will be moving.

Rental yields remain under pressure

In general, investment markets should continue to run ahead of the rental markets. This puts sustained pressure on rental yields, which in many cases have already fallen below the level of 2006/2007. Against the background of only slightly rising yields for German sovereign bonds, the risk premium remains high and the attractiveness of the real estate investment is in place. Solid economic growth is causing a rise in the demand for space in most European office markets, and given mostly moderate construction activity, this is leading to rising office rents. Thus, vacancies in the leading German office locations have by now dropped to the lowest level since 2002, and the rise in office rents for good locations should continue in the range of 2 % - 3 % in 2017.

Risk premium only marginally lower

%

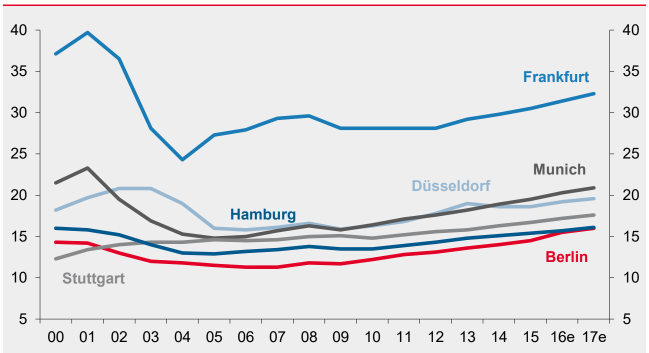


*Berlin, Düsseldorf, Frankfurt, Hamburg, Munich, Stuttgart

Sources: Feri, Datastream, Helaba Research

Office rents in top German locations on the rise

Average office rent in good location, euro/m² monthly



Sources: Feri, Helaba Research

Alternative scenarios for the real estate market

In our **negative alternative scenario** (likelihood: 15 %), the global economy is on the precipice of recession, triggered by increasing restrictions on global trade. Germany is particularly hard hit by this. Anti-European parties gain the majority in the upcoming elections. Investors seek security and flee into German sovereign bonds and US Treasuries. In spite of very low interest rates, real estate suffers a price correction, since the fundamentally poorer state of affairs is a burden.

By contrast, in the **positive alternative scenario** (likelihood: 10 %), global growth continues to accelerate steadily. While real estate loses some of its attractiveness in the face of a stronger rise in interest rates, this effect is largely compensated for by the significantly improved situation in the rental markets. As a result there will be no negative price effects.

[1] See „Markets and Trends 2017: The World is Driving Bumper Cars“, 21 November 2016.

2.2 Open-ended real estate funds: modest return, smaller inflows

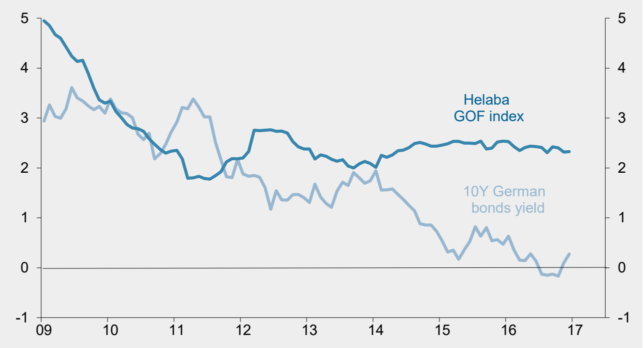
German open-ended funds should post only a marginally higher performance in the new year and remain interesting to investors. The net inflow of funds will not reach the large volume from the previous year.

Only slightly higher performance 2017

The annual performance of the "Helaba GOF-Index" in 2016 is expected to be 2.4 %, similar to the previous two years. The index encompasses nine German open-ended funds (GOF) that are open to private investors; these funds are weighted equally. The liquidity in the portfolios, which no longer accrued interest most recently, is depressing the results. Moreover, the valuation by experts should have the result that positive price trends in many real estate markets will have a weaker and time-delayed effect. For 2017, for the average of the investable public funds we expect only a slightly higher annual performance of 2.7 %. Real estate values in Germany – with a share of around 32 % of the market value by far the largest item in the portfolios – and France (share: 13.6 %) will continue their positive development. However, the important British market (about 10 %) will trend toward more or less weakness, depending on the course of the Brexit negotiations that are set to begin in spring. Finally, the US real estate market, in which on average about one tenth of the funds are invested, is losing dynamism (see p. 4). In spite of the trend reversal in the bond market, the yield on 10-year German sovereign bonds remains low in the new year – we expect a range between 0 % and 1 %. With that, the gap between the annual return on GOF and alternative investments in the bond market will shrink only marginally, and this real estate investment will not lose attractiveness in any palpable way.

Relative attractiveness still in place

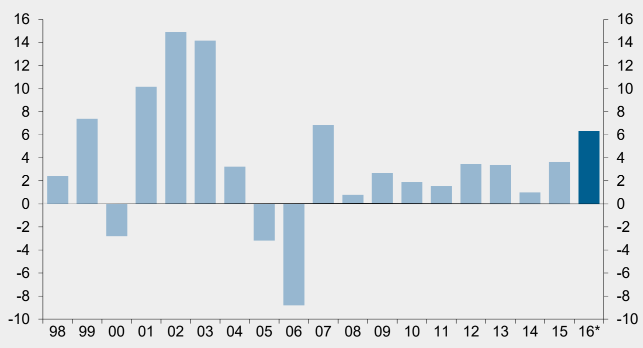
Annual return GOF index and yield on 10-year Bunds, %



Sources: Datastream, Helaba Research

Highest fund inflows in years

Annual net funds inflows in GOF, billion Euro



*2016: January – September

Sources: Datastream, Deutsche Bundesbank, Helaba Research

More fund inflows than desired

Between January and September 2016, net inflows of the GOFs, at nearly 6.3 billion euro, were substantially above the same period during the previous year. Although the trend recently declined for several months, higher inflows were reported again for September at 630 million euro. In spite of measures by some fund management to limit the inflows of funds, the high value of 2007 (6.8 billion euro) is coming into sight. However, that figure was also a reaction to the large outflows of 8.8 billion euro in 2006. The size of the inflows is becoming increasingly problematic for the funds, since liquidity is in most cases already high and suitable properties are harder and harder to find. This goes in hand with the danger of now acquiring properties at inflated prices or diverting into riskier niche markets. We posit that the large fund providers will largely resist that temptation and will stick to their rather conservative investment strategy. However, that will function only if the most recently large inflows in 2017 can be contained, for example through the setting of quotas. But even if the four large providers of GOF should hold back, the market segment of 88 billion euro will continue to grow. That is suggested not least by plans for new open-ended public funds and the re-opening of the last frozen fund at the end of November. Most recently, funds in the amount of 8.8 billion euro were in funds that are being liquidated.

2.3 US real estate after the election

The election of Donald Trump does not fundamentally alter the 2017 outlook for US real estate. We do not believe that euphoria is justified.

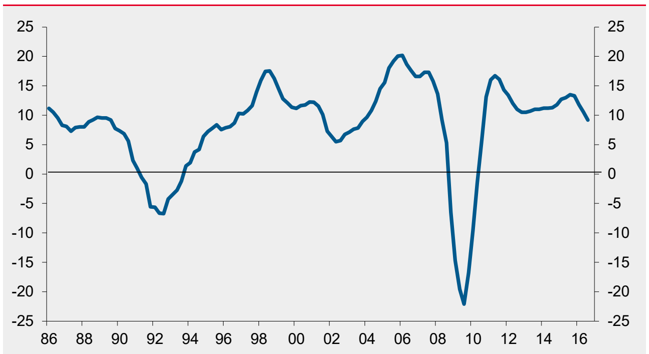
Still great uncertainty about the exact shape of economic policy

The reaction of the capital markets to the surprising electoral victory of Donald Trump was unequivocal. Rising stock prices and a robust rise in yields on US Treasuries suggest that many market participants are now expecting greater economic growth, a strong rise in budget deficits, and more inflation. That verdict is surprising, as there is still great uncertainty about the precise shape of future US economic policy. Only after the new president assumes office in January and the administration gets to work in the spring will we be able to gauge when we can expect what sort of concrete measures. The real estate sector can then be affected in multifarious ways by the repercussions of those measures, with the usual delays.

For example, an improved infrastructure and lower corporate taxes would also benefit the real estate companies. The construction and real estate sector could likewise profit from the intended deregulation, especially in the financial sector, via improved terms of financing. We posit that the real estate tycoon Trump will not burden his own industry with measures specific to this sector. On the whole, however, unlike other forecasters we do not expect a growth boost for the US economy. Potentially positive impulses are countered by presumably growth-dampening effects from the expected protectionist trade policy and a more restrictive immigration policy. All in all, economic growth of 2.2 % can be expected for 2017 – which would be more dynamic than in the euro zone at 1.4 %.

Normalization of returns in the investment market

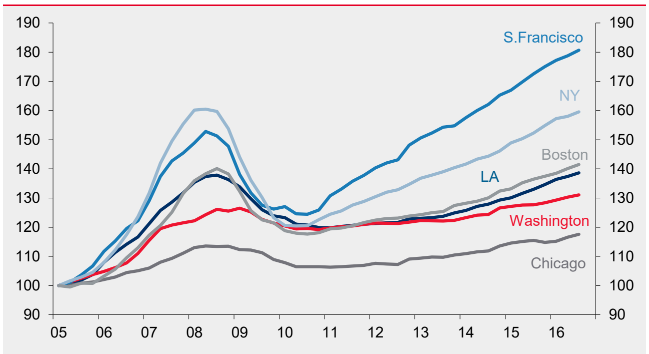
NCREIF Property Index, total return, % y/y



Sources: NCREIF, Datastream, Helaba Research

Office markets with varying dynamic

Effective office rent Q1 2005 = 100



Sources: REIS, Helaba Research

In view of what is by now largely full employment, this growth will not produce any special impulse for the office market. In fact, a restriction on immigration could weigh on sectors that depend on the influx of qualified workers. Positive effects for the retail trade should come less through employment growth or tax relief and more from stronger wage hikes, though overall they should remain moderate. A protectionist trade policy would impair at least parts of the logistics market through higher tariffs, declining imports, and shrinking global trade.

No trend reversal for US real estate in 2017

All in all, from the perspective of today we do not see a trend reversal in US real estate through the change of administration in the White House. The commercial real estate market is at an advanced stage, though not at the end of its upward cycle. Annual total return, as measured by the NCREIF Property Index, has declined to 9.2 % in the third quarter, a year ago it stood at 13.5 %. This normalization should continue in 2017. The biggest risk to the sector should be another robust rise in interest rates, if we do see an especially expansionary fiscal policy with a much higher national debt and a strong rise in inflation expectations. ■