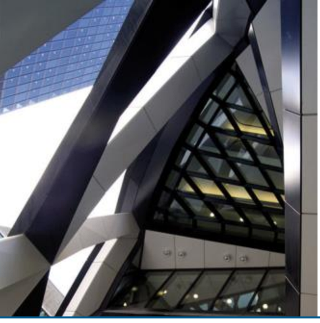

REAL ESTATE REPORT

30 March 2017

Challenges

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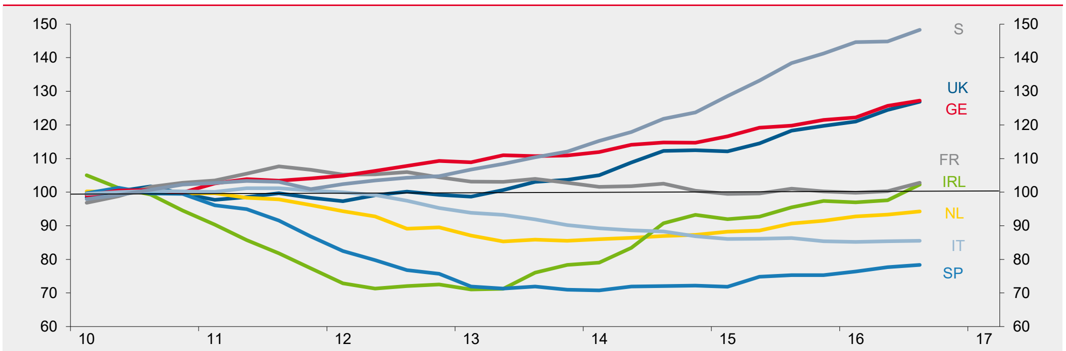
- A collapse of the German housing market is not imminent. When a turnaround will begin and how things will proceed from there can hardly be determined (p. 2)
- The British government has triggered the Brexit. What has happened in the British real estate market in the nine months since the referendum, and where does it go from here? (p. 3)
- The growing online commerce is a major challenge to brick-and-mortar retail trade. This will not leave retail properties unaffected (p. 4)

1 At a glance

German housing prices not at the top by international standards

Housing price index (Eurostat), 2010 = 100



Sources: Datastream, Helaba Research

In the discussion about the price trend in the German housing market (see p. 2), people like to point also to the development of housing prices in other countries. It is true that the German housing market did not experience the price increases – in some cases extreme increases – in the run-up to the financial crisis that we saw in other countries. However, since 2010 German housing prices have been quite far ahead compared to other European countries. According to the indices of the European statistical office, they are at about the same level as the UK. Residential property prices have risen most sharply in Sweden. In Ireland, Spain, or the Netherlands, the recovery process following the housing market crisis has progressed to a greater or lesser extent. By contrast, in Italy the downtrend is continuing. The French housing market is proving less dynamic: in terms of the country average, no meaningful price increases have taken place in recent years.

2 Selected real estate analyses

2.1 German housing market: no panic!

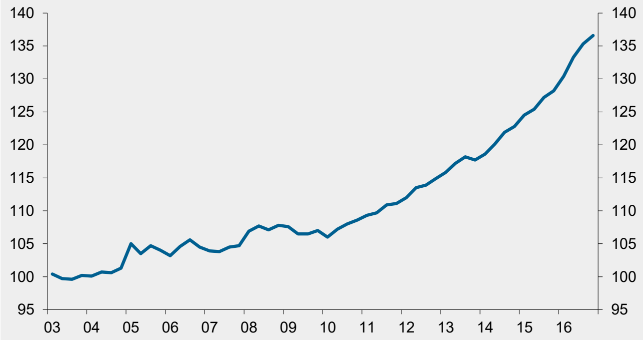
A prominent voice has recently proclaimed the near end of the boom in German housing prices. This has sparked a lively discussion about the outlook for the housing market, a discussion in which we are happy to participate.

Excess valuations say nothing about the timing of a turnaround

German housing prices have been rising since 2010. In terms of a national average, the rise has continued fairly consistently in recent years and has by now reached a respectable level. Should this trend continue at about the same pace, the price increase overall would be equivalent to what we saw in the period between 1987 and 1994. The German Bundesbank has repeatedly pointed to an existing overvaluation – most recently in its February monthly report: "According to current estimates, housing in German towns and cities was overpriced by between 15 % and 30 % in 2016." Excess prices notwithstanding, they alone offer at best indications of how susceptible to correction a housing market is. Whether a bubble exists and when it might burst (or, in the more benign variation: when a downswing in a fundamentally cyclical market begins) are not questions they can answer. Historical experience shows that such a turnaround is usually triggered by an external disruption.

No signs of fatigue so far

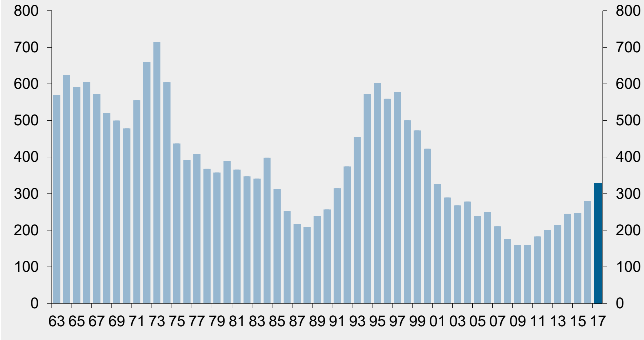
vdp price index for owner-occupied housing 2003 = 100



Sources: vdp (Association of German Pfandbrief Banks), Helaba Research

Need for construction activity continues

Housing completions in Germany*, thousand



*before 1993: West Germany

Sources: Federal Statistical Office, Helaba Research

Fundamental reasons for price increase

The development of supply and demand in the German housing market has so far provided good reasons for a further rise in housing prices, especially in the large conurbations. After all, robustly rising population figures in those areas are creating a growing demand for living space. Although construction activity has been increasing for several years, so far it has lagged behind demand. Even if the level of 300,000 units can be breached this year in housing completions, the tight situation in many large cities will not (yet) ease. Moreover, little is likely to change in 2017 in the very favourable financing conditions, another driver of the upswing.

Of course, the uptrend in the German housing market cannot go on forever, and there is no doubt that it is in a mature phase of the cycle. But it can hardly be determined ahead of time when that upward trend will stop. And where things go from there is also uncertain: perhaps a cooling off with merely moderated price increases, or possibly a downswing with moderate declines. However, we consider a collapse of the German housing market – which tends to be rather less volatile by international standards and is financed rather conservatively – as fairly unlikely. While even the massive oversupply following the end of the reunification boom did lead to a very long phase of weakness, the price declines back then were moderate in terms of a national average.

2.2 British real estate: nine months later and none the wiser

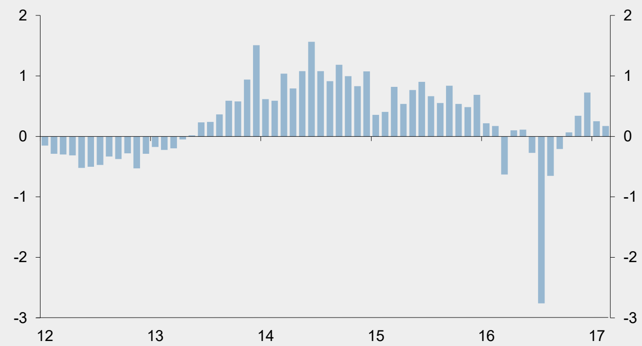
Even nine months after the referendum we are none the wiser about the impending exit of the British from the European Union. Although the Brexit was formally triggered on March 29, major uncertainties persist about the course of the negotiations that will now get under way. But at least the initial effects on the economy and specifically the real estate market can be analysed.

British economy robust so far

So far, the British economy has digested the “Brexit shock” surprisingly well. In the final quarter of 2016, GDP grew robustly at 0.7 % over the previous quarter, which means that economic growth for the year overall reached 1.6 %. Business sentiment slumped only immediately following the referendum, but then returned quickly to the previous optimism. Consumers also proved robust, even if a noticeably setback took place most recently with retail sales. However, only the figures over the next few months will show whether or not this represents a trend reversal. The weak development in investment, at least, could be an expression of the heightened uncertainty concerning the approaching Brexit. The critical factor remains how the exit negotiations between the UK and the European Union, which are to begin in April, will unfold. Should it become apparent that a compromise solution will be found, the economic consequences for the country would be less negative than in the case of a “conflictual divorce.”[1]

So far only moderate corrections

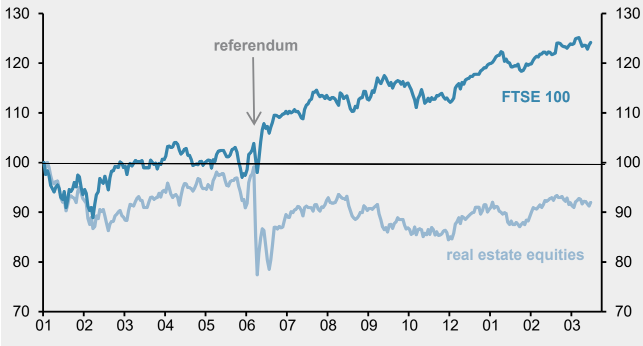
IPD/MSCI Property Index UK, capital growth, % mom



Sources: Datastream, Helaba Research

Real estate stocks pricing in certain problems

British equity indices, 1.1.2016 = 100, total return in lokal currency



Sources: Datastream Helaba Research

The British real estate market has evidently been playing out the compromise scenario so far. Although the transaction volumes in the investment market have declined noticeably – about one quarter for the year as a whole for commercial real estate – the important British market could become interesting again to foreign investors because of the strong depreciation of the pound. The monthly change in capital values reported for British commercial real estate according to the MSCI Real Estate Index briefly dropped noticeably following the referendum, only to recover again toward the end of last year. For the year as a whole, the result was a minus of 2.8 %. However, the price development slowed between December and February.

Renewed downward pressure expected

The most recent consensus forecast by the Investment Property Forum (IPF) shows that the majority of market participants expected another downtrend during the course of this year. However, with an expected value loss of 1 ½ % in 2017, the assessment in the February survey was less negative than in the previous survey in November (-3.6 %). Specifically, the expected decline in real estate prices is – not surprisingly – most pronounced in the office sector (and here especially in London with nearly 5 %), while a slight plus was in fact posited for logistics/industrial property. The British real estate stock market, too, is not showing such a pronounced insouciance: compared to the national stock market, it has lost substantial ground since the referendum and has not recovered in any meaningful way since then.

[1] We have not altered the Brexit scenarios and their probability since the referendum. On this see the Real Estate Report of June 29, 2016: “Real estate markets after the Brexit vote.”

2.3 Online commerce: bogeyman for brick-and-mortar retailers?

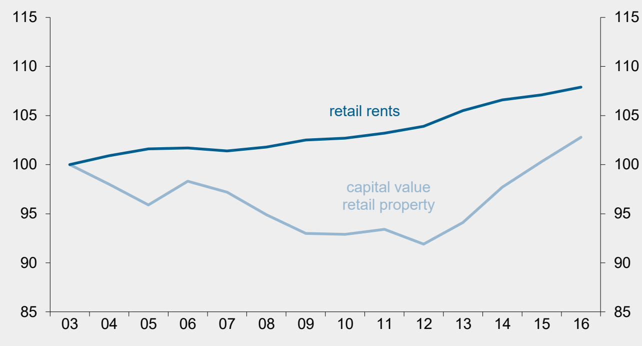
The Internet continues to be a major challenge for brick-and-mortar retailers. The increasing spread of multi-channel strategies does little to change this. Is e-commerce responsible also for the anemic trend in German retail rents most recently?

Online commerce represents 10 % of German retail trade

Three years ago was the last time we examined, in the Real Estate Report, the effects of online commerce on the brick-and-mortar retail trade and thus on retail property in Germany. Since then, sales in internet commerce have risen more strongly than German retail sales overall. According to the data of the German retail trade association HDE, Internet sales grew by a nominal 10.6 % in 2016, whereas they rose around 2 % in retail trade (ex cars, gas stations, and pharmacies). A comparable dynamic is evident for 2017. Through the higher sales growth, the share of online commerce in the last five years increased from 6 % to a solid 9 %, and it should break through the 10 % threshold this year. Although the growing Internet sales are lost to traditional retailers, the latter will be able to continue to post moderately rising sales.

Retail real estate with little dynamism most recently

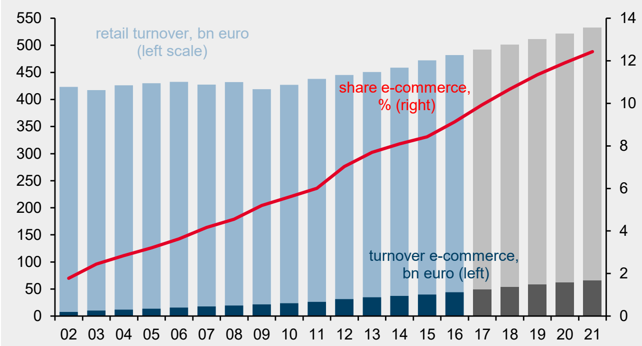
vdp price index for retail real estate, 2003 = 100



Sources: vdp (Association of German Pfandbrief Banks), Helaba Research

Continuous rise in German online commerce

Billion Euro %



Sources: HDE, Helaba Research 2018-2021: Helaba forecast

Polarization between good and bad locations intensifies

The Internet will not replace brick-and-mortar retail trade, which means that attractive retail space in inner cities and shopping malls will be in demand for many years to come. However, not every retailer will be able to pull off a successful “multi-channel” strategy. Even competitive vendors, who are combining their brick-and-mortar stores successfully with the internet, could give up stores with weak sales and thus reduce the demand for space. As a result, estimates by the HDE, which posit a loss of 50,000 stores in Germany in the coming years (against a total number of 445,000, as of 2014), seem reasonable. This is likely to be caused above all by a heightened polarization between good locations and less attractive ones. Affected are primarily smaller and mid-size towns, rural areas, but also neighbourhoods in larger cities. A new push in German e-commerce could come from the grocery business. The internet accounts for only 1 % of sales in this area. Especially large growth rates, heightened activities by major market participants, and the great importance of this segment suggest that already the expected increase in the online share to 5 % within a few years is likely to have considerable repercussions.

Anemic trend in rents fits with structural change

Most recently, retail rents in Germany have stagnated even in good locations in larger cities, and in many smaller cities the trend was in fact downward (in an environment that is actually excellent for the sector). This could already represent repercussions in retail trade of the structural change driven by online commerce. For example, the vdp real estate index for 2016 showed a rise of only 0.7 % with retail rents on new leases, while office properties grew by a solid 3 %. But the capital values still rose by around 2.5 % on retail trade properties. ■