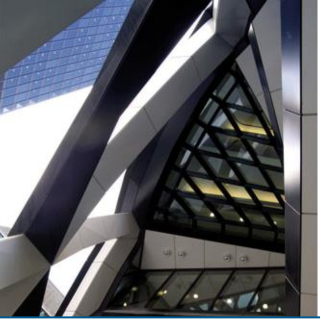

REAL ESTATE REPORT

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Real estate cycle in its tenth year

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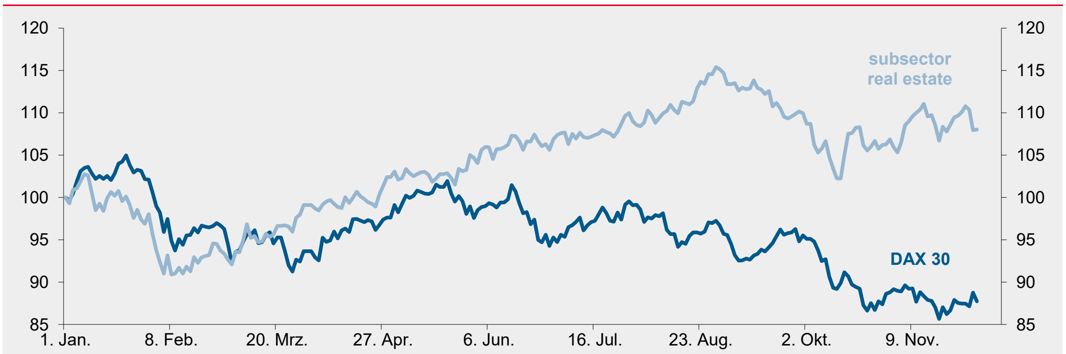
- The upswing in the real estate market is already turning ten years old, but an end is not yet in sight in the coming year (p. 2).
- In spite of the active housing policy, there will be too little construction in the German housing market also in 2019. Prices and rents will continue to rise (p. 3).
- German open-ended real estate fund will continue to post substantial capital inflows in 2019, against the backdrop of a virtually unchanged performance (p. 4).

1 At a glance

German real estate stocks as outperformers

Equity indices, total return, 1.1.2018 = 100



Sources: Datastream, Helaba Research

German real estate stocks reflect the continued good situation of the real estate market. While the DAX, the leading index, has fallen by more than 10 % compared with the beginning of the year, the corresponding sector index is clearly in positive territory. Here, too, losses have been recorded since the peak in the summer. However, real estate stocks did not participate in the recent downward movement of the leading index. The continuing positive development of the rental market, rising real estate prices, and still low interest rates are supporting property stocks. The situation is different in the US, where interest rates are already significantly higher. Here, REITs performed relatively weakly at the beginning of the year and caught up only recently, as they were spared the price declines in the overall market.

2 Selected real estate analyses

2.1 Real estate cycle mature, but not weakened by age

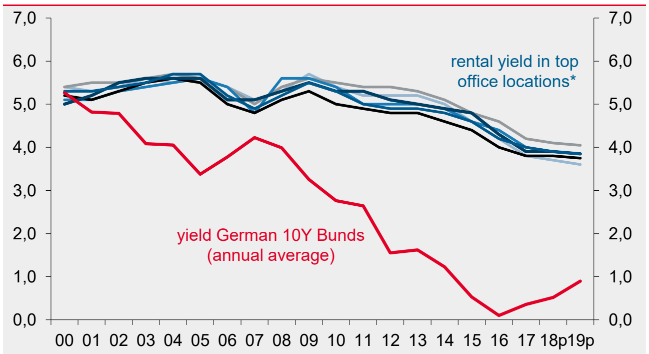
The upswing in the real estate market is entering its tenth year. It is thus in a mature phase. But real estate cycles do not die of old age. Continued low interest rates and robust economic growth will keep the sector fit in 2019. As we do every year, we present three scenarios in our "Markets and Trends 2019" report.[1]

Still an adequate risk premium on German real estate

In our baseline scenario (with a probability of 70 %), the expected rise in interest rates by the end of 2019 does stall the upswing in the German real estate market. The asset class remains relatively attractive in view of the continuing low level of interest rates. This is illustrated by the gap between rental yields on the German office market and yields on 10-year German government bonds, which is far from the critical levels of the years 2000 and 2007. With investment opportunities still scarce, real estate values in Germany and in many other European countries should continue to rise. The situation looks less favourable in the US, where significantly higher yields on the bond market already offer investment alternatives.

Risk premium adequate also in 2019

Rental yield office space and yield 10Y Bunds, %

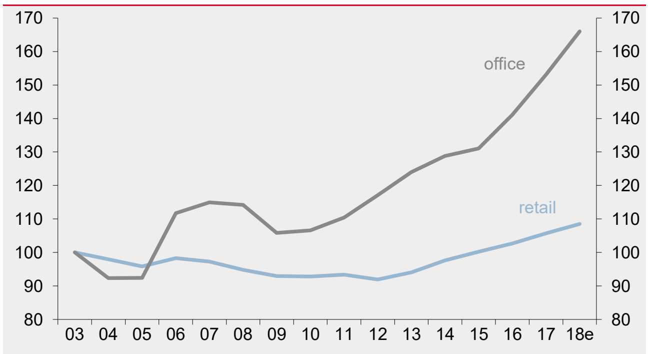


*Berlin, Düsseldorf, Frankfurt, Hamburg, Munich, Stuttgart f=forecast

Sources: Scope, Datastream, Helaba Research

Commercial real estate: office beats retail

vdp Real Estate Price Index Germany, capital value, 2003 = 100



Sources: vdp, Helaba Research e=estimate

On the German office market, the robust economy and a further increase in employment, especially in the major conurbations, are ensuring high demand for space. By contrast, the rental situation in the retail sector is more difficult – especially in submarkets that are affected more by growing online commerce. The other side of the coin is strong demand for logistics real estate. With moderate construction activity and good demand, rents in many segments of the commercial real estate market will continue to rise and vacancy rates will fall in the coming year. In some top office locations, office space is already scarce with vacancy rates of 2 % to 4 %. As the value of real estate will tend to rise again more strongly than rents in 2019, the already high valuation of many properties will move up further.

Real estate in the alternative scenarios

In our negative alternative scenario (20 % probability), an economic slump causes property values to correct, especially in highly overvalued segments. Commercial rents fall due to weak rental demand. By contrast, the German residential market proves relatively stable. Given the high excess demand accumulated in recent years, a significant decline in residential rents is not expected. In the positive scenario (10 %), however, there is even stronger demand for space and thus accelerated growth in rents for commercial properties. Demand in the residential market continues to pick up. Despite higher interest rates, real estate becomes more and more expensive. In ever more market segments, the valuation situation becomes increasingly acute.

[1] Markets and Trends 2019: "Global economy in the gym" with the baseline scenario and the two alternative scenarios, 26 November 2018.

2.2 German housing market: continuing shortages

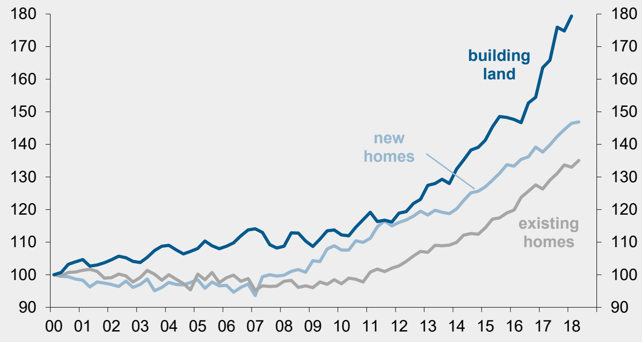
The rise in rents and purchase prices on the German housing market is primarily attributable to the gap between supply and demand, especially in the conurbations. Little will change about this situation in 2019.

Many measures, but moderate effects

Current housing policy activities will not stop the rise in prices on the German housing market in 2019. This is because measures such as the construction child benefit (mostly deadweight effects) or a tightened rental cap (the landlord's obligation to provide information about the previous rent) are not likely to create additional living space. More social housing may be useful, but will not reach the scale needed to provide noticeable relief. The temporary special depreciation of 5 % per year for "affordable housing" that has just been decided is also likely to mostly result in deadweight effects. In view of the limitation to construction or acquisition costs of no more than 3,000 euro/m², this will stimulate construction activity in rural areas rather than in the large cities affected by housing shortages. All these housing policy activities do little to change the fundamental problem: the demand for housing exceeds supply in the conurbations. The high capacity utilisation in the construction industry, which can hardly be expanded in the short term due to the increasing shortage of skilled workers, and the scarcity of building land stand in the way of significantly higher construction activity. It is already apparent that the Federal Government's goal of creating an additional 1.5 million apartments in the current legislative period will not be achieved.

No end to rising prices in sight

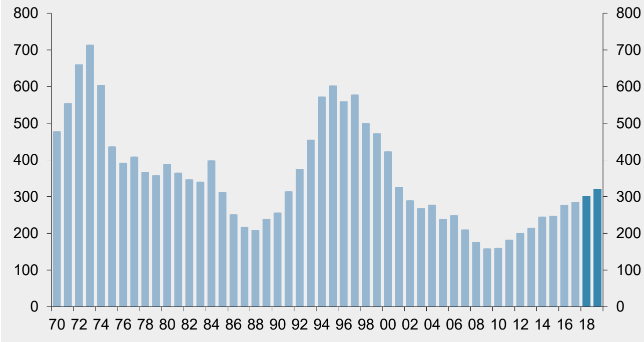
Housing price index Germany, 2000 = 100



Sources: Federal Statistical Office, Helaba Research

More construction, but still not enough

Housing completions Germany*, thousands



*before 1993 West Germany

Sources: Federal Statistical Office, Helaba Research

Construction activity remains below need

Despite the continuation of very favourable financing opportunities and high investor interest, the number of building permits for housing in the first nine months of 2018 was only 2.3 % above the same period last year. The plus of 8.3 % in multi-family house construction at least indicates that construction activity will be expanded where demand is particularly high. By contrast, permits for single-family and two-family homes actually declined (-1.6 % yoy). Therefore, only a total of 320,000 residential units are expected to be completed in 2019 – more than the expected 300,000 units in the previous year, but still too little to noticeably slow the rise in residential property prices. With extra demand estimated at 350,000 to 400,000 residential units per year, the gap between supply and demand is likely to widen further – with the result that purchase prices and rents will continue to rise.

There are some useful starting points for at least slowing the price dynamic: the designation of more building land by the municipalities (which, however, is hardly possible in the short term), faster approval processes, lower property and transfer taxes, cheaper construction through lower or standardized building standards, or the increased use of industrial production methods in residential construction. In contrast, further interventionist moves such as the reform of the rent index ("Mietspiegel") or the recent proposal to limit rent increases to the rate of inflation are not promising.

2.3 German open-ended real estate funds remain en vogue

The performance of German open-ended real estate funds will change little in 2019. In the persistent low-interest rate environment, this investment category remains attractive, especially compared to securities with fixed interest rates. Further inflow of funds is therefore foreseeable.

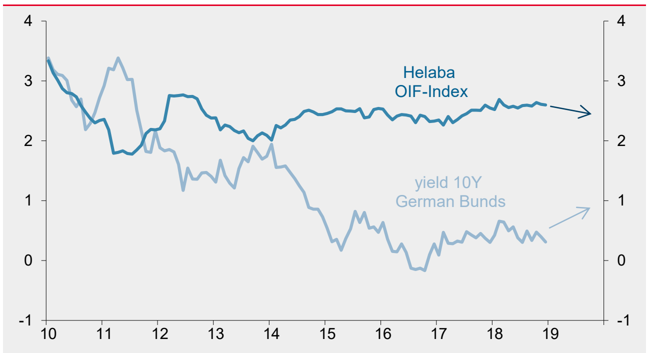
Little change to performance in 2019

The annual performance of the "Helaba OIF Index" is currently 2.6 %. For almost five years now, the performance has been within a narrow range of around 2 ½ %. However, this is clearly below the long-term average of 3.4 % since 2002. The index comprises the average performance of nine large German open-ended mutual property funds of the four leading providers. There are significant differences between the individual funds, ranging from 1.7 % to 3.5 %.

On average for the large mutual funds, we also expect an annual return of 2 ½ % for 2019. Despite slightly rising yields on the German bond market, the gap to fixed-interest investments would still be sufficiently wide to ensure the relative attractiveness of the asset class. The majority of investment properties in the portfolios should continue to appreciate. It should be noted that the value of a fund share reflects the economic situation only with a delay due to the fact that the valuation of individual properties is generally carried out only once a year. We therefore assume that there are still valuation reserves, above all from the boom year 2017 with particularly high economic growth, which could largely compensate for the somewhat more moderate development in 2018 and 2019.

Relative attractiveness of open-ended funds declines slightly

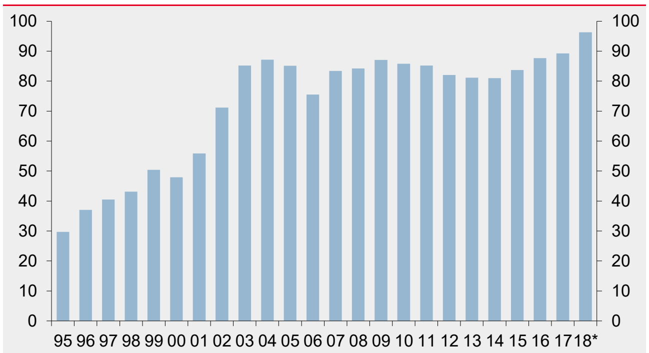
Annual performance Helaba OIF-Index and yield on 10y Bunds, %



Sources: Datastream, Helaba Research

Assets at a record high

Net-assets of German open-ended real estate funds, billion euro



*2018: as of 30 September

Sources: BVI, Helaba Research

Continued robust inflow

The inflows into open-end mutual property funds were robust from January to September at more than € 4 billion. This makes them currently one of the most popular fund investments in Germany. Net inflow into equity funds covered by the industry association BVI amounted to around € 4 billion in the same period, while bond funds even recorded an outflow € 4.7 billion. At around € 800 million, the inflow into real estate funds reported by the Bundesbank for September clearly exceeded those of previous months. Sales were almost entirely attributable to the four major providers. Open-ended mutual property funds thus achieved the highest level of net assets since the fund category was established. More than € 96 billion will have been invested by the end of the year, and the € 100 billion mark could be exceeded next year.

However, fund providers are finding it increasingly difficult to invest the money in suitable properties. According to the association, acquisitions amounting to almost € 1 billion were made in the first half of 2018 (sales of just under € 100 million). At least temporarily, some funds are likely to see rationing in 2019 as well. In view of the continuing shortage of suitable properties in the sought-after top locations and high quality-levels, accelerated real estate purchases are unlikely, and purchases at inflated prices or a switch to riskier market segments could prove a mistake in the next downturn. ■