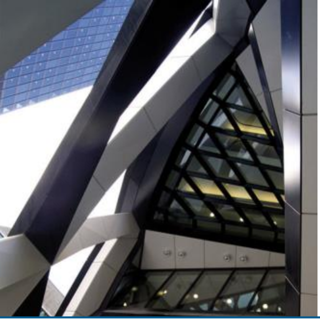

Helaba

REAL ESTATE REPORT

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Upswing continues

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- The upswing in the real estate market is entering its tenth year. While an end is not yet in sight, it would be reckless to ignore the cycle (p. 2).
- Co-working is currently a major theme in real estate. Whether this is a megatrend or more of a passing fashion, that verdict is still out (p. 3).
- Office markets in the northern European countries are moving upwards at different speeds. Stockholm, in particular, is booming (p. 4).

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1 At a glance

Performance review 2018: the year of real estate funds

Annual performance by asset classes*, total return, %

2012	2013	2014	2015	2016	2017	2018
RE Equities euro area 29,2%	Equities Germany 25,5%	RE Equities euro area 23,1%	RE Equities euro area 17,4%	Commodities 10,9%	RE Equities euro area 17,7%	Open-ended RE Funds 2,7%
Equities Germany 29,1%	Equities euro area 21,5%	Bonds euro area 13,0%	Equities Germany 9,6%	Equities Germany 6,9%	Equities Germany 12,5%	Bonds Germany 2,4%
Equities euro area 18,1%	RE Equities euro area 6,5%	Bonds Germany 10,4%	Equities euro area 6,4%	RE Equities euro area 4,7%	Equities euro area 9,2%	Bonds euro area 1,0%
Bonds euro area 11,0%	Bonds euro area 2,2%	Equities euro area 4,0%	Open-ended RE Funds 2,5%	Bonds Germany 4,0%	Open-ended RE Funds 2,5%	Commodities -7,1%
Bonds Germany 4,3%	Open-ended RE Funds 2,0%	Equities Germany 2,7%	Bonds euro area 1,6%	Equities euro area 3,7%	Bonds euro area 0,1%	RE Equities euro area -8,2%
Open-ended RE Funds 2,4%	Bonds Germany -2,2%	Open-ended RE Funds 2,5%	Bonds Germany 0,3%	Bonds euro area 3,3%	Commodities 0,0%	Equities euro area -12,0%
Commodities -1,5%	Commodities -8,4%	Commodities -11,9%	Commodities -15,2%	Open-ended RE Funds 2,4%	Bonds Germany -1,5%	Equities Germany -18,3%

*CRB commodity index, iBoxx bond indexes, DAX, EuroSTOXX50, FTSE EPRA/NAREIT real estate equity index euro area, Helaba OIF index for German open-ended real estate funds
Sources: Datastream, Helaba Research

German open-ended real estate funds led the performance ranking of various asset classes in 2018. This was less due to the fact that the total return of the "Helaba OIF Index," which tracks the average performance of nine large German open-ended real estate funds, improved slightly to 2.7 %. Rather, the high relative attractiveness of real estate results from a poor equity year and the persistently low interest rate environment, which depressed the performance of government bonds. And since there was no money to be made from commodities in 2018 either, this time open-ended real estate funds ended up at the top of the winner's podium. Real estate stocks, on the other hand, were unable to escape the slide in the stock market. Given the rise in stock prices that we expect, the rank order of asset classes could be quite different in 2019.

2 Selected real estate analyses

2.1 Real estate cycle or upswing without end?

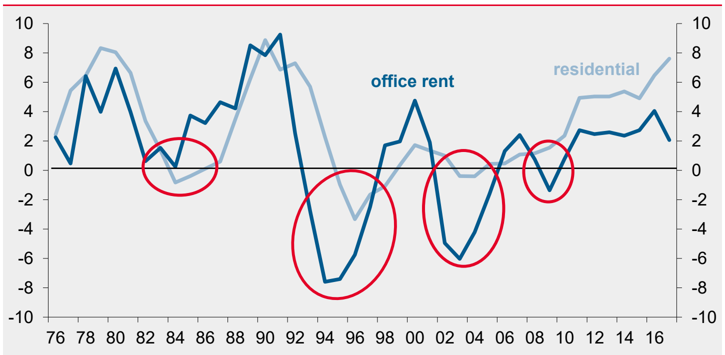
Since real estate prices in Germany have been rising for such a long time, some people assume that the upswing will have to come to an end soon. Others – with a view to still low interest rates and the ECB's continuing excessive monetary policy – declare the cycle dead. However, we believe in the cyclical nature of the economy and of real estate markets.

A look back: four real estate cycles in about 40 years

Reliable data on the German real estate market has been available since the mid-1970s. According to the real estate indices of BulwienGesa, there have been four phases of weakness in Germany since then. These can be seen both in the residential market and in commercial real estate, although in the latter we focus on offices due to the more pronounced cyclical nature (see chart). It is striking that these downturns in the real estate market occur during periods of economic weakness: real GDP in Germany contracted in 1982, 1993, 2003 and 2009, triggered by the oil crisis, the end of the reunification boom, the bursting of the dot-com bubble, and, most recently, the financial crisis. This suggests that the current upswing in the real estate market is not dying of old age on its own, but will presumably be brought to an end by economic events outside the sector. These are usually difficult to predict. In principle, however, what is true for equities also applies to real estate: the higher the valuation, the more susceptible the market becomes to such disruptions.

Who says there are no real estate cycles?

Real estate index Germany (BulwienGesa), % yoy



Sources: Datastream, Helaba Research

Risks: rising interest rates and recession

Two suspects that could end the current upswing in the real estate market are a stronger rise in interest rates and a more pronounced economic downturn, caused in part, for example, by a chaotic "no-deal Brexit" or an escalation in the trade dispute. In our baseline scenario for 2019, however, we do not assume that these risks will materialise. In line with the very cautious approach of the US Federal Reserve, which raised the key interest rate for the first time at the end of 2015 and has not yet caused any visible damage to the real estate market since then, the ECB will also tread carefully in scaling back the expansionary nature of its monetary policy. Interest rates in Germany will rise and eventually reach a level that no longer supports the real estate market – but the probability that this will happen as early as 2019 is low.

There will not be a never-ending real estate upswing this time, either. However, there is a good chance that the upswing, which has been going on for a long time in terms of historical experience, will continue. Market participants should not trust that there is no longer a cycle. Thus, equities have now corrected significantly despite sustained high liquidity. Even if an end to the upswing in real estate is not in sight in the short term, market participants should prepare themselves for it, because this would not be the first time that the turning point comes unexpectedly. The best strategies for more difficult times still are: diversifying as broadly as possible regionally and sectorally, avoiding particularly overheated markets, and limiting the use of debt capital.

2.2 Co-working: fad or megatrend?

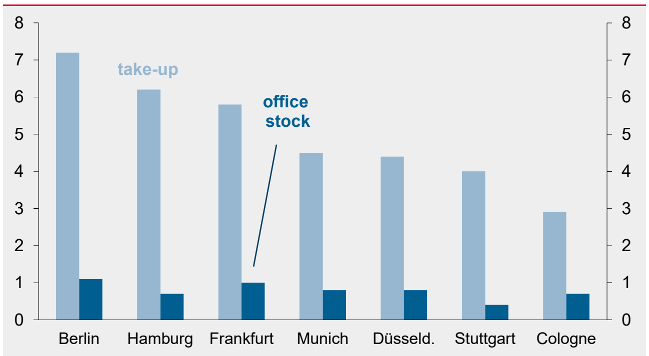
Co-working was one of the most important themes in the real estate industry in 2018. An increasing share of newly rented space is accounted for by these providers of flexible office workplaces. Only the coming years will show whether this is a new megatrend.

Co-working already more than a niche

The importance of co-working for the German office market has increased rapidly since around 2017. If one includes also the more traditional business centres and hybrid spaces (combining classic and open space concepts), there was a total of 760,000 m² of flexible office space in the top seven locations by mid-2018.[1] Its share of rental turnover was already over 5 % – with an upward trend. However, the intensity of the reporting on co-working conceals the fact that the scale is still modest, as such flexible offices make up only about 1 % of the total space in the leading German office locations. Not surprisingly, Berlin, home to a particularly large number of start-ups, is at the top of the list both in terms of absolute space and in relationship to take-up and inventory. Compared to international locations, there is great potential here. Co-working is particularly widespread in London, where it already accounted for 18 % of rental turnover in 2017.[2]

Start-up stronghold Berlin leads the way

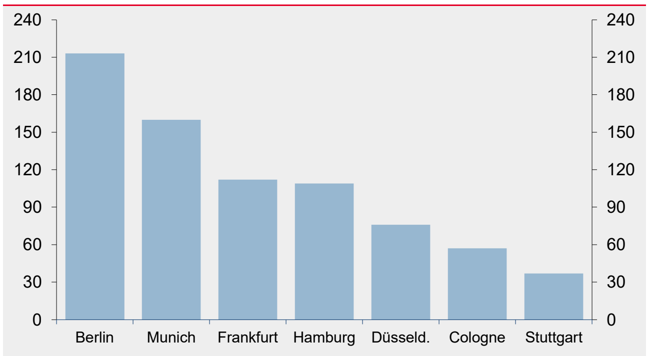
Floor-space turnover and inventory, share of flexible office space*, %



* Business Center, hybrid spaces und co-working
Sources: Jones Lang LaSalle (June 2018), Helaba Research

Nearly 800,000 m² flexible office space in Top 7

Flexible office space* in leading German office locations, '000 m²



* Business Center, hybrid spaces und co-working
Sources: Jones Lang LaSalle (June 2018), Helaba Research

Sustainability test still pending

As far as the prospects for flexible office space in Germany are concerned, however, we would warn against simply projecting forward the very high growth rates. This is because in new business areas, the initially strong momentum often starts to slow down soon. For example, despite the rapid growth of online commerce, its share of total retail sales in Germany is only around 10 %. In international comparisons, one should beware of declaring the highest value in one of many locations to be the generally valid benchmark. Although cities may be in different stages of development, the differing preferences of office users do not necessarily mean that there has to be a convergence. In our opinion, the supposed success model of flexible office space still needs to prove itself in the next downturn. In view of the prevailing shortage of high-quality office space in good locations, expanding companies that are unable to find suitable space are currently happy to resort to temporary, flexible solutions. Will they do this even if demand for space declines and supply is plentiful?

In addition, surveys show that the majority of office employees – including younger employees – by no means prefer open, flexible concepts. In times of a demographically increasing shortage of skilled workers, companies will probably pay more attention to their preferences in the future. Conclusion: Co-working will certainly establish itself permanently on the German office market, which means that is probably not a passing fashion. Whether it is in fact enough for a megatrend in the office market is (still) an open question.

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[1] See Jones Lang LaSalle, Flexible Office Space, Coworking & Co. in den Big 7, June 2018

[2] See Savills Research, Workspace as a Service – Trend or necessity?, June 2018

2.3 Office markets in northern Europe: big differences

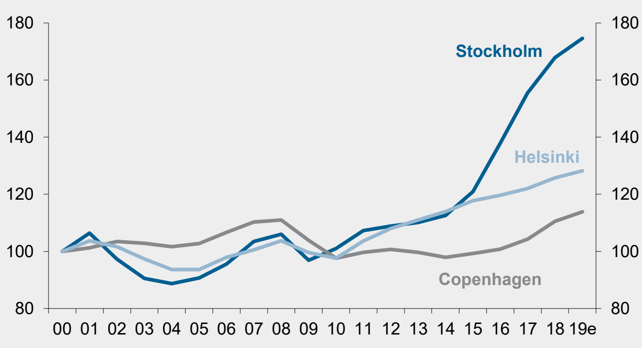
The northern European countries have performed quite differently since the financial crisis. While Sweden has shown above-average economic growth within Europe, Denmark and Finland were late in jumping on the growth bandwagon. This is also reflected in the development of the office markets in the three capital regions.

Stockholm one of the most dynamic office markets in Europe

The office markets in the northern European capitals are of medium size compared to the rest of Europe. With more than 11 million m², Stockholm has the largest stock of office space, ahead of Copenhagen with a solid 10 million m² and Helsinki with around 8 million m². In terms of the level of office rents and rent increases, at least the Swedish capital is on a par with the leading European locations. Here, office rents in good locations are only slightly below those in Paris. By contrast, office space in Copenhagen costs only about half as much and Helsinki does not even reach 60 % of the level in Stockholm. Since 2015, office rents in the Swedish capital have risen by more than 40 %, while the increase in the other two centres has been moderate.

Strong rise in office rents in Stockholm

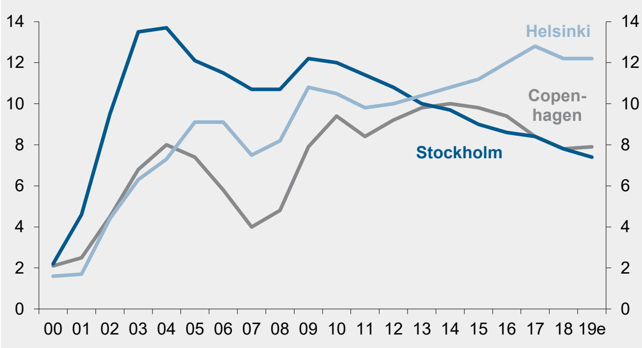
Office rent in good locations in local currency, 2000 = 100



Sources: Scope, Helaba Research

Persistent high vacancy rate in Helsinki

Office vacancy rate, %



Sources: Scope, Helaba Research

The performance of the three office markets corresponds to macroeconomic developments. The strong upswing in Sweden was accompanied by a particularly high rise in employment, especially in the capital region. The situation in the other two countries was less favourable. While Sweden achieved average economic growth of more than 2 ½ % p.a. between 2010 and 2018, the comparable figure for Denmark is around 1 ½ % and for Finland only 1 %. Demand for office space has correspondingly been restrained.

Vacancy rates remain above average

Despite relatively low construction activity in recent years, the vacancy rate in Helsinki has not yet been brought down from its high base of around 12 %. Significantly higher completion volumes were recently recorded in Copenhagen, although demand was more buoyant. It was at least sufficient to reduce the vacancy rate from its peak in 2014, when one tenth of all office space was available, to around 8 %. In Stockholm, too, there is currently still a noteworthy vacancy rate of just under 8 %, although this has been continuously reduced for years from a much higher level. It should be noted here that the vacancy rate in the three northern European office locations is considerably lower in central locations, above all again in Stockholm, where there is already talk of a shortage of space in the Central Business District. For the new year, we expect demand for office space to continue to rise in all three countries, with continued solid economic growth and little change in construction activity. Office rents are likely to increase further, while vacancy rates will remain at a similarly high level. Despite the Swedish central bank's first interest rate hike shortly before Christmas, we consider the risks for the Swedish office market, which is particularly advanced in the cycle, to be manageable. With the key interest rate remaining extremely low, the economy will continue to be supported in 2019, and the central bank is likely to act cautiously with a view to the richly valued commercial and residential real estate market. ■