

## Higher risks, lower returns

- The challenges for real estate investors have increased in the low interest rate environment. They need to lower their expectations for returns or accept more risk (p. 2).
- The Paris office market is presenting itself in good shape in this election year. With major differences within the greater metropolitan region, there are few vacancies at least in central locations, with the result that office rents are rising (p. 3).
- In Germany, commercial construction is now following residential construction and has picked up some dynamism (p. 4).

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## 1 At a glance

### Review of 2016: mixed picture for real estate investments

Annual performance by asset classes\*, %

2010	2011	2012	2013	2014	2015	2016
Commodities 30,0%	Bonds Germany 9,7%	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%
Equities Germany 16,1%	Bonds euro area 3,4%	Equities Germany 29,1%	Equities euro area 21,5%	Bonds euro area 13,0%	Equities Germany 9,6%	Equities Germany 6,9%
RE Equities euro area 14,7%	Open-ended RE Funds 2,2%	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%
Bonds Germany 6,3%	Commodities -10,6%	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 2,4%	Equities euro area -14,1%	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 1,2%	RE Equities euro area -14,3%	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%
Equities euro area -2,8%	Equities Germany -14,7%	Commodities -1,5%	Commodities -8,4%	Commodities -11,9%	Commodities -15,2%	Open-ended RE Funds 2,4%

\*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

The performance of the asset classes was less differentiated in 2016 than in the previous years. After four years with losses, commodities rose to the top this time. Stocks, too, thanks to an end-of-year rally, provided investors with a respectable result. In spite of rising expectations about higher interest rates in the euro area, real estate equities were able on the whole to keep up well with stocks overall. Even sovereign bonds produced a positive result for investors in the low interest rate environment thanks to noticeably price gains. While open-ended real estate funds were still in the middle of the pack the year before, this time they dropped to last place with a largely unchanged performance. The changing ranking in the performance of the various asset classes over the years confirms how important diversification is in a portfolio.

**AUTHORS**  
Dr. Stefan Mitropoulos  
Dr. Stefan Mütze  
research@helaba.de

**EDITOR**  
Patrick Franke

**PUBLISHER**  
Dr. Gertrud R. Traud  
Chief Economist/  
Head of Research

Landesbank  
Hessen-Thüringen  
MAIN TOWER  
Neue Mainzer Str. 52-58  
60311 Frankfurt am Main  
phone: +49 69/91 32-20 24  
fax: +49 69/91 32-22 44

Dr. Stefan Mitropoulos  
phone: +49 69/91 32-46 19

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## 2 Selected real estate analyses

### 2.1 Real estate investment in the low interest rate environment

The extremely expansionary monetary policy caused capital market interest rates to drop to historic lows last year. While long-term interest rates have left the negative terrain in the meanwhile, one should not expect a noticeable rise in Germany in 2017. Little will therefore change for now in the relative attractiveness of real estate and the dilemma of investors.

One of the most important rules of asset allocation is this: anyone who wants to achieve a greater return must be willing to bear more risk. That is true between different asset classes as well as within a given asset category – also in the current low interest rate environment. Continued very low interest rates mean that the strong attractiveness of the asset class real estate vis-à-vis bonds will remain in place for some time yet. Especially institutional investors should be eager to boost the real estate share in their portfolios further. In view of the limited investment opportunities in most real estate markets, the strong investor interest will ensure a continued price rise and declining initial returns.

Since it is becoming increasingly more difficult to acquire suitable properties, investors must lower their expectations of returns significantly or accept higher risks. Both of these things are currently evident in the investment market: thus, the returns in the leading German office centres have dropped below 4 % for the first time, which is even lower than the level during the boom years 2006/2007. At the same time, a higher share of core plus and value add investments is being reported within the total transaction volume.

The challenge of finding the right balance between return and risk in real estate investment has not gotten any easier in the low interest rate environment. But if more risk is being accepted, it should at least be broadly spread out. That is why another basic rule of asset allocation becomes more important during a lack of investment alternatives: within the real estate portfolio, risks should be broadly diversified as much as possible, whether through a regional distribution of real estate projects or through investments in diverse property types. This is based on the assumption that regional real estate markets do not move in precise cyclical lockstep, and also that individual segments of the real estate market – such as offices, residential, retail or logistic – are each subject to different determinants and therefore produce divergent performances.

Some market participants believe that one way out of the lack of investment alternatives – which is getting worse with the persistence of the extreme monetary policy – is to move from the prime locations to smaller cities or niche segments. But these seemingly simple solutions can prove problematic sooner or later: those investments are usually linked to higher risks, though these are usually compensated for with higher net initial returns. For example, smaller office locations are less liquid and have a greater dependence on individual sectors or businesses, which could make it more difficult to find new tenants if important clients move out. On the sectoral side, niche markets like student housing, micro apartments, hotels, car parks, or nursing homes are being discussed much at the moment – investment volumes in these segments in most cases reached record levels last year. However, these niche markets are quite challenging: as properties run by operating companies they usually demand a high degree of expertise. These market segments have one thing in common: as a portfolio addition they may represent a sensible strategy for some investors as a hedge against declining returns or as a way of still being able at all to find properties at acceptable prices. However, because of their limited size, alone, they cannot provide a solution to the lack of investment possibilities in the real estate market: compared to the extensive funds that are currently looking for an investment in the real estate market, these segments are much too small.

Dr. Stefan Mitropoulos  
phone: +49 69/91 32-46 19

Choice between lower  
return or more risk

As risk rises, diversifica-  
tion becomes even  
more important

Niche markets cannot  
solve lack of investment  
alternatives

Dr. Stefan Mitropoulos  
phone: +49 69/91 32-46 19

## 2.2 Paris office market: well situated in the election year

Another highlight in the European election calendar is coming up with the presidential election in France on 23 April (run-off: 7 May). The result can have significant repercussions for the general economic development and specifically for the office market in the capital region. That office market is currently in good shape.

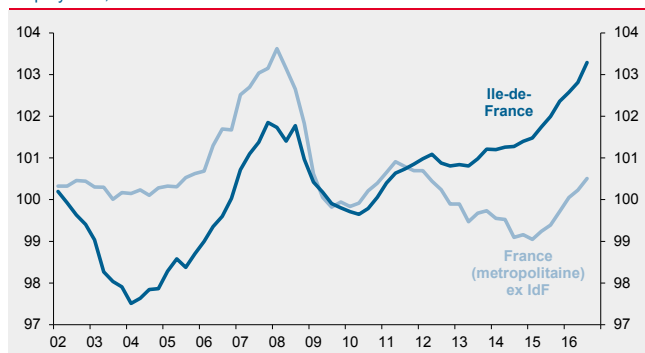
Wide spectrum of concepts for economic policy

The French people have the choice, and the result of the presidential election is likely to be watched with great interest also in other European countries. Voters will be offered a wide spectrum of concepts for economic policy: from a very left-leaning candidate of the Socialist Party and two free-market candidates all the way to the right-wing Front National. The upcoming decision about which direction to take entails both opportunities and risks also for the real estate market. Thus, there is an opportunity to overcome the reform weariness in recent years and thus the chance for accelerated growth and improved background conditions in the labour market. Last year, growth in the French economy came in at a real 1.1 %, which was once again significantly lower than the average of 1.7 % in the euro zone. By contrast, a victory by the populists would entail economic risks for France, but it would also cast into question the cohesion of the European Union.

For all that, the economic starting situation for the dominant Paris office market is not bad at all in the election year. The capital region has been developing much better than the rest of the country. This is reflected chiefly in the above-average employment growth in the Ile-de-France: here employment figures have grown by nearly 4 % since the low in 2010, while the downtrend in the rest of the country persisted much longer, and a moderate job growth has been recorded only since the beginning of 2015.

### Robust rise in employment in metro Paris

Employment, Q1/2001 = 100



Sources: INSEE, Helaba Research

### Paris office market showing itself much recovered

Average office rent in good location, Euro/m<sup>2</sup>

vacancy rate, %



Sources: Feri, Helaba Research

Rising rents only in prime locations

The data on the Paris office market have been accordingly favourable. In the investment market, the good results of the previous year were exceeded in 2016. Transaction volumes in the Paris metropolitan area have moved close to the leading European investment location London, which is being burdened by the uncertainty of Brexit. Rental results, too, showed a favourable trend and speak to a robust demand for office space: thus, at around 1.7 million m<sup>2</sup> in the first nine months of 2016, the volume had a plus of 14 % over the same period in the previous year; for the year as a whole, the total should reach around 2.4 million m<sup>2</sup>. And since office completions have simultaneously fallen to a very low level, the vacancy rate was reduced further. At only around 4 %, manifestations of shortages are likely to appear already in the central locations of Paris. In the metro region, the vacancy rate has fallen below 7 %, though in peripheral locations it is in some places still in the double digit range. Accordingly, office rents in central locations were able to increase noticeable most recently, while average rents in the metro region remained largely stable. For this year, given a return to higher growth in supply, we do not expect any further decline in the vacancy rate. Rent increases should continue to be limited to the desirable central locations.

Dr. Stefan Mütze  
phone: +49 69/91 32-38 50

## 2.3 German commercial construction: weak investment activity

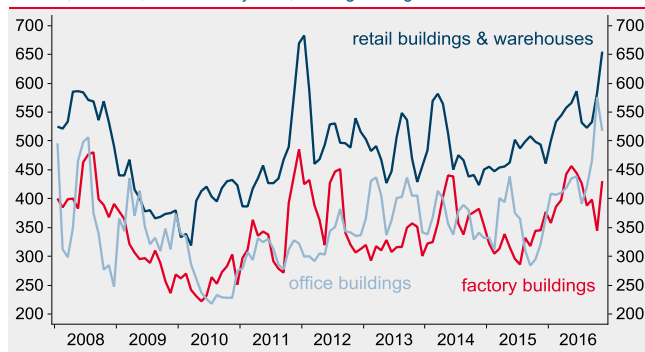
The enormous uncertainty that businesses feel exposed to is dampening investment, a restraint that is also reaching German private non-residential construction. At 1.5 %, it should again grow in 2017 by less than total construction investment in Germany (2.5 %).

Propensity to invest by  
businesses improving  
only haltingly

In 2016, businesses held back on equipment spending even more than in the previous years. Growth was only 1.7 %, the weakest performance since 2013. Investment in commercial construction grew by less than 1 %. The reasons behind the restraint on investment were, apart from the modest demand from the emerging countries including the Russia crisis, above all the enormous uncertainty, which has most recently increased even more. Thus, political crises like those in Italy, uncertainty over the outcome of the election in France, Brexit, and an economic policy in the US that is hard to predict following the election are increasing the wait-and-see attitude on investment. At least some economic hopes have developed most recently: thus, German industrial orders rose 4.3 % in the fourth quarter of 2016, noticeably higher than in the previous three months. The good order situation is already being reflected in rising capacity utilization. Investment to expand capacity is thus becoming more urgent. Because of the expected restraint on the part of businesses, investment activity in 2017, at 4 %, is likely to grow only moderately stronger than in the previous year.

### More office buildings

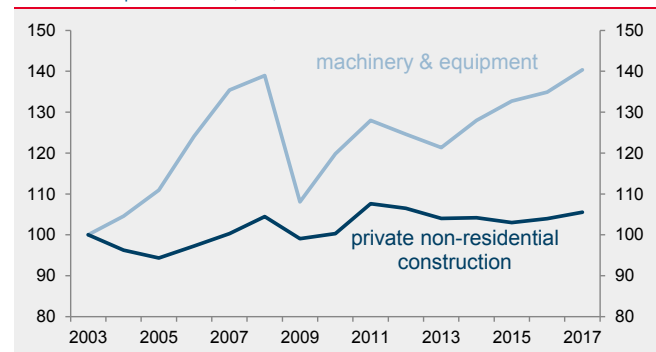
Permits, million €, seasonal adjusted, moving averages



Sources: Macrobond, Helaba Research

### Non-residential construction flat

Gross fixed capital formation, real, Index: Q1 2003 = 100



Sources: Statistisches Bundesamt, Helaba Research

Impetus from more  
employment and a better  
industrial economy

In spite of this negative environment, commercial construction permits grew by around a quarter in 2016. Office buildings showed an above-average trend: the continuous rise in employment has led to a boost in this segment. Growth was also carried by factory buildings as well as by retail properties and warehouses, whereby the dynamic in the former has already waned again most recently. The favourable development in the area of logistics should lead to further growth. Impulses are also coming from the construction activities of Deutsche Bahn, which are registering in commercial construction. Incoming orders in commercial construction rose nearly 11 % in 2016. With that, the dynamic has most recently eased again. This trend could become even stronger should it prove impossible to overcome the global protectionist tendencies. For that reason, in spite of the positive development of the leading indicators, we should expect only a slightly stronger growth of 1.5 % in 2017 (2016: 0.9 %) for total commercial construction.

Over the medium term, as well, commercial construction should expand at a weaker rate than equipment. After all, not every kind of equipment needs new commercial buildings, since some of it can be integrated into existing structures. However, in some cases the buildings need to be adapted, which leads at least to a demand for expansions and renovations. Moreover, equipment includes motor vehicles. As a consequence, investment in commercial construction developed much weaker than equipment already in the last few years. ■