REAL ESTATE REPORT

16 May 2019

No blanket judgments

AUTHOR
Dr. Stefan Mitropoulos
phone: +49 69/91 32-46 19
research@helaba.de

EDITOR
Patrick Heinisch

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

- Investors are taking an increasingly critical view of retail real estate. Are their reservations justified?
- The sustained uncertainty caused by Brexit is by now also having a negative impact on what had been for a very long time a very robust real estate market.
- What is better: A or B locations in the German office market? The answer is not clear-cut.

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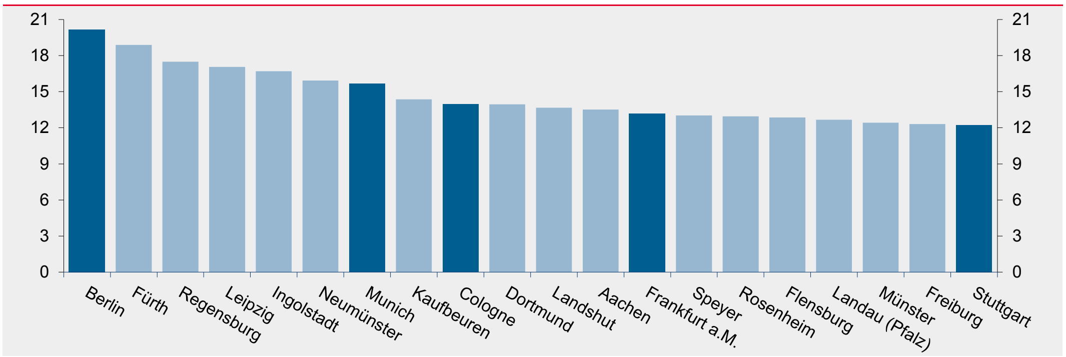
1 At a glance

Biggest employment impulses not only in German prime office locations

Employees subject to social insurance contributions, as of June 30, changes 2013-2018 in %



Source: Federal Statistical Office, Helaba Research

The development of employment in the more than one hundred cities with district status in Germany holds quite a few surprises. In the ranking of percentage employment growth over the period 2013 to 2018, the top spots are held not only by the "usual suspects," such as Berlin with an increase of around 20 %, or Munich, Cologne and Frankfurt, which are also ahead. But who would suspect such a high dynamic in the Bavarian cities of Fürth (rank 2) and Regensburg (3), or in the Rhineland-Palatinate cities of Speyer (14) and Landau (17)? Job growth on this scale is usually accompanied by corresponding impulses for the office and housing markets, but also for local retail trade.

2 Selected real estate analyses

2.1 No reason to be afraid of retail real estate

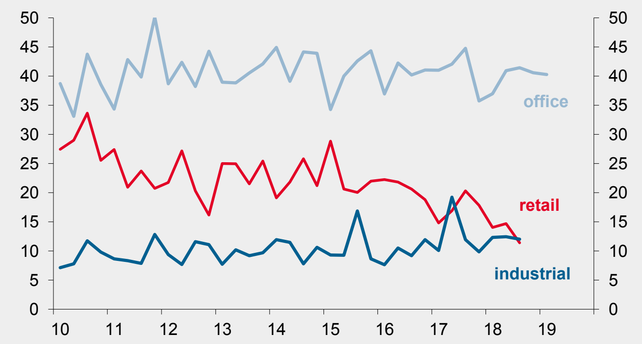
For some time now, poor data from retail property has been accumulating. This is primarily explained with the growing competition from online trading. Investors are increasingly critical of this real estate category – do they have reason to be?

Underperformance in sentiment, performance, and transaction volume

The latest market data seem to speak a clear language: rents for many retail properties have either come to a halt or started declining. Deutsche Hypo's sentiment indicator for retail real estate has clearly decoupled itself from that for other property types since around 2016. The total returns of MSCI Real Estate, which are usually published on an annual basis, show that the special development of the retail segment is not limited to Germany alone. This sector performed significantly better than offices from 2002 to 2006. During the financial crisis, offices were less cyclical, and until 2014 the retail sector performed somewhat better on average than office properties. After a slight underperformance from 2015 to 2017, the gap between the two segments then widened considerably: recently the difference in the total return was five percentage points. This is attributable in particular to the weakness of retail real estate in the United Kingdom, Europe's most important market. Of a total of 17 European markets for which sector data are available, retail performed noticeably worse than office in eleven cases in 2018, while performance was similar in two. Four countries actually reported higher total returns in the retail segment (Austria, Portugal, the Czech Republic, and Denmark).

Retail share of transactions has declined

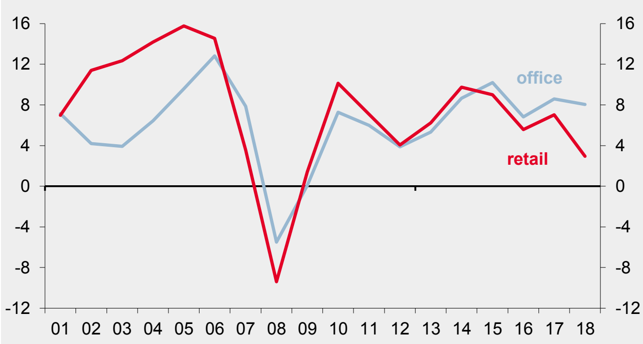
Transaction volume, share by property type* in Europe, %



*ex apartment and hotel
Sources: RCA, Helaba Research

The gap is widening

MSCI Real Estate, total return Europe, % y/y



*weighted by market capitalization, in Euro
Sources: MSCI Real Estate, Helaba Research

Investors less interested in retail real estate

What is remarkable about the weakness of retail real estate is that it coincides with robust private consumption. One obvious explanation seems to be the increase in online retailing. However, this is a long-term trend that is unlikely to be the sole cause of short-term underperformance. The share of e-commerce in Germany has increased by just three percentage points to 10 % over the past five years, and real sales in brick-and-mortar retailing also continue to rise. Possibly the poorer performance is due not only to fundamental reasons, but also to the changed assessment of many investors. This is supported by transaction volumes: only 14.5 % at the European level were attributable to retail real estate in the last quarters, compared with an average of 21 % since 2010. Within the spectrum of retail property there are major differences, in terms of operating forms and location, in the degree to which online trading affects it. Therefore investors should be selective within the sector. However, we are convinced that this property type remains an important building block in any well-diversified real estate portfolio. The growing scepticism towards the market segment could even offer interesting opportunities to investors who are more willing to take risks.

2.2 Brexit uncertainty continues to weigh on British real estate

The UK's departure from the European Union has been postponed to the end of October, and in the short term there is no danger of a "no deal" Brexit. Time for the British real estate market to breathe a sigh of relief?

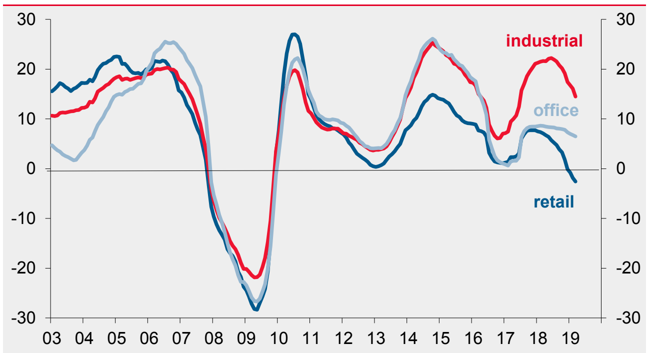
Brexit was once again postponed and the British are now even taking part in the European elections. However, this chapter is far from over. Almost three years after the referendum, the future relationship of the United Kingdom to the European Union is still unclear. A "no deal" Brexit, which would presumably lead the British economy into recession, could be prevented for now. But the next critical deadline at the end of October is also approaching without negotiations making any visible progress. Against the backdrop of this persistently high uncertainty, the UK economy and real estate market have so far done surprisingly well. Economic growth has declined since 2016, but has stabilised at a low level and could reach 1.2 % in 2019 as a whole without a "chaos" Brexit.

Real estate market by now in a downtrend again

Transaction volumes on the commercial real estate market had collapsed from a high level in 2016, but then quickly normalized. Many international investors did not want to do without this largest and most liquid European real estate market in a regionally diversified portfolio and took advantage of favourable buying opportunities resulting from the exchange rate. From the final quarter of 2018 onwards, however, transaction volumes again fell sharply as political uncertainty increased once more. The performance of British real estate shows a similar picture. The house price indicators (chart on the right) signal a significant slowdown in price increases. In contrast the commercial sector shows a wave-like development (chart on the left). Here, the slump in the total return immediately following the referendum was quickly ironed out. Since then, however, the performance has weakened again from over 11 % year-on year in the first half of 2018 to only 5.6 % most recently.

Commercial real estate: second Brexit slump

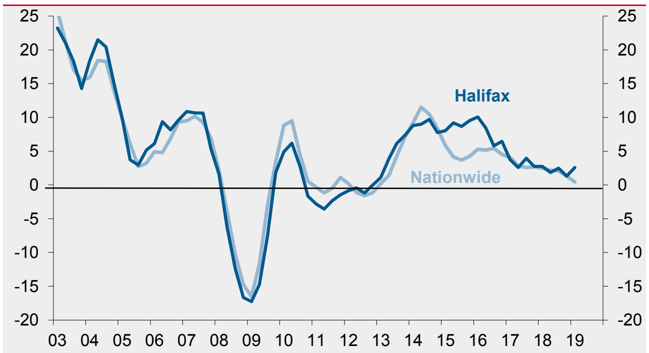
IPD Property Index UK, total return, % y/y



Sources: MSCI Real Estate, Helaba Research

Rise in housing prices has slowed strongly

House price indices, % y/y



Sources: Datastream, Helaba Research

Slightly lower real estate values expected in 2019/2020

However, these averages conceal very different performances in the different commercial segments: While the latest available data still show a total return of 14.5 % for the industrial segment and at least 6.5 % for offices, retail real estate has plunged into negative territory. Even under the still probable scenario of a negotiated Brexit, expectations for the UK investment market remain moderate over the next few years. For example, participants in the Investment Property Forum survey in February assumed an average total return on British commercial real estate of 2.4 % for 2019 and 3.5 % for 2020. This would mean that property values would fall slightly. It remains to be seen whether, following the recent postponement of the Brexit date, the assessments of the market watchdogs in the next survey scheduled for the end of May will be more positive.

2.3 German office market: A locations better than B locations?

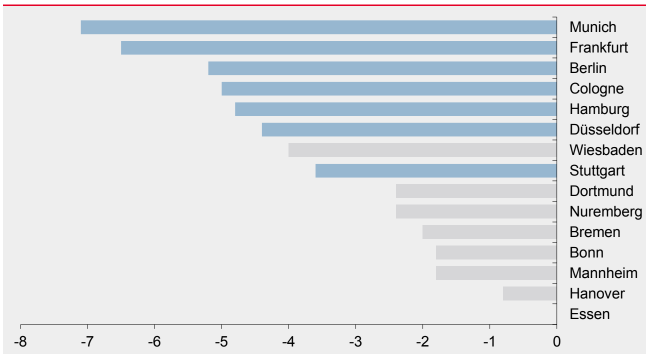
The lack of investment alternatives is likely to persist for some time. This means that real estate investors will have to continue to be satisfied with very low rental yields. This applies in particular to the scarce investment opportunities for first-class properties in prime locations. Beyond these core properties, a somewhat higher return is possible.

Dominance of top 7 office locations

Investments away from the leading office centres are no longer an insider's tip. For some real estate investors, B locations can be a sensible strategy for achieving their target return at all. However, due to their moderate size, the smaller regional markets are hardly suited to meet the high demand in the investment market. The seven largest German office locations currently have 82 million m² of space, the next smaller ones only around 26 million m². It is therefore hardly surprising that, on average over the past few years, around four-fifths of the turnover in German office properties has been generated in A locations. If significantly more funds are now diverted from the core segment to B locations, the risk premium there would melt away more rapidly and the relative attractiveness would quickly diminish. The development of rental yields shows that this has not been the case to date. We compare the leading German office centres by office space (seven A locations) with the next smaller cities (eight B locations). Since the financial crisis, the gap between A and B locations in terms of rental yields in good office locations has widened steadily to 160 basis points – the long-term average is only around 60 basis points.

Biggest decline in vacancies in top cities

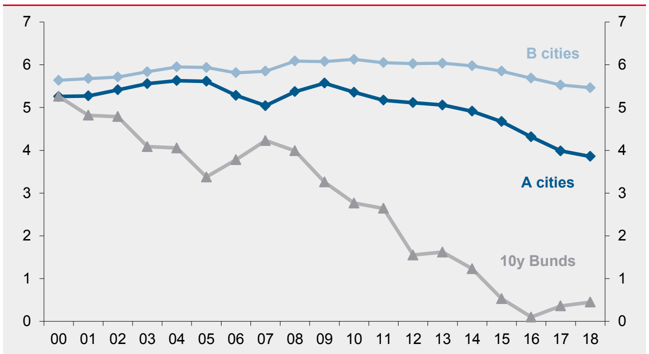
Office vacancy rate, change 2010-2018, percentage points



Sources: Scope, Helaba Research

Gap between A and B cities has widened

Rental yield in good locations and yield on German 10-year bonds, %



Sources: Scope, Helaba Research

Advantages and disadvantages of B locations

In the past, the traditionally stronger investor interest in top locations was often accompanied by speculative construction activity during boom phases and thus the risk of an oversupply. This is not yet the case in the current cycle. Smaller office centres usually show less fluctuation in completion volumes, vacancies, and rents. The flipside of the more stable development is that there is less potential for value appreciation in the upswing. Since 2010, the (unweighted) vacancy rate in the A cities has fallen by more than five percentage points on average, while the vacancy rate in the smaller markets has only fallen by around two percentage points. But at the end of 2018, the average share of vacant office space in the B locations was 3.6 % and thus still below that of the A office markets at 4.6 %. There is no clear pattern of rent increases in good locations during this period. Apart from the positive outlier Berlin (+70 %), there is a similarly wide range of rent increases for A and B locations, with A locations doing somewhat better. A disadvantage of smaller locations is the often less balanced sector mix. The greater dependence on individual sectors or companies could make re-letting more difficult if important tenants disappear. However, this disadvantage – see above – is usually offset by higher rental yields in the smaller markets. There is no clear answer to the question of whether investors should only consider large or smaller office centres when making investment decisions. Both categories have specific advantages and disadvantages that suggest a different mix depending on the investment strategy and preferences. ■