REAL ESTATE REPORT

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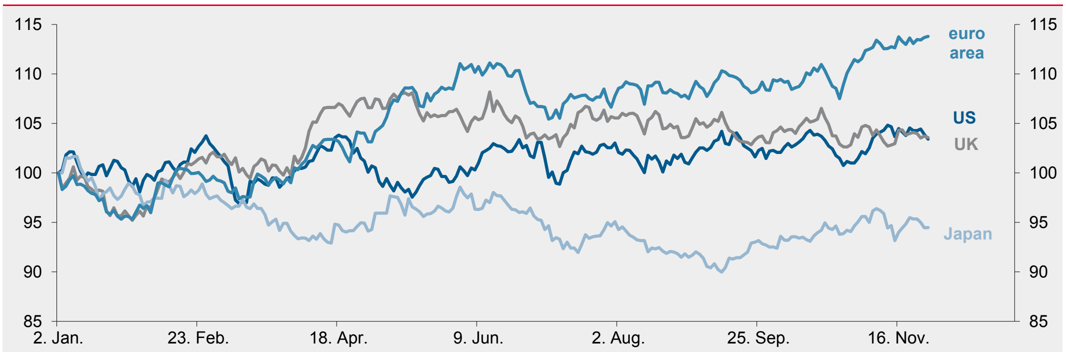
- The uptrend in the real estate market is entering its ninth year and is thus in a “mature” phase. Still, conditions remain positive in 2018.
- In the next year the German housing market again will see too little construction, in spite of high demand. The result is a continued rise in prices and rents.
- Despite good sales, we are seeing numerous insolvencies in the US. However, the impact on retail properties is still moderate.

1 At a glance

Real estate stocks 2017: And the winner is…
Real estate equity indices* in local currency, 2 January 2017 = 100



*FTSE EPRA/NAREIT real estate equity indices, total return
as of 28 November 2017
Sources: Datastream, Helaba Research

While real estate stocks advanced in many countries and regions in 2017, for the most part they were not able to keep pace with the equity market overall. A regional comparison reveals considerable divergences in performance. For example European property stocks developed much better this year so far than real estate stocks in the US and especially in Japan. Within the European market, equities from the euro area did better than British stocks burdened by Brexit uncertainties. The weak performance of US REITs is surprising against the backdrop of the overall US equity market, which posted a rise that was well above average. Are investors pricing in a real estate cycle that is already very well advanced, or have they become more cautious in the face of the US central bank’s continuing interest rate hikes?

2 Selected real estate analyses

2.1 Outlook 2018: upturn entering its ninth year

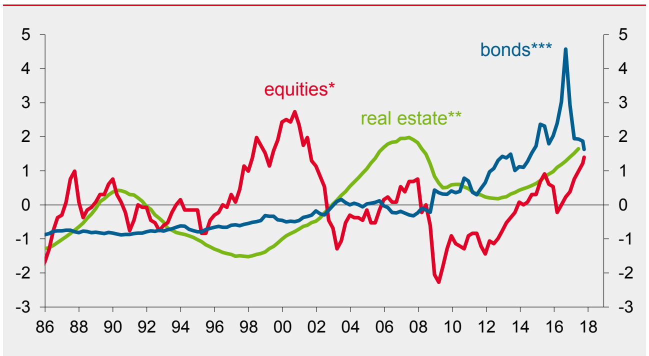
Real estate finds itself in a seemingly perfect environment: a strong economy, very low interest rates, moderate construction activity... Are there any risks at all? As every year, we present three scenarios in our outlook "Markets and Trends 2018".[1]

Strong demand with moderate supply in the real estate market

In the coming year, too, investors would like to invest their ample liquidity in real estate. But their shopping experience in 2018 is likely to be often disappointing, since "bargains" have long since vanished from the market. High-quality properties are largely sold out and are hardly being replenished, given the moderate construction activity. And who wants to invest in lower-quality properties that come with greater risks?

Globally not only real estate is highly valued...

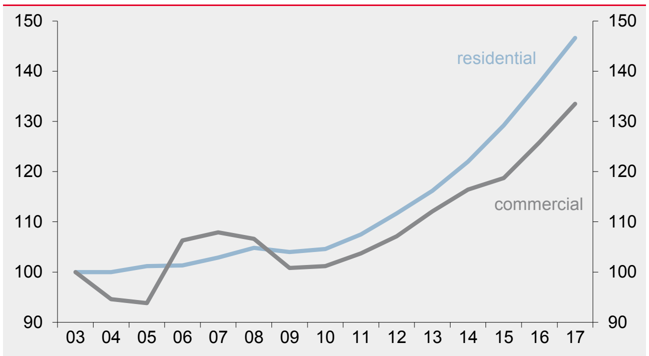
Distance from long-term average in standard deviations



*Price/cash-flow ratio equities world ** Purchase price/rent ratio OECD countries
*** Inverse of yields on sovereign bonds worldwide
Sources: Bloomberg, Datastream, Helaba Research

German real estate prices in continued uptrend

vdp real estate price index Germany, annual average, 2003 = 100



Sources: vdp, Helaba Research

Cycle already in mature phase

Measured in terms of historical yardsticks, the real estate cycle is already in a "mature" phase. Still, there are no signs that the uptrend will come to an end already in 2018, since conditions remain positive. However, excessive valuations can already be observed today in many real estate markets, and they are not being noticeably reduced even by a positive trend in rents. Real estate prices thus continue to rise – in Germany both in the housing market and in the commercial sector. Thanks to the lively demand for space, office properties should tend to develop better than retail properties, which are suffering increasingly from the rapid growth in e-commerce – especially in less favourable locations. Market participants are not yet unduly euphoric, and lending remains largely unremarkable. At least these indicators argue against an overheating at this time. Presumably the greatest risk for real estate, which – like the other asset classes – is by now richly valued, lies in a pronounced rise in interest rates.

Real estate in our three scenarios for 2018

In the baseline scenario of our outlook for 2018, to which we accord a probability of 70 %, real estate is able to maintain its relative attractiveness in spite of a slight rise in yields in the bond market. In the negative alternative scenario (10 % probability), the real estate markets prove susceptible to correction. The anaemic economy leads to a shrinking demand for space and rising vacancies. Declining rents and price corrections are the result. In the positive alternative scenario (20 % probability), real estate loses some of its relative attractiveness in the face of rising yields in the bond market, which means that the demand in the investment market calms down. However, the markedly better economic situation is reflected in higher rental income and declining vacancies, with the result that a continued positive development of real estate values should be expected.

[1] For more details see „Markets and Trends 2018: Shopping Centre – Nothing Comes for Free" with baseline scenario and two alternative scenarios from 20 November 2017.

2.2 German residential property prices continue to rise

Prices for German residential properties will continue to move up in 2018, since there is little change to the forces driving the upswing. A marked rise in construction activity is not in sight.

More than 300,000 housing completions still not enough

The German housing market will be characterized in 2018 by persistent strong demand against the backdrop of at best a moderate rise in supply. Notwithstanding somewhat higher mortgage rates, the financing conditions remain very favourable. The population is growing, even if not nearly as robustly as it did in the exceptional year of 2015. Especially the strong internal migration into the large conurbations will persist. Overall, there is an annual demand of around 400,000 housing units in Germany. Next year, housing construction should rise from an estimated 300,000 to about 320,000. However, not least the already high capacity utilization in the German construction sector will prevent a more robust increase. Most recently, the sector was working at a capacity utilization of nearly 78 %; even during the reunification boom in the mid-1990s, that figure was never higher than 70 %. By now this is also being reflected in building prices in residential construction: at 3 % higher in Q3 compared to the previous year, they are posting the biggest increase since 2008. The years 1995 to 2006 saw a drastic reduction in the construction work force by nearly 1.2 million to only 1.8 million. Since then, the number of jobs in the sector has grown again to just below 2 million; however, the increasingly tight German labour market is turning more and more into a limiting factor.

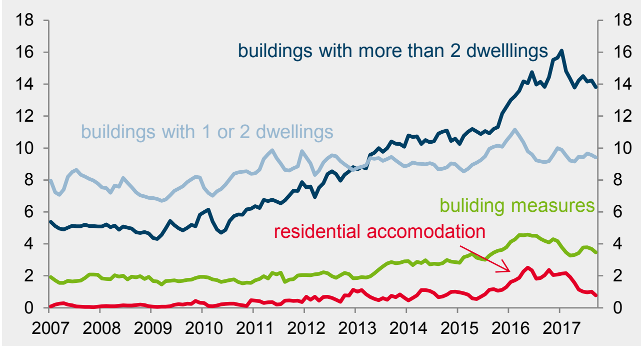
Much more is not possible

Capacity utilization in the German construction sector, %

Sources: Datastream, Helaba Research

Residential construction permits no longer rising

Permits for residential buildings, thousands per month*



*seasonally adjusted

Sources: Macrobond, Helaba Research

Construction permits currently argue against a robust rise in residential building activity. To be sure, the decline of around 7 % in the first nine months of 2017 compared to the same period the previous year must be qualified: for one, half of that is attributable to declining permits specifically for residential accommodations, the result of the declining influx of refugees; for another, permits were brought forward in 2016 due to regulatory changes.

Housing policy activities of a new government?

Possible housing policy measures by a new German government will probably be postponed well into the new year, which means that their effect will manifest itself only in the year after that. Things being discussed include improved write-off possibilities, the reintroduction of a child construction allowance, and more public housing. Depending on the makeup of the next federal government, a tightening of the (currently not very effective) rent control cannot be ruled out, which could then even have a negative impact on housing construction activity. Important approaches for overcoming the housing shortage, such as incentives for the creation of additional building land or improved planning capacities of the building authorities, should not be neglected. Overall, housing prices will continue to rise in 2018, especially in the metropolitan areas. At worst the upward trend in especially expensive central city locations could come up against a limit as affordability has deteriorated for many potential buyers. These could then be forced to move to the periphery of the metro areas.

2.3 US retail: Dying US malls in spite of booming consumption?

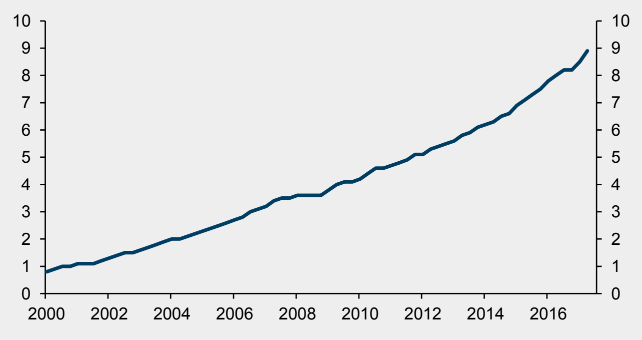
The negative headlines about dying stores and insolvencies in the US retail trade do not seem to fit with the positive data on private consumer spending. Are there reasons to be concerned about retail properties?

Structural burdens on stationary retail trade

Consumer spending by private households, which accounts for nearly 70 % of GDP in the US, has grown noticeably since 2013. Growth rates of price-adjusted 2.5 % to 3.5 % are almost on par with the "good old days" of the late 1990s. However, not every retailer necessarily benefits from this. Services are playing an ever larger role, while the share of retail sales in consumer spending is declining – since 2000 by no less than five percentage points. Another structural burden for stationary retailers is the dynamic growth in e-commerce. The share of retail sales that are done online has by now risen to 9 %. Most recently, about 40 % of the overall sales growth in the sector was accounted for by e-commerce.

E-commerce continuously growing in importance

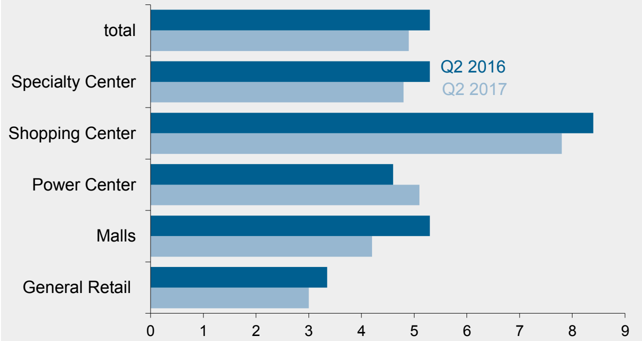
Share of e-commerce of US retail sales, %



Sources: Macrobond, Helaba Research

No drama among US shopping centres

Vacancy rate, %



Sources: JLL Retail Outlook, Q2 2016 and Q2 2017, Helaba Research

More store closures and insolvencies

For a little more than a year, we have seen a noticeable rise in store closures in the US, about half of which are probably attributable to the most recent clustering of (larger) bankruptcies in the sector. By contrast, in Germany the number of bankruptcies in the retail sector has declined steadily in recent years. Moreover, the most recently stagnating employment in the US retail sector lagged well behind overall job growth (+1.6 % yoy). In the public discussion, this is seen as closely connected to online commerce. Here one should bear in mind that while e-commerce in the US holds an importance that is very similar to what is the case in Germany, it is up against much greater per capita retail floor space. However, since the expansion of e-commerce is taking place as a long-term trend, this alone can hardly explain the sudden rise in bankruptcies. An important role is likely also played by the in part very high debt levels of a few retail chains. A number of companies, especially from the high-yield segment, took on a lot of debt at extremely low interest rates in recent years, and now find themselves with growing refinancing difficulties against the backdrop of a slow rise in interest rates and a large volume of maturing debt. These difficulties are reflected not least by the equity market, where retail REITs have been clearly underperforming the REIT segment as a whole for more than a year. Finally, the price trend for retail properties (measured against the real estate price index of RCA) lagged most recently noticeably behind the other commercial real estate segments.

In spite of these difficulties, at least the rental market for retail property is showing itself to be quite robust, and a major wave of mall deaths is nowhere in sight yet. Evidently, it is proving possible to largely fill empty sales space with new tenants. Thus, vacancy rates actually declined slightly during the last twelve months, with the exception of so called Power Centers, for which a slight rise of around half a percentage point was reported compared to the previous year. ■