pbbIX
Office Property Market Germany
2019 | Q2

DEUTSCHE PFANDBRIEFBANK

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Overview

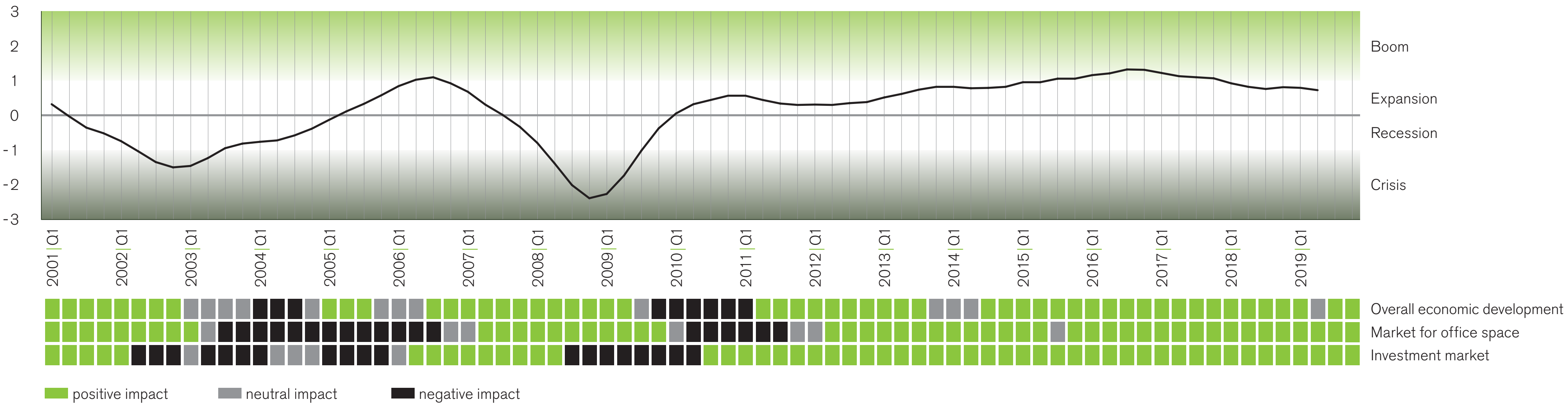
The BIG 7 office markets **currently find themselves in a challenging environment:** they face pressure from unfavourable economic prospects and political uncertainties on the one hand, while encountering rising office rents, a lack of rental space and a shortage of suitable investment properties on the other. Expansive powers continue to dominate for the time being. The pbbIX real estate index remained expansive (at 0.73 points) in the second quarter of 2019, but eased for the second time in succession.

The index is boosted in particular by the **markets for office space** and – to a lesser extent – by the investment markets. Vacancies on the markets for office space have fallen further, leading to an exceptional shortage of vacant space and hence to rising rents for newly let space. Although the economic prospects have become significantly bleaker, existing excess demand suggests that rents will continue to rise for the time being.

Real estate investments are thus receiving support from rental development. In addition, **interest rates on the capital markets** have fallen – rather than increasing – over recent months. This also encourages direct investments in the office property markets, which are currently moving sideways at a comparatively high level.

It is not easy to forecast any future trend. The risks lie primarily in macroeconomic developments. Sentiment among the companies' senior executives has deteriorated considerably, the current business climate is less satisfactory and a somewhat more sceptical view is being taken of future events.

pbbIX BIG 7 | Index

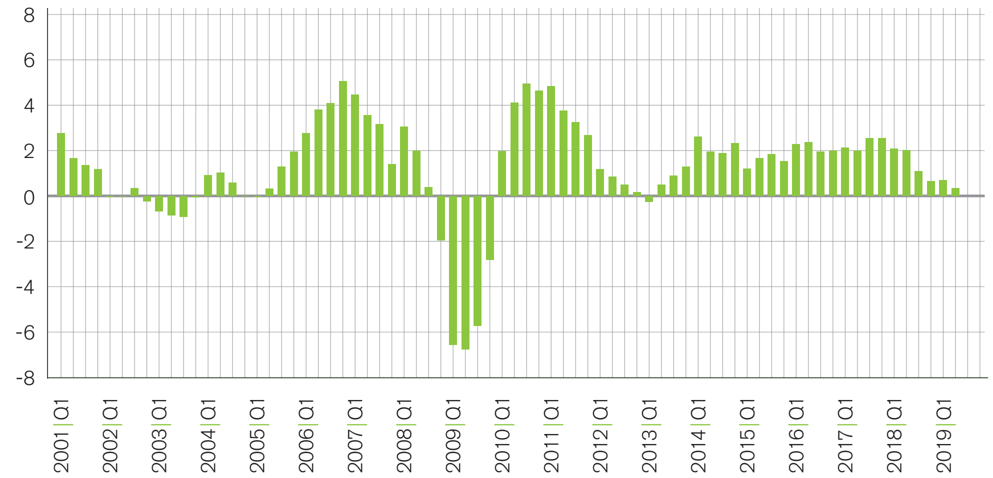


Overall economic outlook

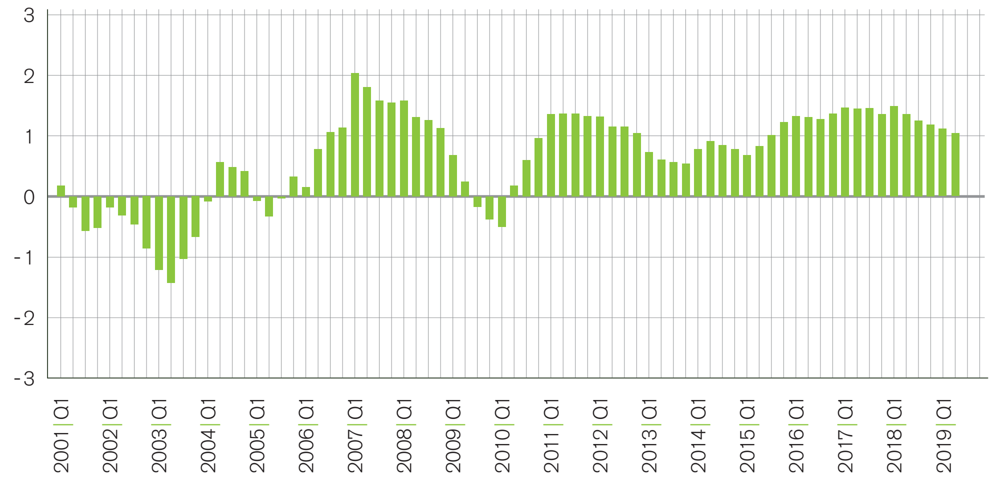
On balance, the latest figures on the performance of the German economy are sobering. The **order situation** in the German manufacturing industry deteriorated in the second quarter and, according to recent surveys, is weighing on sentiment among companies which are growing increasingly sceptical about future business prospects. Burdening external economic factors and geopolitical uncertainty remain a source of concern, reducing the willingness to invest among a growing number of companies, and impacting exports. This is compounded by capacity bottlenecks in the construction industry, resulting in stagnating completion volumes, but also, in part, in a marked increase in prices and costs.

On the other hand, positive impetus is generated by essential components of **domestic demand**. Private consumer and public spending remains on an upward trajectory and creates a balance that has prevented real gross domestic product from contracting to date. It remains to be seen whether this scenario will remain intact or if economic output will actually decrease in the near future. However, a pronounced recession with negative rates of change in real gross domestic product over several quarters is not expected. Germany is experiencing a period of reduced economic activity. An assessment of this situation, however, must take into account that unemployment is at a historically low level and production capacity utilisation is very high. The growth in income at least is supporting the services industry and private consumption.

Real gross domestic product | year-on-year change in %



Working population | year-on-year change in %



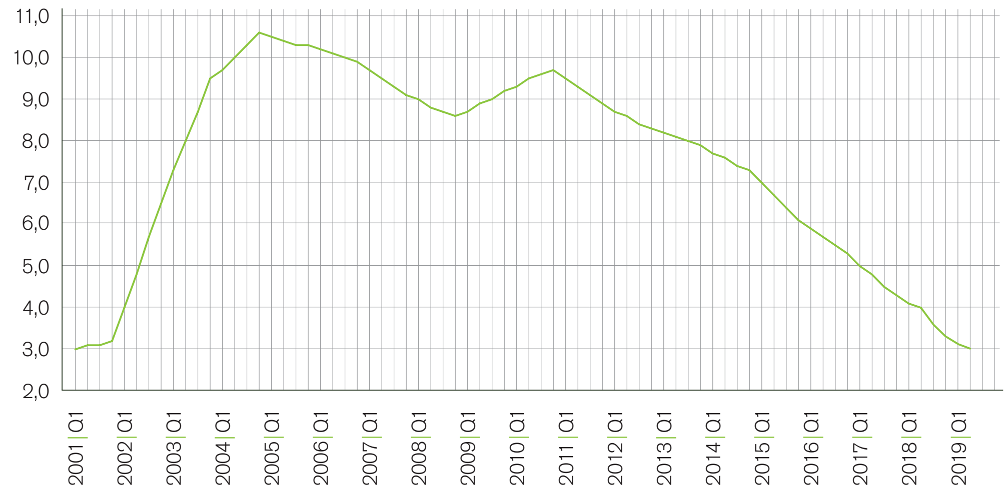
Market for office space

Data for the second quarter of 2019 conveys a clear message: despite all the political and economic risks, the tug-of-war surrounding Brexit, and the uncertainty as to how the trade conflicts will progress, Germany's **big markets for office space are booming**. Vacant office space, letting performance and rising rents for newly let space leave no doubts in this respect.

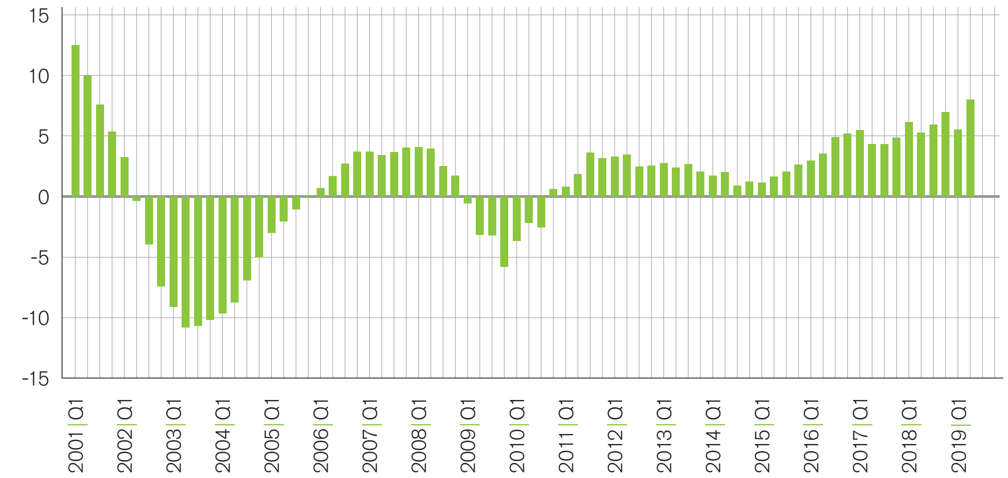
In the period under review, office space vacancies fell again in all BIG 7 markets. Existing **space has not been utilised to such an extent** since the turn of the millennium. Despite having slowed down recently, the rise in the number of office workers continues to put a strain on the market. Furthermore, there are not enough new office buildings being built to balance out the supply side. Even if more building permits are issued again, the number of completions remains low due to exhausted capacities in the construction industry.

The **lack of office space available at short notice** is currently triggering the following effects: one the one hand, companies looking for office space are increasingly prepared to secure space at a very early stage. Brokers expressly state that office space is being increasingly rented off-plan. A substantial share of new office space coming to the market in the quarters ahead is already pre-let. On the other hand, rents for newly let space are rising due to bottlenecks. In the second quarter of 2019, all in all top rents on the BIG 7 markets increased by 2.3 % quarter-on-quarter, or by around 8 % year-on-year.

Office space vacancies (BIG 7) | in % of the portfolio



Top rents (BIG 7) | year-on-year change in %



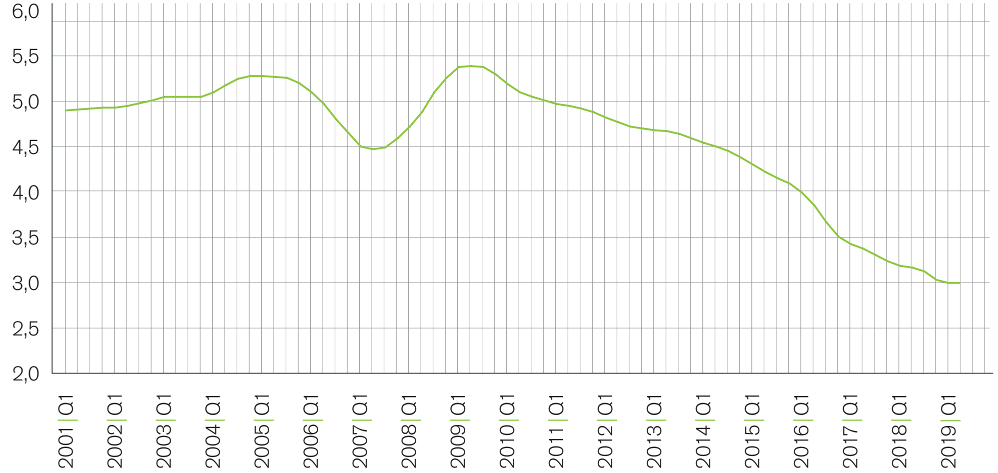
Investment market

Capital inflows fell again in the second quarter of 2019. However, the decline was relatively moderate compared with the previous quarter. Based on preliminary figures from Real Capital Analytics, which are generally revised upwards due to late notifications, capital inflows decreased by roughly 6% from the previous quarter. This minor decline, which is also likely due to the provisional nature of the figures, and the absolute amount of fund inflows do not point towards a turnaround in sentiment; rather, there are signs that market developments will slow down at a high level.

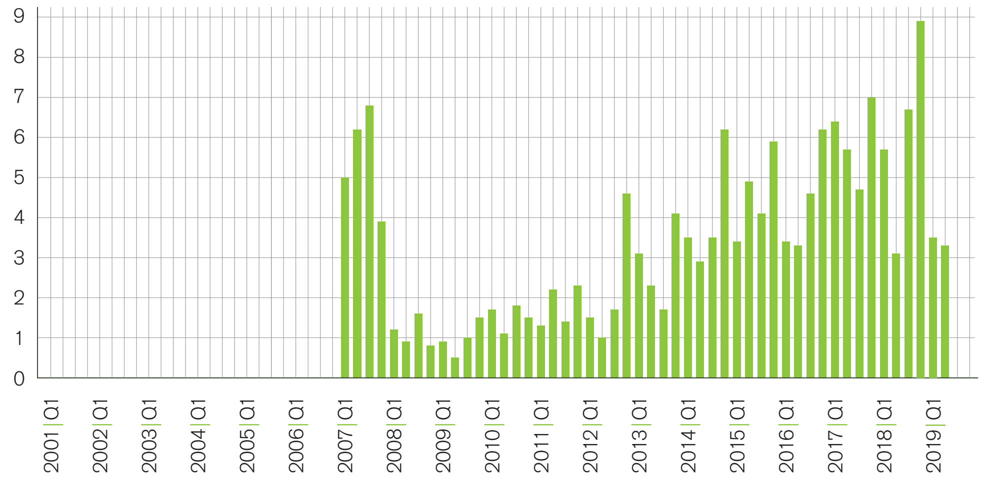
Roughly **two-thirds of the funds came from abroad**, once again benefiting mainly Berlin and Munich. In arithmetic terms, the high international share overall and in these two cities is explained by the fact that cross-border investments increased compared to the previous quarter, while domestic investments fell.

For the first time since mid-2009, **net initial yields halted their decline recently**, but remained at a historically low level of around 3%. It would be too early to draw any conclusions from this about an end to the yield compression: firstly, properties in the core office segment remain in short supply. Secondly, the era of low interest rates shows no signs of coming to an end. As a matter of fact, recently long-term interest rates have even eased somewhat, so that the yield differential between property investments and government bonds has widened again. Expectations about the further course of rents for newly let space also suggest that initial yields for office property will remain under pressure. Property investments are therefore experiencing further tailwinds from interest rates and rents.

Initial net yield (BIG 7) | in %



Investment volume (BIG 7) | in € billion

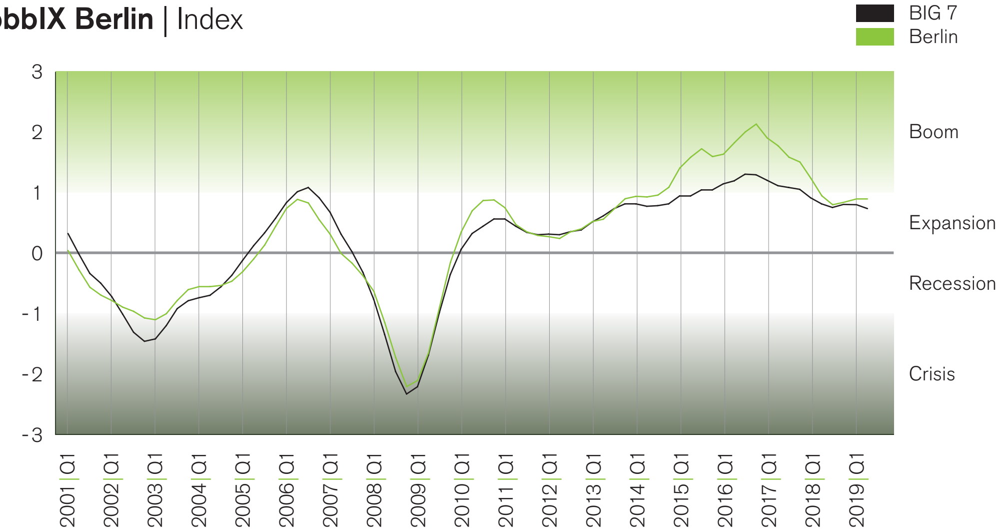


BIG 7

BERLIN

Thanks to many large-volume transactions, such as The Westlight (which is still under construction) and the listed Osram-Höfe, the investment market in Berlin is aiming for a very good result 2019. Overall, the transaction volume in the first half of 2019 exceeded the first half of 2018 by around 60%. Despite the strong demand for a limited supply, yields were stable compared with the previous year and the previous quarter. In contrast, the further drop in the space available on the user market led to another increase in rents, so that – at its peak – the € 35 per sqm threshold was exceeded. All in all, somewhat less office space was taken up than in the previous quarter, nevertheless achieving the third-best half-year result after 2016 and 2017, at around 400,000 sqm.

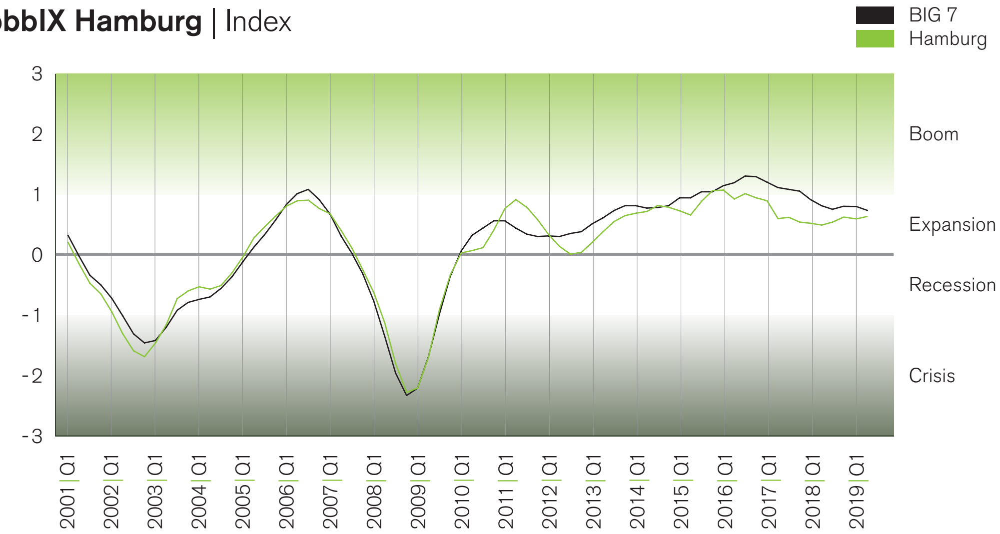
pbbIX Berlin | Index



HAMBURG

Transaction volumes fell once again due to a lack of suitable properties. At slightly less than € 600 million in the first six months, significantly less was spent on office property purchases than in the same period of 2018. The lack of suitable properties for purchase was especially perceptible in the large-volume area. Buying interest is based largely on the good state of the rental market. With a low vacancy rate, the second quarter of 2019 recorded a very high letting performance thanks to some major completions, such as the city's rental of the telecommunications exchange. All in all, the second-best half-year result of the last ten years was achieved, whilst, at the same time, rents continued to increase.

pbbIX Hamburg | Index

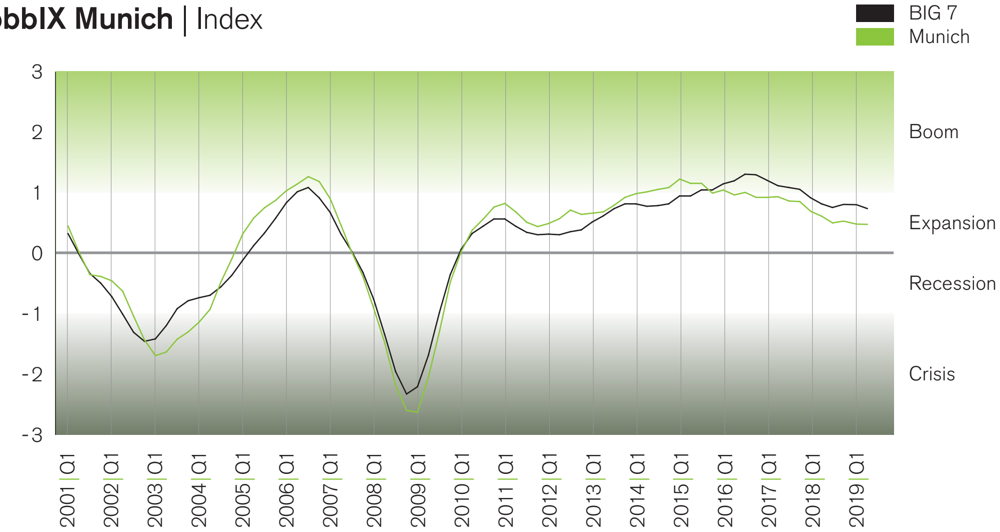


BIG 7

MUNICH

Following a weak start, transaction volumes on the office investment market were significantly higher in the second quarter – at around € 1 billion. This is due, among other things, to the sale of 60% of the Siemens Campus, whose value is estimated at around € 450 million. Overall, office properties with a value of € 1.7 billion were acquired in the first half of the year, marking a significant decline compared with the top result of the previous year. At the same time, yields remained stable during the second quarter. On the user market, the very scarce space available once again prevented a good rental performance. Compared with the first half of 2018, 10% less space was taken up, and large-volume rentals had to be concluded largely in project developments. Accordingly, rents rose once again year-on-year.

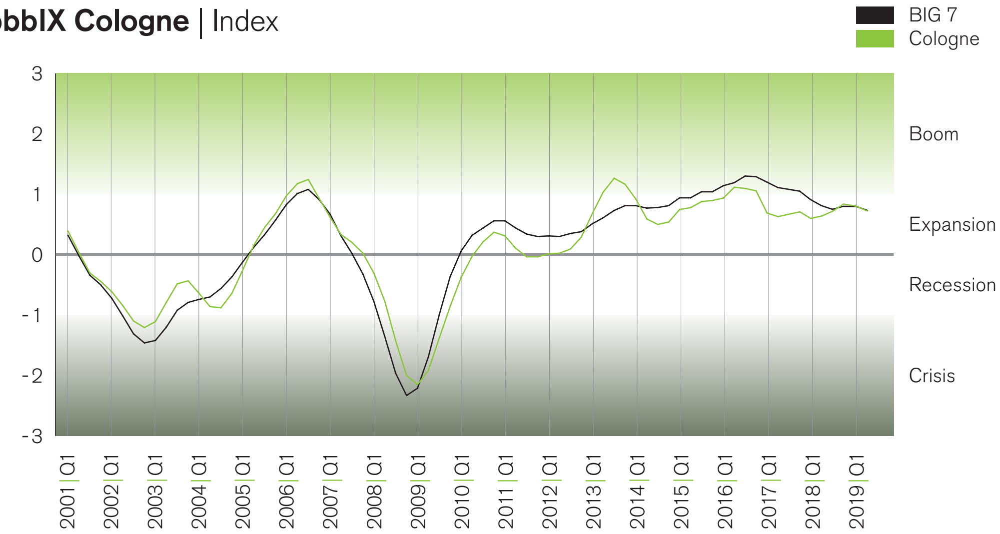
pbbIX Munich | Index



COLOGNE

The second quarter followed on from the good results of the previous quarter. At around € 385 million in the first six months, some 10% more was invested in office property than in the same period of the previous year. Kölnisch Quartier, formerly known as Barthonia Forum, was one of the largest transactions concluded in the second quarter (it was disposed in several separate transactions). The sideways trend in yields seems to be consolidating further. The user market reported rising turnover figures, so that take-up significantly exceeded that of the previous year. The Cologne office market is defined by a shortage of space; the vacancy rate has meanwhile fallen below 3%. At the same time, top rents have increased sharply within one year by around 10%.

pbbIX Cologne | Index

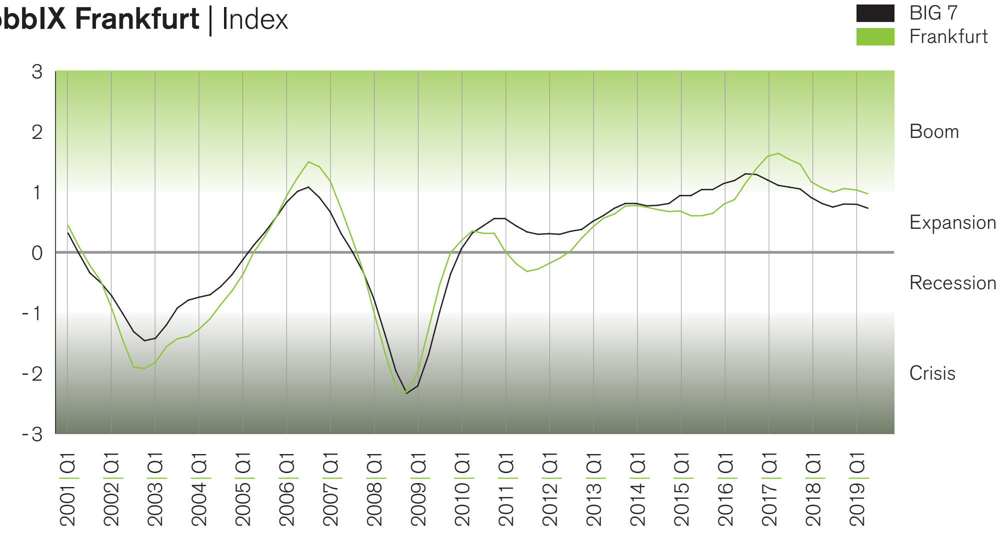


BIG 7

FRANKFURT

A muted first quarter on the investment market was followed by a sharp increase in turnover in the second quarter. All in all, the figure fell only slightly short of previous year's half-year result. More than one third of turnover in the first quarter was attributable to the purchase of the Die Welle complex in the city's West End. This was the second-largest commercial transaction conducted nationwide in the first half of the year. While yields continued to move sideways, rents increased slightly quarter-on-quarter in top locations as well as on average. This was due to a marked increase in demand for space, so that the weak first quarter was more than offset and the previous year's result exceeded by just under 5 %. Thanks to numerous contracts in new-build projects, Frankfurt features the highest pre-letting rate among the BIG 7.

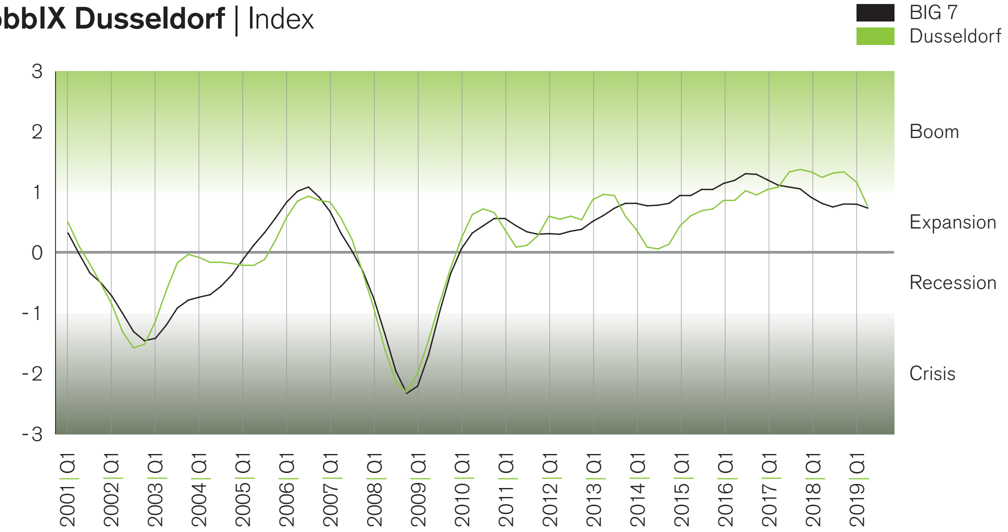
pbbIX Frankfurt | Index



DUSSELDORF

Transaction volumes of around € 500 million in the first half-year were significantly lower compared to the previous year; the reasons were a quiet first quarter and a lack of suitable projects. Market activity was dominated by domestic investors – international investors were therefore responsible for less than one third of the transaction volume. Prime yields were unchanged in recent months, at 3.2 %. The sideways trend in rents continued on the rental market – despite a considerable increase in take-up which, at around 250,000 sqm, recorded the highest figure reached in the last ten years. This was due to some large-scale lettings, e.g. in the MedienHafen (Media Harbour) urban borough on the one hand, and to numerous contract renewals on the other. The vacancy rate fell again and now stands at around 6 %.

pbbIX Dusseldorf | Index

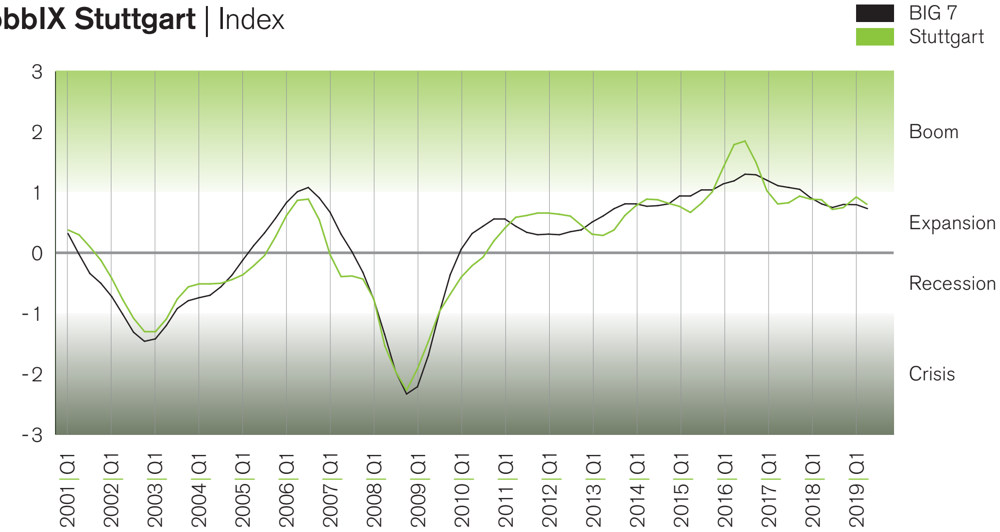


BIG 7

STUTTGART

There is currently little movement on the Stuttgart investment market compared with the previous year's levels. The investment volume in the first half of 2019 was similar to that of the first half of 2018, and prime yields have persisted at just over 3% for the last three quarters. Free space is in extremely short supply; at meanwhile around 1%, the vacancy rate is well below the limit a market should have, not only from the tenants' perspective. The outcome is a very high pre-letting rate. More than 140,000 sqm in office space was taken up in the first six months of 2019. While large-volume contracts were concluded in the first quarter, the second quarter was defined by a large number of smaller units. Top rents were stable compared with the previous quarter despite the shortage of space.

pbbIX Stuttgart | Index



About the pbbIX real estate index

SCOPE AND METHODOLOGY

As the last two decades have shown very clearly, the development of real estate markets is not a continuous trend that is free of disruption – instead, they are characterised by significant cyclical fluctuations. The pbbIX index family tracks these fluctuations on Germany's key office property markets. The index family comprises a total of eight indices: seven individual indices for the office property markets in Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg, Munich and Stuttgart, plus a composite index which tracks overall economic development of the ‚BIG 7' markets.

The indices are based on the results of a dynamic factor model, which brings together eleven variables, using time series to extract the key driving forces for economic trends of office property markets. Specifically, these variables relate to macroeconomic developments, the rental market, and the investment market across the seven office property markets covered. As a preparatory step for the factor analysis, the various market-related indicators are aggregated to form a market indicator measuring a development overall (for example, vacancies or new construction activity). The data list shown below sets out the indicators which were used for the dynamic factor analysis.

In addition to the office property market indices, the presentation contains assessments regarding the components of ‚macroeconomic developments', ‚market for office space', and ‚market for office investments'. The directional impact of these components on the composite indicator is colour-coded: GREEN indicates a positive, BLACK a negative and GREY a neutral impact.

DATA LIST OF THE DYNAMIC FACTOR MODEL

Macro-economic developments
- Real gross domestic product, (YOY change, in %)
- Workforce in the BIG 7 markets (YOY change, in %)
- Consumer prices, (YOY change, in %)
- Current yield (Umlaufrendite) for public-sector bonds with a minimum remaining term of 10 years (in %)

Rental market
- Completed office and administrative buildings (m^2 of floor space in the BIG 7 markets)
- Marketing volume (m^2 of floor space, in the BIG 7 markets)
- Vacancies (% of gross available area, in the BIG 7 markets)
- Top rent (€ per m^2, for the BIG 7 markets
- Average rent (€ per m^2, for the BIG 7markets.

Investment market
- Net initial yield (in %, for the BIG 7 markets)
- Inflow of funds (€ millions)