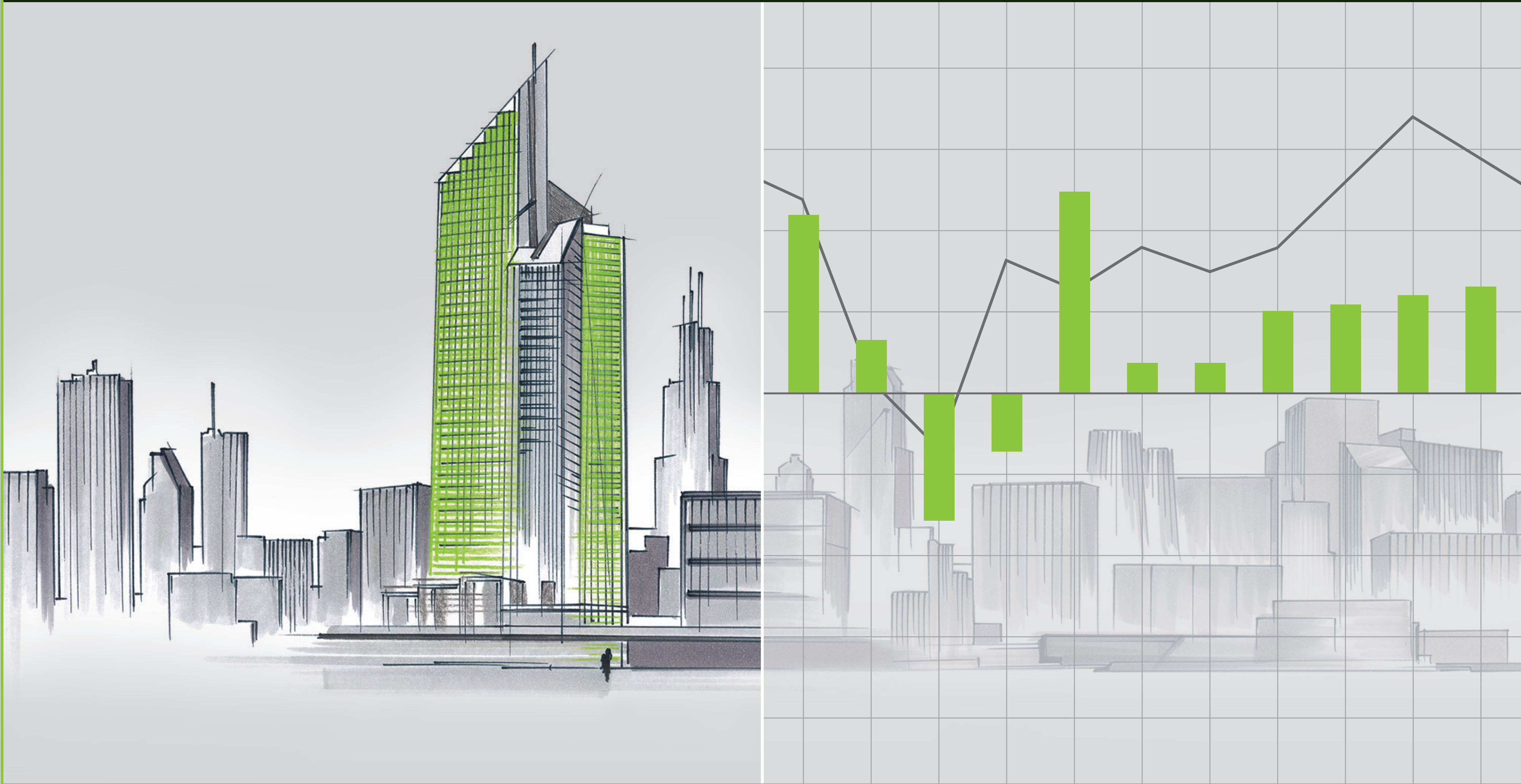
pbbIX
Office Property Market Germany
2019 | Q3

DEUTSCHE PFANDBRIEFBANK



DEUTSCHE PFANDBRIEFBANK

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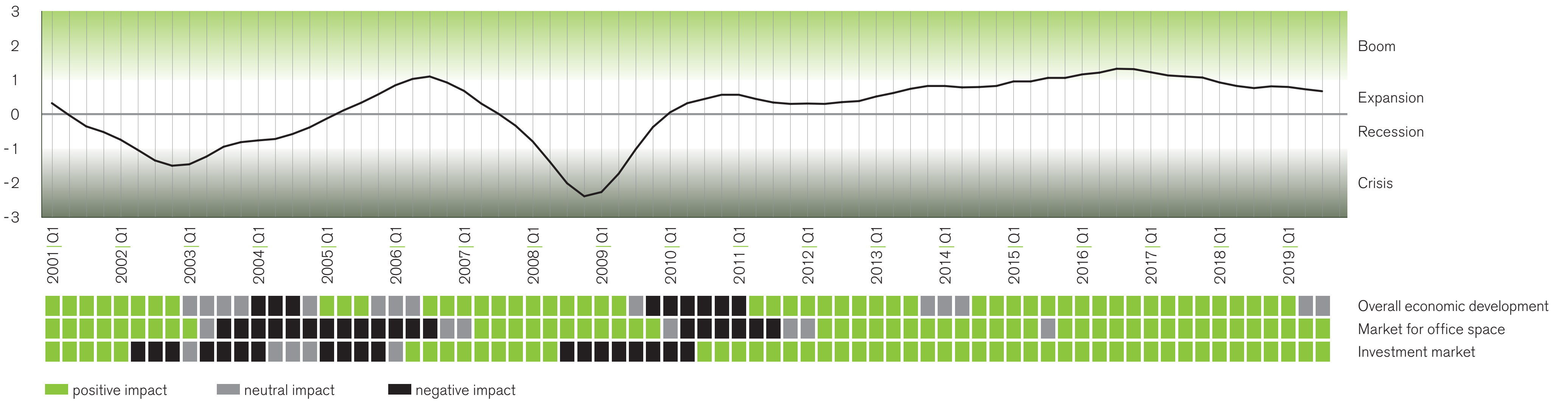
Overview

The pbbIX real estate index, which tracks the development of the BIG 7 office markets in Germany, once again declined slightly in the third quarter. However, at 0.67 points, the pbbIX is still significantly above the zero line. In other words: the seven largest German office markets remain on a **growth trajectory, albeit at a slowing pace**.

In the third quarter of 2019, the **markets for office space and investment continued the very positive development already seen in recent quarters.** At comparatively high letting rates, vacancies eased further whilst rents continued to increase in top locations as well as on average, due to competition for scarce supply. Despite the macroeconomic downturn, demand for office space showed no signs of abating; the markets for office space have remained decidedly robust, even in the face of an increasingly cautious stance adopted by companies when it comes to building production capacity or increasing staffing levels. The situation on the investment markets is similar: in the autumn quarter, cash inflows for office property purchases rose significantly quarter-on-quarter. This increase is exclusively down to domestic investors. With the capital inflows, initial yields once again fell after moving sidewards for several months.

The risks pointed out in the last quarter – with the **economic development especially being a cause for concern** – remain intact. The longer the economic downturn continues, and the more this downturn translates into value creation and employment in the service sector, the more office markets will come under pressure.

pbbIX BIG 7 | Index



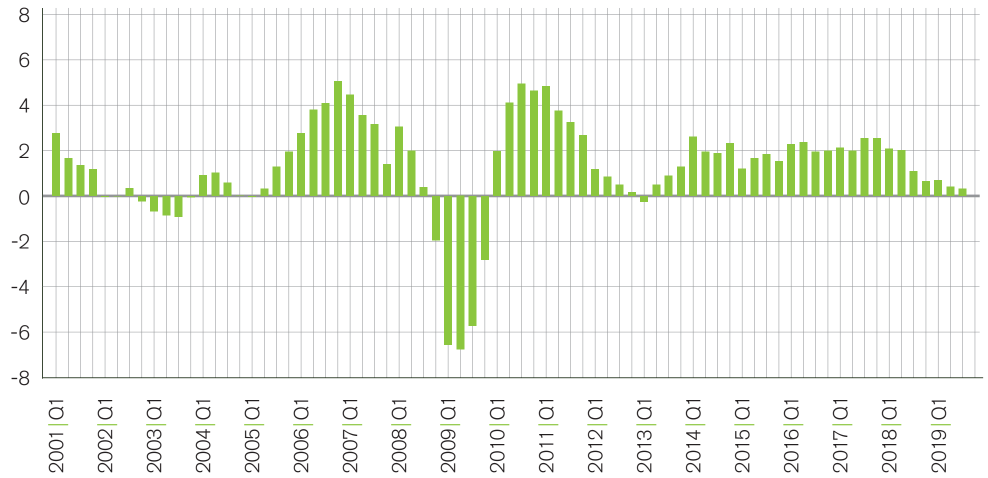
Overall economic outlook

After a slight decrease in real GDP during the second quarter of 2019, Germany's economic development stagnated in the third quarter, with the **main problems coming from the industrial sector.** Production rates have been declining now for approximately one and a half years, due to weak exports demand. Protectionist measures and the still-unresolved Brexit conundrum are dampening German foreign trade.

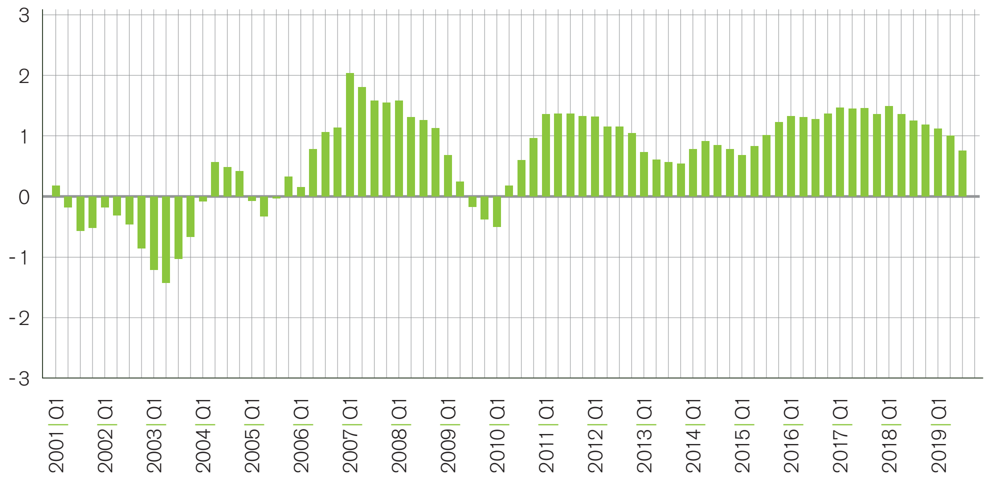
The **service sector** on the other hand has – to date – been boasting a comparatively robust upward trend. Against the background of strong wage increases, a high level of employment, and low interest rates, private consumption and construction investments have a stimulating growth effect. Public consumption is also strengthening the demand.

The question remains as to whether weakness in the industrial sector could extend to the service sector in the short term; Germany's Council of Economic Experts sees some indications of this. According to a survey, companies are being more cautious when it comes to hiring new staff, and the number of vacant positions has been declining for a few months. At the same time, the **experts anticipate no recession,** but rather moderate growth. The ifo Business Climate Index also indicates such a development. Among domestic company executives, sentiment is cautious to slightly positive. Whilst the manufacturing sector sees the current development in a slightly weaker light, it has improved its expectations for the future. Despite a less positive assessment of the current situation, more companies in the service sector are becoming more optimistic.

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



Working population | year-on-year change in %



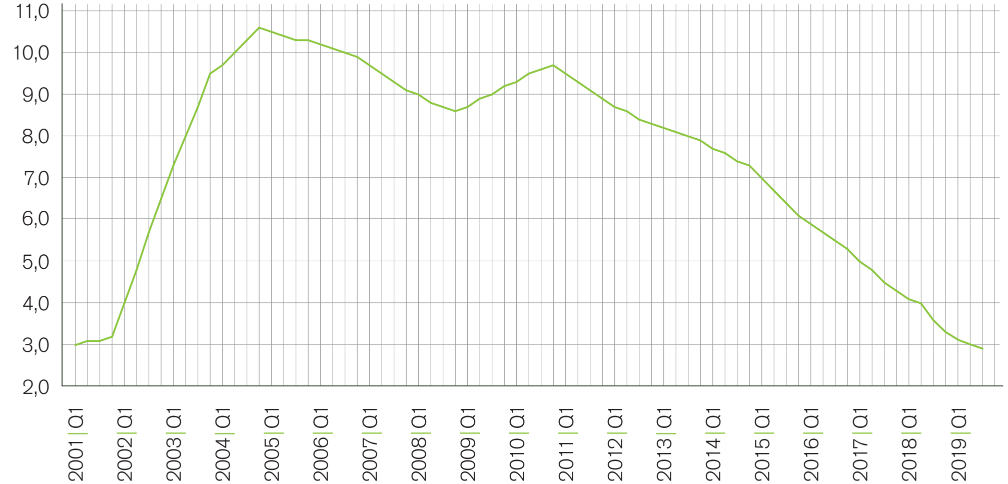
Market for office space

Economic growth and demand for office space are positively correlated: as a rule, higher macroeconomic activity goes hand in hand with higher demand for office space, and vice versa. From this perspective, the euphoria surrounding office markets should gradually subside, turning to disillusionment, since the economy is stagnating and market participants fail to show optimism.

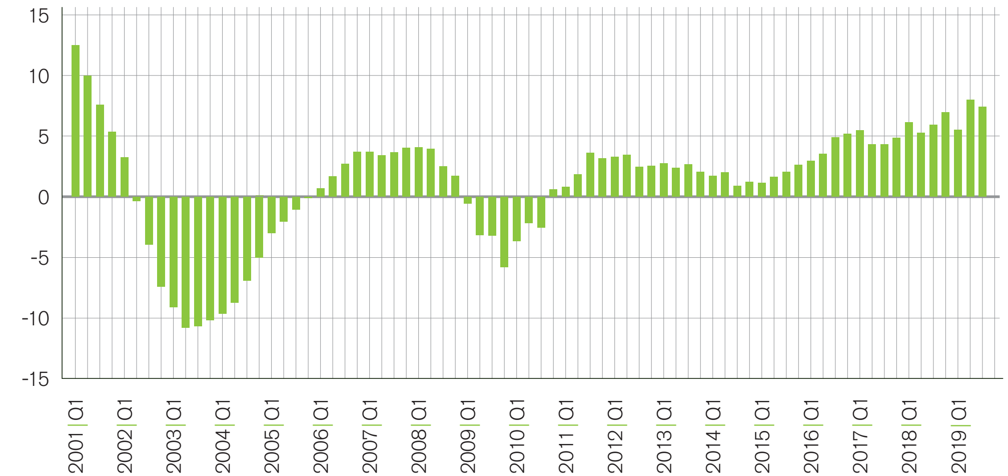
However, **demand for office space was once again substantial** in the quarter under review. According to major estate agents, take-up exceeded the levels seen in the previous quarter, and 2019 is projected to yield a very good result overall. The reasons for this development are manifold: on the one hand, the service sector has been largely spared by the weakness in the German economy until now, on the other, office employment and take-up lag behind the general economy.

The high demand for space has led to office space vacancies falling again in the BIG 7 markets. New construction activity again could not keep up with the demand. Despite the vacancy reduction slightly losing pace, office space available at short-term notice is very rare on the BIG 7 markets. **Rents for newly let space thus increased further in the last few months.** On a weighted average across all seven markets, third-quarter top rents rose by 7.5 % year-on-year.

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



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



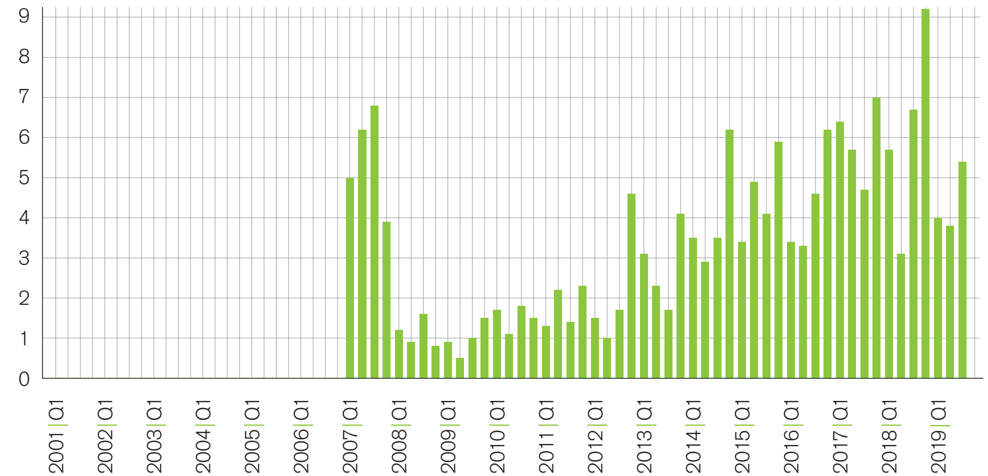
Investment market

Using investment market activity as an indicator for the attractiveness of an offices asset class, offices have been very ‚en vogue' recently. **Cash inflows for office property purchases increased sharply** during the third quarter of 2019. Based on data from Real Capital Analytics, which is generally revised upwards due to late reports, approximately € 5.5 billion-worth of office properties changed hands in the BIG 7 markets. Investment demand apparently remains intact. Domestic investors in particular were keen to spend money, with more than 70% of investments coming from within Germany.

A sideways movement in the second quarter of 2019 was followed by **once again declining initial net yields in the third quarter of 2019.** The reason lies in two related processes: firstly, this development traces the most recent interest rate movement on the capital markets (in a slightly more moderate manner). During the autumn quarter, the current yield *(Umlaufrendite)* for ten-year German Government Bonds averaged -0.54% and was thus 38 basis points below the second-quarter value. Secondly, the very high demand for investment properties exceeds the supply, resulting in rising prices and falling initial yields. A very stable development on the market for office space continues to boost demand.

Initial net yield (BIG 7) | in %

Investment volume (BIG 7) | in € billion

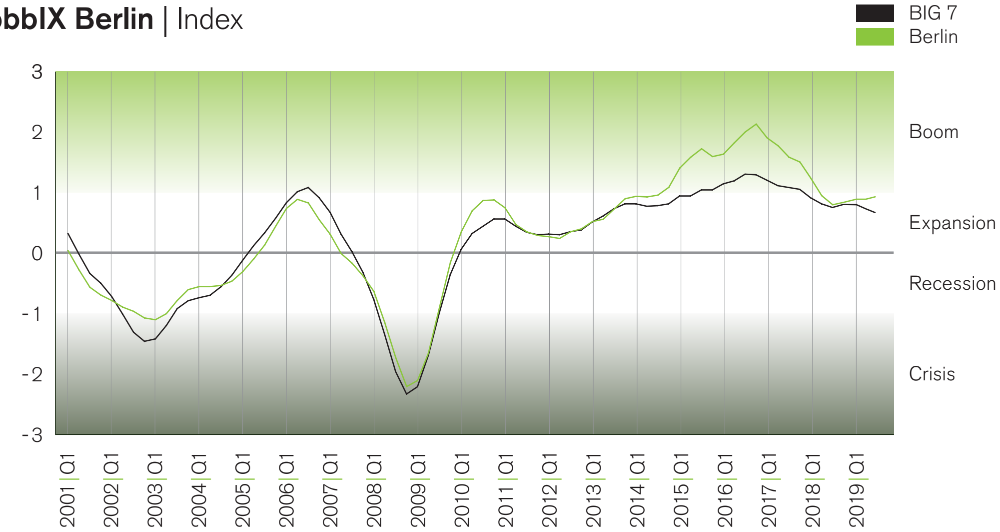


BIG 7

BERLIN

Office tenants as well as investors continue to appreciate Berlin highly; hence, both the rental and the investment markets set new records in the first nine months of 2019. Year-to-date, approximately 750,000 sqm were let – not least thanks to numerous large-volume completions in the third quarter, such as KPMG (approx. 23,000 sqm) and WeCompany / WeWork (13,500 sqm), and a marked increase in office building activity. The rental performance is thus around 25 % higher than in 2018, a year with a high turnover. At the same time, top rents rose to € 37/sqm. Against this background, investors once again focused on office properties. All in all, nearly € 4 billion was invested in this property type during the first three quarters of 2019. High investment demand led to lower yields.

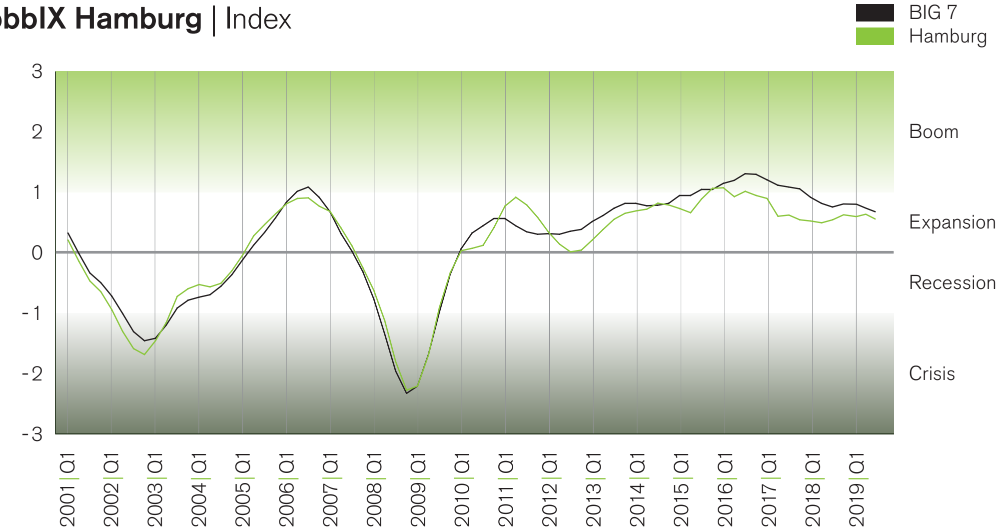
pbbIX Berlin | Index



HAMBURG

During the third quarter the investment market was revived by more supply. In the first nine months, office properties worth more than €1.5 billion have changed hands. However, the good result for the third quarter could not fully offset the lower turnover generated in the first half-year. Overall, transaction volumes during the first three quarters of the year fell short of the previous year's result by 20 %. Due to the high demand, yields decreased a little further, while high pre-letting rates for project developments and the resulting scarcer space available impeded take-up on the rental market. All in all, this year's figure fell slightly short of last year's, whilst office rents continued their upward trend.

pbbIX Hamburg | Index

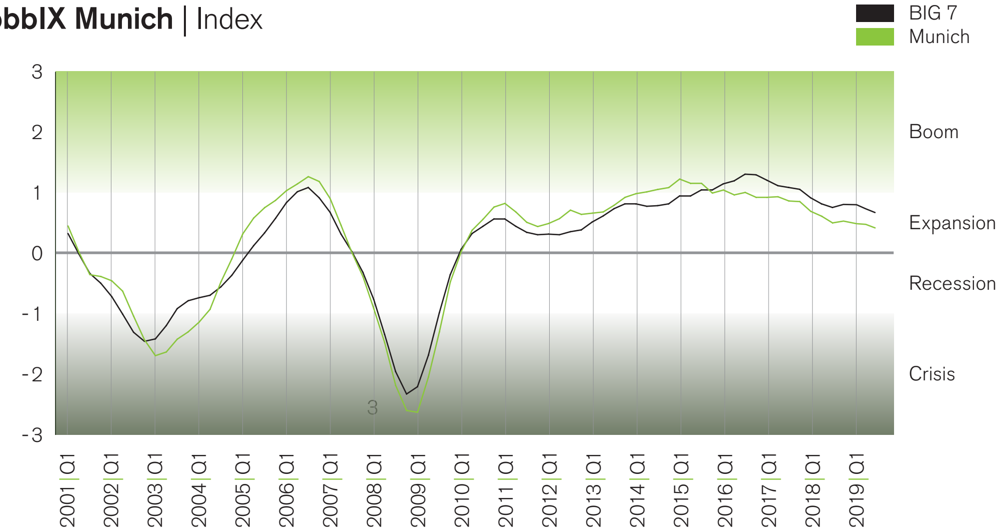


BIG 7

MUNICH

A transaction volume of approximately € 3.8 billion in the first three quarters compares very well to the previous year (+31 %), with the largest share attributable to the third quarter, during which office properties with a value of around € 2 billion were traded. Some large individual deals – such as Kustermannpark, the office complexes Ludwig and Artemis, as well as the disposal of the Millennium Portfolio (HausInvest / Commerz Real) – contributed significantly to this very good result. In contrast to the first half-year trend, yields saw a further moderate decline. The take-up of more than 620,000 sqm only just fell short of the previous year's result on the user market, but it was still the second-highest turnover volume ever achieved. Shortage of space remained an issue despite the increased level of construction, resulting once again in higher office rents.

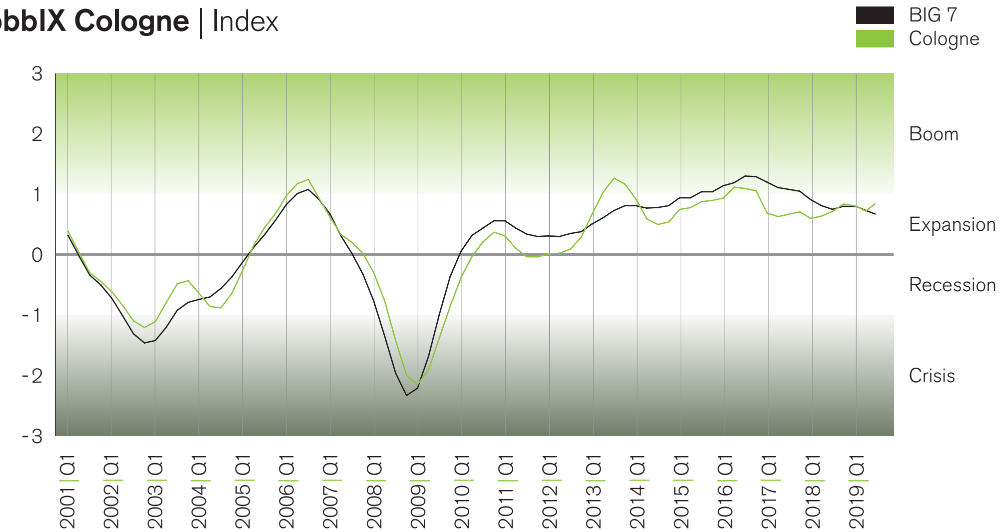
pbbIX Munich | Index



COLOGNE

Compared to other asset classes, the office investment market accelerated significantly in the third quarter. Purchases worth almost € 600 million were made in the first nine months, resulting in a slight increase year-on-year. After moving sideways during the previous quarters, yields dropped again slightly in the past three months as a result of the demand pressure. The rental market was also very buoyant during this period, even though total take-up in the first three quarters fell slightly behind the previous year's figure. Despite increased construction activity, the supply side showed no improvement; vacancies decreased again, thus leading to higher rents.

pbbIX Cologne | Index

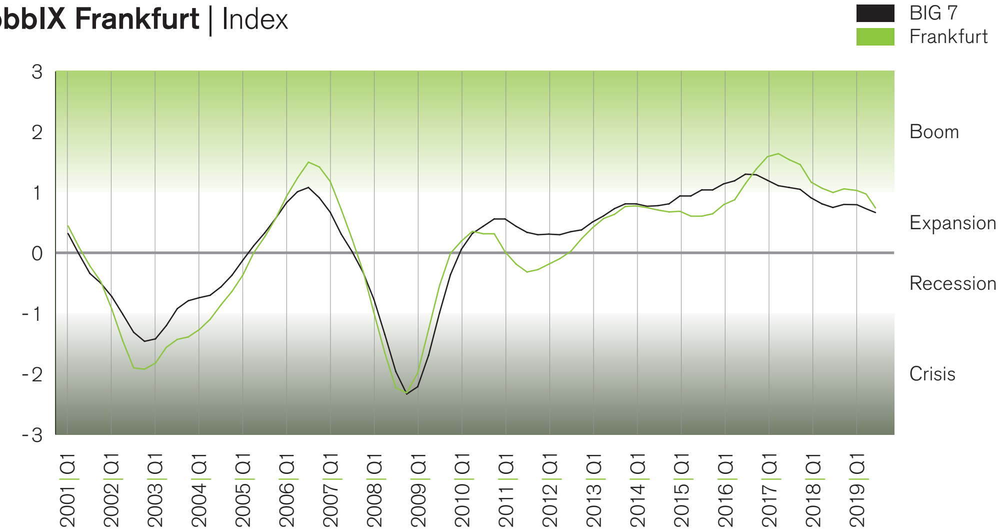


BIG 7

FRANKFURT

In Frankfurt, office properties remain by far the most popular asset class. Thus, it is not surprising that over 80% of the total transaction volume was attributable to this property type in the first nine months. Property disposals from the Millennium Portfolio (Westend Windows, Bock 39) and Dream Global REIT (Werfthaus, K26) were among the largest transactions in Frankfurt, too. Compared to the previous year, transaction volumes were circa 40% lower, albeit from a high comparison basis (2018: € 5.3 billion). Yields dropped again slightly as a result of the high demand. At the same time, a declining vacancy rate was discernible on the rental market – despite lower take-up and supported by lower new construction activity. Scarcity of available space resulted in another rental increase.

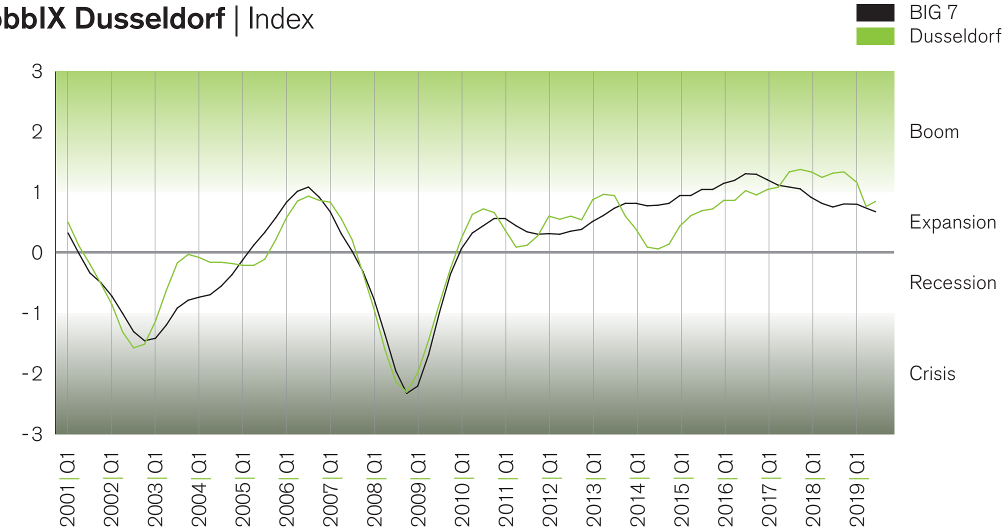
pbbIX Frankfurt | Index



DUSSELDORF

The investment market saw muted development in the third quarter with € 250 million traded. Year-to-date, the volume of € 0.8 billion was significantly lower compared to the first nine months of 2018. As in other cities, the purchase of the Millennium Portfolio and the Dream Global REIT contributed substantial amounts to the third-quarter transaction volume. After moving sideways in the first two quarters of the year, initial yields have recently been recording a negative trend. The rental market should generate an outstanding result. By end of September, nearly 410,000 sqm of space had been taken up, of which more than 160,000 sqm was attributable to the third quarter. Consultancy firms and co-working providers demanded the largest spaces. Quarter-on-quarter, rents were stable.

pbbIX Dusseldorf | Index

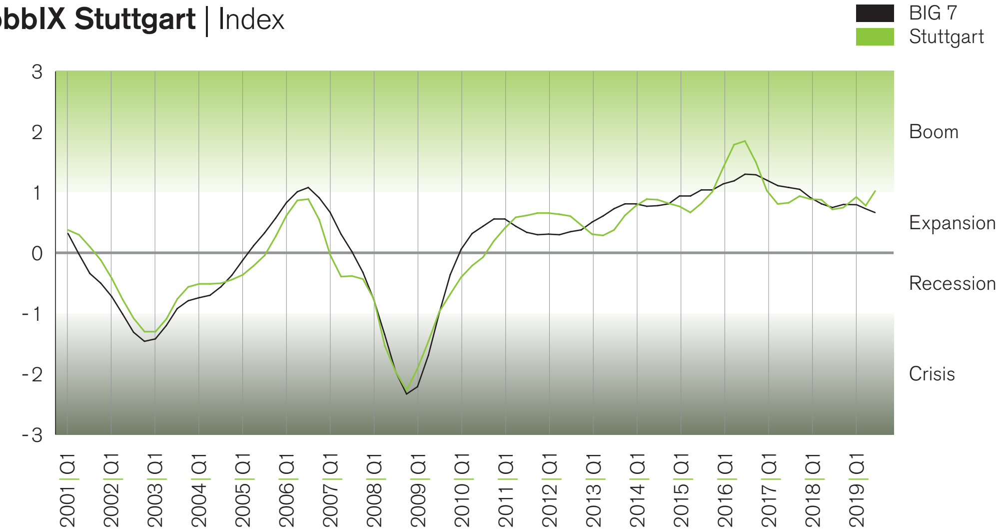


BIG 7

STUTTGART

Capital inflows were high in the third quarter, with the reasons being transactions conducted by the Millennium Portfolio (Rotebühlplatz) and Dream Global REIT (including Oasis III, Officivm). As a result, transactions worth more than € 0.6 billion in total were recorded, thus falling slightly short of the previous year's figure. The sideways movement of prime yields continued once again, but on the other hand the user market was defined by a marked increase in demand. In fact, the first nine months of 2019 saw the highest take-up in recent years, at nearly 260,000 sqm. During the third quarter alone, circa 115,000 sqm was taken up. Against the background of the scarcity of space, approximately 60 % of rental contracts were concluded in project developments. Prime rents once again edged up compared to the previous quarter.

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)