pbbIX
Office Property Market Germany
2021 | Q 1

DEUTSCHE PFANDBRIEFBANK

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Imprint

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Overview

During the **first quarter of 2021 the pbbIX saw a further decline**: it fell from - 1.38 index points in the fourth quarter of 2020 to - 1.51 index points. The downward trend continues – albeit at a much slower pace – mainly due to fewer investments alongside the pandemic-related decline affecting overall economic activity. Adverse influences upon the market for office space were less pronounced.

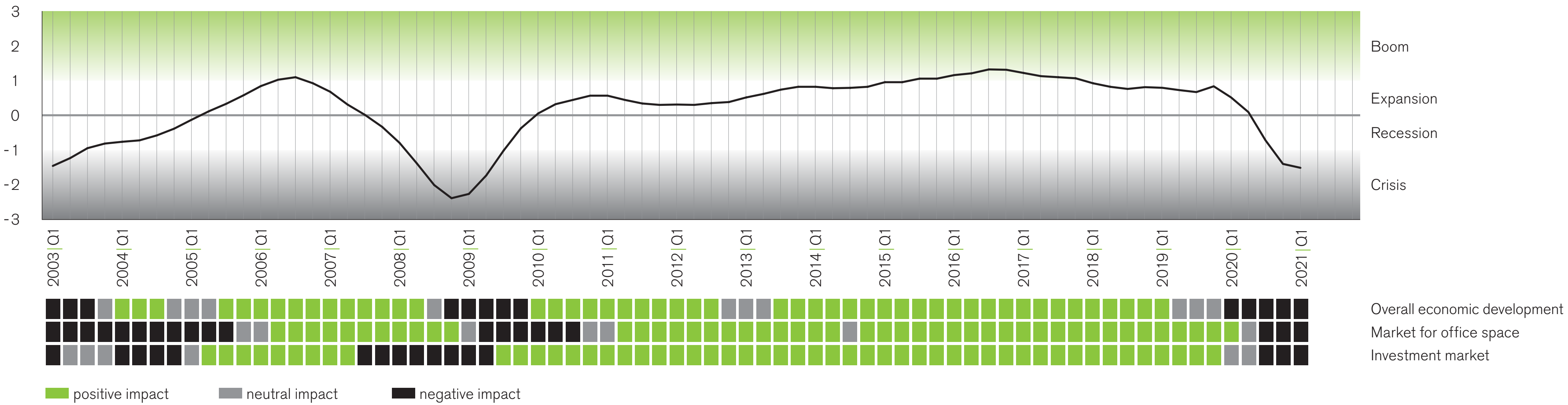
The demand for office space was weak in the first quarter of 2021, but for now it seems to be bottoming out. Whilst vacancy rates were slightly increasing, **rents for newly-let space moved sideways**.

The third wave of the coronavirus and tightening of the lockdown dampened domestic demand while the good development of exports reflects the recovery of the global economy. Howver, overall, **weaker domestic demand** prevailed, pushing macroeconomic activity into negative territory.

Investors in the office market were very cautious. According to data from Real Capital Analytics (RCA), data, **inflows fell** from € 7.3 billion seen in the fourth quarter of 2020 to € 2.1 billion in the first quarter of 2021. Initial yields for first-class properties remained unchanged.

As things stand at the moment, **the pandemic could be overcome in the months ahead**. This could lead to an economic recovery during the year, also reviving the office market. By contrast, structural changes in working practices are exerting pressure on the demand for space.

pbbIX BIG 7 | Index



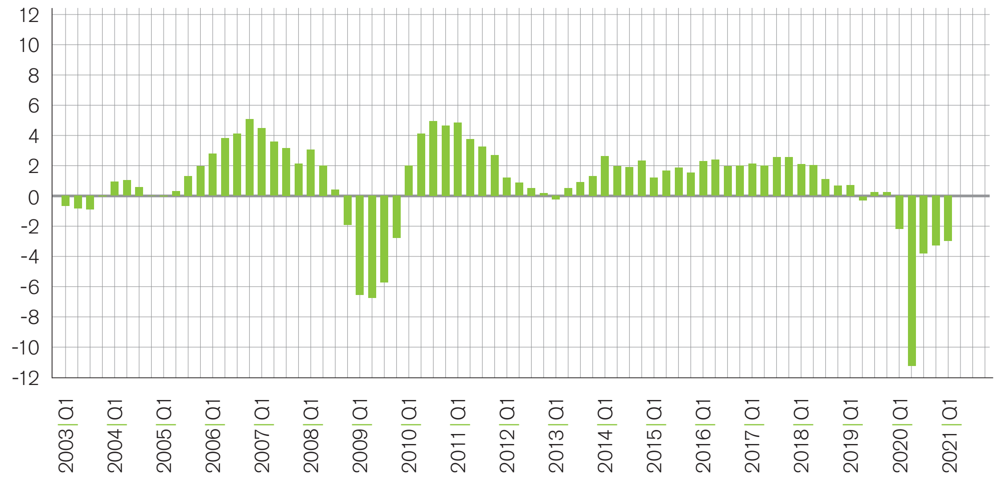
Overall economic outlook

Overall economic production slumped noticeably in the first quarter of 2021. After seasonal and calendar adjustment, real gross domestic product was down 1.7 % on the previous quarter. Domestic demand was mainly burdened by the third wave of infections and the related containment measures. This seriously affected private consumption in particular. Further negative occurrences included the reversal of the temporary VAT relief, the limited availability of goods, intermediate products and operating materials, as well as unfavourable weather conditions in January and February. The construction industry suffered from the reversal of VAT relief and the weather conditions, whereas the limited availability of goods and operating materials also weighed on wholesale and automotive production.

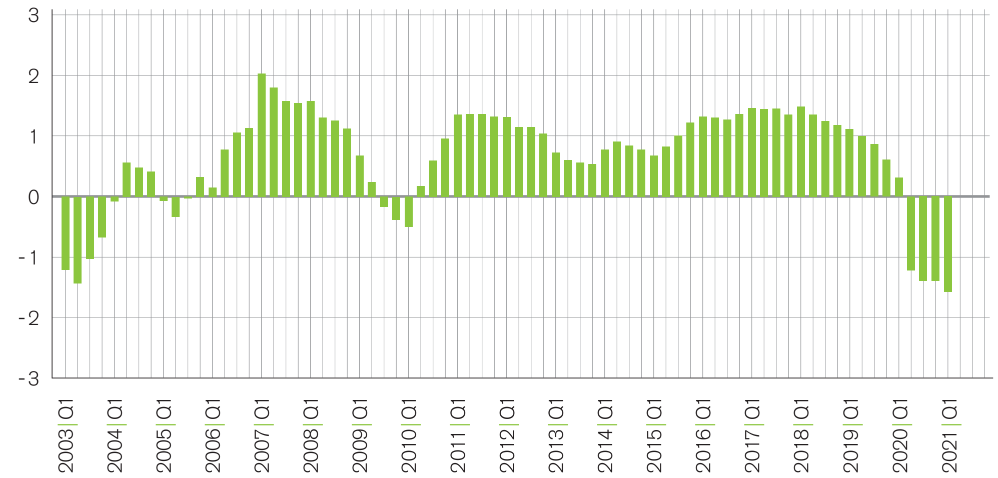
This trend was only partially offset by comparatively healthy foreign demand. The gradual recovery in global economic activity is strengthening the **export business**: exports to countries outside the euro area have significantly picked up since the beginning of the year.

Despite the overall economic problems, **economic sentiment** has brightened further recently, according to the ifo business climate index. In particular, this applies to the manufacturing sector, which is experiencing increasing demand and stronger capacity utilisation. Entrepreneurs surveyed in the services sector – especially in the hospitality and tourism sectors – were less positive: the pandemic has been standing in the way of a more optimistic view until recently. However, as the vaccination campaigns pick up speed, this should change in the months ahead.

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



Working population | year-on-year change in %



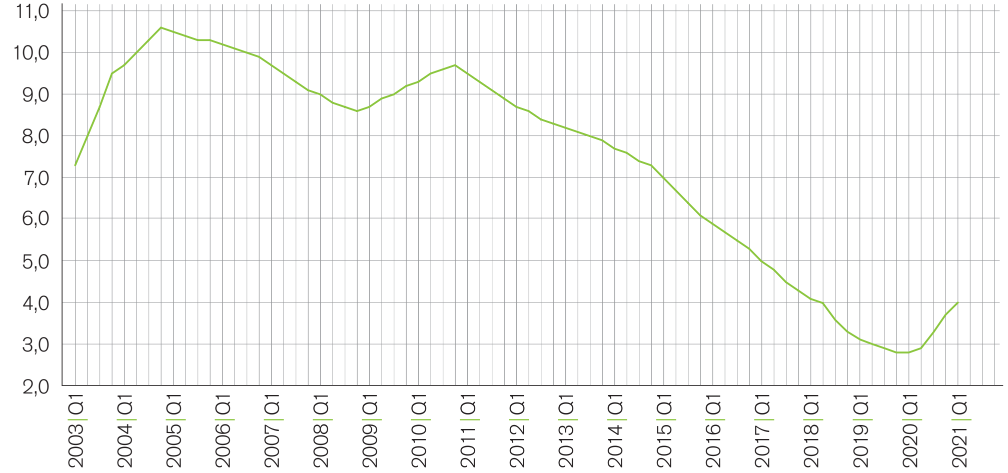
Market for office space

In the period under review, the **letting performance** in the big 7 markets remained more or less on the same level as seen since the beginning of last year. Approximately 720,000 sqm was taken up, which is slightly less year-on-year (Q1 2020: 775,000 sqm) but a small improvement compared to the previous quarter (700,000 sqm). Caution and uncertainty amongst companies is still burdening demand for office space. The situation reflects the economic weakness on the one hand. On the other, there is latent oversupply on the office space market as a consequence of the pandemic, and the unsettled question of what will happen in this regard once the pandemic has been overcome.

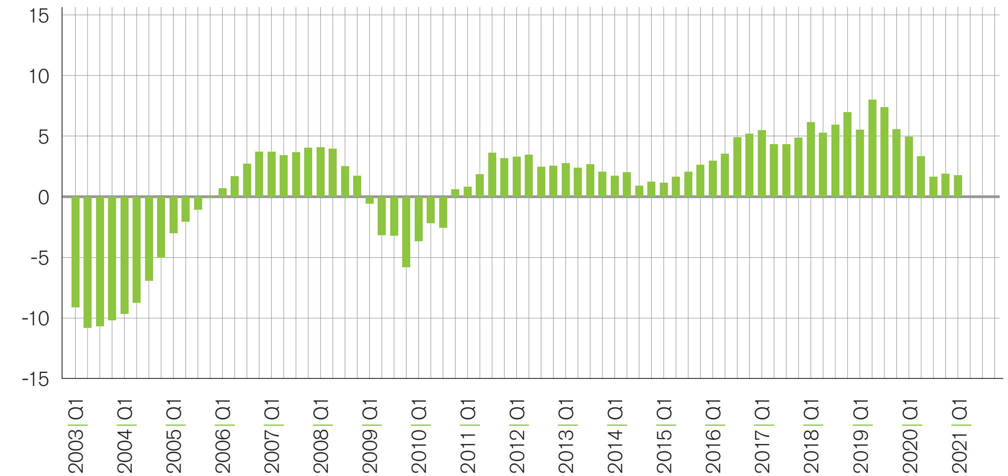
The **vacancy rates** remained on the level of the previous two quarters, as demand did not provide any impulse and the level of new construction was relatively high due to building projects planned before the pandemic. On a weighted average-across all big 7 markets, around 4 % of office space was unlet, equivalent to a 30 bp increase compared to the corresponding period of the previous year.

So far, this increase has had no impact on the performance of **top rents**. While, according to real estate brokers, contract completions required more incentives, top rents in the last quarter remained unchanged in all big 7 markets. Average rents, too, were largely stable. It remains to be seen whether this trend remains intact in the quarters ahead. The oversupply of office space will continue to increase, at least temporarily – and tenants will be keenly aware of their ability to leverage bargaining power resulting from this.

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



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



Investment market

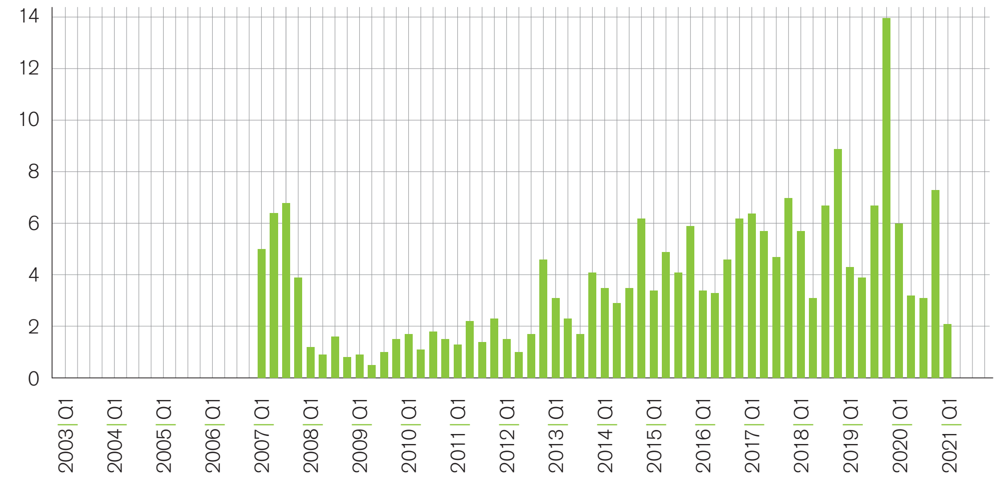
In terms of **inflows**, the office investment market had a modest start into 2021. According to RCA, only € 2.1 billion was invested in the first quarter, undercutting the previous three quarters (similarly impacted by the pandemic) by 50 % on average.

The weak start into the new year not only reflected the usual quarterly fluctuations: firstly, travel restrictions and the surge in infection rates in the first quarter constituted significant hurdles that are difficult to overcome, especially for foreign investors. Secondly, **investors have recently tended to prefer other property types**. Overall, investor behaviour is significantly influenced by the prospects of income and operative stability. In the wake of the COVID-19 pandemic, residential and storage/logistics properties have become more attractive. Investors therefore carefully adjusted their portfolio allocation in order to account for the general trend towards these property types.

Nevertheless, office properties still play a prominent role when it comes to investments in the big 7 markets. Investors do, however, adapt their behaviour to the existing sources of income and uncertainties. This is also reflected by the development of **initial yields** for first-class properties in prime locations, which remained at around 3 % on average across all markets in the first quarter, even though the current yield for 10-year government bonds increased from -0.61 to -0.47.

Net initial yield (BIG 7) | in %

Investment volume (BIG 7) | in € billion

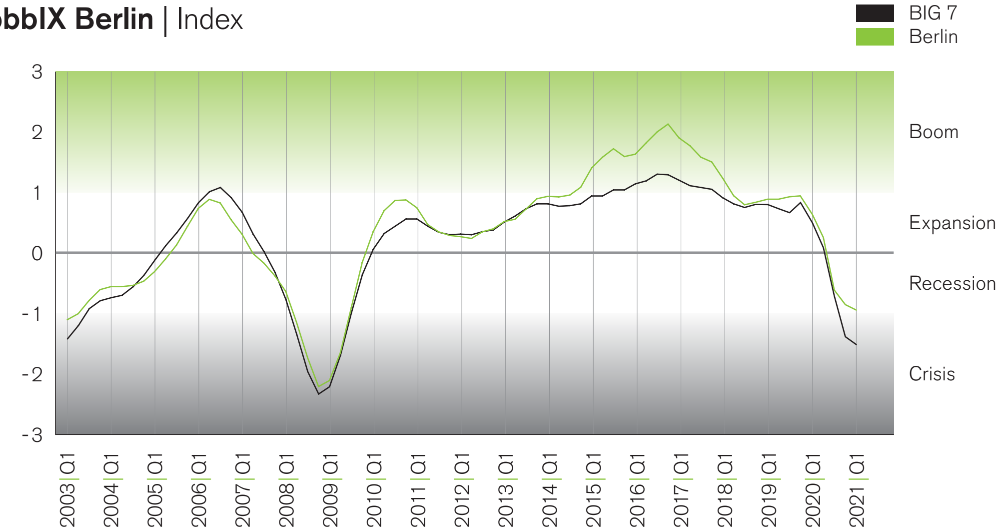


BIG 7

BERLIN

The market for office space in the capital had a good start into the new year. In the first quarter, a total of approximately 210,000 sqm of office space was taken up, significantly exceeding first quarter 2020 levels, and only slightly missing the five-year average. The large real estate brokers recorded several major completions exceeding the 5,000 sqm mark in different industries. Nonetheless, the vacancy rate increased and was at 3.4 % at the end of March, 60 BP above the level of the previous quarter. Top rents were flat, against the year-end level of € 40 per sqm. Compared to the previous quarter and the respective previous year's quarter, which saw a very high level of investments, inflows on the investment market were materially lower. Initial yields remained unchanged.

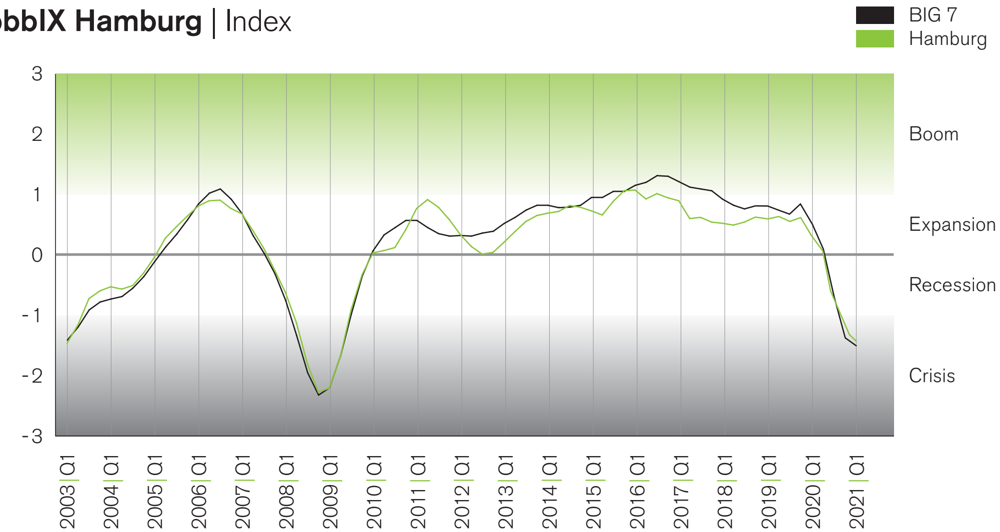
pbbIX Berlin | Index



HAMBURG

Starting at a low level, demand for space has continuously increased over the last quarters. This development continued during the first quarter of 2021, when space take-up amounted to around 135,000 sqm, compared to around 90,000 sqm per quarter in 2020. On the back of the increased space take-up, the vacancy rate decreased slightly to only 2.9 %. Rents – both top and average – remained unchanged compared to the previous quarter. According to RCA, only around € 0.5 billion was spent on the acquisition of office properties in the first quarter of 2021. Thus, investment volume was up compared to the same quarter of the previous year, but significantly down compared to the past three quarters similarly impacted by the pandemic. Yields for first-class properties in prime locations remained unchanged from the previous quarter at 2.7 %.

pbbIX Hamburg | Index

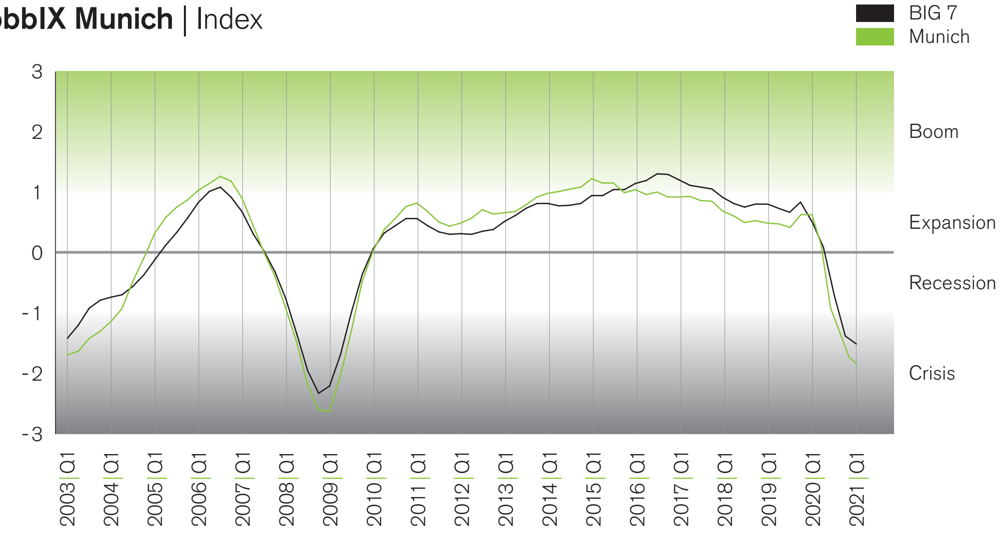


BIG 7

MUNICH

The letting performance was very subdued in the first quarter of 2021. Overall, around 104,000 sqm were let or occupied by owners, which is significantly less than the multi-annual average, but close to the level of the previous quarter. Especially major completions were lacking (no completion above 10,000 sqm.). The increase in vacancies seen since spring 2020 persisted: the vacancy rate rose by 40 bp to 3.4 %. Notwithstanding this development, top rents for first-class properties still amount to € 41 per sqm, while average rents also showed no material change. According to RCA, transaction volumes were at € 170 million. Major estate agents published slightly higher inflows, while also pointing to a very weak first quarter. As at year-end, net initial yields for first-class properties remained unchanged at around 2.7%.

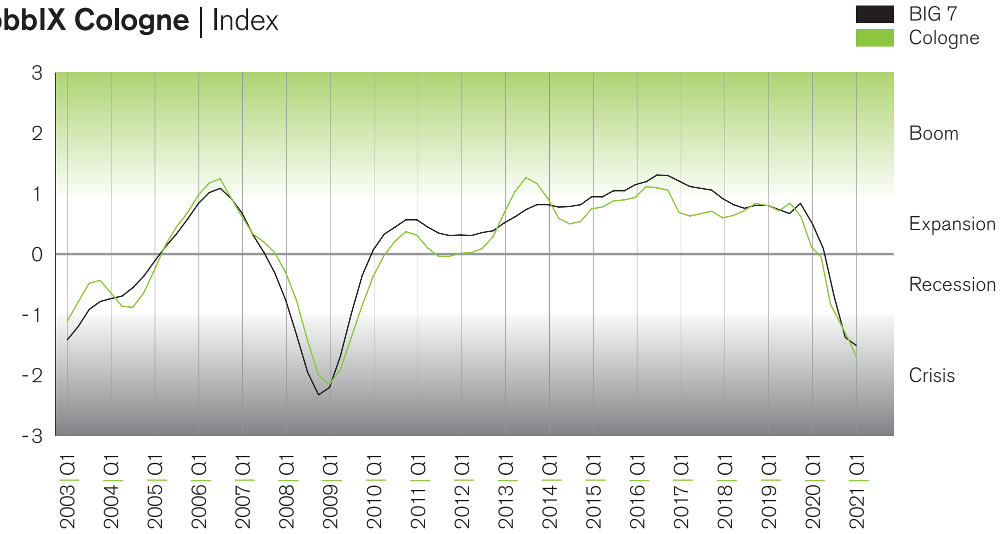
pbbIX Munich | Index



COLOGNE

The Cologne office market had a good start into the year: letting amounted to 89,000 sqm, of which around 40% was attributable to two large-scale lettings. The letting performance thus exceeds the average of the years 2017 to 2019, which saw a quarterly space turnover of around 75,000 sqm. Due to high new letting and low new construction activity, the vacancy rate halted its upward trend and shifted into a sideways movement. At the end of the first quarter, the vacancy rate for office space was at 3 %. Rents for newly-let space remained unchanged for another quarter. According to RCA data, only €68 million was spent on the acquisition of office properties in the first three months. Other sources stated slightly higher, but still low inflows. As at year-end, net initial yields for first-class properties remained unchanged at 3%.

pbbIX Cologne | Index

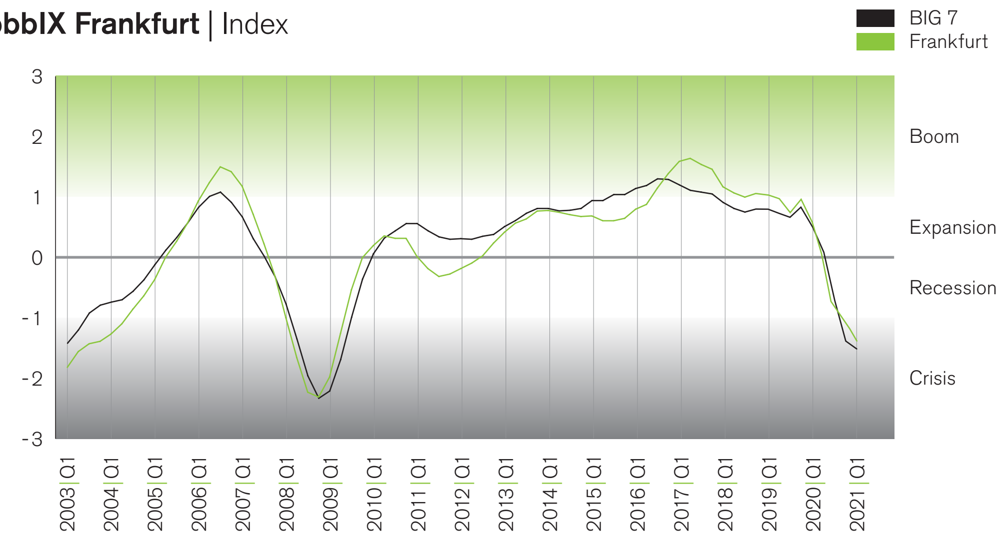


BIG 7

FRANKFURT

Demand for office space has been at a comparatively low level for several quarters now. Around 83,000 sqm was taken up, about as much as the quarterly average of 2020, but materially below the long-term average. The vacancy rate for office space – which in Frankfurt is traditionally high in comparison – increased again to 6.3 %. Sub-lettings were increasing as well, now accounting for almost 1 % of the portfolio, according to real estate agents. Rental development was not yet affected by this, and both top and average rents remained stable. According to RCA data, office property transactions amounted to € 450 million, with domestic inflows accounting for 60%, and inflows from Europe accounting for 40 % of the transactions. Net initial yields for first-class office properties remained unchanged compared to the previous quarter, at 2.8 %.

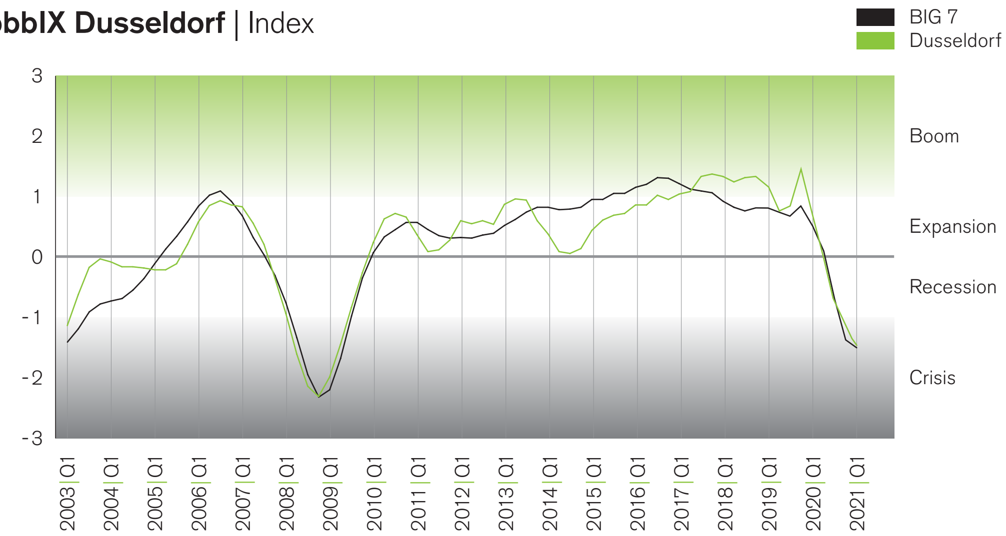
pbbIX Frankfurt | Index



DUSSELDORF

In the first quarter of 2021, the Dusseldorf office market continued the weak demand trend of the previous year. Only 57,000 sqm was taken up, while the quarterly average of 2020 still amounted to 76,000 sqm. Despite low new construction activity, this development led to a renewed increase in office space vacancy rates. At the end of March, the vacancy rate for office space was at 7 %. Nominal top rents were flat at € 28.50 per sqm. The high inflows on the investment market in the fourth quarter of 2020 was followed by a very subdued start to the year: investment volume amounted to around €130 million – only 22 % of the average quarterly investment volume of the past five years. Nevertheless, net initial yields for first-class properties remained unchanged at around 2.95 %.

pbbIX Dusseldorf | Index

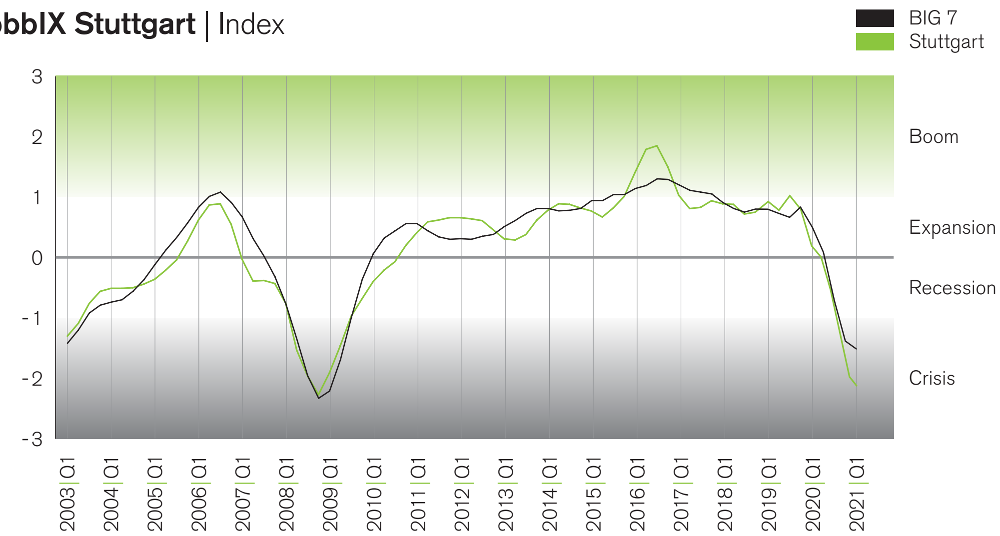


BIG 7

STUTTGART

In the first quarter of 2021, the letting performance was down 7 % compared to the average quarterly level of the past year. Overall, almost 33,000 sqm was taken up by new tenants or owner-occupiers. Vacancy rates decreased slightly, and are very low at just 2 %. However, more space was again offered for sub-letting. Rents for newly-let first-class properties as well as average rents remained unchanged in the period under review. The investment market followed on from the subdued development of the past year without any major changes. Inflows amounted to only € 150 million, which was said to be due to an insufficient supply of investment properties. This point of view was confirmed by the development of prime yields, which – despite higher long-term interest rates – remained at 2.85 %.

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)