pbbIX
Office Property Market Germany
2019 | Q4

DEUTSCHE
PFANDBRIEFBANK

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Overview

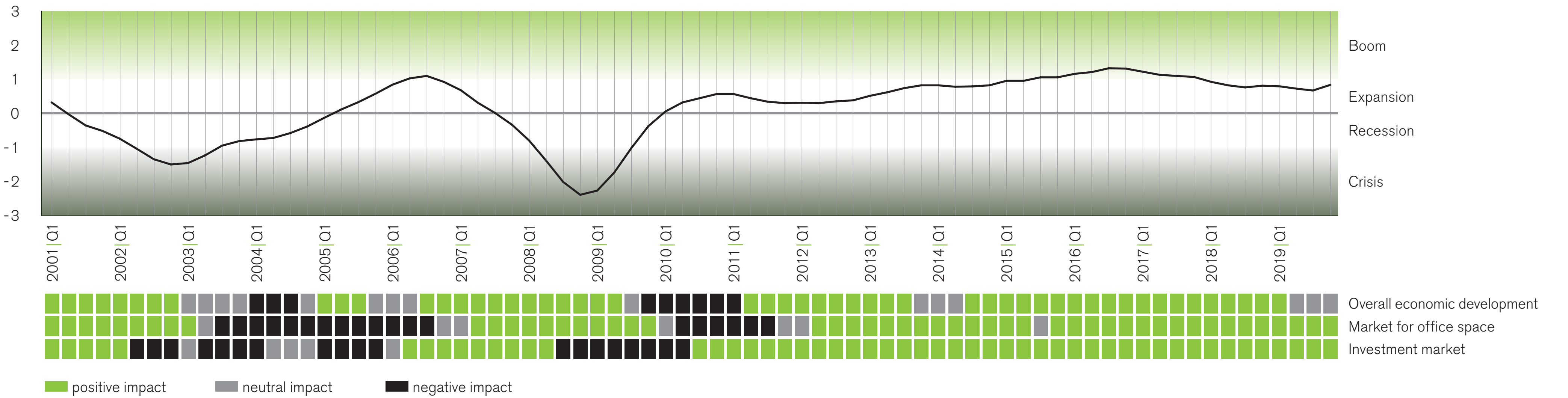
The pbbIX real estate index which tracks the development of the 'big 7' office markets in Germany, rose in the fourth quarter having declined slightly over the last few quarters. At the end of 2019 it stood at 0.83, its **highest value since the first quarter of 2018**. The seven largest German office markets remained on course for growth, and the pace of growth has in fact increased slightly.

The rise in the index was mainly due to the fact that there were **no further negative macroeconomic developments** in the last quarter of 2019. Overall economic development is on a gentle upward path after a weaker development for most of the year. While employment growth has slowed somewhat, there is no sign of a recession. The number of office jobs in the big 7 office markets increased by 3.2% last year, thus providing the basis for the very strong demand for office space.

In the last quarter of 2019, this market continued to show comparatively high letting volumes, decreasing vacancy rates and a continued rise in rents. In the meantime, the number of **new construction** activity kept rising. The favourable conditions on the office space market, combined with low interest rates and a sense of optimism, determined the development on the investment market which was marked by extremely high investment levels. Investors from abroad, in particular, acquired unprecedented amounts of office real estate in Germany. There has been less interest from investors in English-speaking countries.

The first few months of the current year are likely to lag behind last year's high investment activity. There will be a base effect, but this will not change the fact that when looking at the key indicators, the **office property markets look good**.

pbbIX BIG 7 | Index



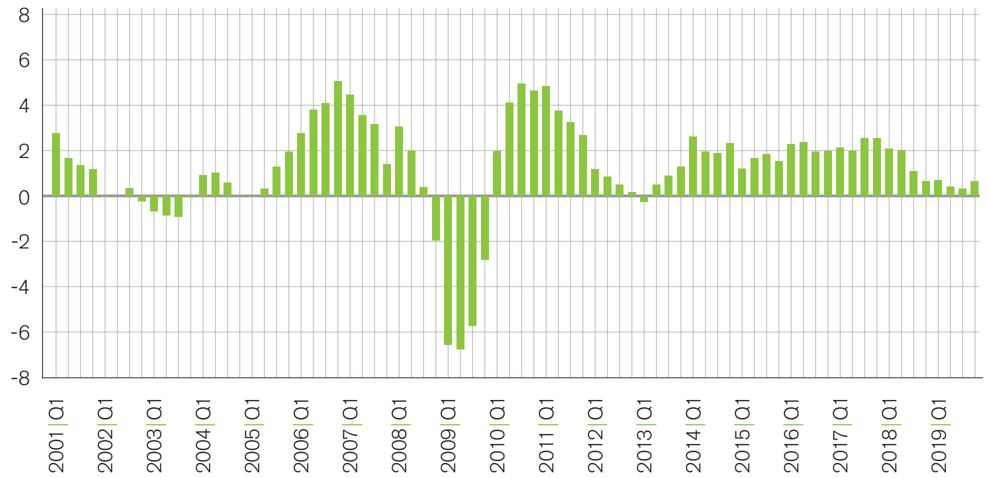
Overall economic outlook

In 2019, economic growth was low due to continued political uncertainty and weak trade flows. Over the year as a whole, **real gross domestic product rose by only 0.6 %**. Companies that rely on exports have suffered particularly badly from declines in export orders and industrial production. This contrasts with those sectors which are more reliant on the domestic economy: they proved resilient and thus averted a recession. The construction sector was especially robust: based on the bulging order books, high production output is expected to continue.

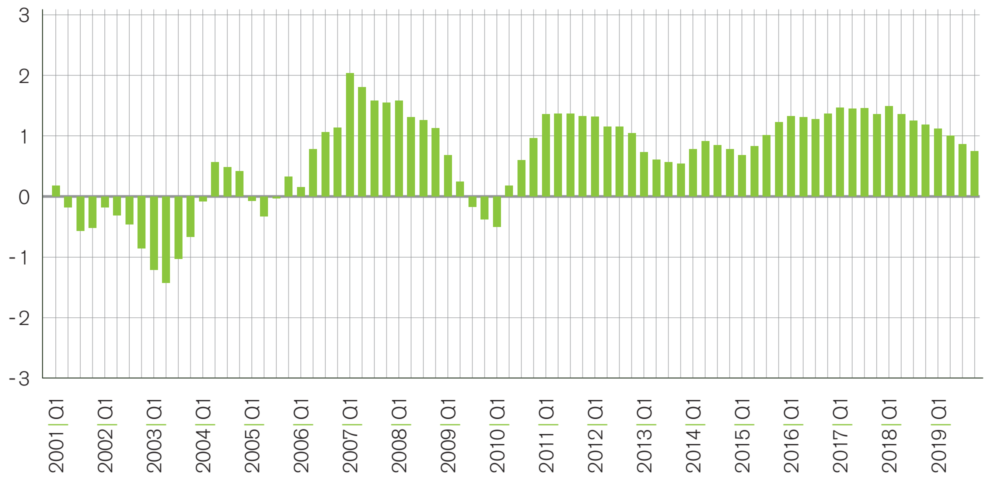
On balance, it is expected that **overall economic production will continue to grow at a very modest rate** for the winter period 2019/2020. At the same time, however, there are signs that the downturn in export-driven industry is coming to an end and is entering a phase of stabilisation. This should mean that – contrary to what was feared in the last quarter – those sectors geared towards the domestic economy will no longer be burdened and are unlikely to be drawn into a downward spiral.

Deutsche Bundesbank refers to this as a **soft landing**. In the German central bank's most recent economic outlook, the German economy is expected to gradually overcome its current weak phase and move towards achieving growth close to potential out-put. This would be equivalent to an increase in gross domestic product of around 1.3%. However, uncertainty remains – for example, given the renewed escalation in trade disputes and a greater slowdown in growth in China as well as the impact of the Corona virus epidemic.

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



Working population | year-on-year change in %



Market for office space

The fourth quarter of 2019 again showed no signs of the market for office space being affected by the weaker economic developments. The usual indicators of market stress, i.e. demand for office space, vacancy rates and rents for newly let space, are **not yet showing any signs of cyclical weakening**. In other words, the market was still in good shape as we moved into 2020.

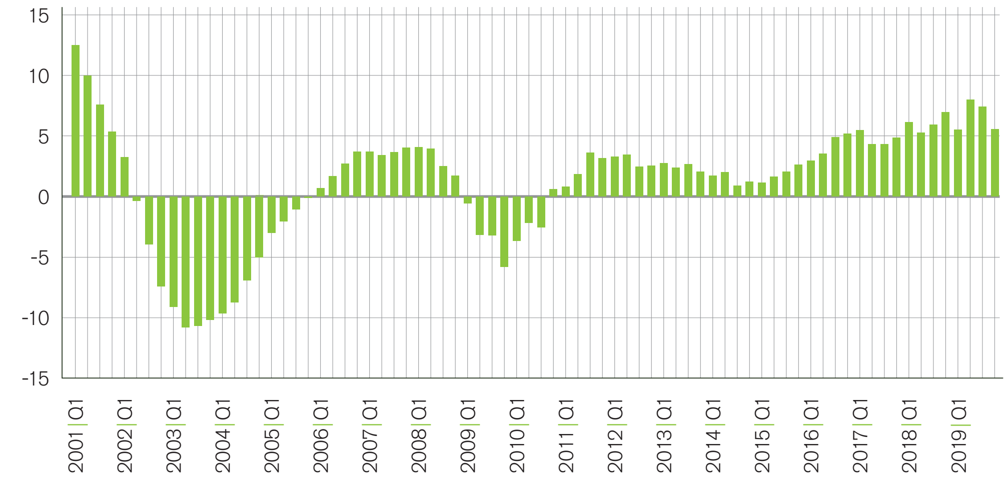
Demand for rented office space remained very high in the fourth quarter. Office space take-up in the big 7 markets was only marginally down on the previous quarter. Over the course of the year, office space take-up was at its highest since the early 1990s, with Berlin showing particularly high take-up rates.

In the wake of this development, **vacancy rates dropped** further towards the end of 2019, which were already at very low levels. However, we are seeing a steady increase in new construction activity. It remains to be seen, though, whether this new construction activity is strong enough to compensate for the gap between supply and demand that has existed for years and thus influenced the development of the market.

At the moment, landlords are the ones calling the shots when it comes to the market for office space. This essentially means that the **increase in rents for newly let space** is yet to peak. In the fourth quarter of 2019, on average, top rents across all the big 7 markets increased by 5.5 % year-on-year. The increase in average rents was even more marked. The total increase across all markets was around 10 % compared with the same quarter of the previous year.

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

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



Investment market

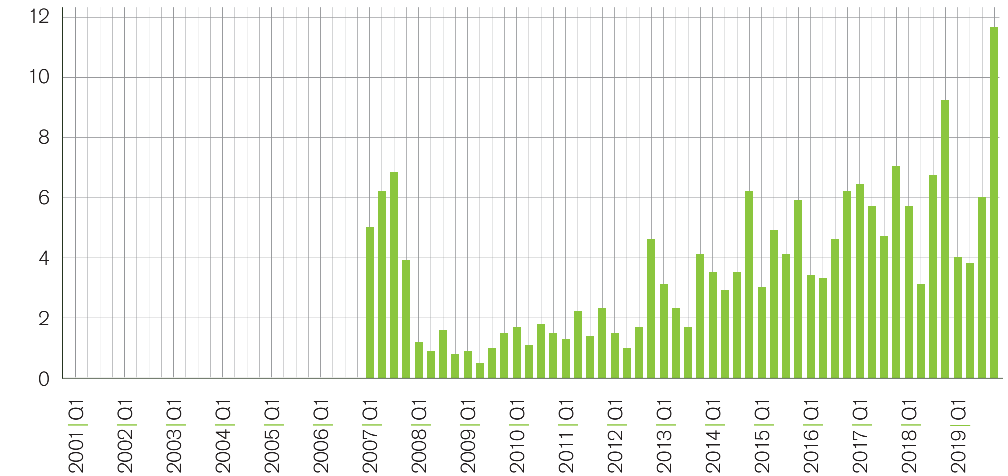
The investment market enjoyed an **exceptionally strong year-end**. Based on figures from Real Capital Analytics, in the fourth quarter, office property in excess of € 11.5 billion was acquired in the big 7 markets, the highest fund inflows of any quarter since the beginning of 2007. This more than compensated for the somewhat weak start to the year, and on balance led to highest annual results to date. In particular, a high level of investment interest came from abroad. At €6.7 billion, almost 60% of the funds came from cross-border investments, mainly in the form of large-volume transactions. There was a particularly high level of activity among investors from outside Europe.

Once again, the very strong demand for office property was reflected in the continued **pressure on net initial yields**, reaching new lows of around 2.9% at the end of 2019. High investment demand and a corresponding decline in yields are closely linked to the exceptionally low interest rates, which are now no longer considered to be just a temporary phenomenon. Low interest rates are channelling more and more capital into the real estate sector, where the „office" asset class is particularly benefiting, due to the solid economic data. Comparatively stable and high rental yields combined with the expectation of positive valuation effects appear to paint a very rosy picture.

This will remain the case for the time being. As a result, the **positive cyclical trend on the investment market** is likely to continue for a while. However, fund inflows from the first quarter of 2020 will be lower than the last quarter of 2019.

Net initial yield (BIG 7) | in %

Investment volume (BIG 7) | in € billion

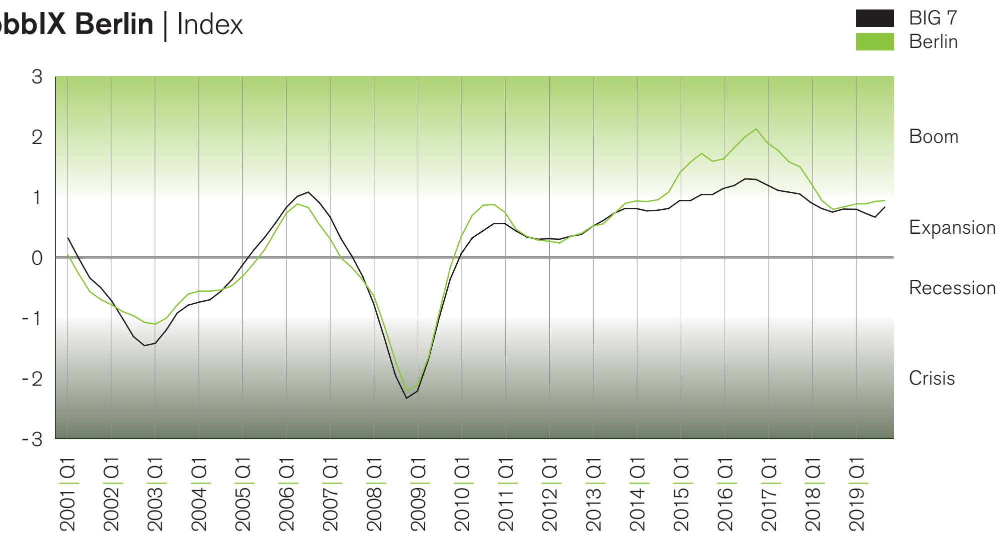


BIG 7

BERLIN

Berlin is excellently placed with regard to key indicators in the rental and investment market. For example, with very little space available in 2019, rental transactions in excess of one million sqm were concluded. A significant proportion of these transactions relate to properties that are yet to be completed. Demand is typically from companies involved in the Internet industry as well as federal ministries and public sector companies. Driven by dynamic demand, rents for newly let space are clearly on the way up despite increasing new construction activity. The very positive developments in the market for office space match the investment market where a new record was set. An outstanding fourth quarter meant that existing office space with a value of around €6.5 billion was acquired during the year.

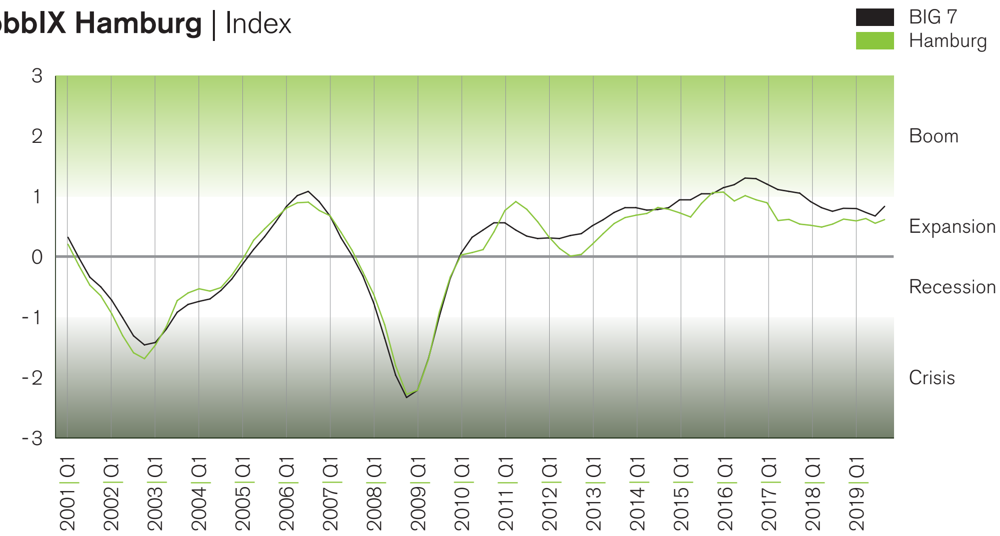
pbbIX Berlin | Index



HAMBURG

Despite relatively high fund inflows over the last two quarters, the Hamburg investment market in 2019 fell short of the previous year's result. According to the figures available to date, office space worth around €2.3 billion changed hands over the year as a whole, compared with just under €3 billion the year before. In the last quarter, it was mainly investors from abroad who were active on the Hamburg market, while domestic investors prevailed in the first nine months of 2019. In the rental market, space take-up fell significantly in the last quarter. The reason for this development was not demand, which grew by 2.6% in terms of office employment, but rather the shortage of available space. Around 3% of office space was vacant at the end of 2019, the last time this was the case was in the early 2000s. Rents responded to the favourable market conditions with yet more increases.

pbbIX Hamburg | Index

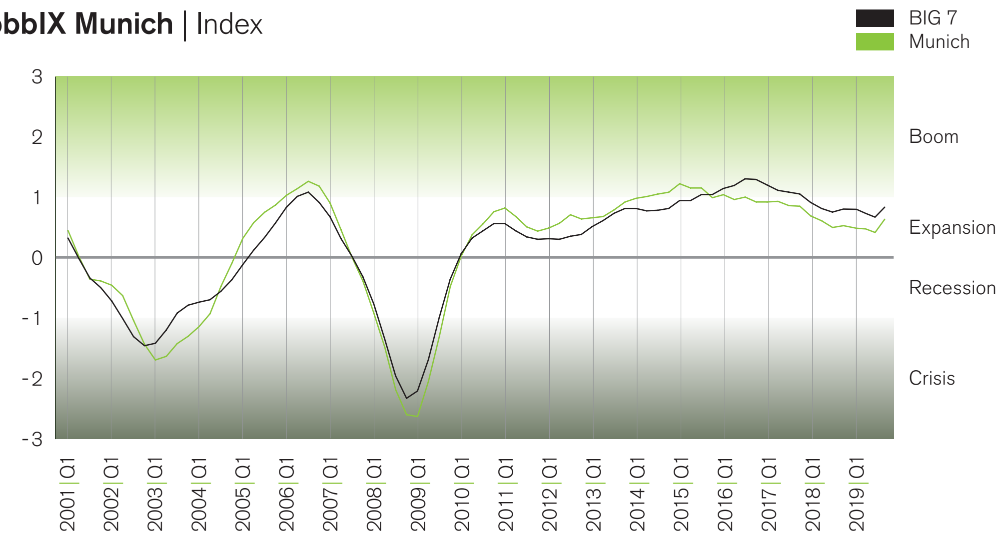


BIG 7

MUNICH

The Munich office market offers outstanding fundamentals. At the end of 2019, vacancy rates were significantly below 2% in the city area and around 6% in the surrounding areas. Office employment rose by 3.5%, leading to a renewed increase in rents due to a shortage of space. At the end of 2019, top rents reached new highs of well over € 40 per sqm, which are likely to be exceeded again in the coming months. Against this backdrop, the Munich investment market recorded very high inflows of funds in the fourth quarter of 2019. A total of € 7.1 billion was spent on the acquisition of office properties over the whole of last year, 44% of which in the last quarter alone. The net initial yields for first-class properties are currently around 2.8% – investors are clearly taking a dim view of the investment risks and a positive view on future rental trends.

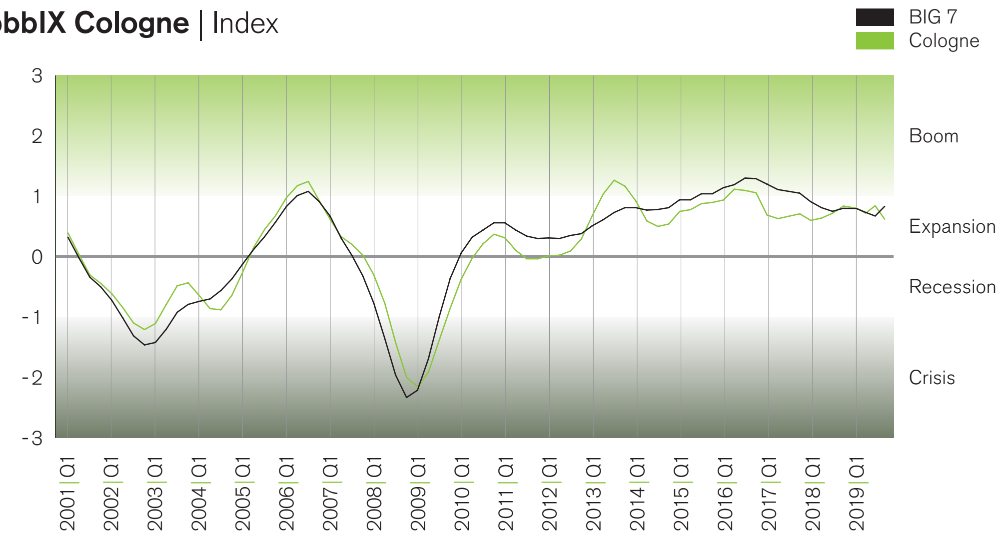
pbbIX Munich | Index



COLOGNE

The latest figures paint a positive picture for Cologne's market for office space. Although letting performance in 2019 was slightly down on the previous year's result at around 5%, a significant increase in office employment, virtually no vacant office space and soaring rents for newly let spaces speak for themselves. The Cologne office market is in good shape. Without any major problems, there has been a relatively high level of new construction activity. At around € 1.2 billion, the investment volume on the Cologne market in the fourth quarter was exceptionally high – unprecedented for a single quarter to see such large sums of money invested in office space.The last quarter accounted for around 62% of the fund inflows.

pbbIX Cologne | Index

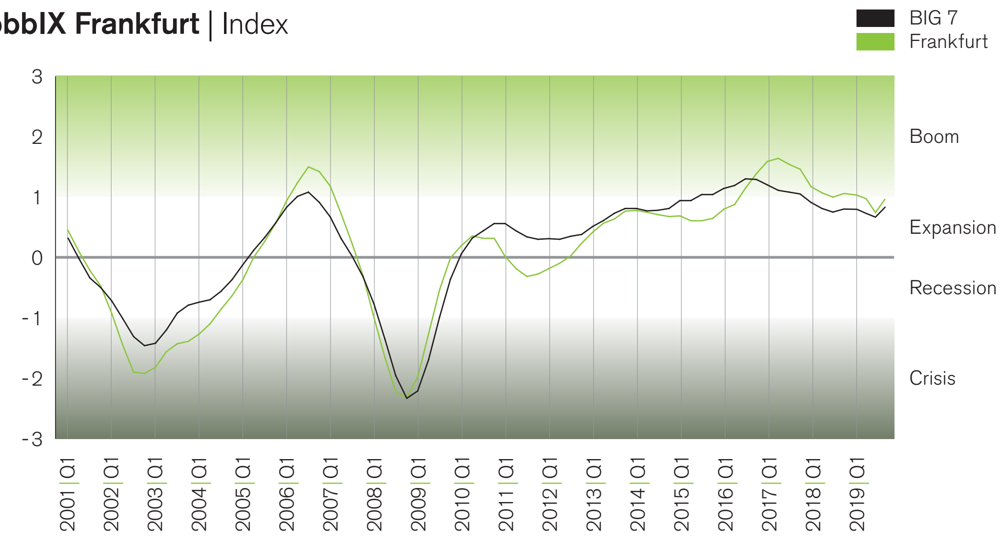


BIG 7

FRANKFURT

Similar to the other big 7 markets, but unrivalled in terms of absolute fund inflows, the Frankfurt market for office investments achieved very strong results in the fourth quarter of 2019. Office space was acquired for around € 3 billion, supported by a number of large-volume deals. Net initial yields have remained virtually unchanged of late; in the fourth quarter of 2019 they stood at around 2.85 % for first-class properties. With office employment rising sharply, the vacancy rate for office space continued to fall over the course of 2019. Depending on the source and the market definition, the share of unused space in all properties was between 5.5 % and 6.5 % at the end of 2019, about one percentage point lower than the previous year. At the same time, rents for newly let space rose by 4 % at their peak and by an average of just under 7 % over the course of the year.

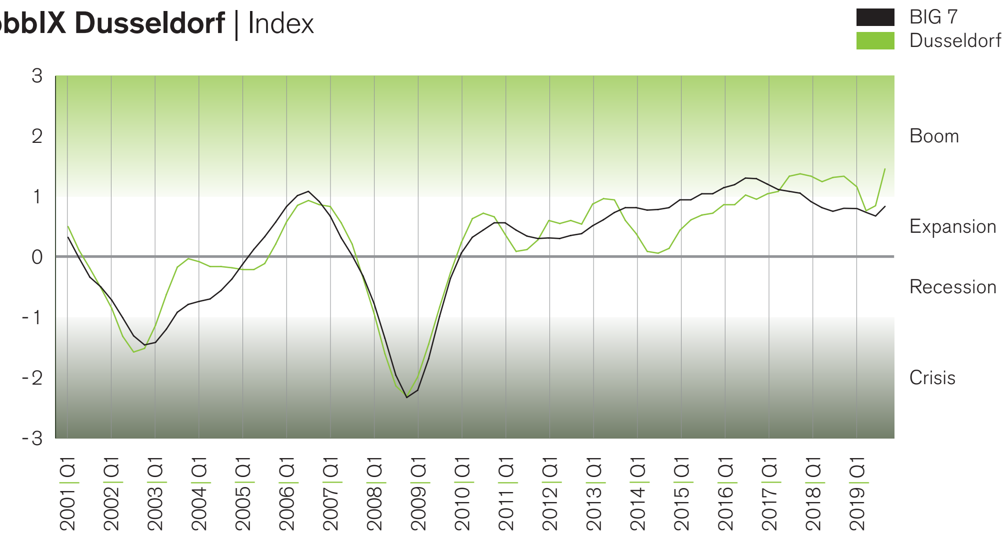
pbbIX Frankfurt | Index



DUSSELDORF

Following a very subdued first nine months, fund inflows on the Düsseldorf investment market increased significantly in the fourth quarter of 2019. The last three months saw almost the same amount invested as for the previous nine months. The net initial yields for first-class properties have not fallen any further recently and now stand at around 3.1 %. In terms of letting performance, Düsseldorf achieved excellent results last year. Nevertheless, the vacancy rate is still high – at least when compared to the average for the big 7 markets. At the end of 2019, around 6 % of office space was vacant, compared with around 6.8 % the previous year. Rents for newly let spaces show a steady increase at their peak, and on average a moderate increase, with peak rents of around € 28.5 per sqm being achieved at the end of 2019.

pbbIX Dusseldorf | Index

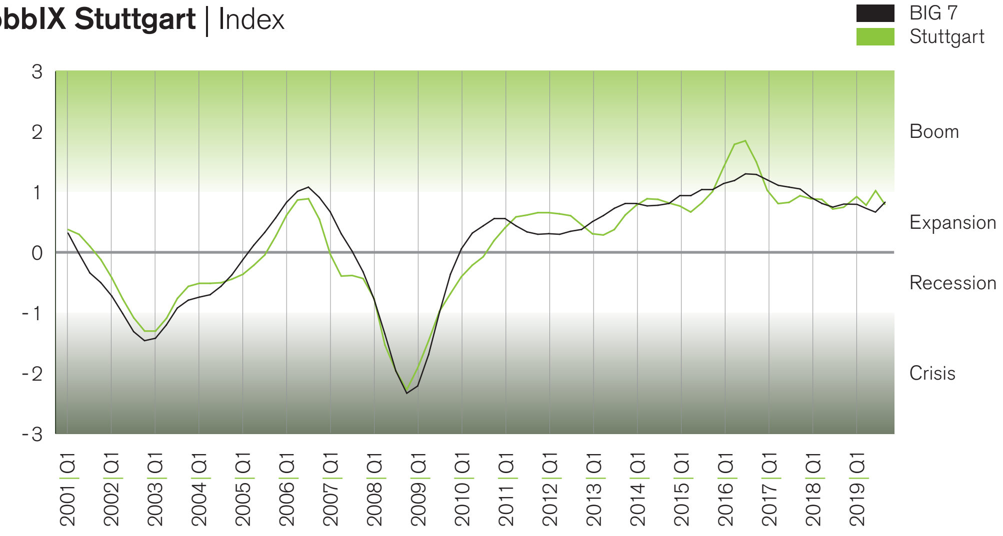


BIG 7

STUTTGART

Stuttgart performed well last year, right through to the last quarter. Against the backdrop of a strong increase in office employment, considerably more space was taken up in 2019 than in the previous year. Free space remained at a low level with slight fluctuations and was under 2 % at yearend. As a result, rents rose sharply at their peak, but were high on average as well. In contrast to the market for office space, developments in the investment market were relatively subdued, if the volume of investments is used as a measure. These were significantly lower than in the other top markets, which is partly due to the high proportion of owner-occupiers in Stuttgart; last year's result was also modest compared with the fund inflows from previous years. Regardless of a slightly better fourth quarter, investments in 2019 remained 35 % below the five-year average.

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)