DIFI-Report

Assessment of the Real Estate Financing Market

Germany | 1st Quarter 2018
Published in March 2018

Assessment of the current situation remains positive; significant downturn in financing expectations

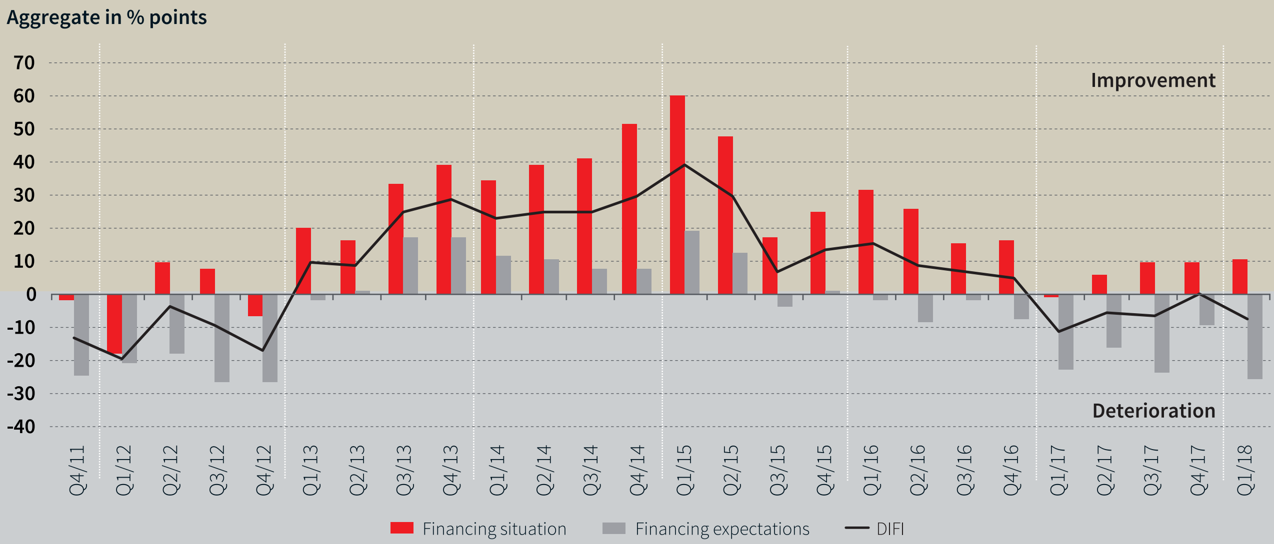
Bank bonds are becoming more expensive

Special question: proportion of total financing business attributable to the Core segment is expected to continue to fall in 2018

The German Real Estate Finance Index (DIFI) reflects survey participants' assessments of the current situation (the last six months) and expectations (the coming six months) for the German real estate financing market. It is produced quarterly and is calculated on the basis of an average of the results for the office, retail, logistics and residential real estate market segments. These figures reflect the percentage of positive and negative responses received from survey participants relating to the current situation in, and financing expectations for, the German real estate market. DIFI is produced and published in cooperation with JLL and the Zentrum für Europäische Wirtschaftsforschung (Centre for European Economic Research, ZEW).

Lower optimism at the start of the year

German Real Estate Finance Index (DIFI)



Average assessment of the current situation in and expectations for the four real estate market segments (Office, Retail, Logistics, Residential).
Source: JLL and ZEW

DIFI below zero despite a continuation of the favourable financing conditions

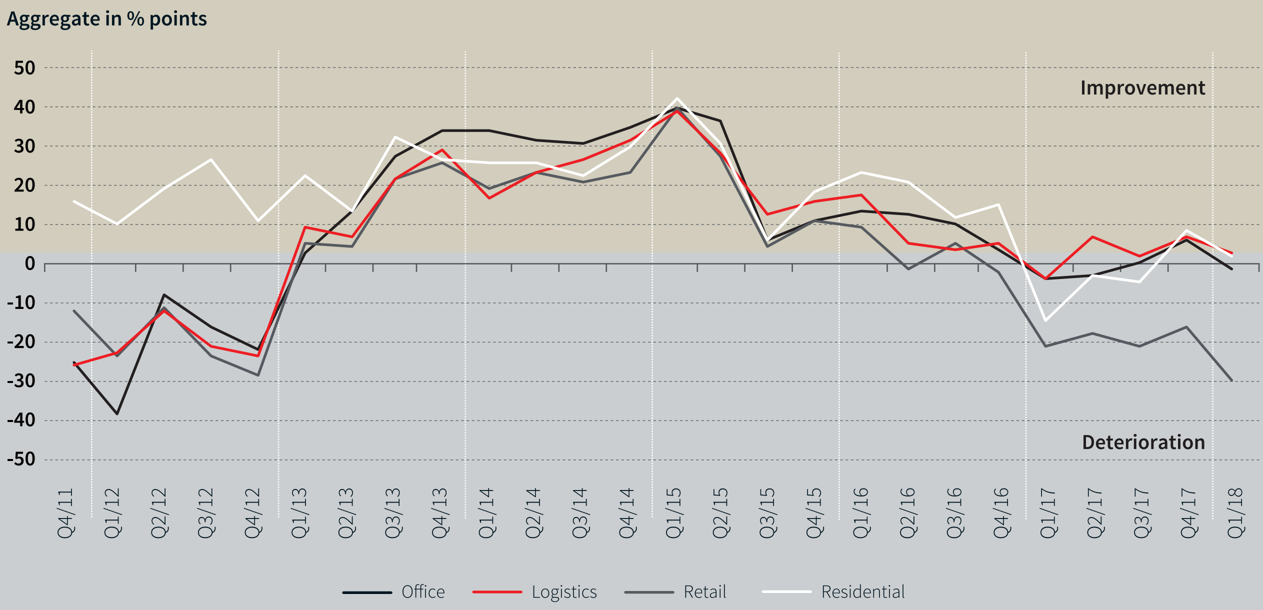
There was a fall of 7.9 points on the **German Real Estate Finance Index (DIFI)** in the first quarter of the New Year despite a continuation of the favourable financing conditions. The new level of **-7.8 points** on the sentiment barometer is again below zero. The fall was driven by noticeably more subdued expectations relating to commercial real estate financing business over the next 6 months: the relevant sub-indicator has fallen to -25.6 points due to less optimistic expectations in all four use segments surveyed. Expectations continued to brighten over the previous quarter. Current sentiment remains good though: 76% of all participants reported that their business situation remained good across all use segments over the past half year, 17% even reported an improvement.

In addition to a continuation in competitive pressure amongst lenders, the deterioration in expectations was due to increased uncertainty relating to demand for real estate financing. With the change of senior management at the US Federal Reserve and the increasing inflationary pressure, expectations relating to a rise in base rates and rising long-term interest rates in the USA have intensified. An increase in interest rates would result in a rise in anticipated yields for real estate investments located there and increase the capital flow into the US commercial real estate market, and at the same time increase pressure on the ECB to raise interest rates in the Eurozone. However, there is currently no reliable indication that interest rates will rise here, even if the effects indicate a certain level of nervousness on the stock markets in early February.

Where are the markets heading for retail property financing?

The assessment of the current situation on the financing market (last 6 months) has changed little since the fourth quarter of 2017: offices, logistics and residential have improved marginally, but there was a slight downturn in the case of retail properties. By contrast, there was a downturn in expectations across all use segments: all sub-balances slid noticeably into minus territory.

Assessment of the real estate financing market by real estate market segment



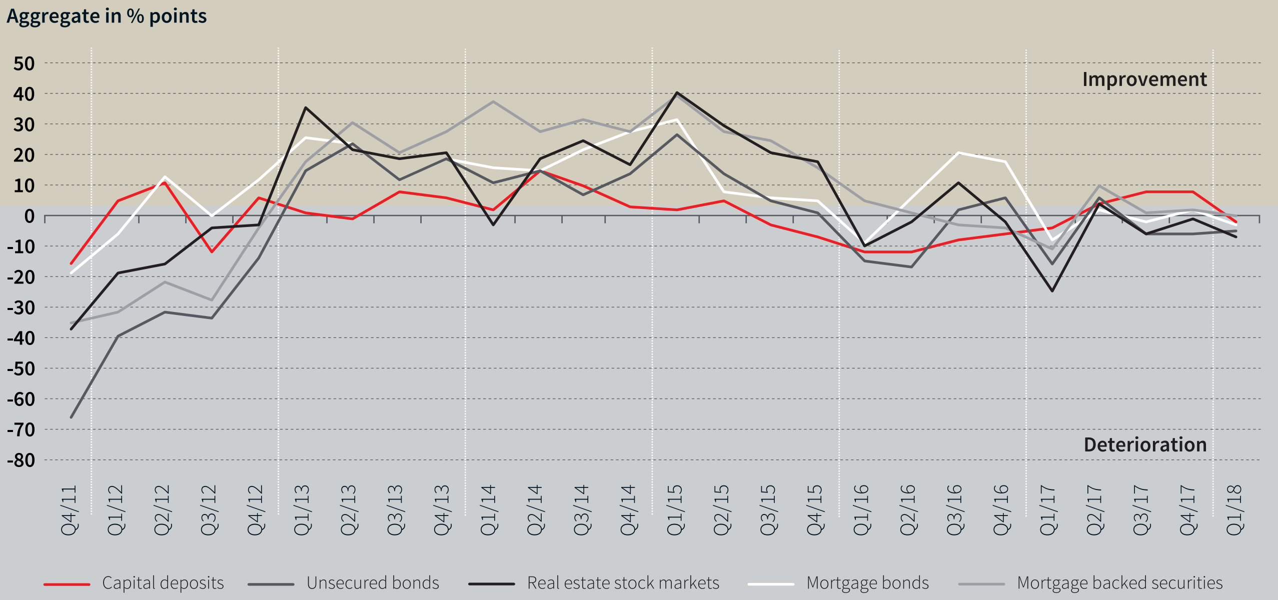
Average assessment of the current situation and expectations by defined real estate market segment.
Source: JLL and ZEW

After the record transaction volume in 2017, lenders continue to have mixed feelings when it comes to developments relating to retail property financing. Whilst the current financing situation is still seen as very well-balanced, the balance of optimistic and pessimistic expectations relating to retail property financing business over the next half year fell to -48.5 points to reach its lowest point since the survey began. Nonetheless, the retail sector itself expects turnovers to rise in 2018 but the anticipated growth will come mainly from online trade. However, it is expected that there will be a slight decrease in space take-up and the number of new leases for retail stores.

Rising costs for bank bonds

There have also been noticeable shifts in assessments relating to the refinancing markets compared to the previous quarter. There is still a positive assessment of refinancing activity over the past 6 months, but expectations are more sceptical for the coming six months; hence, the markets are experiencing something of a fine balance between the current situation and future expectations. There is a certain level of caution relating to expectations: apart from mortgage backed securities, there are negative balances for all other refinancing instruments compared to the previous quarter. The current situation is better than expectations across all instruments, but this could also be due to the suspicion that interest rates will rise in the Eurozone. The spreads between mortgage bonds and government bonds are expected to remain stable over the coming six months. By contrast, most experts expected increased spreads in bank bonds, which is likely to make this type of refinancing instrument more expensive for banks compared to mortgage bonds.

Development of the refinancing markets



Average assessment of the current situation and expectations by refinancing instrument.
Source: JLL and ZEW

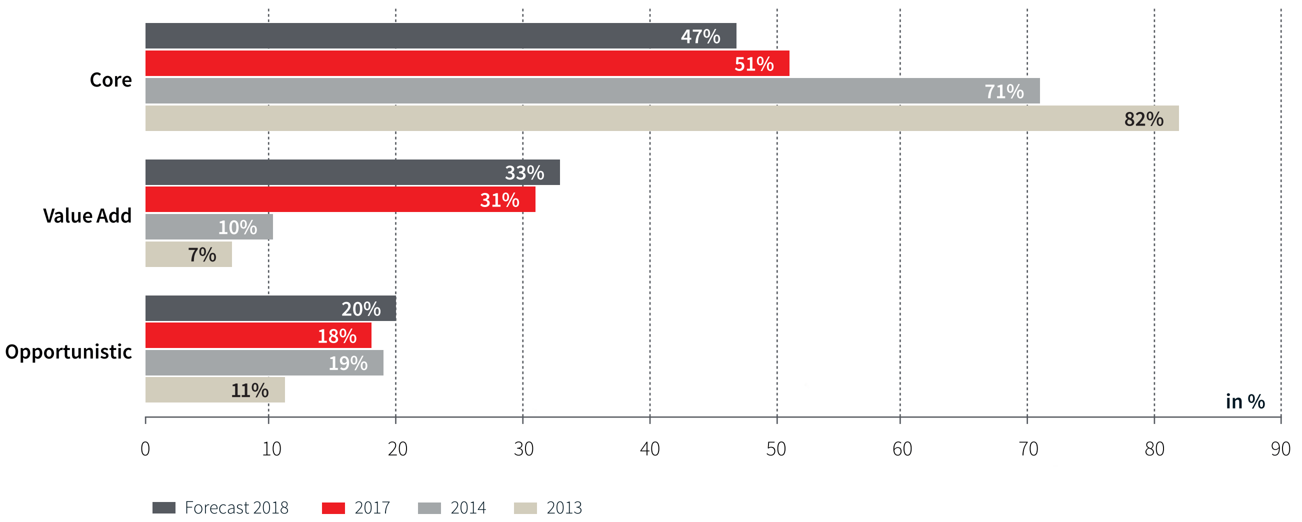
Special question: The proportion of total financing business attributable to the individual risk categories and the development of LTVs

In the current quarter, the financing experts were asked for their assessment of the relative proportions of new financing business and loan extensions attributable to the Core, Value Add and Opportunistic risk categories, firstly in retrospect for 2017 and secondly as a forecast for 2018. Finally, the respondents were asked for their estimates of typical loan-to-value ratios (LTVs) for financing in these three risk categories for both years under review.

The current assessments show a clear trend towards higher yielding, but also higher risk investment types compared to previous surveys. According to the experts, the share of total financing business attributable to the Core segment has fallen significantly from 82% to 51% compared to 2013. By contrast, there is an increase in the Value Add segment from 7% to 31% and in the Opportunistic segment from 11% to 18%. The lenders' forecasts expect this development to continue in 2018. In times of low profit margins, Value Add investments will particularly be popular for low-risk real estate financing.

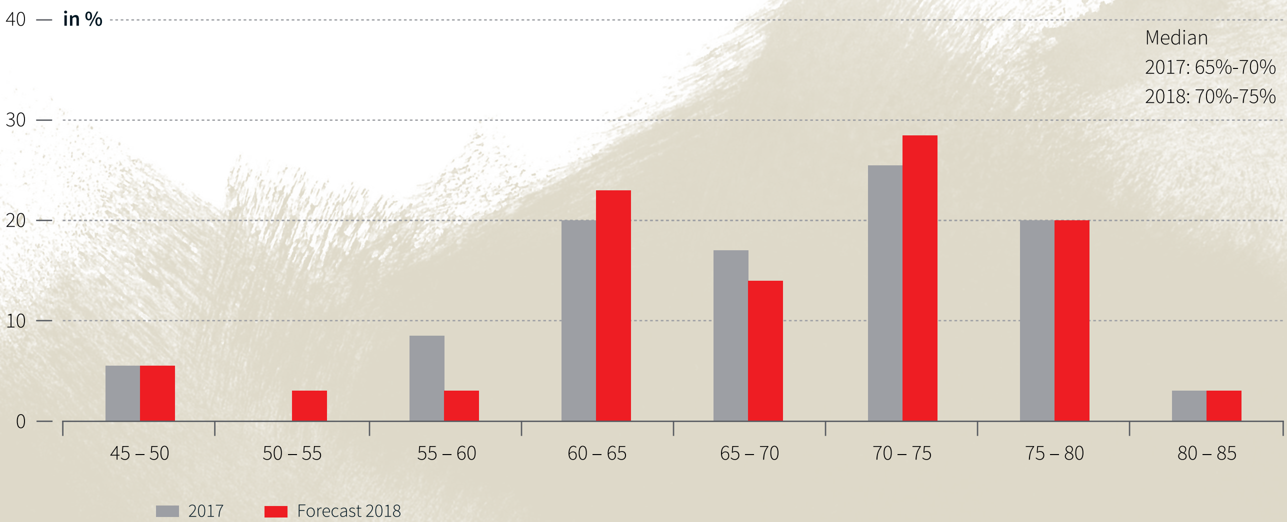
In terms of LTV development within the risk categories under review in 2018, a rise in the average market debt financing rate from 65 – 70% to 70 – 75% is expected only in the Core segment. However, the respondents expect little change in the typical LTV ranges in Value Add and Opportunistic financing. The median LTV would be between 65 – 70% in these risk categories.

Proportion of total new financing business and loan extensions attributable to the individual risk categories



Source: JLL and ZEW

LTV ranges for the Core risk category



Source: JLL and ZEW

DIFI-Report: Results of Responses, 1st Quarter 2018

	improved	Δ Q4	unchanged	Δ Q4	deteriorated	Δ Q4	aggregate	Δ Q4
German Real Estate Finance Index	**11.9**	**(+ 2.9)**	**68.6**	**(-13.5)**	**19.6**	**(+10.6)**	**-7.8**	**(- 7.9)**
Financing situation	**improved**	**Δ Q4**	**unchanged**	**Δ Q4**	**deteriorated**	**Δ Q4**	**aggregate**	**Δ Q4**
Office	17.9	(+ 3.6)	79.5	(- 6.2)	2.6	(+ 2.6)	15.3	(+ 1.0)
Retail	7.8	(+ 0.5)	71.1	(- 9.4)	21.1	(+ 8.9)	-13.3	(- 8.4)
Logistics	23.0	(+ 5.9)	74.4	(- 6.1)	2.6	(+ 0.2)	20.4	(+ 5.7)
Residential	20.5	(+ 3.9)	76.9	(- 4.1)	2.6	(+ 0.2)	17.9	(+ 3.7)
All real estate segments	**17.3**	**(+ 3.5)**	**75.5**	**(- 6.4)**	**7.2**	**(+ 2.9)**	**10.1**	**(+ 0.5)**
Financing expectations	**improve**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**deteriorate**	**Δ Q4**	**aggregate**	**Δ Q4**
Office	5.7	(+ 0.9)	68.6	(-16.8)	25.7	(+15.9)	-20.0	(-15.0)
Retail	3.0	(+ 0.5)	45.5	(-19.5)	51.5	(+19.0)	-48.5	(-18.5)
Logistics	8.6	(+ 3.6)	65.7	(-21.8)	25.7	(+18.2)	-17.1	(-14.6)
Residential	8.3	(+ 3.7)	66.7	(-24.0)	25.0	(+20.3)	-16.7	(-16.6)
All real estate segments	**6.4**	**(+ 2.2)**	**61.6**	**(-20.6)**	**32.0**	**(+18.4)**	**-25.6**	**(-16.2)**

Refinance market situation	improved	Δ Q4	unchanged	Δ Q4	deteriorated	Δ Q4	aggregate	Δ Q4
Capital deposits	10.8	(- 8.1)	81.1	(+ 5.4)	8.1	(+ 2.7)	2.7	(-10.8)
Mortgage bonds	15.4	(+ 5.6)	76.9	(-13.3)	7.7	(+ 7.7)	7.7	(- 2.1)
Unsecured bonds	22.3	(+12.5)	69.4	(-18.4)	8.3	(+ 5.9)	14.0	(+ 6.6)
Mortgage backed securities	17.2	(- 0.1)	75.9	(- 3.4)	6.9	(+ 3.5)	10.3	(- 3.6)
Real estate stock markets	18.7	(- 3.9)	71.9	(+ 7.4)	9.4	(- 3.5)	9.3	(- 0.4)
Refinance market expectations	**improve**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**deteriorate**	**Δ Q4**	**aggregate**	**Δ Q4**
Capital deposits	2.9	(- 6.2)	85.7	(+ 3.9)	11.4	(+ 2.3)	-8.5	(- 8.5)
Mortgage bonds	2.7	(+ 2.7)	78.4	(-13.5)	18.9	(+10.8)	-16.2	(- 8.1)
Unsecured bonds	8.6	(+ 8.6)	57.1	(-21.8)	34.3	(+13.2)	-25.7	(- 4.6)
Mortgage backed securities	3.8	(+ 3.8)	80.8	(- 7.2)	15.4	(+ 3.4)	-11.6	(+ 0.4)
Real estate stock markets	0.0	(- 6.9)	74.2	(+ 1.8)	25.8	(+ 5.1)	-25.8	(-12.0)
Spreads compared to German government bonds	**increase**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**decrease**	**Δ Q4**	**aggregate**	**Δ Q4**
Mortgage bonds	13.5	(- 8.5)	70.3	(- 5.3)	16.2	(+13.8)	-2.7	(-22.3)
Unsecured bank bonds	52.7	(+ 7.7)	44.7	(- 5.3)	2.6	(- 2.4)	50.1	(+10.1)
Segment development	**increase**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**decrease**	**Δ Q4**	**aggregate**	**Δ Q4**
Syndication business (volume)	47.2	(+ 8.8)	50.0	(- 9.0)	2.8	(+ 0.2)	44.4	(+ 8.6)
Underwriting (volume)	18.9	(- 9.3)	73.0	(+11.5)	8.1	(- 2.2)	10.8	(- 7.1)

Comment: The German Real Estate Finance Index survey was carried out between 22.01.2018 and 05.02.2018 and involved 43 experts. These experts were asked for their assessments of the market situation (preceding six months) and market expectations (coming six months). The results shown are the percentages of the response categories and the changes in per cent compared to the previous quarter (Δ previous quarter). The aggregates are calculated from the difference between the positive and negative response categories (such as 'improved' and 'deteriorated'). DIFI is calculated as an unweighted average from the aggregates of the financing situation and financing expectations for all use types. Figures have been rounded to one decimal place.

Source: JLL and ZEW

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