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ZEW Zentrum für Europäische Wirtschaftsforschung GmbH

DIFI-Report

Assessment of the Real Estate Financing Market

Germany | 3rd Quarter 2018
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DIFI shows marginal growth again after some time, thanks to positive assessment of the current situation

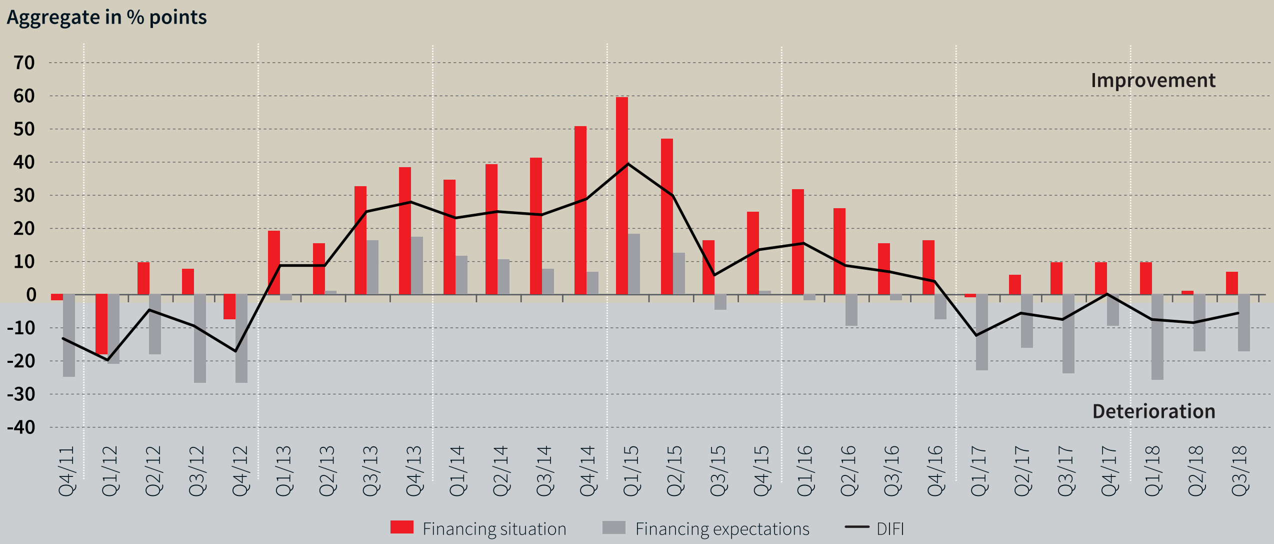
Retail sector is facing challenges

Special topic: mixed risk assessments regarding the financing of flexible office space

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).

Brighter sentiment relating to the current financing situation

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

Assessment of the financing situation remains positive at the same level as last year

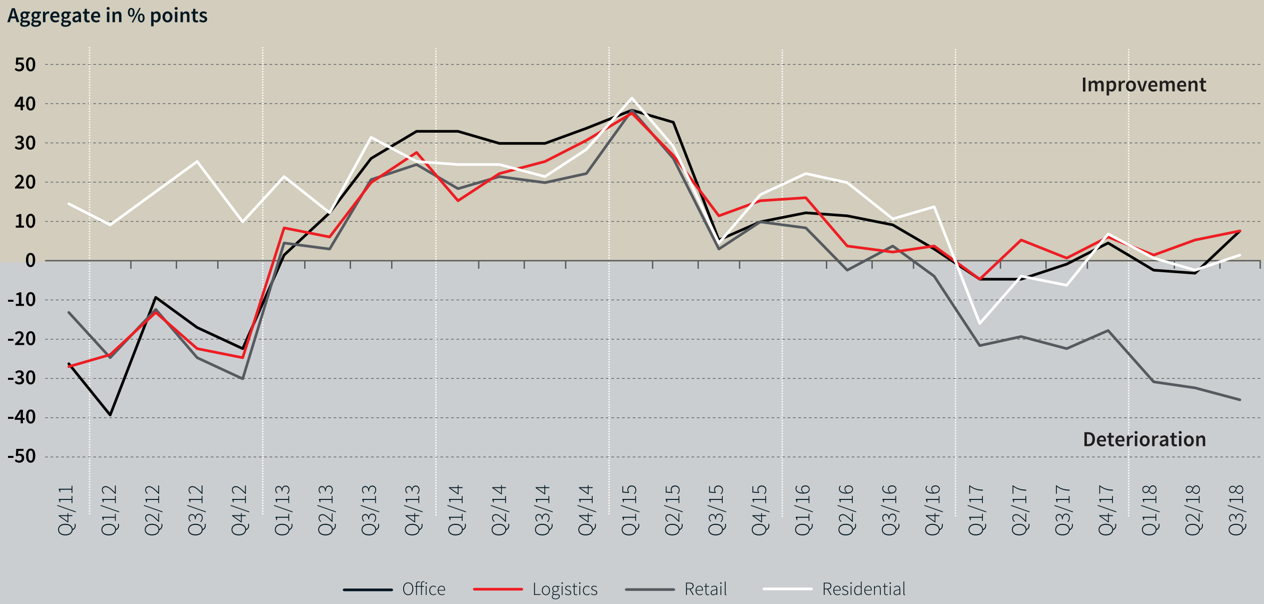
In the third quarter of 2018, the **German Real Estate Finance Index (DIFI)** rose marginally by 3.7 points compared to the previous quarter, and the new position of **-4.5 points** is almost back to the zero mark for the first time this year. The index in this current quarter is the best this year, although it remains in negative territory. The main reason for this slight upswing is the significant improvement in the current financing situation, which has been reflected in a rise from 6.6 points in the previous quarter to 7.2 points in the latest survey. This sub-indicator is therefore at around the same positive level as the previous year. Since the start of the year, there has also been a noticeable marginal upward trend in the financing expectations for the next six months, although sentiment amongst the experts remains heavily subdued (-16.1 points). The main reason for this is a threatened trade war and the possible consequences for German business. A settlement of the dispute could brighten expectations sustainably. Apart from this, as in previous quarters, the anticipated interest rate developments in the Eurozone could be responsible for the negative trend of this sub-indicator. Despite the announcement by the European Central Bank that it will end its bond purchase programme this autumn, this is likely to remain at its current low level for some time.

Bricks-and-mortar retail is under pressure

Although this quarter's DIFI moved marginally in the direction of the zero mark, expectations regarding financing conditions in the next six months are extremely pessimistic (-16.1 points). The main reason for this negative balance is the survey respondents' assessment of financing expectations in the retail segment, which is reflected in an index position of -37.6 points. The experts' assessment in this real estate sector is similar to their view of the financing situation over the last six months. As online retail continually gains in importance, the bricks-and-mortar retail segment now faces great challenges.

The survey respondents' view of the current situation in the logistics real estate sector is still highly divergent

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

(28.0 points), as this sector benefits greatly from online trade and its consequential requirement for warehousing and logistics space. The current financing situation in the office real estate sector is similarly positive: the index position of this indicator is 20.0 points which means a significant rise the experts' assessment of +14.3 points compared to the previous quarter. The residential sector has been highly volatile over the last few quarters but showed a marginal positive balance of 1.8 points in the current quarter.

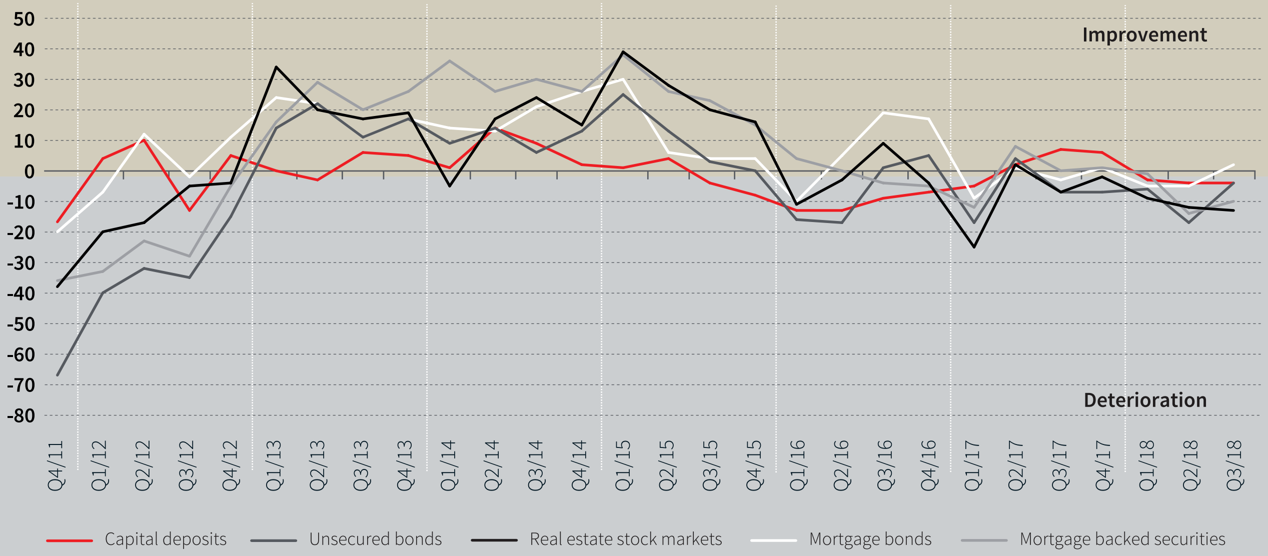
Noticeable slight upward movement on the refinancing markets

In the case of most refinancing instruments there are signs of a slight trend reversal compared to the two previous quarters. Except for Pfandbrief mortgage bonds which have returned to a positive position of 1.9 points during the current quarter for the first time in over a year, all other refinancing instruments are still viewed critically. Capital deposits and real estate stocks have fallen again slightly during the current quarter. The only significant upswing was unsecured bonds which rose by 13.2 points, albeit to a position just under the zero mark. The potential to refinance using mortgage backed securities was viewed more positively by the experts again this quarter. As in the previous quarter, the current refinancing situation is viewed more positively than expectations for the coming half year.

Finance providers are now increasingly focusing on spreading risk when processing deals. In terms of the development of the syndication and underwriting segments, the survey respondents are of the view that syndication business has grown significantly in importance in this quarter compared with the past (39.2 points). The balance in this segment has risen by 17.3 points since the previous quarter.

Development of the refinancing markets

Aggregate in % points



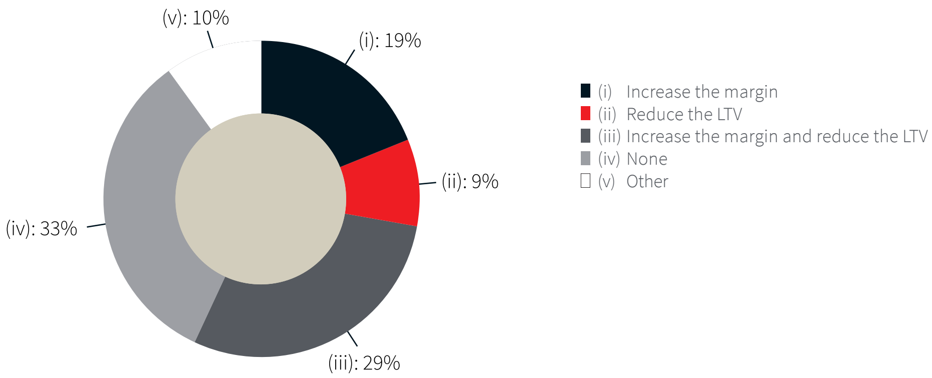
Average assessment of the current situation and expectations by refinancing instrument.
Source: JLL and ZEW

Special topic: the market for flexible office space in Germany

This quarter's special topic deals with the subject of flexible office space. Flexible office space providers are currently an important driver in the German office property market. There are 450 office centres in the major cities Berlin, Düsseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart (equating to 650,000 sqm or 63,000 workspaces), with one third of this space coming onto market over the past 18 months. It remains to be seen whether the significant growth of the flexible office space sector will stand the test of time as market penetration on the real estate markets is occurring at the same time at an economic upswing. The effect of an economic downturn on the sector is also as yet unknown.

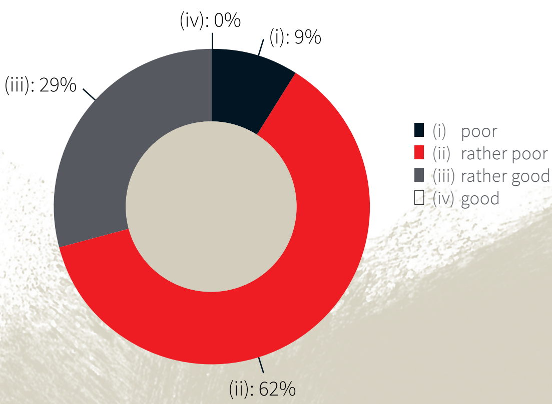
The special topic survey asked the experts whether they would change their lending policy if the principal tenant in an office building they were financing was a flexible office space provider such as WeWork, Design Office or Spaces. They were also asked to assess other parameters assuming a Core property in a city centre location in one of the Big 7 German city markets. Would the experts increase the margin, reduce the LTV or even both? One third of respondents (33%) answered that this type of scenario would have no effect on their lending decision. By contrast, over half of respondents (57%) said that they would adjust at least one of the parameters, margin or LTV, to the detriment of the borrower. These results show that the flexible office space sector is viewed with mixed feelings overall by the experts, and that there is a tendency to tighten conditions compared to conventional office anchors. This caution amongst respondents is presumably because the business model is still new for many market participants and the long-term market development is rather uncertain. Most respondents agree that the transparency in the German flexible office space market and information relating to the operators' business performance is rather poor. To increase transparency in this segment, JLL Research has recently published a report entitled Flexible Office Space – Coworking & Co. in den Big 7.

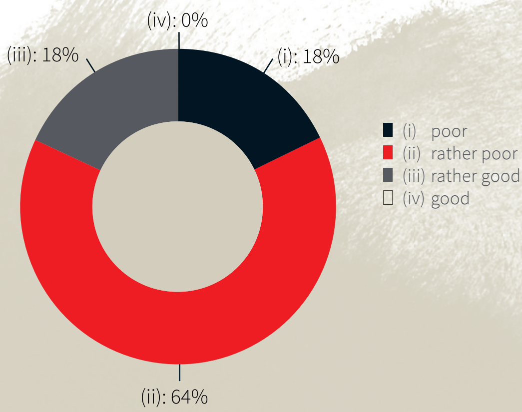
What effect would a flexible office space provider as principal tenant have on your lending policy?



Source: JLL and ZEW

What is your view of the transparency in the German flexible office space market (left) and the transparency relating to operators' business performance (right)?





Source: JLL and ZEW

DIFI-Report: Results of Responses, 3rd Quarter 2018

	improved	Δ Q2	unchanged	Δ Q2	deteriorated	Δ Q2	aggregate	Δ Q2
German Real Estate Finance Index	**11.3**	**(+ 1.8)**	**73.0**	**(+/- 0.0)**	**15.7**	**(- 1.9)**	**-4.5**	**(+ 3.7)**
Financing situation	**improved**	**Δ Q2**	**unchanged**	**Δ Q2**	**deteriorated**	**Δ Q2**	**aggregate**	**Δ Q2**
Office	20.0	(+ 8.6)	80.0	(- 2.9)	0.0	(- 5.7)	20.0	(+14.3)
Retail	8.3	(- 0.3)	50.0	(-10.0)	41.7	(+10.3)	-33.4	(-10.6)
Logistics	32.0	(+ 9.7)	64.0	(- 5.4)	4.0	(- 4.3)	28.0	(+14.0)
Residential	14.3	(+ 3.2)	85.7	(+ 2.4)	0.0	(- 5.6)	14.3	(+ 8.8)
All real estate segments	**18.7**	**(+ 5.3)**	**69.9**	**(- 4.0)**	**11.4**	**(- 1.4)**	**7.2**	**(+ 6.6)**
Financing expectations	**improved**	**Δ Q2**	**remain unchanged**	**Δ Q2**	**deteriorate**	**Δ Q2**	**aggregate**	**Δ Q2**
Office	8.0	(+ 5.2)	80.0	(- 3.3)	12.0	(- 1.9)	-4.0	(+ 7.1)
Retail	4.1	(+ 1.2)	54.2	(+ 2.8)	41.7	(- 4.0)	-37.6	(+ 5.2)
Logistics	0.0	(-11.1)	88.0	(+13.0)	12.0	(- 1.9)	-12.0	(- 9.2)
Residential	3.6	(- 1.8)	82.1	(+ 3.7)	14.3	(- 1.9)	-10.7	(+ 0.1)
All real estate segments	**3.9**	**(- 1.7)**	**76.1**	**(+ 4.1)**	**20.0**	**(- 2.4)**	**-16.1**	**(+ 0.8)**

Refinance market situation	improved	Δ Q2	unchanged	Δ Q2	deteriorated	Δ Q2	aggregate	Δ Q2
Capital deposits	0.0	(- 3.0)	96.3	(- 0.7)	3.7	(+ 3.7)	-3.7	(- 6.7)
Mortgage bonds	10.8	(- 0.3)	82.1	(- 1.2)	7.1	(+ 1.5)	3.7	(- 1.8)
Unsecured bonds	14.8	(+ 3.0)	74.1	(+ 0.6)	11.1	(- 3.6)	3.7	(+ 6.6)
Mortgage backed securities	9.5	(+ 5.8)	81.0	(- 4.2)	9.5	(- 1.6)	0.0	(+ 7.4)
Real estate stock markets	12.5	(- 0.4)	75.0	(+ 0.8)	12.5	(- 0.4)	0.0	(+/- 0.0)
Refinance market expectations	**improve**	**Δ Q2**	**remain unchanged**	**Δ Q2**	**deteriorate**	**Δ Q2**	**aggregate**	**Δ Q2**
Capital deposits	8.0	(+ 4.9)	80.0	(- 4.4)	12.0	(- 0.5)	-4.0	(+ 5.4)
Mortgage bonds	14.8	(+ 9.1)	70.4	(- 3.9)	14.8	(- 5.2)	0.0	(+14.3)
Unsecured bonds	7.7	(+ 4.6)	73.1	(+10.6)	19.2	(-15.2)	-11.5	(+19.8)
Mortgage backed securities	10.0	(+ 6.2)	60.0	(-13.1)	30.0	(+ 6.9)	-20.0	(- 0.7)
Real estate stock markets	8.7	(- 1.3)	56.5	(- 0.2)	34.8	(+ 1.5)	-26.1	(- 2.8)
Spreads compared to German government bonds	**increase**	**Δ Q2**	**remain unchanged**	**Δ Q2**	**decrease**	**Δ Q2**	**aggregate**	**Δ Q2**
Mortgage bonds	39.3	(+19.3)	53.6	(-20.7)	7.1	(+ 1.4)	32.2	(+17.9)
Unsecured bank bonds	46.4	(-11.2)	53.6	(+14.2)	0.0	(- 3.0)	46.4	(- 8.2)
Segment development	**increase**	**Δ Q2**	**remain unchanged**	**Δ Q2**	**decrease**	**Δ Q2**	**aggregate**	**Δ Q2**
Syndication business (volume)	43.5	(+ 9.1)	52.2	(- 0.9)	4.3	(- 8.2)	39.2	(+17.3)
Underwriting (volume)	13.6	(-11.4)	77.3	(+17.9)	9.1	(- 6.5)	4.5	(- 4.9)

Comment: The German Real Estate Finance Index survey was carried out between 06.08.2018 – 27.08.2018 and involved 360 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.

Source: JLL and ZEW

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