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DIFI-Report

Assessment of the Real Estate Financing Market

Germany | 4th Quarter 2018
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Further downturn in the DIFI

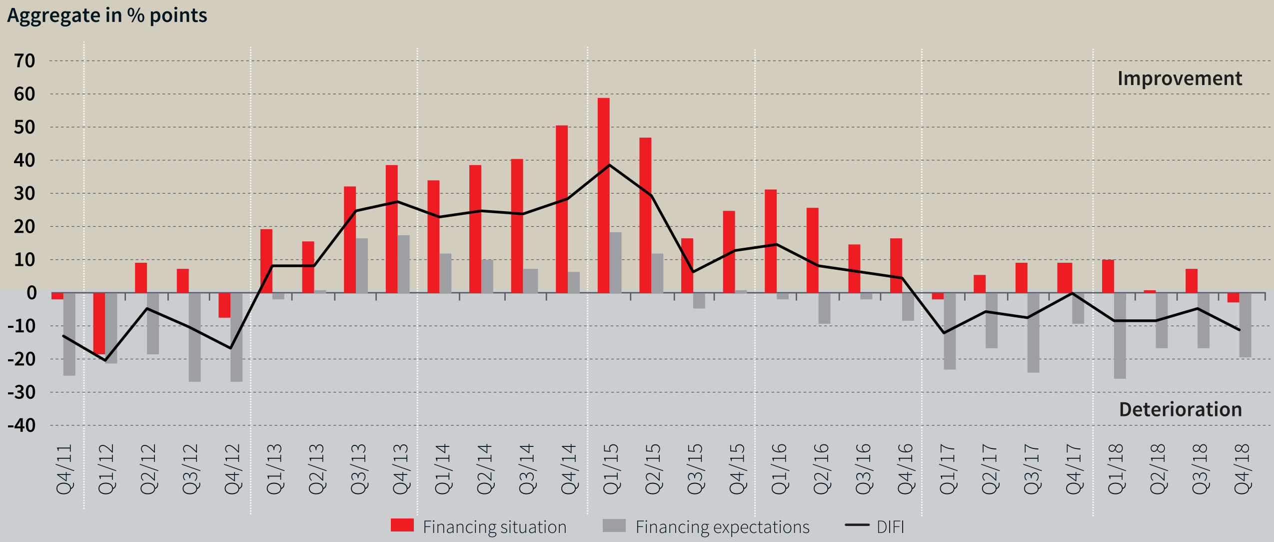
Bricks-and-mortar retail at record low

Special question: prices determined by the lack of alternative investments; sceptical interest rate expectations

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).

Pessimism extends across the board

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

The downturn continues

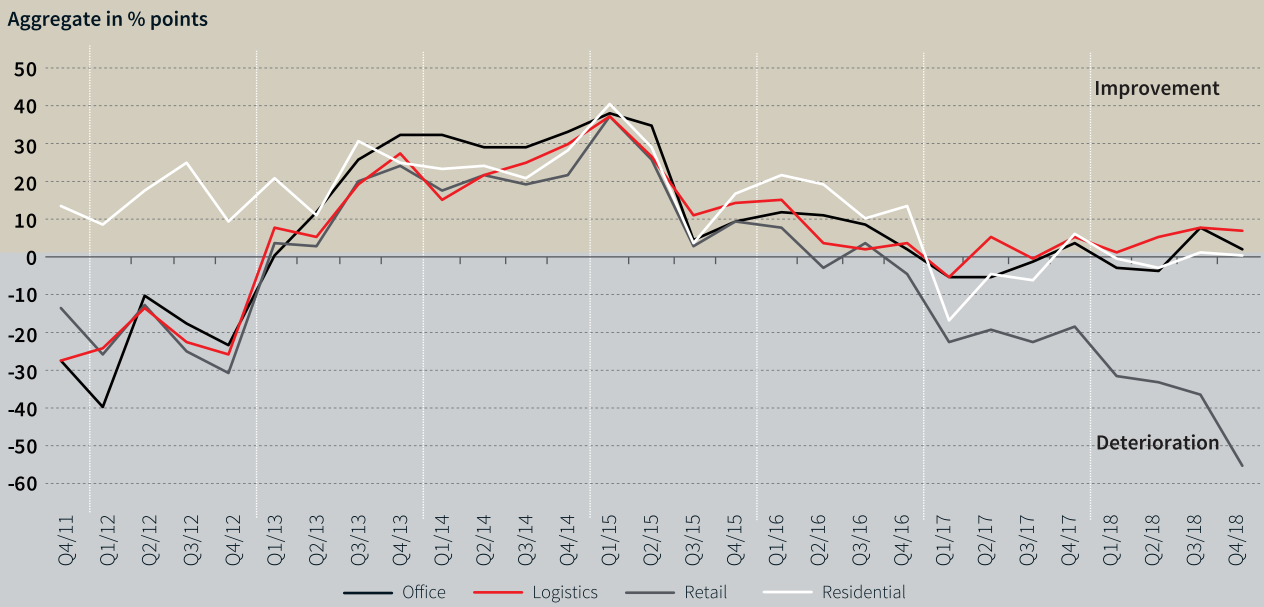
Despite the slight indication of a reversal of trend from the previous quarter, the **German Real Estate Finance Index (DIFI)** slid further into sub-zero territory in the current 4th quarter of 2018. Its new score of **-10.8 points** is the lowest level for almost two calendar years. As in the 1st quarter of 2017 (index score: -12.0 points), this quarter's aggregate comprises the negative assessments of the current financing situation over the last six months and the financing expectations for the coming six months. These have continued to fall by 9.8 points (current situation) and 2.8 points (expectations) compared to the previous quarter. The downward trend which has been prevalent on the real estate financing markets since mid-2015 has continued apace. The experts' assessments in the current quarter are likely to be principally affected by the waning economy in Germany. According to the experts, there is still a buffer of six to nine points between the current market and the subdued sentiment from 2011 and 2012.

Further nosedive in bricks-and-mortar retail

The much more pessimistic assessment of the current financing situation by the experts is again primarily based on the well-established downturn in the bricks-and-mortar retail segment: over half of all respondents (51.5%) stated that the financing situation in the retail property sector has become more subdued over the last six months. In fact, some 57.6% forecast that the financing situation will continue to deteriorate over the coming six months. In contrast to the previous quarter, none of the experts now expect any improvement over the next six months. In the retail property sector, there is a record low of -54.6 points.

The market for logistics properties is normally the principal beneficiary from any downturn in the bricks-and-mortar retail segment. Nonetheless, there is a clear picture emerging in the current quarter. The current financing situation in the office, retail, logistics and residential pro-

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

perty market segments over the last six months has been assessed more negatively compared to the 3rd quarter of 2018, which has resulted in a 9.8 point downturn to a current aggregate of -2.6 points. The financing expectations for the coming half year are just as gloomy: the experts expect little change from the previous quarter and the existing negative aggregate is expected to fall by a further 2.8 points to an aggregate of -18.9 points as a result of the very weak expectations for the bricks-and-mortar retail segment. The slight improvement of 7.4 points in the current aggregate between situation and expectations for the logistics sector is a marginal upwards movement; expectations for the office and residential sectors have worsened slightly compared to the previous quarter.

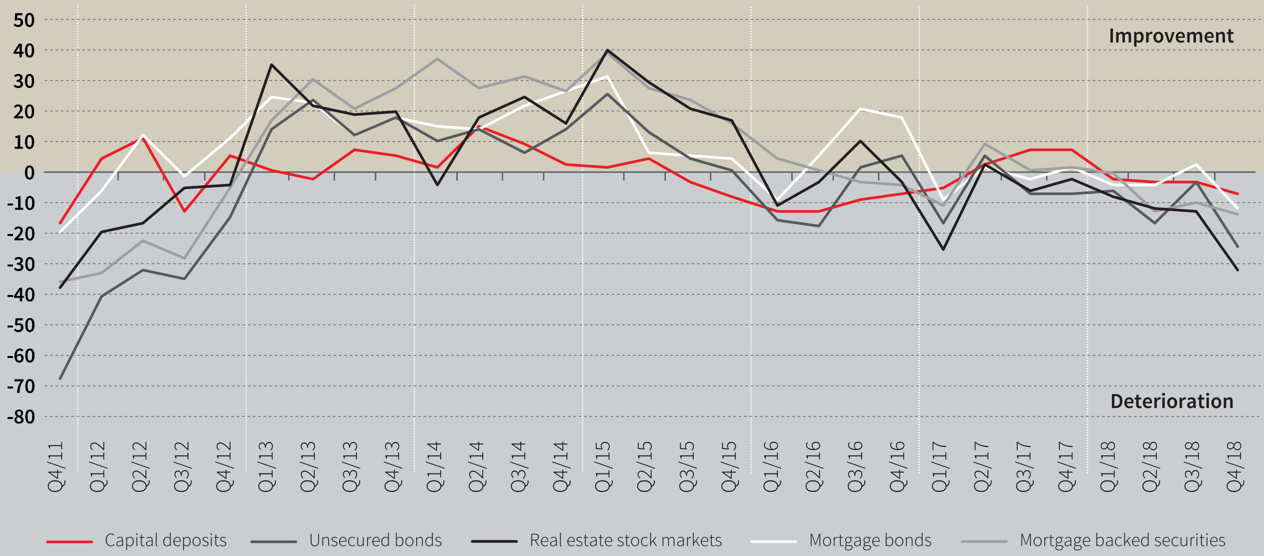
Refinancing conditions expected to worsen

The experts have also delivered generally pessimistic assessments of the refinancing market. In terms of the current situation, only the assessments relating to capital deposits are somewhat improved compared to the previous quarter (+0.3 points), even if this only elevates the current status to a marginal sub-zero aggregate of -3.4 points. Mortgage backed securities remain unchanged at an aggregate of zero, whilst there were some significant deteriorations compared to the previous quarter in Pfandbrief mortgage bonds (-3.7 points), bonds (-14.5 points) and real estate stocks (-19.3 points).

The experts' view the coming six months significantly more pessimistically. Compared to the previous quarter, all instruments are expected to fall by between 6.8 points (capital deposits) and a massive 25.5 points (bonds). The expectations relating to real estate stocks indicate a fall of 18.4 points quarter-on-quarter to an aggregate of -44.5 points. All the positive expectations indicated by the respondents in the 3rd quarter survey are now a thing of the past. This is due above all to the new base rate hike announced by the USA at the end of September and the foreseeable end of the ultra-relaxed monetary policy of the European Central Bank. By contrast, no change is expected in the spreads for Pfandbrief mortgage bonds and unsecured bank bonds over the coming half year.

Development of the refinancing markets

Aggregate in % points



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

Prices driven more by the lack of alternative investments than interest rates

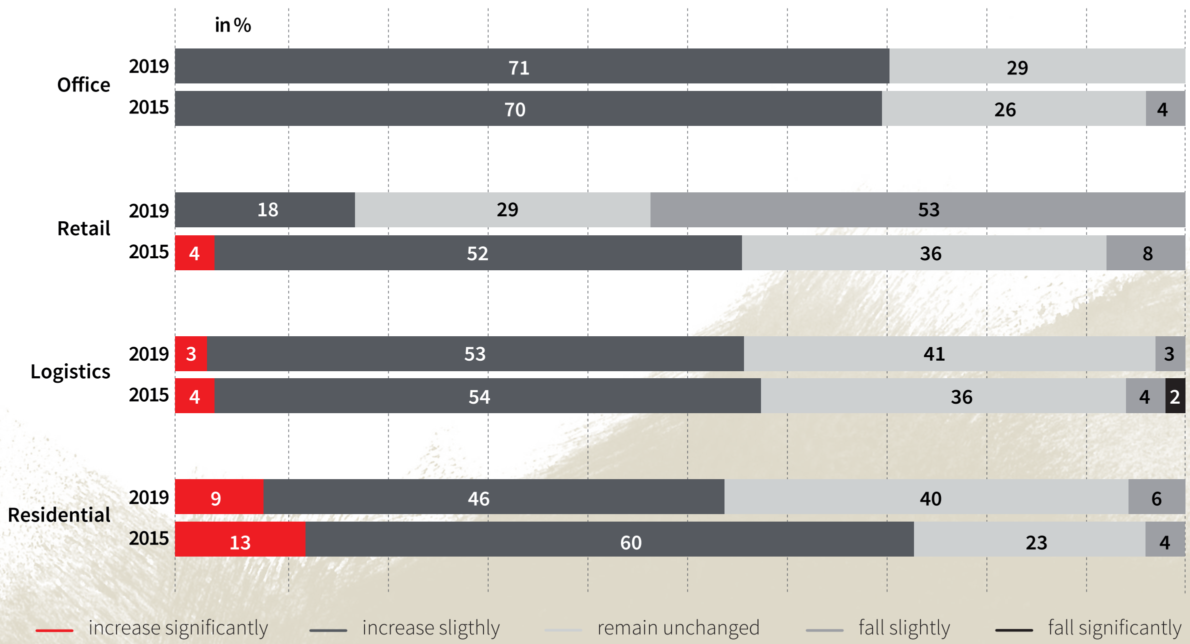
This quarter's special question to the experts is the same as the question in the 4th quarter of 2014. The principal themes are the determining factors driving price development and the development of market values for commercial properties in the Big 7 German cities. For a better understanding, the following text will also present the results from the 2014 survey as well as the current responses.

The first part of the special question asked the participants for the most important determinants of price in the commercial property market. Although the lack of alternative investments is the principal driver (62%), this answer was not as prevalent as in 2014 (69%). According to the experts, the low interest rates have also been driving price growth for commercial properties recently (2018: 29%, 2014: 16%), even if this plays a subordinate role. Other drivers such as pressure to invest due to the high level of liquidity or the overall development of the residential property market which were still being mentioned in 2014 played no role in the current quarter. As in 2014 (2%), there were negligible optimistic expectations in the current quarter (3%). The experts agree: money is cheap and other investment types are less attractive.

The second part of the special question dealt with the further development of market values in the Big 7 cities. In the office, logistics and residential sectors, there is little change compared to Q4 2014. As expected, there are significant distortions in the retail property sector. The growth in online retail has increasingly driven bricks-and-mortar retail stores out of the city centres over the last few years, which is now also indicated by the experts' assessments. Whilst the majority still expected market values in the retail property sector to rise back in 2014, 53% of participants in the current survey expect a slight fall in values. By contrast, no fall in values is expected in the logistics and residential property sectors.

For the last part of the special question, the experts were asked for their views on interest rate expectations for the next two years. The principal statement is that the 3-month Euribor will be at a significantly sub-zero position at the end of 2019 and will remain in negative territory at the end of 2020. This is surprising in the context that on the one hand the European Central Bank intends to keep base rates stable until at least mid-2019 and on the other, there are further interest rate hikes expected from the US Federal Reserve.

Expected trends in market values for commercial properties in the years 2015 and 2019 in the Big 7 German cities



Source: JLL and ZEW

DIFI-Report: Results of Responses, 4th Quarter 2018

	improved	Δ Q3	unchanged	Δ Q3	deteriorated	Δ Q3	aggregate	Δ Q3
German Real Estate Finance Index	**10.0**	**(-1.8)**	**69.4**	**(-2.5)**	**20.7**	**(+4.3)**	**-10.8**	**(-6.3)**
Financing situation	**improved**	**Δ Q3**	**unchanged**	**Δ Q3**	**deteriorated**	**Δ Q3**	**aggregate**	**Δ Q3**
Office	17.6	(- 2.4)	76.5	(- 3.5)	5.9	(+ 5.9)	11.7	(- 8.3)
Retail	0.0	(- 8.3)	48.5	(- 1.5)	51.5	(+ 9.8)	-51.5	(- 18.1)
Logistics	26.5	(- 5.5)	67.6	(+ 3.6)	5.9	(+ 1.9)	20.6	(- 7.4)
Residential	14.7	(+ 0.4)	79.4	(- 6.3)	5.9	(+ 5.9)	8.8	(- 5.5)
All real estate segments	**14.7**	**(- 4.0)**	**68.0**	**(- 1.9)**	**17.3**	**(+ 5.9)**	**-2.6**	**(- 9.8)**
Financing expectations	**improved**	**Δ Q3**	**remain unchanged**	**Δ Q3**	**deteriorate**	**Δ Q3**	**aggregate**	**Δ Q3**
Office	3.0	(- 5.0)	88.2	(+ 8.2)	8.8	(- 3.2)	-5.8	(- 1.8)
Retail	0.0	(- 4.1)	42.4	(- 11.8)	57.6	(+ 15.9)	-57.6	(- 20.0)
Logistics	8.8	(+ 8.8)	76.5	(- 11.5)	14.7	(+ 2.7)	-5.9	(+ 6.1)
Residential	9.0	(+ 5.4)	75.8	(- 6.3)	15.2	(+ 0.9)	-6.2	(+ 4.5)
All real estate segments	**5.2**	**(+ 1.3)**	**70.7**	**(- 5.4)**	**24.1**	**(+ 4.1)**	**-18.9**	**(- 2.8)**

Refinance market situation	improved	Δ Q3	unchanged	Δ Q3	deteriorated	Δ Q3	aggregate	Δ Q3
Capital deposits	6.9	(+ 6.9)	82.8	(-13.5)	10.3	(+ 6.6)	-3.4	(+ 0.3)
Mortgage bonds	10.0	(- 0.8)	80.0	(- 2.1)	10.0	(+ 2.9)	0.0	(- 3.7)
Unsecured bonds	7.1	(- 7.7)	75.0	(+ 0.9)	17.9	(+ 6.8)	-10.8	(- 14.5)
Mortgage backed securities	12.0	(+ 2.5)	76.0	(- 5.0)	12.0	(+ 2.5)	0.0	(+/- 0.0)
Real estate stock markets	11.5	(- 1.0)	57.7	(- 17.3)	30.8	(+18.3)	-19.3	(- 19.3)
Refinance market expectations	**improve**	**Δ Q3**	**remain unchanged**	**Δ Q3**	**deteriorate**	**Δ Q3**	**aggregate**	**Δ Q3**
Capital deposits	7.1	(- 0.9)	75.0	(- 5.0)	17.9	(+ 5.9)	-10.8	(- 6.8)
Mortgage bonds	6.9	(- 7.9)	62.1	(- 8.3)	31.0	(+ 16.2)	-24.1	(- 24.1)
Unsecured bonds	3.7	(- 4.0)	55.6	(- 17.5)	40.7	(+ 21.5)	-37.0	(- 25.5)
Mortgage backed securities	11.5	(+ 1.5)	50.0	(- 10.0)	38.5	(+ 8.5)	-27.0	(- 7.0)
Real estate stock markets	7.4	(- 1.3)	40.7	(- 15.8)	51.9	(+17.1)	-44.5	(- 18.4)
Spreads compared to German government bonds	**increase**	**Δ Q3**	**remain unchanged**	**Δ Q3**	**decrease**	**Δ Q3**	**aggregate**	**Δ Q3**
Mortgage bonds	41.2	(+ 1.9)	52.9	(- 0.7)	5.9	(- 1.2)	35.3	(+ 3.1)
Unsecured bank bonds	51.8	(+ 5.4)	44.8	(- 8.8)	3.4	(+ 3.4)	48.4	(+ 2.0)
Segment development	**increase**	**Δ Q3**	**remain unchanged**	**Δ Q3**	**decrease**	**Δ Q3**	**aggregate**	**Δ Q3**
Syndication business (volume)	42.9	(- 0.6)	46.4	(- 5.8)	10.7	(+ 6.4)	32.2	(- 7.0)
Underwriting (volume)	24.2	(+10.6)	58.6	(-18.7)	17.2	(+ 8.1)	7.0	(+ 2.5)

Comment: The German Real Estate Finance Index survey was carried out between 29.10.2018 – 12.11.2018 and involved 35 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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