JLL

ZEW
Zentrum für Europäische
Wirtschaftsforschung GmbH

DIFI-Report

– 1st Quarter 2017 –

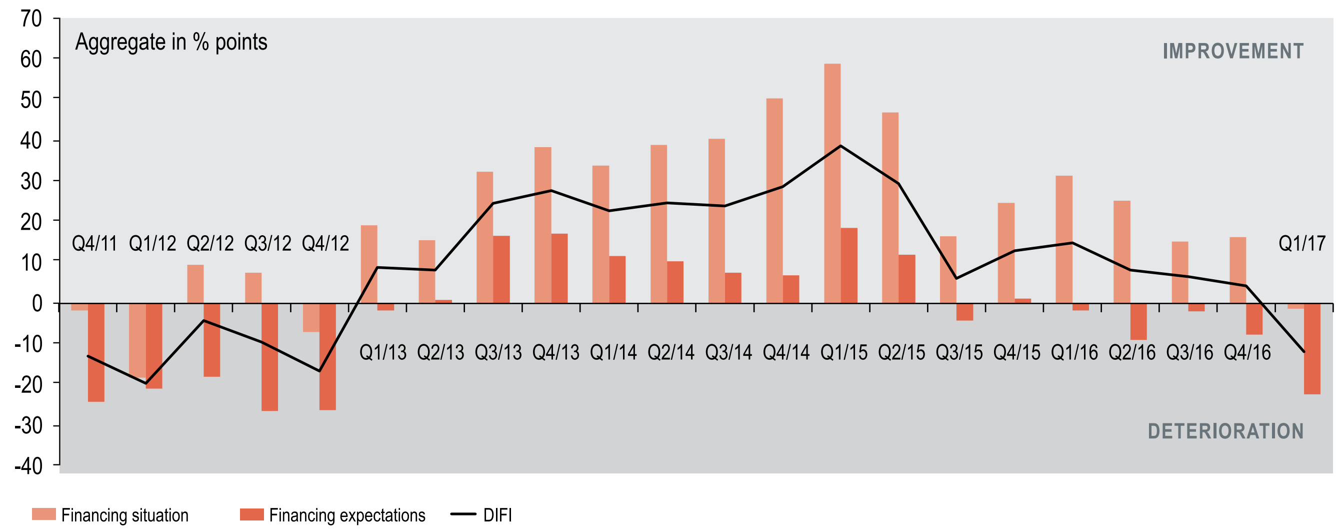
Assessment of the Real Estate Financing Market in Germany

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).

- **DIFI now indicates a marginally negative sentiment following a significant downturn**
- **More pessimistic expectations regarding the refinancing markets**
- **Special question: reasons for the hesitant recovery in the market for commercial mortgage backed securities**

Subdued sentiment in the commercial real estate financing market

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 falls below zero for the first time since 2012

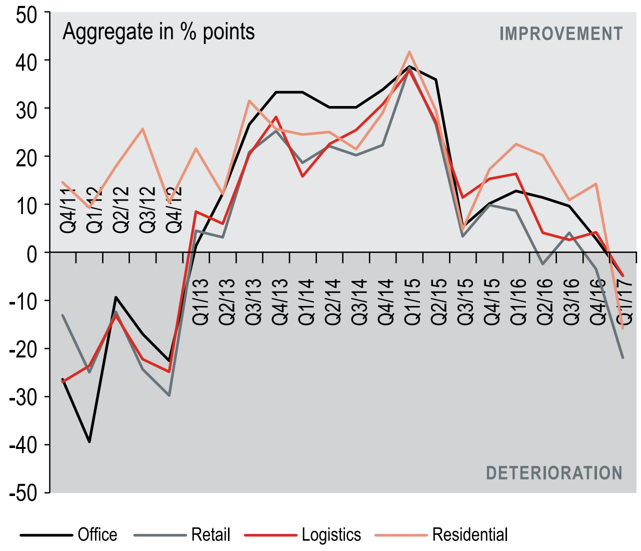
The **German Real Estate Finance Index (DIFI)** has fallen by 16.4 points to **-12.0 points** in the first quarter of 2017. After the fourth fall in succession, the index was back into negative figures for the first time since the fourth quarter of 2012. Sentiment in the commercial real estate financing market has become noticeably more subdued. This is due to both a more negative assessment of the last six months and more pessimistic expectations for the next six months. The aggregates of positive and negative assessments have fallen by 17.7 points to -1.3 points and by 14.9 points to -22.6 points respectively. However, it must be noted that around three quarters of all financing experts surveyed see no change in the financing situation and do not expect any change in financing conditions over the first half of this year. Nonetheless, the continuing trend towards pessimistic expectations means that the survey participants are preparing for a trend reversal in terms of financing conditions.

The significant fall in the DIFI is surprising given the robust overall economic situation in Germany: first estimates show that the GDP grew by 1.9% in 2016, driven by private and public sector spending, which is well above the level many experts had expected. Conversely, there is further (cautious) pessimism in the banking sector. We see this as unchanged, given the increased regulatory requirements and the competition between banks for low risk financing deals. In addition, the abolition of the real estate transfer tax (Grunderwerbsteuer) exemption in the case of share deals is still under discussion. This would have an effect on prices for real estate deals, as the transaction costs would rise accordingly. Despite the scepticism indicated by the negative DIFI, we have not yet noticed any wide-scale concern that interest rates will rise in the short-term.

Downturns across all use types

The decline in current assessments is due to the double-digit downturn across all use types. The most negative assessment of the current financing situation is in the retail property segment with an aggregate of -14.7 points, which equates to a fall of 23.3 points. This is due to falling sales in retail properties in 2016 and the resulting stagnation in rents in the city centres of Grade-A cities. For the

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



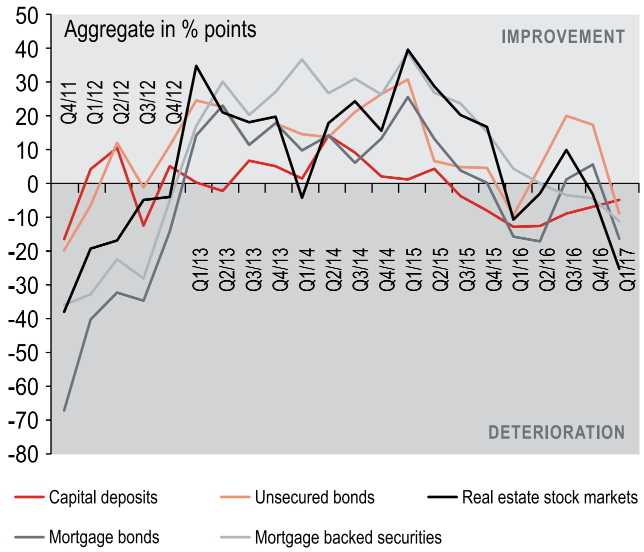
Average assessment of the current situation and expectations by defined real estate market segment. Source: JLL and ZEW

other use types, the current situation is assessed as either almost unchanged or marginally positive. Conversely, the downturn in financing expectations across all use types is very clear. The residential segment in particular collapsed by 38.3 to -31.8 points. This is due to the approx. 50% decrease in transaction volume in the commercial market for residential apartments in 2016, which was mainly due to the lack of both large company takeovers and sales of large volume portfolios of existing properties. The refinancing activities of the institutional residential property owners are mostly complete. The other use types reported less negative decreases, but all now show negative aggregates. Not one single participant from the retail or residential property sectors expects that financing conditions will improve over the next six months.

More pessimistic assessment of the refinancing markets

The pessimistic sentiment also extends to the assessment of the refinancing markets. Regarding the assessment of the current situation, only capital deposits were assessed more positively than in the previous quarter. In terms of the other refinancing instruments, the aggregates fell by up to 25.6 points. Only in the case of capital deposits and mortgage bonds do the survey participants still assess

Development of the refinancing markets



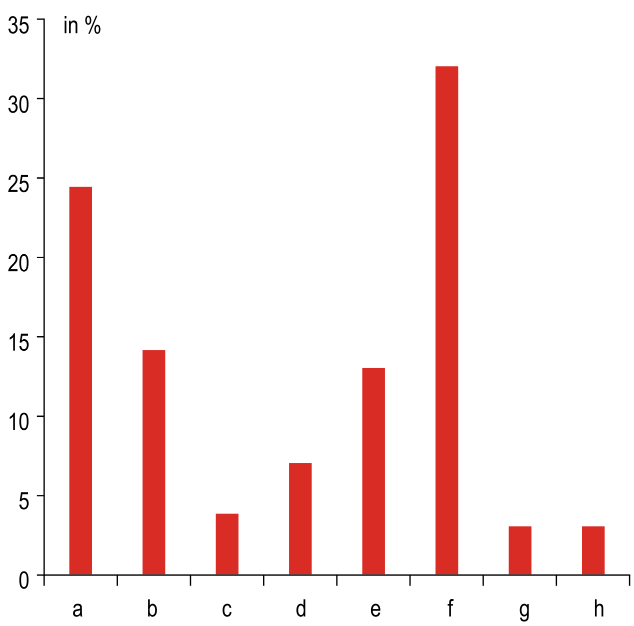
Average assessment of the current situation and expectations by refinancing instrument. Source: JLL and ZEW

the current situation as positive. Conversely, worse conditions are expected for all refinancing instruments over the next six months. The respective aggregates have fallen by between 10.2 and 29.5 points and are now in double digit negative territory. The lowest expectations are in the real estate stocks segment. International interest rate development is likely to have an effect in terms of the assessment of the refinancing markets due to the rise in base rates in the USA from December 2016 and the expected economic policy of US president Trump. The noticeable increase in inflation rate in Germany must also be taken into account. Future challenges will depend on adapting timely to the termination of the European Central Bank's bond purchase programme (Ankaufsprogramm), which is due to end in December 2017.

Special question: CMBS market in Germany

The market for Commercial Mortgage Backed Securities (CMBS) in Germany has not yet fully recovered from the crisis in the financial markets. In the current quarter, the real estate lenders were asked the reasons for this and their assessment as to which initiatives and circumstances would make the CMBS product marketable and competitive again. There were two possible answers to each question. The main reason for the weak CMBS market in Germany was simply the lack of necessity for the product: one third of the answers referred to the financing alternatives available on the German banking market. A further important reason mentioned by the survey participants was again the generally poor image enjoyed by CMBS. One quarter of all respondents mentioned this issue. Poor quality

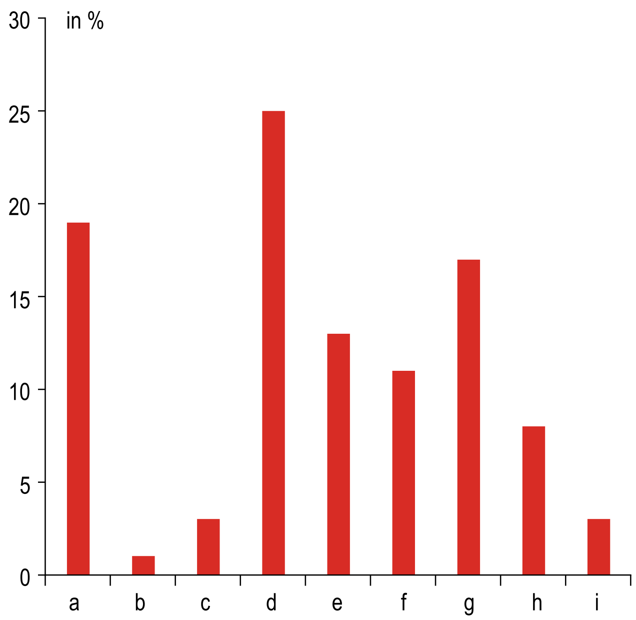
Why has the German CMBS not been revived?



a) The CMBS product (still) has a poor image.
b) The CMBS product is too complex.
c) The CMBS product is too expensive for borrowers.
d) Trust in rating agencies has not been revived.
e) Trust in the CMBS product has not yet been revived.
f) The German banking market offers sufficient alternative financing products.
g) The yields on CMBS tranches are below the minimum yield requirements of CMBS investors.
h) CMBS have not benefited from the ECB's bond purchase programme.

Source: JLL and ZEW

What can make CMBS transactions marketable again?



a) The interest rate in Germany must rise significantly (+2.00% for 10-year swaps).
b) The interest rate in Germany must rise moderately (+1.00% for 10-year swaps).
c) The ECB should relax the purchase criteria for CMBS.
d) The CMBS product should become less complex.
e) The rating agencies should create greater transparency.
f) Launch costs for a CMBS structure must fall dramatically.
g) (Large volume) real estate financing in Germany is still offered on restrictive terms.
h) CMBS investors must reduce their minimum yield requirements.
i) There should be a central marketing campaign to win back trust in the product.

Source: JLL and ZEW

mortgage backed securities were one of the causes of the global financial crisis.

According to one quarter of all survey participants, the German CMBS market is most likely to be revived by the reduction in the product's complexity. Around one fifth of the participants believe that the market could be stimulated by a significant rise in interest rates in Germany of 2% for 10-year swaps and a more restrictive policy regarding (large volume) real estate financing in the country. Conversely, it appears that CMBS are too expensive in the current interest rate environment. Furthermore, traditional lenders are currently offering large volume loans and are therefore disarming a further core argument for the use of a CMBS structure.

DIFI-Report: Results of Responses, 1st Quarter 2017

	improved	Δ Q4	unchanged	Δ Q4	deteriorated	Δ Q4	aggregate	Δ Q4
German Real Estate Finance Index	**6.3**	**(-10.8)**	**75.6**	**(+ 5.3)**	**18.2**	**(+ 5.5)**	**-12.0**	**(-16.4)**
Financing situation	**improved**	**Δ Q4**	**unchanged**	**Δ Q4**	**deteriorated**	**Δ Q4**	**aggregate**	**Δ Q4**
Office	9.7	(-15.2)	85.4	(+16.6)	4.9	(- 1.4)	4.8	(-13.8)
Retail	2.4	(-16.8)	80.5	(+10.3)	17.1	(+ 6.5)	-14.7	(-23.3)
Logistics	14.3	(-10.7)	76.2	(+ 9.5)	9.5	(+ 1.2)	4.8	(-11.9)
Residential	13.9	(-20.9)	72.1	(+19.9)	14.0	(+ 1.0)	-0.1	(-21.9)
All real estate segments	**10.1**	**(-15.9)**	**78.6**	**(+14.1)**	**11.4**	**(+ 1.8)**	**-1.3**	**(-17.7)**
Financing expectations	**improve**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**deteriorate**	**Δ Q4**	**aggregate**	**Δ Q4**
Office	4.9	(- 1.6)	75.6	(+ 1.7)	19.5	(- 0.1)	-14.6	(- 1.5)
Retail	0.0	(- 2.2)	70.7	(- 9.3)	29.3	(+11.5)	-29.3	(-13.7)
Logistics	4.9	(- 3.6)	75.6	(+ 1.1)	19.5	(+ 2.5)	-14.6	(- 6.1)
Residential	0.0	(-15.2)	68.2	(- 7.9)	31.8	(+23.1)	-31.8	(-38.3)
All real estate segments	**2.5**	**(- 5.6)**	**72.5**	**(- 3.6)**	**25.0**	**(+ 9.2)**	**-22.6**	**(-14.9)**

Refinance market situation	improved	Δ Q4	unchanged	Δ Q4	deteriorated	Δ Q4	aggregate	Δ Q4
Capital deposits	10.0	(+ 3.2)	85.0	(+ 7.7)	5.0	(-10.9)	5.0	(+14.1)
Mortgage bonds	14.3	(-15.4)	73.8	(+ 7.8)	11.9	(+ 7.6)	2.4	(-23.0)
Unsecured bonds	14.6	(-10.4)	63.4	(- 4.8)	22.0	(+15.2)	-7.4	(-25.6)
Mortgage backed securities	10.0	(+ 4.3)	76.7	(-11.9)	13.3	(+ 7.6)	-3.3	(- 3.3)
Real estate stock markets	17.2	(- 4.4)	51.4	(-13.5)	31.4	(+17.9)	-14.2	(-22.3)
Refinance market expectations	**improve**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**deteriorate**	**Δ Q4**	**aggregate**	**Δ Q4**
Capital deposits	7.5	(- 2.3)	70.0	(- 5.6)	22.5	(+ 7.9)	-15.0	(-10.2)
Mortgage bonds	0.0	(-13.4)	79.5	(- 2.7)	20.5	(+16.1)	-20.5	(-29.5)
Unsecured bonds	7.7	(- 4.5)	59.0	(- 9.3)	33.3	(+13.8)	-25.6	(-18.3)
Mortgage backed securities	6.5	(+ 0.6)	67.7	(-11.7)	25.8	(+11.1)	-19.3	(-10.5)
Real estate stock markets	3.0	(- 2.9)	57.6	(-15.9)	39.4	(+18.8)	-36.4	(-21.7)
Spreads compared to German government bonds	**increase**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**decrease**	**Δ Q4**	**aggregate**	**Δ Q4**
Mortgage bonds	34.9	(+25.8)	55.8	(-12.4)	9.3	(-13.4)	25.6	(+39.2)
Unsecured bank bonds	53.5	(+12.6)	44.2	(- 3.5)	2.3	(- 9.1)	51.2	(+21.7)
Segment development	**increase**	**Δ Q4**	**remain unchanged**	**Δ Q4**	**decrease**	**Δ Q4**	**aggregate**	**Δ Q4**
Syndication business (volume)	50.0	(+13.7)	37.5	(-14.8)	12.5	(+ 1.1)	37.5	(+12.6)
Underwriting (volume)	33.4	(+ 1.6)	53.8	(- 5.3)	12.8	(+ 3.7)	20.6	(- 2.1)

Comment: The German Real Estate Finance Index survey was carried out between 23.01.2017 and 08.02.2017 and involved 45 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

Zentrum für Europäische Wirtschaftsforschung GmbH

Contacts JLL

Markus Kreuter
Team Leader Debt Advisory Germany
Frankfurt
tel +49 (0) 69 2003 1211
markus.kreuter@eu.jll.com
Internet: jll.de

Helge Scheunemann
Head of Research Germany
Hamburg
tel +49 (0) 40 350011 225
helge.scheunemann@eu.jll.com
Internet: jll.de

Contact ZEW

Dr. Oliver Lerbs
Department International Finance and Financial Management
tel +49 (0) 621 1235 147
fax +49 (0) 621 1235 223
lerbs@zew.de
Internet: www.zew.de; www.zew.eu