MARKET REPORT

GERMANY

2013

Passion for Real Assets


THE SQUAIRE, Frankfurt, Germany

Contents

Dear readers,

Office property markets are reacting rather sluggishly to the economic momentum in Germany. Sluggishly because, although a certain cyclicality is guaranteed, high correlation with the economy exists only indirectly. No comparison with volatile markets such as London or Madrid. This makes it clear that there is an entirely different view of risks among financers, project developers and ultimately investors here in Germany. However, sluggish does not mean unattractive, as becomes visible in the current general economic situation.

So far, we have been experiencing the offshoots of an investment policy focusing very much on risk avoidance – with the consequence that the momentum of lettings, rental prices and refurbishments is reflected mainly in the conditions of scarcity that are becoming clearly manifest. Unlike in earlier market cycles, growth through supply expansion is definitely not what can be observed in the locations at present. Lesson learned – so it may seem at first glance. However, where are these core properties at the top seven German markets now? Up until now, vacant properties from the late 1980s have evidently been faded out by numerous investors as an opportunity to reposition. For this smells too much like project development – that is, it implies a high risk that is difficult to calculate. However, in our view, an extension of the risk-adjusted investment behaviour through project developments, which ultimately constitute refurbishments, including a stringent asset management approach is a sensible strategy so as to avoid allowing a new high price level, which, traditionally, could express itself in reduced attractiveness of Germany as a real estate location.

The excessive activities of 2005-2007 made a big impact on investors here in Germany as well. However, for the current year we expect a considerable increase in importance of an investment strategy that can be boldly described as value add. The feel for a professional relationship between risk and return is back. We attribute a large part of this not only to the improved transparency situation and the advanced market recovery. Above all, the focus of market participants again turns to the DNA of a property investment: value stability considered in the long term.

Those who now see analogies to the system stability obligation in the financial markets desired by politicians are exactly right. The property market system in Germany is branded as a refuge of stability compared with the system in other countries. It is currently defined as the ideal combination of momentum – new impetus comes from the refurbishment activities at the central locations – and the sluggishness of its reaction speed – excluding exaggerations. Critics may remark that the conditions for capital preservation with properties have never been so boring in this country. Precisely that is the response to the "wild years" of the last decade, reply analysts and strategists. Especially since, in our view, the general economic, political and social situation will also not change structurally in the next few years. Here, tactical moments such as Basel III, Solvency II and "Wutbürger I" are already taken into account. If Munich emerges as the winner in our ranking list of 74 locations for the third time in a row, this may correspond exactly to the view of the market.

We hope you enjoy reading the report!

O. Voß T. Beyerle

Oliver Voß Thomas Beyerle

Trends on Germany's office market (management summary)

- The **vacancy rate continued to decline** for Germany's top markets and regional centres last year, although rental activities were down from the prior year due to the economic downturn. The strong labour market also meant that companies' demand for additional office space in 2012 was higher than that for new space.

- An analysis of the top seven locations shows that **decreased demand and take-up affected almost exclusively the peripheral locations**, while the **reduction of vacancy rates took mainly place in the inner-city locations**. Therefore, prime rents in some city centres rose significantly in 2012, while they remained stable in the secondary locations.

- In 2013, supply and demand on the rental markets will remain largely in balance, because the **moderate completion volume** is already more than two-thirds **pre-let. Rent increases** will be **more of an exception** due to the weak economic conditions.

- In particular, **Munich** (high availability of space, little new construction) **and Stuttgart** (insufficient amount of modern spaces), are in a **good position for 2013**, while the Frankfurt market remains burdened by high vacancy rates.

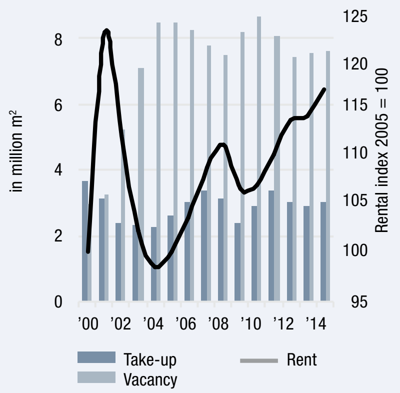
- In this year's **IVG office market scoring**, which has a medium to long-term focus, **Munich** rated **the best** among 74 German office locations. It was followed by Hamburg and then – closely together – the other five major markets: Frankfurt, Cologne, Berlin, Stuttgart and Dusseldorf. **Among the regional centres, Hanover, Nuremberg and Wiesbaden** were at **the top**. At the bottom of the ranking were small, scarcely developed office locations in structurally weak regions in both the eastern and western parts of Germany.

- On the German **investment market** for commercial real estate, the office segment was in the lead once again: The **transaction volume in the office segment grew by more than 50% versus 2011 to some €10.7 billion**, accounting for about two-fifths of all commercial real estate investments. The purchases were again focused more heavily on the **seven largest markets**, which represented **€9.3 billion or 86% of office investments.**

- Significant catalysts on the overall investment market (for all types of use) in 2012 were again investors with a good equity base, whereby the activities of the German real estate funds were lower than they were in the prior year. While the equity funds doubled their acquisitions versus 2012, they reduced their net real estate assets in general, at least in the major markets.

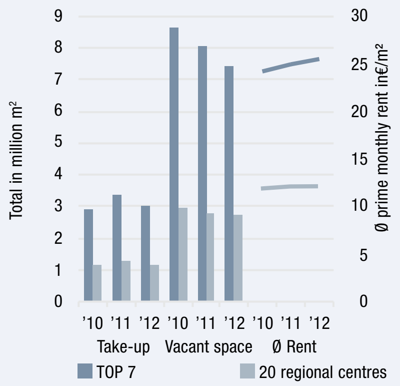
- **Initial yields for prime office properties** at the seven top markets dropped on average from 4.99% to 4.84% last year. The **yield difference versus ten-year German government bonds** still **rose by an average of 335 bps** due to sharp declines in interest rates.

Office markets of the German TOP 7



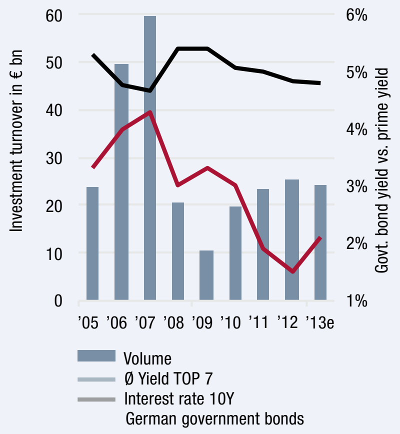
The figure includes Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg, Munich and Stuttgart.
Source: IVG Research

TOP 7 vs. 20 regional centres



Source: IVG Research

Investment market Germany



Source: BNPPRE et al., IVG Research Forecast

- Investors' **risk propensity increased somewhat** over the last year. This is reflected not only by the lower share of core investments in overall transaction volume, but also by the fact that initial yields for prime office space have declined slightly on average – not only in CBD locations of the major markets, but also in surrounding city centre outskirts and regional centres.

- The additional increase in large transactions in January and February indicates that real estate investors' interest in acquisitions in the German office segment remains high. Ultimately the economic recovery hoped for will determine whether this demand will benefit office properties that fall under the risk categories of value-added and opportunistic.

- Another **temporary decline in prime yields** in the major locations cannot be ruled out given the short supply in the core segment.

- **Real estate financing** could be a stumbling block to real estate investments in 2013 due to stricter banking regulations under Basel III and many pending refinancing (such as maturing commercial mortgage based securities).

Implications of IVG research for investment strategies

- Newer, rented **prime properties in the seven top markets**: Relative to the German federal bond interest rates, yields remain attractive and there is no interest rate increase in sight. However, yields will not remain at these low levels forever. Thus, investments imply a re-sale in the short term or a long holding period for real estate in expectation of rising rents.

- Modern rental **office properties in good secondary locations** still offer investors high returns compared with the central locations (little yield compression) and demonstrate relatively high re-rental opportunities. Therefore, they remain attractive for investments.

- Prime fully-let properties in the **best locations of regional centres**: Yields have not declined much despite lower interest rates and stable rental markets. Therefore, this market is still worth entering. However, the regional markets are relatively small and there is low turnover of space on the investment and rental side. Value-added strategies in terms of renting vacant spaces therefore bear a considerable risk in the regional centres.

- **Older existing space**: The supply of modern space is not so small that we would assume a market recovery in the segment for older properties. Therefore, there is a risk with regard to re-rental. There are opportunities for space modernisation and refurbishments if the micro-location of the property is on target for the long term.

- **Modern vacant space** offers asset management opportunities for new rentals as long as the location is right and there is short market supply for modern office properties. However, affordable entry-level prices reflect the risk that the rental process can be very long.

SWOT analysis for the German office property market

Strengths

- Largest office market in Europe with around 90 million m² office stock just in the seven largest locations
- Very competitive, diversified economy with solid public finances
- Long-term stable market, not least due to the high significance of equity-based investors and robust real estate financing
- Diversification opportunities thanks to a multi-polar office market
- Long-term leases: Five years + option of additional five years
- No currency risk for investors from the euro zone

Weaknesses

- Framework conditions for real estate are inconsistent due to the federal system (e.g. differences in the amounts of property acquisition tax)
- Prime yields are close to the low of 2007
- REIT segment not well developed to date
- Market transparency reveals potential for improvement in terms of individual transactions
- Real estate investments are difficult without a local presence
- No legal regulation or standardisation of rent adjustments

Opportunities

- Hardly any speculative new construction: Shortage of modern space
- Modernisation and refurbishment of office space as an opportunity
- Further slight yield compression not only in the seven major markets but also the regional markets: Record difference among the yields from prime office properties and German federal bonds
- Long-term inflationary pressure: Outlook for rent growth
- Bargains for opportunistic investors: Sales by open-ended public funds and distressed sales
- The German market is progressing to an international market
- Development of new investment vehicles such as REITs

Risks

- Revival of the economic crisis in the euro zone
- Substantial structural vacancy: prices in this segment remain under downward pressure
- Bottleneck in real estate financing due to Basel III: Distressed sales could increase
- Mid-term upward pressure on the initial yields due to rising interest rates
- Demographic challenges due to shrinking populations outside the conurbations

Source: IVG Research

- The situation is similar for the acquisition of **speculative new construction plans**, which however carry the risk that the market will be in another downturn at the time of project completion. Given restrictive lending policies, investments must be financed exclusively through equity.

- Office space in **poor secondary locations**: These currently offer low entry-level prices, which indicate a high structural vacancy risk.

- **Over-rented** office space: Given the uncertain economy, there is no guarantee that over-renting relative to market rent can be balanced out in the years to come. This risk is reflected in low initial yields.

- Independent of the respective building-specific features of the "older property – 100% vacant space" category, the current energy situation in particular should be subjected to an intensive assessment as part of the due diligence process. Due to the fact that energy standards are becoming more stringent, this aspect is increasingly seen under the condition of deferred impairment requirements and risk premiums.

Attractiveness of office investments from yield/risk aspects

Building type	Newly refurbished property		Older property		Future development project	
Percentage of properties let	100 %	0 %	100 %	0 %	100 %	0 %
TOP 7: Central location	Average	Average	Average	Average	Average	Avoid
TOP 7: Good secondary location	Attractive	Avoid	Average	Avoid	Attractive	Avoid
TOP 7: Poor locations	Average	Avoid	Avoid	Avoid	Average	Avoid
Regional centre	Attractive	Avoid	Average	Avoid	Attractive	Avoid

From yield/risk perspectives: Attractive Average Avoid

Comment: Schematic, simplified presentation of alternative actions. The acquisition of vacant buildings is based on a value-add strategy in the form of renting or modernisation.

Source: IVG Research

Economy: Germany in comparatively calm waters

Economic growth: sovereign debt crisis remains primary issue

Last year, economic development in Germany was decisively shaped by the high level of uncertainty in the face of the ongoing sovereign debt crisis in southern Europe and the threatened collapse of the European Monetary Union. Against this backdrop, gross investment in Germany declined over the entire course of 2012, and even exports collapsed towards the end of the year. Therefore, the German economy – like most other national economies in the European Union – contracted in the fourth quarter of 2012 (-0.6% on the previous quarter).

In recent months, however, hope has sprouted that this economic downturn will last just a short while. Various announcements and actions by the European Central Bank (potential purchase of government bonds from crisis-hit nations) and European governments (including the banking union) have contributed to the capital markets setting down somewhat and the sovereign debt crisis abating. The Ifo business climate has therefore been showing a turnaround in sentiment since November and even a clear economic upturn in Germany since February.

Some analysts are already raising their economic forecasts in view of the supposed turnaround. For example, Commerzbank is now expecting economic growth of 1.0% in 2013 and even 2.5% in 2014 (2012: just +0.7%). Even though there is now cause for optimism again, the latest discussions about public financial aid for Cyprus, the parliamentary elections in Italy and charges of corruption in Spain all show how unstable the economic situation in Europe – and therefore in Germany – still is. Moreover, the consequences of the financial and sovereign debt crisis, e.g. the pressure to consolidate public budgets due to enormous sovereign debt and the increased regulation of the financial sector, will continue to negatively affect economic development for a long time.

Labour market: high growth in 2012, robust in 2013

Despite the weakening economy, Germany's labour market was in very good condition last year. Overall employment went up 1.1%, considerably more than the economy as a whole. Among the office-related sectors, providers of business services and information and communication companies posted particularly high growth rates with +1.9% and +3.0% respectively, while the financial sector had to undergo a fall in employment of 0.2% over the year as a whole.

Many businesses absorbed the phase of economic weakness in autumn by cutting overtime or introducing short-time work, with the result that employment did not fall even in the fourth quarter. In fact, the seasonally adjusted unemployment rate as defined by Eurostat fell to 5.3% at the end of the year (previous year: 5.6%).

The European Commission anticipates that the unemployment rate in Germany will rise again slightly this year and that the growth in employment in 2013 in particular will be low. However, the fact that the seasonally adjusted number of unemployed in Germany has already fallen in December and January suggests that the trend could turn out more positively than expected.

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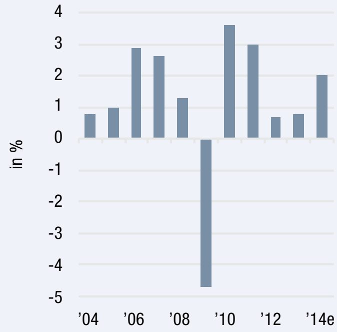
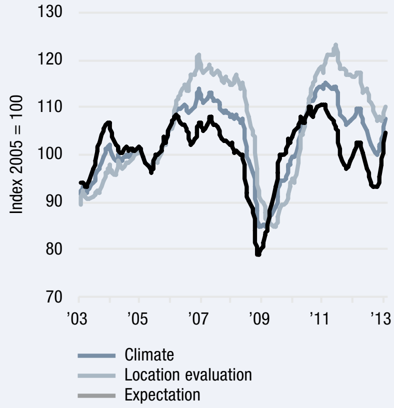
Growth of gross domestic product



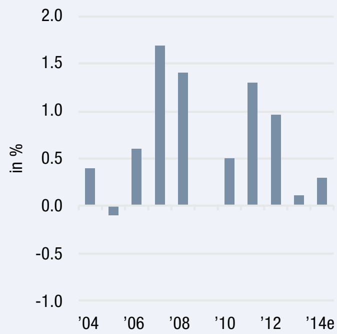
Source: German Federal Statistics Office, IVG Research Forecast

Ifo business climate Germany



Source: Ifo Business Survey

Growth of employment



Source: European Commission

Inflation to remain moderate in 2013

In 2012, consumer price inflation in Germany weakened year-on-year due to the weaker economic situation overall. The annual average rate of inflation was 2.1%. In the current year, the rate of increase of general consumer prices in Germany is likely to fall below even the 2% mark given the rather sluggish economy and the recent appreciation of the euro.

Things will get interesting from 2014: If the predicted economic upturn has a positive impact on the labour market, a significant increase in wages and therefore in unit labour costs can be expected. The latter are an essential determinant of consumer prices, meaning a higher core inflation rate can be expected from 2014. This is all the more true because the European Central Bank – unlike the German Bundesbank in earlier cycles – will in all likelihood not react by increasing interest rates.

The ECB's main priority in the years to come will remain the stabilisation of the European Monetary Union, so the monetary policy of the ECB will be largely focussed on the problems in the crisis-hit countries of southern Europe. For that reason, the ECB's policies will remain expansionary for the time being, i.e. the base rate will remain at 0.75%.

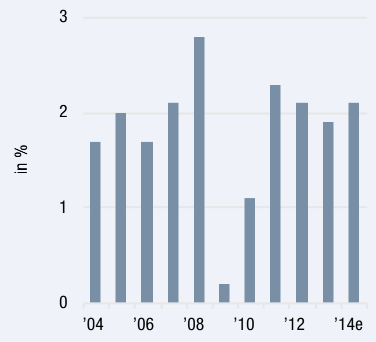
Interest rates for German government bonds and interest structure curve

Over the last twelve months, the German interest structure curve has shifted downwards considerably again as a result of the aggravation of the sovereign debt crisis, as many investors have moved their capital to safe havens such as German bonds. The interest rate for ten-year fixed interest German government bonds was around only 1.5% at the turn of 2012/2013 – significantly below the current inflation rate.

While interest rates will stay low in the short term, in the medium term it is to be expected that the interest structure curve will shift significantly upwards. Because of the general price increases, the low interest rates imply real losses in value. The current low interest rates are solely the result of the ECB's extremely expansionary monetary policy and enormous uncertainty among investors.

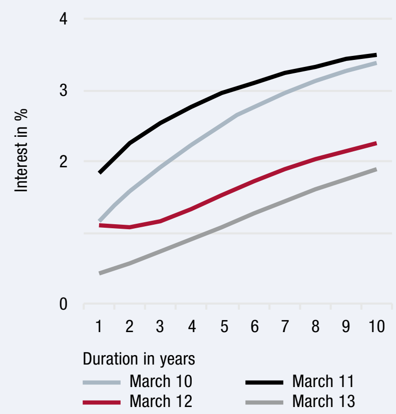
However, when confidence in the capital markets returns, interest rates will trend upwards significantly again, particularly at the long end. At the end of 2013, the interest rate for fixed-interest ten-year German government bonds is expected to be approximately 2% to 2.2%.

Inflation rate



Source: German Bundesbank, IVG Research Forecast

Interest structure curve



Source: Daily press, mid market swap rate

10-year bonds

Source: Oppenheim Research

Office rental markets: stability is trumps

Top seven markets: market recovery has continued

Rental take-up declining, but above the long-term average

Rental activities in the seven largest German office markets (Berlin, Cologne, Düsseldorf, Frankfurt, Hamburg, Munich and Stuttgart) weakened noticeably compared with 2011 as a result of the economic downturn last year. However, a final run at the end of the year ensured that rental take-up was only 8% lower at around 3.1 million m². Against the trend, Frankfurt even posted increased rental activity last year, but the location had not profited from the rental boom in 2011 and therefore started from a comparatively low level.

In Germany, almost all economic sectors were less active as lessees in 2012 than in 2011. Major exceptions were retailers, which expanded their rental activities last year, not least thanks to various large leases by Zalando (approximately 70,000 m²), and public authorities, which took up just as much space in 2012 as in the previous year. In contrast, the take-up of companies from industry and construction declined the most, i.e. by 28%, but was still above the long-term average. Last year, in terms of the seven major office locations, finance companies were again very reticent when it came to new lettings, not least because of restructuring within the banking sector. Providers of business services, i.e. consultancies, marketing and media agencies and larger law firms, had the largest share of take-up again in 2012, but were also less active on the rental market than in the boom year of 2011.

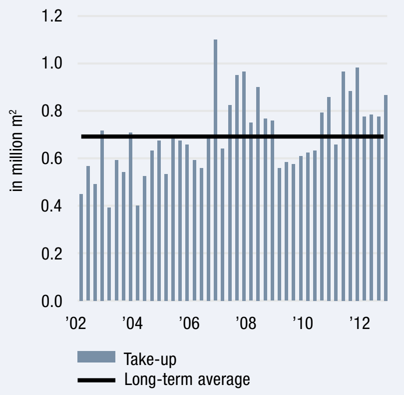
No decline of take-up in city centres

The decline in rental activity affected the city centres, the outskirts of the inner-cities and the peripheries of the seven largest markets to differing degrees last year: while rental take-up in the two central locations – aggregated over all seven cities – barely changed compared with 2011, the office locations on the peripheries saw take-up decline by a quarter. However, the seven locations did not develop uniformly in this regard. For example, while in Frankfurt rental activity relocated from the periphery to the city centre and the city centre outskirts, exactly the opposite was true in the Cologne market. Overall, the rental take-up in Germany's most important locations was split about equally between the city centres, city centre outskirts and the more peripheral locations.

Continued decline in vacancy

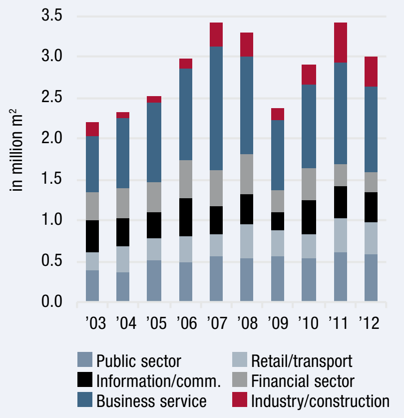
The vacancy rate fell considerably in the seven major office markets last year, namely from 9.2% to 8.5%. This reflects the fact that many companies required additional office space due to the expansion of their workforce – the German labour market was robust up to the end of the year. This meant that net absorption proved very positive in 2012. However, the vacancy development also benefited from the fact that completions proved to be very moderate (very few speculative construction projects) as a delayed consequence of the financial crisis and due to the restrictive lending conditions in project development business and that, in some locations such as Frankfurt, obsolete office space was converted for other uses or even demolished.

TOP 7: Quarterly take-up



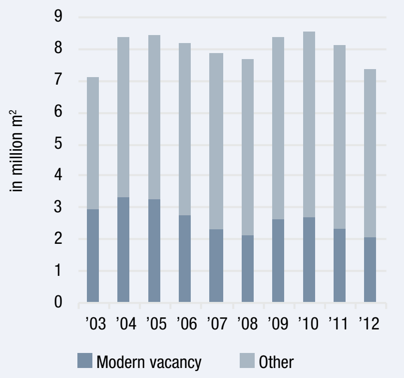
Source: IVG Research based on data from Cushman & Wakefield

TOP 7: Take-up by sector



Source: Calculation IVG Research based on data from BNPPRE

TOP 7: Vacant office space



Source: Calculation IVG Research based on data from BNPPRE

Against this backdrop, total office stock in the major locations grew by only 0.4% last year. The vacancy rate in office space with modern features and characteristics and in other office space fell by the same amount last year – namely by just under 9% in each case. Therefore, the proportion of modern office space in the total vacant space was 29% – the same as at the end of 2011.

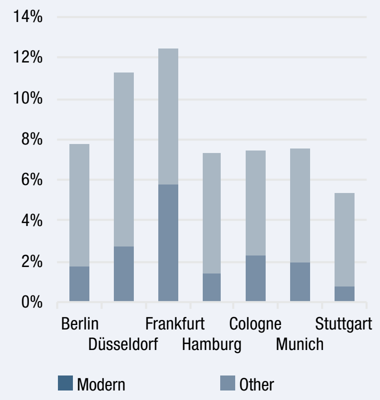
The above-mentioned shifts in the geographical structure of demand for space were reflected in the (aggregated) vacancy trend of the seven locations: while the vacancy rate in the city centres and in the outskirts of the inner-cities fell by 14% and more than 10% respectively in 2012, in the non-central locations and the peripheries it fell by only 5%. The latter category now accounts for approximately 46% of vacant space; the rest is divided equally between the city centres and the city centre outskirts.

The vacancy rates in Frankfurt and Munich fell particularly sharply last year. Düsseldorf and Cologne also posted a noteworthy decline in vacancy, while Berlin and Stuttgart saw no significant change. Nevertheless, of the "big seven", Stuttgart remains the market with the lowest vacancy rate at 5.4% and in particular has the lowest rate of vacancy in modern space, while the supply of office premises available at short notice in the Frankfurt market as a whole is comparatively large with a vacancy rate of 11.3% (a significant portion of which is modern space).

Rent growth in the prime segment subsided in the second half of the year

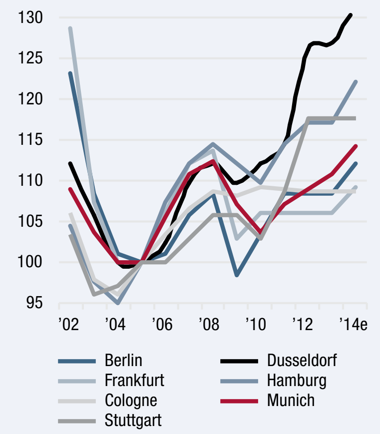
Frankfurt is also the only major location apart from Cologne where there has been no recovery of prime rents in the last two years. In contrast, Düsseldorf (+10.6%) and Stuttgart (+5.4%) ahead of Munich (+3.3%) and Hamburg (+2.0%) posted strong growth in the prime segment over the year. On average, prime rents in the seven major markets increased by 3.0% last year, with the rent increase slowing in the second half of the year due to the economy. Rents for high-quality office space went up in some city fringe locations, such as in Munich, but otherwise remained mostly stable. The upward trend in the prime segment is therefore reflected in positive development of (realised) average rents in only a few locations like Munich and Stuttgart. In Hamburg, average rents actually declined in 2012. The situation with regard to tenant incentives is varied in the individual locations: while they remain high in Frankfurt with rent-free periods of 6 to 9 months (for five-year rental agreements), new tenants in the Berlin office market are barely granted any rent-free period.

Vacancy rate



Source: IVG Research

Index of prime rents basis 2005 = 100



Source: IVG Research

Office markets stay largely in equilibrium in 2013

Various leading indicators such as the Ifo Business Climate Index point towards a renewed economic turnaround for the better. In any case, a slump in the German employment market was not forecast. However, recent events, such as the outcome of the elections in Italy and discussion of a bailout for Cyprus, could cause new uncertainty among businesses and consumers. Therefore, it cannot be ruled out that rental activity will decline again year-on-year, especially as company's decision-making processes are likely to take longer. Companies' demand for additional space will be relatively low as a consequence of their efforts for cost savings, and thus space efficiency, and the expected weak growth in employment. This means that net absorption is expected to be weaker in 2013 than in the previous two years.

As for the supply side of the market, however, completions of new office space are proving relatively moderate in most locations this year. In addition, the new space coming onto the market in 2013 and 2014 is already two thirds pre-let or occupied by the owners. If we consider that this year some of the office buildings that are no longer marketable are being converted to other uses or even demolished, we can assume that demand and supply on the rental markets in the major office locations will largely balance each other this year. This means that the vacancy rate should remain stable in 2013.

Rents take a breather

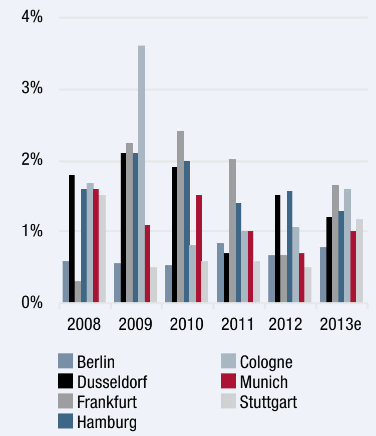
A significant increase in prime rents is not to be expected in most locations due to the weaker economic conditions this year. In this context, it is worth mentioning that the prime rents in locations such as Düsseldorf, Stuttgart and Hamburg have now risen to a level that is much higher than the highest point before the Lehman Brothers disaster. One exception is Munich, where a continued, significant reduction of vacancy – and therefore rent increases for high-quality space – is expected in 2013 in view of the relatively strong economic momentum and low level of completion. The other locations will follow in 2014, if the economy – as generally predicted – regains momentum. Rents for space attributed to structural vacancy will nevertheless remain under downward pressure this year.

On the whole, the prospects for the major German office rental markets therefore remain good this year. However, the comments above have made it clear that there are significant regional differences with regard to developments. Therefore, it is worth taking a specific look at each of the major office locations individually:

Berlin: no signs of fatigue on the rental market

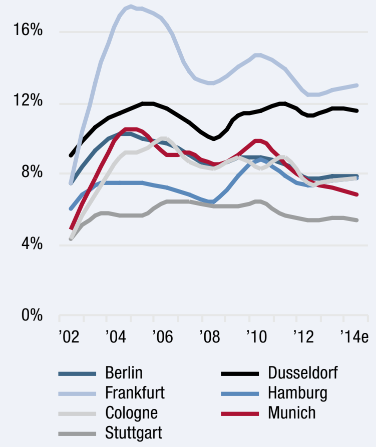
At nearly 550,000 m², rental take-up remained high in 2012 and was down only slightly year-on-year. The clear favourite among tenants was the eastern side of the city centre, which accounted for a good two fifths of rental activity. The greatest take-up was seen inside the urban railway ring, while in the top three city centre locations (City Ost, City West, Potsdamer Platz) one third less space was taken up than in 2011 because of a lack of suitable available space. The high take-up was supported by strong momentum in the segment of large space above 5,000 m², which accounted for a good 40% of the total rental take-up. Online trading platforms generated the highest industry-specific rental take-up at 87,000 m², of which Zalando alone took up nearly 70,000 m². Business-related service providers came second with over 80,000 m², followed by public administration with 78,000 m².

Growth of office stock



Source: IVG Research

Vacancy rates



Source: IVG Research

Due to high demand for office space, the vacant space fell by almost 5% to 1.3 million m² over the year, the lowest level for ten years. The vacancy rate decreased from 8.2% in 2011 to 7.8%. This development was supported by the moderate completion volume of 110,000 m². Just 10% of these new additions are still on the market.

Despite this development, the prime rent remained at €22/m² per month last year. However, rents have effectively risen in different locations. For example, the rent-free periods in five-year rental agreements have fallen from two months to one month. Nominal prime rents in the submarkets of the government district, Hackescher Markt and Tiergarten tended to rise.

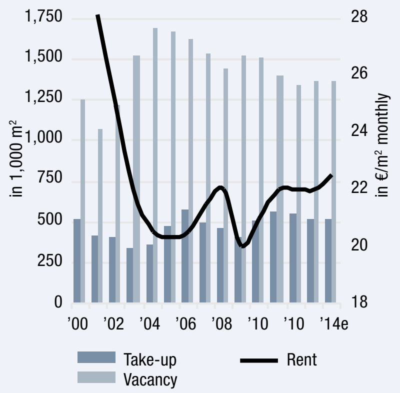
Cologne: good rental take-up despite lack of large lettings

Although last year's rental take-up at around 260,000 m² did not reach the record figure of 2011, a good take-up above the ten-year average was achieved. The decline in take-up is primarily attributable to the lack of major transactions in comparison with the previous year. For instance, no rental agreements for more than 10,000 m² were signed in 2012. However, noteworthy lease prolongations such as the agreement with the REWE Group for 24,000 m² are not accounted for in the take-up statistics. The fact that the market remained dynamic despite the lack of large contracts was the result of the above-average number of contracts overall, which made the good result possible. In relation to the take-up of contracts, space of up to 500 m² took the greatest share at around one third.

Among Cologne's submarkets, the city centre was the most sought-after office location with rental take-up of approximately 75,000 m². In addition, more offices were rented in Lindenthal und Ehrenfeld (11% each) and in Ossendorf (9%). The Deutz location, as the most important submarket on the right bank of the Rhine, had a share in take-up of only 3% last year. Demand for space was difficult to meet here, because the range of suitable properties is very small. On the whole, companies with expansion and relocation plans in Cologne are faced with an insufficient supply of modern, large-scale offices.

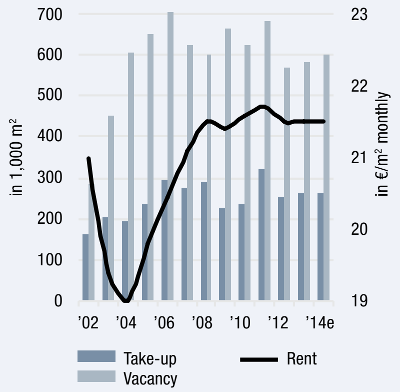
Due to above-average rental activity, the vacancy rate has fallen year-on-year to 7.5%. In connection with this, it is worthy of note that nearly all Cologne submarkets benefited from the reduction. The high structural vacancy of outdated office space no longer in line with market requirements is considered a problem. For example, 69% of vacant space does not have high-quality fixtures and fittings. Most of the structural vacancy stock is concentrated in the city centre and the submarkets of Ehrenfeld and Bayenthal, where around 60% of the vacancies are located. At the end of 2012, the prime rent was €21.5/m² per month – similar to that in the previous year. Rent development in the secondary locations was stable. In 2013, no major change in rents is expected in view of the weak economic prospects.

Office market Berlin



Source: CW/JLL et al., IVG Research Forecast

Office market Cologne



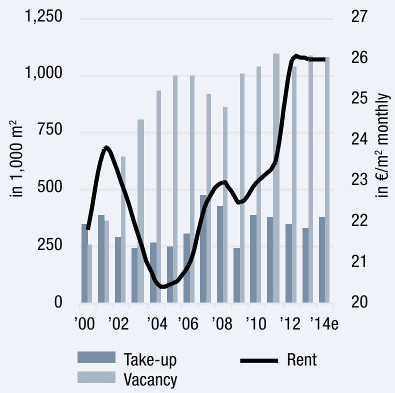
Source: BNPPRE, IVG Research Forecast

Dusseldorf: prime rents soar to a new record high

With rental take-up of 346,000 m² in 2012, the previous year's figure was missed by 4%, but on a positive note the take-up was still well above the ten-year average. Particularly high levels of take-up were seen in the fourth quarter of 2012, when around a third of space was taken up. Due to the two large lettings by the telecommunications companies Deutsche Telekom (16,600 m²) and Huawei (13,000 m²), the Seestern submarket posted by far the highest rental activity, followed by the submarkets of the city centre and the banking district. The strong dominance of demand for first-class space (approximately 55%) must be emphasised. By contrast, old office space was difficult to broker, as in the previous year.

Due to the relatively stable demand for office space, the vacancy rate fell from 12.0% in the previous year to 11.3% in 2012. The reduction of vacancy extended to all submarkets in the Düsseldorf office market area without exception. Vacancy currently constitutes an area of 1.04 million m². The greatest share is in the Grafenberger Allee submarket (105,000 m²), followed by north Düsseldorf (95,500 m²) and the city centre (89,500 m²). An increase in vacancy is to be expected in the near future, however, because Vodafone will successively vacate all its current space following completion of its new campus. However, supported by lettings in the Kö-Bogen and the Dreischeibenhaus and increasing scarcity of modern space in the banking district, the prime rent reached a record high of €26.0/m² per month. A universal trend in rents cannot be discerned. However, a further increase of the prime rent cannot be ruled out if the supply of prime space continues to decrease in the best locations.

Office market Dusseldorf



Source: BNPRRE et al., IVG Research Forecast

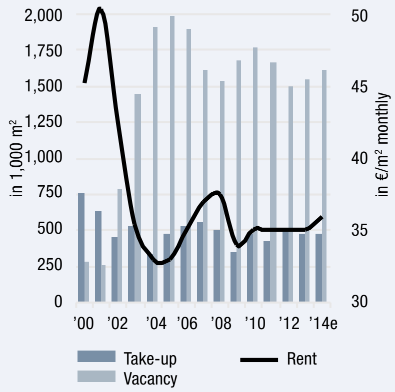
Frankfurt: still no rent growth in the prime segment

Last year, Frankfurt was the only major German office market to post growth in take-up (+20%), but this was based on a weak previous year. The increase in take-up to 512,000 m² in 2012 was primarily attributable to increased rental activity in the city centre submarket. Even so, the airport area saw take-up of around 36,000 m². Alongside companies from Frankfurt's two key industries, finance and consulting, industrial and construction companies were particularly active as lessees last year (e.g. pre-letting of 26,000 m² by Lurgi GmbH in the Mertonviertel submarket).

The vacancy rate on the Frankfurt office market fell sharply from 13.9% to 12.5% last year. This trend reflects the requirement for additional space and the fact that various older office buildings were removed from the market entirely last year to be renovated and/or converted. This means that the stock of space in Frankfurt shrank slightly in 2012. The share of vacant properties attributable to modern space is comparatively high at almost 50%. In addition to the high absolute vacancy level, this may be an explanation as to why Frankfurt – in contrast to most other office strongholds – did not post an increase in the prime rent in the current market cycle (still at €35/m² per month) and why comparatively high tenant incentives are included in new leases here (six to nine rent-free months for five-year rental agreements). In some submarkets, however, very significant rent increases were seen. In the Frankfurt airport submarket, the prime rent is still estimated at €30/m² per month.

This year, the completion volume will more than double compared with 2012, rising to around 190,000 m². Nonetheless, as the majority of newly constructed space has already been let, vacancy should remain largely at the level of the end of 2012.

Office market Frankfurt



Source: CW/JLL et al., IVG Research Forecast

Hamburg: significant fall in take-up year-on-year

In 2012, rental take-up declined 20% year-on-year to approximately 435,000 m². This is due primarily to the lack of large-scale lettings. In the previous year, they made a substantial contribution to the very good result. The main area of rental activity in 2012 was transactions in the 2,001 m² to 5,000 m² segment with a share of 27%, followed by the 501 m² to 1,000 m² segment (approximately 21%). In terms of geographical distribution, the city centre was the most popular submarket, as in the previous year. However, the sharpest increase in take-up was posted in the City Süd district, which is primarily attributable to three major contracts for Praktiker (8,200 m²), ADAC (7,600 m²) and Sharp Electronics (6,000 m²).

Despite the weaker rental take-up year-on-year, vacancy decreased last year. The vacancy rate fell from 7.9% to 7.4%. Overall, the majority of submarkets benefited from the vacancy reduction, although the steepest declines were seen in the HafenCity (-55%) and City (-38%) submarkets. A high completion volume is expected in the current year. However, as only a small proportion of new space is put on the market, this is likely to have only a minor impact on office space vacancy. With steady demand, it is more likely that vacancy will stabilise. After a slight increase, the prime rent is around €24.0/m² per month. Prime rents are not expected to increase any further this year.

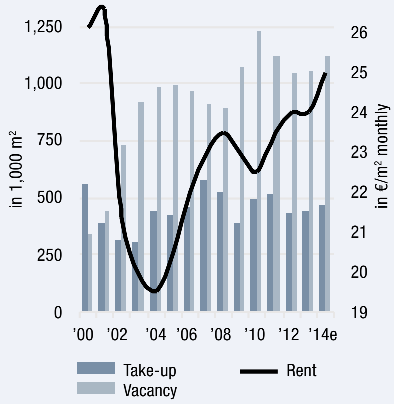
Munich: rents continue to pick up

With take-up of 734,500 m², Munich was again the top office location in Germany in 2012. Although rental take-up was lower than in the record year of 2011 by a fifth, it was a good 10% above the ten-year average. While a quarter of the take-up in 2011 was attributable to numerous large lettings, they made up around only 10% of total take-up last year. The three largest transactions were carried out by Swiss Life (21,000 m²), the City of Munich (19,100 m²) and BMW Peugeot Citroën Electrification (15,500 m²). Otherwise, the transaction volume was spread relatively evenly over all size categories.

A good three quarters of the rental take-up in 2012 took place within city limits. The old town enjoyed stable demand, while the northern and southeastern parts of the city suffered take-up losses of 45% to 60%. In Munich's periphery, take-up declined by 21%.

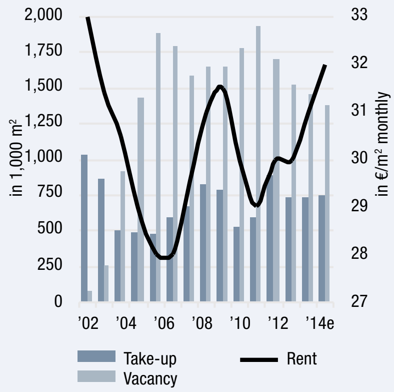
The decline in take-up in 2012 was the expression both of declining overall demand and scarcity in the existing supply of adequate office space in central locations. Munich's total office stock grew by just 1% due to a low level of completion. Office conversion and solid demand prompted vacancy to fall by 11% year-on-year to 1.5 million m². In particular, the supply of modern space fell disproportionately and currently comprises less than a tenth of the vacancy (136,000 m²). The vacancy rate declined from 8.5% to 7.6% in line with the reduction in vacancy. The lowest vacancy rates were seen in the submarkets of the old town (2.1%) and northeast city centre (1.9%). This is already well below the fluctuation reserve of 5%, making it much more difficult to move into these areas. Surplus demand caused average rents to increase by 1.7% to €15.8/m² per month in the city. It is primarily the lower limits of rents that have risen across the board. In the periphery, however, there was an opposing trend with a 1.5% fall. The prime rent increased by 3.3% to €31/m² per month. Because of the current low level of new construction in the Munich office market, the average and the prime rents are likely to keep trending upwards in 2013.

Office market Hamburg



Source: BNPPRE/JLL et al., IVG Research Forecast

Office market Munich



Source: BNPPRE/JLL et al., IVG Research Forecast

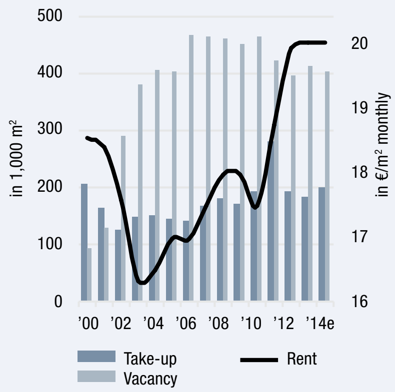
Stuttgart: return to normality after the record year of 2011

Rental activity returned to a "more normal" level in Stuttgart after various major transactions caused rental take-up to surge to an all-time high in the exceptional year of 2011. In 2012, take-up was nevertheless above the long-term average at 190,000 m², even though there was only one large letting above the 10,000 m² mark (occupation of 11,000 m² by Gleiss-Lutz). Demand for space came from a broad base of industries, with consultants, industrial and construction companies and public administration accounting for around 50% of the take-up.

The vacancy rate in Stuttgart continued to decline last year from 5.7% to 5.4% – but not because additional space was occupied, rather because total stock in Stuttgart was reduced as a result of the demolition or redevelopment of office properties not suitable for the market. Among Germany's seven largest markets, Stuttgart therefore has the lowest vacancy rate by far. Against this backdrop, significantly higher rents were obtained for new lettings last year than in the two years before. The prime rent increased by more than 5% to €20/m² per month.

As the completion volume is also proving to be moderate this year at almost 100,000 m² and a significant portion of the new space has already been let, vacancy should remain low. Due to the weak economic conditions, it currently seems rather unlikely that prime rents will rise.

Office market Stuttgart



Source: Colliers/DIP et al., IVG Research Forecast

Regional markets: robust demand triggers vacancy reduction

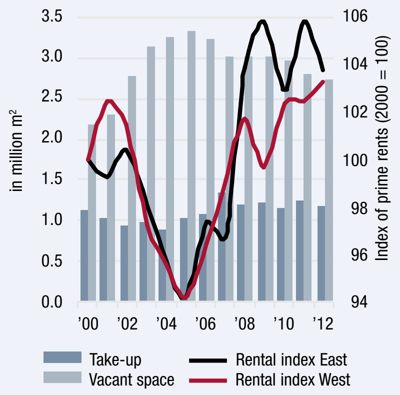
The robust situation on the German office rental market can also be seen when looking at the regional centres – here taking 15 markets in the west and five markets in the east of Germany as an example (see *-symbol on pages 26/27). The decline in take-up in the regional centres averaging 7.6% was similar to that in the seven major locations. On closer examination, it can be determined that rental performance in the regional centres correlates to a great extent with the completion of new office properties. Because less office buildings were completed there last year, total rental take-up in the twenty regional centres we are considering fell from 1.25 million m² in 2011 to 1.15 million m² in 2012. Take-up was nevertheless still 4.2% higher than the average since 2001. Distinguishing between East and West presents a different picture. Take-up in the 15 regional centres of western Germany (947,400 m²) was around 6% above the long-term average, while total rental take-up in the five eastern regional centres (207,000 m²) fell short of the average by 2.5%.

A significant reason for this development was the decline in large-volume office lettings with space greater than 1,000 m². Last year, these were concentrated mainly in a few locations such as Dortmund and Leipzig. In Dortmund, exceptional transactions like the conclusion of a contract for 14,500 m² by Westnetz (RWE) contributed to the fact that the Ruhr metropolis posted its highest take-up since records began at 108,000 m². The other office markets were shaped by small rental transactions below the 1,000 m² mark, which often made up 80% of total take-up. This was true in particular for the eastern German regional centres Rostock, Magdeburg and Potsdam, whose rental take-up last year was a good 38% to 45% below the long-term average (2001 – 2012). Western German regional centres like Duisburg (-23%), Essen (-28%), Neuss (-25%) and Ratingen (45%) were also affected by a considerable decline in take-up.

Total vacant space in the 20 examined regional centres was 2.8 million m² at the end of 2012, which equals a decline of 3.6% on the previous year. The average vacancy rate shed 20 basis points to 6.4% and was well below the average vacancy rate in the top seven locations (8.5%), although the gap closed 50 basis points year-on-year. The difference between East and West remained in 2012: the vacancy rate in the 15 western German office markets is now below 5%, meaning new lettings – particularly of large, modern space – are difficult to achieve. In the five eastern office markets, the vacancy rate is comparatively high at 11.7%.

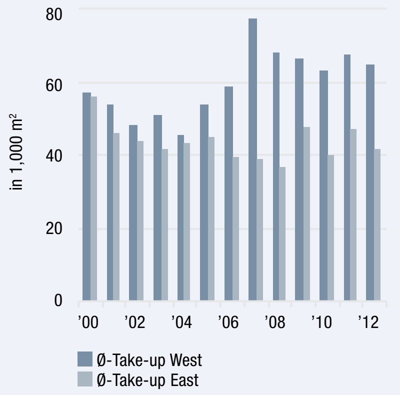
In most cities, prime rents stagnated or increased marginally at best. For instance, prime rents in the western regional centres posted slight growth of 0.6%.

Office market 20 regional centres



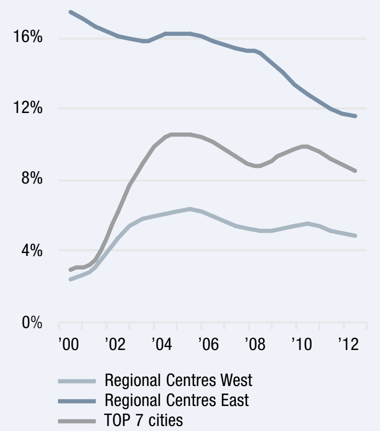
Source: IVG Research

Ø-Take-up regional centres



Source : IVG Research

Vacancy rates

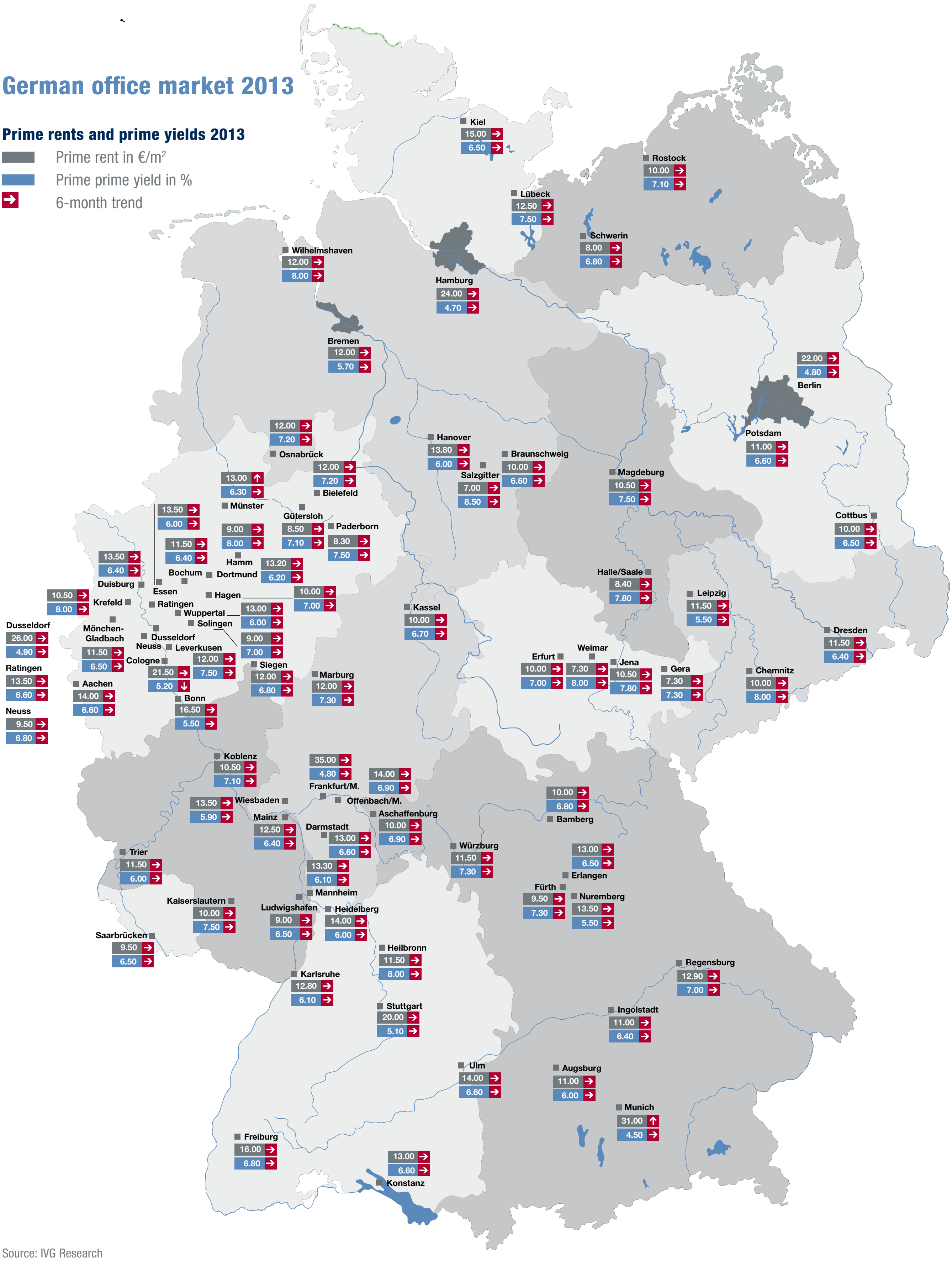


Source : IVG Research

German office market 2013

Prime rents and prime yields 2013

Prime rent in €/m²
Prime prime yield in %
6-month trend



Source: IVG Research

IVG office market scoring: attractiveness of locations for office investments

In the following, 74 selected large cities are compared to each other on the basis of a scoring model in terms of their attractiveness for office real estate investments. In this context, the cities are evaluated according to a range of characteristics that fall under three categories: market size, market risk and future prospects (see Appendix with explanations on the methodology). How the locations performed individually is shown in the table on the right for the overall result and in the map of Germany. A score of 1 stands for a very bad value and 5 for a very good value.

Category	Weighting	Indicators	Period
Market size 33.3%	11.1	Office stock (in million m²)	2012
	11.1	SID* employees (in million)	2012
	11.1	Gross value added (in € million)	2012e
Market risk 33.4%	11.1	Market transparency (index)	2012
	5.6	Volatility of gross value added (in %)	2001-2012
	5.6	Volatility of rental trends (in %)	2001-2012
	11.1	Vacancy rate (in %)	2012/2013
Future prospects 33.3%	11.1	Growth of gross value added (in %)	2001-2012
	11.1	Population growth 2025 (in %)	2012
	11.1	Prognos future opportunities (index)	2010
Total score	**100.0**		

Source: IVG Research * SID = subject to social insurance deductions

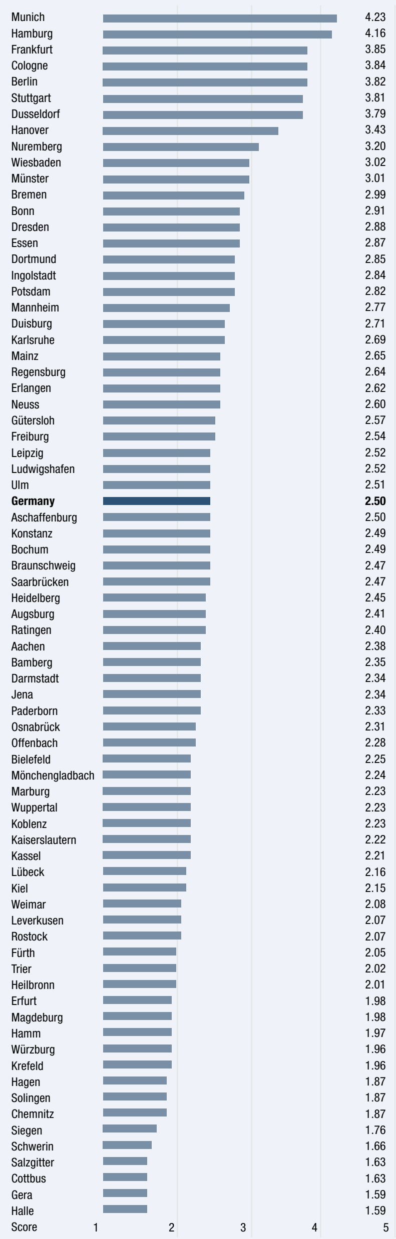
Shifts due to use of more recent population forecast

The sometimes considerable shifts in the new scores compared with the previous year's report were caused primarily by the use of the latest regional planning forecast on population development from the Federal Institute for Research on Building, Urban Affairs and Spatial Development (BBSR). The forecast by the Bertelsmann Foundation used before ended in 2025 at the zenith of population development, whereas the new forecast from BBSR relates to the period up to 2030, therefore providing greater coverage of the years of progressive demographic decline in Germany. For this reason, only 17 of the cities considered now show stable or positive population development. On average, the score for the future prospects category has therefore fallen by 0.17 year on year in the cities covered. This has tended to result in a reduction of total scores because the effect was not compensated for by improvements in scores for vacancy risk (vacancy was reduced in most locations in 2012).

Few changes at the front and back of the pack year on year

Among the top ten locations, Munich holds onto first place with a total score of 4.23, ahead of Hamburg (4.16) and Frankfurt (3.85), while Cologne (4th) and Stuttgart (6th) have swapped places in the scoring. But at 3 basis points, the gap between the two cities is marginal. The change is primarily attributable to the fact that the vacancy rate in Cologne fell more strongly than in Stuttgart last year. This change alone was enough for the cities to swap places despite otherwise equal development of the scores for market size and market risk. Amongst these cities, Berlin (3.82) has held onto its fifth-place position from the previous year. After that, Dusseldorf closes out the group of top locations. Considerably behind are the most important regional centres, starting at eighth place, led by Hanover (3.46) and Nuremberg (3.20). Wiesbaden (3.02) replaces

Office market scoring – overall score



Source : IVG Research

Bonn (2.91) in tenth place. Münster and Bremen are also among the winners, occupying eleventh and twelfth place respectively.

Key factors for a place among the top cities include market size, whereby not only the total office stock is taken into account, but also the number of people in employment and gross value added. Despite the euro crisis, the number of people in employment and gross value added increased in many locations in Germany last year. In contrast, the size of the office market changed only to a small degree due to the low level of new construction. In some cities, the stock of the office market even decreased, since more space to be revitalised or converted was taken from the market there than came onto it. With a view to market size, the seven top markets (Berlin, Dusseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart) are clearly leading the field, with scores between 4 and 5, followed by Germany's regional markets, with scores 2 and 3 for market size. The city of Wiesbaden marks the federal average in market size, with a score of 2.02.

The 10 lowest-scoring cities consist of an equal number from the former East and West Germany. As well as small market size, in most cases a lack of growth prospects, low market transparency and a high level of office vacancies are responsible for the position at the bottom of the scoring. While market transparency could still be influenced positively by the regular provision of office market information, the high vacancy rate in the locations is often structure-related. Revitalisation measures contribute to increasing the marketability of vacant office buildings. However, this is of little help if no need for additional office space emerges due to problems in economic structure.

Gaps in the middle and at the end of the table often only marginal

The majority of the markets investigated are contained in a small section of the rating scale. For instance, Karlsruhe (score 2.69) in 21st place and Kassel (2.21) in 52nd place are close to each other with regard to their scores. Therefore, minor changes in the assessment factors both in the middle section and at the end of the table can lead to a change in ranking order.

Bavaria top among the large regions

In the ranking according to large regions, Bavaria is just ahead of northern Germany (Lower Saxony, Schleswig-Holstein, Hamburg and Bremen), Baden-Württemberg and Hesse. Found below the German average are North-Rhine Westphalia, Saarland/Rhineland-Palatinate as well as the east of Germany.

The high positioning of Bavaria, Baden-Württemberg and northern Germany compared to, for example, North-Rhine Westphalia, is a result not only of the greater economic strength and transparency of the office markets there, but possibly also of the lower level of regional competition of the office markets there. For instance, metropolises such as Ulm (2.51), Ingolstadt (2.84), Regensburg (2.64), Aschaffenburg (2.50) and Braunschweig (2.47) serve a huge rural catchment area and therefore occupy – despite their rather small office markets – good places at the top end of the middle-ranking cities (17th to 34th place), while four of the 10 lowest-ranked cities of the IVG office market scoring are located in the catchment area of the large office markets of the Rhineland (Cologne, Dusseldorf) and the Ruhr (Dortmund).

Scoring ranking according to market size

Munich	1
Hamburg	2
Berlin	3
Frankfurt	4
Cologne	5
Dusseldorf	6
Hanover	7
Stuttgart	8
Nürnberg	9
Bremen	10

Source : IVG Research

Scoring ranking according to market risk

Munich	1
Stuttgart	2
Hamburg	3
Berlin	4
Duisburg	5
Essen	6
Nuremberg	7
Bonn	8
Münster	9
Cologne	10

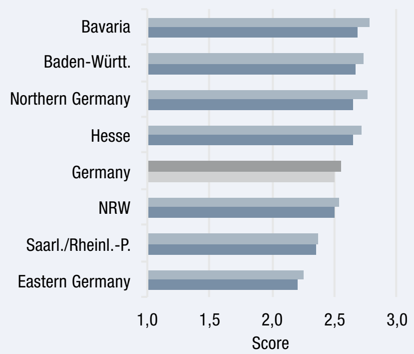
Source : IVG Research

Scoring ranking according to future opportunities

Ingolstadt	1
Potsdam	2
Munich	3
Dusseldorf	4
Jena	5
Hamburg	6
Dresden	7
Stuttgart	8
Konstanz	9
Wiesbaden	10

Source : IVG Research

Big regions by comparison: scoring



Source : IVG Research

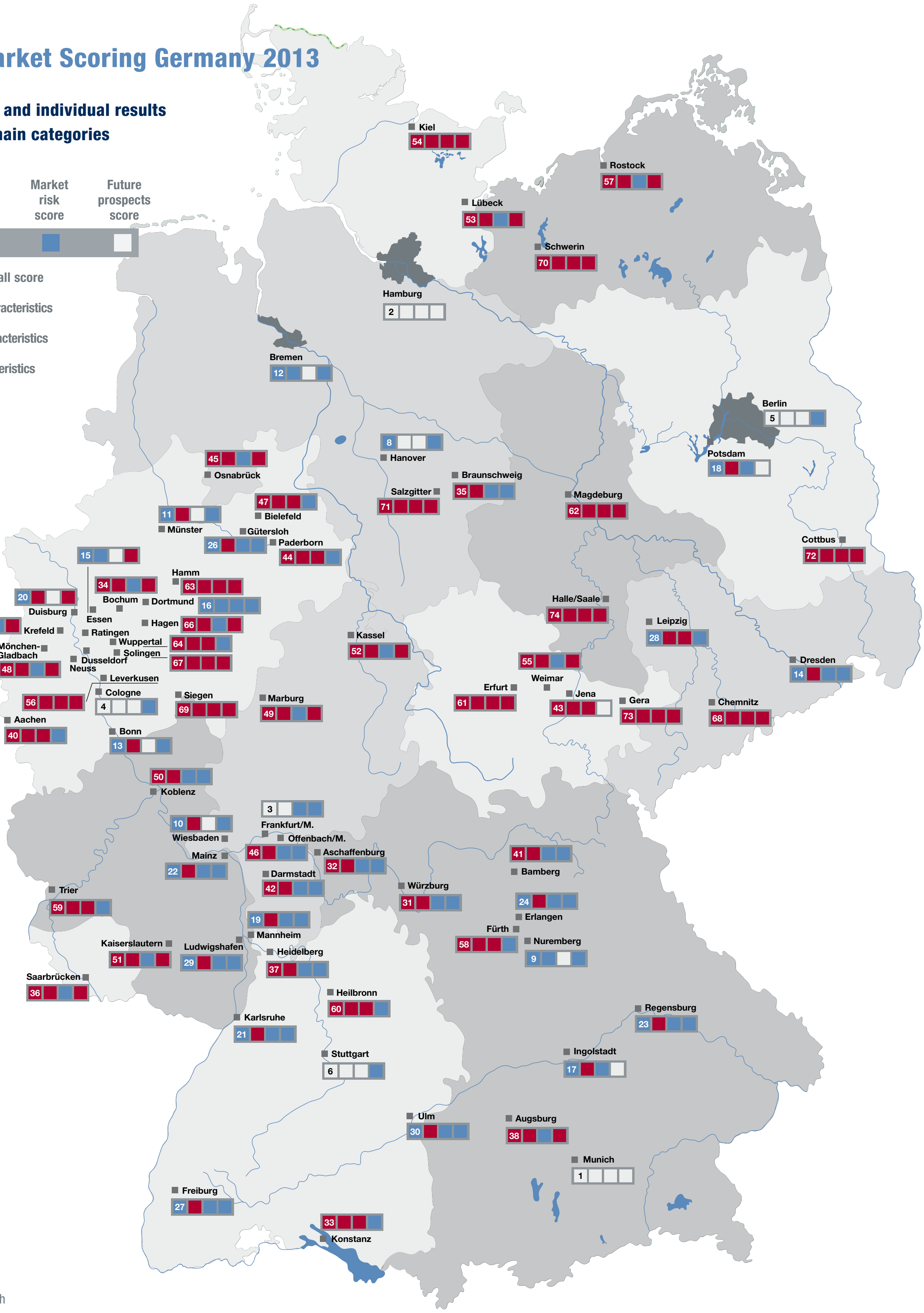
Office Market Scoring Germany 2013

Overall result and individual results in the three main categories

Overall score	Market size score	Market risk score	Future prospects score
1.			

1. Ranking of overall score

- Excellent characteristics (3.5-5.0)
- Average characteristics (2.5-3.5)
- Weak characteristics (1.0-2.5)



Source: IVG Research

Excursus: retail property – differences in rent growth

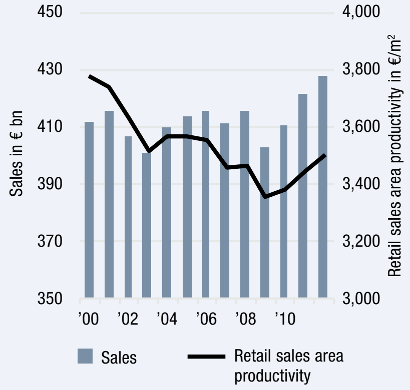
In 2012, German retail generated nominal sales growth for the third consecutive year, despite the sovereign debt crisis in Europe. Retail sales increased by 1.9% year-on-year to €428 billion. After adjustment for inflation, almost all sectors had to face up to stagnating or falling retail sales. Especially the clothing/footwear segment (-2.2%) and department stores (-2.3%) had to accept painful declines in real retail sales. As a consequence of the euro crisis, the mood in German retail deteriorated slightly last year, but remains good compared to other European countries. The retail sales forecasts are modestly optimistic for the current year as well, with an increase of 0.5% predicted.

2012 was marked by spectacular company collapses. Due to the insolvency of the Schlecker Group, 1.8 million m² of retail space was freed up in one go. Existing retail stock therefore decreased to 122.1 million m² nationwide. Catalogue distributor neckermann.de was pushed out of the mail order business because it recognised the trend towards e-commerce too late. Online retail now generates 70% of sales in the mail order business and easily compensates for the decreases in the traditional mail order business. In 1990, the mail order business was still 5% of total retail sales in Germany. Thanks to online retail, this percentage has since increased to almost 10%. Due to rising competitive pressure, only retailers that pursue a holistic approach can successfully compete with online retail on the market.

For this reason, international chain stores initially open only one or two stores as well as an efficient e-commerce platform when they enter the German market in order to sound it out and gain experience before they press further forward with their expansion. The internet is actively used mainly for purchasing clothing (€10.8 billion in sales), electronic items (€4.1 billion), books (€2.6 billion) and computer accessories (€2.5 billion). In contrast, margins in food retail are so narrow that multi-channel strategies here do not even account for 1% of retail sales in the industry.

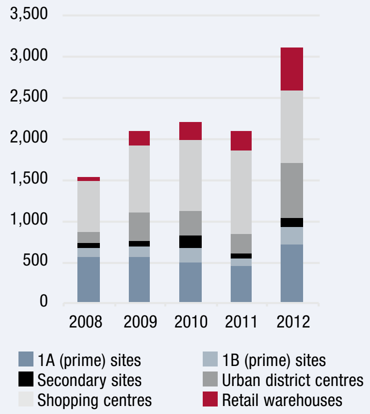
Nevertheless, international retail groups are crowding the German market. Berlin, where most market entries take place, generally acts as a test market. In 2012, CBRE registered more than 3,000 rental transactions in the whole of Germany, approximately 50% more than in the previous year. A third of the lettings related to high street stores, 28% to shopping centres, 13% to urban district centres and 9% to locations for local supply (e.g. grocery stores, drugstores). The percentage of lettings that relates to city centre shops or shopping centres has therefore decreased from 89% to 61% since 2008. More than half (52%) of the transactions related to small shops with floor space of less than 500 m². The most active lessees were in clothing retail (38% of the transactions), catering (18%), the health/beauty segment (11%) and the outdoor segment (8%). According to Jones Lang LaSalle, rental take-up in the city centres of the 10 biggest retail cities decreased by 13% year on year in 2012. However, at 590,000 m², it was well above the average figure for 2007 to 2011 (318,000 m²).

Retail indicators Germany



Source: HDE

Take-up by location/sector

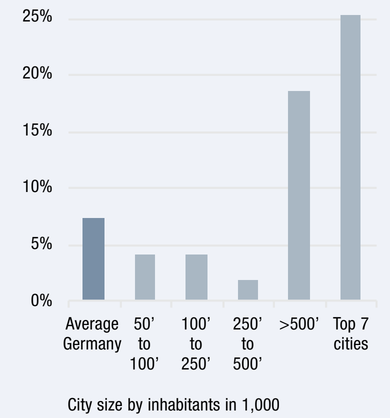


Source: CBRE

Due to the continuing high demand for space, the prime rents for city centre high street shops rose by an average of 1.8% nationwide in 2012. Considered over the period since 2007, the prime pitches in the top seven cities recorded by far the strongest rent growth in the prime segment with an overall increase of 25%, compared to the German average of 7%. In contrast, rent growth since 2007 was below the German average in the cities with less than 500,000 inhabitants. This is often due to the fact that many of these cities – for example, in the Ruhr – are located in the catchment area of even bigger retail metropolises and/or find themselves in competition with dominant regional shopping centres (Centro, Ruhrpark, etc.). The clear outperformer among the top seven cities is Berlin, with total rent growth of 35% since 2007. Due in no small part to modern new space in the prime sites, the prime rents in Frankfurt and Munich rose by 29% and 27% respectively. By far the highest rents are generated in Kaufinger Straße in Munich (€330/m² per month), followed by the Zeil in Frankfurt (€290/m²) and Ku'damm in Berlin (€270/m²).

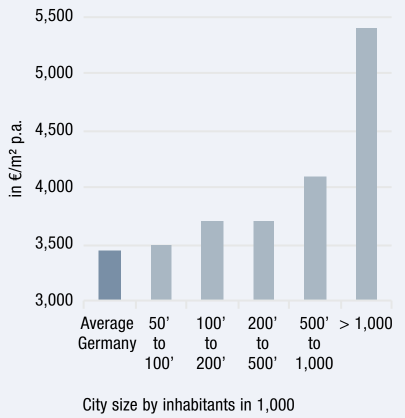
In general, there is a large gap between the most expensive and the cheapest locations in Germany. The weighted prime rent for the 25 most expensive cities (€175/m² per month) is well above the average of the 150 cities investigated (€75/m² per month). Attractive expansion targets are in particular cities with above-average sales productivity per unit area. An example is Nuremberg, which has sales productivity of €4,475/m² – compared to an average of €4,100/m² in large cities with up to 1 million inhabitants – and total rent growth of 40% since 2007. Even the comparatively small city of Würzburg (134,000 inhabitants) excels with above-average sales productivity of approximately €5,470/m² and rent growth of almost 16% since 2007. In view of the increasingly tight supply of space in the top seven cities, it is assumed that retail groups and investors will pay more careful attention to such 'diamonds in the rough' of the German retail landscape in future. Even medium-sized towns with 40,000 to 75,000 inhabitants are stepping into the limelight. A total of 30% of the German population live in their catchment areas. 104 of these towns have more than 200,000 people in their local catchment area. Step-by step development of the retail structures in these smaller, so far rather neglected cities sometimes holds opportunities in the form of above-average rent growth.

Growth of high street rents 2007-2012 in %



Source: Comfort (study of 150 cities across Germany); top seven cities: Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg, Munich, Stuttgart.

Retail sales area productivity by city size



Source: Comfort

Investment market:
office buildings are in demand again

Growth of transaction volume thanks to strong end to year

Due to an intense year-end run, the transaction volume on the German commercial property market rose by 9% year on year to €25.6 billion in 2012. Traditionally, the fourth quarter is the time of year when the highest investment volumes are generated. However, last year, the brightening of the business climate from November, medium-term expected inflation (the ECB will possibly purchase sovereign bonds of the southern European crisis countries under specific conditions) and pull-forward effects resulting from the property acquisition tax increase in Hesse obviously contributed to making the boom at the end of the year due to numerous major transactions considerably stronger than in the previous years.

Office investments last year increased by more than 50%

Last year, office buildings were the property sector that generated the strongest turnover, with a volume of €10.7 billion and a share of more than two-fifths in the investments as a whole. The year-on-year increase in office transactions amounted to more than 50%. In contrast, retail property, the second-strongest sector, had to accept a significant drop in investments by 28% to €7.8 billion. The reason for this development was not so much a lack of investor demand but rather the lack of suitable properties.

In the office sector, the high transaction volume was due not so much to large-volume portfolio investments (volume from office portfolios alone only €500 million), but rather to the accumulation of large individual transactions, including the sale of the Frankfurter Welle for €410 million and of the Allianz headquarters in Munich for €320 million.

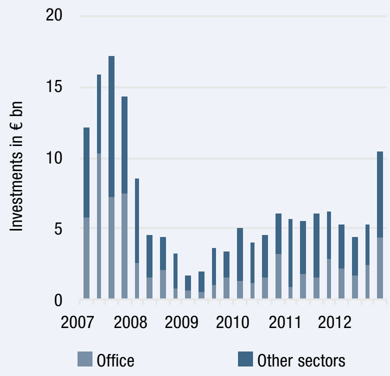
In the office sector, the action is mainly in the big cities

More heavily than in the previous year, office investments again concentrated on the seven largest markets, which accounted for €9.3 billion or 86% of investments in the office sector (previous year: €5.7 billion and share of 81%). Due to the large individual transactions, Munich (€2.8 billion), Frankfurt (€2.2 billion) and Berlin (€1.9 billion) showed very high levels of take-up. Outside the seven major locations, office properties of a value of €1.4 billion were traded last year. This equates to a investment increase of approximately 10% from 2011.

Equity funds considerably more active as buyers than in 2012

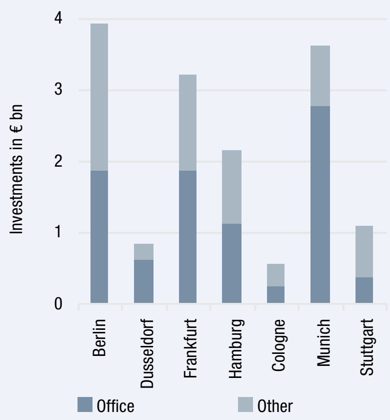
If the investment market for commercial property is considered across all sectors, considerable shifts could be observed with regard to the structure of real estate investors last year. For instance, the (mostly foreign) equity funds more than doubled their purchases year on year to approximately €5.2 billion in 2012. They thus had a 20% share in investment volume last year. At the same time, investments of German fund companies declined from €8.7 billion to €6.8 billion (share in purchases of 26%), with not only the open-ended public property funds (decline from €1.5 billion to €800 million), but also the "Spezialfonds" (-20% to €3.5 billion) and closed-end funds (-13% to €2.5 billion) reducing their activities. This can be partially explained by the fact that their traditional customers invested directly to a heavier degree last year. Private investors increased their investments from €2.5 billion in 2011 to €3.5 billion (14% of investments). Insurance companies and pension funds invested €3.2 billion in 2012, compared to €2.5 billion in 2011. This represents a share in total investments of 13%.

Transaction volume in Germany



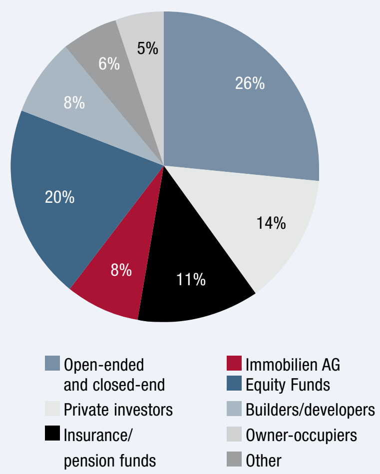
Source: BNPPRE

TOP 7: Transaction volume



Source: BNPPRE and Colliers

Investors in Germany 2012



Source: Calculation IVG Research using BNPPRE data.
Total purchase volume €25.6 billion

Foreign investors, who had a particularly heavy involvement in the large portfolio purchases, accounted for approximately two-fifths of purchases and sales on the German investment market last year. This means that their net assets position in German commercial property remained largely stable.

Banks further reduce their portfolio in the major locations

With respect to net investors in the six large markets (excluding Stuttgart; share of office space in investments 62%), the trend of the previous years continued in 2012. Investor groups with a solid equity base were again more heavily involved in purchases than in sales. This was the case for private investors as well as insurance funds and pension funds, but also for all three types of German fund vehicles. In contrast, foreign equity funds as well as builders, project developers and banks were again active as net sellers on the market. Banks cut their stock of commercial real estate through sales by €1.9 billion last year alone.

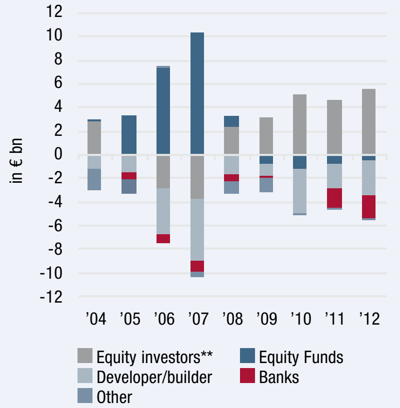
Yield compression continues in 2012

Last year, yields on prime office properties fell further in the seven biggest markets, from an average of 4.99% to 4.84%. The range in these locations now extends from 4.5% in Munich to (unchanged) 5.2% in Cologne. Yield compression essentially reflects the fact that investors have moved their capital into supposedly secure forms of investment in the last year in view of the sovereign debt crisis in the eurozone, be it now long-running German federal savings bonds or simply core properties let on a long-term basis. However, in the prime office properties segment, the fall in yields was approximately 14 basis points, modest compared with ten-year German government bonds. Last year, these securities posted a decline of 40 basis points to approximately 1.5%. This means that the difference in yields between prime office real estate in the top markets and German government bonds even increased further to an average of 335 basis points last year, despite compression. As a result, office buildings still appear attractive as an asset class despite the fall in yields.

Moreover, last year there were signs that investors' appetite for risk has increased. For example, Jones Lang LaSalle shows an increased share in transactions in the core-plus segment for Germany. One result of this development in the office sector is that initial yields fell not only in the central business districts, but also in the city centre outskirts of the seven major office locations, namely from an average of 5.75% to 5.70%. In contrast, initial yields for high-quality, fully let office properties in the peripheries were unchanged at 6.75%.

The somewhat higher appetite for risk on the part of investors is also shown by the fact that investment volumes in the regional centres rose – as already mentioned – and that here too a slight decline of prime yields on average among the locations could be observed.

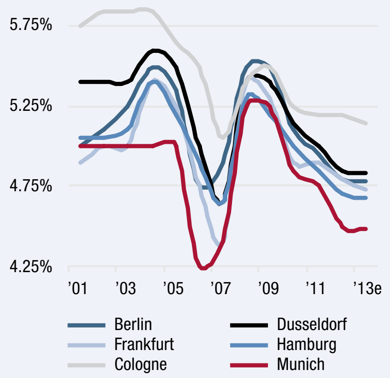
Net investors in 6 major markets*



* Big 7 without Stuttgart
** "Equity Investors" include: Open-ended & closed-end funds, insurance companies, pension funds and private investors.

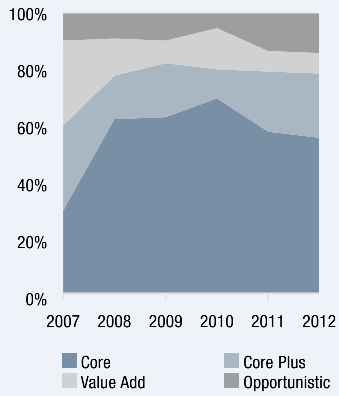
Source: IVG Research based on data from BNPPRE.

Prime office initial yields



Source: IVG Research

Investments in risk categories



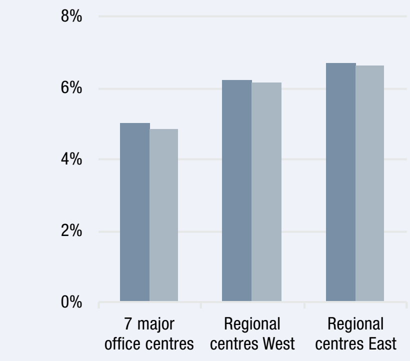
Source: IVG Research

Fundamental data reflected in office yields

The following figure offers an impression of the level at which the prime yields in the individual cities and in the groups of locations have moved last. It also sets these in relation to the score values that have been derived in Chapter 4 for the individual office markets. The negatively inclined, black (regression) line makes clear that the differences in the fundamental market conditions are reflected in the achievable yields. Office buildings in the smaller, badly functioning markets with a weak economic structure find acceptance among investors only if they can generate a high risk premium compared to office investments in the large, liquid markets. Conversely, the large, transparent office markets show comparatively low structural investment risks. Hence, office buildings there achieve relatively high prices and low initial yields.

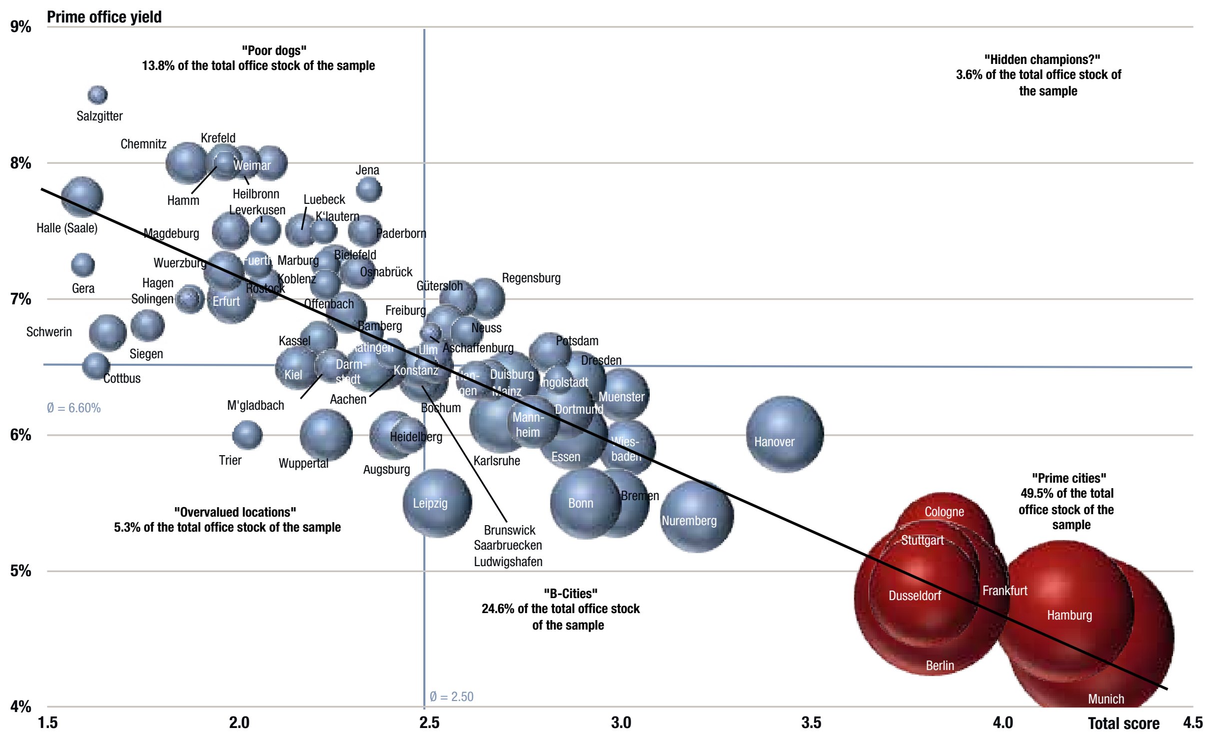
The black (regression) line expresses which initial yields are generated on average by first-class property in an office location with a specific total score. Thus, investments in office markets above the line are comparatively cheap, locations below the line comparatively expensive. The position of the individual office markets relative to the black line thus offers a first indication as to which locations offer their investors comparatively attractive prime yields. However, when interpreting the data, it should be noted that the deviations can partly be explained by factors that were not taken into account in the scoring model. For example, in the model, the current market situation

Ø Prime office yields



Source: IVG Research

Office market scoring and prime yield 2013



Source: IVG Research. The size of the circles represents the size of the regional office stock.

is assessed only through the vacancy rate, but not through rental growth expectations, which have a strong impact on yields. However, for an initial selection of locations in the sense of the top-down approach, the figure offers valuable guidelines for investments.

Uncertainties in 2013 despite high investments at the start of the year

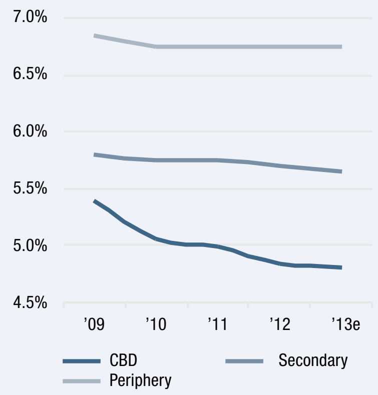
Various major office transactions since the start of the year, e.g. the purchase of an SEB portfolio by Canadian company Dundee REIT for approximately €420 million, the acquisition of the Xanadu portfolio by a private equity investor for €180 million, the purchase of the Munich-based Medienfabrik by Allianz for €90 million and that of the T11 office tower in Frankfurt by IVG Institutional Funds, indicate that office buildings are just as highly demanded by investors this year as last year.

However, the scarce supply of suitable properties could – similarly to in the retail real estate sector last year – prove to be an obstacle to investment. It is questionable to what extent the mass of investors are actually willing to switch to office properties outside the core segment and to enter into higher investment risks. Thus will ultimately depend on whether and how quickly the economy actually recovers in Germany and its neighbouring countries. Should the hoped-for economic upswing occur, modern office space will become considerably scarcer due to the low level of new construction activity. Thus, high-quality office properties with certain vacancies and shorter remaining leases will actually be able to offer high yield opportunities. On the other hand, should the economic outlook in Europe worsen again due to a deterioration of the political crisis in Italy, investors' focus will again concentrate on the core segment.

Another possible obstacle to investments is the restrictive issuance of loans on the property financing market. In the current year, a large number of loans in the form of commercial mortgage-based securities are due to be extended. At the same time, there are signs that banks are withdrawing further from the property financing business in light of the regulations under Basel III. This results in opportunities for new lenders such as insurance companies, pension schemes and debt funds as well as for investors, who – as in the case of the Xanadu portfolio (failed CMBS financing) – can take capital from the predicament of the former owners of properties.

Even though the yields for prime office properties in some major office locations such as Berlin and Hamburg came ominously close to the record low of mid-2007, various factors suggest that yield compression will continue in the current year, albeit on a small scale. These are, namely, the high investment pressure on investors, the unusually high difference in yields between property and German government bonds, the high preference of investors for first-class property and the supply shortage in the core segment. However, the low yield level is not carved in stone forever. But a significant rise in interest rates – which, like an economic depression, could trigger a turnaround in yield development – is not currently on the horizon.

TOP 7: Ø Prime initial yields



Source: IVG Research

Major office transactions 2012 (selection)

Location	Object	Value € m
Frankfurt	Frankfurter Welle	410.0
Unterföhring	Allianz headquarters	320.0
Frankfurt	Trianon (57 % share)	233.0
Munich	Ten Towers	206.0
Stuttgart	Postquartier	138.0
Frankfurt	Junghof	135.0
Munich	Brienner Str. 40	135.0
Dusseldorf	Sky Office	118.0
Munich	KPMG	114.0

Source: IVG Research

Annex: German office market comparison 2013

City	Office market stock (in million m²)	Vacancy rate		Prime rent in €/m² per month		Prime yield (net) in%	
	Beginning of 2013	Beginning of 2013	Trend	Beginning of 2013	Trend	Beginning of 2013	Trend
Aachen	1.50	9.1	►	14.00	►	6.6	►
Aschaffenburg	0.32	5.9	►	10.00	►	6.9	►
Augsburg	1.70	5.9	►	11.00	►	6.0	►
Bamberg	0.39	5.1	►	10.00	►	6.8	►
Berlin	17.28	7.8	►	22.00	►	4.8	►
Bielefeld	1.20	20.0	►	12.00	►	7.2	►
Bochum *	1.55	5.8	►	11.50	►	6.4	►
Bonn *	3.70	3.4	►	16.50	►	5.5	►
Braunschweig	1.20	6.3	►	10.00	►	6.6	►
Bremen *	3.39	3.6	►	12.00	►	5.7	►
Chemnitz	1.30	13.0	►	10.00	►	8.0	►
Cologne	7.56	7.5	►	21.50	►	5.2	▼
Cottbus	0.52	20.0	►	10.00	►	6.5	►
Darmstadt	1.73	4.5	▼	13.00	►	6.6	►
Dortmund *	2.94	5.3	►	13.20	►	6.2	►
Dresden *	2.43	11.6	►	11.50	►	6.4	►
Duisburg *	2.50	3.0	►	13.50	►	6.4	►
Dusseldorf	8.90	11.3	▲	26.00	►	4.9	►
Erfurt	1.80	18.0	►	10.00	►	7.0	►
Erlangen	1.00	1.3	►	13.00	►	6.5	►
Essen *	3.62	4.7	►	13.50	►	6.0	►
Frankfurt	11.97	12.5	►	35.00	►	4.8	►
Freiburg	1.27	2.5	►	16.00	►	6.8	►
Fürth	0.54	9.5	►	9.50	►	7.3	►
Gera	0.40	12.0	►	7.30	►	7.3	►
Gütersloh	1.06	5.3	▲	8.50	►	7.1	►
Hagen	0.61	6.2	►	10.00	►	7.0	►
Halle	1.25	11.7	►	8.40	►	7.8	►
Hamburg	14.70	7.4	▲	24.00	►	4.7	►
Hamm	0.38	9.2	►	9.00	►	8.0	►
Hanover *	4.30	4.3	►	13.80	►	6.0	►
Heidelberg	0.90	6.0	►	14.00	►	6.0	►
Heilbronn	0.80	10.0	►	11.50	►	8.0	►
Ingolstadt	0.56	3.8	►	11.00	►	6.4	►
Jena	0.48	10.2	▲	10.50	►	7.8	►
Kaiserslautern	0.49	4.7	►	10.00	►	7.5	►
Karlsruhe	2.93	4.8	►	12.80	►	6.1	►
Kassel	1.03	7.2	►	10.00	►	6.7	►
Kiel	1.45	8.0	►	15.00	►	6.5	►
Koblenz	0.61	6.1	►	10.50	►	7.1	►

6-month trend: ► = stable ▼ = falling ▲ = rising
Cf. selection of regional centres on page 15

continued on the next page

Annex: German office market comparison 2013 (continued)

City	Office market stock (in million m²)	Vacancy rate		Prime rent in €/m² per month		Prime yield (net) in%	
	Beginning of 2013	Beginning of 2013	Trend	Beginning of 2013	Trend	Beginning of 2013	Trend
Konstanz	0.40	7.5	►	13.00	►	6.6	►
Krefeld	0.98	9.0	►	10.50	►	8.0	►
Leipzig *	3.33	15.6	▼	11.50	►	5.5	►
Leverkusen	0.65	6.0	►	12.00	►	7.5	►
Lübeck	0.80	2.5	►	12.50	►	7.5	►
Ludwigshafen	0.82	4.7	►	9.00	►	6.5	►
Magdeburg *	1.03	13.5	►	10.50	►	7.5	►
Mainz *	1.27	5.7	►	12.50	►	6.4	►
Mannheim *	1.94	4.6	►	13.30	►	6.1	►
Marburg	0.56	6.0	►	12.00	►	7.3	►
Mönchengladbach *	0.80	5.7	►	11.50	►	6.5	►
Munich	20.00	7.6	▼	31.00	▲	4.5	►
Münster *	2.10	5.8	►	13.00	▲	6.3	►
Neuss *	0.75	11.8	►	9.50	►	6.8	►
Nuremberg *	3.86	7.2	►	13.50	►	5.5	►
Offenbach	1.25	7.6	►	14.00	►	6.9	►
Osnabrück	0.87	4.0	►	12.00	►	7.2	►
Paderborn	0.79	9.0	►	8.30	►	7.5	►
Potsdam *	1.24	4.0	►	11.00	►	6.6	►
Ratingen *	0.61	12.5	►	13.50	►	6.6	►
Regensburg	1.23	8.9	►	12.90	►	7.0	►
Rostock *	0.86	5.1	►	10.00	►	7.1	►
Saarbrücken	1.28	2.0	►	9.50	►	6.5	►
Salzgitter	0.26	k.A.		7.00	►	8.5	►
Schwerin	1.00	19.0	►	8.00	►	6.8	►
Siegen	0.77	18.8	►	12.00	►	6.8	►
Solingen	0.34	13.2	►	9.00	►	7.0	►
Stuttgart	7.40	5.7	►	20.00	►	5.1	►
Trier	0.60	17.9	►	11.50	►	6.0	►
Ulm	0.87	6.4	►	14.00	►	6.6	►
Weimar	0.87	6.0	►	7.30	►	8.0	►
Wiesbaden *	2.33	6.1	►	13.50	►	5.9	►
Wuppertal	1.98	5.7	►	13.00	►	6.0	►
Würzburg	1.16	14.0	►	11.50	►	7.3	►

6-month trend: ► = stable ▼ = falling ▲ = rising
Cf. selection of regional centres on page 15

Source: IVG Research

Office market scoring methodology

Category	Weighting	Indicators	Calculation	Period	Overall weighting
Market size	11.1	Office stock	absolute, in million m²	2012	**33.3**
	11.1	SID* employees	absolute	2012	
	11.1	Gross value-added	absolute	2012e	
Market risk	11.1	Market transparency	Index	2012	**33.4**
	5.6	Volatility of gross value-added	Volatility in %	2001-2012	
	5.6	Volatility of rental trend	Volatility in %	2001-2012	
	11.1	Vacancy rate	in %	2012/2013	
Future prospects	11.1	Growth of gross value-added	in %	2001-2011	**33.3**
	11.1	Population growth 2025	in %	2012	
	11.1	Prognos future prospects	Index	2010	
	100.0				**100.0**

Source: IVG Research

* SID = subject to social insurance deductions

The aim of this scoring model is to provide a long-term foundation on which to base decisions to invest in the German office market. The choice of locations examined involved selecting cities from all the main economic areas and conurbations, even if their office markets were economically insignificant in overall terms. This decision was influenced by the assessment arrived at by various studies, which show that the seven major markets of Berlin, Dusseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart together do not even account for a quarter of all German office stock. Furthermore, real estate portfolios frequently include office buildings outside of these seven strongholds. Therefore, it seems logical to maximise the spatial coverage in the city scoring.

In order to restrict the selection, only cities with more than 50,000 inhabitants were examined. Another criterion is the excess regional significance of the cities investigated both in economic and political terms. Consequently, the random sample includes the capital cities of all 16 Federal States along with representative cities from the 12 major metropolitan regions of Germany. The macroeconomic data analysis takes place at county level. The data pool is composed of official population, economic and unemployment statistics as well as performance indicators from Prognos and our own research at the branches of IVG, estate agents and business development entities of the cities investigated. There are several possible reasons why a city may not appear in the scoring: Many of the potential locations for investigation – such as in the Ruhr region – may exhibit a high degree of similarity in terms of the indicators to be analysed, which means that the cities actually included in the scoring serve as a reference parameter; alternatively, the available data basis may be insufficient or incomplete.

A total of ten indicators to describe the office market were chosen and then summarised into three categories. In this case, the individual indicators are included with the same weighting in the scoring. The only exception made is regarding the volatility of the gross value-added and rental trend due to their high positive correlation with one another. On aggregate, both factors have the same weighting as the other factors. Depending on the values recorded, the various cities are allocated a score of between 1 (low) and 5 (very high), with the rankings created in a linear fashion based on the underlying data.

The **market size** category, which is quantified using the indicators of office stock, number of employees subject to statutory social insurance and gross added value, describes the status quo of the locations. A large office stock, high employment figures and a high level of gross added value are generally indicative of well-established and successful office markets. As a result, these locations are then allocated a higher score.

Since the size of a market alone is not a determinant of good investments, the **market risk** in the individual locations is analysed. When making their decisions, investors look for security. For this reason, the market transparency factor takes into account the availability of office market data and information about the cities. Frequent publications issued by as many different institutions and market participants as possible indicate a high level of transparency (score 5). The lack of publications or a lack of knowledge among the majority of market participants regarding the size, take-up and vacancies in a particular market point to a lack of transparency (score 1). An overview of the dynamic of the markets based on the volatility and vacancy rate is provided. Since the majority of investors tend to have a low tolerance for risk and a preference for stable cash flows, pronounced volatility and high vacancies are penalised with low scores.

Ultimately, it is important to many investors to make investments in markets that offer good future opportunities. The opportunities presented by the various markets are therefore examined in the **future prospects** category. Here, it is assumed that the growth in gross value creation of the past few years gives an indication of future economic success. The population forecasts of the Federal Institute for Research on Building, Urban Affairs and Spatial Development (BBSR) are a further indication of which regions will develop positively in future, while the Future Atlas of Prognos AG offers a different consideration of the causes (innovation, attractiveness, education, affluence) for this assessment. The higher the anticipated growth or the better the assessment of future opportunities, the higher the score allocated to the locations.

Glossary

Net absorption
Change in total space occupation, approximated via
Net absorption = Change in space stock – change in vacant space

Prime rent
The rent payable for a building unit of the highest quality in the best location

Net initial yields for prime properties

$$\text{Prime yield} = \frac{\text{rental income} - \text{non-recoverable operating costs}}{\text{acquisition costs incl. acquisition taxes}}$$

Take-up
Gross take-up generated from letting or occupation of a property by an owner-occupier

Vacant space
The supply of office space available immediately (= generally within three months)

Vacancy rate
The level of vacancy with reference to the total stock of (office) space

Germany's Investment Universe 2013

"Still on track" – this is how the current situation on Germany's office market can best be summarised.

In short:

- The Top-7 markets attract the lion's share of commercial property investments in Germany.
- The regional centres offer very stable market conditions. Therefore, keep an eye on them as well.

Bremen

Starting point for offshore windparks in the North Sea, therefore potential beneficiary of energy turnaround in Germany

Hanover

Important administrative centre and trade fair location. Office market in good shape

Dortmund

Recently very high take-up driven by structural change from heavy industry to a service economy

Essen

Low office take-up due to dominance of owner occupiers in the market

Dusseldorf

Office market with strongest growth of prime rents in 2012. Office desk of the Rhine Ruhr area

Cologne

Strong presence of media and insurance companies. Ongoing rejuvenation of office stock

Bonn

Strong telecommunication and service location, but lack of office supply

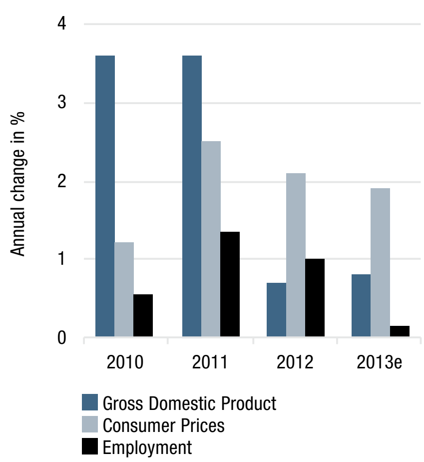
Mannheim

Largest city of the Rhine-Neckar region and important office location

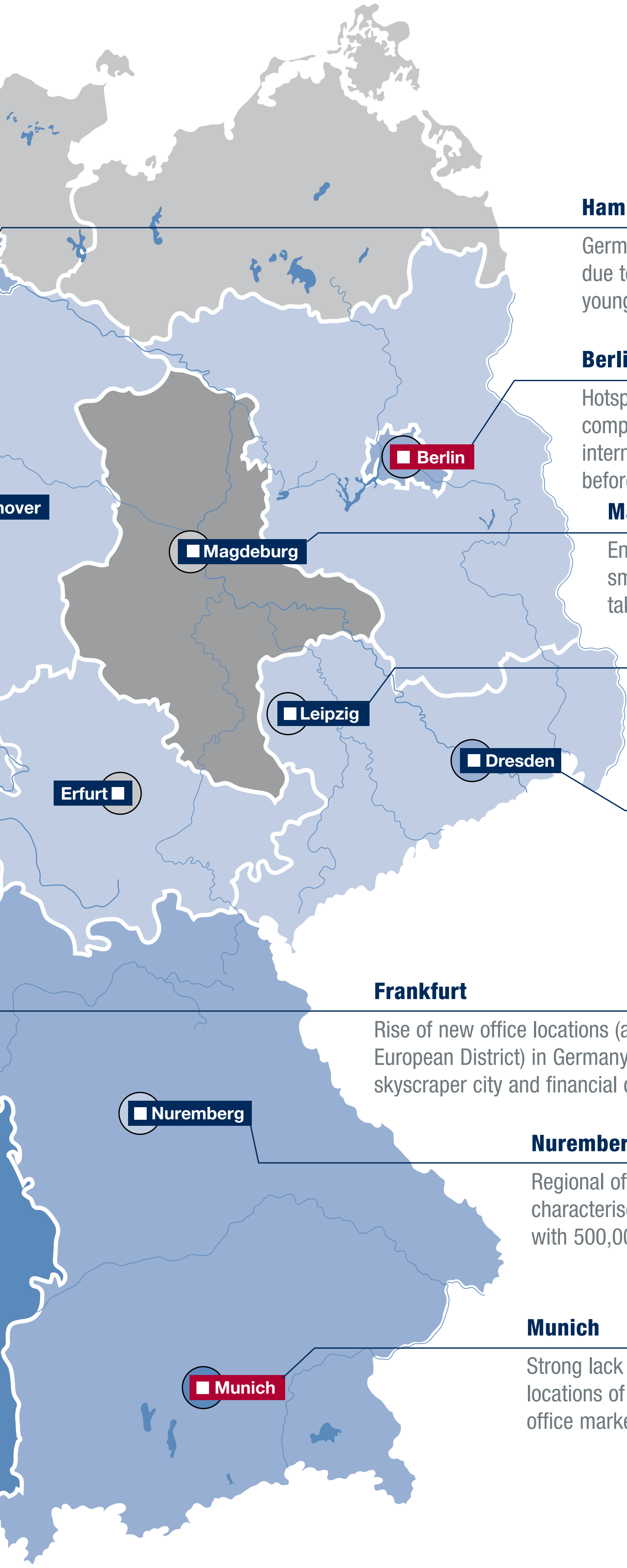
Stuttgart

Lowest vacancy rate among the Top-7 markets (5.3%). Large railway and urban development project Stuttgart 21

Macroeconomic indicators



Source: IVG Research



Hamburg

Germany's gateway to the world due to large port. HafenCity as young central submarket

Berlin

Hotspot among young people, companies and investors, but new international airport not to open before 2015

Magdeburg

Engineering centre with small office market: Low take-up in 2012

Leipzig

Slow, but continuous decline of the high vacancy rate

Dresden

Continued market upturn: Region benefits from major clusters for micro-electronics and ICT

Frankfurt

Rise of new office locations (airport, European District) in Germany's skyscraper city and financial centre

Nuremberg

Regional office market still characterised by stability. City with 500,000 inhabitants

Munich

Strong lack of space in central locations of Germany's largest office market

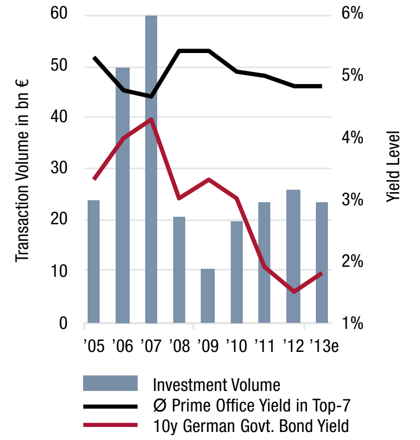
Type of city

- Top Seven
- Regional Centres

Expected regional economic growth

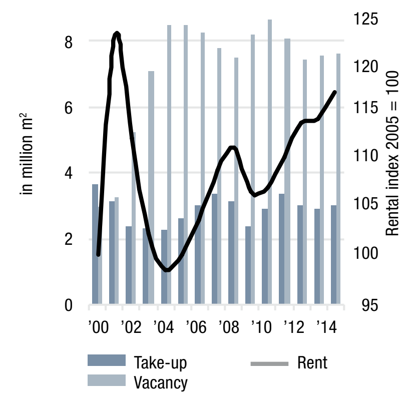
- Far above German average
- Above German average
- German average
- Below German average
- Far below German average

Commercial Real Estate Investments



Source: IVG Research based on agents' data

Office markets of the German TOP 7



The figure includes Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg, Munich and Stuttgart.
Source: IVG Research

Imprint

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