Guest Column: George Salden

The German Property Market: An Eye for Detail is Essential for a Good Return

In the last article we came to the conclusion that, while all known methods of real estate evaluation may have their individual strengths, on the whole it is their weaknesses that show when they are applied to the task of estimating future return. In today's column, we will use the dynamic method for ascertaining future return opportunities. The first step is always microanalysis and therefore, above all, the list of tenants. An accurate compilation of the individual areas makes it possible to examine real estate in regard to its rent structure. In order to work accurately, it is absolutely necessary to maintain a clear distinction between net rent exclusive of heating and utilities, net rent including heating and utilities, gross rent exclusive of heating and utilities, partial rent including operating costs and gross rent including heating and utilities.

The list of tenants is to be viewed from five different perspectives. The first focuses on the span of the rent, i.e. the allocation of square meter rent within the property. Here it must be established how widely distributed the individual rental fees are from one another and what the reasons are for any differences.

The second perspective views the current rental fees of the property in relation to the statutory rent index. This viewpoint provides information about the possibility of increasing rent and makes possible a first insight into the dynamic of the micro market.

Next comes a classification based on market rent. This viewpoint aligns the rents of the investment property to the market rents of the immediate environment.

Fourth is an analysis of the types of rental units that generate rental fees differing in terms of amount. Generally the rent per square meter in a small apartment is greater than that of a larger apartment. The aforementioned four perspectives look at the actual status of the rental units of the property.

Tenant dynamics is directed toward the future, more specifically toward the possible prognosis. In order to enable this, the current rental fees must be simultaneously regarded from five different perspectives.

• The square meter rent indicates how widely distributed the rental fees of real estate are and thereby presents a general potential for increase or adjustment.

• The rent index gives an estimated description of the rent level of the micro market and moreover indicates the legal framework for increasing value.

• Finally, the market rent allows one to view the current rent as part of a cycle of tenants.

Viewed as a whole, this information discloses the dynamics that can be brought forth in the investment property and how the tenant cycle will develop.

Next comes the investment classification that describes the position of the property in its cycle. In this regard one can draw upon the known means of representation in the real estate industry but, in my opinion, they must be given an entirely new emphasis. The goal is to establish a rating for the investment and a possible return - therefore to ascertain an internal rate of return that is dependent on the micro cycle. The concept of investment category is synonymous with investment strategy or investment style. It originated in securities trading and primarily gives information about the relationship of risk and return on an investment. In the real estate industry the separation into investment classes focuses on various features of the investment property. These features include – among many others – the type of use and the condition of the building as well as its position in the life cycle or the vacancy rate.

In regard to life cycle: the differentiation between a technical, an actual and an economic lifespan is decisive for the usability of the property. Because usability by a tenant constitutes a decisive factor for the property, the lifespan is always viewed in its relationship to usability. The piece of real estate is not useful up to the time it is torn down, ruins do not generate revenue. As a result, the life span of every piece of real estate is to be evaluated from various perspectives.

Every piece of real estate passes through various stages during the course of its life. These place diverse demands on administration and management: from the planning of construction up to demolition or total renovation. Every piece of real estate begins its life cycle at the time of project development. Then comes the phase of first use and therefore the time when the real estate generates cash flows. The stage of first use of the real estate comes to an end when rental units of the property become vacant. The reasons for vacancy are diverse and can be found in the negative development of the market as well as in insufficient management of the property. The reason for increasing vacancies is often neglect of repair work or an insufficient effort at tenant acquisition. There are two possibilities for ending the vacancy phase. On the one hand, the property can be torn down or it can be restructured and given a new use. This second use is followed by a new vacancy phase that once again presents the decision between demolition and restoration. This cycle can be repeated until the technical lifespan of the property ends and further restructuring is no longer possible.

Back to investment categories: in the real estate industry the division into the investment categories core, core plus, value added, opportunistic and development has established itself. In the context of the “dynamic method”, the super core and workout categories have been added. Super core rental units are prime properties in prime locations in prime markets that are in prime condition. They consist of the best possible building fabric; their life cycle is at the beginning of a first usage phase and/or a usage phase after total restoration. They are characterised by prominent and desirable locations in prime markets and have exceptional infrastructure connections as well as an outstanding market environment. Super core properties are rented on a long term basis to tenants with a high level of creditworthiness and in this manner guarantee low vacancy risk and minimal fluctuation.

Therefore super core properties generate revenues primarily on the basis of their high annual rental income. Since a large proportion of return on investment is in their sale, super core properties merely bring a maximum return of two to four per cent. On the other hand, an investment in property of this nature is associated with very few risks. An example of super core rental real estate is a totally restored building designated for residential and business use in the best location on Kurfürstendamm in Berlin-Charlottenburg. On the other hand, development properties are associated with greater chances and greater risks. In most cases the rental units have lost their designated use and may be in a dilapidated condition. Project developments in high risk markets also fall into the category of development property.

The concept of the workout investment is less well known in the real estate industry. It originated in the banking sector, where property located in structures subject to company law is generally acquired indirectly through the purchase of non-performing loans. This occurs due to economic dislocations. In the case of a holding period of one half to two years, the expected revenue lies above the fifteen per cent mark. It is important to bear in mind that the actual workout does not describe the condition of the property, but rather a specific situation to which a piece of real estate is subject. A real estate portfolio that suffers from liquidity problems would be categorised under workout. The individual properties making up the portfolio would be assigned to the aforementioned categories as usual.

Without going further into the aforementioned investment categories, super core, core, core plus, value added, opportunistic, development and workout, they not only describe the boundaries of a possible rate of return on equity of between 2 and 15 per cent but also a risk level that can vary from slight to very high.

In conclusion, the real estate is assigned to an investment category on the basis of its life cycle status, its location, its actual characteristics, as well as the structure of its tenants. Moreover, the tenant cycle and the tenant dynamics play a decisive role. However, an analysis of the micro cycle in and of itself is insufficient to create reliable investment ratings. In addition, the big picture must also be taken into account, i.e. the macro cycle must be analysed. This involves issues concerning the rent index: in what direction is market rental moving? What factors and forces influence this development? The next column will deal with these questions in detail...

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