Guest Column: George Salden (6)

The German Property Market: Matching is the Best Way to Ensure a Return

Where are we now? We are acquainted with the micro and macro cycle of our property. This means that we understand how great the difference between the precisely calculated basic rent and the market rent is. We also know how the market rent is developing. The matching of the two means the adjustment of basic rent to market rent. This is a process that generally takes years to accomplish. This is why it is important to look at the development of basic rent in the course of time in addition to the absolute peak potential.

The course of this development depends on several factors: on the one hand, there is a statutory framework that regulates increases in rent, on the other hand terminations involve the danger of vacancies. This makes it necessary to take into consideration how likely it is that an empty residence can be rented out. The indicators therefor are given by the micro cycle and tenant dynamics. On the level of the micro cycle, the average vacancy quota of the direct environment is one - of several - benchmarks as to how easily a residence can once again be rented.

If real estate has both a positive micro cycle and a positive macro cycle, then there are only rarely impediments to a successful investment. The decision is equally easy to make if both cycles show negative prospects because there are no earnings to be obtained but only losses to be incurred.

The decision becomes difficult if one of the two cycles shows “weakness.” For the purposes of example let us assume a highly valuable property in the best location that is itself in good condition and for which there are prospects of at least moderately high rent. Moreover, the vacancy quota is very low. However, at the same time the region is experiencing economic decline and has rather poor economic and social prospects. While in this example the developments in the micro cycle make an investment appear reasonable, the prospects based on the macro cycle are negative. In order to ascertain the sustainable investment value of this investment property, one has to anticipate how real estate develops in the context of an investment. The +/- constellation of this example has, based on matching, chances of producing sustainable earnings, as the core investment has a low risk profile. The real estate in our example thereby fulfils a primary condition for investment activity in markets with negative growth: in the presence of a weak macro cycle, sustainable high rental income is primarily possible in very good locations. Even if the population is shrinking, there is a high likelihood that there will be takers for prime locations, while average or below average locations are threatened by vacancies. In real estate cycles that are experiencing an upswing, the following must therefore apply: the worse the macro cycle, the more attention should be given to secure investment classes. If all investors followed this rough rule of thumb, many bad investments could be avoided. Precisely those investments for which a great level of increase in value is to be expected due to construction measures - and which they also require for their earnings – are in danger of failing during the course of downturns in the real estate cycles and thereby destroy capital. Either these pieces of real estate will not find any buyers after conclusion of the process of increasing their value or the living units will find no tenants, because the demand for housing will rapidly sink in a negative macro market. Large-scale undertakings to increase value can therefore not be carried out.

Now we will deal with the opposite case: negative micro cycle and positive macro cycle. In harmonizing a negative micro cycle with a positive macro cycle, one must pay attention to other features as in the aforementioned example. Let us use as our example a property that, while having rent that is above that of market rent, has nonetheless been experiencing a drop in rental income for some time. The rental income that is now still above the market rent will adjust itself to the level of market rent when the property is once again rented out. The property primarily benefits from its good location and the building structure is in good condition. However, part of the rental units must be renovated. The expenses required for construction work are therefore responsible for causing us to classify the real estate as an “over rented value added investment”. The costs caused to the investment by the renovation work are not covered by a value-increased potential in the micro cycle. An analysis of the micro cycle produces a prognosis for a rent increase that is either extremely small or non-existent. At the same time prognoses for the city or the region are excellent and therefore the rental developments of the prime location in which our real estate is located will not slow down. In such a -/+ scenario, essentially one should always assume that the macro cycle will compensate for the negative prognosis in regard to tenant dynamics. The decisive question posed by such a matching process is to what extent the compensation is sufficient. For the example we have chosen the matching process produces an almost complete compensation for the negative micro cycle. When the market rent increases during the course of the investment, then almost all of the rents can be increased instead of dropped. Yet for this business plan one must note that the cost of an increase in value as well as the possible short-term drop in rental incomes could prevent the earnings associated with the classical value-added investment. The increase in value is nonetheless the decisive factor in this investment that makes a strong macro cycle possible.

The earnings prospects in the example before us are limited, because the renovation measures are planned for the property at the time of acquisition. In the next step it would be prudent to change the property into a core investment because thereby the macro cycle would be completely in pace in the context of a -/+ matching process. In this fashion the largest compensation would be obtained. In the case of a matching of this nature it must always be borne in mind that during the investment cycle the low initial earnings can be increased by means of a high level of growth. This means that the greater the upswing phase is and the longer it lasts, the more likely it will be that there is a turnaround.

At this point, at least so one would think, the investment has been sustainably assessed and all risks have been taken into account. I thought so too and undertook the investments that attained outstanding scores during the matching process. I was sure that I had excluded all potential dangers and that the investment was really sustainable and had been fully calculated. As a general rule this held true for my investments and I received the desired earnings. Yet there were also properties for which the prognoses did not work out as calculated. A transaction involving a rental property on Skalitzer Straße in Berlin-Kreuzberg opened up my eyes, showing me that a single “spanner in the works” was capable of causing all of my plans for earning to fail. Upon the opening of the Oberbaum Bridge, Skalitzer Straße was opened up for freight traffic. This change in the infrastructure rendered all the calculations that I had made useless. If I had been aware of this danger, then my business plan would have taken another turn. Once I had found a spanner in the works for one property investment, I took a look at other instances where my property investments had failed. The result was that in most cases there had been a spanner in the works that had fundamentally changed the premises for the entire investment.

The most “spanners“ belong to one of these four categories, all of which produce results in variance with those predicted through matching. These categories are infrastructure, economics, law and taxes. In the case of infrastructure one must inquire as to scenarios involving such spanners, as to whether future developments can be so named. In order to answer such questions one must look into what planning lies ahead for the competent administration and in politics: are there plans for new streets to be built? Which important stops for public transportation (ÖPNV) are to be phased out? Will future changes to the infrastructure alter developments for traffic of or pedestrians in a manner that is disadvantageous for the property? In this regard it is always important to bear in mind this specific usage and tenant structure of property!

Economic spanner situations are almost all based on financing risks. As a result it is important to review the financial market and economic developments before investing in real estate. How will the general economic situation unfold? What level of interest exists and in what direction is the prime rate going? Are there risks of inflation? Tax spanner situations are closely related. Changes - for example in the case of income tax laws - can have a great effect on earnings. Therefore changes in this regard should be closely followed.

Legal spanners such as a cap on rental prices or new rules for saving energy can have a significant influence and require additional investments in a project development. All these spanners must be taken into consideration before one can begin with the process of considering value increase.

Changes in the political structure can directly affect the framework conditions that apply to real estate investments. This particularly relates to housing policy, something that has a special social relevance. The past years have shown - slogans such as “rent ceilings” and “broker fees” suffice – that in Germany it is essential to investigate political developments within the relevant departments in the context of a complete real estate investment.

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