Guest Column: George Salden (7)

SERIES: The German Property Market: Increasing Values is the Key to Rate of Return

So far so good: we know the value of our real estate. In determining this we have not relied on the traditional methods therefor. Instead, we have used the "dynamic method" to determine and interrelate the microcycle and the macrocycle while at the same time being attentive to factors that could lead to possible rejections. What now? Now the focus must be on identifying whether or not value can be increased and realised during the investment cycle. It is only in this manner that real estate can generate the desired rate of return. Therefore we will now devote ourselves to the second step of the dynamic method: increasing value.

Here, too, a very important paradigm shift is involved: the processes for increasing value must focus on the tenant, because the tenant pays the rent and the rent generates the profit. It is the only factor that raises the value of the real estate and that realises the potential for increase, in that it is the basis therefor. Initially, in the context of increasing value, it is unimportant whether one is dealing with current or new tenants. The rental unit must be designed so that the tenant can maximise its use. Only in this fashion can tenant turnover be prevented or minimised and a sustainable cash flow guaranteed. Since the law dictates that the tenant must agree to every increase in rent, it is all the more important to undertake renovation and refurbishment operations that address the needs of the tenant. A sustainable increase in value that is free of conflict can only be attained by harmonising the individual interests of the tenant with those of the investor.

Active value increase takes place on two levels: first the value of the real estate is increased through construction measures. Second, the revenue of the real estate is increased by raising the rent and through the elimination of vacancies. Both measures not only have a direct effect on the value of the real estate but are also mutually dependent on one another. This is because construction measures should only be undertaken if there is a potential for increasing the rent and the rent can only be increased if the construction measures raise the rental unit to a corresponding level of quality.

And here one must be sure to bear in mind that all measures undertaken to increase value must be coordinated with the micro- and macrocycles. It is only when the construction measures and the rent increases take place in accordance with the cycles that the value of the real estate can be increased and optimal revenue generated. It is not only the entire real estate that must be measured against the cycles but an individual strategy based on the cyclical circumstances must be drafted for each separate rental unit. In practice this insight is not always fully acted upon. In business plans, renovation costs are time and again itemised in a manner that is simply based on the area of the rental unit; sometimes flat rate contributions are simply assigned to each rental unit.

There are basically two possibilities available for increasing the value of real estate: on the one hand elimination of vacancies, rent increases upon change of tenants, rent increases for existing tenants, as well as structural alterations, and on the other hand an increase in the surface area of the real estate itself. The quickest and most effective solution for increasing the annual net rent is the elimination of vacancies. The worst case scenario is that the real estate is completely vacant and the investor must cover all the costs associated therewith without generating any revenue. Such an investment is by all means to be avoided, because it violates the golden rule for increasing the value of real estate: cash on cash! With cash-on-cash management all on-going expenses can be covered by on-going income.

If the vacancies in the real estate are eliminated, then rental increases in the case of changes in tenants can be carried out as a second step in increasing value. Increasing rent for existing tenants is subject to a clearly defined legal process because the investor must operate within a statutory framework. A statutory change undertaken on 1st March, 2013 established that communities could even reduce the capping limit by 15 %, in order to counteract too rapid an increase in rent.

In considering whether or not to undertake construction measures, it is important to take into account analyses of the micro- and macromarkets. They establish the conditions for determining the real net output ratio: the classification of real estate investments provide a starting point in order to ascertain the real net output ratio of renovation work. Through the microcycle the investment costs can be determined, which then serve as a decisive indicator for establishing the investment class and, moreover, for ascribing a certain chance/risk profile to real estate. In order to also actually realise the chances, the value of real estate must be raised to its corresponding potential. Increase of real estate value is often associated with a high level of expense. It is therefore even more important to keep the expenses in their proper relationship to the development potential of real estate and to the desired target revenue.

Since both the potential of real estate and the target revenue are determined by the macrocycle, the cycle plays a special role in connection with increasing value: it establishes what renovation work has a positive value on the real estate and for which property no such positive effect can be attained. Many investors would think that an unrenovated rental unit from the 1970s with an old backsplash and wall-to-wall carpeting would in any case have to be renovated - regardless of the strength of the macrocycle. Yet if the rent in this rental unit is already at the level of the market rent because there is a high demand due to exclusive location, then no potential for increase exists. The rent can no longer be increased - how then are the expenses for renovation to be compensated for?

From the revenue. Expenditures that do not increase value are paid out of the profits of the investor and thereby reduce revenue. On the other hand, it would make good sense to completely renovate the same rental unit, if its current rental price was far below the local market rent because of its poor condition. The increase of the rent would justify the renovation costs. Measures to increase value must therefore always be undertaken in a fashion so they make sense in relation to the potential of the real estate and the prognosis of future market rent.

However, before undertaking measures to increase value, the investor must look into the investment cycle. At what point in the investment cycle does the real estate find itself at the beginning of the process of increasing value and where will it be at the end thereof? In this regard it is to be assumed that a piece of real estate passes through various investment classes during the course of its life cycle. Each piece of real estate - either after it has first been built or after being completely renovated from the ground up - begins as a super core, core or core plus piece of real estate, based upon the location of the property. Super core property is a classification that would be restricted to property in truly exclusive locations experiencing extraordinarily strong macrocycles. In order for property to be assigned a core classification, a good location is necessary. Property that is located in intermediate or ordinary locations merely begins its lifecycle in the core plus class.

Starting with the initial investment classification, the real estate, in a prototypical market cycle, passes through the value-added, opportunistic and development classifications: an increasingly worsening structure, rental units with substantial need of repair, and rejections based on considerations of the macrocycle are the major reasons for a continuing downgrading of the property. The processes that were carried out in the context of a value increase now take place in reverse order for the real estate. By attending to accumulated repairs through renovation as well as by undertaking active tenant management, it is possible to raise the investment classification of a property.

Just how much the value of a property can be increased and what investment classification it reaches at the end of the investment cycle depends greatly on investment strategy, which once again is determined by the cycle itself. One must assume that a long course of value increase through the investment classifications signifies a significant real net output ratio. A great deal more expense for renovation is involved in transforming a development class property into super core real estate than for increasing the value of property in the core plus classification.

In this regard the gross revenue plays an important role in terms of the investment cycle: it provides information concerning the available real net output ratio for value increase measures. The gross revenue provides the ratio that the renovation costs must bear to the value increase. In the case of gross revenues of 10 per cent a sustainable increase of rental income per year of 1,000.00 Euros must therefore not incur costs of more than 10,000.00 Euros.

The money that is available for renovation of a rental unit is always ascertained directly from the market for which the potential increase in value of the individual rental unit is being considered. The starting point for such considerations is the difference between the current effective rent and the previously ascertained target rent. This difference is then projected for the year in order to determine the effect of a rent increase on the annual net earnings. The maximum investment of capital is easy to calculate: the return on investment is to be divided by the rate of return on investment.

In our next column we will turn to that which is our actual goal: how to realise value!

George Salden is the author of the book “Die Dynamische Methode” [The Dynamic Method] based on his 19 years of experience as an expert and manager in property and transaction management which highlights the way towards a whole new method of determining the profitability of properties. He was previously a director at alt+kelber Immobilienmanagement, a subsidiary of conwert Immobilien Invest SE, where he was responsible for major international transactions. He then took over as International Head of M&A at AK Holding GmbH & Co. KG. He is now Head of Transaction/ Executive Board Member at Dr. Lübke & Kelber / Arbireo.