Guest Column: George Salden (8)

SERIES: The German Property Market: Realising Value is the Key to Rate of Return

In this column we will turn our attention to the purchasers of our real estate, who are just as important for our returns as tenants. In this regard we will restrict ourselves to the German real estate market and those involved in it. The closing is of great importance, because it can give rise to up to 70 per cent of the returns. Because real estate gives rise to high acquisition costs, it is of the utmost importance that, at the end of the investment cycle, you place your investment property with an investor who has developed a demand for the real estate.

While it may sound like a platitude, it is nonetheless true that the greatest hindrance in concluding a transaction is differing views concerning the sales price. On the other hand, the chance of having negotiations fail can be minimised if the investor is offered real estate that is suitable for his portfolio. A potential buyer will be more likely to pay a high price for such real estate than for property that requires development through management activities in order to be brought into the proper investment category.

The German real estate market is a significant part of the entire economy, because in the Federal Republic of Germany 82 per cent of the net investment assets are tied up in real estate. Rental units - with over 49 per cent - make up the largest portion thereof. The real estate investment market is correspondingly vigorous. The 2008 crisis has continued to have a negative effect on the transaction market for real estate: between 2007 and 2009 the transaction volume was reduced by almost 80 per cent - from 65.3 billion to 13.4 billion Euros.

After this massive cut the German real estate market is continuing to improve its prospects: in 2014 the transaction volume was once again already 52.7 billion Euros, 13.7 billion of which constituted residential portfolios. In 2015 a total volume of between 50 and 54 billion Euro is expected.

Moreover, developments in the capital market have improved the general conditions for real estate investment: the uncertainty of the financial market, the low level of interest, as well as increased uncertainty as to currency considerations are all reasons why investors are more and more inclined to put their money in real estate. Its quick recovery has strengthened the reputation of the German market as a safe harbour offering a high level of price stability; this view of the German real estate investment market is held both domestically as well as internationally.

Above all, the German real estate market is extremely attractive in regard to investments in residential property. There is a high demand for products from the core segment as well as generally for real estate in 1a and 1b locations. Such property will in all likelihood continue to increase in value in the coming years, while similar growth is not anticipated for real estate on the periphery of B-class cities. In this regard a detailed analysis of the details of the regional submarket must be undertaken. The general outlook merely offers an overview of investor interests and does not take submarkets into account.

Another factor contributing to the differentiated development of regional submarkets is that the interest of the individual investors is extremely diverse. It is therefore essential for an investment that one be acquainted with the types of investors and their requirement profile - above all, in regard to institutional investors, open-ended mutual property funds, closed-end special real estate funds, real estate companies, as well as direct investments/ private placements.

In addition to these players there are still other investors such as project development companies, REITs, housing associations, real estate holding funds, foreign real estate investors, banks, investment companies, pension funds, leasing companies, mixed funds, foundations and the public sector. You should develop both your investment strategies as well as their form with an eye to the major types of investors.

Here we will take insurance companies as a typical representative of the category “institutional investor.” Although certain types of real estate fulfil the investment criteria of insurance companies, the participation of direct insurers in the real estate market is low, with a capital investment value that moves between one and three per cent.

Yet in the meantime insurance companies have come to understand that certain types of real estate fit perfectly into their investment strategy, because both the earnings as well as the duration cover their benefits. Here the focus is on real estate belonging to the investment categories of super core, core or core plus. Property belonging to one of these investment categories meets their guidelines, because it is characterised by low but constant returns that are in the area of about five per cent. The current situation in the German real estate market that is strongly characterised by an excessive demand for precisely this type of property is further raising the prices for core real estate. In order to make your optimal profits at the time of exit, if you are selling to an institutional investor, then the value of the property should have been fully increased to the extent possible.

Real estate stock corporations and real estate investment trusts are stock corporations. Both serve as intermediaries in linking the capital market to the real estate market. In Germany real estate stock corporations merely play a subordinate role. Their capital is at about 45 billion Euros for a market capitalization of 1.5 per cent. The banking firm Ellwanger & Geiger maps the value development of real estate stock corporations in the so-called German Real Estate Stock Index (DIMAX = Deutscher Immobilienaktienindex), which shows a high correlation to the German Stock Index (DAX = Deutscher Aktienindex). Shareholders who take part in a real estate stock corporation invest indirectly in real estate and benefit from the high level of transparency and the liquidity that characterises them.

A special form of the real estate stock corporation is the Real Estate Investment Trust (REIT), which is characterised by tax advantages but also by stricter restrictions. The concept of the REIT comes from the USA and was introduced into Germany with retroactive effect to 2007. While REITs are closely related to real estate stock corporations, they also have the tax transparency of open-ended property funds. REITs as companies are therefore exempt from corporate income tax and trade tax. Only the profits of investors are subject to taxation.

In order to provide REIT investors with a certain amount of security, the real estate must be covered by an equity capital share of at least 45 per cent. Real estate stock corporations enjoy a great deal of freedom in developing their investment strategies, because they are hardly subject to statutory regulation. Statutory provisions also allow REITs to invest in various investment categories.

As a result there are companies that concentrate on developing the value of and maintaining real estate holdings, or developers, who specialise in project development activities. REITs primarily invest in intermediate project development in the core plus und value added investment categories. In this way some companies are able to significantly improve their rate of return even if their investments are subject to a higher level of risk. Increase in value is a highly pertinent factor in the investment strategy of real estate stock corporations. Because they often have both know-how and experience in the area of active real estate management, they buy underdeveloped property and then reintroduce it into the market.

Open-ended real estate funds are characterised as open-ended because neither the number of investors nor the amount of assets under management is limited. Therefore the investors do not take part in the company but rather in their real estate assets. Open-ended real estate funds primarily invest in office real estate, commercial areas, and shopping centres. Residential property constitutes only the small amount of about 5 per cent of the assets under management. Open-ended real estate funds concentrate on property with an intermediate to long-term holding period in good locations and selected cities. Diversification takes place through the acquisition of various investment categories in various regional submarkets. In general, they manifest an investment strategy that avoids risk.

Only occasionally is it augmented by investment categories having a high-risk profile. The individual real estate funds differ markedly in part through their participation in risky investments. In contrast to institutional investors, open-ended real estate funds also purchase value-added property because a high return can only be generated from open-ended real estate funds if a trade component is integrated into their portfolio. Investments that focus on property in the value-added category can earn a good return and it is therefore to be assumed that open-ended property funds can also serve as an exit portal for real estate in the intermediate area of risk. In order for a fund to be able to purchase real estate it must have reached a level where it has disposition over about 15 million Euros. For smaller types of property a special fund is available in part.

Did we cover all the players who are important to us? No, because there are also closed-ended real estate funds, private placement and other types of investors. In addition to an analysis of these market participants, in the following column we will primarily deal with the conclusions to be drawn for participants in the German real estate market.

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