Guest Column: George Salden (9)

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

Welcome to the second part of the series "Realising Value through the Dynamic Method." In the previous edition of REFIRE we turned our attention to the key data of the German real estate market, and then we undertook a thorough review of institutional investors, real estate stock corporations, and REITs, as well as open-ended real estate funds. Today we will concern ourselves with other participants in the market for residential property. Important players in this regard are closed-ended real estate funds. They are invested in by banks, insurance companies, as well as various types of companies in the economy, including companies constituted under the German Civil Code or limited partnerships. They are called "closed-ended," because of the fixed definition of and the limitations on the number of investors, the investment purpose, as well as the assets under management. In this regard, one must differentiate between funds based on one's own capital resources and those based on outside, borrowed capital. Their purpose is to ensure the fund rather than the security of the real property itself. The funds that have been acquired in a closed-ended fund can be sold, but only if a buyer is found who is willing to assume the shares. Under the new KAGB (Kapitalanlagegesetzbuch = German Capital Investment Code) the key points to be monitored are risk spreading and liquidity, which were previously only subject to limited requirements.

After the start-up phase closed-ended funds must demonstrate risk diversification to the BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht = German Federal Financial Supervisory Agency). For example, this qualification is met if investments have been made in a sufficient number of properties. The new July 2013 version of the KAGB has undertaken various important changes to closed-end funds that have subsequently altered business therewith. An important innovation is that closed-end funds are now under the supervision of the BaFin and have thereby lost some of their scope of action.

In Germany closed-ended real estate funds constitute an investment fund that has been recently declining in significance. During the entire year of 2014 3,168 business transactions were completed in the area of closed-ended real estate funds. The nominal capital traded in amounted to 123.8 million Euro, a drop of 4.5% from the previous year.

Closed-ended funds have a bad reputation amongst investors, because of the great losses incurred during the financial crisis. However, the fact of the matter is that today the investment possibilities within closed-ended funds have significantly expanded. That also applies to the risk that is included for the entire spectrum, from conservative all the way to development projects. During the 1990s closed-ended funds were generally used as tax-avoidance schemes and primarily for property in the new German states. Today they are more likely to be oriented toward return on investment. The majority of investments take place in the core segment. For closed-ended real estate funds this offers an optimal investment opportunity for investments in the middle-risk segment.

For the duration of the fund no dividends can be paid out of capital, with the result that a higher return can be attained than with open-ended real estate funds. In addition, the real estate is generally sold at the end of this time period. Therefore, real estate with a developing value that will be realised in trade is especially suited for closed-ended real estate funds. Such possibilities are offered by value-added real estate as well as by opportunity properties. These investments are generally undertaken by so-called project investment funds with a return in the area of 10%. In order to generate such returns, the funds must at least acquire value-added objects. The bottom line: special funds only take risky strategies if they have experience to build to sell, opportunity or development segments.

An additional investment group that is active in the real estate investment market is that of private investors, who undertake investments in the form of private placements. Above all, ownership of real estate is a favourite form of capital investment for people with medium to large assets who seek to ensure financial security in old age. Reasons for this are the often addressed factors of stable value development and a continuing return. A large number of private investors differ from institutional investors in that they generally have smaller investment volumes. Private placements are difficult to characterise because they differ so greatly in regard to all aspects of an investment: from use for the duration to investment strategy, private placements include all aspects of real estate investment in German residential property. Private investors also differ in terms of the category of professionalism they belong to. While wealthy private individuals show a high degree of professionalism, in part through the use of an assets administrator and family offices, small-scale investors often invest based on emotional reasons. It should be noted that it is mostly investors with a high level of professionalism that undertake more risky investment strategies. In order to use private placement as an exit portal the potential buyer should be made subject to precise analysis. The criteria for such an analysis are, in addition to financial soundness, primarily the individual need profile of the private investor. Only thus can the value of the real estate be optimally realised.

In addition to the aforementioned types of investors there are still numerous types of small investment forms that are undertaken in regard to real estate and that therefore can be used as an exit portal from the investment cycle. Another group of investors that is especially focused on the goal of retaining value and therefore make “modestly conservative” investments are foundations. Foundations generally make long-term investments, because they only have an extremely small need for liquidity. All payments out of a foundation are not taken from the assets themselves, but rather from the revenue; therefore foundations invest in real estate belonging to the core segment. In order to increase revenue, a part of the investments can be made in the value-added area. This generally occurs in the case of smaller foundations and mostly indirectly. Only larger foundations are in the position to possess the necessary know-how in order to themselves realise the complex increase in value that value-added investments require.

Real estate leasing companies are also active in the market as investors. They generally transfer the usage rights to the real estate they administer on a long-term basis with an option to renew or buy. The possibilities of leasing are of particular use to non-property companies. Those companies that primarily use their own real estate for business operations often make use of a “sale and lease back” strategy, in order to generate liquidity.

Housing associations are suitable buyers that can serve as an exit from a residential property investment. Their goal is to realise earnings from renting residential property. Even real estate funds that only indirectly engage in real estate investments or project development companies that undertake risky investments in opportunity and development segments, can often be of interest as exit portals. However, due to their speculative character they involve great risk. Opportunity funds act on the basis of a similar concept and, in terms of risk/return profile, even exceed that of project development companies.

In conclusion, it is clear that in order to realise the value of real estate, an optimally prepared exit process is necessary. The exploitation of real estate at the end of the investment cycle can - especially in the case of value-added, development, or opportunity assets - generate the majority of the return. After it has been determined, in the context of the value-increase process, into which investment class the property falls at the end of the investment cycle, then it is decisive for realising value to find the appropriate buyer for the property. In this regard the exit strategy must always be adapted to current market conditions.

However, the realisation of value does not just consist in realising a higher return. Based on the investment strategy, other goals may instead receive emphasis. For example, non-property companies sell their business real estate to leasing companies in order to increase liquidity. The goal of tax savings can also play an important role in the sale of real estate. Yet the determinative personal or business goals should always focus on realising the highest possible added value.

It is indispensable, as has been pointed out, to find the right partner for a sale. This is easiest to do if the real estate to be sold corresponds to the investment strategy of the potential buyer on the market. Depending on which products the potential buyer itself offers, it buys real estate with the corresponding risk/return profile - one only has to seek and find them.

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.