NEW FINANCIAL INVESTORS AT THE GERMAN HOUSING MARKET: BUSINESS MODELS AND FINANCIAL STRATEGIES

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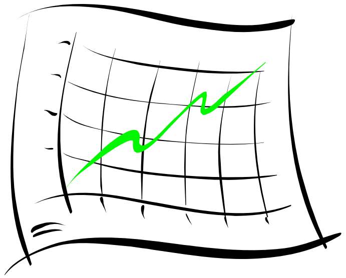
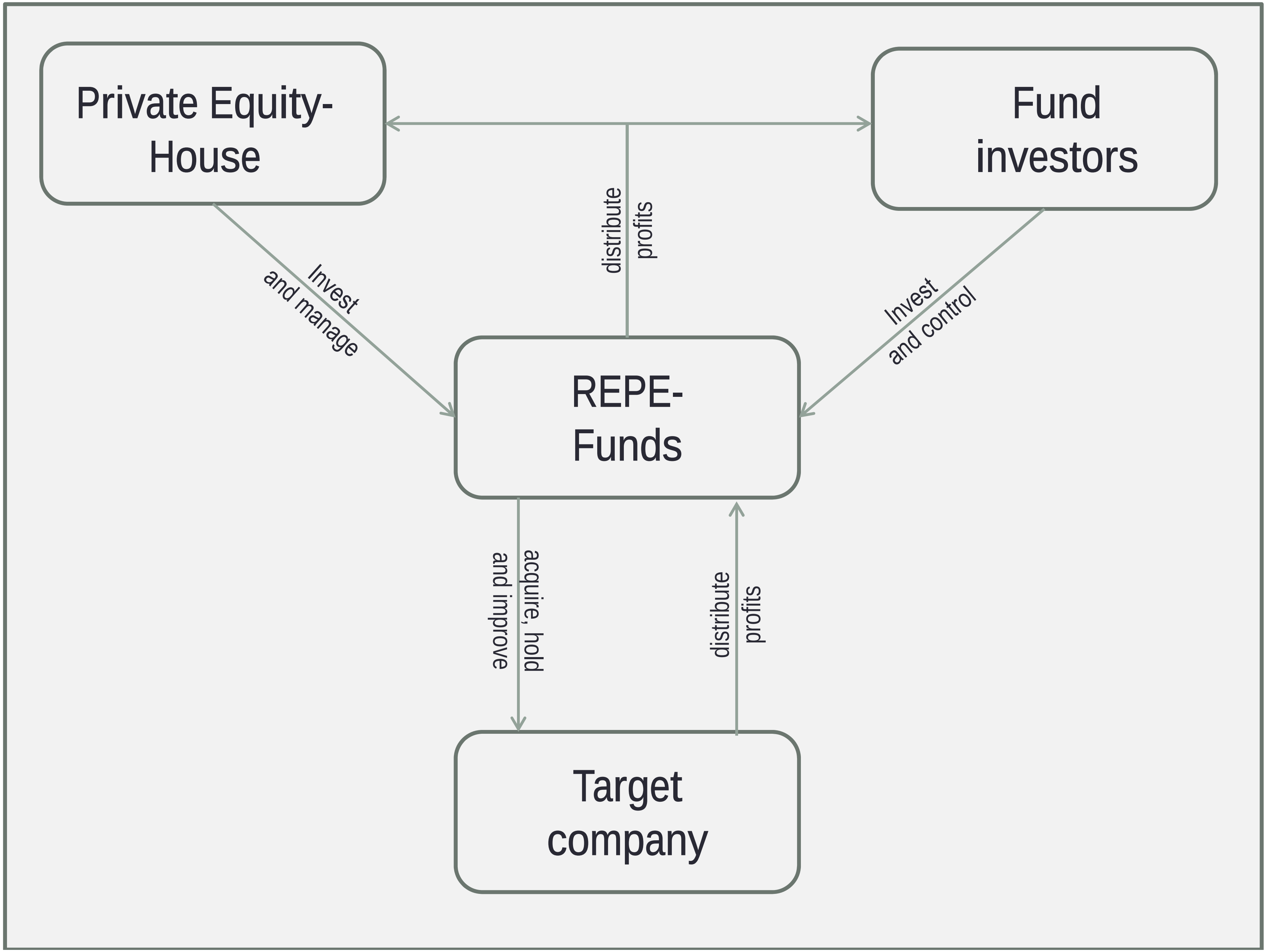
Görlitz – WBG – workshop

25.02.2013

Problem: sale of public and factory-related housing companies to financial investors



- *What is Real Estate Private Equity?*
- *How could financial investors gain such importance in NRW*
- *How do their business models work?*
- *What are the risks?*
- *What can / should houising policy do?*


Private Equity-
House
Fund
investors
distribute
profits
Invest
and manage
Invest
and control
REPE-
Funds
acquire, hold
and improve
distribute
profits
Target
company

Real Estate Private Equity: characteristics

- Non-listed equity capital provided by external investors for real estate takeovers
- High leverage
- active management approach, but individual differences
- Exit perspective from the outset of the investment
- alternative investment outside the regulated banking and investment sector
- Return and risk
- „Blind pool“
- Securitizatíon of takeover loans
- Perfomance-oriented remuneration of fund management

Investment style and return expectations

- High level of entrepreneurial engagement
- Value-added investment style
- 10-15 per cent return after taxes: „Buy low, sell high!“
- Risk-tolerant investors
- Different investment styles: Core / Value Added / Opportunistic
- Sometimes outsourcing of Property / Asset Management

Regulation of REPE

- Very low regulation intensity
- REPE-Fonds are neither banks, nor mutual funds or investment companies
- Harmonized regulation at EU-level: EU directive on Alternative Investment Fund Managers (AIFM)

Sales of large residential portfolios 1999-2011

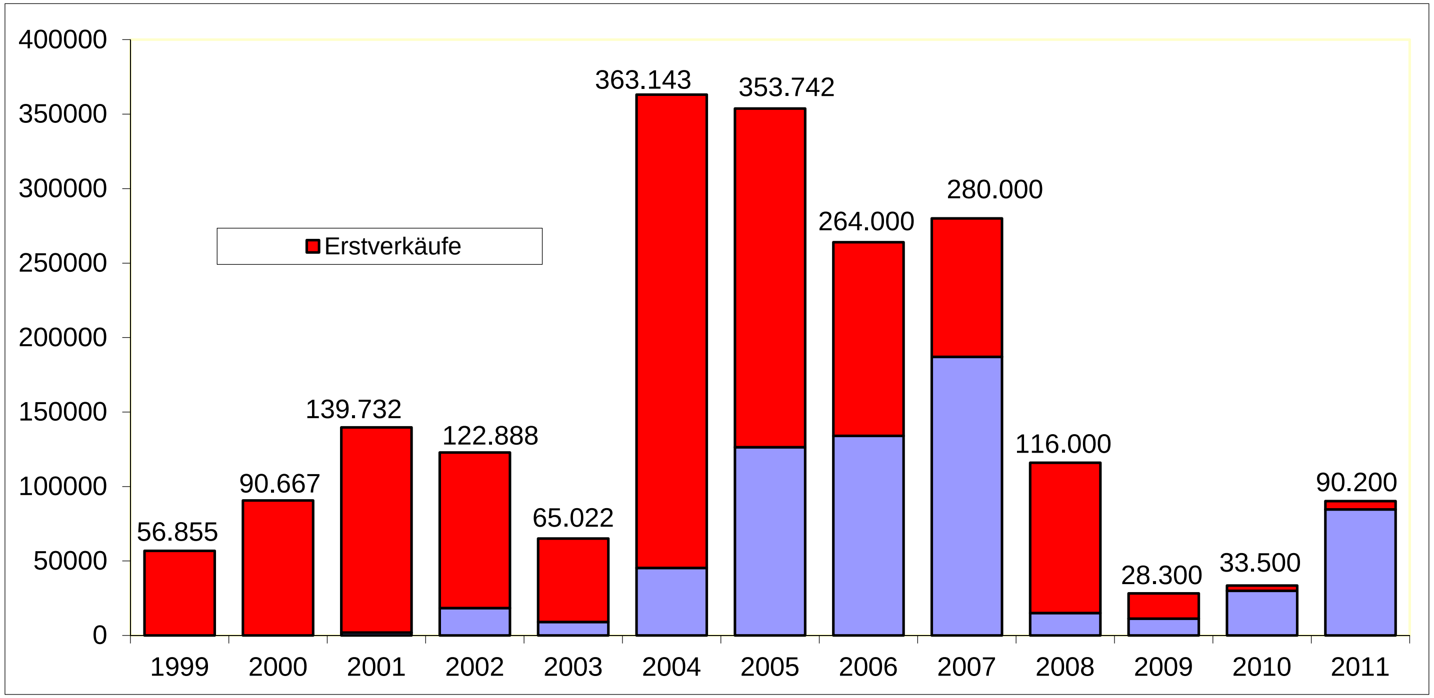


Figure: Sale of large residential portfolios with more than 800 housing units from 1999-2011
Source: BBSR und IfS

Housing Privatization in NRW

- Exchange of public or socially bound capital against private venture capital striving for profit maximazation
- In NRW focus on former company housing stock
- All organizations taken over are former public-interest housing organizations
- Keystone of a cultural transformation?
- Time horizon, return expectations, relationship to local authorities → differences in management and investment behavior

Large block sales in NRW

Date	Company sold	Seller	Buyer	Number of units	Transaction vol. Mrd. €	Purchase price per unit
Sep 08	LEG NRW	Land NRW	Whitehall / Goldman Sachs	93.000	3,40	36.560
Okt 06	Immeo (Thyssen Krupp)	Morgan Stanley / Corpus	Foncière des Régions	39.400	2,10	53.300
Mai 05	Viterra	E.ON	Deutsche Annington	138.000	7,00	50.725
Dez 04	RWE Systems Immobilien	RWE	Deutsche Annington	4.500	0,23	51.100
Dez 04	ThyssenKrupp Immobilien	ThyssenKrupp	Morgan Stanley / Corpus	48.000	2,10	43.750
Jul 04	Gagfah	BfA	Fortress	82.000	3,50	42.683

Table: Summary of significant large block sales for North Rhine-Westphalia

Housing Privatization in NRW

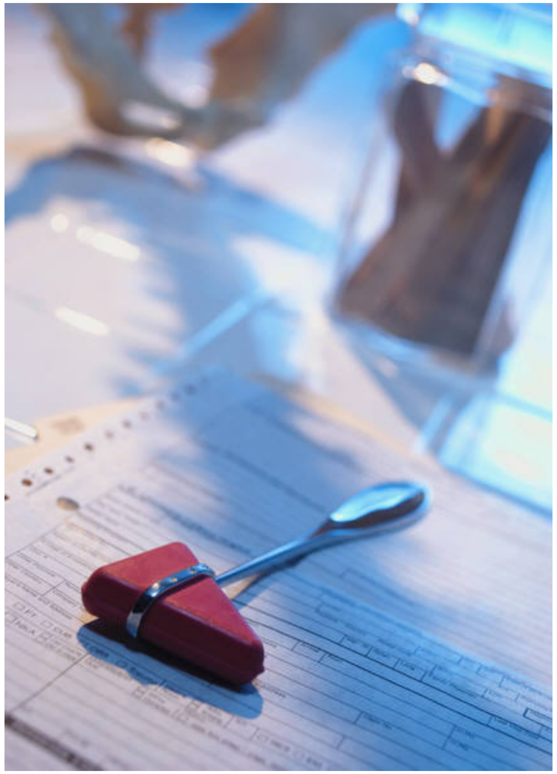
- In the wake of the large transactions in NRW about half a million dwellings have changed their owners
- Current housing stock in NRW under control of financial investors around 320.000 units
- Regional focus of the investments is the Ruhr area
- In Dortmund alone, 45.000 apartments are under control of financial investors, i.e. more than 20 pere cent of the total rental housing stock
- Focus of investments often in disadvantaged neighborhoods and districts

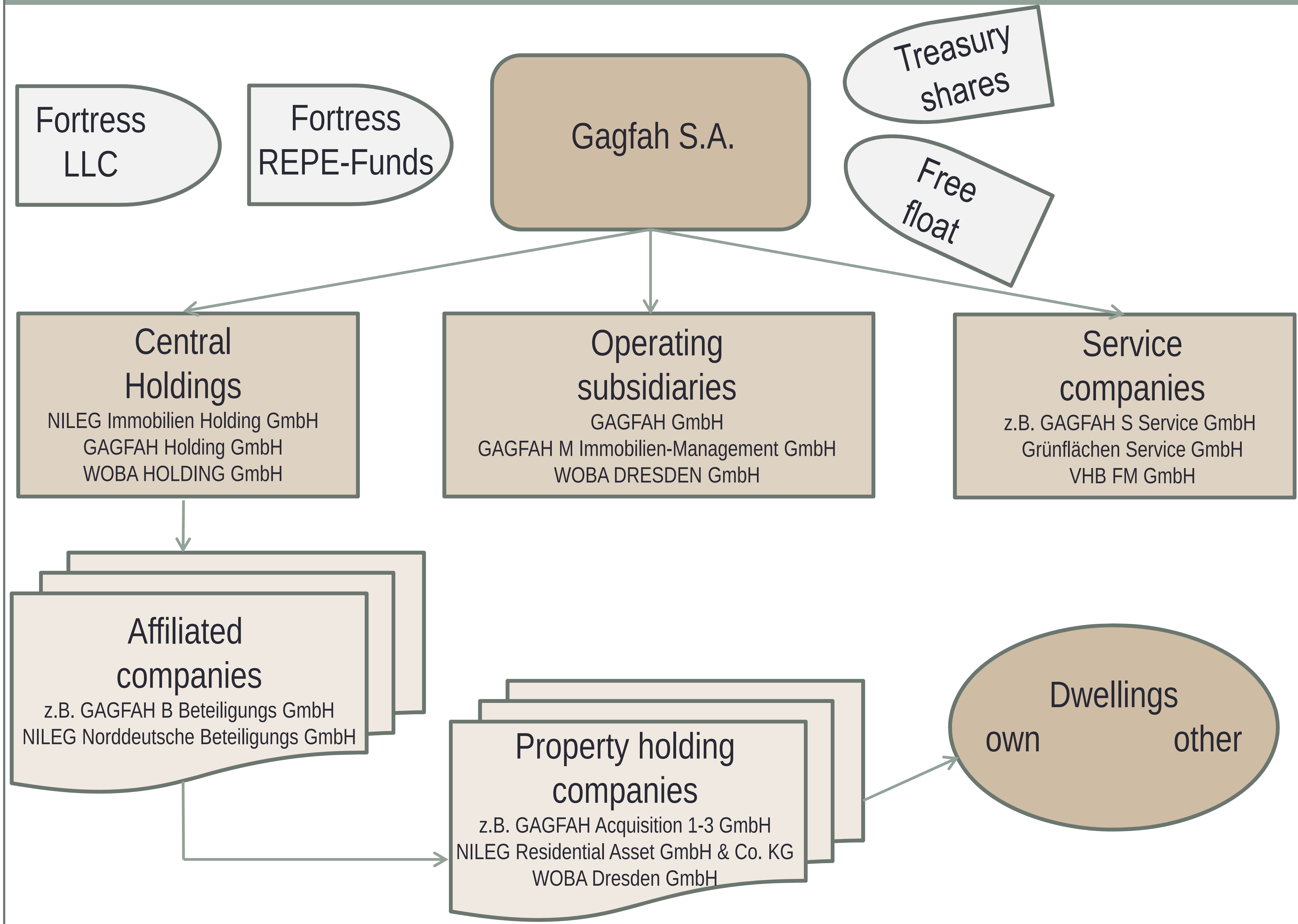
General framework conditions for the engagement of financial investors

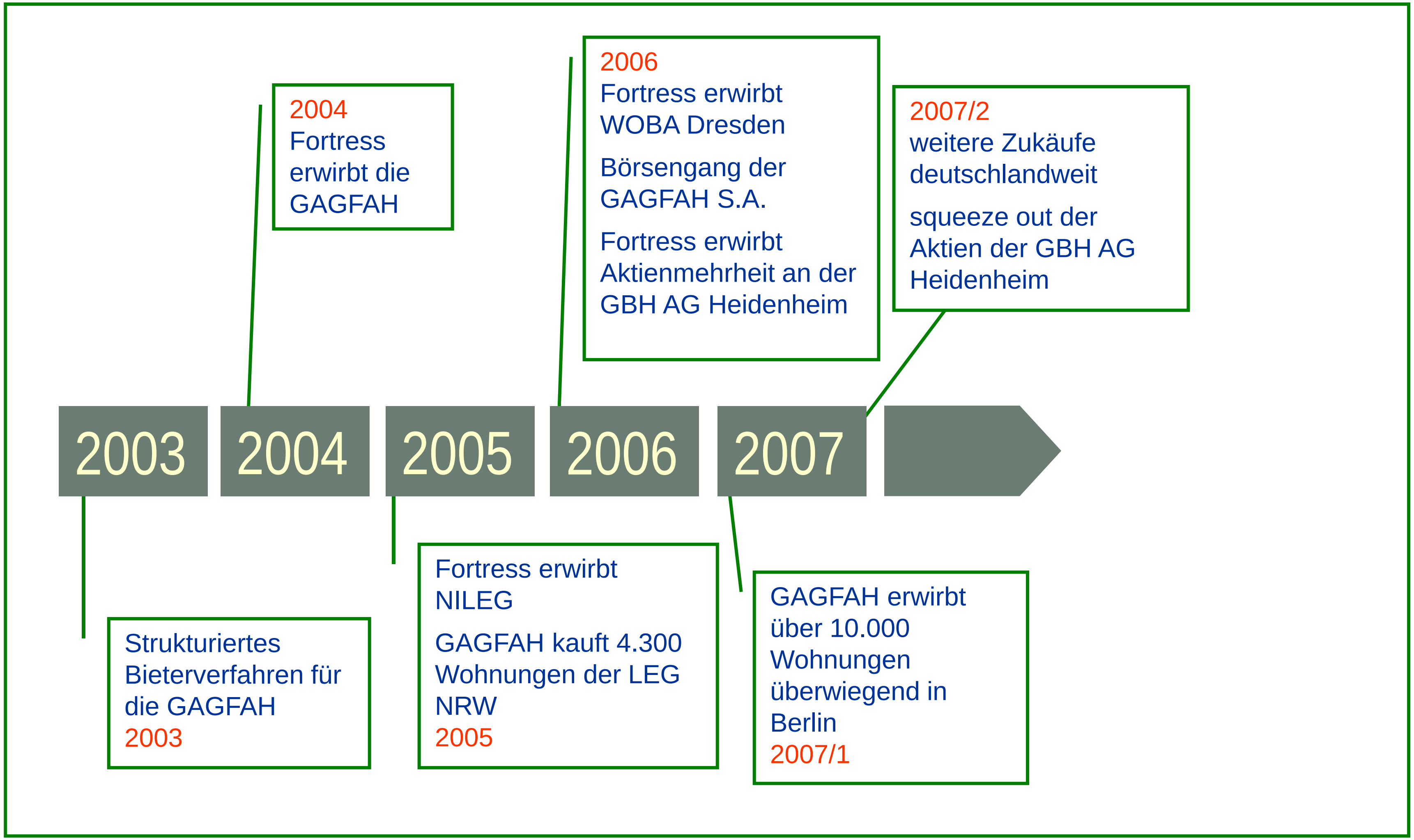
- Financial leverage and monetary policy
- Lax bank regulation: e.g. capital requirements
- Securitization of leveraged loans in the shadow banking system
- Fluctuating risk preferences during the takeover cycle
- House price inflation
- Removal of public interest housing
- Flat-rate withholding tax un untaxed equity
- Local budgets
- Special framework conditions for factory-related housing
- Tax exemption on the ale of domestic corporations

Case studies

- Deutsche Annington
- Gagfah
- Immeo
- LEG
- Babcock & Brown
- Speymill/Goal
- Tower Group
- WVB Centuria




Fortress LLC
Fortress REPE-Funds
Gagfah S.A.
Treasury shares
Free float
Central Holdings
NILEG Immobilien Holding GmbH
GAGFAH Holding GmbH
WOBA HOLDING GmbH
Operating subsidiaries
GAGFAH GmbH
GAGFAH M Immobilien-Management GmbH
WOBA DRESDEN GmbH
Service companies
z.B. GAGFAH S Service GmbH
Grünflächen Service GmbH
VHB FM GmbH
Affiliated companies
z.B. GAGFAH B Beteiligungs GmbH
NILEG Norddeutsche Beteiligungs GmbH
Property holding companies
z.B. GAGFAH Acquisition 1-3 GmbH
NILEG Residential Asset GmbH & Co. KG
WOBA Dresden GmbH
Dwellings
own
other


2003
2004
2005
2006
2007
Strukturiertes Bieterverfahren für die GAGFAH 2003
2004 Fortress erwirbt die GAGFAH
Fortress erwirbt NILEG
GAGFAH kauft 4.300 Wohnungen der LEG NRW 2005
2006 Fortress erwirbt WOBA Dresden
Börsengang der GAGFAH S.A.
Fortress erwirbt Aktienmehrheit an der GBH AG Heidenheim
GAGFAH erwirbt über 10.000 Wohnungen überwiegend in Berlin 2007/1
2007/2 weitere Zukäufe deutschlandweit
squeeze out der Aktien der GBH AG Heidenheim

Gagfah: housing stock

- Reduction of housing stock: to reduce debt?
- Declining rental income and profits from the rental business
- Neglection of maintenance of the housing stock
  - Current maintenance costs 2010: € 6,36 per m^2 and year
  - Modernization expenditure close to zero

Gagfah: value drivers

Value drivers	2005	2006	2007	2008	2009	2010	2011
Vacancy %	6,4	5,5	4,4	3,9	4,9	5,2	5,1
Man. costs per housing unit €	555	486	448	407	391	374	380
Maintenance costs €/m2		7,43	8,62	8,72	6,61	6,36	8,47
CapEx Mio. €				50,8	13,5	3,9	0,9
Rent adjustment over the previous year %		1,2	1,6	2,0	1,3	1,2	1,5

- Earnings potential of significant value drivers exhausted?
- Operations not very profitable. Deutsche Annington is superior in this respect.
- Gagfah is not extremely undercapitalized.

Gagfah: business processes

- Careful centralization
- Less operational activism as compared with Deutsche Annington
- Planning, tender award, construction management and technical audit outsourced to an external service provider
- Caretaker‘s affiliate with an appropriate object allocation
- No major organizational function deficits

Gagfah: Dividend payments

Year	Dividend absolute in Mio. €	Net profit in Mio. €
2006	57,0	142,8
2007	166,9	588,9*
2008	180,5	46,1
2009	180,6	-75,1
2010	135,6	-0,6

Zusammen 721 Mio. €

Table: Dividend payments at Gagfah 2006-2010
Sources: Gagfah-Konzerngeschäftsberichte

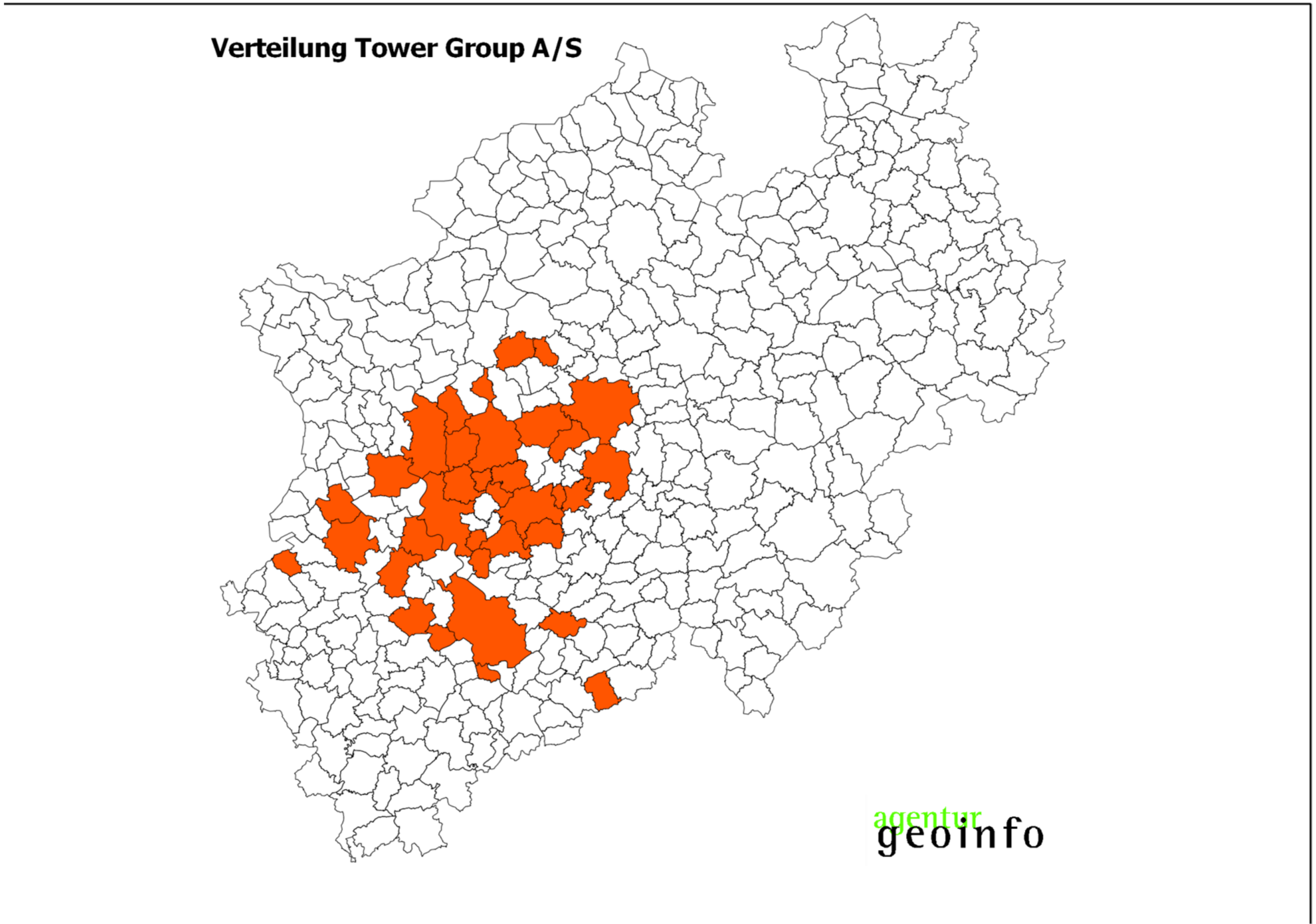
*) davon € 984,2 Mio. Bewertungsgewinne

Gagfah: distribution policy and share buybacks

- Exit further advanced as compared with Deutsche Annington (however, Morgan Stanley was even faster)
  - Successfull IPO in 2006
  - 721 Million Euro Dividend payments
  - Sale of other shares
  - Sales of sub-portfolios
  - Share buybacks: in preparation of future delisting?
- Problem: the structure of their liabilities → 5,5 billionEuro to be refinanced 2013 / 2014
- The housing stock serving as collateral for the two major securitizations is also subject to Social Charters. Larger sales from the sub-portfolios are possible only with permission of the federal pension insurance or the city of Dresden, respectively.

Tower Group

- Tower Group A/S is a public limited company under Danish law
- Tower was initiated in 2006 through the acquisition of a stock exchange shell
- In the period 2006-2008 Tower invested approx. € 575 million mainly in Germany
- Leverage ratio was over 90%
- Financial means provided by German banks (senior loans), Danish banks (junior loans) and corporate bond investors
- The housing stock is distributed as follows: 42% in Berlin, 27% in Wuppertal and 26% in the rest of NRW


Verteilung Tower Group A/S
agentur
geoinfo

Tower Group

- Since 2009 the Tower Group is in fact insolvent
- Over the whole year the company‘s management was occupied with capital restructuring
- A capital reduction and a waiver of both the bondholders and the junior lenders paved the way for the entrance of a new majority shareholder
- New majority owner: BXR Tower B.V., a group company of the Dutch Private equity firm BXR Group

Tower Group

- Despite new funding and new shareholder loans the company was not able to reverse the crisis
- In Mid-2011 four property-holding companies were forced into bankruptcy
- As a result, the group lost control over half of the property portfolio

Tower Group: Fazit

- Semi-professional investor who wanted to jump on the train in a late phase of the acquisition cycle
- Investment thesis unoriginal and undifferentiated
- As a consequence of the investment strategy scattered portfolio structures were established in many places
- Instead of the hoped-for effortless capital gains falling rent revenue due to rising vacancy rates
- High leverage and financial covenants not stress-resistant
- The reorganization measures taken in time of need did not have enough time to take effect.

Measures to optimize ongoing property management

- The measures to optimize ongoing property management can be divided into five groups:
  - Rent increases,
  - Vacancy reduction,
  - Reduction of maintenance and modernization costs,
  - Reduction of administrative costs by active performance management.

Rental policy

Company	2006	2007	2008	2009	2010	2011
GAGFAH	4,76	4,85	4,95	5,02	5,07	5,36
Deutsche Annington	4,67	4,78	4,91	5,00	5,06	5,15
LEG		4,39	4,43	4,52	4,63	
FDL Deutschland		4,71	4,80	4,80	5,06	5,20
Deutschland	5,99	6,01	6,07	6,12	6,20	6,38

Table: Development of average net rents for different housing companies in € per m^2 and month compared with the national average
Sources: Geschäftsberichte und BBSR-Wohnungmarktbeobachtungssystem, IDN ImmoDaten GmbH

Rental policy

Standort	NKM 2006	NKM 2011	Prozentuale Erhöhung im gesamten Zeitraum	Jahresdurch-schnittliche Erhöhung in Prozent
Berlin	4,38	4,97	13,5	2,7
Dresden	4,36	4,77	9,4	1,9
Hamburg	5,08	5,51	8,5	1,7
Köln	6,02	6,52	8,3	1,7
Bielefeld	4,2	4,54	8,1	1,6
Duisburg	4,32	4,58	6,0	1,2
Essen	5,11	5,32	4,1	0,8
Leverkusen	5,29	5,48	3,6	0,7
Dortmund	4,64	4,73	1,9	0,4

Table: Development of average rents (net cold rents NCR) at selected Gagfah locations 2006-2011
Source: Geschäftsberichte

Vacancies and rent losses

Unternehmen	2005	2006	2007	2008	2009	2010	2011
Dt. Annington	6,3	5,7	4,2	3,9	5,9	5,1	4,3
Immeo	4,4	5,2	4,8	3,9	3,6	3,5	
LEG		2,2	2,2	k.A.	3,9	3,6	
GAGFAH	6,4	5,5	4,4	3,9	4,9	5,2	5,1

Table: Vacancy rates in per cent
Source: Geschäftsberichte

Maintenance and Modernization

Unternehmen	2007	2008	2009	2010	2011
GAGFAH	8,62	8,72	6,61	6,36	8,47
Deutsche Annington	9,83	9,73	10,00	10,35	10,81
LEG			9,06	12,78	
FDL Deutschland	6,11	5,44	5,56	5,76	5,43

Table: Maintenance costs at various housing companies in € per m^2 and year
Source: Geschäftsberichte

Maintenance and Modernization

Unternehmen	2007	2008	2009	2010	2011
GAGFAH	18,53	13,60	7,96	6,76	8,57
Deutsche Annington	10,58	15,23	12,65	14,17	16,10
LEG	25,54	19,54	12,80	13,87	
Immeo	13,74	15,01	15,65		

Table: Maintenance and modernization costs at various housing companies in € per m^2 and year
Source: Geschäftsberichte

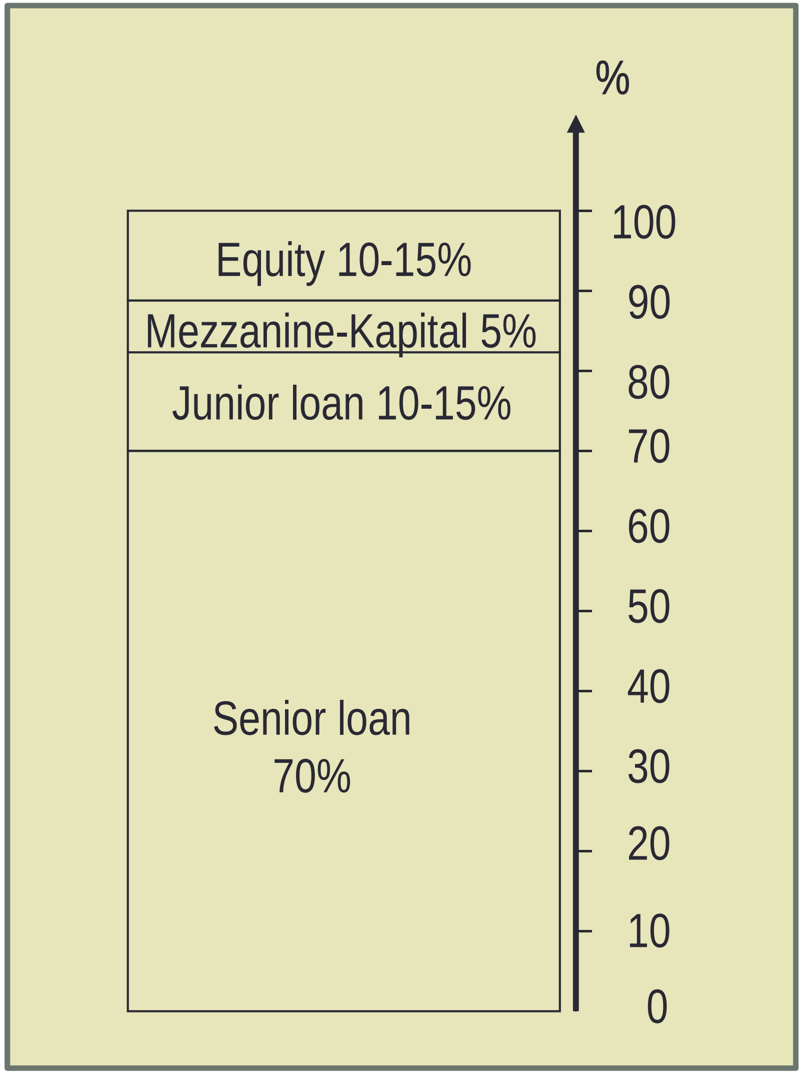
Role of Performance Management

- The different role of Performance Management is a consequence of individual acquisition and exit strategies.
- In all examined investments the achievement of substantial capital gains originally stood in the forefront of the strategy.
- Energetic PM only in face of pressing performance problems or dwindling hopes of passive capital gains
- The splitting of property, asset and property management has always resulted in major problems.

Fazit: Do the new investors behave differently?

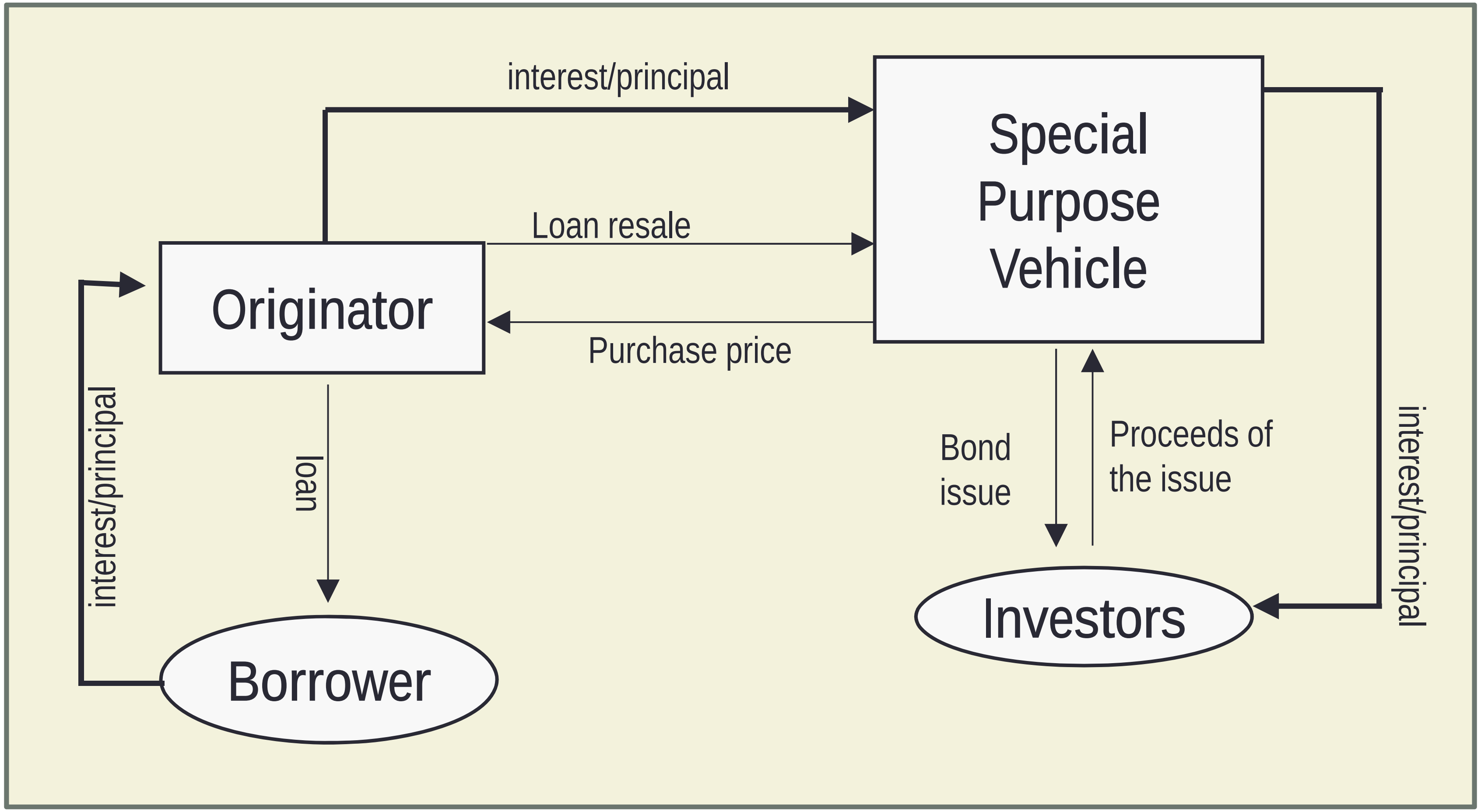
- Strive to varying degrees to tangible and sustainable cost reductions in management by using different value drivers
  - Economies of Scale of large housing portfolios
  - Significant personnel cost reductions by consistent process optimization
  - Significant reduction of ongoing maintenance expenses and focusing of modernization investment
  - Catch up of rent arrears
  - Reduction of vacancy rates
- Fixation of organisations on key financial figures
- Individual differences depending on
  - Development of regional housing markets
  - Time horizon
  - Business model and financing structures and conditions
- The architecture of the financial product limits the scope for action of the housing business

Structured finance



- Structured finance enables risky projects
- Securitization of takeover loans
- Role of Covenants

Basic structure of a securitization



Why securitize?

- Cost: lower interest rate
- Flexibility
- No alternative given size and risk of the transaction

Role of the Covenants

- Clauses that oblige the borrower to maintain certain financial ratios
- For the sake of the security of CMBS bondholders
- Influence on the securities‘ ratings
- Limitation of the autonomy of the fund management
- Types of Covenants:
  - Financial Covenants
  - Non-financial Covenants
  - Information Covenants

What‘s the difference between old and new landlords?

- Combined use of different value drivers up to the limit
- Risk tolerance and financial models: often outrageous failures
- Often property management on a minimal scale
- Exit orientation: tenant privatization and block sales as exit channels
- Permanent pressure on employees

REPE: neoclassical perspective

- Search engine for investment opportunities
- Middlemen with a re-allocation function
- Improvement of capital allocation?
- Properties move to the „best farmers“?
- Functional and sustainable ownership structures?
- It should not be left to the unregulated market forces to decide which landlords operate in a disadvantaged neighbourhood..

REPE: risk and return

- Does the housing market need private venture capital?
- Capital gains are always part of the game.
- Financial investors bet on captal gains, BPR and leverage → high risk exposure
- Negative consequences for other stakeholder groups probable

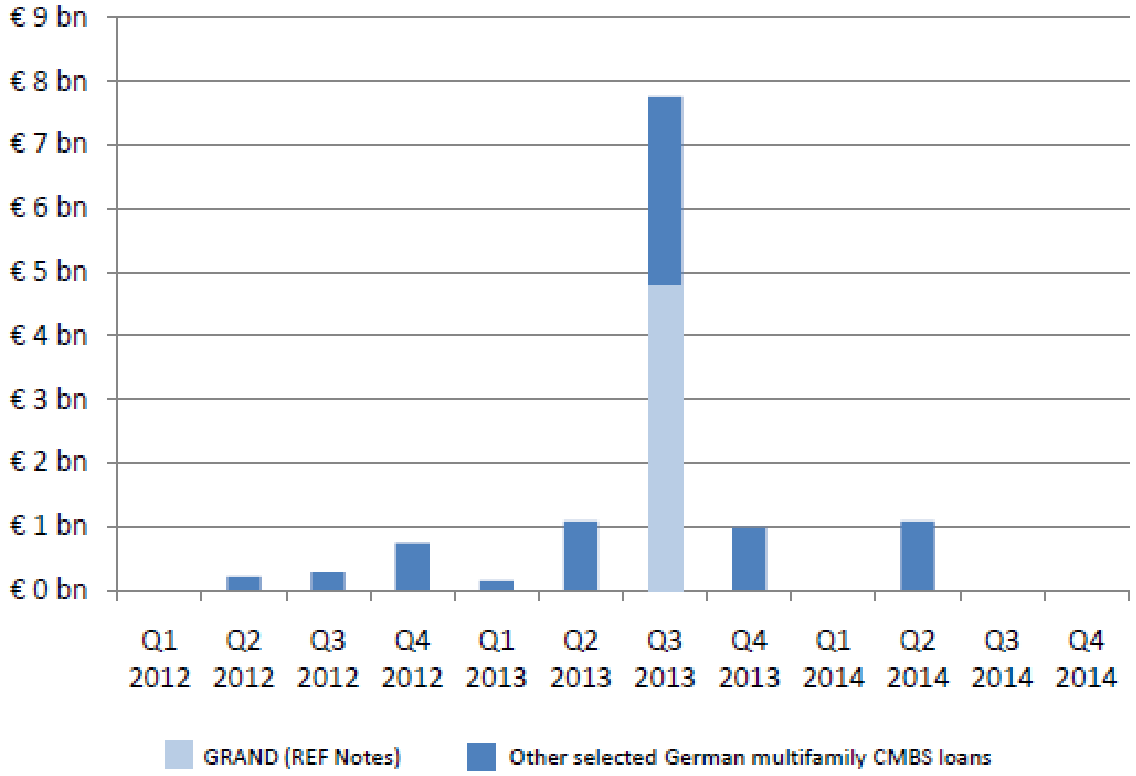
REPE: Negative side effects

- the radical experimental business process reengineering efforts and ongoing organizational reforms with potentially negative consequences for the quality of service
- the selective and unsteady investment behavior with the risk of a significant deterioration of the building substance
- the special financing techniques, resulting in a higher probability of crisis and bankruptcy
- the risk of fragmentation of ownership structures, with the possible consequence of impaired coordination and the occurrence of unprofessional buyers
- the depersonalization and anonymity in the rental business
- the operational flexibility as part of their business models

Sale to financial investors as an open-ended transformation process

- On the platform level, almost all the cases studied qualified as business failures.
- However, these negative economic developments were not necessarily synonymous with corresponding losses for the fund investors.
- For the companies sold however, the sale to financial investors creates a high risk of asset erosion.
- The portfolios and the organizational structures of the companies acquired are substantially transformed in most cases by the new owners.
- It is not possible to estimate the final consequences of a sale to such investors.

Refinancing risks



Source: Brookland research derived from public sources (see table to the right). Securitised balance only

Outstanding large securitizations

	GRAND	GRF	Woba	Quokka
Sponsor	Deutsche Annington	Fortress	Fortress	BGP
Original loan size Bn. €	5,42	2,66	1,07	0,62
Current loan size Bn. €	4,64	2,15	1,07	
Maturity date	Jul-13	Oct-13	May-13	Sept-13
Tail period	Jul-16	Aug-18	unknown	Sept-16
Most recent LTV				

Possible outcomes of critical securitizations

1. The refinancing is concluded with the result that the debtor can meet his contractual obligations fully (examples: HALLAM, GSW, Immeo). This assumes that the financial figures of the collateral portfolios correspond to the requirements of the creditors and the volume of securitization does not exceed the capacity of the markets.
2. The debtor attempts to reduce the outstanding debt balance significantly prior to the rollover by selling objects or sub-portfolios. As a result, the probability that the re-financing is concluded increases. This requires broad and buoyant real estate markets.
3. The debtor judges the prospects for refinancing pessimistically and takes time for negotiations with his creditors before the roll over date with the aim to extend or suspend principal payments (example: Deutsche Annington). Depending on the outcome of these negotiations, an agreement is concluded either that gives relief to the debtor or the negotiations break down and sub-portfolios or the entire portfolio will eventually become insolvent. A happy end requires appropriate liquidity reserves of the creditors and a favorable economic development of the platform.
4. Sub-portfolios or the whole investment become bankrupt despite the efforts of the debtor and liquidation of collateral by trustees and servicers begins.

Refinancing scenarios

Szenario Nummer	Portfolio-qualität	Immobilienpreis-entwicklung	Liquide und risikofreudige Kapitalmärkte	Balloon risk	Risikoklasse
A1	gut	steigend	JA	NEIN	A
B1	schlecht	steigend	JA	NEIN	B
B2	gut	fallend	JA	NEIN	B
B3	gut	steigend	NEIN	NEIN	B
B4	gut	steigend	JA	JA	B
C1	schlecht	fallend	JA	NEIN	C
C2	schlecht	steigend	NEIN	NEIN	C
C3	gut	fallend	NEIN	NEIN	C
C4	gut	steigend	NEIN	JA	C
C5	schlecht	steigend	JA	JA	C
C6	gut	fallend	JA	JA	C
D1	schlecht	fallend	JA	JA	D
D2	schlecht	fallend	NEIN	NEIN	D
D3	schlecht	steigend	NEIN	JA	D
D4	gut	fallend	NEIN	JA	D
E1	schlecht	fallend	NEIN	JA	E

Tabelle: Risikobewertung verschiedener Refinanzierungsszenarien

Measures at a glance

- building code and urban development interventions
- tightening of financial market regulation
- measures to improve the prospects for refinancing and exit for platforms with funding problems
- changes in the real estate transfer tax law
- introduction of a licensing system for commercial landlords
- recovery solutions for insolvency cases

Grasshopper

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