THE PRESIMA

globetrotter

Germany's Residential Real Estate Renaissance

BERLIN, GERMANY

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SPEICHERSTADT, HAMBURG
GERMANY

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This edition of the Globetrotter takes us to Germany, the "land of poets and thinkers." Once a small, unspectacular outpost of the listed real estate universe, the German residential real estate market has evolved a great deal over the last few years. Our research reveals more than meets the eye, with corporate intrigue, significant demographic shifts, and high political stakes.

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AUTHORS
Magid Awad
Peter Zabierek, CFA

CONTACT
Robin Marcoux
rmarcoux@presima.com
514-673-1303

Our 4 key takeaways are

1

Germany is a great place to live

2

Two waves of investors have permanently altered the residential market

3

The market is now approaching a tipping point

4

To continue to grow, investors must innovate

SCHWÄBISCH HALL, GERMANY
source: pixabay.com

Takeaway 1

Germany is a great place to live

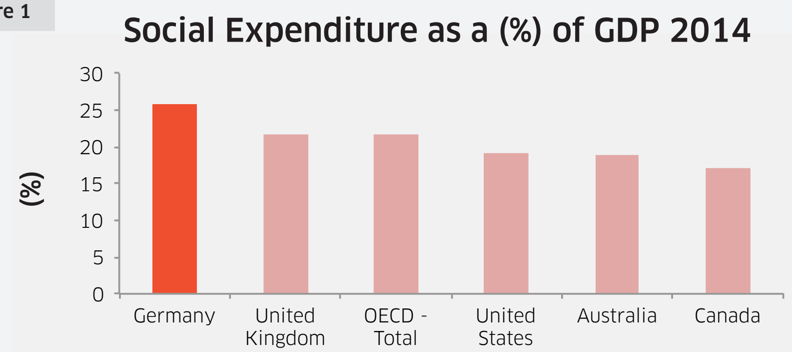
Earlier this year, US News & World Report, in partnership with WPP's BAV Consulting and Wharton School, announced its list of its "Best Countries," with Germany taking the number one spot. The European Union's most populous nation[1] also scored in the Top 10 out of 60 in the areas of citizenship, entrepreneurship, and quality of life[2].

Culturally, Germany has influenced the modern world in many ways. Home to great minds such as Einstein and Beethoven, Germany's scientists and artists have left a lasting imprint on the natural sciences and the arts. Germany has also marked history in sports, most recently with its FIFA World Cup soccer win in 2014. The country is also known for its folk festivals, with the Oktoberfest being the most popular. Germans are recognized for their efficiency, hard work and discipline. The country has built one of the largest and strongest economies in the world.

Economic policy in Germany is based on a concept known locally as "soziale Marktwirtschaft" or a social market economy, which combines free markets and a strong welfare system. This is one of the main reasons Germany has been a top destination for many migrants/refugees.

Figure 1 below highlights the German government's generous social expenditures, which rank high relative to other major developed nations.

Figure 1



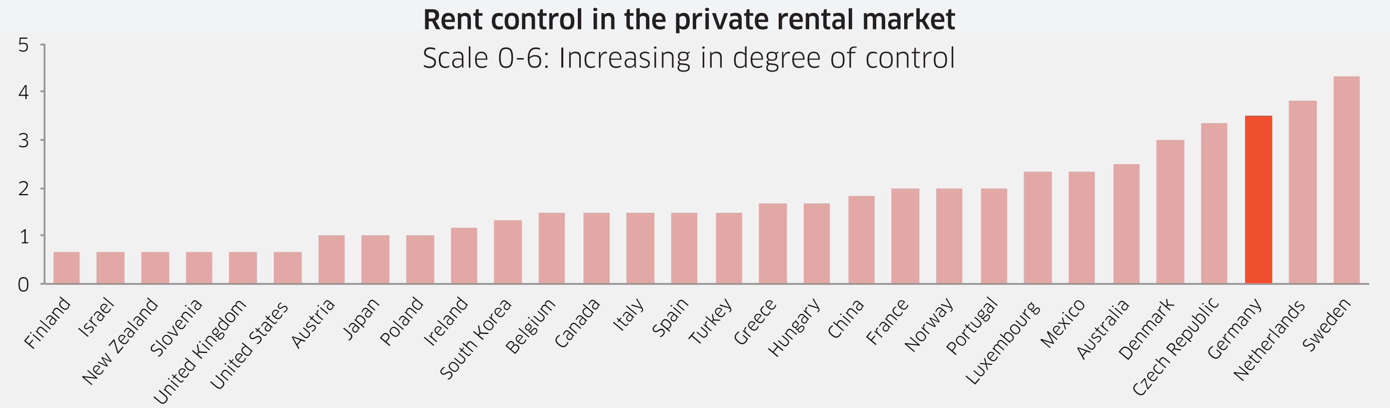
Source: OECD.Stat, Social Expenditure-Aggregated data, 2014
http://stats.oecd.org/Index.aspx?datasetcode=SOCX_AGG

1 Eurostat, Population on January 1st, 2015.
2 U.S. News & World Report, U.S. News, WPP's BAV Consulting and the Wharton School Release Inaugural Best Countries Rankings, January 20, 2016.

The strong social economy manifests itself in the housing sector, as the German government takes great strides to control the cost of housing for renters. Since renters represent a dominant voting bloc, German politicians tend to favor their interests over those of landlords, resulting in a very strict rental regime which limits the ability of private landlords to raise rents. Figure 2 provides some context for the high level of rent regulations in Germany. The OECD study shows that Germany has one of the strongest rent control regimes in the world.

Figure 2

Rental Regulations Compared, Selected OECD Countries



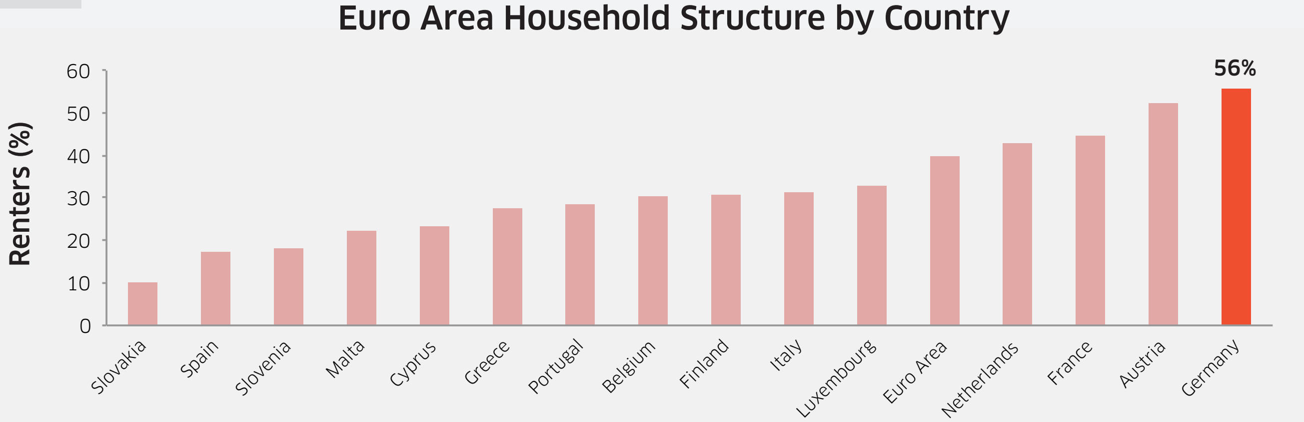
Source: OECD, Economic Policy Reforms 2011: Going For Growth, Figure 4.5. Rental regulations compared, selected OECD countries, 2009. http://www.oecd.org/newsroom/46917384.pdf

As a recent example of the pricing tension between landlords and renters, in May 2015 Berlin's government set rent increases far below where landlords were expecting them. The adjustment was 5.4% while landlords were expecting 8-10%[3]. Furthermore, a new law was passed in 2015 expanded rent controls to include new tenancy agreements (previously only existing leases were regulated).

The strict rent control regime, in addition to the German consumer's propensity to put savings into banks rather than property, offers an explanation as to why Germany has one of the lowest home ownership rates across advanced economies. As shown in Figure 3, Germany has more renters, 56%, than any other country in Europe. ■

Figure 3

Euro Area Household Structure by Country



Source: ECB Statistics Paper Series No 1, April 2013. Table 1.2 Household structure by country. https://www.ecb.europa.eu/pub/pdf/scpsps/ecbsp2.en.pdf

3 Morgan Stanley & Co. International PLC+, Berlin Mietspiegel up 5.4%, May 18, 2015

MONSCHAU, GERMANY
source: pixabay.com

DRESDEN, GERMANY
source: pixabay.com

Takeaway 2

Two waves of investors have permanently altered the residential market

Wave 1: Private equity investors arrive

In the early 2000's, despite regulatory challenges, private equity investors seized an opportunity to consolidate the fractured industry. They were attracted to the cheapness of German home prices, which had significantly lagged growth in other developed markets like the UK and Ireland. In addition, the sector's very low tenancy turnover underpinned the type of stable cash flow profile that leveraged buyout investors covet. There was also a value-add angle, since these residential portfolios were predominantly owned and operated on a not-for-profit basis. There was the opportunity to enhance the quality and service offering through modernizing renovations and efficiency savings, as well as simultaneously offer tenants a path to ownership via privatizations.

At the same time, many municipalities were facing budget constraints and were looking to monetize their residential portfolios. This allowed private equity investors a quick entry at the necessary scale needed to put their investment plan into motion.

Guy Hands of Terra Firma was one of the first movers in the private equity industry's love affair with the German residential market.[4] In early 2000, while he was the head of Nomura's Principal Finance Group, he led the US $4.2 billion purchase of 114,000 retired railway worker apartments from Deutsche Bahn AG, the German Federal Railway. He quickly began running into intense competition. In July 2004, he was out-bid by Fortress Investment Group's €3.5 billion (US $4.2 billion) offer at the auction for the 78,000-unit state-owned ″Gagfah″ housing portfolio. Earlier that year, a consortium including Goldman Sachs and Cerberus Capital bought 66,000 apartments for €2.0 billion (US $2.5 billion), followed closely by Blackstone's €1.4 billion (US $1.6 billion) purchase of 31,300 units in December 2004.[5] Some estimates put the total amount invested in German residential property during the private equity stampede at over US $25 billion.[6]

The city of Dresden nearly wiped out its entire public debt in one stroke through the sale of its 48,000-unit apartment portfolio to Fortress Investment Group for US $1.2 billion.[7] The sale, came with a variety of social charters and restrictions which later created challenges for Fortress. Years later, during the run-up to state elections in 2011, Fortress was sued by the city of Dresden for over €1.1 billion (US $1.4 billion) for the violation of social charters related to privatizations. It later settled for a €40.0 million (US $52 million).[8]

Wave 2:
Listed companies replace bruised private investors

The strict regulatory environment, combined with the political power of tenants, began to cause increasing pain for private equity investors. There was a public backlash against the sudden surge of cash-strapped municipalities selling their social housing portfolios to foreign investors. During a run-up to the 2005 Federal elections, the chairman of the Social Democratic Party, Franz Müntefering, famously referred to foreign private equity investors as ″irresponsible swarms of locusts.″ He accused them of cutting maintenance costs and raising rents with disregard to tenants.[9]

Private equity investment began to slow as cash-strapped municipalities significantly reduced their sales of social housing to foreign investors. Since municipalities represented a big source of supply for early investors, this development frustrated attempts for existing private equity platforms to grow via add-on acquisitions and for aspiring new entrants to quickly achieve the size needed for economies of scale.

In addition, profits from privatizations proved to be much harder to achieve than initially anticipated because of Germans' reluctance to own, the relative cheapness of renting, and the regulatory restrictions around privatizations.

Private equity investment consequently trickled to a near-stop for many years past the Global Financial Crisis (GFC). According to Savills, private equity's proportion of total German residential investment volume collapsed from a 50% high in the years leading up to the GFC to 13% in 2012 and 6% in 2013.[10]

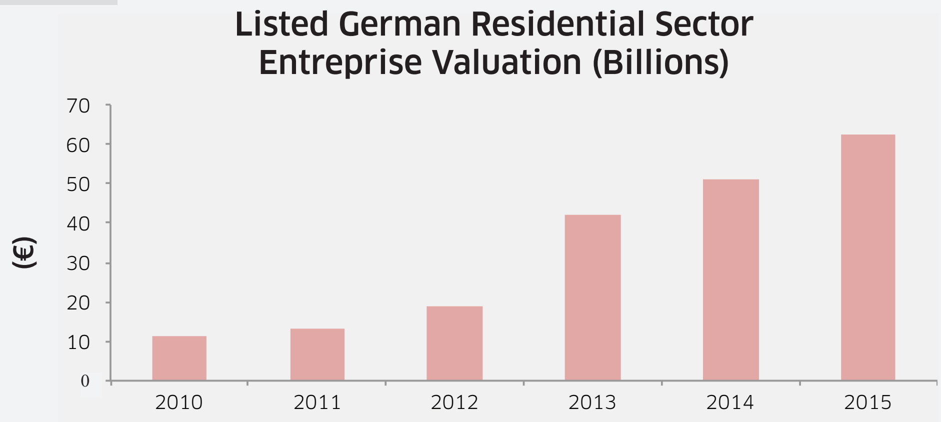
As equity markets recovered from the GFC, investors looked for business models that would avoid the next big decline. In a European environment that lurched from crisis to crisis, listed German residential companies offered a perfect blend of growth and stability. The listed sector then exploded in large part due to the demand from generalist investors. This offered private equity investors what they had been waiting for -- an exit.

4 The Financial Times Ltd., December 14, 2004, Foreign investors prop up a flat market by Jim Pickard.
5 Ibid.
6 The New York Times Company, May 5, 2006, Public Housing in Private Hands, by Mark Landler.
7 Ibid.
8 Thomson Reuters, March 16, 2012, Dresden, Gagfah settle billion-euro lawsuit.
9 Spiegel Online, November 14, 2006, Beware the Locusts: Public Housing Sell-Offs on the Rise in Germany, by David Gordon Smith.
10 Bloomberg, LLC. January 21, 2014. Buyout Firms Shift to German Offices From Housing: Real Estate, by Dalia Fahmy.

There were a variety of factors behind the growth of the listed (publicly traded) German residential sector. First, the German economy was a bright spot within the Eurozone and there was strong generalist investor demand for exposure to Germany. The asset class' inherently slow but steady growth offered by the predominantly 100% domestically-focused operations of German residential companies offered a direct pathway to that exposure versus the other multinational German companies in the DAX. Second, borrowing cost were low. And third, the market saw scale-related synergies. This all led to a massive acquisition spree by the listed companies.

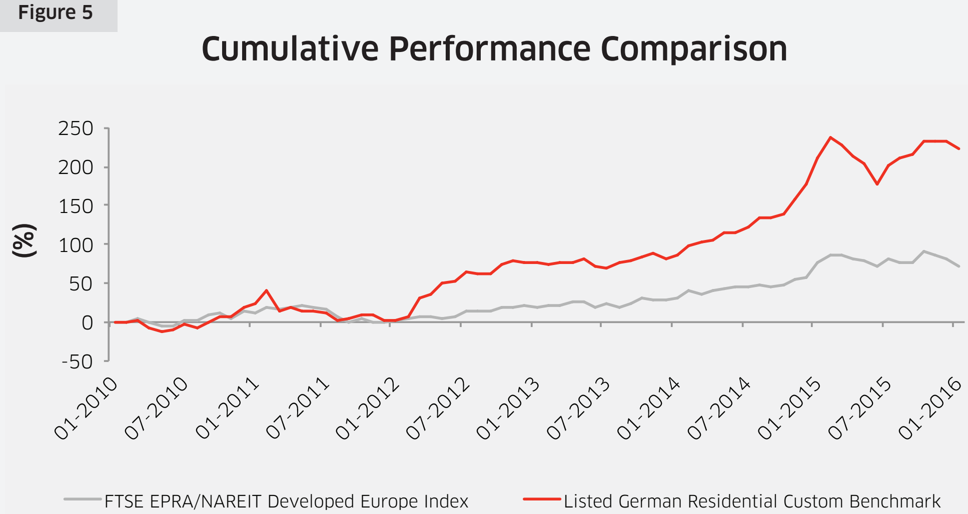
Figure 4 and Figure 5 show the growth of the listed German residential market and its outperformance, respectively. ■

Figure 4



Source: SNL Financial, Companies financial statements, Presima, Inc. estimates.

Figure 5



German Residential Custom Benchmark: Created by Presima Inc. and composed of German residential stocks.
Source: Bloomberg, LLC.

Takeaway 3

The market is now approaching a tipping point

Corporate wrangling

We have seen much intrigue in the German residential property sector over the last few months. The frenzy of mergers and takeovers, starting with Deutsche Wohnen's bid for LEG Immobilien in September 2015 and culminating in Vonovia's subsequent €9.9 billion (US $10.6 billion) hostile bid for Deutsche Wohnen in November, stood in stark contrast to the steady, almost boring nature of the asset class. After receiving Vonovia's bid, Deutsche Wohnen CEO Michael Zahn published a rare personal appeal to Vonovia shareholders, urging them to vote against that company's planned takeover of Deutsche Wohnen and buy stock in his company instead. "You can expect us to do everything in our power to protect our own shareholders against this value-destroying takeover attempt," Zahn said in the letter[11]. In February 2016, Deutsche Wohnen's shareholders voted to reject Vonovia's bid.[12]

Corporate wrangling is currently holding the attention of the press and of the management teams. This has frustrated many in Germany, who see a housing shortage growing more acute as more than one million migrants begin to settle in the country.

A number of listed companies assert that scale will make them more efficient and better able to serve tenants and deliver bottom line results to investors. Detractors see this as an elaborate ego-enhancement exercise led by overzealous CEOs. Tenant groups complain that scaled-up landlords will squeeze out competition and then increase rents.

The heightened rivalry in the sector has its roots in genuine competitive forces, as the fight for quality assets increases. As a result, companies are stretching strategically. Leverage levels are increasing. Companies are climbing up the risk curve to develop new properties. In addition, they are exploring experimental-stage ancillary services such as power and television middle man services, and installing senior friendly amenities within their portfolios.

GERMAN CHANCELLOR, ANGELA MERKEL

source: By (Aleph) - Own work, CC BY-SA 2.5, https://commons.wikimedia.org/w/index.php?curid=3983718

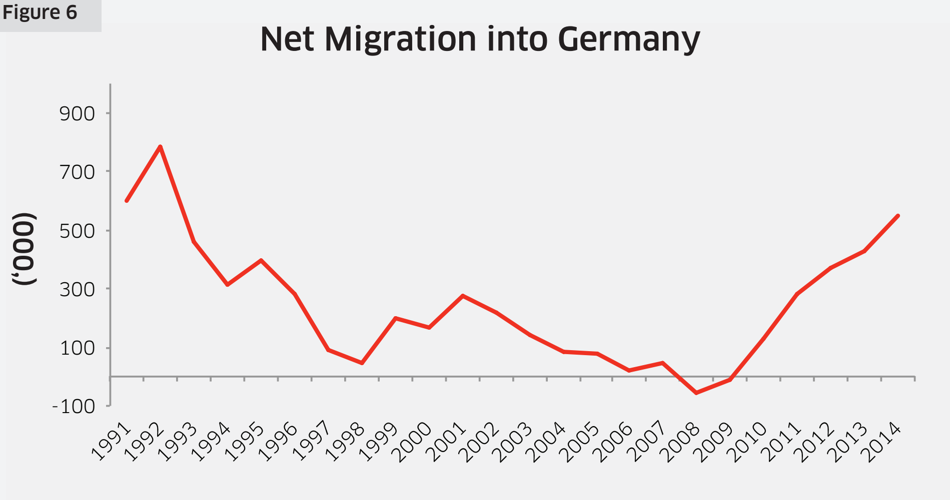
Political backdrop

The corporate drama in the sector is currently set against an evolving political backdrop. First, as highlighted previously, since there is a relatively high percentage of renters (voters) in Germany, property laws have tended to be quite tenant-friendly. Laws governing rents are only getting tighter and more difficult for landlords to push rents up. In addition, for those companies adopting property development strategies, the margins just got thinner in a sector where margins are already relatively low. Starting January 1, 2016, the German government introduced the amendment to the Energy Saving Regulation (EnEV 2014). The new regulation puts additional pressure on new building costs and could potentially increase them by as much as 8% according to sector representatives[13].

11 Bloomberg, LLC. November 8, 2015, Deutsche Wohnen Urges Vonovia Investors to Stop Hostile Takeover, by Dalia Fahmy.
12 Thomson Reuters. February 10, 2016. Vonovia's hostile bid for Deutsche Wohnen crumbles.
13 Green Building Advisor. May 27 2014. German Building Codes Keep Ratcheting Up, by Andrew Dey.

While the German government struggles to deal with the influx of migrants fleeing war and poverty, the German property companies see an opportunity in one million new tenants. Figure 6 shows that net migration to Germany has been increasing since the GFC. Geopolitical strife should only accelerate this trend. Our conversations with management teams suggest that the companies are very excited to see new renters arriving every day. This continues a trend of net migration in Germany since 2010 which is exacerbating the short term housing shortage in certain "hot" markets like Berlin, Frankfurt, Hamburg, Munich, and Dusseldorf. Property companies are quickly adapting to this wave, by focusing efforts on the most popular cities for refugees, and re-thinking apartment layouts to accommodate larger family sizes. ■

Figure 6



Source: Destatis, 2014: Migration between Germany and foreign countries 1991 to 2014: https://www.destatis.de/EN/FactsFigures/SocietyState/Population/Migration/Tables/MigrationTotal.html

Takeway 4

To continue to grow, investors must innovate

One thing is clear: the next phase of value-creation in the German residential market will need to rely on a new playbook. Investors won't be able to rely on the "easy money" of the early days, when professional operators were able to make under-managed assets more profitable, nor will they be able to feast on leverage-fueled transactions, as they have done more recently. Even the most optimistic and aggressive public companies acknowledge that they cannot continue to play by the same rules from a decade ago.

With so many variables, we think there is a wide range of potential outcomes, from wild successes to spectacular failures. (This is good news for stock pickers, of course!) German management teams have not yet shown a strong ability to execute on "blocking and tackling" of property management and operations, and instead have revealed a knack for financial engineering and aggressive asset purchases. That said, our recent conversations with management teams of listed companies reveal some hints of creativity.

Since the summer of 2015, Presima's interviews with German residential management teams have often turned to discussions of new ancillary businesses and other new avenues of growth. While these unchartered business areas are still in the early/experimental stage, we believe they are an exciting and previously underappreciated area for the sector to explore. For example:

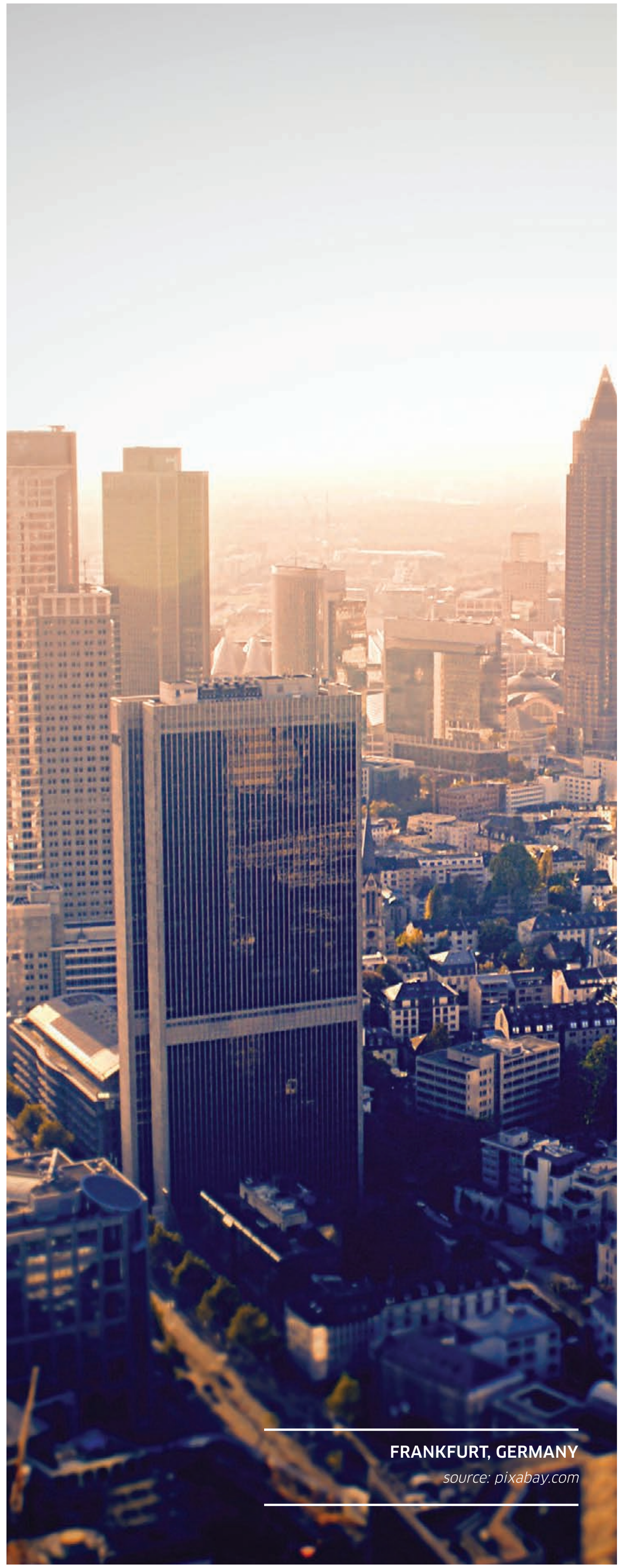
- A few of the companies are launching new apartment construction projects. A previously ignored strategy within the listed sector, the companies are focusing on high-end apartments.
- Landlords are adjusting their ancillary offerings to accommodate seniors who wish to stay in their homes for as long as possible. One landlord in particular has been increasing its efforts to make senior-friendly bathrooms and even experimenting with on-site nurses and heart monitors within its facilities.
- Many German residential companies are leveraging the scale they built as bargaining power when dealing with service providers such as energy firms and TV providers. Consequently, they are able to insert themselves as a middle man between these service providers and their tenants and generate additional cash flow. ■

Conclusion

From nearly nil a decade ago, the publicly traded German residential market has become one of the large geographic-sector markets in Europe's listed property space. It has become too big to ignore.

While we see the market entering a more ″mature″ phase, we believe that it will nonetheless provide portfolio managers in the listed market with many options to make money by investing in attractively-valued stocks.

We do not necessarily think that the ″biggest″ company with the ″best″ portfolio in the "best" markets currently will deliver the best long-term returns. Instead, at this point in the cycle, we think the key will be to identify and invest in those management teams with a long-term vision of the future, who can successfully negotiate the regulatory maze, capitalize on demographic shifts, provide attractive assets and service to tenants, maintain financial flexibility, and operate with an efficient business model. In sum, we think the next chapter will read very differently than the last ones. ■



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source: pixabay.com