

REFIRE REVIEW OF 2008

Traditionally, in our last issue before Christmas, we look back over the previous 20 issues that appeared during the year to see what we were thinking at the time. This is not just for nostalgic reasons - although we too could use all the good cheer we can find over this chilly Yuletide season. No, it serves rather as a check on our own reasoning, to measure how our views, published at the time, stack up AFTER the event, or events, that have led to 2008 being such a tumultuous year for our subscribers and other professionals working in German real estate finance. Here are some excerpts from what we said:

January 15th, 2008

(On the coming year 2008)

...We're going to say this loud and clear. A lot of people are going to get much poorer this year, and among them are many who persist in believing that the credit crisis will have blown over by the end of the second quarter. A few more write-downs, a bit of cleaning up the balance sheet here and there, and we should be back to business as usual, non? No. We're in for a torrid ride, which is going to hit overextended institutions and individuals in the nastiest of ways, as the tentacles of the credit crunch extend into other areas of the economy.

January 30th, 2008

(On George Soros and the 60-year superboom)

...In our view he (Soros) deserves

credit, for his self-awareness of his role as both a market participant on the one hand, driven to be on the profitable side of the trade, and on the other hand, an observer of the damage caused by market participants acting solely in their own interests. Soros believes that the current financial crisis is the culmination of a super boom that has lasted for more than 60 years... We think he's correct on one count, at the very least. The vast, untrammelled credit expansion of the last 15 years is not coming back until we've had a severe contraction. We're inclined to believe that he has his timing right on this one.

...Here in Germany we've just witnessed Hypo Real Estate stock crashing 35% in one day, an unheard-of drop for a DAX 30 listed company. The market punished the company for lying repeatedly about its sub-prime losses, and promptly wiped five times as much off the company's market capitalisation as the extent of the admitted losses. Did the board members know that they were lying? Are the figures now published by most financial institutions entirely fictitious? Were blind eyes turned to the possibility of another outcome in a Soc Gen trader's positions? We certainly think it's possible. We're certain that the desire for oversized commissions will override a multitude of sins.

March 31st, 2008

(On the prospects for commercial property)

...Indeed, despite worldwide acknowledgement of the credit crunch, practitioners in the commercial real estate industry have been slow to recognise the impact that the credit crisis will have on the commercial segment. In Germany and other continental European countries, it seems to have taken until last month for many

sellers to wake up to the new realities. For many, the penny has still not dropped...Optimism in the robustness of the conservative German market still reigns supreme in too many quarters. In our view, current projections for the volume and price levels achievable in Germany for 2008 are still far too rosy, despite the discounts on previous prices and net asset values that can now be had.

...If investment volumes fall by half this year, it still represents a mighty increase over previous levels. With international investors responsible for about 80% of the capital invested in the last two years, many of whom have now disappeared, further price drops are inevitable.

May 5th, 2008

(On German property returns)

Price developments in Germany are seen by the DIW's study as having had a distributing effect on the nation's assets, with one group of consumers, the property owners and landlords, being the losers while another group, the tenants, have profited doubly. Firstly by benefiting from low and stable rents, and secondly by not losing money on property ownership. Hmmm. Recent investors in German commercial property will be asking themselves where this leaves them, and to what extent their capital appreciation is about to return to the long-term German trend rate.

...Figures released last week by IPD show the annual and previous years' returns on the DIX property index, which includes both net cash

flow returns and capital appreciation. Investors are, of course, interested in their total return, and according to the DIX figures, retail property returned 6.8%, followed by residential with 6% and office properties 3.3%. As long as the rental markets across these sectors continue to hold up, Germany will remain an attractive location for the long-term investor...

But what drivers, apart from inflation which pushes up the replacement cost of properties, will provide the impetus over the coming years for the long-awaited capital appreciation, whose time, with the ready availability of cheap finance, was so enthusiastically believed to have come?

May 29th, 2008

(On German consumer retail spending)



...We were happy to see Cordea Savills taking an upbeat view on the prospects for Germany's retail sector. Almost simultaneously, our attention was caught by a rather more sombre report carried out by the German consultancy group BBE Retail Experts, who forecast the emergence of an increasingly pinched German consumer, whose disposable income is increasingly being consumed by fixed living costs, with less and less to spend in the shopping malls of the future.

...According to BBE, German con-

sumers' disposable income will rise by 3.1% in 2008 to €1.565 billion, but the traditional retail sector has been seeing its share of disposable income sinking for several years and is likely to do so this year as well. BBE calculates that retailers' share of private consumption will amount to 29.2% this year, a far cry from the 42.1% of disposable income the sector claimed as recently as 1991. Higher costs for living space, increased charges for water, electricity and gas, a higher burden for health insurance and private old-age pension provisions, all are taking their toll on the amount available for spending in life-style shopping malls.

June 16th, 2008

(On the Whitehall Funds (Goldman Sachs) acquisition of the 95,000-unit LEG residential portfolio)

...So what experience are the earlier, opportunistic buyers of German residential portfolios now gaining, that they wish, in retrospect, they'd had before signing on the dotted line. According to Dekra, Germany's testing, measuring and valuation supremo, earlier portfolio buyers often failed in their duties of technical due diligence on the properties they were buying, and are learning that this negligence is costing them dear.

...

But frequently, the mistakes made were those which had their roots in wishful thinking. Business plans were frequently based on wildly optimistic projections for rent increases or the willingness of tenants to buy their own four walls. The investment required to turn old, unattractive flats into objects of desire was often ignored in the gold rush, particularly where high vacancy rates must have been screaming to the

would-be investors that something was amiss. But in the headlong rush for gold, with credit plentifully available, these minor details were all too often overlooked.

June 30th, 2008

(On German economic self-delusion)

To study the international business press, and listen to German real estate experts talking about the stability of Germany, it would be easy to get the impression that Germany represents a sea of tranquillity surrounded by the collapsing dominoes of overheated and over-borrowed European neighbours. A safe haven, characterised by fiscal rectitude and puritanical thrift, the strength of whose export industry will safely steer its social market economic model back to its rightful role as Europe's economic powerhouse.

...But Germany, for all its strengths, is not immune to the downward pressure on real estate prices that is becoming increasingly visible in other developed markets. Successful exporters need factories, not plush skyscrapers in central business districts. Not having boomed in the same way as other markets is no protection for the German real estate industry against fiscal realities. Those fiscal realities are now marshalling their forces and building up their war-chests to profit from a correction in German prices that has yet to take place.

...Volumes, and prices, have further to fall before we reach the point where private equity investors are seeing true value in re-entering the market. Apart from domestic sellers, there is a size-

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able overhang of distressed (or soon-to-be-distressed) foreign investors who find they don't have the stomach or the financing to see their projects in Germany through to providing the required returns...Banks are looking for three times the level of equity of even a year ago, and charging margins on loans that are triple their previous levels. So, what gives? The answer, as we will find out before this year is up, is that prices will give, that's what. The new challenge, of modernising properties prime and non-prime, and of filling them with satisfied and high-paying tenants, will demand concessions from sellers whose notional idea of the value of their properties has already passed its sell-by date.

July 16th,2008

(On commercial rent levels)

...We expect a further price correction downwards for commercial properties before big investors re-enter the market in a significant way. The conventional view in Germany is that the economy is doing well, rents are rising to reflect the optimistic outlook, unemployment is dropping, vacancy levels are falling, yields are rising. We take issue with a number of these views. It is true that top rents are rising – albeit still well below levels achieved at the height of the dot-com boom. Top rents only tell part of the story, however. They are paid by prestigious banks for whom an extra euro here or there on rent per square metre is not normally contentious.

In Frankfurt, for example, peak rents have risen to about €39.00 per sq.m, well below the rents paid eight years ago of €50.00. Compared to

London or New York, these are low rents, but Frankfurt is a banking centre, and the immediate future for the banks is not looking good. As Germany stagnated in the early part of this decade, all these tenants negotiated their rents downwards, often significantly.

...Long experience in Germany suggests to us that the German economy lags the Anglo-Saxon world, both on the rise and on the fall, by about eighteen months to two years. A sort of puffer-zone exists, an isolating wall of cotton-wool that acts to protect Germany from experiencing the same forces of capitalism, red in tooth and claw, that others are feeling at first hand. This is one of Germany's strengths, allied to a deep official aversion to the collective speculation in money matters that is about to lead to such misery in the UK and the US.

August 27th, 2008

(On German retailing, and the insolvencies of Hertie, Wehmeyer and SinnLeffers)

...That the three groups found buyers at all (from KarstadtQuelle in 2005) was a testimony to mainly Anglo-Saxon investors' belief in German consumers finally loosening their purse strings, and riding heroically to the retailers' rescue. It didn't happen then, and it's not happening now. The savings rate in Germany has risen to 14.5% in response to the recovering and still fairly buoyant economy. Despite rapidly rising costs, more consumers have more money than they had three years ago. But it's not being spent where retail property investors want it spent, and it's not justifying the high prices paid to gain a foothold in the market for retail investment property. Investors whose business models are based on outdated pro-

jections of healthy and rising German spending need to re-examine those assumptions, fast.

...Peak rents for prestige properties are still nominally rising. But across the board, the rising yields we are seeing as credit tightens up across Europe cannot disguise the fact that, outside the primest of locations, in retail as in the office sector, rents will have to fall. They are probably doing so already... In Germany, as elsewhere, the deepening financial crisis will inevitably make its presence felt on the high street. The next quarter's figures will show that it's already happening.

September 17th,2008

(On Frankfurt commercial property)

...The OpernTurm project is a joint venture between Tishman Speyer and the Swiss bank UBS, who has also committed to leasing half the property for their new German headquarters. The rents payable will be the highest in the city – as befits the quality and location of the property.



But there's still time to rent the other half of the property, and share a prestige address with Switzerland's leading bank. Assuming, of course, that it still is Switzerland's leading bank by the time it comes to move in.

...Whatever the two partners see from the windy heights of their latest creation, they've come to the conclusion that now is a good time to sell. They've put the property on the market, reputedly for between €550m and €650m, which would make it Frankfurt's biggest property deal of the year, should it find a buyer soon. *(A sale to German fund KanAm for a lower sum was confirmed shortly after our report, and subsequently cancelled.)*

... But Frankfurt's property market, which has remained relatively immune to the drastically-changing global financial landscape, will soon start to feel the chill winds that are turning the banking world on its head elsewhere. The stability and 'staidness' of the banking industry in Frankfurt, seen by its defendants as a healthy counterweight to its boom and-bust cousins in the more dynamic and free-wheeling London and New York, cannot in itself provide the motor for new banking developments in Europe. London's pre-eminent position in Europe will remain unchallenged, despite the forthcoming layoffs and the shrinkage in the banking industry which will be a feature of the coming years.

...We have often exhorted REFIRE readers to jump in their cars and go foraging around the smaller German towns looking for value in property. These properties may not make the headlines, but with the help of a strong local partner, they can provide attractive returns with low risk. Watching investments in Fannie or Freddie, or Lehman or Merrill or AIG or Washington Mutual or a host of other companies, supposedly as safe as the houses that they back, being

flushed down the pan, we know how the unthinkable can quickly become the horror of the unforgettable. We'd settle for a staid 7% return on our money over the leaner years ahead.

October 3rd, 2008

(On Germany's banks)

...We at REFIRE have watched aghast over the last six months as Finance Minister Peer Steinbrück swatted away reporters anxious to discuss the credit crisis, effectively dismissing the issue as a minor local Anglo-American affair. Ten days ago he abruptly changed his tune, and launched a diatribe at the US, charging the US authorities with the failure to regulate and oversee the banking sector (in stark contrast to safe, secure, all-seeing Germany, we assume). He's now up to his oxers in negotiations with financial watchdog BaFin, the Bundesbank, and the state and federal governments, to salvage the crumbling edifices of the German banking sector.

This will inevitably mean a lot more federal help at taxpayers (and non-taxpayers) expense. He's not alone in Europe, as governments throughout western Europe have spent sleepless nights all this week bailing out their national champions. But he's being disingenuous in denying German complicity in the whole banking collapse that we've been witnessing. The danger is that the wrong lessons are being learned, which may only serve to further stifle entrepreneurial culture in Germany.

The destruction of wealth among German banks and listed property companies has been no less severe than in the world's more free-wheeling and capitalistic economies. ...Tougher times

lie ahead for all. We wonder if there is a German pre-disposition to being school-marmishly disciplinarian at home, where the official culture promotes high-minded morality in fiscal matters, and the urge to let rip on the poker tables overseas - the very places where the shrewdest veterans are trained to spot the patsy at the table. We would be disinclined to think this if the German model had proved itself to be indisputably superior. But, after Hypo Real Estate, the sixth German bank rescue so far, has it?

October 23rd, 2008

(On the German bank bailout)

...The near freezing of the Pfandbrief market is indicative of the state of close-on panic induced by the enforced bailout of Hypo Real Estate, which has cast a long, gloomy shadow over the German investment market...In this, Germany is suffering in the same way as its neighbours, but with the difference that the inbuilt mechanisms in the German financial industry were specifically designed to withstand the follies of more traditionally profligate nations. With sand now jamming up the gears, our real concern is that the counter-measures taken at the darkest hour will prove to be counter-productive to the rapid recovery of a healthily-functioning real estate industry.

...As over-leveraged property investors go back to their banks to re-negotiate their loans, they're increasingly finding that the world has changed utterly since they signed on the dotted line. The banks they're dealing with have a totally new sce-

nario, imposed upon them by shrunken balance sheets, moribund re-financing markets, and new directives issued by either their new government guarantors or draconian new capital rebuilding requirements after the recent stock-market meltdowns.

...And what SHOULD happen next, following massive government bailouts to restore order and liquidity to the markets and to enable banks to repair their balance sheets, certainly won't happen in the manner which the government intervention model predicts. That much can be foreseen.

The Anglo-Saxon economies and others are headed into a period of real recession, which will be exacerbated by falling real residential and commercial property prices. In the absence of above-average inflation, the previous price levels achieved are unlikely to return for the next fifteen to twenty years.

December 9th, 2008

(On the freezing of the German open-ended funds)

...Up until two months ago, with a few minor hiccups in the past, the system largely worked. Record sums were being invested in the open-ended funds sector, and the funds seemed set to stride a cash-strapped Europe and beyond, plucking the choicest real estate morsels at bargain prices by dipping in to their well-filled wallets.

And now what? About 40% of the funds by assets are now frozen to redemptions for at least three months.

The German government guarantee on bank deposits has led to further massive withdrawals from the funds where it is still possible to do so, in favour of government bonds and cash instruments.



...The shenanigans in the German real estate sector in the last two months have spelt the death-knell for the open-ended fund model as we know it. If we at REFIRE were ever inclined to have the odd flutter, we'd be betting on major changes ahead to the rules on open-ended fund investing. We are certainly expecting the pent-up pressure to withdraw capital from the funds to make the official three-month deadline look overly-optimistic.

We think it's likely to be a year or even longer before most investors can withdraw their funds. New rules to prevent institutional investors parking their funds in the vehicle and using them as a cash account, while nominally in force for those investing 1m or more, are going to be written into law and more strictly enforced. More fundamental changes are also afoot.

But in the meantime the funds, until so recently seen as the white knights on an ever gloomier property landscape, will be faced with their own need to maintain adequate liquidity and there will be no escaping the marking of their prime assets to the real, affordable, market. Their investors will now stand for nothing less.

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developing its revenue streams from holding long-term ground leases.

To make cost savings of €5m a year, out go the offices in Frankfurt, Prague and Luxembourg, while their functions are being centralised in head office in Cologne. Of more than 260 subsidiary companies, 50 units are being merged or closed down. Staff numbers have already been reduced by 20% to 100 employees. Non-core activities such as developing asset management capabilities for third parties have been pared back, as has the strategy of acquiring cash-flows on ground leases for solar and photovoltaic plants in southern Europe, in favour of renewed concentration on residential buying and selling, and generating cash from ground leaseholds.

CEO **Michael Jung** is leaving the board at the end of the year, along with fellow board member **Timo Herbrand**, who moves to the supervisory board. In line with its peers, the Vivacon share price has plunged 80% this year, while the company recently withdrew its original full-year profit forecast of €60m.

In light of the almost complete stagnation on the transactions market, Michael Jung recently justified the shift away from large-scale property trading. "We're now concentrating on acquiring cash-flows from ground rents (which Vivacon sells on to the capital markets in the form of securitised vehicles). We're having to adapt our strategy, since we don't see the transaction market coming back to life any time soon."

Germany/Study

New Feri survey shows institutional investors favouring indirect property holding

The fallout from the financial crisis has seen a marked shift in attitude among German institutional investors,