

Research

David Skinner, PhD
Director of Research, Europe
London Office
Tel +44 (0) 20 7758 4883
david.skinner@pramericarei.com

Prudential Real Estate Investors
8 Campus Drive
Parsippany, NJ 07054
USA

Tel 973.683.1745
Fax 973.734.1319
Web www.prudential.com/prei
E-mail prei.reports@prudential.com

Executive Summary

- The German residential sector looks like a defensive play in an environment of rapid asset-price appreciation on the back of excess liquidity in the global financial system.
- International private equity investors seeking opportunistic returns via the purchase of large residential portfolios have dominated activity.
- The sector is evolving rapidly as a wider range of investors is noting its favorable asset- and market-level dynamics.
- First-mover advantage has been exercised. As the market becomes more institutional, achieving opportunistic returns is becoming increasingly challenging.
- The market is far from mature and will continue to provide rich opportunities for investors with a lower cost of capital, seeking more modest target returns.

Introduction

Excess liquidity in the global financial system continues to drive significant price appreciation across a wide range of asset classes. This theme is highly visible in the real estate sector, where strong investor demand over the past two or three years has pushed yields for residential and commercial property – in mature, developing and emerging markets – close to all-time lows. This has occurred despite the general weakness in underlying leasing market fundamentals over much of this time.

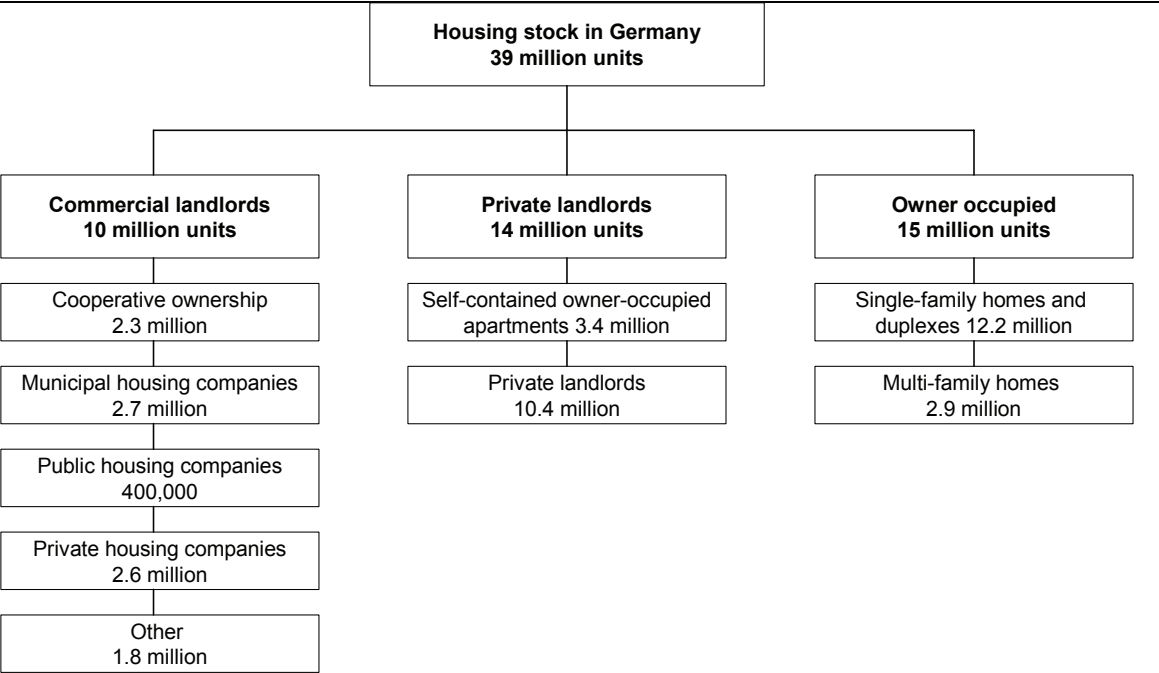
Price appreciation, however, while widespread, has not been universal. One of the most notable exceptions is in the German residential sector, where indexes of national house prices have been fairly static since the early '90s. This seems incongruous when no stone is left unturned in the search for value and when international investor demand for German housing portfolios over the past few years has been strong.

This report provides an overview of the fundamentals of the German residential market and the investment opportunity it offers. Following a brief description of the size and structure of this market, we examine the motivation for the recent interest in the sector and identify and assess the key determinants of future performance.

Stock and Structure

According to the Federal Statistical Office, Germany now has about 40 million housing units, making it Europe’s largest residential property market, with an estimated value of roughly €5 trillion. Of this, small private landlords own about one-third (14 million units). Large professional providers, such as municipal housing associations, public-sector corporations, housing cooperatives and private housing companies manage one-quarter (about 10 million units). The rest, just over 40% (15 million units), are owner-occupied (see Exhibit 1).

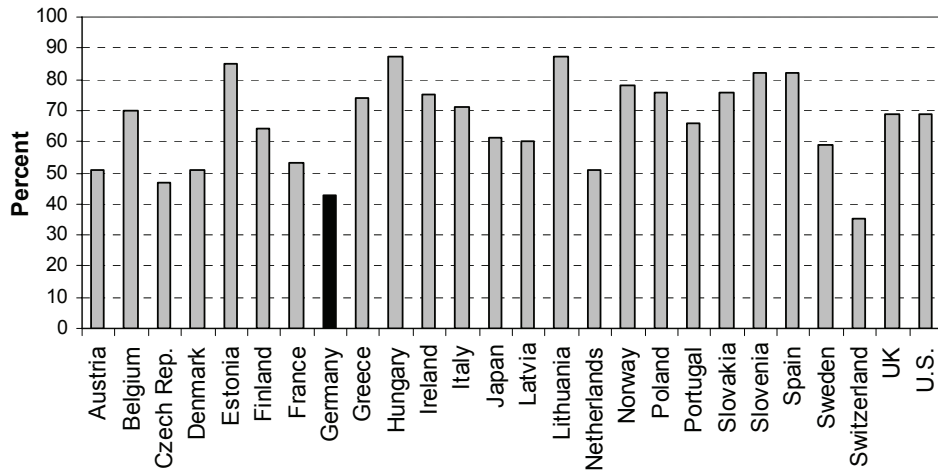
Exhibit 1: Structure of German Housing Market (2002)



Source: Federal Statistic Office

Although varying greatly across cities and regions, by type of housing unit, number of household members and by age and wealth of households, the mean owner-occupation ratio for Germany is very low by international standards (see Exhibit 2), which is partly a function of the structure of the housing stock. Germany’s post-war situation necessitated extensive state intervention in the housing market and led to the construction of subsidized social housing (mainly rented apartment blocks) in and around city centers. At the same time, the government introduced tax incentives for landlords. Thus, Germany has comparatively more apartment blocks and relatively few one- and two-family homes, compared with other countries.

Exhibit 2: Current Owner-Occupation Ratio by Country

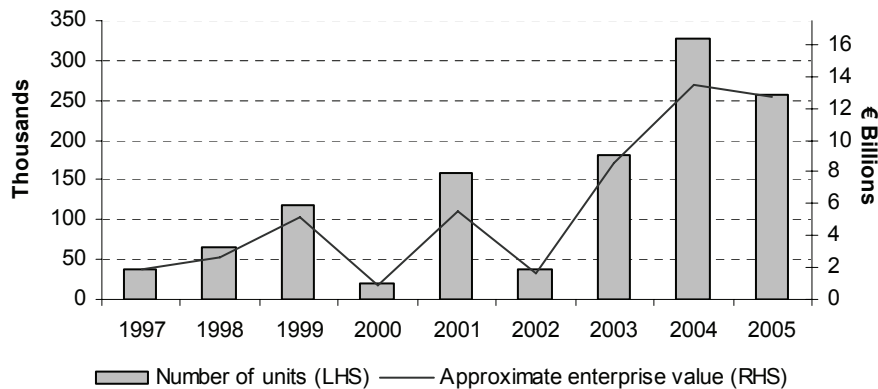


Sources: Eurostat; RICS Housing Review 2005; U.S. Housing Vacancy Survey 2005; Japan Statistical Yearbook 2005

The housing policies of the '60s and renovation programs of the '70s reinforced this trend, as did government support of the rental sector during the housing shortage arising from reunification. Also, public-sector construction companies build a high portion of residential properties, with much of the space let to tenants at subsidized rental rates. These factors, along with high land prices and high construction costs relative to other European countries, erode the relative financial attractiveness of owner occupation.

Concerns about an aging population and its effect on public expenditure have encouraged a policy shift in recent years designed to raise the owner-occupation ratio. At the same time, companies and local authorities are increasingly disposing of residential property portfolios, either because of budgetary pressures or to focus on their core businesses. Since 2000, these entities have sold more than one million units (in transactions of more than 5,000 units), mainly to international investors (see Exhibit 3). Many of these investors are seeking to privatize a significant portion of these units over time, which will also raise the owner-occupation ratio.

Exhibit 3: Residential Portfolio Transactions - Number/Value of Units



Sources: Deutsche Bank; Kempen; Morgan Stanley; UBS; Prudential Real Estate Investors

The Investment Opportunity

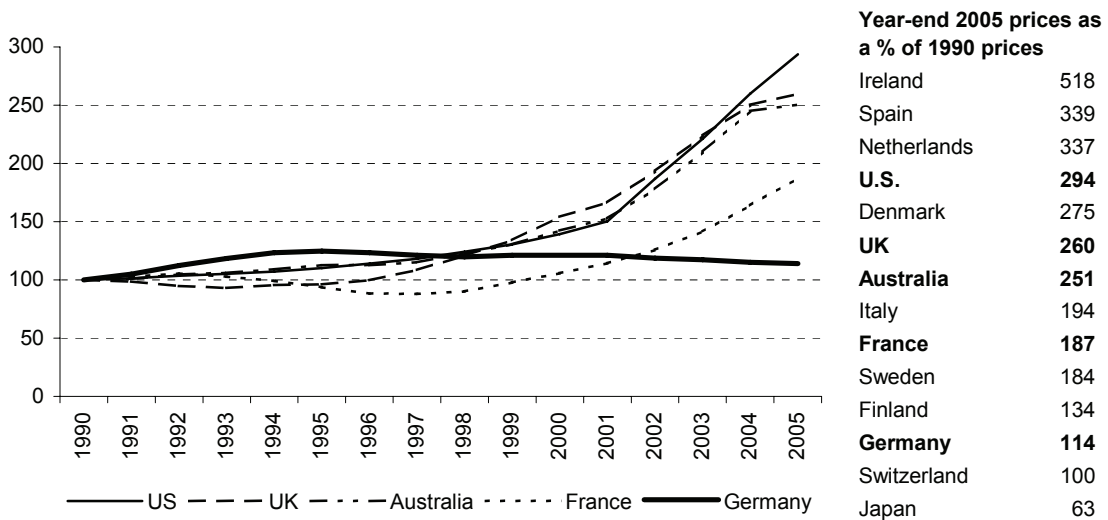
International investors have been active in the German residential sector since the late '90s. Private equity investors seeking opportunistic returns through the acquisition of large residential portfolios have dominated this activity. Undoubtedly, a desire to gain exposure to Europe's largest real estate market has spurred demand: until relatively recently, foreign investors found it difficult to penetrate Germany's commercial real estate sector. However, amid the consolidation of the German residential market, these investors have also been attracted by:

- The low volatility of residential rental yields and reliable and predictable cash flows.
- The ability to enhance rental yields with a more efficient asset management infrastructure and more intensive property management.
- The opportunities to create acquisition platforms to identify and execute deals to reach a desired scale, to replenish privatized stock, and to integrate newly acquired portfolios in a way that capitalizes on operational synergies and economies of scale.
- The positive fundamentals underlying an arbitrage opportunity between portfolio acquisition prices and privatization sale prices in a low-owner-occupation environment.
- A low-interest-rate environment, which can help generate attractive leveraged cash flow returns and (to the extent that mortgages can be serviced more comfortably, thus increasing the attractiveness of owner occupation) can support privatization rates.
- The profile of German house prices over the past decade, which has been fairly flat, in sharp contrast to the housing booms in Western Europe, the U.S. and Australia in recent years (see **Exhibit 4**).

Few of these early investors entered the market with long-term buy-to-hold strategies. Their business models typically depend on developing and improving the operating efficiency of asset management and acquisition platforms to realize synergies and cost-savings from scale, creating value through intensive portfolio management and the maximization of sale proceeds. Potential exits for value realization include sales to owner-occupiers on a unit-by-unit basis, block sales to investors operating further down the risk spectrum, the creation of funds (perhaps through a public market listing) and the securitization of income streams. These investors have often been successful in the pursuit of these strategies.

The past few years have seen the entrance of a different type of investor, focused on longer-term, lower-returning strategies and motivated more by diversification (in some cases to counterbalance overinflated domestic markets) rather than performance enhancement. This group includes private and listed property companies, REITs, pension funds, and high-net-worth individuals. Like the early entrants, these are mainly nondomestic investors, although the number of German investors is also growing. To some extent, the entrance of these investors reflects a partial institutionalization of the German residential sector but also indicates changing market conditions likely to affect performance going forward.

Exhibit 4: 2005 House Prices in Germany Relative to Other Countries (1990 = 100)



Sources: OECD; INSEE; Swiss National Bank; Australian Bureau of Statistics; Japanese Real Estate Institute

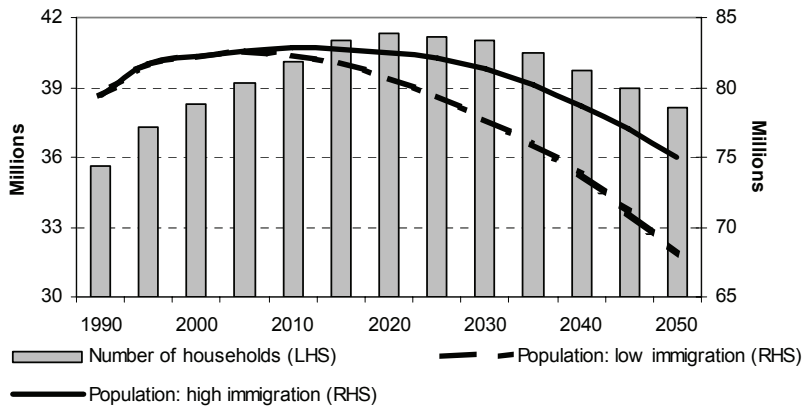
Performance Drivers

A wide variety of factors influence the performance of the German residential sector. The drivers have been well-documented in the literature to-date and in the summary below are separated into those affecting supply and demand at the asset level and those affecting demand for residential portfolios at the market level.

Asset-Level Drivers

On the demand side, while German national population projections are not supportive of occupancy demand over the long term (see Exhibit 5), two key trends will still drive demand well beyond typical investment horizons. First, immigration and regional and urban migration will lead to strong growth for some regions, while others will see net population declines. In general, changes in population will be broadly aligned with the economic strength profile of Germany. However understanding local dynamics will remain a key determinant of investor success.

Exhibit 5: Population Projections and Household Formation



Source: Federal Statistics Office

Second, Germany’s aging population, along with social factors such as young people pursuing independent living, couples starting families later and an increasing divorce rate, are contributing

to the trend of smaller household size and, by implication, to increased living space per person. (Space per person has also grown as a result of changing consumer preferences and increased wealth.) According to the Federal Office of Construction and Regional Development, the number of German households is projected to continue to rise, at least until 2020, despite the anticipated stagnation and ultimate decrease in population. Between now and 2020, the number of households is projected to grow at an annual average rate of 70,000.

In addition to demographic factors, several government policy changes might affect demand for German residential real estate. While economic reform is generally considered to be detrimental to economic performance in the short term, two key components of Germany's reform program could have a beneficial impact on housing demand.

First, due to the government's recent social reforms, Germans are becoming somewhat more reliant on private provisioning for retirement. As real estate continues to be seen as a safe and appropriate (long-term inflation hedge) investment for retirement provision, pension reform will likely have a positive effect on owner-occupier demand for residential property.

Second, since the introduction of the Hartz IV reform, unemployment and social security benefits have not only been greatly reduced but are also subject to means testing. Whether or not people are eligible to receive benefits now depends on their savings, life insurance and spousal income. People will only receive benefits if and when their reserves are used up, subject to allowable deductions. One such deduction is an owner-occupied residence. Anecdotal evidence in the housing privatization market suggests that even when faced with the threat of being laid off, tenants have a propensity to convert whatever savings they have into equity for the acquisition of their rented apartment, with a view to creating a deductible shelter for their assets.

In the 18 months since inception, Hartz IV has had several unintended consequences. Not only has the reform failed to reduce unemployment to the extent envisaged, but welfare costs have increased enormously, thereby jeopardizing the government's efforts to bring finances under control. While modifications to the legislation designed to close some of the loopholes were passed recently, more ambitious reform is expected this fall, which could reverse the positive impact of the initial Hartz IV legislation on the demand for owner-occupied residences.

Another policy issue capable of affecting owner-occupier demand is the abolition of first-time buyers' subsidies in January of this year. While the reduction of this subsidy in 2003 did not noticeably affect prices at that time, anecdotal evidence suggests that its abolition may have had an adverse effect on demand more recently.

The level of liquidity in mortgage markets also influences demand. A new law abolishing penalties for early mortgage payoffs and an anticipated rise in the range and availability of mortgage products in the context of the EU single market are, other things being equal, likely to reduce the costs (borrowing rates and credit margins) associated with mortgage finance, to increase housing turnover and to raise owners' ability to withdraw equity.

Of course, the general interest-rate environment is a more important determinant of financing costs and affordability than the level of liquidity in mortgage markets. Long-term interest rates are the more important benchmark in terms of mortgage affordability (most German mortgages are long-term and fixed-interest). Ten-year government bond yields have been very low by historic standards in recent years, which has had a positive impact on the relative pricing of owner occupation and renting. Clearly, recent increases in longer-term interest rates have eroded the relative attractiveness of owner occupation. Any further rise will affect transaction activity in the housing market and therefore the performance of residential funds, where privatization is a key component of strategy. Importantly, the performance of funds for which relatively low rates of privatization have been assumed is less sensitive to interest-rate movements.

On the supply side, the construction boom, which followed German reunification, led to severe oversupply problems in many markets (which still persist in some) and to an increase in the stock of German residential property of more than 10% during the '90s. At the peak of the boom in the mid-'90s, completions stood at about 600,000 units per annum, according to the Federal Statistical Office. Completions are now running at less than half those levels (280,000 in 2004 and 260,000 in 2005, according to the latest IFO estimates). Over the next 10 years, completion rates are expected to average about 300,000 per annum, which is up compared with the past few years but below the estimated long-term requirement of 350,000.

Other things being equal, transfers of housing portfolios that might help satisfy the demand of a wide array of investors should continue at a robust pace. Severe budgetary pressures among municipalities and public-sector companies, which together account for more than three million units, may accelerate over the next few years. In addition, the first generation of private equity investors are likely to put many units on the market through block sales or through the listing of vehicles, as business plans are realized. Several investment banks close to the market estimate that over the next five years, up to one million units may become available to portfolio investors. However, the sale of housing units to private equity investors, particularly non-Germans, remains a politically charged issue. To the extent that such transactions may be subject to tighter regulation, the future rate of transfers is uncertain.

Market-Level Drivers

Besides the asset-level drivers noted above, a relatively favorable market has attracted investors. First, the German residential market looks defensively priced. While housing and other asset markets worldwide have seen rapid price inflation over the past few years from excess global liquidity, German residential prices are, on average, unchanged compared with the late '90s, albeit with large regional variations. Thus, compared with many European housing markets, relatively little downside risk exists for German house prices. On the contrary, recent OECD analysis of international house prices concludes that relative to fundamentals, the extent of undervaluation in German house prices has risen over the past 10 years.

Second, the combination of tax incentives and subsidies that have historically supported the rental market may erode. Although a politically sensitive issue, budgetary pressures at the local, state and central government level may result in rental controls being reduced over the next few years, which, other things being equal, will raise the attractiveness of owner occupation.

Importantly, as noted above, the business plans of many investors in this market will, through privatization, support this rise in the owner-occupation ratio.

Subsidized rental agreements and the fact that public-sector owners often do not seek to maximize revenues from their housing portfolios mean that portfolio rents can be greatly below market, which offers investors downside protection from weakening rental market conditions. However, rents on existing leases cannot be raised by more than 20% in any three-year period, unless a material change in quality occurs over this time, which limits investors' upside.

A More Challenging Environment Ahead?

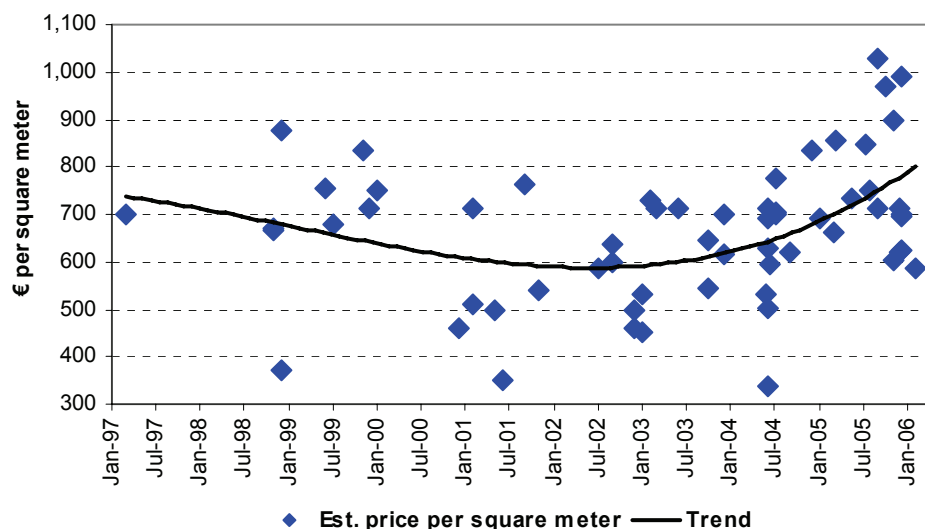
Because a wider range of investors has recognized these relatively auspicious asset- and market-level dynamics, the German residential market is rapidly evolving. Moreover, its evolution is likely to make the achievement of opportunistic returns more difficult for today's new entrants, as the risk-return profile of the sector changes.

Acquisition Environment

As the market has become more institutionalized (partly from the efforts of the early entrants in creating acquisition platforms and asset management infrastructure), the number and type of investors seeking exposure to the sector has grown enormously. A byproduct of this is that competition for newly marketed portfolios has intensified. Anecdotal evidence suggests that recent transactions have commanded initial offers from more than 20 bidders.

As competition for new supply has grown and portfolios are marketed increasingly more professionally, upward pressure on sale prices has occurred on all metrics (price per square meter, price per unit, net rental income yield and purchase price as a multiple of net rent). **Exhibit 6** shows the estimated average price per square meter for a sample of more than 60 different portfolio transactions over the past nine years. The estimated price has risen from about €600 per square

Exhibit 6: Residential Portfolio Transactions



Sources: Deutsche Bank; Kempen; Morgan Stanley; UBS; Prudential Real Estate Investors

meter in 2001-03 to about €800 now. While data on net rental yields is somewhat less reliable, reports exist of portfolios transacting recently on a net rental income yield (current rent net of vacancy as a share of price) of less than 6%. This compares with yields of more than 10% in transactions before 2004. Variations in the quality of the portfolio in terms of condition, location, age, size, type and environment of units may explain part, but not all, of the rise in pricing.

In addition to rising transaction prices, increased competition for stock may also affect investors' ability to achieve sufficient scale in their platforms (in a reasonable time frame) to capitalize on operational synergies and to replenish privatized stock. Indeed, the one million units that are likely to be transferred to the market over the next five years may not be sufficient to satisfy the demands of those investors now active in the market.

These market conditions will certainly benefit those that have achieved their desired scale and are considering block sales as an exit. Equally, however, they could adversely alter the performance of investments where a large part of total return comes from future purchases – time is an enemy of investors seeking opportunistic returns. Competition for portfolios will likely result in increased M&A activity and “strategic partnering.”

Privatization Arbitrage

Other things being equal, the upward pressure on acquisition prices undermines the underlying arbitrage opportunity between acquisition prices and privatization sale prices. The business plans of some opportunistic investors rely on fairly aggressive assumptions regarding the rate of privatization – in some cases in excess of 20% of total units per annum. One of the key drivers of performance is the weighting of the various exit channels, which vary from low-margin bulk and portfolio sales to high-margin vacant, owner-occupier and investor sales. If investors cannot maintain the target sales mix, the probability of being able to achieve opportunistic returns falls.

Privatization rates will depend, to some extent, on the specific characteristics of units within the portfolio. In general, better quality units tend to privatize more easily than poorer quality ones. For example, empirical evidence suggests that units built in the '60s, with balconies, surrounded by open green space, close to good road transport links in the suburbs of metropolitan areas with high employment tend to privatize very well. As the best units are privatized, however, the average quality of the remaining portfolio deteriorates. While new acquisitions can replenish stock, the quality mix is likely to deteriorate over time, especially in a tough acquisition environment. By implication, privatization rates would be expected to deteriorate over time.

Investors' target returns are not typically predicated on positive real house-price growth. Some good arguments support the case for modest real increases in German house prices over the medium to long term, which could be a source of upside. Note, however, that Bulwien forecasts national-level house-price growth of just 1.6% per annum over the next five years (marginally below EIU forecasts of inflation of 1.8% per year over the same time). However, privatization prices, currently averaging about €1,000-1,200 per square meter, but with wide variations by region and quality of units around this band, could come under downward pressure over the short term, as the volume of units available for privatization rises. Clearly, this would also erode the currently attractive premium of privatization prices over portfolio acquisition prices.

A large improvement in Germany's economic outlook could provide a fillip to privatization rates by raising demand for owner-occupied housing (via improved consumer demand, increased job security and higher disposable income), one of the principal catalysts for house-price growth.

Interest Rates

Certain factors in achieving privatization rates are within investors' control, such as hiring a sales force, teaming with finance providers, and decisions over how much and when to renovate buildings for privatization, but other factors are beyond their control. One issue that greatly affects tenants' decision to buy is interest rates. As noted, increases in German longer-term interest rates since the start of 2006 have eroded the relative attractiveness of owner occupation. Any further rise will undoubtedly affect transaction activity in the housing market and, thus, the performance of residential funds, where privatization is a key component of strategy.

Financial markets now anticipate a rise of 125 bps in short-term rates in the euro zone before the end of 2007. Higher short-term rates, in addition to affecting long-term rates if unanticipated by the market, will also impede investors' ability to aggressively leverage the stable and highly predictable cash flow generated by these portfolios. Of course, this leverage potential is further undermined by the fall in portfolio acquisition yields seen in the market over the past few years. Also, higher rates may limit investors' ability to raise additional equity to finance acquisitions.

Residual Portfolios and Exit

Many German residential business plans depend on the creation of value through intensive asset and portfolio management and the maximization of sales proceeds, predicated on ambitious privatization rates. However, as privatization occurs, the quality of residual portfolios declines, with a correspondingly lower valuation per unit. While high levels of capital expenditure can help mitigate this in markets where demand is strong enough to warrant the expense, some units, perhaps in oversupplied markets or in areas where tenant demand is weak, will not warrant it. The exit route in such cases is unproven.

Several large residential investors have stated that they will seek public listings as exits for their portfolios when business plans have been realized. Over the past two years, significant discussion of German tax-transparent, listed real estate investment vehicles has taken place. Although the Federal Department of Finance continues to draft legislation to introduce REITs in January 2007, the structure of the vehicle and the type of assets to be admissible, among other things, remain issues of intense political debate. While the REIT issue is still a risk, several investors have stated their intention to publicly list vehicles if market conditions permit.

Conclusion

Germany's residential sector looks like a defensive play in an environment of rapid asset price appreciation and excess liquidity in the global financial system. The diversification benefits, favorable demographics and low vacancy in some regions, plus the stability of the tenant base and the predictability of income streams, appear to offer substantial downside risk protection.

Construction activity remains limited, while the expectation of growth in the number of households forms the basis of favorable demand-side dynamics. A rise in the homeownership rate is anticipated, and the privately owned and professionally managed rental sector is expanding. While target returns are not typically predicated on a recovery in the German economy or in real house-price inflation, these variables could contribute significant upside.

All opportunity plays, however, are eventually arbitrated away. Changing market conditions can lengthen or shorten the period of opportunity, but sooner or later the opportunity becomes less risky, and returns deteriorate. The result is that the market becomes institutionalized and attracts an investor group seeking lower returns. First-mover advantage has been exercised in the German residential sector, and the ability to earn opportunistic returns is becoming more limited. Projected opportunistic returns are vulnerable to several factors. Among these are falling house prices and the failure of rental value growth to emerge. For some investors, returns are also highly vulnerable to the acquisition price paid for portfolios, a failure to achieve the necessary volume of high-margin privatization sales and a failure to acquire portfolios suitable for disposition through high-margin privatization sales. At the same time, increases in finance costs may dampen the ability to leverage income returns and would also be expected to limit privatization rates.

That said, the market is far from mature and will still provide rich opportunities for investors with a lower cost of capital seeking more modest target returns, and whose business plans depend less on high leverage, rapid privatization rates and achievement of scale. The key to success in this space, however, remains the quality and location of assets in the portfolios and the ability of the management team.

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Prudential Real Estate Investors
8 Campus Drive
Parsippany, NJ 07054
USA

Tel 973.683.1745
Fax 973.734.1319
Web www.prudential.com/prei
E-mail prei.reports@prudential.com

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