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PERSPECTIVES FOR COMMERCIAL REAL ESTATE SECURITIZATION IN GERMANY – A COMPARATIVE ANALYSIS

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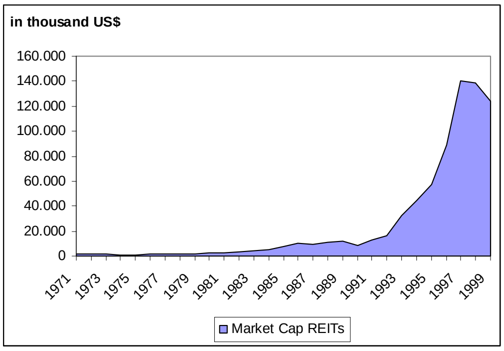
I. Introduction

With the resurgence of Real Estate Investment Trusts in the early 90´ies, the US real estate markets have undergone an enormous dynamic change that continues to exhibit momentum. This is underlined by the explosive increase in the market capitalization of REITs from $ 8.7 billions in 1990 to $ 138.9 billion in 1998 and the growing popularity of Commercial Mortgage Backed Securities and Unsecured Debt Securities as real estate finance crossed the bridge from the traditional balance sheet lending of the 1980s to global capital market financing in the new millennium.



Source: NAREIT

The current situation in Germany and most other European countries looks a little bit different. The public listed real estate is only a fraction of the total commercial real estate markets and the speed of securitization has by far not reached the US level.
In our paper we will analyze important institutional aspects of the German real estate market and their impact on the merits of real estate securitization.

We will have a closer look on the German taxation system, the behavior of German banks and the German banking system itself, and the risk-preferences of German private investors. Our analysis shall explain that these forces have so far exacerbated real estate securitization in Germany.

As some of these institutional aspects themselves are currently in a state of change, we will evaluate - in a second step - the perspectives of commercial real estate securitization in Germany in general and which of the innovative financial real estate investment products are the most promising to succeed in the German market.

II. Real Estate Securities in the US

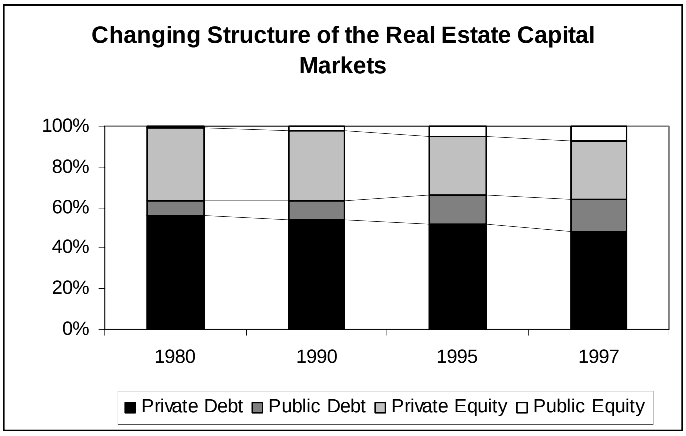
The 1980´s capital flood and the following real depression have facilitated the tremendous development of real estate securities in the US to a great extent. During the 80ies, traditional lenders provided developers loans of more than 100 percent of cost, because of the expectation of rising inflation. The rationale was that a ten percent inflation rate at a 120 percent loan to cost ratio would amortize the loan to 60 percent loan to cost ratio in five years. Additionally, many lenders believed that equity participation of developers were not necessary. As a consequence every developer took the overfinanced loans and excessive development occurred.

When the inflation rate fell dramatically in the late 80ies and the overbuilding in combination with a weak US economy led to a severe depression on the real estate markets at the same time, the property values fell below their financing. The rental incomes were mostly not sufficient to cover interest and amortization payments and many buildings had to file for bankruptcy, the Rockefeller Center in New York was the most prominent.

The only way out of the crisis was to pay down debt with new capital from the equity public capital markets and the Real Estate Investment Trusts were suddenly back in the marketplace after years of abstinence from public notice. Several other factors contributed to the great REIT boom that lasted until 1998. A strong economic growth together with a nearly zero net supply in space promised a quick recovery of the real estate markets in the eyes of analysts and consequently led to a sharp increase in the REIT share prices. As the share prices of REITs went up stronger than the values in the private real estate markets due to the larger capital markets' anticipation of future developments, the costs of capital of public real estate companies were lower than these of private companies and therefore private companies were mostly outbid by REITs in the buying of attractive buildings. The REIT industry grew and grew. Additionally, the traditional financing sources for the private markets had dried up after the recession, when nearly all lending institutions withdrew from real estate financing after heavy losses. Without their former high leverage-ratio private investors had not the necessary funds to finance the capital intensive real estate investments.

Another important factor for the success story of REITs was a tax reform in 1985 which limited the tax deductibility of real estate losses for private investors and therefore made the private real estate investment less attractive and less competitive.
And when, after two to three years of hesitating and observing, institutional investors began to substitute their direct real estate investments for indirect ownership, the REIT markets gained the critical mass to mature with respect to liquidity, transparency, corporate governance and institutional research coverage.
Knowing that the enumeration of reasons is by far not complete we will now turn to public debt markets side.

The deregulation of the thrift industry has triggered the development of the commercial mortgage backed securities market. The thrift industry was generally a conventional residential mortgage lender to the beginning of the 1980´s. With the deregulation of the industry the nature of real estate lending shifted dramatically. Although many institutions had only underwriting experience in the single family business, they were now allowed to make commercial loans. To gain market share many thrifts, especially Savings & Loans proceeded very aggressively and nearly abandoned their core business as originators and investors in single family loans. These institutions were consequently hit very hard by the recession and many of them became insolvent. The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) created the Resolution Trust Corporation (RTC) to foreclose insolvent thrifts. The RTC mission was the liquidation or reorganization of failed thrift institutions. The RTC sold parts of the foreclosed commercial mortgages as CMBS. It is responsible for the creation and acceptance of the securities. With the time investors got more and more sophisticated in pricing these securities correctly and the spreads over US Treasury bills tightened substantially and off balance sheet financing has become a very important source of real estate financing in the US.



Source: Muldavin, Scott., Real Estate Capital Markets Trends, p. 39

Overall, the growth in the CMBS and REITs markets had a major influence in transforming the real estate capital markets in the last years. As shown in the exhibit, the importance of the private sector is declining and the public sector is gaining marketshare.

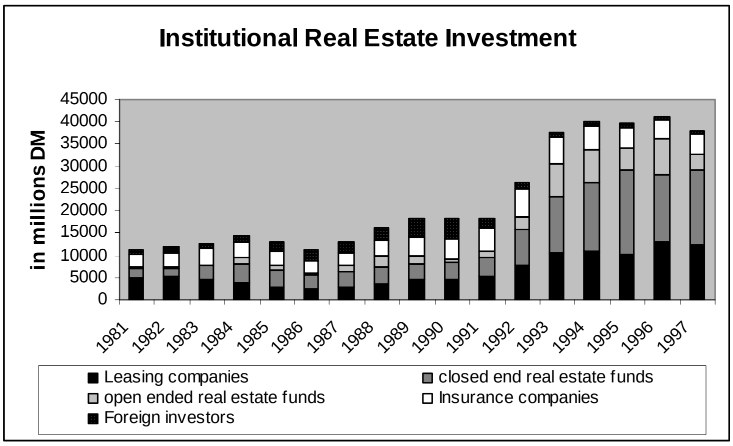
III. Real Estate Securities in Germany

Looking at the real estate markets in Germany we see a strong analogy with respect to external factors or circumstances but a completely different result. While the world economy was in a period of recession at the beginning of the 90ies, Germany was still prospering due to the reunification boom, both in the East and West. Heavy tax subsidies granted by the federal government for investments in the Eastern parts of Germany, attracted many, too many, developers, which developed real estate objects in the East that never had a possibility of economic viability and sold them as a tax deal to investors. In the West, overbuilding occurred when developers wanted to take advantage of the sharp increase in rental and property values resulting from the prospering general economy. All these building activities were financed to a great extent by German banks, without reaching the US leverage ratios however. With the reunification new business opportunities suddenly emerged for German banks and no institution was willing to leave this new business to its competitors. Credit risk management was therefore very much neglected at that time.

When the reunification boom was over, Germany also went into a deep economic recession. As in the US, the recession had a hard impact especially on the real estate markets due to the excessive development the years before. Rental and property values fell seriously and still have not fully recovered till today. Many investors came into severe financial problems, some had to file for bankruptcy, and every lending institution that was engaged in real estate financing had poor loans on its balance sheet.

But neither investors nor banks decided at that time to turn to the public capital markets to restructure the financing of real estate as it happened in the US.

The commercial real estate markets are still dominated by private real estate investments through various kind of investment vehicles, institutional investors such as insurance companies which hold real estate as direct investments, and the so called "Open-ended funds", which are commingled funds.



Source: Bulwien & Partners

And the traditional mortgage loan is still the only debt instrument used in real estate financing.

We will now analyze various factors which exacerbated a development of real estate securities in Germany.

IV. Real estate investment and finance in Germany

1. Taxation in Germany

The German tax system has always favored a private real estate investment over a corporate investment. Losses from private real estate investments were fully deductible from the personal income tax. Together with the above mentioned tax subsidies for the East the financial impact was tremendous. A special tax law allowed investors to depreciate their investments in the East at a rate of 50 percent in the first year. With the special depreciation and a usually high leverage ratio the losses amounted to almost 100 percent of the equity investments in the first year. Investors being in the highest marginal tax rate bracket of more than 50 percent benefited the most as they got half of their equity investments back after one year due to the tax savings. This led to a remarkable paradoxon: The after-tax yields of private real estate investments were often twice as high as the pre-tax yields.

Additionally, there was no capital gains tax for the private investors if they held real estate for more than 2 years. Corporates had to pay a capital gains tax however and the corporate tax rate on retained earnings was also quite high with 45 percent. Special local tax rates also discriminated the corporates against the private investors, as up to 20 percent of the pre federal tax earnings had to be given to the local governments.

To summarize, the German tax law made it impossible for corporates to compete in bidding for attractive real estate against private investment vehicles, as the private after tax capital was much cheaper.

2. German banks

Contrarily to the US, German banks are not concentrated on one specific core business but offer a great variety of financial services. Therefore they have great financial strength and are not dependent on the development of a sole market segment. When many real estate loans defaulted the banks were of course financially hit, but they were never in danger of insolvency. They easily wrote off the poor loans, built up provisions or took the properties from the defaulted investors into their own portfolios to restructure and sell them when the markets has turned around again. But no bank has ever considered to withdraw from the real estate lending business as did the US banks after the real estate depression.

Besides the financial power there are mainly two more reasons to this. First, official German banking regulations and the corresponding refinancing opportunities for banks limit the use of debt to 80-85 percent of the total investment. Secondly, German banks are not only engaged in real estate lending but also heavily in the sponsoring and development of real estate and especially in the distribution of real estate products to its customers. Many German banks developed real estate in the East through subsidiaries, financed the construction and investment phase themselves and then sold equity stakes as a tax deal to their wealthy customers through their distribution networks. This strategy was highly value adding for the banks and the total package compensated for the loan defaults. Currently, the banks suffer more from the rental warranties they have granted for their developed properties to achieve higher selling prices than from defaulting loans.

German banks have a unique instrument to refinance their mortgage loans, the so called “Pfandbrief”. The Pfandbrief, collateralized by high quality mortgage loans and loans to federal, state and local governments, is well accepted in the European bond markets. The spread over German treasury bills has tightened significantly over the years and all new issues are rated AAA. Underwriting mortgage loans was a very profitable business for German banks.

When the competition among banks intensified shortly after the reunification and interest rates fell to historic lows some years later, the credit margins narrowed dramatically and the financial institutions had to expand their business activities to achieve at least the same financial results from the years before. Balance sheet and turnover growth became much more important than high quality credit risk management. Mortgage loans were competitively priced rather than according to their risk. Instead of rationing the real estate financing, German banks extended its financing.

We have seen that unlike in the US, the traditional capital sources never dried up in Germany during the real estate depression. Cheap debt capital has always been available to investors and therefore there was no pressure to turn to the capital markets to refinance properties or even new developments.

3. Private and Institutional Investors, Capital Markets, and Real Estate Returns in Germany

The typical German private investor did not invest in shares, not even in fixed-income bonds, until 3 years ago. He invested in life insurances, saving accounts and real estate of course. As mentioned above, private investors with high personal income placed their funds mainly in closed-end real estate funds with the special tax deal structure to reduce their tax burden. Individuals with lower income and a low risk profile invested their money in the “open-ended funds”, which had a remarkable track record. Since their first listings, the open-ended funds showed positive annual returns for every single year until two years ago. The annual returns were in the range of 5 to 7 percent.

These returns easily matched the returns from the German stock and bond markets. A portfolio of stocks and bonds yielded only 7,4 percent annually between 1973 and 1993 in Germany whereas the US stock and bond markets were able to return 9,1 percent during the same period.

Considering risk, investors were even better off with real estate investments than with stocks and bonds and therefore only 4.2 percent of the total German population had invested in stocks in 1988. As a logical consequence, the capital markets were poorly developed in Germany at the beginning of the 90ies and the managers of the German industrial conglomerates had so far never heard of the concepts of shareholder value, corporate governance or investor relations.

German investors, not being familiar with “regular” stocks and bonds, would have never invested in high volatile real estate stocks, since they had their high yielding tax saving closed-end funds and their moderate yielding low volatile open-ended funds.
Institutional investors such as insurance companies and pension funds only held real estate as direct investments as they could not take advantage of the tax status of closed-end funds and the yields of the open-ended funds were too moderate for them.

Having analyzed the three major reasons that hindered the evolution of real estate securities in Germany in the past, we will now turn our focus on some new trends and regulatory changes as they may give new perspectives for commercial real estate securitization.

V. New trends and regulatory changes

1. Tax reform

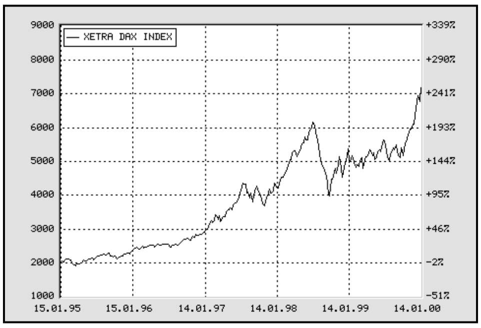
The tax reform from 1999 restricts the tax deductibility of real estate losses from the personal income tax to a great extent, as real estate losses can now only be offset against positive income from other real estate investments and not against other positive income sources as before. This will make the after tax private equity much more expensive. Furthermore shall the corporate tax rates be reduced to only 25 percent in a next step. The after tax capital costs of corporates are no longer discriminated against private investors by the tax law. In contrary, considering that public equity is always cheaper than private equity due to higher liquidity and lower risk through higher transparency, public real estate companies are expected to be very competitive in the next years on the German real estate markets.

2. German banks compete for international capital

In the past few years, equity has become a scarce resource for German banks due to the following reasons: (1) a tremendous balance sheet growth as a result of the reunification and the new business activities that emerged from this, without a corresponding growth rate of earnings however; (2) the writing-off of poor loans and (3) the offsetting of goodwill values against the capital reserves that came from the increasing merger & acquisition activities in the banking industry.

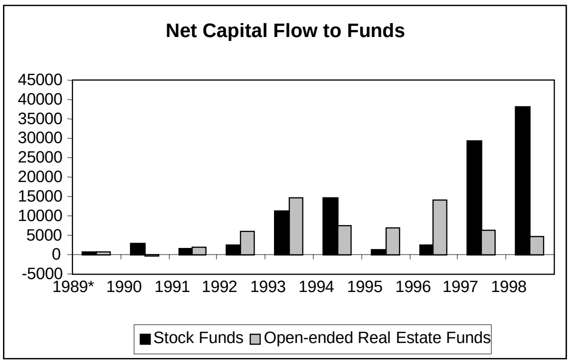
If the banks want to further grow and expand into new profitable business segments, they have to get new equity to fulfill the strict regulatory banking requirements. One possible way not only to obtain tier-I capital but also to increase the shareholder value is to take low yielding assets from the balance sheet by selling them as asset backed securities to the capital markets. As already mentioned, the margins on mortgage loans narrowed significantly over the last years and the return on the equity employed on these assets is very poor. In 1998, there already have been the first two major issues of commercial mortgage backed securities by German banks, including the Deutsche Bank. More issues will follow when the European capital markets' participants learn more about the complicated structure and the pricing of these instruments and banks are undergoing the expected fundamental change from a margin oriented business to a provision oriented business.

3. Stock market euphoria among German investors



The IPO of the German Telekom made the German people a people of shareholders. Massive advertising accompanied the going public of the Telekom and many private investors bought their first stocks ever. In 1998, more than 10 percent of the German population had stocks in their portfolios. The stock market rally of the last three years, the uncertainty with the public pension scheme and increasing daily coverage from the stock exchanges made the ordinary share a very popular investment form within a couple of years.

Investment funds that invest primarily in stocks are since last year the largest group of the investment industry. The once low risk profile German investor know accepts a higher volatile share price development in return for higher yields.



More and more companies from all kind of industries take advantage of this new mentality and go to the public markets to get the necessary funds to finance further growth. Real estate companies with a convincing equity story, good investor relations and a clear dedication to the principles of shareholder value, will surely have a great market acceptance as still many investors want to have real estate in their portfolio for diversification purposes. And now, real estate stocks are serious alternative to the open-ended funds, the closed-end funds and to the direct real estate investment.

VI. Conclusion and Outlook

We have analyzed the current situation of real estate securities in Germany and their perspectives. So far, the German tax system, the German banking system and the behavior of German investors have hampered the emergence of a public real estate market. The current trends and regulatory changes let assume however, that the securitization of commercial real estate will gain momentum in the next years. Crucial for the success of public real estate securities will be the acceptance by institutional investors and a professional coverage by equity and credit analysts however.

With the growth of public equity and debt, real estate markets will become an integral part of the global capital markets. Real estate capital will be more related to real estate market fundamentals and price changes in the global capital markets. The capital markets will require and produce a high level of transparency that was impossible under the traditional funding methods and will act as a regulator for capital. Capital will flow only into commercial real estate markets when the fundamentals are strong and the risk of overbuilding is small. As was shown during the real estate crisis in 1998 in the US, a higher price volatility is paid for the less cyclic behavior.

The other side of the medal is however that events in Russia or in Asia can negatively effect the financing of a shopping mall somewhere in Germany. This unpredictability can create an uncomfortable environment especially for real estate developers who are often dependent on their ability to refinance at specific dates at specific rates in order to avoid default.