Indirect Real Estate Investments

through the take-over of real estate operating companies

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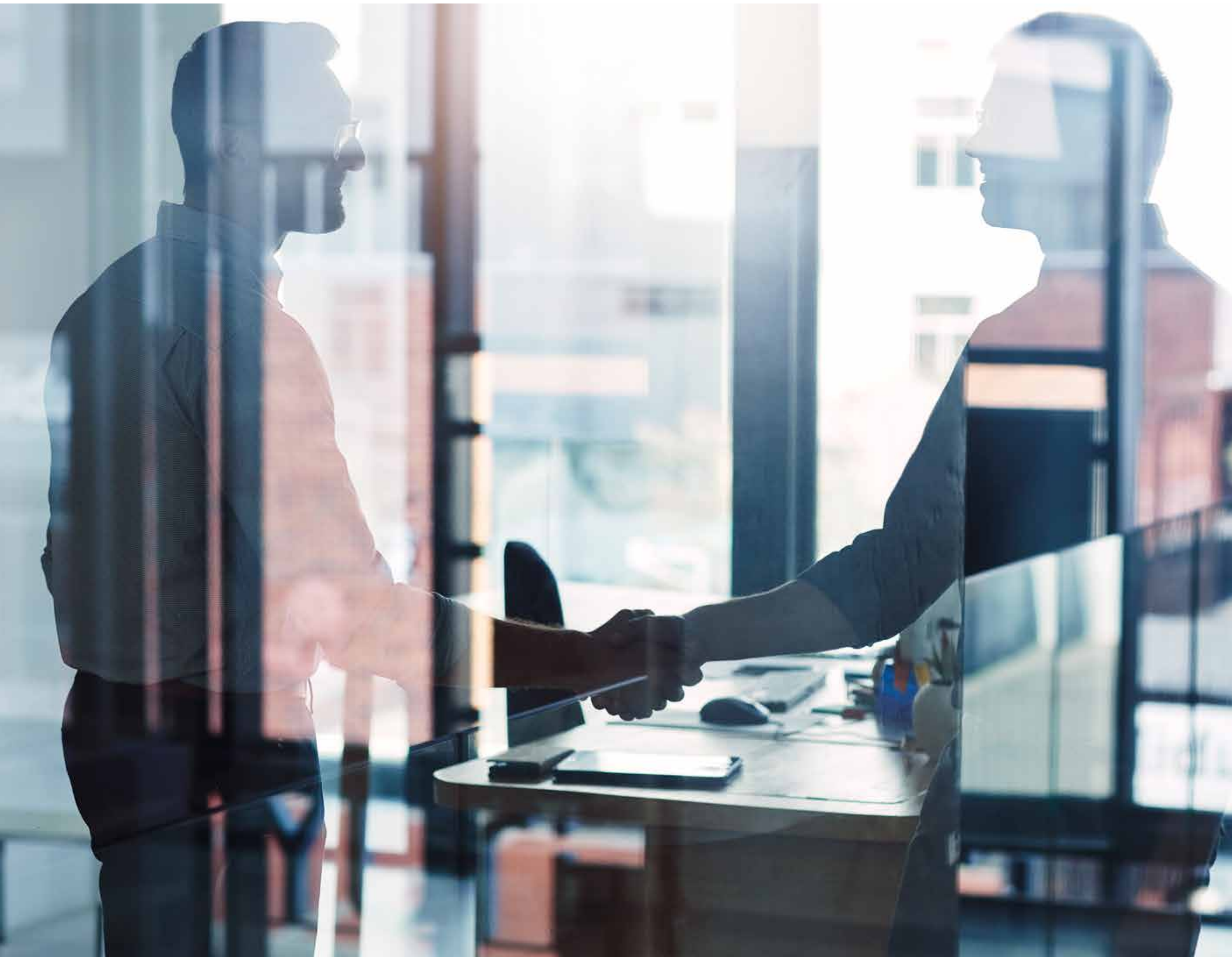
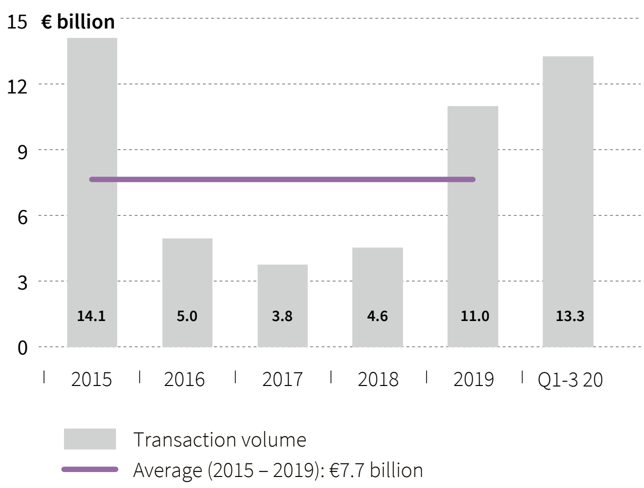


Current situation & market development

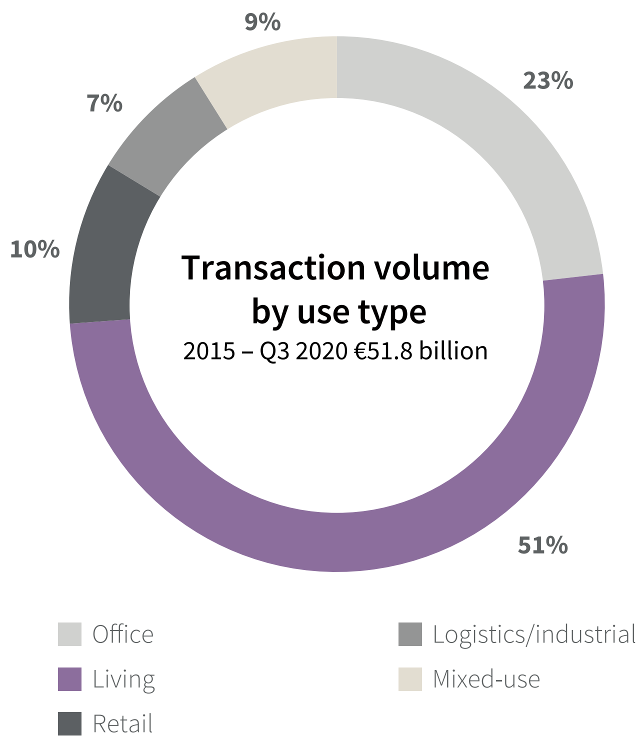
Real estate investment through the acquisition of shares in property companies is all the rage. In Germany, an average volume of €7.7 billion p.a. has been invested in this way in the form of mergers and acquisitions (M&A) since 2015. Even if most real estate deals are transacted as direct investments by way of an asset deal or even a share deal the proportion attributable to indirect investments has risen significantly since 2019. In the period 2016 – 2018, the share of the entire German transaction market attributable to indirect investments was between 5% and 7%; this doubled to 12% in 2019 and has reached 23% over the first three quarters of 2020. These indirect investments involve the take-over of a significant share in a real estate operating company with the intention of becoming the indirect owner of the properties and of the infrastructure of the company (also known as platform deals).

The largest company take-over to date was in 2015, when Deutsche Annington took over Gagfah with residential property assets of around €8 billion. The company was then renamed Vonovia. The second and third largest transactions were concluded five years later in the first quarter of this year and involved the take-over of Adler by Ado Properties (approximately €6 billion) and the almost 80% share in TLG by Aroundtown at a value of around €3.6 billion.

Transaction volume by way of company take-overs



Transaction volume



Indirect investments have taken place in the last five years in almost all asset classes. The share attributable to residential properties over the period under review was by far the highest at 51%, driven by high-volume take-overs of residential operating companies. The dominance of this asset class amongst the deals is hardly surprising as an enormous effort is required to drive corporate growth via direct investments of individual properties, especially in the living segment.

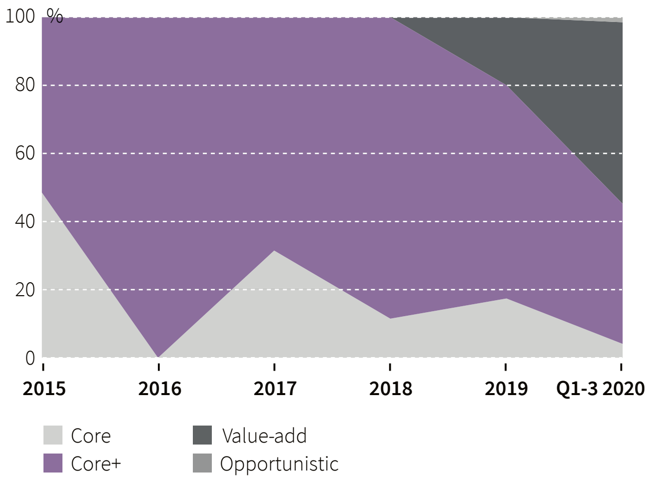
The ranking of the most active asset classes shows offices following at 23%, ahead of retail with 10%. The most active player in the office sector is Blackstone. In 2016, the US-based private equity company took over IVG's Officefirst office portfolio, followed three years later by the take-over of the Canadian REIT Dream Global which is primarily invested in Germany. Both transactions were at prices of over €3 billion.

There were high profile take-overs in 2019 with the 50% shareholding in the department store operator Galeria Karstadt Kaufhof by the Signa-Gruppe belonging to the Hudson's Bay Company (HBC) and in 2015, the French shopping centre operator Klépierre took over its Dutch competitor Corio. 2020 has also seen large-volume company take-overs with the sale of the Metro's Real chain to x+bricks and SCP Group. The value of this deal was in the upper three-digit million Euro range.

There have been - albeit rare - platform deals in the logistics / industrial segment. By far the largest was in 2017 with Blackstone's sale of its Logicor logistics platform to the China Investment Corporation (CIC). The value of the German properties was almost €2 billion.

Looking at the break-down by risk profile, it is clear that the majority of the transaction volume is attributable to the Core+ segment and that the Value-add segment has been growing since 2019. The low share of core transactions is not surprising, as real estate portfolios that have grown over a long period of time are rarely those that exclusively include top properties in best locations and with excellent tenant mix. Furthermore, the above statistics show the higher risk profile of company purchasers and their expectations that active management of the acquired company will result in high values which were not achieved by the previous owner.

Transaction volume by investment risk profile



Highlights

Transaction volume

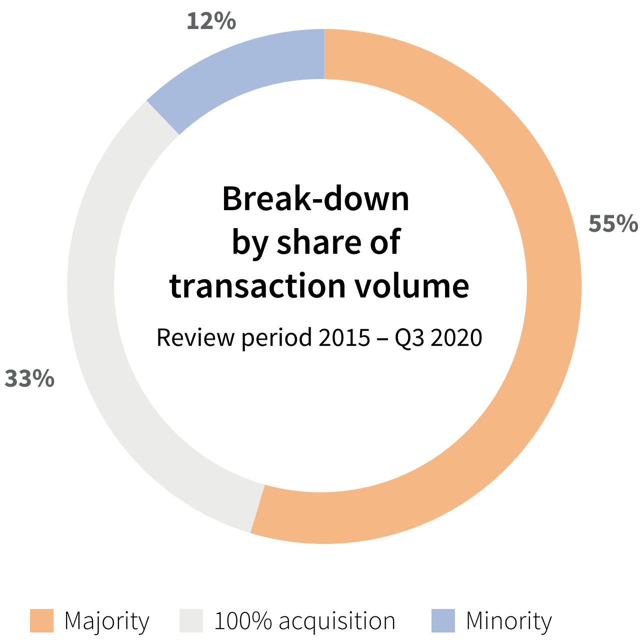
Properties with a combined value of around **€52 billion** have been sold indirectly since 2015, an average of €7.7 billion p.a.

88% of transaction volume is attributable to majority shareholdings or the 100% acquisition of companies

Analysis of acquisition / shareholdings

In order to get a detailed view of the M&A activities in the real estate market, we have categorised the deals depending on the level of participations (>/<50%).

Acquisition and shareholdings



The analysis shows that majority shareholdings (> 50%) accounts for over one half of the total transaction volume over the review period 2015 - Q3 2020. In terms of the number of transactions (around 35% of all deals), it is clear that this break-down is due above all to large-scale transactions such as the take-over of Adler by Ado Properties (around €6 billion) and the almost 80% shareholding in TLG by Aroundtown. With an average purchase of around 83% of shares, the latter was at almost exactly the average level.

Furthermore, around one third of all indirect property investments is attributable to an outright purchase, i.e. a 100% acquisition of a company by the purchaser. This category contributes an absolute share of around €17.1 billion of total transaction volume over the period 2015 - Q3 2020. The highest proportion of outright purchase deals was in 2019 with eight 100% company acquisitions and sales, followed by 2020 with six deals to date.

The other 10 M&A transactions were attributable to minority investments through the purchase of, or shareholding in, less than 50% of company shares. Over 50% of these deals took place in 2019. The transaction volume in this category is around €6.3 billion or around 12%.

Highlights

Transaction volume

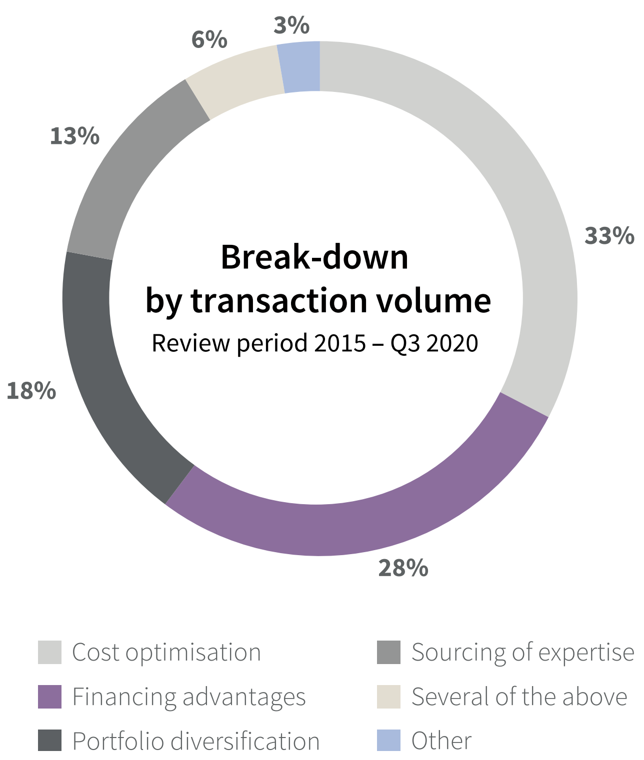
4 key drivers: cost optimisation, financing advantages, diversification, sourcing of expertise

85% of the transaction volume is attributable to Core+ and Value-add investments

Drivers and motivations

In addition to the analysis of the respective acquisitions and shareholdings, it can be seen that M&A activity in the property markets is driven by different interests and motivations. In this context, it appears that there are four key drivers: on the one hand there is cost optimisation by achieving economies of scale and on the other, the leverage of financing advantages in the capital markets, the diversification of portfolios and finally the sourcing of professional staff.

Drivers and motivations



The figures show that cost optimisation is the principal driver of M&A activity in the real estate sector with a share of almost one third of total transaction volume. An important factor has been the challenges faced during the current crisis that have shown the significance of lean cost structures. Over the last few years, M&As have enabled companies to make savings in terms of services such as property management, building works and utilities and materials supplies. In addition, the companies are also developing strategies for the improved allocation of human resources and internal workloads within organisations.

The effect on the capital market is a further key driver of M&A activities in the real estate sector. Since 2015, over one quarter of the indirect property investment transaction volume (28%) has been attributable to financing advantages in the capital market. In this context, it is clear that collateralised financing has become less important for stock exchange-listed companies, and there is now a shift of focus towards the capital markets with financing instruments such as corporate bonds, hybrid debt and commercial paper as alternatives to traditional mortgage lending. Over the last few years, individual listed companies have managed to halve their secured debt on this basis and are now in some cases financed up to over 80% with alternative capital market financing instruments which are dependent upon the credit rating of the company. This means that a top company rating plays a pivotal role in driving profitability by the leveraging of favourable interest rates. Growth stories resulting from take-overs and the optimisation of portfolios through mergers appears to be one instrument by which to improve both creditworthiness and ratings. In individual cases, there are interest rate benefits of over 10 bps to be achieved between two rating levels, which can be a significant saving of billions of Euros when raising capital.

The Covid-19 environment has made it more problematic and expensive for developers to obtain financing as many banks are avoiding project financing altogether. It is not uncommon for asking interest rates to be double-digit for capital raising on the capital market. For developers, there is some benefit to be gained by joining together with a portfolio investor for financing purposes in order to take advantage of the typically better credit rating and bring the interest rate burden down to a fraction of the original rates available to developers.

The liquidity glut driven by the positioning of the European Central Bank continues to exacerbate the product shortfall in the property sector and the unchecked demand is resulting in record prices followed by yield compression in some asset classes. Prior to the Covid-19 crisis, as a reaction to the falling yields, many companies increased the size of their portfolios by making purchases in other regions and countries, and even in alternative asset classes which had not experienced such strong compression up to that point. The intention was to optimise portfolio performance and balance risk to achieve increased resilience. The analysis shows that the third principal motivation on the M&A market is portfolio diversification, which accounted for around 18% of the total transaction volume. This equates to an absolute volume of around €9.1 billion. In terms of the number of transactions, it is worth mentioning at this point that almost two fifths (39%) of all deals were attributable to diversification, whilst cost optimisation and the leveraging of financing advantages accounted for around 14% each.

The pre-Covid trend for the sourcing of additional expertise by the take-over of smaller market players is now less apparent in the current environment, which is also confirmed by the figures. Just 13% of total transaction volume is attributable to indirect property investments for which the primary driver is to source specialist staff. However, it appears that access to relevant professionals and specialist expertise such as in the asset management or property development sectors can often be an additional success factor in uncertain times. For example, despite the Covid-19 crisis, there are still take-overs involving developers. In addition to the actual take-over of portfolio properties and pipelines which are acquired as a result of company take-overs, M&As offer promising opportunities for the acquisition of additional expertise. It is worth mentioning that around 26% of all deals are based on more than one motivation, but these actually contribute little in terms of total indirect investment transaction volume.

Outlook

In 2020, the recent past trend in terms of M&A deals in the property sector continues and, despite the Covid-19 crisis, is showing few signs of abating. The relevance of motivations remains a key factor and there are many signs that the trend may even be gaining pace as the collapse in share prices at the start of the pandemic resulted in favourable market entry conditions for opportunistic investors. And many of which have a short to medium-term investment horizon. They will use the recovery of the capital market to sell the shares they purchased and profit from the rise in stock prices. In view of this, it is anticipated that the volume of indirect investment transaction volume activity in Germany attributable to the take-over of real estate operating companies could again exceed €10 billion in 2021.

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