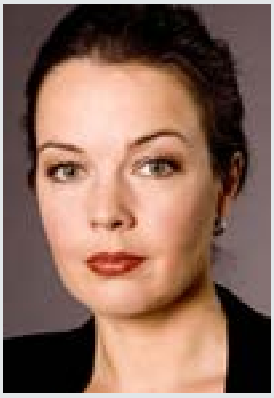
GUEST COLUMN

Chinese capital and German real estate – why we should care

Angela Haupt, MRAG Projekt GmbH & Co. KG

With the pace of Chinese outbound investment accelerating, there is now a clear opportunity for German real estate professionals and companies to gain – even if initially modest - market share of this growing source of international capital, along with the revenues generated from the facilitation and management of invested capital in German real estate assets. As it stands, both funds and mandates are still largely bypassing the local German real estate industry.



On October 6th 2014, new regulations come into effect in China which open the gates for overseas investments of up to USD $1 billion per transaction made by Chinese companies. The new provisions replace, for the most part, a complex and lengthy process of state-sanctioned approval with much simpler registration requirements, as per the Measures for Foreign Investment Management issued by China´s all-powerful Ministry of Commerce (in short "Measures No. 3", by MOFCOM).

In July 2014 a further directive and its implementing rules had already eased outbound investment undertaken by individuals, "Circular 37" by the State Administration of Foreign Exchange (SAFE). Both, Measures No. 3 and Circular 37, removed regulatory uncertainty preventing investment, and have greatly simplified procedures. Chinese investors are now in a position to close deals faster, and to compete for a broader set of targets.

These changes are the most recent - if not the biggest - steps within the general "Going Abroad" policy which the Chinese government initiated in 1999. Within that framework, important milestones for institutional investment were a) the 2010 inclusion of real estate as eligible foreign alternative investment and, b), the 2012 increase of the maximum permissible allocation to real estate from 10% to 15%. The overall maximum for foreign investments remains at 15% for the moment.

Official estimates expect Chinese companies to invest over USD $500 billion internationally over the next five years. Germany, ranked by nominal GDP, should be the fourth-largest global recipient of investment capital. Applying the country weight of a benchmark like the MSCI World GDP Weighted Index, a neutral stance on Germany would accordingly generate a market share of around 8% of all Chinese international real estate allocations. There are, of course, plenty of persuasive arguments as to why Germany should actually exceed this 8% share.

The implications for German real estate market participants in this is that there is a fairly new and growing source of capital and revenues becoming available. In addition, since not only economic fundamentals but also capital flows drive valuations, the investment preferences of Chinese investors will become an increasingly relevant factor in performance.

In 2014, more than 60% of global institutional property funds were allocated to office real estate, followed by retail, industrial and mixed-use. Common features characterizing transactions across all key markets include the acknowledged preference for investing in stable and liquid markets, in established locations, and into income-producing properties. Germany scores highly on all these counts.

The US recovery story vis-a-vis the Euro crisis has not gone unnoticed, either. Preferences may change sooner rather than later, however, because yield compression is in a developed stage, familiarity with a broader range of markets is increasing, and – last, but not least - there is a potential divergence between US and Eurozone monetary policy.

However, the common denominator straddling all these differences, and the one crucial factor underpinning the Chinese outbound strategy, is the need for DIVERSIFICATION.

A good example on the institutional side is insurance group Ping An, which follows a familiar investment principle. Using its domestic bond yields as a risk-free benchmark, the insurance group diversifies into income-producing alternatives with differing yield premiums, for example with its recent London investment in the Lloyds of London building generating an initial 6.1%.

One approach some developers are taking to address one aspect of risk is to target and cater for individual Chinese going abroad. Individual Chinese investors often seek investments that provide residency privileges, foreign passports or other benefits of property ownership where they have business interests or where their children are being educated. Incidentally, Germany is China´s biggest European trade partner, and the largest group of foreign students in Germany now is the Chinese.

Other Chinese developers and their capital providers are seeking alternative approaches for expansion, as they firmly expect domestic policies to negatively impact their industry in China. They are looking for more predictable returns, and are prepared to lower their return expectations in exchange. Returns of 15%

IRR may seem utopian, but must still be viewed in the light of up-till-recent expectations of 30%-50% returns in China. Those days, too, are over.

From a German perspective then, core properties and even project developments in prime locations may not be competitive for the Chinese in respect of pure return considerations. Therefore it is also vital to focus on communicating risk management aspects, as well as the myriad opportunities available in Germany's secondary locations. Current inward investment volumes are not one-off spikes, but a rapidly-growing base level. Reportedly, for 1H14 Chinese outbound investment (OBI) in real estate reached 16 billion USD globally, up 40% over the same period a year earlier.

Not only are the outbound investment (OBI) allocations increasing, but so are both assets under management (AUM) and actual investment expenditure into real estate. The Chinese economy is projected to keep growing far faster than the Western economies and is projected to reach about 20% of global GDP among the top 30 global economies in 2050. That will entail significant wealth creation.

The Chinese mutual fund industry, pooling retail investors' money, is expected to reach USD $1 trn (1,000 billion) AUM by 2015. Keeping up with overall economic growth rates would mean around 8% growth p.a. However, a disproportionate amount of the wealth created is going into real estate, not mutual funds.

With the Chinese government now actively promoting more securities investment to the public, one can only speculate as to how this will boost the listed real estate sector and the role played by real estate fund managers. Just 10% of AUM to real estate as an asset class at an 8% country allocation would sweep an additional USD $8 billion to Germany from retail funds and, assuming 5% growth of AUM, fresh money of more than $400 million p.a. thereafter.

As to wealthy Asian individual investors, there is a traditionally high affinity to real estate, with allocations by family offices and ultra-high net worth individuals (UHNWI) of 30% or more not unusual. The assets held by the top 125 Chinese UHNWI are estimated at USD $360 billion.

Meanwhile, at Chinese institutions, in particular pension funds, assets under management have been growing at twice the rate of GDP growth, albeit from a small base. The mainland China overall pension system encompasses a total AUM of more than 9tr RMB. Of that, insurers had about 5/9 at the end of 2012. They are - and will likely remain - the most active market participants in diversifying their assets across asset classes and global locations. Having said that, Chinese institutions are still underweight real estate at 1% of AUM, including their allocation to domestic real estate.

Both Chinese developers and insurers are branching out into the fast-growing asset and investment management industry as they pool funds from smaller players and generate economies of scale. Several onshore Mainland Chinese asset managers now have offshore Hong Kong subsidiaries. With their access to the mainland, Hong Kong asset managers in general are expected to outperform their foreign competitors in fundraising for outbound international investments.

A 2012 plan, introduced by the China Insurance Regulatory Commission (CIRC), included measures to allow Chinese insurers to outsource funds to external asset managers and securities brokerages and, in a manner similar to the changes to the German KAGG a few years back, this can become a catalyst for reconfigurations in the value chain. In Germany, the effect was to open the field for competition and globalization.

Ultimately, these new changes provide German market participants with an opportunity to capture market share in the increasing funds of Chinese capital for German real estate assets, be it as seller, advisor, developer, co-investor, financier, manager or as a local partner in other ways.

It is important to note that, for the German real estate industry, just earning an allocation to German real estate does not necessarily mean that German firms will be involved in the management of assets or the structuring of the relevant investment vehicles. How much investment is routed via New York, London or Luxembourg, for example?

Last but not least, diversification is not just a one-way street. It is good to have different sources of capital. The performance of assets and asset managers can benefit from positive capital inflows. Unlike fundamentals, however, that any one individual can hardly bring too much influence upon, there ARE many ways in which funds can be attracted to invest in a specific market. Germany has many of these attractions.

In consequence, it is up to the German real estate industry to communicate with and meet proactively with these decision makers and their teams. Go east, Germans, then.

Angela Haupt is a Managing Partner at MRAG Projekt GmbH & Co KG in Berlin, Germany, which she co-founded in 2003. Ms. Haupt has about 20 years of international experience in direct and indirect real estate, investment and risk management, manager selection, capital raising, fund and company formation and from a decade working at leading global asset managers. She specializes in linking real estate and capital markets for German operators and international investors. MRAG is a real estate investment and capital markets advisory firm, focused on inbound investment to Europe from the US and Asia.

The 1st Annual REFIRE German-Chinese Real Estate Forum

REFIRE is bringing top German real estate companies to Hong Kong and mainland China to meet with outbound Chinese investors.

The German real estate market has become increasingly attractive for global investors – not only because of its depth across all asset categories, but also because of the safety and stability of the market for long-term investors.

Increasingly, Chinese companies are looking at the German market, and a number of significant deals have already been transacted.

In order to open up new levels of dialogue between Germany and China in the important area of real estate investment, REFIRE is planning a series of one-day conferences in China to introduce Chinese investors to the German market.

The events will be attended by top executives from German real estate companies and Chinese investor groups. With our Chinese partner, the Beijing event will take place behind closed doors with leading Chinese investor groups in attendance. Further details will follow.

Event Schedule

January 19th 2015	January 21st 2015	January 23rd 2015
HONG KONG	**BEIJING**	**SHANGHAI**

Contact us today to receive more information about the first annual REFIRE real estate forum:

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Lone Star set to float commercial property specialist TLG Immobilien

Now it's official. After months of speculation, much of it public, the eastern German commercial property specialist TLG Immobilien announced that it plans to float on the stock market, with its launch set for before the end of this year. TLG's parent company, the US private equity investor Lone Star Group looks like it's making hay while the sun shines, figuratively. If it happens soon, the launch on the Prime Standard of the Frankfurt Stock Eschange will follow on from two big recent internet IPOs (shoe and textile online seller Zalando, and Rocket Internet) and relative recent strength across the German listed property sector.

Issues of new shares should bring in €100m for further acquisitions, and it is expected that Lone Star will be looking to raise €500m from its part-flotation.

Lone Star bought the commercial division of the former **Treuhand Liegenschaftsgesellschaft** from the German government two years ago for €1.1bn, including €594m in equity, with the rest being debt.

TLG has a mixed portfolio of commercial properties, including high-profile assets such as the *Kulturbrauerei* and the '*Spreestern*' in Berlin, as well as Dresden's *Hotel de Saxe* and retail property *Zwinger Forum*. Prominent blue-chip tenants include **Daimler** and software firm **SAP**, along with several government-backed organisations. Average remaining lease duration is 8 years, and the (EPRA-defined) vacancy rate is a low 4%. About 35% of its rental income comes from retail grocery stores, such as **Edeka** and **REWE** as well as discounters **Aldi** and **Lidl**. The group's real estate assets are now valued at about €1.5bn and it generates annual rental income of €118m.

With solid cashflow and a conservative approach to its financing, TLG earns a 7.3% FFO yield on its net asset value (EPRA NAV) with FFO for the first six months of this year being €26.0m, up 6.6% on last year. The company said it planned to pay out 70-80% of its FFO in dividends.

The net proceeds generated by the IPO will be used to finance 'accretive acquisi-

Share buyback at TAG Immobilien sends strong market signal

Much in the news this month has been the Hamburg-based listed residential property investor TAG Immobilien AG, which announced a huge share buyback program and the imminent departure of its star CEO Rolf Elgeti, see page 3

Deutsche Bank launches new €700m open-ended fund

Deutsche Bank subsidiary Deutsche Asset & Wealth Management (formerly RREEF) is launching a new €700m German open-ended real estate fund, the Grundbesitz Fokus Deutschland. The launch date is 1st October. see page 12

Deutsche Annington joins MDAX, adds 5,000 new units

Germany's largest residential housing company, the listed Bochum-based Deutsche Annington, took a step closer to its long-term goal when it entered the MDAX at the end of September – the second tier of Germany's largest listed companies. The MDAX consists see page 19

German distressed real estate debt on the rise - Study

The amount of distressed debt in Germany's real estate sector is set to rise modestly, largely as a result of postponed transactions in the recent past, concludes the annual *"Survey on Real Estate Financing and Distressed Real Estate Debt in Germany"*, carried out by Corestate see page 14

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tions' in line with TLG's stated strategy to expand the office and retail portfolio in its core regions of Berlin, Dresden/Leipzig, and Rostock on the Baltic coast, where it has been active for 20 years since reunification, as well as for "value-enhancing investments into the company's core portfolio".

Victoria Partners is acting as independent IPO adviser and process coordinator for TLG Immobilien. Banks **JP. Morgan** and **UBS** will act as joint global coordinators and joint bookrunners, while **Kempen & Co**, **Commerzbank** and **HSBC** have also been mandated as joint bookrunners.

> ***"The core portfolio consists of 320 properties, many of them upgraded, with a rental yield of 7.5%. About half the core portfolio comprises office (36%), retail (50%) and hotel assets (15%), with about half in Berlin"***

Over this year's third quarter, TLG bought two further core office assets, increasing the value of its core portfolio to €1.4 bn. At the same time it sold 48 non-core properties with an aggregate value of €70m, the company said. The remaining non-core assets, valued at €100m, are marked down to be sold in the near future.

The core portfolio now consists of 320 properties, many of them upgraded, with an in-place rental yield of 7.5%. About half the core portfolio comprises office (36%), retail (50%) and hotel assets (15%), with about half located in Berlin. When Lone Star bought the portfolio two years ago it had 780 assets across the full commercial property spectrum.

REFIRE: *This looks like a very lucrative part-exit for Lone Star, who are likely to hold on to a good chunk of TLG even after the capital raising and IPO. TLG Immobilien has been trimmed, slimmed and focused since Lone Star bought the group two years ago, after the Berlin government had stumbled a couple of times in its attempts to privatise the whole TLG entity in the preceding couple of years.*

Lone Star bought the commercial assets and TAG Immobilien the residential assets from the old Treuhand property business, which by then had had twenty years to turn itself into a well-managed company focused on its traditional eastern German heartland.

REFIRE has visited the company at its Berlin headquarters on a number of occasions going back a few years – the company in our view has taken admirable pains to explain its evolving strategy and its financial foundations to its diverse stakeholders, who are now about to include a range of private and institutional investors.

REFIRE met recently with finance director Peter Finkbeiner in his office to discuss TLG's approach to financing. Finkbeiner's banking and private equity background left little doubt that the finance function within TLG has clearly been streamlined and simplified since the Lone Star takeover, with (presumably) clearer lines of reporting to a private equity parent than to the myriad political interests that had to be kept in the loop in the old state-owned days. It was very refreshing.

Finkbeiner described what almost sounds like a return to the old days of relationship banking – having deeper and more reliable relationships with a handful of banks who understand your business and who can react quickly in competitive situations. His views underpin the argument that German banks are getting back into the driving seat and seeking closer re-

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Our readers are global investors in real estate, asset managers, REITs and other real estate investing vehicles, lawyers, private investors, public sector authorities – in short, anybody who is interested in staying up-to-date with and learning more about real estate finance in continental Europe.

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