The German listed real estate sector – disproportional representation

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The German Listed Sector - Entering into a new dawn?

One of the most notable features of the European listed sector is the low market capitalisation of the German real estate sector compared to the size of the underlying property market. This article looks at the reasons for this anomaly, and whether, after some encouraging signs in 1H this year this is likely to change in the foreseeable future.

Size of the listed sector relative to the underlying property market

According to EPRA statistics below, Germany has the third largest property market (in terms of underlying value), of the developed economies but is the least securitised. Typically, the listed sector represents ~5-8% of the underlying market, with outliers being Hong Kong at 17% and Australia at 18%. Germany's listed sector represents only 1.6%. Not only is the listed sector relatively small compared to the underlying property market, but it is also not significant relative to the overall equity market.

Fig 1 Size of the listed sector relative to the underlying property market

	Direct Property ($bn)	Listed sector as a % of direct property mkt	Real Estate Secs as a % of Equity mkt
US	6,367	5.90%	2.70%
Japan	2,162	7.60%	4.50%
Germany	1,526	1.60%	1.80%
UK	1,390	4.30%	1.80%
France	1,197	5.80%	4.00%
Hong Kong	1,059	16.80%	3.00%

Source: EPRA, Macquarie Research, August 2011

Size of the German listed sector relative to its European peers

There are, however, a large number of listed companies, but little in the way of critical mass. The table below which has been taken from our proprietary database of all listed stocks globally (just under 2,000) shows the largest European real estate markets by market capitalisation and the number of listed companies.

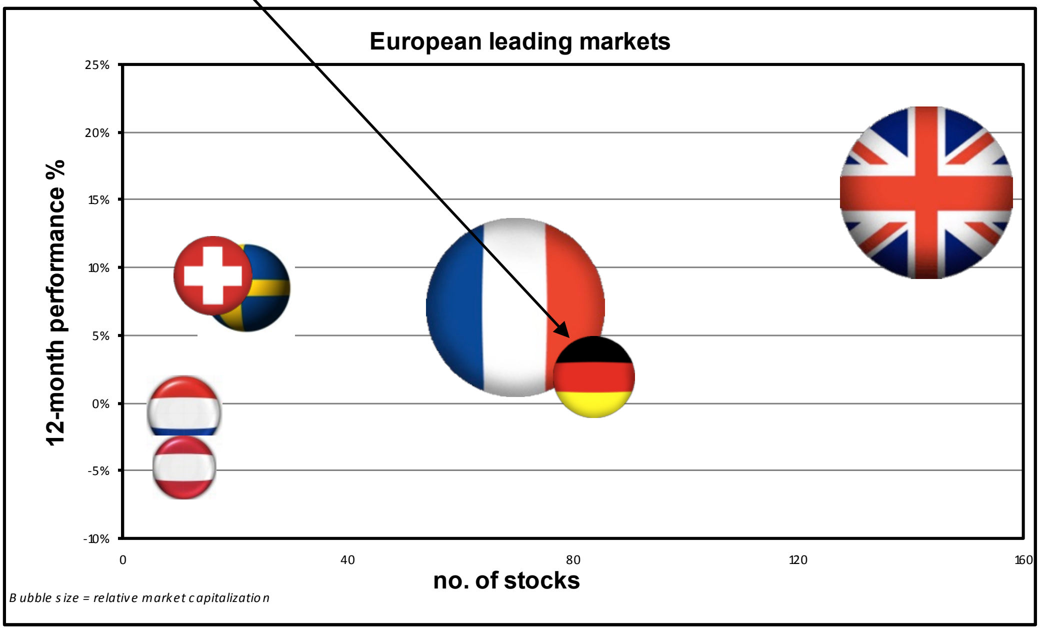
Fig 2 There are 84 listed real estate companies in Germany

	Companies	Mkt. Cap (€m)
France	70	53,875
UK	143	50,512
Sweden	22	15,917
Germany	**84**	**11,517**
Switzerland	16	11,045
Netherlands	11	9,997
Austria	11	7,447

Source: Bloomberg, Macquarie Research, August 201, data as of 11th August 2011

Thus, the UK has the largest number of listed companies in Europe. It should be remembered, however, that in the UK, there are a large number of UK listed stocks (on the AIM market) with overseas assets. Germany has the second-highest number of listed companies, but a combined market capitalisation of only around 20% that of France and 25% that of the UK. On average, the German listed companies are smaller in market Cap and free float terms and experience lower volumes compared against the other major European economies. This has not constrained performance, however, and as can be seen below on the Y axis the German sector has performed in line with its European peers. The size of the bubble represents the market capitalisation. We therefore believe that there is underlying demand for high quality German listed companies, but that options for investors are currently limited.

Fig 3 The German sector has performed in line with its European peers over the last 12 months despite its size



Source: Bloomberg, Macquarie Research, August 201, data as of 11th August 2011

We believe, therefore, that there is investor demand for more listed German REITs – a large number of international investors - that we have regular contact with - have expressed interest in growth in the German market. We look below at the largest European listed real estate companies, ranked by EPRA weighting. As can be seen only one German listed company has a market capitalisation over EUR1bn, which is just outside the top 20 in terms of size within the European real estate sector.

Historic reasons for the lack of securitisation

What then, are the reasons for the lack of scale in the German listed sector?

Firstly it should be noted that there is a general lack of equity ownership amongst German individuals, regardless of sector. According to the latest survey of the Deutsche Aktieninstitut (German Equities Institute) only 5.7% of the German population own equities, compared to a developed market range of 20%-30% (Netherlands 30%, Japan 28%, USA 26% UK 23%).

Secondly, and following on from the lack of equity ownership, the most common form of investment in real estate for non-institutional investors is via the German Open Ended Funds (GOEFs) which are distributed by retail banks. This form of competition for retail investors' money does not exist to the same extent in other European countries.

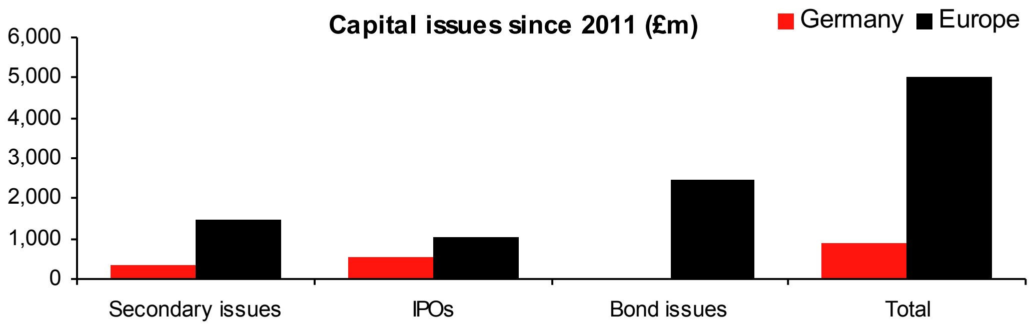
Thirdly, relative to say the UK, there are investor concerns over the level of corporate governance, transparency, and valuation accuracy of, some of German listed real estate companies. It is fair to say that these issues also exist in the German unlisted or private market.

Fourthly, similar to the UK, the German REIT legislation was finally introduced in 2007, exactly at the time when the market peaked, and thus despite a number of companies gaining pre-REIT status the number of REITs in Germany remained very low.

The times are a changing

However, in the last quarter of 2010 and the first half of 2011 we have seen a resurgence of interest in German listed real estate, with two IPOs and €1.5bn, which was larger than a number of equity issues.

Fig 4 Capital issues since 2011 – Europe vs. Germany



Source: IPD, Macquarie Research, August 2011

Will the sector grow? Reasons to be cheerful...

In our view the continued growth of the German listed sector will be dependent upon two factors in particular

1) **A realisation of the relative attractions of G-REITs compared to GOEFs**

   We believe that sentiment towards the open-ended funds has shifted following the well documented redemption issues during the global financial crisis, and credibility issues surrounding the underlying valuations.

   At the end of March 2011, ten funds were temporarily closed due to redemptions and another three were in the process of liquidation. Altogether CBRE estimates that this represents around 31% of the sector by funds under management.

   In the first half of 2011 according to CBRE GOEFs were net sellers, with disposals of €1.5bn outweighing acquisitions of €1.2bn.

   Historically, investors have been unhappy switching from German open-ended funds to the listed sector, as a number of companies suffered reputational issues.

   However, we believe that the G-REIT legislation which was introduced in 2007 provides an ideal vehicle for investors wanting exposure to the direct market, without the style drift and corporate governance issues previously associated with the listed sector. In the Appendix, we provide a table

2) **A desire to participate in the less volatile German property market.**

We believe that the German commercial real estate market has just entered a period where investment capital directed to it will increase substantially, with investors looking for suitable vehicles to participate in the anticipated growth. In a recent survey of investor intentions by CBRE ("European Investor Intentions in 2012", March 2011), 340 institutions were asked the question: "In Europe, which country/region do you believe to be the most attractive for making investment purchases this year?" The overwhelming response was Germany, which attracted 32% of the responses, up from 18% the previous year.

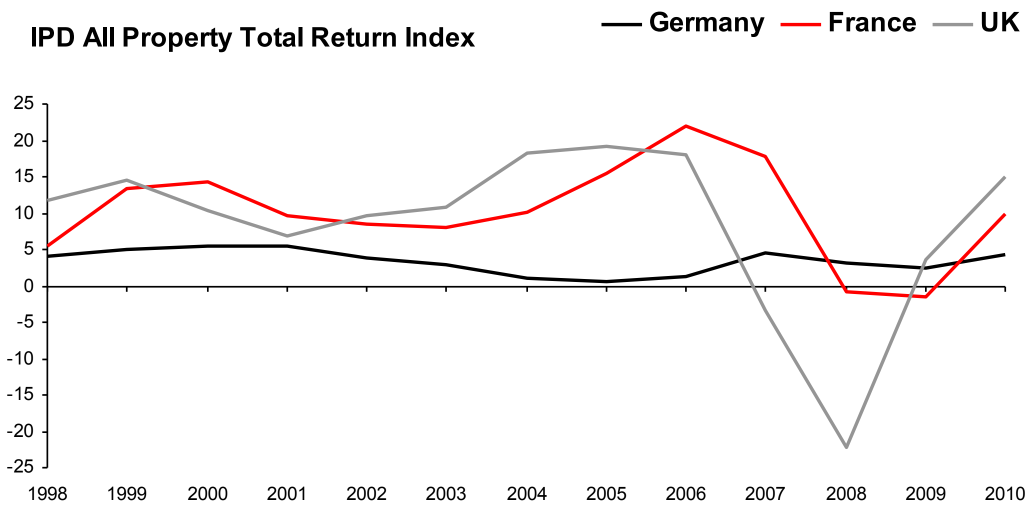
These surveys are an important leading indicator of future capital flows, and thus investment demand, downward pressure on yields, and upward pressure on capital values. In March 2010, when the UK attracted 31% of responses, we saw continued capital inflows and yield compression throughout the course of the year, and there is now a consensus view that the UK market has become fairly (and possibly even over) priced.

This deals with potential European demand, but it is important to note that this has already started to translate into transaction volumes. Germany is strengthening its position as one of the most important investment markets worldwide and in the first quarter of 2011 transaction volumes reached EUR 5.5bn, which was an increase of 18% compared to the same quarter in 2010. Importantly, overseas buyers accounted for nearly 50% of the total. As a result, yields have remained stable in the office sector, and in the case of Berlin firmed marginally by 10 bps to 5.20%.

We expect transaction volumes to increase further in the foreseeable future with some banks having to dispose their real estate investments following regulatory pressure. Moreover several private equity funds still own some of the country's largest commercial and residential portfolios, considering exit scenarios. We therefore agree with CBRE that investment activities in Germany are likely to remain "brisk" and that the commercial transaction volume could amount to EUR 20bn during the rest of the year. Against the background of these transactions one should also expect consolidation to take place among the listed property companies.

In times of economic uncertainty the lower volatility of German office markets, relative to the UK and France, adds to the attractiveness. The chart below shows the total returns in the German, French and UK office markets over the last 14 years. As can be seen, the German market is far less cyclical, with London market returns expected to be moderate during 2011. The reasons for the lower volatility can be found in the geographically more diversified German economy and the greater reliance on absolute valuation methodologies for real estate appraisers.

Fig 5 Comparative property returns UK, Germany and France



Source: IPD, Macquarie Research, August 2011

…at the bottom of the rent cycle…

The final key point is that explains the resurgence of demand for German real estate is that German offices in particular are believed to be at the bottom of the rent cycle. With uncertainty surrounding the impact on consumer expenditure, and therefore retail sales, which determine retail rents, investors are focussing on the office sector globally.

According to the famous Jones Lang LaSalle (JLL) "clock," London office rental growth is on the verge of slowing, as new stock comes onto the market in 2013/14 will relieve the current supply constrained market and upward pressure on rents. By contrast the German office markets, in this case Frankfurt and Berlin are at the bottom of the cycle, with rental growth just starting to appear. To many investors, this appears to be the ideal time to increase weightings to the sector.