

REAL ESTATE: INDIRECT INVESTING

Forging ahead

The dedicated funds used by German institutional investors show strong growth.

Till Entzian explains why

Over the past year, there has been a further sharp increase, by almost exactly one-third, in the managed net fund volume of *Offene Immobilien-Spezialfonds* (open ended investment funds specialising in real estate), from €8.78bn to €11.73bn. This figure shows clearly that in 2002 the branch of investment fund management companies specialising in *Immobilien-Spezialfonds* has been able to continue the success story that began in 1998.

The *Spezialfonds* is so called because it is set up 'specially' for one or more institutional investors. Unlike the *Publikumsfond* (retail fund) the number of investors is limited by law to a maximum of 10. The *Spezialfonds* also differs from a *Publikumsfond* in that the supervisory regulations are slightly less rigorous, with no daily publication of the unit value, having the contract terms checked by auditors rather

than by the supervisory authorities, among other features. Other than in these minor details, there is no difference between the *Spezialfonds* and the retail funds property fund, which now manage assets totalling over €80bn. In most other countries, however, the open ended real estate fund vehicle is unknown, and is sometimes viewed with considerable scepticism. This is because the fund manager cannot sell the fund's assets within one day on the stock market, as is the case with securities, in order to pay out to investors in case of need. But aside from the statutory regulations, holders of units of an open ended property fund are also entitled to surrender their investment fund certificates against payment of the net asset value. We should think of it as a UCITS fund that invests in real estate, rather than in securities. All of the statutory regulations are virtually identical.

The current success of the *Immo-*

bilien Spezialfonds is based on the following advantages that they hold for the institutional investor:

□ Low administrative costs, as in practical terms investors only need to set up one securities portfolio in which to hold their investment fund certificates and then to book the dividend once a year.

□ High transparency, as investors are informed about the important, as well as the less important transactions that take place within their *Spezialfonds* as often as they wish.

□ Simple measurement of performance using regularly calculated unit prices.

□ Securitisation of a real estate portfolio facilitates negotiability and marketability.

□ Small risk of depreciation with possible losses in value by individual real estate assets because of the compensatory effects within the *Sondervermögen* (assets held and managed by the funds separately from the fund company's own assets).

□ Legally regulated distribution of risk.

□ Within certain limits, the investors' balance sheets may be affected by the dividend policy, because the income from the *Sondervermögen* is only entered in the investors' income statements when it is actually paid out.

□ Tax exemption on retained profits from the sale of assets and certain other income. Sale proceeds may at present only be retained on a tax-exempt basis if the fund manager has observed the 10-year time limit.

There is, however some hope that this system-adverse regulation will not be included in the new law on the taxation of investment funds.

□ Transferring a complete real estate portfolio to a *Spezialfonds* creates a simple means of giving other investors a share in this portfolio, either where the original investor(s) aim to withdraw or in order to enlarge the portfolio and improve the diversification.

It is probably because of these advantages that in 2002 institutional investors once again recognised the *Immobilien-Spezialfonds* as the ideal investment instrument, as net fund assets increased as a result of new record sales revenue of €2.9bn. Although in relative terms

this record growth, of 32.9%, is less than in previous years (1999: 57%, 2000: 38%, 2001: 37%), it is still very stable at a very high level.

The number of *Immobilien-Spezialfonds* rose in 2002 from 50 to 60, while at least one fund was wound up. Of the new funds, in each case

one is grouped with the *Immobilien-KAGs* newly launched on the market. The new companies are *Gerling-Investment*, which manages the group's own insurance resources, *LB Immo Invest*, a subsidiary of the *Landesbanks* (central savings banks) of Hamburg, Hessen/Thuringia and Bavaria, originally established as HGA and now renamed, and *Warburg-Henderson Kapitalanlagegesellschaft für Immobilien*, also based in Hamburg. Thus at the end of 2002 there were 17 *Immobilien-fonds-KAGs*, while in 1996 there had been only five such companies.

The number is set to increase again in 2003 by at least a further two providers. Firstly there is KanAm: having established the *KanAm Grund KAG* the year before it has now founded *KanAm Grund Spezialfondsgesellschaft*, which is expected to set up its first *Immobilien-Spezialfonds* by this autumn; and secondly, *IVG Immobilien KAG* has been granted a licence by the Federal Financial Services Supervisory Authority (BaFin) and will also be setting up *Spezialfonds*. In addition, Aarealbank is aiming to establish a real estate KAG which should be setting up *Immobilien-Spezialfonds* immediately it gets approval from the BaFin, possibly in the last quarter. And finally, there are a number of foreign companies, albeit as yet unwilling to be identified, that have some very serious ideas along the same lines.

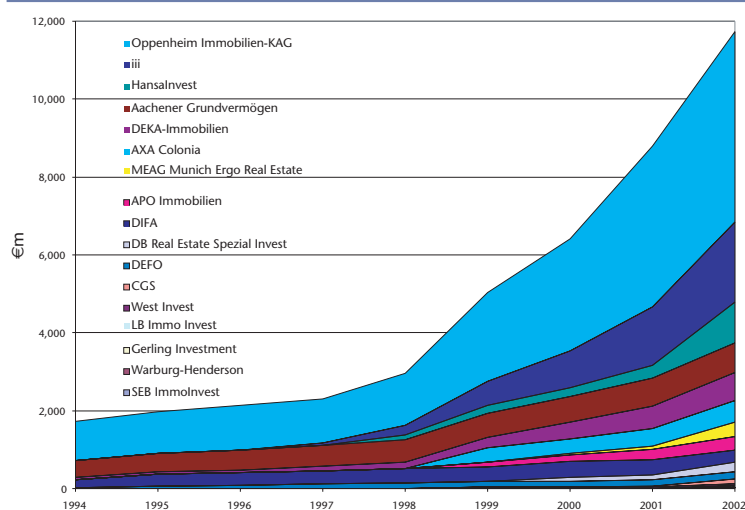
With one exception, all KAGs managed to increase the volume of their *Immobilien-Spezialfonds* in absolute terms. Of these, the leading provider, *Oppenheim Immobilien KAG (OIK)* achieved the highest absolute growth, of €760m. But because this only corresponds to 18% growth for OIK, which is below average, it has lost market share valued at 5.3 percentage points and now has 'only' 42% (see table). The only KAG that lost a mandate was *DIFA*, amounting to €77m. Its market share has therefore fallen from 4.5% to 2.7%.

The main winner in terms of market share was *Hansa Invest*, which increased its share to 9.0%, equivalent to an accrued gain of 5.2 percentage points. *MEAG Munich Ergo Real Estate* too managed to increase its share by 2.4 percentage points to 3.11%, as did *CS Real Estate*, gaining 0.9% to 1.1%.

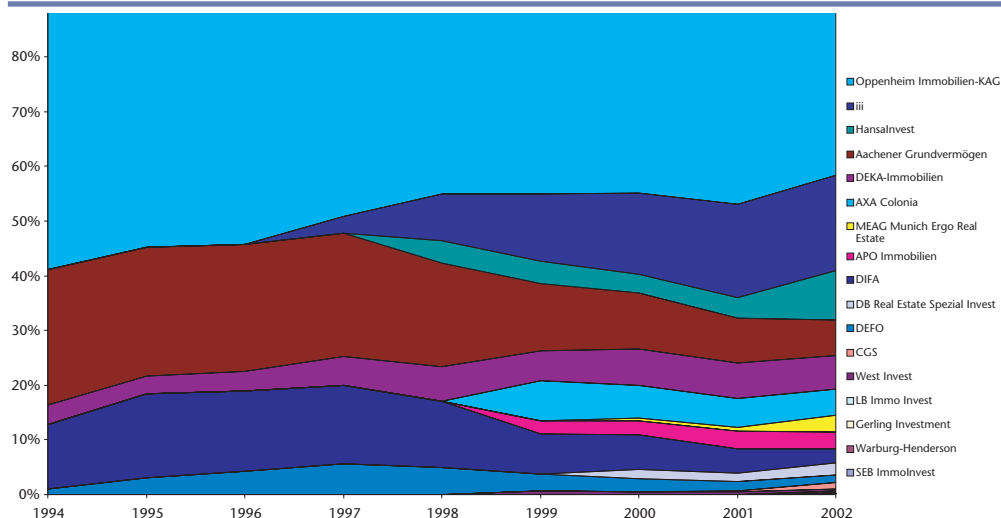
The new providers barely figure in terms of market share. The five new providers from 2001 and 2002 together have a market share of just 1.8%. By contrast, the four companies established in 1999 and 2000 have together already managed to win more than 10% of the market.

For many years, all *Spezialfonds KAGs* have been surveyed about the type of investors that make up their customer base for the *Kandlbinder Reports*. All of the investor groups surveyed have increased their investments in *Immobilien-Spezialfonds*, so that the discernible shifts in their holdings in percentage terms are due solely to variable rates

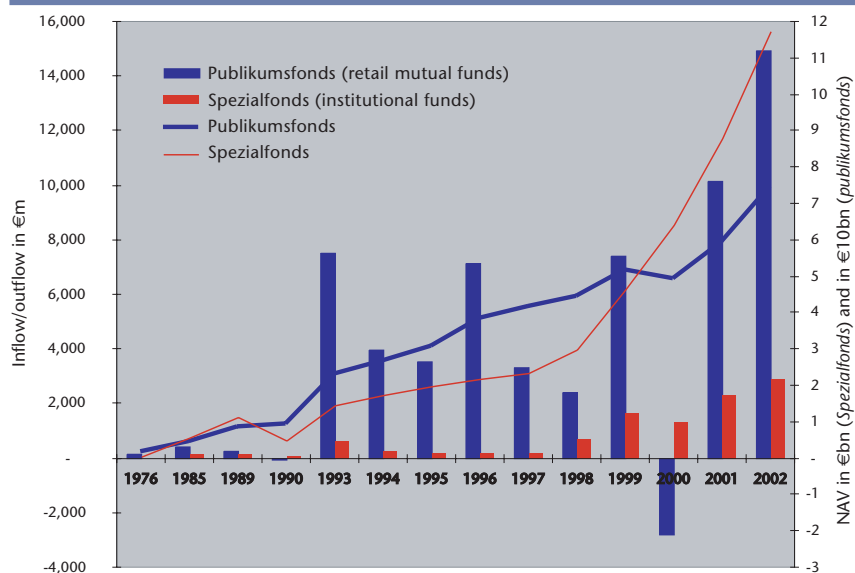
Immobilien-Spezialfonds assets of individual KAGs



Market shares of KAGs in *Immobilien-Spezialfonds* – institutional property funds



NAV and in-/outflow to real estate investment funds



of growth, ie, primarily to differences in sales revenue.

One particularly striking thing is that the insurance industry has for the first time raised the proportion of its holdings in *Immobilien-Spezialfonds* to over 50%, and now holds 55% of the capital invested in this instrument. The year before, the figure had been just 45%. This increase of about 10 percentage points means in absolute terms a €2.3bn, or 57% rise in invested fund assets compared to the previous year.

The pension funds, benefit funds and the occupational, governmental and company provident schemes that are grouped together in the survey under institutionalised retirement schemes have increased their volume by €400m, or 13.1%. Their share of the total volume has, however, consequently fallen from 34% to 29%.

The volume held by foreign investors, however, rose by only 4%, suggesting that – unlike the year before – there was no significant sales revenue from this side. The proportion of foreign investors in the total volume consequently

fell from 9.8% to 7.7%.

The strong growth (+€2.3bn) of insurers in *Immobilien-Spezialfonds* has already been referred to above.

Analysis by BaFin publications of capital investments by insurance companies shows that the trends observed in recent years are continuing:

- the total amount of capital investments by insurance companies is growing steadily (6.7% in 2002, compared to 8.3% in 2001 and 6.8% in 2000);
- it is not just the proportion of direct investment in real estate, but even the absolute amount in this class of assets that is continuing to fall. In 2002 this decrease of 1.1% was less than in 2001 (4.5%), but the proportion of directly held real estate has fallen as a result from 2.8% to 2.6%. In 1996, this share had been 4.5%;
- the rate of increase in investment in *Immobilien-Spezialfonds* is rising, both in absolute values and in ratio to capital investments overall and to directly held real estate investments.

On the basis of the available figures and an evaluation based on the author's own survey, it may be

assumed that real estate fund units held by insurers at the end of 2002 had a total value of €8.7bn. This leads to the following findings:

- for the first time, open ended property funds accounted for a good 1% of the total assets of (direct) insurers. The year before, this share had still been below 0.8%;
- if we consider direct investments in real estate and units in open ended property funds together, this gives a 'real estate values quota' of 3.85%, which is once again an increase. Previously, this quota had fallen continuously from 1996 (4.78%) to 2000 (3.78%), and in 2001 was virtually static at 3.76%. This indicates a trend reversal and shows that insurers are building up their holdings of real estate investments.

One reason for this trend reversal is also the high volatility of the equity markets, which has hit many insurers particularly hard and makes the unspectacular but dependable performance of *Offene Immobilienfonds* look almost idyllic by comparison. Against this background there is every likelihood of further growth. It would come as no surprise if the insurance companies were to more than double the value of their *Immobilien-Spezialfonds* in the next two years to €14bn – €16bn.

It has been possible to evaluate the *Immobilien-Spezialfonds'* latest financial statements or half-year reports. The results reflect the situation as at end of December 2002 only with 97% accuracy. Nevertheless, the results are fully significant, as the evaluation uses the same system every year.

In the composition of the funds, there were three notable trends in 2002: the rise in external funding, the greater use of the opportunities to invest in property companies, and finally the fact that there has

been no further increase in the proportion of foreign investments.

Since 2000 the value of real estate has exceeded the value of the net fund assets. However, the German law on investment fund companies (KAGG) only permits *Spezialfonds* a maximum leverage of 200% (maximum of 50% external funding of properties). The value of the real estate covered by *Immobilien-Spezialfonds* is now just below 114% of the fund assets. Of the 57 funds evaluated, however, 23 apply no leverage at all, and 23 are still below 140%. The highest value is 185%.

Once again, investments in property companies have increased, and according to the evaluation now total €477m, or 4.2% of the fund assets; this percentage has actually risen slightly from 2000 (3.7%) and 2001 (3.6%).

The number of managed properties rose by 216 to 956, an increase of 29%. The value in euros actually rose by 39% to €13.3bn, pointing to the acquisition of a number of larger properties compared to the existing stock.

The proportion of foreign investments in 2002 (2001) in terms of square metres was 2.0m out of a total of 5.7m, or 35.0% (35.2%), in terms of the number of properties 315 out of 956, or 33% (31%), and in terms of the value of the properties €5.0bn out of €12.7bn, or 39.6%. This proportion of foreign investments, just below 40%, shows that investment by the *Immobilien-Spezialfonds* in foreign real estate is very much one of their strengths. The reason is that outsourcing the management of foreign real estate to a KAG specialising in this type of business considerably eases the pressure on the investor.

In 2002, the average value of a property in the *Immobilien-Spezialfonds* surveyed was €13.3m, although the funds are very differently structured. The average property values in most funds, however, is between €6m and €25m.

The average fund volume is €199m (previous year: €179m). Ten funds are managing a volume of less than €50m, with the largest fund having a volume of €980m. In 36 funds the volume is within a range of between €50m and €300m.

An change to German social security legislation (*Sozialgesetzbuch*) should enable state social insurance institutions to invest in *Offene Immobilienfonds*. Because of the poor cash position of these institutions, however, there is little expectation of investors putting much money into them.

The imminent reform of German investment law when the regulation on UCITS amendments is implemented will also have little effect on open ended property funds.

All of this will, however, have absolutely no effect on the more than favourable outlook; *Immobilien-Spezialfonds* will continue to flourish in the coming years.

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COMPOSITION, NUMBER AND VOLUME OF *IMMOBILIEN-SPEZIALFONDS*

KAG	31 Dec 2002			31 Dec 2001		
	Number of funds	Fund value in €m	Market share %	Number of funds	Fund value in €m	Market %
Aachener Grundvermögen	2	765	6.5	2	718	8.2
APO Immobilien	4	359	3.1	4	283	3.2
AXA Colonia	3	560	4.8	3	457	5.2
OGS	2	125	1.1	1	13	0.2
DB Real Estate Spezial Invest	2	248	2.1	1	126	1.4
DEFO	1	171	1.5	1	153	1.8
DEKA-Immobilien	6	709	6.0	5	575	6.5
DIFA	1	314	2.7	2	391	4.5
Gerling Investment	1	19	0.2	-	-	-
HansalInvest	2	1,052	9.0	1	328	3.7
iii	6	2,041	17.5	6	1,498	17.0
LB Immo Invest	1	38	-	-	-	-
MEAG Munich Ergo Real Estate	2	365	3.1	1	67	0.7
Oppenheim Immobilien-KAG	24	4890	41.8	21	4132	47.0
SEB ImmoInvest	1	12	0.1	1	6	0.1
Warburg-Henderson	1	14	0.1	-	-	-
West Invest	1	44	0.4	1	45	0.5
	60*	11,726	100.0	50*	8,792*	100.0

* Figures from the surveys undertaken by Dr Kandlbinder differ from the Bundesbank statistics, but this difference can be accounted for (in 2002 there were 60 funds also with a value of €11,726m, but in 2001 there were only 49 funds with €8,778m in value)