AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES ■ THE JOHNS HOPKINS UNIVERSITY

11

NOVEMBER 2006

Why Germany Should Introduce Real Estate Investment Trusts Now

BY TOBIAS JUST

What is a REIT?

Do REITs fit into the German real estate investment universe?

Are REITs the much feared locusts on the real estate markets?

Why would an introduction of REITs be beneficial for the German economy?

Is there a risk of introducing REITs in Germany too late?

On September 25, 2006 the German finance ministry unveiled draft legislation to introduce Real Estate Investment Trusts (REITs) in Germany. According to an announcement by the finance ministry, the federal cabinet will vote on German REITs on November 2, 2006. Although signals from Berlin regarding the draft legislation were very mixed during the weeks prior to the September 25 announcement, an important step toward launching REITs has been taken. REITs are tax-transparent companies whose main purpose is the management of real estate. The plans in Germany call for the compulsory listing of REITs on the stock market, with 90 percent of their earnings distributed to shareholders.

In 1960, the United States became the first country to admit REITs for public trading, followed just a few years later by the Netherlands. Presently, REITs exist in fifteen countries around the world. The United Kingdom will introduce REITs on January 1, 2007. There are clear signs that listed vehicles are on their way to becoming a new standard instrument for indirect investment in real estate worldwide. Therefore, Germany cannot move quickly enough to position itself as an investment location for real estate companies. At the same time, Germany will benefit from the REITs experiences of other countries, which may provide examples of sensible rules and help Germany to avoid mistakes. Taking into account the lessons-learned from other countries' introduction of REITs could help Germany make up for the starting advantage it lost to the most important European markets—France, which introduced REITs in 2003, and the UK as of 2007.

Naturally, not all the questions raised have been dealt with by the draft bill, nor have all the skeptics been convinced. Several key issues remain to be addressed. Last year, for example, the discussion of a German REIT (G-REIT) was largely reduced to the question of whether the instrument could lead to a loss of tax revenues from foreign institutional investors. This issue overshadowed debate over whether it was generally advantageous to allow REITs to be set up in Germany. However, beyond the finance minister's justified demands that a new measure at least be tax-neutral, emphasizing the benefits of REITs for Germany must remain top priority. This is where analysis of other countries' experiences, particularly those of the United States, plays an important role. All the same, the specific features of the German market must not be disregarded.

A Blueprint in U.S. REITs

REITs were developed in the United States in the 1960s through the Real Estate Investment Trust Act of 1960. The government's objective was to allow the creation of vehicles that enabled retail investors to enjoy investment opportunities otherwise available only to professionals. REITs were given a major boost by the Tax Reform Act of 1986 and the REIT Modernization Act of 1999.

The real estate crisis of the 1980s was a catalyst for the further evolution of REITs; publicly traded REITs were used by the industry to re-capitalize the private real estate companies that had borne the brunt of the crisis. Thus, REITs became an independent, significant market segment on U.S. stock exchanges. Today, the publicly traded equity REITs have real estate assets worth around $340 billion under management.

A typical feature of equity REITs is the variety of strategic directions taken by the market players. In most cases, REITs concentrate on one region or one asset class (office, retail, logistics, etc.); they may also specialize in a combination based on these two factors. The strong focus on regions and/or types of real estate creates pronounced specialization benefits. The U.S. REIT market currently differentiates between nine big sub-segments, i.e. strategy approaches. The biggest segments are office, retail, and residential, which alone cover two-thirds of overall market capitalization. There are also fifteen healthcare REITs and nineteen hotel and leisure REITs.

Thanks to mergers and acquisitions, the REIT sector has consolidated heavily over the past few years, growing from a more-or-less small-scale industry in the early 1990s to one with several very big players today. In each sub-segment, the five biggest companies account for about 80 percent of the market. The ten largest REITs constitute nearly 90 percent of the market cap.

Institutional investors are the most important source of capital for REITs, holding more than half of all outstanding REIT shares. Private, i.e. retail, investors are the second-largest investor group, directly or indirectly holding about 33 percent of REIT shares, via funds. Fourteen percent of the shares are held by management. The large percentage in the hands of management is attributable to a structural bias in the early 1990s toward small and medium-sized businesses.

Existing Indirect Investment Products for Real Estate

Real estate investments should be found in every asset portfolio—they generate a comparatively steady return and develop differently than equity, fixed-income, and liquid assets. Although Germany already offers a broad spectrum of indirect real estate investment products through closed-ended funds, open-ended public funds, special funds, and some real estate stock corporations, there are good arguments for why Germany should introduce REITs as an additional instrument.

Closed-ended funds: Closed-ended funds address a small and limited number of large investors, with the size of the minimum deposit usually being the decisive factor. In most cases, shares of closed-ended funds are virtually untradeable. In their risk/reward profile, closed-ended funds are very similar in nature to investments in real property.

In the past, closed-ended funds were often operated as tax-saving models, i.e. they yielded a return mainly by reducing the tax burden incurred on other types of income. This "external" orientation of the fund initiators explains why, in volume terms, about 40 percent of these funds are currently unprofitable. In light of these characteristics, closed-ended funds are only suitable as an investment vehicle for a small group of private, liquid investors.

Open-ended public funds: Open-ended public funds offer a broadly diversified portfolio of real estate. In principle, they can be redeemed at any time. To secure their liquidity, open-ended funds have sizeable holdings of liquid assets; however, this feature weakens the real estate character of the investment and reduces the overall yield in an environment of low interest rates. Open-ended funds have variable capital, i.e. investors can buy and sell their holdings daily at their market value. If demand for the units fluctuates substantially, this can lead to liquidity problems for the fund. Ideally, open-ended funds are sold to a very large spectrum of retail investors without any major swings in marketing strategy.

Special funds: For all intents and purposes, special funds are open-ended funds that do not address a broad public but instead focus specifically on a very limited number of investors, seldom more than ten. In contrast with open-ended public funds, special funds invest more widely in real estate, i.e. the percentage of their total assets held as liquidity is small. In this way, special funds reflect the opportunities and risks harbored by real estate more directly, and there are pronounced diversification advantages for an investor's entire asset portfolio. However, the products are relatively illiquid, the minimum stake is very large, and the cluster risk—i.e. the concentration of investment on a few objects—is considerable.

Real estate stock corporations: Real estate stock corporations are the instrument most similar in nature to the REIT. These are also public limited companies whose business purpose is to purchase and manage immovable property. Real estate stock corporations are not regulated by special laws. The reason for the (still) limited success of real estate stock corporations in Germany is that, *ceteris paribus*, these companies are inferior to existing tax-transparent funds on account of their tax liability in (price) competition for investment objects. Pressure on these corporations will rise substantially with the introduction of REITs in France and the UK. The small size of a minimum stake, ample liquidity, and high investor protection standards in the stock market make the real estate share a suitable instrument for both institutional and retail investors.

G-REIT: An Important Addition to the Investment Spectrum

G-REITs will be an ideal supplement to the investment spectrum in Germany. U.S. studies provide evidence that in a mixed portfolio, REITs can significantly reduce overall risk while maintaining the level of the yield. This works because the development of the value of REITs cannot be completely reflected by a combination of shares or bonds.

The REIT is an improvement on the little-developed real estate stock corporations. It removes a decisive competitive disadvantage and opens this investment instrument more widely to international investors who are already familiar with REITs in other countries. Generally, REITs address institutional as well as private investors. However, during the first years, when investors and REITs are still gaining experience, mainly institutional investors will take up REIT shares.

While REITs are capital market products and therefore vulnerable to fluctuations, they are not high-risk investments. They are regarded as part of the core plus segment. In other words, they are investments with a moderate risk level that are expected to yield an average return. Over the past few years, the total return on U.S. REITs fell only slightly shy of the return on a broadly defined equity basket. However, the degree of fluctuation was much smaller.

Economic Impact of REITs in Germany

REITs are likely to play an interesting role for the German economy as a whole mainly in light of the following three points:

Professionalization of the sector: REITs will provide a new benchmark for indirect real estate products, which will have a disciplining effect on all market participants. Furthermore, as REITs gain a foothold, real estate research is likely to gather additional momentum; not only will current professors of real estate concentrate on this asset class, but professors of finance, with their highly developed tools for capital market research, will as well. The quality of research will increase, and market participants will be compelled to provide greater transparency and higher quality information.

International capital: International investors are generally welcome in the real estate market because of their expertise. Moreover, their involvement can have a smoothing effect during the ups and downs of the market cycle. With the G-REIT, Germany will create the prerequisites for inflows of long-term institutional capital to the domestic property market. REITs will thus also come to serve as a corrective for the current dominance of real estate opportunity funds in Germany.

Head offices of European players: The introduction of a G-REIT structure may induce sector players to establish or maintain a head office in Germany, which will create additional demand, and thus jobs, for the consulting professions as well. REITs will also lead to greater specialization of the real estate markets, which creates many advantages from which customers will benefit. This type of professionalization also entails benefits for private real estate business. Here, two segments are described in more detail:

- Real estate sector: The G-REIT will introduce a structure that enables real estate companies to attain a new scale of business in the guise of a joint-stock company. The private housing sector in particular could benefit from the introduction of REITs, because municipal housing companies will increasingly need to gear themselves to the sector's very transparent benchmarks. The current debate seems to indicate that pure housing portfolios might be excluded from REIT legislation. Many social democrats fear that REITs will lead to strong rental increases on housing markets. Other observers, however, consider it a mistake to exclude the largest real estate segment from this legislation.

- Trade and industry: Trade and industry will benefit from the introduction of REITs if the move to put immovable assets in a G-REIT is motivated by the lower taxation of "hidden" reserves following their disclosure, as in the French system and the proposed German legislation. Companies will become more flexible financially and thus better equipped for the high degree of competition in global markets. In Germany, nearly 60 percent of all commercial real estate is still on company books; in the United States, the share is only one-third. It goes without saying that companies must own strategic, i.e. core operating, real estate. However, in many sectors the share of "necessary property" is likely very small. Since overall commercial real estate assets in Germany are estimated to total over €1,400 billion, the theoretical potential that can be mobilized—that is, the supply of real estate still unnecessarily held on company books—is enormous. Current estimates show that in the five years following the introduction of REITs, real estate worth up to €60 billion could be brought into REITs.

Significance for the German Government

The government will benefit two-fold from the introduction of REITs. First, state-owned property can be put directly into REITs. Second, it is likely that tax revenues are positively affected by REITs.

THE GOVERNMENT AS A REAL ESTATE OWNER

Despite its wide-ranging disposals over the past few years, the German government remains the country's biggest owner of real estate; the value of residential property, especially that held by local authorities, is estimated to total roughly €100-150 billion. Another €125-150 billion exists in office real estate, in addition to numerous special properties and the public infrastructure. Today, the public sector's real estate portfolios are sold primarily to private equity firms. REITs would develop as additional new bidders in competition with the private equity funds and thus raise bidder discipline.

TAX REVENUES

The current German draft legislation provides a “watertight” proposal to secure the tax base: it is basically a copy of the UK model of the simple joint-stock company with no owner allowed a stake of more than 9.99 percent. This allows fiscal authorities to assume that there will be no tax loopholes undermining their tax estimates.

The *Initiative Finanzstandort Deutschland* estimates that with an exit tax limited to five years, a direct REIT potential totaling about €120 billion will arise over the next five years. This includes the €60 billion in corporate real estate discussed above, as well as residential property and real estate brought in from existing indirect investments. Based on this forecast of the market’s development, the direct increment in tax revenues could approach a net €10 billion. Of course, if residential properties were excluded from the REIT legislation, both the overall market potential and the tax revenues would be significantly smaller.

Conclusions

REITs are a new indirect real estate product that provides a sensible supplement to existing indirect products, especially for institutional investors and high net-worth individuals.

In addition to the creation of an attractive new investment product, the market will see the emergence of an additional benefit for the economy through the attraction of foreign capital. These funds would differ from the current inflows to Germany of private equity funds geared toward short-term investments. The upshot would be that capital inflows from abroad could be placed on a more solid footing over the long term.

A further positive benefit arises in that the market for investments in real estate will become more professional. REITs will need to show a very high performance standard in order to compete successfully for international investment capital in the marketplace. This competition process would raise the efficiency of the entire sector.

The rapid introduction of a G-REIT is desirable because new REIT markets are already developing in France and the UK. Because capital market centers develop strong forces of attraction, Germany should seek to close the current gap between itself and these industry leaders in the race to acquire the scarce talent familiar with this new capital market product. The longer Germany waits, the more difficulty it will face in establishing itself as a locus of professional expertise in the REIT industry.

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