

PATRIZIA Immobilien AG

Recently, **Sheila Hopkins**, managing director – Europe and infrastructure with Institutional Real Estate, Inc, spoke with **Klaus Schmitt** of PATRIZIA Immobilien AG. The following is an excerpt of that conversation.

What is currently happening in the residential real estate market?

We have been seeing a renaissance in German residential real estate for some time, particularly among institutional investors. Renaissance in this context means we are emerging from a period of muted demand. Take German life insurance companies as an example; in the mid-1970s, residential real estate still accounted for an astonishingly high percentage of insurance companies' portfolios, with 50 percent held in the sector on average, and this was during a period when the overall proportion of real estate as a whole was higher than it is today. In other words, the weighting of residential real estate was enormous. However, many insurance companies managed their real estate holdings themselves, which was very labour-intensive, and so, up until just a few years ago, insurance companies were largely divesting themselves of residential real estate in favor of more indirect real estate investment opportunities, for reasons including the level of property management the assets required. During this period we saw a shift toward commercial real estate — firstly office properties and later retail properties. In the recent past, however, insurance companies and other institutional investors have once again adopted a stronger focus on residential real estate. One of the reasons for this is that, for a long time, residential real estate was generally seen as offering substantially lower yields than commercial real estate. Looking at the long-term picture, however — and particularly in times of crisis — this has not proven to be the case. Residential real estate, especially in stable markets such as Germany, has long since become sexy again. It is comparatively secure, income can be reliably forecast — and yields are often higher than people expect.

At a political level, there are repeated discussions about limiting the scope for rent increases. Does this not reduce the expected yields?

We have to keep an eye on the debate, but I don't think this is surprising, particularly in a year during which we will see parliamentary elections in September as well as state elections. Those who invest in the real estate sector and do not completely close their eyes to reality are aware that residential real estate is not only an economic asset, but also a social asset, and that every investment also means acquiring the social components that accompany residential real estate. There is no question that, particularly in Germany, politicians see tenants as potential voters and are keen to protect their interests. The ratio of tenants to homeowners is significantly higher here than in almost every other European country. Germany is a nation of renters, and this means keeping rents at a sensible level is a justifiable political objective. However, I seriously doubt



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years of which were spent as head of the Legal Affairs Department. In 2003, he became head of the Legal Affairs Department at PATRIZIA Immobilien AG and worked as a manager at operating PATRIZIA subsidiaries. He has been a member of the PATRIZIA Immobilien AG Management Board since January 2006.

this will be possible in the long term using the tools that are being discussed. The primary objective must be to increase the availability of residential real estate as a whole — something that can only be achieved if the private sector finds the conditions to be interesting. The role of the public sector is to ensure a correspondingly broad range of available properties, particularly in the more affordable rental segment.

What has to happen in order to make residential real estate even more attractive for institutional investors?

Residential real estate is already extremely attractive for institutional investors, providing they have the right partner, but it remains intensive in terms of administrative effort and must be managed accordingly. The main benefit of residential real estate — as well as its main drawback — is the granularity of the asset. This is the reason for the low risk presented by the asset class as a whole, but it also goes some way to explaining the high level of administrative expense involved, which attracts significant public attention because at the end of the day it is someone's home and is therefore highly sensitive. In our view, this means indirect investment is the most attractive form of investment in residential real estate for institutional investors, providing administrative costs are optimised, to ensure attractive yields can be offered.

How does that work?

Through efficient asset and property management — and, of course, by achieving a certain portfolio size in order to leverage economies of scale.

Economies of scale are also a topic when it comes to your company. Could it be the case that, if anything, your company and the real estate assets you manage are growing too quickly?

It may seem this way when you look at the pure figures for assets under management. However, a closer analysis shows that in the majority of cases the growth in our real estate volume has been accompanied by growth in managers, who already know the assets. In our last two major transactions, at least — LBBW and GBW — we acquired not only the properties but also the companies that had previously administered the properties. Real estate

is always a local business, so it is beneficial — if not essential — to have a team with local expertise. All in all, we are positioned in such a way as to allow us to grow by €1 billion each year through ordinary real estate transactions. We participate in all phases of the value chain, starting with research and acquisition, via portfolio management and optimisation and corresponding asset and property management, through the development of viable exit strategies and subsequent disposal. The experience gained from the exit process is then fed into our research, meaning there is a permanent feedback loop. Needless to say, the larger the portfolio, the greater our involvement at each stage of the value chain, thereby reinforcing our market position further.

Looking at the long term, the demographic outlook for Germany, and hence demand for residential property, is comparatively subdued.

This may well be the case if you are looking at absolute numbers. The German population is getting older, and the long-term population growth trend is a downward one, although there has been a sharp rise in immigration. It remains to be seen what the impact of this immigration will be in terms of long-term population growth. However, the current trend forecasts should not be used to draw any hasty conclusions about demand for real estate in Germany. The impact on individual markets is extremely varied. There are regions that will benefit from population influx over time. Major cities in particular, but also smaller cities, are attractive and draw people toward them. As a matter of principle, it is the economically attractive regions with high population growth and strong demand for residential space that are interesting for us. In Germany, this primarily means Berlin, Frankfurt am Main, Hamburg, Cologne, Düsseldorf, Stuttgart and Munich. “B” locations and university cities are also interesting for our funds, which act as owners of portfolios. In some university cities, the number of students has been high for some time now and vacancy rates for the city as a whole have fallen to around 1 percent. As well as making a distinction between winners and losers in terms of population influx, it should be noted that housing demand per person is generally on the rise as the average household size becomes smaller. Single-person households are extremely commonplace among young people who have yet to start a family, as well as among older people whose partners may have died, for example. The latter population group, who opt to remain in apartments that are fundamentally too large for them, are an important factor. According to official forecasts, demand for residential property will continue to rise for a number of years before declining, albeit only slowly. Another factor is that the previous assumptions concerning migration within the European Union have already had to be revised upward for some cities. As such, it is possible that immigration from abroad will have an even more positive impact on demand for housing than has been assumed to date.

And the increasingly stringent energy restrictions for German residential real estate — will they make construction more expensive, thereby curbing demand?

Germany is a pioneer when it comes to climate protection. And the federal government, as well as the

real estate industry itself, applies high standards with regard to energy-efficient renovations and new construction activity. This is a good thing. Of course, this has an effect on prices, but energy-efficient buildings make back the additional initial expenditure in the longer term thanks to their lower energy-related ancillary costs. In Germany, we have long used the term “second rent” as, in extreme cases, these ancillary costs can be easily as high as the actual rent. This makes them an increasingly important factor for tenants when choosing an apartment. Irrespective of this, energy-efficient buildings are a topic that is by no means restricted to Germany. According to EU regulations, it is expected that only new buildings that conform to a near-zero energy standard will be approved for construction from the end of 2020 onward — which is not all that far in the future. And, as I say, this will apply throughout Europe. This is why it is good that Germany addressed this topic at an early stage. Economically speaking, the move to the new standard will be a great deal less painful because we have already made comparatively good progress.

What is the position of REITs when it comes to investments in German residential real estate? In many countries, such as the United States, they play an enormous role — large-scale developments included.

In Germany, the REIT market is far less developed than in the United States. German REITs are still extremely young and, regrettably, very much in their infancy. In addition, German REITs are prohibited by law from investing in older German real estate portfolios. As such, REITs are not expected to play a particularly substantial role in Germany in the near future, at least when it comes to residential real estate. Traditional listed real estate companies have a longer tradition in Germany and, as far as I am concerned, also a more promising future — although I would certainly welcome the emergence of a strong REIT segment. ❖

CORPORATE OVERVIEW

With around 600 employees in over 10 countries, PATRIZIA Immobilien AG has been active on the real estate market as both an investor and service provider for nearly 30 years. PATRIZIA's range includes the purchase, management, value increase and sale of residential and commercial real estate. As a recognised business partner of large institutional investors, the company operates in Germany and other countries and covers the entire value chain in the real estate industry. At present, the company manages real estate assets worth €10 billion, primarily as co-investor and portfolio manager for insurance companies, pension fund institutions, sovereign wealth funds and savings banks.

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