Also in this section
Quality control 19 Investors target multi-family housing
Exit ahead 21 Deutsche Annington IPO expected
Special circumstances 23 Industry fights to keep spezialfonds

Economic stagnation elsewhere makes Germany best bet for bargains, reports *Lauren Parr*

Opportunistic buyers home in on German distress calls

Germany is a favourite market for opportunistic investors, which have set aside a defined pool of capital for investments in distressed property there. As Phillip Burns, chief executive of Corestate Capital, says: "When it comes to a stressed or distressed deal, you want that to be in a stable, robust economy and Germany is one of the only places in Europe that offers that today."

From direct properties and asset management mandates to co-investments and non-performing loan purchases, German opportunities are piling up, their sources including open-ended funds, banks, securitisations and developers.

There are both distressed assets and distressed sellers – and the two things are not necessarily the same. "We're interested in prime, core assets being sold by distressed sellers as opposed to distressed assets themselves," notes Ronald Dickerman, president of Madison International, for example.

He adds: "Economic stagnation in Europe means there is a lot of caution when it comes to investing. For example, many investors we see are not so crazy about buying a 15% vacant office building. Now we're seeing prime real estate yields expand in Europe, people are questioning whether pricing reflects current risk, given what we know is happening in Europe now."

German housing has allure

This is increasing Germany's allure and one sector investors have increasingly been targeting is residential property. Portfolios of rented multi-family housing have become expensive since more opportunistic buyers started to compete with institutional investors, attracted by the asset class's record for matching inflation and lenders' continued willingness to offer debt secured against it.

Dickerman: "People are questioning whether pricing reflects current risk, given what we know is happening in Europe"

German residential investment volumes hit €6.13bn in the first half of 2012, according to Savills, and are on track to reach €10bn by the end of the year – the highest volume since the market peaked five years ago.

The increase is partly due to the fact that €8.8bn of residential debt is due to be refinanced this year and next, and partly because state-owned landesbanks are being forced to sell their residential assets.

"Mainly we're talking about privatisation, partly triggered by German landesbanks, which needed to be subsidised by the German state and have been told to sell portfolios," says Tim Brückner, executive director at Corpus Sireo.

Landesbank Baden Wurtenberg raised €1.4bn by selling a 21,000-home portfolio; state-owned TLG, which owns 11,500 homes in eastern Germany, is set to be privatised; and BayernLB's GBW property subsidiary is selling 33,000 homes (see pp19-20).

Private borrowers offload assets

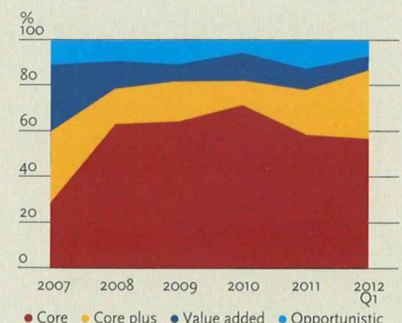
Two of the largest sales this year were by distressed private borrowers: Cerberus won the Speymill portfolio (see panel, right) while Deutsche Wohnen clinched the 23,500-asset BauBeCon portfolio. Barclays sold BauBeCon by exercising a call option over borrowers RREEF and Pirelli's Prelios after successive breaches of loan-to-value covenants and a drop in the properties' value.

Some smaller distressed residential portfolios have been marketed, but most of

European investors remain cautious on assuming risk

Readiness to assume risk in Germany remains low, with most investors going after core properties, according to Jones Lang LaSalle. Investment volumes declined 16% to €9.4bn in H1 2012, the firm said.

Economic uncertainty throughout Europe has fuelled caution among investors generally, although appetite for core-plus assets is expanding owing to a lack of core product. This is driving an increase in demand for high-quality buildings in good, secondary locations.



SOURCE: JONES LANG LASALLE

those that are for sale or coming to the market, like one owned by the Landesbank of Bavaria, are not distressed.

With return expectations becoming harder to achieve at today's prices, "investors are taking a longer look at which route to take", says Brückner.

BayernLB director Gustav Kirschner says opportunistic investors are pursuing portfolios with high vacancy rates and a backlog of maintenance work.

Activum, the German opportunity fund manager founded by former Cerberus partner Saul Goldstein, is redeveloping residential property in Berlin that it acquired from an overseas developer and another insolvent scheme that it bought from the court. Peakside also has exposure to Berlin housing, having acquired one of its two developments there from an Irish developer that wasn't able to inject equity.

Compared with German housing, which usually has very long leases, commercial offices are under more severe pressure in terms of their lease profile. The sector represents the majority of the €27bn-worth of European properties that closed and liquidating German open-ended funds have to sell over the next five years, most of which are in France and Germany.

The majority stake in the Frankfurt Trianon office and residential complex Madison International recently bought came from Morgan Stanley's liquidating P2 Value fund, for example.

Some 11 out of just over 40 German open-ended funds are being wound down, including four of the biggest: AXA ImmoSelect, CS Euroreal, KanAm GrundInvest and SEB ImmoInvest, with €18.8bn alone. It's a major acquisition opportunity – particularly for anyone looking to enter the German office market. The funds' assets are mixed: some are in good locations and offer long-dated income, but there are also plenty of partially vacant buildings.

Prices must fall

Prices need to fall if funds are to dispose of all these assets, sources say. The liquidation process will help facilitate this, as it lifts the restraint over the level at which funds can sell; after the first year, a 5% discount is permitted, rising to 10% after year two.

The pressure on open-ended funds to sell assets could be increased by regulation coming into force next January, which will require funds to lower their loan-to-value ratios from 50% to 30% by the start of 2014.

Opportunities to buy distressed assets, or buy from distressed vendors, could come from parts of the retail sector, especially assets in the former East Germany and properties with discount retailing tenants.

By and large, retail remains a popular asset class, with core and core-plus retail investments heavily sought after and hard to find. A shortage of core product contributed to a 47% year-on-year fall in retail investment in the first half of 2012, down to €3.2bn, according to CBRE's figures.

"Even where the product is not perfect, investors are paying top dollar to step into these situations," says Boris Schran, founding partner and head of acquisitions at Peakside Capital. This supply bottleneck is making international buyers look at secondary locations. "If you do see distress, there will probably be a severe defect in the asset," Schran says.

Jan Dirk Poppinga, CBRE's head of retail investment, Germany, says prices are falling for assets where locations are weak and leases close to expiry. Some international banks are now looking for an exit from such deals. They financed more supermarket portfolios, retail parks and retail warehouses than German banks, which focused on top-quality and were less active in retail.

In many cases, "banks must now find a exit solution. Sometimes the only way is insolvency proceedings," says Poppinga – something he expects to see more of.

Axel Froese, an investment manager with

Cerberus bites off big chunk of Hypo bad bank's assets

Cerberus has been an active buyer of distressed assets in Germany. In July, the US private equity firm picked up one of the first significant packages to be sold by Hypo Real Estate's bad bank: 47 retail assets comprising construction sites, small regional shopping centres in North Rhine-Westphalia and units let to Aldi and Rewe.

The original borrower, JER Partners' European fund, paid around €100m for the assets and Cerberus acquired them for less than the value of Hypo's original financing. JER Partners was a casualty of the downturn and since earlier this year its European assets have been managed for investors by LaSalle Investment Management.

HRE's bad bank, FMS Wertmanagement, reduced its commercial property portfolio by nearly €7bn last year through some sales and loan repayments.

In May, Cerberus bought bankrupt Speymill Deutsche Immobilien Company's 22,000-strong Halk multi-family housing portfolio.

The complex deal involved restructuring SDIC's €985m debt pile with its lenders – Dutch NIBC Bank and German landesbanks Nord LB and HSH Nordbank – and resetting the loans at a market-rate margin of 250 basis points. SDIC defaulted on the loans in 2010 when the portfolio's vacancy rate was 13.5%; Cerberus beat Goldman Sachs, Blackstone and Morgan Stanley to acquire the assets.

Cerberus is making an undisclosed investment, in the form of subordinated debt and equity, which will be used to pay down debt and provide capital expenditure, and some individual assets will be sold to private investors.

Cerberus senior managing director Lee Millstein said at the time: "The banks benefit from this deal by having a large portfolio of non-performing loans converted to performing loans, while stakeholders benefit from Cerberus injecting new capital for improvements and leading the execution of a turn-around of the assets."

Ernst & Young, receiver to SDIC, also agreed the sale of a sub-portfolio that had been securitised in the TOR CMBS, issued by NIBC Bank.

Benson Elliott bought most of the sub-portfolio, with assets in strong locations in Berlin, Frankfurt, Munich and Cologne, out of receivership for its third fund.

"When it comes to a stressed or distressed deal, you want that to be in a stable, robust economy and Germany is one of the only places in Europe that offers that today"
Phillip Burns, Corestate Capital

Cordea Savills, says: "We're interested in going after properties where banks view their exposure critically if a portfolio has a remaining lease maturity of below six or seven years. They don't know whether there is a risk of the tenants moving or only paying half the rent."

Overseas investors as well as lenders are exiting their investments. "We're looking for distress where we can add value," says Stuart Reid, head of Rockspring's German operation. "A lot of that is coming from sponsors in places like Ireland, Spain and the Nordic countries, who entered Germany in the last wave in 2005-07, didn't have a strong local presence or market knowledge and made poor investments that are now facing problems. In many cases, these investors have already gone and banks are left dealing with these investments."

Banks are also grappling with not-so-badly performing properties where loans are approaching maturity which they don't want to refinance, but don't necessarily want to accelerate or enforce.

Activum founder Saul Goldstein sees this as an opening to provide finance. "We're seeing interesting opportunities in mezzanine lending," he says. "We're filling the gap where we would otherwise be an equity buyer." Activum recently provided financing equal to 20% of the cost of a retail and office project in Frankfurt and has also bought notes from lenders at a discount and then executed a debt-for-equity swap to take control of the project.

Reid: "We're looking for distress where we can add value. A lot is coming from sponsors without local market knowledge"

Many of the investors looking at distressed opportunities in Europe are US-style opportunity funds hunting for loan-to-own deals, but in Europe they have not seen the same volume of loans offered for sale as they are seeing in the US.

Banks prepare to go to auction

A number of German balance-sheet lenders are believed to be creating shortlists of potential buyers so that when they're in a position to sell, small auctions may take place.

PricewaterhouseCoopers estimates that the volume of total non-performing real estate loans on German banks' books at the end of 2011 was €196bn, down from €214bn at the end of the previous year.

However, compared with overseas banks, German banks have generally been relatively slow to offload non-performing loans. So far, there have been a few trades of between €100m-150m from banks that are dealing with peripheral, rather than core, exposure to bad property loans.

"Assets are only coming to the market because of an immediate liquidity shortfall; banks are still slow to clean up their books, and events are mostly driven by lease or cash-flow maturity on the underlying assets, rather than loan maturities," says Schran.

Loan sales will take more time "because German banks' balance sheet strength is not fundamentally right and regulation makes it even more difficult for banks to sell loans below book value," Brückner adds. "I expect that over the next 18-24 months, one by one banks might be able to offset write-downs on mid-sized transactions, as it won't any longer be seen as such a political decision."

While the pace of loan disposals has disappointed many would-be investors, acknowledges Colin Fleury, head of secured credit at Henderson, "non-performing consumer loans seem to be an area of focus; banks are trying to shift those, given the higher cost of holding them".

Most market watchers concur that a wave of big distressed loan portfolio sales is unlikely. "I'm pessimistic that we're going to see a wave of big portfolio deals, as certain banks are government-backed and as long as cheap refinancing is available, they are not under any time pressure," says Schran. "Other institutions simply can't afford the necessary write-offs of certain loans."

Distressed assets flow onto the market through CMBS conduits

"We will see a lot of insolvent deals from CMBS conduits coming to the market," says Phillip Burns, chief executive of Corestate, although it will take time "for them to work themselves through".

Pimco bought the Diversity Funding CMBS portfolio, backed by €1.3bn of commercial real estate loans originally owned by Lehman Brothers, from Deutsche Bundesbank in April. Last month it picked up a second package of loans from the bank: Portfolio Green, which is all secured on German property.

The Bundesbank is also thought to be preparing to sell another CMBS portfolio with a €238m face value.

Special servicer Hatfield Philips has hired investment bank Metszler to market the debt secured against the Velvet portfolio of 5,236 German multi-family homes for a second time.

De Leo: "More opportunities will come out as securitised loans come up for maturity"

It pulled an earlier deal to sell the loans to Corestate, partly because it felt an off-market deal would not have generated the highest possible recovery for noteholders of the Titan Europe 2006-2 CMBS.

Keith Breslauer, managing director of Patron Capital, which has just raised €880m for a fourth European opportunity fund, expects to see more deals such as its April acquisition of Dutch company Uni-Invest's 203 assets, which it acquired by buying the defaulted loan backing the CMBS, with TPG.

"We are working on a couple more big ones that are coming up in the next six months," Breslauer says.

Benson Elliot's acquisition of 3,000 homes in the TOR portfolio (see panel, p17), "may be one of the first defaulted CMBS portfolio loans to be resolved, [but] it certainly won't be the last," according to Benson Elliot senior partner Trish Barrigan.

Joseph De Leo, Barrigan's senior partner colleague at Benson Elliot, says: "More opportunities will come out as securitised loans come up for maturity. A lot of bondholders are non-traditional real estate investors – they want liquidity."

This, De Leo reckons, will happen over the next 18 to 24 months. "Leases continue to burn off and capital expenditure will be required," he says. "Noteholders would rather exit than work through the property."

Huge weight of deals are set for refinancing over the next year but quality will ensure stability

Trading soars as investors home in on German housing

At almost €9bn, the volume of loans secured on German multi-family housing that needs to be refinanced by the end of 2013 is massive, yet it has not destabilised the market. This is in large part because the assets backing the loans are mainly good-quality, performing properties and because there is strong demand for them when portfolios come up for sale.

Of the quantum of debt that needs to be refinanced, the largest single transaction is the €4.4bn GRAND CMBS. But its properties aren't distressed, "it's just that the debt is all due on one day", points out Phillip Burns, chief executive of Corestate Capital. A five-year extension of the bonds to 2018 has been proposed by the borrower, Deutsche Annington, in exchange for €504m of equity and a 117-basis point margin increase for bondholders (see p21). The idea is for the outstanding securitised debt to be reduced in tranches.

"If all goes to plan over the next few years, it will be a consensual restructuring and a gradual refinancing, so it's not going to turn out to be anything that the distressed debt guys can get excited about," notes Colin Fleury, head of secured credit at Henderson.

This goes for several of the €6bn-worth of portfolios Savills calculates have been traded in Germany already this year, including Landesbank Baden Wurtenberg's (LBBW's) 21,000-unit portfolio, a sale that was driven by requirements imposed by the European Commision, not because the assets were problematic. Neither is the upcoming sale of 33,000 homes held by state-owned BayernLB's GBW property subsidiary distressed in terms of property – in fact, the assets are considered to be one of the best housing portfolios in Germany.

Nonetheless, some of the 180 portfolio sales in the last 12 months have been distressed. Benson Elliot's purchase of a 3,100-unit Speymill portfolio called Noah was one, while Cerberus bought insolvent Speymill's larger Halk portfolio of 22,000 homes and Corestate picked up 3,000 apartments in Berlin from a foreign vendor that had acquired the assets at the peak of the market. Blackstone acquired over 8,000 residences from administrators to Level One, many of which were in eastern Germany.

Further distressed assets could surface from the €2.18bn Gagfah-sponsored GRF 2006-1 CMBS, the other very large transaction with a loan expiring in 2013. Gagfah, Germany's largest listed residential property company, which is 60% owned by Fortress Investment Group, also intends to sell the 43,000-unit Dresden portfolio owned by Gagfah's Dresden Woba unit to pay off a further €1bn of debt which is securitised in Windermere IX and Deco 14. The Dresden assets were bought for about €1.7bn from the city's government in 2006, but have not generated rental income and sales proceeds sufficient to justify their high purchase price.

Attention turns to Dresden

Gagfah is looking to trade the 42,688 residential, 1,110 commercial, and 8,683 parking units in the less economically buoyant Dresden region of eastern Germany at near par. This side of the country plays second fiddle to western German cities in terms of demand for residential real estate, but the limited buying opportunities in the West have contributed to interest in investment potential there. Investor/asset manager Patrizia's research on the subject last year ranked Dresden as commanding the second-highest rents in the East, after Berlin, and said demand for new accommodation would be high through to 2025, with 40,476 apartments required in Dresden.

Benson Elliot's purchase of two Speymill portfolios (in addition to "Noah", the private equity firm winkled out the 3,000-unit TOR portfolio earlier this year) leads portfolio manager Joseph De Leo to predict: "We're going to see more and more opportunities come from CMBS over the next 18-24 months. There are immediate opportunities in the multi-family sector as a lot of those investments made in the 2004-08 phase are starting to come up for loan maturity."

The TOR portfolio comprised good assets in Berlin, Frankfurt, Munich, Hamburg and Cologne, with 91% occupancy. The investment was a result of uncured covenant breaches and ended up being a maturity issue which led to insolvency. "It was an opportunity that came about through the bondholders pulling the plug on the original sponsors," De Leo recalls. "We had relationships with the servicer and with Berlin Hyp, which allowed us to put the financing together."

The firm sold half of a third, 700-unit residential portfolio in Berlin called Silvertower that it acquired in 2010, taking advantage of substantial liquidity generated by a range of prospective buyers including institutional investors, listed vehicles and high-net-worth individuals. "These are

Top 10 residential portfolio deals in past 12 months

Multi-family is a hot market with over 122,000 units traded and more sales to come

Deal/company	No aptmts	Qtr/yr	Price €/m²	Price €m	Buyer
DKB	25,000	1/2012	640	960	TAG Immobilien
BauBeCon	23,500	2/2012	814	1,234	Deutsche Wohnen
Speymill Halk	22,000	2/2023	704	985	Cerberus/Corpus Sireo
LBBW	21,495	1/2012	1,025	1,435	PATRIZIA-Konsortium
Level One Nr 2	8,160	1/2012	415	200	Blackstone
Level One Nr 1	6,801	3/2011	364	150	Blackstone
Gagfah-Berlin	4,832	4/2011	1,058	330	GSW
Former BVG-WE	4,680	4/2011	1,050	71	Degewo & Gesobau
Speymill "Noah"	3,100	1/2012	812	187	Benson Elliot/Wertgrund
n/a	3,083	3/2011	720	150	TAG Immobilien

SOURCE: BULWIENGESA

the parties we are going to sell assets to. We don't see a lot of the German funds – they're more geared towards buying more stabilised assets," according to De Leo.

Investors are increasingly attracted to multi-family, owing to the fear of inflation, currency risks and uncertainty in the capital markets. High levels of competition could make return expectations for opportunistic investors difficult to reach, however.

"For people who want to come into the sector to buy some of these repositioning portfolios, the pricing is getting more expensive," says Tim Brückner, a director of asset manager Corpus Sireo.

Morgan Stanley was last year said to have allocated €1bn to German residential investments, although commentators reckoned its only option would be to search for distress in order to achieve the 8-10% yields it was aiming for. However, Deutsche Annington says it is achieving 8-9% total returns (see opposite).

Peakside Capital has done some deals in the sector in the past, and is "continuously looking at multi-family but [has] been priced out," says Boris Schran, head of acquisitions at the company. If you go to places with strong demographic trends, like in Munich, where there is high demand for multi-family, it's very tough to get these investments done at a decent price." It has a sizeable portfolio in eastern German growth cities, although even there it has seen quite a price increase.

Axel Froese, an investment manager with Cordea Savills, believes the sector can be "more risky than people think". "A lease contract with an existing tenant is very protected, so the landlord doesn't have the same rights as a landlord in the UK, for example," he warns. "Older schemes of 10 or 15 years have higher non-recoverable costs so the liquidity is often very tight, the value is high, and there is a mismatch."

Insurers and pension funds join queue for multi-family refinancing deals

German banks continue to lend to the multi-family sector and other potential non-bank lenders are also showing interest in the asset class for the first time. Gagfah is talking to German pfandbrief banks and landesbanks, thought to include LBBW, HSH Nordbank, Deutsche Pfandbriefbank, DG Hyp and Landesbank Berlin, as well as insurance companies and pension funds about refinancing its €2.18bn GRF 2006-1 CMBS.

Fortunately, "there is a lot of competition from German banks for multi-family financing," says BayernLB director, Gustav Kirschner. Competition is higher for deals of between €20m and €40m, he notes, while for bigger deals five to 10 banks are active. "Some international banks have stopped in this sector," he adds.

BayernLB lent €500m on multi-family deals over the past 12 months. This included the debt capital it provided for Deutsche Wohnen's €1.24bn purchase of the 23,500-asset BauBeCon portfolio from Barclays. BayernLB, HSH Nordbank, UniCredit Bank, DG Hyp and pbb Deutsche Pfandbriefbank each provided separate facilities with a combined total of €730m, with Deutsche Wohnen investing €430m of equity.

Kirschner: "There is a lot of competition from German banks. Some international banks have stopped in this sector"

Pbb's €285m share – some of which will be syndicated – is an example of the group's "significant headroom to finance multi-family real estate", according to Bernhard Scholz, member of the bank's management board. About €5bn – or 20% – of its €24.6bn real estate portfolio (as of 30 June) was attributed to what pbb calls "commercial residential real estate finance".

Kirschner says there is only so much of this business BayernLB can handle, but its annual capacity exceeds €1bn, on the basis of multi-family being low-risk. "It's good for our pfandbrief refinancing to have a big chunk of multi-family in there," he adds.

Another means of refinancing multi-family could be to use the capital markets. Vitus, a consortium led by Blackstone, is attempting to refinance £580.13m of now-matured debt within the Barclays Capital's 2005-issued Centaurus Eclipse CMBS via a new agency CMBS. The bonds will be sold directly on behalf of the borrower and the cornerstone bond investor is JP Morgan. A preliminary offering circular was due in early September.

Recent debt financing deals

So far, German pfandbrief banks have stepped up to the plate and other lenders are looking at multi-family

Date	Borrower	Amt (€m)	All-in cost pa (%)	LTV (%)	Term (yrs)	No lenders	Comment
11/2011	Goldman Sachs Whitehall Funds	218	4.0	65	8	2	New debt to finance acquisition of €330m Gagfah portfolio in Berlin
02/2012	Patrizia et al	840	3.2	60	8	1	Vendor financing for €1.4bn LBBW portfolio
03/2012	Fonciere Dev Log	568	3.6	n/a	7.5	4	New bank debt to refinance expiring CMBS debt
04/2012	TAG	800*	4.0	83	10	1	Bayern LB €60m vendor financing for €960m acquisition of DKBI
05/2012	Deutsche Wohnen	730	3.5	60	7	5	New debt from BayernLB, HSH Nordbank, UniCredit Bank, DG Hyp and pbb for €1.2bn BauBeCon acquisition
07/2012	Deutsche Annington	4,400	3.4	60	2	1	GRAND CMBS extension with Annington €500m equity injection
06/2012	KWS	23	3.3	n/a	10	3	Debt refinancing provided by a global insurance company and two German commercial banks
06/2012	TAG	85	5.5	n/a	7	n/a	€95m unsecured convertible to pay instalment for DKBI acquisition

SOURCE: MORGAN STANLEY AND REAL ESTATE CAPITAL. * €800m = assumed existing liabilities