PROPERTY FINANCE EUROPE

• European REITs • German non-performing loans (NPLs) • Institutional real estate portfolio investment • Mortgage securitisation, CMBS/RMBS • French office property • Distressed debt • German real estate banking • Special mortgage servicing • US real estate funds in Europe •

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G-REITs should make up 10 years of lost ground in German real estate values

The introduction of German Real Estate Investment Trusts (G-REITs) will, if it happens quickly, allow the nation's property sector to make up the ground it has lost over the last 10 years in comparison to European neighbours, the Netherlands-based Kempen & Co said in a recent research report. **PAGE 3**

Von Köller denies Lone Star move into banking

US-based Lone Star Funds has no plans to move into mainstream banking in Germany, Chairman Karsten von Köller said. **PAGE 4**

European home mortgage sector seen at turning point

The European home mortgage sector presents huge opportunities, particularly in higher-risk lending, a new Mercer Oliver Wyman study says. **PAGE 7**

Recycling possible for east German 'pre-fab' blocks

One of the main obstacles to reviving near-worthless east German residential apartment blocks can be solved by recycling the component parts into low-rise dual-family homes. **PAGE 10**

Depfa surprises with sudden cut of German subsidiary sale

Depfa Bank PLC last week surprised the German banking world by abruptly cancelling the sale of its Wiesbaden-based Deutsche Pfandbriefbank subsidiary, saying bid prices from institutions fell well short of expectations.

"None of the purchase offers we received corresponded to our ideas on price," Depfa Chairman Gerhard Bruckermann told the annual press conference. He had hoped to locate an institution interested in using Depfa as a platform for entering public sector financing in Germany.

The strategic retreat from an attempted sale of Depfa is particularly interesting since the history of the bank over the last few years has been an object lesson in attempts to realign a special institution to the requirements of the modern-day financial system - including how to deploy equity capital to achieve most efficient funding.

Founded in 1922, the Prussian Covered Bond Issuance Institution (Preussischer Pfandbriefanstalt) changed its name after WWII to Deutscher Pfandbriefanstalt, Depfa. In March 1991, Depfa was privatised and floated on the German stock exchange as Deutsche Pfandbrief- und Hypothekenbank AG. Eight years later, in 1999, it changed its name again to DePfa Deutsche Pfandbriefbank AG and, as part of group restructuring, transferred the entire property activities to a separate entity, Deutsche Bau- and Bodenbank AG.

Then, in October 2001, the parent AG convened an extraordinary shareholders' meeting to seek approval for a split into two independent listed banks to specialise in, respectively, public sector finance and real estate activities. In the same month Depfa Bank PLC incorporated in Dublin, Ireland. Four months later, in January 2002, the new company offered its shares to all DePfa Deutsche Pfandbriefbank AG shareholders at 1:1, achieving an overwhelming majority for what was, in effect, a move of the entire institution to Ireland.

Soon afterward Deutsche Bau- and Bodenbank AG was spun off and renamed Aareal Bank AG to pursue real estate activities independently. In March 2002 Depfa Bank PLC, now concentrated solely on public sector lending, was listed on the Frankfurt Stock Exchange. Four months later Aareal, CONT. BACK PAGE COL. 1

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Thank you to all who have registered for notification of Property Finance Europe! We have received a large amount of registrations both on fax and email - many from the City of London, some local in Germany, some from the US and even from as far away as Alaska!

Aside from the serious business of keeping you informed on the topics on the right of the title above, one intriguing aspect of a publication such as PFE is how far it gets around in the world. We were involved in a newsletter in the early 1990s that, to our delight, won several devoted readers in the Central Bank of New Guinea in Papua!

For those who did not receive the first edition of PFE, details of how and why we started are repeated on page 2.

This week we are, for the first time, a download and no longer an attachment.The site - pfeurope.de - is open, as you will probably know if you are reading this. But advance registrations on fax or email are much appreciated. Soon our registration procedure will be available on line prior to download.

One of the main issues in Germany after last week's London conference of the mortgage bank association, VDH, has been Pfandbriefe and the relative merits of covered bonds, German-style, versus, for example, RMBS.

The European Covered Bond Council (ECBC) was set up last November to respond to the growing desire of banks to issue these instruments even without an underlying legal structure. The times they certainly are a-changin'. PFE

DG Hyp founds Immofori for medium-term move into European NPL business

DG Hyp, the Hamburg-based mortgage bank subsidiary of the DZ Bank cooperative central bank, has founded a separate company, Immofori GmbH, to facilitate a medium-term strategic move into the European non-performing loan (NPL) business. Immofori will engage in valuation of distressed debt from large institutional customers and then assist in selling these, the Handelsblatt newspaper reported.

Immofori already had the first contract from its parent DZ, valued at around E500m face value. DG Hyp (Deutsche Genossenschafts-Hypothekenbank AG) did not confirm this. How far and how fast it would move into other European countries has not been determined. "We are examining this option," DG Hyp director Friedrich Piaskowski said. "But we are not likely to be able to turn this into reality within the next two years anyway." CONT. BACK PAGE COL. 2

European Real Estate Investment Trusts: An idea whose time has come?

A Real Estate Investment Trust (REIT) structure was first introduced in Europe in 1969 by The Netherlands with its BIs (fiscale Beleggingsinstelling). It took 19 years for the next European introduction, in Luxembourg in 1988, and then several more before Italy and Spain gave similar structures the green light in the 1990s.

But it was the French introduction of its SIICs (Sociétés d'Investissement Immobiliers Cotés) two years ago that really prompted Germany and the UK to begin to look seriously at the legislative environment for their own national property companies.

Property professionals in Europe feel that REITs is an idea whose time has come. The demographics of ageing 'baby boom' populations, coupled with a wish to diversify from corporate equity after the stock market collapse of 2001, means income yield rather than the hope for capital appreciation has become the principle driver of capital investment. Real estate offers (relatively) stable cash-flows as a strong alternative to fixed income in sovereign bonds that may no longer be quite so risk free when issued by governments seemingly unable to deal with burgeoning budget deficits. To say nothing of corporate blue chips whose ratings, amid globalisation challenges, can slip from AAA to junk within a very few years.

REITs were first introduced in the US in 1960. Australian Listed Property Trusts followed in 1971. But the the real global surge has come in the last 10 years. Pramerica Real Estate Investors calculates that the global listed property sector's equity market capitalisation has more than quadrupled - to over $536bn late last year from $130bn in 1994.

In that time, the equity market capitalisation of US and Australian exchange listed real estate companies has grown at a compound annual rate of more than 20%, compared to 6% for corporate stock market values.

Prudential Real Estate Investors also sees this is a world-wide trend. "In countries throughout Asia, Europe and Latin America, authorities are introducing or considering new tax-transparent property investment vehicles similar to US REITs and Australian listed property trusts," it said in a recent report.

Property has gained acceptance as an asset class, and the market infrastructure is developing rapidly to foster growing investor demand.

"The growth of the global REIT market stems from the confluence of powerful demand and supply forces: short- and long-term demand for stable, income-oriented investments and an expanding universe of real estate investment opportunities that offer relatively attractive yields and modest opportunities for capital growth," the Prudential report said.

PriceWaterhouseCoopers' Uwe Stoschek says Germany would do well to take its place quickly in the rapidly-evolving trend toward stock exchange-listed property holdings, thereby competing for foreign capital inflows into its domestic real estate. In Europe, French SIICs have attracted numerous registrations and produced exit tax revenues for the state budget. This could be used as a model for Europe as a whole.

"REITs can no longer be stopped," Stoschek told a Heuer Dialog seminar in Munich recently. "The international environment shows that a clear trend and a demand exists." But he warned: "To be successful, governments must present a clear and market-oriented concept, otherwise the concept is doomed to failure."

The UK has had Property Investment Funds (PIFs) on the agenda for some time. Legislation now looks likely to be brought before Parliament in late May, after the 5 May General Election. Britain had wanted to try to become the market leader in REITs in Europe, but this has been delayed by a long consultation process.

The immediate vicinity of the Channel Islands raised UK Treasury concerns that onshore property investment vehicles untaxed at source could encourage both private and institutional investors to transfer capital to Guernsey, Jersey or the Isle of Man to invest in them. Further discussion is taking place on this. But the issue of the proportion of assets allowed to be used in property development seems to be resolved: a PIF will be able to earmark 25% for this. It will be allowed to move to a still higher allocation to development projects but must then transfer the excess to an allied external entitity that becomes liable for standard corporation tax.

Germany's similar concerns over tax revenue implications have held up a decision so far by a committee of state and federal legislators meeting in Berlin to consider the REITs issue. However Finance Minister Hans Eichel said in mid-April, since the last meeting earlier this month, that he remains very open

WELCOME TO THIS SECOND EDITION OF PROPERTY FINANCE EUROPE, a newsletter that grew out of an informal information service that we at easetec in Frankfurt have been providing to clients and business friends for some time. Through this, it quickly became clear that the need for English language information in institutional real estate-related issues from the European continent is huge, particularly from US investors who have only recently re-discovered these markets.

PFE aims at a fortnightly report and analysis on a number of themes: all those you can see on the right of our title on the front. The probable authorisation of REITs in Germany and Europe is crucial; also some important changes in German and European banking systems – everything, in other words, to do with property finance on the European continent that you need to know!

Though our name refers to Europe, our initial focus will be Germany. We hope soon to supply more material on France, Italy, Spain and other major continental markets.

PFE will be published on the second and fourth Monday of every month from the easetec offices in Frankfurt am Main. It is independent of investing or selling institutions, and issued free of charge to registered readers via an Adobe PDF download. Registrants will be alerted by an email text message. For now though, simply go onto our open Web site and download. Soon it will be possible to send you a printed, mailed edition should you wish to read PFE in the evening away from the computer, or on the airplane.

Notification of this second edition of PFE has gone out to more than 1,600 addresses - business contacts, friends, commercial and academic institutions and individuals. Please feel free to pass on our download URL link to anyone you feel might be interested.

PFE wishes to stand alone as a commercial venture. We will therefore be seeking paid advertising to take your message out to the professional community. We are also interested in hearing from partners for property data and distribution. Please put us on your distribution list for relevant information on these markets, and events. We need you, the participants in these shifting European real estate markets, to keep us informed so that PFE can keep you informed!

Allan Saunderson, editor@pfeurope.de

to the idea of creating the legal environment for G-REITs within this legislature – providing the concept does not encourage and foster tax evasion.

Time is of the essence, Stoschek says. US REITs are looking to internationalise their portfolios and Europe – and the euro – is one of the destinations of choice.

Since 2001, the Japanese property sector has launched 17 REITs holding $17bn of assets. Singapore has introduced five S-REITs in two years, with $2bn in asset value. South Korea, since 2001, has created nine REITs despite domestic legislation making them complex and time consuming to launch. Increasingly, the European real estate sector is looking toward Brussels to create EU-wide legislation, the Euro-REIT.

PFE COMMENT: Given the push by the new Barroso EU presidency toward unifying the services sector in the 25-country community, it is near certain that REITs will rapidly move up the policy agenda. This is all the more so since the main obstacle in all national reflections is cross-border taxation, both intra- and extra-EU. Low or no-taxation asset management environments in the EU such as Luxembourg, Ireland and the Netherlands will need to cooperate. Brussels will need to reach a multilateral settlement with the US in particular to unify double taxation agreement treatment. PFE

German REITs laws should not limit retail investor stakes or stipulate exchange listing - expert

The current German government concerns over loss of tax income in the introduction of legislation allowing Real Estate Investment Trusts (REITs) are not the only issues that should be examined in detail. Rules for distribution of stock and on REIT listing also need attention, says specialist Stephan Bone-Winkel, professor in real estate at the European Business School in Oestrich-Winkel on the Rhine near Wiesbaden.

In an article for the Handelsblatt newspaper Bone-Winkel said the current debate is not yet producing any solutions for the concerns over use of foreign 'offshore' vehicles to invest in domestic property. Aside from this though, it is important to avoid the excessively rigid criteria for the wide placement of G-REIT equity that some receommend, which would limit retail investors to 9.9% total stake. The government should also consider allowing REITs that are not stock-exchange listed.

"This seems to have been completely ignored in the public discussion and even by companies that are already working on concrete plans for conversion into REITs," Bone-Winkel wrote. For one thing, equity structures would have to be completely overhauled and, for another, the transfer of of property assets by corporates and insurance companies would be made much more difficult.

"Precisely because of the current situation with open-end funds we cannot allow ourselves a separate, special German solution on the topic of REITs," Bone-Winkel said. "We are in an increasingly globalised market for indirect investment in real estate, where REITs have established themselves as a standardised asset class.

"The solutions presently being discussed are dominated by tax questions and are not balanced in economic terms, and therefore not competitive in the world." PFE

G-REITs should allow German property values to recoup 10 years of lost ground

The introduction of German Real Estate Investment Trusts (G-REITs) will, if it happens quickly, allow the nation's property sector to make up the ground it has lost over the last 10 years in comparison to European neighbours, the Netherlands-based Kempen & Co said in a recent research report.

The French experience with SIICs showed that it was important that both listed and unlisted REIT entities should be introduced at once, Kempen Research Director Max Berkelder said. "If the G-REIT including the pre-REIT is introduced in one go instead of in smaller steps (which was the case in France as a result of which the market cap declined first due to delistings), Kempen & Co expects that the German property sector will make up the ground it has lost over the last 10 years in comparison to other countries," Berkelder said in the report.

Germany should learn from the experience of other countries, the research report stressed. Kempen & Co would be positive if the final legislation for G-REITs was in line with what Financial Centre Germany Initiative (IFD) has proposed. *(PFE Vol. 1, No. 1)*.

Kempen sees the positive elements as being:

(i) G-REITs would only apply to listed entities, making tax benefits available to a broader public including private investors rather than circulating in a shadow circuit;

(ii) The 5-year maximum period for corporate real estate to be sold via property-for-share swaps at half of the normal tax rate will encourage corporations to spin off property;

(iii) The opportunity to form a non-listed pre-REIT which becomes a G-REIT over time offers reduced tax burden on capital gains;

(iv) Former housing associations would be able to transform into a G-REIT as well.

"Of course, the introduction of a German REIT will not offer a solution for every problem. Both private and institutional investors look for quality property, which is well managed, which reduces the possibility to spin off low, undermanaged corporate real estate at interesting prices, just because a REIT structure is introduced," Berkelder added. PFE

HSBC sees six sources of real estate for G-REITs & funds on the buy side

Corporate holdings of property, limited conversion of open end funds, closed fund pools, property holdings of insurance groups, public real estate and recent Anglo-Saxon acquirors should be the main suppliers of portfolios to create German Real Estate Investment Trusts (G-REITs) if legislation is introduced next January, an 188-page HSBC study on the topic concluded.

On the demand side would be mutual funds, pension funds, insurance companies and other direct or indirect investment which today is being directed into closed or open-end funds.

HSBC said that because many German conglomerates still held onto huge portfolios of property these were likely to form the main channel of supply to G-REITs. It added, "A second channel feeding the new G-REITs could theoretically be open-end funds that would consider a conversion. We think this is unlikely to happen in the initial stage because the upfront fee

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of 5% charged at the time of investment into an open-end fund is too lucrative for the initiators to give up. It is more likely that open-end funds will converge in the event of large money outflows and the pressure resulting from it."

Closed-end funds were likely to contribute only pools. They were unlikely to convert entirely into REITs. Properties held by insurances were definite candidates, as well as the state sector where the federal, state and local authorities had particularly large holdings of residential property.

"Like the model of Deutsche Wohnen, a residential property spin-off of Deutsche Bank, the government might dispose of its properties via the capital market," HSBC concluded.

"Real Estate opportunity funds have been active buyers in the recent past in Germany and could be considered possible suppliers of properties seeking to exit acquired portfolios via G-REITs."

On the buy side, the bank sees mutual funds as benefiting from an untaxed dividend payment in a REITs structure, and added that in the US, 70-80 mutual funds invest in REITs.

"Likewise, we expect the number of funds interested in REITs in Germany to be high due to the advantages REIT dividends offer in terms of higher performance disclosures," the study said.

Pension funds might also favour G-REITs over fixed income instruments since, "Pension funds in a mature stage have low inflows and high outflows and need high and stable income streams. As the German population is ageing, more and more pension funds will mature and be likely to invest in G-REITs."

Insurance companies were currently shifting focus toward real estate and were highly likely to increase allocations to the asset class in the near future, HSBC said. "In addition, money which today flows into closed-end or open-end funds might be absorbed to a significant amount by G-REITs." If the legislation allows G-REITs to be flexible, transparent, liquid vehicles that can prove they can deliver equal or even superior returns to open-end funds, G-REIT would prosper.

SBC closely analysed the potential impact of REITs legislation on four German limited liability property companies: IVG, AIG Real Estate, Deutsche Euroshop und Vivacon. PFE

Von Köller denies reports that Lone Star plans to move into mainstream bank lending to German corporates

The Dallas-based Lone Star Funds has no plans to move into mainstream banking in Germany but will continue to expand its business in non-performing debt and perhaps also distressed banks, Chairman Karsten von Köller told Structured Finance International (SFI).

In an interview in the March/April SFI, von Köller refuted reports that Lone Star had ambitions to purchase a larger bank in Germany and move into standard lending to medium-size firms and others. "Reports that we want to go into mainstream banking are not true," von Köller told SFI.

"We are only interested in distressed situations. Maybe one day if there is a really distressed bank available we might buy it to work out the portfolios and sell it as a clean bank – but not to go into normal banking."

The impression that Lone Star had mainstream banking ambitions had been raised by criticism of German bank lending inflexibility by senior European partner Bruno Scherrer in the FT earlier this year. Scherrer said the medium-sized corporate sector was finding credit difficult to get because German banks were not prepared to engage in higher-risk lending and price accordingly.

Von Köller also told SFI that Lone Star had set no particularly limit for its capital investment exposure in Germany. Of the $5bn raised in Lone Star Fund V closed last autumn, 30% of it was earmarked for the nation.

"That's $1.5bn of equity, and since the financing of all our transactions is leveraged by at least 70%, that's a lot of financial strength," Koller said. PFE

Kroll, Mercer see no more than €80bn in German NPLs available for sale

The total volume of German distressed assets, or non-performing loans (NPLs), is only about half of the €300bn often cited, and investors should focus on a significantly smaller volume available for sale, around €75-€80bn, a report by Kroll Corporate Advisory and Mercer Oliver Wyman said.

The report said even this remaining volume is not currently targeted by investors nor is it readily marketable because of structural restraints. This has engendered a sense of frustration among investors, especially late-comers, who face a seemingly cramped marketplace.

Kroll and MOW estimated the total volume of bad loans in Germany at €160bn. "Although this represents the largest potential of all European markets it is significantly lower than most estimates," the report, released originally in February, said. It also concluded that the German NPL market faces supply constraints but that current pricing from the investor side appeared appropriate. The highly fragmented German banking system is a barrier to further market development and smaller banks should start pooling their bad loans.

Investors, on the other hand, need strong local expertise on the legal and cultural environment. This, together with workout capabilities are the key drivers of success. "We expect that the issues .. will be addressed and the obstacles facing the bad debt market will be resolved over time," Kroll-MOW said. It anticipated that around €20bn in nominal value in NPLs should be traded in 2005, but the market would decline slightly to around €15bn per year from 2007 onward.

"This market will source assets across a range of customer segments, including consumer loans and small business lending, and will be driven by players in all banking sectors."

PFE COMMENT: These seem quite realistic estimates of the market. The original E300bn NPL estimates were based on a Bundesbank/IMF calculation that 3-5% of German bank assets totalling nearly E7tr were underperforming. This was made in 2002/2003, at the nadir of the economic cycle. Although that was not the strongest economic downturn since the second world war, German banks characterised this period as by far the hardest in terms of impact on their asset base. The truth is they were hit by a 'double-whammy', a cyclical downturn just at the moment when a structural de-industrialisation was accelerating so that corporate cash-flow and profitability had moved rapidly into reverse. Companies and their employees suddenly had a lot more trouble servicing their debts. In the interim, the cycle has lifted and firms have consolidated and downsized. Sizable proportions of credit books have found their way out of intensive care via restructuring/rescheduling and are paying again. Banks have had two or three years now to top up risk provisioning so that the panic level has dropped. Some are also learning how to internally manage bad loans. PFE

German VDH changes name as Pfandbrief exclusivity falls, ECBC set up

Because of the abolition of the exclusive mortgage and savings bank right to issue Pfandbrief, the German Association of German Mortgage Banks (VDH) announced that it will henceforth be open to all banks issuing the 235-year old German covered bond and is changing its name to the Association of German Pfandbrief Banks (VDP).

VDH/VDP President Jürgen Grieger told the annual press conference that the extension of Pfandbrief issuing rights to all German banks means the association will be able to offer all issuers the same benefits that had been reserved to its 18 mortgage bank members. In this way, the VDP hopes to become the first German banking association covering all three 'pillars', private banks, savings banks and the cooperative banking sector. Up to now, each German banking 'pillar' has had its own lobby-group association.

The reform of the 105-year-old Pfandbrief Act, extending issuance rights to all German banks with effect from 19 July 2005, is the direct result of the abolition of state guarantees for public sector banks, and is designed to create a level playing field for all potential issuers. Grieger said mortgage banks are likely to continue to be the main issuers, but they will henceforth also have the right to be involved areas of banking outside real estate lending, and are likely to leverage their core competencies and tap new revenue potential.

Grieger has also taken the German chair of a new pan-European association, the European Covered Bond Council (ECBC), established in November under the auspices of the Brussels-based European Mortgage Federation. At its inauguration, ECBC said its foundation was, "triggered by the tremendous growth of the covered bonds market (volume of outstanding issues has grown to over €1.5 tr in 2003) as well as the continuous product innovations during the past five years. The Council will focus on the developments shaping the economic and regulatory environment of coveredbonds at EU level. The goal is to enhance the visibility of covered bonds at European and global level."

Banks in the UK started refinancing programs using Pfandbrief-like structures about 24 months ago, and one of the most high profile has been the HBOS program of issuance begun in 2003. However banks everywhere in Europe are now examining this structure closely as an important refinancing instrument, alongside securitisation.

An EMF source said: "This has suddenly become such a big area in Europe. All over the continent, countries are busy bringing in new covered bond legislation. We simply realised that the interests of covered bond issuers might be better served in a separate association.

Alongside banks in the mortgage issuance business, ECBC invites membership from other institutions such as rating agencies and investment banks. It is designed less as a political lobby group and more as a forum to exchange ideas on operational issues and best practice. One of the assocation's first actions was to provide a written comment on a recent Moody's proposed rating methodology.

PFE COMMENT: Given the interest in refinancing via covered bonds, the establishment of the ECBC is a timely event. Banks in the UK were the first in Europe, outside Germany to start extensive refinancing programs using Pfandbrief-like structures. EMF secretary general Judith Hardt is leaving to take over the same position in the Federation of European Securities Exchanges. Given the upheaval in the most recent LSE takeover offer by the Deutsche Börse, plus Euronext ambitions, plus possible NYSE activity in Europe following its reverse merger into a listed vehicle last week, she will need a large helping of diplomacy and toughness in equal measure – and long and frequent holidays! We extend her our best wishes and wish her luck. PFE

Weak economy means 2005 unlikely to see much mortgage lending improvement, association says

Weak lending margins mean that the mortgage sector, even after a poor 2004, is unlikely to see much improvement in 2005, German Mortgage Bank Association (VDH) President Jürgen Grieger said.

In 2004, real estate loans made by the association's 18 member banks overall fell 10.2% to €31.2bn, though financing of commercial real estate increased slightly by 1.6% to €20.2bn. Given the difficult market climate, the growth within Germany was primarily driven by finance for existing property, where the most important segments were office and public sector buildings.

"The weak outlook for the economic cycle implies that the property sector in Germany cannot expect any expansion this year," Grieger told the annual news conference. Mortgage banks are the second biggest providers of residential finance in Germany after the savings banks and have a market share of 20.1% and an outstanding volume of home loans totalling €212bn.

"Illustrating the continuing depressed state of the domestic construction industry, VDH figures showed construction loans fell 26% to €11bn last year. Approximately half of this drop was caused by weakening construction activity and the rest due to shrinking demand for financing existing property. Only 27% of all loans went into building new private homes and condominiums compared to around three times this level 10 years ago.

In 1994, overall home mortgages granted for new construction were almost nine times as high as in 2004. Mortgage bank loans to the public sector, the second major refinancing segment via the German Pfandbrief, rose by 17.6% to €89.5bn.

Here, the most important clients were public sector banks (35.9 %) and federal state governments (24 %). Some 30 % of all mortgage bank loan commitments went to foreign borrowers, with the focus on Italian, Spanish and Greek institutions.

Grieger said mortgage banks will be able to remain at the head of Pfandbrief issuance even after the change in the Pfandbrief act to extend to any qualifying institution in Germany. Even though they could now become involved with any business sector, mortgage banks were more likely to stay close to their core expertise.

VDH announced it is changing its name to the Association of German Pfandbrief Banks (VDP) and will henceforth be open to all banks issuing the 235-year old Pfandbrief. PFE

Eon's Viterra sells 14,000 apartments in 2004, plans to speed up privatisations

Viterra AG, planned to be either floated on the stock market or sold to investors this year, said it sold off 14,000 apartments in 2004, 5% more than the year before. CEO Wolfhard Leichnitz told the annual press conference this strategy was continuing and would be accelerated, both for single units but also for multi-family buildings.

Viterra, currently still a subsidiary of the Essen-based Eon conglomerate, owned 152,000 apartments at the start of last year. Despite taking bids from several international funds, it has also mandated Deutsche Bank to investigate the alternative of an IPO as a way of moving forward by this summer.

For 2004, Viterra declared operating profits from sales at €413m, down from €433m in 2003, on group turnover of €988m, down 9%. PFE

Table 1: European & World REITs

Country/ Region	National name	Abbreviation	Introduced
Europe			
Netherlands	fiscale Beleggingsinstelling	BI	1969
Luxembourg	Société d'Investissement à Capital Variable/Fixe	SICAV/F	1988
Italy	Fonds di Investimento Immobiliare	FII	1994
Spain	Real Estate Investment Funds/Companies	REIF/REIC	1994
Belgium	Société d'Investissement à Capital Fixe en Immobilière	SICAFI	1995
France	Société d'Investissement Immobiliers Cotés	SIIC	2003
UK	Property Investment Funds (?)	PIF	2005
Germany	Germany Real Estate Investment Trust (?)	G-REIT	2006
Americas			
US	Real Estate Investment Trust	REIT	1960
Brasil	Fundos de Investimento Immobiliário	FII	1993
Canada	Real Estate Investment Trust	REIT	1994
Mexico	Fondos de Inversión en Bienes Raíces	Fibras	2004
Australasia			
Australia	Listed Property Trust	LPT	1971
Malaysia	Real Estate Investment Trust	REIT	1988
Japan	Japan Real Estate Investment Trust	J-REIT	2000
Korea	Korea Real Estate Investment Trust	K-REIT	2001
Singapore	Singapore Real Estate Investment Trust	S-REIT	2002
Hong Kong	Real Estate Investment Trust	REIT	2003
Taiwan	Real Estate Investment Trust	REIT	2003

Source: PriceWaterhouseCoopers, Property Finance Europe

Fortress' GAGFAH sees 2006 flotation as market valuation, not exit

Fortress Investment Group could place up to 49% of its newly acquired German residential apartment holding company GAGFAH on the stock market next year but is unlikely to do since its flotation is not designed as an exit for Fortress but as a market valuation and capital raising process.

GAGFAH CEO Udo Bachmann told the Immobilien Zeitung (IZ) newspaper that Fortress, which bought the company last year for €3.5bn in a tough bidding competition with the UK's Terra Firma, is allowed to sell just under half of its stake without the permission of the former owners BfA (Bundesversicherungsanstalt für Angestellte). But, "the objective is not an exit for Fortress but the acquisition of additional capital," he said.

GAGFAH has announced it will make a public stock market offering via a capital increased within 18-24 months and raise between €150m and €300m. Fortress Germany head Mathias Moser told IZ, "the valuation the capital market gives us is also important." Plans were not far enough progressed to give further details.

Bachmann has wanted to create a large stock market-listed residential real estate company by floating GAGFAH since 1996. This was not possible under the prior owners.

Neither is the IPO of the company, which owns 80,000 apartments in Germany and manages another 15,400 on behalf of third parties, dependent on Berlin creating legislation for G-REITs. Irrespective of the low-tax reflections for corporate real estate owners adopting REIT structures, GAGFAH would be faced with a large tax liability since, in any flotation, it would have to give up special cooperative status granted by the German federal government in 1991."

The former cooperative form of apartment ownership is the most important basic stock for the creation of German REITs," Bachmann said. "The sector is homogenous in form, measurable and transparent, and has reliable and steady tenants." Creation of AG borse-listed companies from them would be advantageous for retail investors and local authorities alike.

Formerly cooperative apartment holding companies own 2.3m units in Germany, of which between 500,000 and 700,000 are currently up for sale. However present fiscal legislation makes their sale generally unprofitable. GAGFAH and a dozen other companies have therefore formed the German Residential Property-REIT Initiative (IDWR, Initiative Deutscher Wohnimmobilien-REIT) to lobby for the abolition of this obstacle.

Bachmann said this pressure group was in alignment with the Financial Centre Germany Initiative (IFD), which in January presented a study recommendation for REIT legislatiion. However it differed in one aspect: IDWR wanted differentiation between the tax treatment of domestic and of foreign property holdings. PFE

European home mortgage sector seen at turning point, huge opportunities in higher-risk lending

The European residential mortgage sector is at a turning point and presents huge growth opportunities, particularly in higher-risk lending for borrowers with low downpayments, high debt-coverage ratios and unconventional payment flows, effectively the sub-prime market, Mercer Oliver Wyman said in a new report.

A large proportion of European home mortgage markets are untapped, and the sector has the capacity to expand by as much as 15% - €500bn - in the next few years.

The US-based financial services and risk management consultant said, "Many mortgage markets still appear to be credit constrained, with a large population of under-served borrowers. We have identified a 15% market expansion opportunity, equivalent to around €500bn of lending, which will require a combination of greater risk taking by lenders and some modest regulatory changes to facilitate the taking of greater risks."

Growth opportunities exist across all types of lending but over 80% of the total opportunity lies in three risk segments:

1. Low equity, defined as borrowers who typically have equity of around 10%
2. Stretched, defined as borrowers with a high debt service coverage ratio, and
3. Borrowers with a previous credit problem, or an unconventional history (e.g. recent immigrants), effectively the sub-prime market.

"These opportunities offer the highest margins for lenders, often up to double those of traditional mortgage lending. The largest opportunities are in bigger markets that either have less developed specialist sectors (such as Germany) or less developed mortgage markets (such as Italy)," MOW said.

The transition countries Poland, Hungary and the Czech Republic represent medium to long-term opportunities but are currently too small to represent big lending opportunities in the near term, MOW said.

However, the same could have been said of Spain and Portugal on entry into the EU in 1986. Countries such as Denmark and the UK, with relatively deep, mature markets, have relatively limited opportunities for additional lending growth.

Mortgage lenders must address the key issues of risk appetite and management, and the use of efficient funding mechanisms. "We expect the winners to include universal banks with strong debt ratings pushing up into the growing higher-risk sectors, and lower-rated specialists," MOW said. "Where broad and deep capital markets exist, the benefits of a strong lender rating decline since capital market funding can be effectively used to manage lender funding costs.

"In fact, the market for higher risk lending in established markets such as the US and the UK has become dominated by players using the capital markets with lower ratings. Given that the capital markets are growing and deepening across Europe, this suggests that there will be limited natural advantage for the existing universal bank lenders in the higher-risk segments."

MOW expects these markets to be fiercely contested, with the possibility of cross-border or non-bank entry. It sees the winners as having three key characteristics:

1. Superior underwriting management
2. Superior risk management once the risks are acquired, including use of risk mitigation and risk transfer mechanisms, and
3. Superior funding approaches, including a deep understanding of how different funding mechanisms and techniques can be used to lower the overall cost of funding.

The growth of these markets would pose new challenges for regulators. Current regulations tend to impede access to mortgages by borrower segments such as those who can only afford low downpayments.

Prudent growth should be fostered but lenders will be taking on higher risk levels with potentially unfamiliar client bases. Regulators may prefer to see risks isolated with other market participants who are better able to mitigate and manage them. This may mean loosening regulations or encouraging the shift of risk to the capital markets or third-party specialists such as mortgage insurers.

Judith Hardt, Secretary General of the European Mortgage Federation, said in a foreword that the report matched the findings of former Dutch Finance Minister Wim Kok in a report delivered in November to assess the progress towards the implementation of the EU'S Lisbon agenda.

"Mortgages are likely to be one of the key areas of focus of European financial integration efforts, and later this year the European Commission will propose a Green Paper as to what measures it believes are necessary to help the further integration of European mortgage markets," she wrote.

"It is clear, from the study and other work that the core European mortgage borrower is already well served in most markets – the challenge is how to expand the breadthof the market to create a more flexible lending environment across Europe. In this call for more flexible lending, the topic of risk and funding in mortgages has been, too often, overlooked," she wrote. But it would become increasingly central for European lenders over the coming years because:

1. Basel II is going to transform the regulatory environment, from a prudential to a risk-aligned approach leading to a greater focus on capital efficiency and consequent changes in lending approach.

2 Funding instruments are converging and competing as never before – "witness the growth of the covered bond over the past two years – and this is leading to changes in the competitive positions of some lenders as their well-established institutional arrangements shift."

3. Competitors are increasingly crowding the market and competing vigorously, as they build their capital positions. "This competition has given rise to the need for and development of more sophistication in the risk management of mortgage portfolios and to the increased reliance on innovative funding techniques for winners, who find they can originate more volume than they can easily fund."

PFE COMMENT: Certainly for Germany the report matches with what we are seeing in the data, in structural developments and also anecdotally. It is also what we expect to occur in the German market in the quite near future – a vast change in the nature of credit lending ushering in still more change in the banking system. German banking is in a state of transition greater than we have seen in over 20 years of close-up observation. At least part of the motivation – certainly for some of the foreign players either established in Germany or eyeing this market – is the opportunity to do what German banks patently are not: provide credit for lesser risks across the board but priced accordingly. After the massive downturn in the economy in 2001, German banks virtually stopped lending to anything below blue chip in the corporate sector and severely curtailed credit for commercial and residential property. Lone Star Funds partner Bruno Scherrer told the FT in January, for example: "German banks have pulled the plug on many stressed or distressed companies regardless of their business plans to a point where it's really becoming dangerous for the economy." PFE

German office market begins to revive; Frankfurt turnover doubles in first quarter

Turnover in the Frankfurt office market doubled in the first quarter compared to 1Q04; Berlin and Munich were also strong, but the robust state of supply still pushed the vacancy rates higher across the board, a Jones Lang LaSalle report says.

New leasings in Frankfurt am Main more than doubled to 115,000 sq.m. in 1Q05 compared to 55,300 sq. m. in 1Q04. Berlin turnover rose 61% on the same comparison. Munich region office space turnover increased by 24%. Even though this is still below the levels of 2000 for Frankfurt, "a completely new situation has arisen," AtisReal specialist Oliver Barth told the Frankfurter Allgemeine Zeitung. Instead of staring transfixed at the vacancy space of 1.45m sq.m. – equivalent to about 25 high-rise office blocks – a new feeling had come into the business.

Still, this situation was not repeated throughout Germany. Turnover was much more modest in Düsseldorf, and in Hamburg new leasings dropped by 10.3%, the JLL study showed. As well, empty office supply rose by 44% in Frankfurt compared to 1Q04, by 26% in Munich, 17% in Düsseldorf, 10% in Berlin and 2% in Düsseldorf.

Demand for office space collapsed in the harsh economic downturn that followed the bursting of the new economy bubble in 2000 and the terrorist attacks on the World Trade Centre in September 2001. But property specialists believe that the worst is now over.

Lutz Aengevelt, managing director of Aengevelt realty, told the FAZ that the overhang in supply should be gradually dismantled over the next few years and a trend turnround to an increase in office rents was in progress but it would be gradual. Longer-term, current low values meant that the chances for stronger rises in capital valuations and profitable exits from office real estate investments were excellent. PFE

UK non-conforming RMBS market shows stability – Standard & Poors

The performance of UK non-conforming RMBS transactions has proved the strength and stability of underlying unconventional home real estate assets, and upgrades should continue as transactions season and servicers show they can maintain losses at low levels, Standard & Poors said in a report this month.

"These assets have performed consistently well over time and within expectations, which has resulted in no rating downgrades occurring on any of these transactions to date," it said. Deals closed in 2005 included RMS20, SPS 05-1, RMAC 2005-NS1 (GMAC-RFC), and MARS 3 (Matlock Bank Ltd.)

"The delinquency rate has been consistently flat over time, mainly due to low unemployment levels and low interest rates. Low levels of delinquencies drive the low number of defaults. Rising house prices over the last eight or nine years has meant that many of those loans that default have not ultimately realized a loss," S&P said. "During this time borrowers have also had the option of selling their way out of trouble when they fall into arrears, (because of rising house prices) and this too has lessened the default levels."

Dominant forces in this UK segment have been Kensington Group PLC, GMAC-RFC Ltd, along with Britannia Building Society, Southern Pacific Mortgages Ltd., Mortgages PLC, and Preferred Mortgages Ltd.

S&P simultaneously announced the launch of the first performance indices for the UK non-conforming RMBS market. These will be published quarterly, and should become a useful indicator of expected performance for further issuance.

PFE COMMENT: The huge capital gains in the UK market over the last few years – doubling of residential values over five years in most regions – have given an enormous kick start to the sub-prime market in the UK and kept it buoyant. The real test comes once an economic and/or house price downturn hits, as S&P observes in the report. This could well happen very soon now. Apart from Spain and France, the European continent has not yet provided anywhere near such a supportive capital valuation background which would nurture a sub-prime market in quite the same way. Still, we do not expect this to be an insuperable impediment to more flexible home mortgage lending (see also the WOM report) over time in these countries. PFE

Three-pillar German banking structure wobbles in Schleswig-Holstein, Berlin

The public sector savings banks in the north German state of Schleswig-Holstein are likely to be opened in the near future for private sector capital investment, and Berlin is doing the same for its savings bank, the Handelsblatt newspaper reported.

After inconclusive state elections last month, coalition negotiations are in progress in the Schleswig-Holstein capital of Kiel that will lead to a Grand Coalition government of the two largest parties in Germany, the right-of-centre Christian Democrats (CDU) and the left-wing Social Democratic party of Chancellor Gerhard Schröder. The CDU will head this government, ending 13 years of rule by the SPD. State Premier candidate is Peter Harry Carstensen.

The CDU is pressing to open the capital of savings banks in general, but breaching the three-pillar system of German banking is a major system event. If it happens, it will be a revolution for German banking. The debate over allowing private capital into the savings banks has raged for the last few years and continues to be hotly debated from both sides of the political spectrum.

The HB reported that the CDU is insisting in coalition talks that private individuals and other savings banks should be allowed to invest in them. The SPD has blocked this so far, even though the new European Commission has been pressing for a cessation of the exclusive provision of state tax funds to the savings bank sector, and an opening to private capital.

In Berlin, the city's left-wing coalition government is also on the point of deciding to sell the Berliner Savings Bank (Berliner Sparkasse) outright to a private investor.

The plans in Schleswig-Holstein do not however go so far, HB reported. Talks have set on an upper limit of 50% of private capital to be permitted for savings bank investment. As well, each savings bank will have the right to choose if it wishes to open its capital for investment by private individuals – its customers, for example – or other institutions from their sector.

The sale of the Berlin savings bank is part of a larger transaction to save the long-ailing Bankgesellschaft Berlin (BGB). The European Commission decreed last year that in return for allowing city-state subsidy for BGB, it must find new owners for both Landesbank Berlin und its subsidiary Berliner Sparkasse.

The major German private banks, Deutsche and Commerz, are rumoured to be interested. The main obstacle may be however that the sale will be structured to keep in place the traditional public sector legal form, a kind of privatisation through the back door. "If you want to buy into the customers of the Berliner Sparkasse you are going to have to bind the public sector onto your leg," one source told the VWD news service. This made it far less attractive for the German private sector. PFE

German true sale securitisations should be freed from trade tax - recommendation

True sale securitisations in Germany should be freed from obligations to pay trade tax (Gewerbesteuer), according to an advisory opinion requested by the True Sale International GmbH from the European Business School.

Manfred Hommel, professor at the Rhineland-Palatinate-based EBS, said in the opinion that the concerns of the federal government over the loss of tax revenues, if it frees true sale securitisations from trade tax, were not justified. Freeing up the deals would dramatically improve the fiscal environment by boosting the number of deals coming to market. It would bring liquidity into bank balance sheets, freeing-up capital for investment, expansion and pursuance of core business.

Hommel's paper implied that the resulting increases in corporation tax revenues would easily offset the immediate losses of trade tax income.

Only relatively small volumes of true sale securitisations have been executed despite the establishment of the True Sale Initiative in spring last year by 13 German banks under the chairmanship of the KfW Group - re-constituted later into TSI GmbH. Hommel said removal of the trade tax could boost the market volume in the next five years to around €32bn. Trade tax has also been an obstacle to true sale mortgage securitisations in Germany.

PFE COMMENT: In a structured finance transaction, a special purpose vehicle can be considered as a non-financial institutions and is thereby subject to trade tax in Germany. In recent years this has substantially hindered the use of domestically incorporated SPVs for securitisation transactions of German assets, and also boosted the development of synthetic securitisations. But there are signs that the Berlin government is moving in many areas to accommodate the newly disintermediating banking environment. PFE

Recycling may be possible for east German apartment 'pre-fabs'

One of the major obstacles to rehabilitation of apparently near-worthless pre-cast concrete residential blocks in the former east Germany can be solved by recycling the component parts for improved, better-designed buildings. This could therefore offer one 'exit' alternative for parts of the large residential portfolios currently being bought by US and other international investors.

A report in the Immobilien Zeitung newspaper said materials from the pre-fabricated buildings (Plattenbau), whose construction methodology had its echo in the 'prefabs' of post-war Britain, could be profitably re-used in a redevelopment on the same or other sites, according to a recent study..

The study was drawn up by a cooperative working group WBK 21 commissioned by the east German city of Leinefelde and an associated local property management company. The study group was assisted by the specialist department of construction recycling from the Brandenberg Technical University in Cottbus.

Since unification in 1989, buildings containing some 92,000 apartments have been torn down in the former German Democratic Republic by the end of 2004. Federal building ministry state secretary Tilo Braune Federal said state subsidies were available for the dismantling of 177,000. But this was only around half the total of apartment blocks, many of them pre-fabs, planned to be dismantled by 2009.

The WBK 21 study showed a specific example where a five-storey apartment block was dismantled into two storeys and these converted into modern, dual-family row or terraced houses. The upper apartment used the flat roof that resulted as a roof terrace additional feature.

"Around 60% of the construction materials realised by these demolitions can in principle be re-used," architect David Seidl, from the MWM office in Erfurt, told the IZ. MWM has cooperated in the WBK 21 study, along with local architect colleagues Hose, Mühlhausen.

The group, which has given the rebuilding process the somewhat ironic name of 'up-cycling', has calculated that the process can be profitable compared to total demolition and new rebuilding.

A turnkey new home of 128 sq.m. created in this process can be sold in the area for around €133,400. Costs to make it using up-cycling are around 75% of what would be incurred for complete new construction.

Seidl told the IZ the recycling of pre-fabs could be used for buildings with other uses. His company has cooperated with a subsidiary of the state sport association of Brandenburg to use the building materials from demolitions of a pre-fab apartment block to construct a kindergarten.

An information book on this process is available (in German) from the federal building ministry. PFE

Chevallier to head Atisreal European international research team in Paris

European real estate consultancy Atisreal said it has set up an International Research team based in Paris to produce reports on all property market sectors, capitalising on its knowledge of the European and North-American real estate markets.

The team will be headed by Marie Chevallier, formerly head of Atisreal Auguste-Thouard's French research. With a degree in geography and a Masters degree in Urban Development, Chevallier graduated from the Paris Centre de Perfectionnement des Affaires (CPA), and is member of the Royal Institute of Chartered Surveyors (MRICS). She joined Auguste-Thouard in 1990 as an investment consultant prior.

Investment market specialist Cécile Blanchard also joins the team. Previously deputy director of research at Jones Lang LaSalle in Hamburg, Blanchard has an engineering diploma in ommunications and Marketing from the university Paris XIII.

From 1 April Chevallier's former position as head of Atisreal Auguste-Thouard's French research has been taken over by Christophe Pineau, Atisreal said. A graduate of Grenoble's Institut for Political Sciences and Doctor of Economics, Pineau joined Atisreal Auguste-Thouard in 2001 as deputy director of research after having worked as economist for Rexecode, one of the semi public economic research institutes in Paris. PFE

Berlin provides another €200m for east German housing associations to cancel old debts, demolition subsidies

The German federal government in its 2005 budget has provided a further €200m in new funds for cancellation of old debts carried over by 100 housing associations from the former east German administration.

The funds will be distributed by the KfW Group on behalf of the federal building ministry, stocking up total subsidies provided so far for supporting residential housing in the east to over €1.1bn.

Around 300 housing associations experiencing apartment vacancies of at least 15% have received subsidies under the demolition program of the East German City Reconstruction and/or from Berlin's former debt cancellation program.PFE

More than 1m German tenants ready to buy if offer was better - study

Some 1.3m extra households in Germany currently renting would be interested in purchasing their own accommodation if the nature of housing on offer was more appropriate to their needs, according to a study by the research institute Empirica for the association of German state construction savings banks (Landesbausparkassen).

Empirica had concluded that this population group was ready to purchase and had the financing, a report in the Immobilienzeitung newspaper said.

The group mainly comprised older citizens taking a decision in principle to move out of the renting cycle and seek higher quality of family life, as well as singles seeking to put down a long-term investment to build wealth.

The reason the group had not yet bought property was however the "unfavourable and non-demand-orientated homes" being offered in the market - above all in city locations - the LBS association said. PFE

Strong net redemptions from German open-end funds continue in first quarter

German open-ended property funds continued to experience strong net redemption flows in the first quarter of 2005, losing €568m. This would have been much higher if it had not been partially offset by re-investment of dividend income received at the end of 2004, figures from the fund association BVI showed.

However, the outflows continued to be focused heavily on property funds belonging to the Deka Bank group, which have been struggling against a loss of confidence after valuation scandals during 2004, and of the Difa and CGI groups.

By comparison, investors in 1Q05 invested a net €8.9bn in bond funds and €4.2bn in money market funds. Stock market funds, by contrast, experienced net outflow of €1.7bn.

The association reported separately that real estate funds had achieved cumulative capital growth of 23.4% over the last five years, slightly less than the 30.6% of fixed income funds, while share market funds were sharply negative. In a longer-term comparison however equity funds grew by 369% over 20 years and property funds, at 196%, were the weakest. PFE

DEPFA SURPRISES: separately, took the same step.

Bruckermann said last week that Depfa can refinance most efficiently now through the Irish covered bond, and the German Pfandbrief no longer held the importance it did previously in funding activities. But he added that the cancellation of the sale was, "not a strategic change even if we have to alter our internal organisation somewhat."

Deutsche Pfandbriefbank intends to reduce its 97 staff in Wiesbaden, because of overlapping functions with the Irish headquarters. Finance Director Reinhard Grzesik said the group should be able to report net operating profit for the current year of around E500m, up slightly from E490m in 2004, and perhaps E600m in 2006. The approximately 1bn in equity capital in the Wiesbaden subsidiary meant it was overcapitalised, and would transfer a E600- 700m to the Dublin parent bank.

Depfa has already outlined significant plans for expansion into US credit insurance. With total group equity capital topped up to E3.2bn, directors do not expect to have to tap capital markets for new funds any time soon even though the advance into the US would be expensive. "If we really want to get deeply involved in the American market this can only happen by getting into credit insurance with a triple-A rating," Deputy Chairman Thomas Kolbeck told the press conference. PFE

DG HYP MOVES INTO NPLS: Piaskowski said DG Hyp saw two reasons to move into the mortgage NPL business: It has received a full banking licence to engage in Pfandbrief covered bond business after 19 July, taking advantage of the extension of this right to all German banks, and has also amassed long experience in all aspects of the domestic property market. "Because of our activity in private and commercial real estate credit we know the market situation very precisely." Piaskowski said.

DG Hyp's expansion abroad is designed to reduce dependence on the weak domestic property market. It established a presence last year in Paris, Amsterdam and London. This year New York and Stockholm are on the schedule. The initial objective is international business volume of around E1bn, of which it expects half to be sourced abroad.

DG Hyp's operating profit soared last year to E78.8m from E15.8m in 2003 though this was mainly due to extraordinary items. Residential real estate lending sank to E1.4bn from E2.1bn, though the objective for 2005 is new retail mortgage business of E1.7bn. The bank increased the volume of its commercial lending business last year by 13% to 1.9bn.

The new strategy was set under prior DG Hyp chairman Wolf Schumacher, who left to take over at the head of Aareal Bank AG in Wiesbaden from 1 April 2005. Piaskowski is tipped to succeed him. PFE

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