



## GERMAN OPEN-ENDED FUNDS: PAST, PRESENT AND FUTURE

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### EXECUTIVE SUMMARY

The German Open-ended Funds (GOEFs) are clearly benefiting from current market conditions. The credit crunch has taken many investors out of the property market as the availability of debt has become restricted and expensive. The power is now in hands of equity players, like the GOEFs, who have become one of the most prominent buyers in the global investment market.

It is perhaps ironic that one of the reasons the sector is in such a positive position now is its response to problems in the past. As a result of market and corporate governance challenges earlier this decade, the GOEF industry has changed significantly in recent years. The funds' strategies have changed from predominantly investing in the German market to becoming truly global. They are now flexible market players, eager to adopt new strategies.

The introduction of the New Amendments to the German Investment Act at the end of 2007 has further strengthened the sector's flexibility. The two key intentions behind these changes were to increase transparency and improve investor protection, whilst also allowing greater flexibility in the sector's investment options. In these uncertain times the GOEFs, with their proven track-record of stability in returns, should, therefore, continue to grow.

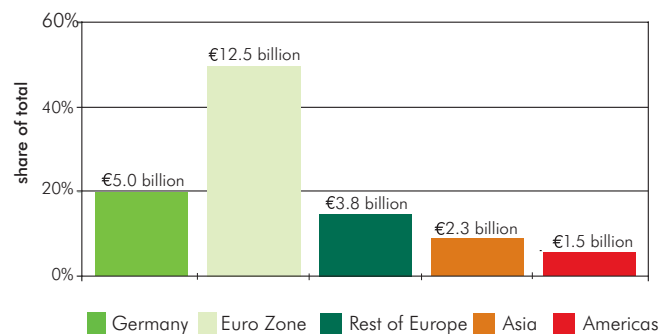
Their current liquidity and expected cash inflows give the GOEFs €25 billion of spending power over the next two years or so. With so much equity in hand the immediate interest lies in what markets will the GOEFs target?

The key findings on the funds' immediate future strategies are :

- The sector will continue to diversify globally, with around 15% allocation toward non-European investments in the medium term. Despite this diversification, Europe will remain the key target market with 85% allocation, of which some 20% will flow towards Germany;
- The target markets will be driven by pricing evolution. As has already happened in the UK and France, the GOEFs will continue to take advantage of recent price falls – with mature and most liquid markets benefiting the most;
- Their investment strategies will also become more conservative. In-line with historic trends, offices are likely to dominate in the short to medium-term, with a shift towards the very core prime assets. Whatever the sector or location, security of income stream and longevity of investment will be key in an uncertain time like this.

### MARKETS THE GOEFs WILL TARGET

Likely allocation of €25 billion purchasing power



Source: CB Richard Ellis

## 1. GERMAN OPEN-ENDED FUND INDUSTRY IN CONTEXT

### Introduction

The German Open-ended Funds (GOEFs) are one of the most prominent groups of investors in the current market. They have been making a comeback since late 2007 and are now capturing headlines across the globe with a series of acquisitions.

Although the sector has been in existence since the late 1950s, it is only since the early-90s that the GOEFs have had a significant presence in the real estate market. Currently the gross asset value of the GOEF sector is around €105 billion, and they have €21 billion in 'cash' available for investment in real estate.

The credit crunch has further increased the prominence of the GOEFs. The funds have never tended to play the cycle, but have concentrated on investing in good quality assets, in highly liquid markets. As equity-rich, risk-averse investors, their buying power has been largely unaffected by the higher cost and limited availability of debt and they have remained active as other, more highly leveraged, buyers have withdrawn from the market.

The GOEFs' prominence in the property market means that their future prospects are attracting increasing attention. This paper analyses the reasons behind their growth and addresses a number of important questions regarding both their immediate and long-term role in the property market:

- Will the GOEFs continue to attract substantial inflows of new capital from their core investors?
- Are they vulnerable to the same sort of capital outflows that were seen from the UK Property Unit Trusts (Britain's equivalent of the open-ended funds) in 2007?
- Assuming the inflows continue, what will be the investment strategy of the GOEFs for their current capital and future inflows?

### The Role of the GOEFs

Historically the GOEFs have attracted their capital from retail investors – individuals making their own decisions on where to invest their savings with the assistance of their financial advisor. These savings are essentially the private pension provision of the German public. The open-ended property funds are just one class within the category of the 'Publikumsfonds' that serve this purpose which also includes bond, equity, money market and managed funds.

In order to protect these private investors the sector is highly regulated, and the GOEFs' investment strategy has been highly influenced by these regulations. However, also crucial is the very high value that these retail investors place on security of capital and stability of returns. The open-ended nature of the funds means that investors are able to redeem their capital at any time, although in practice they have only ever done so when it appeared that the security of their capital is threatened. Investors are also required to pay a 5% fee when they make their initial investment, which further limits the likelihood of money being withdrawn at the first sign of problems.

### Regulation

The sector is highly regulated in order to protect the retail investors who provide the majority of the GOEFs' capital. The most important of these regulations govern the funds use of borrowing and their exposure to currency risk.

Fund level gearing is required by law to be kept at a maximum of 50%, and they usually leverage at significantly below that level. One of the reasons for keeping borrowing well within the legal limit is to provide flexibility in the case of significant capital outflows, a flexibility that has proved useful in the past. This characteristic has also proved to be advantageous in the current credit crunch. Their low level of leverage means that they are exactly the type of highly secure borrower that is still able to access debt and their

available cash gives them strong buying power at a time when there are few other active buyers.

The GOEF regulatory framework also limits currency risk to a maximum of 30% of capital (although up to 100% is allowed if the additional risk is appropriately hedged). With the advent of the euro zone, this currency restriction has been less of a limitation. However, historically it has played a substantial role in funds' investment strategies, as discussed in more detail later in the report.

The other main regulations governing the funds concern liquidity, valuation and disposals.

Investors can redeem their capital at any time. It is therefore important that each fund keeps sufficient money in liquid assets, such as bank deposits or money market instruments, to meet possible redemptions. The minimum level allowed is set by law at 5% of the value of the fund and should be available on a daily basis. There is also a maximum level of 49%. The ability to redeem their investment at any time has been an important factor in building investor confidence in the GOEF sector.

The valuation of the funds' assets is also highly regulated. All assets are required to be valued annually (on the anniversary of their purchase). The valuation must be carried out by a specific group of registered valuers. The basis of valuation is 'sustainable long-term value', rather than the more usual 'mark-to-market' approach. Such valuations are, therefore, 'smoothed' and can differ significantly from the 'achievable sale price' in the market at any particular point in time, with less fluctuation in prices through the peaks and troughs of the cycle. This approach to valuation has been important in stabilising the apparent returns of the GOEFs – although in the recent past there has been concern over whether actual performance has been significantly different from that actually reported at times of rapid price movement. However, one effect of

this approach to valuations is that the funds' investment is highly driven by initial yield.

Valuations are given greater importance by the restriction that prevents GOEFs selling properties at more than a small percentage below the most recent valuation. Particularly at times of rapid price movement this restriction on the sale of properties below 'book value' reduces the funds' flexibility to manage their property holdings.

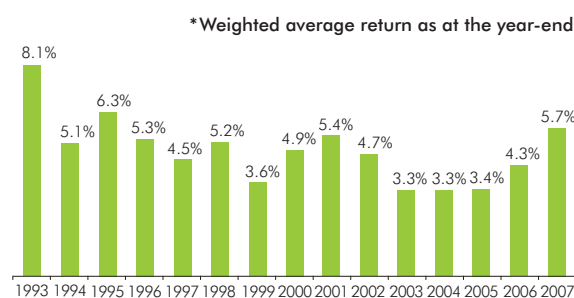
### Performance and Security

The nature of GOEF investments is highly driven by the investor group they are targeting – predominately the general public. German retail investors are very risk averse and see the open-ended funds as a secure 'pension' type investment. To reflect such expectation the funds position themselves as low-risk, long-term investors, with a stable return profile.

Historically, annual returns for the sector as a whole have been maintained at around 5-6% (Figure 1). The main exception to the long-term trend was during 2003–2005, when, due to the poor performance of the German real estate market, returns dropped below the long-term average the sector had targeted.

The desire to maintain returns within this narrow band has led to investment strategies that have targeted the most liquid property sectors – offices and retail property – and properties with high levels of occupancy, long secure leases and good covenants.

### FIGURE 1: HISTORIC RETURNS\* FOR THE GOEF SECTOR



Source: BVI

The relatively low volatility in historic returns for the sector is also true of recent returns on a fund-by-fund basis. In 2007, for example, 16 of the 29 funds (for which information is available) delivered a return of between 5.0% and 6.0%<sup>1</sup>.

This stability of returns has proved attractive to retail investors, particularly in current market conditions. This is especially true when it is compared with the volatility associated with other asset classes. This is clearly shown by the net inflows into the other categories of German public funds over H1 2008: over -€1.3 billion net withdrawals from bond funds, -€1.1 billion from equities, and -€300 million from hedge funds. In this context, the €4.1 billion net inflows registered for the GOEF sector looks very favourable<sup>2</sup>.

The investment characteristics of the GOEFs, driven by these twin considerations of regulation and investor requirements, are summarised in Figure 2.

### Fund Reporting and Information

In addition to relatively stable returns, investors also benefit from detailed, easily accessible information about a fund's status and investments. Investors are able to obtain fund-level information, including fund strategy and, in most cases, reporting on recent asset-specific acquisitions and disposals. This high level of transparency is attractive to both retail and institutional investors.

**FIGURE 2. GOEFs: TYPICAL CHARACTERISTICS**

<b>Philosophy</b>	<ul style="list-style-type: none"> <li>• Traditional income-orientated investors, who are not a 'cycle' player</li> </ul>
<b>Product</b>	<ul style="list-style-type: none"> <li>• Prime good quality assets in key markets, locations</li> </ul>
<b>Sector</b>	<ul style="list-style-type: none"> <li>• Traditionally heavily invested in offices</li> <li>• Recent interest in other major sectors, especially shopping centres and other retail</li> </ul>
<b>Lease</b>	<ul style="list-style-type: none"> <li>• Keen on long leases, low vacancy and strong covenants</li> </ul>
<b>Gearing</b>	<ul style="list-style-type: none"> <li>• By law loan to value at a fund level should not exceed 50%</li> <li>• Typical gearing is usually lower</li> <li>• Preference for easily tradable assets and markets</li> </ul>
<b>Liquidity</b>	<ul style="list-style-type: none"> <li>• Set by law at a minimum 5% of the fund</li> <li>• A maximum of 49% is allowed</li> </ul>
<b>Currency exposure</b>	<ul style="list-style-type: none"> <li>• 30% restriction to currency exposure</li> <li>• However, up to 100% non-euro fund allocation is allowed if fully hedged</li> </ul>

<sup>1</sup> Source: BVI, Scope, March 2008.

<sup>2</sup> Source: BVI, August 2008.

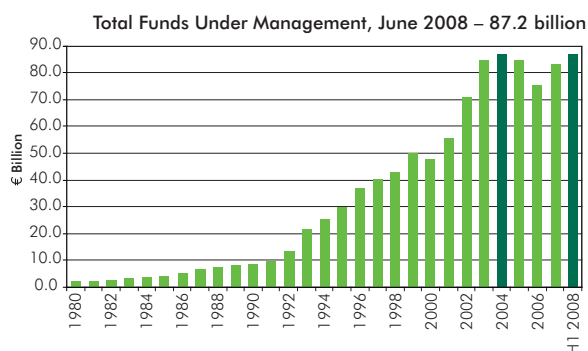
## 2. THE RECENT HISTORY OF THE GOEF SECTOR: THE BUMPY RIDE

Although currently seeing strong flows of capital from investors, the GOEF sector has not always been in such a positive position, experiencing substantial changes in fortune over the last 20 years. A review of the recent history of the sector and the factors that have shaped that history is helpful in gaining an understanding of the current shape of the industry as a whole.

### Growing Industry

The GOEFs have been in existence since late 1950; however, the industry remained relatively small until the 1990s. The first stage of their rapid growth in the 1990s was driven by the increasing trend towards individual pension provision in Germany. Highly tailored towards individual investors, with parent banks providing a network for the sale of units, the open-ended fund sector grew rapidly from €8.4 billion in 1990 to €50.4 billion at the end of 1999, an average rate of 22% per annum. This growth was not unique to the property funds and all categories of 'Publikumsfonds' grew rapidly over this time.

**FIGURE 3: TOTAL SIZE OF GOEFs**



Source: BVI

The boom in the German stock market in the late nineties started to attract money away from the property sector by 2000. However, the bursting of the dot.com bubble and the stock market crash in 2001 swiftly led to the second wave of growth in the GOEF sector. Eager to switch from equities, private investors saw the property funds as a much safer alternative.

At the same time, institutional investors also became interested in the sector, and the large scale of their investments changed the investor profile of the sector as a whole.

A key difference between institutional and retail investors (apart from the size of their individual investments) is that the institutional investors have generally not paid the 5% initial fee that the private investors are charged. Although this has attracted more money to the sector, it has had some disadvantages. The 5% fee acts as disincentive for investors to move money in and out of a fund rapidly. Having not imposed this charge on the institutional investors they are not penalised when redeeming their units within a short period of time.

**Typical fund in 2000: Emergence of the 'new' funds:** Historically the GOEFs invested mainly in their domestic market. During the 1990s the law allowed a maximum of only 20% unhedged currency exposure, which limited their geographic investment horizons. As at 2000, therefore, the vast majority of the GOEFs' capital was still invested in German property. However, two changes at about that time significantly altered that profile.

One of these changes was introduced by the German Investment Act in 2001, which increased the maximum currency exposure within a fund from 20% to 30%. However, the launch of the euro meant that investments in property outside Germany, but in any of the other euro zone countries, no longer counted towards the funds' currency exposure. Therefore, in a short period of time a 20% restriction on investment outside Germany was transformed into a 30% non-euro restriction. This allowed the funds much greater flexibility in their investment strategies.

These fundamental changes were a major turning point. Many new funds were launched aimed at providing greater geographical diversification for the sector, explicitly positioning

themselves as European or Global funds. The existing fund managers started up new diversified funds – for example Deutsche Bank's Grundbesitz Global, launched in January 2000 and DEKA-Immobilien Global, launched in October 2002. However, this new flexibility also attracted new fund managers into the sector – for example, KanAm Grund with KanAm grundinvest Fonds in November 2001 and AXA with AXA Immoselect in June 2002.

At the beginning of this decade, therefore, there were two main categories of GOEF: the bigger, longer established funds, with a high level of exposure to Germany; and smaller, new funds, with much more diversified portfolios and strategies.

The timing of these changes was particularly important as it coincided with a slowing home economy and a period of poor performance in the German property markets.

### The German Open-ended Fund Crisis of 2005/2006

**The build-up to the crisis:** The fall in capital values in the European real estate market in the early 2000's marked the beginning of a new era for the real estate market as a whole. The German real estate market was hit particularly hard, with property values starting to fall rapidly from the beginning of 2002 and not fully recovering until late 2005.

In the early stages of the downturn the GOEFs seemed to be largely unaffected. Net cash flows continued to be positive, with only a few months seeing net withdrawals. However, by late 2004 the inflows slowed as investors became increasingly concerned by the weak real estate market fundamentals in Germany. The funds' high weighting to offices in the major cities meant that they were particularly exposed to the German market downturn as this sector had been left with high vacancy rates due to

over-development in the build up to the dot.com crash.

**The 'shock' events:** The biggest factor in the crisis was clearly the overexposure of the funds to the hard-hit German market. Even with the smoothed performance that the obligatory German valuation approach produced, the funds' performance fell – with the annual returns for the sector as a whole falling below 3.5% throughout 2003-2005. However, this under-performance against the historic trend was only part of the story. What became known as the 'GOEF crisis' was also caused by a series of 'shock' events that reinforced the negative sentiment towards the sector.

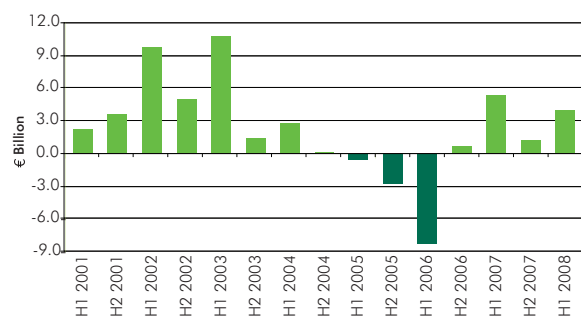
One of the early shocks to undermine confidence in the sector was a series of valuation scandals that were uncovered in 2004/05. There were accusations of bribery and that the funds had 'fixed' their valuations. As the security of investors' capital is dependent on these valuations, anything that undermined confidence in them had a major impact on the sector as a whole. Furthermore, the price at which investors are able to redeem their investment is dependent on the Net Asset Value of the fund and so any fundamental over-valuation actually incentivises investors to withdraw their money.

These problems further weakened investor sentiment in an already falling market, resulting in substantial withdrawals from a number of the funds and in some cases exhausting their liquidity. There were different responses to this lack of liquidity. A number of funds received injections of capital from their parent companies, whilst Deutsche Bank exercised an emergency provision that allowed their Grundbesitz Invest fund to suspend the right of investors to redeem their capital – the first ever 'closure' of a GOEF.

This was not the only fund closure, however. In January 2006 a rating agency posted a negative rating in respect of KanAm US-grundinvest Fonds.

The negative rating was due to issues surrounding its US joint-venture partner Mills Corp, rather than the fund itself. However, such was the lack of confidence in the sector at the time, that despite the success of the investments in which KanAm participated in with Mills, the fund suffered substantial cash withdrawals. These withdrawals spread further to KanAm Grund's European fund – which had no connection to Mills – and that fund had to be closed after withdrawals of €700 million in a single day. The fact that it was so severely affected was ironic, as KanAm Grund did not have a single investment in Germany.

**FIGURE 4: CASH INFLOWS TO GOEFs**



Source: BVI

The continued impact of these events led to substantial withdrawals by private investors. However, the outflow was exacerbated by the rapid withdrawal of the money by institutional investors who, not having paid a 5% entry fee, had no incentive to leave their capital in place. Thus, both the traditional Germany-orientated, as well as the 'new' diversified funds saw significant fall in assets under management throughout late 2005 and early 2006.

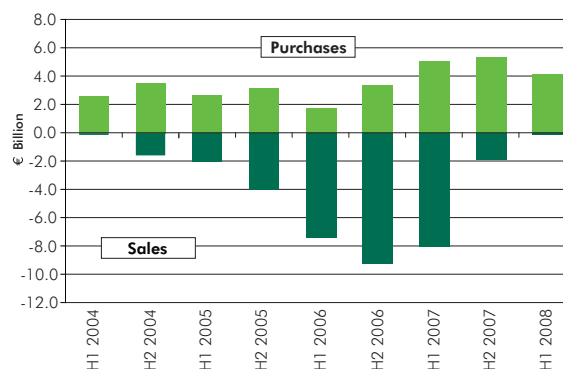
**The Turnaround: Diversification Shapes the New GOEF Sector**

**Portfolio restructuring:** The withdrawals in 2005/2006 have been an important factor in determining the current shape of the GOEF industry. Although, in part, the withdrawals were met by capital injections from the funds'

sponsoring banks and by increased borrowing, some property sales were necessary. Restricted in their strategy due to the regulations that prevent sales of property at significantly below book value, funds were unable to sell German properties that were at that time over-valued relative to the sale price that would be achieved in weak market conditions. Initially it was necessary for the funds to dispose of some of their trophy assets in Europe's most prestigious locations, such as London and Paris. In contrast to Germany, the property market in the rest of Europe was already recovering strongly and valuations of properties outside Germany were at or below market value.

However, the period of heaviest withdrawals also continued with the start of the recovery in the German real estate market. Having historically been almost completely dominated by local investors, the German property market started to attract great interest from foreign investors. In particular, US investors entered the market, hoping to purchase German assets at the bottom of the market cycle in the expectation that Germany would benefit from the economic recovery already established in the rest of Europe. This recovery in demand for German investments eventually enabled the GOEFs to restructure their portfolios. Huge portfolios of German assets – in some cases involving transactions worth more than €2 billion – were sold in 2006 and the first half of 2007.

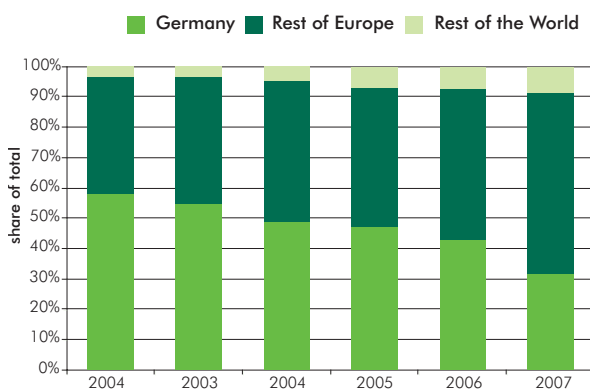
**FIGURE 5: GOEF TOTAL TRANSACTION ACTIVITY IN EUROPE**



Source: CB Richard Ellis

Overall, sales by the GOEF during the two years from mid 2005 to mid 2007 totalled €28.7 billion, with acquisitions of only €13.4 billion. In addition, whilst in the second half of 2005 and first half of 2006 the sales were dominated by non-German assets, in the subsequent 12 months the majority of properties sold were in Germany. The result has been a dramatic change in the distribution of assets in the GOEFs. From being essentially domestic investors in the 1990s, the funds have become major international players and German properties now make up less than a third of their total assets.

**FIGURE 6: GEOGRAPHICAL DISTRIBUTION OF GOEF ASSETS**



Source: BVI

#### **Diversification becomes the key to success:**

By mid-2006 investor confidence had started to return. Net cash inflows into the sector registered a positive €788 million in H2 2006. However, this is the net total for the sector as a whole. Looking at the cash flows at a fund level, it was evident that investors were strongly favouring the geographically diversified European and global funds, rather than those that were still mostly invested in Germany. This prompted further growth of the new funds, the wave that had initially started in the early part of the decade to take advantage of the introduction of euro.

The diversification of their investment strategy has not been limited to geography, the funds have also widened the spread of property sectors that they invest in. Traditionally office-orientated

investors, GOEFs have diversified into a wider spectrum of assets. The retail sector, for example, has grown in importance, with investments in emerging markets, such as Central and Eastern Europe (CEE), showing a strong bias for retail property.

The positive investor sentiment towards the GOEF sector continued into 2007 and the first half of 2008, with net cash inflows reaching €6.7 and €4.1 billion respectively. In part, this turnaround in fortunes of property funds was due to changes in the regulatory framework, designed to restore confidence in the sector.

### 3. REGULATORY CHANGES: THE RESPONSE TO THE CRISIS

A major legacy of the 2005/2006 crisis are the changes in regulation that have been put in place to prevent it from reoccurring.

The last decade has witnessed a rapid evolution of the GOEFs from predominantly local market players into truly global investors. The industry has become increasingly flexible in adopting new strategies and adapting to broader investment market trends.

The introduction of the New Amendments to the German Investment Act at the end of 2007 was designed to further strengthen the sector’s flexibility. The general intention has been to reflect the changes in the broader real estate market, as well as secure legal provisions to avoid past mistakes. Thus, on the one hand, the sector has been deregulated, allowing for greater flexibility in GOEFs’ investment choices. On the other hand, the corporate governance issues that emerged during the 2005-2006 crisis were also addressed, to further strengthen the position and reliability of the industry.

#### Broadening Investment Horizons

The legislative changes allow the funds greater flexibility to invest in different ways. In particular, the ability to invest in property via different investment vehicles enables the funds to enter the growing markets of Russia, China and elsewhere in Asia generally, as the majority of real estate trading there is done via investment vehicles rather than directly. Permission to invest in multiple-level structured real estate companies (although only two-level structures in Germany) will increase flexibility too. The GOEFs will now be able to use Special Purpose Vehicles (SPVs) and other more complex vehicles to invest in property – something that the majority of other international funds have long been able to do.

#### Reflecting on Past Mistakes

Three other major categories of change took place to strengthen the sector’s position as a reliable investment option, demonstrating that the GOEF industry is keen to continue to build on the strong relationships they have with their investors.

**FIGURE 7: KEY AMENDMENTS TO GERMAN INVESTMENT ACT AFFECTING GOEFs**

<b>Broadening Investment Horizons</b>	<ul style="list-style-type: none"> <li>• Ability to invest in property via different investment vehicles;</li> <li>• Property held in real estate companies in which the GOEF has a 100% ownership will count as direct real estate;</li> <li>• Permission to invest in multiple-level structured real estate companies (only two-level structured companies are allowed in Germany).</li> </ul>
<b>Valuation</b>	<ul style="list-style-type: none"> <li>• Initial appraisal to be done by an external valuer, which could include professionals within larger consulting companies;</li> <li>• New obligation to rotate the main appraiser, with the same assets excluded for two years.</li> </ul>
<b>Liquidity Management</b>	<ul style="list-style-type: none"> <li>• Extension of liquidity management of redemptions.</li> <li>• Introduction of pre-set monthly ‘daily return’;</li> <li>• Provisions for a ‘threshold’ to be set to help regulate the liquidity if high redemptions occur.</li> </ul>
<b>Transparency</b>	<ul style="list-style-type: none"> <li>• Highlighting the redemption possibilities in the sale prospectus;</li> <li>• Additional information to be included in reporting;</li> <li>• Proposed specification of adequate risk management system.</li> </ul>

Source: BVI, CB Richard Ellis

Past scandals have led to the introduction of new, more external valuation processes. From now on, the initial appraisal will be performed by a surveyor, who is not a member of the valuation committee. The range of appraisers allowed to value the funds' properties has been widened to include the large brokerage firms, which should improve the quality of valuations and ensure they more closely reflect market conditions. To make the valuation process even more independent, a rotation of valuers has been introduced to ensure that the relationship between fund and valuer does not become too close.

Liquidity is an important quality of the funds for retail investors and changes have been made to clarify investors' rights in this regard. The changes in the law regarding liquidity serve two purposes:

- In the wake of the fund closures of 2005/2006, the rights of investors regarding redemptions are being clarified. Clear redemption options and set monthly redemption dates are to be formalised by funds and should be included in the sales prospectus;
- At the same time the funds' long-term investment strategies are protected by the removal of some redemption rights, although these will mainly impact institutional investors. The most significant of these is a notice period of up to 12 months on large redemptions that exceed a threshold set by the fund.

Matters of transparency have also been addressed, with the funds required to provide more information publicly and to investors. Some of the key facts to be included are current market values, incidental acquisition expenses, and the official valuations of an advisory committee. All of these changes are designed to bring greater transparency to the sector. This is a key element in maintaining investor trust and keeping strong relationships going in the long term.

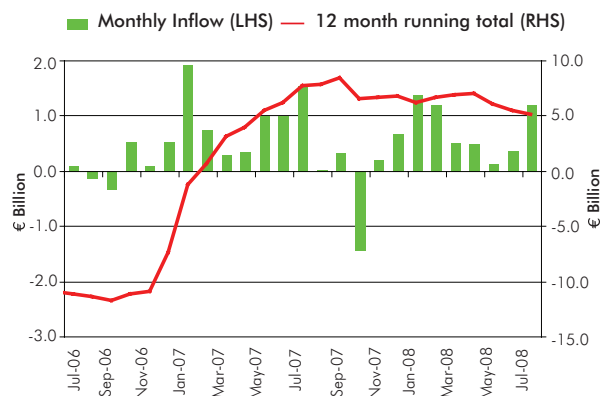
## 4. GERMAN OPEN-ENDED FUNDS IN TODAY'S MARKET

The GOEF sector is clearly benefiting from current market conditions. The credit crunch has changed the balance of power within the property investment market. By limiting the availability of debt and increasing its cost, some potential buyers have been taken out of the market altogether and others have seen their buying power substantially reduced. At the same time, there are owners who have been made eager (if not forced) sellers by the prospect of difficulty in renegotiating existing debt. Buyers with available equity, and who are not dependent on borrowing to enhance returns, are therefore in a strong position. The GOEFs fulfil these criteria and will continue to do so as long as they retain the confidence and strong relationships that they have with their investors.

### Cash Inflows

Since late 2006, the net cash inflows into the GOEFs have been strongly positive, with only one month of net outflows in October 2007 (which was due to a one-off event concerning one particular fund manager).

**FIGURE 8: NET CASH INFLOWS TO GOEFs**



Source: BVI

Sentiment towards the sector has remained strong into 2008. Money has continued to flow into a wide variety of funds, both those invested in the German market, as well as those that are mainly invested outside the country. This reflects the broad-based strengthening in confidence that retail investors have in the industry.

Over the first six months of 2008 the sector has received net €4.1 billion of cash inflows and a further €1.2 billion in July.

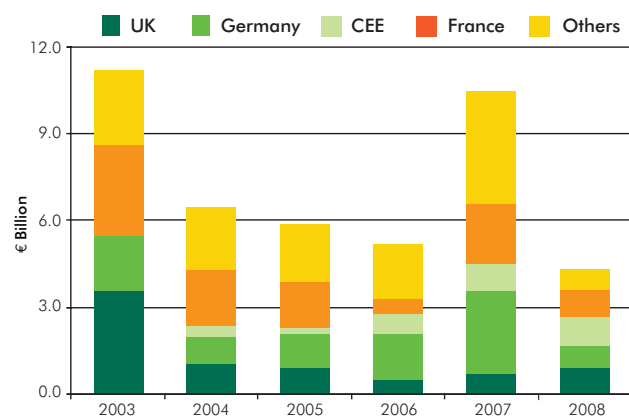
Judging by the net inflows so far, the sector is likely to see inflows this year of around €7 to €8 billion.

The cash inflows are dwarfed by the funds' existing liquidity. As a result of both historic inflows and the disposals of property in Germany discussed earlier, the level of liquidity had reached around €22 billion in February 2008 – 27% of the funds' total capital under management. As a result, a number of funds chose to implement a 'CashStop' earlier in the year. CashStop is a measure that can be used to temporarily stop further cash inflow. Investors are under no legal obligation to comply with the CashStop, but usually do, realising that these advisory announcements are made in their best interests as funds try to regulate excess liquidity. For example, one UBS fund cancelled its CashStop in the last week of January 2008, but had to reintroduce it just a week later, as a result of the very strong inflows of capital.

### Current Investment Activity

As the funds are under an obligation to spend excess liquidity within a year, they have become very active purchasers in the investment market.

### FIGURE 9: GOEF INVESTMENT ACTIVITY IN EUROPE



Source: CB Richard Ellis

This has been made easier by the fact that they no longer have to compete with leveraged buyers, and they have been able to take advantage of recent price falls in some markets. The GOEF sector acquired a total of €4.2 billion in H1 2008 in Europe alone and their sales have been negligible (€152 million). They have also continued their acquisitions outside Europe, with well over €5 billion invested in total across the globe in H1 2008.

This strong level of spending is expected to continue over the next couple of years. Many fund managers have made official announcements on their new investment horizons and how much they have allocated to spend:

**Union Investment, for example, highlighted its funds' strong purchasing power and a particular interest in the Central and South American market by releasing the statement:** "We have exceeded our targets by a considerable margin and there is every prospect that acquisitions in 2008 will surpass last year's figure of 1.5 billion euro... Just some 18 months after market entry, the Chile portfolio already comprises five buildings worth over 100 million euros in total. This gives Union Investment a particularly strong market presence in Central and South America compared to other European property investment management companies."

In Europe, the pricing differentials between the markets in the region have kept the funds well occupied in search for new investment opportunities in late 2007 and to date in 2008.

The UK was identified early on as a buying opportunity by many GOEFs as a result of this market's rapid price softening. The lower prices in London made it particularly attractive. Even as recently as early 2007 the prices in London were too high for the funds. This has changed as capital values fell rapidly, combined with the additional benefit of an obvious absence of the leverage buyers.

Initial yields above 5% are consistent with the level of returns targeted by the GOEFs and as a result a total of €860 million was invested by the German retail funds in the UK in H1 2008, making them one of the biggest investors in the Central London market. For many this has been their first purchase in the UK market since their 'forced' sales back in 2004-2005.

**"Germany's Open-ended Funds have the timing right and are enjoying the luxury position of being one of the few sources of cash in the current market. In combination with the availability of product, this makes the funds very selective. There is a strong preference for larger deals in order to maximize the use of internal resources and profit from discounts on larger lot sizes."**

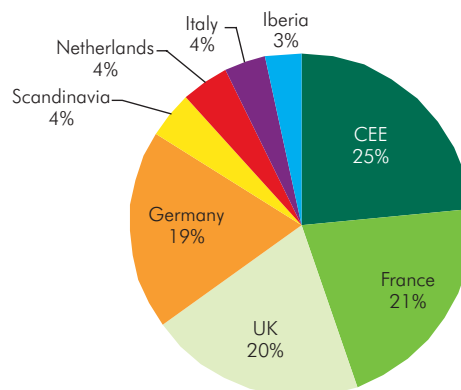
Martien van Deursen, Associate Director,  
German Desk, UK Capital Markets, CBRE

Ironically these purchases were occurring at exactly the time when the UK Property Unit Trusts (PUTs) suffered substantial cash outflows. The UK PUTs consequently became 'keen' sellers to meet these redemptions. This highlights one of the differences between the UK open-ended funds and those in Germany. The UK funds are relatively new (only really taking off in late 2005) and the majority of their assets are in the UK. As retail investors have generally only been putting money into UK Open-ended Funds for a short time, there is not the same long term loyalty to the sector through the market cycles as there is in Germany. Many have, therefore, started to withdraw their money as soon as the UK market began to show signs of a downturn.

In addition to the UK, re-pricing in Paris has also led to a wave of GOEF acquisitions there, totalling €843 million in the first six months of 2008. Activity in Germany was also robust,

## FIGURE 10: GOEF TRANSACTION ACTIVITY IN EUROPE

Total invested in H1 2008: €4.2 billion



Source: CB Richard Ellis

totalling over €800 million, over 50% of which was in the retail sector. Two of the most notable were shopping centre acquisitions of Rhein-Galerie and City Center Bergedorf. The Rhein-Galerie shopping centre was a forward purchase by UIR Union Investment Real Estate AG for its Unilmmo:Deutschland fund. This illustrates that GOEFs will consider forward-funding of prime development to absorb their excess liquidity.

The funds are also continuing to invest in CEE, with over €1 billion invested there in H1 2008. The very first GOEF purchase in Russia took place early in the year, but Poland and Czech Republic also saw activity.

### Future Strategies in an Uncertain Market

The GOEFs' high level of property purchases in 2007 and into 2008 has not actually succeeded in reducing their liquidity levels, as cash inflows have continued to be strong. By mid-2008 some €21 billion of cash was still available to the funds, almost the same as the €22 billion in February this year. This is despite over €5 billion being invested by the sector over the first six months of the year. Thus it is likely that the GOEFs' investment activity will remain exceptionally strong over the next couple of years.

### How much do the GOEFs have available to spend in the short term and where are they most likely to invest?

Although the funds currently hold around €21 billion in cash and other liquid assets, not all of this is available to spend. As previously discussed they are required by law to keep a minimum of 5% of their capital in immediate liquidity to cover possible redemptions. In practice they will maintain a much higher percentage, probably at least 10-12% of the total funds under management, which will account for around €10 billion of the currently available 'cash'.

Based on the net inflows this year so far, it is reasonable to assume another €3 billion net inflows in H2 2008, and a conservative €5 billion (although this could be as high as €10 billion) in 2009. Leveraged at around 30%, this would suggest approximately €25 billion for the GOEFs to spend over the next two years or so. The current priority for the GOEF industry is therefore to implement a strategy that enables them to spend their available cash in the markets that will offer the best return.

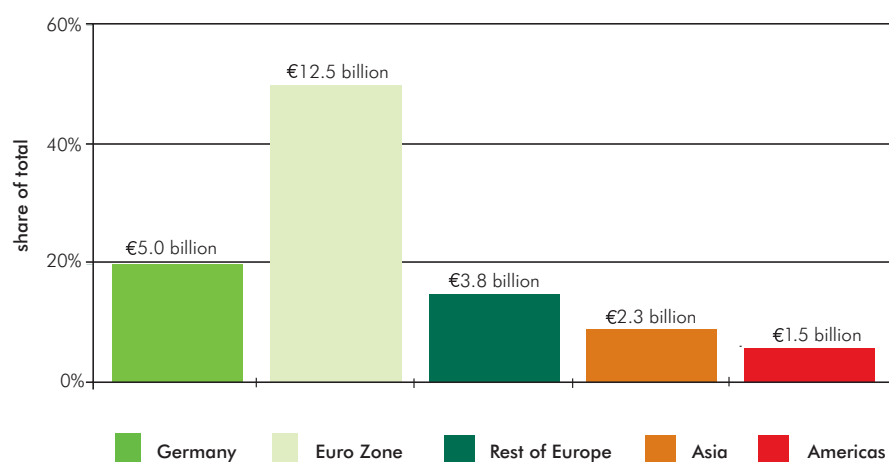
In considering how much is likely to be spent and in which markets, a number of factors must be taken into account:

- the overall legislative framework that guides the sector's investment choices;
- the distribution of cash available between the funds, which then takes into account the specific fund structure and its geographic investment targets; and
- the specific investment opportunities that are likely to be attractive to the sector in the current investment climate.

The figure below illustrates CB Richard Ellis' expectations for the allocation of the €25 billion mid-term spending-power estimated above.

Helped by the legal amendments discussed earlier, the investment horizons for the sector are broadening even further, with emerging markets made much more accessible. This has already been made evident by the sector's investment of over €1 billion outside Europe in H1 2008 (around 20% of the global total). We expect the funds to continue to be active globally, spending around 15% of their resources outside of Europe in the mid-term, based on their currency restrictions and general investment remits.

**FIGURE 11: MARKETS THE GOEFs WILL TARGET**



Source: CB Richard Ellis

Asia has become increasingly interesting for the GOEFs, especially now the use of SPVs and indirect vehicles has been made possible by recent changes to the law. We therefore expect Asia to attract around 10% of their investment over the next few years, further increasing their total weighting to that region.

The other path that some of the funds are likely to follow is the more opportunistic approach to investment, moving to those markets where pricing has changed significantly. This follows what has already happened in the UK, and is now starting to take place in the US, where some GOEFs have already been actively buying this year. This involves a very careful and 'selective' product strategy, with mainly good quality prime office space being targeted so far. This selective approach is illustrated by DekaBank's recent acquisition in the US.

**DekaBank: Return to U.S.A<sup>3</sup>.**

DekaBank, having just recently expanded its holdings on the British property market, is also planning acquisitions on the commercial property market in the U.S.A. Matthias Danne, the management board member responsible for real estate, told the Reuters Global Real Estate Summit that Deka believes "it could be the right point in time to go back" not only to the U.K., but also to the U.S. market—though "cautiously, step by step." When the market offers opportunities—particularly in Washington, D.C., Boston, Seattle, San Francisco, Los Angeles and New York—, Deka would have the wherewithal to invest up to €500mn there.

Despite their further globalisation, in the short to medium term Europe will remain the largest investment market for the GOEFs, especially given the pricing diversity that the region is likely to offer in the current market. The target market list within the region is most likely to be driven by the evolution of pricing in the near term, with the most liquid locations continuing to benefit the most. Around 85% of all funds is expected to continue to target Europe, of which some 20% will flow towards Germany. Within Europe, allocation towards the non-euro markets, mainly

UK and Sweden, is expected to remain robust at around 15%. The funds still have a relatively small proportion of their assets in these markets, which are attractive as a result of their liquidity and the investment opportunities available there.

The other change that can be expected is a refocusing of investment activity on core, prime assets. One of the growing trends in fund activity over the last year or so, particularly in Europe, has been greater interest in 'value-add' investments. This includes active asset management and participation in development. This trend is likely to be reversed, except in special circumstances.

**"Having entered the emerging markets to chase higher returns, yield shift in Western Europe has swiftly brought the GOEFs back into more mature markets. These markets offer greater liquidity, are less risky and easier to price – exactly the features that risk-averse GOEFs are looking for. Their current strategies revolve around capital preservation, limitation of risk and stability of returns."**

Matthias E. Euler, Director German Desk,  
European Capital Markets, CBRE

Current investment strategy needs to reflect the motivations and requirements of their investors, which are diversification, capital preservation and stability of returns – and this is exactly what the GOEF sector will aim to continue delivering. Over the next two years we expect that the open-ended funds will return to focus on good quality, well-located and well-let property. We also expect that the office sector will continue to dominate their buying list, as has already been the case in H1 2008. Considering the risk-profile of the sector, whatever the location, security of income stream and longevity of investment will be the key in the uncertain times like this.

<sup>3</sup> Source: Thomas Daily TD News International, 25th June 2008.

## CONCLUSIONS

Uncertainty in the broader investment market will further benefit German Open-ended Funds. Historically, in times of uncertainty, investors have tended to withdraw their money from other classes of 'Publikumsfonds' in favour of GOEFs and their proven track record of stable returns. This trend has already been evident in the current market and is likely to accelerate in the immediate future, with net cash inflows in the GOEFs sector expected to be strong in the medium-term.

The key to the long-term success for the GOEF industry is in retaining the confidence and strong relationships that they have with their investors, currently and in the future. In comparison with GOEFs, the recently troubled UK Property Unit Trusts (PUTs) are less established and their investors do not have a tradition of staying in the sector through the market cycle. Furthermore, the UK PUTs have attracted a greater proportion of 'active decision makers' looking to benefit from the rising property market, and who are, therefore, quick to leave the sector in a falling market. The GOEF sector, on the other hand, has attracted mainly pension provision-type investment, set aside over a long-term investment horizon.

The GOEF sector continues to evolve. Recent legislative changes have strengthened their position as a safe investment option and shown that the industry is committed to building on its strong relationships and trust with investors. The key changes made respond to the problems experienced during the 2005/2006 crisis:

- Liquidity is now easier to manage without disrupting strategy; and
- The funds' now have greater flexibility in investment options.

The immediate question is what investment strategies the funds will follow in the current market.

Now is an attractive time for GOEFs to be an active investor in the real estate market and take advantage of the opportunity for counter-cyclical investment in the absence of many other classes of investor.

Their current liquidity and expected cash inflows give the GOEFs €25 billion of spending power over the next two years:

- Most of this will stay in Europe due to the 30% limit on currency exposure. However, the sector will continue to diversify globally, especially as they are now able to invest via different investment vehicles. The proportion invested outside Europe will grow further, whilst investment in Germany will continue to decline in terms of the share of total property owned;
- The funds' investment strategies are also likely to become more conservative. With less competition from other investors, the GOEFs will be able to refocus on prime locations, high quality property and security of income.
- In-line with their recent activity and current market uncertainty, the office sector is likely to dominate their short to medium-term strategies. The key characteristics of the product that will be of interest to them will be – long leases, low vacancy and good covenants.

As other, more leveraged, buyers have withdrawn from the market, these equity-rich, risk-averse investors, who are not dependant on borrowing, have strong buying power. The German Open-ended Funds will remain very active investors in the short to medium term, both in absolute terms and most certainly as a proportion of activity in the overall market.

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