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Chazen International Study Tour Report

# Real Estate in London and Berlin

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## A Note from the Authors

The growing prominence of capital markets in today's real estate industry has led to greater investor focus on global real estate opportunities. The trend is manifested through increased economic sophistication of real estate entities and growing capital flows for international investment and development. To explore these themes, Christopher Mayer, the Paul Milstein Professor of Real Estate and director of the MBA Real Estate Program and the Paul Milstein Center for Real Estate at Columbia Business School; Cheryl Carruthers, associate director of the Milstein Center; Camille Douglas, former CFO of Canary Wharf; and 25 students took part in a real estate tour of London and Berlin to gain further understanding of these markets. From March 3 to 13, 2005, we spent five days in each city and met with executives of brokerage houses, investment firms, development companies and opportunity funds to understand the investment opportunities in and capital flows through and these two core European real estate markets.

## Chazen International Study Tours

Designed to enhance the classroom curriculum, Chazen International Study Tours offer students and their faculty adviser an intense, firsthand experience of the business culture of their chosen country or region. Study tours are initiated by students and organized with the help of the Jerome A. Chazen Institute of International Business. During study tours students meet with leading executives and government officials while visiting businesses, factories and cultural sites. Recent destinations include China, France, India, Japan, Russia and Scandinavia.

## Overview of the United Kingdom Real Estate Market

Our initial view of the UK real estate market revealed a setting surprisingly similar to its counterpart in the United States: an abundant amount of capital chases a few deals, which results in price increases and lower cap rates. In addition, much of this capital comes from international sources. According to DTZ Research, in 2004 cross-border purchases accounted for about one third of real estate acquisitions in the United Kingdom. Of these international capital sources, the United States was the largest, contributing $13.5 billion. Retail and residential assets are the major focus of increased investment. However, the fundamentals of the office-space market are not as robust, as the United Kingdom has experienced a few years of slower job growth, which has hurt demand for office space. Currently, office-vacancy rates are high (up to 16 percent in London's city market), there is pressure on rental rates and concessions are often granted in order to rent space. However, signs of improvement on the horizon combined with low interest rates and abundant amounts of capital have maintained interest in the sector.

A second source of capital comes from the pension system. After the equity bubble burst in 2000, investors viewed real estate more favorably for its steady returns and transparent cash flows. After sustaining heavy losses in the stock market, more investors have concluded that real estate should be included in retirement funds. This has led to an increased amount of capital in the system. However, this capital is no longer chasing single-asset deals as in the past. It is now focusing more on investing in specialized funds, similar to the United States, where a pension plan might place a certain percentage of its real estate allocation in an investment fund focusing on value-added retail purchases and another portion in a fund that focuses on core office properties.

## UK Property Investment: Current Trends

The investment market has been strong in the United Kingdom given the significant capital inflows discussed above. Retail has stood out over the past few years. Despite a slower-growing economy, consumer demand has held up, which has supported fundamentals in the sector. This, combined with an increased amount of capital chasing deals, has boded well for investments in the sector.

Investments related to housing have also done quite well in the recent past. Of note, however, is the lack of an institutional multifamily housing sector. Multifamily investments are stable, sought-after purchases for U.S. institutional investors, but large multifamily complexes where an institutional owner could buy a property and take advantage of economies of scale are virtually nonexistent in London and other UK markets. Many of the investments made in the multifamily market are small, private buyers purchasing a few units in multiple locations and renting them out. However, according to Credit Suisse First Boston (CSFB), the development of a more institutional multifamily market could emerge in the future.

The commercial office market has also performed well over the past few years. Yet, as noted above, the performance was driven more by increased amounts of capital than by improving fundamentals. Well-leased, Class A office space demands a premium in the market. One reason for this is the structure of office leases in the United Kingdom: they typically run for 20–25 years and have upward-only clauses. Therefore, if an investor purchases a well-leased property, he or she is essentially buying a tangible asset with an almost bondlike quality, which is very attractive to certain investors. According to British Land, city offices are not meeting their pro forma 7.7–10 percent unleveraged returns. However, London is an international economic powerhouse and very important in the financial world. Therefore, there will always be a strong demand for office space in the city, which will keep investor interest in the sector high.

According to Ian Marcus of CSFB, one of the areas presenting a potentially robust opportunity in the near future is the sale-leaseback market. The United Kingdom has one of the highest owner-occupier percentages (greater than 85 percent). Corporations should not be holding real estate, as it cannot generate as high a return as reinvesting in their primary lines of business. This presents great opportunities for investors to buy properties from corporations divesting their real estate and lease it back to the corporations. According to Marcus, this market could develop even further should corporations decide they want to participate in some of the upside of their real estate by forming joint ventures with property owners rather than just unloading 100 percent of their property.

## UK Real Estate Development: Current Trends

Given the strong fundamentals, well-located retail and housing development in the United Kingdom remains attractive. The real question about development revolves around adding office space. As was stated previously, office-market fundamentals are not overly strong at the moment, but development of office space can still be attractive in cities such as London.

To begin with, there is not a lot of developable land left in London. This shortage, combined with the importance of London in the international economy, makes office development appealing. In addition, the London office market is characterized by old buildings with strange layouts and small floor plates, whereas the financial services industry—a driver of the London economy—demands large floor plates and open space that can accommodate trading floors similar to those found in the United States. As a result, there are opportunities for redevelopment of certain buildings within the city of London. More important, this need for large floor plates led to the creation of Canary Wharf.

We were fortunate enough to spend time at Canary Wharf, both touring the property and meeting with Peter Anderson, Canary Wharf finance director. Development at Canary Wharf began in 1980 when the London Docklands Development Corporation was created to improve the use of the land. Olympia & York eventually took control of the land and began fulfilling the need for the new type of office product in London—larger, more open floor plates for financial services firms. Today, Canary Wharf consists of approximately 9.9 million square feet of office and retail space that is more than 86 percent occupied, with rental rates that are lower than those in other high-end London markets.

## UK REIT Legislation Update

The United Kingdom is currently considering introducing a REIT structure similar to that in the United States. Both investment banks such as Morgan Stanley and CSFB and large public property companies such as British Land are anxiously awaiting the arrival of such a vehicle, which will have a great impact on the market. Analysts from Morgan Stanley believe the introduction of a REIT structure in the United Kingdom could compress cap rates by nearly 150 basis points given the transparency this vehicle could lend to the market. It is hopeful that a REIT structure will be in the market by 2006. If it is not, industry insiders feel this will cause local property companies to seek listings on exchanges outside the United Kingdom.

## Overview of the German Real Estate Market

Germany was one of few industrialized nations to escape the economic challenges of the early 1990s. Much of the country's steady growth in that decade was subsidized by massive government investment to unify East and West Germany. Since reunification, Berlin has served the nation and the world as a symbol of the new German unity. The German government relocated to Berlin from Bonn in 1999, a process that cost $11 billion dollars and helped to spur investment in the city's property market.

In recent years, Germany has struggled to recover from its expansive zeal of the 1990s. Unemployment has topped 17 percent in Berlin and nearly 11 percent nationwide. Real GDP growth has been negative, although initial reports for 2004 look more positive, with GDP at 1.7 percent real-term growth.

## Berlin Market: Current Trends

The Berlin property market mirrors the rise, fall and current struggle for growth that Germany is undergoing.

Berlin's main challenges are oversupply in all sectors and paucity of employment opportunities. Oversupply due to the building boom has caused office vacancy rates to increase since 2000 to approximately 11 percent in 1Q2005. Berlin is Germany's largest office market, with 18 million square meters of lettable space. A cause for optimism in the market is the dwindling volume of new supply, which is expected to be less than 100,000 square meters in 2005, down from an average of 400,000 square meters between 2000 and 2004. Much of the letting activity in 2004 was driven by businesses relocating to better-quality spaces throughout the city. Because of the slow market, yields on office properties have shown signs of decreasing.

Berlin is resplendent with architectural masterpieces by such luminaries as Renzo Piano, Richard Rogers and Christoph Kohlbecker. The Sony Center at the new Potsdamer Platz, which was developed by Tishman Speyer, earned more from development fees than in return on equity. Projects such as this literally cover the painful relics of Nazism and Communist occupation with postcard-quality Class A space, but architecture alone can not lure new industries to Berlin.

The Anschutz Group's Media Spree development is designed to attract media companies to Berlin. Marketing points of the project include an affiliation with Berlin's creative heritage and its young, self-designated "wild" population. The project developers are willing to build loft-style spaces with irregular floor plates in a bid to attract edgier tenants.

Media Spree is located along the banks of the River Spree in East Berlin. Although new construction has nearly stopped due to the supply glut, Paul Abeler, director of investor relations, predicts a total development size of 1.8 million square feet to be completed over the next 20–25 years. The group will break ground on a new building once it reaches a prelease commitment of 60–70 percent (down from 20–30 percent in the mid-1990s). Average leasing commitments are 5–10 years, and rental rates range from €5 to €10/square meter.

Because many German industries entrenched themselves in the free West after World War II, Berlin has found luring them back to be nearly impossible. For example, Frankfurt has been and remains Germany's center of finance. Today, its market for Class A office space is one of few sectors that are considered attractive by national and international core investors.

Currently, international opportunity funds are overlooking short-term economic hurdles to focus on perceived supply-and-demand strengths. At approximately 30 percent, home ownership in Germany is low compared to international peers. Morgan Stanley Real Estate Fund (MSREF) has recently purchased 48,000 apartment units from industrial conglomerate Thyssen-Krupp at €570/square meter in hopes it can resell them to individuals for €800/square meter. MSREF's move into German residential markets is considered peculiar by local investors who are endeavoring to diversify their portfolios away from German exposure.

Deka Immobilien, a German open-ended real estate fund manager, believes that local, well-leased property is overpriced and high vacancy properties are too risky for its investors, many of whom are retail investors. The fund, like many of its competitors in the €80 billion market, is taking advantage of recent legislation that allows it to invest overseas.

## Eastern Europe: Current Trends

As cap rates continue to compress in the United Kingdom and Western Europe, investors and developers have chased yields across the European Union to Central and Eastern Europe. Institutional investors, opportunity funds and international developers are spreading the flow of global capital into new countries, many of which are still struggling to escape the legacy of Communist rule.

Investors who can successfully navigate potential obstacles will benefit from strong market supply-and-demand fundamentals. A dearth of modern building stock will ensure success as countries such as Poland, the Czech Republic, Hungary and Croatia, among many others, integrate into or prepare to join the European Union. Best-in-breed global property developers are well positioned to partner with local experts to replenish outdated Communist-era housing, office and industrial assets.

Hines, a Houston-based global fee developer, planted its flag in Europe in the early 1990s. The firm's London office manages two Western Europe development funds totaling over $600 million in investment and also oversees European investments for two U.S. funds whose global focus includes Eastern Europe as well as Asia and South America. Hines's success in Eastern Europe has been mixed. Mark Sears, managing director, cites as barriers to success a lack of cleanly titled sites and of sophisticated local partners, murky zoning laws that handicap private investment and small deal size. At present, Hines has redirected many of its resources to projects in more transparent markets such as Italy and France.

Potential investors in new European markets are most concerned with a country's prospects for admission to the European Union. AIG/Lincoln's European joint venture has overseen $875 million of investment since its inception in 1997. The AIG/Lincoln development fund applies the classic Trammell Crow development model to Eastern European markets. First, the firm assesses new opportunities by examining national GDP level and growth, political stability, strength of competitors, insurability of assets, existence of local finance institutions, willingness of lenders to finance deals and good returns. If a market passes the requisite analytical hurdles, AIG/Lincoln invests up to $2 million in overhead to establish a regional office and build a staff of nationals with local development expertise. Once a local office is open, the fund can begin to source and develop projects.

The AIG/Lincoln approach combines global capital and local expertise in what many experts believe is the best way to capitalize on new markets, cycles and property types. Investment in new markets is made possible by increased government deregulation, harmonization of participant interests and availability of information. Such trends will promote ownership among local populations and provide a valuable source of portfolio diversity for international investors. Promising sectors to watch include Turkey, whose candidacy for admission to the European Union should be bolstered by its large and young workforce, and Russia, which is experiencing tremendous growth from oil wealth.

## Conclusion

Our academic intent was to study the real estate markets in and capital flows and through London (as a potential center of the world economy) and Berlin (as a gateway to Eastern Europe). The trend of global real estate development and investment was apparent during our trip, both through meetings and tours with local sharpshooters as well as with global developers and investors. Depending on their risk tolerance and yield requirements, the opportunities and strategies of the different firms with whose executives we met were vast.

London's more established economy and access to capital markets make it a more predictable and well defined market.

Berlin, with its massive oversupply and weakened economy, remains more questionable. When the wall fell in 1989, many firms focused there with hopes of massive growth. But growth remains well below expectations, resulting in low prices and tremendous longer-term opportunity.

Both cities, however, remain centers of European real estate—London as a more central location, and Berlin as a gateway to Eastern Europe and future opportunity.

We expect access to capital markets to permit continued growth in global real estate markets. However, sustainable global growth will require the identification or development of sophisticated local partners to provide the transparency and efficiency upon which the capital markets thrive. As local partners seek new, international financing sources and investors pursue new opportunities for portfolio diversification and enhanced returns, we will expect a continued increase in the number of international joint ventures, growth of transparency and expansion of global real estate capital markets.