Corporate Performance Competence Center

Impact of the US subprime crisis on the German housing market

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A. Aims and methods

The US subprime crisis has been in the news since mid-2007. Initially restricted to the American market, the phenomenon rose to global significance due to the issue of structured financial derivatives (known as asset-backed securities). These days, banks and insurance companies invest their money worldwide. German financial institutions responded to the US crisis by repeatedly writing down these financial products – in some cases on a large scale.

In the wake of the crisis, institutional market players, private home owners and would-be buyers alike are facing new challenges. Answers are needed to a series of weighty questions: How will key market indicators (such as privately-owned house rate, housing and rental prices) develop? How is the crisis changing the investor landscape? How is it affecting financing options, both for institutional investors and for private market players? How are the strategies of institutional investors changing? What exit options are feasible to dispose of housing property in the future?

In March 2008, Roland Berger Strategy Consultants conducted an exclusive telephone survey of selected decision makers in the real estate industry. Focusing on precisely these issues, the questionnaire was sent to participants in advance and consisted of two parts. The first part was identical for all respondents. The second part was tailored to different categories of respondents, who included private housing corporations, housing construction companies, property developers, real estate agents, property consultants, property financing companies, strategic management consultants and public organizations/associations (such as tenants' associations).

The core findings of these interviews should give market players a better understanding of how the subprime crisis is affecting the German market. This knowledge can then be put to good use as players prepare their individual strategies:

- Key market indicators such as housing/rental prices and ownership rates will develop along positive lines in the future
- Market players with a short-term focus will withdraw, while investors with large reserves of equity and a long-term orientation will remain
- The cost of borrowing money and the required equity contribution will increase sharply for institutional investors but only slightly for private market players
- Property management is a core aspect of current strategies. Expected returns are receding and retention periods are lengthening
- Lower vacancy rates and value-added services are two key operational levers to drive up the value of asset management
- Smaller block sales of parts of portfolios appear to present a good short-term exit strategy. The sale of housing to existing tenants is becoming slightly more difficult but remains a viable option

B. Trend in market indicators in Germany

The respondents expect key market indicators to develop as follows:

> Housing/rental prices will increase

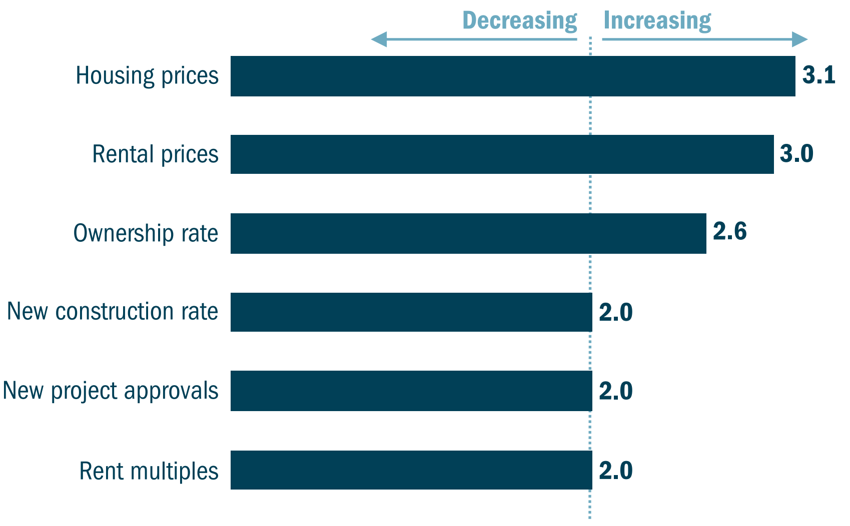
> Privately-owned house rates will rise slightly

> New construction rates, new project approvals and gross rent multiples will remain constant

This positive view of future developments is based on the assumption that housing and rental prices in conurbations such as the Ruhrgebiet, the Rhine-Main area and in larger cities such as Munich, Stuttgart, Hamburg, Frankfurt, Bonn, Cologne, Düsseldorf, etc. will increase significantly.

As far as gross rent multiples are concerned, demand for large transactions is expected to decline now that the subprime crisis has made financing more difficult. On the other hand, supply is decreasing as fewer publicly owned portfolios are coming onto the market. All in all, gross rent multiples will therefore remain broadly constant. The market players surveyed believe that the gross rent multiples, above all for high-quality portfolios in prime locations, will remain consistently high (up to 30x at top locations in Munich, for example). Multiples will, however, vary considerably at different locations within the same city. Berlin-Neukölln, for example, commands significantly lower multiples (12x) than, say, Berlin-Mitte (17x to 20x).

Trend in key market indicators over the next five years [scale]



1 = Decrease 2 = No change 3 = Increase 4 = Sharp increase

Source: Interviews with experts

C. Impact on the activities of various market players

The respondents take the following view of market players' activities:

> Private investors will step up their activities

> Institutional investors will scale back their activities

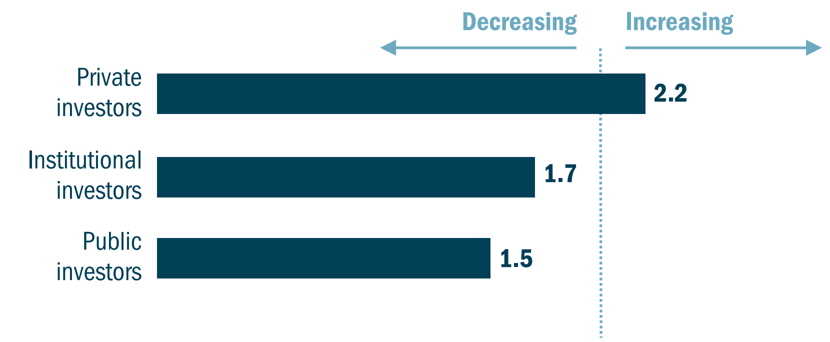
> Public-sector investors will scale back their activities significantly

In particular, larger groups of investors with a long-term focus and substantial reserves of equity are expected to play a more active role in the future. By contrast, institutional investors will shift down a gear, while investors with a short-term focus (such as international private equity funds) will withdraw altogether.

As in 2007 (when Cerberus sold Baubecon, for example), the respondents expect that financial investors will continue to jettison more and more of their portfolios. Their retreat is being driven primarily by higher interest rates, which are making it more difficult to obtain heavily debt-based financing. As a result, financial investors are now often unable to realize their ambitious business plans. Many of them therefore quickly ran for the door during the crisis. The opinion of the respondent market experts is that the goals set for the sale of housing to existing tenants were unrealistically high in many cases.

Up to now, public organizations have mostly played the role of seller, floating large portfolios of housing on the market. In Germany, local and regional governments are now under less pressure to run down their debts. Sales of housing are therefore likely to recede as the need to do so diminishes. Protests and referendums (such as the one in Freiburg) have also expressed public opposition to the sale of local government housing corporations. For all these reasons, these corporations will probably only sell off smaller portfolios in order to avoid public resistance.

Trend in the market activities of different investor groups [scale]



1 = Decrease 2 = No change 3 = Increase

Source: Interviews with experts

D. Impact on financing options

In the US, debtors with poor credit ratings obtained loans or mortgages from banks to build or buy houses. Germany has no comparable segment, or only to a very limited extent. Informed sources indicate that various market players had intended to launch similar credit products here too. Since the outbreak of the crisis in the US, however, these ideas have been abandoned. Even so, the impact of the crisis can still be felt on the German market. The "Landesbanken" in particular – the regional institutions that serve as clearing houses and liquidity managers to state savings banks – have up to now done a brisk trade in financial products that were securitized by mortgage loans to debtors with poor credit ratings. For them, painful write-downs have been the order of the day since the subprime crisis struck.

Two main changes will affect the financing options open to institutional investors in the future:

> Significantly higher borrowing costs

> The requirement for a considerably higher equity contribution

Above all those financial investors who have in the past leveraged extensive borrowings to fund transactions will have a hard time stumping up the money they need in the future. These days, banks insist on more equity before they approve fresh loans.

Private market players will experience similar changes, albeit to a lesser degree:

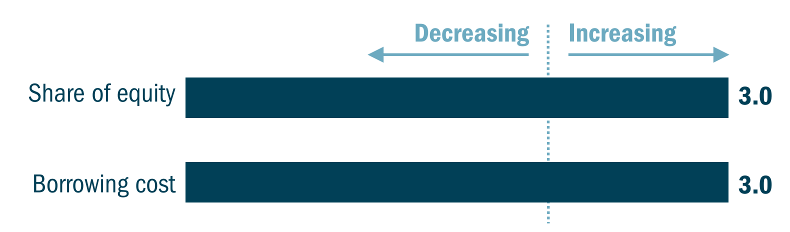
> Slightly higher borrowing costs

> The requirement for a slightly higher deposit

Effective interest rates for 10-year housing loans will settle at around 5%. Experts predict that private home buyers will be able to borrow no more than about 70% of the total cost of a transaction.

The banks themselves will once again increasingly turn to German "Pfandbriefe" (mortgage loans) to finance their lending activities. The experts surveyed believe that a securitization via the capital market will be extremely difficult in the short term. Broadly speaking, investors are skeptical about financing arrangements where the risk of default on the underlying securities is not clear. According to our respondents, a psychological effect on institutional and/or private market players cannot be ruled out entirely. In view of the generally upbeat economic climate, however, any such effect is likely to remain modest.

Trend in financing options for institutional investors [scale]



1 = Decrease 2 = No change 3 = Increase

Source: Interviews with experts

E. Impact on the strategies of institutional investors during the retention period

The following trends in investors' strategies are discernible:

> Greater importance is being attached to property management and the upgrading of objects

> The significance of "financial leverage" is waning

All respondents confirmed a growing trend toward property management, seeing this as an "attractive market niche" and a "strategic success factor for investors". Institutional and public market players are adopting an increasingly professional approach.

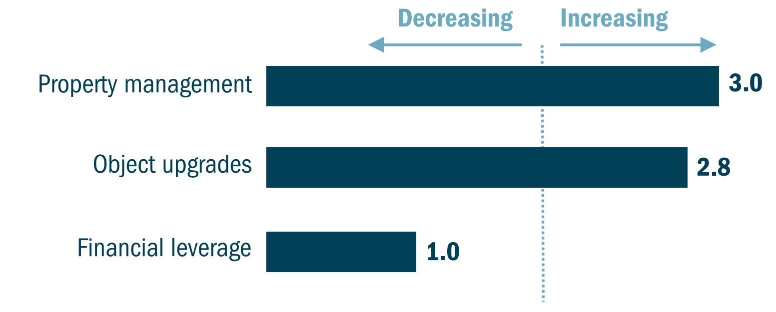
Investment behavior will in the future exhibit the following patterns:

> The average retention period will increase to between 5 and 10 years

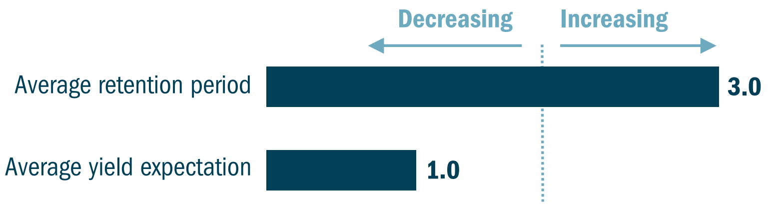
> Average expected returns will decline

Financial investors currently still expect double-digit returns, but believe these will drop to below 10%. Our survey indicates that such lower expected returns too have caused financial investors to withdraw from the market.

Trend in the importance of different strategies for institutional investors [scale]



Trend in investment behavior indicators for institutional investors [scale]



1 = Decrease   2 = No change   3 = Increase

Source: Interviews with experts

As property management grows in importance, the significance of various related levers is increasing, too:

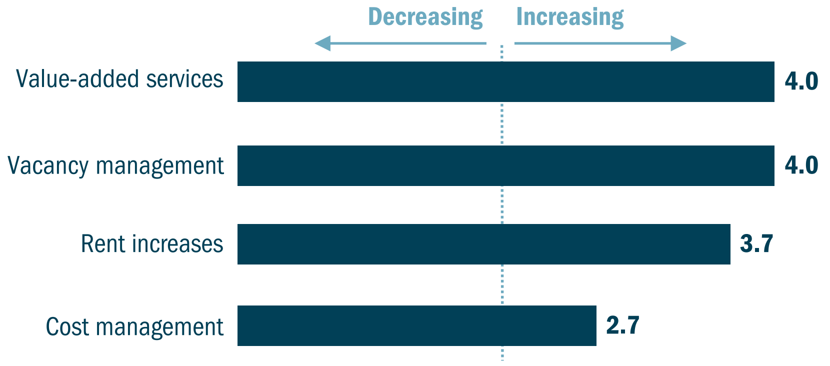
> Lower vacancy rates, value-added services and rent increases will become much more important

> Cost management will become somewhat more important

In search of suitable objects for investment, the respondents recommend close attention to the activities of the previous owners. Various experts believe that the potential for property management could already be exhausted in the case of objects that have changed hands several times. Cost management in particular is frequently used as an optimization lever – and hence erodes its potential over time.

Value-added services suggested by the respondents primarily include delivery services, adaptation to the needs of senior citizens (e.g. fitting wider doors), "green building" (e.g. avoiding the use of hazardous building substances) and energy-efficient living (e.g. the use of solar power). Some were of the opinion that such offerings justify rent increases.

Trend in the importance of various asset management levers for institutional investors [scale]



1 = Decrease 2 = No change 3 = Increase 4 = Sharp increase

Source: Interviews with experts

F. Impact on the exit strategies of institutional investors

The crisis is also influencing the exit strategies of institutional investors:

> It is making it easier to sell portfolios in block deals

> It is making it slightly more difficult to sell housing to existing tenants

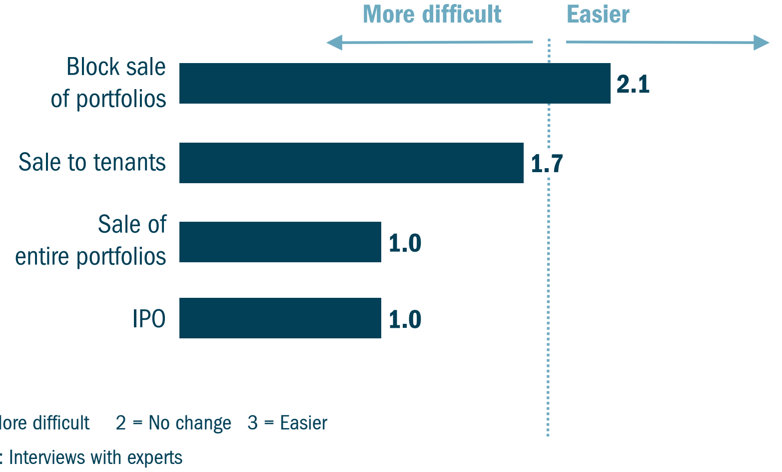
> It is making it significantly more difficult to sell entire portfolios...

> ...and to execute IPOs

More block deals of portfolios are now being sold essentially because it is becoming more difficult to finance larger transactions. Individual market players see EUR 100 million as the ceiling beyond which financing is no longer possible. They expect a trend toward the sale of ever smaller components of portfolios.

The fact that selling housing to existing tenants has become rather more difficult has less to do with the subprime crisis. In Germany, the government's recent abolition of what was known as the home owners' allowance had a greater impact. Our respondents take the view that this abolition has caused many "emerging households" to drop out of the property-buying market. Government subsidies used to make the difference that enabled them to buy their own home. Today, that is no longer the case. The respondents also identified marked regional differences in the privatization rate. Our study revealed an average rate of between about 2 and 5% per annum for high-quality homes in top inner-city locations (e.g. Munich).

Trend in the importance of exit options for institutional investors [scale]



1 = More difficult 2 = No change 3 = Easier

Source: Interviews with experts

G. Outlook

A US-style subprime segment in Germany is apparent only to a very limited extent. Having said that, there is still no sign of an end to the US subprime crisis which has by now turned into a credit crisis with potential effect on the German market. Investors are therefore advised to act cautiously. The IMF puts global losses from this crisis at more than EUR 603 billion. Right now, it is especially difficult to assess the psychological impact on the purchasing behavior of private and institutional investors.

Despite the subprime crisis, the prospects remain bright overall for investors on the German housing market. To seize the opportunities available, however, institutional investors must pay attention to crucial success factors such as regional peculiarities. For private market players, housing in large cities in particular remains an attractive investment opportunity with stable value growth and the prospect of a continued rise in property prices.

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