



# PROPERTY IN PERSPECTIVE

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## From economic crisis to a sustainable recovery – picking up the pieces

Since our spring 2009 edition of *Property in Perspective*, the world has changed dramatically once again. This time, however, some elements have improved which is a welcome change to the negative trend of the past two years. Since early 2009, the financial crisis has turned into an economic crisis. The vital elements of where the global economy currently stands are:

**Systemic risks** Systemic risks of a failure of the entire global financial system seem to be declining although a number of fundamental flaws still need to be addressed. Confidence in the financial system is on the rise again although all policy makers ranging from the European Central Bank to the Fed and from European prime ministers to Obama include a disclaimer in their statements saying that 'they believe that the recovery has started although that is the way it seems for now'. Most policy makers and economists still have some remote fears that the global financial system will face a set-back in H2 2009, leading to a W instead of a V-shaped recovery. The two one million dollar questions going forward will be (i) whether the existing problems in the real estate market will pose a threat to the fragile recovery we have seen so far and (ii) whether policy makers will consider the real estate market problems important enough to support the real estate sector in the form of help and support plans.

**Commercial real estate considered to be a threat** US policy makers are indicating that they might shift their attention to the risks of real estate. This shift in attention is not caused by any idea of helping the real estate sector because it is in trouble. It would be overly optimistic to assume that policy makers feel sorry for the real estate sector. The real reason behind this shift in attention by the Fed is that, if real estate markets remain in the doldrums longer than ex-

pected, the risk is that the Fed may be forced to leave emergency lending programmes in place and keep interest rates close to zero for longer than expected considering the positive signs in the general economy. On the one hand, interest rates might have to be raised again at some point in time in order to prevent inflation rates from creeping up. However, raising interest rates might put even more pressure on the real estate sector than there already is. Such a situation could leave central banks in a catch 22 situation whereby they would like to raise interest rates because of improving economic conditions and the risk of rising inflation, but at the same time cannot raise interest rates because it would endanger the real estate market. The real issue that the Fed might be facing is the following. Real estate in general is lagging behind macroeconomic conditions by some 6 to 9 months. As general economic conditions are still weak, we are seeing increased vacancy, declining rents, falling prices and therefore more pressure on real estate. This trend is expected to remain in place well into 2011 or even 2012. Property values have on average fallen by some -20% (Germany), -35% (US) and -50% (UK). This combination of factors creates problems for a number of economic sectors including the financial sector. Financial institutions with substantial real estate-related credit lines are facing difficulty caused by the weak economy. The risks of this are twofold. First, real estate risks can pose a threat to general economic improve-

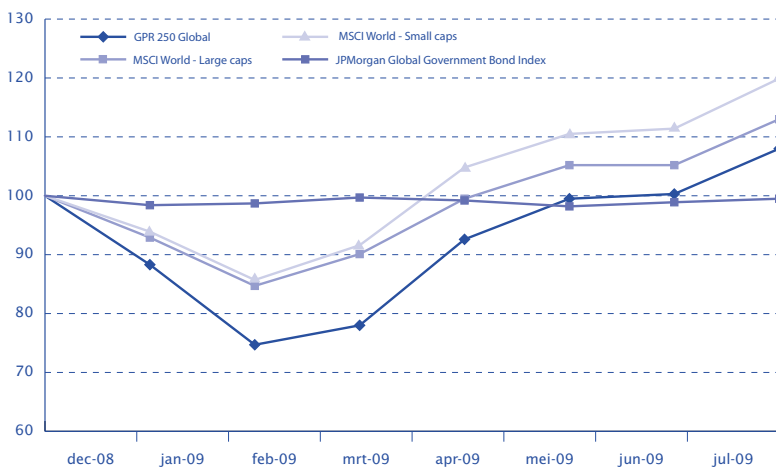
ment going forward. Second, if real estate were to cause unexpected losses to financial institutions, it might spark another financial crisis as financial institutions have not recovered entirely from previous shocks. The question will be whether the Fed, and possibly also the ECB, consider this as a real threat to an economic upturn. If they do, central banks will probably focus their efforts on supporting troubled financial institutions instead of supporting the direct real estate market, as the latter is impossible to manage. Such support of financial institutions might have a beneficial effect in the short term, but we believe that in the long term the real risk is that a bubble might return quicker than expected. The alternative is that central banks will leave the real estate (lending) market as it is and let it solve its own problems. This process will be painful, but might lead to a more sustainable situation in the longer run.

the banking business (investment banking) has become profitable again since Q1 2009, which is true for parties like Goldman and Morgan Stanley. Improving financial markets plus the steep yield curve (were two major reasons for improved operational performance at financial institutions. One could argue that the state of the financial markets provides for ideal market conditions, as long as bad credit lines do not spoil the business.

**Improved equity markets** Equity markets have rebounded by some 44% since the trough in March 2009. An interesting trend is the sequence of improvements. The trough in the market in March 2009 was indicated by declining yields for government bonds (or high prices for government bonds which is the same) to extremely low yield levels (3.5%). This, combined with the fact that central banks have created a steep yield curve by lowering official interest rates, has left investors with limited investment alternatives without taking risks.

**Investor interest is moving up the risk spectrum again** The first result of increasing investor risk appetite was an increased interest in corporate bonds. Corporate bonds combine liquidity with the typically higher security elements of debt (compared to equity) and a better expected return than government bonds. Once that move had been made, many investors returned to listed equities in the form of large caps. Large caps are typically blue chip companies with relatively low risk profiles and highly liquid shares. Small caps have started to perform well again as well. That is remarkable because it shows that investors are already moving up the risk spectrum by buying less liquid securities like small caps. Listed real estate securities fall into this category as well and have shown a rebound of 70% from their March 2009 levels. The risk of the current market is that we could be facing a situation similar to that in 1994 when interest rates started rising and the fundamental improvements in the direct property market took years longer than expected, leading to a second sell-off.

Graph 1: Performances Large caps, Small caps and Real estate securities (Total returns in local currencies)



Source: Global Property Research, datastream and The IBUS Company

**Steep yield curve** Financial institutions have become profitable again thanks to the steep yield curve created by central banks (lowering short term interest rates to virtually zero). There seem to be two sorts of financial institutions at the moment. Institutions that still require fresh injections of capital like Citigroup, Bank of America, RBS, etc., partly caused by write downs on their real estate credit portfolios. The other side of



London Skyline

## SIGNS OF IMPROVEMENT IN THE CENTRAL LONDON OFFICE MARKET

### 'Investors Should Start Taking Notice'

The Central London office market totals approximately 215 million sf. This large, liquid market was one of the first – as far back as 2 years ago – commercial real estate markets in the world to significantly record declines in values during the current down cycle. Of the total stock, approximately 7.7% is vacant and 9.8% is currently available for lease<sup>1</sup>. The available space includes sublease space, which is highly detrimental to rental rates.

The decline in values was brought about by a significant increase in yields in anticipation of declining income levels to be derived from Central London offices. Among the five submarkets that make up the Central London office market, the City and West End markets are the primary ones. Compared to their peak in 2007, yields increased by 250bps in the City from 4.25% to 6.75% at the end of 2Q09 and by 200bps from 3.50% to 5.50% in the West End<sup>2</sup>. These increases in yields alone account for a decrease in capital values of approximately 37%.

The very steep increase already realised in yields appears to have been appropriate given the direction in which the deterioration of the space market fundamentals is headed. The City, with 10% vacancy, up more than 600 basis points from its 2007 low of just below 4%, had the highest vacancy rate of the five primary submarkets at the end of 2Q09. The West End had a vacancy rate of 7.4%, up more than 500 basis points from its 2007 low of just above 2%. In the City, prime rents have declined from GBP 60 per square foot per year to GBP 43 per square foot per year, or more than 28%, and in the West End, prime rents have fallen from GBP 120 per square foot per year to GBP 80 per square foot per year, or more than 33%. In addition, rent-free periods for a 10-year lease have increased from approximately 13.5 months to 33 months in the City and from 12 months to 21 months in the West End.<sup>3</sup> Whereas the deterioration of space market fundamentals is ongoing, the jury is still out on whether yields have corrected by too much and a window of opportunity has presented itself to capitalise on an overcorrection in this market.

What's interesting, however, is that, as of late, investment activity in the Central London office

market has actually already been showing signs of improvement to the extent that yields appear to have stabilised. To us, this recent investment activity does not yet appear to signal a broad recovery suitable for large-scale counter cyclical investment based on fundamentals. Rather, recent investment activity appears to be speculative since fundamentals are still deteriorating and it's not yet clear how refinancing will be dealt with. Having said that, investors should start taking notice, since real opportunities are likely to soon start appearing in this highly competitive market.

With 21 million sf available and some 16.5 million sf vacant and demand still falling, completions with no pre-letting or offers of 5 million sf which are expected shortly carry the very real potential of significantly pushing the vacancy rate up to more than 10%: a level more in line with the level reached during the previous down cycle. In the meantime, take up in Central London (leasing activity) has fallen far below historical levels of some 3.1 million sf per year. The available floor space of 21 million sf (almost 10% of total stock) consists of almost 60% second hand space. This is the type of space that's actually seeing the majority of leasing activity, as new completed and pre-let take up is minimal. Grade A space is capturing approximately 50% of take up. These performances lead us to conclude that leasing activity is still very weak and tenants have not begun a flight to quality. We believe these are both clear signals that rents most likely have still further to fall.

In addition to the space market fundamentals being very weak at the moment, substantial risks also remain in refinancing activity. The current situation appears to be that the actual size of the rather acute problem of constrained

<sup>1</sup> CB Richard Ellis, Inc.

<sup>2</sup> CB Richard Ellis, Inc.

<sup>3</sup> CB Richard Ellis, Inc.

refinancing possibilities is exactly the reason that the real problems haven't surfaced (yet). Both financiers and owners are hoping time will heal at least most of the problems out there. If assets start performing better while lenders are still willing and able to extend loan maturities, some projects may survive. According to CBRE Investors, 70% of outstanding loans in the UK, which total GBP 228 billion, will fall due before 2014, with almost 20% being payable as early as in/at the end of 2009. With GBP 159.6 billion falling due within the next 5 years and no clear outlook or hard data pointing in the direction of much better performance, it is likely that deal flow will accelerate substantially – despite the 'extend and pretend' efforts being put in at the moment.

At present, a large share of investment transactions is being done by foreign buyers. Most of these investors are most likely taking into consideration the still low level of sterling. Compared to year-end 2006, sterling is still down approximately 15% against the dollar, 20% against the euro and 30% against the Yen. Even after the recent rent declines, Central London offices still have some of the highest rents in the world, which stems for a large part from the high land component. These foreign buyers are thus buying up 'real assets' at a high, albeit not always safe, yield in a currency that they would like to have exposure to. Even in a market where fundamentals are weakening this could be a sound investment strategy, albeit a speculative one.

The longer term outlook for Central London is in our opinion actually quite favourable: re-pricing has been significant compared to the longer term potential of this market place. New construction is limited and is likely to remain subdued for some time to come. Whether or not further re-pricing will take place based on even weaker performance in the short term remains to be seen. Regardless of this, with no clear view yet on how the refinancing market will play out, deal flow is likely to remain depressed. The current high yields of Central London offices make the need for debt funding, in order to achieve attractive returns on investment, less pressing. As such, investors who do not necessarily need debt are very well positioned to acquire high yielding office buildings in Central London. Investors should seriously start considering this market, as real opportunities are highly likely to present themselves in the not too distant future.



Work in progress

## German residential market: case study Salzgitter

IBUS acquired a portfolio of 1,352 residential units in Salzgitter, Braunschweig and Cologne in September 2006 for EUR 53 million (excluding costs) or around EUR 39,000 per unit. The vacancy in the portfolio in Salzgitter at the moment of acquisition in 2006 was 21.0% of which 80% could be considered structural vacancy because of major maintenance issues. Over the past three years, the vacancy rate has dropped to 16.3%. This article attempts to describe how, even in the current economic conditions and in a weaker demographic area like Salzgitter, it is possible to achieve positive income growth (rising rents and declining vacancy rates). There are two major reasons for the improving occupancy rate in this particular portfolio. The first is the EUR 10 million focused investment programme of which about one third has been spent to date. The reason this investment programme is possible is that the portfolio was acquired at a low price, leaving room for additional investment. The second reason lies in the fact that competitors in Salzgitter like Colonia Real Estate, Vivacon and Babcock & Brown seem to have scaled down investments in their units. A detailed recap of the 'value added' strategy that has been applied to date is given below.

### THE INVESTMENT

Part of the acquisition plan for this portfolio included a total of 1,000 apartment units in Salzgitter. The units are spread over 36 separate buildings and are all located in Salzgitter-Lebenstedt. Salzgitter as a city consists of 26 individual villages, put together by the national socialist regime in WWII. The city has an industrial background as Salzgitter was historically the steel production capital of Germany. For obvious reasons, the national socialist regime wanted to have this in the centre of the country. The city stretches over a large area. Today, major employers in the Salzgitter area are Salzgitter AG (steel), Volkswagen (car manufacturing), Bosch (electrical engineering), Alstom (world leader in transport and energy infrastructure) and MAN trucks. Economic activity in the Salzgitter area has suffered from the downturn of the German economy as a whole, as a number of these industrial companies scaled down production for a number of weeks in 2008 and early 2009. Unemployment in Salzgitter has increased from 9.3% to 9.8% (former West Germany 6.9%) but it seems to be stabilising at the 10% level. The population of Salzgitter has been declining since the early 2000s, by around 1% per annum. The city now has some 100,000 inhabitants, down from a peak level of 118,000 in the 90s. This trend can incidentally be seen across many German areas. There is limited willingness to move to Salzgitter. People prefer commuting from cities like Braunschweig, Hanover and the surrounding area into Salzgitter. Contrary to the trend in Germany, the number of total households in Salzgitter is decreasing as well. Of the

total population of 100,000 inhabitants, some 43,000 live in Salzgitter-Lebenstedt, which is the area closest to the city centre (see graph). IBUS' portfolio is located in Salzgitter-Lebenstedt.

Picture 1: Map of Salzgitter



The average vacancy rate for German apartments is around 3.7%, but this number is substantially higher for Salzgitter, being around 10%. The Salzgitter apartment market can be described as a tenant's market. Competition amongst landlords is fierce and tenants are looking for the best deals. As a result of all these trends, market asking rents have declined in Salzgitter from EUR 4.94 per sqm in 2007 to EUR 4.76 per sqm at present.

#### ANALYSIS AND INVESTMENT PROGRAM

The promising aspect of the investment is that despite the low market rents (EUR 4.76 per sqm), low economic activity and a declining population, it transpires that vacancy rates can be reduced and rents per sqm raised. IBUS has started a EUR 10 million investment programme, which translates to around EUR 10,000 per apartment. That may not seem much, but for these amounts, it is possible to transform an apartment structurally including changing wall insulation, improving the kitchen, improving the bathroom and installing new floor covering. Backed by the investment programme, IBUS was able to sign 157 new leases in 2008, which is an increase of 12% compared to 2007. In 2009, the average rent per sqm for new leases on the IBUS assets in Salzgitter was EUR 5.13 per sqm. The investment programme has led to a situation in which rent levels on new leases in the IBUS assets are above market levels. The average rent per sqm for the IBUS portfolio in Salzgitter increased slightly from EUR 4.73 per sqm in 2007 to EUR 4.83 per sqm by mid 2009.

The credit crisis is also changing the Salzgitter apartment market in another way, as it also affects the competitive field amongst major landlords in Salzgitter. In June 2009, four subsidiaries of Vivacon filed for insolvency. This affected almost 4,000 residential units (in Kassel and Salzgitter) of approximately 10,000 residential units which are part of the Vivacon group. It is likely that Vivacon stopped investing in its Salzgitter assets some time ago as the company is suffering from cash shortages. This will have an impact on the occupancy numbers Vivacon has for its Salzgitter assets. Another institutional landlord in Salzgitter is Colonia Real Estate (CRE), which owns some 8,700 apartment units in Salzgitter, of which around 6,300 are lo-

cated in Salzgitter-Lebenstedt. CRE has invested substantial amounts in the Salzgitter holdings over the past years. However, maintaining and upgrading the CRE assets has been done as a combination of maintaining the outside of the buildings as well as upgrading individual apartments. CRE is now rumoured to command an average rent per sqm of EUR 4.58 per sqm, which might make it hard to justify the major investments it has made. The third institutional owner in Salzgitter is the Australian company, Babcock & Brown. Babcock & Brown went bankrupt early in 2009. Its assets are being managed by the German firm, Krüger Immobilien, which is running B&B's funds at present. It is not known whether Krüger is planning to spend fresh money on its Salzgitter assets. If investors in the former B&B funds are not willing to invest fresh money in the Salzgitter assets, there is a risk of increasing vacancy rates for the B&B assets as well. Apart from the investment programme, the 'social approach' to tenants is also an important tool to achieve operational results. IBUS encourages its property managers to play an active role in community management and provide for a social backbone in the area. A crucial aspect in this is the cooperation with the Diakonie, the social workers of local church communities. They provide programmes for children, the unemployed, senior citizens, etc., to foster a safe and positive social environment.

#### THE RATIONALE OF THE SALZGITTER TENANT

Salzgitter tenants tend to be less willing to pay a higher rent merely for the fact that a building looks good on the outside. Tenants are willing to pay for improvements in the apartments themselves but less for improvements to the outside of a building. The difference can be seen in the rent for a building that has been upgraded on both the outside as well as the inside being some EUR 5.40 per sqm, whereas the rent for apartments that have been modified on the inside tend to be EUR 5.20 per sqm. The difference of EUR 0.20 per sqm does not justify substantial investments in the facade of a building. This is a driver for IBUS' investment programme, which has been carried out thus far in collaboration with a local engineering firm. All investments are carefully weighed against the aspect of whether the investment will lead to additional

income. As a result, the upgrading investments made in IBUS' assets thus far have involved the installation of central heating in one building, individual apartment upgrades once they vacate, improved insulation and transformation of balconies into 'winter gardens'. The installation of winter gardens (see picture) leads to lower energy expenses as well as a large lettable floor space. These investments have led to increasing rents and decreasing recurring costs.

In conclusion, although the Salzgitter market fundamentals are challenging, the market does offer opportunities when assets are bought at a price that still leaves room for additional capital expenditure in a market that can be described as a tenant's market.

IBUS owns and manages around 4,000 apartments in Germany. These holdings are spread over several funds.

Pictures 2: Examples refurbishment Kieselgrund, Salzgitter



Wintergarden from inside



Wintergarden from outside



Before refurbishment



After refurbishment

## Institutional real estate funds – Lessons learned

The real estate market is going through a difficult period. This is not only true for real estate managers, tenants and financing banks but also for the investors who have invested in the sector.

Marleen Bosma-Verhaegh<sup>4</sup> and Peter van Gool<sup>5</sup> recently published study, which sheds light on the issues that a Dutch institutional investors are currently facing.

Over the past decade most Dutch institutional investors have replaced their direct real estate investments (domestic and foreign) by investments in private real estate funds (or 'non-listed real estate funds'). The rationale behind this move was to shift away from management-intensive direct real estate assets towards relatively easily manageable (or so it was thought) investments in private real estate funds. The management of private real estate funds would consist of a selection phase, a due diligence phase and monitoring of the fund investments (possibly combined with having a seat on the advisory committee of the fund). In practice, driven by the downturn in the market, some of the objectives like an easily manageable portfolio have turned out to be different in practice. It is important to mention in this respect that Dutch institutional investors used to own their direct estate holdings on an all equity basis, so leverage was not used at all.

Some of the recent issues are:

**Leverage related issues** This ranges from funds that have used short term financing, which is shorter than the life time or holding period of the asset, leading to refinancing risks. The INREV Debt Study 2009 shows that 20% to 30% of investors say they are affected by funds that can no longer meet debt obligations, possibly leading to forced sales. In other cases, downward valuations have led to gearing or LTV levels, which are substantially higher than those anticipated at the set-up of the fund (funds with LTV targets of 50%, ending up with no equity at all). It has even led some institutional investors like BPF (the pension fund for the Dutch construction industry) to redefine their definition of core investments. According to BPF, core investments not only have to comply with quality standards on the real estate level, but also need

have hardly any or no gearing at all. Reduction of leverage can be countered by new equity contributions from investors or sales of assets (at current distressed prices). It might be possible to attract new equity in some cases (as long as the problems are not related to the state of the underlying assets), but new equity requires preferential treatment and higher returns which dilutes existing investors according to the investor responses in the study. We believe that these issues show that legal documents are not a good indicator of what sort of situations a fund might end up in in practice. We believe that investors looking for limited or no gearing at all should therefore only invest in all equity vehicles (no gearing allowed) or go for a mandate/separate account which contains a precise definition of gearing policy.

**Limited partner related issues** We already touched upon this topic in our spring 2009 edition of Property in Perspective. It turns out that some institutional and other investors are not able to meet their contractual obligations for new capital contributions according to the study of Bosma and Verhaegh. It is even rumoured in the market that there are cases in the market where institutional investors have over-allocated contributions to new vehicles in the belief that 'the market would remain so overheated that capital contributions would never be all called in'. This turns out to be a misjudgement, as in the current market some real estate fund managers are even asking for higher equity contributions than was anticipated at the start of the fund. This trend has led many investors to reconsider whether they want to be in funds with a large number of non like-minded other investors. In practice, requiring information about other investors will prove to be difficult if not impossible in good market conditions. We believe that the best thing institutional investors can do to avoid this problem is to team up as a club and approach a real estate fund manager together or ask for a mandate/separate account if limited partner risks want to be avoided for good.

<sup>4</sup> Marleen Bosma – Verhaegh is real estate fund manager at Blue Sky Group, which manages the KLM pension funds amongst others.

<sup>5</sup> Peter van Gool is professor of real estate at the Amsterdam School of Real Estate and responsible for strategy and acquisitions at SPF Beheer, which manages the capital of the Dutch railways amongst others.



*How to exit?*

PROPERTY IN PERSPECTIVE

**Fee related issues** Institutional investors indicate that some real estate fund managers are no longer incentivised because of the reduced chances of achieving performance fees as a result of the big market declines. This is especially true for investments made in 2006 and 2007 at the peak of the market. If the real estate fund manager, or individuals in the management team, have not contributed capital to the fund themselves, the hurdle to overcome before performance fees start coming in might not be enough to stay focused. It might be more beneficial for the real estate fund manager to set up a new fund with new conditions and fees. A very important aspect in this discussion is the fees, and asset management fees in particular. Generally speaking, it can be said that for funds that were initiated in the period 2006 and 2007 (with high asset prices), it was harder to be able to present realistic and appealing fund returns. In a hot investment market, there are several ways for the real estate fund manager to improve estimated returns for a new fund: (i) lowering asset management fees, (ii) lowering the hurdle for performance fees and/or (iii) increasing the estimated future growth in the financial model. It is our opinion that the impact of lowering asset management fees is greater than when one-off fees (like placement, subscription and acquisition fees) are lowered, as asset management fees are paid annually. The risk is that there are funds in the market which are based on asset management fees that are too low to operate the necessary asset management activities. Asset management fees that are too low could endanger the continuity of the real estate management organisation itself. It is our view that investors will have to accept that performing asset management services is a labour intensive business, which costs money, especially when it involves adding value to existing real estate assets. A debate was recently held between investors and real estate fund managers based on Verhaegh and Van Gool's study. The outcome of this debate was that most investors agreed that asset management fees should cover a real estate fund manager's recurring expenses as long as an explanation is given of what the actual costs are that the real estate fund manager is facing. The performance fee is considered to be something on top by the investors in this debate. Moreover, investors indicated that many funds contain a large number of different fees

(INREV has found 52 different types of fees). The investors argued that this should be rationalised in the future to make things simpler.

**Exit related issues** Many funds have a predefined term. Now that real estate markets have experienced substantial declines, the real estate fund manager might not be inclined to terminate the fund at the predefined term as it would not bring him any performance related fees if assets were sold now. The investor, on the other hand, might want to get his money back. A vital element in this discussion apart from the lack of alignment of interest between real estate fund manager and investors is that assets need to be sold in order to be able to terminate a fund. We believe that this is an issue that seemed to have disappeared entirely from the check-lists of both fund managers and investors is the type and volume of real estate that needs to be sold in order to realise an exit. There are not many parties that are able to buy a EUR 150 million shopping centre, even in good market conditions. If a fund needs a portfolio sale in order to achieve an exit, the market risk involved in this sale will be greater than when individual assets could be sold as well. It is our view that the same holds true for portfolios of smaller sizes or types of real estate that are less unique and are therefore interesting to a larger range of possible buyers.

Some of the key principles of the IBUS approach over the years have been: (i) IBUS typically uses financing with a maturity that is in line with the estimated holding period of the assets and uses conservative financing levels. IBUS currently has an average gearing level below 60% on its investments. (ii) IBUS typically buys types of real estate for which the exit risks are as limited as possible (alternative use of the assets and volume are regarded as vital elements in order to achieve an exit). (iii) IBUS will typically not apply external appraisals during the term of a fund as the real asset value will only show at the moment of disposal. This implies that IBUS only applies performance fees once the proceeds have been realised through a sale of assets. (iv) IBUS has shifted away from predominantly office investment towards rental apartments across its holdings over the past 5 years in order to reduce investment risks.

## Student housing: flavour of the day or here to stay?

Investors are looking for investments in sectors that show resilient returns in a negative economic environment, especially in uncertain economic conditions. An investor requirement is that a sector should not only outperform in negative economic times, but it should also show positive returns in better economic times. Even in a relatively well-developed real estate market like the US, the student housing market is a new market. The first specialist investment/development firms in this field were established there in the mid 90s. Significant US players in campus accommodation are American Campus Communities (ACC), Campus Living Villages, Education Realty Trust (EDR) and Prime Property Investors, but also more generalist real estate boutiques like Blue Vista Capital Partners have done transactions in student housing. American Campus Communities and a number of others have become stock-listed since 2004, implying that the sector is also relatively new on the stock exchange.

According to Green Street Advisors, which produces research on the US market, student housing investments combine a couple of interesting characteristics that are different compared to the two typical drivers for the general apartment market: interest rates and employment growth. Important factors that affect student housing are:

The world population is becoming better educated, and this trend appears to intensify in negative economic times. This means that even in countries with an ageing population, it is highly possible that student housing is facing positive demographics and therefore growing demand for student housing space;

Universities tend to lack capacity, knowledge or financial resources to provide students with sufficient housing. That provides an interesting opportunity for entrepreneurs and market players. Having said that, typical 60s/70s and 80s housing accommodation stock tends to be of low quality, suffers from poor maintenance and lacks amenities like wireless internet, sports/fitness facilities that are required by students these days. This implies that both in the US as well as in Europe, it is expected that student housing will change fundamentally over the next 10 years and will become more professional.

Such positive characteristics do not imply that student housing is a no-brainer in which every investor will be able to make money. Student housing has a number of unique characteristics which make it a difficult sector to operate in:

**Location is very important.** Obviously, this is important for any piece of real estate but even more so for student housing. Proximity to the university campus location is crucial. Location is even more important for off-campus student housing than for on-campus housing. This is especially true for student housing in Europe which is usually scattered throughout a city. Distances for off-campus housing should be limited to short bike rides, a walk or good public transport connections. Land on campus sites is usually owned by the university, but not all universities have the capacity and/or financial resources to provide students with quality housing. This provides opportunities for market parties like specialist student housing developers. Quality of location should be reflected in a lower net initial yield for better located properties. In the current market conditions, these differences in net initial yield between well and badly located properties are returning. Rental growth prospects for student housing have been strong despite the economic and credit crisis. Green Street's research shows that rental growth in the US for on-campus student housing has shown increases in rents of some 4 – 5% per annum over the past 10 years whereas off-campus accommodation has shown rental growth more or less in line with inflation. The reason for this is the higher vulnerability of off-campus housing to new development.

**Operationally intensive.** Student housing requires substantial management effort comparable to self storage or lodging. Lease contracts are shorter than in the apartment market, turnover of tenants is higher, the leasing season is



Student at work

directly influenced by the start and end of the academic year and cleaning and repairs are an essential part of the business. In a way, management intensity is a barrier to entry for new players.

**Operational numbers** Rents per unit/sqm are higher for student accommodation than in the general apartment market due to smaller floor space per student and more students per apartment. Operational expenses per unit are higher compared to apartments in general due to higher tenant turnover, shorter lease periods, higher cleaning and repair costs and higher broker fees for finding new tenants. Again, this shows the operational character of the student housing market.

#### HOW HAS STUDENT HOUSING DONE IN THE CRISIS?

**Transaction volume.** Real Capital Analytics reveals interesting numbers on the US student housing market. Numbers over the 12 months preceding Q1 2009 show that the volume of properties that changed hands was up by 24% versus -71% for US apartments. One should remember though that these numbers are based on a limited number of transactions per quarter.

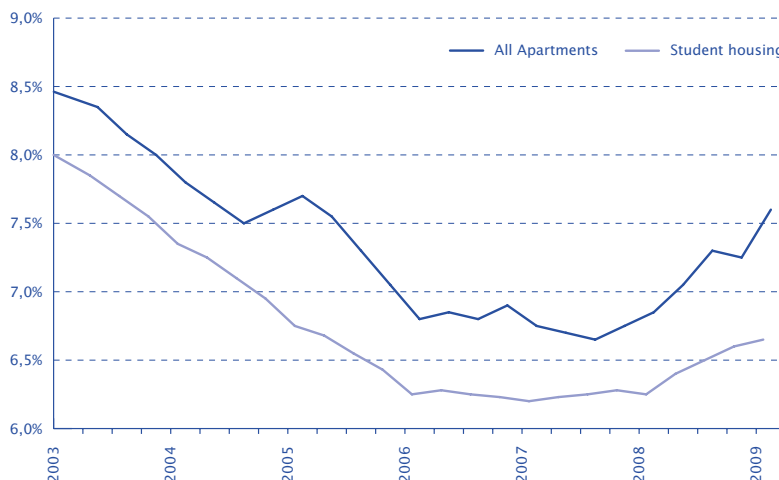
**Net operating income.** Student housing in the US has not experienced the same negative side effects as those in the low interest environment in the period 2002 - 2005 when many apartment renters became home buyers. The opposite is true for the period from 2007 to the present. Student housing has shown persistent growth, thereby behaving relatively independently of macro-economic trends. At the current low base, this could also imply that future growth prospects are better for apartments than for student housing because of the hits the apartment market has already taken.

**Yield gap has declined.** Based on the relative strength of student housing's Net Operating Income compared to the general apartment market, the yield gap has declined from around 150 bps some five years ago to 80 - 90 bps at present. Graph 2 shows that yields for US student accommodation track the apartment market closely with a gap that reflects its man-

agement intensity and its specific asset characteristics that make alternative use less appropriate. The reason for this is that student housing cannot be easily converted into conventional apartments because of the specific location and layout of student housing assets. Older student housing buildings or less desirable properties can become obsolete due to new supply leaving the owner with limited options, which explains the yield gap. Moreover, in the overheated investment market of 2006 and 2007, many investors were looking for new market niches, which drove down the yield spread because of the relatively small size of the student housing market. For a certain number of US multi-family housing assets with the right characteristics like location, proximity to a university and set-up of the building, conversion to a student housing asset might even be a consideration leading to better future returns and less operating income volatility.

IBUS believes that the student housing market has interesting long-term prospects, not only in the US but in Europe as well. IBUS owns a small number of student housing assets in Germany.

Graph 2: Yield development US apartments and US student housing.



Source: Real Capital Analytics

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## France

### *The IBUS Company completes office development in Paris*

The IBUS Company has successfully completed its office development Iliade in Paris. The building has a GLA of 18,000 sqm and is located in Massy, within the 2nd inner ring of Paris. The property has been sold to a French institutional investor for EUR 54 million with a rental guarantee of one year. The letting process has been started. The building was officially opened on 25 June 2009.

The expected IRR to investors is estimated to come in at approx. 10% per annum. These return figures are based on the assumption that no rental contracts will be agreed in the year of the rental guarantee. Distributions to investors will be made in the period to come. The fund has been placed as a private placement to a limited investor group.

The Iliade office development is one of IBUS' largest developments, both in sqm as well in investment volume. IBUS is pleased with the achievement of this project considering the challenging market conditions.

## Germany

### *The IBUS Company announces successful placement of Duits Woningfonds IV (German Residential Fund IV)*

The IBUS Company announces the successful placement of its Duits Woningfonds IV (German Residential Fund IV, 'The Fund'). The investments of the Fund consist of a residential and retail portfolio of 173 residential units and 12 retail units with a combined investment volume of EUR 10.5 million. The investments are located in the city of Oldenburg and the Goslar district.

The Fund has been placed with a combination of existing and new IBUS investors. IBUS has chosen for a size per participation of EUR 25,000 for this Fund. The investment memorandum for the Fund has been approved by the Autoriteit Financiële Markten (Dutch authority for the financial markets). Moreover, the Stichting Transparantie Vastgoedfondsen (Institution for Transparency of Property Funds) has approved the investment memorandum of the Fund as well.

Duits Woningfonds IV is IBUS' 7th German investment fund.

## Netherlands

### *IBUS presents at Nyenrode university*

IBUS has presented at the Center for Wealth Management at Nyenrode University in Breukelen (Netherlands). The presentation of IBUS was part of a course for family officers at the Center for Wealth Management. IBUS was happy to agree to another round of presentations for a new course, which will start in November 2009.



Bad Doberan, Germany



Krijgsman 6  
P.O. Box 8010  
1180 LA Amstelveen  
T. +31 (0)20-755 90 00  
F. +31 (0)20-755 90 90  
E-mail: [info@ibus.nl](mailto:info@ibus.nl)  
[www.ibus.nl](http://www.ibus.nl)

The IBUS Company is an independent group established in 1992 by Onno Husken, former Chief Executive Officer of Wereldhave N.V. and Kempen & Co. IBUS develops and invests in office, retail, residential and hotel properties in the United States, Europe and Asia. Since inception, 48 real estate funds, with a total investment consideration in excess of €1.2 billion, have been introduced with private and institutional investors. Over the years, more than half of these investments were successfully sold. IBUS also uses its real estate knowledge and experience to advise financial institutions, listed companies and institutional investors. These assignments are directed towards portfolio analysis, asset allocation policy, investment strategy and second opinions on direct and indirect real estate investments. IBUS is based in offices in Amstelveen (The Netherlands), Washington DC (United States) and Ho Chi Minh City (Vietnam).