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Closed-end Real Estate Funds

Secondary market buyers in seventh heaven

Michael Siefert stands out. Even these days he is among the folks that are happy. The reason: The boss of the German branch of Madison Real Estate makes a living buying secondary market shares in closed-end funds. There are plenty of them around right now and by and large still cheaper than before. Other investors, too, like the H.F.S. Zweitmarktfonds Deutschland 2 or Tivoli are above plan in their respective investment volumes. Dietmar Schloz, managing director of H.F.S., which is part of Wealthcap, is already considering a third secondary market fund.

“Never before have we been receiving as many inquiries from sellers as now,” said Siefert. That is good news for him because he has a private equity backing him looking for investment of another 200 mil. in shares of closed-end funds .One-third of altogether US $ 300 mil. is already invested. The goal for the investors is a 15 % return on equity capital (IRR) per year. Until now the German branch of Madison International Realty in New York has invested some US $ 250 mil. through various vehicles in fund shares. Participation in U.S. real estate funds accounts for half of that amount, the remaining 50 % are principally committed in Germany and to a lesser extent in English and Dutch funds.

That Siefert talks about the best of times ever experienced by his company is due to many factors including the fact that a growing number of institutional investors seeks to exit part of their real estate investments. It is not so much a matter of emergency sales but of uncertainties in respect to markets in which the funds are invested. Therefore Siefert thinks it is likely that the financial crisis will soon lead to higher vacancy rates, for instance in the office market. Shares of funds invested in such buildings would then decline in value. It is therefore to be expected that investors are now considering selling such shares. Madison strives for a share amounting to US $ 3 to 4 mil. per targeted fund. However the company buys participations starting at US $ 50.000. Madison conducts most of these transactions via the sponsors. In addition the Frankfurt office does business via banks and secondary market exchanges.

Fund share prices decline

Business at the secondary market exchanges is growing thanks to the financial crisis. The German exchange in Hamburg has traded shares worth nominally 100 mil. euros (of which well over 80 % were real estate funds). However, that far from suffices to reach the year’s target of 150 mil euros but in recent weeks trade in real estate funds pulled ahead. In October alone the platform dealt in shares of real estate funds to the tune of10 mil. euros. Chairman Alex Gadeberg attributes the boom in sales particularly to institutional investors relying more on real estate in view of the turbulences impacting international capital markets. Furthermore many private investors are currently reweighting their holdings.

The German secondary market reports sharp growth rates as well. In the third quarter of this year more property fund shares were traded than in any quarter ever before. At EUR 13.3 mil., these funds accounted for 47 % of the nominal trading value, an unusual development considering that traditionally the Hamburg market traded primarily in shipbuilding funds. In the first six months of this year the share of real estate funds in the trading volume accounted for merely 10 % of the EUR 46 mil. volume.

The second Secondary Market Fund of H.F.S. Munich is one of the exchanges' customers. According to Schloz the fund has been buying since 2003 and will be fully invested by mid-year in 2009. By this time it has invested 130 mil. of its 166 mil. euros. Originally the H.F.S. managing director wanted to take until 2013 to flesh out the fund. That it is moving ahead much faster now, Schloz explains, is due to the fact that many investors want to divest their shares to benefit their liquidity. It would be good for his fund if prices fell as a result of too many offers. The fund is to pay out 6 % annually.

Tivoli Investments, Luxembourg, has until now on average paid 100 %, according to Managing Director Ward T. Dietrich of the U.S. parent company. Jocelyn Laudet who was hired to conduct the European business of the company, left at mid-year. No successor has been named as yet. Tivoli has invested more than US $ 45 mil. in secondary market shares, especially in U.S. real estate funds. In the future some U.S. $ 50 million is to be added annually. In terms of purchasing shares Dietrich is counting on higher risk premiums soon and therefore significantly lower acquisition prices. This could eliminate one of the problems in connection with acquiring fund shares. Until now Dietrich considers himself hampered by price expectations that are too high on the part of many potential buyers. In addition some investors reject the idea of transferring their shares to Tivoli.

HTB: “Only 5 % are purchasable”

In the meantime HTB, the Bremen-based underwriter, as well as Real Invest in Hamburg (see interview this page) are doggedly pursuing stronger participation in the business of real estate fund shares. Managing Director Lars Clasen has introduced a second secondary market fund. It has a volume of 10 mil. euros, an increase to 15 mil. is possible. The fund purchases shares of German funds with mixed-use real estate holdings, including, in addition to offices and commercial space, expressly also operator-owned real estate. In purchasing shares HTB is relying on the appraisal expertise of Feri. According to the participation invitation the fund is to yield a pre-tax return of 7 % per year.

In the meantime the predecessor fund has invested 12 mil. of the 14.6 mil. euros that are available, indicated Clasen. Due to delays in acquisitions the fund expects to pay out 3 % at most, rather than the projected 6 %. However as of 2009 the product is to yield the targeted 6 % per year. Clasen does not foresee a broad retreat in prices - n any case not of funds that are of interest to him. “I consider only 5 % of the market volume as purchasable,” he said. That means that most of the offers fail the initial reviews, for example, because the funds are not organized as a KG [limited partnership] or their real estate is not located in Germany. Nevertheless Clasen wants to increase business. For 2009 he is looking to an acquisition volume of 10 mil. euros, 20 mil. euros by 2010. (bb).