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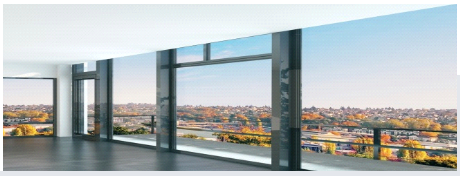
Transformation Management Experts

White Paper



360° Kompetenz für rundum beste Aussichten

Entry- and Exit-Strategies for Corporates

Value-Add of fixed Capital by market-oriented Portfolio-Management

Leading practitioners such as academics of the CREM-Business call for a lower equity ratio of Corporates, as it is already standard in the Anglo-Saxon area. The focus of the discussion is directed towards the Exit in the different configurations. On the other hand the question of the optimal ownership ratio for a company follows both directions: Entry and Exit resulting from real estate ownership. This article interprets | transforms the traditional issue "Monetarisation" for modern CREM and shows the monetary potential of market-oriented Portfolio-Management by means of a case study.

Optimal Ownership ratio

The question of ownership always is subject to the justification for the fixation of hardly convertible capital. In this connection German CREM-Managers are getting a vital momentum by the present capital market situation. For the answer is:

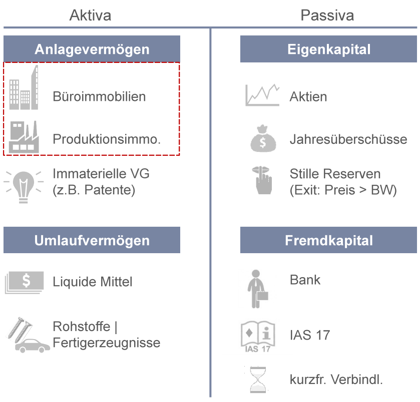
"The ownership ration of a company at Status-Quo is optimal."

Reduction of the ownership ratio is unappealing because

- ownership (AfA plus interest) is cheaper than rent on the long run,
- currently, significantly more favourable financing terms of bank loans or debentures are possible as well as
- derecognition effect on the balance sheet does no longer apply due to revision of IAS 17.

An increase of the ownership ratio is unappealing because

- capital generates higher profit in core business,
- investments in illiquid assets are unappealing and
- balance sheet neutrality applies between ownership and property-type tenancies by IAS 17.



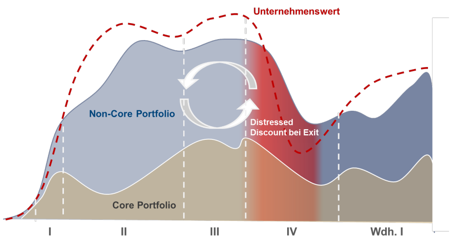
Pic. 1: Company property in balance sheet

Due to these circumstances, the restraint of CREM-Manager in the scope of monetarisation reasonable - a tendency towards the increase of the ownership ratio is questionable.

Role of the Portfolio-Management

The above aspects arise from a financial and financially strategic perspective. They leave firstly portfolio strategy and secondly portfolio respiration unconsidered:

- Example Strategy: review whether all strategically core real estate (Core-Immobilien) are in ownership (decrease of property costs, ensuring continuation of operation, control); alternatively review of tenancy agreements on whether long-term use is possible in a cost and risk optimised way. Additionally review of the question of ownership in case of real estate with minor strategical relevance, yet high fungibility (Non-Core).
- Example respiration: Incidents in the development of core-business (M&A, Expansion, Relocations, organic growth) have impact on the real estate portfolio. The consequence of this are fluctuations as to the portfolio size bus especially also changes or the portfolio types (Core becomes Non-Core and vice-versa).



Pic. 2: Cyclicality Core Business and Portfolio

- Phase I: In case of moderate growth gradually core real estate is implemented in the portfolio.
- Phase II: In case of significant growth generally leasing is preferred:
  - Increased operative flexibility
  - Uncertainty at great market growth
  - Ad-hoc requirement of spaces
- Phase III: "Saturated" market growth with high and constant Core-share. Relatively high, seemingly constant Non-Core-share. Actual gross portfolio handling = leasing and acquisition | project development plus re-letting and sale.

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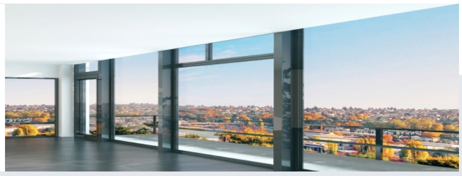

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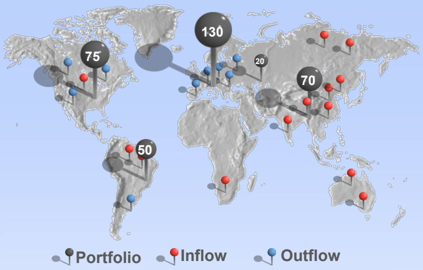
"Based on our project experience we calculate in Phase III with a portfolio turnover of ca. 10% per year."

- Phase IV: Stress in core business, e.g. loss of sales markets followed by liquidity problems and significant portfolio regrouping. Subsequently Phase I (Relaunch) starts again.

These movements have to be managed in the frame of a holistic Entry- and Exit-Strategy.

Real Estate portfolio

Inflow: M&A, JVs, Expansion
Outflow: Carve-Out, Exit
Relocation: Consolidation, shifting of target markets



Target Inflow: Optimised decision Own-vs.-Lease considering Exit
Target Outflow: Minimisation Discount via time pressure, brokerage and external value creation via redevelopments.

Market orientation means:

- Consideration Exit at investment decisions (Alternative usability, market cycle | price level, value add profit)
- Avoidance | Reduction of Discounts, such as e.g. in Phase IV
- Adjustment Own-vs.-Lease threshold values according to corporate strategy
  - Availability of liquidity without using for Expansion, R&D etc.
  - Influence on analyst-relevant return indicators

Entry- and Exit-Strategy: "playground" portfolio management

Generally an investment (Entry) in real estate is only carried pout in three cases:

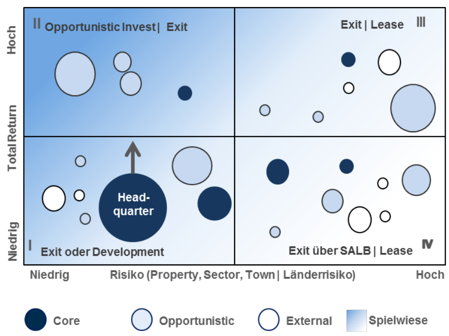
- Necessity of control due to long-term perspective (Core)
- Availability of liquidity which cannot be used in core business or in R&D
- Profit real estate exceed profit core business

In mirror image, a sale (Exit) is only carried out in following cases;

- Synergy effects by consolidation
- Liquidity requirement in core business
- Market value > book value
- Non-Core-Object

Precondition for an optimised Entry- und Exit-decision is transparency regarding locations, ownership structure and position in lifecycle of core business and object. Moreover, risk-profit score values of every property are required apart Portfolio-Cluster (Core, Non-Core): profit measuring via market or attractiveness matrix, risk measuring via market or presumptions concerning sensitiveness towards Micro- and Macro environment.

Risk-Profit-Measuring (exemplarily)



The worse the risk-profit ratio ("bottom right side") the sooner an Exit is prepared resp. an Entry is avoided, In quadrant I ("bottom left side") an Exit should be prepared or alternatively a redevelopment should be carried out in order to be able to sell the property at a later more favourite date under better conditions. In quadrants III and IV ("right side") an Exit strategy is clearly pursued. This can be optimised upon real leave of the property (defined Exit-date) via Sale & Lease-Back.

The real "Playground" of portfolio management is shown in quadrant II ("top left side"). Here an "Invest and Hold"-Strategy is pursued by opportunistic Exit in dependence of the real estate market cycle and the above mentioned provisions for a sale.

Hereby the portfolio management achieves the following goals, which lower the total costs and risks of real estate:

- Geographic concentration | consolidation (increase portfolio consolidation | asset-efficiency)
- Development of a long-term invested Exit-Strategy in the scope of the location-strategy for minimising Discount
- Coordination cross-departmental modifications of space requirement

Practicability of a market-oriented portfolio management

For the realisation of the described approach there are two impediments:

1. The effort regarding transparency and object strategy based on it cannot be fully provided for an international portfolio. In the beginning lease objects are less in focus than Core-properties with "felt" low profit and risk scores.
2. Decisive obstacle for an optimised Exit-Strategy is the existence of a buyer with appropriate willingness to pay.

"Corporates and Investors are incompatible."

Investors are deterred by the complexity of corporate real estate what can be seen as main driver of above-average Discounts.

Due to these apparently superable impediments the potential of market-oriented portfolio management becomes clear: Generation of optimised real estate values concerning profit and risk at coincident minimising of the Discount. Basis of this is applicable

- Transparency by adequate Reporting
- no time pressure
- Minimising of external margins (Broker, Developer)
- Insourcing of added value at the beginning and the end of the real estate cycle

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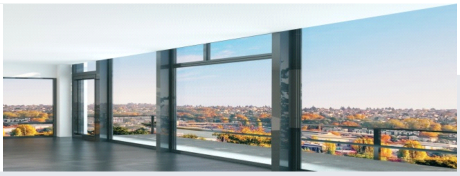

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The game with investors

The requests of the investors have to be considered in the wording of Entry- and Exit-Strategies. These are in particular:

- Adequate transaction volume at location
- Flexibility of building | possibility of Re-development
- Multi-Tenant-capability| divisible lease spaces
- Costs of reconstruction exceed purchase price
- Market rent exceeds present rent
- Track-Record of Corporate as "reliable" leaseholder

So it is possible for CREM to generate a bigger piece of the cake, particularly by:

- Strategic use of Sale & Lease-Back-transactions (precondition is defined Exit)
- Maximising Lease-Incentives by prolongation („Quick-Wins")
- Development of Multi-Tenant-locations with defined Exit
- Optimising of tax advantages and compensations to city and municipalities upon choice of location
- Resale option at the expiration of the tenancy agreement at a lower price

On one side one can argue that these potentials are not easily be achieved, particularly the last item. However:

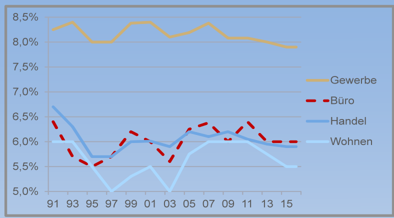
"Investors will comply with this trend on the long run."

The competition of investors for Core-properties (here Core is meant in the sense of the investment category) in connection with high investment needs applies continuously more pressure on the returns.

Moreover the decision makers on the investors' side are only a few years in the respective position and their target setting does not comprehend the period of a real estate life-cycle. The short-term memory allows the "game" with the investors.

Further one will have to head for corporate real estate, also due to reasons of risk diversification (see Info box). By this, the repeating trend ensues that Anglo-Saxon practice is implemented as well in Germany with time delay. Over there "Industrial REITs" with attractive profit-risk profile is already established.

Risk-Yield-Profile of Corporate Real Estate Outperformance of Core via Corporate Real Estate (Source: IPD)

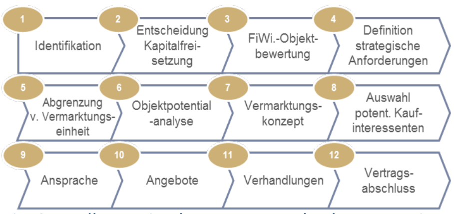


- Industrial Real Estate disposes on the cash flow basis a higher yield with lower variance over 25 years
- Prime-Locations and prime usages (office, residential) dispose of a higher volatility due to the bigger transaction volume, transparency via investor focus, high tenant fluctuation despite good credit-worthiness

Further Optimisation by RE Vehicle

What traditionally is understood as monetarisation are so called "big solutions" of significant volumes or the capital market solution via real estate companies | funds. The argument for this is often "financial flexibility". But Corporates are consistently not corresponding to the idea, in spite presently "relaxed" corporate environment, to provide for a possible illiquidity in the future.

In the context of these remarks, however, RE-Vehicles serve for further optimisation of the Entry- and Exit-Strategy. Hereby the required infrastructure is created to meet the needs of the investors faster and better and thus further decrease the discount on corporate real estate.

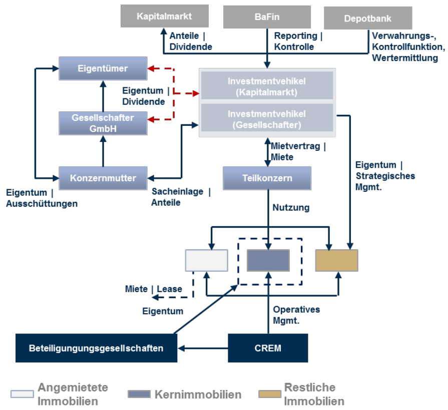


Pic. 3: Well-practised process standards upon Exit

Depending on Corporate-Strategy the configuration of a RE-Vehicle may have different results. This is featured under assessment of

- Interests of the parent company, e.g. rating, solvency …
- Fiscal impacts
- Preliminary time of realisation
- Foundation costs and running expenses
- Liquidity
- Chances | Risks.

"Individual and contribution funds solve the conflict area of interests"



Pic. 4: Project example individual funds

Preconditions are ca. 50 Mio. Euro equity as well as a preliminary time of merely a half-year for

- Coordination with partners (price, asset, date, dividend flow)
- Approach and selection Service-KAG
- Selection of appropriate real estate
- Development infrastructure for Entry | Exit (interfaces and processes)

Authors

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