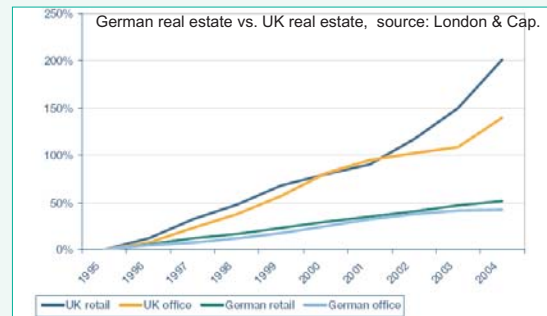
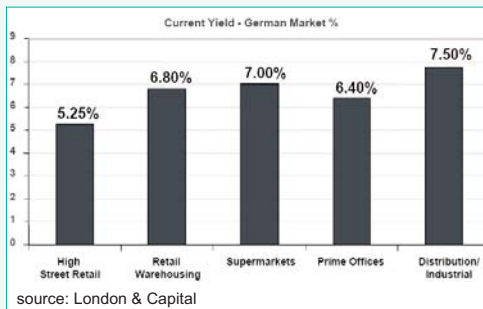




REAL ESTATE



Iain Keys, director of real estate



Iain Keys draws on his experience of managing London and Capital's **German Real Estate Fund** and explains why now is an opportune time to invest in this space...

From an investor's perspective - what have been the significant developments within the German real estate market?

The main change is really the economic improvement. This has attracted a lot of investors which will drive yield compression short term and the economic recovery will drive rental growth longer term.

What are the peculiarities exhibited by real estate investments in Germany? Do they differ significantly from those observed in the US and Asia?

Germany benefits from economic growth potential with low borrowing which compares more favourably to the US. Asia is an altogether different story and the benefit for Germany is lower risk and easier access to the market than in most Asian markets.

Would you say now is an „opportune“ time to invest in German real estate, or is the market already showing signs of over heating?

Germany offers compelling opportunities to investors across key sectors of the commercial property market. The country has a mature regulatory environment in which property rights are entrenched. Crucially, there is a good availability of attractively priced stock on the German market. Whilst UK commercial property yields fell to sub 5.5% in 2005, similar quality stock in Germany can be sourced at yields between 6.75% and 7.25%, providing considerable scope for capital growth. Borrowing can be sourced at a total cost of 4.1% per annum (taking a Euribor rate of 3.05% and a margin of 1.05%). Taken in tandem with high yields on commercial property, low borrowing rates create an opportunity for considerable yield arbitrage.

Another significant factor is that long lease terms can be sourced on the German market. Indeed, whilst the length of leases is typically not as high as in the UK (where duration can be 20 years and higher), there is nonetheless a sufficient availability of leases of 10 years duration and upwards. This compares favourably with other European markets.

I believe the German real estate market is definitely not overheating as one has to compare Germany with the other European markets. Hence, it is still the right time to get in. Longer term rental growth is the key to this - ie as this is not just a short term yield compression game.

Based on your experience, what are the risks involved and how do you go about mitigating them?

Seeking good advice is the best way to mitigate risks (structures, taxes etc.) in a foreign market. Interest rates could rise so we fix our borrowing at the time of purchase. A larger risk is the economy not improving - but this seems increasingly unlikely based on the present flow of economic data.

Do you expect a blow out in yields? When and with what consequences?

No, I do not.

Within real estate, is the potential to perform higher in certain areas - commercial, residential, recreational?

We feel the best sectors are out of town retail and logistics as they offer higher purchase yields than high street retail and offices and better rental growth potential. A lack of development will lead to more activity and therefore growth as the economy recovers.

Why have you chosen to focus on commercial real estate related investments?

It has growth potential; the opportunity to arbitrage on purchase yield over borrowing and it is an established market that has a "system" (eg land registry).

However, a highly selective approach is imperative, as the attractiveness of the outlook varies from sector to sector in the German commercial real estate market. Our fund maintains a bias toward the retail sector, particularly the supermarket and retail warehousing submarkets. Retail warehousing units can currently be sourced with a yield in a range of 6.75% and 7.5%, while yields for supermarket premises range between 6.5% and 7.5%. There is a large presence of strong covenants (including Metro, Rewe, Edeka, Netto and Lidl) and our focus will be on new stock (implying lower maintenance costs). Land supply constraints are a further key support for existing stock in this sector.

The outlook is also attractive for the distribution warehousing (logistics) sector. The market is displaying clear signs of a shortage of investment grade product, and going forward planning constraints mean that the feed through of fresh stock will likely lag demand, acting as a key source of yield compression.

With regard to the office sector, whilst many domestic German funds have traditionally had a very high proportion of their holdings in this area, we adopt a cautious stance due to the existence of a considerable supply overhang. It will take a sustained further increase in business confidence to clear this glut, which has accumulated over a long period, so it is expected that only a few pursuable opportunities will arise. Meanwhile, buying opportunities in the high street retail sector are restricted (a large proportion of stock is held by investors as very long term investments).

The impact of G-REITs for other real estate investment vehicles?

In my view there has been no great impact - in my view, it is similar to UK. property which shows a low correlation to other asset classes. So I struggle to see why one would want to gain access to property in an equity format bearing in mind the current volatility in the equities markets.

Comments/remarks...

Our German Real Estate Fund has grown to over EUR 400mn in a year and we have another EUR 350mn under offer. Access to the market whilst yields are still attractive is a key to a successful future for the fund.