

HPBA OFF-MARKET-STUDY

September 2018



Foreword by John Amram

In recent years, real estate has gained more relevance as an asset class for institutional investors. This positive development in demand has meant that the competition between investors for attractive real estate transactions has increased significantly, with a potential seller now faced with a much larger number of potential buyers.

In such a keenly-fought market situation, investment criteria such as certainty of execution and the specifics of the contractual structure for the buyer and seller are just as important as the purchase price. If an investment project fails to come about – something which often happens only after a commitment of several months – this is associated for example with high due diligence and opportunity costs for the buyer. After all, he will not have been able to allocate his capital elsewhere or focus on other highly promising offers – and at the end of the day he will have wasted his time. But for institutional sellers, the question of the transaction model is also important from a strategic matching perspective. It is frequently the case that numerous details have to be scrutinised as a consequence of the corporate strategy and that compliance regulations also have to be observed. With a failed public transaction, the seller not only has to contend with lost time, unnecessary administrative demands and opportunity costs, but also faces the risk of the property being publicly perceived as “damaged goods” – for example, if the desired price is not achieved in a bidding process and the seller opts not to conclude the transaction.

Investment criteria such as a high degree of execution certainty, strategic matching, transparency and discretion are fundamentally dependent on the respective transaction model. But which of these qualities characterise off-market transactions, which, after all, account for four out of every ten transactions? What are the benefits and drawbacks compared to classic on-market transactions? Until now it has been difficult to make a direct comparison as off-market transactions are extremely individual in their design as a rule and, moreover, they are executed discretely. Statements could thus only be made on the basis of personal experiences. Likewise, the size of the market has been unknown to date. On the basis of the following study by HPBA and bulwiengesa AG, for which nearly 700 prominent representatives of professional and institutional real estate markets were surveyed, we are able to reach qualitative and quantitative findings for the first time ever.

One of the most important results of the study is that the certainty of execution with off-market models is significantly greater than with classic on-market procedures – and that for this reason many investors are also prepared to accept a price delta of as much as 10 %. At the same time, it has been revealed that the strategic matching between the trade partners is more effective as a result of the individual structuring options of off-market processes. Furthermore, the study rebuts a number of common preconceptions and potential fears on the part of market participants. Thus, for example, it did not categorically confirm that off-market transactions are likely to be associated with a possible loss of transparency in the course of the process. Moreover, off-market transactions are only in part of the cases inconsistent with the in-house compliance rules of the participants.

The HPBA Off-Market-Study regards itself as the first in a series of future research projects on the specifics of the off-market segment and on the most important differences vis-à-vis conventional processes. This important initial study was only possible thanks to the many responses and the cooperation of the surveyed market players. I would like to express my sincere thanks to them.

John Amram, Managing Director HPBA
September 2018



Summary

The objective of this study is that of analysing the size of the off-market segment on the German real estate market as well as the specific characteristics of off-market transactions. In addition, the panel – comprising institutional real estate investors as well as family offices and private equity investors – was surveyed on the benefits and drawbacks compared to on-market processes.

The study reveals that 96 % of the surveyed market participants – virtually all of them, therefore – pursue off-market transactions. The transaction volume thus

generated, amounted to approx. 40 billion euros in 2017. This corresponds to 36 % of the entire transaction volume. Among the most important benefits stated are a greater degree of discretion, an improvement in the probability of concluding a deal, and more efficient matching between the buyer and the seller. The more flexible structuring possibilities are also stated. So as to attain such benefits, 77 % of the respondents accept a price delta of as much as 10 % when purchasing a property.

Introduction

The following study on the topic of off-market transactions on the German real estate market is a pioneering work. To date, there has been no in-depth analysis of the “off-market” phenomenon, neither in the research conducted by the major commercial and mortgage banks or by the major brokerage companies nor in an academic context. This step has become all the more necessary as off-market transactions are associated with a higher degree of professionalism, in particular due to the recent massive price increase on the German real estate market. On the other hand, this form of transaction conflicts with the ever louder calls for more transparency when it comes to the topic of real estate.

This is undoubtedly also applicable in a global context, in which the Anglo-Saxon markets are still regarded as more transparent compared to the German market. But the off-market segment – which is just as lacking in transparency – is regarded there as “sophisticated” and highly professional.

Cooperation between HPBA and bulwiengesa

The following study, the first of its kind, was made possible thanks to the support provided by HPBA Off-Market Solutions in Berlin and the academic work of bulwiengesa. The surveyed panel of experienced experts was compiled jointly by both companies, as was the questionnaire that was utilised.

It was a matter of key importance for both companies that the following results be presented in order to initiate a public debate on this topic. It is important to conduct similar calculations and surveys in other projects so as to improve the validity of the results. International comparisons will also soon be necessary. Nevertheless, the data and graphics on the following pages already allow for well-founded, and in part also surprising, conclusions to be drawn.

For whom are the results interesting?

The backgrounds and volumes of the off-market transactions are likely to cause quite a stir, not only in the specialist world of institutional real estate investors. German urban development planners and business development agencies will also note with interest that the figures on the German real estate investment market available until now only reflect some of the driving forces. Likewise, it seems obvious that financiers and credit institutions will devote greater attention to these figures. Ultimately this means, among other things, that the market liquidity is significantly higher than assumed to date. Without attaching any emphasis to this in the synopsis of the study, off-market transactions are also of particular significance away from the metropolitan areas and are relevant across all locations.

Not least of all, the information is important for the current nationwide discussion of real estate share deals, the sale of companies with a significant share of their assets in the form of buildings and properties, therefore. It is possible that share deals are currently being transacted more frequently in the off-market segment than in the traditional market. These could also be topics for the coming years and future issues of this HPBA Off-Market-Study. In this respect it is necessary, among other things, to await the public response to this report.

Note:

In the following off-market structures are compared with “on-market structures” at various points. This refers to the institutional transactions which are published in specialist media and industry reports and which are often subject to a public bidding procedure. It is the traditional real estate transaction market which is referred to in the Anglo-Saxon environment as “open market”.

Definition and approach

Off-market real estate transactions have been scarcely defined to date. For the first time ever in Germany, the HPBA Off-Market Study 2018 provides concrete figures on the off-market segment.

The definition used by bulwiengesa and HPBA is:

“An off-market transaction in the real estate sector describes the trading of one or more properties in the form of a sale or swap deal, which – in contrast to structured bidding procedures or marketing through brokerage platforms – take place behind closed doors. The trading takes place on the basis of specifically addressing a small group of investors or exclusive bilateral negotiations with just one potential buyer by the seller himself or through a specialist off-market mediator. In a non-formal process, the procedure can be structured flexibly with respect to transaction volume, contractual modalities and timeframe in line with the individual needs of the buyer and/or seller.”

With an off-market transaction the motives for the purchase and the reasons for the sale can therefore remain confidential. An on-market transaction, in contrast, can for example: be a bidding procedure, be facilitated through traditional brokerage activities or be offered on online brokerage platforms.

With an off-market transaction the sale is specifically initiated by the seller himself or through contact being established by an off-market mediator. In a non-formalised process, the procedure can be structured flexibly for example with respect to the selection of the investor, contractual modalities and timeframe.

The HPBA Off-Market-Study examines and measures the German market for off-market transactions. To this end, a survey was conducted for the first time ever in 2017/2018; this is now to be repeated annually and thus serve as the foundation for the “measurement of the off-market segment”.

The market will become more transparent with the aid of the survey. In the long term it may also create even better transaction conditions. The respondents were the most important players on the professional real estate markets. The panel is a specific selection comprising,

among others, managers of classic institutional investor groups such as real estate funds, insurers, pension funds and pension schemes, as well as managers from family offices, private equity investors and other institutional investor groups.

The selection of the surveyed companies was conducted by bulwiengesa in consultation with HPBA. A total of 682 persons were selected for the survey, whereby bulwiengesa and HPBA each contributed half of the contacts. Thus, the original target size of 400 persons for the panel was exceeded by a considerable number.

A questionnaire was prepared prior to the survey comprising closed-end as well as open-ended questions. The respondents had the possibility to quantify their answers precisely in the framework of a scaling system.

So as to expand the scope of this target group the questionnaire was prepared in both German and English.

As discretion plays an extraordinarily major significance with the surveyed topic the survey was conducted anonymously.

The questionnaire was drawn up with the aid of a tool developed by bulwiengesa, “Survey Desk”, an online survey tool. Following the initial invitation two reminders were sent to the selected companies. The survey was conducted over a period of two months.

Qualitative expert interviews were conducted in addition to the survey. The interviews were intended to expand on the findings gained from the questionnaire, which were for the main part descriptive, and the personal input of the market experts was intended to plug any knowledge gaps.

Both the questionnaires and the expert interviews were evaluated and analysed pursuant to scientific standards of empirical social research.

The survey is to be conducted once a year in the future. The results from the set of questions will be summarised in a report which specifically looks at the development of the off-market segment in Germany and will be supplemented by topical issues of relevance.

Results

Both the structured written survey and the open expert survey brought forth clear and in part surprising findings on off-market transactions on the German real estate market.

Market penetration of off-market transactions

As the data set for off-market transactions has been very small to date, bulwiengesa determined the transaction volume so as to be able to better depict the market penetration of off-market transactions.

The transaction volume in the off-market segment in 2017 was somewhere between the institutional transaction volume of ca. 71 billion euros reported by brokers and professional real estate companies and the volume of ca. 240 billion euros which may be roughly derived from the German statistics on real estate transfer tax or which is stated by Arbeitskreis der Oberen Gutachter-

ausschüsse (AK OGA) [Working Group of Senior Valuation Expert Committees].

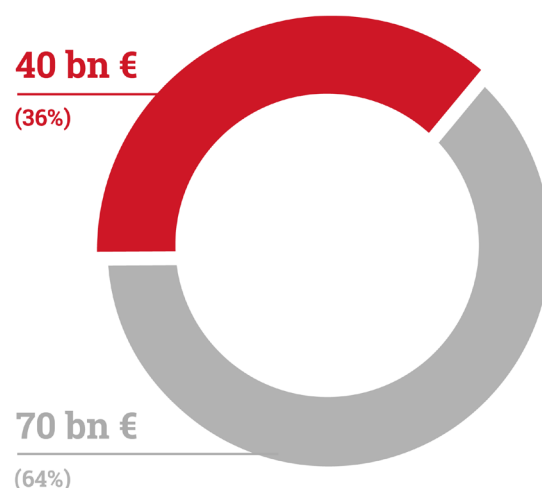
If one places the focus on the institutional real estate market, which is accounted for by major investors, companies and family offices, the large yet fragmented market for private residential market transactions has to be removed from the equation above all. The volume for this market has been set at approx. 130 billion euros p.a. for single- and two-family houses as well as condominiums.

Initially this means there remains a transaction volume of 110 billion euros with business properties, multi-family houses etc. This would correspond to an off-market volume of nearly 40 billion euros p.a.

This approach – with an institutional volume of some 70 billion euros – would mean the off-market volume amounts to an additional market volume of nearly 60%.

Transaction volume 2017 – on-market and off-market

- On-market transaction volume
- Off-market transaction volume



Source: Bulwiengesa · HPBA Off-Market-Study

**Transaction volume
110 billion euros**
(from statistics of Valuation
Expert Committees)

**Transaction volume
70 billion euros**
(reported by banks and brokers)

**Remaining off-market
transaction volume
40 billion euros**

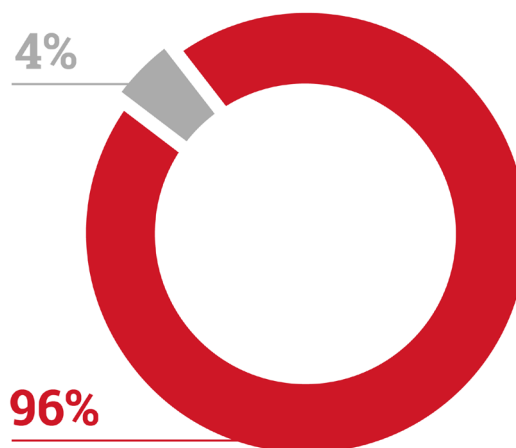
In the off-market segment share deals play an important role, i.e. sales of companies whose real estate assets are only a part of their total assets. These company sales are not subject to the payment of real estate transfer tax; thus in Germany, as in other industrialised nations, it is scarcely possible to analyse them from a statistical stance in the off-market segment.

Share deals are included in the institutional transaction volume of 70 billion euros. Therefore a direct comparison with the transaction volumes of 110 and 240 billion euros p.a., which are based on the transactions entered under land register legislation (asset deals), is not consistent. The share of 20 % in share deals throughout Germany estimated by experts (as much as a share of 80 % in mature office real estate markets such as Frankfurt am Main) would further increase the off-market volume of 40 billion euros by 20 %, to nearly 50 billion euros. This has to be verified in further work in the framework of the HPBA-bulwiengesa project, however.

These figures already illustrate the enormous significance occupied by off-market transactions in the German investment market. This is also revealed by the panel survey: thus virtually all the surveyed companies (96 %) stated that they pursued off-market transactions in 2017. This can also be interpreted as meaning that there is a high affinity to off-market transactions on the part of buyers in particular.

If a company is owner-managed, in the event of a sale it has a greater tendency towards off-market transactions – this interesting and manifest conclusion is endorsed by the expert discussions. The converse argument would mean that heavily regulated and public companies would be more likely to tend towards bidding procedures and make use of the brokerage companies customarily found on the market. In addition, it has to be stated here, however, that there are quite a lot of mixed forms, and a clear separation is only possible with great difficulty, therefore.

Have you participated in off-market transactions in the past 12 months?



Source: Bulwiengesa - HPBA Off-Market-Study

Characteristics of off-market transactions

One of the prime benefits of an off-market transaction is its exclusivity. The desired property can be secured for a transaction by investors away from the public market. For sellers it is possible to choose the buyer taking into account strategic considerations.

Moreover, the likelihood of a transaction being concluded is increased due to the strategic matching between the buyer and seller. The analysis of the questionnaire shows that a much greater chance of success can be observed compared to on-market transactions. Several models are feasible for this matching depending on whether the initiative is taken by the buyer or the seller and how many potential buyers are involved. In addition to direct sales and exclusive brokerage endeavours there is the possibility to make a detailed preselection of several investors and allow these to submit their bids in a process similar to a tendering procedure. The selection is based on criteria which the seller – frequently in cooperation, together with the broker – lays down himself and which thus suit his selling and corporate strategy. The group of potential buyers thus comprises only qualified investors and is therefore usually smaller than with a classic bidding procedure. Individual participants

therefore explicitly commit themselves to an upper limit with regard to the number of bidders so as not to dilute the benefits of preselection.

More than every second off-market transaction successful

Thus, 51.5 % of the respondents – more than half, therefore – stated that the success rate of an off-market transaction (purchases and sales) was more than 50 %. With an on-market transaction the corresponding figure is 35.4 %.

This difference becomes even clearer if only the respective on- and off-market purchases are considered: While for 49.2 % of all the surveyed buyers more than every second off-market transaction was taken to a successful conclusion, with on-market transactions this is only the case with 27.7 % of the buyers.

Other benefits of off-market transactions were also a matter for discussion within the framework of the survey.

Was the number of completed sales with your on- or off-market transaction endeavours in the past 12 months higher than 50 per cent?

Positive responses in per cent.

- On-market transaction volume
- Off-market transaction volume



Source: Bulwiengesa - HPBA Off-Market-Study

Benefits of off-market transactions

90.6 % of the respondents agreed with the statement that in the case of off-market transactions a suitable degree of discretion is to be found with the participants involved in the selling process. Discretion is regarded as a fundamental benefit of off-market deals, therefore.

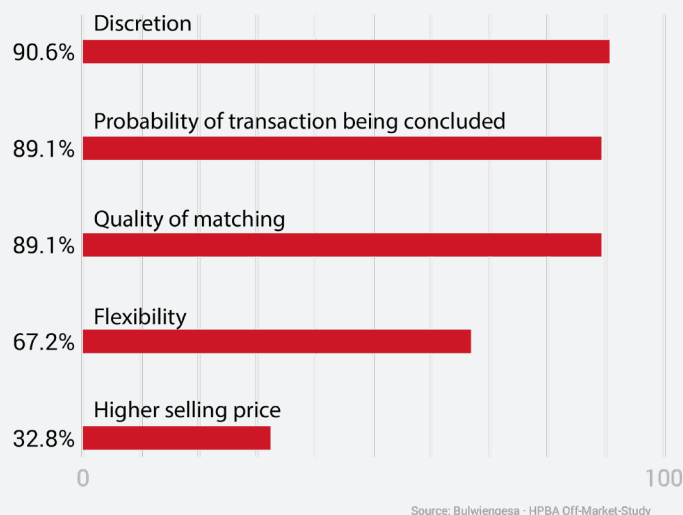
89.1 % of the respondents agree with the statement that the probability of a transaction being concluded is higher with off-market transactions than with on-market transactions – an interesting result in a market which clings so firmly to structured bidding procedures.

89.1 % of the respondents are likewise convinced that the strategic matching between investor and investment object is better. The targeted matching of buyer and seller not only saves transaction time, but also increases the probability of a successful conclusion to a transaction.

Benefits of off-market transactions compared to on-market transactions

Answers from respondents in per cent.

32.8 % believe that in the event of a sale a higher price may be attained than with an on-market transaction. Thus, a good price appears to be a relevant but not the most important argument for an off-market deal.



Hardly any drawbacks from a subjective stance

The respondents were requested for their assessment regarding the possible drawbacks of off-market transactions. To this end statements were put forward which the participants evaluated as to their degree of agreement. The analysis shows that as far as the respondents are concerned there are no significant drawbacks.

Lack of transparency

The statement that off-market transactions are “significantly less transparent than structured bidding procedures” for the parties involved was rejected by a total of more than half of the respondents. 34,4 % did not generally agree; 18,8 % did not agree at all. A lack of transparency is thus not a decisive drawback as far as many survey participants are concerned. However, 12.5 % of the respondents totally agreed to this statement.

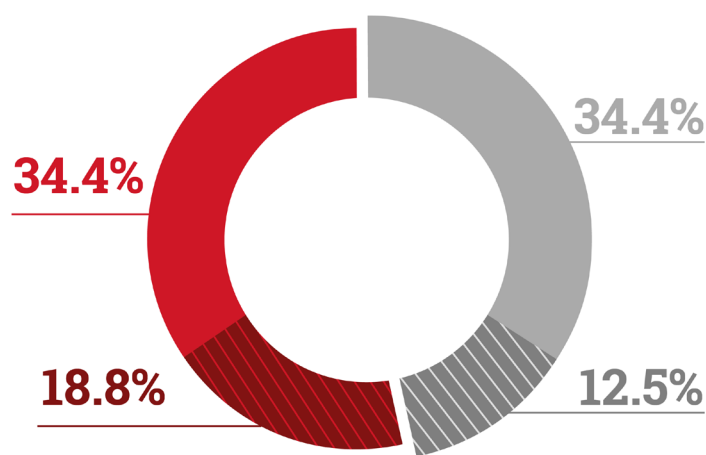
This is due, among other things, to the differing models for off-market transactions. With a model similar to a bidding procedure the potential investors submit their

bids in a manner that is transparent for the seller. Thus, the latter has the possibility to compare the various bids and can demonstrate in accordance with audit requirements that the best price has been attained. In addition, the preselection of potential investors is made on the basis of a catalogue of criteria laid down by the seller or service provider. If this is implemented with a sufficient degree of detail, then details regarding the contractual design, the approach to deferred tax issues or the payment modalities, for example, may be recorded from the very outset and communicated in a transparent manner. In a conventional bidding procedure such details are not initially evident as a rule or are qualified in detail.

Moreover, a number of respondents stress that an important aspect of off-market deals is the mutual trust between buyer and seller. Here it becomes apparent that individual transactions can lead to the development of long-term business relationships. The more open communication between buyer and seller was also explicitly commended, something which runs contrary to any possible lack of transparency.

Are off-market processes significantly less transparent than structured bidding processes?

- do not agree at all
- do not agree generally
- agree generally
- agree entirely



Source: Bulwiengesa - HPBA Off-Market-Study

Corporate Governance

The statement that a company's own governance is "frequently at odds with the process" was also contradicted by more than half of the respondents, with 31.3 % not agreeing with this statement at all. Although there are numerous governance criteria for real estate purchases and sales on the part of institutional investors, these often do not explicitly concern a decision as to whether to conduct on- or off-market transactions, but concern the structure of the investment, for example the equity capital ratio for buyers or the structuring as a share deal or asset deal. Accordingly, depending on the design of the transaction structure, off-market processes can, as a rule, fulfil the compliance criteria just like on-market deals.

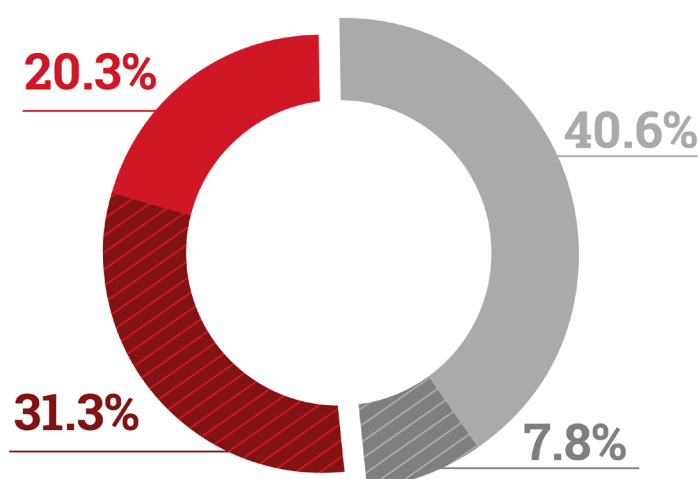
The fact that institutional and publicly listed investors are faced with a higher workload in the analysis and evaluation of differing transaction models is clear to the respondents. Some individuals reported, however, that off-market deals ease comprehensibility with com-

pliance issues. In particular, if a company's own governance policy places certain demands on transaction partners, for example so as to meet the company's own sustainability targets or fulfil tax provisions, off-market processes can quickly create clarity thanks to the targeted selection of possible contractual partners.

In contrast, 48.4 % of the respondents tend to agree with the statement that in the case of off-market deals their own governance is "frequently at odds with the process". This figure also includes the 7.8 % who agree completely with this statement. In individual cases the company's own governance guidelines actually appear to prescribe structured bidding procedures or similar on-market models. However, it more frequently seems to be the case that the off-market process has to have a specific design to meet with the company's own compliance – for example by addressing a minimum number of investors so as to adhere to audit requirements.

Does your own governance frequently contradict the process?

- do not agree at all
- do not agree generally
- agree generally
- agree entirely



Source: Bulwiengesa - HPBA Off-Market-Study

Factors that determine the value of real estate transactions

The survey shows: there are numerous benefits for the majority of the surveyed companies in the context of off-market transactions.

Discretion and speed, deal certainty as well as the price attained – these are the characteristics with which off-market deals can score points with sellers above all. And if a suitable buyer cannot be found with an off-market process, there is still the possibility for an on-market process. The switch from the on-market segment to the off-market segment is considerably more difficult. If the property has already been on the market for a long time, the interest of potential buyers declines drastically. If a

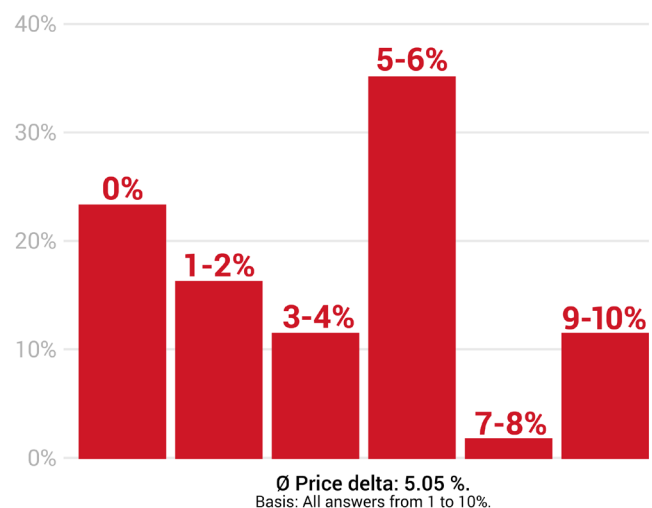
buyer can be found, a significant reduction in the purchase price is often to be expected.

Price delta with off-market transactions

As a result of the deal certainty between the parties – as well as the other above-mentioned benefits – numerous buyers accept a price delta compared to on-market transactions. The largest group of respondents regards a percentage mark-up of 5-6 % as being reasonable with an off-market transaction. A price delta of 9-10 % is still regarded as reasonable by 12,3 % of the respondents.

What in your opinion is an appropriate price delta for the benefits with off-market transactions?

Answers in per cent.



Source: Bulwiengesa - HPBA Off-Market-Study

Conclusion

“Everybody is doing it”

The most surprising result from this first more in-depth analysis of the off-market segment for German real estate transactions was the clear finding that this form of transaction is in no way merely a marginal phenomenon. On the contrary: the open real estate market with regular publications of market data and the secure functioning off-market segment are two sides of the same coin as it were. Only a minority of 4 % of the panel surveyed here did not pursue an off-market transaction in 2017. The basic statement is a clear one: all the actors on the German institutional real estate market utilise relatively secure and simple buyer-seller structures without there being any major reporting on such transactions.

On the whole, the objective of looking more intensively at the off-market topic has been worthwhile. The topic will, on the basis of this report, undoubtedly be of interest for a wider group.

Overview of the most important results

Off-market real estate transactions attained a transaction volume in 2017 of, at a rough estimate, € 40 bn. This corresponds to 36 % of the entire real estate transaction market in Germany if on-market and off-market transactions are considered jointly.

The commitment to off-market transactions is very high among the institutional actors. 96 % of the surveyed companies pursued off-market transactions in 2017.

The fundamental benefits of off-market transactions listed by the real estate market actors are

- the more suitable level of discretion,
- the greater probability of concluding a transaction, as well as
- the improved strategic matching.

In addition, the survey results clearly indicate that for just over more than half of the respondents there are no drawbacks with regard to

- transparency and
- compliance.

For the largest group of respondents, the price mark-up felt to be reasonable for an off-market transaction compared to customary market prices is 5-6 %.

On the whole, the objective of looking more intensively at the off-market topic has been worthwhile. The topic will, on the basis of this report, undoubtedly be of interest for a wider group.



Impressum

HPBA GmbH
Kurfürstendamm 67
10707 Berlin

Kontakt
Telefon: +49 (0) 30 88 71 338-0
Telefax: +49 (0) 30 88 71 338-11
E-Mail: info@hpba.eu

Registereintrag
Eintragung im Handelsregister.
Registergericht: Berlin-Charlottenburg
Registernummer: HRB 120987 B

HPBA
Off-Market-Solutions

bulwiengesa AG
Wallstraße 61
10179 Berlin

Kontakt:
Telefon: +49 (0) 30 27 87 68-0
Telefax: +49 (0) 30 27 87 68-68
E-Mail: info@bulwiengesa.de

Registereintrag:
Eintragung im Handelsregister
Registergericht: Berlin-Charlottenburg
Registernummer: HRB 95407 B

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