Guest Column: George Salden (12)

SERIES: The German Real Estate Market: Compiling a Rating is the Key to Rate of Return

Welcome to the finale! This column brings us to the end of our overview of the characteristics of the German real estate market. We are now well acquainted with the dynamic method for calculating rate of return. However, there is one last matter to consider: real estate ratings.

In the last two columns that appeared we demonstrated that the external financial reporting that is common in Germany provides important figures that are used in the dynamic method to determine the return possibilities of a real estate investment. At first glance it would seem that all information necessary for a real estate investment has been compiled and analysed: the value of the real estate is known and the investment is presented on the balance sheet level.
The classic methodology of property valuation concludes its work at this point. The discounted cash flow method is most certainly an effective way of presenting a real estate investment as a business case, however, its area of application ends there. As we have already determined, all procedures ascertain the actual value of real estate. Yet they do not provide any help in regard to a potential decision to buy. Two essential questions remain open:

1. How long should real estate be held before being resold?
2. Is the purchase advantageous if one takes into account the complete investment cycle, including purchase, management and resale?

In determining the optimal investment period all projected cash flows and other values that are used in compiling profit and loss accounts, balance sheets and cash flow statements must be taken into consideration and a business case must thereby be prepared. Yet when one is speaking of a specific business case, this is not correct.

This is because the calculation of an optimal investment period requires that each holding period be treated as a unique case. Only thus is it possible to adequately take into account the various cash flows for the period of management and the time and amount of the projected resale values. In this second stage the results provided by each business case must be compared. We have chosen the internal rate of return (IRR) as our method. This enables one to arrive at a different internal rate of return for any resale time. Using this decision-making criterion, one can also determine when the property is to be resold so that the invested capital is being used efficiently. Once this point is determined the investment has been fully defined. In the final step it is only necessary to rate the investment. Stated differently: what risk is associated with the return to be realised?

In practice there are various approaches to rating real estate. None of them have as yet firmly established themselves as the leader. The main reason for uncertainty in regard to rating real estate is the non-transparent procedure involved. More specifically, there is no agreement as to how real estate ratings must be structured and what information they are to provide. The dynamic rating that is presented here is therefore not a rating in the sense of a credit assessment, but rather the classification of property on the basis of the chances and risks of an investment, which thereby assesses its quality. The goal of a rating is to determine if it is advantageous to purchase a certain piece of property. The first criterion in this regard is the opportunity offered by an investment. This is determined, as described above, by ascertaining the optimal resale point by taking into consideration all payment flows over the entire investment cycle and the internal return therefrom.

Such a decision can generally not be made solely on the basis of the internal interest rate. The reason therefor is that estimations and assumptions must be made concerning the future development of income and expenditures. It is at this point that one encounters difficulties. They may take the form of lack of experience, insufficient knowledge of the market or even attempts at manipulation, all with the result that the projected development differs from that which actually takes place. The result remains the same: the calculated internal interest rate does not correspond with the internal return that is finally realised through the investment.

The starting point of dynamic rating is to design a standard that is largely resistant to unrealistic assumptions. This is achieved by taking a second factor into account in addition to the internal rate of return: risk.

Risk is a concept that is frequently used. The various meanings subsumed thereunder are as various as its use. It is therefore important to initially define what we understand as risk both generally and specifically. The lowest common denominator thereby is the following definition: “Description of an event with the possibility of a negative outcome.” In concrete terms, what constitutes negative outcome is determined from context, on the basis of perspective, as well as from personal preference. In dynamic rating, risk is the possibility that cash flows that have been projected based on individual assumptions may deviate from the income and payment that one would assume based on knowledge and application of the marketplace. Similar to the insurance industry these negative effects are multiplied by likelihood to quantify the realised risk. The result is a monetary amount. In order to normalise this measure of risk, the amount must be viewed in relation to the initial price paid at the start of the investment. Only thus can the measure of risk for real estate be compared in relation to different prices.

A limitation should be briefly mentioned at this point: a critical component of forecasted cash flows are the on-going costs for managing the real estate. Here certain levels of expense must be assumed based on the nature of the property. Whether or not these assumptions are realistic can only be verified based on a comparison with historical market data. These costs can also enter into the risk calculation. The case is similar with other costs that must be taken into consideration, e.g. reconstruction costs, loss of rent, or asset management expenses. In contrast thereto, in regard to forecasting the future interest rate that must be paid for follow-up financing, no figure that represents an exact expectancy value can be established. As a result this variable must be excluded from risk assessment for systematic reasons.

The probability values used to determine the measure of risk are derived from the market place. Such probabilities are usually not represented by a single value but instead spread over a recurring pattern. Dynamic rating relies on how this data is distributed in the investment market. In this regard it should be noted that almost all cost parameters relevant to a real estate investment business case are normally distributed approximately in their appearance and can be displayed in terms of a Gaussian distribution curve. This enables a presentation of the probability with which certain risk scenarios may occur.

Finally, the expectation of return and the measure of risk make allocation of a rating code possible. The classification system of the dynamic method is hereby closely related to that used by credit rating agencies. It is divided from Aaa, minimal credit risk, to Ccc, very high credit risk. It must then be decided which rating code is to be assigned when a certain risk X and a certain internal interest rate Y are ascertained. The dynamic method then proceeds in evaluating the collected information concerning the chance/risk profile of an investment, rates it, and in this way makes comparison possible. The classification is based on investment grade. Each class has its own investment/risk profile, because as mentioned in previous sections one anticipates different returns according to different investment classes. For super core real estate one already anticipates a significantly lower return from a good investment than in the case of development real estate.

Through dynamic rating based on market data, the dynamic method opens up completely new opportunities for assessment. This is because both the rate of return on a real estate investment and the inherent risk are assessed. The dynamic method thereby makes possible a holistic evaluation of all aspects of an investment. A special aspect of the dynamic rating method is that unrealistic accounting methods are no longer possible. If a cost item is changed, then both the rate of return and the risk increase. An investment is not thereby rendered “better” and placed in a higher classification category.

If at the end you say or rather ask: “That’s all well and good, but does it work?”, then I can answer you with the utmost conviction: “Yes it does, because my colleagues and I have long worked according to this method - day by day and transaction by transaction.”

George Salden is the author of the book “Die Dynamische Methode” [The Dynamic Method] based on his 19 years of experience as an expert and manager in property and transaction management which highlights the way towards a whole new method of determining the profitability of properties. He was previously a director at alt+kelber Immobilienmanagement, a subsidiary of conwert Immobilien Invest SE, where he was responsible for major international transactions. He then took over as International Head of M&A at AK Holding GmbH & Co. KG. He is now Head of Transaction/ Executive Board Member at Dr. Lübke & Kelber / Arbireo.