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OPPORTUNITIES FOR SUCCESSFUL REAL ESTATE TRANSACTIONS ARE ON THE RISE

High interest rates are pressuring real estate companies, while creating new opportunities for private equity investors.

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The rapid rise in financing costs surprised most market observers: after a long period of low interest rates, costs increased repeatedly over the course of just a few months last year. Instead of 0.5%, companies now regularly face rates of 4% or more.

For real estate decision makers, the change in interest rates marks a historic turning point. Without cheap debt capital, generating solid returns becomes much more difficult. More importantly, many companies can expect high depreciation and painful losses, given that industry ratings and stock prices have been under increasing pressure since the summer.

Companies relying on short-term bonds are particularly affected. At the end of 2022, headlines increasingly forecasted impending downturns and difficult creditor negotiations. So what is next?

Over the coming weeks and months, real estate boards and executives' decisions will broadly impact the real estate and transactional markets — while simultaneously creating opportunities for investors. The following factors and developments will be particularly relevant for decision makers.

- ***Lower real estate prices***

After the initial shock, real estate transactions were on the rise again in the first few weeks of 2023. However, some sellers have been forced to accept heavy discounts on prime office yields. However, fewer transactions mean that the market cannot yet access sound analysis or statistics to support this as an industry-wide development.

Given the discounts, the current delay in sales (despite an urgent need for revenue) comes as no surprise. Decision makers know that selling real estate at low prices can prompt creditors to question an entire portfolio's value. Transactions could therefore create additional problems.

Nonetheless, despite a lack of sales, adverse valuation adjustments still threaten to increase debt levels — and could potentially entitle creditors to terminate bonds, which is a risky step. The sector currently faces huge uncertainty regarding the timings and volume of value adjustments. Even auditors are affected since, in some cases, real estate companies are unable to hire auditors to test their balance sheets. However, this valuation problem likely exists due to special factors and not the general market situation.

Difficult negotiations

Given the difficulty with real estate sales, decision makers are trying to alleviate financial problems in other ways, such as negotiating with funders to extend loan terms or secure other concessions. While such negotiations are not uncommon, companies will run into difficulties when they need additional loans or capital injections.

In parallel to negotiations, executives are trying to increase rental revenue. Current figures from the Federal Statistical Office (Destatis) show that commercial rents increased in the first three quarters of last year, despite an economically challenging environment. This difficult situation suggests that institutional landlords in particular will be more determined to enact rent increases this year.

However, stakeholders have relatively little leeway in the market. The demand for office properties is significantly down because of the pandemic-era shift to working from home, while ongoing soft consumer demand is straining the retail property market.

Fewer new builds

In addition to rising interest rates, high material costs and supply-chain issues pose major challenges for real estate companies undertaking new construction projects. Their general reluctance to begin new projects therefore comes as no surprise; according to Destatis, the German authorities approved 297,453 apartments in the first three quarters of last year. In the commercial sector, the most recent number of construction permits per month also fell significantly below expectations.

Numerous factors suggest this trend will continue for the foreseeable future. Shortly before Christmas, a survey by the German Economic Institute (IW) showed that sentiment among decision makers in the real estate sector has reached a new low, and companies are experiencing a "winter of discontent." Project developers seem to display a particularly pessimistic outlook.

Increasing transactions

Extracting concessions from creditors, taking advantage of rent increase margins, reducing costs: in many cases these options may not suffice to overcome challenges. Restructurings and other transactions in the real estate industry will therefore become increasingly likely in the coming months.

Private equity firms are thus seeing new opportunities. For example, their debt funds may be attractive to companies that cannot achieve concessions from their creditors despite solid performance, e.g., because individual funders block negotiating solutions or are constricted themselves due to regulatory requirements.

In addition, investors will see opportunities to take over real estate companies — including their buildings and land — in whole or in part. These takeover deal prices will be attractive: the German real estate market has long been considered overvalued, so international investors are preparing to enter the German market as deal values drop.

Overcapacity in construction

In order to participate in attractive deals, investors will rely on the fact that, in addition to sellers, construction and trade companies are ready to negotiate price concessions. While the construction industry has built large capacities during the long-term boom, reduced construction orders no longer guarantee companies will be operating at full capacity. For example, Destatis figures show that the order intake in the construction industry was recently in decline. Given the "winter of discontent", this trend will likely continue.

The above details prove how significant uncertainty can present new opportunities for investors — and not just in emergency sales. Even owners who are not fighting for survival are willing to sell despite the price cuts, often because they bought their properties a long time ago and will therefore still generate profit.

Even if the window for cheap acquisitions closes again — for example, if a welcomed easing of the geopolitical situation arrives — stakeholders would be wise to watch the German real estate market closely. Since interest rates will likely rise considerably above the level of previous years, and remain high for the foreseeable future, numerous real estate companies will feel the need to adjust in the medium and long term. These interest rates, coupled with an increasing pressure to sell, open opportunities that private equity companies can benefit from.