EXITS

Breaking new ground

How Terra Firma executed an exit with a twist for a classic private equity investment-play

Though private equity real estate is a term that is meant to capture a variety of strategies and capital, it is not often that one sees a pure private equity approach to real estate.

Which is why Terra Firma's 13-year investment in Deutsche Annington has had the private equity industry in Europe sit up and take notice.

Not only has the London-based company led by Guy Hands 'returned' €4 billion to investors for a private equity strategy applied to a major property company in Germany, it has done so in a way that mixes classic 'buyer rationale', operational value creation, and a public market exit with the unconventional – it offered limited partners in the single-asset fund owning Deutsche Annington the chance to take their distribution in the form of shares in the company instead of cash.

In an exclusive interview, *PERE* sat down with Arjan Breure, Terra Firma's financial managing director and Robbie Bar, operational managing director, to talk about the seminal transaction, which began in 2001 when London-based Terra Firma acquired 64,000 residential units from the German Federal Railways that was running the properties on a not-for-profit basis.

Breure and Barr explained this was a perfect situation for the firm because it was on the hunt for asset-backed businesses in "essential industries in need of fundamental change".

Barr said: "This was a real operational job given there were 200,000 flats in the end. Fundamentally when we went in there, we saw a business that needed a better product for its tenants. There were lots of issues. It took ages for people to get repairs done. If someone wanted a new contract it was a long, tedious process, and there were quite large vacancies, so one of the things we concentrated on were ways to shorten that period. When we started it was several months that flats were vacant, but then we started showing people around flats before the tenant left to accelerate the process. We got it down to about 17 days."

The original assets were spread over 10 separate regions in Germany, each having different tenant systems and processes. Terra Firma brought in a new top layer of management, recruiting internationally-experienced bosses from large well-run companies including a chief executive officer from BP. "In the early days we looked for people who could actually transform businesses," said Barr.

Breure added: "We think of it as a consumer industry where you want to give the best kind of experience. You want to provide as high a quality as possible at the lowest cost."

Terra Firma centralized operations at Deutsche Annington such as IT. The company created a call center to deal with tenants' queries. It also reduced headcount. More recently - in the last two years in fact - it also insourced a structure for repairs.

As Barr explained, the outsourced system of repairs was "not working". "We found the communication wasn't great. We were chasing someone because they hadn't paid the rent, but that was because the outsourced repair company hadn't repaired the window. We needed to get closer to the tenant, so we recruited a lot of caretakers, and secondly, after a tender, we created a joint venture company to run repairs. If someone called the call center, we could get the repair done with the joint venture company. We saved a lot of cost. We constantly spent on maintenance - about €10 per square meter, so €90 million a year on flats."

The rental income generated would be reinvested for the operational side of the business, including modernizing flats. It was possible to increase rents, but only when the regional government allowed it or if the company "aligned itself" with what the local government wanted. The company found it could make an 8 percent unleveraged return on investing in property by making them more energy efficient, which tenants liked because they got lower bills, and it also made flats compatible for the elderly by making door entrances wider and removing steps to shower rooms.

Breure and Barr: smooth operators

The average rental growth in Germany for the last five to ten years has been 1.8 percent but at Deutsche Annington it was 2.2 percent, noted Breure.

Meantime it was selling some units to tenants when it made business-sense to do so. "We have a value for each unit," explained Breure. "If a tenant comes and says he wants to buy the property for 20 percent more, then we would sell. It is an opportunistic business. It was also helpful because owners of properties would take better care of the flats and the communal areas, thus keeping costs down further." Not every flat was for sale. It could only be done on a block-by-basis, converting them to condominiums. It was a process that happened early on and the company has sold about 2,300 flats per year. Since 2006, there have been no more blocks for sale, but sales have continued. It has offloaded around 40,000 apartments in total.

Through economies of scale and efficiencies, Deutsche Annington became the biggest private rental sector landlord in Germany and its task was also to become the lowest cost. It found itself in the best position to buy portfolios that came up for sale.

Over the course of 12 years, Deutshe Annington made about 10 acquisitions. It went from 64,000 to 200,000 units.

Investors

The whole Deutsche Annington company was held in a single-asset fund, TFDA, and Terra Firma went for a classic exit on the public markets - but with a twist.

In July 2013, Deutsche Annington listed on the Frankfurt Stock Exchange offering €575 million in shares. Terra Firma sold around €400 million of primary equity at €16.50 a share and also €100 million of secondary capital. Following the IPO, TFDA's stake was reduced to 67.3 percent.

But what happened in May 2014 represented a twist. Terra Firma exited the company, but offered investors the option to take payment in shares if they wished to continue. This crystallized a 1.9x gross cash-on-cash multiple for the investment or around €4 billion.

Every one of the investors decided to go for the share option which involved a 90 day share lock-up. Since then, shares have risen more than 10 percent from €20 to €23.

Breure said: "It is something I started thinking about a year in advance and in on-going dialogue, further refined it. The stock was robust in March this year and in May we executed. When we first raised the fund, we went to a few select investors and told them we believed there was a long-dated opportunity in German housing and that it would take a while to get the value out of it. We created a 10-year fund. Towards the end, not every investor wanted the same holding period, so I started thinking about creating a structure so that the investors could decide on their holding period. In dialogue with them and also the investment banks, we actually came to a situation where we felt everyone could benefit."

Deutsche Annington HQ: A classic private equity investment play with a twist

Certain banks that were limited partners had "new philosophies" about investing in private equity funds and wanted to sell, but others wanted to stay in via ownership of shares. Explained Breure, "They believed there was a lot more to come in terms of German housing."

The investor/shareholders include the Abu Dhabi Investment Authority (ADIA) and the UK's Wellcome Trust – both of which had to disclose their interest under stock exchange rules.

Shares in the company would have to crash around 50 percent at least in order for such investors to lose their profit. They are sitting at the current share price on a 2x multiple. To actually lose their initial investment, the share price would need to go to zero.

"We did this also because we believe it was good for our investors and for having good relationships with our investors," said Breure.

Terra Firma no longer receives management fees as a result of the decision, but Breure added: "Having good relations and doing things that investors want is good practice for the company and for us to continue in business with them. This is really an end of a journey. It has been a 13-year investment. It was an acquisition of size, we saw something before anyone else saw the opportunity. We are very proud we built the largest and we believe the best private rental landlord in Germany." ◻

Most read on PERENews.com [Europe] last two months

1 OCH-ZIFF CONSOLIDATES

A summer of departures got under way as *PERE* revealed how David Gillerman, Och-Ziff Capital Management's managing director for Europe, was to make way for up to six new hires reporting directly to senior principal Steve Orbuch in New York as the hedge fund's real estate division ramps up in the region.

2 NBIM PLOTS $26BN ASSUALT

Norges Bank Investment Management (NBIM), the steward of the roughly $860 billion Norwegian Government Pension Fund Global, has laid out a plan to build a global property investment portfolio by investing approximately $26 billion in the asset class over the next three years. To date, NBIM has assembled a real estate portfolio valued at approximately $10 billion.

3 ABERDEEN DEPARTURES

The reconfiguration of London-listed asset management firm Aberdeen Asset Management's multi-manager strategies into one alternatives division has led to the departures of senior executives from its property multi-manager business. Real estate multi-management is now one of four "specialist investment desks" alongside indirect investment strategies for hedge funds and private equity and a direct investment desk for infrastructure investments.

4 KLEIN TO LEAVE PARK HILL

Audrey Klein, the managing director of Park Hill Real Estate Group in London, has departed the firm to go in-house. Klein, who is based in London, founded the European real estate division of the placement agency owned by The Blackstone Group. She left in July and expected to take a role as global head of marketing in the London office of Aerium, the pan-European real estate investment management firm with around €6.1 billion of assets.

5 AXA GLOBAL HEAD DEPARTS

The global head of investor relations and capital markets at AXA Real Estate Investment Managers has resigned from the group and will take a new position at a New York-based firm, *PERE* has learned. Dietrich Heidtmann, who joined AXA in September 2012 with global responsibility for all investor relations activities, will begin a new role at GTIS Partners.