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TITLE PAGE

INVESTING

GERMAN NURSING HOMES , A SEXY … INVESTMENT

Bet on nursing homes real estate in Germany returns 6% p.a. without risks. Germany is one of the few countries that didn't experience a real estate bubble and which has a well funded pension system. **By Myret ZAKI**

Caption photograph
GROWTH: The German nursing homes market is set to grow at 5% p.a.

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Caption below photograph:
" The German health system is good and the contribution of the State is insured at 80%

For a minimum investment of EUR 150'000, if you are a "qualified" investor, or for a minimum of EUR 1 million for an institutional investor, you could earn 6% p.a. by investing in a safe investment: the German nursing home real estate. "The sector benefits from an implicit guaranty from the Government, the homes are strictly controlled and are regularly rated by the ministry of health. There is therefore very few solvability and bankruptcy problems in the sector" explains Dominique Morisod partner of Threestones Capital. Threestones Capital invested in 12 assets in Germany for a total of EUR 60 million financed at 70% by senior debt.

GERMANY, FIRST OF CLASS

The German nursing home sector is not only the biggest nursing homes sector in Europe with 45% of the total market but also the safest. Germany is probably the only country that has adequately anticipated the cost of the "aging population". In Germany, 80% of the costs are covered by an insurance system that was put in place in 1994. The scheme is fully funded until 2020 and a slight increase in the insured contributions could cover the costs going forward.

Even in Geneva, 70-80% of the elderly population does not have a pension enabling them to pay the full price of a nursing home, and working until the age of 70 has become a subject of debate.

In the US, the current total short term deficit is estimated at USD 3'000 billion. In 5-10 years from now, a big flow of 70-80 years old people will increase the problem in the US, but also in Europe. In relative terms, Germany is doing better than its peers. " The Germans do not have a pension problem as the anglo-saxon media are arguing, says Dominique Morisod, the health insurance system provides quality services and is for 80% covered by the state insurance and social security. The nursing costs are de-facto controlled by the state as some of the costs are anyway supported by the government."

UNCORRELATED WITH GDP

As a rock of stability out-performing the rest of the continent, Germany offers a number of specific advantages.

"When they entered the EURO, the Germans had a strong currency. This forced them to increase their productivity by voluntarily freezing the salaries and by working extra hours" explains Dominique Morisod. Moreover, the integration of East Germany was an additional problem for the country. The cost for the population was very high and the Germans accepted a substantial tax increase. This tax burden is now ending with the finalization of the East Germany integration process.

Germany is now preparing for a tax reduction, when most of the neighboring countries will, on the contrary, experience a significant tax increase.

The unemployment rate, one of the key issues of the East German integration is now steadily decreasing thanks to the companies regained productivity of an economy supported by the "Mittelstand". All these SME's (which often have revenues in excess of EUR 1 billion) constitute a network of companies that were able to keep their roots and manufacturing activities in Germany.

In absolute terms, the trade balance of Germany is now more important than the Chinese one, and the internal consumption is growing. Germany is now collecting the benefits of this transformation and enjoys the weakness of the EUR to boost its exports. The dynamics of this leading and model country which represents today more than 50% of the European economy is also demonstrated by the 26% gain of the "DAX" market index in the last 12 months.

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From 1990, the residential real estate in Germany did not experience a "bubble" such as the US or UK market. In the last 8 to 10 years, the price increase was only 5% on average. As a comparison, the real estate in Germany is 10 times less expensive than in Switzerland. One could buy a property in Switzerland for CHF 8'000-10'000 a sqm, as to EUR 800 - 1'500 a sqm in Germany.

Whilst Germany is the only country which didn't experience a real estate "bubble", Germany is also the country which offers the highest returns in the EURO zone. Within the real estate sector, the nursing homes market is the most interesting market for Threestones Capital.

NO REAL ESTATE BUBBLE

Affordable prices and high yields are the two key components of the nursing homes real estate sector in Germany. In reality, the operators are not very profitable in Germany, and are even less profitable in Switzerland. The investment opportunity lies in the yields and capital gain potential derived from the build-up of a real estate portfolio. "We buy the real estate assets and rent them to nursing homes operators" explains Dominique Morisod. "The operators can then use the proceeds to grow their business. The nursing home sector is not only de-correlated from the German GDP, but it also even out-performed the GDP. Between 2001 and 2007, the nursing home market increased by 4.45% p.a .while the German GDP grew only by an average of 1.45% p.a. In 2009, The German GDP decreased by more than 5% while the nursing sector grew by 5%.

Most of the performance of a fund such as Threestones comes from the rents. The yield at acquisition of a German nursing home asset is generally between 8% and 9%. After leverage, management fees, costs and debt service, the investor can count on a total net performance of 9% to 10% p.a. and a cash net dividend of 6% p.a.

Another specificity of the German nursing homes market is its low concentration. 90% of the market is not in the hands of major operators. The German market is still more fragmented that France or US for example, where the major players have 1-1.5 billion revenues. Generally, the main operators in Germany generate approx. EUR 250 million in revenues. There is also an opportunity for investment funds to ride the consolidation wave.

In line with the ageing population, we will see a strong future demand for infrastructure in this market. According to an OECD report issued in March, the number of OECD population above 65 will increase from 85 million to 350 million in 2050. The German market alone will need an additional 213’000 beds in the next 10 years.

HOW TO INVEST IN THE NURSING HOMES SECTOR?

Private Equity fonds look to maximize the rental value, which translates into divend.

Similar to the Hotel industry The nursing homes business model is composed of two elements: the nursing home operator who is providing services (nursing, food and beverage) to the residents and the real estate. In order to grow, the operator needs to control its fixed costs, i.e. the real estate investments. Whenever possible, the operator will keep the management of the home and divest the real estate. By doing so, he will be able to take on other homes under management, thus growing its business without increasing its fixed costs. However, certain major nursing homes operators still own the real estate assets and become interesting targets for private equity investors. Operators are even more attractive if the real estate is not highly leveraged.

1st Step: The financial investor acquires the operator and restructures the business by separating the nursing home management from the real estate. Both businesses are then held by separate entities in tax friendly jurisdictions.

2nd Step: The financial engineering. The financial investor prefers to maximize the leverage and minimize the use of own capital. However, the leverage will have to stay within decent limits in order for the business to remain attractive for a strategic buyer or for an IPO.

3rd Step: Thanks to the high rent charged to the nursing home operator, the financial investor receives substantial dividends and the real estate investment is rapidly repaid. The financial investor divests the real estate after a few years.

Dominique Morisod is against such an aggressive approach. “At Threestones, our objective is not to charge high rent in order to pay out excessive dividends and get out as fast as possible, but to work with growing medium size operators to consolidate the market. We receive the rent from the market, that’s all we do”

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