Asset Deals as an Option for Successful Inorganic Growth in the Property Management Market


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The low interest rate environment and the high values that the real estate sector has maintained in Germany in recent years, compared to other investment classes, serves to keep the demand for property assets high, not only among individuals but also among domestic and foreign institutional investors alike. Consequently, despite an increase in construction activity, there is still a supply squeeze in most of Germany's big towns and cities.

Project developers, real estate companies and investors do not just build and purchase property, they also have a need for their properties to be managed to a high level, on both the commercial and the technical front, by a property management company. A high level of professionalism is therefore required from existing property managers.

The 23,000 or so companies operating in the property management business employ an average of five people including the owner[1]. Nearly 40% of the firms generate annual revenues of less than 50k EUR, in a sign of how fragmented the market is right now. More and more companies are endeavoring to grow by acquiring other firms (inorganic growth) in a bid to strengthen their market position and in many cases also to expand their service portfolio.

But what is the best way to realize a growth strategy of this kind? One option that can be considered besides acquiring a company through a share deal is the possibility of an asset deal. Unlike the best-known type of M&A transaction, the share deal, where shares in a company are sold by the shareholders themselves, an asset deal involves selling all or some of the company's operating assets and contracts (referred to collectively as assets).

The option of acquiring a company through an asset deal in the property management business offers an opportunity for rapid growth, leading to synergies and improved economies of scale.

This article discusses asset deals as a growth option in the property management context.

General characteristics and challenges of an asset deal compared with a share deal

Asset deals and share deals each involve different types of liability risk. In a share deal, the buyer is also acquiring the company's past liabilities, both real and potential, and therefore needs to conduct a thorough due diligence check prior to the acquisition in order to examine the target company's profitability and its risks. In an asset deal, the seller continues to be liable for company obligations.

An important aspect of an asset deal is the fact that contracts with both customers and staff can only be transferred to the buyer's company with the consent of the parties involved. By way of example, management agreements with customers can only be transferred to the buyer with the written consent of the customer.

One of the advantages of a share deal is the fact that all of the seller's contracts normally remain in place when the shares are acquired, giving the buyer a higher level of certainty regarding the transaction itself and future planning premises for the acquisition. The only exceptions are management contracts with a change-of-control clause enabling the customer to terminate the agreement in the event of a change of ownership.

An asset deal gives the buyer the chance to select out the assets they want to acquire and to restrict their purchase to those. In the property management business these will predominantly be the management agreements with individual customers. There are three different types of customer relationships – with people in owner-occupied apartments (WEG), people in rented apartments (MHV) and people with individual ownership (SEV) – each being approached in a different way, both within the due diligence and in the direct customer contact that happens during the transfer of the management agreements.

Aside from customer relationships, experienced personnel are also among the factors that create value for the buyer in an asset deal. Section 613a of the German civil code (BGB) stipulates that employees can object to their employment contract being transferred to the buyer within a month of being informed. This carries a certain level of acquisition risk for the buyer, given that the success of an asset deal can be dependent on the motivation of the work force in the target company to a large extent. Sellers for their part are normally very keen not only to transfer their contracts but also the corresponding employees to the new company. It is therefore advisable to seek thorough legal advice from employment law experts prior to the transfer of contracts and staff.

With the various assets to be acquired

[1] Volks- und Raiffeisenbanken Branchenbrief: GK 117 Hausverwaltung (10/2016), p.3.

+ Advantages of asset deals	+ Advantages of a share deal
• Greater flexibility for the buyer, in that they choose which assets and contracts they wish to acquire • No need to take over any past liabilities or legacy risks • Opportunity to renegotiate/simplify contracts in the course of the acquisition • More straightforward transaction structure and less extensive scope of due diligence	• Greater planning certainty, given that the seller's contracts can be taken over without the customers' and employees' consent • Streamlined purchase contract since none of the assets need to be determined in detail under the principle of legal certainty • Less tax on the purchase price achieved
− Disadvantages of asset deals	**− Disadvantages of a share deal**
• Less planning certainty, given that both customers and employees must agree to a transfer • Acquisition risk owing to dependency on the success of the takeover of customer agreements and staff contracts • Less attractive to the seller due to the higher tax on the purchase price achieved • More extensive purchase contract required because the assets and contracts concerned need to be separately defined and valued • More time required owing to more extensive communication and the need to get the necessary agreements	• Acquisition risk owing to the assumption of liabilities and risks from the past • Extensive due diligence to value the parts of the company that will be taken over • Risk of taking on unprofitable contracts

Fig. 1: Summary of the advantages and disadvantages of asset deals vs. share deals

in an asset deal being individually specified in the purchase agreement, the buyer can be assured of legal certainty[2] over each asset and all of the employment, contractual and legal relationships it brings with it. These can therefore be unequivocally distinguished from the parts of the company that are not being sold. Consequently, the purchase agreement is considerably longer and more detailed than that of a share deal.
Section 20(2) of the German Condominium Act[3] stipulates that even if the residents' association does not consent to the takeover, there is still an obligation to fulfill the terms of the management agreement even if the selling company only continues to exist legally as an empty shell, owning no assets and employing no staff. Faced with this situation, the only thing the seller can do is come to an agreement with the residents' association to terminate the management agreement as soon as possible and to continue providing services under the agreement until such time as it is effectively terminated. This risk for both buyer and seller is very difficult to foresee in the due diligence stage and to factor in to the contract negotiations.
Another important aspect when it comes to asset and share deals is the difference in the tax treatment of the two transaction types for the seller. A share deal is clearly more advantageous from a tax point of view for the selling party, and this is an important element in the company valuation and price setting stage of the process. It is advisable to seek legal advice from tax professionals prior to negotiations.
A comparison of the two transaction types reveals that a share deal is more advantageous for many companies and is therefore the more common option in practice. That's not to say that an asset deal is not an interesting alternative, given that in opting for a share deal the buyer accepts the risk of potentially acquiring bad assets and possible future risks from past liabilities. Furthermore, in some cases an asset deal is the only possible deal, such as when the property management business is just one of several business lines owned by the company concerned.

Due diligence as an essential tool to support an asset deal

Due diligence is an indispensable part of checking what you are buying. The key element is the analysis of management agreements. Within the due diligence it is important to note that the management agreements are normally concluded for a limited period of time, which means that the pressure is on to achieve their successful acquisition and integration. In Germany, the maximum length of contract for which a property management company can be assigned to an apartment complex under the German Condominium Act[4] is five years. In practice, agreement terms usually run for three to five years for owner-occupied apartments (WEG) and for just one year in the case of rented apartments (MHV) and individual ownership (SEV).
Besides considering the term, the due diligence should also examine the value of the management agreements, which can only be assessed after a detailed analysis of the various service components in the different customer agreements.
In addition to revenues and contractually agreed services, it is also necessary to look in detail at the variable and fixed costs that will be transferred over with the asset deal. The biggest cost block in the property management business are personnel costs (normally making up 50%–75% of expenditure). The terms laid down in the work contracts and subsequent changes and additions, including possible pension obligations, need to be analyzed and valued. In addition, the cost and the components of the business's other operating expen-

[2] Section 854 ff. BGB Principle of Legal Certainty
[3] Section 20(2) German Condominium Act
[4] Section 26(1) German Condominium Act

diture (e.g. rental costs for business premises and costs of the ERP system) should also be examined in the due diligence and valued taking into account any possible optimization potential. See figure 2 for an illustration of the business and contractual aspects that need to be considered and valued prior to an asset deal.

The outcome of the due diligence can be summarized in the form of a business plan based on the situation as is and including the planned business effects. The business plan is therefore a key element in calculating the right purchase price. Depending on the size and relevance of the asset deal, the plan may also depict several scenarios with different business trends. How meaningful and accurate the business plan is depends greatly on the preparations made by the buyer themselves in terms of the structure of the due diligence, combined with the quantity and quality of the data provided by the seller and the time available for the due diligence.

The financing concept is the basis for laying down the underlying premises for financing the purchase price and specifying the precise payments to be made. There are various payment options that can be negotiated aside from a fixed payment at a fixed time. An earn-out model[5] (also known as "debtor warrant") is one common and popular form of payment. This involves making a fixed payment for part of the cost, followed by several phased installments paid according to the level of success achieved. The success-based installments are often defined by how well certain contractually agreed parameters are actually achieved. In the case of an asset deal in the property management industry, such parameters mainly include the proportion of management agreements actually transferred, the term of the various agreements, and the extent of the agreed management fees. While an earn-out model does enable the purchase price to be flexibly adapted to match the rate of success achieved in transferring over management agreements, it does not diminish the buyer's risk of potentially having to continue to fulfill long-term management agreements where tenants withhold their consent to a takeover.

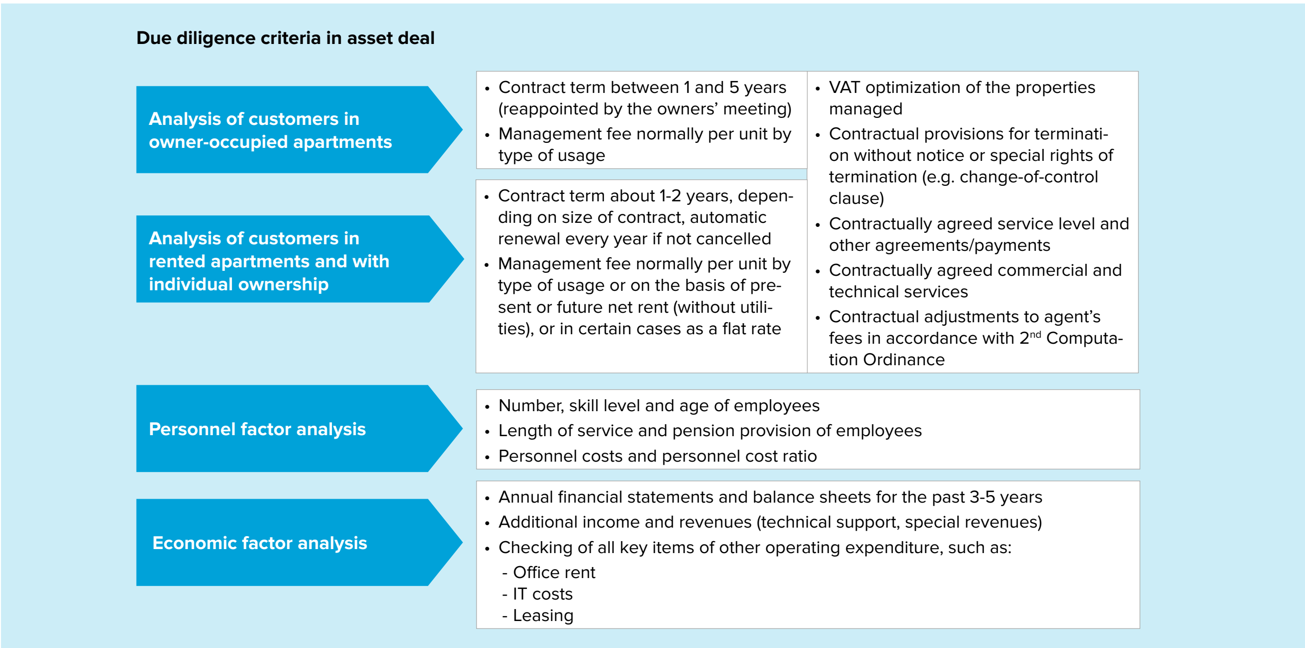

Fig. 2: Indicative due diligence criteria for analyzing a property management business, by category

Closing an asset deal in the property management business

Three significant dates are set during contract negotiations: the signing date, transfer date and closing date.

The signing date is the day on which the purchase agreement is signed and the terms of the transaction agreed in writing.

The closing date is the day on which all conditions precedent (laid down in the purchase contract) occur, in other words the date on which the purchase contract legally takes effect. The conditions precedent include payment of the agreed purchase price (or an installment thereof) and consent from the responsible shareholder bodies and antitrust approvals, as required. Closing normally takes place on a banking day, given that this is the date on which payment passes from one party to the other.

The transfer date is the day on which the transfer takes place from an accounting and business point of view. The date is set in the purchase contract and is usually at the start of a year, quarter or month. This makes it easier to distinguish business responsibility for services and costs between the buyer and the seller. Transfer day and closing day are normally quite close together.

The gap between signing and closing will depend on the size and complexity of the asset deal. It must provide sufficient time for the seller to carve the assets out of its business and for the buyer to make preparations for proper post merger integration (PMI). But closing should not be left too long as it is in everybody's best interests to provide a level of certainty for the seller's customers and staff alike. The gap is normally about 2–6 months.

[5] van Kann, J. (2009): Praxishandbuch Unternehmenskauf: Leitfaden Mergers & Acquisitions. Stuttgart: Schäffer-Poeschel. 57 f.

As the parties approach agreement in the contract negotiations for the asset deal, preparations should take place for making contact with customers and informing service providers so that the buyer can start talking to the seller's customers and staff as soon as the asset deal is signed. The need to obtain consent from several parties means that this will take longer and require more communication. Making thorough preparations in plenty of time helps to prevent a lack of timely information from causing customers and employees to look around for new service providers or employers.

Property management and the management of owner-occupied apartments in particular is very much a people-centered business. This means that information needs to be provided to employees sensitively and the takeover of staff from the seller's company needs to be done in a structured manner. Besides losing a wealth of specialist expertise and knowledge of property specifics if staff choose not to transfer to the buyer's company, it also makes it more difficult to convince customers of the benefits of allowing their agreement to be transferred. Being able to say "Nothing will change for you on a day to day basis" can work wonders in getting customers to consent.

Against this backdrop, there is a fundamental distinction to be made between taking over the property management agreements relating to rented apartments (MHV) and those relating to owner-occupied apartments (WEG). In the absence of consent, agreements relating to rented apartments have relatively short notice periods of 1 year, and so they can be terminated relatively quickly by either the buyer or the owner on the grounds of business discontinuation. In the case of owner-occupied apartments, the takeover is subject to approval at a property owners' meeting with a quorum. If the annual owners' meeting has already been held prior to the announcement of the asset deal, a special meeting of the owners must be called and must have a quorum in order for consent to be agreed.

Once the owners have given their consent, it is in both cases possible to take over the existing agreement as is or to negotiate a new agreement with the customers whose business you are taking over. The latter is the more attractive option as it provides the opportunity to renegotiate the scope of services and the terms of the agreement or to align agreements with those of the buyer.

As soon as you determine which assets are going to be taken over you need to start planning the approvals you will need to obtain for the subsequent takeover itself. This stage is often referred to as post merger integration (PMI). The aim of PMI is to make the process of taking over the company's assets and contracts as smooth as possible, assuming corresponding agreement on the part of customers or staff, as required. PMI is mainly concerned with preparing, structuring and implementing the measures involved in taking over the assets, often supported by a temporary project organization. The implementation project extends beyond the actual closing date to manage the ongoing communications with customers and employees, realize the necessary changes in processes and organizational structures and potentially transfer everything into a new ERP system, as applicable.

Summary

The diverse and multi-layered nature of the property management market means that service providers are under growing pressure to put their own organizations on a more effective and efficient footing and to differentiate themselves from other property management companies by offering an extended service portfolio. Inorganic growth creates new options here and can allow you to exploit economies of scale and additional synergies.

A good way of doing this is by acquiring assets through an asset deal. The key advantage over a share deal is that an asset deal gives the buyer greater flexibility in that they are able to choose precisely which assets and contracts they

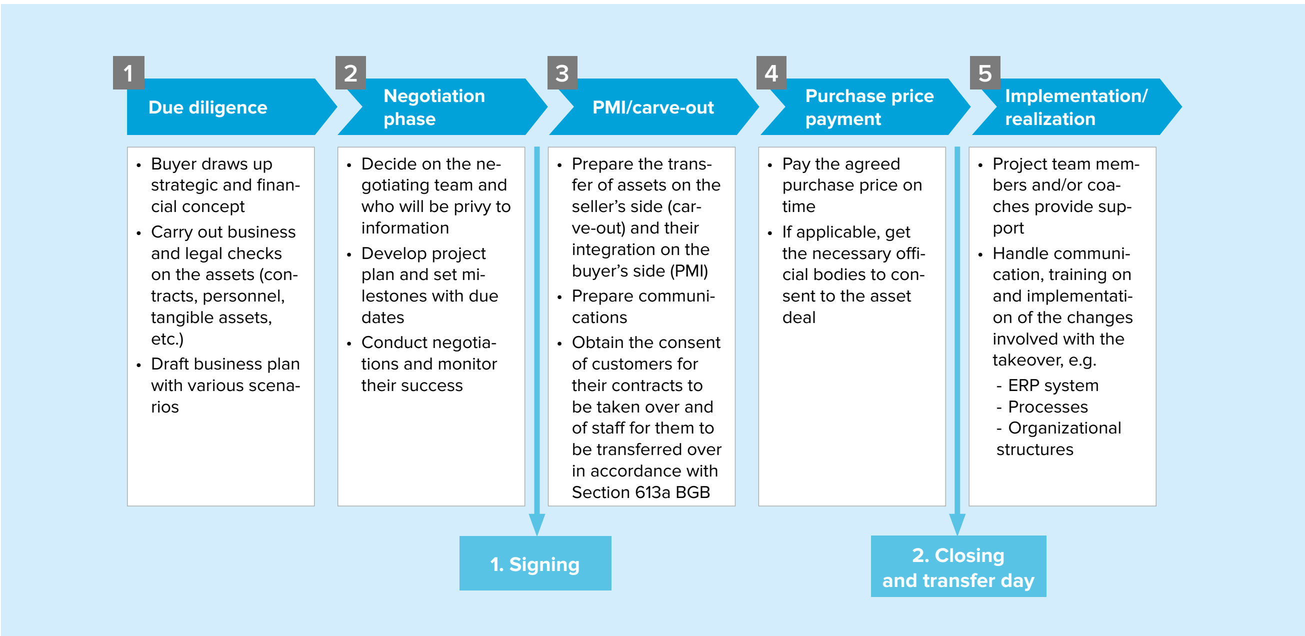

Fig. 3: Indicative procedure in an asset deal

wish to purchase, and they do not have to take over any past liabilities or legacy risks. The main disadvantages over a share deal lie in the fact that customers need to give their consent and staff need to agree to a transfer, meaning that the buyer does not have quite so much planning security. And when negotiating the asset deal the selling party needs to take into account the higher tax on whatever purchase price they achieve.

On the basis of a due diligence check, the acquisition needs to be well planned and structured and have all the relevant due dates scheduled. It is also important to have the process managed and monitored by the right project team. The business plan is the most important tool to determine the best purchase price and to spot the opportunities and risks of the asset deal in advance.

Add value with RITTERWALD

RITTERWALD knows the real estate market inside out and has accompanied numerous asset and share deals in this area in recent years, supporting both the buy side and the sell side of the transaction. Ultimately the assets or company shares were successfully transferred from the seller and integrated into the buyer's organization.

Do you have questions regarding this topic?

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