

CORPORATE GOVERNANCE IN THE REAL ESTATE INDUSTRY

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*This article has been developed at the **ebs REAL ESTATE CENTER** of the EUROPEAN BUSINESS SCHOOL. We are grateful to the Initiative Corporate Governance der deutschen Immobilienwirtschaft e.V. for its financial support.
We wish to thank the participants of the twentieth ARES Annual Conference and the anonymous referees for their helpful comments.*

CORPORATE GOVERNANCE AND REAL ESTATE INDUSTRY

Executive Summary

Real estate is nowadays a global business and corporate governance therefore an important issue for international investors, lenders, occupiers and developers worldwide. Some of the major issues real estate companies are concerned with today are standardized property valuation, transparency, executive compensation, board member's qualification and board appraisal, investor's relations and corporate rating. Corporate governance has to be perceived as a big opportunity for real estate industries worldwide in order to improve their reputation and to become more professional.

1 Introduction

Corporate Governance is these days a well-known term in the ears of international investors, lenders, occupiers and developers worldwide. One indicator is the fact that at MIPIM 2004 a panel discussion on "European Real Estate talks Corporate Governance" awoke a lot of interest (see Schiller, 2004). Jones Lang LaSalle latest research shows that transparency is not equally distributed among real estate markets (see JLL, 2004). The United States and United Kingdom "stand out as beacons of high transparency" whereas most European countries are seen as less transparent. Even though most of these countries have made progress mainly due to the process of European integration concerning financial, legal and fiscal aspects, spectacular insolvencies in the German real estate industry at the end of

the last century e.g. Philipp Holzmann (construction company) or Bankgesellschaft Berlin (issuer of closed-end real estate funds) could not be prevented. They made obvious that more attention should be paid to corporate governance and corporate control.

In order to gain and maintain investor's confidence, real estate companies all over the world have to become more transparent especially in the field of property valuation and executive compensation as well as board appraisal and board independence.

This article will look at general corporate governance principles and the principal-agent relationship behind it and outline differences in corporate governance in the United States, the United Kingdom and Germany. Furthermore we will explain why corporate governance is such an important issue for real estate related companies and what conclusions German property companies have drawn from this insight. The paper ends with some preliminary findings of the corporate governance status in the German real estate industry.

2 General corporate governance principles

In order to outline general corporate governance principles, we first have to define what corporate governance is about. Besides the difference in corporate structure (one-tier (U.S. & U.K.) vs. two-tier board (Germany)), perceptions of how board members should be held responsible for their actions differ.

2.1 Definition

There are a number of definitions which all have a common focus on the relationships between management/supervisory board, capital markets and investors. Corporate Governance is seen as a set of rules that ensures not only efficient management and

leadership but also corporate control, so that the agent (management) is called accountable for corporate performance and the return on the invested capital paid to the principal (investor). By specifying the rights and responsibilities of these two groups, a structure is given through which the company's objectives and the means of attaining those objectives are set and performance is monitored.

A clear-cut definition of corporate governance is hard to find. A very broad and detailed overview of the American definition of Corporate Governance was given by Shleifer/Vishny (1997). They define Corporate Governance as the process "that deals with the way in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer/Vishney, 1997, p. 737). The focus hereby is on the relationship between investors and management. In addition, Shleifer/Vishny defined investors as equity and debt holder of the company (Prigge, 1998, p. 946). Corporate control is being carried out mostly externally by the financial markets which demand a high level of transparency.

Concerning the target groups of Corporate Governance, the Western-European and especially German way of interpreting is much broader than the American one and driven by the stakeholder approach. Corporate Governance structures include the relationships between the company's management, owners, creditors, employees, suppliers, clients and other stakeholders (Deutschland Grundsatzkommission Corporate Governance, 2000; Berliner Initiativkreis German Code of Corporate Governance 2000, OECD, 2004, p. 11). These relationships as a whole can be described as Corporate Governance. The definition used in this article describes corporate governance as the legal rules,

institutional arrangements and practices that determine who controls business corporations, and who gets the benefits that flows from them. Corporate governance issues include how major policy decisions are made in business corporations, how various stakeholders can influence the process, who is held accountable for performance and what performance standards are applicable. Hence, the governance problem to be solved in setting up any corporation is to create a mechanism for selecting and overseeing the firm's managers that fosters cooperative behaviour among the multiple participants, discourages abuses by decision makers, and still provides sufficient freedom of action to encourage innovation and risk taking (Blair, 1999, p. 1453).

2.2 Principal-agent problem

The Agency Theory, which is a sub domain of New Institutional Economics, deals with the economic analysis of legal contractual relationships and is based on two parties, principal and agent. The investor is represented by the principal and the management as the investor's agent. The principal employs the agent to fulfil a task in his name, grants the agent a limited freedom of choice and remunerates him. After the contract is closed, the asymmetrically distribution of information can be observed in two ways: Firstly the efforts of the agent cannot be measured directly by the principal. The agent will therefore maximize his own utility function and probably seldom act in the interest of the principal. As a result of the occurring divergence the principal will start monitoring the agent's actions (monitoring expenditures). Secondly the agent makes observations that the principal does not make and thereby improves his information level.

The two concepts of agency theory relevant in this case (after the contract is closed) are adverse selection and moral hazard. Adverse selection occurs if the agent claims to have a certain ability or knowledge he already knows he cannot provide in the end. Moral hazard describes the risk that the agent will put in much less effort than promised in order to achieve the principal's goals. This could happen if an agent advises multiple clients and the incentive contract between agent and principal is ineffective and/or incomplete. (Richter/Furubotn, 1999, p. 163, see also Williamson, 1985, Jensen/Meckling, 1976, Ross 1973, Jensen, 1983, Akerlof, 1970, Arrow, 1985, Fama, 1980, Fama/Jensen, 1983 and Fama/French, 1999).

The separation of ownership and control and the hereby occurring asymmetric distribution of information may also lead to the following problems:

1. Effort provision problem (poor management decision-making and shirking),
2. Risk preference problem (management uses corporate control rights to hedge by accepting low but safe NPV-projects, often excessive diversification),
3. Time preference problem (short-termism of managerial decision making, failure to exploit long-term growth opportunities) and
4. Overinvestment problem (management withholds free cash flows from shareholders and invests in low value projects (with negative economic returns)).

Ex-ante control mechanism to resolve these agency problems could be a change in the capital structure policy. Increasing the debt/equity ratio of a company raises the weight of fixed relative to residual claims. This implies an increase in the firm's financial distress risk and therefore

puts performance pressure on the company's management. A well-functioning supervisory board should monitor management as long as information flows ensure transparency. Block owners with a long-term investment horizon may use their formal and informal channels of communication and control. By introducing equity ownership and performance pay into management compensation, congruity with shareholder's preferences might be improved. Opportunistic behaviour by the management would lead to a depreciation of the manager's human capital (probably lower alternative wage offers, reduced re-employment opportunities, negative reputation effects).

Ex-post corrective mechanism could be that underperforming companies might become targets for raiders with the consequence that managers would loose their jobs. A concentration of equity ownership might improve the effectiveness of direct monitoring. Structural deficiencies of institutionalized monitoring could be overcome by altering the "rules of the game" for information provision by management and co-decision-making.

In the end, the key to success is mutual trust. Incentive fees, due diligence or referral can certainly reduce conflicts of interest, adverse selection or moral hazard but not eliminate them perfectly. At the end of the day, only the development of mutual trust between all parties will lead to a beneficial solution for all.

2.3 Corporate governance in the U.S. and U.K.

In July 2002, U.S. Congress passed the Sarbanes-Oxley-Act and changed corporate governance rules which had been imposed until then only by the stock exchanges. The Sarbanes-Oxley-Act improved significantly U.S. securities laws governing companies offering securities in

the U.S. or being listed on a stock exchange in the U.S and thus has enhanced the liability standards of board members. The Act's strongest provisions relate to criminal penalties for certifying reports that do not fairly present the issuer's financial circumstances.

In summer 2002, the board of the New York Stock Exchange (NYSE) adopted new standards and changes to existing corporate governance and disclosure practices and submitted a rule filing to the U.S. Securities and Exchange Commission (SEC) for review and approval.

NASDAQ also proposed several changes to its corporate governance rules aiming at increasing the accountability and transparency of NASDAQ-listed companies and harmonizing NASDAQ rules with the Sarbanes-Oxley-Act.

Both initiatives (NYSE & NASDAQ) focused besides other issues on a clearer definition of an "independent" director, the need for a majority of independent directors on corporate boards, expansion of audit committee's authority, and enforcing qualification requirements for audit committee members. The SEC approved these orders in November 2003 (see SEC 2003).

Due to the importance of corporate governance to business prosperity and accountability, the Cadbury Committee drafted a corporate governance code of best practice in the United Kingdom in 1992. The Code was updated by the Hampel Committee in 1998 embracing Cadbury, the Greenbury recommendations on directors' remuneration (1995) and the Committee's own work. The latest version of the code, effective since July 2003, contains main and supporting principles and provisions. The existing Listing Rules by the Financial Services Authority require listed companies to make disclosures statement on how they apply the principles in the Code, covering both main and

supporting principles, and to confirm that they with the Code's provisions or if not provide an explanation ("comply and explain" approach). This approach has been in operation for over ten years and that has been widely welcomed by company boards and by investors. It gives companies free hand to explain their governance policies in the light of the Code's principles, including any special circumstances that may apply to the company's business and may have led to a particular approach, see Financial Reporting Council, 2003.

2.4 Corporate governance in Germany

In the past, most German companies didn't depend that much on the capital markets. Individuals and banks used to be major shareholders with a blocking minority and free-float was low. Cross-shareholding with partnering companies or fund-lending institutions was normal and members from important clients and suppliers were sitting on the company's supervisory board.

Therefore, Germany cannot easily be compared with other European nations in matters of corporate governance, owing to the highly specific legal framework within which German companies operate. The two-tier board structure comprising the executive board (Vorstand) and the supervisory board (Aufsichtsrat) are mandatory for stock corporations.

Executive board

The executive board is in charge of the day-to-day operations of the firm. Its members are appointed for five years by the supervisory board and can be reappointed and dismissed by it. Besides, the supervisory board fixes remunerations of the executive board members traditionally derived from performance (surplus in the annual income statement) or the stock market (stock options). The

executive board represents the company in its business dealings and legal affairs, see §§ 76-78 AktGⁱ.

The Vorstand which consists only of inside directors has full and exclusive operational responsibility and the Aufsichtsrat has supervisory control.

Supervisory board

The supervisory board is appointed by the shareholders at the annual general meeting (AGM), exerts substantial independent influence on management and has three primary functions: to appoint, monitor, and dismiss members of the executive boardⁱⁱ; draft the annual financial statement for presentation at the annual shareholders meeting; and approve major business decisions proposed by the management board concerning, for example, expansions, acquisitions, restructurings, or financing. Members of the supervisory board are appointed for four year terms by cooption, that is, by the incumbent members of the supervisory board. An individual cannot serve on both the supervisory and executive boards of the same company. In practice, the executive board has a very large influence on appointments to the supervisory board.

The supervisory board consists of at least three members and at most 21 persons depending on the stated capital of the corporation, see § 95 AktG. The average supervisory board has about 13 members. One person is allowed to fill in up to five seats on supervisory boards.

The very high proportion of employee representatives (49% of directors on average, see Heidrick & Struggles, 2003, p. 22) is typical throughout Germany. Based on various laws about co-determination, between one-third to one-half of the seats on the supervisory boardsⁱⁱⁱ are held by the employees or the unions. However, the chairman of the German

supervisory board holds the tie-breaking vote, and this position is usually held by a person (frequently a banker) in favour of management's concerns. Although this legislation has helped to secure social partnership and harmony in the past decades, there is a growing awareness that this situation might be an obstacle to further improvement of the efficiency of boards in Germany. Recent corporate governance initiatives focus on the legal framework and the constraints it places on flexibility. The most critical question might be perhaps, how can efficiency be improved given that a large proportion of directors on the supervisory board are employee representatives?

Shareholders and institutional investors

Financial intermediaries, holding equity positions, and shareholders per se may have little impact on controlling managers. However, their equity stakes are occasionally large, and they are considered long-term, "patient" investors. Consequently, financial intermediaries frequently obtain seats on the supervisory board (Pension funds and insurance companies own less equity in Germany (7.1%) than in the U.S. (24.7%). Data are for 1993 and are taken from Gelauff and Broeder, 1997, p. 46). The role of German banks is much greater than in the United States, where banks are largely prohibited from owning equity and, until very recently, were small by the standards of Continental Europe. By contrast, banks have a long-standing and prominent role on the corporate landscape in Germany where they hold large positions in both debt and equity and actively serve on, and frequently chair, supervisory boards.

Networks of outside board members are also potentially important for control. These individuals hold positions on the supervisory boards of several companies, and/or they are "distinguished experts"

drawn from the ranks of politicians, civil servants, lawyers, professors, and former directors. With their perspective and experience, these outside board members may provide valuable advice to firms.

German Corporate Governance Code

In July 2002, the government commission “Corporate Governance”, also known as Cromme Commission^{iv}, appointed by the German Minister of Justice, presented the German Corporate Governance Code to the public. Just like the Cadbury Commission in Great Britain, the aim of the Cromme Commission was to make Germany’s corporate governance rules more transparent for national and international investors thus strengthening confidence in the management of German corporations.

The Code deals with all major issues namely the inadequate focus on shareholder interests, the German two-tier system of executive board and supervisory board and its lacking independence, the inadequate transparency of German corporate governance as well as the limited autonomy of financial statement auditors.

The Code addresses these points by provisions and stipulations, also taking into consideration the legal framework. The Code is an excellent example of self commitment by industry (soft law) and will, by its “comply or explain rule”, complement latest legal changes e.g. the German Transparency and Disclosure law. Any company unwilling to comply with the recommendations of the Code must issue a compliance statement and make it available to the public on their corporate website. Through the declaration of conformity pursuant to Article 161 of the Stock Corporation Act (AktG) as amended by the Transparency and Disclosure Law (TransPuG)^v, the Code now has a legal basis.

The aim of the German Corporate Governance Code^{vi} was/is to make Germany’s corporate governance rules transparent for both national and international investors, thus strengthening confidence in the management of German corporations. The code incorporates elements from many different laws in one framework, and adds new recommendations to it. It addresses all major criticisms – especially from the international community – levelled against German corporate governance, namely

- inadequate focus on shareholder interests;
- the two-tier system of executive board and supervisory board;
- inadequate transparency of German corporate governance;
- inadequate independence of German supervisory boards;
- limited independence of financial statement auditors.

Each of these five points is addressed in the provisions and stipulations of the Code, also taking into consideration the legal framework. The code is based on three sets of rules:

1. laws that companies must follow,
2. optional recommendations (if companies choose not to comply with these, they have to explain why), and
3. suggestions which companies can follow or not with no requirement for disclosure.

The Government Commission will address further corporate governance issues relating to areas such as the audit committee, accounting and financial statement auditing, conflicts of interest in the supervisory board and the switch from

executive board chairmanship to supervisory board chairmanship. The Government Commission agreed that it would first observe and assess further developments. In addition, the Government Commission with its working groups will study the EU Commission's action plan and incorporate its findings where applicable in its resolutions.

The Commission's recent focus is in particular on the issue of appropriate and transparent executive compensation and experience to date with the implementation of the German Corporate Governance Code at exchange-listed corporations. Practice has shown that all the issues in the debate surrounding executive compensation are already dealt with generally in the Code. The Commission's primary aim was therefore to further clarify and concretize certain aspects with a view to eliminating the weaknesses revealed in implementation to date. These clarifications served the purpose of bringing greater transparency to German executive compensation systems. To allow investors to assess whether executive performance and compensation are properly correlated, the compensation system including its individual components of fixed salary, bonus and long-term success-related component, as well as the actual amounts paid must be consistently disclosed. If performance criteria are not only strictly adhered to but also openly communicated, criticism of executive pay will start to fade and trust in companies will grow. The Commission is convinced that flexible self-regulation by business is preferable to statutory regulation wherever possible.

3 Real estate specific corporate governance rules

3.1 The need for specific rules

The question is whether the general corporate governance codes are sufficient for companies in the real estate business or whether real estate specific rules should be added.

Real estate is different from other asset classes. Its immobility and long value chain, the multitude of involved parties, high investment stakes, long-term investment cycles and mostly a lack of market transparency and market data underline its complex nature.

Consequently, investors favor a similar transparency and professionalism as in stock and bond markets. The maturity of real estate markets worldwide shows huge differences. From a corporate governance perspective in many countries a bunch of deficits exist:

- lack of professional qualification of management,
- no regular property valuations,
- no disclosure of the market value of real estate assets and the appraisal methods,
- insufficient control of possible conflicts of interest (corporate opportunities),
- no efficient control of management of subsidiary companies operating in the real estate business,
- no explanation of corporate strategy, future lines of business and growth forecasts.

In Germany for instance, the listed property companies ("Immobilien-AGs") underlie the same regulations as all other publicly listed corporations. There are no special tax advantages for Immobilien-AGs. Discussion on the introduction of REITs in Germany has just started. German accounting rules do not require property companies, not even Immobilien-AGs to disclose the market value of their real estate or the appraisal methods used.

The German Company law does not even provide that listed property companies carry out regular valuations. In the past, German listed property companies experienced only modest interest of investors and traded at a discount from their NAV. The history of German listed property companies is diverse. Most are spin-offs of former non-property companies that gave up their real estate activities in order to focus on their core-competence or closed down their original line of business (textile, mining, brewery, and engineering) and focused on actively managing their property assets. These companies are still dominated by their original owners and free float in general is too low to attract outside investors (with the exception of IVG). The market capitalization of Immobilien-AGs amounts to (only) approximately 6.5 bn. € at the beginning of 2004, see Ellwanger & Geiger^{vii}.

The German market for indirect property investment instruments in Germany is dominated by open-end real estate funds which have been very successful in attracting new money over the past years (from the middle of 2000 to the middle of 2003, assets under management by open-end real estate funds have nearly doubled from € 47.8 to € 84,6 billion, see BVI).

The transparency of open-end funds is rather high (e.g. yearly valuations, disclosure of market values and appraisal methods). They have been rated by Moody's and the BVI introduced compliance regulations ("Wohlverhaltensregeln").

Most likely the existence of general corporate governance codes will not improve the situation which has been described above. However, only comprehensible decision and control mechanisms, a reduction of information asymmetries, a high property expertise of

the management enforce the confidence of investors worldwide.

Real estate specific corporate governance rules which address the deficits are effective means to achieve more transparency and professionalism.

3.2 Initiative corporate governance of the German real estate industry

In order to create more transparency and better corporate governance, a group of more than 50 renowned companies in the German real estate industry formed the "Initiative Corporate Governance der deutschen Immobilienwirtschaft e.V." (Initiative Corporate Governance of the German Real Estate Industry)^{viii} in 2002, adapting the German Corporate Governance Code to the needs of the real estate industry. The initiative includes listed property companies, open-end real estate funds, consulting companies and privately held real estate companies (see appendix 3)

The board consists of representatives of the initiators (EUROPEAN BUSINESS SCHOOL and Heidrick&Struggles), the CEO of the largest German listed property company (IVG), the former CEO of an open-end real estate fund (DIFA) and a senior equity partner of a large law firm (Clifford Chance).

Board members and representatives of the member of the initiative formed working groups which developed a set of rules which were passed by the general meeting. The foundation of the Initiative Corporate Governance of the German Real Estate industry will speed up the development of good governance throughout the industry and set quality standards.

3.3 Corporate governance rules for the German real estate industry

To provide an ethical and practical foundation for all further actions and to foster business ethics, the initiative framed “Ten Commandments” for property companies despite of their legal form which document general guidelines of conduct (see appendix 1).

The “Ten Commandments” deal mainly with the qualification of members of the executive and supervisory board, the valuation of real estate assets, the prevention of conflicts of interest and the information policy of real estate enterprises.^{ix}

All members of the Initiative have to sign the declaration of self-commitment (“Ten Commandments”).

Because of the diversity of the real estate sector, special sets of regulations have been and will be created in addition to the “Ten Commandments”.

The “Code for joint-stock real estate corporations” is aimed explicitly at listed real estate corporations, listed non-property companies owning real estate e.g. Deutsche Telekom, Deutsche Bank, Siemens, and large limited liability property companies (see appendix 2).

Supplements to the German Corporate Governance Code that are important for corporations in the real estate business are marked with an “i” and emphasized in bold type (see appendix 2).

The following example illustrates the methodology:

German Corporate Governance Code 7.1.1

Shareholders and third parties are mainly informed by the Consolidated Financial Statements. They shall be informed during the financial year by means of interim reports. The Consolidated Financial Statement and interim reports shall be prepared under observance of internationally recognised accounting principles. For corporate law purposes (calculation of dividend, shareholder

protection), Annual Financial Statements will be prepared according to national regulations (German Commercial Code), which also form the basis of taxation.

German Corporate Governance Code for joint-stock real estate corporations 7.1.1.i

Legally recognised valuation methods must be used for the valuation of real estate. These valuation methods, and changes to them, must be explained in the annex to the annual accounts, together with the reasons for them. The business report or the annex should also state the market value (excluding real estate investment assets used by the company itself) and the valuation methods used for its determination, together with any changes made to them. If no market value is stated in relation to the individual real estate asset, the greatest possible transparency should be achieved by stating generally applicable (e.g. DIX regional and/or use-specific clusters that were assessed on the basis of the individual market values.

Particular points of the “Code for joint-stock real estate corporations” are:

- appraisal issues, e.g. clear, comprehensible and standardized appraisal methods,
- more frequent property valuations and timely publication of these new data,
- a clear-cut picture of the companies’ major shareholdings and financial involvements,
- more professional qualification of executive and supervisory board members as well as company employees,
- the composition of supervisory boards, for example the establishment of property-related committees,

- the handling of possible conflicts of interest (corporate opportunities) which management may encounter,
- the increase of transparency in director's dealings and share ownership by members of the executive or supervisory board,
- and a more intense cooperation between supervisory board and the company's auditor.^x

In order to fit the growing impact of internationalization in the area of property valuation and accounting (IAS/IFRS, US-GAAP), this code is regularly revised. The Initiative has currently established the following working groups:

- Rating
- Trust Companies
- Transparency
- Compliance

3.4 The role of real estate associations

To live the code the recommendations of two associations should be respected: the European Public Real Estate Association (EPRA)^{xi} and the European Association for Investors in Non-listed Real Estate Vehicles (INREV).^{xii}

EPRA has developed best practices policy recommendations what real estate related information on the sub-portfolio and on the property level should be published. Up till now, only two German real estate companies have adopted these so far. EPRA also recommends that all valuations of the company's property should be conducted by external appraisers to increase investors' level of confidence in the objective nature of the valuation, be disclosed at least once a year, and all assets owned by a company should be valued as of the same date (see van Ommen, 2004).

INREV has established a committee on reporting which "is bringing investors and fund sponsors together with lawyers and accountants to attempt to agree on basic guidelines for investor reporting – an area of widely divergent practice in the current market" (see Roberts, 2004, p. 62).

3.5 Preliminary results of the corporate governance status in the German real estate industry

A survey measuring the current status of corporate governance in the German real estate industry was conducted in fall 2003 by the **ebs** Real Estate Center. 357 questionnaires were sent out to CEOs of real estate corporations and 68 valid questionnaires (return rate of 19%) could be analyzed.

These 68 companies were composed of 35 stock corporations (19 listed and 16 non-listed) and 33 limited liability corporations. As seen on exhibit 1, the composition of the core competences of these companies was quite broad representing most sectors of the German real estate industry.

Concerning the popularity of the term corporate governance (see exhibit 2), almost all CEOs (97%) responded that corporate governance is an issue they know about, which underlines the need for further information, communication and institutionalization on corporate governance related real estate issues.

The level of interest, shown in exhibit 3, is high. The majority of the questioned companies responded that corporate governance is on their agenda and an issue they will learn more about.

As outlined in exhibit 4, a majority believes that corporate governance plays a vital role in the German real estate industry.

Whether good corporate governance increases enterprise value in the long run (see exhibit 5) is not answered clearly. Depending on the efforts done in order to

improve corporate transparency, companies see corporate governance as a long-term value driver. Prominent examples, like German IVG AG, who are known for their outstanding transparency, believe in the positive contribution of corporate governance to shareholder value. Asked about the newly published Corporate Governance Code for the German real estate industry (see exhibit 6), almost 60% responded that the Code is known which shows the interest in this topic and the good communication of the Initiative Corporate Governance of the German Real Estate Industry.

Only very few companies have so far developed their own corporate governance principles (28%) as seen in exhibit 7. In some cases rules of conduct already exist (16%) and companies are planning to design their own principles (18%). Almost 40% do not have any corporate governance principles and are very interested in a standardized, real-estate related set of corporate governance principles.

Exhibit 8 finally gives an impression on how good corporate governance could be practised. As earlier mentioned, valuation issues, detailed asset and portfolio information, NAV-calculation, risk management and qualification of management are perceived as key issues to improve corporate governance.

4 Conclusion

Corporate Governance has to be perceived as a big opportunity for the real estate industry in order to improve its image and reputation and to become more professional. Transparency and professionalism are key issues namely for listed property companies. In conjunction with comprehensible decision and control mechanisms, investors' confidence in this industry will rise and information asymmetries will be reduced.

In the future, complying with the Code will enhance a company's corporate rating and improve financing terms and conditions according to the Basel II Accord.

The German real estate industry is the first industry sector in Germany and also worldwide that has adapted a general Corporate Governance Code to its specific needs.

The real estate industry especially in those countries which have no mature markets yet should follow the example given by the Initiative Corporate Governance of the German real estate industry.

Endnotes

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- ⁱ AktG stands for Aktiengesetz/Stock Corporation law. It corresponds with NYSE rules.
- ⁱⁱ Kaplan, 1994, reports turnover rates of 12% (excluding cases of death and illness) for the United States and 10% for Germany.
- ⁱⁱⁱ German co-determination laws require that, for listed companies with 500 or more employees, one-third of the seats on the supervisory board must be held by persons elected by the employees. The fraction increases to one-half for stock companies with 2,000 or more employees.
- ^{iv} The Cromme Commission was named after its chairman Dr. Gerhard Cromme.
- ^v The German Transparency and Disclosure Law (TransPuG) became effective on July 26th, 2002.
- ^{vi} The Code can be downloaded at <http://www.corporate-governance-code.de/eng/kodex/index.html>.
- ^{vii} The market capitalization of German listed property companies can be measured by the Ellwanger&Geiger (E&G) Dimax. Dimax is a share index which documents the development of all German quoted real estate enterprises since 1988. Index information can be downloaded at: [http://www.privatbank.de/web/home.nsf/VCO/VSIN-59XEBA/\\$file/dimlist.pdf](http://www.privatbank.de/web/home.nsf/VCO/VSIN-59XEBA/$file/dimlist.pdf)
- ^{viii} For more information, www.immo-initiative.de
- ^{ix} The „Ten Commandments“ can be downloaded at <http://www.immo-initiative.de/international/kodex/principles.pdf>
- ^x The text of the supplement to the German Corporate Governance Code is to be found in the appendix.
- ^{xi} For more information, www.epra.com.
- ^{xii} More information about INREV can be found at www.inrev.org.

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Appendix 1

Principles of proper and honourable management in the real estate industry („Ten Commandments“)

1. The **corporate management** operates the real estate business exclusively in the interests of the shareholders/trustors (“investors”) and is committed to the aim of increasing the value of the enterprise/real estate assets.
2. **Professionalism, transparency and fairness** towards investors, business partners, tenants, staff and the general public comprise the indispensable basis of entrepreneurial activity in the real estate sector that is important for the national economy. Compliance with these fundamental rules creates confidence in the real estate economy.
3. The corporate management has the **necessary suitability and sufficient experience**. In case of groups of companies, this also applies to a reasonable extent to the principal companies. The corporate management guarantees the continuous further training of management, specialist staff and future executives.
4. **Expert** supervisory and consulting bodies increase the quality of decisions for real estate transactions. These bodies will be constituted accordingly, and will receive clear, comprehensive, forward-thinking information from the enterprise’s management.
5. Suitable valuation of real estate assets will be carried out with recognised valuation methods by qualified, independent experts on the basis of up-to-date objective market information. The valuation method and its alteration, and the **market values** of the existing real estate, will be explained in a suitable way.
6. Real estate transactions usually involve large capital commitments and often a long-term planning horizon. For this reason, the establishment and continued development of an internal supervision system and a system of **risk management** is indispensable.
7. **Conflicts of interest** between staff, members of the management, supervisory and consultancy bodies on the one hand and the real estate enterprises will be avoided or exposed by suitable rules.
8. The **audit of the annual accounts** serves to protect lenders of capital and to inspire confidence. The criteria of independence and qualification will be strictly observed in the selection of the auditing company.
9. The business model of the real estate enterprise, the **organisational structure** and the participation relationships will be clearly set forth, and any changes to them explained.
10. The **information policy** is characterised by the principles of trustworthiness and equal treatment. Real estate enterprises inform institutional and private investors in Germany and abroad, along with other market participants, in an objective, clear, comprehensive way at the same time, in a suitable form and language and in the appropriate media.

Appendix 2

Supplement to the German Corporate Governance for joint-stock real estate corporations

1.i Preamble for the Real Estate Industry

The German Corporate Governance Code is hereby appropriately supplemented for public limited companies operating real estate business, that are currently listed (e.g. IVG), or intended for future listing, on the stock exchange ("real estate enterprises"). The supplements also apply to other public limited companies of any sector that

- hold a significant amount of real estate themselves or through affiliated enterprises, or conclude and implement real estate transactions either directly or through participations ("real estate transactions")
- or provide services for such transactions (generally "real estate enterprises").

3.1.i

The executive board and the supervisory board in the principal companies in groups of companies must carefully monitor the management of the transactions of dependent companies, in particular with regard to real estate activities.

3.3.i

As far as real estate enterprises are concerned, this in particular applies to fundamental alterations of valuation methods the purchase and sale of real estate and project development of the enterprise's own sites above a threshold to be fixed depending on the size of the enterprise.

3.9.i

Real estate transactions between the enterprise and members of the executive board or the supervisory board should be avoided. To the extent to which they are nevertheless concluded, they must be subject to the consent of the supervisory board.

4.2.i

Members of the executive board of companies that operate in the real estate business must have relevant training or sufficient experience. In executive boards of companies whose group companies operate in the real estate business to an extent that can have a considerable influence on the assets situation, the financial situation and the income situation of the controlling enterprise, at least one member of the executive board should have special knowledge or sufficient experience in the real estate business.

4.3.6.i

In case of real estate transactions by the enterprise, even the appearance of a conflict of interest should be avoided. In every such transaction, the interests of the enterprise alone must

be safeguarded. Members of the executive board may under no circumstances derive personal advantages from transactions of the enterprise.

Privately conducted real estate transactions and private commissions regarding such transactions by members of the executive board should be disclosed to the chairman of the supervisory board.

The members of the executive board should ensure compliance with the principles for the avoidance of conflicts of interest, in particular in case of

- transactions between associated enterprises
- the purchase and sale of real estate
- the award of commissions in the real estate sphere.

The supervisory board should establish rules of procedure for individual cases.

5.1.1.i

In case of real estate transactions of considerable importance, the supervisory board should

- ensure that its members are informed sufficiently well and in good time,
- appropriately regulate the frequency and time budget for meetings in accordance with the transaction volume and the business requirements,
- assist the members in fulfilling their supervisory function more easily.

Banking institutions can establish special rules for rescue bids that may diverge from this.

5.3.2.i

In real estate enterprises, the supervisory board or the audit committee should deal with the valuation of the existing real estate assets. This task can also be transferred to a separate valuation committee.

5.4.1.i

In supervisory boards of companies whose group companies operate in the real estate business to an extent that can have a considerable influence on the assets situation, the financial situation and the income situation of the controlling enterprise, at least one member of the supervisory board should have special knowledge or sufficient experience in the real estate business.

In supervisory boards of real estate companies, a sufficient number of supervisory board members should have such special knowledge or experience.

5.5.1.i

Fig. 4.3.6.i applies by analogy to the members of the supervisory board.

6.1.i

Real estate companies should also publicise real estate transactions without delay if their respective total volume exceeds 5 % of the balance sheet value of the sites and buildings that are shown as fixed assets, floating assets and participation assets. This does not apply to rescue bids by banking institutions.

7.1.1.i

Legally recognised valuation methods must be used for the valuation of real estate. These valuation methods, and changes to them, must be explained in the annex to the annual accounts, together with the reasons for them. The business report or the annex should also state the market value (excluding real estate investment assets used by the company itself) and the valuation methods used for its determination, together with any changes made to them. If no market value is stated in relation to the individual real estate asset, the greatest possible transparency should be achieved by stating generally applicable (e.g. DIX) regional and/or use-specific clusters that were assessed on the basis of the individual market values.

7.2.2.i

Contracts with auditors concerning additional consultancy services for real estate companies should be submitted to the supervisory board for consent if the cumulative fees due for these services exceed 50 % of the remuneration for the annual audit. Section 114 of the Stock Corporation Act applies by analogy to this extent.

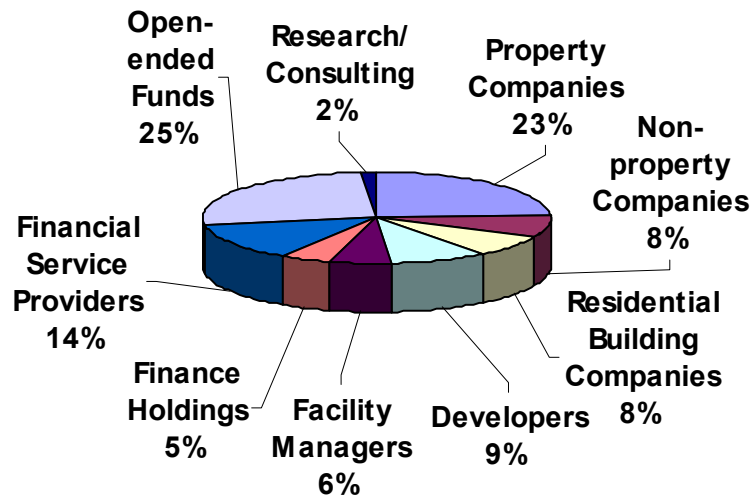
Appendix 3

Corporate Members of the Initiative Corporate Governance of the German Real Estate Industry:

- Aareal Bank AG
- Aengevelt Immobilien GmbH & Co. KG
- AGIV Real Estate AG
- ABG Allg. Bauträgersgesellschaft GmbH & Co KG
- Aurelis Real Estate GmbH & Co. KG
- AXA Investment Managers Deutschland GmbH
- Bauwert Property Group GmbH
- Bilfinger Berger AG
- Bülow AG
- CBP Cronauer Beratung Planung GmbH
- The Carlyle Group
- Clifford Chance
- Corpus Immobiliengruppe GmbH & Co. KG
- DB Real Estate Investment GmbH
- DB Services Management GmbH
- DG Hyp Deutsche Genossenschafts-Hypothekenbank AG
- DeTeImmobilien GmbH
- Deloitte & Touche GmbH
- Deutsche Annington Immobilien GmbH
- Deutsche Hypothekenbank AG
- DIFA Deutsche Immobilien Fonds AG
- ebs Immobilienakademie GmbH
- ECE Projektmanagement GmbH & Co. KG
- EPRA
- Ernst & Young Real Estate GmbH
- Eurohypo AG
- Fraport AG
- GAGFAH Gemeinnützige Aktien-Gesellschaft für Angestellten-Heimstätten
- GARBE Investment KG
- GLL Real Estate Partners GmbH
- Heidrick & Struggles Unternehmensberatung GmbH & Co. KG
- HIH Hamburgische Immobilien Handlung GmbH
- HPP Hentrich - Petschnigg & Partner KG
- IKB Deutsche Industriebank AG
- Investa Projektentwicklungs- und Verwaltungs GmbH
- IVG Immobilien AG
- Jamestown US-Immobilien GmbH
- Jones Lang LaSalle GmbH
- KanAm International GmbH
- Lafarge Roofing GmbH
- MAB Projektentwicklung GmbH
- MEAG Real Estate Management GmbH
- Oppenheim Immobilien-Kapitalanlagegesellschaft mbH

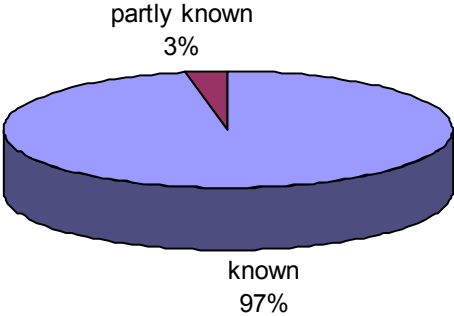
- Patrizia Immobilien AG
- PWC Pricewaterhouse Coopers Corporate Finance Beratung GmbH
- TAG Tegernsee Immobilien- und Beteiligungsgesellschaft AG
- Tishman Speyer Properties Deutschland GmbH
- TMW Immobilien AG
- Viterro AG
- Vivico Real Estate GmbH

Exhibit 1



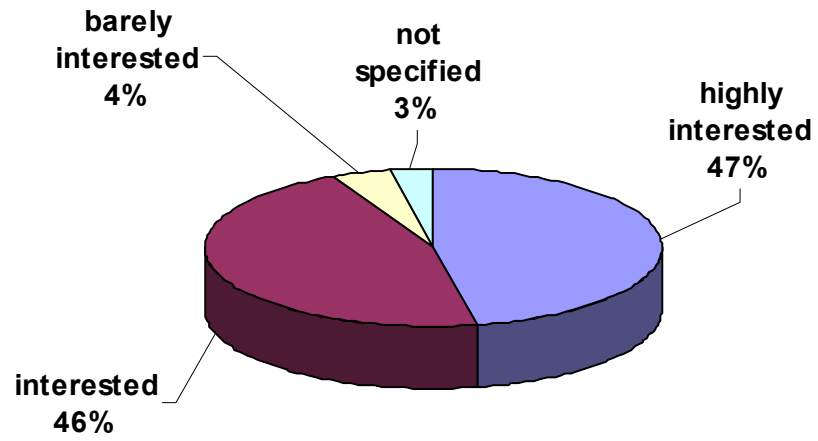
Composition of the returned 68 questionnaires according to the companies' real estate core competences

Exhibit 2



Level of popularity of the term corporate governance among German real estate companies. n=68.

Exhibit 3



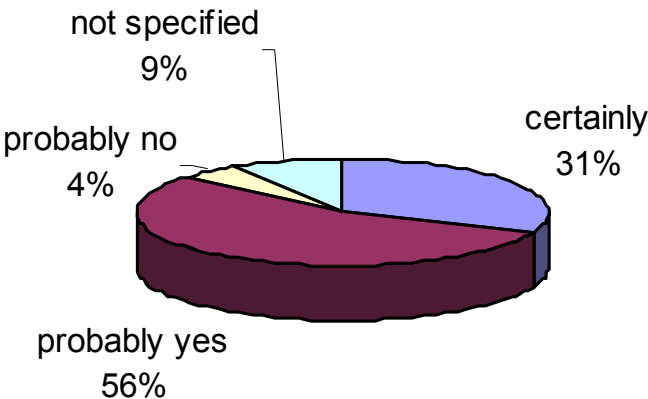
Level of interest in Corporate Governance among the 68 responding German real estate companies.

Exhibit 4



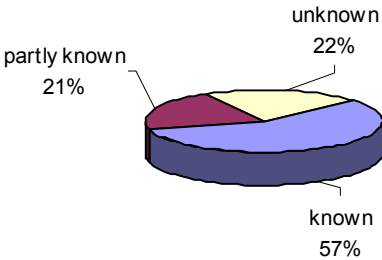
Does corporate governance play a vital role in the German real estate industry?
n=68.

Exhibit 5



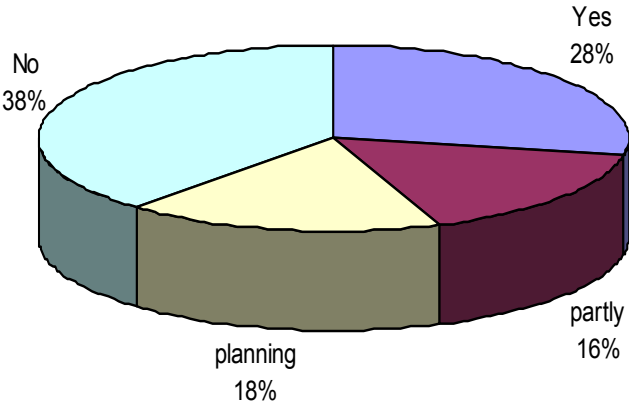
Does good corporate governance increase enterprise value in the long run? n=68.

Exhibit 6



Degree of familiarity with/publicity of the Corporate Governance Code for the German real estate industry. n=68.

Exhibit 7



Does your company have its own corporate governance principles? n=68.

What Information is from your Point of View important for a good Corporate Governance in the Real Estate Industry ?

