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Chair of Business Administration, especially Construction Business Management

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Executive Report of the Research Project

„Equity Solutions for Project Finance of PPP-Building Projects - Integration of Financial Intermediaries with special Consideration of Project Risks and Interests of Medium Sized Companies "

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Impressum

Project director and editor

Prof. Dr.-Ing. Dipl.-Kfm. Dieter Jacob
TU Bergakademie Freiberg
Faculty of Business Administration and Economics
Chair of Business Administration, especially Construction Business Management
Lessingstr. 45
09596 Freiberg
Tel.: 03731 / 39 – 40 82
Fax: 03731 / 39 – 40 92
jacob@bwl.tu-freiberg.de
http://fak6.tu-freiberg.de/Baubetriebslehre

Prof. Dr. Andreas Horsch
TU Bergakademie Freiberg
Faculty of Business Administration and Economics
Chair of Business Administration, especially Investment and Finance
Lessingstr. 45
09596 Freiberg
Tel.: 03731 / 39 - 2005
Fax: 03731 / 39 – 40 53
andreas.horsch@bwl.tu-freiberg.de
http://fak6.tu-freiberg.de/Investition-und-Finanzierung/

Co-authors

Members of the Chair of Business Administration and Economics, especially Construction Business Management at the Technische Universität Bergakademie Freiberg:
Dipl.-Kfm., Dipl.-Wi.-Ing. Armin Ilka
Dipl.-Kffr. Corinna Hilbig
Members of the Chair of Business Administration and Economics, especially Investment and Finance at the Technische Universität Bergakademie Freiberg:
Dipl.-Kffr. Juliane Boller
Employee PSPC GmbH
Dr. Klaus Riebeling

Editing

Dr. Constanze Stuhr
Chair of Business Administration and Economics, especially Construction Business Management at the Technische Universität Bergakademie Freiberg

Project Steering Group

Mr Pols	Bundesministerium für Verkehr, Bau und Stadtentwicklung
Mr Rein	Bundesamt für Bauwesen und Raumordnung
Mr Dr. Stiepelmann/ Ms Dr. Cordes	Hauptverband der Deutschen Bauindustrie e.V.
Mr Siebels/ Mr Dr. Strüver	Bundesministerium der Finanzen
Mr Prof. Dr. Robl/ Mr Heide	Zentralverband des Deutschen Baugewerbes

1 Aim of research task

The aim of this research project is to develop marketable methods of providing equity for the project finance of PPP-projects and to design the necessary parameters. The development of methods of providing equity shares is essentially based on the survey and analysis of financing and other aspects of PPP-projects, for example the PPP specific process of participation in equity as well as the project specific ability to integrate types of participation and medium sized businesses in the German market place. When observing types of equity participation one can differentiate between primary and secondary markets (see diagram 1).

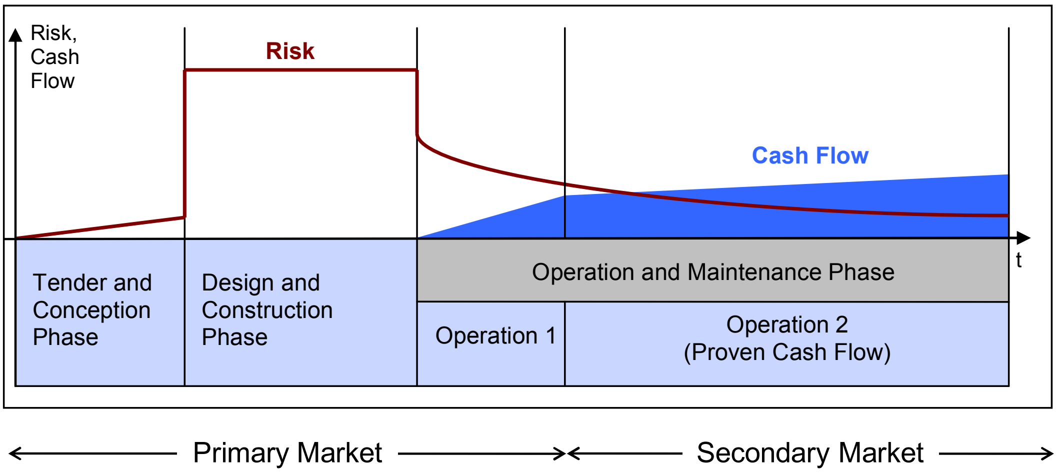

Diagram 1: Risk and Cash Flow development in the life-cycle of a PPP project (see also: Walther, Ursula – Vortrag 7. EU-Symposium, Berlin 2007)

When creating appropriate solutions under the parameters of the German PPP-market, the effects on the participation of equity need to be considered. The analysis of the parameters in Germany has taken into account the market development, the tendering of PPP projects, the PPP standardization process as well as a selection of PPP specific legislation. It is of great importance to maintain a market and implementation orientated approach in developing equity participation solutions for the new German market, which is still at a developing stage from an equity financing aspect, in order to ensure bankability of PPP projects. To satisfy this requirement, a comparative study of different countries is undertaken, in order to reflect on the developments in similar, but at the same time more mature markets. In addition, the theoretical solutions are to be expanded by way of a two stage empirical investigation (questionnaire, expert interviews of financial intermediaries).

A central aim of the report is to include results, which present tangible best case guidelines for equity participation in PPP-projects in Germany as well as describe the structure of project financed PPP-projects with the integration of medium sized businesses. The guidelines are to provide a basis to achieve further efficiency improvements, especially efficient equity based financial structures for PPP-projects.

2 Research Procedure

The research was based on two different methodological approaches. Firstly, relevant literature was analysed on a theoretical basis to determine the current fundamentals of equity participation in PPP projects at national and international level (Great Britain, Italy and France). Secondly, respective experts from sectors of a) financial intermediaries based on standardized questionnaires, and b) of medium sized businesses based on structured interviews were asked to obtain empirical evidence.

3 Summary of Results

The research report is divided into six chapters. Next to the introductory **chapter one**, **chapter two** presents the theoretical principles of methods to provide equity from external sources to finance PPP-project companies. Providers of equity are legal persons or institutions, which provide financial resources to businesses on a pro-rata, profit related, residual, open-term basis. Equity from external sources fulfils a series of typical functions such as realisation, distribution of profits, financing, representation as well as distribution of losses or allocation of liability. It can not only be provided by project sponsors as part of their every business activities, but also by external investors.

The risk-return-profile of equity invested in a business is significantly influenced by the equity base. The greater the amount of equity, the better its credit rating and debt capacity and the lower the default risk to the equity provider. However, equity providers are interested to keep the equity contribution low in order to benefit from a higher leverage ratio and maximise their return on equity. Equity providers thus will include in their negotiations as to the risk premium the amount of equity existing and their preference over leverage ratios. As a result, a robust ratio of equity to debt needs to be achieved so that the project is founded on a stable financial structure. Not least with a view to the debt service and interest payments. An investor with an equity contribution to a PPP-project finance scheme is on the one hand interested in a risk related premium and long term value increments. On the other hand he needs to be flexible enough in order to de-invest at any time. This is catered for by the existence of a functioning secondary market, which is characterised by the following factors: level of transaction costs, market liquidity, assurance of anonymity, price determination mechanism, transaction performance and transparency.

Project finance for PPP building projects will be investigated further in **chapter three**. From a European perspective, Germany is far behind when it comes to financing PPP-projects by means of project finance. Only 25 of 135 projects (18 % by January 2010) that have been awarded to date in the building sector were realized on the basis of project finance. The average investment volume was 42.5 million Euros in the classical PPP-sectors of education, administration, and justice. The majority of projects were either public sector owned or leasehold without buyer option.

The equity contributions required by debt financiers for project finance schemes were in the order of 0 to 13 %, on average approximately 7 %. In the majority of cases, the equity requirement was contributed by the sponsors involved in the operations. In some projects the equity was replaced by way of a letter of guarantee from a financial intermediary. In two projects the equity was contributed during the operating phase by financial intermediaries. In fact, equity was substituted by placement in closed property funds.

Project finance at a certain investment volume for PPP-projects can fundamentally be advantageous in comparison to finance on conditions close to public sector loans, albeit more costly, since financing structures with public sector non-recourse forfeiture compromise the principle of risk transfer over the life-cycle. The use of different types and sources of equity as well as a project specific structure of guarantees is to ensure the contractually bound repayment of debt and at the same time the return on equity required by contributors of equity (financial institutions, sponsors, financial intermediaries). The financial structure and guarantees required are determined by the risk profile of the specific project. The design and construction phase is especially risk prone, since risks in respect to ground conditions, existing structures, design, permits and construction easily lead to delay and additional costs. The operating risk in the ramping up period is highly rated as routine operations need time to establish. Once performance reliability of operations has been demonstrated, the risk profile flattens noticeably. The cash flow thus proves to be stable and robust. The risks described are largely passed through back-to-back from the project company (special purpose company – SPV) onto the contractors. During the construction phase a performance bond on behalf of the contractor guarantees the performance of construction work. Furthermore, he will provide a bank guarantee for defaults during the operating phase. With service commencement and the start of payments by the public sector client the debtor, in other words the SPV, is required to set up reserve accounts for debt repayment and maintenance reserve fund. The rights of the SPV to receive payments are forfeited to the financial institution providing debt. The contractor responsible for operations provides a performance bond.

Financial intermediaries can contribute equity or equity guarantees early in PPP-projects during the design or construction phase. As a result of legally prescribed investment limits and return-risk-profiles of most property investment vehicles the focus of investments will centre on the low risk profile operating phase with robust cash flow.

Chapter four focuses on the comparative study of countries. The PPP-market in **Great Britain** is mature with 900 PFI-projects already completed and a ratio of PPP-projects of 10 % to 15 %. A range of standardized contracts exists for PFI projects. Public sector institutions benefit from a Value Added Tax refund scheme. In the realization of PFI-projects the public sector is either owner or will purchase the PFI-facility. The majority of projects are funded by project finance, which as a rule includes the establishment of a SPV in the form of a PLC. Contractors to the SPV are generally larger construction and facility management companies. Small and medium sized companies are usually subcontractors to the larger companies. Funding is usually made up from 90 % debt and 10 % equity. Debt is either provided by banks as credit or bond issue. Equity in turn consists of a small proportion of shares and largely subordinated debt, since their interest payments are tax deductible for SPV's. Equity contributors include contractors to the SPV (e.g. Skanska, Balfour Beatty), PPP investment funds (e.g. Innisfree), banks (e.g. Bank of Scotland), insurances (e.g. AXA, Allianz) and pension funds (e.g. Greater Manchester Pension Fund). Additionally, a substantial secondary market exists for interests in PFI-SPV's. An example of a typical PPP investment fund is the *Primary Fund 2004* established by Innisfree, which comprises predominantly large institutional investors. The expectations for the return on equity are much dependant on the specific project and vary according to project phase between 6 % and 15 %. Financial intermediaries take charge of conceptional tasks, such as financial advisory services or supply management.

The PPP-market in **Italy** has achieved from today's viewpoint a reasonable level of liquidity and transparency in its history of 15 years. This has become noticeable through the statistical analysis of PPP-projects and the existence of a general information platform. PPP-projects are visibly politically supported and are legally implemented by the public sector as an alternative method of procurement. Their legal status is regularly updated and adapted. This has manifested itself again with the combination of subsidy and economic stimulus programmes with PPP-projects and underlines once more the political willingness. Positive factors seen as a requirement for participation by institutional investors in PPP-projects are high market liquidity and an advanced operating phase, to say that there exist a large number of projects with advanced operating phases. Notable in this context is the recent successful establishment of the Fondo PPP Italia as a vehicle for the participation of equity in Italian PPP-projects with contributions of European banks and development banks. Other private sector led infrastructure investors are represented in the Italian participation market. The project example illustrates an effective and efficient realization of PPP-projects and return on equity expectations are cited in the order of up to 12 % for a participating period of at least 6 years.

The PPP-market in **France** is characterized by its long term experience in the sector of transport infrastructure concessions. Only in 2002 did the realization of PPP-projects extend to the public building sector. Initially, different contract models were developed for the public sector branches, a situation which changed with the introduction of the partnership contract (Contrat de Partenariat) in 2004 to be used in all PPP building projects. Half of the projects awarded in the period from January 2004 until September 2009 were in the health sector. The financing of a French PPP-project is typically a combination of non-recourse forfeiting, project finance and equity. The proportion of equity is dependent on the technical and building complexity of the project and as rule ranges between 1 %and 15 %. The implementation of PPP-projects to realize public sector buildings is supported politically by an ongoing development of the jurisdiction. A new law was introduced in February to strengthen PPP during the persisting financial crisis, which allows for guarantees to secure financing at a value of up to 80 % of investment volume. Furthermore, the state owned Caisse des Dépôts (French development bank) has set aside so called Fonds d'Epargne (saving funds) to co-finance PPP-projects. The parameters for the participation of institutional investors in PPP-projects are positive on account of a high number of projects and respective diversification across many building sectors. Equity investments in PPP projects are either transacted by means of investment and infrastructure funds or as direct investments by institutional investors.

The fourth chapter discusses the **adoption** in Germany of lessons learned from the study of countries, separated into areas of parameters, market development and equity contribution. With reference to the parameters that were examined, it was found that in all three countries organizations were set up to support, control and evaluate PPP-projects. Concerning the public sector comparator to ensure value for money in the realization of PPP-projects it can be observed, that with an increasing deal flow the complexity reduces. In connection with the standardisation of contracts it is from Great Britain that most can be learned. By utilising standard contracts the bankability of PPP projects improves and associated transaction costs are reduced. In the development of a standard contract for the German market one should especially consider the clauses within the standard contract that refer to a change of shareholder. Additionally, in all three countries a value added tax refund scheme is in operation. This avoids the additional burden brought about by a value added tax for the public sector when awarding a PPP-project.

One can say that the market development in Britain in comparison to Italy, France and Germany is the most advanced in respect to volume and number of projects. In Great Britain and France medium sized businesses are only involved in PPP-projects as specialised subcontractors as a rule. In France, the legislator has allowed awarding authorities to make the proportion of work subcontracted to medium sized companies an evaluation criterion in the tendering of PPP-projects. Only in Italy are medium sized companies involved as operative partners at a primary level in PPP-projects and sometimes even involved as partners of the SPV, on account that there exist a large number of small PPP-projects. Project finance represents the dominant method of finance in Great Britain and Italy. In France project finance and non-recourse forfeiture are combined. Therefore, in all three countries equity is required for PPP-projects.

The market for equity contributions is most advanced in Great Britain. An explanation is that a change of shareholders is not overly restrictive and that a large number of projects have been implemented in a variety of building sectors giving rise to a mature secondary market. This, to a lesser extent, is also true for France. The study has demonstrated that in neighbouring European countries institutional equity is primarily invested in PPP-projects by means of infrastructure funds. With a view to participating medium sized companies it was not possible to identify an investment vehicle especially facilitating their involvement with PPP-projects. In summary, it is true to say that the market for participating equity in PPP-projects has developed to a greater extent abroad than in Germany. Concluding, one could surmise that on the one hand the legal parameters for PPP-participation in Germany are not yet readily developed, and that on the other hand the low number of projects has prevented a mature secondary market from becoming established.

Chapter five takes a look at the different types of participation vehicles. **Open property funds** are governed by the regulations of the German Investment law. They focus their investment activities on office buildings, hotels or retail property, which typically generate stable rental income and an expected long term increase in value. Their long term investment horizon and reliable regulation afforded by the investment law lets them appear to be in a favourable position for contributing equity to PPP-projects. Their moderate rate of return expectations and risk adverse behaviour relates favourable to the requirements for PPP-projects to rate as investment objects. However, an engagement of German open property funds as equity investors in PPP-projects has not yet materialised. Reservations, it can be argued, lie in the dilution of the portfolio, a complex and thus transaction cost intensive asset management process and a limited secondary market restricting sale opportunities. Specialist property funds are not as intensively regulated under the investment law as public property funds, since they are restricted to institutional investors, less well protected under the law. They are therefore in a position to pursue a more risk friendly investment strategy. The decision, which strategy to adopt, rests directly or indirectly with the investor himself. So far, no investment has been observed to have been undertaken in a PPP-project by such an investment fund. Such an investment could, however, occur at short notice if the investors wished to do so.

PPP-funds are equally open funds and can be divided into public funds, so called Infrastructure Special Fund according to cl. 90a InvG, and specialist funds, so called Infrastructure Specialist Special Fund according to cl. 91 InvG. They were introduced as new investment instruments in the investment law in 2007. Infrastructure Special Funds are heavily regulated under cl. 90b InvG. These regulations stipulate for the protection of individual investors that they can only invest in PPP SPV’s after the completion of the construction phase and this to a maximum of 10 % in any one SPV and thus represent a low risk class of investment. They are suitable for low risk PPP-projects such as school or administrative buildings. To support the development of Infrastructure Special Funds two amendments to the investment law have been proposed. For one, Infrastructure Special Funds should be allowed to invest up to 20 % of the value of the Special Fund in SPV's during the construction phase. Secondly, it has been proposed that a maximum of 20 % to 30 % can be invested in any one SPV. The existing limit of 10 % is not feasible against a background of only limited market volume for participating equity. Infrastructure Specialist Special Funds have no such restricted investment limits, if the investors decide as such. Investments can be undertaken in PPP-projects which are still in the construction phase. The return-risk profile is basically dependent upon whether investments are primarily undertaken in SPV's during the construction phase, during the operating phase or over the entire project life cycle. The possibility that an investor committee can exert influence over the investments of the Infrastructure Specialist Special Fund, opens up the potential to invest in more low risk friendly projects, if the investors so decide. Infrastructure Specialist Special Funds can thus invest in low risk PPP-projects such as schools or in high risk PPP-projects such as hospitals. They are especially suited as investment instruments for institutional investors such as insurances and pension funds, which want to participate indirectly in PPP-projects by way of Infrastructure Specialist Special Funds. So far, neither Infrastructure Special Funds nor Infrastructure Specialist Special Funds have been set up.

Closed property funds are set up to collect equity and to fund one or more normally known properties. They are not governed by any regulations of the investment law. For reason, only a limited number of investment opportunities exist, risk diversification is only marginally possible. In 2008, they achieved an average rate of return of 6.7 %. The investment duration is normally between 10 to 20 years and the preferred sector is traditional office accommodation. The long term robust cash flows, low volatility of PPP returns and the credit rating of the public sector as contract party render PPP-projects an attractive investment category. Administrative buildings are particularly attractive on account of their greater alternative usage in comparison to other PPP-building projects and low technical complexity of transferred operating services. The required rate of return for equity contributions to SPV's in the building sector are between 6 % and 15 %, depending on the risk profile. The purchase of shares by the investment funds and the offering of equity occur at the point of completion of the project and commencement of services. The holding represents a long term investment and an interest in a liquid or regulated secondary market for shares of closed property funds does not exist. Closed property funds are responsible even at an early stage of the tendering process for substantial services such as financial advisory services, tender management, the checking of tender documents and the negotiations with banks. Within the SPV they bear the residual value and financing risks.

While **Real Estate Investment Trusts** have already been established for a considerable time as a listed instrument for indirect property investments, they have been introduced in Germany retroactively to January 2007 with the law for establishing German property limited companies with shares listed on the stock exchange. So called G-REITs have to invest a minimum of 75 % of their assets in property or have to earn 75 % of their net income from renting, leasing and sale of property in order to be exempt from business and corporate income tax (§ 16 Abs. 1, S. 1 f. REITG). 90 % of distributable earnings have to be transferred to the investors. REIT's are primarily providing property related services and can bear a comprehensive range of risks, which are diversified across a large number of projects. Investments in PPP-projects or SPV's are generally possible, as long as they are a private company. A prerequisite for REIT's to become engaged is that the SPV holds ownership rights or real rights of usage and exclusively provides property related services. An indirect investment in PPP-projects by way of closed property funds is possible as well.

Life insurance companies are regulated by the BaFin. Assets of life insurances are categorized into fixed and free reserves. The VAG and AnlV restrict fixed reserves in respect of rating, rate of return, liquidity as well as composition and spread. Free reserves are not bound by any restrictions in respect of investments. Life insurers are therefore to be classified as conservative investors with a low return-risk profile. They follow a low risk investment strategy with an investment horizon of between 20 to 30 years. They are particularly suitable for investments after the completion of the early operating phase up to the near end of the operating phase. Their primary motive for investing in the late operating phase is to earn long term robust dividends. Thus, they are an ideal instrument to secure shares on the secondary market. An investment during the construction phase will only be undertaken when all permits have been obtained and significant risks are no longer expected. Larger insurance companies, such as Allianz, Munich Re, HUK-COBURG, AXA und Talanx prefer a direct holding. Smaller insurance companies tend to invest in PPP-projects indirectly (for example via Infrastructure Specialist Special Fund) as they do not possess the critical mass in order to build up and maintain their own asset management resource. Life insurances have so far not become active in the German market as from their perspective no attractive PPP-projects have yet been available.

The **urban renewal funds** which have been set up under the European initiative JESSICA with revolving assets have reached an advanced stage of preparation in Germany and are expected to undertake their first projects in 2010. The responsibility for their implementation in Germany rests with the states, and take on different structures with a range for activities limited to the state boundaries. The idea of urban renewal funds is similar to that of PPP-projects. The combination of public sector funds with private sector equity in the shape of a fund is aimed at equity contributions to commercially non viable urban renewal projects. A lack of practical experience allows a judgement as to their suitability as equity contributors to PPP-building projects only to be taken at a theoretical level. That they become involved can not generally be excluded from today's standpoint. An important prerequisite will be, what returns on equity PPP-projects can be generated and how robust these will be.

Real Estate Private Equity (REPE) and the securitized type of **REPE-funds** are categorized as high risk. As investors they are not bound by any specific regulations and are therefore especially flexible on the equity market and can pursue short term and individual investment strategies. They primarily invest in projects with a high potential of value growth and correspondingly of high risk such as office accommodation in 1b-locations, property with poor rental conditions and hotels threatened by insolvency. Their return expectations are high. At the same time they are not only risk friendly but also able and willing to contribute smart money (especially management services for their investment projects). With a time horizon of three to five years they concentrate however on projects with a rather short term potential of value growth, which relates to PPP-investments that are green-field or new-build during the construction phase only. Their suitability as contributors of equity for PPP-project financing is thus clearly restricted.

The **income tax treatment of PPP-holding vehicles** is dependent on their legal status and their related restrictions. Closed property funds, leasing funds and private equity funds are usually set up as private companies. Private companies are not themselves subject to income or corporate income tax. The so called transparency principle is followed. Private companies however, are themselves subject to the business tax as long as they are commercially active and not only provide asset management services. A requirement for business tax can be induced by a commercial nature. The income tax treatment of open property funds and PPP-funds is regulated in the investment law. Special funds are treated as tax neutral special purpose funds from a tax point of view, which means that they are exempt from both corporate income and business tax. Equity investment companies are established as public limited or limited companies and are thus treated as corporate companies. The income tax treatment of Real Estate Investment Trusts is regulated in the REIT-G. As long as REIT's fulfil the requirements according to cl. 8 to 15 REIT-G, they are exempt from both corporate income and business tax. Insurances and pension funds are usually exempt from corporate income tax.

To begin with **Chapter six** describes those services that are provided by financial intermediaries involved in the PPP participation process. Services most suited for financial intermediaries are financial advisory, negotiation with banks, economic and legal appraisal of tendering documents and project proposals, financial documentation and tender management. The services provided are considered to be as relatively influential in determining the competitiveness of the bidding consortium.

Afterwards, the profile and requirements that medium sized companies have to meet when involved in the realisation of project financed PPP-projects are presented. Medium sized companies do not normally posses specific commercial expertise in the area of project finance. They can manage independently investment volumes of up to 20 million Euros and are capable of contributing equity for the construction phase. In order to set up a competitive consortium with medium sized businesses a capable equity partner should bring along specific commercial knowledge of project finance and contribute equity at the latest with the commencement of the operating phase during the life cycle of the PPP-project. Additionally, he should generate investment volumes suitable for medium sized businesses of up to 20 million Euros.

Subsequently, the PPP-participation vehicles introduced in chapter five are investigated, in order to judge their appropriateness when working in cooperation with medium sized companies. With the amendment of the investment law in 2007 open property funds were allowed to participate in PPP-projects by way of investing in the right of usufruct of property, which are used in the fulfilment of public sector duties. A lack of investment opportunities in projects of sufficient investment volume (approx. 100 million Euros) as well as the absence of a secondary market for PPP-holdings means that PPP are unattractive for initiators of open property funds. For the reason of demanding requirements, as to volume and expertise of operative partners, a cooperation with medium sized companies is not to be expected.

PPP-funds, in contrast, could be valuable strategic partners for the cooperation with medium sized companies, as long as they will be set up and invest in projects of suitable size for medium sized companies. The investment law requires that the managers responsible must have extensive knowledge in the area of PPP-projects funded by project finance. Closed property funds are based on their long term investment horizons and extensive services in the PPP-sector, partners equally suitable for medium sized businesses. In contrast to PPP-funds, early practical experience exists. REIT's were introduced in Germany as late as 2007, so that the market is at a very early stage of development. In the long term, participation in PPP-projects is possible as a low risk addition to the portfolio. PPP-investments are currently, however, not part of the investment focus. As PPP expertise is missing, one does not expect these to be appropriate for the cooperation with medium sized companies.

Smaller insurance companies and pension funds could be appropriate indirectly for cooperating with medium sized companies, in order to establish participation instruments (as for example a PPP-specialist fund) in the market. Larger insurance companies and pension funds do not focus on investment volumes that are appropriate for medium sized companies and are thus not normally suited for the cooperation with medium sized companies.

In making an investment decision, Real Estate Private Equity funds require a high rate of return, short investment durations of up to six years and the opportunity to sell a holding on the secondary market. A holding by REPE-investors is possible during the project development phase, which means for the duration of tendering, design and construction.

A special case of participating holding vehicles are urban renewal funds. These invest on behalf of the public sector and could also facilitate the realization of small projects appropriate for medium sized companies.

Chapter six finally investigates the opportunity and potential of incorporating medium sized investment companies and development banks. Medium sized investment companies do not invest directly in SPV's, but solely in medium sized businesses. They usually become involved as sleeping partners. In some cases, where it appears to be appropriate, they partake openly. Projects with a small volume of investment are usually not attractive to financial intermediaries, so that medium sized companies lack a partner for the contribution of equity. This is a situation where development banks are in a position to take on a key role in setting up, for example, a public PPP-fund, which is to invest in small projects and allows companies after the completion of the construction phase to reinvest their equity in new projects.