Residential Market Germany - December 2023

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Savills Research

Opportunities and risks in the German residential market

Fundamentals ● Consequences of regulation ● New construction yay, existing buildings nay?

Opportunities and risks in the German residential real estate market

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“Housing is a constant requirement” is a common and quite correct phrase in the real estate market. However, demand on the investment market for residential real estate is currently subdued. Many institutional investors in particular seem to have turned their backs on the market for the time being. But is it advisable to refrain from further purchases of German residential real estate, even if it is only temporary? What arguments are there for continuing to invest in German residential real estate and what risks are there on the market? In the following, we summarize what we believe are the key points from the perspective of risk-averse long-term investors.

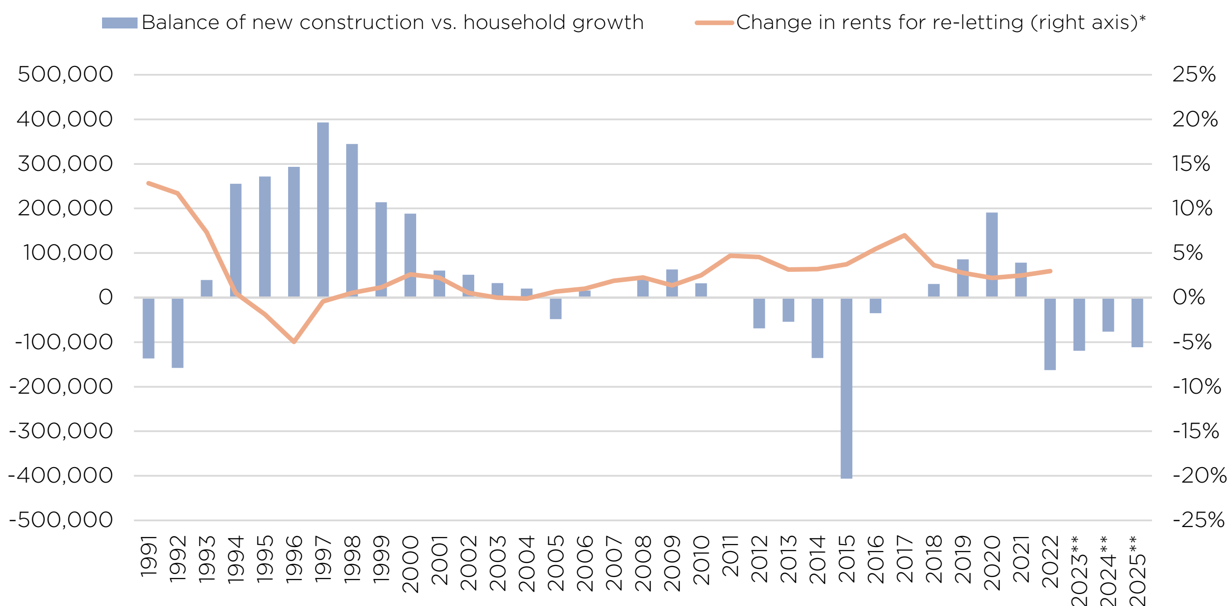
Residential property for risk diversification

First of all, residential real estate can be considered as a potential investment simply in terms of risk diversification within multi-asset portfolios. Residential real estate investments have a low long-term correlation with the bond and stock market. This has been the case in the past and will most likely continue to be the case in the future. The size and relative importance of the asset class can also be an argument for residential real estate investments. According to the Federal Statistical Office, the net fixed assets of German residential buildings amounted to more than 7.5 trillion euros last year. Even after deducting owner-occupied residential properties, residential buildings are likely to make up the largest position in the German economy’s fixed assets. An investment in residential property therefore represents a stake in the most important tangible asset of one of the world’s largest economies. As only around 4% of German rental apartments are owned by listed residential real estate companies, there is hardly any way around direct investments or participation in real estate fund vehicles when investing in the residential market.

Unprecedentedly stable earnings

German residential property also promises continuous monthly rental income. In the past 30 years, Germany only experienced a multi-year phase of falling new contract rents in the mid-1990s. Stimulated by government subsidies, a construction boom set in during this period and significantly more apartments were completed each year than households were added (Graph 1).

Graph 1: Rental development in the 127 RIWIS cities vs. relative construction activity



Source Bulwiengesa, Savills / * in the 127 RIWIS cities; weighted by market size (number of households); ** number of completed units according to forecast by ifo Institut; own estimation of household growth

> "There is virtually no downside risk to residential rents over the next few years. With the exception of very creditworthy government bonds, hardly any other asset class offers such downside protection of the incomes."

A massive increase in supply was therefore the decisive factor for falling new contract rents. In contrast, the last twenty years have been characterized by below-average construction activity in a long-term comparison. Overall, more households joined the housing market than residential units were completed. As a result, the average of the 127 RIWIS cities has not seen a fall in new contract rents in a single year since 1997 and vacancy rates have fallen to well below 2% in many housing markets.

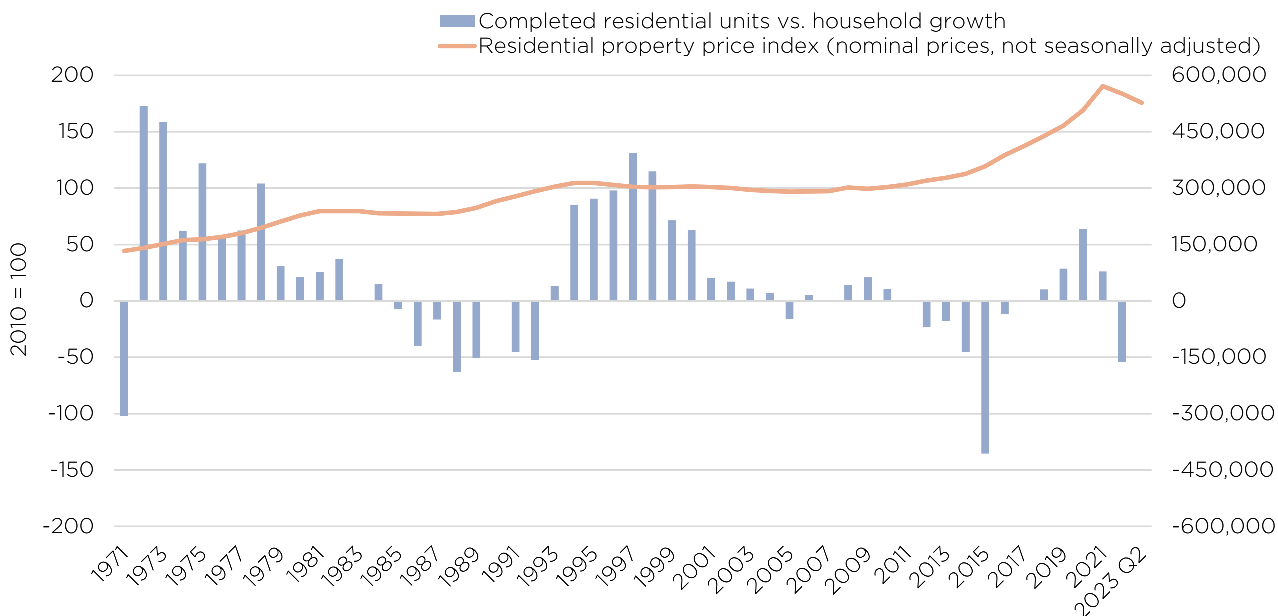
The scenario of excessive new construction activity can also be virtually ruled out for the coming years. While the shortage of housing is greater than it has been for decades, significantly fewer new residential construction projects are being started and many projects that have already been initiated are being postponed or canceled. The number of residential building permits from January to August 2023 was around 28% lower than in the same period last year. At the same time, according to the ifo Institute, around 22% of residential construction companies reported canceled orders in October, which is the highest figure since records began in 1991. Accordingly, the ifo Institute assumes that the number of completed apartments will fall to just 175,000 by 2025. The vacancy rates, which are already very low in many places, are therefore likely to fall further, reducing the risk of structural vacancies in many portfolios to a minimum. From the perspective of risk-averse long-term investors, there is therefore virtually no downside risk to new contract rents over the next few years. Instead, they can expect rents to rise in the long term. A fall in rents for existing contracts is practically impossible anyway. In a tight rental market with an average fluctuation rate of only around 5%, which may fall even further due to shortages, investors can therefore be sure that their income will at least remain stable in the long term.

With the exception of government bonds with very high credit ratings, hardly any other asset class offers such long-term downside protection. Unlike long-term government bonds, German residential real estate even promises potential for rent increases during the holding period. This makes residential real estate an attractive defensive investment in multi-asset portfolios. The fact that housing is and will remain a non-substitutable basic need also contributes to the defensive character of residential real estate investments. The residential sector is therefore not subject to any relevant transformation risk, in contrast to other economic sectors such as brick-and-mortar retail or the automotive industry.

Sharpest price correction in recent history offers a unique opportunity to enter the market

While the fundamental conditions are extremely robust, prices on the residential investment market have fallen sharply. This is the sharpest price correction in recent history (Graph 2). The low-interest phase of the past market cycle has led to a reallocation of capital into real estate and thus also to a long-lasting and at the same time exceptionally steep rise in residential property prices. In our view, the current decline in house prices is therefore purely interest rate-induced. However, a look at price trends over the past fifty years makes it

Graph 2: Residential property prices vs. supply-demand ratio



Source Bank for International Settlements / Federal Reserve Bank of St. Louis, Bulwiengesa, Federal Statistical Office

-27%
Average prices for multi-family houses have already fallen by around 27% in real terms compared to the last high.

clear that the historically unique phase of sharply rising prices was not only driven by interest rates, but was also fundamentally underpinned in view of the below-average volume of new construction.

The fact that the fundamental supply shortage will even worsen in the short term counteracts the interest rate effect. This could mean that the current downturn in the housing market is shorter than previous periods of falling prices. The downturns in the mid-1980s, the second half of the 1990s and the first half of the 2000s lasted between 15 and 27 quarters (Graph 3). The current decline in prices began in Q3 2022, i.e. only around five quarters ago. From our perspective, it seems unlikely that the price correction on the housing market is already over. However, the slump in residential construction and the prospect of further declines in vacancy rates suggest a faster recovery than in the noughties.

It is clear that the sharp price correction is creating an almost unique opportunity for investors to enter the market. According to data from the Bank for International Settlements and the German Real Estate Index (GREIX), average prices for apartment buildings in Germany have already fallen by around 27% in real terms compared to the last high. Although further price declines are possible, capital values are likely to rise again in the long term given the scarcity of housing as a commodity. In a study, Deutsche Bank points out that residential real estate prices in Germany typically rise in line with inflation in the long term. According to the authors, there must be special circumstances when prices in an economy as a whole rise sharply and stagnate or fall in the long term in what is in many respects the most important asset class with the highest investment volumes.

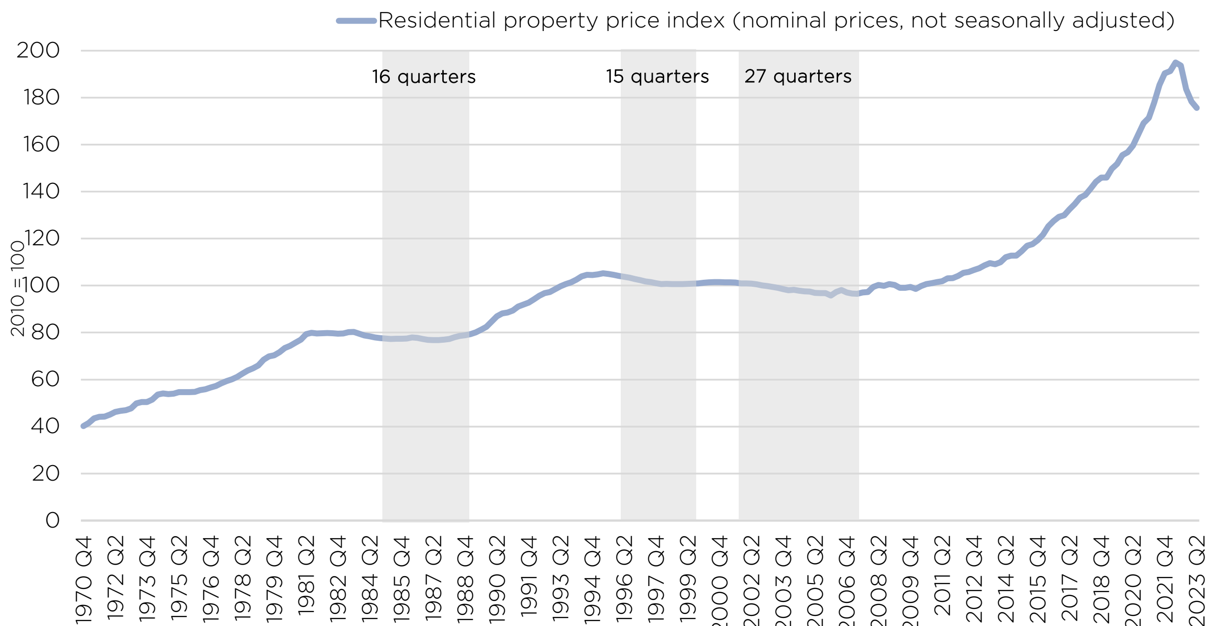
This means that a window of opportunity has opened up for investors to purchase German multi-family homes for capital values that in retrospect probably appear low. This applies in particular to existing properties, where the capital values are usually far below the production costs for new-build properties. However, this window of opportunity could close again relatively quickly. In any case, long-term investors are acquiring a product with virtually no downside risk in terms of income and even the prospect of rising rental income in the long term.

Regulation - a double-edged sword

After looking at the supply-demand ratio, there can in principle be no doubt that German residential real estate is a defensive core investment. However, there is one major risk factor in the German residential market: regulation.

Strong regulation is a double-edged sword from the perspective of risk-averse long-term investors. Strong regulation of rents tends to inhibit supply. It is therefore also likely to have played its part in the fact that the supply shortage intensified from 2015 in particular and strong rent and purchase price increases were observed on the market. This is because it was in 2015 that the rent cap ("Mietpreisbremse") was introduced in Germany. This marked something of a prelude to further regulatory tightening, such as the reduction of the modernization levy and capping limit ("Kappungsgrenze") or the extension of the observation period for rent indexes. Such measures reduce the potential for rent increases in the housing stock and thus cap investors' returns. Keeping rents low through regulation also ensures an inefficient distribution of housing as a commodity and encourages high consumption of living space. The inefficient utilization of the housing stock is therefore a major cause of the supply shortage. From the perspective of risk-averse investors, strong regulation of rents is the basis for protection against declining returns.

Graph 3: Previous downturns in house prices in Germany



Source Bank for International Settlements / Federal Reserve Bank of St. Louis

> "The less accessible the regulated stock is for households wishing to move, the more demand is likely to shift to the unregulated part of the market and drive up rents there in the long term."

The rent cap does not apply to residential buildings built after October 2014, meaning that the current regulatory framework divides the market into a regulated and a more or less unregulated part. From an investor's perspective, the two parts of the market differ considerably.

Capped potential for rent increases in the regulated housing stock

The strong regulatory protection of existing tenants coupled with the low volume of new construction has led to a significant rent gap between rents in existing and new contracts. As a result, relocations for tenant households - even if the living space is reduced - are generally associated with significantly higher rental costs. As a result, the frequency of moves has decreased. In the Berlin portfolios of the member companies of the Association of Berlin-Brandenburg Housing Companies (BBU), the fluctuation rate in 2021 was only 5.3% (Graph 4). We consider similarly low fluctuation rates to be realistic in many other tight housing markets.

From an investor's perspective, this means that a new lease can only be signed every 19 years on average, which slows down rent increases in the portfolio. According to the last microcensus, the average net cold rent in urban districts was €7.20 per sq m /month in 2022. In the 2018 microcensus, this figure was €6.60 per sq m /month. Although these two figures cannot be compared on a one-to-one basis due to changes in methodology, the results are a good indication of moderate overall increases in existing rental agreements given the respective sample sizes. In addition, the microcensus also includes households with new leases in the calculation, which means that the average amount and rate of increase in existing leases is likely to be even lower. Due to the lower frequency of relocations, fewer new leases are included in the calculation of the rent index, which dampens the increase in the rent index rents or the so-called local comparative rent. This results in a positive feedback loop, so to speak, which additionally limits rent increases in existing contracts.

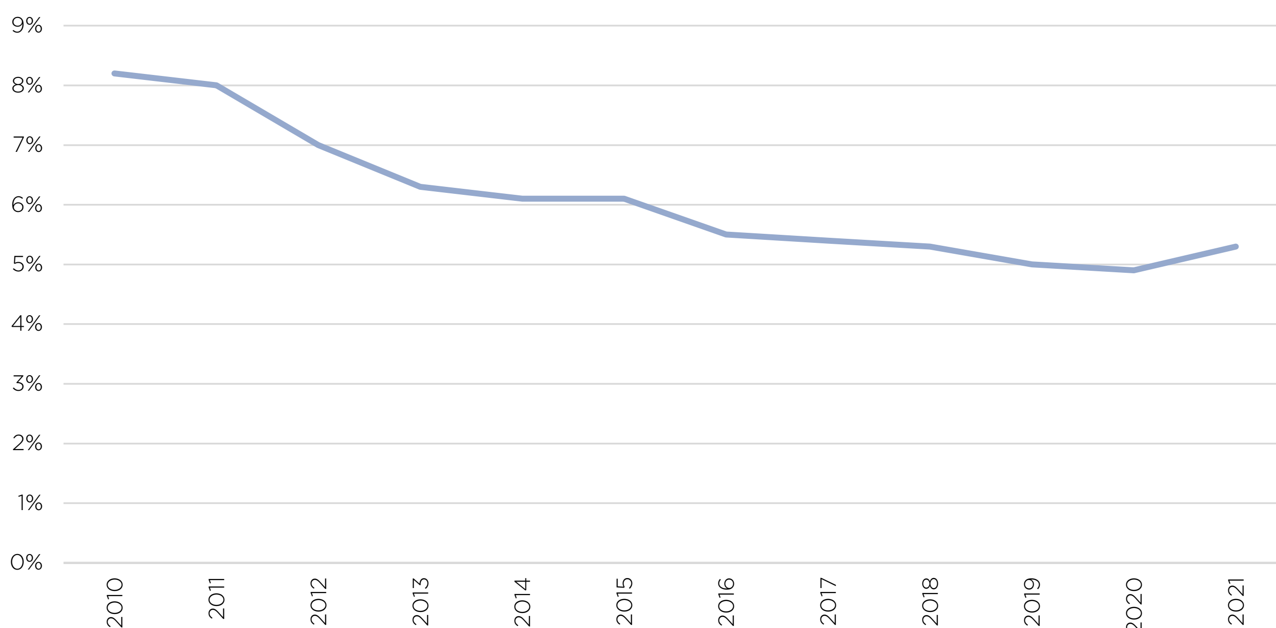
Lock-in effect in the regulated housing stock drives rents in the unregulated part of the market

In view of the low rate of new construction, an increase in fluctuation currently seems unlikely, meaning that existing and new rents are likely to diverge further. The further increase in the rent gap is likely to further reduce the willingness to move and reinforce the lock-in effect on the housing market. Housing is already inefficiently distributed in Germany today - according to a study by IW Cologne, 6% of households in major cities tend to live in apartments that are too large and another 6% live in overcrowded apartments. The less accessible the regulated stock is for households willing to move, the more demand is likely to shift to the unregulated part of the market and drive up rents there in the long term. According to reports from large portfolio owners, fluctuation is also noticeably higher in new builds and index-linked or graduated rental agreements are more common. Investors who focus on buying new builds can therefore benefit from the strong regulation on the German housing market.

The biggest risk on the income side is the unpredictability of the regulator

In view of the high inflation rate, the conclusion of index-linked rental agreements has presumably become more popular with landlords recently. However, there were immediate calls from politicians for index-linked rents to be regulated. This brings us to what we see as the real risk for risk-averse

Graph 4: Fluctuation in Berlin (in the portfolios of BBU member companies*)



Source BBU Verband Berlin-Brandenburgischer Wohnungsunternehmen e. V. / * represent 44% of all rental apartments in Berlin

> A look back at the 20th century shows that politicians have always intervened massively in the market in times of major housing shortages. Should there be further rent regulation, new builds are likely to be largely excluded once again.

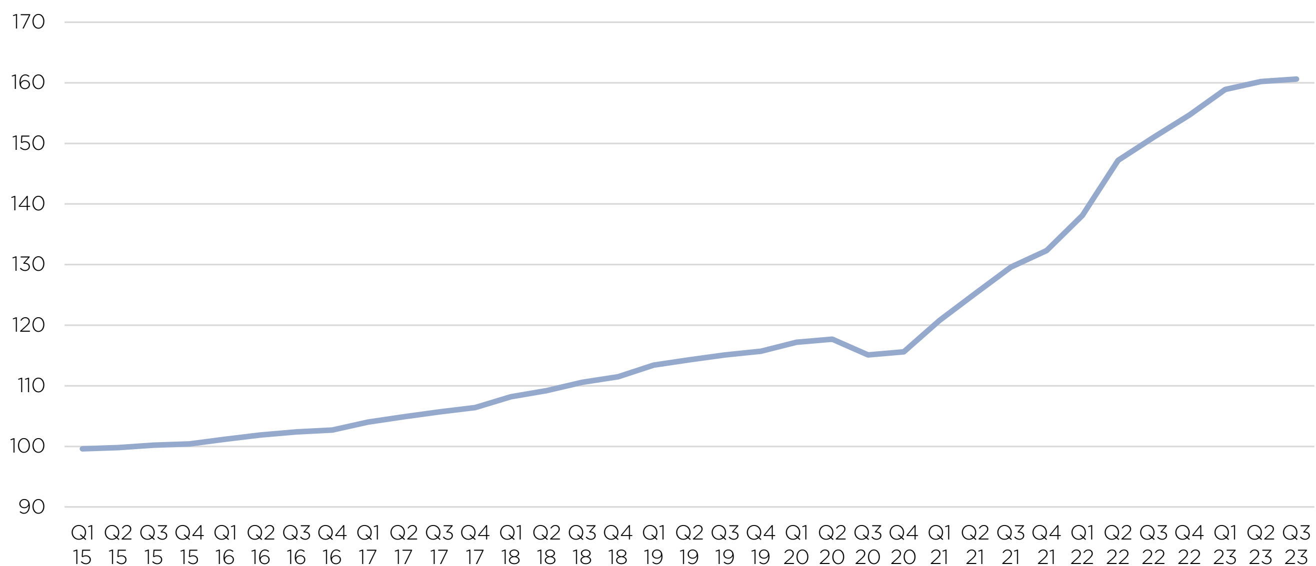
investors: the unpredictability of further regulation of the market. In the summer of this year, the SPD parliamentary group called for a three-year nationwide rent freeze and the public debate on housing can be described as heated. According to a survey by R+V Insurance, 60% of Germans are afraid that housing will become unaffordable. This makes it the second biggest fear among the population. Such a widespread fear of no longer being able to afford one of the most basic needs is socially explosive and will put increasing pressure on politicians to act. A look back at the 20th century shows that politicians in Germany have always intervened massively in the market in times of major housing shortages, whether by capping rents or through massive subsidies for new construction. In view of the high construction costs, a massive subsidy for new construction on the part of the federal and state governments seems unrealistic to us at the moment, especially as other political departments are also calling for more funding. In addition, the limited capacities of the construction industry are likely to stand in the way of completions of well over 400,000 residential units per year, as even when the construction industry reported full capacity utilization, housing completions remained noticeably below this mark. One alternative from a political perspective could therefore be a further restriction on rent increases. Although this would not solve the problems on the housing market, it could be seen as a "gift" to a broad electorate. Concrete plans for further regulation of existing or even new contract rents are not currently publicly known. However, if there is further rent regulation, new builds are likely to be largely excluded once again, as politicians cannot in principle risk a further decline in new build activity. In such a scenario, the division between the regulated and the largely unregulated part of the market would become even more pronounced.

Rent regulation and rising costs - a toxic mix?

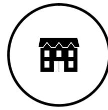
The regulatory cap on rent increases in the housing stock is particularly critical in the face of rising costs. For example, prices for the maintenance and repair of apartments have risen by almost 13% within twelve months (as at September 2023). Although falling order backlogs at construction companies will presumably provide some relief, construction costs (Graph 5) are not expected to fall significantly.

In the long term, the worsening shortage of skilled workers is likely to have a price-driving effect, both in the case of modernization and maintenance measures and in facility management. As a result, costs in the regulated part of the market could rise faster than rental income in the coming years. This will reduce the profitability of letting apartments in this part of the market.

Graph 5: Construction price index for residential properties (indexed; 2015 = 100)



Source Federal Statistical Office



16 %

Around 16% of German multi-family buildings have energy efficiency classes G or H and are therefore exposed to the risk of a regulatory refurbishment requirement.

Additional costs due to energy-efficient refurbishment and CO_2 levy

Particularly in the case of existing properties with below-average energy quality, landlords face additional costs. It is clear that a higher renovation rate of existing buildings is necessary to achieve the European climate goals. The European Union and many scientific studies have concluded that the focus should initially be on the buildings with the poorest energy performance, the so-called worst performing buildings. In Germany, this would probably initially affect buildings in energy efficiency classes G and H. Around 16% of German multi-family buildings have such energy efficiency classes (Graph 6) and are therefore exposed to the risk of a regulatory refurbishment requirement.

It is currently unclear whether, in what form and when the European Union will impose some kind of mandatory refurbishment. Nevertheless, there is a cost risk for such properties, especially as there are also political demands for a further cap on the allocation of modernization costs. For risk-averse investors, residential properties in efficiency classes G and H are therefore likely to be ruled out as investments for the time being. However, if there is a kind of mandatory refurbishment, we do not believe that it would be in the interests of politicians to write off around 16% of the multi-family housing stock in principle. This would result in two possible scenarios. In the first scenario, mandatory refurbishment would be accompanied by extensive support measures or tax incentives. In this case, efficiency classes G and H could also become investable again, especially as the preservation of existing buildings and the avoidance of embodied carbon could also contribute to the sustainability goals of many investors. In addition, given the lower capacity utilization of construction companies, more construction capacity should be available for renovating existing buildings, at least in the coming years.

In the second scenario, mandatory refurbishment goes hand in hand with a demolition ban, either to secure the supply of housing or with the aim of avoiding additional embodied carbon. In such a case, landlords would face high and unavoidable costs and investors should immediately consider the sale of any respective portfolio properties in such a scenario.

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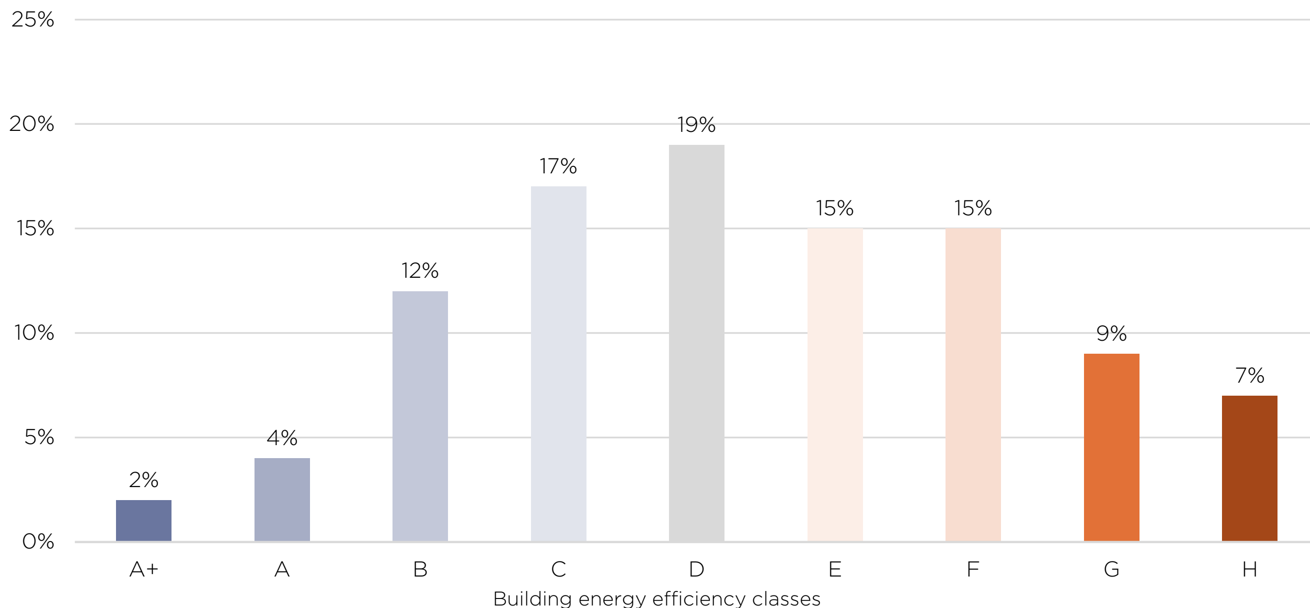
Irrespective of possible refurbishment requirements, owners of older existing buildings are already faced with additional costs. Since the beginning of 2023, the CO_2 levy has been split between landlords and tenants depending on the building's CO_2 emissions. While the landlord does not have to bear any of the costs for the most energy-efficient buildings - usually new buildings - the landlord bears up to 95% of the CO_2 levy for the worst performing properties. There are exceptions in the case of listed buildings and district heating connections, for example. In practice, the impact of this taxation on profitability also depends on the micro-location and the achievable rent level. According to a model calculation, the CO_2 tax can account for around 1% of net operating income for a typical old multi-family building in a good location in Berlin with high achievable rents. For unrenovated 1960s buildings in regions with low rent levels, however, the levy can easily amount to 5% to 10% of net operating income and thus mean a considerable reduction in profitability, especially as the price of emission certificates will rise.

Graph 6: Multi-family stock by energy efficiency class



Source Prof. Dr. Sven Bienert based on Bundesministerium für Wirtschaft und Energie (2020)

“In our opinion, the current situation in the unregulated part of the housing market is exceptionally investor-friendly.”

Summary: New construction yay, existing buildings nay?

In view of the fundamental data and the regulatory environment, we believe that German residential real estate remains a defensive investment for risk-averse long-term investors. In particular, the combination of a de facto hedge against declines in income on the one hand and the prospect of increased income during the holding period on the other is unparalleled. In the regulated part of the market, however, there is a latent risk of further limits on rent increases. In the case of older existing properties with poor energy efficiency classes, there is also a cost risk. If investors already have such properties in their portfolio, it may be advisable to hold them for the time being and wait for future regulations. Purchasing such properties, on the other hand, requires a greater acceptance of risk.

The situation in the unregulated part of the market is completely different. This part of the market is likely to become even more attractive for investors in the event of stricter rent regulation. As an excess of new construction activity seems unlikely in the future, the lack of supply on the housing market is also likely to be cemented. In our opinion, the current situation for the unregulated part of the market is therefore exceptionally investor-friendly.
In our opinion, the prospect of remarkably secure and even rising rental incomes could also lead to a lower yield spread between residential real estate and long-dated German government bonds in the future than in the past market cycle.

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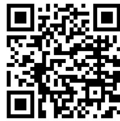

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