Germany's privately held property firms reap gains from investment strategy

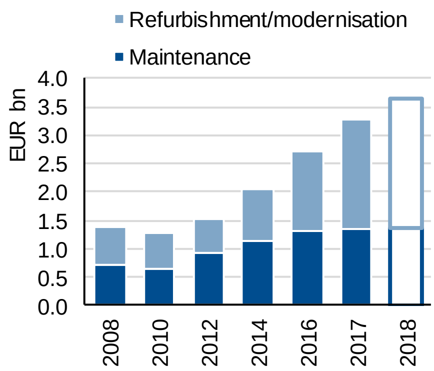
Germany's largest private-sector, residential real estate firms have almost tripled spending on maintenance and refurbishment since 2008, leading to gains in rents and property values that have outpaced the rest of the market, inflation and the wider economy.

Spending by the 20 largest German housing companies that form part of this study rose to around EUR 3.6bn in 2018 from EUR 1.4bn 10 years earlier. The increase in investment is predominately driven by the top 10 privately owned companies that invested EUR 2.6bn in 2018 - representing a threefold increase since 2008. The reason: Investing in existing property portfolios currently offers better returns than buying new holdings and helps maximise asset values. In contrast, the top 10 state-owned companies invested around EUR 1.0bn, little changed in the period.

Private-sector firms have taken advantage of German regulations which allow landlords to increase rents beyond rental limits – such as the Mietpreisbremse or 'rent cap' – if they modernise and refurbish their housing stock. If they do so, they can increase rents for tenants by up to 11% of the refurbishment costs or let at market rents for new tenants. That maximum was lowered to a baseline of 8% at the start of 2019.

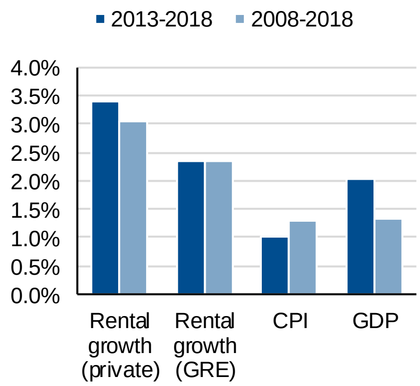
The new, less generous regulations are a response to relatively steep rent increases in urban areas. They, in turn, reflect the lack of any significant pick-up in construction activity to relieve pressures on the housing market. Occupancy rates are rising, at above 96% for the privately held and publicly controlled companies that Scope tracks.

Figure 1: Total spending on maintenance and refurbishment (EUR bn)



Source: Scope

Figure 2: Weighted average annual rental growth versus CPI and GDP*



Sources: DESTATIS, Scope

The value-focused strategy of German real estate firms is clear from our analysis of 20 of Germany's 25 biggest residential property companies by number of residential units. That shows that overall yearly spending on maintenance and refurbishment rose by around three times to EUR 3.6bn in 2018 from EUR 1.4bn in 2008, equivalent to EUR 35 per sq m compared with EUR 24 in 2008.

What separates privately held companies such as Vonovia S. E., Deutsche Wohnen AG, LEG Immobilien AG, Vivawest GmbH and TAG Immobilien AG – just to name the five biggest – from publicly controlled rivals is their success in extracting gains in yearly rental income well above German inflation and GDP growth between 2013 and 2018. Rental gains have proved much more modest for state owned residential real estate companies.

* CPI = Consumer Price Index
GDP = Gross Domestic Product
GRE = Government Related Entity

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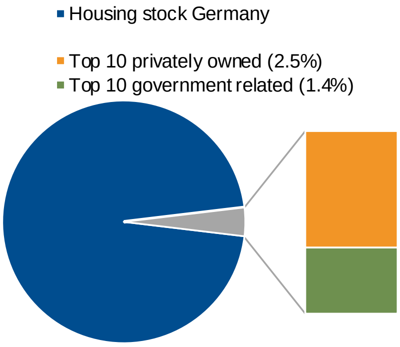
Figure 3: Housing stock Germany



Sources: DESTATIS, Scope

The private-sector companies' success represents the fruits of their hefty investment in maintenance and especially refurbishment in the past five years, well ahead of the rest of the residential real estate sector. Refurbishment made up more than two thirds of such investment in 2018, up from less than half 10 years earlier.

Low vacancy rates, running at less than 4%, are another reason why property companies have focused on increasing rents, usually by one of three main methods. First, companies can take advantage of the vagueness of the rent cap regulation which limits increases on re-lettings to 10% in tight local rental markets based on a local reference rent which varies from area to area. Secondly, they can side-step rent caps by investing in the modernisation of the homes in question. Thirdly, they can include furnishings as an extra but mandatory part of the rental agreement. Tenants have challenged landlords over alleged breaches of the Mietpreisbremse in some instances, but such challenges remain very rare, with court decisions not necessarily going in the tenants' favour (Figure 6).

Strategic shift at top privately held property companies pays off

The German residential real estate market began to consolidate in the early 2000s. By 2018, the number of apartments owned by today's top 10 privately held German firms had increased to above one million, up from around 300,000 in 2008.

Figure 4: Largest residential landlords in Germany (sorted by residential units)

Company	GRE	residential units (thousands)	Scope's peer group	Core market in Germany
Vonovia S.E.		358	yes	Dresden
Deutsche Wohnen AG		164	yes	Berlin
LEG Immobilien AG		134	yes	Dortmund
SAGA Unternehmensgruppe	yes	133	yes	Hamburg
Vivawest GmbH		122	yes	na
TAG Immobilien AG		84	yes	Salzgitter
Grand City Properties S.A.		83	yes	Berlin
degewo AG	yes	66	yes	Berlin
ADLER Real Estate AG		61	yes	Wilhelmshaven
GEWOBAG	yes	60	yes	Berlin
HOWOGE GmbH	yes	60	yes	Berlin
Nassauische Heimstätte mbH	yes	58	yes	na
ABG Frankfurt Holding	yes	52	yes	Frankfurt
Stadt und Land mbH	yes	44	yes	Berlin
GAG Immobilien AG	yes	44	yes	Cologne
GWH Immobilien Holding GmbH	yes	44		na
GEWOBA AG	yes	42	yes	Bremen
Covivio S.A.		41	yes	Berlin
GESOBAU AG	yes	39	yes	Berlin
WIRO Wohnungsgesellschaft mbH	yes	35		Rostock
LWB mbH	yes	35		Leipzig
GEWOFAG Holding mbH	yes	34		Munich
Dawonia Real Estate GmbH & Co. KG		29		Munich
ADO Properties S.A.		22	yes	Berlin
Akelius AB		22	yes	Berlin

Source: public information on peer group, Scope

However, their market share made up only 2.5% of the overall German housing stock with more dominant exposure in their respective core markets (e.g. Vonovia S.E. – 13%

in Dresden; Deutsche Wohnen AG – 6% in Berlin; LEG Immobilien AG – 4% in Dortmund; TAG Immobilien – 17% in Salzgitter).

The top 10 government related residential real estate corporates had fairly stable portfolio sizes, increasing slightly to 600,000 by end-2018 from 560,000 in 2008, representing a market share of 1.4%. We expect a steeper increase in the years to follow, boosted by the growing development pipeline at these companies as well as public and political pressure (e.g. Nassauische Heimstätte Wohnungs- und Entwicklungsgesellschaft mbH 4,900 units, HOWOGE Wohnungsbaugesellschaft mbH 4,600 units, SAGA Unternehmensgruppe 10,000 units).

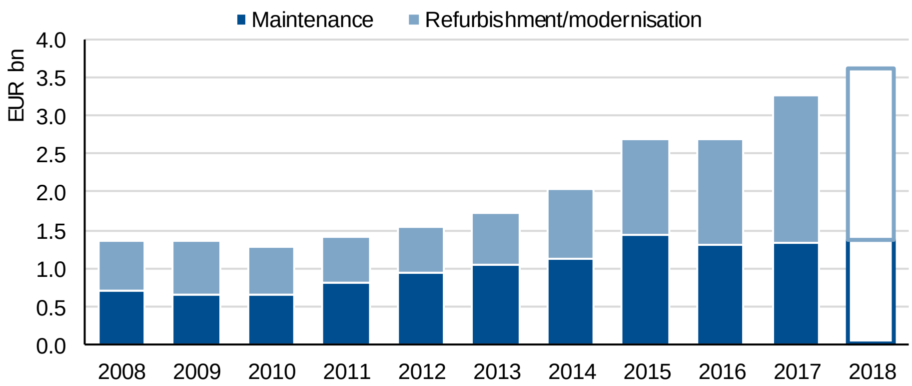
1.7 million residential units owned by largest landlords in Germany

The total number of units owned by Scope's peer group (Figure 4) amounts to 1.7 million. These units are predominantly located in urban areas, given that the average area of units in their portfolios is around 63 sq m compared with the national average of 92 sq m. The supply-demand imbalance in urban areas is growing, encouraging both privately and state owned companies to invest heavily in their portfolios.

Spending on existing stock climbed to EUR 3.6bn in 2017

Investments by Scope's peer group climbed to EUR 3.6bn in 2018 (EUR 35 per sq m) from EUR 1.3bn to EUR 1.5bn per annum between 2008 and 2013. However, the investment behaviour of privately held companies differs materially from their government related counterparts.

Figure 5: Spending on maintenance and refurbishment/modernization/new construction



Source: Scope

Top 10 privately held residential corporates spent EUR 41 per sq m)

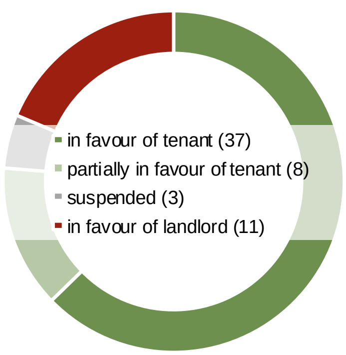
TOP 10 privately held companies

Up to the early 2010s – when demand and supply were still well balanced – privately held corporates focused on cost reduction with regard to maintenance and refurbishment spending. The companies' approach has changed dramatically in recent years. Total investment by the largest privately held corporates reached EUR 2.6bn in 2018, and up to EUR 41 per sq m per annum, equivalent to a doubling in spending per sq m since 2008.

With demand for apartments and multifamily housing picking up in densely populated areas, investments in existing stock, especially refurbishments, have become more attractive for their landlords. While refurbishments made up only 45% of spending in 2008, they hit 70% in 2018.

The reason: the return on investment has become higher and more predictable compared with the acquisition of i) larger portfolios (which has become rare since 2016) or ii) smaller competitors. Encouraged by regulation, landlords were able to pass on 11% of refurbishment costs to tenants on an annual basis. As noted, the investment strategy also

Figure 6: Court decisions (Germany) regarding the 'Mietpreisbremse'



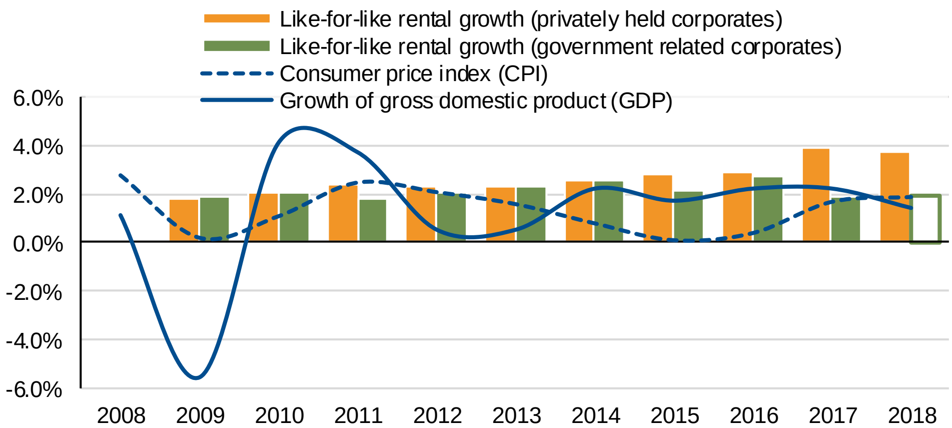
Sources: DIW Berlin, BMJV, Scope

helped companies sidestep the rent controls introduced by the Mietpreisbremse in 2015 (see also German housing companies invest heavily in existing portfolios).

Property owners have to show that spending on modernisation reflects one third of construction costs for a comparable apartment (e.g. German Federal Court of Justice [BGH], judgement of 10.08.2010 – VIII ZR 316/09 -, WuM) to prove eligibility to re-let properties with increases in rent beyond the rental limit.

Thanks to their hefty investments, privately held companies have extracted gains in yearly rental income well above German inflation and GDP growth. Between 2013 and 2018, like-for-like rental income rose 3.4% on average compared with compound annual growth rates of 1.0% and 2.0% for inflation and GDP.

Figure 7: Rental growth vs. CPI and GDP development



Sources: DESTATIS, Scope

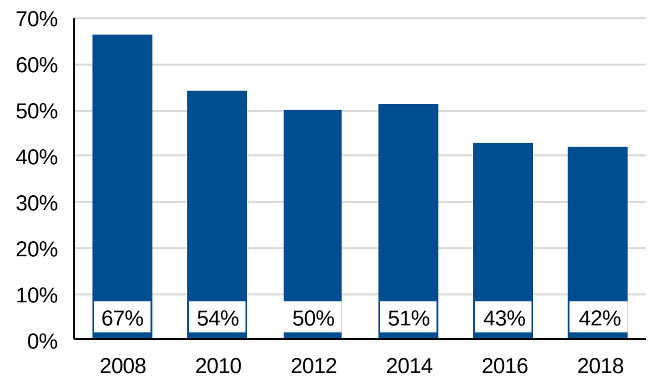
Credit metrics have improved significantly

The value focused strategy of privately held German real estate firms is increasingly contributing to higher portfolio valuations, thus improving credit metrics. Loan/value ratios in particular are decreasing steadily thanks to increasing rents and yield compression (Figure 8). We believe like-for-like rent growth will remain strong in 2019 and 2020. We therefore forecast a further improvement in companies’ asset values even if a period of yield compression seems to be coming to an end. While loan/value ratios are decreasing, companies are using the headroom afforded by improving valuations to finance heavy investments in their portfolios by adding relatively low yielding debt to their balance sheet. Consequently, leverage, as measured by the Scope-adjusted debt/EBITDA of privately held housing corporates and excluding more volatile fair value adjustments, has largely remained unchanged over the last three years (Residential Real Estate Corporates Going all in).

The great improvement in rental income has also positively influenced profitability. This has the knock-on effect of ensuring greater interest cover (in addition to the benefits of the low interest rate environment) and provides a useful cushion should the cost of refinancing debt become more expensive (Figure 9).

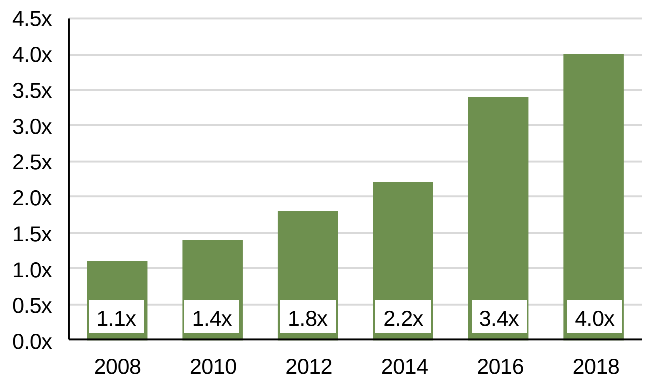
Figure 8: Credit metrics of privately held residential real estate corporates

Loan/value (median)



Source: Scope

EBITDA interest cover (median)



Source: Scope

However, in successfully maximising the long-term value of their property portfolios by focusing on increasing rents - even at the cost of near-term profitability and below-average occupancy - the companies run the risk of a regulatory backlash.

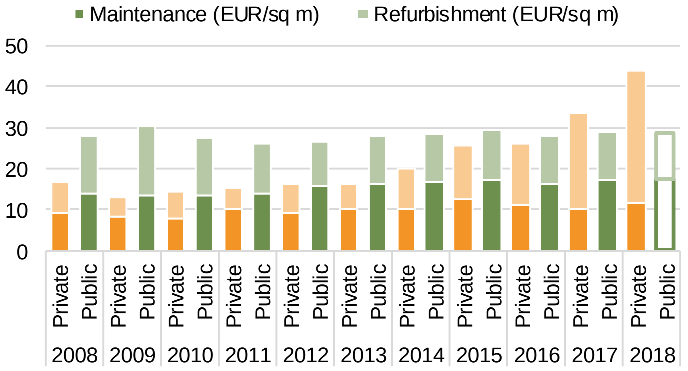
Investment strategy of top 10 state owned companies has changed gear

Today, government related real estate firms differ from their privately owned rivals when it comes to investing in existing housing stock. Over the past 10 years, total expenditure of the top 10 government related companies has remained almost unchanged, at around EUR 1bn per annum and EUR 28 per sq m and year.

GRE corporate expenditure is stable

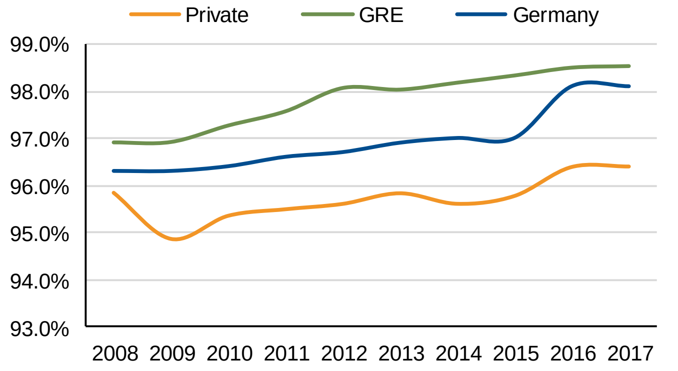
In previous years, state owned companies were under pressure to improve their financial performance in line with privately held companies. They were also expected to enhance the quality of their real estate stock or risk being sold off to the private sector. Investment in modernisation rose to around 50% of capital spending in the years before 2010.

Figure 9: Spending split of investments



Sources: public information on Scope's peer group, Scope

Figure 10: Occupancy



Sources: public information on Scope's peer group, Statista.de, Scope

From becoming profitable to fulfilment of public need

Since then, such spending has declined. As occupancy and rents rose, municipalities' pressure on public-sector landlords shifted to ensuring that housing remained affordable. This was reflected in a variety of measures across Germany to limit rent increases, such as Berlin's 'Mietenbündnis' in 2012 which was updated in 2016 and, more recently, the 'Mietpreisbegrenzung', or rent limit, introduced at Nassauische Heimstätten I Wohnstadt, a firm owned by Hessen. Rent controls and efforts to increase the number of homes owned by government related property companies have inevitably detracted from the returns the companies can expect from investing in modernizing their properties.

Spending on modernization (which includes new construction) has fallen to 40% of total spending. Like-for-like rent growth has remained broadly in line with GDP growth of around 2.0% (compound annual growth rate) for the past five years. The difference in rent increases between privately and publicly held corporates becomes even more apparent, if we look at rent increases for re-let properties. Privately held corporates usually try to capture the full rent reversion[1] potential while government related corporates are increasingly reducing the share of apartments to be re-let at market prices.

Addressing the imbalance in supply and demand

New regulation will mute investment in existing stock

With new construction unable to close the widening gap between supply and demand, we see an ominous combination of relatively low vacancy and steep increases in market rents. This situation has led to a sharp rise in the (still comparably low) housing cost ratio for German households. Coupled with the relatively low share of owner-occupied housing in Germany, this market imbalance affects a comparatively high proportion of German households. We therefore expect new regulation of rental limits as well as a stricter framework for guidance on local rents (the 'Mietspiegel'), following the new rules already implemented with regard to the passing on of modernization costs to tenants. We anticipate that such initiatives will mute investment activity in existing stock in the years ahead. Instead, state and privately owned corporates will focus more on new construction as the best option to fulfil their public-sector obligations and/or to increase rental income and benefit from the housing shortage.

Greater focus on new construction meets capacity constraints

However, we believe construction by companies in Scope's peer group and other market participants will not be enough to overcome the supply-demand imbalance in the short to medium term for three main reasons:

1. Insufficient construction capacity (see also Scope's Construction Outlook) in the German market
2. Relatively lengthy approval procedures and high statutory requirements
3. limited availability of land

In view of these factors, new completions are expected to remain below demand at 300,000 per year vs. 375,000 according to government data. The widening gap between supply and demand for urban areas and the increase in average costs per sq m for new developments (construction costs +18%; land costs +30% both from 2008 to YE 2016 according to DESTATIS) are likely to lead to further steep increases in rents for newly developed apartments.

Positive credit outlook for German residential real estate companies

In such circumstances, German residential real estate companies remain set for continued growth in rental income, with little downside risk for property valuations, ensuring a positive credit outlook for the sector.

[1] Difference between the rent provided by the existing contract and the market rent.

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