Berlin freezes rents
City risks consequences for property sector

Berlin's decision to freeze most rents for five years is set to have unfavourable financial consequences for property owners, developers and ultimately tenants – without necessarily solving the city's acute housing shortage.

Berlin rent freeze in a nutshell:

- Berlin Senate agreed on the cornerstones of new regulations on residential rents on 18 June, 2019 which are set to come into force 1 January, 2020.
- Existing lease contracts would exclude rent increases for five years (the "rent freeze").
- Maximum rents will be set; existing rents could be cut to that lower ceiling (the "rent cap").
- New leases can bear the maximum rent of the preceding lease contract.
- Modernisation work entailing a rent increase of more than EUR0.50 per square metre requires permission from the government.

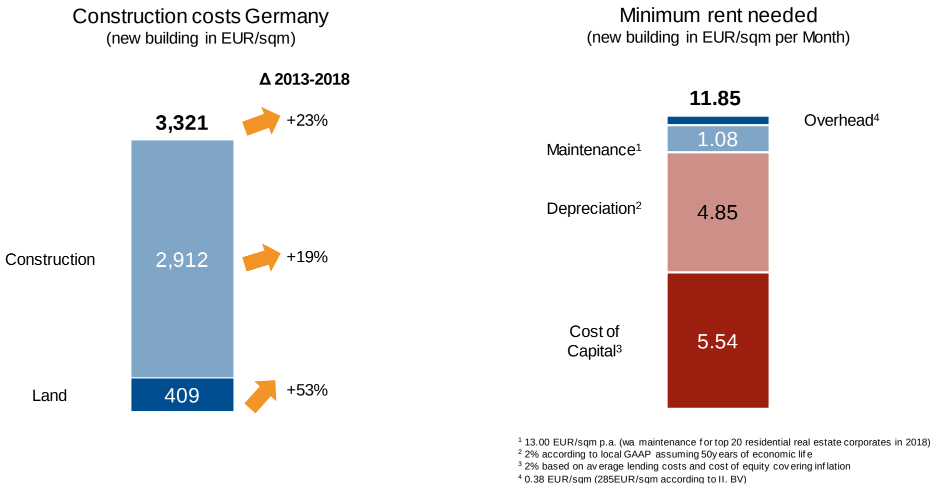
Exemptions:

- Properties built from January 2020.
- Leases that are already rent-controlled.

A temporary freeze on rent increases would put downward pressure on property values, thereby increasing the leverage ratios of property companies. The resulting higher leverage and increased planning uncertainty would weigh on profitability, pushing up the cost of capital and reducing the financial headroom for landlords to invest in maintenance, refurbishment and modernisation. The resulting decline in the quality of the assets and property services would conflict with tenants' readiness to pay more rent when landlords are willing to invest more in their properties, according to a study by Allensbach[1].

Our concern is these extra financial pressures on property companies could exacerbate the imbalances in the Berlin housing market and partially offset some of the more positive measures underway to improve the supply of new homes. These measures include the provision of promotional loans by the state-owned Investitionsbank Berlin for new developments of subsidised apartments, the improving home-building pipeline among government-owned real estate companies – though a target of 40,000 new units by the end of 2021 goes only part way to meeting the 100,000 shortfall estimated by the Berlin authorities - and local government (re)purchases of land and residential units.

Figure 1: Construction costs and minimum rents needed[2]



Sources: Destatis, Scope, II. BV, public information of peer group

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1 Mieterzufriedenheitsstudie Allensbach Institut 07/2019
2 Please note; in case a developer/landlord wants a risk adequate premium of 5-8% on its equity (assuming a loan/value ratio of 80% and 2% interest rate) cost of capital would rise to 2.6-3.2%, implying rents need to be EUR13.51 to EUR15.17.

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Landlords who put new units on the market ahead of the planned implementation of the rent freeze from January 2020 face extra financial pressure. With costs of deploying new apartments up by 23% within the past 5 years, minimum rents - even considering today's artificially low cost of debt - are close to EUR12 per sq m.

A rent ceiling below that threshold would be to the disadvantage of landlords that had put properties on the market on the assumption these would be exempt from the rental brake put in place since 2015. The resulting squeeze on profitability also risks reducing the financial room for manoeuvre that companies have more generally for coping with any future increase in interest rates or investing in expanding or upgrading property portfolios. Growing financial pressures will also likely curb property companies' appetite to maintain their development pipelines, fearing policy might change again in the future.

For the politicians, tenant and housing associations backing the rent controls, the impact on rebalancing demand and supply in Berlin housing stock is likely to be modest at best, with the unintended consequence of encouraging gentrification of urban residential areas rather than opening them up for lower-income families.

Consequences of the rent freeze are plentiful

The fundamental problem is the lack of sufficient supply of new homes. New construction continues to lag the issuance of new building permits in Germany, standing at around 287,000 units and 347,000 units respectively in 2018, according to government data. This not only fell short of the federal government's target of 375,000 units a year to address the lack of supply, but also adds to the backlog of unbuilt, but approved, units that is likely to surpass the all-time high of 653,000 units at year-end 2017. The backlog is the consequence in part of building-sector capacity constraints (see Scope's Construction Outlook 2019) as well as – in rare cases – speculation. Given the Berlin Senate's current proposals and numerous ideas on defining exceptions to the cap/freeze, the changing incentives and potential loopholes may have unintended consequences for the property market:

- Landlords will increasingly prefer tenants best able to meet monthly rents than favour low-income home seekers.
- Frozen rents will paradoxically favour better-off tenants who will be tempted to rent larger homes knowing that rents are not going to rise.
- Landlords will inevitably seek alternative ways to find income growth, through renting out home equipment and furnishings at rising tariffs.
- Vacated units are likely to be converted into owner-occupied units to attract market prices.
- New development likely to be focused on building high-quality homes in existing neighbourhoods, eventually leading to further gentrification.
- The number of building permissions and completions set to fall given that developers are already required to provide a certain amount of social housing for new developments, subsidised by the remainder.
- Investment in refurbishment and/or modernisation (eg: energy efficiency) will decline given landlords' reduced ability to pass on costs to tenants.
- Similarly, there will be less incentive for landlords to undertake maintenance beyond the absolute minimum as those costs directly eat into corporate profitability.

Uncertainty expected to reduce building completions

Property developers do not like uncertainty. The lack of clarity over medium-term policy and rental limits might change the share of develop-to-sell real-estate ventures at the cost of develop-to-hold ones. That is unlikely to encourage developers to step up building activity to meet demand.

In the case of Berlin, new buildings put up between 2015 and 2019 have been exempt from the city's rental-brake mechanism but would be included in the rental cap plan which only excludes future new buildings. The problem facing any developer, trying to judge future cash flow, is whether those new buildings would later be included in future rental-brake and rental-cap regulations - themselves functions of local politics - which might further change the economics of Berlin building projects for the worse.

Ever increasing construction costs and rising land prices are set to exaggerate this trend as property developers that focused on a develop-to-hold strategy find it hard to pass on those increases to tenants through higher rents.

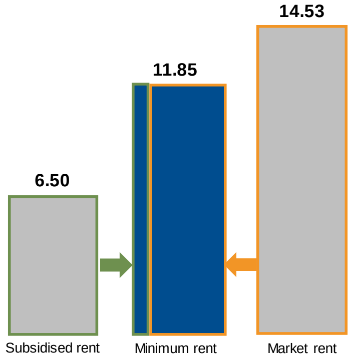
Implementation of maximum rents strongly reduce profitability

Berlin's planned implementation of maximum rents (discussions tend to be around EUR9 per sq m) to provide affordable housing, present property developers and politicians with a major economic challenge as the table in figure 1 illustrates.

Using some conservative assumptions on maintenance costs and overheads in addition to prevailing interest and inflation rates, our analysis shows that landlords require minimum rents of around EUR12 per sq m to cover their operational costs for properties built since 2015 on the assumption they would be exempt from the rental brake.

The problem is that current rents already factor in the cost developers face of subsidising a mandatory proportion of social housing at low rents. This commitment lifts market rents to more than EUR14 per sq m. Setting a maximum rent below that threshold would squeeze profitability, especially for small landlords and/or private individuals that entered the market more recently. As a consequence, Scope would expect an increase in distressed loans in the coming years, if the rent freeze including the rent cap is implemented, through impaired cash flows and property values.

Figure 2: Subsidised rents and its financing[3]



The new rent limits will naturally put upward pressure on rents for any properties excluded from the rental cap/freeze (e.g. new developments or furnished apartments). That in turn is likely to encourage gentrification as developers will be under pressure to provide properties only at rents that ensure an adequate return on investment - EUR15 per sq m or higher[2].

Secondly, should developers and landlords opt for more debt rather than equity to finance new developments to take advantage of current low interest rates, that exposes tenants not benefiting from rental limits to sharp future increases in rent should interest rates turn up, presenting extra risk for landlords in case of floating-rate debt or the near-term end of fixed-rate period.

In neither case do rent controls provide an economic incentive for developers to build affordable homes to address the acute housing shortage in Berlin and other German cities.

[3] Within this example 1/3 of subsidised rents cover only 18% of income needed to meet operational costs of a newly developed flat

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