

German real estate: risks rise after Berlin vote

Will expropriation threat deter investment?



The recent referendum in favour of putting thousands of apartments in Berlin in public ownership could strain the finances of real estate firms with a large part of residential portfolios in the German capital, depending on the degree of compensation. However, the implementation of the referendum faces significant legal and political challenges. The outcome remains to be seen, but it could lead to rising credit risks for real estate companies, put in danger climate-linked investment and ultimately weaken Berlin and Germany as an investment location.

Last month's referendum vote in Berlin on transferring around 240,000 homes into public ownership - equivalent to around 15% of the city's housing stock - was approved by voters with a majority of 56%. The potential financial impact on the real estate companies concerned (see **Figure 1**) depends on the final compensation for any forced transfer of property. Estimates vary widely. Backers of the initiative put costs at EUR 7bn-14bn, well below a state senate's estimate of EUR 29bn-36bn. A transfer at below-market prices could financially damage real estate firms most exposed to the Berlin residential market.

The result of the referendum is not legally binding. There are significant political and legal hurdles to cross for it to come into force, not least the fragmented political make-up of the Berlin senate after the 26 September election. We expect a watered-down draft law would be tabled in the Bundesrat, including the obligation to limit rent increases and further conversions from rental to owner-occupied apartments, a cap on rents (structured similarly to the 'Mietpreisbremse') and the development of additional affordable housing. We expect any law proposed will eventually be subject to a judgement by the Federal Constitutional Court.

The potential risk attached to any legislation is that potential expropriation ('Vergesellschaftung') on this scale would diminish the German residential property sector's appeal for domestic and foreign investors. By deterring private-sector investment, the vote could complicate efforts to address the housing sector's contribution to carbon-dioxide emissions, which carries significant costs for owners and tenants.

The near-term financial implications of expropriating property companies are most visible by looking at the loan/value ratio of Deutsche Wohnen SE, which holds around 73% of its property portfolio in the capital. The ratio would increase by around 40pp in the case of minimal compensation. In contrast, the change for Vonovia SE - a larger, more diversified company for which Berlin makes up only 10% of its property portfolio - would be marginal from a financial-risk perspective. Vonovia is in the process of acquiring Deutsche Wohnen. For the merged group, the measures in Berlin would also be clearly noticeable. If Berlin's approach was applied nationally, the impact would be much greater.

However, depending on how drastic the final measures in Berlin turn out to be, the companies in question (Figure 1) should expect some degree of adverse impact across a significant share of their Berlin portfolios, with negative consequences for their profitability, weighing on their business-risk profile and ultimately impacting their credit quality. This would in turn potentially increase funding costs.

The longer-term implications for real estate asset managers in Germany is that this could provide a precedent for other German states and cities - and even in other cities in Europe where housing costs continue to rise rapidly. Social housing in Germany is increasingly prominent in policy debates. This is driven by the increasing cost of housing relative to wages, caused by, among other factors, low net public investment over the last decade for social housing projects, a growing population and increased housing demand, and rising prices of land and construction.

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Bloomberg: RESP SCOP

Berlin rents up by 42% since 2016

In Germany, rental prices have risen by 8.4% since 2016. Munich remains the frontrunner and in Berlin rents have risen by around 42% to EUR 12.80 per m² in the same period. Compared to other major European cities, this puts Berlin in the midfield. By contrast, at EUR 32-35 per m², Paris remains one of the most expensive cities in Europe.

Government action discourages investment and modernisation

In Berlin itself, such government action would likely have other consequences for the local property market, such as discouraging private investment and modernisation. Private-sector investors would likely hold back from developing new rental accommodation and upgrading and refurbishing existing apartments. Other recent transactions - such as the purchase of 14,750 apartments from the portfolios of Vonovia and Deutsche Wohnen by HOWOGE, degewo and berlinovo - have also shown that the transfer from private to public ownership can be implemented using market solutions.

Figure 1: Real estate companies with more than 3,000 apartments in Berlin

Company	# of apartments as at YE 2020		Fair value (EUR m) as at YE 2020	
	Berlin	Germany	Berlin	Germany
Deutsche Wohnen SE	114,191	155,408	19,999	26,168
Vonovia SE	43,171	350,878	7,816	47,783
Adler Group S.A.	19,864	69,722	4,461	8,313
Covivio Immobilien GmbH*	15,813	39,672	n.a.	n.a.
Akelius Residential Property AB	14,418	17,632	3,079	3,935
Heimstaden Bostad AB*	more than 3,000	7,300	n.a.	n.a.
TAG Immobilien AG	10,370	82,545	n.a.	n.a.
Grand City Properties SA	7,821	61,050	1,895	6,754
Blackstone Property Partners Europe S�rl.	3,699	4,569	n.a.	n.a.
William Pears Group*	more than 3,000	n.a.	n.a.	n.a.
IMW Immobilien SE*	more than 3,000	n.a.	n.a.	n.a.
Albert Immo und Victoria Immo Properties S�rl.*	more than 3,000	n.a.	n.a.	n.a.

* YE 2019 Source: public information of listed companies, taz.de

Climate-related goals putting upwards pressure on rents

Another longer-term consequence could be to place the new owners of the apartments in Berlin, in case of expropriation, at loggerheads with policy makers. Political and regulatory pressure is mounting for heavier environment-related investment to improve buildings' energy efficiency and ensure that the real-estate sector and cities diminish their considerable carbon-dioxide emissions footprint as part of meeting Germany's and the EU's ambitious climate-related goals. While this would support asset quality of the housing stock, it is also putting upwards pressure on costs.

Policymakers and real estate industry to work together to tackle climate-related goals

Currently, around one third of CO₂ emissions in Germany are building-related. The German government has set a target of a nearly climate-neutral real estate stock by 2050. To achieve the federal government's goal, not only must new buildings be built in a climate-neutral manner, but the refurbishment of existing buildings will also become mandatory. However, to reduce CO₂ emissions, a strategic approach by the real estate industry and policymakers is essential. Smaller companies, individuals as well as government-owned entities - in the case of stronger rent-control regulation - mostly do not have the deep pockets to undertake investments needed to achieve Berlin's goal of becoming climate neutral by 2050. Tighter regulation would thus not only deter private investment but also raise the need for additional subsidies to undertake investment in new buildings and upgrades.

Divergent impact on companies' creditworthiness

Limiting rent increases beyond current levels and/or a federal law that allows the introduction of rental caps would inevitably have a less significant impact on the cash flow and creditworthiness of large residential real estate firms with diversified portfolios.



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Small, medium-sized property firms more at risk

More at risk are smaller and medium-sized or geographically concentrated companies which have acquired properties on the grounds that rents would increase in the medium term at least, even though initial rental yields remain modest at around 3%. Akelius Residential Property AB, for example, would have suffered considerably from its Berlin exposure before the sale of its Germany portfolio to Swedish rival Heimstaden Bostad AB. In contrast, TAG Immobilien AG, which owns a portfolio of Berlin real estate with a comparatively low average rent, would be less affected. Generally, we believe tenants are the ones affected most, as they might now find new landlords less attentive than in the past to refurbishment and upgrades.



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