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## ***Reitway's German Apartment Recap***

- *Rising apartment prices are the escape valve for the disequilibria between limited supply and rising demand*
- *Listed apartment landlords are unlikely to convert to the REIT-model in the foreseeable future*
- *Vonovia's innovative management team is unlocking value for its shareholders*

At 8% of our portfolio, the German Apartment sector is currently a significant “thematic investment” here at Reitway Global. In this note we provide a recap on our investment thesis, the REIT-status of these companies and how they are unlocking value for shareholders.

### **1. Background to the market**

There are 41 million flats in Germany, most of which were constructed by public authorities during Germany's post-war rebuild in the 1950s and 1960s. Listed landlords currently own less than 10% of this sector, with the balance owned largely by individuals, private companies and communal organisations.

The German population is more inclined to rent than own their apartments, with home ownership levels of just 45% compared to the UK and US, which are both at 65%.

The housing market is highly regulated and rental increases are capped according to the Mietspiegel (rent-tables). Fortunately, German authorities are mindful of the need to incentivise housing development in order to improve living standards. **Expenses relating to the upgrading and modernisation of apartments are therefore allowed to be passed on to renters through substantial rent hikes** (more on this later).

**So why would one invest in the German housing market if the demographics are in decline and rents are regulated?**

Immigration is adding considerable demand

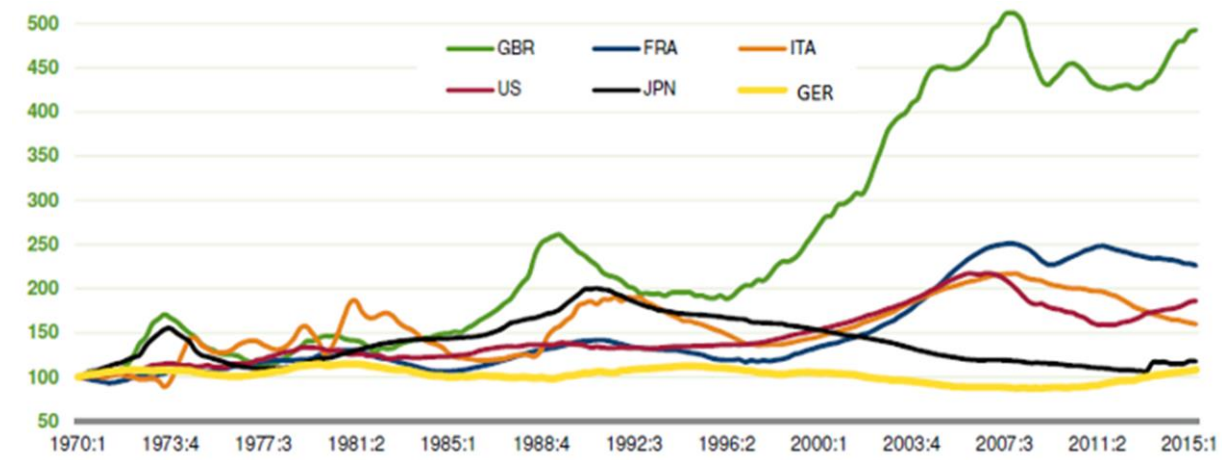
The answer lies in the strength of the German economy relative to the rest of Europe, with unemployed Europeans from weaker economies migrating to Germany in search of better job opportunities.

In addition, the population has also been boosted by the arrival of more than 1 million refugees that are fleeing the carnage in the Middle-East. **The considerable increase in immigration is offsetting the local decline fuelled by Germany's ageing population.**

German house prices are exceptionally affordable

House prices in Germany have lagged those of similar developed nations for over 40 years with no real growth between 1970 and 2010 (see Chart 1 that follows).

**Chart 1: Germany's housing market finally turned the corner in 2010, after 40 years of zero real capital appreciation**



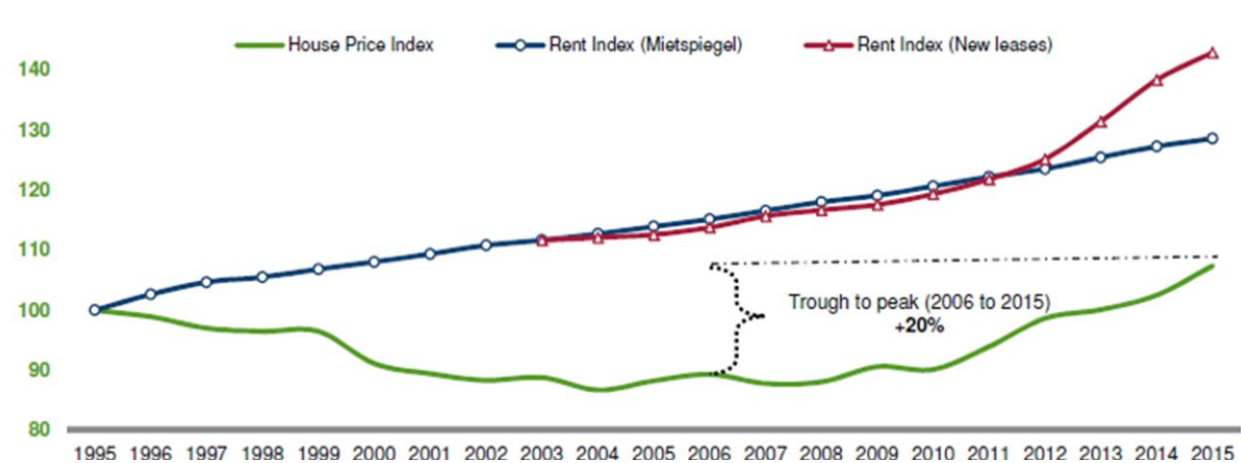
Source: Green Street Advisors

Despite some price appreciation over the past 5 years, a standard new apartment typically costs only 3 times the gross annual salary of the average German resident, whereas the same apartment would fetch 7 times one's salary in the UK and as much as 9 times in France.

### Demand outpacing supply

Demand for German apartments, aided by staggering immigrant inflows, is currently far greater than the number of planned and completed new developments. The key barrier here is that due to high building costs, it remains cheaper to buy an existing apartment than to build a new one. This disequilibria between demand and supply is resulting in rental increases on new leases that are hitting the +10% limit of the rent table. Despite the recent good run in house prices, capital appreciation is still lagging behind rents over the longer term. (See Chart 2).

**Chart 2: There is significant room for German house prices to draw level with rental growth**



Source: Green Street Advisors

In our view, higher house and apartment prices should act as the escape valve for this unsustainable pressure cooker of rising demand and constrained supply. **We therefore expect a continued rise in German apartment prices until it reaches a more reasonable level relative to rents.**

## 2. Well-run companies, but why haven't they embraced the REIT-model?

Residential properties built in Germany before January 2007 unfortunately do not qualify to be *"housed as Real Estate Investment Trusts"*, Reitway's preferred form of listed property investment.

The reason for excluding residential property from German REIT legislation is a political one, as the government doesn't want its citizens to face market-forces that could result in a backlash from German voters.

The listed residential operators (such as Vonovia and Deutsche Wohnen) own only a small proportion of apartments that were built after January 2007. Hence, the chances of these companies qualifying for REIT status in the future is slim, unless there is a significant change in political stance.

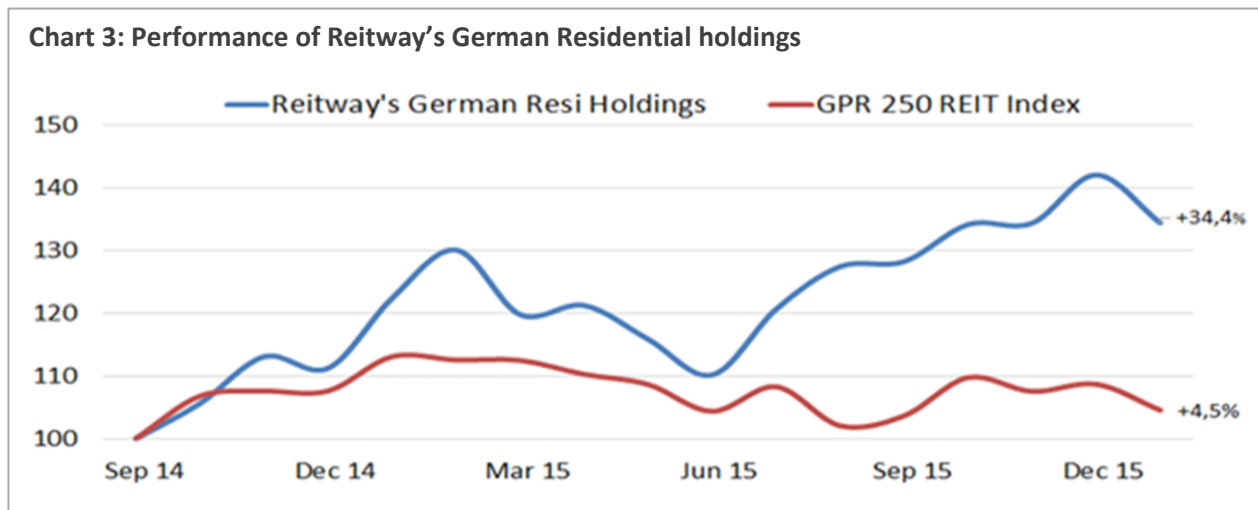
## 3. Vonovia: Unlocking higher rents through modernisation of its portfolio

Vonovia, the largest listed residential operator in Germany, is an excellent example of how an innovative management team is unlocking the value of higher market rents, whilst improving the valuations and housing standards of their buildings.

German authorities are well aware of the need to incentivise improved living standards and as such, **landlords are permitted to charge full market-determined rents when a significant apartment upgrade or modernisation is implemented.**

In 2013, Vonovia made the decision to embark on an ambitious, €500 million investment program to upgrade its mostly B-class apartments in order to take advantage of this incentive. As a result, the investment program has helped improve the quality of its portfolio and attractiveness to tenants. Crucially, it has also allowed the company to "capture" higher rents than would have otherwise been available to the company as outlined by the rent table or Mietspiegel.

Vonovia is beginning to see the fruits of its investment program, achieving rental growth of 2.5% in real terms and increasing its Funds From Operations by 27% in FY2015. The company forms an important part of our overall exposure to the German apartment sector, which has performed very well relative to the Global REIT market as the following chart shows.



#### 4. Conclusion

The German Apartment sector is showing extremely strong fundamentals, but must be considered in context alongside peculiarities like the Mietspiegel.

These shares have contributed meaningfully to the returns of our portfolio and our clients should continue to benefit from owning them, as long as the narrative continues to play itself out. [REITWAY](#)

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