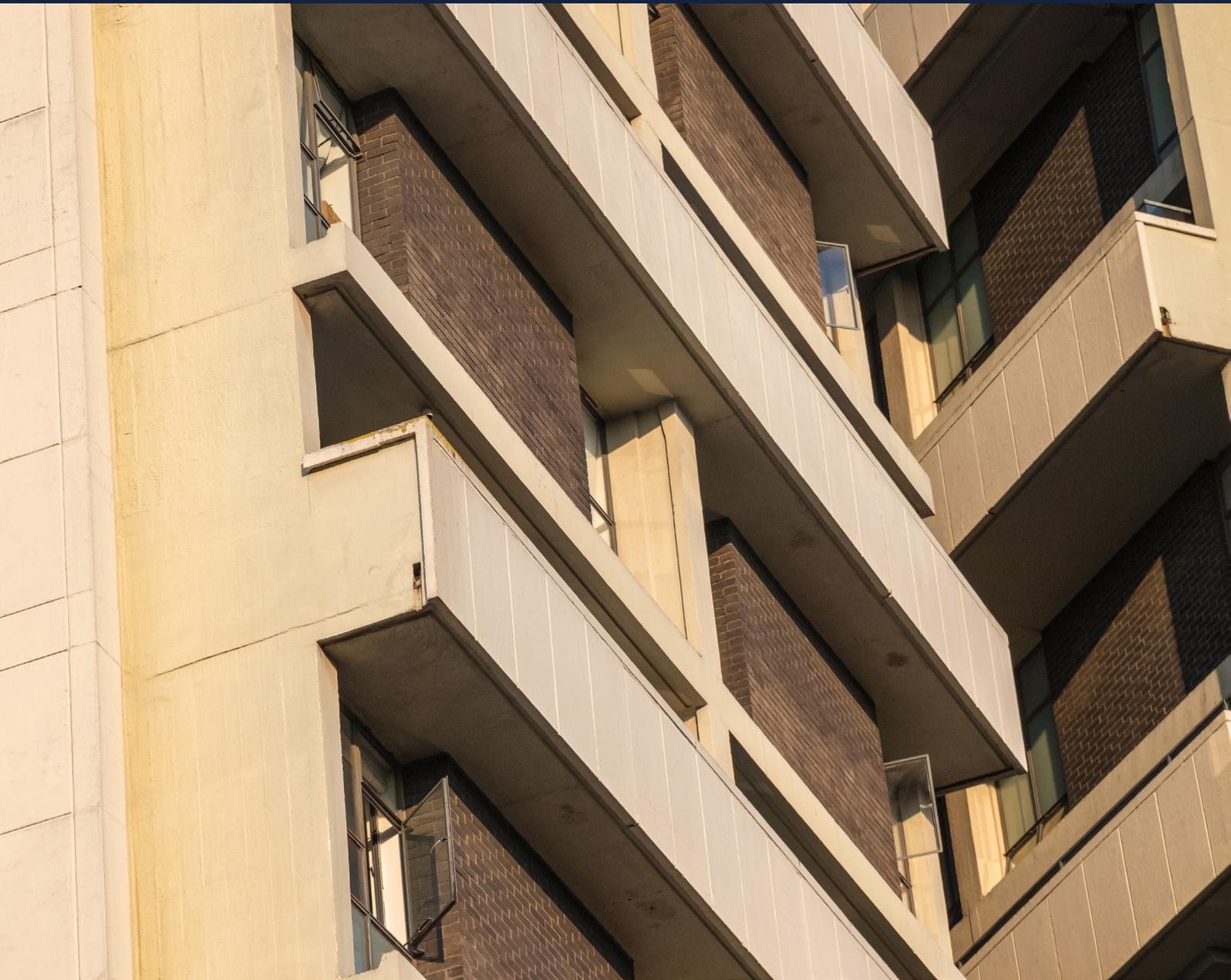


German Residential Portfolios: Market Outlook

**After a challenging few years for real estate,
investors are buoyed by the prospect of recovery.**

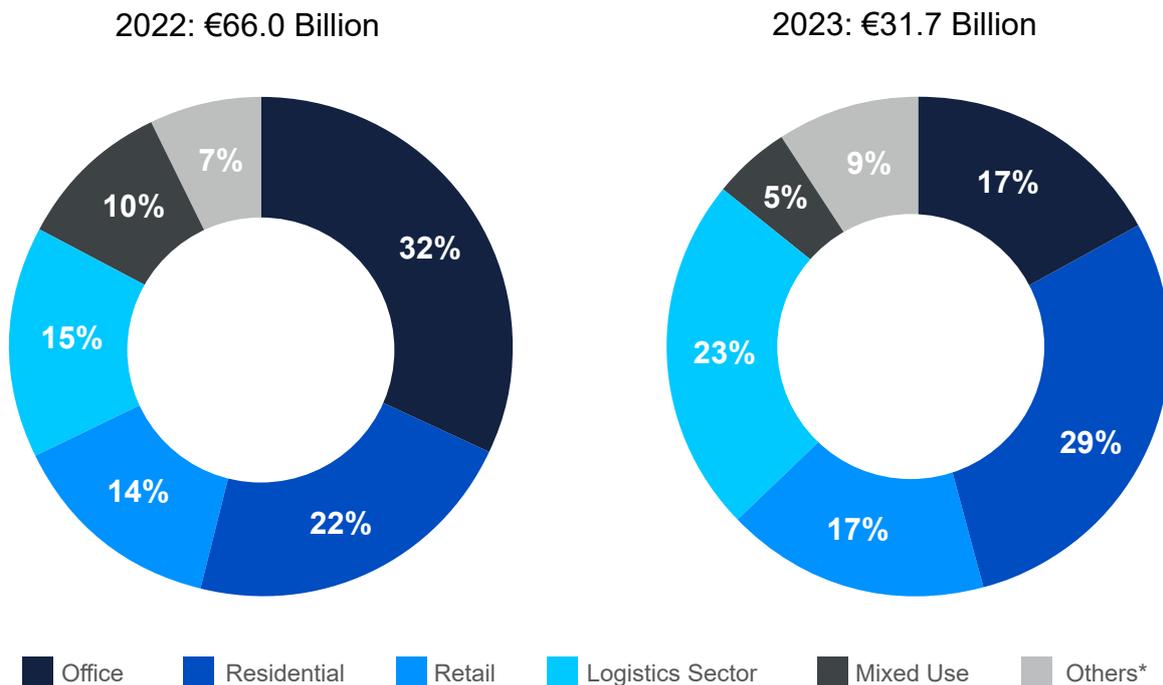


As investors scrutinise German residential real estate opportunities in 2024, the environment looks very different from a year ago. While some large deals were executed in 2023 despite pressures in the market, the outlook for this year indicates a healthy sector in which, after prices decreased, investors can find interesting opportunities.

How Has the Real Estate Market Coped With Recent Turbulence?

The total volume of German real estate transactions halved from €66 billion in 2022 to €31 billion in 2023. Indeed, every segment of the market took a hit, but residential investments dropped much less than the office and industrial investments. Consequently, residential investments grew as a proportion of total real estate deals from 22% in 2022 to 29% in 2023, making it the most popular asset class.

Transaction Volume Germany



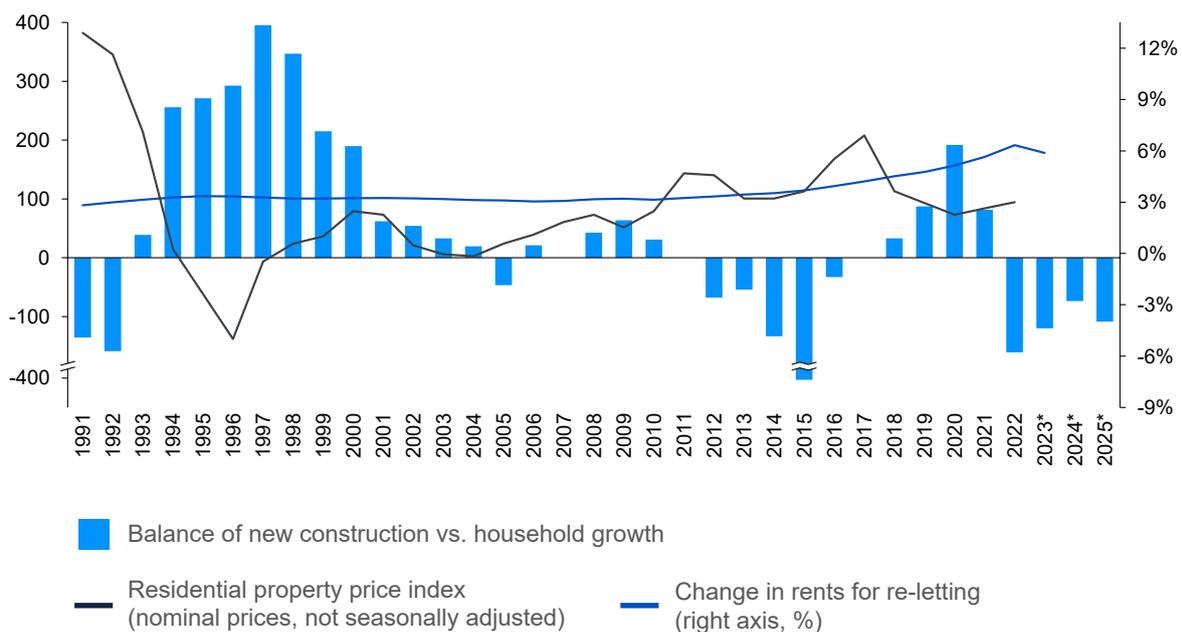
*Hotels, plots, and special-purpose real estate
Source: JLL. Last updated: January 2024.

The office space market across Germany's "Big 7" cities has suffered from weak demand since the end of 2022, as evidenced by the development of rental properties. Although there was a slight increase in the fourth quarter compared to the weaker previous quarters, the office rental volume remained low at 740,000 m². Throughout 2022, only 2.5 million m² were rented, compared to 3.5 million m² the previous year, marking the lowest rental volume since the crisis year of 2009 and a decrease of 28% compared to the previous year. As the economy recovers, an increase in office space turnover is expected throughout 2024.

New construction activity was also more restrained. According to ifo Institute data, nearly 50% of all construction companies reported a lack of orders in October 2023, compared to less than 20% in October 2022. Moreover, the housing industry anticipates a sharp decline in completions. While the federal government had planned to provide for 400,000 new apartments annually, including 100,000 social housing units, completions fell from 293,393 apartments in 2021 to around 280,000 apartments in 2022; 242,000 in 2023; and a mere 214,000 in 2024. This shortfall highlights the significant gap between the government's housing targets and the actual output, underscoring the challenges the industry faces in ramping up production to meet demand and policy objectives.

Looking forward, market expectations are that the Federal Reserve and the European Central Bank could start lowering interest rates as early as Q2 2024, and inflation risks are abating. Mortgage risks are lower in Germany as borrowers have longer fixed-term interest rates, which should limit the probability of widespread payment shocks. US investors quadrupled their investment share in German residential real estate last year and we expect that appetite to continue.

Rent and Price Development and Outlook



Source: Federal Reserve Bank of St Louis, BIS, Latham & Watkins Tactical Opportunities Analysis

The supply-demand imbalance caused by limited supply in the housing market and a slump in new residential construction is expected to improve fundamentally. Rent premiums across major cities in Germany increased slightly at the end of last year, and deal flow in the residential market picked up.

2023 was a tough test for the real estate industry and 2024 will also prove challenging; however, market participants now have a clearer perspective of what the future holds. Given that interest rates are expected to at least remain stable, there is optimism that 2024 will mark the bottoming-out of the crisis and the beginning of recovery. Nonetheless, there is a general consensus that the industry will need to work hard over the next few years to return to the path of success.

Rent Adjustments

How the market might develop in 2025 and the potential for rent adjustments are key factors in assessing German residential investment opportunities. Rent adjustments are widely regulated under German law and are only possible in certain circumstances:

- By mutual agreement at any time during the lease term
- If agreements are made before or upon signing the lease for stepped rent or index rent changes during the term of the lease
- Unilaterally if the landlord wishes to increase up to the standard local comparative rate, or to increase after refurbishment

Deviations at the tenants' expense are not possible in residential leases, with rules prohibiting agreements to increase caps, to change lock-up periods, or to deviate from formal requirements.

Stepped Rent

Stepped rent arrangements allow for rent increases to be fixed at certain dates on signing of the contract. Rules state that rents cannot change more than once a year, the amount of the increase must be stated clearly in the agreement and not as a percentage, and other rent increases are not allowed (with the only exception being for installation of modernised heating).

Stepped rents mean the future of rent increases is clear for both landlords and tenants, and all relevant information is included in the lease agreement. However, the downside is the inability to take account of comparative market rents or inflation rates.

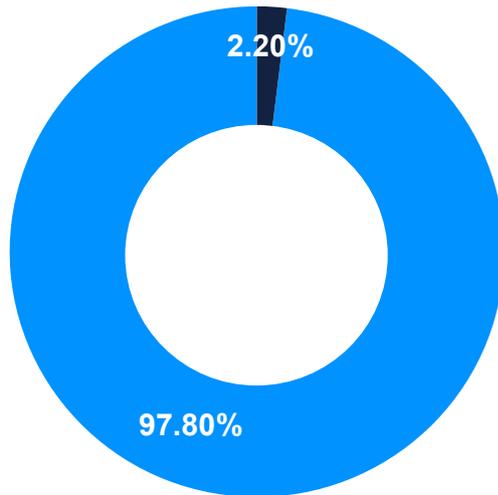
Index Rent

With an index rent arrangement, rent is linked to the German consumer price index (CPI), and rent increases linked to property upgrades are only allowed in exceptional circumstances. Rent can only increase once a year and cannot increase automatically, because tenants cannot be expected to track the CPI. Instead, landlords must provide a written request and at least a month's notice to the tenant.

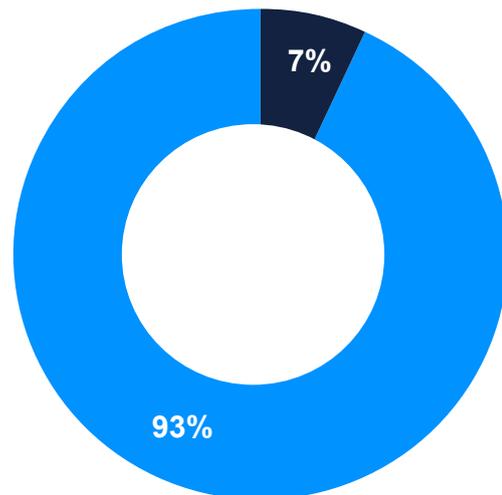
Upwards-only provisions and minimum initial rents are not allowed, but if a rent increase is capped then the same can be done for rent reductions. After years of low price rises, German inflation hit record levels in 2022 and 2023 and, as a result, the proportion of lease agreements containing indexation grew from 2.2% to 7% post-2020. In major German cities, indexed rents were agreed for around 30% of leases in 2022.

Index Rent

Existing Lease Agreements



New Lease Agreements (Concluded After 2020)



■ Without Indexation ■ With Indexation

Source: <https://www.iwkoeln.de/presse/iw-nachrichten/ralph-henger-christian-oberst-nur-22-prozent-haben-eine-indexmiete-abgeschlossen.html>

Post-Refurbishment Increases

If a landlord invests capital to modernise a building after the rent period starts, they may unilaterally increase rent. Permitted refurbishments include improvements to energy efficiency or reductions in water consumption, improvements to living conditions, or refurbishments required by authorities. Maintenance, repairs, improvements to equipment and furnishings, and luxury refurbishments (such as swimming pools) are not allowed as a justification for rent increases.

After refurbishment, annual rent can be increased by up to 8% of the costs incurred for the property, with a maximum increase in monthly rent of €3 per m² over six years.

Local Comparative Rent

A landlord can also unilaterally increase rent if there has been an increase in the local comparative rent, which is the average rent for a comparable living space in the municipality, or a comparable municipality, during the last six years. The landlord must request an increase in writing to the tenant, with proof of the local comparative rent increase, and the rent must then remain unchanged for at least 15 months.

These rent increases can only be claimed at least 12 months into the rent agreement and there is a maximum increase of 20%, or 15% in areas with challenging housing markets. Rent increases for refurbishment are also still permitted.

Cost Rent

Investors will likely encounter state-subsidised construction when considering large portfolios of German residential real estate. In those cases, cost rent is applied and even stricter rules are in place on rent increases. Rent is calculated to take account of capital costs, operating costs, and repair costs, and the objective is a cost-covering rent that does not generate profit, but avoids losses.

Rent Freezes

In addition to the rules prohibiting rent increases during the lease period, in 2015 Germany imposed a rent freeze aimed at limiting rents at the start of leases. The only permissible rent at the outset is now the local comparative rent plus 10%, with the freeze being a temporary measure that allows state governments to make changes every five years until 2025.

Exceptions to the rent freeze do apply when the previous rent was above the local comparative rent plus 10%, when modernisations are taken into account, when the apartment was first leased post-2014, and in the event of a first letting after refurbishment.

The landlord has a duty to inform the tenant about planned increases, and there are consequences for non-compliance. The rent freeze applies alongside stepped rent, where conditions must be checked for each step of the rent, and it must be observed at the start of a lease if index rent is applied.

Pre-Emption Rights

Pre-emption rights are used in certain areas to secure the interests of the municipality in preserving the social structure, the urban development, or a housing subsidy. The rights apply to the sale of properties where the municipality can take the place of the purchaser, with the exercise of the pre-emption requirement requiring an effective third-party purchase and the purchase price corresponding to the price agreed between the seller and purchaser.

The exercise of the pre-emption right must be justified by the public good and, since 2021, a change to the law has allowed a municipality to reduce the purchase price to market value.

The seller must inform the municipality of the content of the purchase agreement in relevant areas, and then the municipality has three months to decide whether or not to exercise its rights. Until then, the land register is effectively blocked.

Upcoming Legal Changes

Proposals to implement a cap on index rents for residential properties have long been discussed, with the Hamburg Senate proposing in November 2022 that index rents should be permitted to rise by a maximum of 3.5% per year even if costs of living rise more. However, the federal council has called on the federal government to propose its own rules, including an alternative CPI that excludes certain metrics, such as fuel.

An extension of the rent freeze until 2029 is widely anticipated after the extension was included in the coalition agreement. Meanwhile, the federal government's goal of creating 400,000 new apartments per year remains, though a further reduction to the cap for local comparative rates to 11% in areas with tight housing markets is possible.

There is an ongoing discussion as to the merits of extending pre-emption rights to share deals, given that they currently only apply to pure asset deals. While municipalities have called for reform, there is no draft legislation so far, meaning change is unlikely this year.



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