



VALUE-ADD POTENTIAL IN THE HOUSING MARKET

A REPORT

by the Savills Residential Capital
Markets team with contributions from
Savills Research and GSK Stockmann

GERMANY

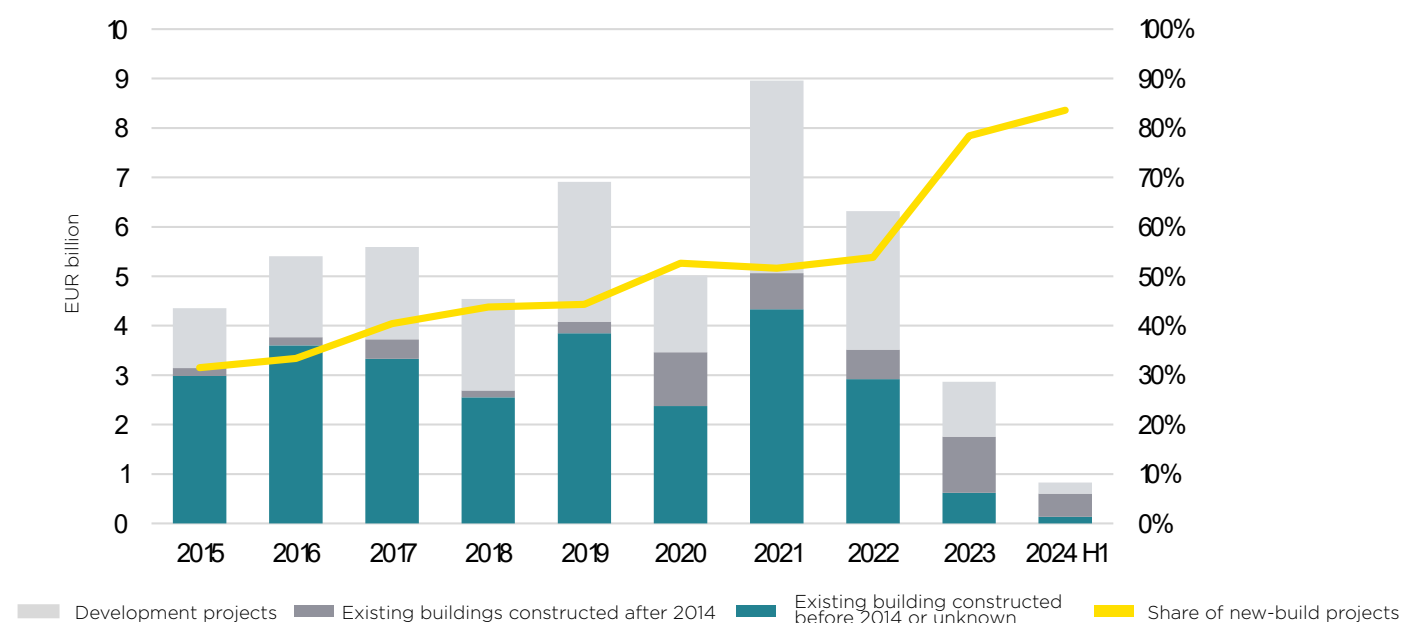
New-build trend among institutional investors

Residential real estate has become increasingly popular with many investors in recent years. This includes, in particular, institutional multi-asset investors such as insurance companies and pension funds, which often aim for a higher proportion of residential properties in their portfolios.

This international trend on the real estate investment market has even been observed in Germany, despite the fact that residential property has been an established asset class in the country for decades. Alongside real estate companies, institutional investors have been one of the most important groups of buyers of apartment buildings in the last ten years, whether through investments in special funds or direct investment. Institutional investors have focused primarily on new-build projects. In 2023, around 39% of the volume purchased by insurance companies and pension funds as well as open-ended special funds were development projects. A further 40% of the volume was generated by existing properties built after 2014. These newer existing properties are exempt from rent controls and are therefore less regulated than older properties.

In addition to the fact that many players have stricter sustainability targets and are looking to minimise their renovation risk, the lower regulatory risk is most likely the driving factor behind demand for new-build projects among institutional investors. In recent years, this demand has increased even more, most likely also in response to the increasing regulation of older properties. In fact, **according to our assessment**, the current mixed environment in the unregulated part of the market – i.e. for new buildings – **is also very investor-friendly**. For instance, the lock-in mechanism on the housing market is likely to further increase rents in the unregulated segment of the market, while new buildings are often subject to graduated or indexed rent agreements anyway.

FIG. 1 RESIDENTIAL PROPERTY ACQUISITIONS OF INSTITUTIONAL INVESTORS BY CONSTRUCTION YEAR*



Source Savills/ *exclusively transactions with at least 50 apartments; institutional investors = insurance companies and pension funds, open-ended special funds, fund managers

“The lock-in mechanism on the housing market is likely to further increase rents in the unregulated segment of the market, while new buildings are often subject to graduated or indexed rent agreements anyway.”

Marco Högl
Head of Residential Capital Markets



Declining supply of new builds

While focussing on new-build projects might therefore seem to be a sensible strategy for risk-averse long-term investors right now, new builds can also present a number of challenges. Firstly, a significant decline in the construction of new buildings is anticipated in the coming years, meaning that fewer such products will reach the investment market. For example, the number of approved residential units in apartment buildings in 2023 fell by a quarter compared to the previous year.

Although this means that construction activity has not plummeted as sharply as for detached and semi-detached houses (- 47%), in view of the **continuing high rate of cancelled residential construction projects** and the insolvencies of various major developers, significantly lower completion rates for apartment buildings can also be expected in the coming years. Based on the **ifo Institute's forecast for new builds**, which predicts a total of only 175,000 completed residential units for 2026, and given that apartment buildings accounted for a share of 62% of all building applications approved in the years 2021 to 2023, the number of completed residential units in new apartment buildings could fall to below 110,000 in 2026. For comparison, this figure was still around 156,300 in 2023. However, not all of these new-build projects are suitable for institutional investors due to the

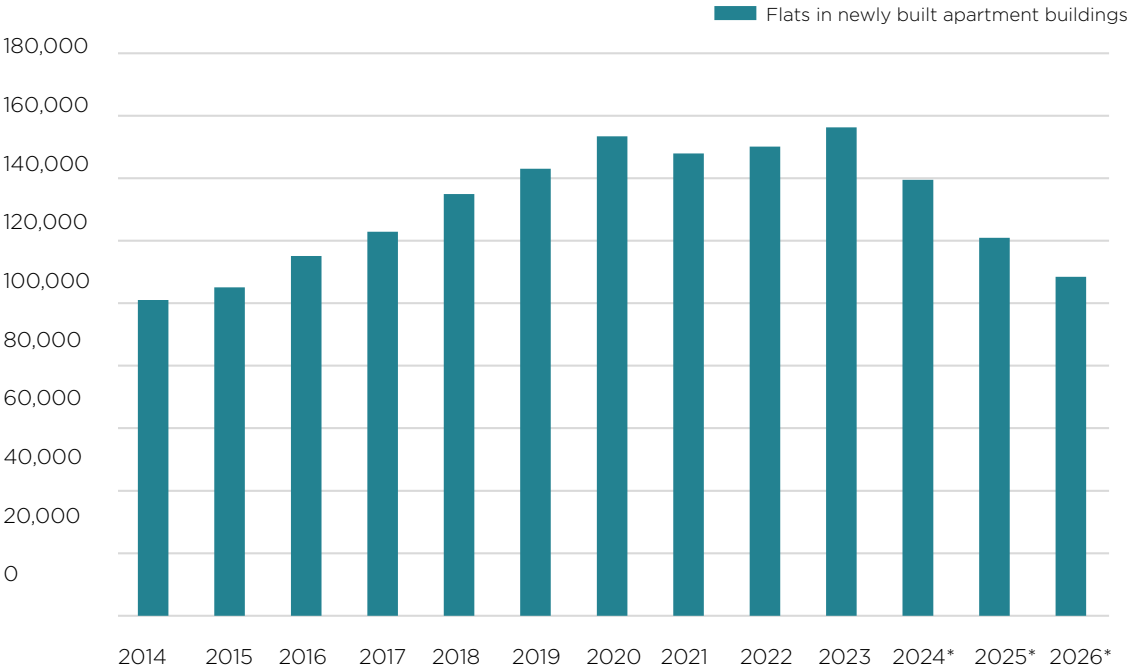
size of the property and quality of the location. In addition, around 9% of the units in apartment buildings approved in the last three years are in the hands of public and non-profit developers, who are generally unlikely to sell. A further 43% of the approved apartments in the last three years were owner-occupied flats in apartment buildings, which are generally not investment properties for institutional buyers. Although sales of owner-occupied flats also slumped in the wake of the turnaround in interest rates, there have recently been increasing indications that demand is picking up again. As rental flats look set to remain scarce for the foreseeable future, more households could switch to owner-occupied housing, with the **declining-balance depreciation** of 5% per year on owner-occupied properties likely acting as a further incentive. We believe that the proportion of owner-occupied flats in new builds could rise again in the future, reducing the stock available to institutional investors. In the years before the start of the interest rate turnaround, many investors acquired development projects with long lead times, with many developers opting for this type of sale as an alternative to selling individual owner-occupied apartments. In the wake of a number of developers declaring insolvency and housing projects being postponed or cancelled altogether, many investors and financiers

are currently unwilling or unable to purchase development projects at such an early stage.

Another challenge with new builds and ultimately the reason for the slump in the number of applications being approved is the disparity between the construction and financing costs and the amount of rent that can be achieved on the market. According to **ZIA's Spring Report**, the so-called "cost rent" for unsubsidised, newly built housing at the beginning of the year was around EUR 21.00/sqm. In view of the relatively stable construction costs and interest rates, this level is unlikely to have changed much in the past year. However, such rents are extremely difficult to achieve in many rental markets. In our experience, even if rents in this range are achievable, investors should be prepared for higher tenant turnover or vacancy costs. According to a **study by the Urban Land Institute**, housing affordability is one of the biggest concerns for real estate investors in Europe and could increase their reluctance to acquire new-build projects. Investors with a focus on new builds can avoid the challenges associated with development projects by turning their attention to newer existing buildings. According to a **survey by Industria**, this is exactly what an increasing number of institutional investors are doing. However, a large proportion of recent new buildings are likely to be in the hands of long-term owners or part-owners and, given the price correction on the residential investment market, the number of owners willing to sell in this segment of the market will probably remain negligible. One

alternative for institutional investors previously focussed on new builds could be to acquire older buildings that have been refurbished to improve their energy-efficiency, as these properties not only have good energy standards but also lower rents – two criteria that are compatible with many investors' ESG requirements. In the following, we will present the current situation in greater detail together with possible approaches for "manage-to-green" strategies, and outline the opportunities and risks associated with the purchase, subsequent energy-efficient refurbishment and resale.

FIG. 2 COMPLETED FLATS IN APARTMENT BUILDINGS IN GERMANY



Source Federal Statistical Office/ * own forecast based on ifo Institute data



Great potential in upgrading existing properties

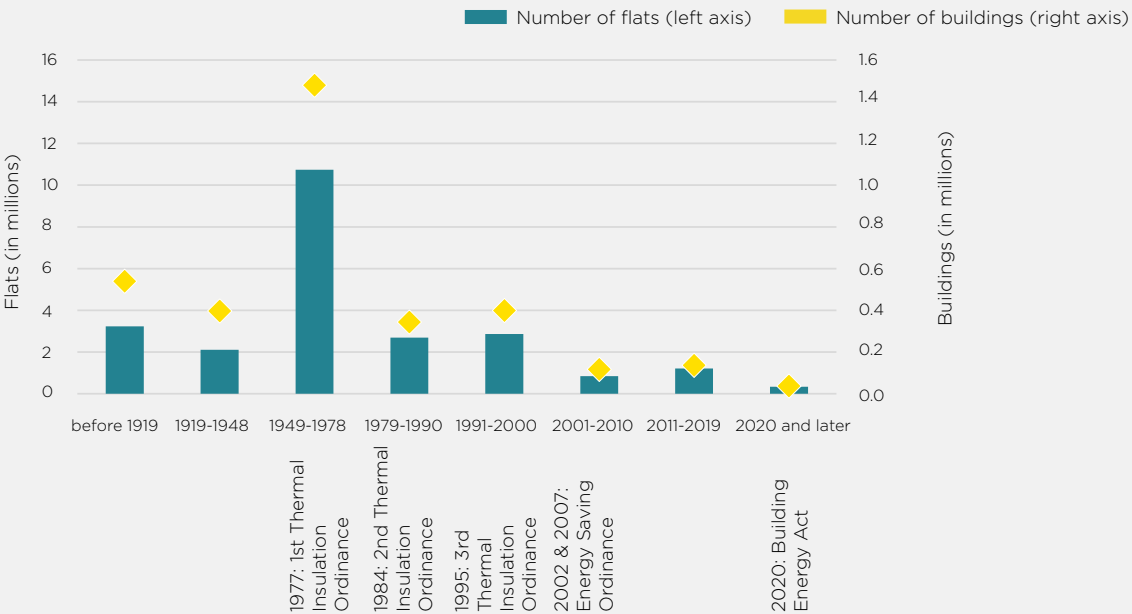
Germany's housing stock is in great need of refurbishment and upgrading. Around 70% of all apartment buildings and around two-thirds of all flats located in such buildings were built before the first Thermal Insulation Ordinance came into force in 1977. According to a **study by ARGE Kiel** (Institute for Sustainable Construction), around a third of these buildings are still in their original condition and have never been modernised. Only one third of the apartment blocks built before 1977 have been upgraded to a higher energy efficiency level through extensive modernisation work. The bottom line is that there is great potential for refurbishment and upgrading even just in this age group of buildings. However, many properties from the 1980s and early 1990s are by now also likely to be in need of major refurbishment.

Overall, 46% of all apartment buildings in Germany have an energy efficiency rating of E or worse. This is because they usually have outdated or inadequate insulation and inefficient heating systems. This also means that owners pay a higher share of the carbon levy, which reduces their margin. As the price of CO2 gradually increases, so will the financial burden on owners of buildings with poor energy performance. There is also a latent risk of stricter regulation. Although the EU decided against introducing a mandatory

renovation obligation for the worst performing residential buildings, the member states have pledged to reducing primary energy consumption in the housing sector by 22% by 2035. Given the current condition of Germany's housing stock and the current developments in residential construction, it remains to be seen whether this target can be achieved through legislative incentives or whether additional regulation will be introduced in the future. In addition to the CO2 costs, owners are also facing rising maintenance costs, especially for buildings that have not been modernised for many years. Since 2021 in particular, prices for maintenance and repairs of residential buildings have been growing faster than actual net "cold" rents, which also has a negative impact on margins for many owners of older buildings.

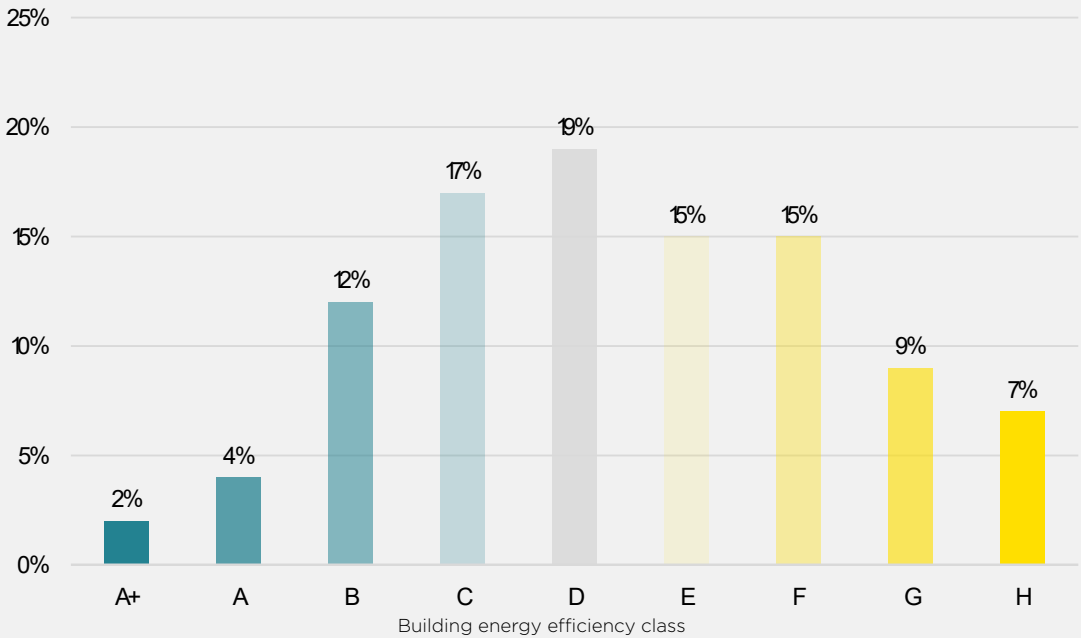
Overall, there are growing incentives and pressure to carry out more extensive refurbishment measures in older buildings.

FIG. 3 APARTMENT BUILDINGS BY CONSTRUCTION YEAR (2022)



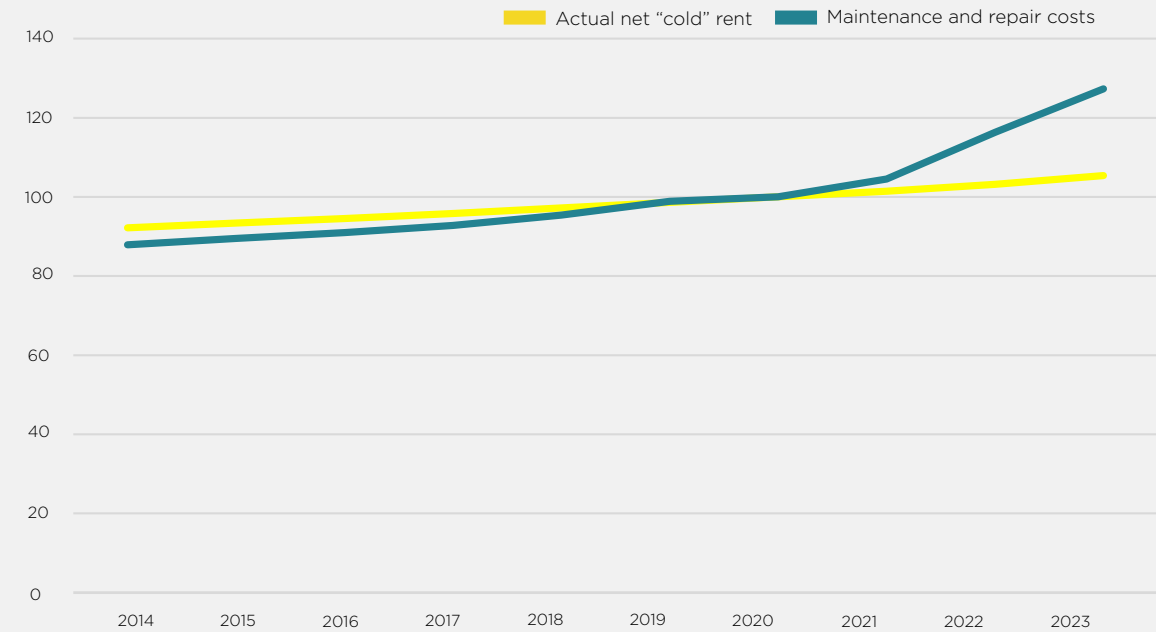
Source Statistical Offices of the Federal and State Governments of Germany / Building and flat numbers from the 2022 census

FIG. 4 APARTMENT BUILDINGS BY ENERGY EFFICIENCY CLASS



Source Professor Sven Bienert based on the German Federal Ministry for Economic Affairs and Energy (2020)

FIG. 5 CONSUMER PRICE INDEX: REGULATED RENTS AND SHARPLY RISING COSTS



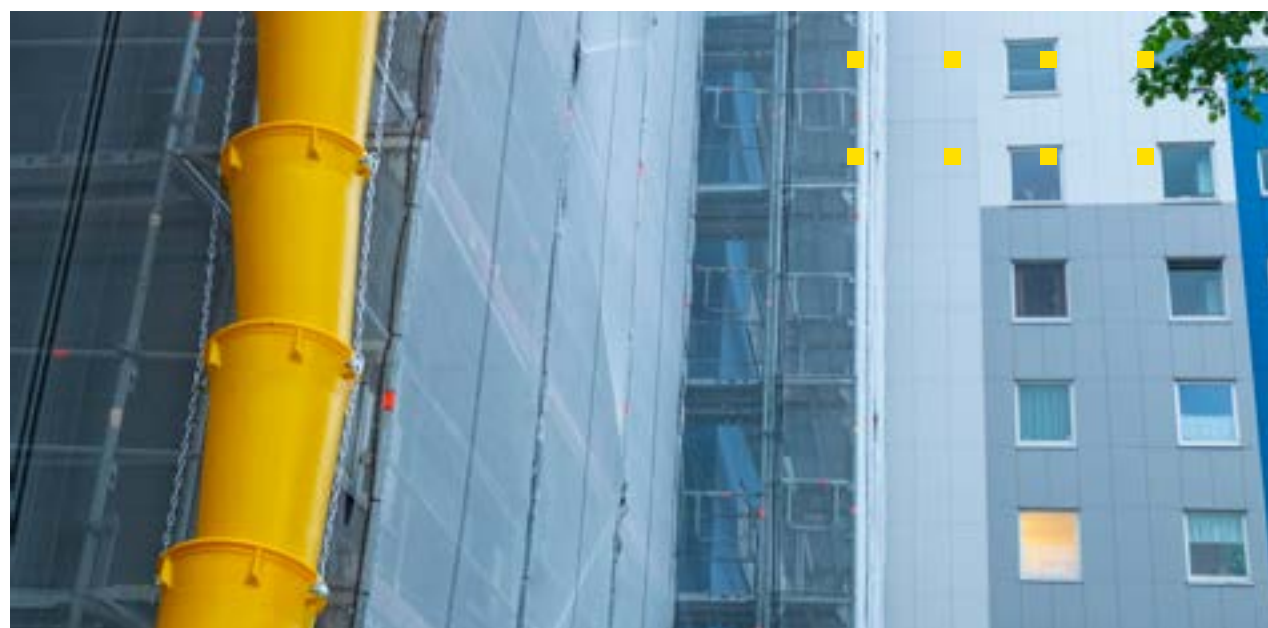
Source Federal Statistical Office of Germany

Refurbishment efforts lag as more owners look to sell

In practice, however, according to a **study by the German Institute of Economic Research (DIW Berlin)**, investment in energy-efficient refurbishment in Germany has been lagging for many years. At present, renovation rates are falling even further. The rate of energy-efficient refurbishments in 2023 was just 0.7%, according to a **study commissioned by the German Energy-Efficient Building Envelope Association (BuVEG)**. This is down compared to the previous year (0.88%) and well below the targeted 2% refurbishment rate considered necessary to meet the climate targets in the building sector.

One of the likely reasons for the low level of energy-efficient refurbishment is the sharp rise in costs. According to the Federal Statistical Office, prices for thermal insulation composite systems rose by 27% between 2021 and 2023 alone. In the years prior to this massive increase in construction costs, one of the main factors likely to have discouraged refurbishment of existing buildings was the almost complete lack of available capacity in the construction industry, in part due to the focus on new builds. Policymakers also likely played a role in reducing the incentives for refurbishment when they lowered the modernisation allocation (that landlords are permitted to pass on to tenants) from 11% to 8% from the start of 2019. In addition, some municipalities, such as Berlin, have designated an increasing number of neighbourhood preservation areas where renovation is often more difficult or subject to more bureaucratic hurdles. The fact that

a significant percentage of the apartment buildings in Germany are owned by private individuals likely plays a major role as well. According to the 2022 census, 41% of apartment buildings are owned by private individuals and a further 33% are in the hands of owners' associations, which are usually also made up of private individuals. Even the majority (56%) of large apartment blocks with 13 or more units are owned by private individuals or owners' associations. For the majority of private owners, comprehensive energy-efficient renovations are either too expensive or time-consuming due to the organisational and bureaucratic processes involved. However, in our experience, even professional investors whose core business is not property management are often reluctant to comprehensively refurbish their portfolio themselves. Instead, they simply shed these properties in need of refurbishment from their portfolios. Overall, we are observing a growing willingness to sell among long-term owners of older properties.

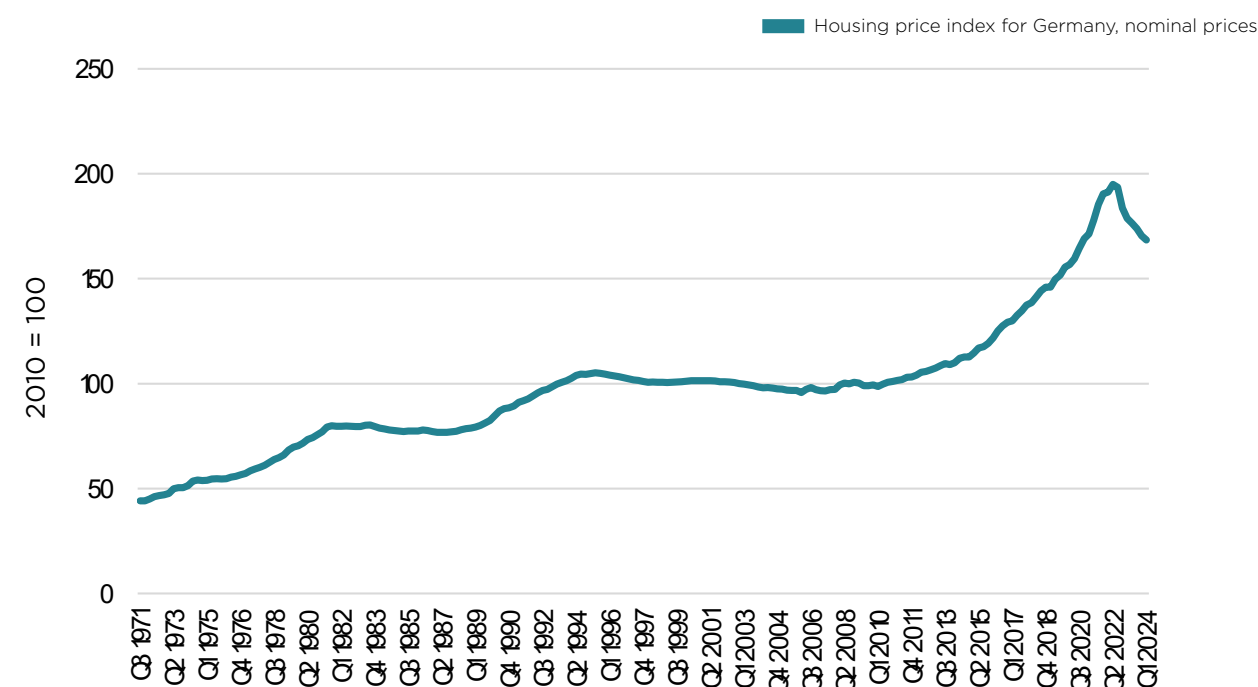


Lower starting prices for unrenovated properties

Owners looking to sell existing buildings of poor quality can expect significant markdowns on the purchase price, as potential buyers factor in the cost of impending refurbishment work into their offers. According to an **analysis by ImmoScout24**, the asking prices for flats and detached houses in energy efficiency class H were between 33% and 51% lower than those in the top energy efficiency class, depending on the location. In the case of apartment buildings, we are seeing price differences of 20 to 30% between properties in the highest energy efficiency class and those in efficiency classes G or H. While lower selling prices for unrenovated

buildings may act as a deterrent for many owners at first, they will in many cases have owned the properties for decades and thus benefited from steadily rising rents and considerable increases in capital value over this period. For example, the housing price index is still around 60% higher than in the 1990s, despite the sharp fall in prices following the turnaround in interest rates. This means that owners of unrenovated buildings are willing to sell even in the current market environment, creating opportunities for value-add buyers.

FIG. 6 **RESIDENTIAL PROPERTY PRICE INDEX (2010 = 100; NOT SEASONALLY ADJUSTED)**



Source Bank for International Settlements / Federal Reserve Bank of St. Louis

The purchase prices that can actually be achieved for properties in need of energy-efficient refurbishment vary greatly and depend on the location, the property in question and the level of renovation required as well as the potential for other upgrades. Based on our observations, larger value-add properties in A cities and attractive B cities can currently be acquired at a price of approx. EUR 2,000/sqm. Selling prices for larger value-add portfolios or properties in secondary locations are often less than EUR 1,500/sqm. Buyers with a manage-to-green approach primarily include project developers and specialised value-add funds.

How much does energy-efficient refurbishment cost?

As with purchase prices, the estimated costs of energy-efficient refurbishments can vary widely in practice. This is attributable not only to the fact that investors may have varying refurbishment goals, but also to the specific features of the property in question. One relevant factor is, for example, whether the building can be connected to a district heating system or whether the heating system in the building needs to be replaced or modernised. Then there are also economies of scale to be considered in energy-efficient refurbishments, with relatively homogeneous portfolios and larger residential complexes likely to be more cost-effective to renovate than more fragmented portfolios with varying building quality. Against this backdrop, serial refurbishment solutions are on the rise. According to the **German Energy Agency**, one in four apartments that received funding under the Federal Funding for Efficient Buildings (Bundesförderung für effiziente Gebäude, “BEG”) programme in the first quarter of 2024 was renovated in this way.

There are a number of measures that can generate high energy savings at relatively low cost. **According to the German Business Initiative for Energy Efficiency (DENEFF)**, examples of these include blow-in insulation for exterior walls or cellar ceilings. When considering the cost-benefit ratio

of energy-efficient refurbishments, it makes more sense to upgrade buildings to energy class C rather than the highest possible level of A/A+. This was the finding of a **study conducted by the University of Regensburg on behalf of the housing industry association GdW**, which found that refurbishing existing properties at GdW companies to meet the energy standard “Effizienzhaus 115” would be around 57% cheaper than refurbishing them in accordance with “Effizienzhaus 55”. A **study by ARGE Kiel in cooperation with the Pestel Institute and LCEE** also recommends not aiming for the highest efficiency standard when building new housing from an overall economic perspective.

Based on our observations, investors calculate energy-efficient refurbishment costs of between EUR 700 and 1,500/sqm in their manage-to-green strategies. The BKI Construction Costs Atlas 2024 indicates average modernisation costs of EUR 1,200/sqm of residential space for residential buildings built after 1945, although it also found a fairly wide range.

What are the options for adjusting the rent?

In addition to the classic rent adjustment options provided under Section 558 of the German Civil Code (“Baugesetzbuch”, BGB), the costs for energy-efficient refurbishments can be passed on to tenants via the rent. The allocation for modernisation costs must not exceed 8% per year, but is also limited in absolute terms to EUR 3/sqm within six years. If the rent was less than EUR 7/sqm before the modernisation work, the tenant allocation is capped at EUR 2/sqm within six years. Against this backdrop, manage-to-green strategies would appear to be a more worthwhile investment in the case of properties with starting rents of at least EUR 7/sqm.

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Matti Schenk
Associate Director Research



Rent adjustments

Authors: Dr. Philip Huperz, Maximiliane Bartsch, Claudia Maria Laszuk

There are several options for rent adjustments in German tenancy law. For example, indexation clauses can be agreed in lease agreements. There are also statutory regulations that enable landlords to raise the agreed rent in the course of ongoing asset management on the basis of modernisation measures or higher comparative rents in the local area.

Nevertheless, the statutory restrictions on private autonomy, such as rent control (the “Mietpreisbremse”), must always be observed.

1. Contractual rent adjustment options

The parties to a lease can agree on a **graduated rent** or an **indexed rent** either when drawing up the original lease agreement or at a later date through addenda to the lease agreement. In the case of graduated rent, rent increases in the form of fixed monetary amounts at specific intervals in the future are agreed in the lease agreement. Such increases are only permitted once a year. However, these kinds of clauses are invalid if the percentage increase is not shown as a fixed amount in the lease agreement or if the clause is not agreed by the parties in writing. It should also be considered that in areas where the housing market is under pressure, each individual adjustment must be measured against the permissible rent in accordance with the rent control regulations. If an indexed rent is agreed, however, the value of the rent is secured by linking it to the changes in the Consumer Price Index for Germany calculated on a monthly basis by the Federal Statistical Office.

The agreement of such clauses is also subject to certain legal requirements. For example, the indexed rent must be agreed in writing. Upwards-only clauses, which only allow rent increases but not reductions, are also not permitted. Landlords wishing to enforce a rent increase must also notify their tenants in a suitable manner in text form providing all the legally required information. Moreover, the statutory rent control restrictions only apply to the original rent, not to subsequent rent adjustments.



2. Rent adjustment options provided by law

Under German tenancy law, rent may be adjusted in line with the **local comparative rent** (Section 558 German Civil Code, “BGB”) or following **modernisation measures** (Section 559 BGB).

If the legal requirements are met, the landlord is entitled to demand the tenant’s consent to an increase in the rent to bring it in line with the local comparative rent, i.e. the average rent for comparable housing in the same or comparable municipalities. The main condition for this is that the rent must have remained unchanged for 15 months at the time at which the increase shall take effect. The rent cap, which prevents rents from being increased by more than 20% within three years, must also be observed. This cap is even reduced to 15% in certain municipalities or parts of municipalities which have been designated by order of the respective state government as being at risk of not having an adequate supply of rental housing at reasonable conditions for the local population. According to the German Tenants’ Association, 413 municipalities in Germany were subject to this cap as of January 2024. In addition, the coalition agreement adopted by the current federal government proposes that rents in areas where the housing market is under particular pressure may only be increased by 11% instead of 15% in the future. However, the federal government has not yet finalised any draft legislation.

If modernisation measures have been carried out, the landlord has the option of increasing the annual rent by up to 8% of the costs incurred for the rental unit (Section 559 BGB). This includes, for example, energy-efficient modernisation measures, the sustainable reduction of water consumption, the installation of fibre-optic connections, as well as lasting improvements to living conditions and the creation of new residential space. If the annual rent is increased, then, leaving aside the increases in accordance with Sections 558 or 560 BGB, the monthly rent generally may not increase by more than EUR 3.00/sqm of residential space over the

course of six years. If the monthly rent before the rent increase is less than EUR 7.00/sqm of residential space, the maximum increase is EUR 2.00/sqm.

The landlord may choose whether to increase the rent in accordance with the statutory requirements of Sections 559 or 558 BGB after carrying out modernisation measures. A combination of both options is also possible under certain conditions. For instance, the landlord may increase the rent in accordance with Section 559 BGB based on the modernisation work carried out and thus pass on the modernisation costs to the tenant within the scope permitted by this statutory provision. If, after the adjustment based on the modernisation work, the rent is still lower than the local comparative rent, the landlord can adjust the rent to the local comparative rent, using the modernised rental unit as the basis for the calculation.



We are currently observing excellent investment conditions: good starting prices, lots of potential for rent increases and a subsidy environment with a strong focus on the refurbishment of existing properties.



3. Limitations on agreed rent

Irrespective of the above rent adjustment options, the parties to the lease may still be limited in their ability to freely agree on the amount of rent owed if the respective state government has issued an official order designating certain regions, municipalities and/or cities as areas where the housing market is under pressure.

This may be the case especially if – as stipulated in Section 556d BGB – rents are increasing at a significantly higher rate than the average throughout the Federal Republic of Germany, if the rent accounts for a significantly higher portion of household expenses on average than the average throughout Germany, if the residential population is growing without new housing being built to meet this demand, or if a low vacancy rate is faced with high demand.

If a city or municipality is designated as an area where the housing market is under pressure by official order of the respective state government, the rent control regulations apply. In such cases, rents that exceed the local comparative rent by more than 10% are not permissible (Section 556d BGB). In general, the landlord must then repay any rent paid in excess to the tenant in accordance with Section 556g BGB. Rents that exceed this limit are still permissible, provided that a statutory exception or special case applies and the tenant has been informed to this effect.

One such exception is, for example, if the previous rent owed for a period of at least one year prior to the start of a new tenancy was higher than the rent currently permitted under the rent control regulations. The rent control constraints may also be loosened for apartments completed after 1 October 2014 or being let and used for the

first time after comprehensive modernisation, or if modernisation measures within the meaning of Section 555b BGB have been carried out within three years prior to the start of the tenancy.

However, exceptions to rent controls and other special cases are subject to strict conditions. For example, modernisation work is only considered “comprehensive” if the construction costs are equivalent to around one third of the cost of a new building and the quality of the modernised residential space is also comparable to that of newly created space. With average new housing construction costs at around EUR 2,000.00/sqm, a landlord would have to incur modernisation costs of around EUR 700.00/sqm and the quality of the rental space would have to at least come close to that of a new building once construction work is complete. Due to inflation, average construction costs are also likely to have increased significantly in the meantime.

Different rules may apply if the landlord only lets the residential space for temporary use or if the unit is furnished.

Subsidies

Authors: Rebecca Comtesse, Louisa Hecker

Creating affordable and suitable housing in cities is one of the key socio-political challenges facing the real estate sector. In the face of rising financing and construction costs, developers and buyers are showing an increased interest in subsidised housing as an attractive investment vehicle.

There are a wide variety of offers and subsidy programmes available for subsidised housing throughout Germany at a federal, state and municipal level, each with its own set of legal and technical requirements.

Under current legislation (with legislative authority regarding housing subsidies generally in the hands of the federal states), funding is available not only for the construction of new buildings, but also for the refurbishment of existing residential buildings, e.g. for the complete refurbishment of houses or flats to make them more energy-efficient, or simply for the installation of more environmentally friendly heating systems.

At the federal level, for example, the state-owned development bank Kreditanstalt für Wiederaufbau (KfW) provides subsidies for the following measures, subject to various conditions

- the purchase of existing properties;

- individual energy-efficient improvements which have already been supported by grants in residential buildings;
- the use of renewable energies; or
- housing conversions for senior citizens.

Depending on the specific case, funding is provided in the form of an interest-free or low-interest loan or in some cases in the form of grants. For all types of (housing) subsidies, particular attention should always be paid to the relevant application deadlines and the technical specifications, as well as whether participation in certain subsidy programmes can be combined with other subsidies or not.

It is therefore important to analyse the desired subsidy carefully before starting construction or concluding a purchase agreement (i.e. before the start of the project (Vorhabenbeginn)) and to avoid concluding any contracts that could stand in the way of the subsidy.

Buyers of subsidised properties may also become subject to a number of obligations towards the granting authority. The possibility of taking over existing subsidies – and how to do this in the proper way – as well as the economic implications of this therefore need to be understood and factored into any cost calculations.



A worthwhile investment

– from both an ecological *and* economic point of view?

Refurbishing an existing residential building to make it more energy-efficient can reduce the associated carbon footprint **by around 50% compared to a new build**. From an ecological perspective, it therefore makes more sense to renovate an existing building than to replace it with a new one, as the latter generates a large amount of what are known as **grey emissions**. When it comes to ecological sustainability, the question for real estate companies is no longer whether manage-to-green measures are a worthwhile investment for the future, but rather how they can successfully implement these measures in practical terms – including from an economic perspective.

In practice, companies generally only pursue a manage-to-green approach if they can secure a profitable return on their investment costs or increase the value of their properties. The main factors determining the profitability of manage-to-green measures are the purchase price, the costs of the energy-efficient refurbishment, any rent increases that can potentially be achieved and the realisable selling price to an end investor.

What little advice there is for property owners in this regard is simply to “calculate everything down to the last penny”, while popular science studies that systematically evaluate the economic efficiency of manage-to-green approaches in a generally applicable way are few and far between. As purchase prices and refurbishment costs can vary widely, manage-to-green opportunities must always be assessed on a case-by-case basis, making it difficult to make any general statements on their economic viability. Ultimately, however, we can say one thing: If a business model did not create economic added value, we would not see it being deployed on the market. And practical experience clearly shows that such approaches have already taken root.

When considering the economic viability of a project, the use of subsidies can be a significant lever for ensuring the profitability of a manage-to-green approach. The funding landscape in Germany is extremely diverse, with subsidy programmes available across all federal levels. There are a total of **16 funding institutions** at state level, with the state-owned investment and development bank KfW Bankengruppe playing a central role as a nationwide institution. KfW offers, for example, targeted subsidy programmes for the energy-efficient refurbishment of existing properties, providing attractive support for would-be renovators. One advantage of this broad funding landscape is the ability to combine various subsidies, making it considerably easier to

carry out energy-efficient renovations. However, getting a clear overview of the programmes that are available and navigating this complex funding landscape presents its own challenges. In our experience, the profitability of an energy-efficient refurbishment cannot be guaranteed without the leverage provided by subsidies.

Around the same time as the end of the last real estate market cycle, a portion of the available funding was allocated specifically to the energy-efficient refurbishment of existing properties. This appears to have been at the expense of funding for the construction of new buildings. The well-intentioned rationale behind this legislative decision was explicitly to promote climate-friendly conversions within Germany's housing stock and to curb the deadweight losses of new construction subsidies experienced during the real estate boom. While the almost concurrent change in the market environment initially led to a flood of applications, it was unable to halt the slump in construction of new buildings and, as a result, did not have the hoped-for effect on the modernisation of existing properties. In practice, subsidies were in many cases cut off without warning as soon as the respective funding pots dried up and changes were made to the subsidy programmes without sufficient advance warning. This has created considerable uncertainty, making it much more difficult to guarantee the necessary planning security for such projects. This has led to scepticism and reduced confidence in the reliability of the available funding structures. A practical solution to sustainably increase refurbishment rates in Germany's housing stock would be to expand the available state funding.

In manage-to-green modernisation projects, it is not just the value-add investor who ultimately benefits from an increase in the property value; acquiring such refurbished properties can also have advantages for institutional end investors, allowing them to obtain an existing property that will continue to meet the regulatory requirements for years to come. Rents in such properties are noticeably lower than for new buildings and therefore more affordable for tenants, contributing to the social aspect of ESG. At the same time, the purchase price for a refurbished property is lower than the cost price for constructing new buildings in major cities, which according to a study by ARGE Kiel averaged EUR 4,318/sqm at the end of 2023. In practice, however, it is usually very difficult for investors to secure such properties given the competitive environment.

As purchase prices and refurbishment costs can vary widely, manage-to-green opportunities must always be assessed on a case-by-case basis, making it difficult to make any general statements on their economic viability.

Laura Wetzel
Senior Consultant
Operational Capital Markets



Creating further added value through additional storeys and redensification

Alongside carrying out refurbishment work to make existing buildings more energy-efficient, other means of increasing property value include adding additional storeys and redensification. According to a **study by ARGE Kiel**, adding storeys to residential buildings built between the 1950s and 1990s could potentially create an additional 1.5 million flats. According to a **study by TU Darmstadt and the Pestel Institute**, creating additional residential space by adding storeys is generally cheaper than building new homes, as already developed plots in urban centres can be used.

Many neighbourhoods built between the 1950s and 1970s are likely to be particularly

suitable for this kind of extension. As these are often large and not yet densely populated urban areas, they often have significant reserves of land, meaning that additional residential units can be built. According to a **study by Bulwiengesa**, neighbourhoods built in the 1950s to 1960s alone have a theoretical redensification potential equivalent to 625,000 flats. From an investor's point of view, synergies can be achieved by combining the addition of storeys with refurbishment measures. In addition, many such existing neighbourhoods are likely to be suitable for serial refurbishment, for example according to the Dutch "Energysprong" model, which can increase cost efficiency.

Planning law

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When it comes to societal requirements and/or expectations, such as the constantly growing housing shortage, the law is often a few steps behind, prompting politicians to hectic legislative reactions. Public building law in Germany is divided into planning law (the German Federal Building Code (Baugesetzbuch, "BauGB"), i.e., "whether" construction is possible) and building regulations (determined by state law, i.e., "how" construction needs to be carried out).

In accordance with Section 1 (5) BauGB, the core principle of planning law has always been "sustainable urban development", which "should be achieved primarily through internal development measures". Redensification, especially in urban centres, is therefore a core element of this sustainable development and not a new idea. According to Section 31 (3) BauGB, in areas where there is pressure on the housing market as defined by Section 201a BauGB – currently primarily in large cities such as Hamburg, Berlin, Düsseldorf or Cologne – residential housing projects may, in certain cases, be exempt from the determinations of an existing development plan. This allows for the approval of construction projects, such as the addition of storeys to residential buildings, even if they change the "basic intention underlying the plan". These provisions of the BauGB are now to be generously expanded: On 4 September 2024, the Federal Cabinet approved draft legislation to strengthen integrated urban development. The bill allows for more flexibility with regard to Section 31 (3) BauGB, making building extensions, in particular the construction of additional storeys, possible in any area and not just in areas where the housing market is under pressure (Section 201a BauGB), without having to amend the development plan. A particularly significant change included in this legislative initiative is the planned introduction of Section 246e BauGB-E, also known as the "residential construction turbo section" ("Wohnungsbau-Turbo-Paragraf"). This would facilitate residential construction in areas where the housing market is under pressure (Section 201a BauGB), regardless of the determined type of use (residential area, commercial area or even an industrial area, etc.). Furthermore, the development planning is to

be completed within twelve months. Building regulations are also being adapted at state level to facilitate the redensification of residential housing. In Berlin, for example, the most recent amendment to the Building Code of Berlin (Bauordnung Berlin, "BauO Bln") has made the alteration and change of use of attic floors for residential use, including the construction of dormers, in unplanned interior areas (Section 34 (1) sentence 1 BauGB) generally exempt from approval in accordance with Section 62 (2) no. 1 c) BauO Bln. Moreover, in accordance with Sections 39 (4) sentence 1, 50 (1) sentence 6 BauO Bln, roof extensions and the addition of further storeys to existing buildings are permitted up to a maximum of two storeys without requiring the installation of a lift system. In addition, on 26 August 2024, the Berlin Senate presented the "Faster Construction Law" ("Schneller-Bauen-Gesetz") to the Berlin House of Representatives, which aims to ensure faster processing of building applications, especially for residential construction.

In 2023, the federal and state governments also agreed on the "Construction Turbo Pact" ("Bau-Turbo-Pakt"), a package of measures to speed up planning and approval procedures. Following an amendment to Section 67 of the Model Building Regulation (Musterbauordnung, "MBO"), deviations from the usual rules and regulations may be permitted under the state building regulations (cf. Section 67 (1) sentence 2 no. 3 BauO Bln, Section 69 (1) sentence 3 no. 2 BauO NRW, etc.) in order to make way for "new forms of construction and housing" (also known as "Gebäudetyp-E") that can be realised more quickly, more easily and more cost-effectively.

In legal practice however, ongoing amendments and/or expansions to the existing legal principles are less important. While the mentioned (planned) changes are to be welcomed in principle, because they facilitate redensification and the creation of more residential housing, a certain "mindset" in legal practice is needed to make effective use of the (already existing) legal instruments.



Manage-to-green – a summary

The renovation of older properties to make them more energy-efficient can be a profitable strategy to add value, especially if this is combined with subsidy programmes and additional residential space can be created by adding storeys or through redensification. “Manage-to-green” projects offer various advantages for stakeholders.

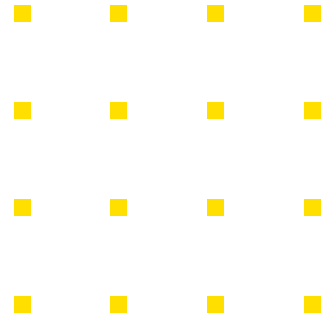
A key benefit of such projects is the improvement in the energy efficiency of existing buildings, which contributes to the “E” in ESG from an investor’s perspective. Refurbishment measures also create higher-quality residential space. At the same time, even if rent increases are unavoidable, the rent can be kept significantly below that of new-build flats. This helps to keep rents affordable, which is a key criterion in terms of social sustainability (the “S” in ESG).

Another crucial aspect is the preservation of so-called “grey energy”, which remains tied up in existing buildings. Compared to conventional new-build projects, which use a lot of resources, refurbishments and modernisations are generally much more environmentally friendly. Grey energy has come to play an increasingly significant role in the public and political debate in recent years, and it is not unlikely that this aspect will also become a higher priority for institutional investors in the future.

There are further advantages to creating additional residential space by adding storeys or through redensification. For one, it means that existing sites can be used without new building zones having to be designated. This not only makes ecological sense, as it prevents more open spaces from being built over, but is also advantageous at the municipal level, as the existing infrastructure can be utilised. This often makes redevelopment of existing sites more cost-effective and efficient than greenfield development.

For these reasons, institutional investors may view existing properties that have undergone energy-efficient refurbishment as an attractive investment product.

Once refurbished, these properties meet a long-term, legally compliant energy efficiency standard and are significantly cheaper than new builds. However, while manage-to-green projects offer many advantages, they also come with a number of obstacles and restrictions. Under the current allocation rules for modernisation costs, the refurbishment costs can only be partially passed on to tenants through the rent. Particularly in housing markets with low market rents and higher vacancy rates, the scope for rent increases is limited, even when concluding a new lease. This makes manage-to-green strategies in such areas generally unprofitable, especially as institutional end investors are also turning away from these housing markets. For this reason, manage-to-green approaches are in practice likely to be limited to regions with overstretched housing markets. In larger portfolios, varying building quality and levels of refurbishment can make it difficult to carry out energy-efficient refurbishment measures. Maintaining a portfolio that is as homogeneous as possible with residential complexes above a certain minimum size can make manage-to-green projects more manageable and increase efficiency and profitability. It is also crucial that subsidy programmes are maintained and expanded so that capital can be channelled into such modernisation measures and the climate and refurbishment targets for Germany’s housing stock can be achieved.



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