European Living Refurbishment

September 2024

IN A NUTSHELL

- Across many of Europe's major cities there is an acute lack of housing, particularly rental stock. Supply shortages, urban demand and a plunging development pipeline is supporting rental growth across Europe.
- We see the refurbishment of residential space as part of a broader value add strategy. Supply shortages are the primary reason for refurbishment, but changing occupier needs, growing demand for smaller units, and environmental considerations also play significant roles.
- This strategy primarily targets the modernisation of older stock, capturing rental growth and optimising unit sizes. We would also explore opportunities to increase floorspace where feasible and appropriate.
- We believe investors should have a particular focus on inner city locations across major cities in the German and Dutch housing market given the high share of older stock and the relatively large built-to rent-sector in these markets.

Sitting here in London and Frankfurt, rarely a day goes by without one of us reading in the press a story about housing. Shortages, mortgages, rents, regulation, affordability, and planning. Housing is high up on the agenda, not just here in the UK and Germany, but across much of the globe.

This is not surprising. Across many of Europe's major cities there is an acute lack of housing, particularly rental stock. For example, by the end of last year, the average residential vacancy rate in Germany's top 7 cities was less than 1%, with Frankfurt, Munich, and Hamburg essentially full.[1]

There are many proposed solutions to these housing challenges. Some have focused on the demand side and market intervention, regulating rents, or providing increased security of tenure. While providing temporary relief for incumbent tenants, there is growing evidence to suggest this does not provide a long-term solution to supply issues.

Therefore, we strongly believe the solution to housing shortages lies in increased development. This will likely come in many forms, from the development of greenfield sites to the repositioning of obsolete commercial stock – such as obsolete offices – into residential space.

One area we think is often overlooked, is the refurbishment of aged residential into modern stock, able to meet the needs of today's tenant base. Not only do we believe there will be ample demand for this type of space, forming part of the solution to the housing shortage, this approach could provide a compelling investment strategy for real estate investors, looking to actively manage space, and achieve value add returns.

Why residential refurbishment?

Supply, regulation, risk, and return

We see the refurbishment of residential space as part of a broader value add strategy. It is not the only approach, but in some locations and across certain assets we believe it could be the most appropriate method of delivering high-quality space and achieving value-add-level returns.

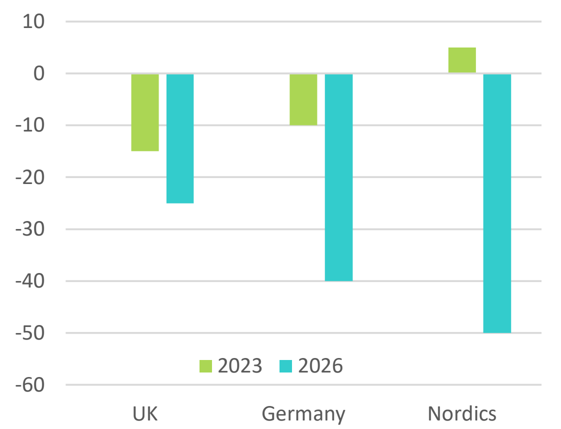
Supply shortages are the primary reason for refurbishing residential spaces. However, changing occupier needs, growing demand for smaller units, and environmental

[1] CBRE, empirica, June 2024

considerations also play significant roles. These factors collectively drive the push towards modernising existing properties to better meet current and future housing demands.

Supply shortages have been exacerbated by recent market events, notably rising construction and financing costs, falling real estate values, and the collapse of development companies. As shown in the chart below, residential completions – already well down in some markets – are projected to fall sharply over the coming years.

Residential Completions (% change compared to 2022)



Source: Greenstreet, April 2024

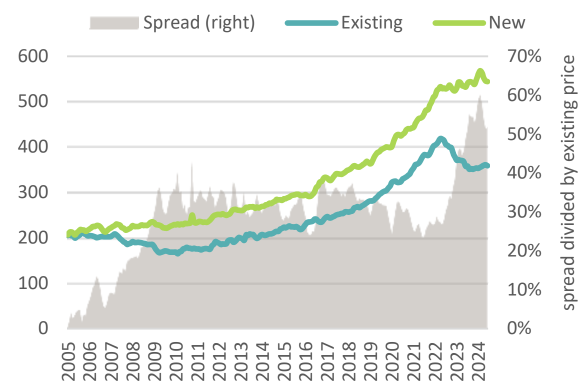
But it's not just about a lack of new supply. Regulatory changes are also increasing the need for better quality stock. As we've said in previous reports, we are unlikely to build our way out of climate change, and as such government and our industry would need to improve the current stock.

We are seeing an increasing number of governments implementing minimum energy standards across commercial real estate, including residential rental stock. For example, from next year all newly rented properties in the UK will require an EPC of at least a C. This is also visible when looking at price developments by energy efficiency.

For example, the price discount for properties in Germany with weak EPC rating has increased significantly. The discount between buildings with best energy classes A/A+ compared to worst classes G/H rose from -12% to -29% in the two years to third quarter 2023.[2]

Regulatory changes are expected to accelerate an already established trend in the diverging performance between new and existing stock. Whether driven by environmental regulations, build quality, occupier preferences, or the investment cycle, in Germany amongst other places, we've observed a widening spread in the value of new build and existing stock. This has become most apparent during the market correction of the past two years, with new build values broadly unchanged, compared to a 15% value loss on existing stock.[3] The trend is also observable in other regions across Europe. In the UK, the price difference between new and existing stock more than doubled from 16% to 40% over past two years.[4]

Germany: Residential House Price (€'000)

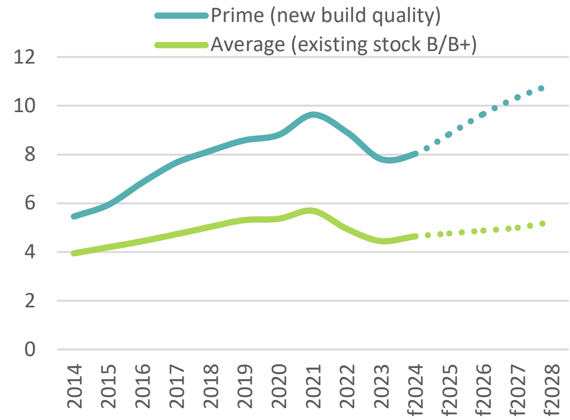


Source: Macrobond, Europace, July 31, 2024

We anticipate this trend to continue for the rest of the decade. With shortages of high quality and modern space exacerbated by the reduced level of construction, as well as ongoing environmental pressures from regulators and tenants potentially driving a green premium, we forecast that prime (new build quality) values may grow at twice the pace of average stock. Not only does this support current investments into this part of the market, but it also increases the alpha of transforming weaker quality stock into modern assets.

[2] JLL, April 2024.
[3] Europace, July 2024.
[4] HM Land Registry UK, July 2024

European Multifamily Capital Values (€'000 per square metre)



Source: Greenstreet, DWS, June 2024

The case for refurbishment goes beyond returns. This approach could also be lower on the risk spectrum when compared to some of the other approaches to transforming assets into rental residential. Planning risks are expected to be low. The locations are established for residential use, with associated amenities. These assets should have an operational track record, helping to determine levels of demand, tenant mix, optimal configurations, and appropriate rental levels.

Furthermore, this approach is likely to require less development activity. Pandemic-related supply bottlenecks, material shortages, energy prices and labour shortages raised total development costs, and while the recent moderation of construction inflation does support a more active management approach going forward, development risks remain.

Investment strategy

Modernisation and extensions in Germany & Netherlands

This strategy would primarily target the modernisation of older stock, capturing rental growth and optimising unit sizes. This involves updating interiors, improving layouts, and ensuring each unit meets contemporary living standards, making them more attractive to potential tenants and increasing rental income.

We would also explore opportunities to increase floorspace where feasible and appropriate. This could involve extending existing structures or converting unused spaces into additional living areas. By delivering more space, we could potentially enhance the property's value and appeal, providing tenants with more comfortable and versatile living environments.

Refurbishment efforts would focus on modernisation and energy efficiency improvements. Upgrading energy certifications to meet regulatory standards not only helps ensure compliance but could potentially reduce overall running costs. Implementing energy-efficient systems and materials could potentially lower utility bills for tenants, making the units more desirable and environmentally friendly.

Additionally, we would aim to provide modern amenities that cater to current market demands. This includes installing high-speed internet, smart home features, and potentially communal spaces such as gyms. These enhancements could boost tenant satisfaction and retention, potentially leading to a more profitable and sustainable investment.

Access to stock of an appropriate scale is likely to limit the focus of this strategy to a select number of European cities. While all major cities may provide select opportunities, we believe that with their large and well-established rental markets, the German and Dutch markets are likely to offer the greatest scope. In some instances, both these markets will present challenges around rental regulation, although with sufficient change, and a keen understanding of the market, we believe capturing value add returns is achievable.

In general, we prefer inner city locations across major cities, where the delivery of improved assets is well aligned with the rental tone of the location, affordable, but high enough to compensate for the cost of delivering the refurbishment.

Source: DWS Images, May 2024

Real Estate Research Team

Office Locations

Frankfurt
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
45 Cannon Street
London, EC4m 5SB
United Kingdom
Tel: +44 20 754 58000

New York
875 Third Avenue
26th Floor
New York
NY 10022-6225
United States
Tel: +1 212 454 3414

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
15th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
18th Floor
Tokyo
Japan
Tel: +81 3 5156 6000

Sydney
Level 16, Deutsche Bank Place
Corner of Hunter and Phillip Streets
Sydney NSW 2000
Australia
Tel: +61 2 8258 1234

Teams

Global

Kevin White, CFA
Global Co-Head of Real Estate Research

Simon Wallace
Global Co-Head of Real Estate Research

Americas

Brooks Wells
Head of Research, Americas

Liliana Diaconu, CFA
Office & Retail Research

Ross Adams
Industrial Research

Sharim Sohail
Self-Storage Research

Europe

Ruben Bos, CFA
Head of Real Estate Investment Strategy, Europe

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Carsten Lieser
Property Market Research

Martin Lippmann
Head of Real Estate Research, Europe

Asia Pacific

Koichiro Obu
Head of Real Estate Research, Asia Pacific

Seng-Hong Teng
Property Market Research

Hyunwoo Kim
Property Market Research

Matthew Persson
Property Market Research

Authors

Simon Wallace
Global Co-Head of Real Estate Research

Carsten Lieser
Research Analyst Real Estate

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