German Residential valuations looking shaky

DECEMBER 2022

SESFIKILE CAPITAL
Property Investments

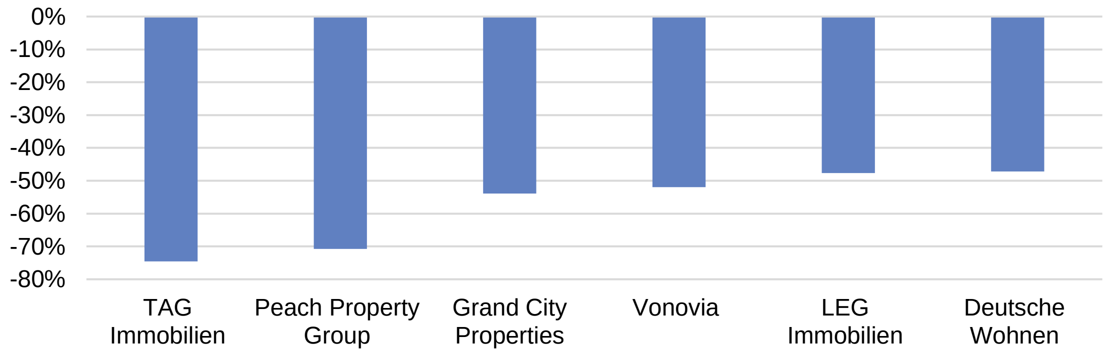
T +27 11 684 2681 | **E** info@sescap.co.za | **W** www.sesfikilecapital.com
2nd Floor, 18 The High Street, Melrose Arch, Johannesburg, South Africa, 2076

Date: 14 December 2022

German Residential stocks have been amongst the worst-performing property companies in 2022. The sector has lost c.51% this year, well below the FTSE/EPRA Nareit Developed Rental Index, down 23.4% in USD (see chart 01 below). Once a darling of the European real estate market, the sector faced a perfect storm of headwinds in 2022, leading to its underperformance.

Chart 01

German Residential year-to-date total return



Source: Bloomberg, Sesfikile analysis

Rental affordability has come into the spotlight since mid-june following the spike in European gas, power and food prices. At current forward prices, energy bills will peak early next year at c.€500/month for a typical German family, implying a c.200% increase vs. 2021. Germany's government has approved a draft law to cap the price of electricity and gas by granting customers a fixed volume of supplies at reduced rates. The caps will remain in place until at least April 2024. In addition to energy costs, food prices have soared by nearly 20%, with inflation at its highest rate in 30 years.

The sector has experienced 14 years of uninterrupted yield compression. However, with interest rates rising rapidly over the past few months in response to higher inflation, there is mounting concern that asset valuations will need to adjust accordingly, with double-digit write-downs possibly on the horizon.

The transactional market has stalled, with buyers sitting on the sidelines waiting to see where interest rates and bond yields settle. This has created limited transactional evidence to support current valuations. LEG Immobilien ("LEG") has guided for a 3-5% decline this quarter and highlighted Moody's report, which forecasted a 10% decline next year. Leverage in the listed German Residential market is generally high, with loan-to-value (LTV) ratios around 42-51%, making the sub-sector one of the more vulnerable places to invest. With asset values at risk of sharp decline, so will LTV ratios push upwards to uncomfortable levels, necessitating capital raises and or dividend cuts.

The larger players in the sector have taken different responses to these balance sheet challenges; LEG appears to be facing it head-on, maintaining its disposal programme and switching to a cash-based strategy through a change to its reporting metrics from funds from operations (FFO) to Adjusted Funds from operations (AFFO). AFFO accounts for capital expenditure and reduces the amount on which dividends are payable. On the other hand, Vonovia has adopted a more wait-and-see approach, still placing greater reliance on disposals (in a dormant transactional market) while ruling out any equity raise or change to its dividend policy until further evidence is presented.

To be clear, the sector still enjoys strong fundamentals, evidenced by vacancies in the mid-2% levels and limited supply in all major cities. Nationally, the current supply at 285,000 units continues to fail to meet demand, which is projected to be 400,000 per annum. Due to rental regulations, development yields have failed to entice developers that continue to face escalating construction costs. Therefore, German Residential remains a defensive cashflow-generating asset class, but the near-term valuation wobbles cannot be avoided.

Naeem Tilly

Head of Research and Portfolio Manager, Sesfikile Capital