

Pipe Work Restoration

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Introduction

The topic pipe work restoration can be explained in two different ways. The author can either explain the technical method of doing the restoration, or explain in an economical manner. This essay will focus on the economical method and will explain how to carry out good pipe work restoration, in combination with modernization in order to raise the rent.

Pipe Work Restoration

Why should a property owner perform a pipe work restoration? The first indications are many cases of blockages within a short time period. A lot of pipes have burst and the cost of repairing those pipes has increased. The water pressure decreases, especially in the upper floors, and the tenants are not very satisfied with this situation. This means the water pipes have exceeded their functional life expectancy. Mostly they consist of old material, therefore the property owner should change all water, and sewer pipes. This pipe work restoration is expensive, but in comparison with the increasing costs of repair this investment should be seen as a good decision, especially in combination with a rent increase.

Pipe Work Restoration without Modernization

Pipe work restoration in Germany is usually normal maintenance work; this means the property owner cannot raise the rent because he does not increase the standard of the apartments. The solution is to combine the pipe work restoration with modernization, e.g. building new bathrooms of a higher standard. This solution allows the possibility of raising the rent. As a result of this solution, we will not consider normal pipe work restoration without modernization as an option.

Pipe Work Restoration with Modernization

There are many legal constraints in Germany against raising the rent after performing a modernization. The following paragraphs will provide an overview of how to perform a good modernization in Germany.

What is a Modernization?

A modernization means to do structural measures to improve the living conditions of the tenants. These measures can be the installation of a sound insulation, central heating, a lift or new improved bathrooms. Other measures, for improving the outside facilities, e.g. creation of parking lots, playgrounds or parks; are also actions which will raise the living standard of the tenants. Another group of modernization work is measures for saving energy or water, e.g. installation of heat insulation or water meter. The extension of the attic storey can also be considered as a modernization.

The first steps of a modernization

The property owner has to inform the tenants at least three month before the work should begin. This notification has to include the following parts:

- The start date of the work.
- The explanation of the measures.
- The duration of the work.
- The expected rent increase for every tenant after modernization is complete.

If the property owner keeps within the legal requirements, the tenant has to accept the work and the tenants are not allowed to deny access to their apartment. There are only a few points where the tenant has the right to disagree to the modernization:

- Installation of a central heating during the winter.
- The bathroom and kitchen are out of commission for several weeks.
- Decrease in the living conditions because of a new floor plan for the apartment (e.g. one room is too small to use).

After receiving notification from the property owner the tenant has the possibility of terminating the rental contract. The tenant gets a special termination clause: They have to send their

termination on the last day of the following month after receiving notification, at the latest. The rental contract will terminate at the end of the following month.

An example to simplify this special termination clause:

- 10.02.2008: receive notification.
- 31.03.2008: last day to send termination to property owner.
- 30.04.2008: termination of rental contract.

Even if the tenants have the mandatory regulation of accepting the work, the property owner should send every tenant a written agreement of acceptance to the work. The tenants have to sign this agreement and send it back to the property owner. This agreement will help to avoid delays in getting access to the apartments. There can be problems with tenants who do not sign this agreement and deny access to the apartments. The craftsmen cannot do their work and the planned duration will suffer delays. For these tenants who do not give access to their apartments, the property owner has to contact a lawyer to get a legal solution.

It is often easier to carry out modernization if you have an empty building. On the one hand, you can be sure that you will get access to every apartment and that your time schedule will be on time. Furthermore, to keep the time schedule for pipe work restoration is very hard, even in an empty building. However, an empty building also means that you have to have a very good organisation for letting, in order to find new tenants at short notice after the modernization is finished.

On the other hand, you will not receive any rental income, so your financial situation is better when your tenants stay in their apartments during the modernization.

In the meantime, the property owner should have completed the building contracts with the companies responsible for doing the pipe work restoration, and the modernization. It is very important to have a good time schedule and a weekly meeting to discuss the problems and the current state of affairs. Pipe work restoration has to be made “string by string”, because the pipes run vertically. The property owner should use his warranty if any problems occur.

How to raise the rent after the modernization

The property owner can choose between three options for raising the rent of the current tenants after making a modernization:

- Pass on 11% of the costs for the modernization to the tenants.
- Raise the rent to the comparative rent common for the location (compared to the standard after modernization).
- A combination of the two above mentioned possibilities (raise the rent to the comparative rent common for the location, compared to the standard before modernization and pass on 11% of the costs).

The property owner can pass on 11% of the costs for the modernization to the tenants. There has to be a detailed description describing the breakdown of the costs for each apartment:

- 5.000 € costs for modernization for apartment A (size: 65 sqm)
- 11% = 550 € p.a.
- 45,83 € p.m. (equals 0,71 € sqm/p.m.)
- Yield: $550 \text{ €} / 5.000 \text{ €} = 11\%$

The tenant has to pay 45,83 € each month for the modernization of his apartment additional to the monthly rent.

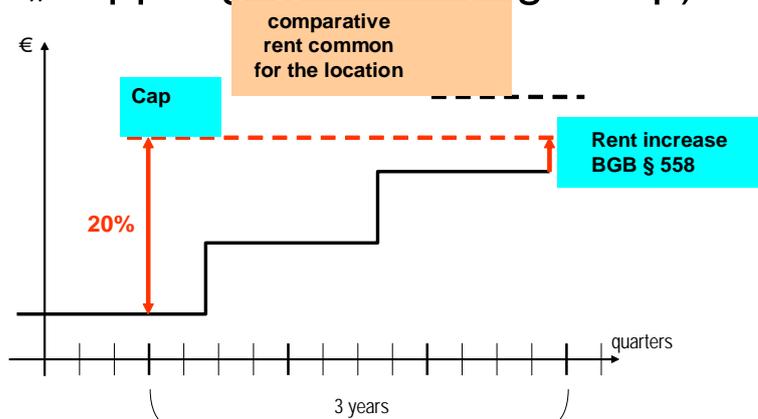
The increase in the rent is permissible, if the living conditions for the tenants have improved (see above “What is modernization”). The property owner can only pass on the costs for the modernization, not other costs such as:

- Credit costs
- Development costs
- Notary/ lawyer
- Costs for land register
- Administration costs
- Loss of rent
- Costs of repair
- Maintenance costs.

The property owner has to deduct subsidies.

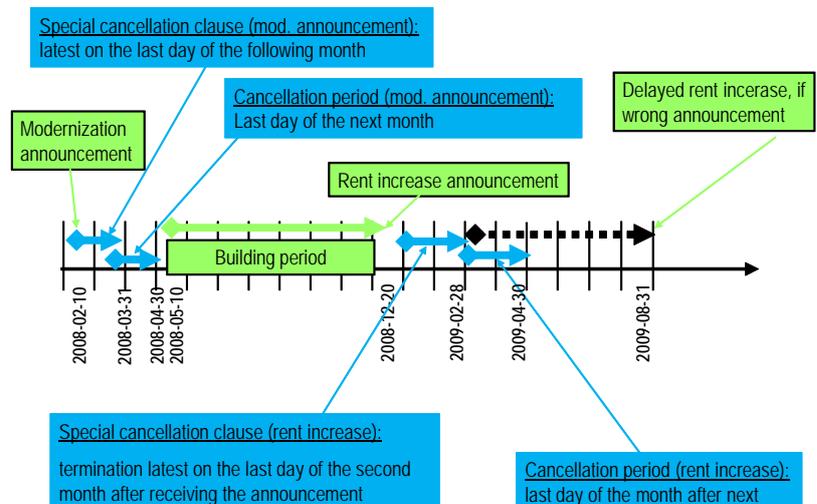
If the property owner chooses this option, they do not have to consider the so called “Kappungsgrenze”. “Kappungsgrenze” is a legal cap in Germany, which allows property owners to raise the rent by a maximum of 20 % within a three year period:

„Kappungsgrenze“ (legal cap)



If the property owner chooses this “11%-pass-on-method” the property owner does not have to receive written agreement back from the tenant accepting the higher rent. The new rent has to be paid from the beginning of the third month after receiving the final rent increase notification (received December 2008, new rent beginning from the 1st March 2009). If the real modernization costs are much higher (more than 10%) than the expected and notified costs, the new rent has to be paid at the beginning of the ninth month (1st September 2009) after receiving the final notification. The tenant again has a special termination clause. They have to send their termination on the last day of the second month after receiving the notification, at the latest. The rental contract will terminate at the end of the month after next.

Modernization: terms



The property owner is not allowed to raise the rent if the tenant

- has a stepped rental contract.
- had no obligation to accept the modernization.
- has a rental contract with an exclusion of rental increases.

To rental increase, to the comparative rent common for the location (compared to the standard after modernization) the landlord has to compare with the rent index. The rent index is the compilation of the comparative rent for the location divided in several possible standards and sizes of apartments. The property owner has to compare each apartment with this rent index, and has to calculate how to raise the rent in every apartment:

- Apartment A:
 - 65 sqm
 - With central heating
 - Modern bathroom
 - Comparative rent: 6.00 €/sqm
 - Current rent: 4.80 €/sqm
 - Costs for modernization: 5.000 €

The rent index shows that the landlord could raise the rent from 4.80 €/sqm up to 6.00 €/sqm. However, the property owner is not allowed to exceed the cap of 20 % rent increase within the three year period. Therefore, they are allowed to raise the rent from 4.80 €/sqm up to 5.76 €/sqm. The yield is 15.0 %:

$$\frac{(5,76 \frac{\text{€}}{\text{sqm}} - 4,80 \frac{\text{€}}{\text{sqm}}) \cdot 65 \text{ sqm} \cdot 12}{5.000 \text{ €}} = 15.0 \%$$

The new rent has to be paid from the beginning of the third month after receiving the final notification; the tenant has to sign an agreement that he accepts the new rent.

Making this calculation we meet a problem scenario, an empty apartment after modernization, would best suit receiving the highest possible rent for this apartment. If this apartment is occupied, we can raise the rent up to 5.76 €/sqm. If this apartment was vacant, then we could lease this apartment to a new tenant, who would pay us more than 5.76 €/sqm, because the market rent is much higher, e.g. 6.00 €/sqm. The yield would be 18.7 %:

$$\frac{(6,00 \frac{\text{€}}{\text{sqm}} - 4,80 \frac{\text{€}}{\text{sqm}}) \cdot 65 \text{ sqm} \cdot 12}{5.000 \text{ €}} = 18.7 \%$$

However, it can take time until you will find a new tenant, and vacancy provides you no yield.

The property owner can also combine two options:

1. raise the rent to the comparative rent common for the location, compared to the standard before modernization **and**
2. pass on 11% of the costs for the modernization.

Please take a look at annex 1, to see all the possible variations of rental increase method, in combination with modernization. To get the best possible result, the property owner has to calculate each possibility and ensure keeping to the legal regulations.

Modernization in a vacant or occupied building?

The main question for many property owners in Germany is, whether or not they do their modernization in a vacant or a partly occupied house.

The advantages of doing the modernization in a vacant building are:

- No problems with tenants during modernization.
- Possibility of leasing the vacant apartments at market rent level after modernization.
- No time schedule delay because of non-cooperating tenants.

The disadvantages of doing the modernization in a vacant building are:

- Time consuming until last tenant moves out.
- High risk in re-letting the vacant apartments.
- Risk, whether the expected rent will be paid.
- Time will pass by until the last apartment will be occupied.
- No rental income during modernization.

The advantages of doing the modernization in a partly occupied building are:

- Rental income during modernization.
- Lower risk in re-letting only some vacant apartments.
- Pass on 11% of the modernization costs to the current tenants.

The disadvantages of doing the modernization in a partly occupied building are:

- Time schedule delay because of non-cooperating tenants.
- Trouble with tenants because of the modernization measures.
- Legal restrictions do not allow raising the rent from the current tenants up to the market rent.

All in all, it is not possible to give a general answer as to whether it is better to do modernization in a vacant, or in a partly occupied building. The decision should be taken by looking at the current market situation (rent, demand), the current rent level in the building, the possibilities of raising the rent of the current tenants, and the expected problems with the tenants during the modernization.

Summary

Pipe work restoration should be done in conjunction with a modernization program, to increase the living standard of the tenants and to raise the rent. The property owner has to keep within the legal constraints before, during, and after the modernization in order to increase the rent. They have to decide which rental increase method is the best on a case-by-case basis. The decision to make the modernization in a vacant or an occupied building should be taken by looking at the current market situation and the property owner's readiness to assume risk.

Annex 1: Rent increase: modernization (§§ 558, 559 BGB)

