Residential real estate

Happy tenants equals happy landlords

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Contents

Executive summary

There are sound reasons why residential investors should focus on minimising tenant turnover rather than maximising rents.

- A stable income return with long-term growth prospects is one of the key attributes attracting investors to European residential property. Most investors understand the importance of rental growth prospects. However, we argue that tenant turnover is often more important for good investment performance.
- Replacing tenants incurs significant costs for refurbishments, re-letting and vacancies. This can amount to several months of lost rental income (Fact box 1).
- Average tenant turnover varies significantly from country to country. For instance, in Germany, tenants tend to stay in their rented housing four times longer than those in Britain. All else, being equal, an investment in low-turnover markets such as Germany will generate much higher net income than a higher-turnover market such as the most of the UK. There are many reasons for these differences, but we argue that the lease structure is a large part of the explanation.
- In Germany and most other European countries, leases are typically open-ended or very long. Additionally, rents are inflation-linked during the lease period. For a long time, rental growth in major cities has far exceeded inflation. Therefore, tenants are motivated to remain in their accommodation as a move will cost them significantly higher rents. By contrast, UK residential leases are typically six months fixed term. Thereafter, the landlord is free to ask for market rent. With strong market rental growth in the UK in recent years, this has often led to unaffordable rents at lease expiry. We believe this partly accounts for high tenant turnover.
- This paper investigates real life examples and theoretical exercises to illustrate the relationship between rental increases and tenant turnover for residential properties. **We conclude that maximising residential rents might not be the best way to increase investment returns, because unaffordable rents risk increasing tenant turnover.** Conversely, tenants who can afford their rent and are happy with the service and amenities provided will stay for longer. This has a positive effect on the net income the landlord receives, which can outweigh the return achieved from chasing rental growth.

Figure 1: Indicative costs associated with tenant turnover[1]

Refurbishments/fit out	1 months rent
Broker/advertising/letting	1 months rent
Void/vacancy	0.5 months rent
Total	**2.5 months rent**

[1] Disclaimer: costs and voids vary significantly from market to market and depend on residential type, quality and other factors.

The cost of tenants moving out

"One of the most important success criteria for good performance from core residential investments is managing tenant turnover."

We manage over €6bn of residential assets in Germany and several other European countries. Our long experience of this market tells us that one of the most important success criteria for good performance from core residential investments is managing tenant turnover, and the costs associated with this.

While normal maintenance costs typically relate to the building's age, replacing tenants who have moved out is also very expensive. When a tenant moves out, there will normally be costs for light refurbishments, fit-outs and repairs. In addition, the landlord must pay broker fees, advertising or other letting costs. These are on top of lost rent while the property is left empty between tenants.

The costs attached to high tenant turnover reduce income returns and hence hurt asset-level performance. We use case studies to evaluate these effects later in this paper.

This implies that landlords should balance the decision between pursuing rental growth and maximising operational efficiency. In our view, a greater focus on the latter is incredibly important.

Factors influencing tenant turnover

One of the greatest determinants of tenant turnover is rental growth. With rents rising strongly in many cities and markets, it is important to consider how a sharp increase in rents might fuel higher tenant turnover.

Some countries use tenant protective lease regulations in order to limit gross income growth for landlords. We believe these regulations also reduce tenant turnover and in many cases boost net rents. The obvious reason for this is that it offers tenants security in knowing they can stay in their leased homes for longer at affordable levels. In countries where tenant protection is lower, private home ownership is typically higher, as people seek long-stay security.

European residential lease durations, rent regulations, tenant preferences and market practices vary across countries, markets and sub sectors (Figure 2 and 3). In most European markets, residential leases are open-ended. They offer a short notice period of just three months, which can be drawn by the tenant only. Hence, how long the tenant stays depends on how happy he or she is with the overall living situation, with rent an important factor.

In the UK, where the Private Rented Sector (PRS), is relatively small but growing, standard UK residential leases are six-month assured shorthold tenancies (ASTs), or one-year ASTs with a break at six months. Market rental growth has been very strong in the major UK cities, and leases are exposed to market levels annually.

We believe this is one reason for the relatively high turnover in UK residential property, which has a clear influence on the net incomes achieved by investors.

Figure 2: Estimated average lease duration in Europe

Country	Typical lease duration	Typical annual turnover
Germany	11.8 years	8.5%
Sweden	10.0 years	10%
Spain	10.0 years	10%
Austria	8.5 years	12%
Netherlands	6.3 years	16%
Finland	5.0 years	20%
France	3.7 years	27%
Belgium	3.3 years	30%
UK	2.5 years	40%

Source: abrdn.

Figure 3: Average lease duration in selected German cities

City	Lease duration	Turnover
Berlin	17 years	5.9%
München	15 years	6.7%
Frankfurt	15 years	6.8%
Stuttgart	14 years	7.0%
Hamburg	13.5 years	7.4%
Köln	13.5 years	7.4%
Düsseldorf	13 years	7.8%
Germany	11.8 years	8.5%
Leipzig	11.6 years	8.6%
Dresden	10.9 years	9.2%

Source: Techem 2018.

Based on our experience of managing over €6 billion of residential assets, turnover rates vary greatly, depending on unit size or residential type. Students and young professionals tend to rent one-room apartments. Their flexible and changing life situation applies also to their housing needs. Therefore, tenant turnover can often be as high as 35-40% per annum (p.a.), even in Germany. The landlord should expect a high turnover cost and loss of rental income. For this flexibility, tenants have to pay a higher rent per square meter. Real estate investors can often get a higher yield (approx. 25 bps) for investing in assets with small units or student living. This compensates for the increased costs and voids related to higher turnover.

Conversely, our management experience with family housing suggests that tenants tend to stay for much longer periods. A turnover ratio of 10-15% p.a. is common for the German market. Leases in most European markets are normally linked to the Consumer Price Index (CPI). This limits excessive rental growth for as long as the tenant stays in the unit. While CPI growth in recent years has been much lower than growth in market rents, a large proportion of the market is currently under-rented. This prevents the landlord from capturing full market rent upside, but typically leads to lower tenant turnover.

Tenant satisfaction and resultant turnover rates are not only influenced by rent. Amenities such as concierge services, fitness facilities, parcel pick-up and tenant-apps are becoming increasingly important in promoting tenant satisfaction. Our focus on ESG in our residential buildings is something that is important for many tenants. For instance, solar panels are serving as a power source in several of our buildings and we are looking into investing in geothermal heating for some of our assets in the colder Nordic countries. Sufficient levels of maintenance, good services and operations are also vital in keeping tenants satisfied. The result is better competitiveness in the letting market. And happy tenants create a lifeworthy environment resulting in happy tenants.

To sum up, we could argue that based on analysing our own holdings in family homes:

- tenants tend to stay longer compared with micro living
- rents are lower on a per-square-metre basis
- vacancy duration at turnover is higher.

In the following case studies, we show the impact of turnover on rent. We aim to establish whether, from a net-income perspective, it is better to link leases to CPI and keep tenant turnover low.

Or, alternatively, if it more rewarding to realise strong(er) ERV growth at the cost of higher turnover.

"Tenant satisfaction and resultant turnover rates are not only influenced by rent. Amenities such as concierge services, fitness facilities, parcel pick-up and tenant-apps are becoming increasingly important in promoting tenant satisfaction."

Case study:

A theoretical exercise

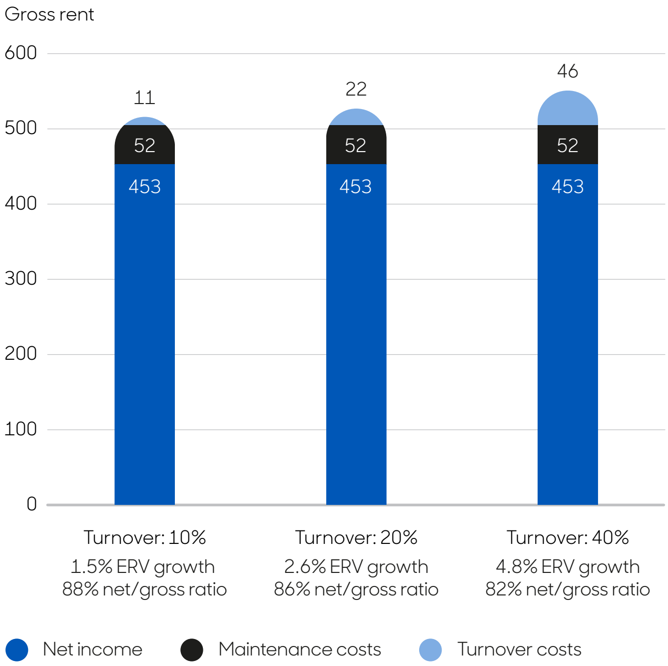
In this simple exercise, we compare three scenarios: 10%, 20% and 40% tenant turnover. Initial rent for all scenarios is 100 and leases are linked to CPI growth of 1.5%. The running maintenance costs are assumed to be 10% of year-one rents (= 10), and costs are assumed to follow CPI. We assume the following turnover- related costs:

- one month's rent in capex and repairs
- one month's rent in letting costs (broker fee and advertising)
- 0.5 months vacancy.

In scenario 1 with lowest turnover (10%), rents are assumed to follow CPI growth of 1.5%.

Figure 1 shows the rental growth required for scenario 2 and scenario 3 to generate the same net rental income as scenario 1 over five years.

Figure 1: Net income received over five years in three scenarios – what rental growth is required to compensate for higher turnover?



Source: abrdn, February 2019.

Case study:

A real life example with detailed cost breakdown

To show in more detail how turnover is a drag on investors' income, we include an analysis based on the experience of two actual assets we manage in Germany. The assets were constructed in 2013-15. They have a market conform apartment mix, focusing on one and two-bedroom apartments (2-3 ZKB). To ensure a fair comparison, we assume both assets are leased at 12.50 EUR/m^2, which we define as Estimated Rental Value (ERV) in year one. Thereafter, the assets perform differently.

Asset one has low tenant turnover of 10% p.a. and stable 100% CPI-linked leases with an annual rental growth of 1.75% (based on long-term CPI assumptions). For asset two, we assume 25% tenant turnover p.a.. Both scenarios are realistic. We now ask, what impact does each scenario have on the net income received by the property owner.

We calculate net rental income as shown in Figure 5:

- For asset one, we calculate a net rent for the second year of 11.53€/m^2 (see Figure 4). This takes account of the above-mentioned cost assumptions and CPI-like rental-value growth (see Figure 7).
- For asset two, we start with the same gross rent of €12.50 per m^2. However, we now assume 25% turnover. This has a massive impact on letting and turnover-related costs. Indeed, we would require an annual rental-value growth of 7.35% to achieve the same net rental income in year two (€11.53 per m^2 in this case. See Figure 8).
- Taking into account that 75% of the units will have CPI-linked leases, most of that growth would have to come from the 25%turnover – which is unlikely to be achieved.
- In asset one, the investor retains 90.6% of the gross rent as net income. By contrast, this figure is only 85.9% for asset two.

To better understand the impact of costs and the level of rental growth needed to achieve a similar net income, we model both assets in the waterfall charts below.

Figure 5: schematic calculation of gross-to-net income

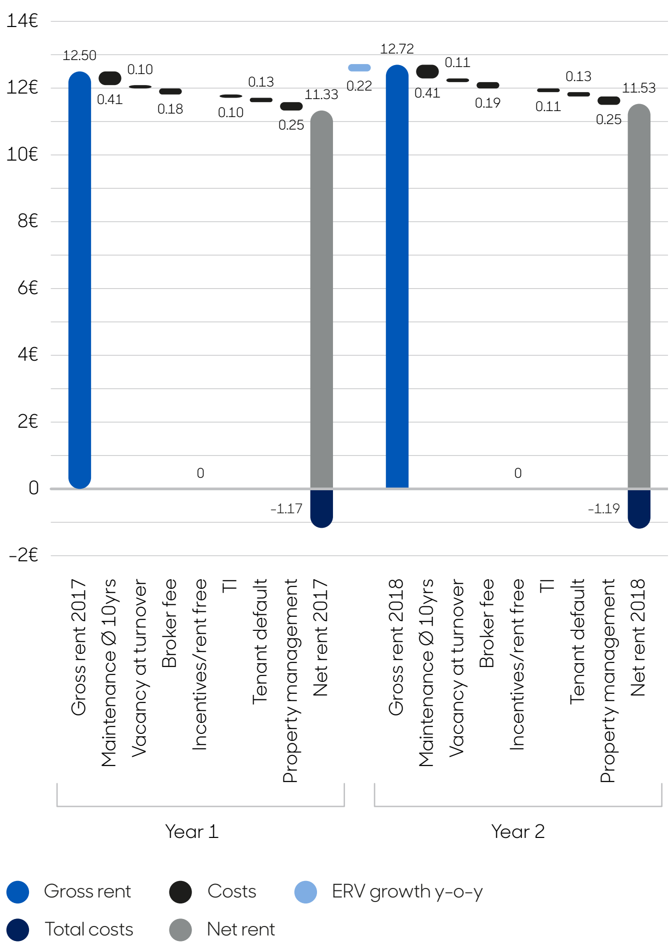
Gross rent
– cost of repairs
– voids and letting costs
– management fees
Equals: Net income

Source: abrdn.

Figure 6: case study - comparison of two PRS assets

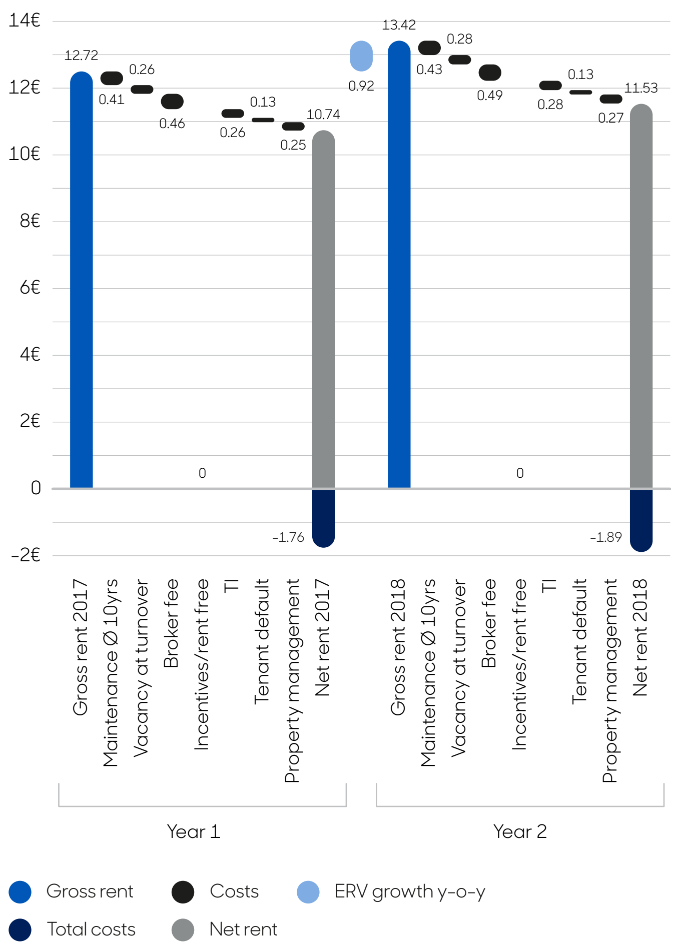
	Asset 1	Asset 2
Tenant turnover	10%	25%
Gross rental value growth (17/18)	€0.22 / 1.75%	€0.92 / 7.35%
Gross rent (31/10/17)	€12.50	€12.50
Total operating costs 2017	€1.17/m^2/a	€1.76/m^2/a
Net rent (2017)	€11.33	€10.74
Gross rent (31/10/18)	€12.72	€13.42
Total operating costs 2018	€1.19/m^2/a	€1.89/m^2/a
Net rent (2018)	€11.53	€11.53
Gross/Net ratio	90.6%	85.9%

Figure 7: asset 1 - income waterfall at 10% turnover and 1,75% growth



Source: abrdn, February 2019.

Figure 8: asset 2 - income waterfall at 25% turnover and 7,35% growth



Source: abrdn, February 2019.

Conclusion

Our case studies underline the importance of management quality and efficiency within residential buildings. We believe a manager can make a significant difference to the rents received by influencing the layout, fit-out and quality of residential buildings. We advise investing in amenities and services that enhance tenant satisfaction and the competitiveness of our buildings.

In addition, our work shows that efficient management of turnover costs is crucial in determining net rents received – far more so than commonly perceived by the market. In general, we prefer not to push rents for new leases if we believe it will negatively influence tenant turnover.

For a residential investor investing across European property markets, tenant turnover in each country should be carefully analysed when deciding which investment offers the best prospects.

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