

## Issues for owners of rental properties

How can the quality and performance of rental houses be improved? There is evidence that rental homes are in poorer condition than owner-occupied houses. The upgrades required can be surprisingly inexpensive, but tenants may not want or be able to pay more. There are alternative models that could benefit both property owners and tenants.



**AROUND 26%** of houses were rentals in 1991, but today that figure is over 35%. A fall in housing affordability is adding pressure to the rental market. By several measures, houses in many areas are unaffordable or severely unaffordable. Houses that previously could not be rented because of their poor condition may be entering the rental stock because of demand.

The BRANZ House Condition Survey 2015 found there is already a problem. On average, rental properties were twice as likely to smell damp and nearly three times as likely to feel damp compared to owner-occupied homes. Rented houses were only half as likely to be considered well maintained.

The research discussed here is part of the BRANZ research programme 'Exceeding the minimum'. As 78% of rental properties are owned by the private sector, the research asks:

'Why don't owners of private rental properties choose features that exceed the minimum standards, and how can we change this?' The aim is to identify barriers to an improved rental stock and find potential solutions.

### What repairs are needed?

The House Condition Survey identified 14 components more likely to require repair in rental houses than owner-occupied housing, from kitchen linings and joinery to doors and windows.

BRANZ calculated the cost to bring these components up to near-new condition. Very few houses required complete replacement of components. Linings, for example, largely required a repaint or a replacement of one section. Many components just required cleaning or minor alterations.

For over half the rental stock, less than \$5,000 would bring it up to the same standard as a typical owner-occupied home (Figure 1). At the 75th percentile, the repair costs are around \$7,500.

As well as components in worse condition in rental housing than owner-occupied housing, other components are also likely to need some work to bring them up to near-new standards.

A calculation of the total repairs required found that over 50% of houses in the rental stock require less than \$10,000 of repairs (Figure 2). At the 75th percentile, \$17,000 is required.

While repair costs may be low compared to property values, owners still face the issue of recouping this investment. Owners pay for the improvements, but the

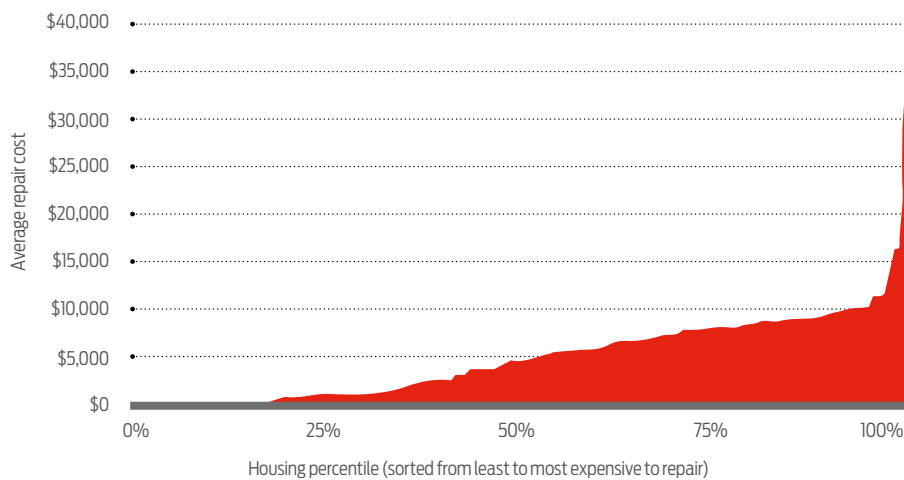


Figure 1. Average cost of repairs per rental property for components more likely to require repair in rental houses than owner-occupied housing.

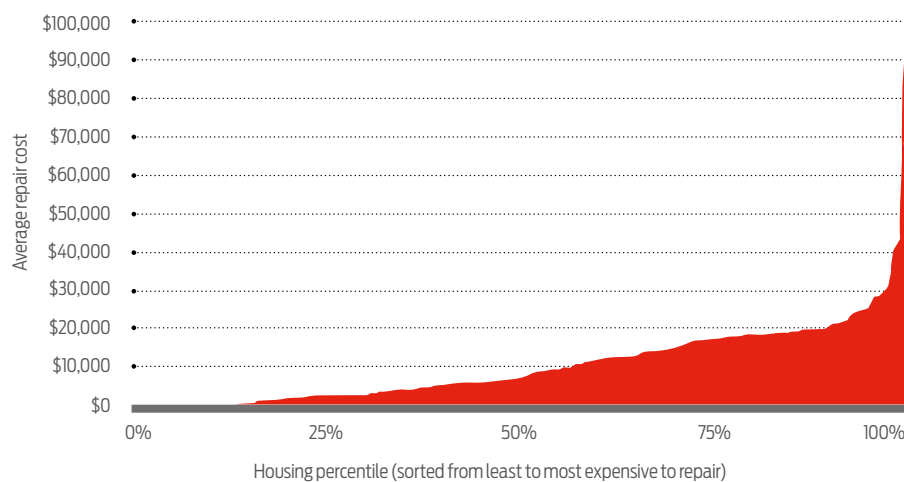


Figure 2. Average cost of total repairs for rental housing.

immediate benefits (such as lower energy bills and/or increased comfort) fall to the tenants. Owners may not want or be able to pay for repairs they do not immediately benefit from, and tenants may not want or be able to pay more for the benefits. There is little incentive for rental property owners to invest in their properties.

### Financial considerations for tenants

A BRANZ survey collected data from 339 people renting their home. Asked about what was important in choosing their current residence, 79% mentioned rental price. Many did not consider other costs such as energy costs, perhaps because these are difficult to measure before moving into a property. Of the

tenants who indicated that rental price was an important factor in choosing their home, 43% did not consider other costs.

About half of the tenants said that they could not afford to pay any more rent. A third said they could pay more but would not be willing to. Just 18% would be willing and able to pay more in rent for a better-quality rental.

### Forecasts for rental property

BRANZ projections suggest that, by 2038, there are likely to be 225,000 more rental units than the number from the 2013 Census. Many are likely to be occupied by older tenants – the number of people 65 years or over in rental accommodation is likely to more than double between 2013 and 2038.

By 2038, there are also likely to be another 11,000 rental houses that will require modification to allow tenants with disabilities to live there.

There will be more multi-family households renting who may require more bedrooms and multiple common areas such as kitchens. There are currently fewer large rental houses than in the owner-occupied stock. The number of bedrooms is the second most important criterion for tenants choosing a rental property.

### Opportunities for meeting future needs

Developing the rental stock to meet future needs may be difficult. Adapting some successful overseas models may help:

- Build-to-rent schemes, where an investor buys a property off the plans and rents it out after completion. One possible model in this approach is shell and fit-out. The owner provides the building shell and a one-off payment towards the fit-out, which is capitalised over the length of the tenancy. The tenant arranges the fit-out to meet their needs and is responsible for its maintenance. There is a 5–15-year contract between property owner and tenant, a little like a commercial property lease.
- Real estate investment trusts (REITs), which can increase housing supply by providing capital for development and long-term ownership. In the USA, residential REITs own and operate large apartment complexes. In the UK, REITs have provided capital to housing associations that provide affordable rental dwellings. REITs require considerable scale to be cost-effective – both large individual developments and a large portfolio.
- Energy performance certificates (EPCs) for houses. EPCs are common in Europe. Certificate ratings range from A (the most energy-efficient dwelling) to G (a highly inefficient dwelling). Energy labels help solve the problem where tenants cannot assess the energy efficiency of a house. Dutch, Welsh and English studies have found that A and B-labelled homes sell at a price premium while G-labelled dwellings sell at a discount.



### Build-to-rent approach

An alternative model based on the build-to-rent concept could provide improved housing quality, greater security and length of tenure and the freedom for tenants to customise their housing.

A new shell and fit-out model would resemble a commercial lease. There is a 5–15-year contract, and the tenant commits to a basic shell structure. The owner provides a one-off payment towards the fit-out, which is capitalised over the length of the tenancy. The tenant arranges and maintains the interior fit-out to suit their needs. The owner receives slightly less rent than if they provided the fit-out. However, as they are not responsible for interior maintenance, they have lower costs. This may lead to more predictable revenue.

BRANZ made a financial comparison of the shell and fit-out model against buying an existing house to rent out and building a complete new house and renting it out.

The new-build model and shell and fit-out model offer a much higher net present value (NPV) than the existing stock model (Figure 3). (Net present value looks at costs and benefits adjusted for the time value of money.) Whether the owner sells the property at 10, 20 or 30 years, NPV is higher. The new-build and shell and fit-out models generate a positive cash flow earlier than the existing stock

model, primarily due to reduced maintenance/repair costs.

Implementing the shell and fit-out model would require amendment to the Residential Tenancies Act 1986.

### Real estate investment trusts

To encourage uptake of build-to-rent models, individuals could consider combining into a REIT. A successful REIT could achieve sufficient scale to sustain a development pipeline and a cost-effective management structure, supporting returns that are competitive with small-scale property investment. As long-term investors, REITs could offer the long-term tenancies required for the build-to-rent model. In a large and liquid REIT, individual investors could enter and exit without disrupting long-term tenancies. For REITs to be viable in New Zealand, they would need equivalent or preferable tax treatment to small-scale property investors to ensure risk-appropriate returns competitive with other investments.

### Energy performance certificates

Tenants could benefit from an increased understanding of the performance of a home and may be willing to pay more rent in return for reduced energy costs. A rating for the performance of rental houses could be useful.

The research discussed here is part of the BRANZ research programme 'Exceeding the minimum'. It aims to identify barriers to an improved rental stock and find potential solutions. For more information, see Curtis, M. & Brunson, N. (2018). *Building to rent*. BRANZ Study Report SR390. Judgeford, New Zealand: BRANZ Ltd.

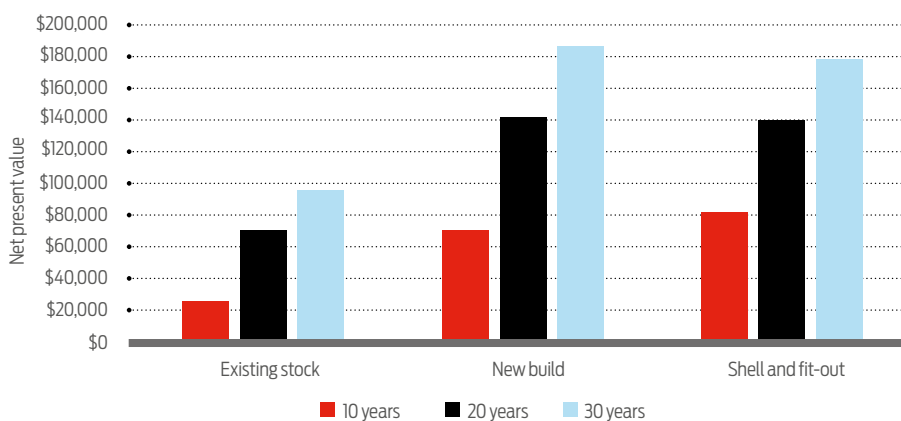


Figure 3. Net present value of different rental models at a 10, 20 and 30-year investment horizon.

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