Lazy landlords, not legalities, often keep rents below what is needed to make a building pay

Achieving market rents

LEGAL AFFAIRS

STEVEN READ

There are many owner-managed and professionally managed buildings that are not achieving market rents on the turnover of units, and/or where the allowable annual rent increases are not being given.

The lower income that is generated substantially impacts on the amount of financing that the buildings can obtain, and the price that can be achieved if marketed.

There are many reasons why the rents on turnover are not at market, often due to either the manager/owner setting the rents not being aware of the rent potential, or being aware yet purposely setting the rents below market. Rents for existing tenants often fall behind market as allowed rent increases are often not given to existing tenants.

The rents may unwittingly be set below market if the person responsible is not aware of the current rental trends, particularly the seasonal variation in rents.

> In many instances rents are $50 to $75 per month below the true market

The main reason why rents are set below market is that it is easier. It is easier for the resident manager who has to show the unit fewer times before it is rented; it is easier for the property manager who can report low or no vacancy loss; and it is easier as the person setting the rents does not have to research the rental potential or test the market. If the rents on turnover are kept below market, it will limit the rent differential between new and existing tenants (which may reduce conflict between tenants and management). One of the problems with buildings that are below market is that there may be the tendency for greater deferred maintenance, as the cash-flow may not allow adequate ongoing repairs and maintenance. If a tenant is paying below market rents, they will be less likely to complain about the state of the building or suite.

Direct loss

In many instances, units are rented at rates that are some $50 to $75 per month below market. This loss of income, representing $600 to $900 per unit per annum, is not available for suite upgrades or ongoing repairs and maintenance. The rent on turnover sets the base from which subsequent rent increases are given, compounding the negative impact over time.

Markets often have seasonal variation in rental rates. In the late 1980s and early 1990s, the **Canada Mortgage and Housing Corporation** Market Rental Reports for the Lower Mainland were published in the summer and winter, based on surveys undertaken in April and October of each year. These surveys became annual in the mid-1990s, published in the winter only, and based on the October survey results. The April surveys typically indicated a higher vacancy rate than the October surveys. The rent increases were larger between April and October than October through April.

In the Vancouver area, there is a substantial student population attending post-secondary institutions, resulting in high demand for rental accommodations when the school year begins in September. The demand for rental accommodations is lower in the winter months as fewer students begin their studies in January, and since fewer tenants want to move close to the winter holidays or when the weather is inclement. Property owners and/or managers should recognize the seasonal variation in rental potential and take advantage of the higher income potential that exists during certain periods of the year.

Slippage

Rents may slip behind market rates over time, despite an allowable increase. An analysis of the CMHC annual rental market report supports this observation. The allowed rent increases over the past few years has been in the region of 4 per cent per year, however, the CMHC. Rental Market Report survey results indicate that the rents in the West End have increased by a lesser extent.

Rent increases are often not given as landlords may decide that they would rather accept a lower rent than risk losing a good tenant, incurring the expense of renting a unit and potentially having a unit sitting vacant.

On turnover, the unit may have deferred maintenance that requires attention, and the rental potential of the unit may not be maximized until the deferred maintenance is corrected. Holding the unit off the market until the deferred maintenance is corrected will likely result in higher rents, however, there will be a loss of income while the unit is being renovated and during the leasing period. Many existing tenants would be willing to pay a higher rent if the units were upgraded, and working with long-term tenants to upgrade their units in return for higher rents may correct deferred maintenance and make a unit more marketable on eventual turnover.

Whether units are rented at below market rates, or if rents fall below market over time, the impact on financing is very pronounced. A unit that is achieving rents that are $75 per month under market would finance approximately $10,000 less than the same unit that is achieving market rents. This represents a potential $500,000 difference in financing for a 50-unit building.

Sale price

It is not unusual, in buildings that have had long-term ownership and where there is no mortgage, for the rents to be as much as 30 per cent below market due to low rents on turnover, and limited annual rental increases. In these instances, the financing potential of the building is severely impacted.

A building that is achieving market rents that may sell at a 4.5 per cent yield rate would only be able to obtain 50 per cent to 55 per cent financing based on a 1.2 debt service ratio, a mortgage with a 25-year amortization and an interest rate of 5.5 per cent. The same building, if obtaining rent that is 30 per cent below market, would only able to obtain 25 per cent to 30 per cent financing. The building that is achieving rents that are 30 per cent below market would require approximately 50 per cent more equity, which could eliminate a large pool of the potential purchasers.

If your property is professionally managed, it is important to establish the parameters for its operation if the goal is to maximize the income potential.

It is often worthwhile to have an independent party undertake a rental survey in order to establish the income potential of an apartment building and to determine the upside potential that may exist. The rental survey should determine the upside that may exist both on an “as is” basis, and also as if cosmetic upgrades are undertaken.◆

Steven Read is an appraiser with Burgess Cawley Sullivan and Associates and specializes in the rental housing market. Read can be contacted at 604-331-7302 or e-mail at sread@bcappraisers.com.