

# Market rent and optimizing new rents

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## Introduction

For residential real estate companies one primary task is to rent out flats. In order to increase the value of the properties one should rent flats at their market value. Hence it is necessary to know the market rent and strive to let the flats at this rate. The aim of this essay is to show how market prices are created in theory and in residential practice show how new rents can be optimized against the background of German market conditions.

## Conclusion

To summarize the outcome of this essay one can confirm the following points:

- Germanys housing market is dominated by the rental market.
- Generally rents are freely negotiable in Germany.
- The socially disadvantaged are subsidized.
- Market rent should be a indicator of a shortage of availability.
- To optimize new rents one has to be aware about the market rent, the standard of the property, the flat, and if necessary change it.

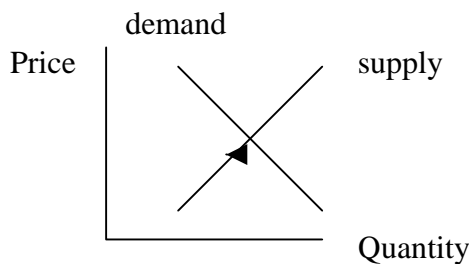
## Market rent

### Theory: Perfectly competitive market

In neoclassical economics and micro-economics, **perfect competition** describes a market in which there are many firms, all producing homogeneous goods. In the long term, such markets are efficient. In general a perfectly competitive market is characterized by the fact that no single firm has influence on the price of the product it sells. Because the conditions for perfect competition are very strict, there are few perfectly competitive markets.

The model of a **perfectly competitive market** is described by the following characteristics:

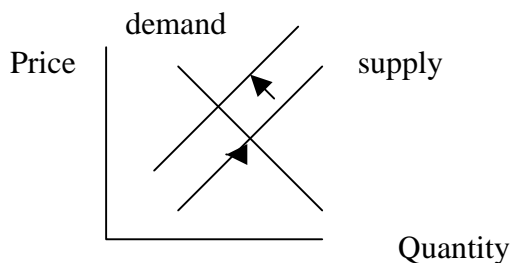
- **Polypoly:** Many Sellers and many buyers;  
There are many consumers that are willing and able to buy the product at a certain price and on the other hand many producers willing and able to supply the product at a certain price.
- **Perfect information,** both for sellers and buyers;  
Therefore transaction costs can be disregarded
- **Homogenous products:**  
The offered products are exactly the same
- **No personal preferences;**  
All market players make rational decisions
- **Meaninglessness of time and space**
- **Market equilibrium:**  
The amount of goods/services offered by sellers equals exactly the amount sought by buyers. There is an equilibrium price / market price



*Picture 1: Supply and demand in a perfect competition*

The point of intersection shows the market equilibrium, when supply and demand exactly meet each other.

Example of development of supply and demand in a protected market:



*Picture 2: Supply and demand in a protected market*

A protection of buyers means that the supply is reduced due to the fact that less potential sellers are willing offer the product “under value” or the ones that are willing postulate a risk premium for the higher risk. Both effects lead to higher prices.

So to the theory, let us now have a look at the German residential market.

### **Germany's housing market**

Germany's housing market traditionally consists of a predominant rental market. The rate of homeownership is 43 percent, very low related to the UK or Spain with 70 to 80 percent. The low importance of homeownership in Germany is due to the following constraints:

- High land prices especially in areas with a high population density
- High construction costs
- High long-term capital lockout of equity and debt. Many households are not able or willing to have long-term liabilities.
- Flexibility for entering job opportunities

On the one hand the market for rented flats is functions reasonably with a good supply of tenants that are protected by law. The German tenant organization DMB ("Deutscher Mieterbund") is very strong and defends the rights of the tenants. Renting flats is more attractive than a homeownership especially in the younger phase of life. It is important to be flexible without high capital lockouts to be able to react on job opportunities. There is a trend tending toward smaller households despite a constant or slightly decreasing population in Germany. In most cases there are good relationships between tenants and landlords.

On the other hand when it comes to construction of rental flats there is competition for the limited capital. Investors in rented flats need long-term security regarding regulatory framework. The current jurisdiction has been very complicated during the last years. Especially the clause concerning the renovation of a rented flat which means that a tenant has to paint the walls and clean the flat before leaving, this became in most cases invalid as a result of the current legislation. This was the cause of a lot of lawsuits between tenants and landlords recently and causes insecurity for investors and tenants.

*Generally rents are freely negotiable in Germany.* There is no regulation regarding the upper level of the rent unless an extortionate limit is exceeded. This means in practice that the rent of an offered flat should not exceed 20 percent of the comparative rent common for the location. The authority in Germany tries to protect the tenants and maybe assumes that the citizen is not able to estimate the costs and prices on the rent market as for other products.

## Social Housing Policy

A task of the authority is to help households that are not able to pay the market rent and landlords would not willing to rent to socially disadvantaged potential tenants for fear of having higher risk of losses of rents. They would prefer a potential client with a higher income, due to the fact that there is a need for regulating the market. There are three essential requirements to the social housing that should be fulfilled:

- **Equality** as a principle of the constitution: All households with the same attributes should get the same benefit
- **Justice** as a principle of a social state: only the socially disadvantaged should be aided
- **Cost efficiency** as a principle of economy: Goal is to spend the lowest amount possible to achieve the highest benefit for the tenant.

There are two different methods of social housing policy:

- Advancement of objects (flats)
- Advancement of subjects (tenants)

The advancement of objects (subsidized housing) is not a useful solution for the following reasons:

- The *equality principle* is not fulfilled, because only a small amount of all households that could apply for such a flat get it.
- The *justice principle* is not fulfilled, because in most cases the most socially disadvantaged do not get the flat.
- The *efficiency principle* is also not met, because social housing is expensive, and there is no focus on the demands of the future users.

The advancement of subjects (housing subsidy) is the better solution. Households with a low income can apply for housing subsidy.

- The *equality principle* is fulfilled, because every household that meets the conditions for getting a subsidy has a right to get housing subsidy
- The *justice principle* is fulfilled, because the amount of the subsidy depends on the income, size of the household, and the subsidy ends when these conditions are no longer there.
- The *efficiency principle* also is fulfilled, because the subsidy recipient can look for a proper flat on the free market. On the other hand the costs for the subsidy are low and the subsidy is more goal-oriented related to social housing.

The main advantage of the subsidy is that the market is not divided and the rent is not reduced in price.

## **Desirable principles for the rental legislation**

Professor Dr. Johann Eekhoff, a German economist and residential expert in tenancy law, postulates the following essential principles that a functional rental market needs:

- Clear task sharing between market and authority  
Private suppliers that economically build maintain and administrate flats and the authority that subsidizes social disadvantaged if necessary.
- **Control function** of the rents only without regulations  
Only without regulation rents can be an indicator of shortage of flats. A rent that is regulated and lower than usual leads to a reduced supply and lower quality.
- Social policy under economical circumstances

## **Comparative rent common for the location**

There are two different ways of finding out the comparative rent common for the location.

- Rent index
- Three comparable flats

For most of the big cities in Germany there is a rent index that is released by the local tenant organizations and the local landlord organizations.

The other method is to find three comparative flats in the same location, with the same size, in the same equipment

The comparative rent common for the location can give an impression of the rent level in a city but usually do not represent the market rent.

## **Offered rents**

ImmobilienScout24, Immonet or Immowelt are the most important online market places for flats in Germany. Everyone can deviate from the currently offered rents, the market rent, and analyze it e.g. after the following criteria.

- City/part of the city
- Size of the flat
- Equipment
- Location (“Growing” locations)

The development of the offered rents on the online forums can be for example monthly with these criteria monitored, recorded and analyzed. With this kind of market research changes in market rent can deviate. It is important to confirm that offered rents are normally higher than the actual closed rents (fair market rents). One can say that market rent is on average 3 – 5 percent lower than the offered rent. Fair market rents can deviate from

offered rents and therefore offered rents are indicators of changes in the market rent.

### **Fair market rent**

As discussed before, generally the rents are freely negotiable and depend on supply and demand in Germany.

The suppliers of flats are residential real estate investors or landlords. One can say that during the last years there was a trend to more and more professional landlords that wanted to get a payback on their investment that is at least as high as they would get by investing in an alternative investment. Investors require security that in the future, the rent will depend on supply and demand. Only in this case can they be sure to realize their investment goal.

The new investing supplier defines the level of the rent in a manner that they want to get at least a “normal” return on their investment; they would not choose to invest in new buildings if they reduce the rent level. They define the quantity of flats and save a proper return on their earlier investments. Hence, periods of structured vacancy and losses are limited, as well as periods of very low vacancy.

Supply always depends on demand, which means that if there are low rents there is low willingness to build new flats and if after a certain period of time there is shortage of flats and the rents increase, the willingness also increase to build new flats. Rents indicate where flats are in shortage. Through analysis it becomes visible, which size of flat, the fixtures and fittings, and the location a certain supply of flats is given. Despite of imperfectness of the markets, it is the best system of letting flats to potential users that see the highest value of benefit in exactly this specific flat.

In a functional market, rents are indicators of vacancy and demand. Possible reasons for high market rent are for example that there is a low supply of flats and a high demand; on the other hand that there is a low vacancy. On the other hand, a high supply and at the same time a low demand in flats with accompanying high vacancy is normally reflected by a low market rent.

### **Optimizing new rentals**

A residential real estate company makes its money through rent. As the value of a property depends on the current rent level in the property, one can increase the value of a property when the current rent level is lower than the market rent. Hence, in growing locations one can increase the value of the property

during the mid and long terms. For that reason it is important to buy in A or B locations in growing cities.

Example:

If you wait for a tenant that is willing to pay the market rent or above (depending on the standard of the flat) you have to keep in mind that this could mean a higher vacancy ratio in a property. With a normal fluctuation of 10% this has just a short term negative effect to the vacancy.

If you assume a normal fluctuation of 10% in a property, which means that a tenant stays on average 10 years in a rented flat you get every month for ten years the requested rent instead of maybe a lower amount. Another effect is that a potential buyer of the property would pay the factor (multiplier) on the whole amount of cold rents in the property.

## **Optimize new rents**

To rent on the market rent you have to be aware of it. Market analyses on immobilienscout24 are necessary. The development of the offered rents compared with the recently rented flats in a property provides a good picture about how the markets move and how this has an impact in the property.

To exploit rent potential, flats need to be prepared and renovated, if necessary and profitable, to lift it to a level that allows postulating the market rent. One can not change the location or the property, but the standard of the property and the flat can be changed.

To optimize the renting process, which means to get the market rent, a landlord has a lot of measures on hand.

Measures in a property:

- Reduction of neglected maintenance
- Normal current maintenance
- Nice outside facilities, façade, stairwell etc.
- Energy saving measures
- Extra equipment (e.g. laundry facilities)

Measures in a flat

- Basic cleaning
- No ongoing matters with the old tenant
- Renovation (paint, new floors, new bathrooms etc)
- Extra equipment (e.g. kitchen)

Measures in marketing

- Good online marketing with nice pictures.
- Good letting personal that know the market.

- Real estate brokers that get their fee via the landlord, which makes it more attractive for potential clients to let the flat.
- The letting personal should wait for a tenant that is willing to pay the requested rent and ask the potential tenants for feedback regarding the flat and the rent.
- If a flat is rented within one week, one should think about the price of the flat this could mean that the market rent was underestimated.
- If one can not get the market rent or the amount that one assumes to be the market rent, there is the possibility of being satisfied with a lower rent now but negotiate a clause in the leasing agreements that is called *stepped rents* (“Staffelmiete”). This means that for example every year the rent is automatically increased by a certain amount for a terminated period. Another possibility is to be satisfied with a lower rent and negotiate an *indexed rent* which means that every year the rent is increased by the percentage development of the *German cost of living index* that is a measure of the inflation in Germany.

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