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Residential rent regulations

Can there be a fair and balanced approach?

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EXECUTIVE SUMMARY:

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Residential rent regulation is typically perceived to disincentivise investors with the debate often binary.

In our view, rent regulations are not necessarily a barrier to investing in the European Living sector.

There is a variety of rent regulations, and while some disincentivise investment, there are established forms that accommodate long-term investment.

Fair and balanced regulation is arguably a major contributor to the defensiveness of the residential asset class.

Balanced policy can give certainty to residents, policy makers and investors alike; suggesting the need for strategic housing policy and goals set independent of the short-term political cycle.

In our report, European residential rent regulations – can there be a fair and balanced approach? (April 2023) we discuss the background and implications of residential rent regulations (rent controls) for investors. This subject is of critical importance for investors to understand in the formulation of their long-term residential investment strategies, and is likely of great interest for investors motivated by their impact upon society.

The consequence of the considerable demand-supply imbalances for European residential rental properties has been strong, and likely ongoing, rental growth. This is an appealing characteristic for investors keen to deploy capital into the sector*. However, it clearly increases the challenges of rental affordability for residents. It is unsurprising that policy makers have increased the implementation and discussion around rental regulations; but can there be a fair and balanced approach that serves the needs of residents alongside meeting the long-term goals of investors?

The use of, or prospect of, rent regulations is widely believed by investors to remove the motivation to invest new capital or improvement expenditure upon existing investments. Critically, we conclude that this is an overly simplistic view and investors should recognise the wide variety of rental regulations that exist. In other words, the debate is far from binary. Whilst some regulations disincentivise existing or potential investors, there are established forms of regulation that accommodate the deployment of long-term capital supporting the delivery, and ongoing maintenance, of residential rental properties.

* Savills/Savills IM European Living Investor Survey 2023

In simple terms, a form of acceptable rent regulation is likely to include:

- Controlled rent increases through the duration of the tenancy, and likely no limit on the duration.
- An ability to capture market reversion between tenancies.
- Rent adjustments, linked to capital expenditure, where appropriate.

This should give certainty to residents, policy makers and investors alike; residents get long-term homes with clarity around the progression of fairly priced rents, whilst investors remain motivated to maintain and improve the buildings with clarity around their income. For this to work, housing policy needs long-term stability; strategic goals set independent of the short-term political cycle and with that stability investors will be able to confidently underwrite the risks around their investments and potentially increase the capital that surveys identify that investors wish to deploy into the sector.

In the full paper we cover the spectrum of existing European rent regulations.

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Residential rent regulations can work, but they need to be approached with the concepts of fairness and stability in mind.

WHAT DO RENT REGULATIONS LOOK LIKE?

There are, broadly speaking, three generations of rent control:

- First-generation controls freeze the initial rent at a specific level for a set period of time, as seen briefly in Berlin in 2020.
- Second-generation controls limit rent increases during a tenancy (based on landlord costs and/or price indexation) and between tenancies using either a local reference index or by a tribunal. Second-generation controls are prominent in most European countries.
- Third-generation rent controls; control rental increases during a tenancy (based on landlord costs and/or price indexation) while being unregulated between tenancies.

RENT REGULATIONS COME IN VARIOUS FORMS AND CAN HAVE SURPRISING RESULTS

A recent academic paper has looked at resident protections in the US multifamily rental market in relation to net operating income (NOI). Perhaps surprisingly, the study found that states with greater renter protection had rental units that displayed lower initial cap rates and higher NOI[1].

The study also found that higher future rents can be achieved in states with greater residents' protections as well as lower delinquency or missed rental payments - and lower void rates.

Residents who stay for longer contribute to community and reduce costs associated with resident rotation. In other words, happy residents benefit communities and are more profitable for investors.

SO WHY THE FUSS?

Rent controls have seen a resurgence in Europe in the last five years. As witnessed in Denmark, France, Ireland, Spain, Scotland and recently the Netherlands.

WHEN POLICYMAKERS GET IT BADLY WRONG

The DW und Co. Enteigen referendum in Berlin was a movement that emerged in April 2020 intended to bring housing owned by large private landlords back under public control. In the same year the MietenWoG Bln or Mietendeckel (five-year rent freeze) came into force on 23rd February 2020. This policy introduced a five-year rent freeze on units built prior to 2014 but this was eventually ruled to conflict with national legislation and ended on the 25th March 2021.

Despite being short lived, the Mietendeckel saw a contraction in units made available for rent, and while it lowered rent costs for incumbent residents in regulated stock, it also resulted in rental pressure for modern units. As availability contracted, rental growth rose by c.10% in 2021[2]. Furthermore, landlords reduced capital investment into the older stock due to changes in capital expenditure recovery.

It is also possible that the changes to permissible rent

1 McCollum. M & Milcheva.S, How 'Bad' is Renter Protection for Institutional Investment in Multifamily Housing? 18th October 2021

2 Eurostat Agents Survey, data as at end 2022

adjustments following major modernization projects, currently capped at a maximum of 8% p.a. of the total costs incurred by landlords, encouraged some investors to exit the market.

SOME EXAMPLES OF FAIR AND BALANCED RENT REGULATIONS

In Denmark there are layers of regulation, but generally apartments built pre-1991 are regulated (cost-determined rent) and post-1991 apartment rents are negotiated on a 'what is it worth' basis, as long as the rent is not unreasonably high (typically based on inflation or net price index (NPI).

In August 2022, in light of the cost-of-living crisis, a temporary rent cap was introduced on both new tenancies and intra-tenancy rent adjustments for unregulated units of up to 4% per annum over 2023 and 2024 reflecting a second-generation regulation. An exception exists, with landlords able to raise the rent by more than 4%, if they can prove that any of their operating expenses have increased by more than this (this cannot exceed the NPI). This temporary cap will be replaced in 2025 with a new index, albeit the Danish government are still deciding on the details at the time of writing.

The Netherlands rental market is broadly divided into groups: social housing for which the defining criteria is a points-based system, and above the maximum points threshold is private market stock. Until recently private rents were uncapped during a tenancy. However, like Denmark, for a period of three years (1st May 2021 until 1st May 2024) the annual intra-tenancy rent increase for private market units is limited by law. The maximum rent increase is inflation plus 1%, or (as of 2023) wage growth plus 1% when the wage growth is lower than the rate of inflation[3]. Importantly, rents on new leases are unaffected, meaning for a unit that is let at a discount, a landlord can adjust this on renewal. This resembles something getting close to a third-generation system for the private market.

The bigger issue in the Dutch market is the adjustment the Waardering Onroerende Zaken (WOZ) tax system. This is used to value property and the decision to cap the weight of WOZ used to help determine rental unit values will result in lower rents on private market units. For units that sit just above the maximum points (recently increased) this change will draw some of these units into the social market (affecting residents and investors) and shrink private market stock further.

> "In both markets, indefinite leases prevail, providing residents with stability and both remain highly popular investment markets with long-term institutional investors. These examples in our view represent fair and balanced approaches.

REGULATIONS PROVIDE A RELIABLE FRAMEWORK FOR LONG-TERM INVESTORS

In Europe, arguably a major contributor to the defensive characteristics of the residential asset class is the regulatory framework. Lease duration, often indefinite, and limits on rental growth prevent excessive over-renting (when landlords increase rents by too much relative to the market) and provide investors with some downside protection during market corrections - when rents on commercial property typically display greater volatility. Residents have some certainty as to cost and right of tenure, which tend to lead to longer tenancies; beyond the scope of this paper, we suggest that longer duration renting supports communities. However, this needs to be balanced with the ability to charge a rent that ensures costs are covered when buildings are maintained and/or upgraded.

As the consultancy Green Street has noted, regulation can provide a level of built-in reversionary rental growth that makes income stable, assuming the rent on a given unit is below market

3 Government of the Netherlands, rented housing, www.government.nl/topics/housing/rented-housing

rent[4]. In other words, there is always capacity to raise rents to compensate for the some of the discount to the market. The lower rent volatility and stable income helps to generate attractive risk-adjusted returns and allows capital to be deployed more efficiently for many multi-asset investors.

Figure 1 highlights the point around low volatility and regulations. It shows Sweden, one of Europe's most regulated multifamily markets, to have very low rental growth volatility, Germany in the middle while the unregulated UK** sits at the opposite end of the spectrum.

An uncertain and restrictive policy environment, subject to ad-hoc changes, disincentivises existing as well as potential investors and can exacerbate conditions for residents indirectly. While most markets have some form of rent control, a third-generation approach seems most fair and balanced in our view. To manage such political risk is to stay well informed about political party manifestos, regularly review government policy and to have diverse exposure to regulated markets.

SUMMARY

Savills IM like most long-term institutional investors wants to do the right thing by residents and balance this with investment returns. However, we recognise that onerous and poorly conceived policies can exacerbate inequalities and can make investment unattractive. Bottom line though, regulation is not a reason to avoid investing in the sector.

A form of acceptable rent regulation is likely close to a third-generation form of control, especially when there are indefinite tenancies. Allowing rents to be re-set between tenancies and adjusted for inflation during a residency is fair and balanced. As Berlin demonstrated with overly restrictive controls, these can cause issues for residents, policy makers and investors. Denmark has shown consistent rent regulation policy and the Netherlands, despite arguably too much change around taxation, provides a framework that is likely to remain interesting for long-term core institutional investors as well as potential opportunities for core-plus investors.

AN INDEPENDENT BODY FOR HOUSING?

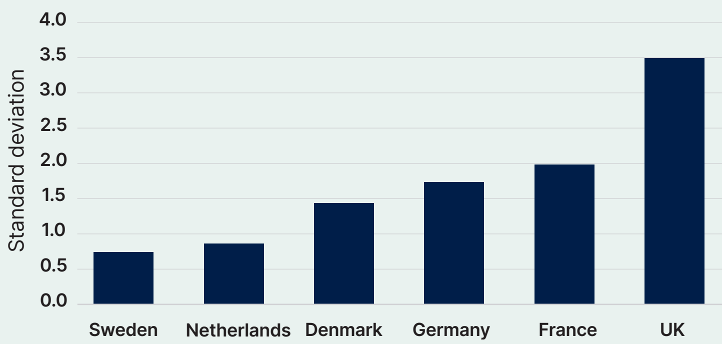
We acknowledge the pro-cyclical nature of housing markets as well as the complex nature of land assembly and construction mean realistically it is difficult to change conditions in the short-term.

However, with clear long-term policy, policy makers and investors can be more strategic in delivering new housing. In our view, the most constructive way forward would be for governments to create an independent body, unaffected by short-term political cycles, setting strategic policies and targets with a primary mandate of improving the delivery of new housing.

This will help mitigate restrictive rental regulations and hopefully promote a more balanced approach to housing policy, with residents as the ultimate long-term beneficiaries.

FIGURE 1:

Rental growth volatility 2000 - 2021



Source: Savills IM, MSCI, data as at October 2022

4 Residential Insights: Rental Regulation – 21st December 2021, Green Street
** Scotland recently introduced rent controls

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