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NC Rental Market Outlook… Why All that Glitters is not Gold in Rental Investing

The past year in single family rental housing has been an interesting one to say the least. Things technically haven't changed much, but it does seem as though the market is being shuffled around more than ever. Multi-family on the other hand is undergoing much less subtle shifts. In this letter I want to discuss a few metrics you tend to hear a lot about, and a few that are also very important but rarely discussed.

TURNOVER…

While rarely discussed in the media, it's a major part of rental investing. If you consistently lease to excellent tenants that pay on time, and take great care of the home, turnover is the metric most likely to cost landlords money. On nicer properties, typically much more than repairs will. Without a doubt turnover has increased over the past couple years. We recently saw our average lease term drop from slightly over three years, to about 2.5. That's pretty significant. Even with great tenants, you still typically must deal with 30 days vacancy, as well as cleaning and touch ups. Those expenses average around 10% of your yearly rental income.

To put this in perspective, our average repair costs in 2016 were less than 3%, and the majority of that came from a handful of properties. Our nicer rentals were closer to 1.5%. We've always excelled at keeping turnover to a minimum, but as of late we've been focusing on possible solutions to help keep them longer despite a more transient trend.

VACANCY…

Of course vacancy is a highly sought after metric for landlords, particularly owners of apartments / multi-family complexes. Vacancy though is a vague metric. So many things contribute to vacancy issues. It's important to know when crunching profit and loss financials, as it gives you an idea of what potential a rental may have, and how well overall it's been managed to that point, but to really gain anything helpful you have to go past vacancy. Issues that contribute to higher vacancy rate can be

- *Inattention to marketing / tenant leads*
- *Bad property condition*
- *Poor application choices*
- *Terrible neighborhood*
- *Refusing to work with good tenants on minor upgrade requests*
- *Aggressive rent raises*
- *As well as other smaller issues… Most revolve around a landlords' inability to make decisions based on return on investment, rather than emotion.*

A couple critical points about vacancy that many owners don't properly account for are…

- *Vacant homes tend to have significantly more maintenance issues with things like HVAC's and water heaters after a tenant moves in. We see it all the time.*
- *Vacancy has a direct cost to owners that must be weighed in the pricing question. Pricing is an art not a science.*
- *Consider this, the average home rents for $1000 a month. When that home is vacant the owner is directly losing $33 per day in potential rent. You'll effectively reduce your rental rate by $50 a month in just 17 days.*
- *Wait there's more. High quality tenants do not overpay for a rental. They expect and get good deals, that is why they have great credit and finances. When you save money on vacancy by offering more competitive rents, you attract higher quality tenants by default.*

Makes that $50 per month reduction we're recommending seem a lot more sensible doesn't it? This is exacerbated as the rent increases

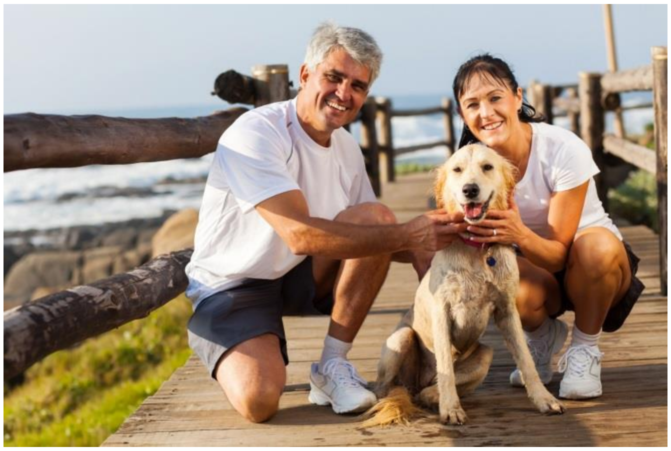
- *Vacant homes are a liability. Clearly there is more security risk to the property itself, drifters can target them, and if a pipe bursts it could be days before it's noticed. While we have never had this occur, we have heard stories of outside HVAC units being stolen.*

One thing in our opinion that doesn't negatively contribute to vacancy is taking a hard line on non-payment. Once again ROI plays into this issue, but experience has shown us that unless a tenant has proven to be excellent, accepting excuses on non-payment is consistently a huge mistake.

RETURN ON INVESTMENT…

Also a vague metric, but something if committed to, is guaranteed to make you a better paid landlord. I'll give an excellent example we often come across. Pets: often we have an owner tell us they don't want pets in their unit due to damage concerns. That makes sense if you are renting to tenants that have nothing to lose. There is added risk. However, if like us, you only rent to tenants that will most likely take good care of the rental, let's consider how no pet's works against an owners' income. First, at least 70% of leads that we receive have a pet of some sort. By restricting this population, you are now reducing your potential renter pool to less than one third of what it could have been. This stands to reason that you will experience longer vacancy, and most likely a lower rental rate. We've found that no pets nearly double the amount of time required to market, and reduces the potential rental rate by about 10%. You only need to look to communities that restrict pets to see the proof. In my hometown of Wilmington, there is a gorgeous community called Ashton Place. They do not allow renters to have pets, and as a result rents for this community across the board are substantially less than average. With a garage, a huge loft, and

1800+ sqft, these townhomes should rent for 1300+; instead they typically average $1100. We also charge a hefty pet fee usually $150 or more. So if we have a $1000 a month rental, which rents for $900 instead, sits vacant for an additional 30 days, and doesn't collect the pet fee, we now have $1250 invested in restricting pets. Most $1000 rentals can replace all carpet for less than $1250. It is however, extremely rare to have a pet damage carpet beyond repair. Our saying has always been that we've had a few tenant problems, but we've never had a pet problem. What we mean is



that if the tenant is going to let the pet destroy the carpet, the tenant themselves most likely would have anyways… The big exception is puppies, and that is why we restrict age. That's measuring return on investment professionally…

RENTAL RATE…

We tend to run into three types of owners, those that only focus on rate, those the focus on razor thin spending, and those that see the bigger picture. Here are a few examples. Qualified tenants are getting harder to find. The best way to attract quality tenants is to have a home in good shape, and to have a competitive rate. AAA quality tenants are not going to pay $1100 for a $1000 a month rental. You know who will? Those having a tough time getting approved. This plays into vacancy also, as sloppy tenants are guaranteed to increase both vacancy, and expenses. So if we average it out over 3 years, reducing your rate by $100 a month would cost you $3600. However, by holding out for that final $100 you substantially increase your odds for dozens of terrible problems such as lease breaks, excessive damage, high turnover, several months of vacancy, eviction hearings etc. It's similar to buying bonds over stocks. Stocks pay more if you're willing to put in the work / risk, but bonds make it easy for you to sleep at night… Save the gambling for Vegas, go with the safe bet, highly qualified tenants.

That brings us to tenant quality. This is without a doubt, the metric we by far care most about. While we have had phenomenal success in keeping our properties filled with great tenants, we have stepped *into some horrible situations. I've seen damage top $10,000 on $400K homes as a result of nothing more than bad management decisions. If you must paint and recarpet an entire house, you are looking at several thousand dollars for an average home. It takes an extremely high rate to offset the added expense, and the odds are heavily against you. In the past 10 months we have had to increase our average declined apps by 100%. Until recently we declined 2 applications on average per property, but as of late that number has shot up to 4. This certainly translates into somewhat more vacancy, and slightly lower rates, but once again, averaged over the long run, the return on those decisions more than pays off. We attribute this issue to the huge sales market rush that's occurred recently. Basically, if they are qualified, they most likely purchased a home in the past 12 months. This means a large number of those that didn't, are not very qualified. While the sales side seems to be normalizing, we still expect this issue to grow.*

We believe tenant quality will be the most challenging aspect of rental management for the next several years. Rental rates have softened lately, and vacancy is starting to creep up, but these problems are unimportant relative to extreme difficulty in finding tenants that can be trusted to pay, and maintain the home properly. We don't expect a major decline in rental rates anytime soon. Nor do we expect to see vacancy take off, but the future for landlords and rental managers does appear to be more challenging than years past. So our point is that landlords are going to want to adjust their expectations going forward. At a time when the media is finally touting the great rental market, we are seeing things become more challenging, and those that ignore the signs are sure to pay the price. It's a tough sell at times to convince an owner that it would probably be a good idea to accept a AAA tenants offer despite the fact that's it's 5-10% lower than what their neighbor rented their home for, but when you really consider all the moving parts, you will find that the Victory management method is built for the long run. We play the long run odds, not short term gratification.

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