Part-sales as an investment strategy

Analysis of part-selling of residential units in the Netherlands

dr. Jos E. Janssen

AZL Vastgoed

ir. Bert J.J. Teuben

ROZ/IPD Property Index

dr. Aart Hordijk

Visiting associate professor University of Delft, the Real Estate Council of the Netherlands (ROZ) and at the ROZ/IPD Property Index

Correspondence address:
E: Bert Teuben (teuben@vno-ncw.nl)
M: ROZ/IPD Property Index, Bezuidenhoutseweg 12, NL-2594 AV The Hague, The Netherlands
T: +31 70 349 0198, F: +31 70 349 0127

Abstract

The ROZ/IPD Property index is established in 1994 to publicize an independent index on directly held real estate in the Netherlands. The real estate universe is split into the sectors: retail, offices, industrial, residential and mixed use/other. The residential sector consists of almost 45 % of the total investment universe. The residential investments became popular due to the subsidiaries given by the Dutch government. Since 1990 investors have wanted to reduce their residential investments and also to improve their portfolio's quality. The quality improvement has been achieved due to the sale of old properties and the purchase or development of new properties. The sale can be achieved by two methods full-sales and part-sales. Full-sales are determined as sales of complete apartment and house blocks. Part-sales are determined as sales of individual units to the current tenant or sale to an individual buyer when a tenant leaves. One other motivation for part-selling besides the renewal of the portfolio is the high return of those activities.

In the past several studies have been carried out on full-sales, but no quantitative study has been carried out on the characteristics of part-sales. In the Netherlands part-sales are common nowadays. In the past, until approximately 1995, part-selling was considered to be inappropriate for decent property investors. Currently, however, many institutional investors are selling individual units. Since 2000, approximately € 250 million of the total amount of € 18 billion residential investments has been disinvested by part-sales every year by those institutional investors*. In the UK and the USA this isn't a usual property investment activity, but in other European countries like France this is also a common activity. In this paper the returns on part-sales will be analysed using data from the ROZ/IPD property index. The returns will be compared against the returns of all residential investments in the Netherlands. Besides this comparison also the drivers of the return on the part-sales will be examined.

* ROZ/IPD property index

Contents of paper:

1. Introduction

This paper considers the investment choices of Dutch institutional residential property investors in the selling off of individual residential units. The residential units owned by these investors represent a small share of the total number for rent: 5% as at the end of 2005.

The proportion of housing stock in the Netherlands that is owner-occupied has grown consistently over the last twenty years. Of 6.4 million houses[1], 3.4 million are owner-occupied (53%) and 3 million rented (47%). Twenty years ago these figures were 43% owner-occupied and 57% rented. The reason for this change is that since the 1980s between 70% and 80% of new property each year has consisted owner-occupied properties, whilst housing corporations and investors have been selling residential property. Of the 3 million rented properties, 2.3 million of these are now owned by housing corporations, around 550,000 are owned by private investors or by (limited) partnerships, and only 175,000 are owned by institutional investors (IVBN Annual Report 2005).

In a short period of time the number of units in the portfolios of most Dutch investors has shrunk considerably. In the past seven years alone more than 30,000 units have been sold, through full sales or part sales (total value € 3 billion). 'Full sales' here means the sale by an investor of a housing block and 'part sales' means the sale of individual residential units when they become vacant or sale to the current tenant.

The market leader in institutional residential investing – Vesteda – has sold almost 20,000 units during the last seven years. Most investors have tried both methods of sale. Only a few investors have second thoughts about this management activity. Nevertheless, it is certainly not the case that housing has a short holding period. On the contrary. On the basis of sales during the period 1995- 2005 housing continued to remain for the longest period in a portfolio, with an average of 24 years, whilst shops had the shortest holding period with an average of 13 years, and offices with an average 14 year holding period. (Hordijk et al, 2006)

This paper examines investments characteristics of part sales.

(Dis)investment policies for housing investors

There are various policy-related considerations regarding the sale of housing:

1. Favourable market conditions. Due to the current low interest rates there is a lot of interest in buying property, especially in the cheaper price brackets (up to € 150,000). The interest amongst both sitting tenants and investors in buying existing units has been so great over the last seven years that institutional investors no longer participate in tenders because private investors can purchase for much lower gross initial yields (GIYs). The interest increased due the low interest rates and the restrictions for institutional investors regarding leverage. In the case of the sale of a housing block, over the last few years an average of between 20 and 22 times the rent is offered, with a peak of 28 times the rent (sources: Property NL,Vastgoedmarkt 2005/ 2006).

2. Strategic considerations for the investor or manager. The residential properties do not fit within the investment profile. It is very dependent on level of maintenance, or poor location, the housing is not something the market is looking for, or it has too little potential for rental and/or increase in value. Investors wish to keep their portfolios up to date through dynamic asset

[1] The total housing stock of 6.4 million houses is made up of independent accommodation units. Dependent accommodation units, such as student bedsits, rooms in nursing homes, houses for the elderly, houseboats and caravans are therefore excluded.

management. All of this means that not only, there is need for carefully-judged sell off housing, but also carefully-judged acquisition of property. Such purchases require the availability up of capital and a common way to do this is the generated investment potential from sales.

3. Maintaining levels of cash flow for shareholders. Shareholders normally choose housing investments due to their good track record, but also due to the lower risk profile. The yield is relatively low compare to other property sectors, but so is the risk. This puts pressure on the asset manager to perform and to focus on as high income return as possible. The manager has the opportunity to focus on the cash-flow return. On the one hand, this means that rental income is optimised. The appropriate management activities involve targeted investment in the block (e.g. new kitchens or bathrooms), good marketing aimed at leasing to target groups, improvement in client satisfaction through market rent where possible. These activities taken together contribute to the tenant being willing to pay a higher rent as well as to avoid or at least reduce the incidence of vacant units. On the other hand, the investor may try to optimise the indirect return, either directly through full sales or indirectly and in the longer term through part sales. To focus sales of individual houses on yield is regarded as a means of creating extra value or extra yield compared to full sales. The systematically positive returns in the ROZ/IPD Property index give positive encouragement to this way of thinking.

Seen in this light, it is hardly surprising that investors have sold a lot of housing. Nevertheless this raises a number of questions. What opportunities are there for reinvestment? And is the vacant value greater or less than the book value? What is the relationship between the value of the individual sale and its value through continued income and the book value of the housing? Is the aim of an end investor who enters into a long-term commitment with an area and users of real estate not at odds with the disposal of such property? What is the added value of the management to the sales revenues where individual units are sold off? This paper will seek answers to a number of these questions.

2. Literature review

The yield from part sales of housing is the result of a future-orientated valuation. According to the Dutch valuation guidelines there are two methods that are both based, more or less, on the converting into cash of future revenues; the so-called Net Initial Yield method (NIY) and the Discounted Cash Flow method (DCF). The highest value forms the basis for the result of the valuations. In 2004, according to ROZ/ IPD Vastgoedindex, between 60% and 70% of housing investments by institutional investors were valued using the DCF method.

THE DFC method can be expressed by the following formula[2]:

$$MV = \{[CF1 / (1 + Mdr)^1 + CF2/ (1 + Mdr)^2 + \ldots\ldots\ldots.. + CFn / (1 + Mdr)^n]\}/ (1+ PC)$$

Whereby:
MV = market value
CFn = cash flow in period n
Mdr = market discount rate (vendor pays costs)
PC = purchaser pays costs (as %)

The return on the full or part sale of houses is based on the preceding valuation of the housing block. This valuation is the cash value of the future cash flow from the housing block. It is therefore a prognosis of future yields from the sale of the residential units and the exploitation of the block which, combined with a required return or discount rate, determine the current market value of the block. In the case of an ongoing project for the sale of individual units, the valuation of the block is updated each year. By achieving an extra return with regard to this latest block valuation above the level of the standing investments (achieved by, for example, higher sales revenues) there is a contribution of the full or part sale of individual housing units to the portfolio yield as measured in the ROZ/IPD benchmark. The management question is whether this extra return can be traced back to the return

[2] Applying this formula the market value is the same as the cash value of all expected future cash flows, including the assumed net revenue from sale at the end of the period under consideration. Empty units and changes to the actual market rents automatically lead, in principle, when applying the DCF method, to a change in the market value. The lack of rental income due to units being empty, rent-free periods, the contribution to refurbishment costs and other incentives results in lower cash flows and, where the discount rate remains the same, to a lower market value.

from all manner of management initiatives and not to the valuation, since the principles for revaluation are the same for both standing investments and the sale of individual units in blocks.

The management return by sales of an individual unit can be linked to the outcome of the various estimations in block valuations. The most important differentiating factors are the realisation of higher sales revenues than forecast, the realisation of a quicker sale of the units, the realisation of a better income return and higher growth in value of the unsold units, etc. than forecast in the underlying valuation.

Through good marketing, the prior renovation of housing – whether extensive or not – the sale first of the better housing, etc., the value of empty units and the interest in them can be increased. Alongside this immediate management return, the return on a block being sold unit by unit can be improved even more by a decreased discount rate. This will arise mostly as a result of a decreased interest rate. A lower premium during the sale of individual units, certainly in the case of the individual sale of apartments, whereby the investor at some point in time lose his control of the block, usually appears inopportune. Irrespective of non-influencable factors such as the market interest rate, the management return is determined by the 'best preparation' for sale and exploitation.
From a more analytical perspective, one could conclude that returns from the sale of individual units are determined by the quality of the underlying valuations. Over recent years it does appear that the quality of the valuations has been improved. This is partly explained by the increase in market information and transparency, and partly by the greater professionalism of the valuer. Valuation reports are being more critically assessed and subjected to international standards. Valuers are looking more towards definite points of contact with market references and have a greater sense of the risks taken by investors. Various pieces of research show that the increase in vacant value and the turnover rate was often underestimated by valuers and portfolio managers and it is precisely these which have had a particularly big influence on returns, higher than the income returns (Bogerd 2000, van Gool en ten Have 2006, Scholten 2003).

3. Data

Since 1995 the "ROZ/IPD Vastgoedindex" (the Dutch national property index) has provided its participants with a reliable analyses on the performance of Dutch real estate. The index consists out of different sectors, the residential sector is the largest sector with a value of € 18 billion (43 % of the total universe). The total number of properties is approximately 2500 residential objects with over 120.000 residential units. The residential is on average the best performing sector with a average return of 12.2 % on standing investments since 1995. Based on the historic time-series the average return is 9.9 % since 1977, compared to an average return of 9.6 % for all sectors.

During the past decade there was considerabel investment activity in the residential sector. In total over € 4 billion is invested in residential properties, besides those investments over € 7 billion has been sold. In table 1 the total amount of sold properties is shown over 2004 and 2005. The total receipts could be divided into two categories the full-sales and part-sales. The full-sales are properties being sold as a whole property at one certain point in time and part-sales are the sale of individual units. Since 2000 every year the part-sales receipts represent a volume of over € 250 million.

Table 1: Investment activity in € million for the residential sector in ROZ/IPD index.

	Purchases	Sales	Part sales	Development & improvement	Total Net Invest
2004					
Multi family	211	-262	-184	209	-26
Single family	34	-453	-267	53	-634
2005					
Multi family	354	-592	-192	357	-70
Single family	289	-665	-248	112	-511

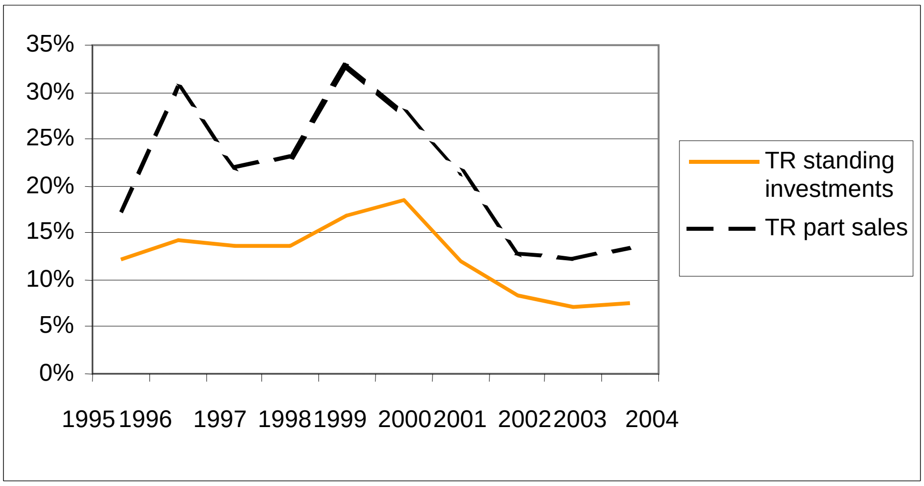
Source: ROZ/IPD Netherlands property index.

4. Return analyses

a. Return part sales vs. Return standing investments

The valuation guidelines for the ROZ/IPD index require a valuation based on including the possibility of selling individual units. The value is calculated by using a Discounted cash flow model. Due to the fact that of the whole property with all privileges and obligations of the current rental contracts the value is less than the sum of the value of vacant residential units. The vacant value is the price, which could be received if a dwelling is sold on the open market without a rental agreement. The market value is approximately 80 % of the sum of the vacant value of the individual units. Due to the timing effect of cash-flows an out-performance could be realized. In the figure 1 the out-performance realised by part-selling is compared to the return on standing investments.

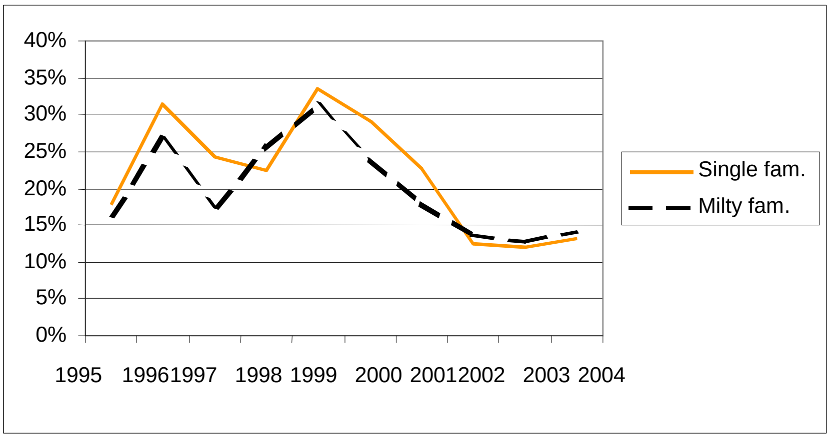
Figure 1: Total returns on standing investments and part-sales (1995-2004)



b. The return op part sales analysed

In this part of the paper the return of part-sales will be analysed. The Dutch investment residential universe can be split in several segments. The main split in the Dutch residential sector is the difference between single and multi family houses. In figure 2 the results are shown for the investment total returns. The results don't differ very much from each other for the multi and single family houses.

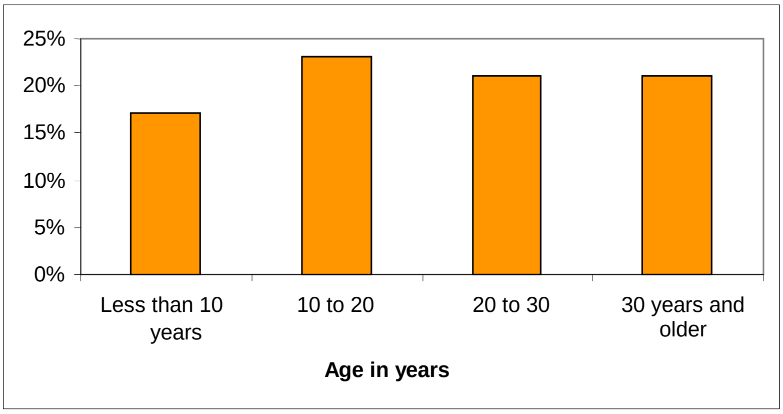
Figure 2: Total returns on part sales divided into single and multi family houses. (1995-2004)



The second most important split can be made between the rental categories in the Netherlands. The residential sector and in particular the residential units with a rental level below € 479 per month (2004) is controlled by the government. The government controls the rent level calculation (based on the quality of the residential unit) and the yearly rent indexation below this level. Often the rent below € 479 isn't equal to the maximum achievable rent based on open market circumstances. The owner occupier residential market isn't regulated by the government and is an open market. Those two reasons result in higher than average results due to part-selling for the relatively low rental categories. In general the part selling results are lower if the rental levels are higher and the rent is based on the open market rent instead of the government controlled rental level.

Figure 3: Total returns divided into rental categories. (1995-2004)

Figure 4: Total returns divided into different age classes of the properties. (1995-2004)



In the analyses also the returns by age of the property are analysed. (figure 4) The results don't differ considerably by the age of the residential properties exept the properties with an age of less than 10 years. A remark has to be made, often the untis with high rental levels are constructed after 1990.

Part-selling is a long lasting process. Some investors don't do any part-selling at all and instead they sell the whole property to a part-selling specialist. Other investors start the part-selling their selves and after two years they sell the remaining units to a other (often private) investor. The main reason is that in the start of the process the highest returns could be realized. Other investors keep a property in their portfolio till the last unit has been sold. In figure 5 the returns are shown for the properties after the start of the part selling process, for example 5 years represents a property with part-sales in the four previous years and the year itself. The returns in the figure are shown as the difference of the average return of all part-sales and the returns of part-selling for properties which are in this process for x years and also compared to the standing investments. The highest returns are realised in the first two years. In general even if the property is in the part selling process over 3 years the returns is higher compared to the average standing investments return over the same period. One exception in the analyses is the 7th year, but this could be caused due of small sample size.

Figure 5: Relative total return for properties based on the number of years in part-selling stage. The relative total returns on the part sales are shown compared to the average return on the part sales and on the standing investment during that specific year categorized by year in the part-selling stage. (1995-2004)

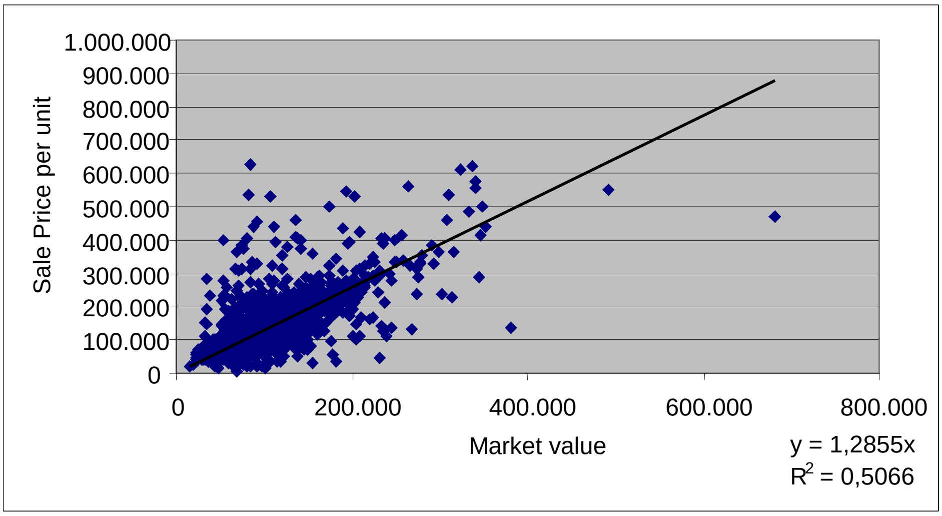
In table 2 The spread of the returns is shown for the analysed property characteristics and also the part-selling process in years. The main conclusion is that the results are most affected by the year of measurement. The year of measurement is also the main driver for the differences of the returns on the standing investments. The second driver for the differences between the returns are the rental categories, and also the age of the property. A remark has to be made due to the fact that the date of construction and the rental categories are correlated. Also the number of years in the part-selling stage has a significant influence on the returns.

Table 2: Overview of analysed part-selling characteristics and the effect on the total returns. (1995-2004)

	Min.	Max.	Difference
Different years	12 %	33 %	21 %
Rental categories	15 %	24 %	9 %
Type of residential property	19 %	21 %	2 %
Number of years in part- selling stage	-4 %	+2 %	6 %
Age of property	17 %	23 %	6 %

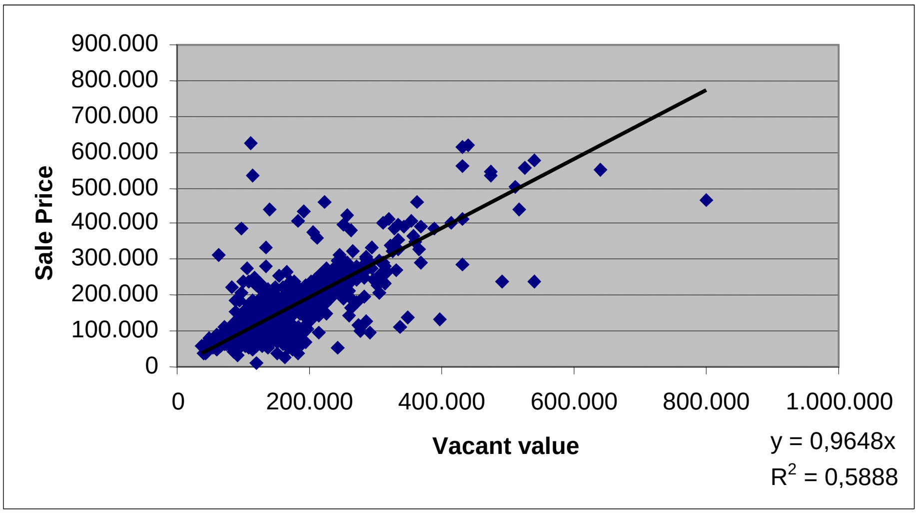
5. Sales prices

Figure 6: Relationship between the market value per unit, based on current obligations, and the achieved sale price of individual units with no obligations. (1995-2004)



In figure 6 the market value of the whole block (per unit) is compared to the sale price of vacant units. The difference between the vacant value and the market value of the units is approximately 30 % during the period 1995-2004. This 30 % difference occurs due to the fact that the landlord has got obligations to the current tenants and the difference of the current cash-flows and the future cash-flows. Is some cases in particular in the well located areas, where high price are being paid for the ownership of individual units and the rental level is protected by the government, there are large differences between the total vacant value and the market value of the property.

Figure 7: Difference between achieved sale price per unit and the vacant value for per unit. (2000-2004)



Since the introduction of the ROZ/IPD index in the Netherlands the data collection has been become more sophisticated. One field, which has been added, is the vacant value. The vacant value is the estimated price, which could be achieved is a vacant unit is sold on the open market. Since 2000 data is collected on the vacant values and the data collection comprehends now approximately 95 % of the total universe (2005). And since the introduction of the new field the quality of the data has improved. The difference of the sale price and the vacant value (based on valuations) is compared in figure 7 for the period 2000-2004 and in table 3 more in detail. The (net) sale prices are approximately 4 % lower than the assumed vacant value. One reason for this difference could be landlord giving incentives to current tenants for buying their own rented house. Those incentives encourages people to buy their house and results into higher cash-flows and sale turn-over rate for the investor in the first two years.

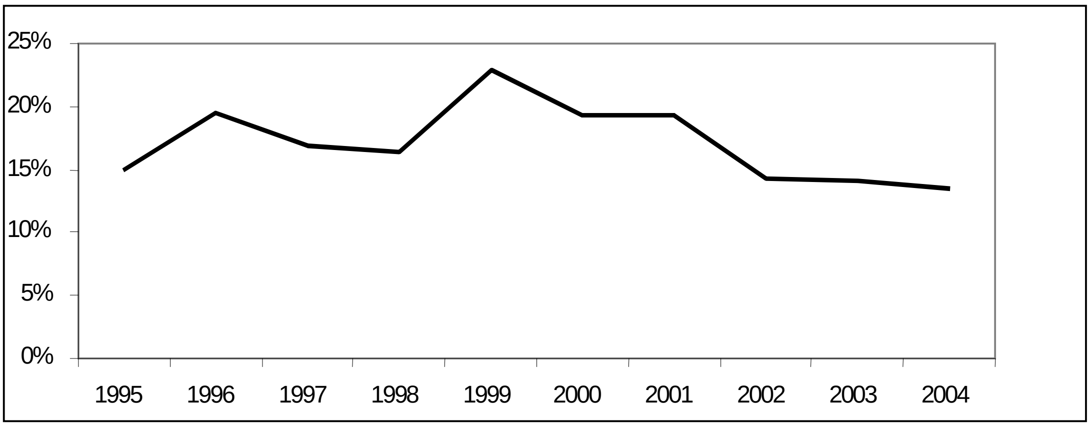
Table 3: Difference between achieved sale price per unit and the vacant value for per unit.

	2000	2001	2002	2003	2004	2000-2004
R square	1,038	0,967	0,969	0,981	0,945	0,965
Coefficients	0,532	0,733	0,585	0,510	0,733	0,589

6. Turnover rate

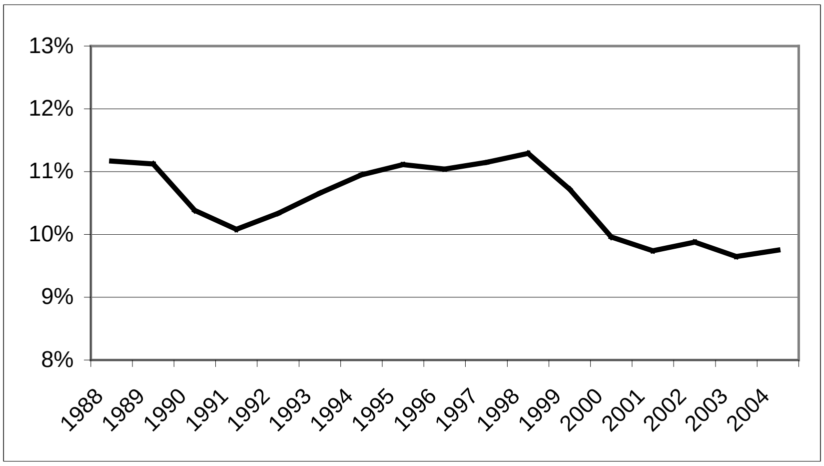
One of the key driver on the return besides the achieved sale prices is the turnover rate of the sold units. The turnover rate affects the timing of the cash flows. The turnover rate can be split into two parts; the tenancy turnover rate and the sale turnover rate. The sale turnover rate is a result of the current tenants buying their houses in the first and second year and in some cases the sale of vacant units. In this analyses this split couldn't be made due to the fact no data on this topic is collected by the ROZ/IPD property index.

Figure 8: Sale turnover rate. (1995-2004)



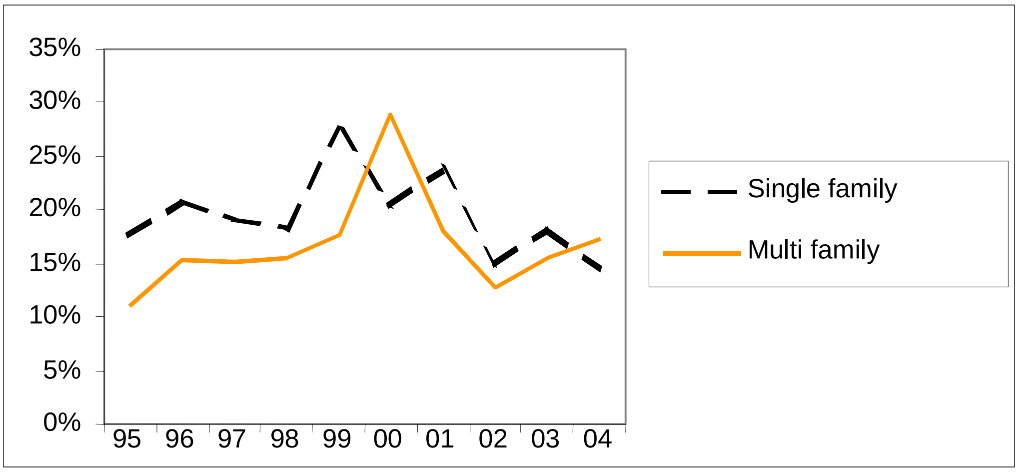
In figure 8 the sale turnover rate is shown. The tenancy turnover rate became lower in the past few years. This is an phenomenon in the whole Dutch rental housing market. In figure 9 the turnover rate for the whole Dutch residential market is shown including owner occupied properties. The same picture (lower turnover rate after 2000) could be seen both in the total Dutch residential market and the sale turnover rate.

Figure 9: Turnover rate the Dutch housing market both rental market and owner-occupiers. (1988-2004)



Source: CBS

Figure 10: Turnover rate divided into single and multi family houses. (1995-2004)



In figure 10 the turnover rates are shown for single and multi family houses. In eight out of the ten years the turnover rate for the single family houses is higher, but no clear pattern could be recognised. The turnover rate differs considerable for the different rental categories. (figure 11)

Figure 11: Turnover rate divided into rental category. (1995-2004)

The turnover rate also differs considerable for the part-selling stage. In the first two years the turnover rate is high compared to the average. The sale to current tenants and in some cases vacant units cause the higher turnover rate in the two first years of the part-selling process. The figure for the first year could raise due to the fact that the part-sales sometimes starts during the year and doesn't start in January. The data on part sales is only collected on a annual bases and not on a more frequent bases.

Figure 12: Turnover rate analysed by the number of years in part-selling stage. (1995-2004)

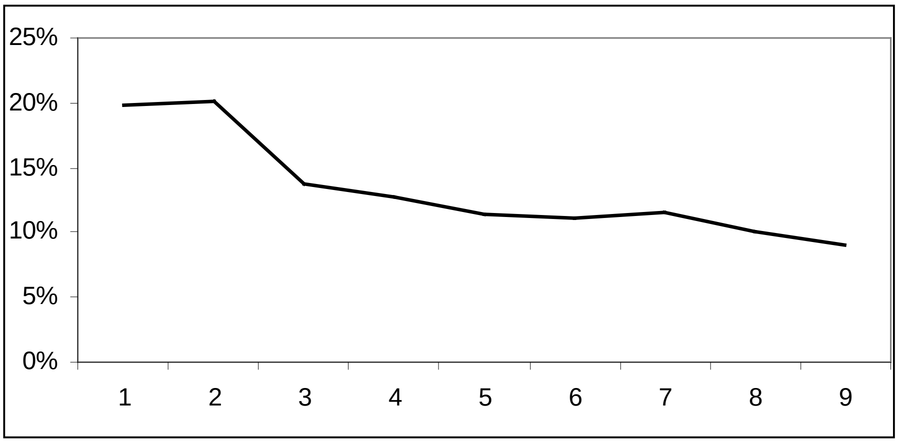
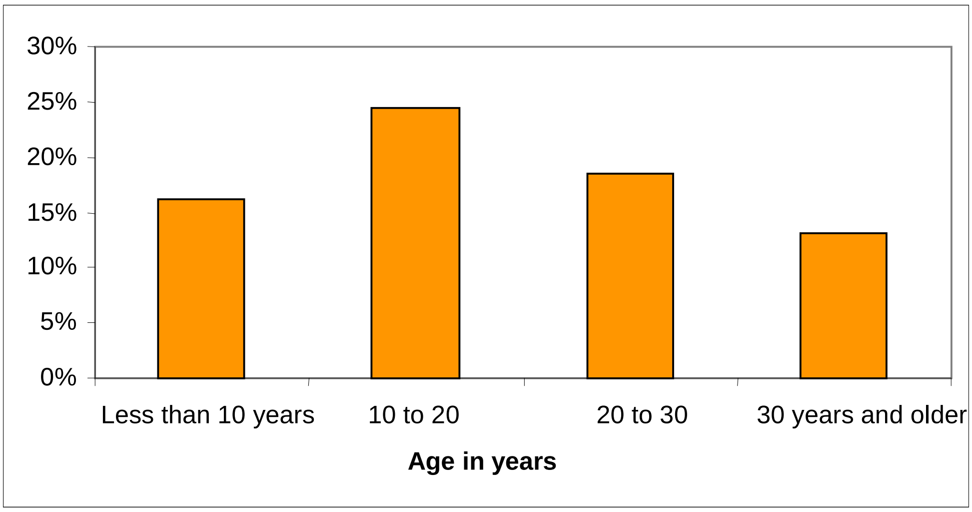


Figure 13: Turnover rate divided into different age classes of the properties. (1995-2004)



The sale turnover rate of new constructed properties is low compared to the older properties.

One remark has to be made for the high correlation between the age of buildings and the rental categories. The high turnover rate for the high rental categories could be the result of a large proportion of tenants who rent a property for a short period (e.i. expats and serviced apartments). The key driver for the sale turn-over rate is the number of years the property is in part-selling stage. Besides the number of years in part selling stage also the rental level and the age of the property affects the turnover rate.

Table 4: Overview of analysed part-selling characteristics and the effect on the turnover rate. (1995-2004).

	Min.	Max.	Difference
Different years	14 %	23 %	9 %
Rental categories	17 %	22 %	5 %
Type of residential property	17 %	20 %	3 %
Number of years in part-selling stage	10 %	20 %	10 %
Age of property	17 %	23 %	6 %

7. Conclusions and recommendation for further research

Conclusion:

Over the last 10 years the increase in value of rented units in the Netherlands has greatly outpaced inflation thanks to the considerable increase in value of owner occupied houses. A consequence of this big increase in value was that institutional investors have sold a relatively large number of units over the last decade – both full sales and part sales. Both sales methods have contributed significantly to the total yield for investors. Valuers and portfolio managers have considerably underestimated the sale returns. In the future, the quality of valuations will continue to improve through faster availability of, and improved access to, more information (see previous observations). A consequence of the sales boom is that portfolios have become much smaller in number of units, but the value of the portfolios increased. The opportunities for reinvestment remain limited due to the scarcity of rented property and the continuing interest of private investors. In the first two years of selling individual units it seems that good returns can be made.

The main driver for the return is the year of measurement. In all analyses on investments returns the year of measurement is one of the most influencing factors. In table 5 the results for the different characteristics are shown. The main conclusion is that there is a strong relation ship between the total return and the turnover rate.

Table 5: Overview of analysed part-selling characteristics and the effect on the total returns and the turnover rate. (1995-2004).

	Differences					
	Total return			Turnover rate		
	Min.	Max.	difference	Min.	Max.	difference
Different years	12 %	33 %	**21 %**	14 %	23 %	**9 %**
Rental categories	15 %	24 %	**9 %**	17 %	22 %	5 %
Type of residential property	19 %	21 %	2 %	17 %	20 %	3 %
Number of years in part-selling stage	-4 %	+2 %	**6 %**	10 %	20 %	**10 %**
Age of property	17 %	23 %	**6 %**	17 %	23 %	**6 %**

Recommendations:

Data collection on individual unit level:
Data on the fact of a property has been sold to a current tenant or on the open market.

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