Inflation and rent adjustment in residential real estate - discipline wins

By Nikolai Stengel, Dr Roger Stettler, 07.09.2022

Inflation has a negative impact on the cost structure of property owners and lowers the value of rental income. A consistent adjustment of rents to inflation - both for existing tenancies and for new tenants - preserves at least part of the purchasing power of the income. These adjustments are necessary, regardless of the development of the reference interest rate. A higher level of debt also helps as protection against inflation, as the cash value of the loan reduces over time.

Rising inflation

Inflation in all major Western economies has continued to rise in recent months and is already well above 8% p.a. in the USA, the European Union and the UK.[1] The inflation rate in Switzerland is still significantly lower at 3.4% (as of July), but is also rising (see Figure 1).

Figure 1: Inflation rate (annualised)

	Sept 2020	Sept 2021	March 2022	July 2022
USA	1.4%	5.4%	8.4%	8.5%
United Kingdom	0.5%	3.1%	7.0%	10.1%
European Union	-0.3%	3.4%	7.8%	8.9%
Switzerland	-0.8%	1.0%	2.4%	3.4%

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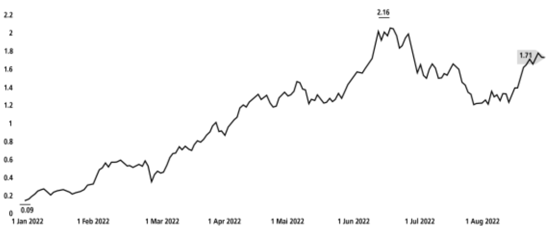
At the same time - after rising above 2% until June 2022 - long-term interest rates in Switzerland have fallen back again and are currently at 1.71% (as of 31.8.2022) for the 10-year SWAP.

Figure 2: 10-year SWAP rate



[1] Compare also the articles "Five Hypotheses on Swiss Real Estate and Rising Inflation" and "Real Estate, Real Estate Income and Inflation" at https://www.hyrock.ch/about-us/news/

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Rents and inflation

Inflation affects the returns for real estate investors. The real value or the purchasing power of the rent decreases due to inflation. At the same time, various nominal costs increase, especially for maintenance and renovation. The extent to which the investor is negatively affected by inflation depends on the share of inflation he can pass on to the tenant. In contrast to rents for commercial properties and retail space, which are typically indexed to inflation, residential properties require active action on the part of the landlord in order to at least partially secure income.

Rent adjustments for residential properties

In the case of residential properties, the reference interest rate collected quarterly by the Federal Office of Housing (BWO) is an important factor in rent adjustments. The interest rate thus collected is based on the volume-weighted average interest rate of Swiss banks' domestic mortgages and is rounded to the nearest quarter of a percent.

Given the current interest rate development and the inherent inertia of the reference interest rate due to the dominance of fixed mortgages, an increase in the reference interest rate is not to be expected in the medium term - or only with a considerable time lag - even in the event of a short-term increase in interest rates.

In addition, an adjustment of the rent based on the general price development - usually 0.5% p.a. - as well as 40% of the change in the national consumer price index (CPI) collected by the Federal Statistical Office is possible in all cases.

Additional rental cost and rent

Additional rental costs (especially for heating/energy) are currently rising particularly sharply. Professional landlords charge these costs separately, except in rare exceptions, and charge the tenants according to the actual costs. The resulting increase in housing costs can regularly lead to problems for tenants with a tight budget – especially if no lump-sum payment on account has been agreed in an appropriate amount. Especially for persons with low incomes, it should also be checked before a rent adjustment whether an additional rent adjustment can be borne in addition to the rising ancillary costs, or whether an increased rent can be enforced in the event of a possible change of tenant.

Implementation of rent increase - simulation

The first step is to analyse how the property compares to new leases in the market today in terms of rent. If the rent of the individual flat is below or within the market, an adjustment is possible in practice.

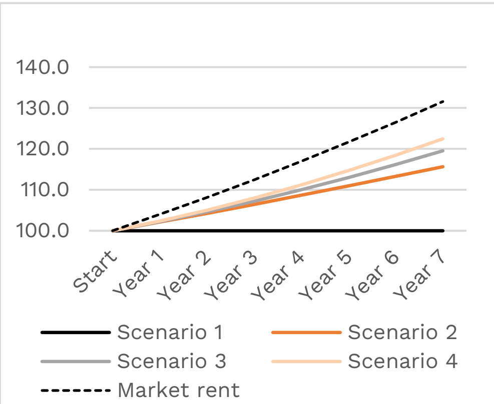
The effect of consistent adaptation over time is considerable.

To illustrate this, we have created a model. With a consistent adjustment to the market rent when tenants change and an annual adjustment of the rent to inflation / market rent within the limits of what is legally possible, the nominal rental income after 7 years is approx. 23% higher than if adjustments are waived or if no adjustment is made when tenants change (see following illustration).

Rent development

Assumptions:

- Inflation / market rent of 4% p.a.
- Change of tenant after 7 years
- Constant reference interest rate
- All flats rented at the market price at the start
- No change in the reference interest rate



Scenarios:

1) No rent adjustment in existing buildings and for new lettings:→ Flat line
2) Maximum rent adjustment for existing tenants (0.4*4% +0.5% flat rate), none for new tenants:→ Rent grows by 2.1% p.a.
3) Maximum rent adjustment for existing tenants (0.4*4% + 0.5% flat rate), 50% for new tenants
4) Maximum rent adjustment for existing tenants (0.4*4% + 0.5% flat rate), 100% for new tenants)

It should be noted that even with a consistent adjustment, the rent cannot keep pace with inflation / market rent, so the landlord suffers a real loss of purchasing power.

Implementation of rent increase in practice

According to Art. 269d CO, a rent adjustment is legally possible on the next possible termination date and the form for the rent adjustment must be received by the tenant at least 10 days before the beginning of the notice period according to Art. 269d para. 1 CO. Depending on the notice period, there is thus - even without a possible objection according to Art. 270b para. 1 CO - a considerable time delay until an increase can be implemented.

Despite the effort, practice shows that a regular - e.g. annual - adjustment is superior to an irregular adjustment.

Firstly, a moderate regular annual adjustment is more predictable for the tenant than, for example, a large adjustment after several years.

Secondly, a periodic adjustment keeps the difference to the market rent smaller, which offers various advantages, such as a lower necessary adjustment in case of a change of tenant.

Change of tenant - market consistently

In the case of extra-terminal terminations, a tenant may release himself from his obligations early by proposing a reasonable tenant (see Art. 264 para. 1 CO). In addition, especially in the case of sought-after properties - i.e. rented below the market price - tenants are happy to present potential new tenants who are willing to continue the tenancy on identical or slightly higher terms.

This offers advantages to administration, as marketing is no longer necessary.

However, in an inflationary environment, one of the few possibilities to maintain the purchasing power of the rent is taken away without an adjustment of the rent when a tenant changes. Therefore, in case of doubt, it is advisable to actually increase the rent to the market price at this point and - if necessary - to carry out one's own marketing or to demand one from the external management.

Positive: Reduced value of debt

A low interest rate environment combined with high inflation leads to an ongoing reduction in the real debt of debtors.

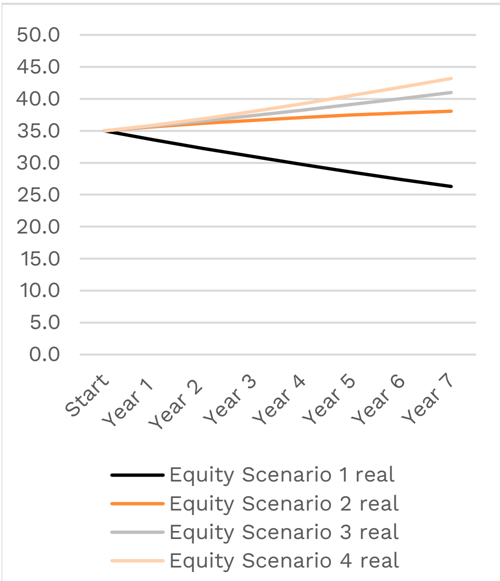
Therefore, at an inflation rate of 4% p.a., a debt is reduced by approx. 25% in real terms after 7 years. If, at the same time, it is possible to increase the nominal income, the equity capital - assuming constant valuation factors for real estate - is continuously increased in real terms even with moderate debt.[2]

Thus, assuming an inflation / increase in market rent of 4%, a consequent redistribution of inflation and general price increase as well as consequent letting at the market price when tenants change, the real value of the equity capital is 23% higher after 7 years (see chart below). This assumes an initial debt of 65% of the value.

Development of present value of equity

Assumptions:

- Debt of 65% at the beginning
- Inflation / market rent of 4% p.a.
- Change of tenant after 7 years
- Constant reference interest rate
- All flats rented at the market price at the start
- No change in the reference interest rate



Scenarios:

1) No rent adjustment in existing and new tenancies
2) Maximum rent adjustment existing (0.4*4% +0.5% flat rate), none for new leases
3) Maximum rent adjustment for existing tenants (0.4*4% + 0.5% flat rate), 50% for new tenants
4) Maximum rent adjustment for existing tenants (0.4*4% + 0.5% flat rate), 100% for new tenants)

[2] This is without taking into account tax effects such as deferred property gains taxes.

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Active Management rents

Swiss investors in residential real estate are currently confronted with an unusual environment: Rising inflation combined with low interest rates. Inflation without adjustment of the reference interest rate leads to a steady loss of purchasing power for the landlord under Swiss tenancy law. This can only be countered with a combination of measures, including in particular the periodic adjustment of rents due to inflation and general cost increases, and in particular a consistent adjustment of rents to the market each time there is a change of tenant. Over the years, the real value of the equity can thus be more than just maintained.

In particular, the purchasing power of equity can be supported by the use of higher leverage since it serves as a natural hedge against inflation in an environment of negative real interest rates.

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