



In a Slow Year, Best Practices for Managing Renter Credit Quality to Maximize Occupancy and Rents

By Jay Harris, Vice President, First Advantage SafeRent, Inc.

It is nearly impossible to go a day without being reminded of the economic stress that is shaking the nation — as job losses increase and apartment living alternatives become cheaper, the multifamily industry is feeling the pinch. In 2008, apartment applicant traffic on a national, same-store basis was down 8% against the prior year.

Properties of each class showed similar decline rates in their same-store applicant volume: Class A properties were down 7.2%, Class B were down 7.9%, and Class C properties declined 8.1%. Yet First Advantage SafeRent's unique national data and market-leading credit risk analytics reveal that, at the market and portfolio level, resident demographics and operating performance varied widely.

In the year ahead, for many properties in many markets, apartment demand is expected to shrink further. It would not be surprising to see same-store demand off 10-15% by the end of 2009 over 2008's low levels. Negative short-term drivers include;

- An increase in unemployment rates throughout 2009, to levels not seen in the apartment industry in a generation. 25-34 year olds – the demographic group with one of the highest propensities to rent – are expected to have the highest unemployment rate.
- Increasingly affordable home purchase terms, helped by falling home prices, low mortgage interest rates, and a new housing tax credit that reduces home purchase costs.
- A historically large number of single-family homes for rent, still held by motivated owners.

These negatives will be mitigated by two familiar, longer-term apartment demand drivers: continuing immigration growth and the large number of “echo boom” consumers coming into their prime renting years. Also, demand for apartments may benefit from federal stimulus spending and related efforts to strengthen the housing, commercial credit and securities, and commercial banking sectors.

In the face of shrinking demand and greater industry attention to property operations, well-run operators and asset-managers are deploying these five industry best practices to maximize portfolio value.

Don't Guess – Statistically Measure the Risk of Lease Default

Well-run companies maximize property value and net operating income (NOI) by using rank-ordered risk scores to accept those applicants that are the best qualified candidates to meet their lease obligations and renewals. Companies using statistical lease modeling benefit by using a tool that incorporates deeper data and can better predict the unique payment behaviors of renters.

Without a thorough picture of applicant history, operators needlessly admit those applicants that drive up skips and bad debt. Use of a screening company, such as First Advantage SafeRent, which offers landlord-tenant records and a statistical model that provides a validated risk score, presents a far more complete picture of an applicant's overall likelihood to fulfill their lease obligations than using just credit by itself.



Without a statistically validated scoring model, properties are forced to make decisions on applicant risk that are more intuitive. This leaves companies in a position of guessing exactly which elements of their applicant selection criteria to change when the market changes – without having a way to measure the effect of such a change. For instance, in this currently soft market what do you change within your screening criteria to increase occupancy? Do you change the income-to-rent ratio? Or the number of trade lines?

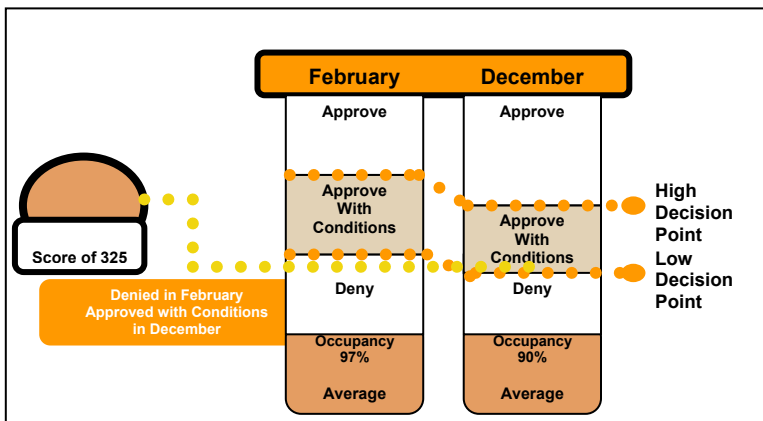
More importantly, besides determining what to modify, you would have to determine how much to modify each element. It is important to understand that the impact of those changes is difficult if not impossible to gauge – until it appears as bad debt and delinquency increases in the portfolio's financial statement.

Accept Only the Credit Risk Needed to Meet Operating Goals

Using a statistically validated score as a constant measure of applicant risk is essential to managing renter credit quality. When companies have the ability to rank order risk and differentiate among marginal applicants, owners and operators have an operating advantage, especially in a down market.

With a statistical model, you don't have to change how you evaluate an applicant to react to a declining market. What does change is your ability to proactively increase your risk tolerance. With a statistical model you have the ability to rank order applicants by risk enabling you to move the risk tolerance "bar" just far enough to capture enough "next risk tier" applicants to meet your properties leasing and occupancy goals. Taking the best-qualified applicants from available demand ensures that management has maximized its ability to push rents and minimized its exposure to skips and defaults.

Rank Order Applicants by Risk With Statistical Scoring



In contrast, modifying individual criteria within a rule of thumb model creates uncertainty about the outcome – will tweaking a few rules lead a property to admit too many defaulting applicants? Will it inadvertently screen out those applicants that would have performed well if their likelihood of lease default had first been statistically verified?

Actively Manage Risk Tolerance Levels and Utilize a Conditional Range

It is very important to actively manage risk tolerance levels and utilize a conditional acceptance range at every property to maximize occupancy and performance. Maximizing additional risk tolerance strategies (increased deposit requirements, additional co-signer, and shorter lease terms) will help offset any additional financial risk that the property may incur. Additionally, utilizing the conditional range effectively can allow properties to expand their risk tolerance thresholds further than they normally would while achieving bad debt and occupancy goals. It has been demonstrated that imposing additional conditions on applicants will help improve resident performance.



Conversely, actively managing risk tolerance levels at properties that do not see a decline in demand is also important. If the demand is high relative to supply, properties can begin to tighten levels and focus on filling vacant units with the best, most highly qualified available traffic. Improving renter credit quality by tightening risk tolerance levels will help improve property performance by reducing bad debt and increasing lease fulfillment. Furthermore, we expect that residents with higher credit quality are more likely to accept increases in rent.

Forecast Demand Against Supply to Develop Marketing, Closing and Retention Strategies

Property- and portfolio-specific trends in renter credit quality, volume, and acceptance criteria are more important to operators than general national trends. In our experience, apartment properties that forecast upcoming expirations against projected demand are the exception, not the rule. Yet this data is readily available.

By applying the following simple calculations from your resident screening history, properties can yield valuable insight and pricing power when handling applicant traffic in 2009:

(a) Track a property's volume and credit quality of applicant demand against historical levels. Look at the overall number of applicants in the same quarter one and two years ago. Anticipate that demand this year may be off 10-15% from last year's volume, all else equal. Also, adjust for any differences in marketing (e.g., higher/lower budgets, improved online presence, improved prospect targeting) that impacted the numbers in one quarter but not the other.

Keep in mind that in most markets and property classes seasonality is a key reality of resident traffic. Your second quarter sees the greatest number and the best-qualified applicants, while quarters one and four show the least and weakest credit quality traffic. Thus, don't expect the next 90 days to match the last 90 days. Instead, match the upcoming quarter against the same quarter a year ago.

(b) Forecast your upcoming available unit supply, based on current levels of expirations, renewals, and skips. Well-run properties today are going the extra mile to retain residents in the face of the slow year ahead – even at the cost of offering concessions under certain conditions.

(c) Subtracting demand (a) from supply (b). Do you anticipate a surplus of units or applicants in the quarter ahead? A substantial shortfall in applicants suggests you can/should take steps now to retain residents. An excess of projected applicants over available units should be considered with caution — after all, skips may go higher in 2009 given the anticipated increase in unemployment. But if you expect excess demand even under conservative assumptions, you may have a rare spot of pricing power at that property in the quarter ahead.

(d) Run your model to “stress-test” your assumptions with less demand than you originally anticipated. At the extremes, First Advantage SafeRent customers experienced swings in qualified demand of +/- 30-50% in 2008 vs. the same quarter a year before.

Review Marketing and Resident Applicant Demographics

An ongoing and thorough review of marketing efforts, closing effectiveness and target marketing spend is crucial. Make sure you are reviewing the originating zip codes of your applicants and compare the acceptance percentage and risk scores from each area. You'll also want to look at acceptance rates by marketing source to make sure the media bringing in the most qualified leases are getting an adequate marketing spend. Cross-reference this information to target the highest yielding zip codes with the most effective marketing communications to ensure you are driving in the most qualified applicants while practicing efficient marketing spending.



Also evaluate whether the scores, incomes, and prior rent trends of your applicant base is experiencing significant change. Are your properties attracting the same credit quality of applicants, just fewer of them? Or are scores and incomes of your resident population falling off compared to prior measures at the same time your applicant volume is on the decline? The latter case may suggest more significant repositioning, target marketing, curb appeal, and site-level management efforts are needed.

Conclusion

Property operators and asset managers can expect extra time in the spotlight in what promises to be a rocky year ahead. To respond, well-run companies are rank-ordering applicant risk, actively managing credit criteria in response to market conditions, and using property-specific operating history to inform key operating decisions. Using these simple but powerful best practices, strategic operators can attract the best and largest share of a diminishing pool of qualified applicants, meet operating goals, and position properties to weather the economic uncertainty ahead.

About the Author:

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