The Economics of Tenant Retention

An e-Book by **Zillow Rentals**

BEST PRACTICES IN

RENTAL MARKETING

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The Economics of Tenant Retention: Happy Tenants Drive Profit

Tenant retention is one of the most cost-effective strategies property managers and owners can implement. Think about it: a good tenant is your unofficial business partner. As long as they're satisfied with the unit, you will benefit from uninterrupted rent payments.

Alternatively, tenant turnover is costly. Recruiting new occupants involves spending money on marketing while losing money on a vacant unit. The profit you lose during the turnover period could be altogether avoided if you focus on retention. By maintaining your property and fostering tenant satisfaction, residents are encouraged to remain in the unit, giving you steady cash flow and maximized profits.

Obstacles to managing a property are expenses largely beyond your control: property maintenance, utilities, property taxes, mortgage payments, insurance, and HOA fees. When modest rent increases aren't leaving you with enough profit after paying these bills, an effective way to improve your property's financial performance is to reduce tenant churn, or the cost of turnover.

In this guide, we'll break down the economics behind tenant retention and look at how applying strategies to reduce turnover will have a positive impact on your profits, operating budget, and long-term success as a rental property manager.

Photo: Jrwooley6 (Flickr)

Tenant Retention: Why Does it Matter?

At the moment, all your units are full. You're done with your job until you receive a work order for repairs or a tenant moves out, right? Wrong. It's great to revel in the great feeling of having 100% occupancy, but your job doesn't end there – now your goal is to convince tenants to *stay* in your units.

Save time and money. Encouraging residents to stay with you is worth your time because each occupied unit is equal to one less listing to market on Craigslist, a steady stream of rent payments to your account, and so on. The cost and effort that goes into filling a vacancy adds up! Stop losing money and operate with an optimal budget by retaining tenants. You'll spend less money and time on marketing and turnover maintenance, which translates to reduced costs and increased income.

Focus on great service. Over 60% of customer turnover is controllable, with staff performance the largest determining factor in why a tenant moves out. To reach your tenant retention goal, your residents need to be satisfied with their current living situation. As a property manager, there's a lot you can do to leverage your service for better retention and occupancy rates. It's important to be up-to-date on your tenants' perceptions and concerns. Know where their priorities lie and respond to them with top-notch customer service, since your financial situation depends on their satisfaction.

To reach your tenant retention goal, your residents need to be satisfied with their current living situation.

Retention means greater profit. The Journal of Property Management revealed that on average, a retained resident is worth almost $900 each year on top of rent payments. Each time a resident moves out, a unit is vacant for an average of 1.5 months. If the tenant retains their lease, the property saves $1,350 as well as the additional costs that would go to marketing the vacancy.

In order to implement a better tenant retention strategy, it's important to know exactly how much a tenant is worth to your business. This may seem like a daunting task, but in actuality, you already have all the information you need at your fingertips (in your financial records). Read on — we'll show you how to look at your numbers, and how reducing resident churn will help you put your balance in the green.

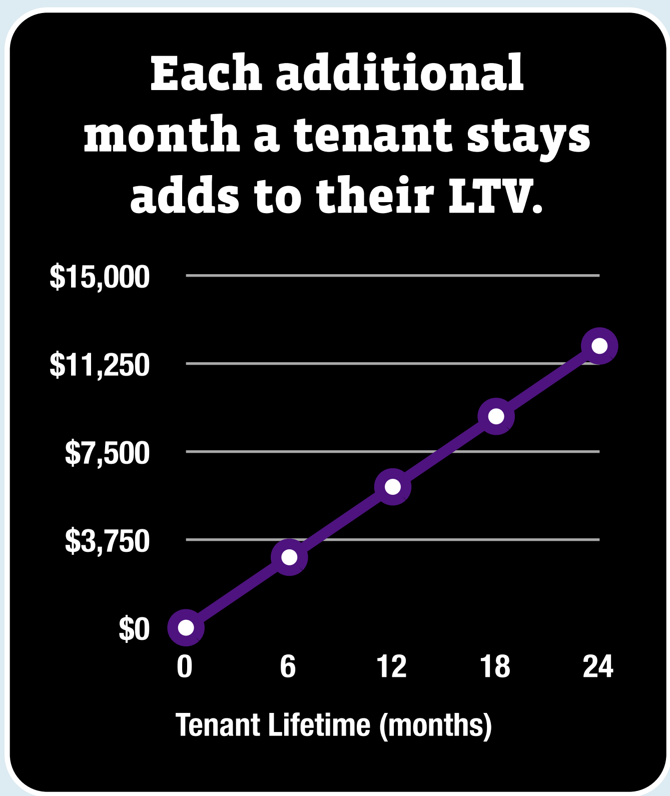
LTV: Lifetime Value of a Tenant

The lifetime value of a tenant is the profit that you'll make for the period of time they're renting from you.

Keeping tenants longer boosts your profits. If your rental price is $500 a month and the average tenant 'lifetime' is 20 months, that's a lifetime value of $10,000. What if they stayed an additional 6 months? That's an additional $3,000 generated from each tenant. Keeping residents in your unit means you won't have to market vacancies, and on top of that you don't open yourself to the risk of renting to a non-paying or problem tenant.

Knowing the LTV helps you decide where you can best spend your money to influence tenant retention. We mentioned previously that the average retained resident is worth almost $900 each year to the property, in addition to rent payments. Assume 1 year's rent is $6,000. If you know that a tenant's LTV is $6,900 (1 year in rent plus the $900), you'll be much less hesitant to make a repair in the unit costing $500 because you're still making $6,400.

Measuring tenant lifetime value and using it as a metric will highlight the importance of customer service. Long-term tenant satisfaction is more valuable than maximizing short-term value, especially in the case of keeping great residents. Before imposing a steep rent increase, knowing the risk you open yourself up to will help you determine if the increase is worth it. Your renter has the option of going somewhere else for a better deal, drastically reducing their LTV. Will a $200 rent hike increase the likelihood of retention, or are you better off using that money to make unit improvements, resulting in increased lease renewal? It costs tenants time, money, and hassle to move in and out of your unit, so



encouraging them to stay by being a responsive property manager can go a long way.

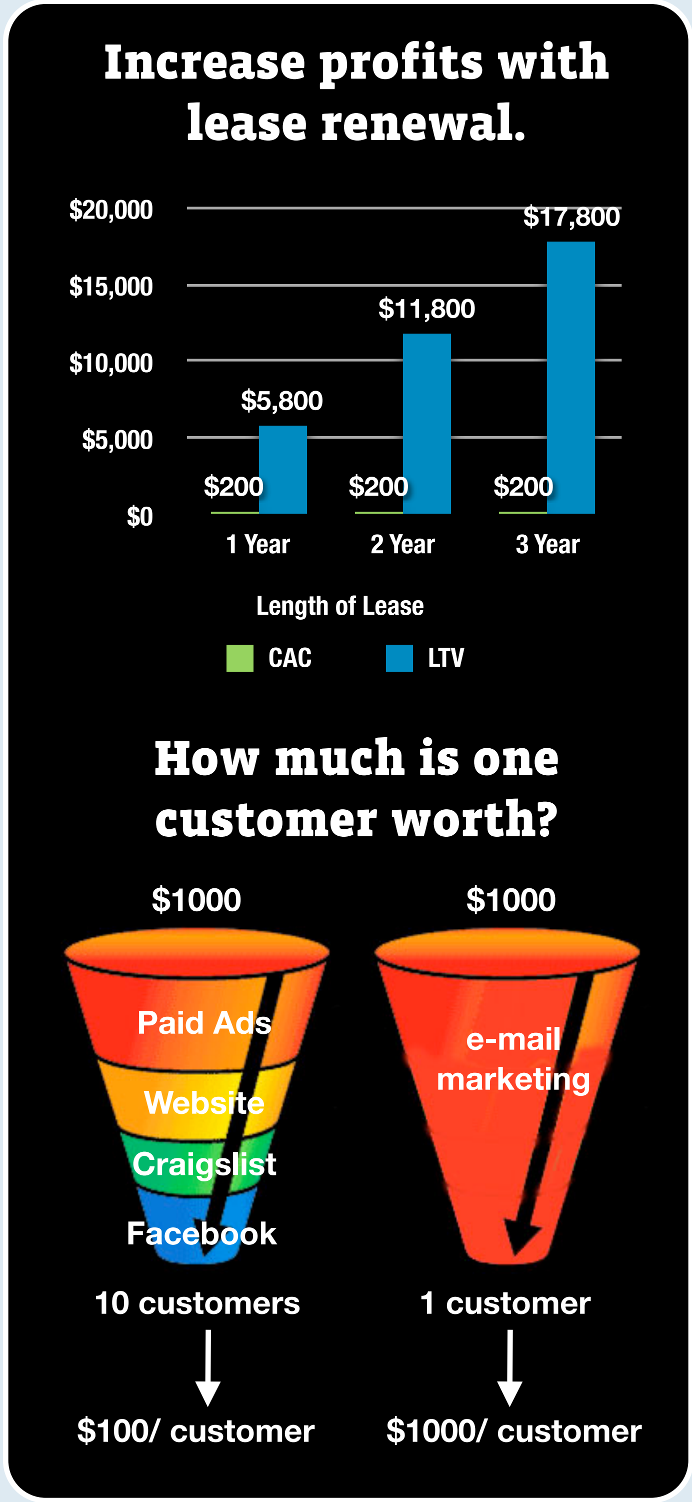
Retained tenants generate more profit because you save money from not having to market vacancies. In order to accurately calculate a tenant's LTV, you also need to know how much it cost for you to fill the unit. This measurement is your Cost to Acquire a Customer.

CAC: Cost to Acquire a Customer

Before your new tenant has even moved in, you've already spent money to acquire him. The Cost to Acquire a Customer (CAC) is how much you spend for one customer. If you're paying to share listings on third-party sites or hire brokers, how effective is it? The easiest way to tell is to look at how many renters these marketing avenues are bringing in.

How much are you spending? If your marketing budget is $1000 and it gives you 10 customers, you're spending $100/customer. Alternatively, if you're spending that much in one channel (e-mail marketing) and it only gets you 1 customer, you're paying $1000 for 1 customer, which is too much! This is why it's important to know where your marketing is most cost-effective and worth your time. Map your marketing spending in a funnel similar to the one on the right. Look at how much you're spending in each marketing channel, and track where those costs are coming from. Ask yourself: How much is one customer worth, and how much am I willing to spend to acquire a tenant?

Knowing the CAC will allow you to be smart about portioning your marketing budget. Look at the breakdown of your marketing spending and the leads that result from those efforts. The CAC should always be less than the tenant's Lifetime Value (LTV), and you always want the CAC to be decreasing - this means more profit for you!



For example: It costs $200 to acquire a tenant. If a tenant's 1 year lifetime value is $6000 (rent is $500/month x 12 for a 1 year lease), this means that you will make $5800 the first year of their lease, and $6000 the second year. You save $200 for each additional year they stay with you because you don't need to spend money to market a vacancy. Your CAC is $200 and the LTV for a 1-year lease is $5800, so the tenant is definitely profitable.

As you can see, your CAC also depends on how long a tenant rents from you, so convincing them to renew their lease for a second or third year will make them even more profitable. This is why you should focus on retention.

We broke down the numbers to make it simple, but remember that the costs of property maintenance, repairs, mortgage payments and taxes will also factor into a tenant's LTV. Once you subtract those costs from the period they're paying rent, you get their net LTV.

LTV and CAC: Tying Them Together

Why is knowing the LTV and CAC important? These two numbers work together to tell you how well you're budgeting your income.

Here's how LTV and CAC fit together in an easy-to-understand ratio:

$$\frac{\text{LTV}}{\text{CAC}} = \frac{\$20}{\$1} = \$20$$

You want this number to increase.

To make a profit from your rental property, your CAC should always be less than the tenant's LTV. Otherwise, you're losing money. Take a look at the ratio above. What this means is that for every $1 you spend, you are getting $20 in return. In this case, your customer lifetime value (LTV) ratio is 20 to 1. For example, if you're spending $1 to acquire a customer and their LTV is $20, you are earning back 20 times the amount spent.

Form a budget. By working out how much each tenant is worth (LTV), you now know how much you should spend to acquire a new tenant. If filling a vacant unit costs $200, you'll know that spending $500 on a bench advertisement is a waste of money. Use the CAC and tenant LTV to get a clearer idea of how to portion your marketing budget, run your property efficiently, and generate more profit.

Take the next step. You've figured out how much you're spending to fill each vacancy. Now imagine having to spend that amount on each unit, each year, re-tenanting. Your bank account is much better off if you get your residents to renew their lease - you'll cut down on marketing spending. Understanding LTV and CAC makes it clear how resident retention shapes your profit. There's more: in order to see how much money you save with each lease renewal, you also need to know how much income you lose in the average turnover, which we'll cover in the next section.

> **Instead of marketing towards new tenants, focus time and energy retaining existing residents.**

The Cost of a Vacancy

Tenant turnover has a huge impact on your bottom line. Research by the National Apartment Association (NAA) has shown that each move-out costs over $4,000. Why not save that money and increase profits by encouraging good tenants to stay?

Vacancies impact your operating budget. Every time a tenant moves out for an avoidable reason, you have the upfront vacancy loss of 4-8 weeks of rent. Once you factor in the concessions (maintenance costs, utilities, taxes), you're already easily lost about 2 month's worth of rent.

The existence of vacant space can significantly impact your profits. Turnover costs include loss of rent payments, unit repairs, and other hard costs that can amount to over $4,000. You can see the breakdown in the chart on the next page, based on national average rent and concession data from Axiometrics, a provider of market information for U.S. apartment properties.

All these costs add up fast! Retaining tenants will save you from these expenses, protect your revenue, and reduce the negative impact on your operating budget. Instead of marketing towards new tenants, it's worth it to focus time and energy retaining existing residents. To do this, you'll need to focus on increasing their level of satisfaction – tenants who value your service will be reluctant to deal with the hassle of relocation.

Measure Resident "Churn"

Resident churn, or the cost of tenant turnover, can significantly cut into your cash flow. Once you know the economic cost of each resident, you'll know why satisfied

Tenant Turnover Cost Breakdown

Assumptions:	Average
Average rent	$947
Average vacancy loss days	40
Average concessions	$772
Maintenance tech average hourly	$18.32
Maintenance tech average hours to turn a unit	9
Leasing agent average hourly	$16.96
Leasing agent average hours to show & rent a unit	10
Calculations:	
Vacancy loss	$1,263
Concessions	$772
Leasing staff time/cost	$170
Marketing/advertising costs	$356
Resident referral/locator fee	$444
Leasing commission	$40
Carpet cleaning or replacement cost	$136
Appliance repair or replacement cost	$292
Painting cost	$197
Maintenance staff time/cost	$165
Miscellaneous maintenance costs (parts, etc.)	$141
Apartment cleaning	$71
Total:	**$4,047**

Source: Multifamily Insiders, The True Cost of Turnover, 2010.

tenants add value to your business.

You can measure the costs of resident turnover by calculating a "churn index." The data needed to calculate the index is found in your monthly financial statement. A good index will tell you the cost, in dollars, of losing a resident, as well as the annual cost of residents who are lost. On top of lost rent, what are your turnover costs?

Example: if each tenant turnover is costing you $4,000 (see the breakdown for this total on the left) and you have 10 empty units in your 100-unit property, you're losing $40,000, despite your 90% occupancy rate.

From the surface, a 90% occupied building seems like a healthy rental property, when in reality you're losing $40,000 due to churn. Add in a result of the SatisFacts retention survey, where 60% of turnover is controllable with better customer service, and you've identified how you can reduce the 10-unit vacancy.

By figuring out your churn and identifying the most common cause of turnover, you're able to make better decisions to keep residents happy.

Know how much churn is costing you. When costs are spread out in your expense categories, it's hard to catch how much and where you're losing money – this is why knowing your churn index will help you manage your property. It will clearly identify the costs associated with a turnover and tell you how those costs are cutting into your cash flow.

Is Your Property Generating Profit?

As a property manager or owner, your goal is to make a profit from your rentals. We've showed you how tenant turnover is costly, and why retention adds to their LTV. Now, let's take a look at your cash flow. Retention can increase your profits because receiving steady rent payments while cutting down on vacancy expenses will reduce your maintenance costs.

Calculate cash flow. You probably already have an idea of whether or not you're making money from your rentals, but the proof is in the numbers. If the idea of calculating your cash flow makes you groan, don't worry – it's not as complicated as you think. In fact, you already have all the numbers on your tax returns. Here is the formula, we'll explain it in more detail below:

Cash Flow Formula:

Rents received (Schedule E)
- Rental expenses (Schedule E)
- Total principal and interest mortgage payments
- Total basis (cost) of all improvements and replacements (Form 4562)

= True cash flow

Let's break it down even more:

1. Look at your Schedule E (Rent and royalty income) from your last federal income tax return.
2. Subtract your "Rental and royalty expenses" from your "Rents received."
3. From that number, subtract your total mortgage payments for the year (12 x monthly payment), including both principal and interest, not just the interest you deducted on your tax return.
4. Now subtract the total cost of improvements added that year, like parking lot repaving or new appliances. Include the depreciation of the assets. You can find this number in Form 4562 (Depreciation and amortization).
5. You've now calculated your true cash flow!

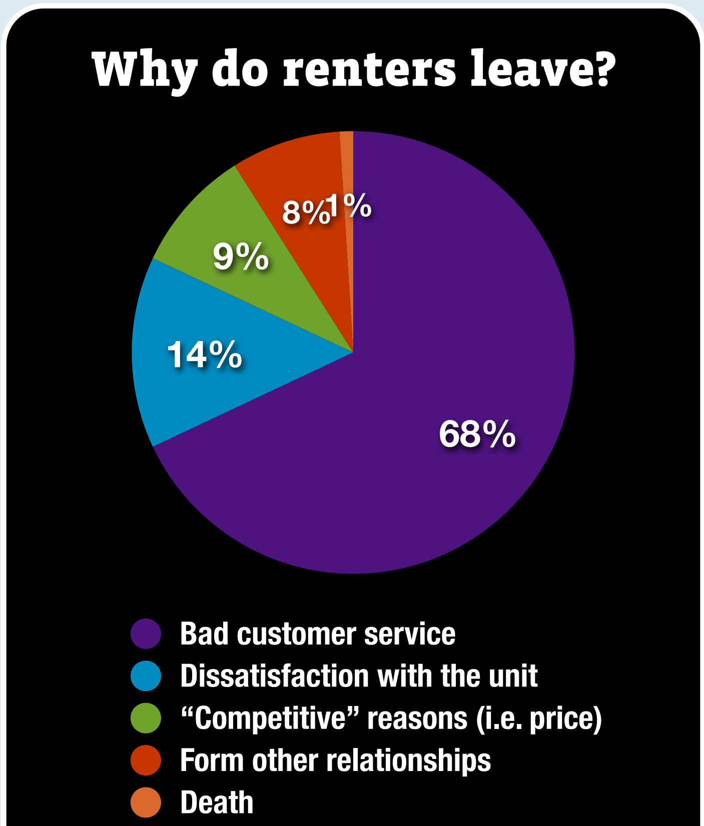
Now how does tenant retention play into all of this? In order to understand why retaining a tenant will generate more cash flow than re-tenanting, you need to know how much you spend to operate and maintain your property. Well, we already know that with resident retention, you collect more rent and cut down on expenses associated with a vacancy. This means that by reducing tenant turnover, you'll have a higher total when you subtract your expenses from the total rent collected (#2 above). That trickles down to an increased true cash flow. When you know how retention influences your profit, you can make educated decisions about spending money and time on improving customer satisfaction.

"It's impossible to avoid vacancies."

No matter how hard you try to work with angry tenants to avoid vacancies, you won't be able to have a zero turnover rate. Some tenant churn is unavoidable – renters turn into buyers and renters are forced to move due to job changes.

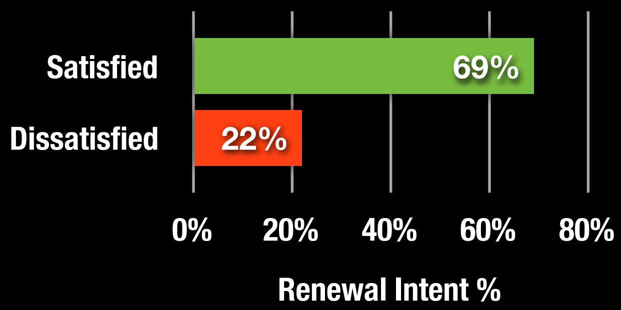
Renters are naturally a transient population. Is trying to retain them pointless? Flexibility is a perk of renting, but chances are, not all of your tenants want to deal with the inconvenience of relocating every single year. In this sense, using tenant retention strategies to encourage residents to renew their lease benefits both you and the renter.

Why do renters leave? In the graph below, you can see the breakdown for the reasons tenants decide to leave. The principle reason for tenant loss is bad customer service - which is completely under your control!



Data from CRMGuru, The Perception Gap.

Property management influences retention



Tenants satisfied with property management are more than **3x's as likely** to renew.

Research by Kingsley Associates

Risk/Revenue Matrix

Probability of leaving soon

Life-Time Value		High	Medium	Low
	High	Priority A	Priority B	Priority C
	Medium	Priority B	Priority B	Priority C
	Low	Priority C	Priority C	Priority C

A risk/revenue matrix helps you map a tenant's likelihood of moving out. Focus your efforts on the high and medium-value tenants.

Control tenant turnover. Research by SatisFacts, an authority on resident satisfaction surveys, showed that over 60% of customer turnover is controllable, with staff performance the largest determining factor in why a tenant moves out. In 83% of cases where renters leave, it's caused by a triggering event. This means that the majority of tenant loss is avoidable. Recognize that people can go somewhere else for the same service – how can your property remain competitive?

Create a tenant retention plan.

Since the principal cause of losing tenants is bad staff performance, recognizing the value of customer service can help you retain them and prevent the much more costly turnover.

Your goal is 100% retention. You'll always have tenants who will need to relocate because of jobs or life circumstances, but concentrate on offering residents the best experience possible while they're under your management. This will result in the highest occupancy rate possible.

Communicate with your residents. Treat tenants with respect and be considerate of their needs. Once they move into your unit, focus on delivering great service so you instill rental loyalty and trust. Being responsive and providing excellent customer service will motivate existing tenants to stay. Engage your tenants with raffles, informative newsletters, and seasonal events. Being involved with your apartment community shows residents that you care about their experience, increasing their perceived value of your services.

Experiment with promotions and discounts. Renewal bonuses, free last month's rent and wi-fi? Phone and cable companies offer deals and free services because they work. The lifetime value of a customer is far greater than the cost of free texts, or in your case, free utilities.

Encouraging tenants to renew their lease. You'll increase your building's profitability as well as reduce the number of dissatisfied tenants. Another perk of having satisfied residents is that they'll be less resistant to rent increases as market costs force you to raise your prices – another positive impact on income.

Prioritize your tenant retention efforts. Your time is valuable and you can't be everywhere at once, so be smart about retention and know who to focus on. How can you determine the 'retention value' of a tenant? By categorizing your tenants into a risk/revenue matrix like the one above, you can clearly see which residents will benefit the most from your retention efforts.

Tenants are divided into 3 segments: high, medium, and low lifetime value. Focus your efforts on the high and medium-value group.

High value: Tenants most likely to move out.
Low value: Your most loyal tenants, who will stay with you no matter what.

Once you know which tenants are most likely to move out, you'll know who to give extra priority to. Concentrate on improving their experience in your unit by pledging to respond to their complaints in a timely fashion.

Use Customer Relationship Management (CRM) software. Implementing customer relationship management will help you organize, automate, and evaluate your retention efforts. Instead of manually keeping track of lease anniversaries and work orders, CRM software will keep everything in one place. With CRM software, you can improve your customer service by keeping track of leases, tenant records, maintenance activity, and all other documents so you can focus on the bigger picture of nurturing satisfied tenants.

Survey tenants and change. Experimenting with a million different strategies to improve tenant experience takes time. Reach out to residents in periodic surveys; they'll help you identify problem areas where you can improve. Asking for feedback isn't a sign that you don't know what you're doing – it's a loyalty-generating process in itself, showing residents that you're committed to their needs. By focusing on great customer service, you're on track to retain tenants and increase your profit.

Glossary:

LTV: Lifetime value of a customer. This is the amount a tenant will add to your cash flow in the period they rent from you.

CAC: Cost to acquire a customer. Your CAC is the dollar amount it costs to fill one "churn index" with data from your financial records.

Net: Income or total amount after taxes and deductions. Example: net LTV, net income.

NOI: Net Operating Income. Your NOI is the gross income minus the total cost of your operating expenses (not including mortgage payments).

Tenant "churn": The cost of resident turnover. You can measure the costs of resident turnover by calculating a "churn index" with data from your financial records.

Risk/Revenue Matrix: A chart that maps the lifetime value and the likelihood to defect.

About Zillow Rentals

Zillow Rentals is a branch of Zillow, Inc. (Nasdaq: Z), the leading real estate marketplace, and operates as part of Zillow's growing rentals marketplace.

Zillow Rentals connects rental marketers to availabilities being shared by property managers in realtime.

Thousands of leasing agents use Zillow Rentals daily to track and market their vacancies to prospective tenants.

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