

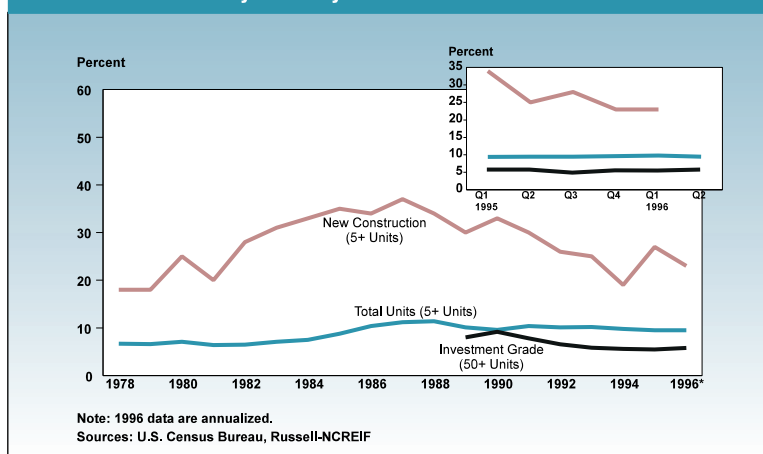
Rental Market Enters Era of Change

ALTHOUGH THE MULTIFAMILY housing sector has enjoyed solid renter demand both this year and last, this level of support for high-rise and garden apartments becomes more problematic to sustain in the future. The supply of renters is shifting while increasingly popular rental-housing alternatives—such as single-family and manufactured housing—are vying for market share.

Changing market conditions do not, however, play out in the same way for all segments of the general multifamily market, which encompasses all rental buildings of five or more units. For instance, the investment-grade slice, meaning professionally managed apartment buildings of 50 or more units, performs better by most measures. These top-of-the-market properties do react to general market trends; in the case of a down market they respond less dramatically and recover sooner than properties in the broader market.

Much of the recent vigor seen in the multifamily market stems from the long-awaited absorption of the rental-housing overhang from the mid to late 1980s. Concurrently, continued immigration and growth in the number of unrelated individuals living together has bolstered household formations over the past two years. Taken together,

EXHIBIT 1: Multifamily Vacancy Rates



by Donald S. Bradley

these indicators of dwindling supply and growing demand have helped encourage strong interest among investors willing to fund more apartment construction.

In fact, a burst of speculative investor activity in rental housing a year ago nearly succeeded in undermining the equilibrium between renter demand and rental supply that the market has enjoyed for the past two years. Investor financing flowing into the apartment sector in 1995 stimulated the largest surge of new rental units to reach the market in several years. Developers, to their credit, responded with sufficient restraint to avoid repeating the mistakes of the overbuilt 1980s (see “Multifamily Moves Ahead,” *SMM*, Summer 1995). Once again, though, the improved fortunes of the rental industry may place the supply-demand balance at risk.

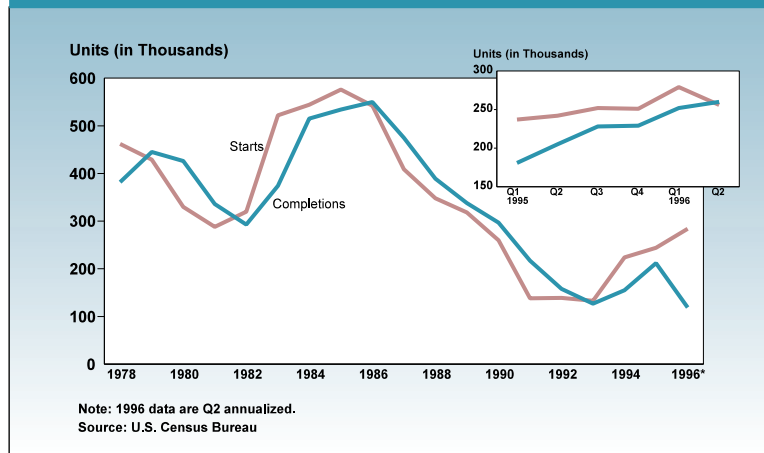
Recovery or Relapse?

The multifamily market had, by many measures, finally recovered in early 1995 from the disastrous 1980s. A little more than a year later, however, many of the same indicators were sending mixed messages, including some signs in the first two quarters of 1996 that suggested a softening in the rental market.

On the demand side, the multifamily vacancy rate overall (*Exhibit 1*) increased slightly to an annualized 9.5 percent from 9.4 percent at the start of 1995. The annualized vacancy rate for investment-grade projects—the sector in which Freddie Mac has concentrated most of its recent financing efforts—remained unchanged in second quarter 1996 from the 5.8-percent rate

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EXHIBIT 2: Multifamily Starts and Completions



that prevailed in early 1995.

Rents improved over that time frame, with the median real rent on a newly built unit climbing 3 percent from a year earlier to about \$615 in first quarter 1996.

The supply indicators (*Exhibit 2*) also rose. Construction starts through the second quarter of 1996 skipped ahead, on an annualized basis, to 256,000 units from the 237,000 units started at the beginning of 1995. The number of units actually reaching completion and coming on the market jumped to an annualized 260,000 units in first quarter 1996, a 44-percent gain over the same quarter a year earlier.

Reversing course, the new-construction vacancy rate, which shot up an alarming 70 percent in the first three months of 1995 over the preceding year to an annualized 34 percent, was telling a different story more recently, as *Exhibit 1* also shows. By the first quarter of 1996, it

had cooled off by 11 percentage points, with only 23 percent of new units awaiting their first tenants. (This vacancy rate is an inverse expression of the three-month new-construction absorption rate.)

Nonetheless, the marketplace may find it difficult to maintain an economically viable new-construction vacancy rate in the months ahead. The supply pipeline is bulging once again, with an estimated 700,000 units started since 1994, many of which will not hit the rental market until some time in 1997.

So far, a favorable 11.6-percent return has held investor interest in purchasing or lending money on multifamily residential properties. What's more, multifamily loans were still paying a respectable 7.9-percent interest rate as of September. However, the spread between the typical multifamily mortgage (a 10-year bullet, 30-year amortizing loan) and the 10-year

Treasury note has been narrowing. In 1993, for example an average 2-percentage-point gap separated the two. For the first nine months of this year, though, the spread has shrunk to 1.4 percentage points, perhaps enough to pull more investor funds into the less risky Treasury alternative.

Where Future Demand Lies

Housing demand is influenced by four principle factors: household growth, changing household characteristics, household income and lifestyle preferences. Significant shifts in any of these areas can alter profoundly the size of the demand and type of housing that satisfies this demand.

The expected pace of household formation during the remainder of the decade favors housing generally and the rental sector specifically. On average, household growth should replicate the healthy 1.2 million formations recorded annually in the 1980s, only to stall at the turn of the century. The clip will not resume until five to 10 years later, when the children of the baby boomers reach adulthood and strike out on their own.

The relative strength of the rental market is linked inextricably to the robustness of the home-sales market. The bad news for the rental market, then, is that the remarkable gains in the single-family ownership market over the past two years

will continue. An additional 2.3 million households made the transition to homeownership during a period when home buyers could secure long-term mortgage rates in the 7.5-percent range.

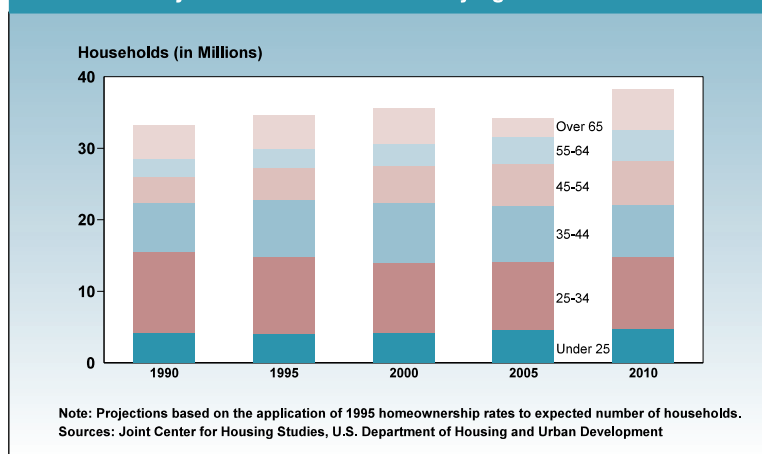
Consequently, the proportion of renters slipped to 34.6 percent of households in second quarter 1996 from 35.3 percent for all of 1995. The outlook for inflation, interest rates and the overall economy all point to further ownership gains, coming at the expense of the rental market, until 2001.

The two ends of the economic spectrum will account for much of the anticipated increase in housing demand that the multifamily rental sector will be called on to satisfy. Upper-income “lifestyle” renters will dominate the market for newer, higher-rent properties. Income-constrained “economic” renters will compete for an ever-decreasing supply of low-cost rental housing.

Affluence links the new lifestyle renters together. Regardless of whether these tenants are singles, empty nesters or seniors, all make average household incomes in the mid-\$60,000 range. They can afford to buy but prefer the convenience, flexibility and freedom from maintenance that renting offers.

Among lifestyle renters, near-seniors and seniors will dominate the market (*Exhibit 3*). The

EXHIBIT 3: Projected Renter Households by Age of Household Head



younger of the two age groups, those 45 to 65 years old, will swell to 51 percent—approximately 15.7 million—over the next 15 years. At the same time, the number of households with heads over age 65 will grow as well, accounting for one in every 10 households by the year 2010. To keep the loyalties of these tenants, prized by landlords because of their low turnover rates, the rental industry must learn to cater to the increasing physical limitations of a clientele that wants to age in familiar surroundings.

The number of professionals who do a portion, if not all, of their work at home will constitute another lifestyle niche. With about one-quarter of multifamily unit renters fitting this description, according to Urban Land Institute research, these technologically sophisticated households will command enough market pull to inspire the availability of home-office

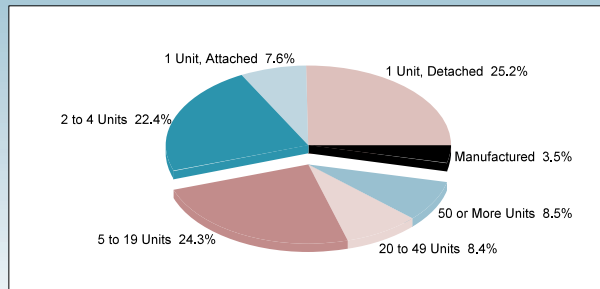
space, telecommunications cabling and access to business-oriented services.

At the other economic extreme, the growing ranks of low-income households who earn 80 percent or less of median area income will exceed the supply of apartments affordable to them.

An expanding immigrant population will place additional stress on the affordable rental supply. The influx of newcomers and their U.S.-born offspring accounted for almost 40 percent of the total population growth in the country since 1980, according to U.S. Census Bureau estimates. By 2050, immigrants will contribute 93 percent of the population growth. That translates into a net gain of close to 1 million people annually for the next 54 years.

The affordable-housing squeeze that results from the press of new immigrants will impact almost exclusively the 11 gateway cities that have absorbed

EXHIBIT 4: Structural Composition of Rental Market



Source: 1993 American Housing Survey

more than 71 percent of the inflow between 1980 and 1990. The California cities of Los Angeles, San Francisco and San Diego are now home to 32.6 percent of recent immigrants, while New York has assimilated 19.6 percent. Other popular ports of entry include Miami, Chicago, Washington, D.C., Houston, Boston, Dallas/Fort Worth and Philadelphia, but each city has absorbed less than a 6-percent share of new arrivals.

Of course, increases in population do not in and of themselves translate into greater housing-unit demand. The household-formation rate among almost every age group of immigrants falls significantly below that of native-born residents. At the same time, the Latin Americans and Asians who have relocated here in the largest numbers are the most likely to form households significantly larger in size than average. The median Hispanic rental-

household size, for example, is 3.1 people compared to the overall rental-household size of 2.0 occupants.

Nor do population gains automatically add to new rental-housing demand when other options

exist, such as doubled-up households, group-housing arrangements, prolonged residency with parents and a shift into other housing choices.

Owners of affordable units who are tempted to increase rents will undoubtedly meet with resistance from tenants already feeling the pinch of income erosion. Such a collision might well result in more volatile renter turnover, an expensive proposition many apartment owners may prefer to avoid.

Renters May Flock to Other Choices

The population changes underway in this country virtually guarantee steeper demands for rental housing for the next several decades, but the extent to which multifamily rental properties will benefit from this trend is less clear. Institutionally owned high-rise and garden apartments may constitute the common image of rental

housing, but other housing choices actually command a larger piece of the rental market and are well positioned to capture a great deal of the new demand that demographic changes will generate.

Single-family rentals are bound to prove particularly threatening to the multifamily housing sector. Single-family rental properties, already regarded as attractive financial ventures by individual investors, are likely to grow in number given the propensity of the marketplace to overshoot new construction demand. Any resulting excess of single-family homes can therefore be pressed into service as rentals.

Coincidentally, larger immigrant households will be drawn to larger rental units than those sought by other groups. However, apartment units of three or more bedrooms are in limited supply, further enhancing the appeal of single-family homes. What's more, an average single-family home offers 1,722 square feet of living space while a typical three-bedroom apartment unit provides only 1,404 square feet.

Even now, one-family detached and attached homes constitute nearly one-third of the rental supply (*Exhibit 4*). When combined with the 22-percent share contributed by duplexes, triplexes and quadraplexes, these nontraditional rental-housing choices easily constitute more

than half of the rental stock. Smaller apartment properties of five units to 19 units provide 24 percent of the country's rental space. That leaves larger rental properties of at least 20 units accounting for a mere 17 percent of the market.

Manufactured-housing units for rent represent just under 4 percent of the rental market but nonetheless pose an unexpected and growing challenge to the multifamily sector.

Manufactured-housing units, which are often referred to as mobile homes, offer a low-cost alternative to buying or renting. This largely accounts for the surprising level of manufactured-housing placements, unmatched since the early 1970s, that has led shipments to nearly double since 1991. In 1995 alone, manufactured housing producers fortified the housing stock with another 340,000 units.

Determined to shed its "tin can" image, the manufactured-housing industry has dedicated itself to producing a better-quality product. Between 1986 and 1995, the placement of units of double-wide size or larger has risen to 49 percent from 35 percent. So, too, has the median size of the typical manufactured-housing unit jumped to 1,280 square feet from 1,035 square feet.

The addition of air conditioning and a host of other features once rarely found in manufactured housing now enables this

The apartment industry must meet the special needs of large niches into which newly formed households will separate.

housing alternative to compete successfully with most lower-end and many middle-range apartment units on the amenities front. Many manufactured-home communities also now provide recreational facilities and landscaping features on par with conventional rental complexes. Even with these substantive improvements in quality, sales prices for manufactured housing average a low \$36,000, exclusive of land.

A Cautionary Tale

Caution has served as the hallmark for the recovery of the multifamily housing sector since it first soared in the early 1980s, when the properties were valued more as tax shelters than revenue producers. The industry crashed shortly after 1986 when a tax-law change abruptly eliminated many of the tax advantages and the

negative cash flows caught up with the owners who overpaid for properties. However, there is no guarantee that the multifamily speculators of tomorrow will take the 1980s boom-bust lesson to heart. They could once again succumb to the temptation of quick profits, only to overstimulate the apartment supply and suffer unfortunate consequences.

Furthermore, multifamily housing providers represent but a portion of the overall rental market—and a relatively small one, at that. They are in competition not only with one another's apartment holdings but with single-family houses and other rental-housing alternatives. Staying competitive from now on also means the apartment industry must work to meet the special needs of the large niches into which newly formed households will separate.

The rental market is entering an era that need not resemble either the boom days of the early 1980s or the bust years of the decade's latter half. Successfully navigating the middle ground is fast becoming the test that multifamily enterprises must pass if they are to thrive. **SMM**