



## RENTAL MARKET CONDITIONS

By most measures, the rental housing market has recovered from the Great Recession. Now that vacancy rate declines and rent increases are moderating, markets may be approaching balance. A clear sign of renewed health is the strong return of most private sources of mortgage financing. Going forward, though, a large unknown is how impending reform of the government role in the mortgage market will affect the cost and availability of credit for rental properties.

### MOVING INTO BALANCE

While the owner-occupied market only began to show clear signs of recovery in 2012, rental markets have steadily improved for several years. From a record high of 10.6 percent in 2009, the vacancy rate turned down in 2010 and has continued to slide, averaging 8.4 percent in the first three quarters of 2013. After four consecutive years of downward momentum, the US rental vacancy rate is now well below its average in the 2000s and approaching levels last seen during the 1990s (**Figure 19**). Whether vacancy rates have further to fall is difficult to judge because there is no clear benchmark for what represents market balance, given the upward drift in vacancy rates over the last few decades.

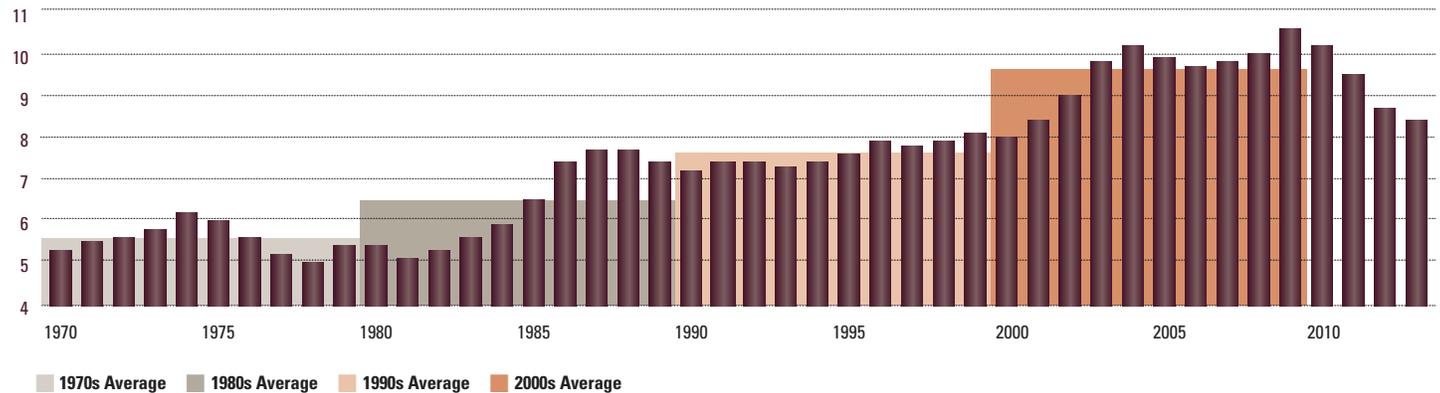
While vacancies for larger rental buildings posted both the sharpest rise before and the sharpest drop after their recessionary peak in 2009, rates for all structure types have eased. Over the past three years, the vacancy rate for apartment buildings with 10 or more units declined by 3.1 percentage points and that for buildings with five to nine units by 2.8 percentage points. The overall rate for buildings with at least five units—accounting for 42 percent of the rental housing stock—stands at about 9.1 percent. Remarkably, soaring demand was more than enough to absorb the 2.7 million single-family homes that flooded into the rental market after 2007. Indeed, vacancy rates for single-family rentals barely increased during the recession and have fallen 1.8 percentage points since 2009 to just 8.1 percent. Vacancy rates in small multifamily buildings with two to four units have followed a similar path.

Throughout the downturn and recovery, vacancy rates for professionally managed apartments—favored by large institutional investors—started out and remained much lower than in the broader rental market. Still, MPP Research data indicate that vacancy rates in this segment spiked by more than 4.1 percentage points from 3.9 percent in mid-2006 to 8.0 percent at the end of 2009, before retreating to 4.7 percent in the second quarter of 2013. Meanwhile, the cycle in

FIGURE 19

## After Stair-Stepping Upward for Decades, Rental Vacancy Rates Are on the Decline

Rental Vacancy Rate (Percent)



Note: The vacancy rate for 2013 is the quarterly average through the third quarter.  
Source: US Census Bureau, Housing Vacancy Surveys via Moody's Economy.com.

vacancy rates for all multifamily rentals was similar in timing but slightly more subdued.

### RENTS ON THE RISE

The consumer price index (CPI) for contract rents—which excludes tenant-paid utilities and covers all rental housing in the country—is a key indicator of national trends. By this measure, the increase in nominal rents began to slow in late 2008 as the recession took hold and then bottomed out in mid-2010 (Figure 20). Rent growth then accelerated steadily through 2011 before stabilizing at about a 2.8 percent annual rate through September 2013, outpacing the rise in overall prices.

Data from MPF Research for professionally managed properties, however, show much more volatility in rents over the past few years. The disparity between the two sources reflects both differences in management of the properties and how each survey measures changes in rents. The MPF data show a much steeper falloff at the start of the recession, with nominal rent declines reaching fully 4.8 percent year-over-year in the third quarter of 2009. Like the CPI, though, this measure indicates that rents turned up in mid-2010 and continued to gain momentum into late 2011, reaching 4.8 percent by year end. The MPF measure also suggests that rental market tightening began to moderate in 2012, with rent increases slowing to a 3.1 percent annual rate by mid-2013—roughly matching the change in the CPI rent index but still exceeding general price inflation by more than a full percentage point.

Nearly every major metropolitan area has shared in the rental recovery. As of the second quarter of 2013, 90 of the 93 metro areas tracked by MPF Research reported annual rent increases, about the same number as at the end of 2012. Of this group, 20 metros posted gains of 3.5 percent or more, outstripping overall inflation by more than 2.0 percentage points. In 27 other metros, rents rose somewhat more slowly but were still up by at least 2.5 percent, or 1.0–2.0 percentage points above inflation.

The metropolitan areas where rents have risen the most tend to have the strongest employment growth. For example, metros with rent increases exceeding 3.5 percent saw job gains of 2.4 percent in 2012. Most of these areas—including Austin, Corpus Christi, Houston, San Francisco, San Jose, and Santa Rosa—are concentrated in the West and South. In contrast, job growth in metros with the smallest rent increases or actual declines averaged just 1.4 percent in 2012.

However, some loss of momentum was also evident in 2012, with rent increases and occupancy growth moderating in most major metropolitan areas. Only a few metros—again primarily in the South and West—posted annual gains surpassing the previous year's change. Data through the first half of 2013 suggest that occupancy rates and rent increases in most areas were roughly similar to those in 2012.

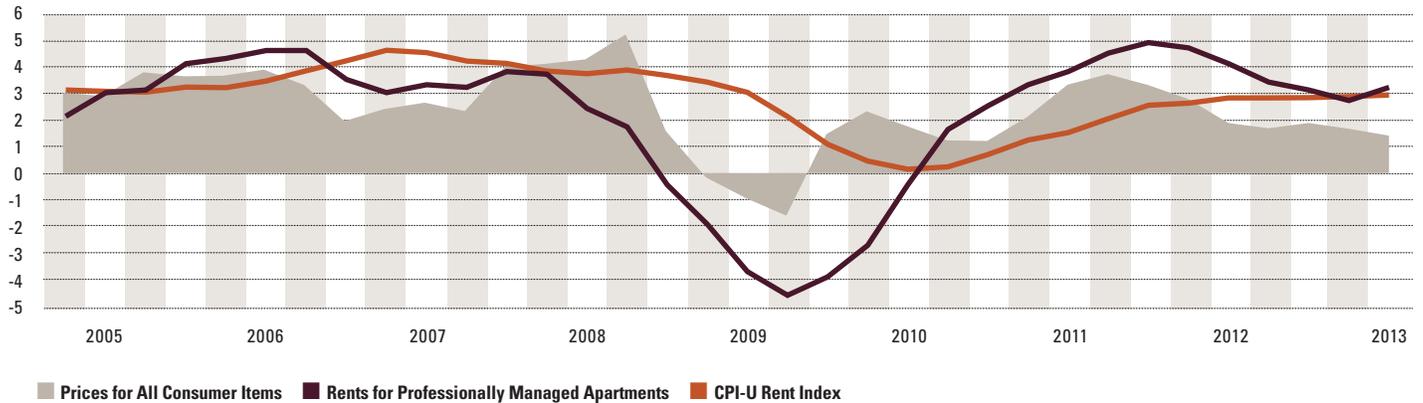
### MULTIFAMILY CONSTRUCTION OUT IN FRONT

After hitting an all-time low in 2009, multifamily construction ticked up in 2010 and then surged in 2011 even as single-

FIGURE 20

### Rent Increases Have Picked Up Pace and Now Exceed Overall Inflation

Annual Change (Percent)

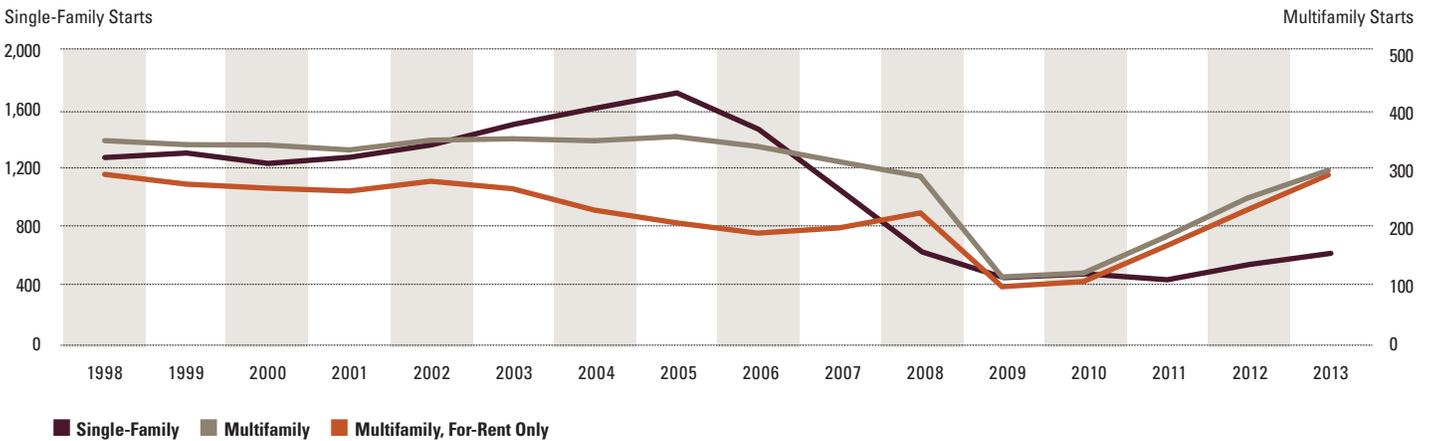


Notes: Prices for All Consumer Items is the CPI-U for All Items. Rents for professionally managed apartment communities are from MPF Research. The CPI-U Rent Index is for primary residence. Sources: US Bureau of Labor Statistics; MPF Research.

FIGURE 21

### Multifamily Construction Has Rebounded Much More Strongly than Single-Family Activity

Thousands of Units



Note: The 2013 estimate is based on the average monthly seasonally adjusted annual rate through August. Source: JCHS tabulations of US Census Bureau, New Residential Construction.

family starts found a new bottom (Figure 21). The momentum continued in 2012, with multifamily starts up another 38 percent. Overall housing starts rose by 194,000 units between 2010 and 2012, with multifamily construction accounting for two-thirds of the increase. Multifamily starts climbed another 31 percent through the first eight months of 2013 to a seasonally adjusted annual rate of 294,000 units—still well below the 340,000 annual average prevailing in the decade before the downturn. While single-family construction has

recently regained steam, the multifamily sector is still responsible for an outsized share of construction activity, accounting for one in three new units as of mid-2013 compared with just one in five in the 1990s and 2000s.

The rebound in multifamily construction is evident across the country. Over two-thirds of the 100 largest metros issued more multifamily permits in 2012 than 2011, while fully one-third issued more in 2012 than in the 2000s on average.

Through August 2013, the number of multifamily permits in these metros was up by more than 20 percent from a year earlier. However, there are some notable differences across markets. At one extreme, the pace of permitting in Portland (OR) and Orlando more than doubled, while activity in Miami, Atlanta, and Phoenix jumped by 70 percent or more. At the other extreme, Dallas, Houston, Charlotte, and Washington, DC, posted year-over-year declines after several years of strong growth.

The surge in multifamily construction has raised some concerns about potential overbuilding in certain markets. While activity in some metros has indeed surpassed peak rates in the 2000s, growth in renter households has also been much stronger than in that decade. Rather than past construction volumes, rent levels and rental vacancy rates are more reliable indicators of whether supply is outstripping demand.

By those measures, there is no evidence of overbuilding yet in areas with the most construction activity in recent years. Nevertheless, the lags between multifamily starts and completions mean that units begun in 2011 only began to come on line in 2012. In fact, the number of newly completed units rose to only 166,200 in 2012, representing a 20 percent increase over 2011 and the first year-over-year gain since 2007–08. Indeed, in all three markets where multifamily permits exceeded their 2000s peaks in 2012 (Austin, Raleigh, and Washington, DC), the pace of permitting slowed markedly through the first half of 2013 while vacancy rates held below

5.0 percent. Rent increases in Washington, DC, also slowed noticeably, which may signal that additions to supply have caught up with demand.

### PROPERTY OWNERS PROSPERING

With vacancy rates falling and rents rising, the financial performance of investment-grade properties improved markedly over the past three years. According to the National Council of Real Estate Investment Fiduciaries (NCREIF), the net operating income (NOI) for institutionally owned apartments was up by at least 4.9 percent annually over the past 12 quarters.

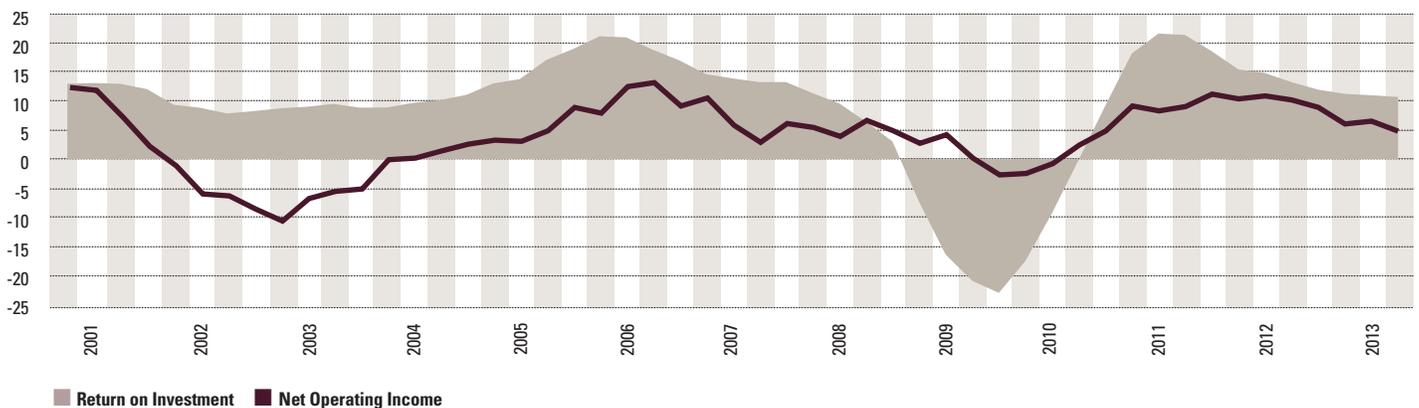
The rebound in apartment property prices is even more impressive. Since bottoming out in the fourth quarter of 2009, Moody's Commercial Property Price Index for apartment buildings climbed by 62 percent to a new high in mid-2013. NCREIF's transaction-based price index shows a more moderate but still substantial increase of 53 percent. By contrast, the S&P/Case-Shiller® US National Home Price Index indicates that single-family house prices rose only 6.0 percent over this period. With these increases in NOI and appraised property values, the annual return on investment for apartment owners has remained above 10 percent since late 2010 (**Figure 22**).

Declines in delinquency rates for multifamily loans mirror the strength of the apartment property market. Through the early and mid-2000s, the share of multifamily loans held by FDIC-

FIGURE 22

### Rental Properties Have Generated Solid Returns for the Past Three Years

Annual Rate (Percent)

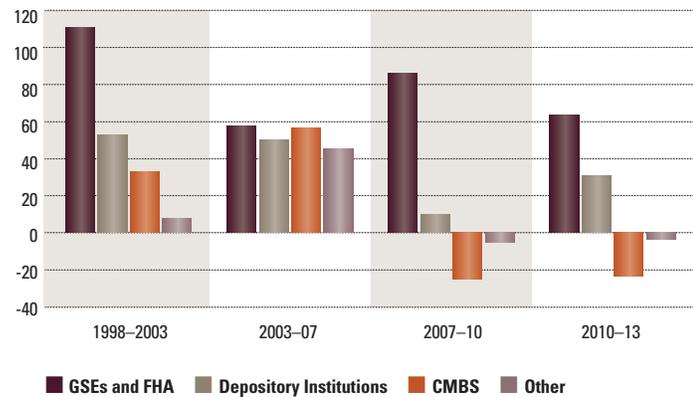


Notes: Data are for apartments. Net operating income is defined as gross rental income plus any other income less operating expenses. Annual rates are calculated across four quarters. Source: JCHS tabulations of National Council of Real Estate Investment Fiduciaries (NCREIF) data.

FIGURE 23

## Federal Sources of Lending Have Backstopped the Rental Market Throughout the Downturn and Recovery

Change in Outstanding Loan Volume (Billions of dollars)



Notes: Data for 2013 are through the second quarter. CMBS are commercial mortgage backed securities issued by private firms. Other includes state and local governments, life insurance companies, pension funds, REITs, finance companies, and businesses.

Source: Mortgage Bankers Association calculations based on Federal Reserve Board, Flow of Funds, and FDIC data.

insured institutions that were at least 90 days past due or in nonaccrual status hovered below 1.0 percent. But by the third quarter of 2010, that share had shot up to 5.4 percent. Since then, though, the share of noncurrent multifamily loans held by FDIC-insured institutions fell for 10 consecutive quarters, retreating to 1.5 percent in the first half of 2013. By comparison, the recovery in the owner-occupied market has been much slower, with the noncurrent share of loans on one- to four-unit properties hitting 11.4 percent in the first quarter of 2010 before moderating to a still high 9.5 percent in mid-2013.

Delinquencies on multifamily loans held in commercial mortgage backed securities (CMBS) have been slower to recede. According to Moody's Delinquency Tracker, the share of CMBS loans that were 60 or more days past due, in foreclosure, or in possession of the lender—a much broader measure of troubled loans than reported by the FDIC—peaked at 15.9 percent in early 2011 and then eased to 10.5 percent by mid-2013. While this market segment is finally on a path to improved performance, at this rate it will be a long time before delinquencies return to those prevailing before the housing market crash.

Meanwhile, the share of multifamily loans held or backed by Fannie Mae and Freddie Mac (government sponsored enterprises or GSEs) that are 60 or more days delinquent remained under 1.0 percent throughout the housing market downturn.

This performance indicates that, unlike on the single-family side, the GSEs did not participate in the “race to the bottom” by relaxing screening and underwriting standards. On the contrary, the low delinquency rates on their loans indicate that Fannie and Freddie remained more disciplined than other market players through risk sharing arrangements and careful oversight of lenders.

### MULTIFAMILY LENDING IN RECOVERY

Over the past two decades, multifamily lending activity has fluctuated with the financial fortunes of rental properties. The dollar volume of multifamily loans outstanding increased steadily in the late 1990s as the market recovered from weak conditions at the start of the decade. Multifamily lending picked up even more in 2003–07 as the housing market boomed. But when the Great Recession took hold, both net operating incomes and property values plunged while loan delinquencies soared, bringing lending growth to a halt. Increases in outstanding loan volumes dropped off sharply in 2008 and remained weak through 2010, but then rebounded in 2011 as low interest rates and a burgeoning recovery in the broader rental market created a favorable environment for both borrowers and lenders.

In the decade leading up to the Great Recession, the GSEs fueled a substantial share of the growth in outstanding loans—outdistancing depository institutions that had once been the single largest source of multifamily lending—and greatly expanded their market shares (Figure 23). Much of the growth in federally backed lending occurred before the market heated up after 2003. Private asset-backed securities then emerged as an increasingly important source of funding, accounting for more than a quarter (27 percent) of net loan growth in 2003–07. A combination of state and local governments, life insurance companies, and other financial institutions also expanded their lending during those years, sourcing another 22 percent. The strong flow of credit for multifamily properties during this period helped to propel a sharp rise in property values, mirroring trends in the owner-occupied market.

Once the recession hit, however, loans backed by the GSEs and FHA accounted for the lion's share of multifamily lending, supporting the market between 2007 and 2010 when private capital was scarce. During this period, depository institutions and other lenders substantially reduced loan originations as market conditions deteriorated. New issuances of private asset-backed securities also ceased amid the overall weakness of the market and the very high default rates for such loans.

The GSEs and FHA have continued to play a prominent role in the multifamily market since the recovery in private lending began in 2010. The Mortgage Bankers Association (MBA) estimates that annual originations backed by the GSEs nearly doubled between 2009 and 2012, while loans insured by FHA were up five-fold. The MBA data also indicate that private lending is reviving, attesting to lenders' confidence in the multifamily recovery. Originations by depositories exceeded their pre-recession levels in 2012, and those by life insurance companies approached their previous peak. In contrast, lending through the private-label securities market, state and local governments, and other sources remained moribund.

However, lending activity varies considerably by market segment. According to data reported under the Home Mortgage Disclosure Act (which excludes many of the largest commercial lenders that are not involved in the single-family market), the volume of small-balance loans fell off much more sharply between 2006 and 2011 than that of large-balance loans. Multifamily loans of less than \$1 million dropped by 42 percent over this period, while loans of \$1.0–2.5 million were down by 16 percent. These declines are several times larger than the 3 percent dip in loans between \$2.5 million and \$25 million, which account for about half the market. Indeed, the volume of loans over \$25 million actually increased by 19 percent even as the rest of the market had yet to recover.

Since depository institutions had been the principal source of financing for smaller properties (and hence small-balance loans), it is no surprise that the lending decline was more severe in this part of the market. But given that smaller multifamily properties account for an outsized share of affordable rental units, it will be important to monitor whether the lending recovery extends to this segment.

Lending activity in low-income and minority neighborhoods also plunged in 2006–11, reflecting in part the greater reliance on small-balance loans in these areas as well as widespread neighborhood distress. Over this period, multifamily

loan volumes were down 15 percent in low-income areas and 22 percent in minority communities, although up 8 percent in high-income neighborhoods and 12 percent in predominantly white areas.

To foster further increases in private participation, the Federal Housing Finance Agency (FHFA—the regulator and conservator of the GSEs) has signaled its intent to set a ceiling on the amount of multifamily lending that the GSEs can back in 2013. While the caps are fairly high—\$30 billion for Fannie Mae and \$26 billion for Freddie Mac—FHFA intends to further reduce GSE lending volumes over the next several years either by lowering these limits or by such actions as restricting loan products, requiring stricter underwriting, or increasing loan pricing. With lending by depository institutions and life insurance companies increasing, the market may well be able to adjust to these restrictions. The bigger question, however, is how the financial reforms now under debate will redefine the government's role in backstopping the multifamily market. Recent experience clearly demonstrates the importance of federal support for multifamily lending when financial crises drive private lenders out of the market.

#### THE OUTLOOK

By virtually all rental market indicators, the recovery from the Great Recession has been strong. The most telling sign is the occasional alarms raised by some analysts that new rental construction may be overshooting the mark. But with vacancies still falling, rents rising, and the number of renter households increasing rapidly, there seems little reason for immediate concern. Given the lengthy lags in multifamily completions, though, overbuilding could occur in select markets. The more important issue for the multifamily rental market is how proposed reforms will affect the availability of financing for a range of rental properties—and particularly the traditionally underserved small property segment that makes up a significant share of the privately owned affordable rental stock.