



RENTAL HOUSING PRODUCTION

A complex mix of market forces and public policy has altered the dynamics of rental housing construction. Although record-low interest rates and tax incentives have helped to stimulate investment in the multifamily sector, the supply of affordable rental housing has expanded little over the past decade. Indeed, despite some softness at the high end, rents in the broader market have continued to rise as millions of low-cost units drop out of the inventory. Looking ahead, density restrictions and the resulting pressure on land prices will limit production of multifamily apartments affordable to the vast majority of renters.

RENTAL CONSTRUCTION

From 1994 to 2003, some 3 million newly built units were added to the rental inventory. Of this total, 2.3 million were apartments in multifamily structures and another 700,000 were new single-family and manufactured homes for rent (Table A-7). But construction of fully 2.0 million units simply offsets demolition and/or conversion of rentals to the owner market. On net, these additions thus expanded the rental housing stock by just over 1.0 million units, bringing the inventory to 37.2 million.

Despite weak growth in the demand for rental housing, the pace of multifamily construction remained surprisingly close to its decade-long average of 300,000 units annually. One explanation is that many new multifamily units are destined for the owner market. Indeed, with rental vacancies on the rise and single-family home prices soaring, more than a fifth of multifamily units built since 2001 have been targeted for sale as condominiums. This means that new construction for the rental market has fallen well below levels recorded in the mid-1990s (Figure 9).

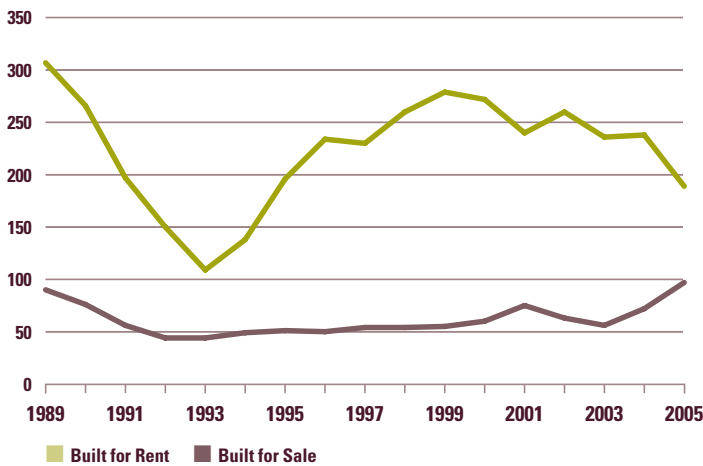
Also contributing to the overall stability of multifamily production is the Low-Income Housing Tax Credit (LIHTC) program, the nation's largest affordable housing initiative. Created by the Tax Reform Act of 1986, this program provides generous tax benefits for developers agreeing to build modest-quality housing and set rents within reach of lower-income families. After a slow start, the program has generated close to 90,000 units annually since the mid-1990s. Nearly 60 percent of LIHTC rental units are newly built, with the balance added through rehabilitation of older subsidized apartments.

CHARACTERISTICS OF NEW UNITS

Continuing a decades-long trend, rental housing construction is strongest in the fast-growing regions of the country. Over the past 10 years, nearly half of all rental production has been concentrated in the South and another quarter in the West. In the

FIGURE 9 Multifamily Rental Construction Has Softened

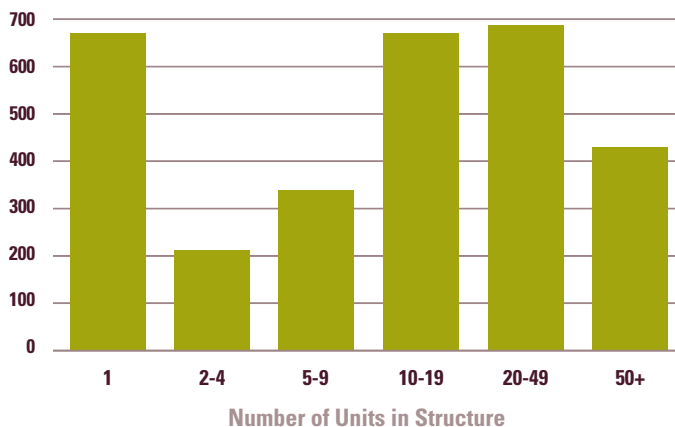
Units Completed (Thousands)



Source: US Census Bureau, Construction Statistics.

FIGURE 10 Over Half of New Rentals Are in Buildings With 10 or More Units

Units Completed, 1994-2003 (Thousands)



Note: Single-family properties include manufactured housing.
Source: Table A-7.

slower-growing portions of the North and Midwest, rental construction activity has primarily replaced units demolished or otherwise removed from the inventory, although these regions have experienced some surplus supply as well.

Without the contribution of LIHTC units, rental construction in the Northeast and Midwest would have lagged even further. According to a recent HUD report, LIHTC units accounted for 36 percent of all new multifamily units added

in the Northeast and for 26 percent of those added in the Midwest between 1995 and 2002. In contrast, LIHTC units represented just 20 percent of production in the South and West during this period.

As the number of renter households in the lower-density portions of the West and South continues to grow, single-family and manufactured homes for rent have emerged as a significant component of rental construction. Nevertheless, over half of all newly built rentals are in structures with 10 or more units (Figure 10). In part, this reflects advances in construction technology and a growing acceptance of apartment living, but growth of the LIHTC program also plays a role. HUD reports that the average project size of tax credit developments has increased steadily since the program's inception and now stands close to 80 units. With half of all tax credit units located in developments with 50 or more units, large multifamily structures have become the fastest-growing segment of the rental housing market.

Meanwhile, the number of rental units in two- to four-unit buildings has fallen by 441,000 (5.4 percent) to 7.7 million over the past decade (Table A-7). Between 1994 and 2003, just 213,000 rental apartments were added in small multifamily structures—only a third the number needed to replace the 654,000 units lost in this category.

The stock of single-family rentals (including both site-built and manufactured homes) has also dropped significantly, although losses were more than offset by construction of nearly 700,000 new single-family units and net conversion of over 400,000 owner-occupied homes to rentals. These conversions are a common phenomenon in the older inner suburbs of slower-growth areas in the North and Midwest. Similarly, growth of the rental housing inventory in the South and West was propelled in part by conversion of over 250,000 manufactured homes from owner to renter status.

CHANGES IN MORTGAGE FINANCE

Innovations in mortgage finance have helped to stimulate multifamily production over the past decade. In particular, the share of multifamily mortgages (defined in the industry as loans on properties with five or more apartments) traded in the secondary market has more than tripled to over 30 percent. The rising share of multifamily mortgage debt held in mortgage-backed securities, along with greater standardization of underwriting criteria and loan documentation, has created a larger, more stable, and less expensive supply of capital for developers as well as better diversification for investors.

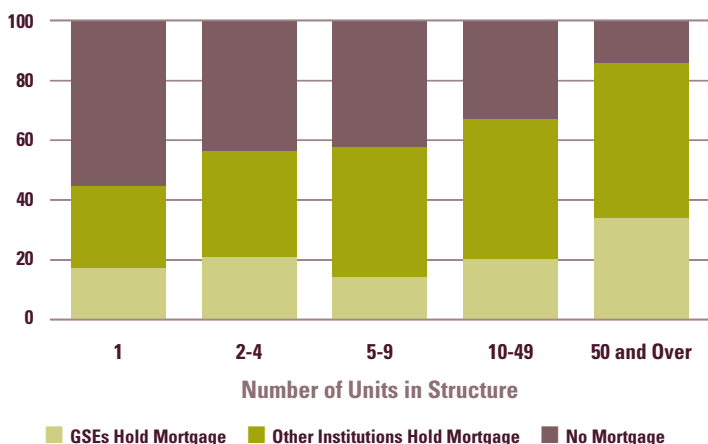
But the growing secondary market primarily benefits owners and developers of large properties. According to the 2001 Survey of Residential Finance, 86 percent of all rental properties with 50 or more units had mortgages, thanks in large measure to the growing presence of Fannie Mae and Freddie Mac in the market (Table A-8). These two Government Sponsored Enterprises (GSEs) are much less apt to provide financing for smaller multifamily properties, whose mortgages generally come from banks and thrifts. Indeed, the GSEs hold mortgages on less than 20 percent of the properties with five to nine units (Figure 11).

Enhanced access to the secondary market provides owners with significant advantages. Most securitized lending is fixed-rate, non-recourse and intermediate term (10 to 30 years). Given the reluctance of the GSEs to focus on smaller properties, little wonder that only 38 percent of properties with 5 to 49 units have a level payment mortgage with a term longer than 10 years. For owners of properties with 50 or more units, the share nearly doubles to 64 percent.

The costs and complexity of administering subsidies make developing smaller affordable housing projects no less onerous than building a large development. As a result, today's supply-side housing programs, particularly the LIHTC, typically subsidize larger construction projects, even though most renters in need of assistance currently live in smaller buildings.

FIGURE 11 Smaller Property Owners Have Limited Access to Mortgage Capital

Shares of Rental Properties with Financing (Percent)



Notes: Single units include single-family detached and attached homes and condominium units for rent. They do not include manufactured homes.
Source: Table A-8.

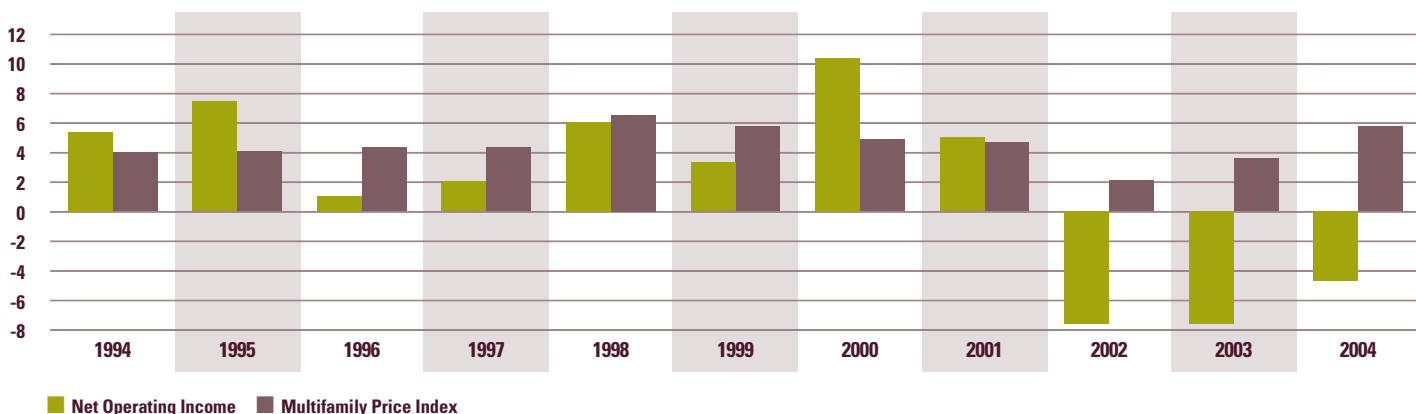
RISING INVESTOR DEMAND

A final factor that has bolstered multifamily production in recent years is strong investor demand. With record-low interest rates holding down financing costs, multifamily housing provides attractive yields relative to many competing fixed-income and equity investments. In fact, the sale prices of high-end apartment buildings climbed more than 10 percent from 2002 to 2004, at the same time that net operating incomes were down 20 percent (Figure 12).

As in the single-family market, rising valuations in the multifamily sector have raised fears of a dramatic price correction. While overbuilding could lead to a near-term drop in prices, long-term valuations reflect replacement costs. A recent Joint Center study suggests that land price appreciation was

FIGURE 12 Apartment Building Prices Have Continued to Rise Even Though Rent Revenues Have Fallen

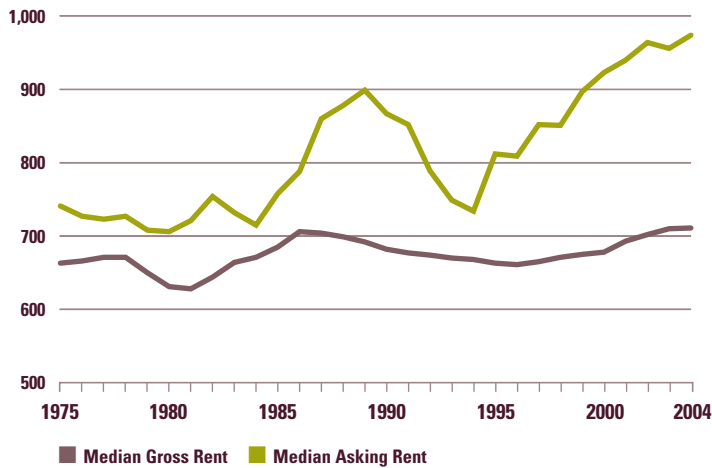
Annual Percent Change



Source: JCHS tabulations of data provided by National Council of Real Estate Investment Fiduciaries.

FIGURE 13**Rents for Newly Constructed Apartments Far Exceed Rents for Existing Units**

2004 Dollars



Source: Table A-2.

responsible for over three-quarters of the inflation-adjusted increase in construction costs over the past 10 years. Without a drastic relaxation of land use restrictions, the values of rental apartment buildings are therefore likely to continue their ascent—especially in highly desirable neighborhoods with little remaining developable land.

On the plus side, strong valuations have also encouraged rental property owners to reinvest in their buildings. After years of sub-par spending, owners increased their real (inflation-adjusted) expenditures on repairs and improvements by 14 percent from 2001 to 2003, bringing total outlays to \$58.5 billion. Improvement spending slowed somewhat in 2004, but to a still-strong \$55.1 billion (Table A-1).

With interest rates now on the rise, investments in new multifamily construction are likely to moderate. At the same time, though, higher interest rates could boost rental demand by making homeownership less attractive. Increased demand would likely reduce vacancy rates and help restore balance to the high-end apartment market, although the adjustment process may take years. In any case, speculative investment in multifamily rentals appears to have run its course.

SUPPLY-SIDE CONCERNS

While market rents may fluctuate from year to year, in the long run they must reflect the cost of building new units.

With today’s high land prices in most metropolitan areas and with restrictions on allowable densities, developers can no longer build affordable housing without subsidy.

In 1994, the median monthly asking rent for newly constructed, privately owned, unsubsidized units was \$734—only about 10 percent higher than the median for all rental units. Since then, median asking rents for newly built apartments have climbed sharply, although the recent rise in vacancies has moderated these increases. Even so, the 2004 median asking rent was up to \$974, more than 37 percent above the median for all units (Figure 13).

Most newly constructed units thus charge rents far above what the majority of renters can afford. At the 30-percent-of-income standard, a household needs an income of \$38,960 to afford the median rent on a newly built apartment. While as many as 30 percent of renters have incomes at least that high, the median asking rent of \$974 is well out of reach for the 40 percent of renters with incomes of less than \$20,600.

Fueling some of the increase in asking rents is the fact that newly constructed units are larger and provide more amenities than older apartments. In 2004, some 57 percent of all new multifamily apartments had two or more bathrooms, compared with just 35 percent of units built in 1984. Over this same period, the median size of newly built apartments increased by a third to 1,160 square feet (Table A-1).

While new construction activity has focused on the high-end market, building for the “middle market” (units with rents between the 40th and 80th percentiles) has also been robust. Indeed, the middle market’s share of new construction in the past decade has remained in line with its share of the existing stock. Again, the LIHTC program has played an important role in adding middle market units, especially in the distressed center cities of the Northeast and Midwest.

THE OUTLOOK

Between the aging of the echo boomers and the continuing influx of immigrants, demand for modest rental apartments is likely to increase in the years ahead. But rising land prices and density restrictions in many jurisdictions have significantly raised the long-run costs of supplying housing that the vast majority of renters can afford. Although the high end of the rental market is still adjusting from a period of overbuilding, it seems inevitable that developers will continue to focus on this housing market segment—bringing little relief to the many renters with limited ability to pay.