



RENTAL PRODUCTION AND SUPPLY

Despite a sharp uptick in the number of renter households, construction of multifamily units for rent declined in 2007 for the fifth straight year. Even so, growth in the rental inventory has accelerated as the excess supply of housing in the for-sale market has forced many owners to attempt to rent out vacant single-family homes, condos, and vacation properties. Although expanding the overall supply, these additions are generally higher-quality units that provide little relief to the large and growing number of low-income renters who struggle to afford even marginal housing. This mismatch between supply and demand will severely limit the market's ability to absorb the excess rental units sitting empty in communities across the country.

RENTAL CONSTRUCTION SLOWDOWN

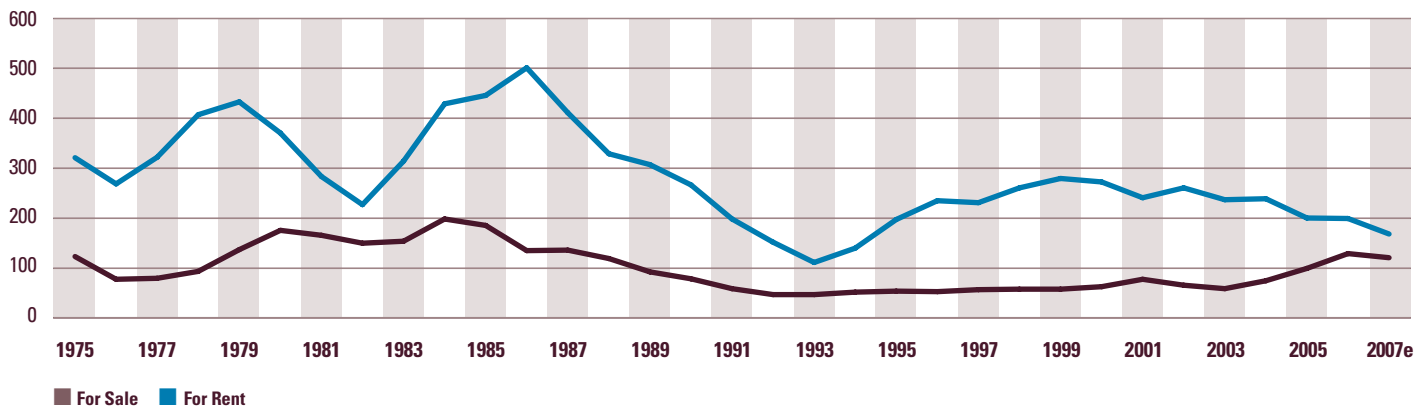
Multifamily completions—including both units built for rent and condominiums and cooperative apartments built for sale—have hovered near 300,000 units annually for much of this decade. Building on the strength of the homeownership boom, multifamily developers ramped up construction in the for-sale market starting in 2004. Completions of multifamily units for rent were down to 169,000 units by 2007—the lowest level since the deep recession of the early 1990s and only one-third of the record set in 1986 (Figure 10).

According to the US Census Bureau, the sharpest cutbacks in multifamily rentals have been in the Midwest, where production fell to just 19,000 units in 2007—a 60 percent decline since 2004. Only the South, a region with relatively rapid renter household growth and relatively modest building costs, bucked the trend. Rental production in the region did decline to 89,000 units in 2007, but this represents only a 20 percent drop from the 2004 level.

Multifamily rental production would have fallen even further without the Low Income Housing Tax Credit (LIHTC) program. Created by the Tax Reform Act of 1986, the LIHTC

FIGURE 10 Multifamily Construction Has Fallen Well Below Historical Peaks

Completions (Thousands)

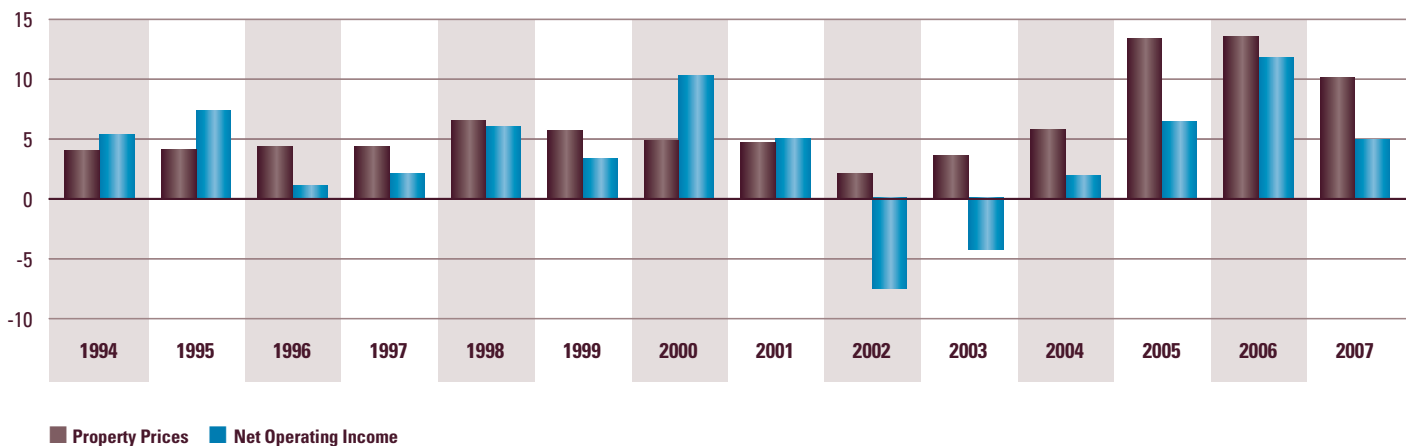


Source: US Census Bureau, New Residential Construction.

FIGURE 11

Apartment Property Prices Are Rising Faster than Their Net Operating Income

Annual Percent Change



Source: National Council of Real Estate Investment Fiduciaries.

program provides tax breaks to developers in exchange for set-asides of units affordable to lower-income households. According to the National Council of State Housing Agencies, some 75,000 LIHTC units—more than 40 percent of total multifamily production—were built in 2006.

The limited amount of rental construction that is taking place today consists primarily of larger apartment buildings. Over the period from 1996 through 2005, 1.3 million of the 3.2 million rentals completed were in structures with 20 or more units, and another 1.0 million rentals were in buildings with 5–19 units. Over the same period, completions of multifamily rentals in structures with two to four apartments—historically the mainstay of many urban rental markets—totaled about 200,000, while site-built and manufactured single-family homes added another 733,000 (Table A-7).

The increasing focus on larger structures reflects a variety of factors, but the LIHTC program plays a significant role. The US Department of Housing and Urban Development reports that the average number of units in tax-credit developments has steadily risen since the program’s inception and now stands at close to 80 units. With tax-credit units accounting for increasing shares of all multifamily construction, little wonder that large multifamily structures have become the fastest-growing segment of the rental housing inventory.

SURGE IN LARGE PROPERTY VALUATIONS

Even as construction of multifamily rentals fell steadily from 2002 to 2007, investment in large multifamily properties

accelerated. The combination of record-low interest rates, rising occupancy rates, and attractive yields helped to lift sales and prices of apartment complexes starting in 2003. Hefty increases in net operating income brought in even more investors, with property prices advancing 50 percent from 2003 to 2007 (Figure 11).

One of the forces driving investment mid-decade was the growing demand for condominiums. In markets across the country, the relative affordability of condos and the availability of easy financing terms sparked new interest in multifamily for-sale units. For buyers, condos provided a means of attaining homeownership in higher-density locations at less cost than single-family units. For developers, conversion of multifamily rental properties into condos was a good alternative to the high costs of new construction. Investors bought buildings from landlords facing weak rental demand, renovated the units, and then sold the condos to individual homebuyers or investors seeking a quick profit.

The run-up in rental property sales was sudden and dramatic. Acquisitions by condo converters of multifamily properties selling for at least \$5 million rose ten-fold from 2003 to 2005, to more than \$30 billion. According to Real Capital Analytics, the number of units in these larger rental properties converted to condos expanded from a few thousand in 2003 to 235,000 in 2005—a figure that exceeds new multifamily rental completions in that year. The conversion boom was a distinctly regional trend, with over 40 percent of transaction volume in 2004–2006 located in the Southeast (particularly Florida).

But by the middle of 2006, condo conversions were falling out of favor even faster than they had gained it. For the year as a whole, acquisitions of multifamily properties for conversion to condos dropped to less than \$10 billion and the number of units converted fell to less than 60,000. By 2007, the market for condo conversions had all but disappeared while thousands of units remained in the pipeline.

The condo boom and bust is not without precedent. From 1981 to 1985, completions of multifamily units for sale averaged 120,000 units annually. But as the market's ability to absorb this level of production slowed in the second half of the decade, some 343,000 units in condo and coop buildings reverted to the rental market.

A similar dynamic appears to be in place. Although current condo owners can attempt to rent out their vacant units until the for-sale market rebounds, the ability of the rental market to absorb a significant share of this excess is questionable. The fact that many condominiums are now in the midst of a complex foreclosure process adds further uncertainty to the timing of the condo market adjustment.

FOCUS ON THE HIGH END

With apartment construction focused increasingly on the high end of the market, asking rents have moved up steadily since 1999. In part, higher asking rents reflect the upward drift in the size and quality of multifamily rentals being built. In 2006, the median size of multifamily rentals set a record of 1,192 square feet, while the share of apartments with three or more bedrooms, air conditioning, and other amenities set records as well.

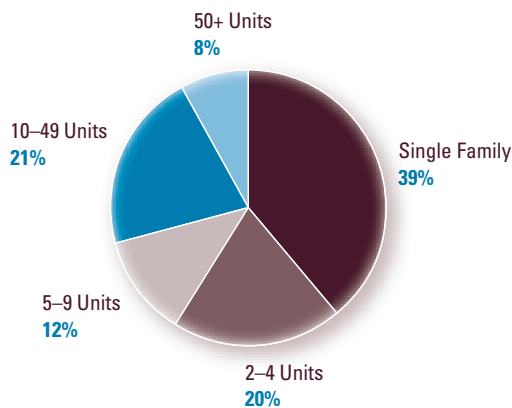
At the same time, the persistent rise in development costs has sharply curtailed the construction of modest-quality, affordable rental housing. Although materials such as wood and wallboard have become cheaper in recent years, metal prices and especially labor costs have climbed. Indeed, average annual cost increases for multifamily construction ranged from -0.1 percent to 2.2 percent from 1996 to 2003, never exceeding the change in general consumer price inflation. From 2004 to 2006, however, construction costs were up more than 7 percent annually (more than double the rise in consumer price inflation), before dropping back to 3 percent in 2007.

Even more important are soaring land costs. A recent Federal Reserve Board study concludes that the price of residential land has increased almost 250 percent faster than inflation since 1975. Restrictive zoning and land use practices have added to the price pressures by limiting the amount of land available for multifamily construction, while complex building requirements have extended construction time. Given the reality of rapidly rising land prices, builders increasingly target production to high-end consumers or rely on LIHTC or other forms of subsidy to help offset high development costs.

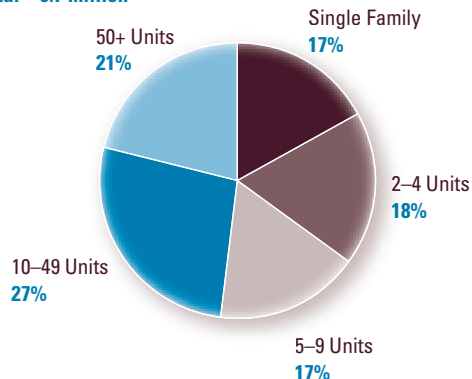
Even allowing for the growing importance of LIHTC units in the overall construction mix, the median asking rent for newly built apartments in buildings with five or more units nevertheless stood at a record high of \$1,057 in 2006—well above the \$766 median gross rent for all units and up more than 30 percent from mid-1990s levels. As a result, only 20,000 new unfurnished apartments renting for less than \$750 a month were completed in 2006, despite being the types of units most in demand.

FIGURE 12 Most Renters Live in Single-Family Homes Or Small Multifamily Apartment Buildings

Share of Renters Living in Unsubsidized Units Total = 30 million



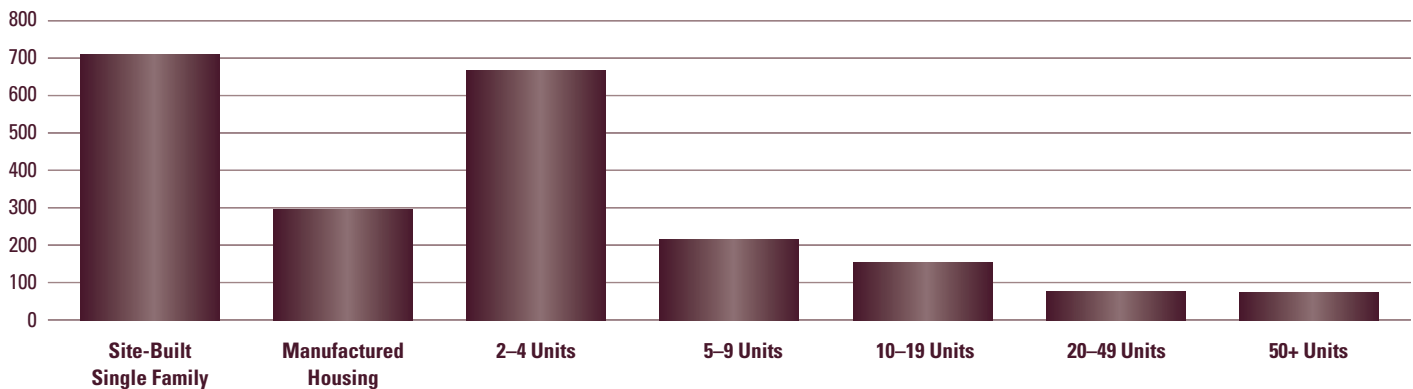
Share of Renters Living in Subsidized Units Total = 6.7 million



Note: Single-family units include manufactured housing.
Source: JCHS tabulations of the 2005 American Housing Survey, using JCHS-adjusted weights.

FIGURE 13 Inventory Losses Focus on Smaller Properties

Rental Units in 1995 Permanently Removed from the Stock by 2005 (Thousands)



Source: Table A-7.

Although demand for better-quality, higher-priced rentals does exist in many metropolitan areas, the annual income required to afford (using the 30-percent-of-income standard) a monthly rent of \$1,057 is \$42,280. Given that the median renter income in 2006 was just \$29,000, most newly built units are well beyond the reach of the majority of renters.

LOSS OF AFFORDABLE RENTAL HOUSING

More than 80 percent of all renters, as well as more than 70 percent of renters with incomes in the lowest quartile, live in privately owned, unsubsidized housing. Unlike newly built units, most of the unsubsidized rental stock consists of single-family residences (including manufactured homes), two- to four-family structures, and smaller apartment buildings with 5–49 units (Figure 12).

The assisted rental inventory is also predominantly in these smaller properties, including units rented by voucher holders as well as public housing and project-based developments located in smaller metropolitan and nonmetropolitan areas. In fact, only one-fifth of assisted rentals are in buildings with 50 or more units. Larger subsidized properties are typically older public housing, project-based developments, or newly built LIHTC projects.

Most of the privately owned, small multifamily rental stock was built at least 30 years ago, when construction techniques and capital markets were less sophisticated and households were less affluent. Much of this inventory is now in need of substantial repair. According to the American Housing

Survey, 3 million private market rental units have severe structural deficiencies and are at risk of loss.

From 1995 to 2005, nearly 2.2 million of the 37 million initially available rental units (occupied and vacant) were demolished or otherwise permanently removed from the inventory. Though representing just 6 percent of the 1995 rental stock, these losses offset nearly 70 percent of the 3.2 million new rental units built over the decade. While occurring across all types of properties, losses among single-family and small multifamily rentals have been particularly high—in fact more than three times those of units in large multifamily buildings (Figure 13). Also experiencing high losses are communities with large shares of older, lower-quality, and structurally inadequate units.

Relative to the low levels of rental construction over this period, these losses are even more troubling. Indeed, between 1995 and 2005, two rental units were permanently removed from the inventory for every three units built (Table A-7). Inventory losses were highest in the Northeast, where two rental units were lost for every one built. In the Midwest, construction of 596,000 rental units barely offset removals of 441,000. Within metropolitan areas, center cities were particularly hard hit by the rental losses since most new construction occurs in outlying areas.

SHIFTS IN MORTGAGE FINANCE

The changing structure of the mortgage industry has had a noticeable impact on the multifamily housing market.

During the 1990s, the share of multifamily mortgages that were placed in mortgage-backed securities and traded in the secondary markets grew steadily. Along with increased standardization of underwriting criteria and loan documentation, these trends created a larger, more stable, and less expensive source of capital for rental property owners and developers, while also providing greater diversification for investors.

At the same time, a dual mortgage delivery system began to emerge. Individuals and investors seeking to purchase, rehabilitate, or build smaller rental properties were increasingly served by a distinctly different set of mortgage products, provided by a distinctly different set of lenders, than those financing larger rental properties. The Survey of Residential Finance documents that by 2001, some 86 percent of all apartment properties with 50 or more units had a mortgage, and as many as 65 percent of these properties had a level-payment, fixed-rate loan. In contrast, only 58 percent of five- to nine-unit apartment buildings had a mortgage, and just a third had level-payment, fixed-rate mortgages (Figure 14).

While Fannie Mae, Freddie Mac, and the Federal Housing Administration have greatly expanded access to capital for one- to four-unit rentals, they draw a distinction between owner-occupied and absentee-owner buildings. In 2001, less than one-third of all absentee-owned, one- to four-unit rental properties had level-payment, fixed-rate financing,

and over half had no mortgage at all. By way of comparison, two out of three owner-occupied, one- to four-unit properties had mortgages.

Lacking access to longer-term, level-payment mortgages, absentee owners apparently increased their use of higher-risk subprime loans to purchase or refinance their small multifamily properties. According to Home Mortgage Disclosure Act data, in 2006 higher-risk subprime loans accounted for 30 percent of first lien home purchase mortgages made to nonresident owners of one- to four-unit properties located in metropolitan areas. In lower-income minority communities, this share approached 50 percent (Table A-8).

Although the data are limited, it appears that foreclosures of subprime mortgages on absentee-owned, one- to four-unit properties are also on the rise in communities across the country, just as they are for owner-occupied housing. Indeed, the Mortgage Bankers Association reports that nearly 20 percent of foreclosures involve these small investment properties. Foreclosures of rental properties are not only costly for the owners, but they also typically lead to the eviction of tenants. In addition, foreclosures can undermine the stability of already weak neighborhoods by depressing local property values, discouraging investment, and attracting crime.

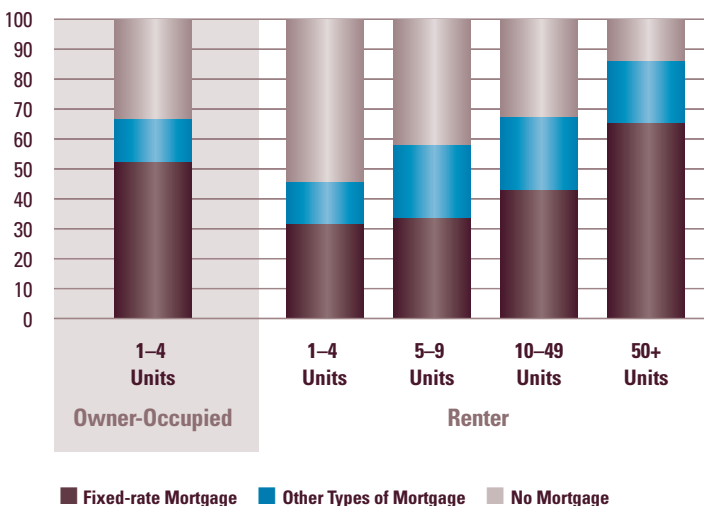
THE OUTLOOK

The unprecedented turmoil in mortgage and construction markets makes the outlook cloudy at best. In its January 2008 survey of market conditions, the National Multi Housing Council reports that executives of apartment-related firms were increasingly pessimistic about accessing equity financing for new projects and about the prospects for both the multifamily rental and for-sale markets.

The biggest wildcard is how foreclosures of both single-family and small multifamily properties alter the supply of rentals. In the short term, these units add to the stock of vacant housing held off the market as they work their way through the complex foreclosure process. In the longer term, because many of these foreclosures are in distressed urban markets where renters are concentrated, they could well accelerate the inventory losses that are already under way. In many urban areas, it could take many years to restore stability to rental housing markets.

FIGURE 14 Owners of Small Multifamily Properties Have Limited Access to Mortgage Capital

Share of Properties with Financing (Percent)



Note: One- to four-unit properties do not include manufactured homes and condominiums.
Source: US Census Bureau, Survey of Residential Finance.