



RENTAL HOUSING

Rental markets turned a corner in 2005. For the first time in years, the number of renter households rose and the national rental vacancy rate fell. Improving job growth sparked demand just as lower multifamily rental production and higher condo conversion activity helped to trim supply, restoring balance to markets. With house prices high and climbing, renting was a relative bargain in many areas.

STRENGTHENING MARKETS

Rental demand revived in all four regions of the country last year. Despite only modest year-over-year job gains, the Midwest posted the strongest growth in renter households. There and in the South, growth in renters in fact outpaced that of owners, forcing the homeownership rate down. In the Northeast and West, in contrast, increases in owners outdid solid renter gains.

While demand for rental housing strengthened across all age and racial/ethnic groups, increases among middle-aged adults were noteworthy because they were even larger than among younger households. In addition, the rate of renter growth was highest among African American households, a group that is particularly sensitive to economic cycles.

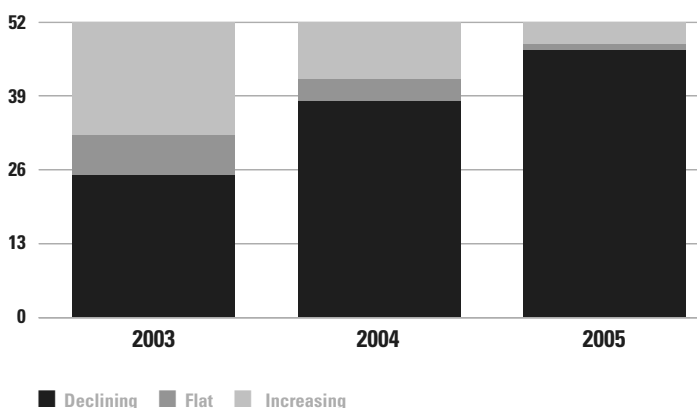
On the supply side, a slowdown in multifamily rental construction from 275,000 units in 2002 to 203,000 units in 2005, together with an increase in condo conversions, helped the rental market recover. Real Capital Analytics reports that condo conversions reduced the supply of rental apartments by at least 63,000 units in 2004 and another 195,000 in 2005. With these adjustments, the national rental vacancy rate retreated for the first time in four years, falling from 10.2 percent in 2004 to 9.6 percent at the end of 2005. Already lower vacancy rates for low-cost rentals (with rents under \$300) also edged down last year from 6.8 percent to 6.7 percent.

The recovery spread to a growing number of metropolitan areas last year. Vacancy rates were down in 47 of the 52 metro markets surveyed annually by M|PF Yieldstar, compared with 38 a year earlier and just 25 two years earlier (Figure 27). Rents also firmed in most places, with 41 of these metro areas reporting effective rent increases. Many of the markets posting the biggest rent gains were the same areas that had suffered the sharpest declines in recent years, including Austin, Boston, Phoenix and the San Francisco Bay area.

Meanwhile, investor appetite for multifamily properties was undimmed. For the past four years, institutional investors have bid up prices on apartment buildings despite weakness in rent revenues. Investors in rentals are betting that appreciation and

Figure 27 Rental Markets Are Tightening In an Increasing Number of Metros

Metro Areas by Change in Vacancy Rates (Q4:04–Q4:05)



Note: "Flat" is defined as an increase of 0.0–0.5 percentage point.
Source: M|PF Yieldstar, Inc.

lower interest rates will help their leveraged investments outperform stocks and bonds. Indeed, with investor demand still strong, net operating incomes stabilizing, and condo conversions rising, values of apartment buildings soared 13.5 percent in 2005—the first double-digit increase since 1984.

DEMAND SHIFTS

Although their numbers have barely increased in more than a decade, the characteristics of renter households have changed

dramatically. With rapid growth of the nation’s Hispanic and Asian populations, the minority share of renter households swelled from 31 percent in 1990 to 43 percent in 2004 (Figure 28). Most of this increase was centered in the Southwest. The ongoing influx of immigrants added to the sizable minority populations in Nevada, California, Arizona and Texas. Each of these states saw the minority share of renters increase by more than 10 percentage points in the 1990s. Even in the Northeast states of Massachusetts, Connecticut, and Pennsylvania, the minority share rose by more than five percentage points.

Domestic migration has also boosted the number of renters living in many parts of the South and West. Even in fast-growing states where homeownership rates are rising, renter household growth has been brisk. Between 2001 and 2004, the number of renter households increased by more than 35,000 in Arizona, Georgia, Washington, and both Carolinas (Table W-5). In contrast, the number of renter households fell in several states that experienced both slow household growth and rising homeownership rates, including New Jersey, Illinois, Massachusetts and New York.

Still, the regional shares of renter households shift only slowly. For example, while the number of renter households in the Sunbelt has risen steadily, the share living in the South only inched up from 33 percent in 1990 to 35 percent in 2004, and in the West from 24 percent to 25 percent. This was even the case in the states with the fastest household growth. For example, Arizona’s and Nevada’s share of the nation’s renter households increased just 0.3–0.4 percentage point.

Figure 28 The Minority Share of Renters Has Increased Sharply

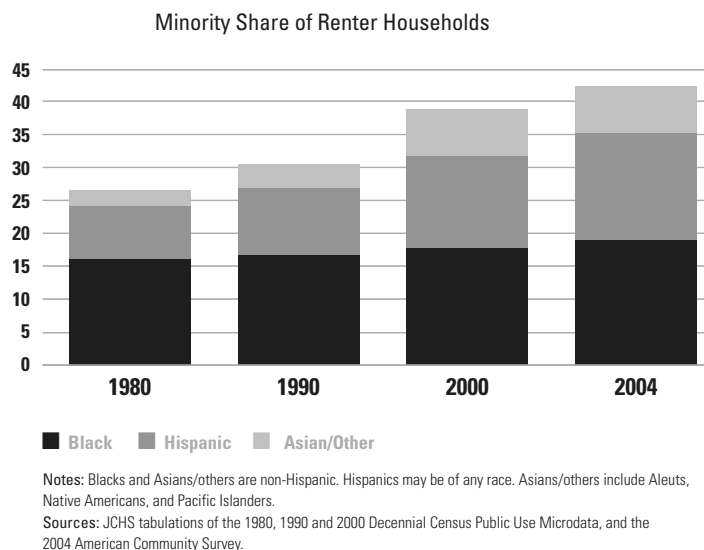


Figure 29 New Construction Has Added Significantly to the Rental Stock in Many States

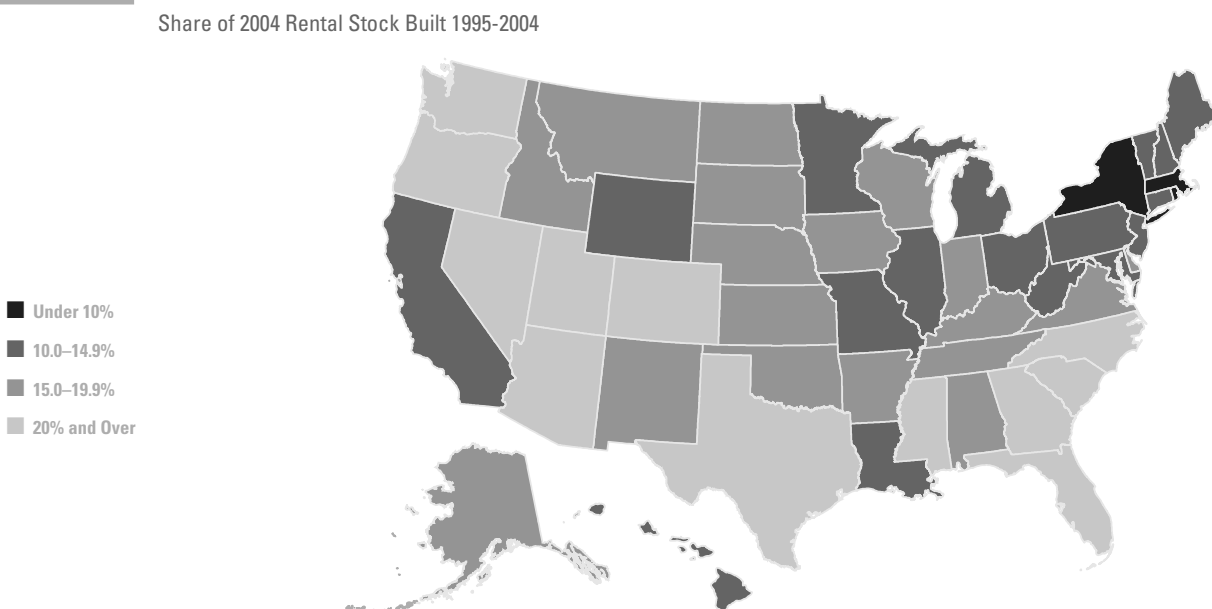
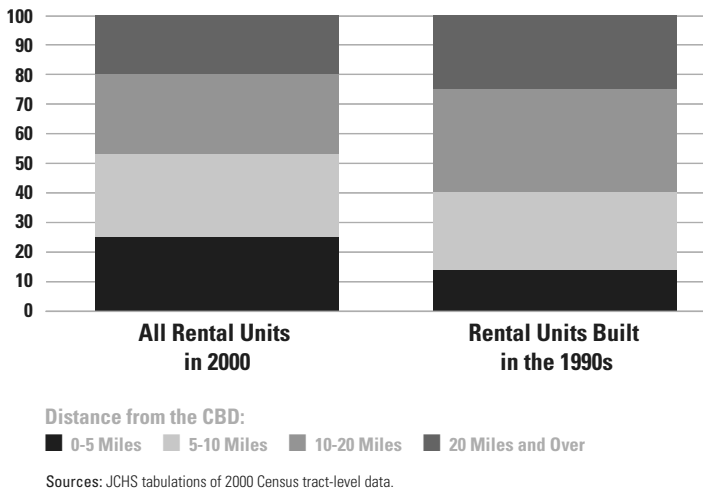


Figure 30

Rental Construction Is Moving To the Metro Fringe

Distribution of Rental Units in the 91 Largest Metro Regions



Similarly, the long-term trend toward decentralized development has resulted in only modest growth in the share of renters living greater distances from the center city in the last decade. Overall, the share of renter households located 10+ miles from the CBDs of the 91 largest metro regions increased from 45 percent in 1990 to 47 percent in 2000, while the share located 20+ miles out increased from 19 percent to 20 percent.

But even with these shifts, rental housing remains concentrated in or near cities. In these same 91 metro regions, one-quarter of renter households still lived within five miles of the CBD in 2000, and more than half lived within ten miles. Indeed, in the years from 1970 to 2000, the median distance of renters from the center cities only increased from 7.4 miles to 9.4 miles, while that of owners went from 9.8 miles to 13.8 miles.

CONSTRUCTION PATTERNS

Strong replacement demand and household growth are setting the pace for rental construction. In markets with no net growth in renter households, replacement demand for units lost to disasters, demolition, or condo conversion has been the driving force. In fact, replacement demand has been surprisingly strong even in many slow-growing states. For example, new rental units built in New York, which actually lost renters from 2000 to 2004, outnumbered the total built in Nevada, New Mexico, and Utah combined—three of the four states with the highest rates of household growth.

Over the past ten or so years, though, new construction has contributed the most to the rental stocks of the fastest-growing

states. Growth in demand in Arizona and Nevada, for instance, has been so strong that about one-quarter of their rental inventories in 2004 was built within the previous 10 years (Figure 29). In seven other states, more than one in eight rental units were also that new.

Increases in the fastest-growing metros have been even more stunning. In particular, a whopping 39 percent of Las Vegas rentals in 2000 were built within the previous decade, as were at least one-quarter of rentals in Orlando and Raleigh-Durham. Although owner-occupied housing units were added at an even more rapid pace, expansion of the rental housing stock in such metros was substantial.

In absolute terms, the largest gains in rental units occurred in a mix of fast- and slow-growing metros. New York, Los Angeles, Atlanta and Dallas added the most rentals during the 1990s, augmenting their stocks by more than 100,000 units each. In addition to New York and Los Angeles, other slower-growing metros that ranked in the top ten for rental additions were Chicago and Washington, DC.

Much of this new rental construction took place at the metropolitan edge and beyond (Figure 30). In large, older metros such as Boston, Chicago and Detroit, more than half of the rentals added in the 1990s were built 20 or more miles from city centers. The areas where new rental construction occurred closer to city centers were primarily smaller metros (such as Ann Arbor, New Haven, and Providence) that drew overflow demand from larger neighboring metros (Detroit, New York, and Boston). Construction activity has also been strong in non-metropolitan areas, which accounted for only 17 percent of the nation's rental housing in 2003 but 22 percent of units built within the previous 10 years.

CHANGING COMPOSITION OF THE STOCK

The building types and price points of new rentals have also changed over the past decade. In particular, new multifamily rental construction has shifted decidedly toward larger structures. While more than a third of renters live in single-family homes, nearly two-thirds live in increasingly large multifamily buildings. As a result, the rental stock has become somewhat more weighted toward one-unit and large multi-unit properties.

Between 1999 and 2004, the share of multifamily rental units completed in structures with at least 50 units shot up from 13 percent to 24 percent. This trend, however, varies by location. In places with a legacy of higher-density construction like Minneapolis and Houston, or with severe land constraints like San Jose, new rental properties tend to be larger. In places with ample supplies of land such as Bakersfield, Fresno, and Scranton, new rental properties tend to be smaller.

At the same time, the share of newly built multifamily rental units in structures with two to four apartments dropped from nine percent in 1999 to five percent in 2004. This shift in construction activity, combined with higher loss rates for small rental properties, contributed to net losses of more than half a million units in small multifamily buildings over this period.

Regardless of the size of the structures, newer units are likely to have rents at the high end of the distribution (Figure 31). Almost two-thirds of all market-rate apartments completed in 2004 had initial asking rents of \$850 and over. Nevertheless, an additional 12 percent of these units had rents under \$650.

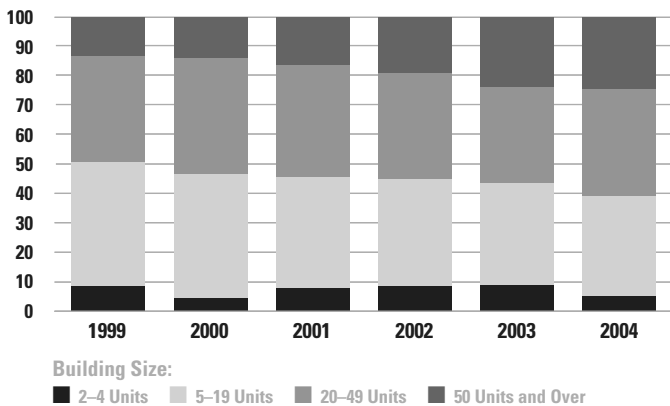
RENTAL PROPERTY OWNERSHIP

Even before the surge in investor purchases of single-family homes in 2005, some 4.3 million households reported earning rental income from a second property. In fact, individuals own more than half of all rental units in the United States (Figure 32). Property revenues are a significant resource for these owners, accounting for about 11 percent of household income for those under age 60, 14 percent for those in their 60s, and 25 percent for those in their 70s and over.

Rental property owners tend to be older and wealthier, at least in part because they have accumulated equity in both their

Figure 31 Newer Units Are Increasingly In Larger Buildings...

Distribution of Multifamily Rental Completions (Percent)



Sources: Census Bureau, Survey of Construction and Survey of Market Absorption of Apartments.

...And Have Higher Rents

Distribution of Units Completed in Buildings with at Least Five Apartments (Percent)

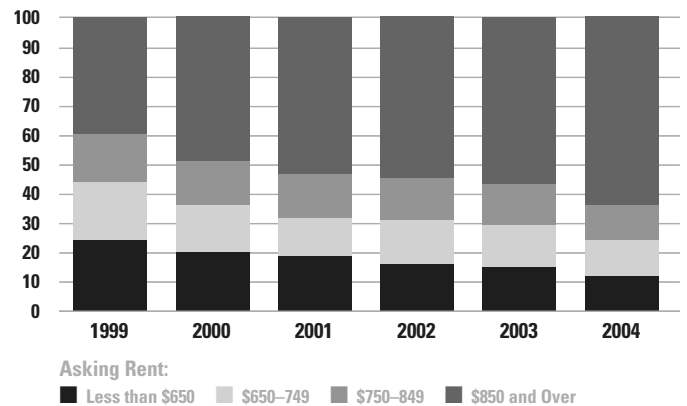
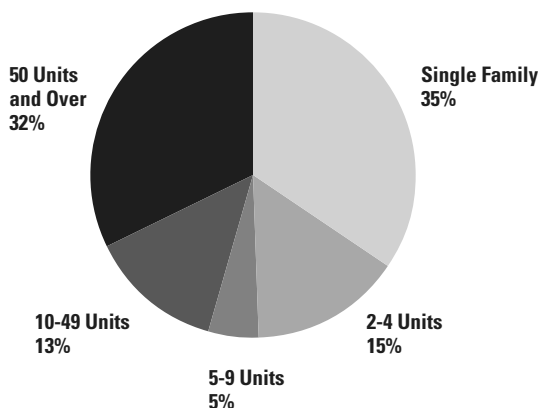
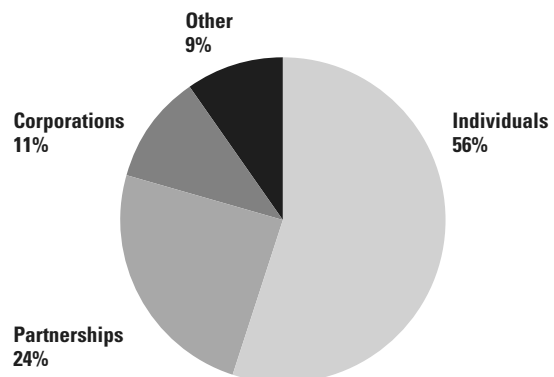


Figure 32 Much of the Rental Stock Is in Small Properties and Owned by Individuals

Property Size

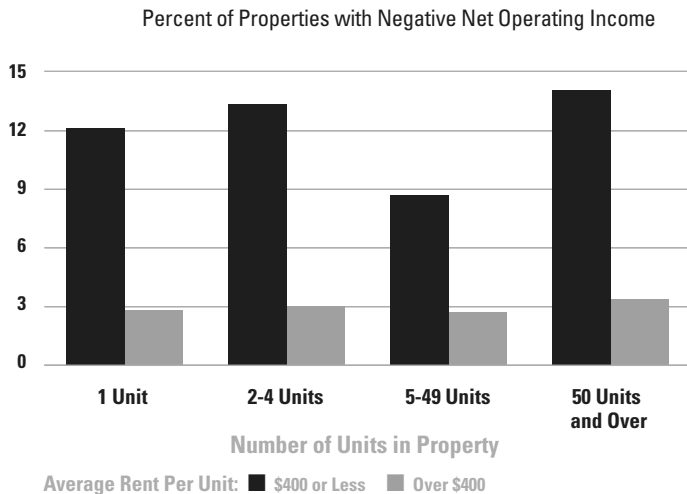


Ownership



Source: JCHS tabulations of the 2001 Residential Finance Survey.

Figure 33 **Low-Rent Units Are at Great Risk of Loss**



primary residence and their rental units. Most, however, are not well diversified because they own too few properties to spread risks across different markets. Indeed, 3.4 million of the 4.3 million owners report having only one rental property, and at least a third of these own only one single-family rental. For such households, a temporary vacancy can bring rental income down to zero. Even those owning a few properties are vulnerable because they tend to buy within a small geographic area. This means a downturn in a single market can erode the value of all their rental holdings.

With one-quarter of individual rental property owners aged 55 to 64 and another quarter aged 65 and over, many now or soon will rely on rents as a principal source of household income. In addition, these older owners tend to manage their rental properties themselves. Indeed, small property owners in general seldom hire professional managers because they would have to sacrifice some of their rental income. As a result, only one in five rental units owned by individuals or married couples are under professional management.

In sharp contrast to individual owners, institutions invest primarily in larger rental properties. Fully six in ten institutionally owned rentals are in properties with 50 or more units, compared with less than six percent of rentals owned by individuals and married couples. In addition, the largest companies own multiple properties in different parts of the country to protect themselves against isolated local downturns. More than 70 percent of institutionally owned units are professionally managed.

Institutions buy properties that are newer on average and command higher rents than those held by individuals. Indeed,

nearly two-thirds of institutionally owned units are in properties built after 1990 and only a quarter are in properties built before 1960. Some 64 percent of institutionally owned units have average rents of \$450 or more, compared with 46 percent of individually owned units.

PRESERVING AFFORDABLE RENTALS

The nation has been losing affordable rental housing for more than 30 years. This is the housing stock that is affordable, at 30 percent of income, to the third of renter households with incomes of \$16,000 or less. From 1993 to 2003, the inventory of these units—with inflation-adjusted rents of \$400 or less, including utilities—plunged by 1.2 million. With such drastic losses to upgrading, abandonment, or demolition, the shortage of rentals affordable and available to low-income households was a dismal 5.4 million.

As dire as the situation already is, even more risks lie ahead. A significant portion of the remaining affordable stock is in financial distress (Figure 33). In 2001, owners of fully 12 percent of all rental properties with average rents of \$400 or less reported negative net operating income—an unsustainable condition that points to accelerating losses of low-cost units going forward.

Removals of affordable rentals are especially alarming because preserving low-cost units is usually far more cost-efficient than building them new. In addition, losses to deterioration and abandonment erode the quality of neighborhood life and can exacerbate the economic decline of entire communities. Despite the urgent need, available federal subsidies and tax incentives have been insufficient to forestall, let alone reverse, the growing deficit in affordable rental housing.

THE OUTLOOK

Predicting future growth in renter households is complicated, especially in light of the unusually favorable environment for homeownership in recent years. But the large expected increase in the number of people in their 20s and 30s over the next 10 years is a clear positive for the rental market. In addition, given current trends in home prices and interest rates, conditions are likely to turn in favor of rental markets in the coming years.

Given strong growth in the young adult population, the healthy pace of household growth, and the lower ownership rates of younger householders, the number of renter households should increase by at least 1.8 million by 2015. Minorities will be responsible for the entire gain, eventually accounting for the majority of renter households. If age-specific homeownership rates fall back the way they did after the 1980s recession, however, renter household growth could be much higher. ■