



Rental Housing

The rental market has gained strength over the past year, bringing good news to investors. Demand has picked up sharply, vacancy rates have started to retreat, and rents are turning up. With new construction still depressed, markets are likely to continue to tighten. But rising rents, together with ongoing losses of the low-cost stock, mean declining affordability for the millions of lower-income households that make rental housing their homes.

RESURGENCE OF RENTAL DEMAND

While the homeowner market remains mired in foreclosures and weak demand, rental market conditions have improved. Indeed, renter household growth has outpaced owner household growth for four consecutive years. From 2006 to 2010, the number of renter households jumped by 692,000 annually on average, to 37 million, while the number of owner households fell on net by 201,000 annually. This is a complete reversal from the preceding decade and a half, when homeowners drove the vast majority of household growth and the number of renters stagnated.

Two trends underlie this shift: the rising number of renters who have deferred homebuying, and the rising number of owners who have switched back to renting. In the past few years, an unusually large share of typical first-time buyers—married couples and younger households—have remained renters. Indeed, while the number of households aged 25–34 increased by 1 percent from 2007 to 2009, the number of households in this age group that bought their first homes fell 14 percent during this period. The number of first-time homebuyers in the 35–44 year-old age group fell even more sharply, down 21 percent. The trend among married couples is similar, with a 19 percent drop in first-time homebuyers despite no change in their overall numbers.

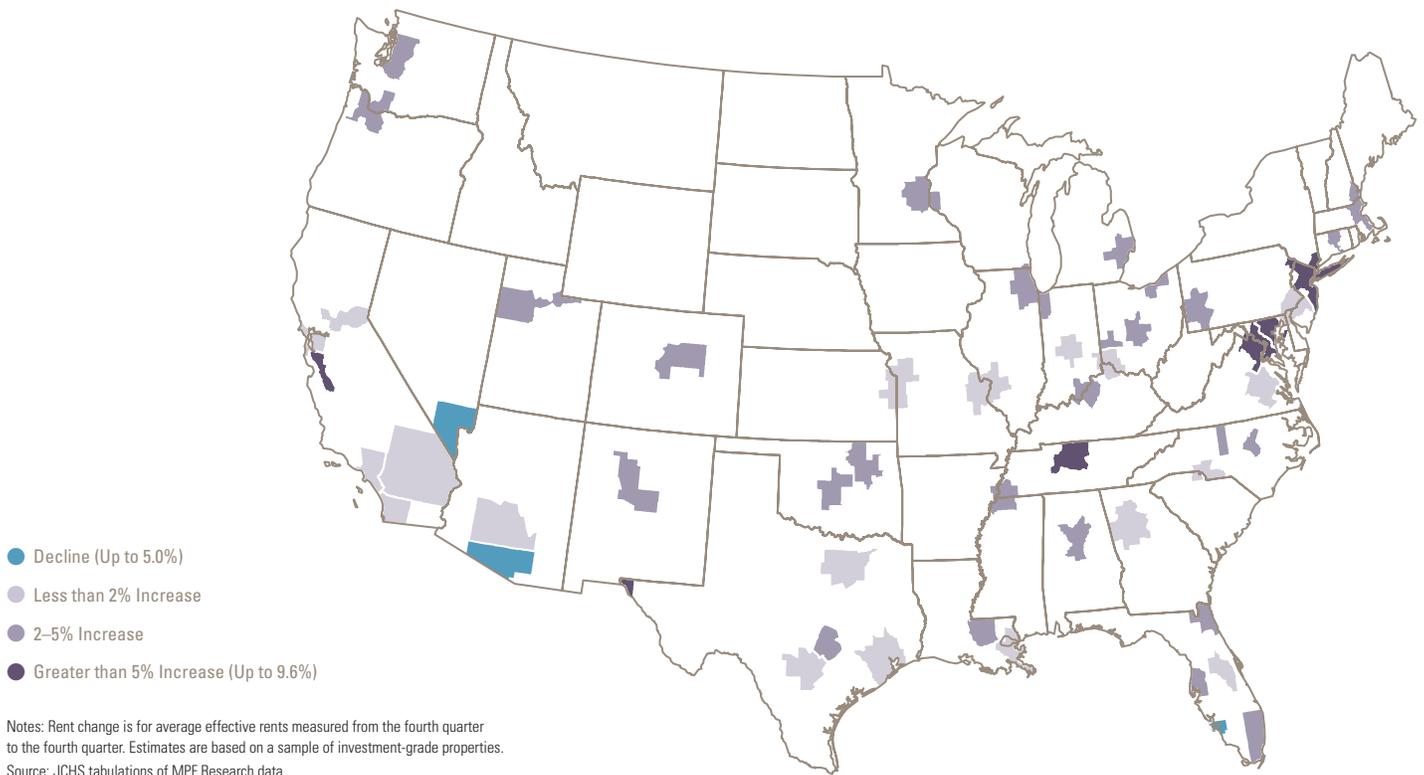
With home values still falling in many markets, even would-be homebuyers appear to be waiting on the sidelines until they are convinced that prices have bottomed out. But the improving economy and affordable home prices may be leading more renters to think about buying. The latest Fannie Mae National Housing Survey indicates that the percentage of renters saying they will probably continue to rent the next time they move declined to 54 percent in the first quarter of 2011, down from a peak of 59 percent in June 2010.

Meanwhile, recession-induced income and job losses have forced many former homeowners to turn to renting. According to CoreLogic, owners lost some 3.5 million homes to foreclosure from 2008 through 2010. Taking into account that some share of these properties were investor-owned, these foreclosures have displaced millions of renters as well. And although the number of delinquent loans is finally ebbing, the volume of foreclosures and short sales continues to

FIGURE 22

Rental Markets Are Tightening in Most of the Largest Metros

Change in Nominal Rents, 2009-10 (Percent)



rise as lenders work through a huge backlog of troubled loans. Thus, many more owners will become renters in the coming years—and will remain so for some time as they build savings and reestablish their credit ratings.

STABILIZING VACANCIES AND RENTS

After peaking at 10.6 percent in 2009, the national rental vacancy rate edged down to 10.2 percent in 2010. The absorption of excess units appears to be gaining momentum, however, with the overall rate ending the year at 9.4 percent—the lowest quarterly posting since early 2003. The drop in vacancies was concentrated in multifamily buildings, while rates for single-family rentals have held steady since 2005.

Early findings from the 2010 Decennial Census, which provides the most comprehensive count of units and households, suggest that vacancy rates may have been even lower last year than these estimates indicate. Nevertheless, the Housing Vacancy Survey shows that rental vacancy rates vary widely across metropolitan areas, ranging from 4.2 percent in Portland to 19.0 percent in Orlando. Among the metros with the lowest rates

are historically tight rental markets such as Boston, New York, and Los Angeles, where vacancies have been elevated for the past two years but still remain 3–5 percentage points below the national rate.

At the other extreme, vacancy rates are still at record highs in many areas hard hit by both the recession and foreclosures, where many for-sale homes were shifted to the rental market. At the height of the housing boom in 2006, rental vacancy rates in several overheated markets (including Riverside, Tampa, and Las Vegas, along with Phoenix and Orlando) had dipped below the 9.7 percent national average. Since then, though, rates have soared to decade highs. But even in metros such as Memphis that largely avoided housing price bubbles, rates doubled from 2006 to 2009. In these markets, faltering local economies and high unemployment forced more doubling up with friends and family.

Rents, however, appear to be on the rise. After flattening in 2009, nominal rents began to increase in the second half of 2010. According to Axiometrics, rent concessions (free or discounted rent incorporated into the lease term) also dropped

from 7.6 percent to 5.2 percent of asking rents over the course of last year. Similarly, MPF Research found that nominal rents for professionally managed properties with five or more units (adjusted for concessions) were up 2.3 percent from the fourth quarter of 2009 to the fourth quarter of 2010, outpacing overall price inflation and partially offsetting the 4.1 percent drop in the previous year.

While the overall trend in rents is positive, increases vary across the country (Figure 22). The largest gains are again in metropolitan areas with some of the highest rents and lowest vacancy rates. In traditionally tight markets such as New York, San Jose, and Washington, DC, nominal rents climbed by more than 5 percent in 2010. In contrast, the average increase was just 1.7 percent in the West and 2.5 percent in the South. These regions are home to the only 3 metro markets (of the 64 tracked) where average rents actually fell last year: Las Vegas, Fort Myers, and Tucson.

ADDITIONS TO THE RENTAL SUPPLY

Despite the recent growth in rental demand, new multifamily production has lagged. According to the Census of Construction, completions of rental units in multifamily structures (with two or more units) dipped to their lowest level in 17 years, totaling just 124,000 in 2010 after averaging 224,000 per year from 2000 to 2008.

But not all rental housing is in multifamily structures. In fact, single-family homes make up a significant—and growing—share of the stock. Switching of single-family units from the for-sale inventory to the rental stock not only provides needed

housing for renters, but has also helped to stabilize the homeowner market by reducing the excess vacant supply. Between 2005 and 2009, the net addition of 1.7 million households lifted the single-family share of occupied rentals from 31.0 percent to 33.7 percent. Moreover, about 22.6 percent of the 2009 single-family rental stock had been owner units just two years earlier.

Overall, the shift of units from the owner to the rental market has more than offset the slump in new construction, explaining why vacancy rates rose despite the falloff in production and the significant influx of renters. Additions to the rental stock from existing owner units have soared since 2005, exceeding 1.8 million from 2007 to 2009 and far outpacing the number contributed by new construction (Figure 23).

Although multifamily rental completions declined in 2010, production may be about to revive. After bottoming out in 2009 at just 92,000 units, a low not seen since World War II, multifamily rental starts picked up slightly to 101,000 units in 2010. While a promising upturn, last year's starts were less than half the 232,000 units averaged each year in 2000–8, and even further below levels in the 1980s and 1990s.

The recovery in multifamily production is already spreading to a broad range of metros. In fact, markets in some of the states hardest hit by the foreclosure crisis posted some of the largest increases in multifamily permits in 2010, including San Jose, Los Angeles, and Miami. Other metros that saw a large jump in permits were Seattle and Chicago.

MULTIFAMILY MORTGAGE MARKETS

Multifamily lending surged from 1998 to 2008, nearly doubling in volume from \$430 billion to \$830 billion in real terms. By 2009, though, lending activity slowed to a trickle as delinquency and foreclosure rates soared and credit markets tightened. Performance has been particularly dismal for loans held in commercial mortgage backed securities (CMBS), where the share of delinquent or foreclosed loans doubled from about 7 percent in 2009 to 14 percent in 2010. In stark contrast, the share of troubled multifamily rental loans is 5 percent for banks and thrifts, and just 1 percent or less for Fannie Mae, Freddie Mac, and FHA.

The climb in multifamily loan delinquencies has led to stricter underwriting standards, especially among private lenders. According to the Federal Reserve survey of senior loan officers, standards for multifamily and commercial real estate loans started to tighten in 2005 as mortgage markets began to implode. By 2008, 88 percent of respondents on net reported more stringent standards. This share fell back to zero in January 2011, indicating that lenders were no longer tightening (although not necessarily loosening) their underwriting criteria.

With private lenders restricting the flow of credit, the GSEs and FHA have accounted for nearly all of the growth in

FIGURE 23

Conversion of Owner-Occupied Units Has Contributed an Increasingly Large Share of Rental Stock Growth Over the Past Decade

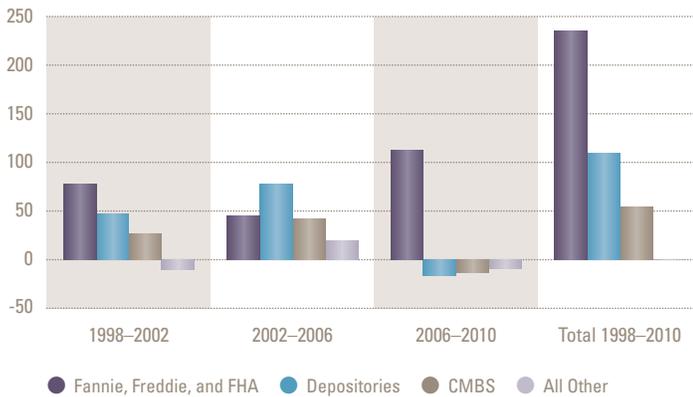


Note: New rental completions include both single-family and multifamily units.
Source: JCHS tabulations of US Census Bureau, Census of Construction and American Housing Surveys.

FIGURE 24

Fannie Mae, Freddie Mac, and FHA Have Fueled a Large Share of Multifamily Lending Growth Since the 1990s

Change in Multifamily Mortgage Debt Holdings (Billions of 2010 dollars)



Notes: Holdings are in the form of either multifamily mortgages or securities on loans in mortgage pools. CMBS includes all holdings in privately issued asset-backed securities. All other holders include nonfinancial corporate businesses, nonfarm noncorporate business, private pension funds, insurance companies, finance companies, state and local governments, and REITs. Dollar values are adjusted for inflation by the CPI-U for All Items.

Source: JCHS tabulations of Federal Reserve, Flow of Funds.

multifamily lending since 2008. From the fourth quarter of 2007 to the fourth quarter of 2010, their share of outstanding multifamily debt was up 30 percent. In fact, the multifamily loan volume for the GSEs more than doubled over the past decade, making them the largest lender in the market (Figure 24). FHA also expanded its multifamily lending substantially, bringing the total volume to nearly \$11 billion in 2010 and accounting for nearly 25 percent of the market last year. With this increase, the number of rental units financed with FHA support tripled from about 49,000 in 2008 to more than 150,000 in 2010.

The GSEs, however, cannot guarantee construction loans and have therefore been unable to prop up lending in this market segment. The limited availability of funding for acquisition, development, and construction (ADC) financing may slow the development of rental housing as demand picks up. The credit crunch has been particularly tough for smaller builders, who generally have more difficulty securing ADC financing because they rely primarily on local banks for loans. Large commercial builders, in contrast, can access credit from capital markets. According to a National Association of Homebuilders (NAHB) survey conducted in the fourth quarter of 2010, 52 percent of smaller builders (with less than \$1 million in revenues) had put multifamily rental projects on hold until the financing climate improves, compared with 35 percent of larger builders (with more than \$5 million in revenues).

Nonetheless, fewer firms are now delaying new multifamily construction projects. From the third quarter of 2009 to the fourth quarter of 2010, the overall share of respondents putting projects on hold fell from 57 percent to 43 percent. FHA may be helping to support this rebound, having raised its multifamily lending for new construction and substantial rehabilitation nearly four-fold, from \$1.0 billion to \$3.8 billion, between fiscal years 2008 and 2010.

With vacancy rates falling and rents increasing by late 2010, cash flow and property values are improving for the first time in years. The National Council of Real Estate Investment Fiduciaries (NCREIF) reports that net operating income for apartments rose 8.7 percent from the fourth quarter of 2009 to the fourth quarter of 2010. And Moody's/REAL commercial property price index indicates that, although still 27.6 percent below their 2007 peak, apartment prices jumped 19.7 percent from the trough in the third quarter of 2009 to the fourth quarter of 2010. With this turnaround, multifamily delinquencies and foreclosures may recede and owners may find it easier to refinance or extend their loans. Although the multifamily mortgage market is still weighed down by thousands of distressed loans, burgeoning demand for rentals should bring better credit conditions for developers.

EROSION OF THE AFFORDABLE SUPPLY

New construction helps to keep the rental supply at sustainable levels not only by meeting the needs of additional households, but also by replacing losses from the aging stock. However, newly constructed units are usually more expensive than existing ones, which drives up the average overall cost of rental housing. In 2009, construction and land costs for units in new multifamily structures averaged about \$110,000, and the median asking rent was \$1,067. To be affordable to the median renter in 2009 (at the 30-percent-of-income standard), however, the rent would have to be much lower at \$775 or less.

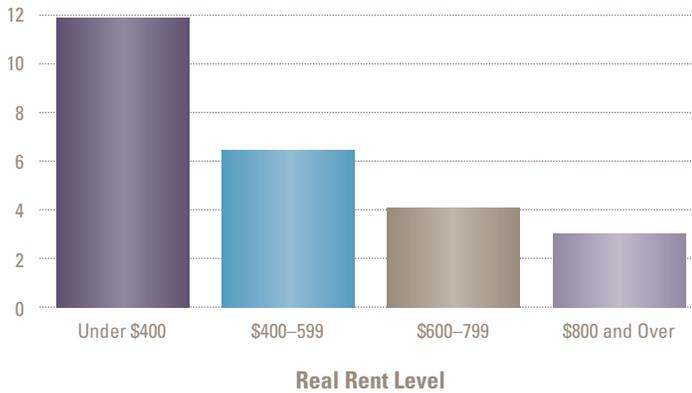
At the same time, many lowest-cost rentals are being permanently lost from the stock, largely because the rents they earn cannot cover the costs of adequate maintenance. In fact, the American Housing Survey indicates that despite the net addition of 2.6 million rentals, the number of units with rents of \$400 or less in 2009 inflation-adjusted dollars fell from 6.2 million in 1999 to 5.6 million in 2009. Many of the losses were due to demolition and other forms of permanent removal. By 2009, nearly 12 percent of the low-cost rentals that existed in 1999 had been lost—twice the share for units renting for \$400–799, and four times the share of units renting for \$800 or more (Figure 25). Many of the low-cost rental units that remain are in older, more at-risk buildings.

The growing number of low-income renters adds to the pressure on the affordable stock. Between 2003 and 2009, the number of renters with very low incomes (below 50 percent of area medians) jumped from 16.3 million to 18.0 million. Meanwhile, the number of housing units that were afford-

FIGURE 25

Low-Cost Rentals Are at Especially High Risk of Permanent Loss

Share of 1999 Rental Units Permanently Removed from the Stock by 2009 (Percent)



Note: All dollar values are 2009 dollars, adjusted for inflation by the CPI-U for All Items.
Source: JCHS tabulations of US Census Bureau, 1999 and 2009 American Housing Surveys.

able to households at that income level, in adequate condition, and not occupied by higher-income renters fell from 12.0 million to 11.6 million. The affordable housing shortage for this group thus widened sharply from 4.3 million to 6.4 million units.

The shortage of affordable rentals was even more acute for extremely low-income renters (earning less than 30 percent of area medians). In 2003, there was one affordable, available, and adequate unit for every 2.5 extremely low-income renters. By 2009, one unit existed for every 2.9 such renters. As the rental market continues to tighten and the competition for low-cost housing intensifies, the gap between the demand for and supply of affordable rentals will only increase.

THE OUTLOOK

As the economic recovery takes hold, rental demand is likely to remain strong thanks to the aging of the echo-boom generation into young adulthood—the years when they are most likely to form independent households. The recession has apparently led many young adults to delay living on their own, given that the percentage of households with additional adults (persons age 18 and older other than the household head and spouse) was up 0.9 percentage point in 2008–9. This translates to 1.1 million households, which may even underestimate the extent of doubling up because surveys may miss transient residents. As job growth picks up, more of those under age 30 should head out on their own and add to rental demand.

Although the baby boomers will not contribute much to overall rental demand, they will change the age composition of the renter population. With substantial growth in the number of elderly renters, demand for housing that meets their needs—including subsidized rentals—will increase accordingly.

Future immigration trends will also affect growth in rental households. Immigrants tend to be young adults, and foreign-born households of all ages are more likely than native-born households to rent. After slowing during the 2000s for the first time in more than 30 years, immigration will likely rebound once the economy picks up steam. Stricter government controls may, however, keep future inflows below pre-recession levels.

Attitudes about homeownership are another unknown. The ongoing weakness in house prices appears to be making renters wary about buying. In addition, a multitude of other factors—including impaired credit from the foreclosure crisis and deep recession, stricter mortgage underwriting standards, and continued uncertainty about the direction of the economy—make renting a more common choice. Nevertheless, with home price declines and low interest rates pushing affordability indexes to record levels, homebuying activity could siphon off some rental demand.