



RENTAL MARKET CONDITIONS

Rising rents, low and declining vacancy rates, and double-digit growth in multifamily construction all point to strong rental markets. Multifamily property prices are also soaring, attracting new capital from investors and private lenders. For renter households, however, increasingly tight market conditions have meant even more limited availability of housing that they can afford.

RENTS RISING ACROSS THE NATION

Perhaps the clearest sign of rental market strength is the widespread rise in rents. Indeed, the consumer price index (CPI) for contract rents (a broad and therefore conservative measure) indicates that rents are climbing at an accelerating rate. After increasing by an average of 2.7 percent annually since 2011, nominal rents were up 3.5 percent during the 12 months ending September 2015 (**Figure 16**). With overall inflation slowing to just 0.4 percent, the real increase in rents in the preceding 24 months was larger than in any other two-year period since 1987.

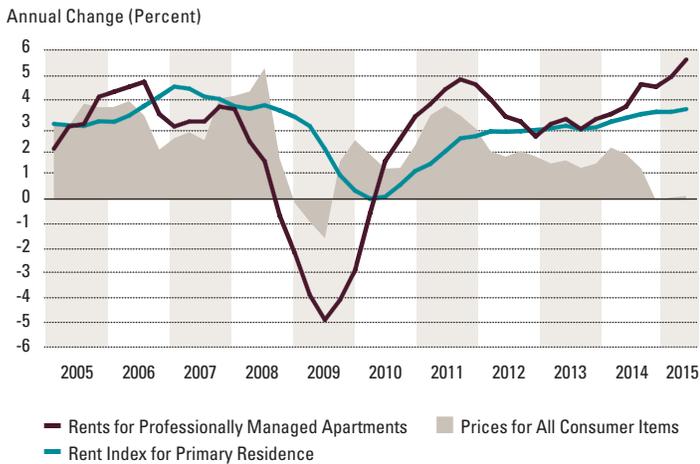
Other rent indexes confirm this trend. In fact, data from MPF Research, which cover professionally managed apartments and tend to be more responsive to changing market conditions than the CPI for rent, show an even larger jump. According to MPF's same-store measure, nominal apartment rents were up at a 5.6 percent annual rate in the third quarter of 2015, with some markets—including Portland, San Francisco, Fort Myers, and Denver—reporting increases of 10 percent or more.

Rents for newly constructed units are rising especially rapidly. The Survey of Market Absorption indicates that the median asking rent for a newly completed apartment hit \$1,372 in 2014—nearly 50 percent above the US median rent of \$934. This marked a 7 percent increase in new-unit median rents last year and a 26 percent increase over the previous two years.

Nationwide, rent gains in all of the 94 metro areas tracked by MPF Research exceeded overall inflation in the third quarter of 2015. Year-over-year increases in markets in the South and West were especially large, with real rents in 32 metros in those regions climbing 5.0 percent or more. Increases were more modest in metros of the Northeast (3.8 percent) and Midwest (3.5 percent). Meanwhile, rents in Des Moines, Pittsburgh, and Toledo edged up by less than 2.0 percent in the third quarter. Other metros with similarly small rent

FIGURE 16

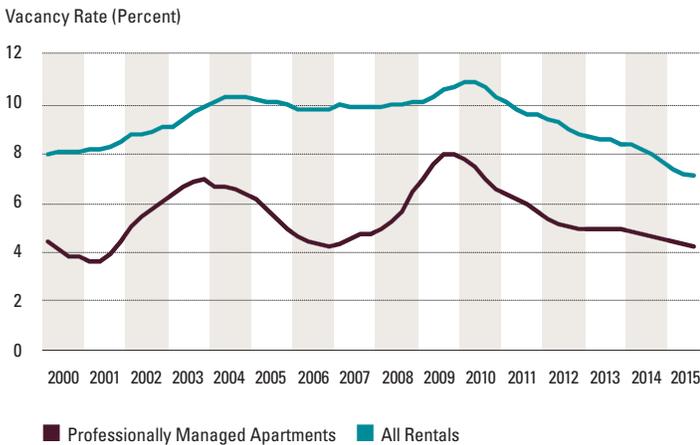
Rent Increases Continue to Outpace Inflation



Source: JCHS tabulations of US Bureau of Labor Statistics and MPF Research data.

FIGURE 17

Rental Markets Continue to Tighten



Note: Estimates are four-quarter rolling averages. Data for 2015 are as of the third quarter.
Source: JCHS tabulations of US Census Bureau, Housing Vacancy Surveys via Moody's economy.com and MPF Research data.

increases were scattered throughout the South, including Washington, DC, Baltimore, Virginia Beach, and Little Rock.

The typical gross rent ranged from as high as \$1,780 in San Jose to as low as \$630 in Youngstown. In high-cost markets—including Honolulu, Washington, DC, San Francisco, and Oxnard—median rents exceeded \$1,500 per month. Monthly rents in Bridgeport, San Diego, Los Angeles, New York, and Boston also stood at or above \$1,250. Other metros where rents exceeded \$1,100 include Seattle, Riverside, Miami, and Baltimore.

VACANCY RATES AT NEW LOWS

The national rental vacancy rate averaged 7.1 percent in the first three quarters of 2015, its lowest point in 30 years. After hitting a record 10.6 percent in 2009, the vacancy rate declined for nearly six consecutive years with the addition of roughly a million net new renters annually. Rates in the West fell 4.0 percentage points over this period, to just 5.1 percent, while rates in the Northeast declined 1.6 percentage points, to 5.6 percent. Although also down sharply since 2009, rental vacancy rates in the Midwest and South were still relatively high at 7.7 percent and 8.9 percent, respectively, in the first three quarters of this year.

Vacancy rates for all structure types have dropped. According to the Housing Vacancy Survey, apartments in buildings with 2–4 units (which tend to be the most affordable) had the lowest vacancy rate of 6.7 percent through the first three quarters of 2015, while the rate for single-family rentals was slightly higher at 7.0 percent. In both cases, vacancy rates now stand below their averages for the past two decades. But the largest decline in vacancies has been for units in buildings with five or more apartments, with rates falling from 12.3 percent in 2009 to 7.6 percent so far in 2015.

Although trending lower, vacancy rates for professionally managed apartments exhibit a similar pattern (Figure 17). MPF Research reports that vacancy rates for these units peaked at 8 percent in the fourth quarter of 2009 before dipping to just 4 percent in the third quarter of 2015.

With most newly constructed units charging rents well above what the typical renter can afford, budget-constrained households must compete for a shrinking supply of lower-cost units. Housing Vacancy Survey data indicate that vacancy rates among units renting for under \$800 per month (in nominal terms) fell by just 2.5 percentage points in 2009–2014. However, given rent inflation, demolitions, and growth in rental demand, the number of vacant units in this rent range fell by more than 700,000, accounting for most of the 1.0 million-unit reduction in vacant rentals over this period. The rapid disappearance of vacant units with lower rents leaves even fewer units available for the ever-expanding ranks of lower- and middle-income renters.

THE SURGE IN MULTIFAMILY CONSTRUCTION

Completions of new multifamily apartments were running at a 313,000 unit annual rate in mid-2015, with 96 percent of those units intended for the rental market. These additions to the stock came on top of 264,000 completions in

2014, which already marked a 35 percent jump from 2013. Multifamily completions are now at the same annual rate averaged in 1998–2007 before the housing crisis hit (Figure 18).

Multifamily units built for rental tend to be smaller than those built for purchase. As a result, the typical unit completed in 2014 was 1,070 square feet, down from a high of 1,200 square feet in 2007 when rentals accounted for only

60 percent of multifamily completions. Along with lower square footage, these new units have fewer bedrooms. Just over half of all new apartments in 2014 were studios and one-bedrooms, up from 42 percent five years earlier and 38 percent ten years earlier.

In addition, recently completed multifamily units are much more likely to be in large buildings, with 83 percent of apartments built in 2014 located in properties with 20 or more units. By comparison, the average share of new units added in large buildings in 1972–2014 was just 46 percent. Meanwhile, apartments in structures with 2–4 units plummeted from 20 percent of completions in the early 1980s to just 3 percent in 2014.

The ongoing growth in multifamily construction starts suggests that the building boom will continue. Starts were at a 401,000 unit annual rate in the first nine months of 2015, more than 3.5 times the all-time low of 108,900 units in 2009 and higher than at any point since the 1980s. Meanwhile, the number of multifamily permits was up 17 percent in the first nine months of 2015 from year-earlier levels, signaling an expanding pipeline of new rentals.

The pace of multifamily permitting exceeds pre-crisis levels in more than a third of the nation's 100 largest metros. This list is led by San Jose, Austin, Houston, and Dallas, where permits in 2012–2014 were 35 percent or more above average annual levels in 1998–2007. Permitting has also rebounded

FIGURE 18

Multifamily Starts Are at Their Highest Level Since the 1980s, and Completions Are Set to Increase

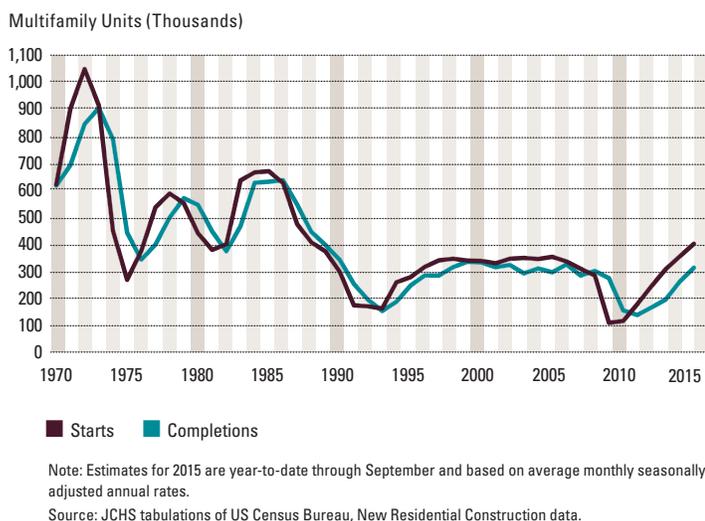
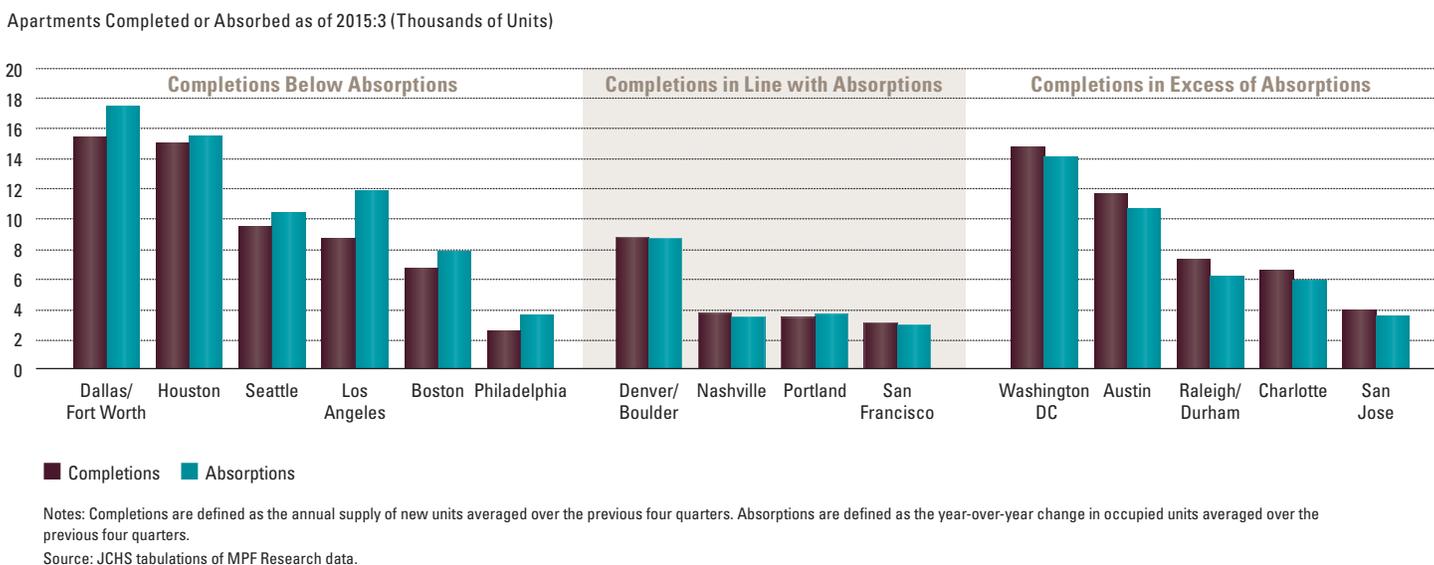


FIGURE 19

Absorptions of New Rentals Still Outpace Completions in Several Hot Construction Markets



strongly in high-growth Denver, Nashville, and Raleigh, in coastal metros of the West (such as Seattle and Portland), and in certain high-cost metros on the East Coast (including Boston, Philadelphia, and Washington, DC). Many of these areas have had some of the lowest vacancy rates and sharp-est rent increases posted in recent years.

Noticeably absent from this group are some of California's once-hot markets (including Riverside and San Diego), along with formerly high-growth metros in the South and Southwest (such as Atlanta, Miami, Tampa, Las Vegas, and Phoenix). These markets were especially hard hit by the foreclosure crisis and, in most cases, locations where conversions of single-family homes played a large role in absorbing rental demand.

Many of the metros where multifamily permitting has been weakest (including St. Louis, Cleveland, Cincinnati, and Milwaukee) are located in the Midwest, where employment growth has lagged. Chicago and Detroit have also experienced below-average growth in rental construction. Other smaller metros of the Northeast (such as Providence and Hartford) have also had below-average job growth and limited multifamily construction activity.

In the majority of metros where multifamily construction has boomed, absorptions of rental units still exceed supply coming online (**Figure 19**). In Los Angeles, for example,

even with completions running at an average annual rate of 8,800, absorptions were still 3,200 higher. Similarly, demand outstripped new supply in Dallas/Fort Worth by 2,100 units. Other high-growth construction markets, such as Denver/Boulder, Nashville, and Portland, appear to be close to balance. In several other metros where absorption rates have trailed completions (including Austin and Raleigh/Durham), vacancy rates have changed little over the past year.

STRONG RETURNS ON RENTAL INVESTMENTS

With higher rents and lower vacancy rates, rental property investments continue to perform well. According to the National Council of Real Estate Investment Fiduciaries (NCREIF), annual returns on multifamily properties increased to 12.0 percent in the third quarter of 2015. After topping out at more than 20 percent in early 2011, returns remain well above the 9.5 percent rate averaged since 1984.

Income growth has helped to boost returns. Net operating income (NOI) for institutionally owned apartments increased by 7 percent annually on average over the past six years and climbed just over 10 percent as of mid-2015. Much of the growth in overall returns reflects the significant rise in multifamily property prices, which soared 15.2 percent in the past year. As of September 2015, prices exceeded their previous peak by fully a third, far outpacing the rebound in single-family home prices (**Figure 20**).

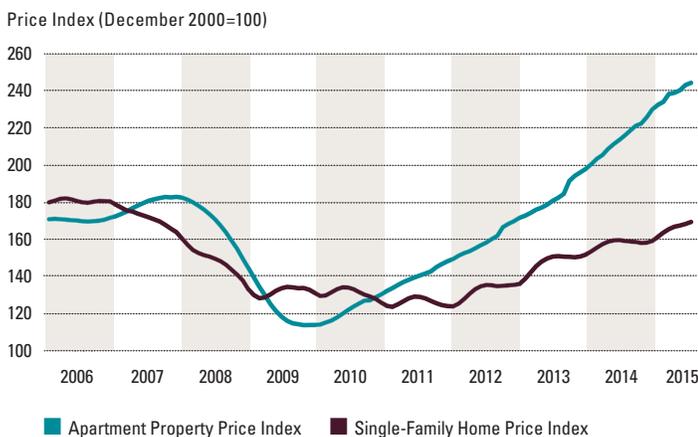
Price appreciation has been substantial in many areas, particularly in Northeastern and West Coast metros as well as Denver, Dallas, Houston, and Austin. According to Real Capital Analytics data, apartment property prices as of mid-2015 in New York City, Orlando, and San Francisco were up at least 145 percent from the fourth quarter of 2009. With these gains, rental property prices in New York City were double their previous peak while those in San Francisco were up 86 percent from their previous peak.

Prices of mid- and high-rise apartment properties have rebounded the most and are now 66 percent above 2007 levels. In contrast, prices for low-rise garden apartment properties exceed the previous peak by a more modest 23 percent. Prices for properties in urban, walkable areas are also up 85 percent from past peaks, far more than prices for properties in highly walkable suburbs (32 percent) and in car-dependent suburbs (up 21 percent).

Strong growth in multifamily property prices has driven down purchase capitalization or "cap" rates (expected net

FIGURE 20

Prices for Apartment Properties Have Rebounded Well Beyond Their Previous Peak

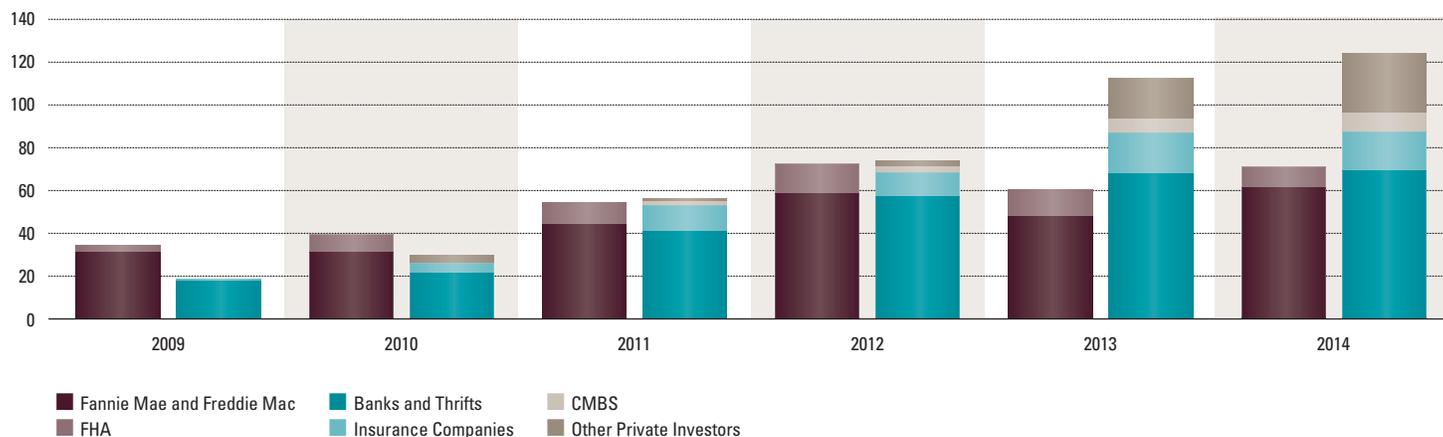


Note: Estimates for 2015 are through September.
Sources: CoreLogic, US National Home Price Index; Moody's Investors Service and Real Capital Analytics, Commercial Property Price Index for Apartments.

FIGURE 21

Private Lenders Have Ramped Up Multifamily Lending, Reducing the Government's Footprint in the Market

Multifamily Loan Originations (Billions of dollars)



Source: Mortgage Bankers Association of America.

operating income as a share of the purchase price). NCREIF reports that cap rates for investment-grade apartment properties declined to just under 5 percent in mid-2015, a level not seen since the peak of the housing bubble. Indeed, the extremely low cap rates in some of the tightest, highest-cost markets—such as Manhattan and San Francisco—leave little spread with Treasury yields. Such low cap rates suggest that investors are sticking to major markets that they consider less risky.

The rise in rental property values also reflects increased investments to maintain and upgrade the stock. Indeed, total spending on improvements, maintenance, and repairs to the rental stock has picked up with the rise in prices, increasing from just under \$50 billion in 2010 to nearly \$60 billion in 2014. According to a recent National Apartment Association survey, nominal per-unit expenditures on apartments in large, professionally managed properties rose from an average of \$1,070 to \$1,520 over this period.

FALLING DELINQUENCY RATES

Rising rental property prices and incomes have helped drive down delinquency rates for most types of multifamily loans. The share of multifamily loans held by FDIC-insured institutions that were at least 90 days past due or in non-accrual status stood at just 0.34 percent in the second quarter of 2015, compared with 4.65 percent at the peak in 2010. The 60-day delinquency rates for commercial/multifamily loans held by life insurance companies (0.06 percent), Freddie Mac

(0.01 percent), and Fannie Mae (0.05 percent) remained low throughout this period.

In contrast, delinquency rates for multifamily loans held in commercial mortgage backed securities (CMBS) rose more sharply during the recession and have been slower to recover. Moody's Delinquency Tracker shows that the share of CMBS loans that were 60 or more days past due, in foreclosure, or in the lender's possession peaked at nearly 16 percent in early 2011 before steadily retreating to just under 8 percent in September 2015. While this more inclusive measure of delinquencies is naturally higher than that for other types of multifamily loans, the delinquent share of CMBS loans is still well above its pre-crisis level of less than 1.0 percent.

TRENDS IN MULTIFAMILY FINANCE

Given the strong financial performance of multifamily rental properties, lending activity has increased sharply. The Mortgage Bankers Association reports that the volume of multifamily loans outstanding (including both originations and repayment/write-offs of existing loans) expanded by another \$65 billion in 2014 and hit \$1 trillion in 2015. In nominal terms, balances grew by 17 percent between 2011 and 2014. In sharp contrast, the balance of single-family mortgage debt outstanding was essentially flat in 2014 and stood 3 percent below its 2011 level. Indeed, while multifamily mortgage debt outstanding is at a new high that far exceeds mid-2000s levels, single-family balances remain 13 percent below their 2008 peak.

The private sector has jumped back into the multifamily lending market, significantly reducing the agency and government sponsored enterprise (GSE) share of these loans (**Figure 21**). From 2012 to 2014, multifamily lending by banks and thrifts, insurance companies, CMBS, and all other investors was up a combined 68 percent. At the same time, lending backed by Fannie Mae and Freddie Mac increased by just 5 percent, and lending by FHA fell 29 percent. As a result, the combined government share of multifamily originations dropped from 65 percent at the height of the credit crisis in 2009 to about half in 2012, and then to 36 percent in 2014. Even so, the total volume of government-backed originations more than doubled over this period.

The market for multifamily loans—particularly small loans—includes thousands of lenders. Some 2,876 lenders made 14 multifamily loans on average in 2014, with 1,884 lenders reporting an average loan size under \$1 million. Overall, 24 percent of multifamily loans last year were for \$1 million or less, and 65 percent were for \$3 million or less. By volume, however, small loans make up only a small share (3 percent) of a market where the average multifamily loan in 2014 was \$4.8 million.

Despite recent increases in multifamily lending, concerns remain about the availability of capital in traditionally underserved and hard-to-serve markets, including small metros, economically disadvantaged communities, low-income neighborhoods, and rental properties with 5–50 units. A variety of factors make it difficult to serve these segments. For example, underwriting for multifamily loans is done at the property level, entailing certain fixed costs that can be expensive on a per-unit basis for small property owners. Lenders also recognize that maintenance and repairs keep profit margins tight for these owners, and fewer units mean that a single vacancy can have a significant impact on rental income. In addition, the unique characteristics of smaller properties and the diversity of underwriting standards that lenders use make small multifamily loans difficult to bundle into securities that can be sold on the secondary market.

Some changes are being made to address these concerns. In particular, the Federal Housing Finance Agency (FHFA) and HUD recently proposed several new products and initiatives to encourage more lending to small multifamily property owners. In 2014, FHFA excluded small multifamily loans from the caps on multifamily purchases and proposed a new purchase goal for the GSEs in 2015–2017. In addition, Freddie Mac launched a Small Balance Loan initiative last year to buy and securitize multifamily loans in the \$1–5 million range. And in July 2015, FHA introduced a new lending platform called the Section 542 Small Building Risk Sharing Initiative, partnering with high-capacity lenders such as community development financial institutions to provide long-term, fixed-rate loans of up to \$5 million to property owners in high-cost areas.

THE OUTLOOK

Rising rents and low vacancy rates have yielded solid income gains for property owners, double-digit growth in property prices, and a surge in construction of and investment in multifamily rental buildings. Indeed, with 412,000 permits issued and 355,000 units started in 2014, annual completions of multifamily units in 2015 are on track to top the 313,000 level averaged in the decade before the downturn. Although these additions to the rental stock should help to slow market tightening, demand continues to outpace supply in most metros, keeping pressure on rents and vacancy rates.

Today's relatively easy access to capital may be masking unsolved problems related to traditionally underserved markets. Federal regulations remain up in the air, along with the fate of Freddie Mac and Fannie Mae—two major players in multifamily finance. With low interest rates fueling the current growth in multifamily construction, it is also unclear whether rates will rise before the rental supply expands enough to alleviate market tightness. At the same time, though, the strong expansion of multifamily lending could lead to future overbuilding in some markets, given the long construction pipeline and the sharp growth in permitting in most metropolitan areas.