

# The Multi-Family Rental Housing Outlook

*The prospects  
for the see-sawing  
rental apartment industry.*

**2000 WAS THE BEST** year for rental apartments since the early 1980s. Rents rose almost 10 percent nationally, with double-digit increases in the Northeast and on the West Coast. In the Spring of 2001, however, the apartment markets turned down sharply, and the last nine months of 2001 brought significant negative absorption for apartments. 2001 ended with market conditions markedly worse than when the year began.

While each recession is unique, typically the United States has gone into recessions as a result of rising interest rates, excessive inventory build-ups, or an external shock to the economy like the OPEC oil embargo of the 1970s. In the mid-

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1970s apartment starts slowed, but a rebounding economy and strong baby boomer absorption drove annual starts to 370,000 units by 1977. Rental increases averaged a little over 5 percent during the same period and overbuilding was quickly absorbed, except for a few cities such as Orlando. While household growth slowed to 1.3 million in 1975, for the rest of the decade household growth averaged almost 1.5 million annually.

The 1982 recession was different in several respects from the 1975 recession. While the prime rate peaked in 1974 at 12.5 percent, it reached 21 percent in 1981 and the housing market virtually shut down. Growth slowed to 391,000 units/year by 1983, and rental apartment starts averaged only 195,000 units/year between 1980 and 1982. In spite of a weak economy from 1980 through 1983, the Tax Recovery Act of 1981 gave owners of income properties substantial depreciation tax shelter benefits. As a result, developers built largely independent of market demand. As the economy strengthened in 1984, the apartment development industry began producing rental housing at a rate of more than 400,000 units/year between 1984 and 1986. While the 1986 Tax Reform Act eliminated virtually all tax benefits, the development industry had created its own momentum, which carried through 1990 despite weakening market conditions.

Thus the 1991 recession took place at a time when the industry was most vulnerable, with significant overbuilding resulting from a long period of excessive supply. Multifamily vacancy rates peaked in the second quarter of 1988 at 12 percent and remained above 9 percent until 1998. With the entire real estate industry hemorrhaging by 1991, liquidity dried up and between 1991 and 1993 apartment starts fell to approximately 100,000 units/year—most of which were “affordable” housing. With more than 2 million new jobs created in 1993 and another 3.5 million new jobs in 1994, the excessive apartment inventory began to be absorbed, and by 1994 markets started firming except in California, which was in balance by mid-decade.

By the mid-1990s the equity real estate investment trusts were flourishing and investment analysts began following REITS and their markets. As a consequence, transparency became much more important to real estate investors, who focus on starts and absorption. Throughout the 1990s, there appeared to be much more discipline on the part of both investors and developers, with investors requiring developers in most instances to significantly co-invest; that is, to contribute some of the equity from their own funds. Apartment starts peaked during this cycle in 1998, and gradually trended down through 2001 in spite of the

strong absorption during 2000. A decade-low vacancy rate existed by the end of 2001. Although job growth was positive through the first quarter of 2001, the U.S. economy lost approximately 1.4 million jobs during the last nine months of 2001, with job losses rapidly accelerating in the fourth quarter. The Federal Reserve lowered interest rates to combat the looming recession, which encouraged homeownership. Apartment residents left for newly affordable home ownership—in some instances with mortgage payments lower than their apartment rents. As a result of job losses and rising home ownership, apartment demand faltered. The twelve months ending March 31, 2002 saw negative apartment absorption and greater use of concessions than ever before.

What is needed once again to get supply and demand back in balance is a strong cutback in development combined with the increased absorption, which should result from the growth and higher interest rates that normally accompany a recovery.

#### CAPITAL AVAILABILITY

Driven by a desire for “credit quality,” during the 1970s and 1980s investors favored office buildings, shopping centers, hotels, and industrial properties. However, apartments were generally viewed as high-risk investments since tenants had no credit. As

a result of the depression in real estate values in the early 1990s and the mid-decade recovery, analysts began focusing on the performance of the different types of income properties during the downturn. To their surprise, many concluded that apartments had outperformed other product types, and at the same time seemed to have less risk, especially during times of economic weakness. Joseph Gyourko and Peter Linneman, in a paper on the merits of investing in apartments versus office buildings, characterized this lower risk for apartments as resulting from “the law of large numbers”—the fact that whatever the state of the economy, at any point in time a large number of individual households need shelter. Businesses, on the other hand, tended to contract during recessions and could forego expansions as well as downsize to use less office space. Further, although no single apartment tenant was “credit quality,” taken as a whole they represented a low risk of default.

By the mid-1990s investors were more favorably inclined toward apartments, believing that they provided a more predictable return than other income properties. In a recent advertisement in *PREA Quarterly*, SSR points out that since the founding of the NCREIF Property Index in 1978, apartments have delivered the highest return of any property type. Consequently, as a result of strong performance throughout the second half of

the 1990s and continuing through 2000, development capital was increasingly available for rental apartments.

At the beginning of the last decade, garden-style apartments dominated production, as the population sprawled away from the central cities. In order to avoid the kind of overbuilding that occurred in the late 1980s, investors increasingly focused on “infill” locations. Infill brought higher land costs and a need to build higher densities, and new apartment product began to evolve with an increasing number of units built closer to the urban core, with densities ranging upwards of 50 units/acre. A strong economy gave many young singles high salaries, and many chose close-in mid-rise apartments with monthly rents frequently above \$1.50/square foot. Capital was abundant for infill developments and investors even began making capital available for high-rise product in many of our larger metropolitan areas. As a result of strong property performance, capital—both debt and equity (along with mezzanine debt)—became readily available for projects with experienced developers.

As a result of apartments’ strong performance, institutional investors also allocated substantial funds to apartment acquisitions. In the supply-constrained markets of the West Coast and the Northeast, cap rates in the 7 percent range became commonplace, and sellers often found themselves with more than 10 buyers bidding on properties. As apartment

markets weakened in spring 2001, the spread between bid and ask widened. As a result of lower interest rates, owners have been able to refinance, rather than sell, and fewer properties are trading as a result. Notwithstanding increased use of concessions and softer apartment markets, there is still a lot of capital trying to buy rental housing.

#### APARTMENT PRICING TRENDS

Simply stated, apartment prices are a function of a cap rate applied to net operating income. As apartments become more popular, cap rates decrease and buyers tend to use higher economic occupancies to justify higher prices in order to compete. Historically, California has enjoyed a cap rate “premium,” with cap rates typically 1 percent lower in the Bay Area and Southern California’s coastal communities than in other markets. This cap rate differential disappeared during the last recession, but reappeared in the late 1990s, as rent increases reached double digits in Southern California as well as the Bay Area. At the height of this recent cycle, buyers would trend rents and use 95 percent economic occupancy in order to “justify” prices high enough to beat out the competition.

As 2001 progressed it became more difficult for buyers to assess the net operat-

ing income they would achieve once they closed. Concessions exist in virtually every marketplace; developers are using two months free rent in many markets in an attempt to accelerate lease-ups. Sellers obviously want buyers to assume that markets will return to balance within a short time after acquiring an asset, and are reluctant to sell on the basis of currently depressed net operating income (NOI). Thus, in many markets the spread between buyers and sellers is further widening and sellers are refinancing.

Cap rates vary geographically, by age and by product type. On the West Coast and in the Northeast, 7 percent cap rates are common for new apartments, and some cap rates range as low as 6 percent in markets where future rent growth can be reasonably expected. At the opposite end of the spectrum, secondary and tertiary markets such as Athens, Georgia and Greenville, South Carolina command cap rates of 8.75 percent or above for new apartments with conservative rent trending. Older properties typically carry higher cap rates, particularly if there is product obsolescence. Cap rates also vary by product type, with the lowest cap rates typically applied to high rise rental projects—particularly near urban centers. Mid-rise/high-density projects additionally enjoy cap rate advantages over garden apartments. In many instances, a high-rise can be expected to trade at a cap rate 10 percent to 15 percent lower than a garden

apartment, with a high-density in-fill project carrying a cap rate advantage of 5 percent to 10 percent.

As we enter the third quarter of 2002, investors' appetite for apartments remains strong, in spite of overbuilding. For buyers the most difficult issue to pin down is today's effective rent. With concessions so commonplace, revenue is much harder to estimate than expenses.

#### WHAT ABOUT SUPPLY?

From a low of 98,000 apartment starts in 1993, starts peaked in 1998 at 261,000 apartments in buildings with more than five units. Surprisingly, production fell at the rate of about 4 percent per year for the next three years, with 2001 starts estimated at 230,000 units. Since the economy generated approximately 3 million jobs annually for the four years ending in 2000, it appeared that 230,000 starts might even be inadequate to meet demand. Unfortunately, the economy reversed course and lost more than 1 million jobs in 2001, a swing of more than 4 million jobs year to year. Negative absorption, primarily driven by the emptying of corporate housing during 2001, left a vacancy in Class A and B apartments more than 2 percent higher at the end of 2001 than at the beginning.

Since today there are very few firm apartment markets in the United States, it

is logical to expect that apartment starts will moderate considerably during 2002. Because there is so much investment interest in multi-family housing, starts may fall below 200,000 units this year, but not near the 100,000 average for the early nineties. Of course, during 2002 most of the 230,000 units started in 2001 will come on-line and therefore markets will be soft through the balance of the year—even if the economy were to begin a meaningful recovery by mid-year.

In order for markets to return to balance, the home ownership rate must stabilize at approximately 68 percent, or even fall back towards its historic average of 64 percent. Recent home price inflation combined with low interest rates and strong consumer confidence has led households at the homeownership margin to buy homes rather than rent. The apartment industry has contributed to this increase in homeownership by building a large number of new apartments at rent levels that are high enough to give an apartment occupant a homeownership choice with a mortgage payment equal to, or sometimes less than, apartment rents. Needless to say, the homeownership real estate tax and interest deductions help push renters toward ownership.

Of the various factors mentioned above, a curtailment of new supply is the most critical for getting supply and demand back in balance. Each year in

this country more than 100,000 rental apartments are lost to obsolescence, fire, and flood, as well as condo conversions. With more transparency about apartment markets than ever before starts should fall to 150,000 to 175,000 units this year and to stay at this level at least through 2004. Unfortunately, through the second quarter of 2002 investors appear to be ignoring overbuilding in their zest to invest in apartments, and starts for 2002 may unfortunately exceed 200,000.

#### THE OUTLOOK

It is reasonably certain that 2002 and most likely 2003 will be a weak year for apartment operations in virtually every market. The important question is: When will concessions begin to diminish and effective rents rise? Variables affecting this issue have been previously discussed and include: whether home ownership continues to increase, pushing the homeownership rate above 68 percent, or begins to recede to its early 1990 rate of 64 percent; whether apartment starts fall to the low to mid-100,000s (including 75,000 to 90,000 affordable units), or continue closer to 200,000; and, whether the economy gathers momentum throughout 2002, once again creating meaningful job growth, and ultimately returning to a level

near 3 million new jobs per year as occurred in 1997 through 2000.

Highly leveraged apartment owners who took ownership prior to 2001 will clearly suffer through several years of flat to declining net operating income between 2001 and 2003 in most markets. With favorable demographics, as the sizeable Echo Baby Boom enters the first-time renter years, owners should expect returns to once again be strong beginning in 2004 presuming a curtailment of new starts in 2003.

Apartment buyers looking to acquire properties in 2002 will find sellers continuing to price as if it were certain that NOIs would recover during 2003. Some brokers maintain that cap rates have even decreased in the past 12 months. Buying opportunities should improve in 2002 if the economic recovery is stalled, or at best shallow, since some highly leveraged owners are likely to feel pressure to sell as the cycle persists. There is a lot of capital currently on the sidelines looking for sellers to become more realistic about near-term prospects for net operating income. Only time will tell if this will happen.

#### **MARKET DISCIPLINE?**

Comparing the supply and demand cycle during the latest slowdown to the serious overbuilding that took place in the late

1980s is difficult at this point in time. The overbuilding that took place during the late 1980s was set in motion by the 1981 Tax Recovery Act, which provided generous tax benefits, with a particular bias in favor of multi-family rental housing. Once developers understood the tax act, they responded by increasing development, and syndicators became significant investors as they raised capital from various high-income professionals to provide them with income tax shelter in syndicated properties. The production of multi-family rental housing almost doubled between 1981 and 1983 and peaked in 1985 with 451,000 apartment unit starts. While new supply dropped after the 1985 peak, it continued above 200,000 units per year until 1991 when it dropped to half of 1990's 216,000 starts. As previously discussed, the cyclical peak in production occurred in 1998, and a slow reduction in development of approximately 4 percent per year took place for the next three years. With almost unprecedented absorption in 2000, the markets firmed as the M/PF Research's survey of Class A and B apartments showed vacancy rates averaging 3.5 percent at December 31, 2000. Needless to say, it appeared that discipline had taken hold and that we were building new supply at or slightly below demand.

Unfortunately, as has been common in U.S. economic history, the economy's direction again changed after a remarkable

ten-year growth. During the second half of the 1990s annual demand for new apartments appeared to approximate 240,000 units (bearing in mind that approximately 110,000 units are lost annually to obsolescence). In a recessionary environment with negative job growth, apartment residents tend to downsize, double-up, and/or move back home. This negative absorption was compounded by continuous home buying as increasing home prices and low interest rates resulted in residents with sufficient economic certainty moving out of rental apartments to buy homes. As a consequence, what looked like a disciplined industry building to equilibrium has turned into overbuilding exemplified by significant concessions.

Thus, one might conclude that our industry showed “market discipline” during this development cycle. While that is true, it is equally clear that economic downturns accompanied by negative apartment absorption tend to happen periodically and typically without warning. As a result, our industry must be prepared to weather two or three poor operating years before a return to meaningful net operating income growth. Unquestionably, we have largely avoided operating deficits as a result of low interest rates, and I believe the apartment industry has responsibly financed new developments/acquisitions with more equity than ever before. As a result, the real estate industry, and the

apartment industry in particular, will weather this downturn significantly better than we did in the early 1980s and meaningfully better than we did in the mid-1970s. However, a continuous stretch of new market rate development during the first two quarters of 2002 is troubling, and may push market recovery into 2004 or even 2005 in some markets.