

Multifamily Supply: Too Much or Not Enough

A BERKSHIRE RESEARCH VIEWPOINT

October 2016



Berkshire



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SUMMARY

With an expected surge in new apartment supply in 2017, some investors have expressed concern about the potential for major deterioration in apartment occupancy and rent growth. Given the current baseline economic outlook of continuing job growth, such a scenario is unlikely. Moreover, fundamentals in most markets should remain balanced with moderating, rather than negative, operational performance.

Key observations based on our research include the following:

- Despite the rapid increase in completions this year, there remains an aggregate deficit of supply relative to demand nationally, with most markets experiencing supply deficits to varying degrees.
- Vacancy rates remain below historical norms across markets and most should be able to absorb higher levels of supply.
- More balanced market conditions will likely be reached within a year, but strong renter demand driven by demographic trends and lingering pent-up demand among young adults, greater propensity to rent, faster population growth in urban areas and tightening lender standards for new development could prolong the cycle.
- Given projected growth in supply relative to jobs, as well as current low vacancy across most markets, the majority of markets face low or moderate supply risk.
- Vacancy rates will likely surpass historical norms in 2017 in about a dozen markets including Nashville, Newark, Stamford, Houston, New York, Austin, Orange County, San Jose, San Francisco, Washington D.C., Baltimore and Atlanta. These markets could be more impacted by supply and should be carefully monitored.
- Given the concentration of new supply in urban cores, such centrally located submarkets are more likely to transition from the expansion phase to the saturation phase of the cycle sooner than their suburban counterparts.
- In general, vacancy is lower in the edges of the urban/suburban divide and the middle range of the rent distribution due to proximity to both urban and suburban job centers and relative affordability. However, the very high end of the rent distribution also has low vacancy primarily due to strong renter-by-choice demand for high-quality product in premier urban locations.

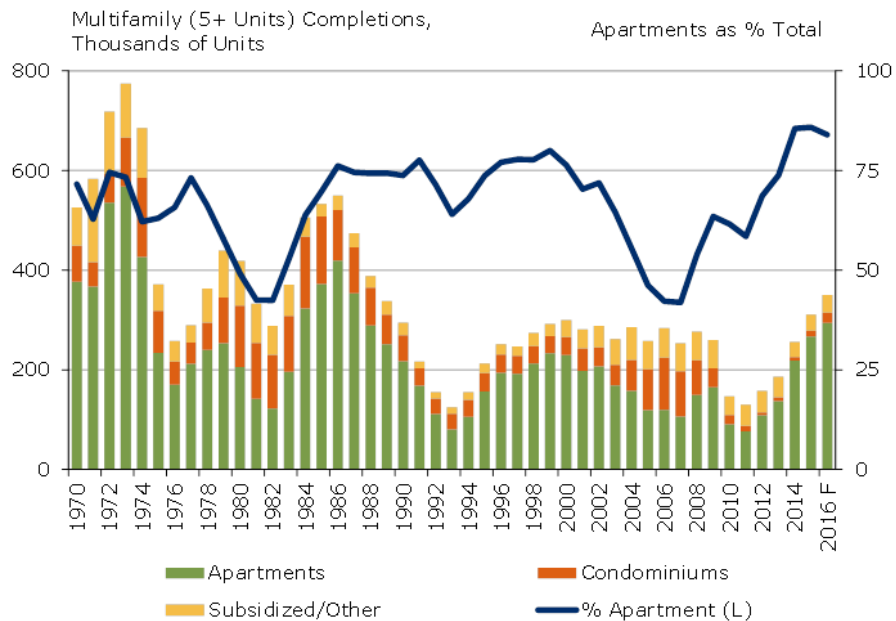
THE NATIONAL AGGREGATE SUPPLY DEFICIT

Despite the recent surge in multifamily completions, there remains an aggregate deficit of supply relative to demand nationally and in most markets.

Multifamily completions and permits have been rising steadily since the U.S. economy and housing market began its recovery in 2010. The pace of new multifamily development has been notably higher compared not only to single-family, but also to all major commercial real estate sectors. This, along with the maturation of the economic and real estate cycles, has triggered concerns about potential multifamily over-supply and subsequent deterioration in occupancy and rent growth.

The year-to-date pace of multifamily (five or more units) completions in the U.S. is about 310,000 units on an annualized basis, with about 85% being more traditional rental apartments. While this is the highest level of rental apartment completions since the late 1980s, the rate is still about 1.3% of the inventory, close to the average of the last 30 years. The year-to-date pace of multifamily permits, which lead completions by about a year, is about 380,000 units, 1.5% of the inventory or slightly above the 30-year average.

Multifamily Completions by Sub-Type



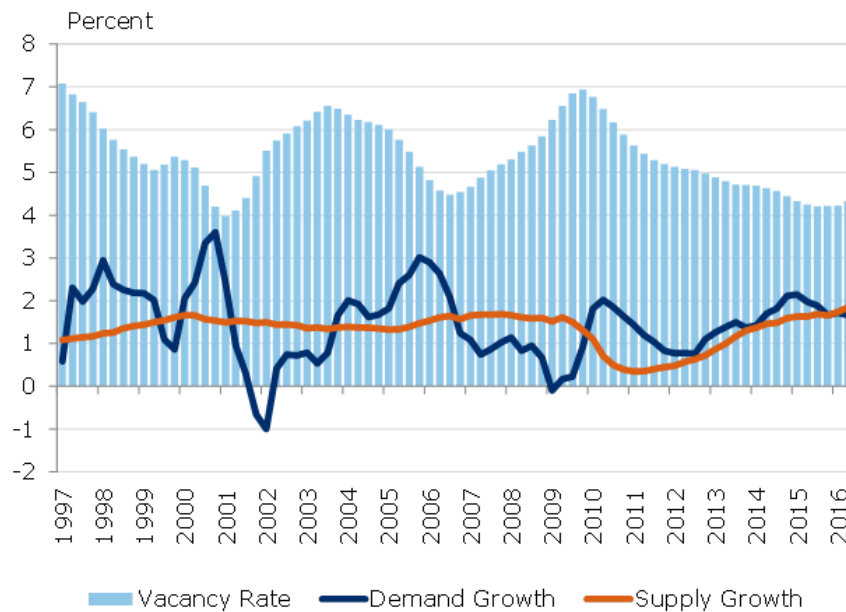
Sources: Bureau of the Census, Berkshire Group Research.

While growth in national demand has been slowing since early 2015, it was still ahead of supply at the end of the year. Growth in supply caught up with demand early in 2016 and exceeded it by mid-year for the first time since 2010. Markets covered by Berkshire Research are experiencing a similar trend with supply now growing by 1.8% on a year-over-year basis compared to demand growth of 1.7%.

In most markets it might take up to twelve months before vacancy rates return to historical norms.

Supply growth that outpaces demand could push vacancy rates higher, but current rates remain at historically low levels nationally. In most markets it might take up to twelve months before vacancy rates return to historical norms.

Multifamily Demand and Supply Growth in Berkshire Markets

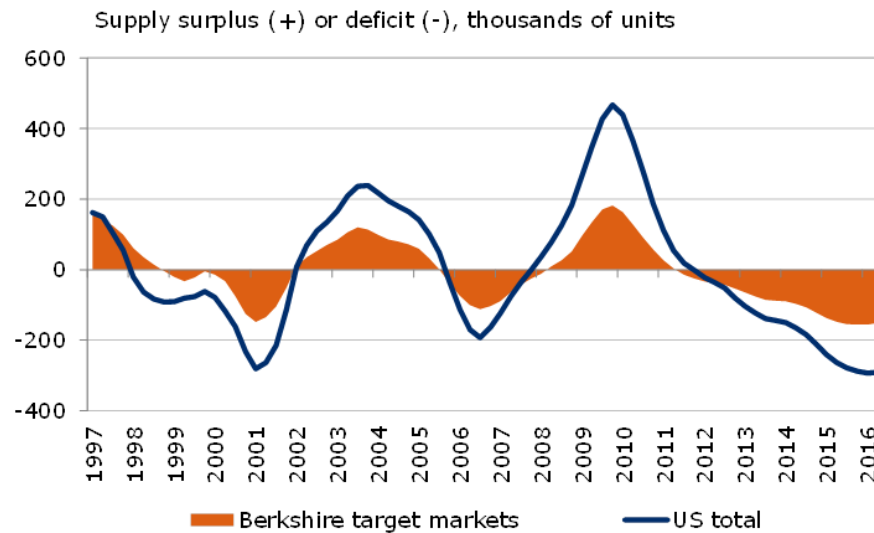


Sources: Axiometrics, Berkshire Group Research.

Historical trends suggest that U.S. multifamily supply should stabilize near the current pace of 300,000 units per year. However, this may not be enough to meet the current demand, given the gap between broader rental demand and supply that has formed over the past decade. While both rental demand and supply as shares of the total housing demand and supply are the highest in 50 years, the rental demand share still exceeds supply by a fairly tangible margin of over 50 basis points, which translates into 750,000 units.

Assuming that over half of this deficit is closed by the conversion of existing single-family units (currently owner-occupied or vacant) into rentals, there will still be a need for over 300,000 units of rental multifamily just to close the gap, which is a full year of new supply at the current pace of deliveries.

Multifamily Supply Surplus and Deficit



Sources: Axiometrics, Berkshire Group Research.

Beyond the near-term horizon of the next 12-24 months, multifamily completions should stabilize slightly above current levels. Historically, new supply has been strongly linked with real (inflation-adjusted) rent levels, reacting quickly to any changes. While real rent levels are now above historical averages in major markets, multifamily supply is still catching up.

Another factor that will likely contribute to stabilization of new supply after 2017 is tightening standards for lenders providing financing for new multifamily development. If lender underwriting for new construction remains conservative, this should constrain new supply and mitigate the risk of slower job growth and apartment demand that is currently projected to take place in 2018 and beyond.

Rising new supply is likely to push the national average vacancy rate up by about 100 basis points from its historically low level today. Even with the tangible increase in the average vacancy rate, it will still remain near the historical norm of about 5.5% allowing rent growth to continue but at a slower rate. With rents expected to grow only slightly above consumer inflation, completions should begin moderating after 2017 and largely keep up with demand.

Nationally, the current vacancy rate is 4.3%, 120 basis points below the long-term average and the current aggregate supply deficit is about 290,000 units (or 1.2% of the inventory). Assuming that the market behaves as it has at similar times in previous cycles (2000 and 2006), it will likely return to equilibrium in 2017, all else being equal.

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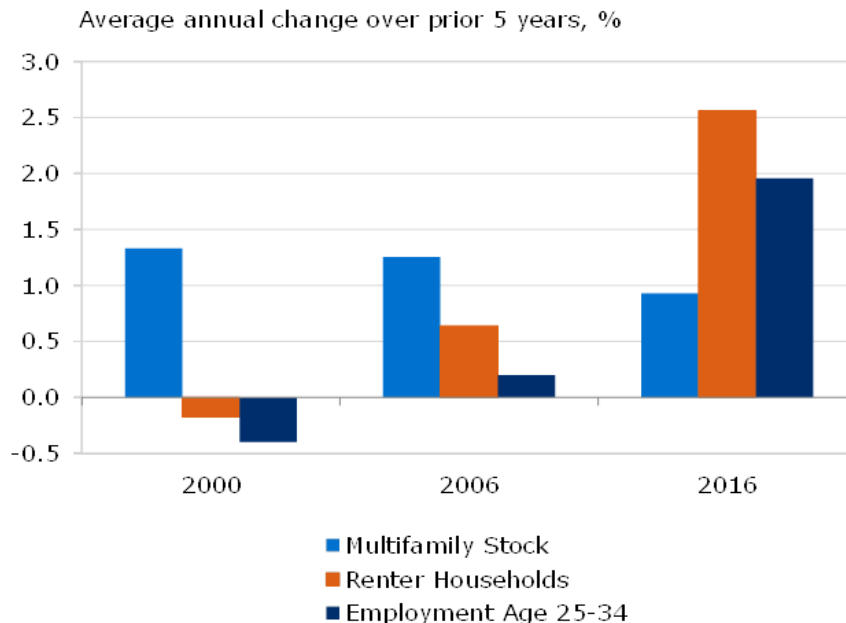
It is possible that rebalancing in the U.S. multifamily market could take longer than a year due to strong renter demand fueled by a number of factors and lender constraints on supply.

WHAT COULD PROLONG THE EXPANSION?

Projected job growth alone may not be sufficient in evaluating the duration of this cycle because a number of other factors make it quite different from the last two, including much stronger growth in broad rental demand, employment and prime renter households (ages 25-34). In addition, shifting long-term demographics (including the aging of the population and rise in single-person living) as well as resurgent urbanization, further complicate the traditional analysis.

The chart below shows average annual changes in total employment, renter households and multifamily stock over five-year periods preceding two previous vacancy troughs and compares them to the current point in the cycle.

Growth in Multifamily Supply vs. Demand Drivers



Source: Axiometrics, Berkshire Group Research.

Over the last five years, growth in multifamily stock has averaged about 0.9% per year, compared to 1.3% over the five-year periods preceding 2000 and 2006. At the same time, growth in renter households and employment for population aged 25-34 has been much stronger, averaging 2.6% and 1.9% per year, respectively. In contrast, renter household and employment growth for population aged 25-34 declined from 1995 to 2000 and increased only slightly from 2001 to 2006. With much stronger growth of key demand drivers in the current cycle, it could take up to two years to bring the vacancy rate back to its historical norm under current conditions or more than two years if the tightening in construction lending reported in recent months continues and further slows the pace of new supply.

Two major demographic trends are contributing to strong growth in broad rental demand—rapid growth among single-person households and households under the age of 35. Both groups are key drivers of multifamily demand, accounting for 49% and 35%, respectively. Growth among these groups is expected to continue over the next five years, further supporting multifamily demand.

Households under the age of 35 are a major source of pent-up housing demand. The share of these young adults living at home was 31.5% in 2015 compared to an average of 27.5% from 1985-2005, implying that there are 3.5 million more young adults living with their parents than a decade ago. As these young adults begin to move out and form their own households, they have the potential to further boost multifamily demand beyond current demand growth projections.

Furthermore, this is the first real estate cycle experiencing the transition of the Baby Boomer generation (a population of approximately 76 million) into retirement. While the majority of this group owns single-family homes, the size of this age group is so large that even a slight shift in preference towards renting, a trend observed in recent years, has the potential to generate strong absolute demand for apartments.

This cycle has also been accompanied by a more tangible population growth in the central cities compared to the last two cycles. It is only recently that multifamily supply started to catch up with the surging demand mainly at the higher end of the rent spectrum, and there are indications of a significant supply deficit for mid- and low-priced urban apartment product.

EVALUATING NEAR-TERM SUPPLY RISK ACROSS MARKETS

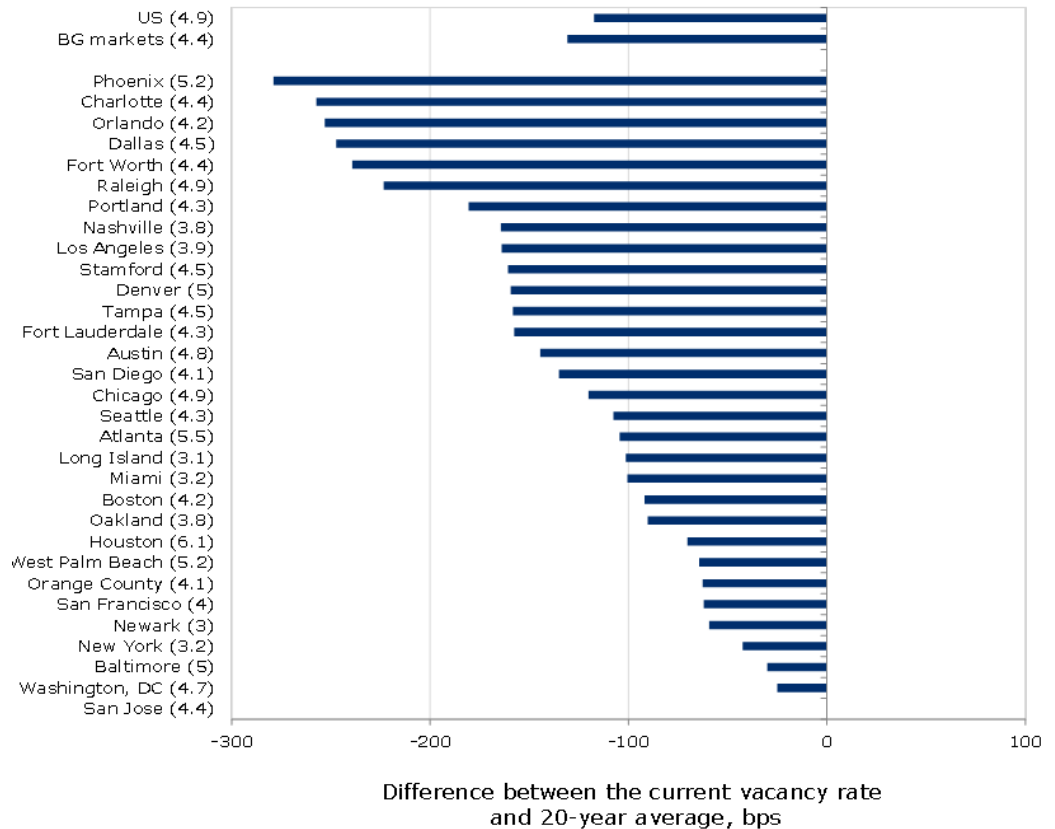
All major markets are currently tight by historical standards and are experiencing multifamily supply deficits to a larger or lesser degree as a result. The national vacancy rate is 120 basis points below the 20-year average except for a handful of markets, including Phoenix, Orlando, Charlotte, Dallas and Fort Worth, where the gap is more than twice as wide. At the same time, the current vacancy rates are at or only slightly below the historical norms in San Jose, Washington, D.C., Baltimore, New York, Newark and San Francisco.

All else being equal, markets where vacancy rates are low by historical standards are better positioned to deal with near-term supply pressures. Of course, much also depends on how quickly new supply might be growing relative to local demand.

Markets with higher current multifamily supply deficits tend to have lower near-term supply risk. Phoenix, Raleigh, Orlando, Fort Lauderdale, Los Angeles, Chicago, Tampa and Oakland remain relatively under-supplied and present more opportunities for additional new development in the near term. In contrast, Nashville, Newark, Stamford, Houston, New York, Austin, Orange County, San Jose, and Atlanta are facing higher supply risk in the near-term given their development pipelines relative to job growth and their current points in the vacancy cycle.

All major markets are currently tight by historical standards and are therefore experiencing multifamily supply deficits to a larger or lesser degree.

Supply Deficit across Markets



(*) number in parentheses shows the average vacancy last over the last 4 quarters
 BG markets: Simple average of the markets shown on this chart
 Sources: Axiometrics, Berkshire Group Research.

Most urban and suburban submarkets remain tight by historical standards and need more new supply to achieve more balanced conditions.

CURRENT CONDITIONS ACROSS SUBMARKETS AND CLASSES OF PRODUCT

In addition to evaluating supply/demand balance at the metro-level, current conditions for 419 suburban and 102 urban submarkets across our 31 target markets were analyzed. Class of product also was evaluated to highlight any variances in potential supply risk.

The submarket-level analysis shows that suburbs are currently facing a slightly higher supply deficit relative to urban areas. The average vacancy rate across suburban submarkets is 4.4%, or about 120 basis points below the historical average, while the average vacancy rate in the urban submarkets is 4.2%, or 100 basis points below the norm. Most urban and suburban submarkets remain tight by historical standards and need more new supply to achieve more balanced conditions.

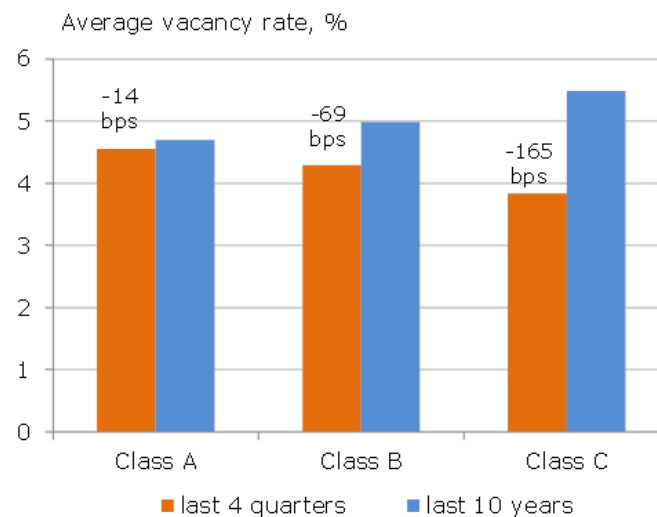
At the same time, multifamily permitting rates are tangibly higher than renter household growth in the cities, while they are about the same in the suburbs, which also suggests potentially higher near-term supply risks in the urban submarkets. However, this risk could be mitigated if

urban apartment supply growth slows down after 2017 while the growth in renter households increases or keeps its current pace.

The contrast between urban and suburban supply trends is also reflected in the dynamics of performance by class of product. The current vacancy rate for Class A is essentially back to its 10-year average and slightly above the average vacancy rate for Class B and C properties. In contrast, there remains a wider cushion between the current and historical vacancy rates for Class B and especially Class C product both in cities and the suburbs.

Overall, apartment supply is now closer to being in balance with demand in urban submarkets and Class A product, while apartment supply still appears to be lagging demand in suburban submarkets and Class B and C product.

Vacancy Rates by Class of Apartment Product

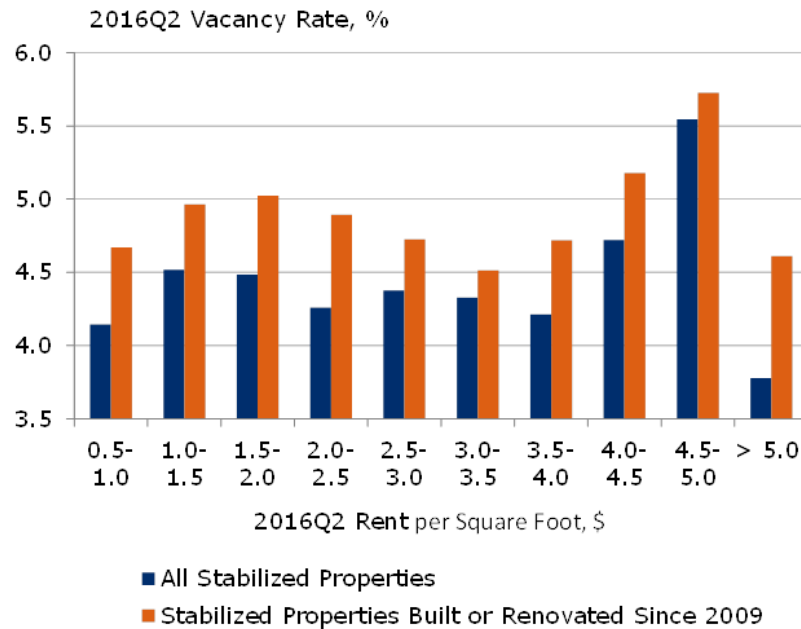


Sources: Axiometrics, Berkshire Group Research.

Overall, apartment supply is now closer to being in balance with demand in urban submarkets and Class A product, while apartment supply still appears to be lagging demand in suburban submarkets and Class B and C product.

Beyond strict submarket or class definitions, there is also substantial variation in vacancy rates across the rent spectrum. Vacancy rates are the highest for properties with rents per square foot in the \$4.50-\$5.00 range followed by the \$4.00-\$4.50 range, while vacancy rates for properties with rents above \$5.00 and those in the \$3.00-\$4.00 range are among the lowest—suggesting a different dynamic on the low and high end of the class A product relative to its middle.

Current Vacancy Rates across the Rent Spectrum



Sources: Axiometrics, Berkshire Group Research.

In examining vacancy rates grouped by incremental distances from the city, properties within one mile of the city center have the highest vacancy rates, but these rates drop substantially for properties located on the edge of cities (within 3-5 miles from the center). Many of these properties also have rents in the range of \$3.00-\$4.00 per square foot, suggesting a potential supply deficit for high-quality urban apartment product at a more competitive price point close to the center.

CONCLUSION

On a national level in the aggregate, the deficit of multifamily supply indicates that there is not enough. U.S. rental demand has expanded at a record rate over the past decade, and despite the recent increase in new multifamily construction and the massive conversions of previously owner-occupied single-family homes into rentals, the market remains tight by historical standards. However, some markets, locations and types of product face higher near-term supply risk as their vacancy rates are likely to surpass historical averages within the next year, which could put a more pronounced stress on rent growth at this stage in the cycle. High-end apartment product in the central urban core is particularly exposed to this elevated risk.

However, when evaluating supply risk for a specific investment, it is important to evaluate market conditions along the entire spectrum of rents and locations, rather than the often rigid and limited submarket and class categories. A closer look at the distribution of vacancy rates by more incremental segments of rents and distances from the city center shows that the edges of the urban/suburban divide and the middle range and very high end of the rent distribution are potential investment targets.

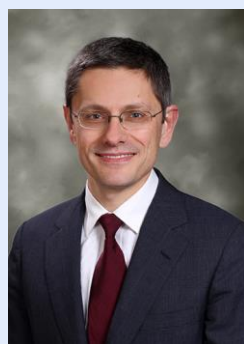
The edges of the urban/suburban divide and the middle and very high end of the rent distribution face lower supply risk.

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Mr. Nechayev leads the development of original real estate research at Berkshire Group. He is a recognized real estate economist specializing in multifamily markets, with nearly two decades of industry experience counseling institutional and private clients. Mr. Nechayev holds a Masters in City Planning from the Massachusetts Institute of Technology, and is a graduate of the National Economic University of Kiev, Ukraine. He is a member of both the Urban Land Institute and National Multifamily Housing Council.



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