Buying into Rental?: Tracking the Multifamily Real Estate Market

September 2011

Brian Bailey: *Welcome to the Federal Reserve Bank of Atlanta's* Perspectives on Real Estate *podcast series. I'm Brian Bailey with the Federal Reserve Bank of Atlanta. Today, we're talking with Ron Johnsey, president of Axiometrics.*

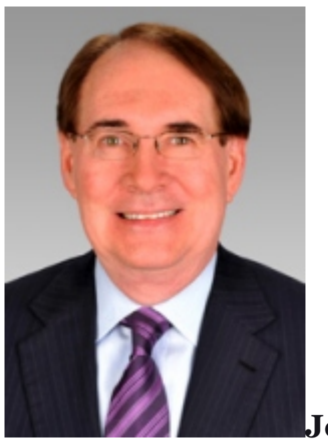
Ron has over 25 years of experience in the development, financing, marketing, and property management of commercial and residential properties. In 1994, he founded Axiometrics to measure the performance of the apartment sector. Axiometrics tracks over 14,000 properties on a monthly basis in over 300 U.S. markets.

Taking advantage of Ron's extensive experience and specialized perspective, this podcast will explore the state of multifamily real estate through discussing trends, challenges, and opportunities facing the apartment sector.

Ron, thank you for joining me today.

Ron Johnsey: Brian, I'm glad to be here.

Bailey: *Please give us an overview of the current conditions impacting the multifamily real estate market.*



Johnsey: Well, the multifamily real estate market is performing at the highest level I have seen in over 15 years that I've been in this business. The primary driver for demand for apartments is job growth, and even though job growth has been anemic, and in some markets it's even declining, at the national level, we're seeing about 1.3 million jobs being created since at least July 2010 to July 2011. So, we're getting a little bit of help from job growth.

But, the other thing going on is that we're seeing renter household formation at record levels—it's over 1.4 million based on the census's latest numbers. And this is occurring because we see the homeownership rate declining from 69 percent to 66 percent today. And there is less interest in owning homes because the buyer sentiment is just not there. The renters that would move out to buy homes, they see the home prices declining, they see that they have to have higher down payments, better FICO scores, and so on, and all of this is working to create more renter demand for conventional market-rate apartments.

Now, demographically, you also know that there is the "echo boomer" generation. They are starting to enter the prime renting age cohort of 24 to 34 years of age, so that's helping. We know that the job growth in this age cohort is well above the national average—it's maybe around 3 percent. We also see that there's a low unemployment rate for college graduates, and so all of those things are helping create really strong demand.

Now, the other thing that is really significant as well is that there's very little supply. If we look at supply over the past three years—and I'm going to count 2009, 2010, and then 2011 year-to-date through July—we were averaging about 140,000 multifamily units permitted. That is almost a record low. If you go to 2009, I think, it *would* be a record low. So, historically, we supplied well over, let's say, 400,000 historically, and the long-term trend, and the most recent—it may be in the 300,000 range—but this is a huge difference in supply that basically make the apartment market really tight. And then at the property level, we are also seeing that turnover rates—in other words, move-outs to homeownership—are at historically low levels. Typically, you have 20 percent of your turnover rate attributable to first-time homebuyers. We're seeing that more in the 11 percent range. So renters are staying put, they're not traveling, and that's resulting in really strong apartment fundamentals.

Bailey: *Over the last 15 years, multifamily occupancy rates have averaged approximately 94 percent. The occupancy for quarter 2 of 2011 was 94 percent. In your opinion, Ron, with an occupancy rate that by historical standards might be considered average, should we be concerned with an effective rent growth rate that is higher than normal?*

Johnsey: No, I really don't because I think the apartment market will take care of itself, and what I mean by that is that renters will opt to control their housing costs. In other words, if you're a renter and you're paying a thousand bucks a month and they increase your rent to $1,100, what that renter will do is say, "OK, I can't afford this increase, so I'm going to go find another floor plan that is priced about the same." So it means that they may move down the food chain, so they may move from an "A" property to a "B+", and then someone in a "B" may move down to a "B-". The other things that can happen with these increases, and that would also result in a more stable occupancy rate, is that renters will start to double up again. In the decline, we saw renters that were worried about their jobs find roommates to lower their housing costs. Well, that effect can take place, again, as these rents are escalating at these great rates. So renters will then double up; they can move back home; they might even start renting single-family homes—you get three roommates, you rent a three-bedroom house, and you really lower your housing costs.

Bailey: *You touched earlier on the single-family rental market, and the increases in that. Can you tell us, how much impact is the home foreclosure crisis having on demand for apartments? Is the foreclosure crisis/lack of credit issue artificially inflating demand for multifamily product?*

Johnsey: I think it's causing the homeownership rate to drop, and renting is benefiting from that because we are seeing more renter household formation. It basically just helps the apartment market because it makes homeownership less attractive. Renters are less likely to buy a home when there is foreclosure because they are concerned about prices. Who wants to go buy a home, but then see its value go down?

But, let me just say one other thing, too, is that renter housing has always been a way station to single-family homeownership. You cannot, in my opinion—you know, the typical apartment is not designed for raising a family. So if you want to raise a family you are probably going to move into a single-family home, and I just don't see that changing. So I think that's why the homeownership rate will probably "revert to the mean," as they say, maybe around 65 percent, and we might see the turnover rate in apartments (move-out to first-time homeownership) increase back to its historical level. But, you know, the foreclosures make buyer sentiment that much more difficult.

Bailey: *You touched on this earlier. We've seen an uptick in the number of permits pulled recently on projects. What trends are you seeing on the multifamily supply side right now?*

Johnsey: Well, as I said earlier, it is at historically low levels. If the U.S. is maybe 140,000 units on average, and the long-term average is probably in the 340,000 range, so it is very low at this particular point in time. However, because we're having such strong apartment market fundamentals, we're starting to see the permitting activity pick up, and even though it's picking up percentage-wise, it's sort of a statistical recovery, you might call it. In other words, if you go from 1,000 units per minute to 2,000, well that's a 100 percent increase. We're seeing that effect going on right now. And there are markets like Dallas, where, from a year ago, July permitting is up 200 percent, Seattle is up 150 percent, Austin is 249 percent, Miami is 173 percent. But you can look at Tampa—Tampa is still down 1.3 percent, Charlotte's down 30 percent, but, you know, Raleigh's up 100 percent. So, it really depends by market. San Jose is an exception—it's already exceeded its peak in terms of permitting. But, again, that market has some really strong apartment market fundamentals. It is the strongest apartment market in the United States right now.

Bailey: *Given that the multifamily sector has been the healthiest sector in commercial real estate for some time, and that it has been able to readily attract investors and financing, do you have concerns that the sector may deteriorate or experience over-supply in the future?*

Johnsey: Yes, I do. But, you know, this is a cyclical industry. Again, the strong apartment fundamentals will eventually generate oversupply. I think it's just hard to break old habits. It's hard to see, you know, what's going on. A developer will go into a market, find a site, and build on it, and he'll look around and say, "Well, I've got the best site. I have the best product. I got great financing. I'll capture more of the market share." And you sort of have this idea that just takes hold. And then you have to add the—when you talk about oversupply, it relates really to, what is the demand versus the supply? And I really don't see oversupply hitting until maybe 2015 or 2016. But, again, it really depends on, what is the job growth at that point in time? We will have, again, close to record levels of deliveries in those years. Will we have the job growth? And we're forecasting something like 2.5 percent job growth at the national level. And so, will that occur? If that doesn't occur, then we would have, obviously a correction. But, looking out at our forecast into 2016, we do see the impact of that excess supply starting to hit. It is going to happen. But, again, the severity of it is going to depend on what the demand for it is. Are we going to get robust job growth? Right now, we are benefiting from record renter household formation, but once the single-family market gets back in swing, then we'll see more production, we'll see home prices going up, and that will feed more single-family production. And, right now, we're seeing prices of multifamily products escalating, and that's contributing to supply as well.

So, all those forces are going to come together. We have a great opportunity over the next three to four years in the apartment industry. But you get into those 2014, 2015, 2016 years, there's a lot of—let's call it "shocks"— that could happen also that could change these outcomes.

Bailey: *Ron, thank you for joining us today.*

Johnsey: I really appreciate it.

Bailey: *This concludes our podcast with Ron Johnsey, president of Axiometrics. For more podcasts on this topic and others, please visit the Atlanta Fed's website at frbatlanta.org.*

If you have comments or questions, please e-mail podcast@frbatlanta.org. Thanks for listening.