A Multi-Dimensional View of MULTIFAMILY

BY JAMIE WOODWELL

The multifamily market is coming back strong, with new demand fueled partly by former homeowners. Will the trend hold?

The last few years have been a period of dramatic change for the U.S. economy and its real estate markets. With most of the focus on single-family owned housing, the degree to which change has come to multifamily apartment markets may not be getting the attention it deserves. Multifamily markets are shifting rapidly, and the ways in which builders, owners, lenders and investors interpret and respond to these changes will affect multifamily finance for years to come.

The market

According to the U.S. Census Bureau's *American Housing Survey,* of the 111.8 million households living in the United States in 2009, 35 million (or 32 percent) rented their homes, including 15 million (or 14 percent of the total) who rented apartments in multifamily (five-plus-unit) buildings.

The degree to which households rent versus own has been on a rollercoaster in recent years.

From 1994 to 2004, the share of households that owned their homes rose from 64 percent to 69.4 percent. The share of households renting fell from 36 percent to 30.6 percent.

From the perspective of rental housing markets, the 6 percentage point rise in the homeownership rate more than negated the impact of household growth over the period. From the end of 1993 to the end of 2004, the United States added 12 million households, but because of the move to homeownership, demand for rental housing declined by 2 million households (see Figure 1).

In response to the move to homeownership from 1994 to 2004, construction of new homes climbed from 1.6 million units in 2000 to 2.1 million units in 2005, according to Census Bureau data. During that period, single-family home construction grew from 1.2 million units to 1.7 million units per year, while construction of multifamily properties remained relatively flat in the range of 290,000 to 315,000 units per year.

The numbers confirm that as households increasingly moved to single-family homeownership, new construction did as well.

These statistics differentiate by the number of units in the property being built, but not whether a property was intended for sale to owner-occupants or to be leased to renters. Other data show that even among the multifamily properties being built, an increasing share of units was intended to be owner-occupied rather than rented.

According to census surveys, in 2000, 22 percent of the units started in buildings with two or more units were being built with the intention of selling the units—generally as condominiums. With the growing trend toward homeownership, that number rose to 45 percent in 2006.

But starting in 2005, these trends reversed course—dramatically.

Over the period of the early 2000s, the percent of U.S. homes sitting vacant steadily climbed. At the beginning of 2000, 7.9 percent of rental units were vacant and for rent, and 1.6 percent of owner units were vacant and for sale. The share of rental units sitting vacant climbed to 10.1 percent in 2007 and the share of owner units vacant climbed to 2.8 percent. The number of vacant homes exceeded 6 million.

These historic levels of excess supply brought construction to a halt. Total housing starts fell from 2 million units in 2005 to 554,000 units in 2009. Single-family starts fell from 1.7 million units to 445,000 units, and multifamily starts fell from 311,000 units to 91,000 units.

New supply wasn't the only aspect of the market to respond. As turbulence in—and uncertainty about—the single-family homeownership market pushed more households to rent, housing demand shifted radically.

A quick rule of thumb is that all else being equal, a 1 percentage point decrease in the homeownership rate translates to a 3 percent increase in demand for rental housing.

Since peaking at 69.4 percent in 2004, the homeownership rate has fallen to 66.6 percent as of the fourth quarter of 2010. The share of households renting has risen from 30.6 percent to 33.4 percent.

Even without taking household growth into account, the change in the homeownership rate between 2004 and 2010 has meant a 10 percent increase in demand for rental housing. Adding to rental demand is the fact that the United States added 4.28 million households between the end of 2004 and 2010.

The result: The number of renter households increased by 4.35 million and the number of owner households remained essentially flat.

Multifamily fundamentals

Fundamentals in the multifamily apartment market are being whipsawed by these changes.

According to data from New York–based Reis Inc., apartment vacancy rates rose from 5.5 percent in 2006 to 8 percent at the end of 2009 as recession-bred contraction in the number of households pulled back on apartment demand.

With a return of household growth and a drop in the homeownership rate, vacancies fell to 6.6 percent as of the end of fourth-quarter 2010.

The falling vacancy rates have staunched drops in rents. After peaking at $1,051 per unit in 2008, average asking rents at investment-grade properties fell to $1,026 at the end of 2009—a 2 percent decline. They have since worked back up by 2 percent, to $1,043 per month as of the end of 2010.

Incomes at multifamily properties are more volatile than at many other types of income-producing properties. The relatively short lease terms mean nearly every unit has an opportunity to re-price during a recession. This contrasts with longer lease-term properties such as office buildings or shopping malls, which may see only a fraction of their leases turn over during a downturn.

As a result, changes in vacancy rates and asking rents had a more immediate impact on multifamily properties' incomes than on many other property types.

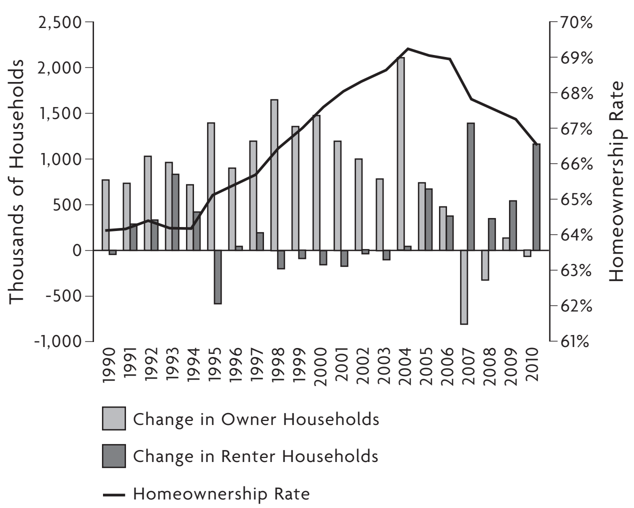
According to data from Charlottesville, Virginia–based SNL Financial LLC, among real estate investment trusts (REITs), the year-over-year weighted average median decline in same-property net operating income (NOI) peaked at 6.6 percent for multifamily properties (in the fourth quarter of 2009), compared with recession-high declines of 20.7 percent for hotel properties, 5.9 percent for shopping centers, 4.8 percent for regional malls, 4.8 percent for industrial properties and 2.9 percent for office properties (see Figure 2).

Short lease terms and improving fundamentals mean that multifamily properties have bounced back more quickly, with median REIT incomes turning positive in the third quarter of 2010 while many other property types remain at a standstill.

Property sales and values

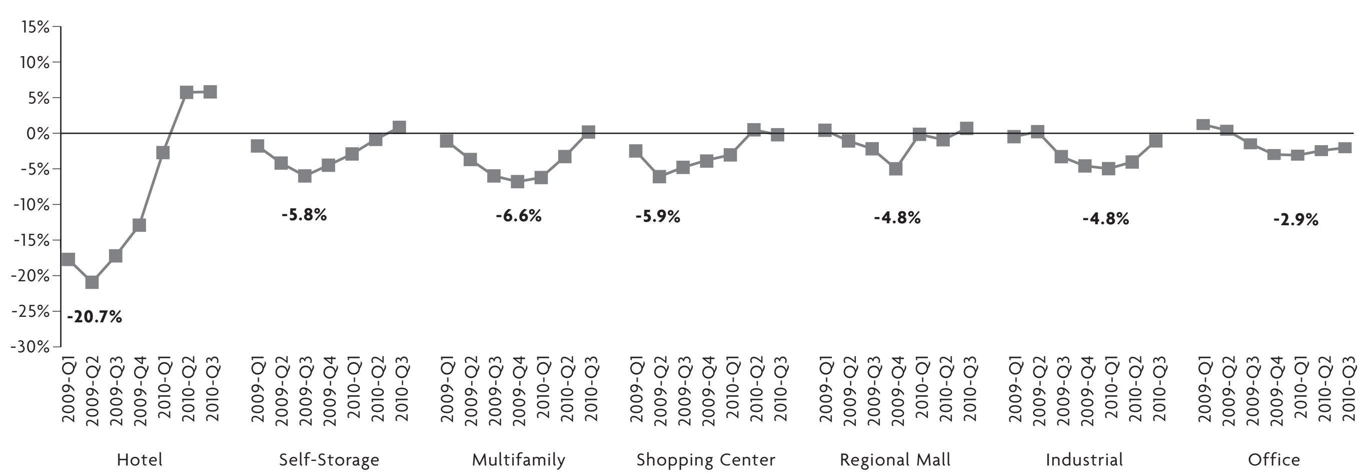
After peaking during the 2006 and 2007 period, prices on

Figure **1** **Year-Over-Year Changes in the Number of Owner- and Renter-Occupied Households, and Homeownership Rate**



SOURCES: Census Bureau, Mortgage Bankers Association (MBA)

Figure **2** **Year-Over-Year Change in Real Estate Investment Trust (REIT) "Same-Property" Net Operating Incomes (NOIs), Q1 2009–Q3 2010**



SOURCES: SNL Financial, MBA

multifamily properties fell during the recession roughly in line with prices of other types of income-producing properties. According to data from New York–based Moody's Investors Service's Commercial Property Price Indices (CPPI), the recession brought a 40 percent peak-to-trough decline in multifamily property prices, compared with declines of 39 percent for retail properties, 38 percent for industrial properties and 36 percent for office properties.

Since bottoming out, prices for apartment properties have climbed 20 percent, compared with increases of 5 percent for industrial properties, 10 percent for office properties and 15 percent for retail.

With pricing getting stronger, the average cap rate on apartment loan commitments reported by the American Council of Life Insurers (ACLI), Washington, D.C., during the fourth quarter was just 5.9 percent (see Figure 3).

Financing

Multifamily originations increased by 20 percent between 2009 and 2010—among the smallest increases of any property type. The minimal increase was mainly driven by the fact that Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA) remained active in the market in 2008 and 2009, while originations by many other investors declined.

Over the last three years, multifamily markets have been dominated by government and government-sponsored lenders. The Mortgage Bankers Association's (MBA's) annual commercial/multifamily origination surveys showed that in 2009, Fannie Mae and Freddie Mac accounted for more than 80 percent of the dollar volume of multifamily originations. That fell to just over 60 percent in 2010, as FHA's share increased to roughly 25 percent.

By the fourth quarter, competition from life companies and others had heated up, providing some competition for the government-supported lenders. Total fourth-quarter 2010 commercial and multifamily originations were 88 percent higher than fourth-quarter 2009 volumes, and life company originations were 170 percent higher.

Low interest rates, stabilizing market fundamentals and rebounding property values are all helping the finance market, but have by no means relieved all the stress.

Mortgage performance

For most investor groups, multifamily mortgages have performed roughly in line with other commercial mortgages.

MBA's quarterly *Commercial/Multifamily Delinquency Rates Among Major Investor Groups* report shows the delinquency rates for multifamily and commercial mortgages held by life insurance companies are both extremely low, particularly given the depth of the recession, and generally parallel the performance of multifamily loans held by Fannie Mae and Freddie Mac.

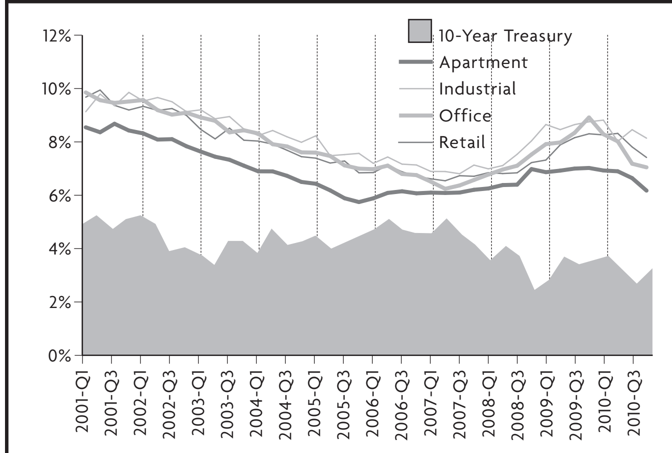
At banks and thrifts, the multifamily and commercial mortgage 90-plus-day delinquency rates have both increased during the last three years, peaking in the latter half of 2010 at 4.36 percent for commercial mortgages and 4.67 percent for multifamily mortgages (see Figure 4).

The exception to this parity in the performance of multifamily and commercial mortgages is in the commercial mortgage-backed securities (CMBS) market. Here, the multifamily 30-plus-day delinquency rate (including real estate–owned [REO]) ended 2010 at 14.9 percent, while the rates for other commercial property types ranged from 14.6 percent for hotels to 9.6 percent for industrial, 8.1 percent for retail and 7.4 percent for office properties.

A number of factors likely contribute to this higher rate. In developing pools of loans for CMBS, securitizers sought a diverse group of loans across geography, property type and other criteria. This was reinforced by rating methodologies that gave added credit for an ample inclusion of multifamily mortgages.

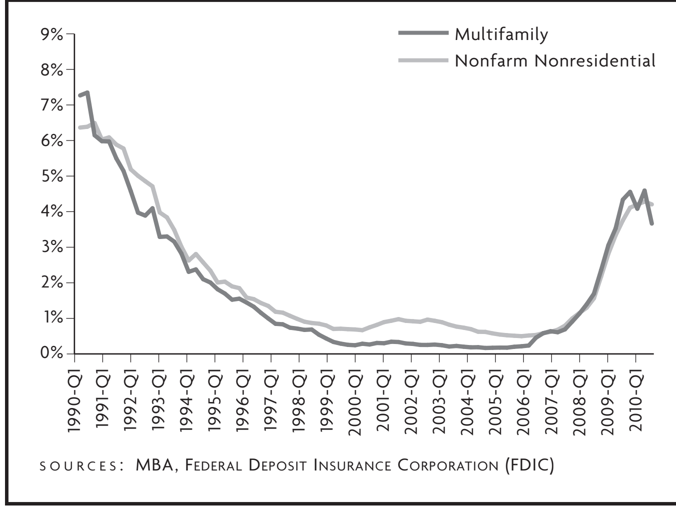
In addition, Fannie Mae and Freddie Mac were avid consumers of CMBS bonds tied to multifamily loans within a pool. Based on data from the Federal Reserve and the Federal Housing Finance Agency (FHFA), approximately three-quarters of all CMBS funding for

Figure **3** **Commercial/Multifamily Capitalization Rates, Properties and Portfolios, $5 Million and Greater**



SOURCES: Real Capital Analytics, Federal Reserve Board

Figure **4** **90-Plus-Day Delinquency Rates at Banks/Thrifts**



SOURCES: MBA, Federal Deposit Insurance Corporation (FDIC) multifamily mortgages came from Fannie Mae and Freddie Mac. All these factors meant originators were heavily incented to compete for multifamily product for CMBS.

As multifamily market fundamentals have firmed, so has the performance of multifamily mortgages, with multifamily mortgages performing considerably better during this recession than during the last major real estate crash of the late 1980s/early 1990s.

Outlook

Multifamily rental markets have benefitted from the turmoil in the single-family ownership market. The fall in the homeownership rate has created a surge in demand for rental housing, filling vacant units and bringing stability to rents and property incomes.

The biggest factor in how multifamily markets will perform in coming years will be how homeownership trends play out from here.

Continued uncertainty, weak fundamentals and tight credit could all continue to put downward pressure on the homeownership rate. At the same time, low interest rates, housing affordability and a wave of potential new homeowners could counterbalance, or mute, these trends.

Should homeownership rates continue to decline, the net effect will be that most, if not all, household growth—1 million households a year or more—will translate into rental demand, a share of which will look to multifamily rental. Should the homeownership rate stabilize, rental demand will equate to approximately one-third of household growth—approximately 300,000 households per year. Should the homeownership rate start to grow again, rental demand will come in lower.

The multifamily market is rebounding more quickly from the effects of the Great Recession than other property types. Continued weakness in the single-family ownership market is likely to extend that trend. **MB**

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