Inflation/Housing

Apartment Execs: Rents Continue to Break Records, But Increases Now More Muted

- *The Days of Double Digit Increases Are Gone, Now in the 1 Pct to 5 Pct Range*
- *Even With Occupancy Rates in the Mid-90s, Incentives Spotted on Luxury Units*
- *Economics Dictate to Build Luxury, Creating a Squeeze in Workforce Housing*

By Gary Rosenberger

NEW YORK (EconoPlay) Oct. 13 – Apartment rents continue to break records heading into the slow time of the year – but the trajectory is flattening on a cluster of new supply and on the failure of wage growth to keep pace with rents, industry officials say.

The rent trajectory, which not long ago hit double-digits in some major markets, now runs anywhere from 1% to 5%, with the national average closer to 2% or 3%.

Occupancy rates are still fluctuating in the mid-90s – even with millennials back on a home ownership track, if not quite with the same enthusiasm as prior generations.

In reality there are two apartment markets moving independently of each other.

Land, labor, and construction costs, along with high impact fees, dictated that luxury development was the way to go. But the very rich represent a limited universe of buyers and luxury is on the verge of being overbuilt in some markets.

That has compelled developers to offer incentives (one month's free rent or free parking) to bring occupancy rates up, or otherwise slow the pace of construction.

Meanwhile, affordable housing got little attention during the run up, prompting a shortage of workforce housing – a big issue for communities that can't attract public and private sector workers because there's no place for them to live.

Trendy micro-apartments have been a partial answer to the problem, but their utility ends the minute young people decide to move in together to raise a family.

"It's been a strong year. But it seems, for some reason, that last year was a little better here," said Debbie Done, president of Apartment Search, a locator service in St. Louis.

Boeing had something to do with that flux. New defense contracts generated a spike in relocations to St. Louis last year, "but there was a bit of a stall this year," she said.

“There was even a freeze for a while, but now we’re getting more of a flow from Boeing again. That’s important for us because a lot of what we do is relocation business.”

Rents haven’t moved much last year to this year. Done estimates the increases are on the order of 1% to 2%. “We’re also seeing a lot of new construction coming up. We saw new properties come in towards the end of last year into this year, and more to come next year. So there’s a bit of a surge,” she said.

A greater supply of apartment rentals is good for the apartment search business and for renters, as it sparks more competition among landlords that stabilizes rents.

“We didn’t see anything in the way of incentives in the spring and summer, but we probably will start seeing some in the fall and winter when traffic slows down,” she said. “But it won’t be anything like years ago when we saw incentives of three months’ free rent. Those days are long gone.”

Smaller Upticks

“Rents are still on an upward trajectory, but they are location specific and property specific,” said Joy Anzalone, chief operating officer at Burton Carol Management in Cleveland with properties in Ohio, Michigan, and Florida.

Rents are higher because people are still choosing to rent. “So it’s a good time to be in the apartment business,” she said.

But the rent trajectory flattens as the market approaches a peak because it’s easier to raise rents from a low benchmark. “You also have to provide value,” she said. “You can’t ask for a price that’s not fair for what you are renting.”

Among the states where she operates, Michigan has been her best market in terms of occupancy, with Florida “right there with it.”

Ohio, too, is strong but “more location specific” and if rents there are flattening, “they’re not going backwards,” she said. “We’re just having smaller upticks.”

Has the rental market peaked? “The only way to know that is to know the future, so I don’t know that,” Anzalone replied. “But I’ve been around for a lot of years and I know that at some point this will end. I just don’t know when.”

Kevin Miller, president of Westside Rentals with seven offices covering Santa Barbara to San Diego, is seeing landlords offering move-in incentives to raise occupancy for the first time since the depths of the recession.

“There’s a pocket in downtown LA where we are seeing that. They’ve built nearly 6,000 units in the last two years with 10,000 more slated to hit the market in the next couple of years,” he said.

With that much new supply, rents are leveling off. “So there seems to be a little more normality, which is a new thing out here,” he said.

Rent increases are 3% to 5% inland and 5% to 8% by the water. “But that used to be 10 or 12 percent, even more. I don’t think we’ll see double-digit increase anymore for a while,” Miller said.

As the benchmark on rents increases, it gets more difficult to justify the percentage increases achieved at a lower base. “You also get to the point where you are finally seeing new inventory hit the market, so you’ve got to be a little strategic,” he noted.

A Bifurcated Market

The new units coming in cover the extreme ends of the housing spectrum. There’s luxury, chock full of amenities and technology (one development even offers butler services) with the other end consisting of micro apartments.

“That’s the new thing all over the country, and it’s no different out here. They are more affordable and close to work, but you obviously sacrifice space. They’re being built for the millennials that just moved out of their parents’ houses,” Miller said.

“The problem is that there is nothing in the middle. What is in the middle is the 20- to 30-year-old building, where the landlord is not in the mood to revamp because it is already full of good tenants,” he said.

He does worry about the possibility that developers may have gone overboard on luxury apartments, if only because the audience for luxury is relatively small.

“It’s a slippery slope, especially for the guys that are late to the game. The first ones got filled and are doing fine. But we are seeing one-month free rent and tons of concessions in downtown LA because there is so much new inventory,” he said. “They see the cranes, so they want to get their buildings filled.”

Millennials moving out of their parents’ homes are keeping rents high. “Even if they wanted to buy, prices are high and so are down payments. Plus you have tough lending conditions. So it’s a three-headed monster – good luck,” Miller said.

“I think the rental market is strong, and I think we’ll see at least another year of rent increases,” said Hans Hagen, president of Hans Hagen Commercial Properties based in Maple Grove, Minnesota, operating some 500 units near the Twin Cities.

Rents continue to rise because developers are rehabbing decades-old buildings and running up rental prices, complicating the comparisons. However, he roughly estimates local rents are up in the 2.5% to 3.0% range.

Wage growth has lagged rent increases in this recovery, squeezing working-class communities. “The new product in downturn areas is getting smaller and smaller. They’re now building 450-square-foot units for young people and charging $2 a square foot, which is fine for now. But as millennials get married and have children, what will happen to those units in 10 years?” Hagen asks.

“There’s a housing affordability problem going on. Developers buy a building and renovate it then they have to charge more for rent,” he said. “If you could build at a lower cost and rent to lower-wage people, you would do it in a heartbeat. But the government impact fees alone add a minimum of $15,000 to $35,000 per unit.”

So developers are now in a precarious position of not satisfying a mass market while possibly overbuilding for a luxury segment with a relatively small customer base.

“If the government tells you that 20 percent of what you produce has to be affordable, what you do is jack up the price for everyone else. Frequently, they give you some subsidy or special financing, but that usually only covers a part of the impact fees they lay on you,” Hagen said. “It creates an undersupply of affordable housing and an oversupply of luxury.”

The Big Short

Tamela Coval, executive strategist for CORT Destination Services in Cincinnati, a national relocation service provider, notes that her tweeter feeds are abuzz over “running out of apartments to rent.”

September occupancy rates for the entire nation sat at 95.1%, which is impressive, even if down a hair from August and year ago. “September marked the seventh straight month in which occupancy has been above 95.0% on a national basis,” she said.

Yet “apartment construction in some markets has slowed a bit,” she added. “But it was kind of needed to because there is a tendency to overbuild in multifamily.”

Some metro markets continued to break records while a smattering posted declines owing to new construction. So average rents in September grew by 2.6%, well above the historical norm of 2.2% but also the lowest increase since July 2010.

Labor shortages are contributing to the supply crunch, forcing construction delays. “A lot of units that had been predicted for the fourth quarter have been adjusted for delivery in 2017,” she said.

Yet so little of that coming inventory will be affordable housing. In her home base of Atlanta, businesses are crying out for worker housing, yet developers only answer the call for luxury, crimping the supply of workers who can't afford to live in Atlanta.

"It's funny to listen to Donald Trump talk about how bad the inner cities are. Here in Atlanta the 'inner city' is very expensive," she quipped.

Coval doesn't see an answer to the affordable housing crisis that doesn't involve public subsidies. To demonstrate the point, the Urban Land Institute created a computer game for politicians and housing advocates to play that shows all the minefields that developers confront in attempting to build for the masses.

The game even includes strategies for ripping off architects and suppliers, for making the units smaller, and even raising rents to a point where tenants can't afford food. "The only way to win the game is to get public subsidies to help cover costs," she noted.

Meanwhile, the number of people that live in households that pay more than half of their income for housing has grown to 114 million. "That's a third of our nation's population. That's the highest ever recorded," she said.

The London Experience

"We're seeing that, on average, rents are still increasing across the country, but at a slower pace than last year and 2014 and 2013," said Doug Culkin, president and CEO of the National Apartment Association.

Larger markets that once saw double-digit rent increases "are now feeling the pressure of an influx of new supply," he added.

There is no shortage of demand, especially from millennials starting out and from empty nesters looking to downgrade and letting a landlord handle the responsibilities of property management.

Other drivers of apartment demand include people who got burnt by the housing crash and no longer view a home purchase as a no-brainer. "Every quarter since 2008 has seen the home ownership percentage drop," Culkin said.

Beyond that, "more people are choosing to rent because of the flexibility of it," he said. "Millennials like to rent where they work and play and where there's public transportation. As they start receiving promotions and being transferred, it's so much easier to get out of an apartment lease."

His research department sees rents continuing to rise at the national level but closer to the historical norm of 3% to 5%. "In the last couple of years, rent increases have

averaged 7 or 8 percent. West of the Mississippi there were eight or nine cities that had double digit rent increases, including San Francisco, Seattle, Los Angeles, and San Jose," Culkin said.

Meanwhile, occupancy rates remain in the mid to high 90s, which suggests multifamily, including luxury, is not yet overbuilt.

He, too, concedes a problem with a lack of affordable housing. "If you look at the cost of land and the cost of construction supplies and labor, if you look at the increased taxes being put on developers because local governments are all trying to balance their budgets, by the time you finish you can't price for workforce housing," he said.

That leaves firemen, teachers, and policemen having to drive two hours to be where they are needed. "Local governments will have to work with builders to provide incentives for workforce housing," Culkin said.

He cited an interesting experiment he witnessed in London in which the city gave developers municipal land in return for a small cut of the income stream and a place to house workers. "They took a longer-term view that even if they take a small percentage of the overall project and income stream, the big benefit is that housing will be provided at an affordable cost to the workforce needed in the cities and London still gets an income stream from rents over the long haul," he said.

Right now, multifamily rentals look like they can make out in good economic times and bad. "One of the beneficiaries of the fallout from the subprime debacle was obviously multifamily," Culkin noted. "A lot of folks that lost homes had to live somewhere, and landlords made the decision that people that had been paying mortgages could pay rent."

The Labor Department releases September PPI Friday and September CPI on Tuesday, Oct. 18 both at 8:30 am ET. Housing starts data is released Wednesday, Oct. 19 at 8:30 am ET.

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