Inflation/Rents

Apartment Execs: National Rents Plateau at Highs But Begin Teetering at Luxury

- *A Nagging Sense That Good Times Won't Last Forever, That a Correction Is Likely*
- *As Luxury Gluts Downtown Markets, Affordable Housing Becomes a Sweet Spot*
- *Unprecedented Three Months' Free Rent Incentives In New York and Elsewhere*

By Gary Rosenberger

MIAMI BEACH (EconoPlay) March 14 – National apartment occupancy rates and rents are maintaining near highs on jobs and millennial demographics, but new luxury spaces in now glutted downtown areas are taking an ominous turn, industry officials say.

The sweet spot now is in affordable housing, which developers virtually ignored after the crash and where rampant shortages are heating up outlying markets.

After a great multi-year run, there's an uneasy feeling that the apartment market is due for a correction, and shakeouts are already apparent in places where luxury is king – New York, San Francisco, Houston, and name almost any city in Florida.

The political tide is less certain despite a president who earned his stripes as a developer of multifamily housing and who promises to reduce taxes and to deregulate.

But housing has been burnt in the past by tax reform – and policies aimed at heating the economy could face the harsh scrutiny of the Federal Reserve.

The last time tax reform was tried in 1986 it burnt developers who saw tax write-offs specific to real estate whittled away, prompting a plunge in property values.

The industry is also on the alert for any drop-off in foreign in-migration on the heels of anti-immigrant policies embraced by Donald Trump. But at this early stage no specific problems are being reported.

While it's still a fine time to be a landlord, the business is a two-way street – and any market correction would be a cause for celebration for tenants.

"The relocation business has been tough for a couple years. But we're definitely starting to see growth for the first time in a very long time," said Jeff Rowe, vice president at CORT Destination Services in Cincinnati, a national relocation service provider. "For us it started to turn around on the first of the year."

That's relatively recent, so it's too early to call a trend. "But every indicator we have is that employee relocation is starting to see increased activity," he said.

But Rowe represents tenants, which often makes him a reverse indicator. His business wasn't as hot when landlords had their pick of tenants. "I can tell you we are not having the struggles in finding inventory that we had historically," he said. "We are starting to see shorter term leases of less than six months become options again."

Landlords, particularly in luxury segments and most notably in Texas, are granting significant concessions. "I've heard as high as three and a half months' free rent on a 12-month lease in Houston. I don't remember in my time concessions that steep, including during the recession. If they were there, I missed them."

Property management firms had been reluctant to pay finders' fees to relocation companies, but are doing so now. "When they had very high occupancy, they didn't need our traffic. They didn't want a renter hand-delivered by us," Rowe said. "They were full and didn't want to pay the commission. If you are sitting at 98 percent occupancy you're not going to pay a premium for traffic. They're in a very different place now."

Interestingly, he sees no softening from companies relocating workers to the United States, despite growing anti-immigrant sentiment. "We are actually more excited about the U.S. inbound activity than even the domestic moves. So we definitely haven't had an issue there, but we are only talking 6 or 7 weeks into a new Administration," Rowe said.

Affordable Housing Shortages

"Actually, this industry is pretty bullish still," said Tamela Coval, a consultant based in Atlanta. "They might be offering concessions for luxury apartments, but you have to put it in perspective – rents are higher than they ever were, ever."

Multifamily owners "have never gotten as much rent and when they have to give even some of it back in concessions, they don't like it," she said.

The best performing segment is the one developers pooh-poohed after the crash. "Affordable workforce housing is in severe shortage," she said. "Developers that updated older assets and added bells and whistles like wi-fi to older suburban properties are experiencing good times because that's where we see the demand."

"I think the market is still strong," said Paula Munger, director of industry research and analysis for the National Apartment Association in Arlington, Virginia. "I sometimes feel like a broken record. I do a quarterly market overview, and while there's all kinds of waiting for things to change, they don't."

However, “there have been pockets of decline in the last few months in some core downtown markets where luxury housing was overbuilt. It’s just not enough to impact the national average on rents,” she said.

The fundamental drivers haven’t changed. Young people rent after they graduate – and with home prices so high they tend to stay in rentals longer. Their baby-boomer parents are also prone to return to rental spaces for the convenience it offers.

“Couple that with supply constraints of single-family and starter homes, and with mortgage rates rising, it will drive people to the apartment market,” she said.

So why is luxury beginning to show cracks? “It’s a classic supply-demand mismatch. Developers couldn’t build affordable properties because it just didn’t pencil,” she said. “But there were not enough people making the incomes to afford these places.”

Another topic of discussion is politics. “There is still a question mark as it relates to tax reform. The last time we tried it in 1986 it was not good for real estate,” she said.

Landlords will be looking to protect tax breaks specific to real estate, like life-kind exchanges where capital gains taxes are deferred for those who exchange real estate for comparable properties instead of an outright sale.

“The hope is that a developer like President Trump will find ways to make it easier to conduct business with fewer regulations and less taxes. But I also think developers are being realistic. Trump may be a developer and he may have a Republican House and Senate, but they don’t agree on everything,” Munger said.

Past the Peak of the Cycle

Any strengths or weaknesses in the apartment market are a matter of location. “The suburbs of Detroit continue to be crazy on fire, and pickings are slim when it comes to buying multifamily product,” said Joy Anzalone, chief operating officer at Burton Carol Management in Cleveland with footprints in Ohio, Michigan, and Florida.

But she is beginning to suspect that the Florida market has hit its peak and has already begun to turn. “Occupancy is still strong, just not as strong as it was a year or two or even three years ago,” she said. “I don’t know 100 percent the answer on why it’s turning. I just know it is. In Florida, there is so much new construction and too much exuberance, which is scary.”

Particularly worrisome is that new construction was focused entirely on luxury, or the semblance of luxury. “Nobody is building new product without granite countertops, stainless steel appliances, hardwood surfaces, and full amenities,” she said. “Nobody is building moderate.”

That exuberance reminds her of 2005 and 2006. “When we have great times what follows is not great times, and my fear is that we are nearing that cycle,” Anzalone said. “Right now a small bungalow in a marginal neighborhood that used to sell for $60,000 is now selling for $180,000, and that is bound to crash.”

She also sees softening in Ohio. “The market is still great but vacancies are higher than they were a year ago,” she said. “I think new development is outpacing demand.”

The problem is new product without accompanying job growth. People did move into trendy downtown neighborhoods but abandoned outer areas. Eventually there’s a breaking point because people are just “stirring the soup,” not making the pot bigger.

“I’m an optimist but I’m also a realist – and my experience over 35 years says that the rental market swings,” Anzalone said. “We are getting to the tail end of the height of the market, and it will swing back to normal. It hasn’t been normal since around 2010 or 2011. It’s been really outstanding, but normalness will soon take over.”

But normal, when standing next to outstanding, has a way of looking bleak, she said.

New York City Breakdown

The epicenter of fear is in places like New York City, where developers jumped on the luxury bandwagon and grossly overestimated the potential audience of the cash-rich.

“I think there is now officially a glut of new construction. There isn’t a new project that I know of that isn’t offering incentives like one, two, and even three months free rent, which I never saw before,” said Larry Rosenberg, president of RDNY (Rent Direct New York), a web-based rental locator covering the entire metro market.

Another sign of landlords’ buckling is they are paying brokers full commissions, a sign that they’ve lost their bargaining edge. “Downtown Brooklyn is definitely in a glut and we’re seeing rents come down,” he said. “Every landlord is still probing to see how much they can push. They come up with a number but then back off to rent it.”

He sees New York’s economy under stress. “The tourism drop in New York City is significant because of all the businesses that rely on tourism. That will be a problem soon for housing,” Rosenberg predicts.

Some of this can be laid on the feet of the Trump Administration, which has fanned a xenophobic vibe off-putting to foreign tourists and, possibly, foreign professionals looking to relocate to the city – another downer for landlords desperate to fill vacancies.

“The overall economic environment was pretty good when the Trump Administration came in, and now uncertainty is permeating the market,” Rosenberg said.

The stock market rally, which should be good for New York, is predicated on the enactment of the traditional Republican platform. “I think that spurred the business optimism, but now the political confusion is beginning to assert itself,” Rosenberg said.

Making matters more difficult is that landlords don’t have leeway to reduce rents because their construction loans were based on projections of rental income. “If they don’t meet their projections, the banks can accelerate the loan repayments,” he said.

So they sidestep the problem by keeping the base rents intact while offering ridiculous incentives to keep up a charade of maintaining the agreed-upon rents.

Landlords brought this on themselves. They took vulnerable neighborhoods, refashioned them into luxury and jacked up rents – chasing away the young and hopeful and squeezing working-class tenants with deep roots.

“Right now we have the largest inventory that we had in our history. The glut of apartments is something I have not seen to this extent I think ever,” he said. “I know that’s a bold statement. But I believe that there are actually more vacancies in New York City than ever before, and I know landlords are not announcing all of their vacancies.”

His website will have a handful of listings in a complex and a totally different set of listings the second, third, and fourth weeks. Then the cycle repeats with that first week’s listings. “It’s like a game of musical chairs. They don’t want people to know how many real vacancies there are so they enhance the desirability of their building,” he said.

His first inkling of trouble was in October. “Since then it has only gotten worse,” Rosenberg said. “Two years ago I started seeing more young people skip their New York years and going to other cities. Everything I see now confirms that.”

With people who actually run the city – teachers, firemen, police – no longer in place, New York City’s rich now stand on a tenuous foundation of … other rich people.

Luxury buildings have set-asides for lower-income tenants. “When these set-asides become available, I post them. They are getting tens of thousands of applications for 20 or 30 units. It speaks to the desperation of lower-income residents,” Rosenberg said.

Those that bankrolled this bubble “are starting to sweat profusely,” he added. “I think a wave of foreclosures could have a very adverse impact on the banking sector, and we know how that cascades throughout the economy.”

But there are still normal, fully functional markets out there, too.

“I would say things are going reasonably well – very well, as a matter of fact,” said Hans Hagen, president of Hans Hagen Commercial Properties in Maple Grove, Minnesota, operating some 500 units around the Twin Cities. “We are absolutely fully occupied other than turnovers.”

What drives his market now is what drove it in the past: People who went belly up in the crash became renters and stayed renters because it’s not longer cheaper to buy.

Homebuilders responded to the crash by converting for sale signs into for rent signs. But as average home prices in the Twin Cities rebounded to $360,000, it became unreachable for the young and the previously foreclosed.

“Rental is stronger for the demographic that doesn’t have the income to buy a new house,” he said. “They are still paying off college debt, and they’re not ready to move into a house and have babies. So everything in terms of ownership is pushed back.”

And that’s driving up rents to this day, with typical increases in a 2.0% to 2.5% range.

Summer vacation rentals also look like they will sparkle this year.

“The summer vacation home rental market for 2017 looks great,” said Julie Liddle of Julie Liddle's Private Adirondack Vacation Rental Homes in upstate New York.

“I have been taking reservations for summer since January and already some of my homes are filling up fast,” she said. “The weather last year was great. Now we just have to keep our fingers crossed that Mother Nature will cooperate and give us another wonderful sunny, warm summer.”

Demand is strong enough that some of her bigger listings saw rent increases of “a couple hundred dollars” a week, up about 7%. “I don’t have as many larger homes that will sleep 10 or more so these are the ones that got an increase in price. The smaller homes didn’t have an increase,” she said.

From her standpoint, neither geopolitics nor the Dow plays a significant role. “People are still very interested in coming to the Adirondacks for vacation and that’s a good thing for me and our small little town of Old Forge,” Liddle said.

The Labor Department releases February CPI on Wednesday at 8:30 am ET. Housing starts data is released on Thursday. Construction spending data is released on April 3.

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