



Multifamily Market Commentary – February 2019

2019 Multifamily Affordable Outlook – An Overwhelming Need for Workforce Housing

Multifamily housing affordability is likely to face significant headwinds in 2019. Due to the corporate tax rate declining to 21 percent from 35 percent under the Tax Cut and Jobs Act of 2018 (TCJA), the value of tax credits has declined significantly. This decline, coupled with the absence of an offsetting permanent increase in the total national allocation of Low Income Housing Tax Credits (LIHTC), has resulted in less capital available to build and preserve affordable multifamily housing. More market-rate multifamily rentals are expected to deliver this year, but these will primarily be more expensive, Class A units. In addition, the market-rate multifamily sector is expected to see continuing rent growth. As a result, rents are not expected to decline in the coming year and make housing more affordable.

However, the TCJA did introduce a few incentives that may have some positive impact in supporting affordable rentals. One of these is Opportunity Zones, which allow investors to defer gains for investment in primarily disadvantaged neighborhoods. Another incentive is income averaging for LIHTC properties, allowing some flexibility in meeting regulatory income restrictions. In addition, the fiscal year 2018 omnibus spending bill provided a four-year, 12.5 percent annual increase to the 9 percent LIHTC allocation. However, this temporary increase is unlikely to offset the overall reduction in affordable unit production.

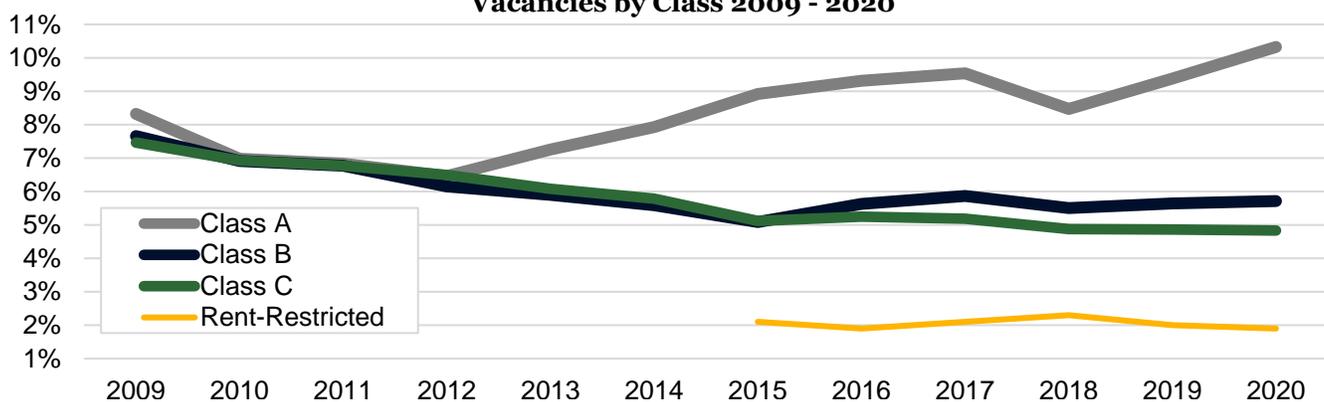
While some of these incentives are certainly welcome, they are unlikely to reverse the significant erosion in multifamily affordability seen since the end of the Great Recession. There continues to be an overwhelming need for all types of affordable multifamily units.

Workforce Housing Includes Both Subsidized and Unsubsidized Rental Properties

The nation’s workforce includes families across the income spectrum living in both subsidized and unsubsidized market-rate apartments. At one end is rent-restricted housing subsidized by LIHTC, the Section 8 program, and a growing number of state and local inclusionary housing incentive initiatives.

Market-rate properties that do not receive support from government housing programs, but generally have more affordable rents than Class A properties, are at another point on the spectrum. These units may be more affordable to low- and moderate-income households due to their age, condition, or location, and are usually referred to as Class B and C units. Unlike rent-restricted units, these Class B and C units are not required to maintain housing costs at affordable levels; therefore asking rents are fluid and based on supply and demand.

Vacancies by Class 2009 - 2020



Source: CoStar, Reis, Inc.

Note: Class A is approximated by CoStar five- and four-star category properties. Class B approximated by three-star category. Class C is approximated by two-star and one-star category data. Rent-Restricted data from Reis.

Vacancy Rates for Workforce Housing Remain Low...

Ongoing demand for affordable rental units has kept the estimated vacancy rate very low for the types of apartments affordable to many working renters. As shown in the chart above, vacancy rates for Class B and C properties bottomed out in 2015 at 5.1 percent and have barely budged since. The estimated vacancy rate for Class C apartments, which tend to be



some of the most affordable, was only 4.9 percent as of the end of 2018, according to CoStar. Vacancies at rent-restricted properties were even tighter – only 2.3 percent, according to Reis.

These include properties with rent-restricted units that benefit from LIHTC and Project-Based Section 8 programs. Even vacancies at middle-market Class B apartments remained low at 5.5 percent. Only vacancies at Class A units remained elevated at 8.5 percent as of the end of 2018. The discrepancy in vacancies shows the demand for units affordable to workforce renters remains strong. The vacancy rate for the Class B and C segments are 3.0 or more percentage points below that of Class A rentals.

...and Are Unlikely to Rise

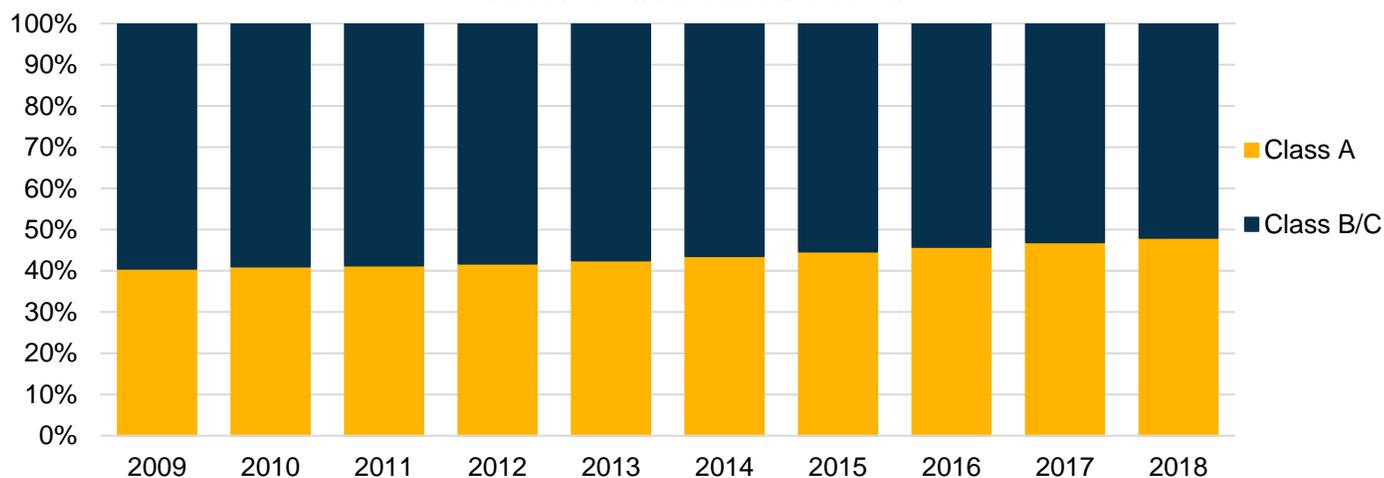
The vacancy rates at apartments affordable to workforce households are unlikely to rise anytime soon. According to Reis, vacancies at rent restricted apartments should remain below 2.1 percent through 2020. According to CoStar, vacancies at more affordable Class B and C properties should rise to just 5.7 percent and fall to 4.8 percent, respectively, through 2020, which would still leave them below the historical average of 6.0 percent. By contrast, the vacancy rate at Class A properties could rise to as high as 10.3 percent by the end of 2020, as continuing deliveries meet slowing job growth.

New Supply Has Not Benefitted Lower Income Working Renters

It is expensive to build new units. Construction costs, including labor and materials, continue to rise. According to *Multifamily Cost of Regulation*, jointly released by the National Association of Home Builders and the National Multifamily Housing Council in June 2018, regulation imposed by all levels of government accounts for over 30 percent of the average cost of a new multifamily development. In addition, local zoning restrictions may limit density, thereby restricting the number of units built. As a result, not only is most new supply expensive, but delivery of new units is not evenly distributed across the country. Development is now concentrated in only about 10 metros, most of which command higher asking rents, such as New York; Washington, DC; and Seattle.

The number of new Class A units has grown by just under 1.4 million units from the end of 2009 to the end of 2018 and now totals about 5.3 million units, according to Reis. A renter household would have to earn almost \$89,000 a year to be able to afford the average Class A rent of \$2,224 on a newly constructed apartment in 2018.

Class A Stock vs. Class B/C Stock



Share of Affordable Class B and C has Declined

Source: Reis, Inc.

From 2009 to 2013, an estimated 165,000 Class B and C units were lost on average annually, primarily due to obsolescence or gentrification. More recently, an estimated 120,000 units per year are lost on average. The slowdown can be attributed to the strong demand for rentals since the end of the recession. According to the May 2018 Joint Center for Housing Studies (JCHS) of Harvard University's report, *Proactive Preservation of Unsubsidized Affordable Housing in Emerging Markets*, gentrifying neighborhoods with strong demand for multifamily rentals ended up having many of their older – and therefore usually more affordable – market-rate properties renovated into more expensive Class A units since that is usually more cost-effective than new construction. As a result, the share of more affordable Class B and C units has declined to about 52 percent of stock as of the end of 2018 compared to an estimated 59 percent as of the end of 2009, as shown above.



Rent Growth Higher for Affordable Rentals...

According to CoStar, asking rent growth in the Class B and C segments outstripped the Class A segment over the past few years, as shown in the adjacent chart. Rent growth for the Class C segment, where rents are likely comparable to those for rent-restricted units, grew by an estimated 2.9 percent in 2018 to about \$1,034 per month. Rent growth for Class B units was even stronger at 3.4 percent, resulting in an estimated \$1,190 per month. Both segments grew well above the pace of inflation, which averaged 2.4 percent in 2018.

...and It Is Likely to Continue

Going forward, 2019 new supply deliveries are expected to start to spill over to the Class B and C segments thanks to slowing or even negative rent growth on high rent Class A units in some submarkets. This should dampen the rent increases that owners can command on more affordable units. Even so, rent growth for all types of multifamily rentals should remain positive, doing little to improve affordability.

CoStar projects that in 2019 rent growth in the middle market Class B segment will moderate but remain positive at 2.7 percent, and rent growth in the Class C segment will moderate to an estimated 2.4 percent. In both cases, rent growth will still be higher than the 2.3 percent rate projected for the Class A segment.

Wage Growth Slowly Strengthening...

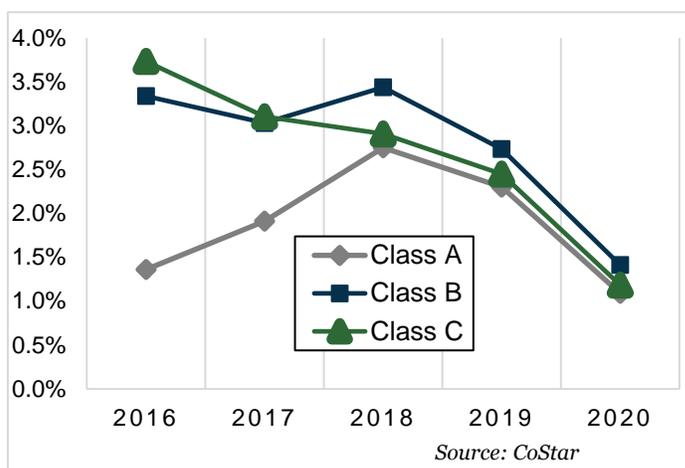
Wages measure earnings from working, while income can include non-work earnings such as interest and dividends. While growth in income will help with rental affordability, many renters rely solely on wages, making wage growth an important indicator of affordability.

As shown in the chart below, as of December 2018, the year-over-year change in private sector nominal average hourly earnings for all non-farm employees strengthened considerably to 3.2 percent, which was the fastest pace of growth seen since the Great Recession ended in June of 2009. Even the wage growth of production and nonsupervisory employees grew by 3.3 percent.

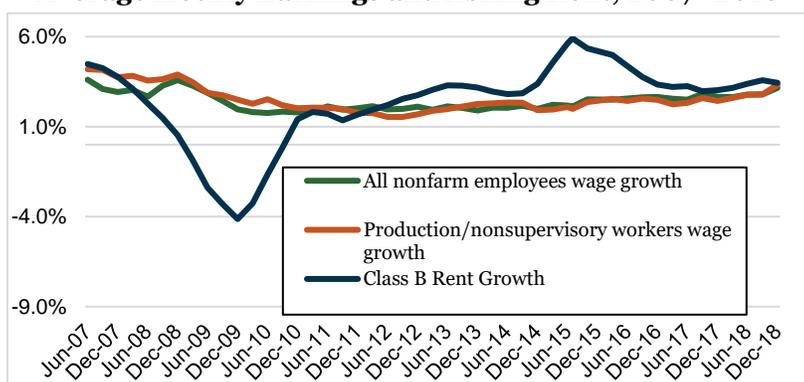
... but Rent Growth Still Higher

Rental affordability primarily improves when wage growth meaningfully outpaces rent growth. However, as shown in the adjacent chart, year-over-year rent growth in the middle market Class B segment has outpaced the wage growth of non-production/non-supervisory employees for 27 consecutive quarters – almost seven years now. Indeed, year-over-year rent growth for middle market Class B units was 3.4 percent at the end of 2018, according to CoStar. The ongoing mismatch between the pace of rent growth and wage growth has made many working renters cost-burdened since they must spend more and more to keep up with increasing rent levels.

CoStar Asking Rent Growth Forecast 2016-2020



Year-over-year Change in Private Sector Nominal Average Hourly Earnings and Asking Rent, 2007–2018



Source: CoStar, Economic Policy Institute;

<https://www.epi.org/nominal-wage-tracker/#chart-unemployment-rate>



A Crisis of Cost-Burdened Renters

Including single-family renters, almost half of renter households – 20.2 million – are cost-burdened, meaning they spend more than 30 percent of their income on rent and utilities. Of even greater concern, the number of severely cost-burdened renter households – those paying more than half of their household income for housing – totaled nearly 11.0 million, or just over a quarter of all renter households. This represents a 21 percent increase since just 2005. As shown below, 27 percent of renter households living in apartments are severely cost-burdened compared to just 10 percent of owner households.

KEY AFFORDABLE HOUSING TERMS

Affordable Rent: When a household spends less than 30% of gross income on housing costs (rent + utilities).

Cost Burdened: When a household spends more than 30% of their gross income on housing costs.

Area Median Income (AMI): The income for a city where half of households earn more and half of households earn less.

Extremely Low Income (ELI): Households with income at or below 30% of AMI.

Very Low Income (VLI): Households with income from 30.1% to 50% of AMI.

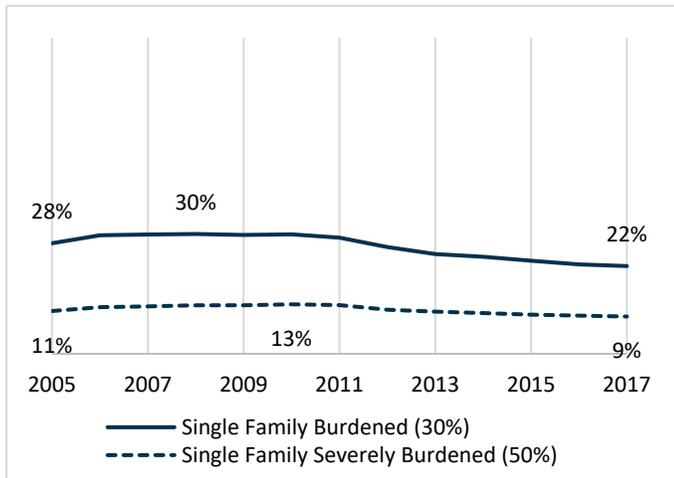
Low Income (LI): Households with income from 50.1% to 80% of AMI.

Moderate Income (MI): Workforce households with income from 81% to 120% of AMI.

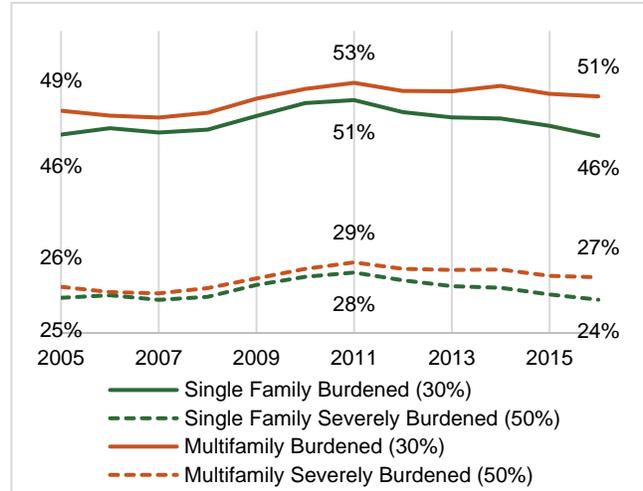
High-Income: Households with income above 120% of AMI.

Cost-Burdened and Severely Cost-Burdened

Share of Single-Family Owner Households



Share of Renter Households



Source: Fannie Mae, American Community Survey (ACS) PUMS data, 2005-2017

Definitions: Households are housing cost burdened if they spend more than 30% of their income on monthly housing costs; severely cost burdened if they spend more than 50% of their income. For homeowners, monthly housing costs include mortgage payments + insurance + utilities; for renters monthly housing costs are rent + utilities.

Severe Cost Burdens Exist Across the U.S.

While nationwide about one quarter of renter households are severely cost-burdened, there are metro areas where the share of severely cost-burdened renters is significantly higher. According to *The State of the Nation's Housing 2018*, almost 32 percent of renter households in the Los Angeles metro and 29 percent in the New York metro spend over half of their income on rent and utilities.

However, it's not just the coasts that are affected. About 31 percent of renter households in the New Orleans metro and around 27 percent of renter households in the Cleveland, Detroit, Chicago, and Little Rock metro areas are also severely cost-burdened.

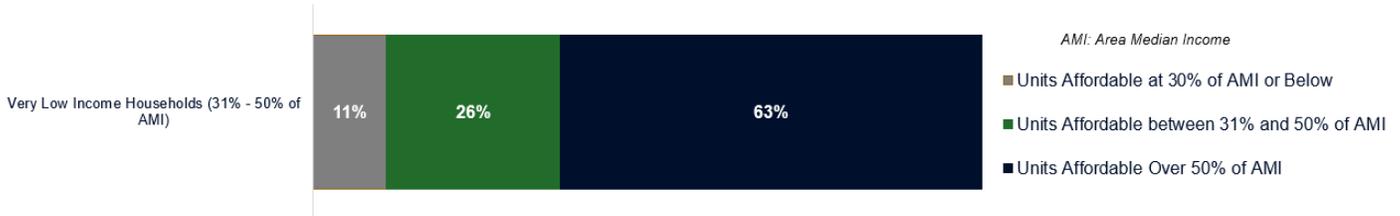
Smaller metro areas also have above average shares of renters that are cost-burdened. For instance, an estimated 35 percent of renter households in Fresno and 28 percent in Syracuse are severely cost-burdened.



Cost Burdens Worse for Lowest Income Working Households

Over 80 percent of renter households earning less than 50 percent of area median income (AMI) are cost-burdened and almost 60 percent are severely cost-burdened. This includes both extremely low income (ELI) renter households that earn just up to 30 percent of AMI and very low income (VLI) renter households that earn between 30.1 and 50 percent of AMI. As a result, as shown on the chart below, almost 2 out of every 3 VLI renters are living in units that are only affordable to households at higher income levels, thereby creating a housing cost burden for those renters who can least afford it.

Where do Apartment Renters Earning Less than Half of the Median Income for Their City Live?

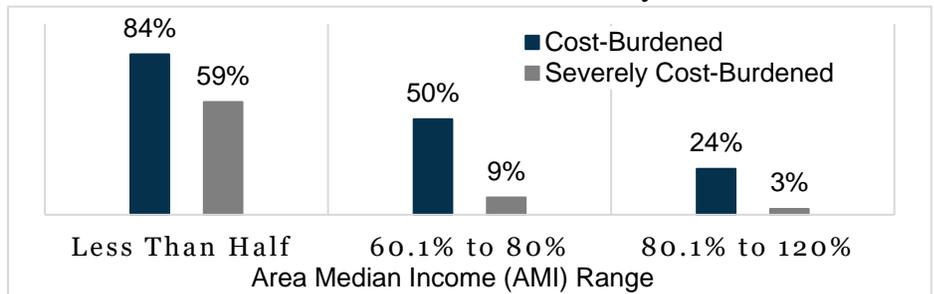


Source: 2017 American Community Survey, Fannie Mae

Middle Income Working Renters are also Cost Burdened

As shown in the adjacent chart, half of all renter households earning between 60.1 and 80 percent of AMI remain cost-burdened, while 9.0 percent of these households are severely cost-burdened. Almost one in four moderate income (MI) households, those earning between 80.1 and 120 percent of AMI, are cost-burdened, and another 3.0 percent are severely cost-burdened.

Share of Cost Burdened Renters by Income

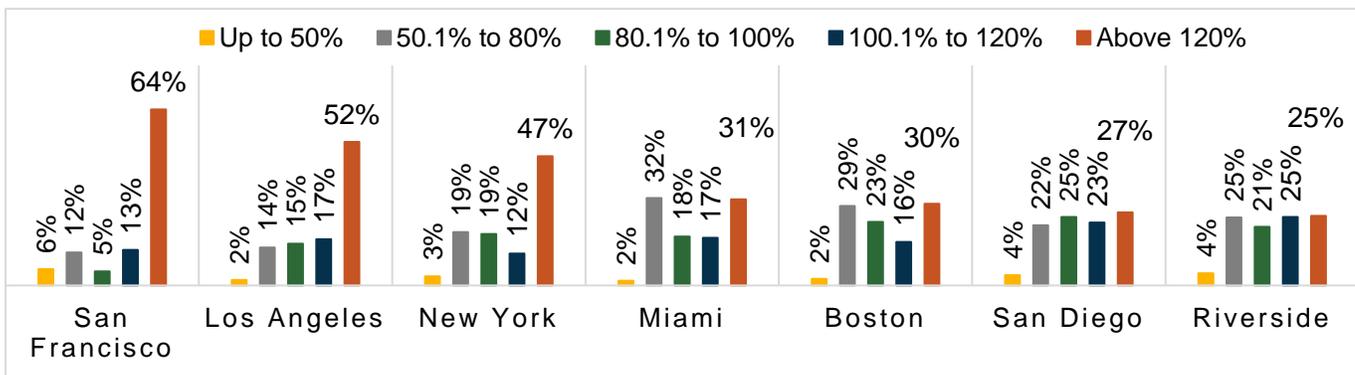


Source: Fannie Mae, 2017 ACS PUMS data

Large Portion of Rentals Affordable Only to Highest Income Households in Some Metros

In some large metros a large portion of apartments are only affordable to the highest-income working renter households, as shown in the chart below. It's likely no surprise that in San Francisco, Los Angeles, and New York, 64 percent, 52 percent, and 47 percent of multifamily stock, respectively, is only affordable to those renters earning more than 120 percent of AMI. However, other metros are less obvious. A quarter of apartments in Miami and Riverside metros are only affordable to the highest-income renter households who earn more than 120 percent of AMI.

Share of Apartment Stock Affordable by Income Band



Source: CoStar

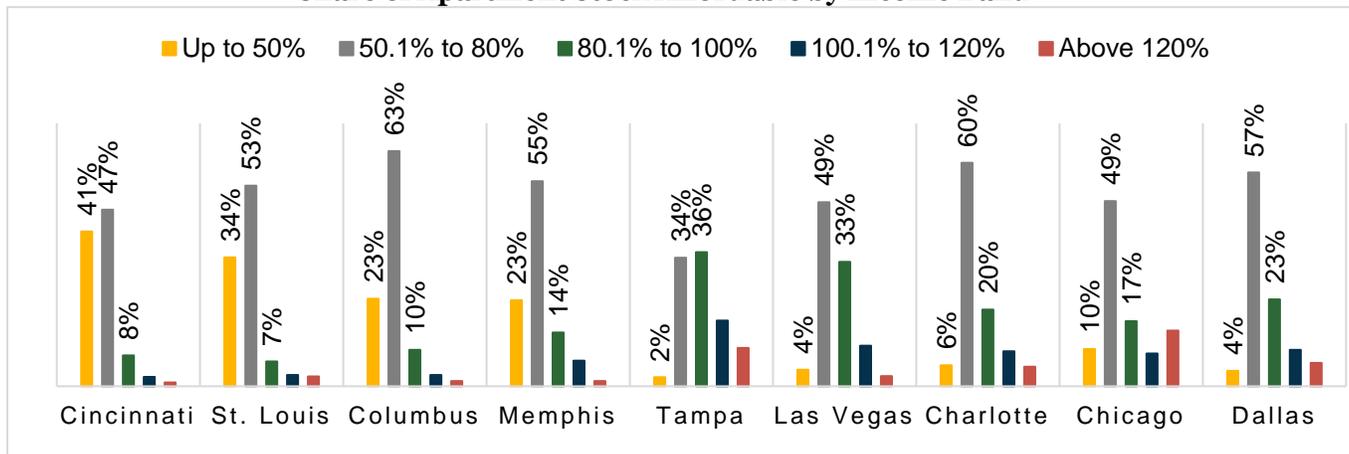
Note: Calculations based on CoStar database of apartments/rents and FHFA AMI files.



Some Metros Have More Affordable Rental Stock

There are a number of metros with a higher concentration of affordable rentals. These metros tend to be in the Midwest or less populous, as shown in the chart below. For instance, in Memphis, Columbus, St. Louis, and Cincinnati, a quarter or more of the housing stock is affordable to households earning half of AMI. Some metros, mostly located in the South and in Texas, also have additional affordable stock. Tampa, Las Vegas, San Antonio, Charlotte, and even Chicago, have more than 48 percent of their multifamily rental stock affordable to LI renter households.

Share of Apartment Stock Affordable by Income Band



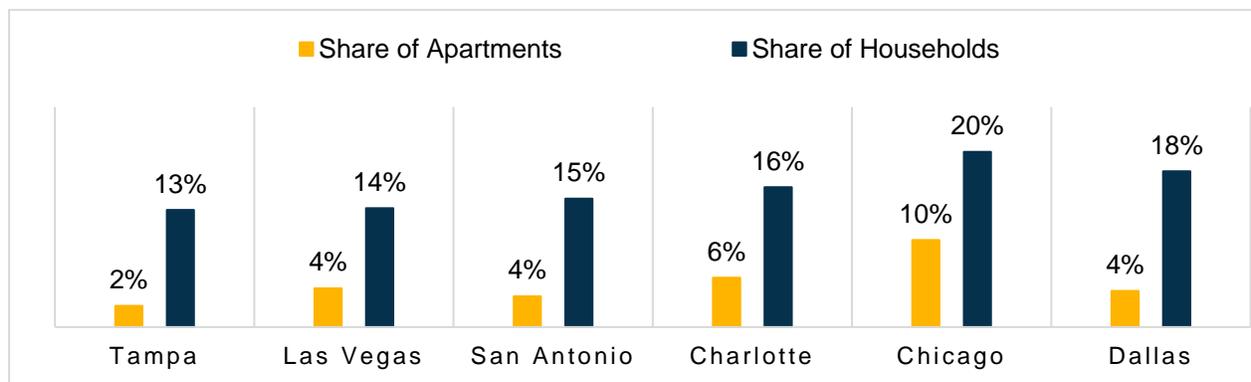
Source: CoStar

Note: Calculations based on CoStar database of apartments/rents and FHFA AMI files.

Some Affordable Metros Lack Affordable Apartments

However, there is still a shortage of affordable housing in many of these metros. That's because the share of renter households earning less than half of median income for their local area is higher than the share of stock affordable to these renter households. That lack of affordable supply forces many of these renters into units that are more expensive and that are affordable to households earning more than 50 percent of AMI. As seen in the chart below, even though Dallas is considered a fairly affordable metro, 18 percent of renter households earn only up to half of the median income, far greater than the 4.0 percent of stock potentially available. Similarly, while 13 percent of renter households in Tampa earn no more than 50 percent of the metro's AMI, only 2.0 percent of its multifamily rental stock is affordable to this income group.

Share of Renter Households Earning Up to Half of AMI vs. Apartments Affordable to These Households



Source: CoStar

Note: Calculations based on CoStar database of apartments/rents and FHFA AMI files.



And Not Enough Rent-Restricted Housing...

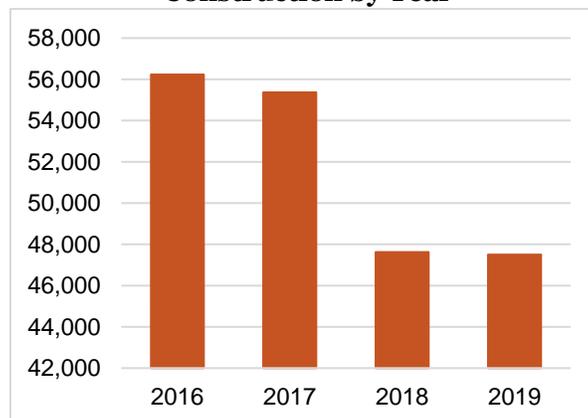
Even though households at the lower end of the income spectrum need rent-restricted housing, there is a limited supply of this type of rental housing due to funding limitations. While LIHTC, Section 8, and public housing help working families significantly reduce their housing cost burdens, current availability is overwhelmed by the sheer number of VLI and ELI households. According to the Center on Budget and Policy Priorities, only one in four eligible households receive any rental assistance.

...and Production has Fallen Off

The LIHTC program has been the highest producer of new affordable workforce housing, creating an estimated 3.0 million units since the program began in 1986. However, with the corporate tax rate declining to 21 percent, the value of tax credits has declined significantly. Coupled with the absence of an offsetting permanent increase in the total national allocation of LIHTC, this has resulted in less capital available to build and preserve new affordable housing.

Even though the fiscal year 2018 omnibus spending bill provided a temporary four-year 12.5 percent annual increase to the 9 percent LIHTC allocation, it has not been enough to offset the overall reduction in the production of new rent-restricted apartments. According to data from CoStar, as shown in the table to the right, annual construction of new rent-restricted affordable units has fallen about 15 percent, from an estimated 56,200 new units in 2016 to only about 47,500 units in 2018 and 2019. In fact, according to estimates by Novogradac & Company LLP, the future supply of affordable rental housing could be reduced by nearly 235,000 homes over 10 years.

Rent-Restricted Units Under Construction by Year



Source: CoStar, based affordable stock. Excludes renovations.

Inclusionary Zoning Programs Support Growth of Affordable Rentals

To address the increasing need for additional supply of affordable workforce housing, many local jurisdictions have begun creating or strengthening their existing inclusionary housing programs to create or preserve additional units for those lower income households that may not otherwise qualify for a subsidized unit. Inclusionary zoning programs vary and are offered by local or state government agencies to provide developers of new Class A multifamily rental housing certain benefits for including affordable units in these properties. Benefits may include density bonuses, an expedited permitting process, fee waivers, or even relaxed development standards. However, many of these inclusionary programs are new and voluntary, and the set-asides for affordable units can be as low as just 5.0 percent of the new units developed. As a result, it is unclear whether these programs will be able to increase the supply of rent-restricted units.

Property Preservation is an Efficient Aid in Combating Supply Shortfalls

Rent growth has been outpacing both inflation and wage growth since the end of the Great Recession. In addition, the national vacancy rate remains well below its longer-term average of 6.0 percent. Both factors are the result of the nation's ongoing supply/demand imbalance in many metros and are placing stress on the supply of affordable housing available to many renters.

Creating more affordable housing for workforce renters relies on the multifamily sector's ability to add more units each year than are lost from the existing housing stock. While building new affordable single-family and multifamily housing is critical to solving the affordable housing crisis, protecting and preserving the existing stock is equally important. Therefore, it is critical to ensure that an ample flow of debt and equity capital is available to support property owners who preserve the long-term affordability of their properties and seek to extend the useful life of their properties by rehabilitating them and making capital investments that reduce ongoing operating costs.



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