FEBRUARY 2020

2020 Affordability Outlook – Growing Mismatch Between Multifamily Supply and Renter Needs

Over the past few years, deliveries of new multifamily supply have consisted primarily of more expensive Class A units, leading to a growing mismatch between the needs of many working renter households and the stock of apartments available to rent. The mismatch has been exacerbated by increased demand for apartments even as the number of single-family homes rented has declined.

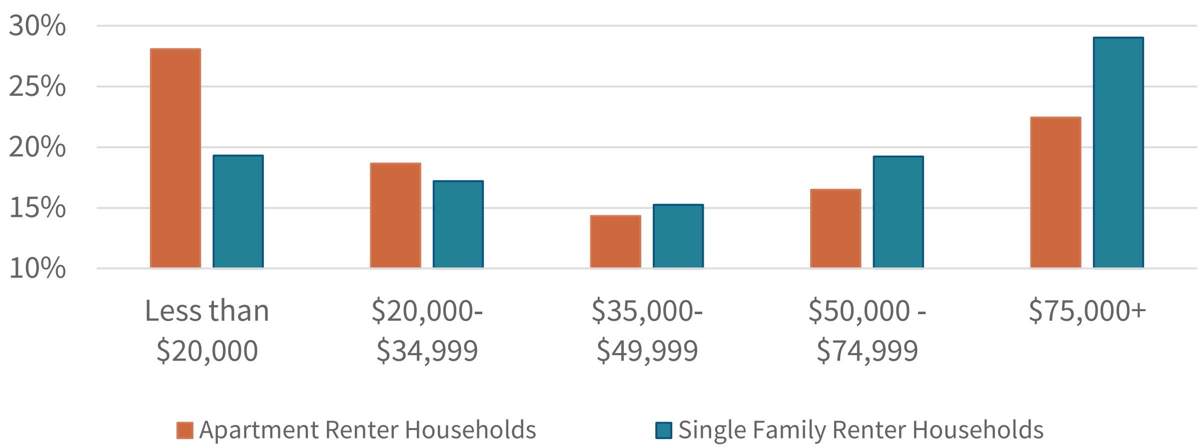
Fewer Single-Family Renter Households

According to the 2018 American Community Survey, there are 22.3 million single-family units and just 19.5 million multifamily units occupied by renter households. However, since 2013, the number of single-family units occupied by renters has declined by slightly more than 250,000 households, while the number of multifamily units occupied by renter households has grown by an estimated 1.6 million households.

Multifamily Renters Earn Less than Single-Family Renters

Apartment renter households tend to be less well off than renter households occupying single-family units. The median household income for apartment renter households is $38,000 compared with $48,000 for renters of single-family detached homes and townhomes. As shown in the chart below, only 36% of renter households occupying single-family detached homes and townhomes earn less than $35,000 per year. In contrast, almost half of all apartment renter households, 47%, earn less than $35,000 per year. This represents just over 9 million renters. Another 2.8 million renter households occupying apartments earn between $35,000 and $49,999 per year. However, while multifamily renter households tend to be lower income, incomes needed to afford the new market rate apartments are high.

Distribution of Household Income for Apartment Renters vs. Single-Family Renters



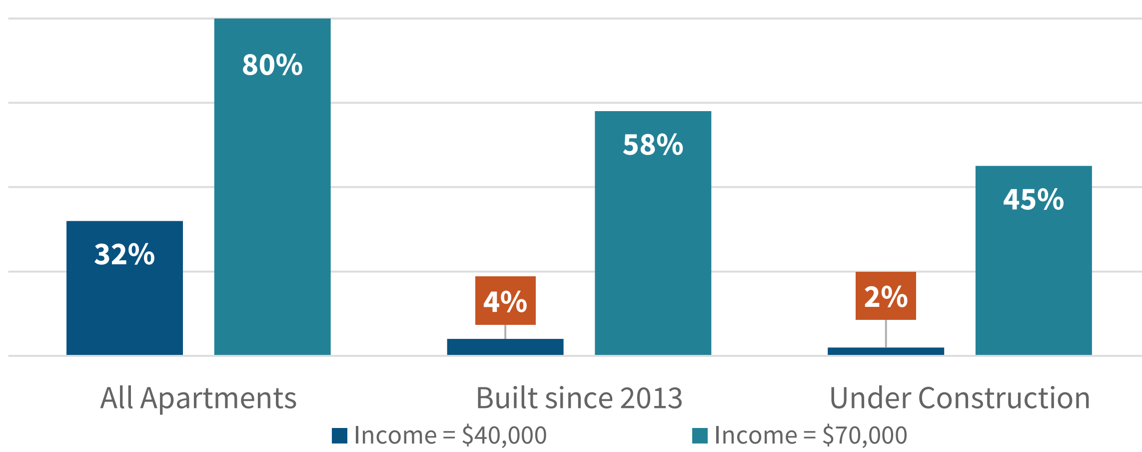
Source: National Multifamily Housing Council

Higher Incomes Needed to Afford Most New Market-Rate Apartments

An apartment is considered affordable when a renter household occupying the unit spends no more than 30 percent of household income on rent and utilities. According to data from CoStar, as of fourth quarter 2019, only a third of market-rate apartments were affordable to renter households earning $40,000 per year. This indicates that less than half of the stock of market-rate apartments are affordable to the average apartment renter household, which earns a median income of $38,000 per year.

The share of market-rate apartments affordable to the average renter household falls significantly for newer apartments. Only 4% of market-rate apartments built within the past five years are affordable to a renter household earning $40,000 annually. In fact, only 58% – or about three-in-five – newer market-rate apartments were affordable at an annual income of $70,000. In addition, while rents are not certain until a unit is occupied, less than half of the units currently under construction appear to be affordable to an occupying renter household earning $70,000 based on stated rent targets, according to CoStar.

Share of Apartments Affordable at Select Household Incomes as of Q4 2019



Source: CoStar Portfolio Strategy
Assumes 30% of income needed to afford apartment, data excludes federally subsidized units.
Note: Rents for units under construction will not be known until unit is leased.

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 various government programs, including Low-Income Housing Tax Credits (LIHTC), the U.S. Department of Housing and Urban Development's Section 8 program, and a growing number of state and local inclusionary housing incentive initiatives.

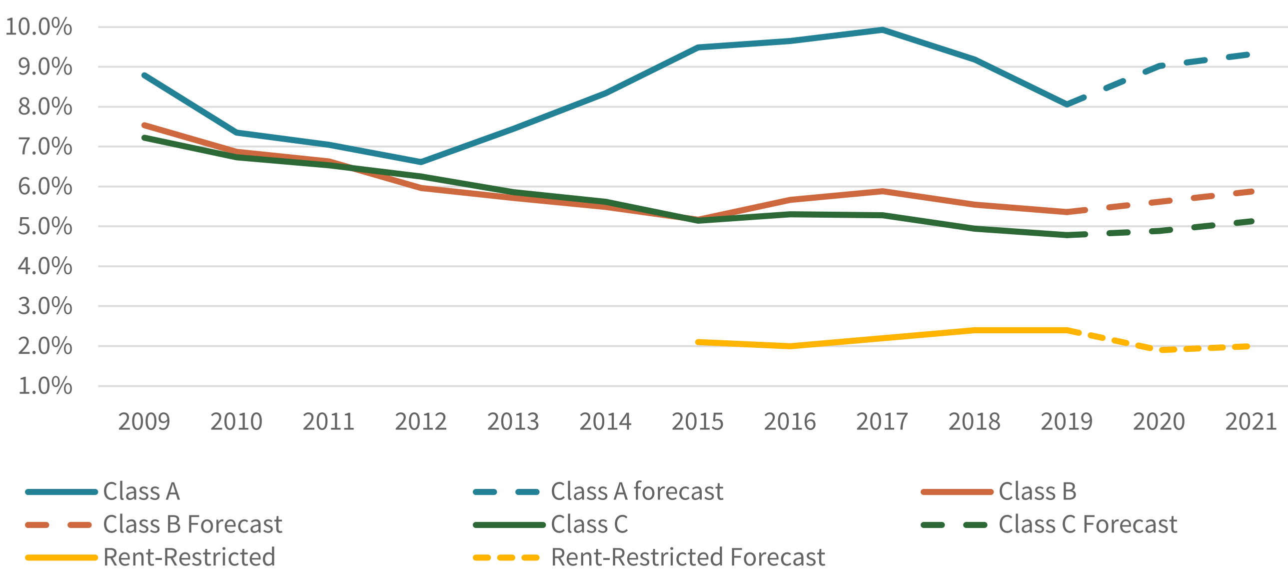
At the other end of the spectrum there are market-rate units that do not receive support from government housing programs, but nevertheless still offer affordable rents in their local market. These units, which are usually referred to as class B and C units, may be more affordable to low- and middle-income households due to various factors, including the age of the property, as well as its condition or location. 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 local supply and demand factors.

Vacancy Rates for Workforce Housing Remain Low…

Ongoing demand for affordable rental units has kept the estimated vacancy rate very low for many class B and C units. As shown in the chart below, vacancy rates for these more affordable units bottomed out in 2015 at 5.1% and have barely budged since. The estimated vacancy rate for class C apartments, which tend to be some of the most affordable available, was only 4.8% as of the end of 2019, according to CoStar. Vacancies at rent-restricted properties, meaning those with public subsidies, were even tighter at only 2.4%, according to Reis.

Even vacancies at middle-market class B apartments remained low at 5.4 percent. Only vacancies at class A units, which are the most expensive, remained elevated at 8.1 percent as of the end of 2019, according to CoStar. 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 about 3.0 percentage points below that of class A rental units.

Multifamily Vacancies by Class 2009 - 2021



Source: CoStar, Reis, Inc.
Note: Class A is approximated by CoStar five- and four-star category properties. Class B is approximated by three-star category. Class C is approximated by CoStar's two-star and one-star category data. Rent-Restricted data from Reis based on LIHTC units.

…and Are Unlikely to Rise in the Near Term

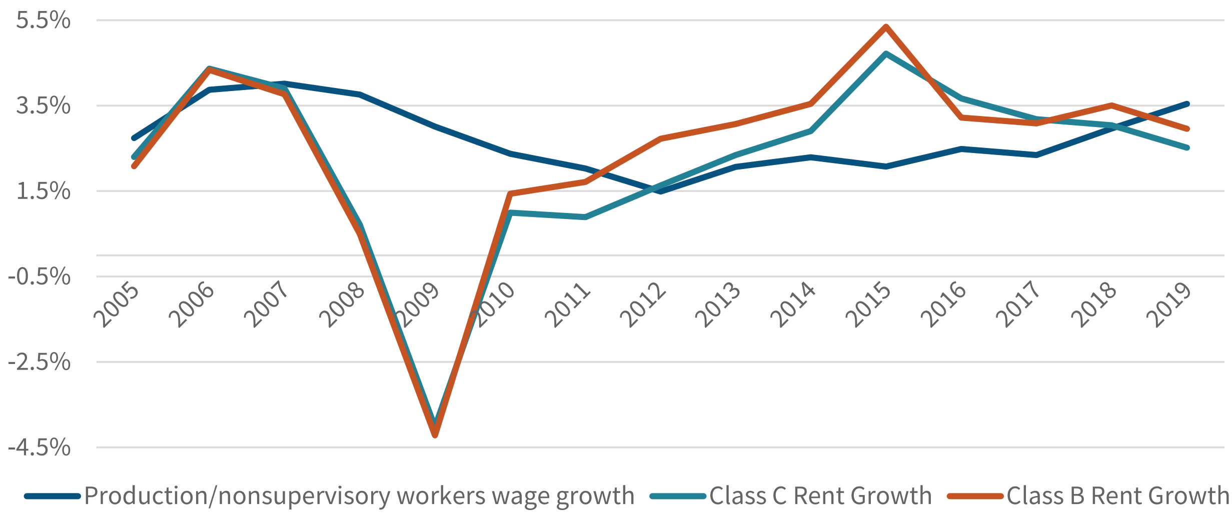
We do not expect the vacancy rates at apartment units affordable to workforce households to rise anytime soon. According to Reis, vacancies at rent-restricted apartments are expected to remain below 2.1 percent through 2020. According to CoStar, vacancies at class B and C properties are expected to rise to just 5.9 percent and 5.1 percent, respectively, through 2020, which would leave them below the historical average of 6.0 percent. In contrast, the vacancy rate at class A properties could rise to as high as 9.3 percent by the end of 2020, as continuing deliveries meet potentially slowing job growth.

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 helps rental affordability, there are renters that rely solely on wages, making wage growth an important indicator of rental affordability.

According to the National Conference of State Legislatures, 14 states increased their minimum wages in 2019. Also, with the unemployment rate at 3.5% as of December 2019, more employers are feeling the pressure to increase wages to attract and retain qualified employees. As a result, as of December 2019, the year-over-year change in private sector nominal average hourly earnings of production and nonsupervisory employees strengthened considerably to 3.5%, which was the fastest pace of growth since the Great Recession ended in June of 2009.

Year-over-Year Change in Private Sector Nominal Average Hourly Earnings and Asking Rent, 2007–2019



Source: Moody's Analytics – Current Employment Survey for earnings, CoStar for rent growth. Note: Class B is approximated by CoStar's three-star category. Class C is approximated by CoStar's two-star and one-star category data .

… Finally Inching Above Rent Growth

Rental affordability generally improves when wage growth meaningfully outpaces rent growth. As shown in the chart above, the wage growth of non-production/nonsupervisory employees finally outpaced year-over-year rent growth in class B and C units last year. According to data from CoStar, year-over-year rent growth for class B units was 3.0% at the end of 2019 and 2.5% for class C apartments, compared to annual wage growth of 3.5% for production and non-supervisory employees. However, this recent reversal does little to offset the effect of the preceding seven years, when rent growth for Class B and C apartments still outpaced wage growth.

According to CoStar, the average monthly asking rent for a class C apartment as of Q4 2019 was approximately $1,075, class B was approximately $1,245, and class A averaged $1,770. As a result, the rent for the average class A apartment is currently about 65% higher than the average class C apartment and about 43% higher than the average class B apartment.

Some States Enact Rent Control…

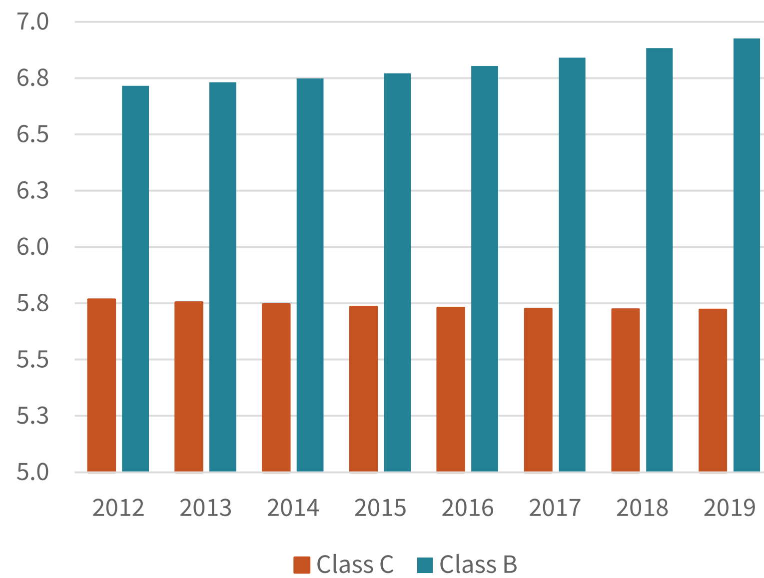
Some expensive cities, such as New York and San Francisco, have long had some form of mandated rent control or rent stabilization. However, prior to 2019, there was no state with statewide rent control. Due to concern about rapidly rising rents for many renter households, a number of states have adopted rent control measures. In 2019, three states -- California, Oregon, and New York -- passed some form of rent control.

All three state laws passed in 2019 also strengthened tenant protections. In addition, California and Oregon passed what were widely considered "anti-gouging" rent control laws, with a cap on rent linked to an inflation factor plus 5% and 7%, respectively. New York's rent cap is set by the New York Rent Board and has averaged 2% or less annually over the past five years.

… as Affordable Supply Stagnates

As shown in the adjacent chart, the inventory of class C units, which are considered the most affordable units available in a market, have been on the decline since 2012. Indeed, the supply of class C units has fallen by an estimated 100,000 units, according to data from CoStar. Further, the supply of class B middle-market units has only grown by 200,000 units since 2012. By contrast, the number of apartments occupied by renters has grown by over 1.6 million, amplifying the need for more affordable rentals.

Class B and C Inventory (2012-2019) (Millions)



Source: CoStar

Federal, State, and Local Programs Help Support New Affordable Supply

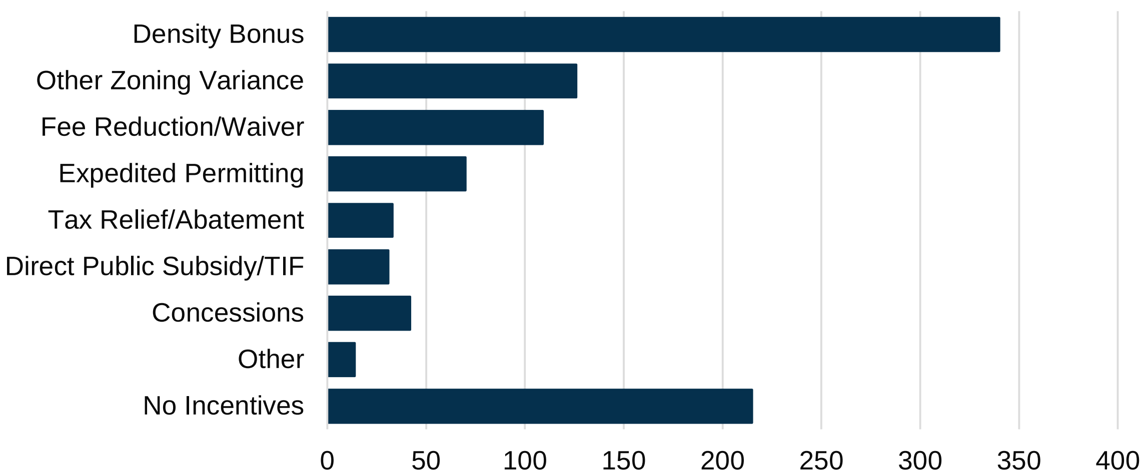
Federal, state, and local programs work to increase the supply of new affordable rentals. For instance, the LIHTC program is the primary way the federal government works to increase the supply of affordable housing. It is the largest source of affordable housing in the United States currently, having created approximately 3 million housing units since it began in 1987, with approximately 100,000 units completed annually, according to the National Council of State Housing Agencies.

There are a also number of state and local governments adopting inclusionary housing programs that provide developers with incentives to include affordable units in new, primarily market-rate apartment developments.

Density Bonuses Encourage Affordable Supply

As shown in the chart below, about 350 jurisdictions provide a density bonus to developers to increase affordable supply. This is, by far, the incentive most frequently used to create new affordable supply by state and local governments. Density bonuses permit developers to build more units on the same amount of land, which helps developers offset the cost of providing a share of new apartments with a rent restriction to keep them affordable.

Incentives Offered to Developers to Include Affordable Units by Number of Programs



Source: Grounded Solutions Network
Survey data as of March 2019

Tax Abatement Programs Also Help Increase Affordable Supply

Tax abatements are a financial incentive that state and local governments also use to encourage developers to include affordable rentals in new market-rate developments. One example is Seattle's Multifamily Tax Exemption (MFTE) program, which provides a 100% tax exemption lasting 10 to 12 years for buildings that set aside 20% of units as income-restricted for a range of low- and moderate-income households. According to the city of Seattle, between 1998 and May 2018, the MFTE program created approximately 4,000 rent-restricted units in more than 190 apartment buildings.

Another example is New York City's 421-a program, also known as Affordable New York. Property owners receive a long-term real estate tax abatement in exchange for setting aside a portion of units for low-to-moderate income residents and subjecting the remaining market-rate units to rent stabilization for the duration of the abatement period. The 2019 Housing Supply Report issued by the New York City Rent Guidelines Board estimates that there are currently 116,000 rent stabilized apartments that were created by the 421-a tax abatement program.

Preservation of Existing Stock is Critical

Creating more affordable multifamily rental housing relies on the multifamily sector's ability to add more units each year than are lost from the existing housing stock. Building new affordable single-family and multifamily rental housing is critical to solving the nation's affordable housing crisis. However, it is equally important to protect and preserve the existing stock of older, more affordable apartments. As a result, we believe it is critical to ensure that an ample flow of debt and equity capital is available to support property owners interested in preserving the long-term affordability of their properties. Capital investments reduce ongoing operating costs and extend the property's useful life.

2020 Outlook: Continued Pressure on Affordability

We do not expect our outlook for the affordability of the multifamily sector to improve in 2020. Although the wage growth of nonsupervisory employees finally inched past rent growth for affordable class B and C apartments in 2019, we do not believe this reversal does enough to offset the effect of the preceding seven years when rent growth for affordable segments still outpaced wage growth. In addition, slowing rent growth in these affordable segments of apartments is likely more a reflection of inadequate supply than slowing demand, as the vacancy rates in these segments remain low. According to the Dodge Data & Analytics Supply Track, more than 476,000 apartments are expected to be delivered in 2020. However, much of the new supply consists of more expensive, class A units and is primarily concentrated in about 10 to 12 metro areas. As a result, we believe that renter households are unlikely to see any meaningful improvement in affordability in 2020.

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February 2020

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