Multifamily Economic and Market Commentary

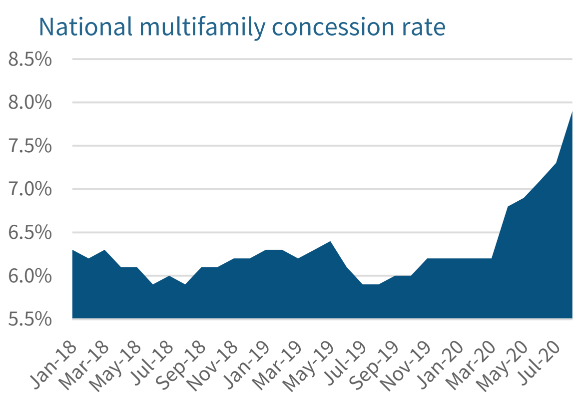
OCTOBER 2020

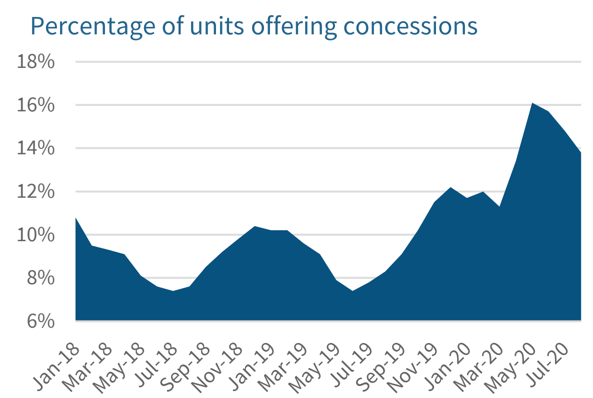
Pandemic Spurs Rising Concessions

Multifamily market fundamentals have softened since the onset of the COVID-19 pandemic earlier this year. The substantial job losses experienced across the country have greatly impacted many tenants, as well as prospective ones. At the same time, some of the nation's largest multifamily markets have been experiencing a significant supply surge, with only specific metropolitan areas experiencing construction prohibitions, as housing construction was generally considered to be an essential activity.

In a competitive market, concessions are one of the ways property owners attract tenants. Concessions are enticements with an economic value for renters, such as periods of free rent, free utilities, or other amenities. Recent concessions data from RealPage, Inc. have shown show that, on a national basis and in most markets around the country, property owners have increased the value of the concessions they have been offering in order to attract and retain paying tenants in a stressed and increasingly competitive market.

Overall, the value of concessions (for those units offering concessions) has surged to almost 8% of annual asking rents – about a month's free rent – after staying well below 6.5% for several years. Over the past year, the percentage of units offering concessions has also risen significantly, rising from around 8% in May 2019 to 16% in May 2020. While the number of units with concessions has declined slightly, falling to about 14% as of August 2020, as more of the economy has emerged from shutdowns the overall level remains well above pre-pandemic levels, as seen in the chart below.





Note: The monthly percentage includes units in properties that are in a stabilized status solely for the current month. *Source: RealPage, Inc.*

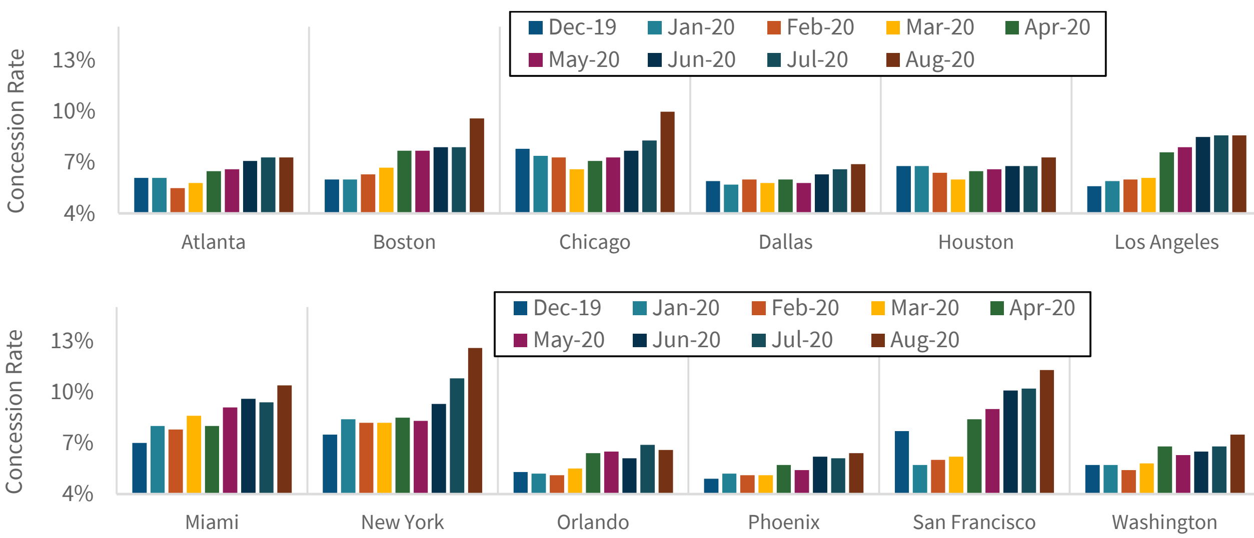
Despite the nation's economic slowdown since the start of the pandemic, multifamily markets continue to see a surge in the supply of new apartments. So far in 2020, the industry has completed over 246,000 new apartment units, with another 204,000 units under construction and currently scheduled to complete this year, according to Dodge Data & Analytics. That's after the industry added over 384,000 units in 2019. The industry has managed high levels of new units for the past several years, but that market was supported by strong job growth creating new tenants and households. The economic dislocation caused by COVID-19 has reversed those trends, with millions of people remaining unemployed.

Concessions rising in expensive markets

Although nearly 450,000 new apartment units may be completed in 2020, these units are not evenly distributed on a national basis. As has been the case for the past several years, much of the new apartment supply is concentrated in specific submarkets in approximately 12 metropolitan areas. The most active metros in the country for apartment development continue to be New York, Washington, D.C., Los Angeles, Houston, and Dallas. New York has more than 71,600 units under way, while the other three exceed 25,000 units each. Austin, Seattle, and Boston follow with slightly fewer units, and Orlando, Atlanta, Phoenix, and Miami round out the top 12.

The combination of increased supply and differing impacts of the COVID-19 pandemic – and its related job losses – has resulted in rising concessions in many metros. As seen in the charts below, every one of the metros listed has seen a rise in concessions since the end of 2019. And more expensive metro areas with generally higher rent levels, like New York, Boston, and San Francisco, have recently seen a noticeably larger increase in concessions.

Multifamily concession rate by market – select metros



Source: RealPage, Inc.

For context, a month of free rent is a concession rate of 8.3%. New York has seen the largest rise in concessions among these selected markets: the value of concessions offered has risen 5.1 percentage points from 7.5% at the end of 2019, to 12.6% in August 2020. San Francisco and Boston have experienced similarly significant increases: both metros have seen concessions rise 3.6 percentage points from the end of 2019, with San Francisco's overall level increasing to 11.3% and Boston's increasing to 9.6%.

Orlando, which has one of the lower rent levels among the metros listed above, has shown surprising strength so far in 2020, with the overall level of concessions rising only modestly and remaining relatively low. Its tourism-centric economy was shocked by the shutdown of its major theme parks, but over the past few months most have at least partially re-opened. As a result, concessions in Orlando have risen only relatively slightly, from 5.3% at the end of 2019 to 6.6% as of August. Phoenix is another economy with a significant tourism component, and it too has seen a modest rise: concessions there were 4.9% at the end of 2019 and have risen only to 6.4%.

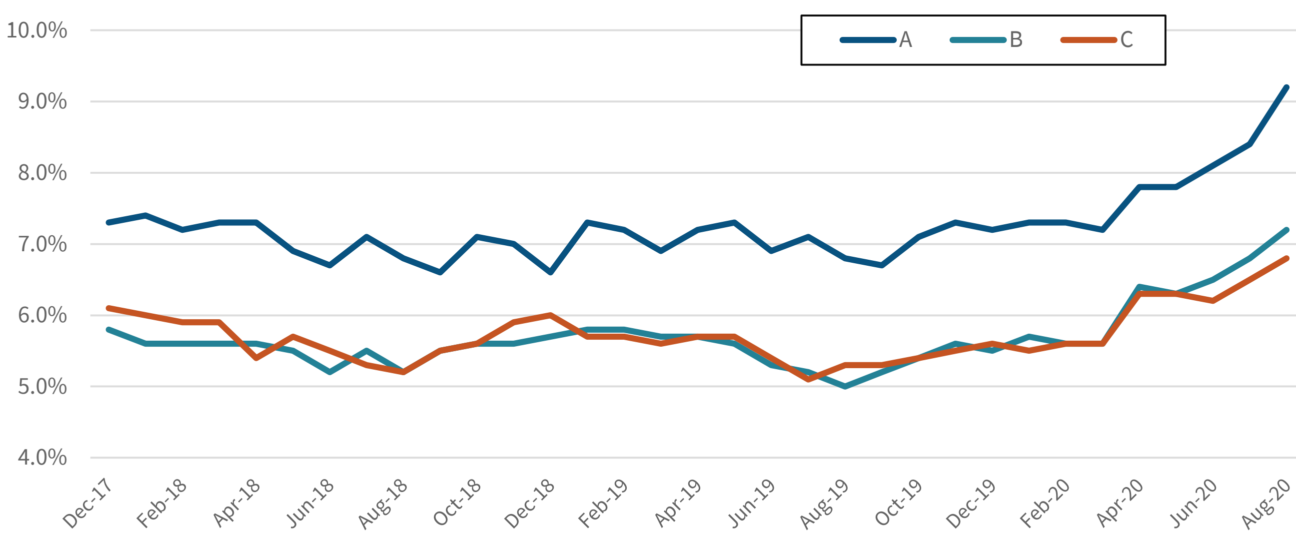
Class A concessions higher and rising

Developers have primarily been building more luxurious Class A units during this multi-year surge of new apartments. As has been the case for the past several years, increased competition among these projects has resulted in property owners often having to offer greater concessions. This trend has been amplified since the onset of the COVID-19 pandemic.

At the end of 2019, the level of Class A concessions was 7.2%. It remained approximately at that level until April 2020, when it rose 0.6 percentage points during the month to 7.8%. It has continued to rise in the ensuing months, increasing to 9.2% in August 2020. Considering that over 246,000 units have already been completed, and another 204,000 units are underway and are scheduled to be completed this year, we believe it highly likely that Class A concessions will continue to rise during the remainder of the year.

Classes B and C have not been immune to the overall rise, and both classes have seen an increase since the start of the COVID-19 pandemic. Class B concessions ended 2019 at 5.5% and generally held steady until March; Class C began the year at 5.6%. Both segments have seen a rise in concessions since March, rising to 7.2% and 6.8% for Classes B and C , respectively, as seen in the chart below.

National concession rates by class



Source: RealPage, Inc.

The rise in Class A concessions is a concern for the overall industry, as the trends in Class A often pull the other segments of the industry in the same direction. In prior periods when Class A conditions have softened, tenants often used the opportunity to seek out units with better amenities, given that rents for higher quality units became more attainable. In general, the reverse does not happen; tenants do not tend to move back into lower quality units when those rents fall. So as Class A rents stabilize or decline due to weakened underlying economic conditions, some Class B and C units will likely have to follow suit, to keep tenants in place or offer them an even better value with a lower overall rent level.

Concessions likely to continue rising

Prior to the COVID-19 pandemic, the nation's multifamily apartment market had remained quite stable for an extended period. The economic shock resulting from the pandemic has significantly softened conditions in the market, with declining asking rents and rising vacancy levels. The previously robust market conditions resulted in developers being very active in producing new apartment units. But now that demand has softened, these new units will be entering into a much different environment than was expected when the projects began.

The plunge in overall demand was evident starting primarily in the second quarter, when asking rent levels fell and vacancy rose. The rising level of concessions in July and August indicates the softness has continued through the summer. The rising concession levels seen in many metro areas across the country, coupled with the continued delivery of new units, indicates that the apartment market is likely in for several more months or quarters of below average performance. And while the pandemic has been nationwide, we believe that the rising level of concessions in some of the nation's most expensive markets indicates that the weakness will be felt primarily in some of the nation's major multifamily metros.

We expect that concessions will continue to increase, particularly for Class A units, as the wave of new supply is delivered over the next several quarters. We also expect that the Class B and C concessions will rise, albeit at lower levels, since some tenants may be able to move up to those Class A units offering generous concessions. We expect that as the national economy continues its recovery over the next 12 months, the likely resulting increase in demand stemming from improving employment gains should help to reverse some of these current trends.

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