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Why the Multifamily Market Still Has Room to Run

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Nelson: "Many people are willing to spend a greater share of their income on rent, so rent's share of the household budget has been going up. But there is a limit to just how far it can go."

SAN FRANCISCO—Population and demographic trends like reduced **homeownership** and **millennials** delaying marriage and children create long-term structural advantages for multifamily that other sectors lack, according to **Colliers International**'s chief economist **Andrew Nelson**. As the company readies its latest **multifamily** spotlight, GlobeSt.com spoke exclusively with Nelson, along with **Cindy H. Cooke**, senior EVP of multifamily investments, and **Will Mathews**, VP and principal for Colliers' multifamily advisory group in the East region, about what puts multifamily in the driver's seat among commercial asset classes, and why investors still see opportunity in the sector.

As a result of urbanization and millennials' propensity for renting over buying, Nelson says multifamily occupancy rates are near a historical high. While he does expect them to level off, the multifamily market will remain fundamentally sound.

"Colliers research shows that cap rates for **apartments** averaged 5.4% in Q3, the lowest of any property type, which reflects the high regard the sector is held in by investors, particularly **foreign investors** who are willing to pay for stable cash flows."

Rent growth has moved much faster than household income in recent years, which means renters are paying an increasing share of their income on rents. Nelson says there is a limit to how much renters can bear and some of the more expensive markets are starting to inch closer to that limit. But while the rate of multifamily growth is expected to slow, there remains a lot of upside, he says.

"We believe supply-demand fundamentals and **capital-market** forces will remain favorable for some time. Recent **housing trends** have created a positive perfect storm for the multifamily sector, which was the first to recover after the **recession** and the first to reach new peaks during the expansion," he says. "There are a bunch of things working in favor of multifamily sector."

A broad trend working in multifamily's favor is that homeownership rates have fallen. Nelson says those figures peaked even before the housing crisis peaked in the 2000s and have been coming down steadily since.

"They've gone down substantially and consistently," he says. "Some people expected homeownership rates to hit bottom and start to rise again, but there's been no indication that that the current trend will reverse or plateau."

Cooke tells GlobeSt.com the cultural shift from single-family ownership to renting that has occurred this cycle is expected to continue. "The ease and convenience of renting versus ownership is the new lifestyle that is attracting a large portion of the population," she says. "This live, work and play mentality has created more renters by choice versus by need. From millennials to professionals to retirees, all are embracing this new lifestyle."

Nelson says all the gains in occupancy housing since the recession have been among renters. "The number of owner/occupied units is about 2% less than it was at the end of the recession. Meanwhile, the gain in renter-occupied units is up 20%—that's quite a dramatic difference in those patterns," he says.

And Mathews says demand continues to outpace supply in all but a small minority of markets nationally.

"The line of demarcation when judging whether a marketplace is under-built or over-built is five new jobs compared to one permitted multifamily unit. The only top-20 city below the five-to-one ratio is Houston, which proves a significant majority of the country is well positioned for sustainable staying power."

This cycle is additionally prolonged by favorable employment growth coupled with a lack of new supply due to government **regulations**, Mathews adds. "These factors have created an insulated marketplace. Because of the regulatory burden **Dodd-Frank** has placed on banks requiring them to hold significantly more **capital** on their balance sheets as a means of mitigating potential risk, other lenders such as mortgage **REITs**, **private equity** and **life-insurance companies** are seeking to fill the void."

Nelson says millennials overall are dealing with a few things that favor renters. First, as a result of the plunge caused by the housing crisis, which hit the budgets and wealth of a lot of households, many millennials are no longer able to afford a down payment or have the credit to be able to get a mortgage. In addition, some millennials have **student debt,** so this is especially true for them, and with prices rising, they can't get on the ladder. Second, as a result of the **housing crisis**, a lot of people were turned off by the idea of investing in a home. Nelson points out that not everybody feels this way, but says it just takes a few percent of people to make that kind of assessment and it has a huge implication for the housing markets. Third, the way millennials are living—going to school longer, deferring marriage, having families later—they prefer to live in a more urbanized kind of environment, a live/work/play environment that favors renting not only in CBDs, but in more-dynamic suburbs, too.

"I fully expect Millennials will grow up, get out of school, form families and will ultimately want to buy a house, but fewer of them at any time are marrying and having children, and there are fewer people who want to buy a house," says Nelson.

Cap rates for multifamily are about the lowest overall among the property sectors now, and that's in part because growth prospects have been so strong, Nelson adds. "They've kind of flattened recently, and that reflects changing fortunes and fundamentals versus changing capital-market conditions.

We're finally getting more of a supply response, with apartment **construction** ramping up in major markets especially. Nelson says this development is much needed. "We have a great need for more housing that has not kept up with the population growth," he says. "It's good we're getting more units coming online. We're starting to see vacancy rates rise overall and rent growth start to moderate as a result. But looking out over the next few years, based on permit data, supply will increase at a more moderate pace, demand will keep increasing and population growth and lifestyle changes will continue to favor renters, so we will see vacancy rates begin to decline again a few years out. We will also see similar trends in cap rates."

So, with rent growth rising at a much higher rate than household income, how much more rent growth can the multifamily sector sustain? Nelson says it's tough to predict where it tops out exactly, but in some of the more expensive markets like San Francisco and New York, we're seeing rent-growth resistance, and rents are actually starting to come down.

"Many people are willing to spend a greater share of their income on rent, so rent's share of the household budget has been going up. But there is a limit to just how far it can go," he says. "I think this is more a story for some of the more-expensive markets versus others where rents—although they're up and increasing more than incomes—are not nearly as much of an issue."

He says **wage and income growth** over the next couple of years should support rent growth, but we will see moderation in rent growth because rents have gotten unaffordable, and the supply situation is changing.

Nelson also believes some moderation in rent growth is actually positive. "Rents can't keep growing to the moon. Market fundamentals ultimately say that it needs to grow in some relation to income, so it can't keep growing the way it has," he says. "But rent levels are sufficiently high now that it allows for the profitable construction of new units. I believe we are undersupplied in many markets, and we could use some more housing construction, particularly of more affordable units. This expansion has been largely for luxury units, which may benefit the broader housing markets, but it's less direct, and especially the most expensive markets could use more workforce housing as well as housing for young people just starting out."

Cooke says the majority of **development** has been occurring in downtown and urban-core locations throughout the country. Absorption has been strong, but since most of the development has been class-A and mostly built in only urban-core locations, some of the new multifamily communities are starting to feel the impact of their competitors.

“It has been extremely interesting watching some of the urban-core markets such as Seattle and Denver where there was great concern about overbuilding, but the jobs just kept coming and absorption was tremendous, and markets like Phoenix, where development is more spread-out than just downtowns with four highly active areas of **construction**. All the suburban areas including Metro Phoenix are lacking multifamily construction for the job and population growth that is occurring. Therefore, we are seeing a lot of renovation of existing multifamily communities with strong rent increases in the suburbs.”

Mathews says the answer to the question of whether multifamily development is keeping pace with demand, the short answer is yes. “We cover all of the markets on the East Coast, and we have seen dramatic absorption velocity in all major MSAs including New York, Boston, Atlanta, Miami and Tampa. When analyzing all of the market dynamics, it’s fair to say this cycle still has life. We very well could be in the 7th or 8th inning, but this game is going into extra innings as this ‘super cycle’ maintains positive momentum, robust fundamentals and a scarcity of construction-debt capital.”
