



RENTAL HOUSING

With conditions still favoring homeownership and lingering weakness in many sectors of the labor market, demand for rental housing remained soft in 2004. Rental vacancy rates hit a record high in the first quarter of the year and inflation-adjusted rents were flat nationally. As a result, completions of multifamily rentals held near their depressed 2003 level of about 240,000 apartments. Nevertheless, a rental recovery is slowly spreading.

With job growth picking up and new construction throttled back, more rental markets are on the mend. The strength of the comeback depends largely on the direction of the economy. If interest rates were to shoot up or house price inflation slow sharply, rental demand could rebound quickly and send rents back up sharply, adding to the growing share of renters who already face severe housing cost burdens.

THE WIDENING RENT RECOVERY

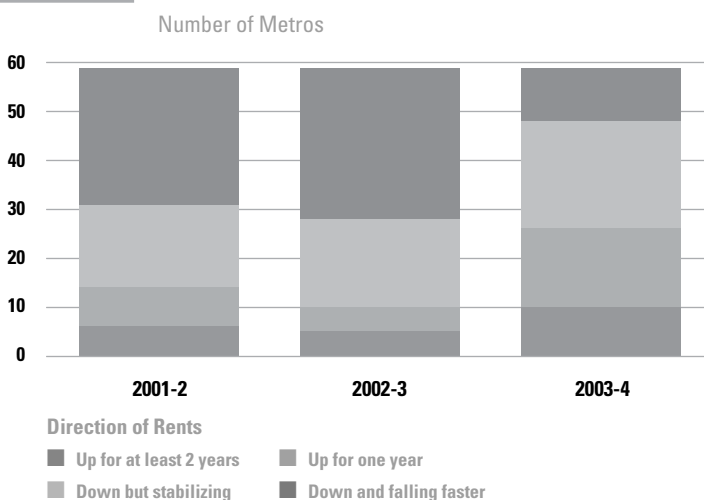
While performance at the metro level was decidedly mixed, more rental markets showed signs of improvement in 2004 than in the prior two years combined. Of the 59 metro areas covered by M|PF Yieldstar, real rents in 26 were stable or on the rise—even after accounting for concessions landlords may have offered to attract tenants (Fig. 23). Rents in Newark, Norfolk, and Riverside posted the largest one-year increases, while those in Boston, Boulder and Detroit showed the largest one-year declines.

Even the areas hardest hit by the recession are starting to revive. After years of real effective rent declines, the Las Vegas, Miami, and Washington, DC markets all saw an upturn in 2004. The double-digit slide in rents in the metros at the epicenter of the dot.com bust—namely, Oakland, San Francisco, and San Jose—also came to a halt. In other technology-heavy economies like Austin and Seattle, the freefall in rents may also be at an end. In Boston, however, the drop in rents accelerated in 2004 to a pace that surpassed the previous two years' declines combined.

Falling rents are symptomatic of the weakness in demand and minimal growth in supply over the past several years. Nationally, rental vacancy rates climbed for five consecutive years to a peak above 10 percent in the first quarter of 2004. The rate for structures with five or more units topped out in the second quarter at 12 percent. Trends now point to better news for most rental markets, with 41 of the 59 metros surveyed by M|PF Yieldstar reporting flat or declining average vacancy rates in 2004.

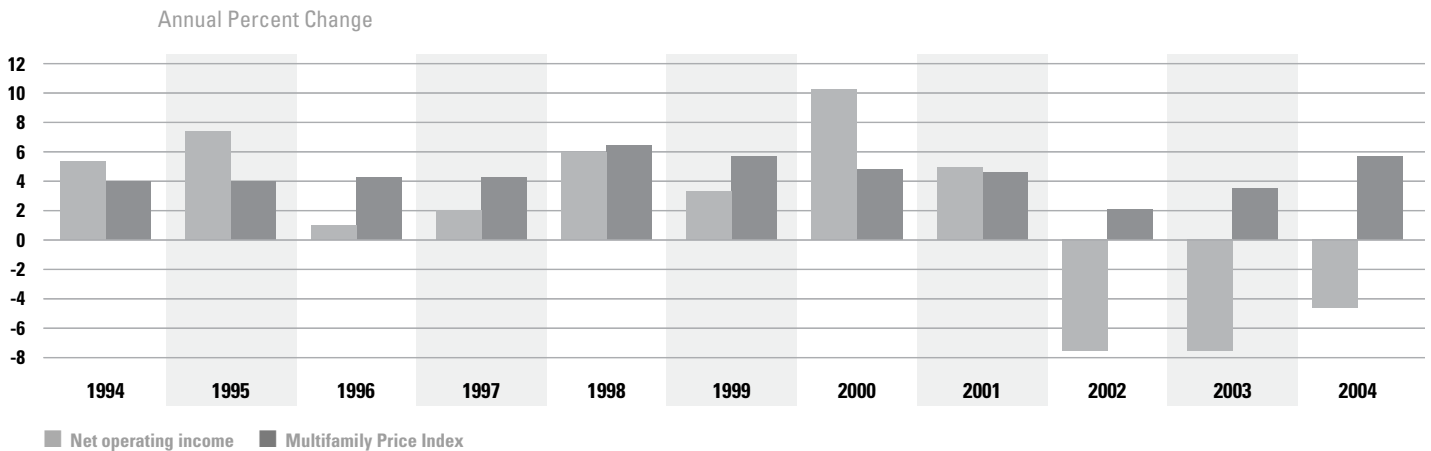
Vacant units are concentrated at both ends of the rent distribution. At the high end of the market, the run-up in vacancy rates likely reflects an oversupply of new rentals at a time when job-related moves—the most common reason for renting an expen-

Figure 23 Rents Are Recovering in More Markets



Notes: Change is based on average real rents over the four quarters of each year in the 59 metro areas surveyed by M|PF Yieldstar. For a list of metro areas evaluated, see Table W-5 at www.jchs.harvard.edu. Source: JCHS tabulations of data provided by M|PF Yieldstar, Inc.

Figure 24 Apartment Prices Have Continued to Rise Even as Rent Revenues Have Fallen



Note: Change based on average of four quarters.

Source: JCHS tabulations of data provided by National Council of Real Estate Investment Fiduciaries.

sive apartment—have been on hold. At the low end, however, the increase is more a sign of the poor condition of the units.

While still lower than that for multifamily rentals, the vacancy rate for single-family rentals has been rising even more rapidly. From 1993 to 2003, the number of vacant single-family rentals was up by 47 percent or 375,000 units. Part of this increase was sparked by low interest rates and attractive investment opportunities that encouraged more owners to try to rent out rather than sell their homes when they moved.

But the share of renters living in single-family homes peaked at 37.5 percent in the late 1990s, and rising vacancy rates suggest demand may be tapped out. Fully five out of six single-family rentals are owned by individuals or married couples, and many of these landlords have only a few rental properties. With homeownership still siphoning off renters, the weakness in single-family rental demand puts the incomes of these small-scale landlords especially at risk, because even a single vacancy can sharply reduce their total revenues.

STRONG MULTIFAMILY INVESTMENT DEMAND

Despite the softness in rents, prices of multifamily properties are still on the rise. According to the National Council of Real Estate Investment Fiduciaries, net operating incomes (rents less operating expenses) of high-end apartment buildings fell 20 percent between 2001 and 2004, but the sales prices of these properties were up more than 10 percent (Fig. 24).

Multifamily properties continue to attract investors in part because record-low interest rates have reduced financing costs. In addition, multifamily housing still provides more attractive yields than many competing fixed income and equity investments. The

hot market for investment properties has helped to shore up production of multifamily rentals and condominiums even at a time when vacancies are high and rents are weak.

If interest rates climb, the higher cost of servicing debt on properties will put more pressure on prices. At the same time, though, higher interest rates could boost rental demand by making homeownership less attractive. This would likely reduce vacancies and lift rents, thereby offsetting the impact of higher rates on prices. Moreover, given that pension funds and real estate investment trusts have been behind much of the recent spate of purchases, there is less chance of a sharp correction in multifamily prices. These owners rely less on leverage to earn acceptable returns and are therefore less sensitive to interest-rate increases.

Strong valuations and low interest rates have also encouraged current rental property owners to reinvest in their apartment buildings. After years of sub-par spending, property owners increased expenditures on repairs and improvements by 6 percent in 2002 and 8 percent in 2003, before backing off again in 2004.

DEMOGRAPHIC DEMAND SHIFTS

Although their numbers have not changed appreciably since 1993, renter households have become much more diverse. In just 10 years, the minority share of renter households jumped from 31 percent to 43 percent—fueled in large measure by immigration (Table A-9). By 2003, immigrants headed 16 percent of all renter households and nearly 30 percent of all minority renter households. The immigrant share among Hispanic renters was even higher, at 54 percent.

Much of the growth occurred among middle-income (earning between \$21,000 and \$75,000) minority households, who now

make up more than one-fifth of all renters. Nevertheless, the numbers of low-income renters increased while the numbers of high-income renters decreased (Fig. 25). As a result, the already substantial gap between median renter and owner incomes widened from \$21,265 in 1993 to \$25,200 by 2003 in real terms. In contrast, the disparity in incomes between white and minority renters narrowed because of especially strong increases among middle-income minority renters and especially large losses of higher-income white renters.

Like homeowners, more and more renters are moving to the Sunbelt and to the suburbs. Between 1993 and 2003, the number of renter households in the South and West rose by 800,000, but remained flat in the Northeast and declined in the Midwest. While the number of central city renters in the Northeast and

West did show an increase, the number of suburban renters in the South and West was up even more.

On net, the number of renter households living in the suburbs rose by about two percent while the number living in central cities fell by one percent. Meanwhile, the total number of renter households in non-metro areas remained stable, although these households also made a shift from the Midwest to the South and West.

STRONG REPLACEMENT DEMAND

While fully 3.3 million of the rental units standing in 2003 were built within the previous 10 years, the total rental stock expanded by only about 1.2 million units over the decade. This means that about 2.1 million newly constructed rentals simply replaced units lost through demolition, abandonment, or conversion to owner and nonresidential uses. Given that the numbers of units changing from rental-to-owned status and vice versa essentially offset each other, most of the units replaced were permanently lost from the housing stock.

Indeed, more than a third of the rental units built since 1993 are located in places that have seen net declines in renter households—specifically, the central cities of the South and Midwest, and the suburban and non-metro areas of the Northeast and Midwest (Fig. 26). Rental construction in these areas went primarily to replace lost units, although some surplus units contributed to rising vacancies. In contrast, in locations where renters have been growing in number, just over half of the new construction went to meet increased demand, 27 percent to replace lost units, and 20 percent to surplus over demand (Table A-10).

DWINDLING SUPPLY OF LOW-COST RENTALS

While replacing old units improves the overall quality of the rental stock, it also reduces the low-cost supply. Among units built since

Figure 25 Growth in Minority Renters Has Offset Losses of White Renters

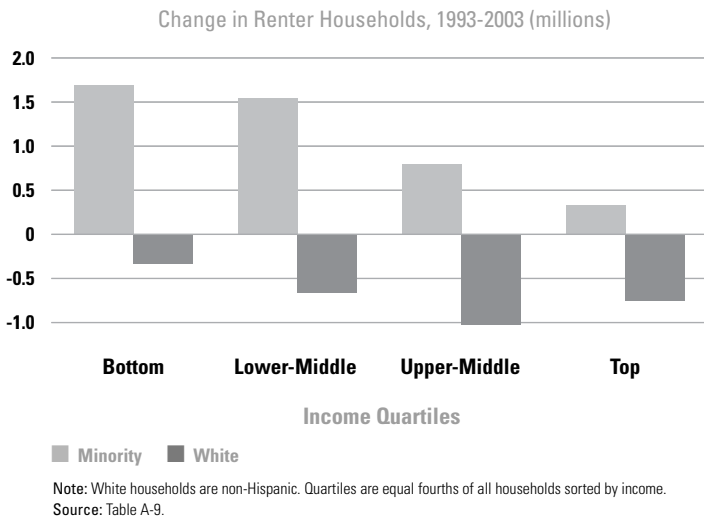


Figure 26 Most New Construction Has Merely Replaced Losses from the Rental Stock

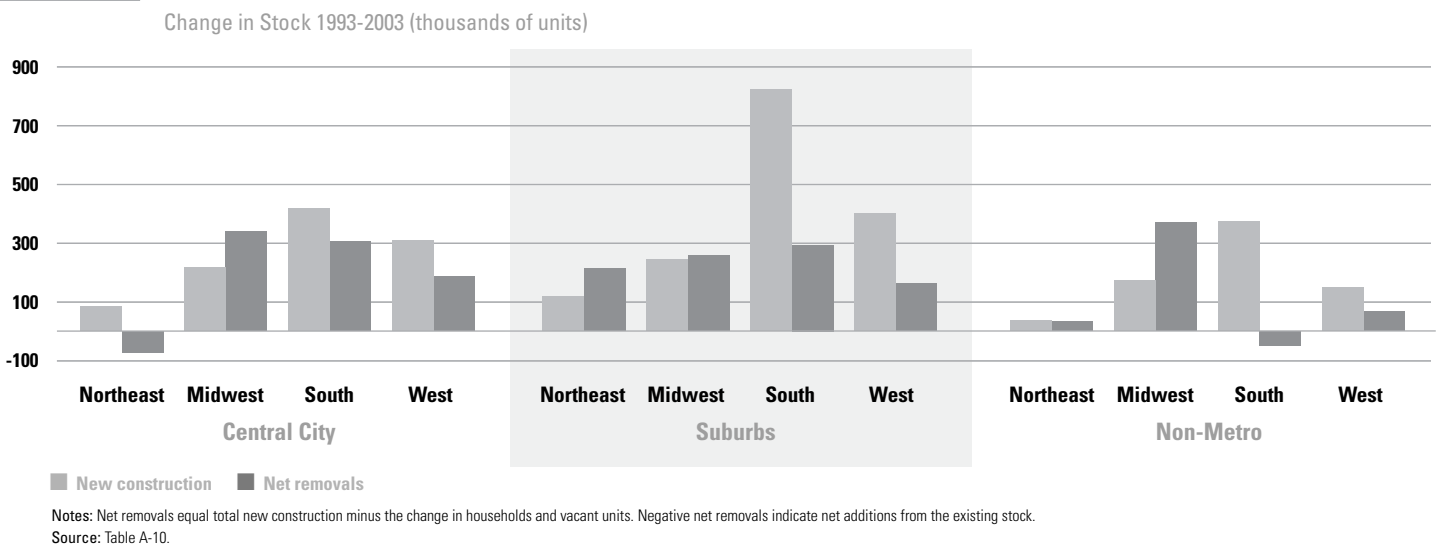
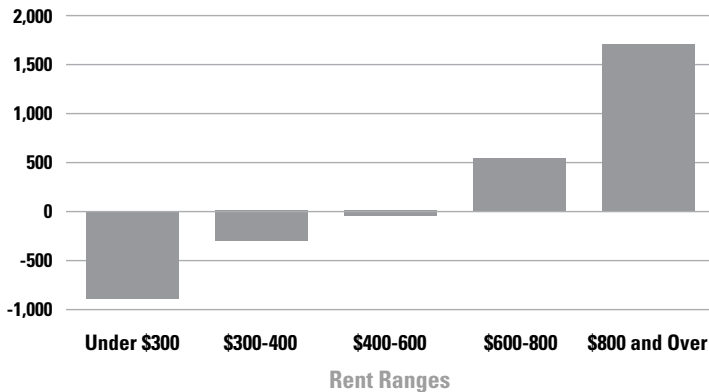


Figure 27 **The Low-Cost Rental Stock Continues to Shrink**

Change in Units 1993-2003 (thousands)



Notes: Includes occupied and vacant for-rent units. Ranges are based on real 2003 rents, including utilities.
Source: JCHS tabulations of the 1993 and 2003 American Housing Surveys, using adjusted weights for 2003.

Figure 28 **Long Vacancies Signal Future Losses of Low-Cost Rental Stock**

Share of vacant units in 2003 (percent)



Notes: Ranges based on 2003 gross rents including utilities. Excludes units vacant for six months or less.
Source: JCHS tabulations of the 2003 American Housing Survey, using adjusted weights.

2000, for example, 43 percent rent for more than \$800. By comparison, just one-quarter of existing units have rents that high. Moreover, only 10 percent of rentals built since 2000 rent for less than \$400, compared with 25 percent of existing units.

At such low levels, new construction is unable to keep up with the pace of losses from the low-cost stock. Nationally, the number of units renting for less than \$400 fell by 13 percent—or more than 1.2 million—between 1993 and 2003 (Fig. 27). As a result, their share of all rentals fell from 26 percent to 22 percent. These units—the only ones affordable to the 31 percent of renter households with incomes under \$16,000—are thus disappearing at an alarming rate. In fact, new construction is adding on net only apartments that rent for at least \$600, and more commonly

\$800. Requiring an income of at least \$32,000 to afford, rents of \$800 are well out of reach for most renters.

The economic boom of the 1990s did little to improve the mismatch between the number of renters with household incomes of \$16,000 or less and the number of affordable and available (not occupied by households with higher incomes) rentals. Indeed, between 1993 and 2003, the shortfall in affordable and available units remained essentially unchanged at 5.2 million.

But at the same time, vacancy rates within the low-cost stock increased from 5.0 percent to 9.1 percent. While this might seem to indicate that the supply is more than adequate, many of these units are in deplorable condition and essentially uninhabitable. Indeed, about 10 percent of vacant low-cost rentals have been empty for at least two years, suggesting that these units are headed down the path to removal through disinvestment and abandonment (Fig. 28). Excluding long-empty units, the vacancy rate for rentals priced under \$400 is 8.3 percent—almost 2 percentage points lower than the overall rental vacancy rate.

Two regulatory obstacles to preserving the steadily shrinking low-cost stock are the adverse tax consequences for property owners who want to sell and the stringent construction codes governing rehabilitation of rundown buildings. In some cases, owners face federal taxes that far exceed any profit they might expect from selling. Measures to provide so-called exit tax relief and to exempt rehabilitation projects from standards intended for new construction would motivate more owners to sell or upgrade their properties rather than let them deteriorate.

THE OUTLOOK

The home-buying boom has held growth in renter households near zero for the past ten years. The rental market recovery should therefore remain only gradual unless home price deflation makes homeownership less attractive or if rising prices and interest rates make it simply unattainable.

In the longer term, the age distribution of the population and the rising number of minority and immigrant households slightly favor rental markets. For at least the next 20 years, the children of the baby boomers will help shore up the market for starter apartments. At the same time, their aging parents will begin to look more toward luxury apartments or assisted living in rental communities.

Meanwhile, it is increasingly likely that low-cost units will continue to disappear from the supply—regardless of whether rental markets turn out to be strong or weak. Stemming these losses will take concerted efforts on the parts of federal, state and local governments alike. ■