Multifamily has been among the hottest asset classes through the post-financial crisis recovery—and we believe there’s still room to run.

Driven by a combination of demographic, economic and social factors, demand for multifamily has produced a 42.4 percent rise in effective rents between Q1 2010 and Q3 2016, according to Axiometrics—far more than for other property sectors. The entire commercial real estate sector has performed well during the economic recovery, but multifamily has outperformed the CPPI National All-Property Index, virtually doubling since Q3 2009.

For investors today, the main question is whether the multifamily cycle has peaked. Our short answer is “no.” The longer answer is that future improvements in multifamily fundamentals and pricing are likely to slow to more normal levels, but we do see demand for apartments in the U.S. remaining strong. While supply has risen from cyclical lows, we expect capital market forces will keep vacancy rates from rising significantly.

Of course, investing in commercial real estate is very localized and each metro area has its own fundamental drivers. We will examine the national trends and drill down into the major metro markets to see how they compare in terms of rent growth potential over the next few years.

**Key Takeaways**

- Population growth and social trends such as urbanization, falling homeownership rates, later marriage and lower birth rates create long-term unique structural advantages for the multifamily sector.
- Occupancy rates are near historical highs. While we expect them to drop slightly, market conditions will likely remain fundamentally sound.
- Capitalization rates for apartments averaged 5.4 percent in Q3 2016, the lowest of any property type, reflecting strong investor confidence in these assets.
- Rents have risen much higher than household incomes in recent years and some of the more expensive markets are nearing the limit of what renters can bear.
- While the rate of multifamily growth is expected to slow, we believe supply-demand fundamentals and capital market forces will remain favorable for some time.
Themes in Top Metro Areas

› **EXPLOSIVE GROWTH** continues to drive metros like Seattle, Denver, Dallas and Boston that produce highly educated young workers in fields such as technology, biotechnology, research and development and health care. These markets have amenities and are extremely attractive to businesses seeking skilled workers. **Areas to watch:** Whether rent growth can maintain the brisk pace of the last few years in the face of the large amount of new supply.

› **DEMAND OUTPACES SUPPLY** in metros such as Baltimore and Minneapolis. These markets are fairly affordable and have a relatively weak supply pipeline, which is promising. **Areas to watch:** Employment growth in both metros is weak, so demand may not support more than moderate rent gains.

› **OIL PRICE DROP BLINDSIDES HOUSTON** where job growth has been cut at the same time a wave of supply is coming online. **Areas to watch:** Rent growth should be virtually flat in this market for the next few years.

› **SUN BELT MIGRATION** can be seen in the growth in markets like Tampa, Orlando, Phoenix, Atlanta and Miami. These metros have a strong combination of growing populations, job growth and affordability. **Areas to watch:** After several years of strong rent growth, sustaining this momentum will become more challenging. These metros are also the most susceptible to an economic downturn, which could put a quick stop to growth.

› **24/7 CITIES CONTINUE TO GROW** including New York, Washington, D.C., San Francisco and Los Angeles. As the city centers fill, there is no shortage of infill projects reclaiming areas outside the centers. Investor demand, particularly from outside the country, is extremely strong in these core markets and boosts liquidity. **Areas to watch:** These metros have the highest rents in the country but that also means there are limits to future increases based on household income. Pricing is also near all-time highs with capitalization rates of 3—4 percent for stable assets.
Demographics Bolster Demand for Multifamily

The U.S. population is projected to increase by nearly 26 million people to 347.3 million by 2025, according to the U.S. Census Bureau. At 75.4 million in 2015, the millennial cohort officially surpassed their Baby Boomer parents as the largest living generation in America. What’s more, the number of millennials in the prime renter age range of 20–34 isn’t set to peak until the middle of the next decade, which should bode well for current and future apartment owners.

Social trends are another powerful driver. Millennials are moving to apartment-dominated urban areas, marrying later and having fewer children. On the other end of the age spectrum, the retiring Baby Boomer generation is increasingly renting near metro areas with entertainment and proximity to family in mind.

These demographic and social trends are playing out against an economic backdrop that seems likely to keep millennials in the multifamily market for the foreseeable future. More than 15 million jobs have been created since the recovery began in 2009, but many young professionals find themselves in lower-paying roles and thus unable to save enough to purchase a home.

In fact, the homeownership rate in the U.S. tumbled from the historical high of 69.2 percent in 2004 to 63.5 percent as of Q3 2016—the lowest level since 1965. According to the U.S. Census Bureau, as the number of households in the U.S. rose by 7.2 million over the past decade, renter-occupied units increased by 9.3 million while owner-occupied units dropped by 2.1 million.

With younger generations struggling with college debt and banks tightening on credit, many millennials are unable to afford a down payment or qualify for a mortgage, meaning that homeownership is not likely to rise any time soon.

Supply and Lending Dynamics Favor Multifamily

Multifamily permits dropped from almost 400,000 units in 2006 to just over 100,000 in 2009, as the financial crisis left a lasting impact on development. But as the market recovered, so did supply. Since 2004, the country added almost 900,000 rental units. Not all of those units are multifamily—also on the rise are student housing, senior housing and single-family rentals—but the trend is significant.

New supply is expected to hit a cyclical high greater than 350,000 by the end of the year and then begin to level off or even decline slightly. Nationally, the number of new units added is likely to remain more or less on par with demand over the next few years. Thus, while occupancy rates will tick up slightly with the surge in new supply, we expect the market will remain fundamentally sound with occupancy remaining near its historic highs.

Multifamily is also bolstered by a tremendous amount of liquidity not enjoyed by other property sectors. Government-sponsored agencies such as Fannie Mae and Freddie Mac provide roughly 45 percent of the debt for multifamily properties. Banks, insurance companies and commercial mortgage-backed securities lenders are also actively courting apartment owners. Construction lending has become more difficult since regulators imposed higher capital charges on banks in 2015, but this has also limited overbuilding.
Multifamily: Metro by Metro

Overall conditions for multifamily are positive, but there are significant differences in the fundamental drivers and outlook among different metro areas. We examine how the major metros in the U.S. stack up based on key factors we believe will determine rent growth potential over the next few years. Below we present the top 20 Metropolitan Statistical Areas (MSA) within the areas of job growth, supply growth, affordability and submarket concentration.

**Job growth.** No factor is more important than job growth for driving rental demand.

**Supply growth (including recent additions and units under construction).** New supply can push rents to levels when it raises the quality of the stock, but new construction ultimately limits rent growth.

**Affordability.** We assess affordability on the industry rule of thumb that tenants spend no more than 30 percent of gross income on rent.

**Submarket concentration.** Markets are more vulnerable to oversupply when new construction is highly concentrated.

*MSA names above have been shortened for display purposes*
Prospects for rent growth depend not only on the strength of the individual drivers (job growth, supply, affordability, etc.), but by the interrelation of those factors. Comparing drivers in context provides a fuller picture of the market fundamentals.

**Job Growth vs. Supply**

Job growth creates demand for apartments, which supports rent growth to the degree that market is not oversupplied. To that end, we calculated the ratio of jobs created to units delivered between Q4 2013 and Q2 2016, and then compared that ratio to the percentage supply growth in each metro since Q4 2016 including units currently under construction. Metros with the highest number of jobs created per new unit delivered were, for the most part, large coastal metros (New York, Los Angeles, San Francisco, Orange County) that have limited land and strict zoning laws that limit construction.

Metros with the largest construction pipelines per new job include Houston, Boston, Seattle, Denver and Washington, D.C. Houston stands out as a red flag in both metrics, largely because job growth plummeted in the wake of falling energy prices. Dallas has the greatest amount of construction in the pipeline, but it also has been a job magnet as corporations move there for low costs and favorable business climate. Seattle, Denver and Boston have seen a boom in supply, but they also feature strong university systems that produce highly educated young workers, and rapidly growing populations drawn by the “18-hour” lifestyle.

The long-term population shift to warmer-weather locales in the South, Southeast and Southwest also produces favorable long-term metrics in metros such as Tampa, Atlanta, Phoenix and Orlando.

**Affordability vs. Submarket Concentration**

We compared the submarket concentration of new supply against affordability, as measured by the weighted average effective rent as a percentage of median household income. Properties in metros with a high concentration of new supply in the top three submarkets and low levels of affordability are likely to see less rent growth going forward because relatively few renters can afford the premium rents in these select neighborhoods.

San Francisco stands out as a market with both a high level of recent supply in the top three markets (nearly 90 percent) and relatively low levels of affordability (rents are 46 percent of median household income). In fact, rent growth in San Francisco has cooled significantly in recent months as rents grow to levels that are unaffordable to most tenants. The story is similar in Orange County, which (like San Francisco) has high barriers to construction that limits new supply and has high rents in relation to median income. Demand in those metros is strong, but rent growth will be moderated by affordability.

Los Angeles and New York are (by our standard) the two least affordable metros, which will limit how much property owners can raise rents. But those metros also have more diversity in the areas where supply is being created, which should help produce rent growth in submarkets that are appealing to middle-income renters.

Meanwhile, Dallas and Washington, D.C. are among the most affordable metros and also have the most diverse supply pipelines in terms of geography, increasing the potential to raise rents. Both metros are also regional centers that are attracting young professionals. However, the sheer amount of new supply in both metros is likely to limit increases until the new stock is absorbed.
Despite Positive Outlook, Some Potential Pitfalls Exist

Our expectations for the continued strength of multifamily are based on demand driven by population growth and social trends such as falling homeownership, later marriage and lower birth rates, and urbanization. In that regard, multifamily has long-term structural advantages over other commercial property segments.

Despite these favorable demand factors, investors need to watch several issues with caution. For example, the multifamily sector has benefited from the widespread availability of debt through Fannie Mae and Freddie Mac, which have been setting new volume records each year on lending to apartments. However, these government-sponsored enterprises are likely to be reformed or even eliminated in the coming years, though the details are unclear as Republicans in Congress have proposed competing plans.

Another concern is the economy, with GDP registering the slowest growth since the recession. Moreover, although the major leading economic indicators are still fairly strong, the seven years of expansion leads to fears that a recession is inevitable at some point. Nonetheless, we expect continued moderate growth for at least the near term.

Oversupply is not a major concern in most of the country because apartment development is generally highest in areas where demand is strong. However, there are individual metros with huge pipelines of new product that may cause a market imbalance. The most pressing issue is that rents have risen much higher than household incomes in recent years. In some cases, renters are willing to pay a higher share of income than previous generations because they value the amenities and lifestyle in high-cost markets. However, there is a limit to how much renters can bear and some of the more expensive markets have been testing that limit.

Supply is complicated by building costs, local building codes and availability of financing and land. Roughly three-quarters of new inventory built in this cycle encompasses luxury units, while demand is concentrated at lower pricing points. That will likely put a damper on rent increases in coming years, especially in the high-end part of the market.

In sum, the strongest returns in this cycle are likely behind us. Property yields are at historical lows and unlikely to go lower, especially as interest rates are likely at rock bottom. Rent growth has been above-trend since Q4 2010, which means growth is likely to moderate. Strong investor demand will maintain asset values, but future appreciation will mostly come from gains in operating income.

But if the multifamily sector is unlikely to maintain the same level of returns it has over the last half-dozen years, we still expect that fundamentals will remain strong for some time to come. However, investors should temper expectations to reasonable levels and choose among markets that have the best combination of safety, liquidity and prospects for growth.

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