Fannie Mae

Multifamily Market Commentary – February 2018

2018 Multifamily Affordable Market Outlook – A Long Way to Go

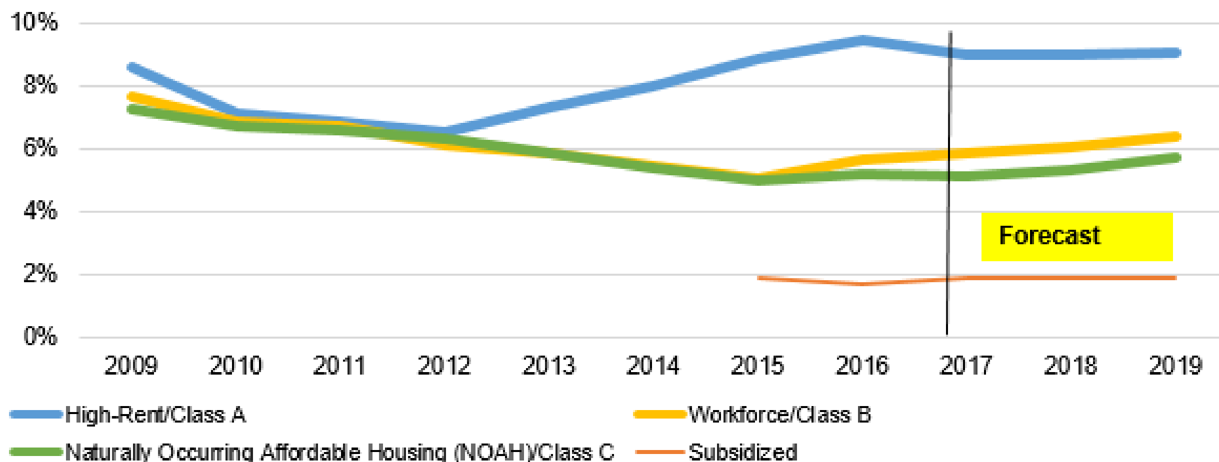
Momentum in the overall multifamily sector will likely slow in 2018 due to elevated levels of new supply. As a result, the national vacancy rate is expected to increase slightly in 2018, and, while rent growth should remain positive, it is expected to grow at a more modest pace. This is likely to do little to reverse the significant erosion in affordability of multifamily rentals seen since the end of the recession.

Vacancies for Affordable Rentals Likely at Trough

As shown in the chart below, after bottoming out in 2015, vacancy for affordable rentals remains low. According to CoStar, vacancies for units in the Workforce category, which generally corresponds to Class B units, rose slightly to 5.8 percent as of the end of 2017, after reaching as low as 5.0 percent in 2015. Vacancies for even lower-cost rentals in the Naturally Occurring Affordable Housing (NOAH) category, which generally corresponds to Class C units, rose slightly to 5.1 percent as of the end of 2017, an increase of 0.1 percent from the trough recorded in 2015. Even with these increases, these vacancies remain on the low side by historical standards.

Vacancies for rent-restricted affordable properties remain even tighter. As of the end of 2017, Reis, Inc., estimates a 1.9 percent vacancy rate for rent-restricted properties, which consist of multifamily rental properties assisted with federal Low Income Housing Tax Credits (LIHTC) and Section 8 project-based vouchers, reflecting ongoing demand for all types of affordable multifamily rentals.

Vacancies by Affordable Market Segment 2009-2019



Source: CoStar, REIS, Inc.

Note: CoStar High-Rent Segment is approximated by five and four star category properties. CoStar Workforce Segment approximated by three star category properties. CoStar Naturally Occurring Affordable Housing (NOAH) category approximated by two star and one star category properties.

Vacancy Levels for Affordable Multifamily Rentals Expected to Remain Relatively Stable

According to the Dodge Data & Analytics SupplyTrack Construction Pipeline, which distinguishes between multifamily properties consisting of either apartment or condo units, about 381,000 apartment units were completed in 2017 and another 443,000 units are expected to come online in 2018. Most of this new supply is believed to consist of Class A units, which command the highest rent levels in their location.

According to CoStar, although its estimated vacancy rate for the high rent/Class A multifamily segment declined slightly in 2017 to 8.9 percent, it is expected to remain elevated at about 9.0 percent in 2018 due to anticipated new completions.

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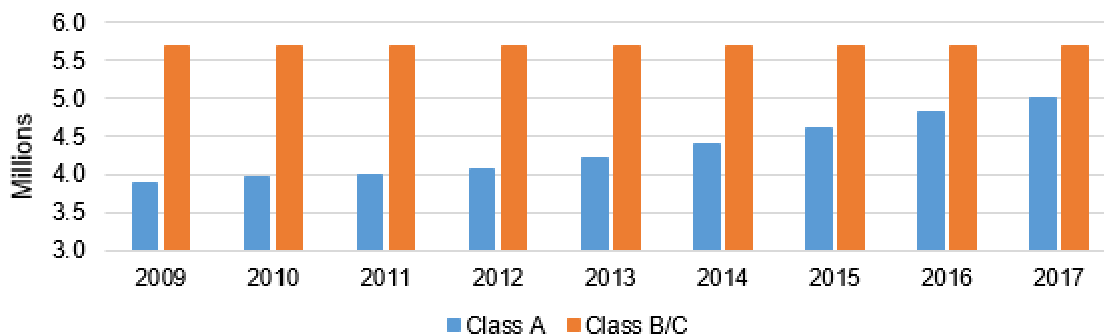
Furthermore, although CoStar's Workforce/Class B vacancy forecast calls for vacancy to rise slightly in 2018 to 6.0 percent, it is expected to remain approximately 3.0 percent below the high rent/Class A category in 2018. Similarly, vacancies in the NOAH category/Class C category are expected to rise modestly to 5.3 percent in 2018 but remain well below the anticipated 9.0 percent vacancy rate of high rent/Class A units. By comparison, Reis estimates that there will be little change in vacancies at rent-restricted properties, for which vacancies are expected to remain below 2.0 percent over the next 12 to 24 months.

Little New Affordable Class B/C Supply

As most new multifamily supply underway over the past few years has been clustered in the high rent/Class A segment, there has been little growth in the stock of the more affordable Class B/C segment, as shown in the chart below. Strong demand for multifamily rentals has also prompted developers to renovate more affordable Class B/C properties into Class A properties which command the highest rents. The net impact of the two trends has been that while the number of Class A units has grown by an estimated 1.1 million units or so since the end of the recession to an estimated 5.0 million units, the number of Class B/C units is estimated to have remained virtually unchanged at an estimated 5.7 million units, according to the sample data tracked by Reis, Inc. This trend is unlikely to change in the next 12 to 24 months as most of the new supply underway is estimated to consist of Class A units.

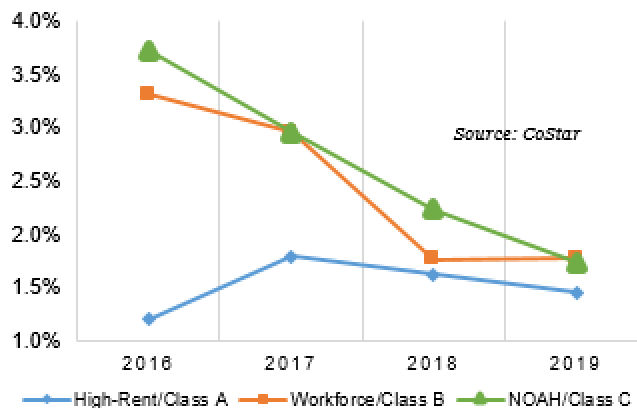
Class A Properties vs. Class B/C Properties



Source: REIS, Inc.

Rent Growth for Affordable Units Remained Elevated in 2017

According to CoStar, rent growth was positive for all classes of rentals in 2017, as shown in the adjacent chart. However, asking rent growth in both the Workforce/Class B category and NOAH/Class C categories outpaced that for Class A rental units by an estimated 1.0 percent – a still significant premium. Rent growth for units in the Workforce/Class B category grew by an estimated 2.9 percent in 2017, to end the year at $1,152. Rent growth for the NOAH/Class C segment, where rents are likely comparable to those for rent-restricted units, grew by an estimated 3.0 percent in 2017, to an estimated $1,003. Both segments still grew well above the pace of inflation, which stood at 2.1 percent year-over-year, as of the end of December 2017.



Going forward, the onslaught of new supply expected in 2018 should start to spill over to Workforce and NOAH units as slowing or even negative rent growth on high rent/Class A units in some submarkets dampens the increases in rent that owners can command on more affordable units. Even so, rent growth for all types of multifamily rentals should remain positive, doing little to improve affordability.

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Rent Growth Expected to Ease Slightly

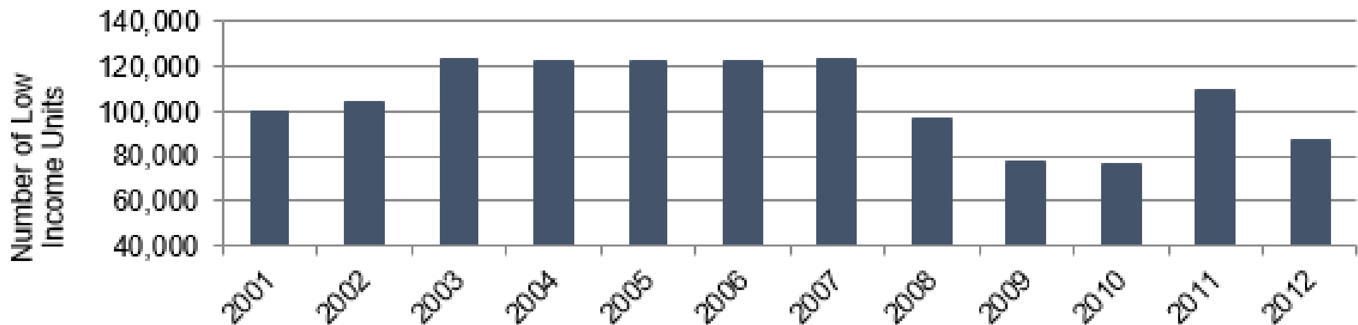
The expectation for 2018 is that rent growth in the Workforce/Class B rental category will moderate but remain positive at 1.8 percent. Similarly, rent growth in the NOAH/Class C category is projected to moderate to an estimated 2.2 percent. In both cases, rent growth will be above the 1.6 percent rate projected by CoStar for those units in the high rent/Class A segment.

Rent-Restricted Supply is the Main Source of New Affordable Housing

Most new affordable multifamily supply falls into the Targeted Affordable category, which is generally funded by LIHTC. Since its creation in 1986, the LIHTC program has created almost 3 million units and an estimated 2.4 million low-income units. Many of these units are now older and require a new infusion of credits for renovation, leaving fewer credits available for constructing new units.

As shown in the chart below, after falling below 80,000 units during the recession, the number of new rent-restricted units placed in service appeared to be returning to more normalized levels of about 90,000 to 100,000, based on the most recent data from the U.S. Department of Housing and Urban Development's (HUD) LIHTC database. The actual number may be even higher, however, as this data has a lag in reporting and may be subject to upward revisions. Even so, the recent Tax Cuts and Jobs Act (TCJA) may cause these numbers to plunge.

Low Income Housing Tax Credits (LIHTC) placed in Service Since 2000



Source: HUD Low Income Tax Credit Database; based on low income units only

Tax Cut Increases Need for Gap Funding

While the TCJA left LIHTC intact, the decline in the corporate tax rate from 35 percent to 21 percent will likely still have negative consequences for new rent-restricted supply. Tax credits are now less valuable and their price has declined substantially since discussions on implementing a corporate tax cut began last year.

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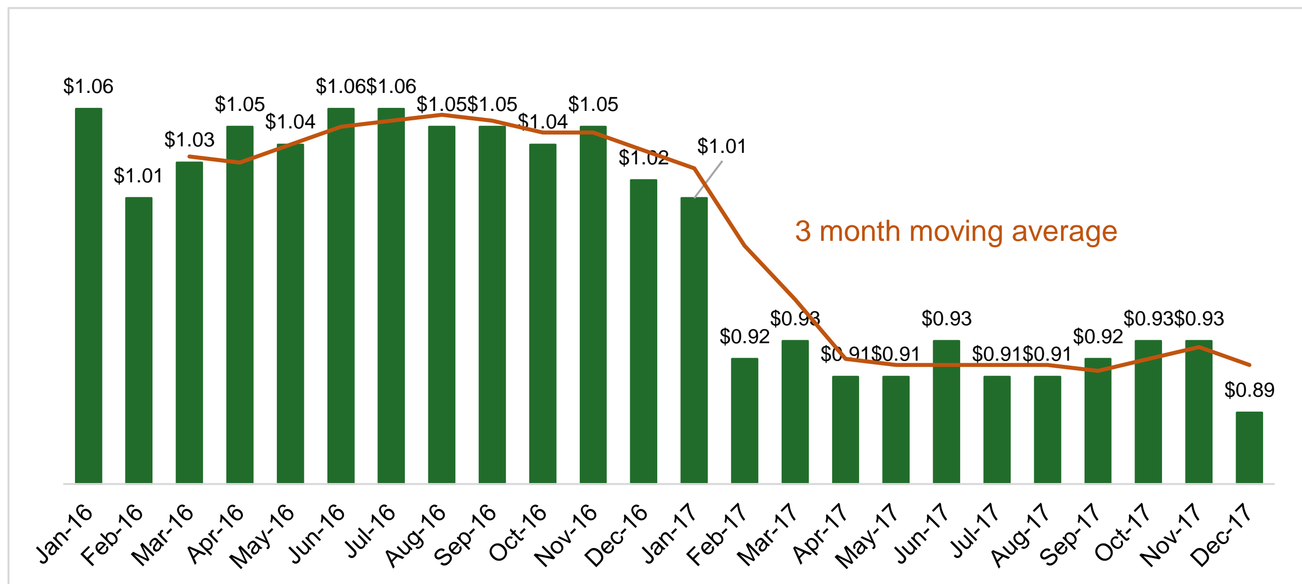
In fact, at the start of discussions in early 2017, the LIHTC investment market assumed there would be a lowering of the corporate tax rate to 25 percent, which caused the value of a LIHTC credit to decline from $1.01 in January 2017 to $0.92 in February, as shown in the chart below. However, the final corporate tax rate of 21 percent caused the price to decline further, to $0.89 as of December 2017. This means that developers may end up struggling on new projects to fill the financing gap left by lower proceeds from the sale of LIHTC.

Low Income Housing Tax Credit Equity Pricing per Credit (January 2016 – December 2017)



Source: Novogradac & Company LLP; https://www.novoco.com/atom/165191

Fannie Mae Re-Enters LIHTC Market

In late 2017, the Federal Housing Finance Agency (FHFA) approved Fannie Mae's re-entry into the LIHTC market as an equity investor to provide support for the production and preservation of affordable rental housing. Some of the anticipated lower pricing may be partially mitigated by the GSEs' re-entry into the LIHTC market.

Furthermore, Fannie Mae's first LIHTC investment fund closed in February of 2018. The fund will invest up to $100 million in markets impacted by Hurricane Harvey, as well as rural markets and Native American housing, by backing multifamily projects in these underserved areas with funding for rehabilitation and construction. The fund will also work to incorporate resiliency features into properties that are situated in markets subject to flood and storm activity.

The Upside of Tax Reform

Tax reform also contained some good news in the form of a new program that could provide funding for affordable housing. Among other incentives, the TCJA allows investors to defer (up to nine years) paying tax on gains if those gains are invested in Qualified Opportunity Funds that in turn invest in economically distressed communities designated by the governor of each state. These areas are known as qualified "Opportunity Zones."

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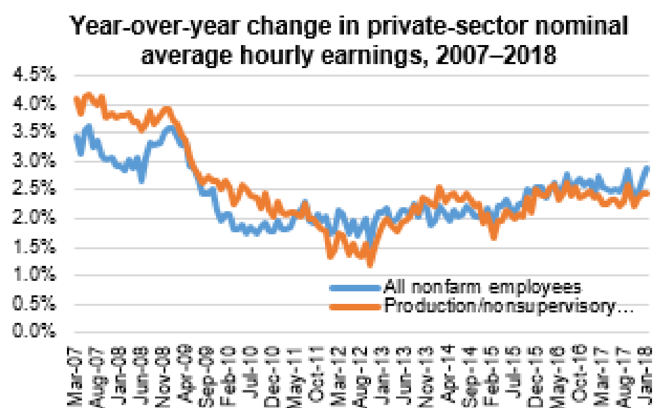
Wage Growth Slowly Strengthening

Wages measure earnings from work, while income can include non-work earnings such as interest and dividends. While growth in income will help with rental affordability, many renters rely solely on wages, making wage growth an important indicator of affordability.

As shown in the adjacent chart, as of January 2018, the year-over-year change in private-sector nominal average hourly earnings for all non-farm employees strengthened considerably to 2.9 percent, which was the fastest pace of growth seen since June 2009. However, the wage growth of production and nonsupervisory employees, some of whom are likely renters, lagged at just 2.4 percent.



Source: Economic Policy Institute; https://www.epi.org/nominal-wage-tracker/#chart-unemployment-rate

Economic Improvement Continues in 2018

Meaningful improvement in rental affordability can only be attained when wage growth meaningfully outpaces rent growth. With the recent tax cuts anticipated to stimulate the economy, Fannie Mae revised its economic growth forecast for 2018 upward by 0.6 percentage points to 2.7 percent and anticipates the addition of over 2 million jobs. The improved outlook stems largely from stronger anticipated consumer spending and business equipment investment.

With the unemployment rate at just 4.1 percent, and employment adding a strong 200,000 new jobs in January 2018, it is hopeful that wage growth will continue to strengthen and perhaps even outpace rent growth in 2018.

2018 Affordable Multifamily Outlook: A Long Way to Go

The outlook for affordable multifamily housing for the coming year is mixed with both positive and negative trends. On one hand, rent growth is likely to slow and wages are likely to strengthen in 2018, positive signs for the affordability of multifamily housing. On the other hand, the production of new rent-restricted housing will struggle due to the growing need for additional gap financing. According to the recently released America's Rental Housing report from the Harvard Joint Center for Housing Studies, an estimated one quarter of renters spend over half of their income on rent and utilities. As a result, the supply/demand imbalance for all types of affordable housing is expected to remain an ongoing issue for at least the next 12 to 24 months – if not longer.

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