The Apartment Sector's Undersupply Problem

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Spring lease-up season will tell us "a lot about the strength of the market going forward," McRoberts says.

ARLINGTON, VA—Is the multifamily sector getting ahead of itself? It's a question that has been posed by a fair number of industry members lately, in view of a deceleration of rent growth and the perception that some markets may become, or already have become, overbuilt. However, on a national level it's not a view that PGIM Real Estate Finance's Michael McRoberts would share, although he does advocate keeping a weather eye on certain metrics.

Managing director with PGIM Real Estate Finance, McRoberts moderated a panel discussion at the Mortgage Bankers Association's Commercial Real Estate Finance/Multifamily Housing Convention & Expo in San Diego last month. That conversation focused on income growth and affordability as key drivers, and while national economic fundamentals appear solid, he tells GlobeSt.com that staying on top of demand for middle- and lower-income rentals is a concern.

GlobeSt.com: We've been hearing that the multifamily sector is, if not softening, at least losing some of its momentum. What's your take?

Michael McRoberts: It's tough to make a gross generalization, because different markets have different strengths, different pockets of strength and supply issues that have been going on. But nationally, I don't think there's a serious risk of real deterioration and individually, in most markets, I don't see a big problem in the future.

GlobeSt.com: With regard to the question of oversupply, is it accurate to say that it's not so much markets that are getting overbuilt as specific submarkets?

McRoberts: There's clearly a need to look at it that way. It'll be interesting to look at it from the standpoint of the yearly cycle, as we're coming into leasing season. We've had a lot of deliveries and this particular spring where we've seen some pretty significant weakness is going to tell us a lot about the strength of the market going forward. If we get a strong lease-up season this spring and we can get through this next year without any real deterioration, I think we're in pretty good shape. You'll start to see the deliveries trail off in 2018, 2019 and 2020, so hopefully we'll see the market stabilize.

GlobeSt.com: The apartment sector has been buoyed by a stable economy and long-term demographic trends. Do you see either changing in the near term or long term?

McRoberts: No, it feels as though we've got good, steady job growth. We'll see what happens with the current administration, but it seems as though they're pro-business, and they're looking to stimulate some growth. As far as monetary policy goes, it doesn't look as though we're going to see any dramatic spikes that would reduce the momentum we've built up, so we'll have pretty good sledding over the next couple of years.

From a housing unit perspective, given those economic indicators and the demographics that we've got going on, as well as the immigration that's occurring, the country needs about 1.6 million to 1.8 million units per year to be developed over the next few years. We're only producing about 1.2 million to 1.3 million—that's a combination of single-family and multifamily—so we're undersupplying the market in terms of demand drivers and household growth.

GlobeSt.com: Are we seeing an imbalance of development leaning toward the class A end of the spectrum?

McRoberts: There's no question about it. In order to make new development work today, you need certain rent levels, and those rent levels happen to fall into the higher-income bracket. So new development is going to be urban infill, transportation-oriented to cater to the people who can afford the higher rents. It's just a fact of how the economics work on developing.

One of the other issues that's compounding this is that now we've got some turbulence in the tax credit market, which is working at the lower end of the market. The prospects of corporate tax reform, or changes that lower the corporate tax rates, have really disrupted the demand for the credits that fuel development at the lower end. So we really have a housing shortage issue going on with respect to people at middle- and lower-income levels.

GlobeSt.com: For investors, are there opportunities in this potential shortfall?

McRoberts: We're starting to see that now, because there were some developers who got into the land two or three years ago and have begun to deliver those units. They did it at a lower basis with respect to their land costs and their construction costs, and they're coming into the market with class A product thinking they'll have 95% occupancy at the rents they pro forma-ed. What we're seeing is that they're having to give up a month, and in some cases two months of concessions, so their rental income is less than what they expected, and their business plan was to sell. Some people are holding and trying to get through that wave of lease-up concessions, and then some had a plan to sell, so they're going to sell.

There are some opportunities out there, and we're starting to see that now. In fact, we're looking at two large transactions; the purchaser is one of our clients, and they're looking to buy an asset at well below what the expectation was six to 12 months ago.

GlobeSt.com: While multifamily has been primarily focused on the under-35 cohort in the past few years, we're starting to see people in their 50s, 60 and beyond turning to rentals. Do you expect this trend to accelerate?

McRoberts: I definitely think it will accelerate as the Baby Boomers get closer to retirement, and are starting to think about moving into a renter situation. It's becoming an option for them where it really wasn't five or 10 years ago.