Promising Predictions for the 2011 Apartment Industry

Jan 11, 2011

By Keat Foong, Executive Editor

Is it really possible that 2011 will usher in one of the strongest apartment markets ever? Some economists think that forces such as an improving economy and continued turmoil in the singlefamily housing market are conspiring to produce an environment in which the industry will be experiencing almost back-to-trend rent levels, occupancy growth and rent increases that may even be comparable to statistics obtained during the glory days of the mid-2000s.

“I have been in the business for 30 years, and this will be one of the best apartment markets that I have ever seen,” says one of the more bullish analysts, Ron Johnsey, president of Axiometrics Inc.

Gleb Nechayev, senior economist, Global Research and Consulting-Econometric Advisors at CB Richard Ellis, forecasts that average economic rent will reach $1,130 per unit by the end of this year. This level is a mere 3 percent below the $1,167 achieved at the height of the apartment market in the third quarter of 2008.

There is a good chance, says Nechayev, that the actual rent may even surpass what he foresees. “What’s driving rents now is not only the job creation, but also rapid expansion in the number of renter households by necessity, mainly due to foreclosures,” he adds.

Rents may jump

Get ready for continued firming of occupancies this year. Johnsey’s forecasts call for the average vacancy rate to drop in 2011 to 5.8 percent—a solid statistic considering apartment properties aim for vacancy rates of 5 percent for optimal rent increases. The higher occupancy levels will burn off concessions. Consequently, effective rents will increase, Johnsey forecasts, by 5 percent in 2011. This number compares impressively with rent increases of 5.94 percent achieved in the last peak in the second quarter of 2006. “That tells us it’s a very robust apartment market, when you can hike the rents and still increase occupancy,” says Johnsey.

Ron Witten, president of Witten Advisors LLC, has similar projections for apartment fundamentals. Witten, who studies buildings of five-plus units, says the average national apartment occupancy level will be above 95 percent by the end of the year. That should translate to an effective rent growth rate at the end of 2011 of 4.5 percent, which he says is “well above average” and “very strong.”

This year, the apartment market could be continuing the trend established in 2010, when conditions improved markedly and rapidly, and perhaps somewhat unexpectedly, during the course of the year. “It’s amazing. It was as though someone turned the light switch on in January 2010,” says Johnsey. According to Johnsey, rents fell for 17 consecutive months through December 2009, but turned positive beginning in January of 2010. Rents were 0.2 percent in January 10, and remained positive for almost every month through the fall of 2010.

The apartment market bottomed in the fourth quarter of 2009, explains Delores Conway, professor of statistics and real estate economics at the Simon School of Business at the University of Rochester. But by the end of 2010, it had already enjoyed three consecutive quarters in a row of recovery, she says. By then, occupancies were on the way up in most markets, while rents were improving in many, notes Witten.

The national vacancy rate fell on a year-over-year basis from 7.8 to 7.1 percent, says Conway. “This is a big drop,” she says, adding that the last time there was such a significant improvement in the vacancy rate was in 2005. Net absorption was 160,000 units through late last year, she adds. “That, to me, indicates the apartment market [was] really starting to recover, and the recovery appears to be firm.”

Economy improves slowly

Most economists expect GDP growth in 2011 to be 2 percent to 3 percent—not much higher than 2010’s expected GDP expansion of around 2.5 percent. According to Conway, the current economic recovery is unlike most recoveries, in which there typically is a “pop” in activity after the recession. “We [expect] economic growth this year to proceed at a reasonable, but slow, rate,” says Conway.

Uncertainty, as well as the weak housing market, combined with the housing and financial crises, are the reasons behind what is expected to be a slow climb out of tepid economic-growth land. “Although interest rates are very low, it is very, very difficult to obtain loans for small businesses, which are usually the ones to lead the way on the path to recovery,” says Conway. “And a lot of the leverage held over from the days of the financial crisis have yet to be unwound,” she notes.

The apartment industry, whose health usually depends on the level of employment, rebounded surprisingly robustly last year. However, job growth has only been moderate at best, and many economists expect it will take several more years before the 8 million-plus jobs lost in this past recession will be recovered. “It will probably be 2015 before the employment level will be back to where it is desirable,” predicts Witten.

Witten says unemployment will remain “very high” in 2011, between 9 percent and 10 percent, through the end of the year. Axiometric’s Johnsey believes it will be 2013 before there will be robust job growth. He predicts an annual average job growth rate of 378,000 jobs per month in 2013. Meanwhile, he expects about 172,000 jobs to be created this year, at an annual average rate of 1.6 percent. This is a weak number, considering 125,000-150,000 additional jobs are needed per month just to absorb new workers entering the labor force. With an extension of the Bush tax cuts for the middle class and high-income earners, however, economic growth may be stronger, he says. Witten also projects 2 million-plus jobs created this year, versus 1 million or fewer in 2010.

Homeownership is suppressed

So why will demand for apartments continue to be firm in 2011 despite the lackluster employment levels? One reason is that in an uncertain economy that is still finding its way, residents are staying put in their apartment units, and consumers are choosing to rent instead of buying homes. “It is a part of the outcome of high unemployment and relative uncertainty of the economy, which has increased the propensity to rent rather than buy,” says Witten.

Furthermore, there is little pressure to buy homes, notes Conway, given that home prices are flat or still declining in many areas of the country and interest rates are remaining low. Indeed, the Standard & Poor’s/Case-Shiller home price index fell further, by 0.7 percent, in September, compared to the previous month.

The homeownership rate—66.9 percent in the third quarter—has tumbled from its peak level of 69.2 percent, achieved in the fourth quarter of 2004 during the height of the condo boom. Witten thinks the homeownership rate will fall further this year before heading up. REIT executives note that every 1 percent drop in the homeownership rate translates into more than 1 million new renters.

The continuing trend of home foreclosures, though unfortunate for those affected, may also be making a good situation for apartments great. It is a major reason why apartments will perform strongly this year. A record 2.82 million homes were foreclosed in 2009, and 2010 was on track to have 1 million additional foreclosures, though the foreclosure rate seems to have begun to stabilize, if not decline, toward the end of last year. In October 2010, one in every 389 housing units received a foreclosure filing. While they can give rise to a shadow inventory of rentals, foreclosures also drive masses of former homeowners into rentals as they lose their homes, and push dissatisfied residents staying in under-managed home rentals into apartments.

While job creation has yet to kick in significantly for a number of years, the state of the economy as an engine for the robust apartment numbers cannot be discounted. There was some job recovery in some parts of the country, says Conway, such as New York, New Jersey, Boston and the Silicon Valley. “There were great environments for effective rent growth,” agrees Johnsey.

According to Johnsey, the slowly improving economy—at least in some parts of the country—will continue to drive up the level of household formation. After a year of doubling up during the downturn, residents, including Echo Boomers who moved in with their parents, will continue to decouple and seek their own apartments as the economy improves.

Aggravating the effects of strong demand for apartments, new construction will fall further this year, Witten projects. He predicts that apartment completions (of five-plus units) will fall from 108,000 units in 2010 to a mere 70,000 units in 2011—a fraction of the 200,000-250,000 units that are the norm. But new construction may gear up again starting this year as credit becomes more available. In fact, Johnsey suggests making the most of opportunities now as he predicts that the apartment occupancy rate will flatten at 95.4 percent between 2012 and 2014, and weaken starting in 2014. Rent growth will fall to 3.4 percent in 2014 as a result of increased levels of construction beginning in 2011 or 2012. In the meantime, however, NOI will start rising again and that will, ultimately, further increase apartment valuations in 2011, he points out.

Related Posts:

- Top U.S. Real Estate Companies
- Manhattanites Flock to Yorkville’s Family-Friendly Condos
- Midwest Apartment Market on Rebound