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# Apartments first commercial investment to show signs of recovery

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Apartment performance turned the corner during the second quarter, as modest private-sector job growth and stronger household formation released some of the pent-up renter demand accumulated through the downturn. Improvements were broad-based, with 70% of all major U.S. apartment markets recording occupancy gains. As 2010 progresses, more pent-up demand for apartments will be released, particularly among the estimated 2.2 million young adults who have moved back with their parents since 2005. The outlook brightens considerably for 2011 and beyond amid expectations for improved economic growth, powerful demographic shifts supporting a surge in renter demand and limited new construction. These trends will likely result in a shortage of apartments nationwide, driving rent growth to above-average levels by 2012 or 2013.

After stabilizing earlier this year, apartment vacancy slipped 20 basis points to 7.8% during the second quarter. Approximately 46,000 apartments were absorbed, the strongest demand since late 2000. The surge reflects the release of pent-up demand amid moderate private-sector job creation, as more young individuals moved out of their family homes and renters who doubled up through the downturn re-established independent households. During the first six months of the year, 10 metro areas accounted for 55% of the absorption recorded nationwide; combined, these markets added 212,000 jobs, equivalent to approximately one-quarter of all positions created in the U.S. during that time.

Foreclosure-related increases to renter demand continue. At the same time, tight lending and high down payment requirements preclude many renters from purchasing homes; as of mid-2010, just 8% of residential mortgages originated allowed for down payments of less than 10%, compared to 29% in 2007. The homeownership rate has dropped considerably in recent years as a result of these trends. Even during the first half, when the homebuyer tax credit remained in effect, the homeownership rate slipped 40 basis points to 66.9%, the lowest level reported since 1999. Over the past year, owner-occupied housing declined by 42,000 units, while renter-occupied housing increased. A large share of new renter demand was satisfied by available shadow stock, however, as foreclosed families often gravitate toward single-family rentals over apartments.

Developers delivered 29,200 apartments in the second quarter, up slightly from the previous quarter but down 18% from the same period in 2009. Many of the projects completed through the first half were started ahead of the downturn in renter demand, with a more dramatic slowdown in deliveries anticipated later this year; fewer than 30,000 units will come online during the second half.

During the second quarter, rents increased and concessions declined for the second consecutive period. Asking rents rose 0.4% to $1,021 per month, while effective rates gained 0.6% to $946 per month. Concessions peaked late last year at 7.8% of asking rents, or slightly more than four weeks of free rent on a one-year lease, and have since slipped to 7.3% of asking rates, still well above the long-term average of 4%. Despite regaining some pricing power, owners will likely wait until 2011 to raise rents more substantially, instead focusing on attracting tenants and filling vacant units.

Apartment transactions accelerated during the second quarter, hitting the highest level since late 2008. Increases were driven largely by the $5 million to $10 million and $20 million to $40 million segments, as larger private investors and REITs/institutions moved off the sidelines. Investors have begun to accept that a wave of deeply discounted, distressed opportunities may never materialize. At the same time, financing constraints eased, as the agencies and life insurance companies became more aggressive in their pursuit of high-quality deals.

Improvements in fundamentals will continue through the second half as moderate job growth persists, renter household formation accelerates and new supply drops off. By the end of 2010, vacancy will slip to 7.4%, while asking and effective rents will rise further, registering annual gains of 2% and 3%, respectively.

Construction will remain limited in the near term as developers continue to encounter difficulties securing financing and penciling out new projects at current rents, setting the stage for an undersupply situation and above-trend rent growth beginning in 2012. Also, the apartment market stands to benefit from the aging of echo boomers, which will lead to the addition of four million individuals to the prime renter cohort from 2010 to 2015. Based on expectations that strict mortgage standards and elevated down payment requirements will persist for several years to come, most young adults will head for the renter pool.

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