Peak Apartment Supply: Winners and Losers

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Aaron Cole: Ladies and gentlemen, thank you for your patience and, once again, welcome to today's live webcast, "Peak Apartment Supply: Winners and Losers." And before we get started with today, let me quickly point out some of the items on your console and how you can participate.

Today's presentation utilizes a dynamic console that allows you to adjust and resize any of the windows available to you. To do that, you can simply click on the window that you wish to move or resize and then move it to your preference or resize it by clicking on the very bottom right portion of that window, again, to resize to your preference.

We, of course, encourage you to get the most out of today's presentation by asking any questions that you may have, and you can easily do that by locating the Q&A window. Go ahead and type your question in there and hit the "submit" button, and we'll be taking as many questions as we have time for at the conclusion of today's presentation.

We are also going to be showing you a couple of polls, and we would greatly appreciate your participation on those polling questions. Go ahead and click on the radio button that best corresponds to your answer within the slide viewing area once you see the poll and be sure to hit the "submit" button to register your vote and thank you, again, for voting on those.

Lastly, if you need any technical assistance, we would request that you submit your technical-related question through that Q&A window, and we'll be more than happy to help resolve any issues that you might be experiencing.

We are excited today to have Aimée Baumiller from PNC's Real Estate Market Analytics group join us as our presenter here for today. Today's presentation will focus on apartment supply in 2017 and market and product winners and the opportunities for the future. We will facilitate a question-and-answer session at the end of the presentation, as I mentioned. Aimée, with that, welcome, and I'll turn the floor over to you.

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Aimée Baumiller: Okay, thanks for the intro, Aaron. So diving straight into the market fundamentals, this is my favorite chart because it shows the blind demand as well as the vacancy. So we have supply completions in blue, and demand as net absorption in orange, and vacancy is the green line.

So this first slide is showing a little bit of a jump in vacancy in the first quarter as that 4.4% compared to 3.9% at year-end 2016. So this is still below the 10-year average of 5.3%. So I think a little bit of the jump for first quarter is a seasonal variation, so we see higher vacancies in the winter months. The 50 basis-point jump does seem a little bit higher than the usual seasonal variation, and we're also seeing negative net absorption for the first time since 2012, close to 20,000 units of net move-outs.

True first quarters are typically weaker in terms of leasing, but demand just couldn't keep up with the level of new supply that we had to deliver, and that number was about 73,000 units in first quarter. On an annual basis, the market absorbed about 237,000 units, while 303,000 new units were completed, and that was a 30-year high.

Demand is not quite keeping up with supply, at this point, so our vacancy is raising higher. We do expect vacancy will likely hit higher but just a little bit, just maybe another 50 basis points over the next year to about 5%. Next slide.

Okay, so this slide, I wanted to show a little bit of historic perspective, so how our current supply levels are comparing to the last few decades. So if you look at the chart on the left, we see permitting levels for both single-family and multi-family as well as the line for the total. And the green line represents multi-family permitting, and we see the line elevated from the very low levels in 2009 and 2010.

So we are facing peak apartment supply for this cycle, but we are still well below the construction boom that took place in the mid-1980s. So look at the chart on the right. This is showing what Axiometrics had tracked in new apartment supply going back to 1997. Axiometrics and a few other data providers, like MPF, are expecting 2017 to be the peak year apartment supply. But as we've seen in years past with construction delays, a lot of units slide into the next year. So we might see a combination of 2017 and 2018 combined as the peak of apartment supply, not a single year.

So in the chart on the right, Axiometrics is predicting somewhere between 350,000 and 400,000 completions for 2017. Some data providers are pegging the number even higher, close to 410,000 units.

Looking ahead to 2019 and beyond, completions are expected to diminish. So, again, on the chart on the right, the forecast completions don't drop off too much after 2017, but other data providers do show us a more significant dropoff. And I will get into later, it is going to be very market-specific. So let's look at supply by market. Next slide.

Okay, so when we think about supply peaking, we're talking about on the national basis. Construction activity has been quite lumpy with concentrations in certain top markets. Just 15 markets accounted for half of new construction in this cycle. This chart showing the top 25 markets sorted by the number of units delivering in 2017. This chart includes only those properties that are under construction, so the 2018 totals will likely come in a little higher as the planned project breaks ground.

And, let's see, the totals for 2017 and 2018, they are likely to change based on what I said before — construction delays — but I think these are very good estimates based on first quarter data. And not surprisingly, New York tops the list with over 27,000 units delivering this year — a bit less in 2018 but still construction is very active there.

Dallas and Houston come in second and third places. What's notable is that Houston is really showing a large dropoff in deliveries for 2018, going from about 20,000 completions in 2017 to only 5,000 units delivered in 2018. On the other hand, the market not really showing much of a dropoff in 2018 is Washington, D.C. with almost 12,000 deliveries expected in 2017 and another 10,000-some units expected in 2018. So in D.C. we saw a little bit of the supply peak, I believe, in 2015. And then levels went down a little bit. They're going to go back up again. LA looks like its supply peak is evenly spread between 2017 and 2018.

So let's now turn towards which sub-markets are experiencing the most construction activity. Next slide.

So when we break down the deliveries by sub-market, we can really see the areas where supply is concentrated. Looking at the top 25 sub-markets, sorted by 2017 deliveries, we see that many of the same markets — but take a look at the sub-markets within the top markets. Those sub-markets with the most deliveries in 2017, those are concentrated in a lot of urban sub-markets.

King's County, Brooklyn, leading the way with almost 7,500 units expected to be completed in 2017. Other urban sub-markets in New York, like Queens, Mid-Town West, Hudson Waterfront, or Jersey City, they are all showing the heaviest construction activity. Outside of New York, we have downtown Seattle, Montrose River Oaks in Houston, Downtown Nashville, and Downtown Denver. And Gold Coast River North sub-market or Chicago is also seeing a lot of new supply this year as well. With the exception of maybe Queens, Miami, and Westlake Downtown LA, which has more completions in 2018, 2017 is the year where mostly urban sub-markets will see the most construction activity.

So when I look at this chart, because 2018 deliveries tend to be generally lower, we do expect any jump in vacancy in 2017 going into 2018, I think it should be rather temporary, depending on the market. And we think that, given some time to absorb the surge of supply, these sub-markets will settle down and will get back to their vacancies that are more in line with historic averages. Next slide.

What's like this data another way? So instead of ranking the markets in terms of sheer number of deliveries, let's look at which markets are experiencing the largest expansion to their existing supply. So while New York might be the leader in terms of simple number of units, Nashville is experiencing the largest boom relative to existing inventory. So in other words, New York had a larger existing base than Nashville, so Nashville's percentage increase is going to be greater, even if its construction numbers are lower.

And all of these markets are showing rising vacancy rates in either mostly flat to slightly declining rents on a quarterly basis. But looking at vacancy rates, all are relatively low, still in single digits. Only San Antonio is about 7%. But relative to its historic average, it's only slightly elevated for San Antonio. At a 7.6% expansion to existing supply, Nashville is leading the way, and vacancy is still generally low at 5.1%, and quarterly rent for us is still positive, although a little flat.

Take a look at Charlotte. It looks like this market has more unit plans underway, so construction activity is still quite robust. If Charlotte sees a bit fewer deliveries in 2018, in 2019 completions might creep back up again. The same deal goes for Orlando, Dallas, and Seattle. There's still quite a hefty pipeline in these markets, so we might not see much of a lull in 2019 and 2020.

All right, let's start with our first poll question. "Which market in the first quarter have the most sub-markets showing up in the top 25 by apartment supply expansion?"

So let's think now — all of these markets have experienced apartment construction booms, but which one seems to have been more widespread across the whole metro area versus just concentrated in a few sub-markets? It's a little tricky because all these choices have been getting a lot of media attention for apartment supply.

I'll give you a few more moments. Okay, a couple more moments. Let's see how you scored.

Okay, the most popular answer was Houston followed by D.C. Well, the correct answer was C, D.C. In the list of the top 25 sub-markets by supply expansion, D.C. has four sub-markets. Denver and San Antonio are runners-up with three sub-markets each, so you were close. Houston actually has zero sub-markets in the top 25, so that's surprising that was the most popular answer — zero sub-markets. Its most concentrated sub-market is Montrose River Oak, and that's coming in at number 52. But that one, while there are a lot of units seen delivered in 2017, as we saw on a previous slide, this sub-market is only expanding their base by 8.7%. Still a good number, but vacancies rising, but it has a larger base to grow from.

Here you can see — in this chart you can see the top 25 sub-markets with D.C. having four of them; Denver and San Antonio each having three. So, again, ranking the sub-markets but this time by expansion through existing supply rather by number of units. We see another way. Many sub-markets, these are urban or downtown sub-markets. Capitol Hill, Southwest D.C., Downtown Charlotte, Downtown Denver, Downtown San Diego, Old Town Alexandria, Downtown LA, and Chicago's Loop. The list goes on.

Some sub-markets showing up on this list seem to be in more rural areas, just a couple of those, outlying suburbs, which would make sense because they have rather small bases to grow from — small bases of existing inventory to grow from with some supply additions.

So this table, pay attention to those sub-markets with the largest positive vacancy basis point changes over the last year combined with declining rents. So fitting that description would be Dallas's Rockwall County, number 3 on the list, as well as Downtown Nashville and Downtown Denver. But as I mentioned on the last slide, I think any jumps in vacancy are likely to be temporary as demand catches up to meet the new supply.

So markets showing up on this list with negative basis point changes and positive rent growth, they're showing very strong demand in the face of elevated supply, I think. Winners here include Old Town Alexandria in D.C., Upper or Lower Merion in Philadelphia, and the outlying suburbs in D.C. Stafford County. Next slide.

Okay, let's now turn to product concentration. Looking at apartment vacancy by class, we can see that over the last 10 years, while Class A shown as the blue line, typically has a lower historic average vacancy compared to Class C, the green line. In the first quarter we see them having switched places. Now Class A has higher vacancy, 6.4%, and Class C has the lowest vacancy, 3.8%. Class A is higher than usual, and Class A is lower than usual. Note that this chart is showing a 12-month trailing average, so we can really see that Class A vacancy has been trending higher over the last four years after tightening following the downturn.

Class B and C vacancies fell steadily since the downturn but have not shown an uptick in vacancy like Class A has. So given what we know about the location concentrations in supply, the most supply being constructed in just a few markets, mostly coastal markets. It really comes as no surprise that the new supply — that most of the new supply is likely Class A products. Let's check the next slide.

Rent growth by class — so here we see all three classes are decelerating a bit, coming off cyclical highs in 2015 and 2016 to more moderate rent growth currently. Compared to their historic averages, however, they're still quite healthy, I think. What sticks out to me in this chart is middle-tier Class B rent growth is surpassing upper tier Class A rent growth.

What's likely happening here is that competition from new supplies weighing on rent increases in top-tier products. We're seeing rising concessions at newly delivered projects that you want to bring in new renters to quickly reach stabilization and more and more apartment operators tend to be offering discounts. And the sub-markets that we're seeing the most supply surges tend to be those that are offering concessions — a couple of different exceptions to that.

Another trend we're noticing is that in markets where the rent delta is between top and middle-tier products is the smallest. For example, we've seen the difference in rent being the smallest in southern markets. Class B renters can easily jump from Class B to Class A products, especially when there's a concession being offered. It makes it a little more affordable for them.

Further, Class B and C products being from investor interest with value-add propositions bringing the older, tired product up-to-date with renovated interiors as well as a lot of updated amenities.

So depending on the level of improvements in the local competition, renovated units can rent for significantly higher than non-renovated units. Let's do another poll question.

Okay, let's test our knowledge. "Which markets in the first quarter are in the winning top 10 rent growth leader?" A, San Jose, Houston, Cleveland; B, Dallas, Las Vegas, Seattle; C, Denver, Chicago, Minneapolis; or San Francisco, St. Louis, and New York. I'll give you a minute.

I think this one is tricky also, because some of the markets that were rent growth leaders last year, they're not anymore. Some other, what we call, "late to the party" markets. They're showing some nice rent growth later in the cycle. I'll give you another minute.

Let's see, okay, let's look at the tally. Okay, so most of you said Dallas, Las Vegas, Seattle. Oh, you're actually correct this time. That's the right answer. Well, let me just explain, okay, so C was a trick, because those markets they're also quite strong just not in the top 10. Denver is number 11, Chicago is in the 20s, and Minneapolis is, I believe, number 14. A and D were dead giveaways. A and D markets are actually showing up in the bottom 10 markets for rent growth, but only New York, Houston, Pittsburgh, and San Francisco are showing annual rent declines. And the rest of these markets still has positive rent growth, but they're not quite as strong as the leaders.

Let's turn the slide to C. So here's the rent growth ranking. The markets like San Francisco and San Jose are now at the bottom of the pile. They enjoyed several years of astonishing rent growth, and so now they're correcting a little bit. Markets like Sacramento and Las Vegas, they were incredibly late to the party, but they're now recording very robust rent growth as we see here — just a little bit late in the expansion cycle.

It's heartening to see some markets we mentioned earlier in the presentation. The market's seen peak levels of supply like Dallas, Atlanta, and Charlotte. They are now posting very strong rent growth numbers.

These markets are seeing such strength in job and household growth that this really helps support the absorption of new apartment units. Also, I should mention, Nashville is not even in the top 10 or bottom 10. It comes in at number 16 with annual rent growth of 4.7%. Still higher than the national average despite having such a supply surge lately.

Let's now check out the vacancy ranking. Here we have the top 10 and bottom 10 markets by vacancy rates. New York, Minneapolis, Northern New Jersey, all have a very tight — they're all very tight markets, and they usually are. Houston, Raleigh, San Antonio, they're showing the highest vacancy rate. Earlier, when I highlighted the high supply markets, I mentioned that the rising vacancy rates were likely to be temporary until the market had a chance to absorb the supply. How temporary? I don't really know, but the fact that many high-supply markets even with a little bit elevated vacancy rate, they're still showing pretty healthy rent growth. So that's very encouraging.

For example, Atlanta is in the bottom 10 markets for vacancy, but it's also in the top 10 markets for rent growth. Next slide.

Finally, I wanted to show how walkability is impacting apartment values. As the chart clearly demonstrates using Real Capital Analytic CPPI, renters and apartment investors see walkability both in CB urban and suburban areas as being very valuable, and they're willing to pay for it.

I don't have a slide for rent growth in walkability, but from my experience looking at lots of individual properties and transactions, that trend is positive there as well. Urban versus suburban doesn't really matter so much as walkability matters. And it doesn't just seem to be the millennials moving away from driving cars so much, as the trend is becoming a little bit more widespread.

In my market research role at PNC, when I evaluate individual deals, I can tell you that we do take into account the property's walk score. I look it up all the time. It really does strengthen the desirability of the project. I think it's becoming more and more important, and I'm glad to see that those numbers are showing that.

So let's wrap it up and move to the last slide. So I've talked about location concentrations and product concentrations. I've showed you how we're seeing a lot of new supply, mostly top-tier luxury product being constructed in mostly urban sub-markets. These concentrations, they are pressuring the Class A segments, which acts to elevate vacancy and slow down rent growth.

But I do see a lot of opportunities remaining in the apartment market. We still have a lot of opportunities. Suburban sub-markets, especially those with high job growth and better walkability, those are key areas without a lot of new supply in most cases, and some untapped demand for apartments. Many inner ring suburbs with inventories that's mostly older, Class B and C stock — those tend to be key opportunities for value-add place.

And these inner ring suburbs — some markets, they might not have a lot of new supply because they're already built out or they might have high barriers to entry. So purchasing these properties and renovating them can offer an alternative to new construction. We also see this product as having a much deeper pool of demand, as they're just much more affordable to the average renter. And as we saw on the previous slide, the impact of walkability in both urban and suburban areas can have an enormous impact on apartment values.

Okay, so that about wraps it up. Let's jump into the question-and-answer portion of the webcast.

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Aaron Cole: Okay, Aimée, great. Thank you very much. As Aimée just said, let's go ahead and take some questions. We did start a few minutes late today, and we've got a lot of questions here, so we'll get through as many as we can get through with the time remaining. And, as a reminder, if you do want to ask a question, you can submit that through the Q&A window. Make sure you hit the "submit" button to register that question.

Okay, taking a look at our first question, Aimée, "Is Class A supply a concern?"

Aimée Baumiller: Okay, so I presented a slide earlier that showed Class A vacancy rising over the last four years, and Class B and C vacancy declined. I do think Class A product is actually what is driving overall vacancy higher on a national basis, at least. And most of the new supply being built today is luxury top-tier products, so I am keeping an eye on Class A supply. Class A rents, they're also slowing down quite a bit. So I do think it's worth keeping an eye on it.

It's not surprising, though, since newly constructed projects are having to offer more concessions because there's so much more competition. I think it's time for another question.

Aaron Cole: Okay. Let's go to next question — "Are you seeing a deceleration in supply after 2017 and 2018?"

Aimée Baumiller: I think it really depends on the market. The slide I presented earlier shows the units planned for some of our top high-supply markets. Let's see, Charlotte, for example, has more units planned and underway. So construction activity is still quite high. Charlotte is an example of a market that there's not really going to be a big dropoff, so I think if Charlotte sees a bit fewer deliveries in 2018, 2019 completions could be higher. There's a little bit more of a pipeline in that market.

The same deal for Orlando, Dallas, and Seattle. Those markets still have the heavy pipelines. We might not see too much of a lull in 2019 and 2020. So I think some markets are showing — I think there are a lot of markets showing a dropoff in supply in 2019, but there are a lot of exceptions to that as well. We do still have a pretty big pipeline of planned projects.

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Aaron Cole: Very good. And I think we have time to squeeze in one more question here for today. The last question will be "Do you see any rental properties transitioning to condos to serve the unmet demand for entry-level homes?"

Aimée Baumiller: I haven't really seen this trend of existing rental properties going condo. I haven't seen that happening at all in this cycle, but some new construction of condos starting to re-emerge. I've seen that happen but probably just in markets like New York and Miami, if I remember correctly. But that's a trend that I'm definitely keeping an eye on, and I'll be tracking that, going forward.

Aaron Cole: Sure. Okay, fantastic. Ladies and gentlemen, I do think that is going to be it for today, as we're almost out of time. But, Aimée, thank you for a great presentation today. And, ladies and gentlemen, before you leave here for today, a PDF of today's presentation as well as a CTP recertification credit document is now available for you to download in the green resource list file folder widget that you'll find in the lower center portion of your screen. Click on that to open it up.

You should also now see a link to a short survey on your screen, and your feedback is, of course, very important to us, and we greatly appreciate any of your thoughts on today's session. With that, we'll go ahead and wrap up today's event. Once again, thank you for joining us. We'll see you next time.

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