AEGON Asset Management

Real Assets Research
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AEGON **INSIGHTS**

Medium-quality apartments still a sweet spot, but location matters

By Real Assets Research Team

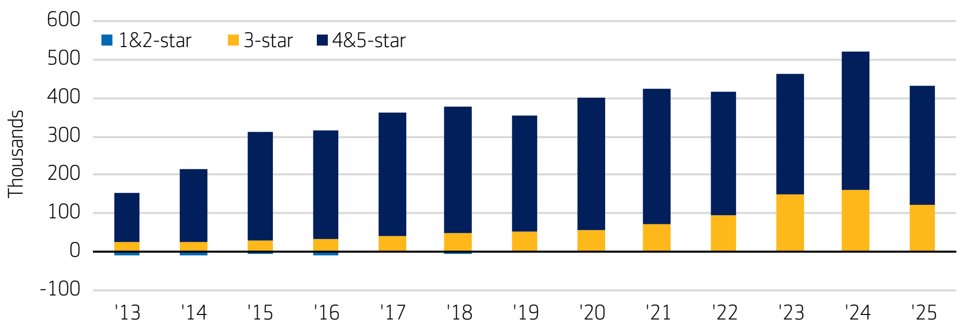
Key takeaways

- *Higher-quality (defined as a 4&5-star CoStar rating) apartment construction has been booming and contributing to higher vacancy rates with downward pressure on rents.*
- *The medium-quality (defined as a 3-star CoStar rating) apartment market segment has had scant inflow of new construction; modest vacancy rate increases and solid rent growth.*
- *Results vary by market. Metro-area data suggest some relocation of tenants from medium-quality units to over-supplied higher-quality units. Those metros have had weaker higher-quality rent growth making the relocations attractive.*
- *Current vacancy rates in higher-quality market segments hint to the degree of difficulty associated with absorbing this year's strong inflow of new construction across metro areas. Absorption will take time, but conditions are not historically unprecedented.*
- *Higher-quality supply is challenging but affordable medium-quality apartments are still in short supply with rent growth prospects positive but still varied across metro areas.*

Delivery of new apartments still strong

Apartment construction has been booming in recent years propelled by the historically low interest rates in place during the pandemic. In early 2023, a record one million units were under construction. While the reversal of cheap borrowing in 2022 put a damper on plans for new apartment construction projects, the pullback will not materialize into a subdued volume of deliveries until 2025 (exhibit 1).[1] The relatively long construction period (24-to-36 months) required for the mid-rise and hi-rise apartments that dominate the pipeline accounts for the delay. Until the drop-off in deliveries materializes, the supply inflow is challenging demand and contributing to rising vacancy rates and downward pressure on rents, especially in the higher-quality sub-sector of the market. For investors in affordable medium-quality apartments, the question is whether this inflow of new supply threatens the potential investment performance of the medium-quality sub-sector. In this paper, we examine the data and conclude that higher-quality supply is indeed challenging but affordable medium-quality apartments are still in short supply with rent growth prospects positive but still varied across metro areas.

Exhibit 1: Apartment net delivered units by class

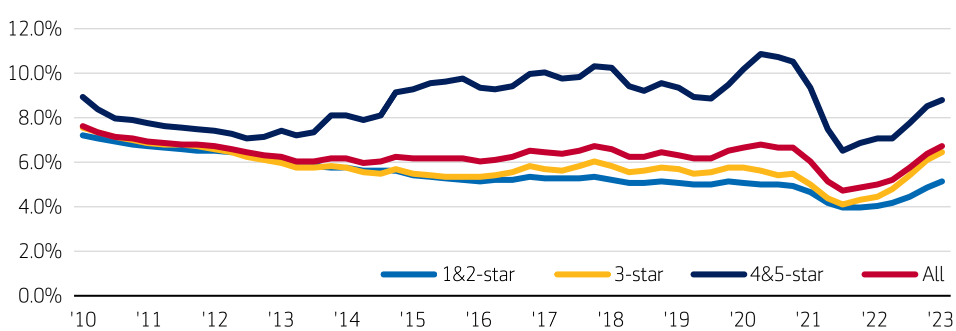


Source: CoStar Reality Information Inc., annual data as of March 31, 2023.

Digesting new supply is taking time

Absorbing the new supply has not been painless; data shows some notable backup as shown in exhibit 2. While the increase in the national apartment vacancy rate from 4.9% in 2021 to 6.7% as of March 31, 2023, is material, it is important to note that 4.9% was an historical anomaly and vacancy rates north of 6.0% were the norm at least after the global financial crisis. Nonetheless, the jump in vacancies is considerable and worth probing. The bulk of the increase occurred higher-quality stock. In that segment, the vacancy rate was 8.8%, up from 6.9% in 2021. For apartments deemed medium quality, the vacancy rate was 6.5%, up from 4.3% in 2021. The lowest-quality stock deemed 1&2-star, 4&5-star also experienced an increase, from 4.0% in 2021 to 5.1%.[1]

Exhibit 2: Apartment vacancy rate by class



Source: CoStar Realty Information Inc., annual data as of March 31, 2023.

The jump in the vacancy rate in the higher-quality segment is understandable. Construction is focused on that segment as the most lucrative especially due to inflated costs of land, labor and building materials. New supply in the higher-quality segment was almost three times larger than new supply in the medium-quality segment over the 2021-22 period. The additions amounted to 12% of the higher-quality segment but only 3% of the medium-quality segment. Digesting the inflow in 2021 was smooth as household formation soared, which helped to stoke a 14.8% jump in higher-quality rents despite the delivery of new projects. But, in 2022, indigestion took hold and rents managed only a 2.8% increase with further easing noted early this year. Interestingly, the medium-quality segment is also suffering some rent reversal despite its paltry new supply. Growth in medium-quality rents eased to 4.2% in 2022 and 2.7% early this year from 11.6% in 2021 (exhibit 3).

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The weakening in rent growth in the medium-quality segment clearly reflects that segment's increase in vacancy rate related to essentially flat absorption rather than any significant new supply. The flat absorption is surprising in light of the well-known scarcity of medium-quality apartments.[1,2]

Exhibit 3: New supply in higher-quality apartments starting to impact rent growth in both higher- and medium-quality segments

	Medium-quality	Higher-quality
New supply in 2021/22 as % of stock	3%	12%
2021 rent growth	11.6%	14.8%
2022 rent growth	4.2%	2.8%

Interplay of medium- and higher-quality apartments across metro areas

To explore further, we examine more detailed data on medium- and higher-quality apartments as well as the pattern of results across metro areas. Our conclusions suggest that medium-quality apartments are still in short supply while the excess in higher-quality apartments is not out of line historically, but it will take some time to be absorbed. We believe, alarm is not warranted.

As shown in exhibit 4 on the next page, the distribution of medium-quality vacancy rates for the largest fifty metro areas shows that 11 of the 50 endured only minor increases of one percentage point or less in 2022 with another 18 posting increases below the 2.2 percentage point average vacancy rate increase. For these 29 metro areas, medium-quality vacancy rates averaged 5.1% at year-end 2022, well beneath the national average 6.1% for the medium-quality segment and lower than the overall medium-quality vacancy rate history for the last decade. Effective medium-quality rent growth in these 29 metros averaged 4.8% in 2022. **These readings demonstrate that medium-quality apartments remain in tight supply across a wide swath of metro areas.**[1]

Exhibit 4: Top 50 MSAs class B rent growth and vacancy rate (2022)

		3-star market segment		4-star market segment	
	How many?	Vacancy rate	Rent growth	Vacancy rate	Rent growth
Metros with vacancy rate increase above 2.2% average	21*	8.6%	3.5%	9.1%	1.4%
Metros with vacancy rate increase below 2.2% average	29**	5.1%	4.8%	7.9%	3.5%

As of December 31, 2022. *21 metros: Jacksonville, Salt Lake City, Memphis, Las Vegas, Austin, San Antonio, Sacramento, Oklahoma City, Houston, Phoenix, Orlando, Tampa, Birmingham, Richmond, Atlanta, Dallas, Detroit, Saint Louis, Norfolk, New Orleans, Nashville. **29 metros: Charlotte, Raleigh, Baltimore, Cincinnati, Inland Empire, Indianapolis, Hartford, Miami, Cleveland, Pittsburgh, Minneapolis, San Diego, Kansas City, Denver, Seattle, Philadelphia, Portland, Louisville, San Francisco, Washington, Boston, Los Angeles, Columbus, Milwaukee, Buffalo, Providence, New York, Chicago, San Jose

These 29 metros were well-supplied with new higher-quality apartments, but they managed to absorb them while maintaining higher-quality rent growth of 3.5%. The metros in this group included those with extremely expensive housing stock such as San Francisco, Los Angeles, and San Jose as well as those with extremely strong recent population growth such as Charlotte, Denver, and Seattle.[1]

The remaining 21 metros posted more severe medium-quality vacancy rate increases averaging 3.4 percentage points and bringing their average medium-quality vacancy rate to 8.6%. Nineteen of these metros suffered negative absorption of medium-quality apartments. In these metros, demand was not strong enough to absorb the inflow of higher-quality units. Even though that inflow was essentially in line with the pace at the 29 stronger metros, demand just could not cope.[1]

Statistically, the negative absorption of medium-quality apartments in these 21 metros is negatively correlated with positive absorption of higher-quality units. This suggests some pull of tenants from lower-quality to higher-quality supply. The pull is further suggested by the weak 1.4% rent growth for higher-quality apartments in these 21 metros as vacancy rates popped to just over 9%. Metros in this group include historically strong markets facing a glut of supply such as Nashville, Salt Lake City, and Jacksonville along with historically weak metros such as St. Louis and Oklahoma City, where even small additions to supply are slow to be digested.[1]

The possibility that medium-quality tenants could be pulled into higher-quality stock is not farfetched. Apartment tenants are highly mobile making rearrangement across quality segments possible if not likely as relative rents evolve. Short-term one-or-two-year leases are common if not universal in the US apartment sector. Such short-term commitments allow tenants flexibility to move as desired and allow landlords flexibility to raise rents as tenant turnover and market conditions allow. Tenants do move fairly frequently. In 2019, Census data show that 24% of renter households moved. As the pandemic took hold, that ratio dropped to slightly below 20% by 2021. Most movers (65%) relocated within the same county and 43% of those movers reported moving to new or better housing.[3] But, that new or better housing may come with a higher cost. This limits demand for those higher-rent apartments to households that can afford the higher rents.

To summarize results for the 21 weaker metros (shown in the red dots in exhibit 5), deliveries of higher-quality supply may have pulled some tenants from lower-quality medium-quality units. This relocation is associated with somewhat higher medium-quality vacancy rates, 8.6% versus 5.1% in the tighter metros, and somewhat lower rent growth 3.5% versus 4.8%. But maintaining rent growth at the 3.5% pace suggests that the pull of tenants from medium-quality to higher-quality units was modest.[1]

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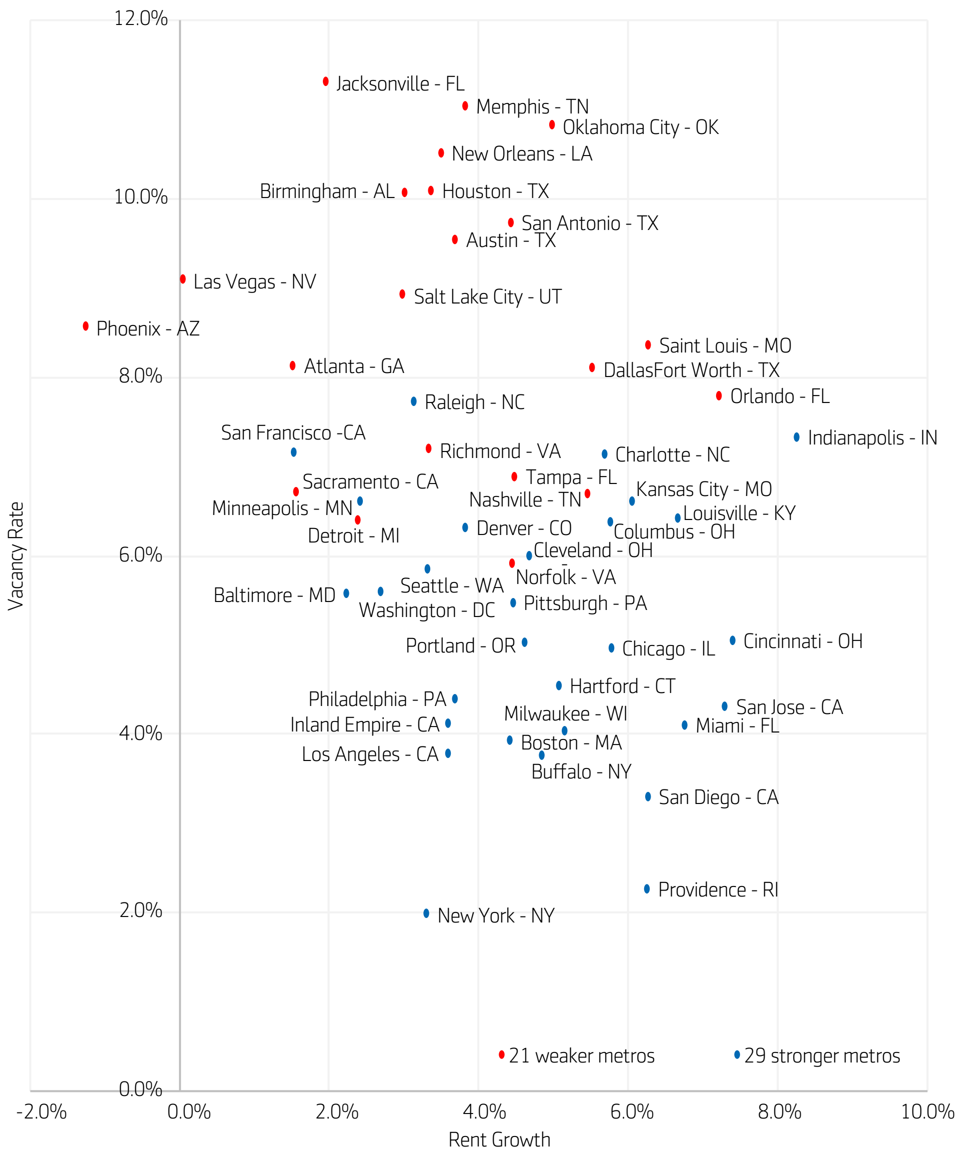
Exhibit 5: Summary - top 50 MSA class B rent growth and vacancy rate (2022)



Source: CoStar Realty Information Inc., annual data as of March 31, 2023.

Looking ahead

As shown in exhibit 1, medium-quality supply inflow in 2023 will be small but a flood of higher-quality apartments is under construction. Prospects for fast absorption of these higher-quality units are less than positive in light of the weaker economic growth, slowing employment growth, bank concerns, and abundant downside uncertainty expected to prevail through the year. The best predictor of the impact of the inflow is the level of current vacancy rates for higher-quality units. For high vacancy metros, absorption might require rent concessions beyond those that compromised 2022 effective rent growth as shown in exhibit 4. Lenders and investors in this market segment are well-advised to examine their rent growth assumptions. Those with a longer-term horizons can expect relief as the construction pipeline empties out by mid-decade. Pull-back in development financing from banks will help to bring about renewed equilibrium.

Conclusions

National average indicators for the apartment sector show rising vacancy rates and weaker effective rent growth for 2022 and the beginning of 2023. Medium-quality apartments were relatively less affected with the majority of the top 50 metros maintaining vacancy rates below the last decade's history. Tight vacancy rates contributed to ongoing solid growth in effective rents. Lenders and investors with modest expectations should not be disappointed in the performance of the medium-quality segment.

The higher-quality segment did not fare as well but lumpy deliveries that take time to absorb are not unusual in this market segment. Lenders and investors in this segment might have been charmed by developers focused on double-digit 2021 rent growth but most should have recognized its evanescence.

[1] CoStar Realty Information Inc. March 31, 2023.
[2] US Census Bureau. Housing Vacancies and Homeownership. January 31, 2023.
[3] Joint Center for Housing Studies of Harvard University. March 4, 2022.

Disclosures

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