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Apartment Resources

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Apartment Resources is a monthly publication designed for apartment developers, lenders and builders involved in all forms of multifamily housing.

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The starts information that multifamily professionals need to know

Cover Your Ears: The Next Multifamily Boom is Coming—Or is it?

Beware! Rumbblings of a coming multifamily boom are in the air. Articles in the real estate trade press have been predicting big things for multifamily on all sides: ownership, development, financing, managing, and investing.

Based on the past experience of the multifamily market, it is better to take a close look at these projections before buying into the coming boom theory. We have been convinced for some time that the multifamily market can support additional, well-researched, targeted development—but a boom could be a disaster.

The most common reason we hear that a multifamily boom is on the way is that construction has been down so long that a multifamily construction boom is not only inevitable, but desirable. This myth we hope to destroy.

Easy Money and Baby Boomers

To examine the boom theory, it is necessary to get a quick historic perspective on the last boom. The boom of the 1980s was fueled primarily by the following two factors: 1) the availability of easy financing and 2) the Baby Boomers' need for new units.

First, let's look at the availability of easy money. The deregulation of the savings and loan industry combined with the more favorable passive loss write-offs to create an atmosphere in which due diligence was often not even due, and more often not very diligent. It was often more important to get the deal done than to examine whether units were needed or whether they fit well into the existing market. Often, nobody checked the pipeline. The results: overbuilt markets where supply and demand were radically out of balance, uncompetitive cookie-cutter projects, and financial ruin for many in the industry.

So, the bankers and the government agencies that regulate them reacted (some say overreacted). The easy deals of the mid-1980s became harder to swing because the federal agencies clamped down on real

estate loans. Better due diligence was required. The traditional money sources dried up. Some developers that could be retooled to do developments for which they could get funding (condominiums, low-income housing Tax Credit units, or single-family). Others went bankrupt or left the development business.

If anyone has learned from the mistakes of the 1980s, it has been the bankers. The traditional industry financing sources have become much more canny about what they will and will not fund. Because of their past problems with multifamily and the new regulatory requirements, many in the industry are still wary about funding multifamily. Unless the banking industry goes all out for multifamily, there will not likely be a multifamily boom. However, since multifamily may well be in a position to outperform other commercial real estate development (office, retail, industrial) bankers will take a look at funding multifamily at a higher level; they will just require better product and better due diligence. While financing may loosen some, it will not loosen to the level necessary for a boom.

Second, let's look at the Baby Boomers. The Baby Boomer generation (those born between 1945 and 1964) has been fueling the multifamily boom for the last 25 years. In the early 1970s the first wave of the Baby Boomers needed new units and the first wave of the multifamily boom was on. In the 1980s, they needed new upscale apartments to supplement the older units of the 1970s, which were aging.

The 1980s presented an atmosphere in which due diligence was often not even due, and more often not very diligent. We think that most bankers have learned from their mistakes, even if some developers often seem hellbent on repeating them.

The problem in the 1990s is that the Baby Boomers are aging in place and leaving their move-up and *upscale* units for single-family housing. One of the trends we have noticed over the last year that we have reported here and in the national trade journals is that even upscale developments are beginning to show the effects of the low interest rates for single-family housing. Upscale units traditionally lose fewer tenants to single-family than mid-range units because they are populated largely by “renters by choice” who like the amenities and lifestyle offered by apartment living. These renters by choice are now choosing to become single-family owners for two primary reasons:

- 1) the continued low interest rates have increased their buying power to the point where they can often afford single-family housing that is better than traditional “starter homes,” and more of a quality level with the upscale amenities to which they have become accustomed.
- 2) they are afraid that the interest rates will not stay low much longer and that this may be their last window of opportunity to get into single-family ownership with all its financial benefits.

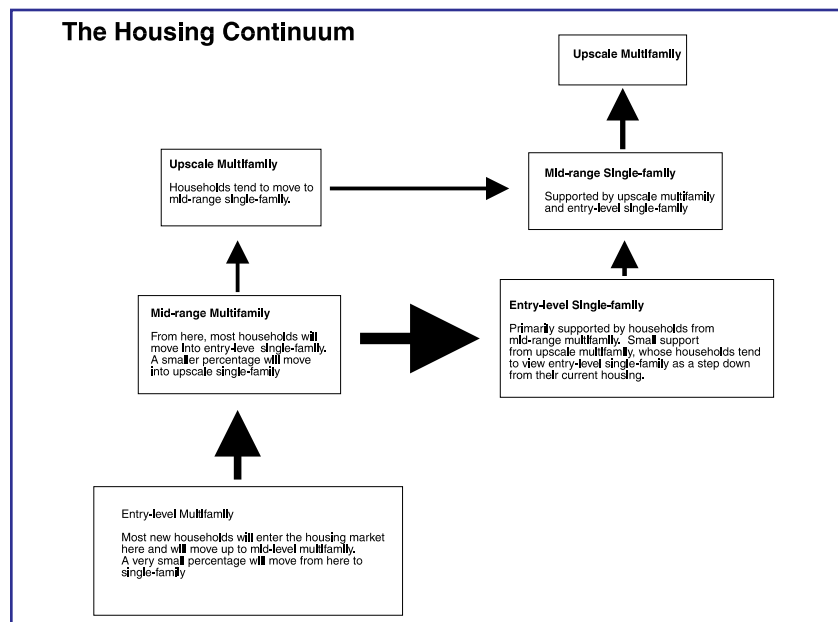
The result: Baby Boomers are now beginning to leave the multifamily market in larger numbers at the top end, *and demographics make it likely that they will be difficult to replace, particularly at the high end.* The continued low interest rates have caused multifamily at all levels to lose tenants to single-family, but the mid-

range properties have been particularly hard hit. Upscale properties depend on mid-range properties to supply them with tenants, and therefore the upscale properties will continue to feel the results of the low interest rates long after interest rates have increased.

These demand factors are particularly important because most new traditionally-financed multifamily development will be mid-range and upscale units due to increasing land and development costs, as well as recent increases in the cost of building material (such as lumber). Therefore, new traditionally-financed developments will come on-line in the sectors that are currently performing the worst in most markets—and that will be the slowest to recover, particularly if there is a rush of new buildings.

Why will these sectors be slow to recover? The youngest Baby Boomers are now 29, and will quickly be aging out of the prime multifamily rental age group (18-34). In 1990, there were 19.8 million households in the 25 to 34 age range. In 1993, the estimate is 19.2 million households, a decrease of 3.4%. By 1998, this total is projected to decrease to 17.8 million, a decrease of 7.3% in just 5 years as the tail end of the Baby Boom ages out of this age range. (See Table 1 on Page 4.)

Meanwhile, the 35 to 44 age range is expected to increase 16.5% and the 45 to 54 age group is expected to increase 39.7% between 1990 and 1998 as the Baby Boomers march onward to middle age.



The Housing Continuum

The Housing Continuum diagram at left is an illustration of how typical households change housing throughout the course of a lifetime. The boxes are indicative of a segment's size, while the size of an arrow indicates the number of households moving in this direction. Households tend to start in entry-level housing, move into mid-range multifamily and then into either entry-level single-family or upscale multifamily. This diagram indicates how each market segment depends on the one below for support. A decrease in the number of entry-level households will create a lack of support for options higher up the continuum.

In 1990, households in the 15 to 35 age range totaled 27.1% of all households in the United States. In 1993, this had decreased to 25.9%. By 1998, this will decrease to 22.2% of all households.

So, what do these numbers mean? They mean that at the same time that some in the industry are pushing for an apartment boom that the number of households in our traditional target age range is shrinking dramatically. They mean that new apartment development must focus on filling gaps in the existing market, and an apartment boom cannot be supported by just filling the gaps.

Putting on the Spin

It is interesting to note that the boom-mongers are even trying to put a spin on the raw demographics. They say that while it is true that there will be fewer renters in the traditional age groups (18-35), this loss will be compensated for by factors such as lifestyle changes, lower home appreciation rates, a slowdown in income growth, and the “graying of the population.”

For example, it is difficult to understand how slower home appreciation rates are likely to keep people in multifamily housing who want and can afford to own a single-family home. In the April issue of *Apartment Resources*, we did an article profiling first-time homebuyers based on unpublished distributions from the 1989 *American Housing Survey*. When first-time

homebuyers were asked what their reasons for moving were, they responded as follows: 44.5% cited financial reasons, and the rest gave other reasons, including “to establish their own household” (23.4%), “needed larger house or apartment” (11.0%), or “wanted better home” (10.4%). While some of the 44.5% citing financial reasons for moving might be deterred by slowing home appreciation rates, over half of the first-time home buyers moved primarily for other reasons. In addition, financial reasons would also include other benefits of home ownership, primarily building equity and the mortgage interest tax deduction.

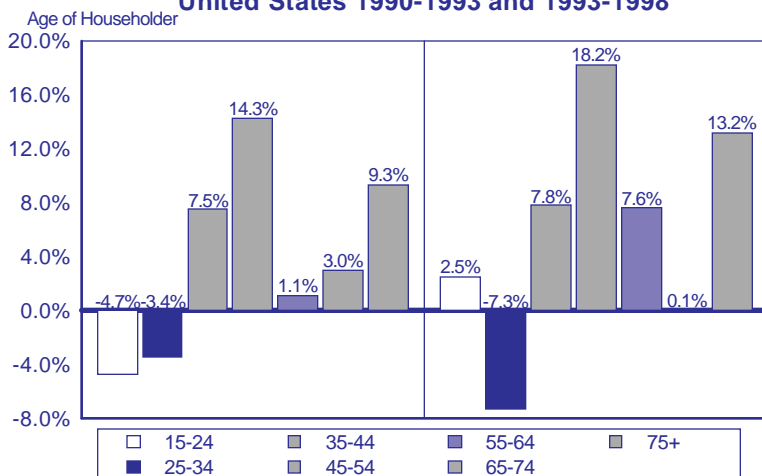
Another factor often cited by boom-mongers is the slowing rate of income growth, often as an indicator that fewer households will be able to afford single-family housing in the future and form a permanent renter class. While it is true that the rate of income growth is slowing, this factor is also offset by low interest rates and the continuing high numbers of two-income families. Should the economy pick up substantially, income growth should follow.

The Graying of America?

A third factor often cited is the “graying of America.” We have been hearing for years now about how the aging of America is going to provide a boom for multifamily, but that boom is still years away. Yes, it is true that older households rent at a higher rate than any but the 25 to 29 age group, but our studies show that

Table 1

**Percent Change in Number of Total Households
United States 1990-1993 and 1993-1998**



Sources: Claritas/NPDC and The Danter Company

Baby Boomers—and Everyone Else

Table 1 indicates household estimates and projections for the United States since 1990. As the chart indicates, the number of households in the 25-34 age range has declined over the last three years, and will continue to decline for the next five years. Targeting product will become even more important as the traditional apartment market continues to decline. Those products that focus on serving a target market (even one within the traditional age group) will be rewarded with better-performing properties than those who have failed to learn from the 80s.

they move far less often. Our studies also show that the independent-living boom is still years away. The early edge of the Baby Boom will not hit 65 until the year **2011**. While it is true that people are living longer, it is also true that they are living longer at home. A recent telephone survey conducted by the American Association of Retired Persons (*Understanding Senior Housing for the 1990's*) indicated that 84% of those surveyed (over 55) would really like to stay in their own home and never move. We expect that Baby Boomers will be no exception in wanting to stay in their homes as long as they can maintain them. It is likely, in fact that we may not see Boomers moving into rental apartments on a large scale until they are 70 or 75, or maybe even older, postponing the boom in elderly housing until 2016 or beyond.

We are much more likely to see Baby Boomers investing in condominiums as they age. Condominiums present the financial and tax benefits of home ownership to a generation raised on the home ownership lifestyle—without the hassles of home maintenance.

Existing Supply and Existing Markets

Another factor often not taken into account by the boom-mongers is the existing supply and its performance. While building new units designed for the needs of today's renters will be profitable, older units will suffer as a result. Despite the record low new construction levels, we have noticed that many large projects of the 1970s have been struggling for the last 3 or 4 years to attract the number of tenants necessary to remain full because of aging units and large turnover. In addition, these units are facing increased competition for entry-level tenants from Tax

Over two-fifths (43.4%) of respondents to our industry poll indicated that they thought their market was already overbuilt—even after several years of record low construction levels.

Credit projects. These problems will be magnified with the permanent renewal of the Tax Credit program and the predicted boom if it occurs.

In many places, the existing market is not performing well. In a recent issue of *Apartment Resources*, we asked you how your apartment market was performing. We also gave the same survey to apartment professionals at meetings in the Midwest. The most telling response was that almost two-thirds (66.0%) of our respondents expected the modern apartment market in their city to get worse, while only 32.1% expected it to get better.

Over two-fifths of the respondents also felt that their market was **already** overbuilt. A total of 43.4% said their apartment market was very or somewhat overbuilt. And this is after several years of very slow construction! A slightly lower percent (39.6%) said supply in their market was “about right.” Only 17.0% said that their market was very or somewhat underbuilt.

Vacancies varied between markets. Almost one-fourth of the respondents (22.6%) said that, despite the years of slow construction, vacancies in their market were higher at the time of survey than they had been the previous year at the same time. Just under half said that vacancies were lower (45.3%) while almost a third (32.1%) said that vacancies were about the same.

These respondents also had a generally pessimistic view of the current financing climate in their city. Only 30.1% indicated that the climate was good or excellent. A total of 26.4% said fair, while 34.0% said poor or impossible and 9.4% did not know.

Most of the people who are pushing the apartment boom theory are not actually in the field trying to develop and rent apartments. They are usually bankers, accountants or economists who may be out of touch with what is really happening in the field.

Due to our market feasibility work, we spend a significant amount of time and effort in the field surveying apartment projects in markets across the country. Our 100% Data Base methodology requires us to survey all the modern apartments in each market we study. As a result, we see each market at all pricing and amenity levels. If the existing supply were presenting a convincing argument for drastically increased new construction, it would show up in our field surveys as increasing rents and decreasing vacancies. However, as

we check our current field surveys against our historical data base, we find that rents are tending to remain stable or increasing only slightly and vacancies are in many cases tending to increase due to loss of households to single-family housing—even in markets with little construction. In many markets, we see projects decreasing rents to fill vacant units!

Some Conclusions

An apartment boom may be coming; however, we do not think it is supportable or desirable. Because so many in the industry are pushing for a boom, it is inevitable that some will listen and that construction levels will go up in the near-term. It is important to be prepared for the upcoming increase in development.

First—when you develop, be prepared by having a target market. The demographics indicate that the market for the large-scale untargeted projects of the past is simply not there. Target your project conceptually, economically, and geographically or, as we often say, "the right product at the right price in the right place."

Concept: identify renter groups (or potential renter groups) that are being underserved or not at all served by existing product. Product designed for nobody in particular will attract nobody in particular. Target marketing allows the blending of product design with marketing to attract renters who *need* and *want* your product.

Economics: identify economic gaps in a market that can support additional development. Pricing product correctly within a market cannot truly be accomplished with the use of selected comparables. Only a 100% data base that identifies all product in a market can identify proper pricing levels to maximize support and minimize tenant loss.

Geography: location is still important, but it is important to understand location as only one factor

Developers who survive the nineties will be those who create the right product at the right price in the right location.

complementing the selection of product and price point. A "hot" location can be a loser if it contains a poorly-designed project.

Second—think small. Our research indicates that smaller projects will perform better in a market that will be experiencing fewer entry-level households. The problems associated with turnover will decrease, as will rent-up time. In addition, smaller projects targeted and designed to meet the needs of a specific market segment have lower turnover rate, can generate larger premiums, and will keep renters in the multifamily pool longer because they are in housing that meets their needs.

Third—Choose your markets and product carefully. Due diligence becomes even more important with the decreasing base of entry-level renters and the larger existing supply. Only good due diligence can identify markets in need of housing and identify niches within those markets for future development. The 1980s taught us what can happen when the relationship of housing supply and demand is ignored in favor of the laws of capital supply and demand.

Fourth—if you are currently an owner or manager, it will be important to identify ways in which your community can cope if your market were to suddenly see an increase in new construction. A large-scale new construction boom could be devastating for owners of existing marginal product. Identify the strengths and weaknesses of your community and how it compares to today's new development. Prepare an action plan. Renovate if necessary. Identify marketing strategies to increase traffic. Identify a target market that your community can serve. If your product is hopelessly obsolete, change it or get out while you can. The Danter Company offers strategic rehabilitation studies that can help you make these assessments.

There is room in the multifamily industry for more construction than has occurred in the last two years. If the industry focuses on maintaining a sustainable level of smart development, there will be substantial opportunity in the market for those who want to produce a quality, targeted product that meets a market need. However, a large-scale boom could be devastating to an industry that is on its way to recovery. Heeding those who are calling for or predicting a new multifamily boom could wipe out the recovery the market has experienced so far.

StartsWatch

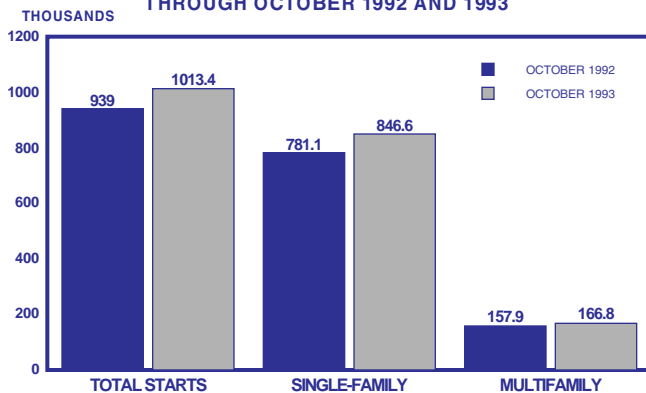
Total starts through October 1993 are up 7.9% from October 1992 according to StartsWatch, a tracking of housing starts as reported by the United States Census Bureau C-40 Construction Reports.

Multifamily starts through October 1993 are up 5.6% from October 1992 and single-family starts are up 8.4%. The overall increase is due mostly to a large increase

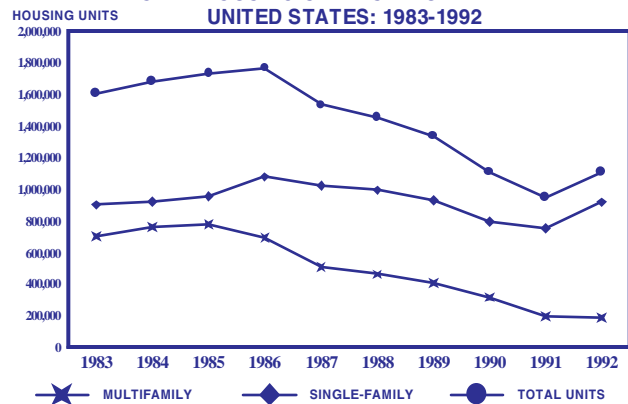
(19.7%) in the South. Multifamily starts were up slightly in the Midwest (2.6%) and in the Northeast (1.4%). Multifamily starts were down 6.4% in the West.

Single-family starts through October 1993 are up in all regions, led by a 10.5% increase in the South. In other regions, single-family starts are up 9.1% in the West, 6.3% in the Midwest, and 6.0% in the Northeast.

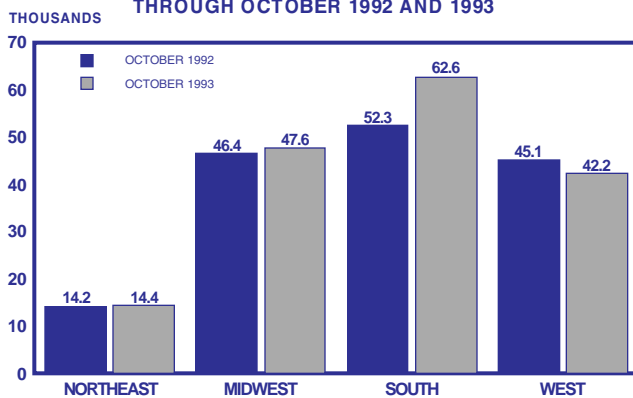
YEAR-TO-DATE HOUSING STARTS BY TYPE THROUGH OCTOBER 1992 AND 1993



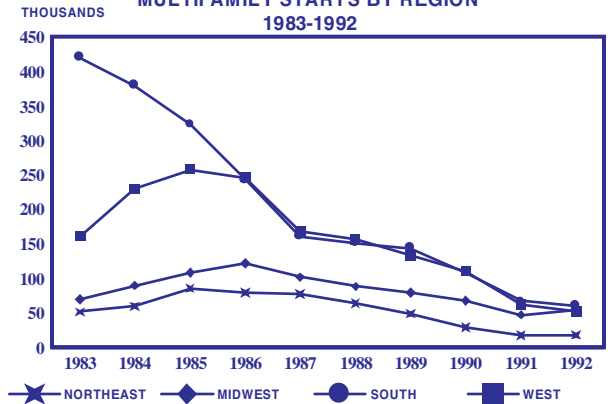
TOTAL HOUSING STARTS BY UNIT TYPE UNITED STATES: 1983-1992



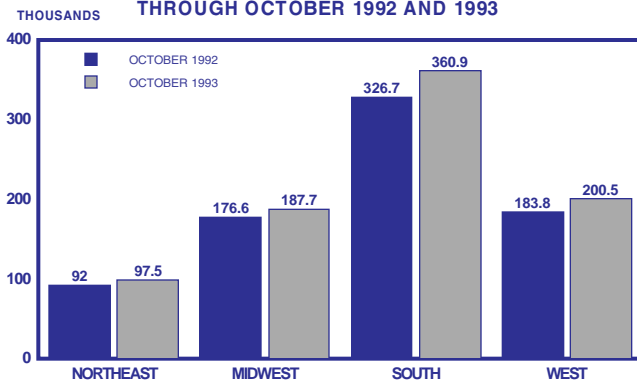
YEAR-TO-DATE MULTIFAMILY STARTS BY REGION THROUGH OCTOBER 1992 AND 1993



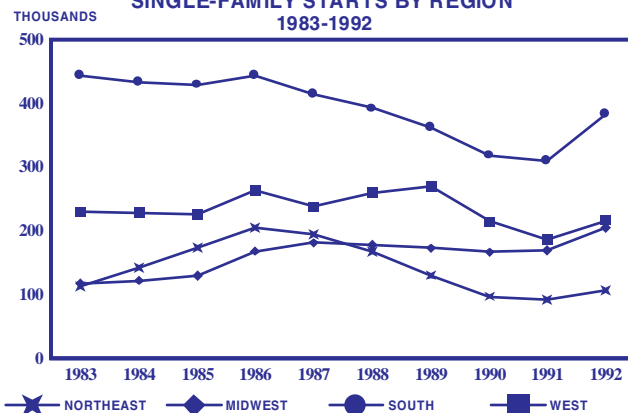
MULTIFAMILY STARTS BY REGION 1983-1992



YEAR-TO-DATE SINGLE-FAMILY STARTS BY REGION THROUGH OCTOBER 1992 AND 1993



SINGLE-FAMILY STARTS BY REGION 1983-1992



News and Notes

- In case you missed the article by Kenneth Danter, President of The Danter Company, in the July issue of *Mortgage Banking*, give us a call and we will be happy to send you a copy. Issues addressed include interpreting rent and vacancy surveys and trended versus untrended rents.
- The Danter Company is pleased to announce *The Danter Apartment Rent and Vacancy Series*. Call us at 1-800-532-6837 to find out for which cities the report is available.
- Don't forget that The Danter Company is more than the best source of information on apartments. We are a full-service real estate firm that also studies condominium, single-family, golf course, motel/hotel, retail, office, industrial, congregate care/assisted-living, nursing home, resort, marina, and mobile/manufactured home development. Call us to find out how we can meet all of your real estate research needs.
- We would like to welcome members of the National Housing and Rehabilitation Association. As an official analyst for the organization, The Danter Company provides this newsletter without charge to all association members.
- Kenneth Danter, President of the Danter Company and nationally-recognized expert on real estate development and trends, is available for speaking engagements. He has addressed numerous regional and national associations and conferences and local apartment associations throughout the country on issues of importance to multifamily professionals.
- In case you missed it, "Apartment Lending After the Boom" is now available in reprint. Written by Kenneth Danter especially for *Mortgage Banking*, this article details survival strategies for the nineties that no multifamily professional should be without. Call, write, or fax us today to get your copy.
- The Danter Company has moved. Our new address is 30 Spruce Street, Columbus, OH 43215. Our phone and fax numbers remain the same: (614) 221-9096 (phone) and (614) 221-4271 (fax).

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