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Midyear Check Up: Luxury Apartments

Midyear 2022

Lack of Alternatives, Unique Amenities Support Luxury Renter Demand

Robust renter demand for upscale Class A apartment units has helped push absorption of the U.S. rental stock to record levels over the past couple years, resulting in low vacancy and sizable rent growth. This performance is being assisted by the nation's housing inventory, which continues to fall well short of need. The country's Class A apartment communities also offer lifestyle characteristics that are very appealing for a large block of households. The robust demand for luxury apartments and resulting strong fundamentals have yielded attractive investment returns.

High inflation, rising interest rates and the economy's increasing vulnerability to recession are influencing future market performance, and must be considered when determining near-term investment strategies. Downside risk perhaps plays a more important part of the conversation than was the case earlier in the year. Even with those risk factors considered, however, the outlook for luxury apartment demand is healthy advancing into the second half of the year.

Despite Cooldown, Persistent Housing Shortages Fortify Performance

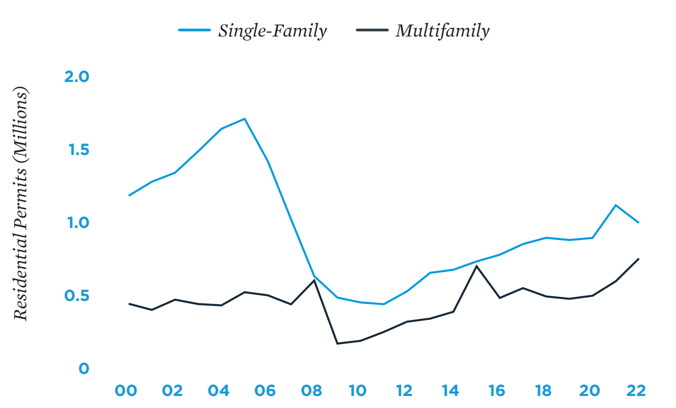
Housing completions, which are trending up slightly in 2022, are helping align supply and demand for the short term, keeping the nation's housing shortage that developed over the past decade from getting worse. Annual single-family and multifamily housing completions totaled 1.46 million units in May, rising roughly 9 percent year-over-year and hitting the highest level since 2007. At the same time, availability of existing housing units loosened modestly. June's inventory of unsold existing single-family homes on the market inched up to 1.02 million, a 2.7-month supply at the current sales pace. The vacancy rate for existing apartments came in at 3.2 percent during the second quarter, up a hair from the all-time lows established in late 2021 and early 2022. The vacancy rate for luxury Class A properties, which compete for renters more directly with new supply, came in at 3.8 percent, also up slightly from earlier in the year. While housing availability is improving in the moment, there is still not enough product coming on stream long-term to meaningfully move the needle on the earlier shortfall, estimated at over 1.5 million units.

Housing demand headwinds are anticipated in the immediate future, in large part reflecting the cooling economic outlook resulting from high inflation and rising interest rates, which could slow further household formation. Home sales volumes are already trending downward. Net demand for apartments could also take a hit if renters currently living alone opt to live with others.

More moderate housing demand expected ahead is not necessarily a large concern for the overall health of the for-sale market, given that supply additions should also cool. June's annual single-family home permit volume of 970,000 units was off roughly 11 percent year-over-year, and deteriorating homebuilder confidence levels signal that construction activity will likely slow further over the coming months.

For apartments, permits issued during the year-ending in June climbed nearly 30 percent on a year-over-year basis, totaling over 720,000 units. While that headline authorization number is sizable, overbuilding does not appear to be a real danger. For the most part, construction is heaviest exactly in the spots where it needs to be — metros and neighborhoods that have witnessed prodigious apartment demand in recent years. In the worst-case situation, vacancies will somewhat rise in late 2022 and during 2023. Given that the national vacancy rate is at one of its lowest levels in more than 30 years, availability could climb by 150 to 200 basis points across most locales, and the marketplace would still be tight enough to likely sustain rent growth at levels similar to overall price inflation.

Multifamily Permitting Activity Picking Up



Housing permits are seasonally adjusted annualized rates reported on June of each year
Sources: IPA Research Services; Freddie Mac; National Association of Realtors

Home Purchasing Grows More Challenging

The costs of homeownership are soaring, limiting the number of households — even relatively affluent households — who can make the move from renting to buying. In turn, healthy demand for high-end apartments appears sustainable.

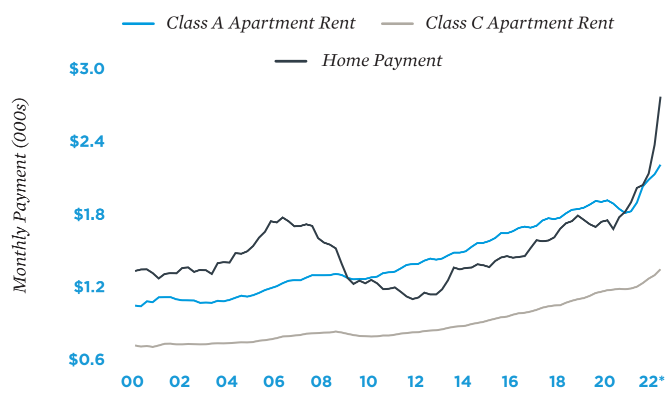
The median price for an existing single-family home soared to $404,000 in May, crossing the $400,000 threshold for the first time. Over the same span, the average rate for a 30-year fixed-rate mortgage jumped to 5.8 percent. Both metrics stayed about the same in June. In this situation, a household buying a home at that median price is taking on a monthly housing payment of $2,740.

Going back just two years to early 2020, right before the COVID-19 pandemic, the monthly mortgage cost for buying an existing, median-priced home was far lower at just over $1,700. Thus, the number of households financially qualified to buy has slumped quickly and dramatically. Of course, apartment rents have also increased over the same period of time, but the cost savings achieved by renting versus buying is increasing.

The nation's average apartment rent reached $1,740 during the second quarter, up 16.9 percent year-over-year. For the typical apartment renting household, then, the monthly payment is 37 percent below the monthly cost to buy. The average Class A apartment effective rent is now up to $2,180 per month. Even in these best-quality units, households are paying 21 percent less to rent than to buy the typical home.

The gap between purchase and rental costs obviously varies quite a bit from one area of the country to another. As most would expect, the differences are generally greatest in the Northeast and along the West Coast, but Austin and Denver are a couple interior metros that also register huge price premiums to buy.

Multifamily Cost-Advantage Apparent



* Through 2Q
Mortgage payments based on quarterly median home price for a 30-year fixed rate mortgage, 90% LTV, taxes, insurance, and PMI
Sources: IPA Research Services; RealPage, Inc.; Freddie Mac; National Association of Realtors

Lifestyle Preferences Should Not Be Overlooked

When considering the performance prospects for luxury apartment communities, the math looks good, but the results won't end up being only about the math. Encouragingly, hard-to-quantify influences related to lifestyle preferences tend to enhance the investment appeal of this type of housing product.

When weighing the benefits of renting a luxury apartment versus buying a typical existing single-family home, buyers gain the opportunity to build some home equity and generally end up with more space. That additional space can certainly add value for some households, given that more people are now working from home. However, there are also countering benefits to luxury apartment living, factors that are sometimes ignored.

The most obvious advantage for Class A apartments is simply that they are luxury residences. The quality of finish-out materials will surpass what's in the median-priced (generally older) single-family home. The apartment property's tech package will be superior in most cases, and the rental property will be loaded up with common area amenities lacking in single-family homes.

Location also tends to favor the luxury apartment development. These properties are concentrated in better-quality neighborhoods, closer to key job centers, that are well-served by supporting retail establishments, entertainment facilities and public transit access points.

Finally, customer service tends to be a priority for upscale property managers, as they tend to heavily prioritize their residents' well-being. Trusted renter satisfaction scores for Class A properties have also been generally improving during the past couple years, even when rents have been rising significantly.

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