



Multifamily Market Commentary – February 2017

Affordable Multifamily Outlook – Incremental Improvement Expected in 2017

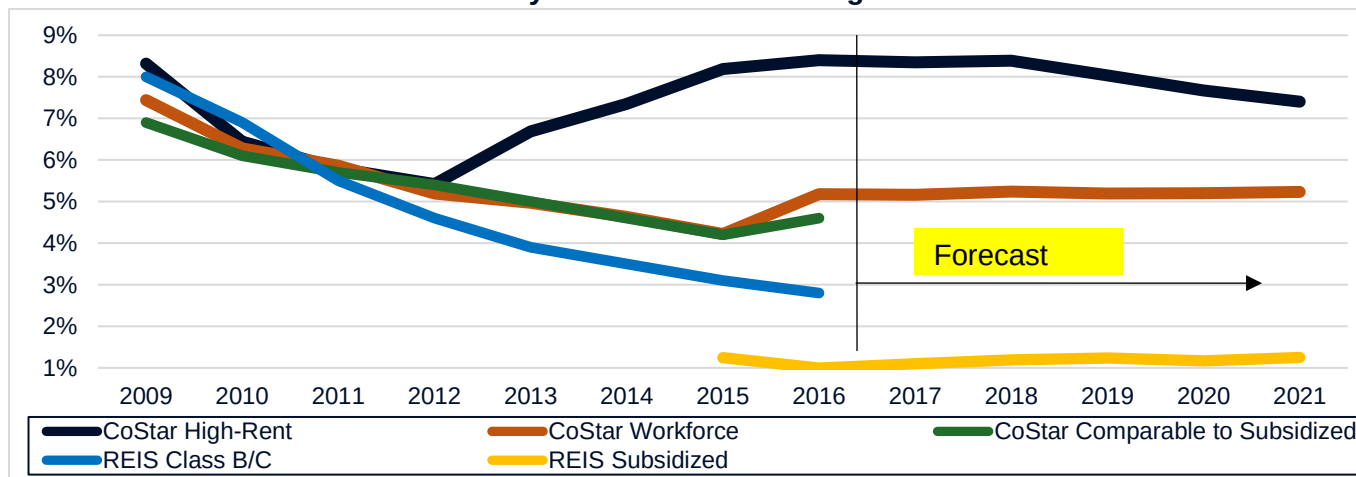
We expect momentum in the overall multifamily sector to slow in 2017 due to elevated levels of new supply and moderating job growth. As a result, the national vacancy rate is expected to increase while rent growth remains positive but grows at a lower – and more normalized – pace. While in theory this should lead to incremental improvement in the affordability of the multifamily rental market, in actuality it is likely to end up doing little to reverse the significant erosion in affordability of multifamily rentals seen since the end of the recession.

Naturally-Occurring Affordable Rentals Tightened After Recession

As shown in the chart below, vacancies tightened considerably from 2009 to 2015 for affordable multifamily rentals (i.e., those affordable to working households, labeled “Workforce”, and even lower cost rentals comparable in rent to subsidized multifamily rentals, labeled “Comparable to Subsidized”). According to third-party data provider CoStar, vacancies for both categories of multifamily rentals fell to just 4.2 percent in 2015 from 7.4 percent in 2009 for Workforce and 6.9 percent for the Comparable to Subsidized category.

However, vacancy rates for affordable multifamily rentals may be even tighter. Third-party data vendor Reis, Inc. estimated vacancies for all non-subsidized Class B/C multifamily rentals at just 2.8 percent as of Q4 2016. However, that vacancy rate is not far from Reis’ estimated 1.0 percent vacancy rate for subsidized rentals, which consists of multifamily rental properties subsidized with federal Low Income Housing Tax Credits (LIHTC) and Section 8 project-based vouchers, reflecting ongoing demand for all types of affordable multifamily rentals.

Vacancies by Affordable Market Segment 2009 - 2021



Note: CoStar High-Rent Segment is approximated by five and four star category properties. CoStar Workforce Segment is approximated by three star category. CoStar Comparable to Subsidized category approximated by two star and one star category data. CoStar does not provide projections of two and one star category, so no forecast is available.

Vacancy Levels for Affordable Multifamily Rentals Likely to Remain Stable

According to the Dodge Data & Analytics Construction Pipeline, which distinguishes between multifamily properties consisting of either apartment or condo units, based on data through January 2017, another 404,000 units are expected to come online in 2017. Most of this new supply is believed to consist of Class A units, which command the highest rent levels in their location.

According to CoStar, its estimated vacancy rate for the High-Rent Class A multifamily segment has been rising over the past few years and is expected to remain elevated at over 8.0 percent in 2017 and 2018 due to these new completions. CoStar’s Workforce vacancy forecast is expected to remain approximately 3.0 percent below its High-Rent forecast of about 5.25 percent over the next 12 to 24 months, as shown in the chart above.

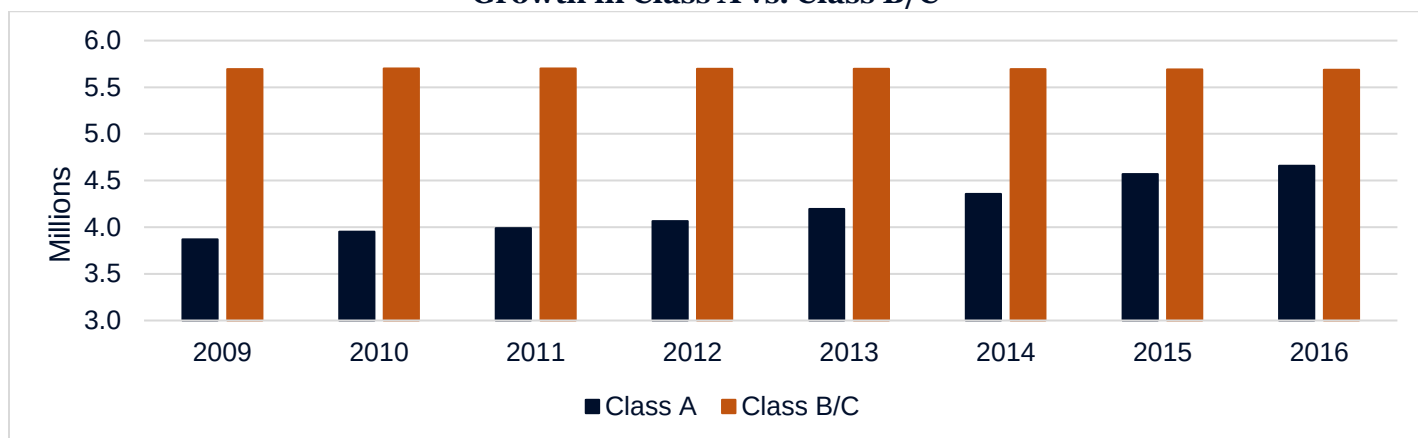
In comparison, Reis projects that vacancies at subsidized properties will likely remain well below 2.0 percent over the next 12 to 24 months.



Little New Naturally-Occurring Affordable Supply

As most of the past few years' new affordable supply has been clustered in the High-Rent Class A segment, it appears that there has been little growth in the stock of the more affordable Class B/C segment, as shown in the chart below. Strong demand for multifamily rentals has even prompted developers to renovate more affordable Class B/C properties into Class A. The net impact of the two trends has been that while the number of Class A units grew by an estimated 800,000 since the end of the recession to an estimated 4.7 million units, the number of Class B/C units remained virtually unchanged at an estimated 5.7 million units, according to the sample data tracked by Reis. This trend is unlikely to change in the next 12 to 24 months as most of the new supply underway is estimated to consist of Class A units.

Growth in Class A vs. Class B/C



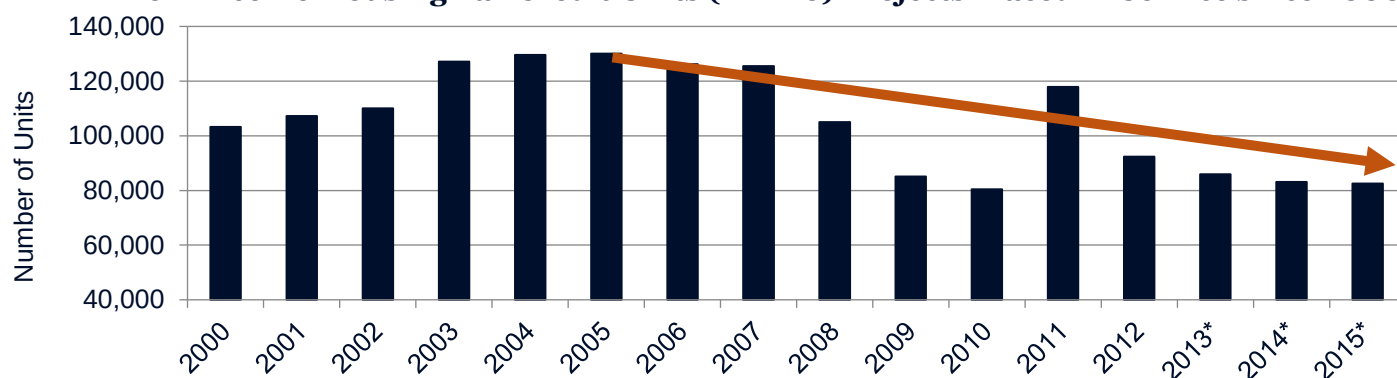
Source: Reis, Inc.

Subsidized Supply is Also Struggling

Most new affordable multifamily supply falls into the subsidized category, which is funded by LIHTC. Since its creation in 1986, the LIHTC program has created over 2.5 million affordable units that remain in the program. Many of these units are older and require an infusion of credits for renovation, which leaves fewer credits for new units.

The number of new LIHTC units placed in service appears to have been steadily declining, as shown in the chart below. With rising construction costs and reductions to other state and federal subsidy programs, the number of LIHTC units placed in service appears to have fallen by an estimated 25 percent on average annually from pre-2005 levels, based on the most recent data available. (It is important to note that this data is based on projecting allocations of LIHTC subsidies published by allocating Housing Finance Agencies to estimated completion dates and may be subject to revisions)

Low Income Housing Tax Credit Units (LIHTC) Projects Placed in Service since 2000



Source: HUD Low Income Tax Credit Database as of October 2000-2012; Integratec Tax Credit Central estimates 2013-2015 based on HFA allocations.

* Estimates only, based on HFA allocations. Integratec assumed 15% of the current year allocations, 60% of the prior year allocations and 25% of two years prior allocations would be placed in service. For example, 2014 reflects 15% of the 2014 allocations, 60% of the 2013 allocations, and 25% of the 2012 allocations.

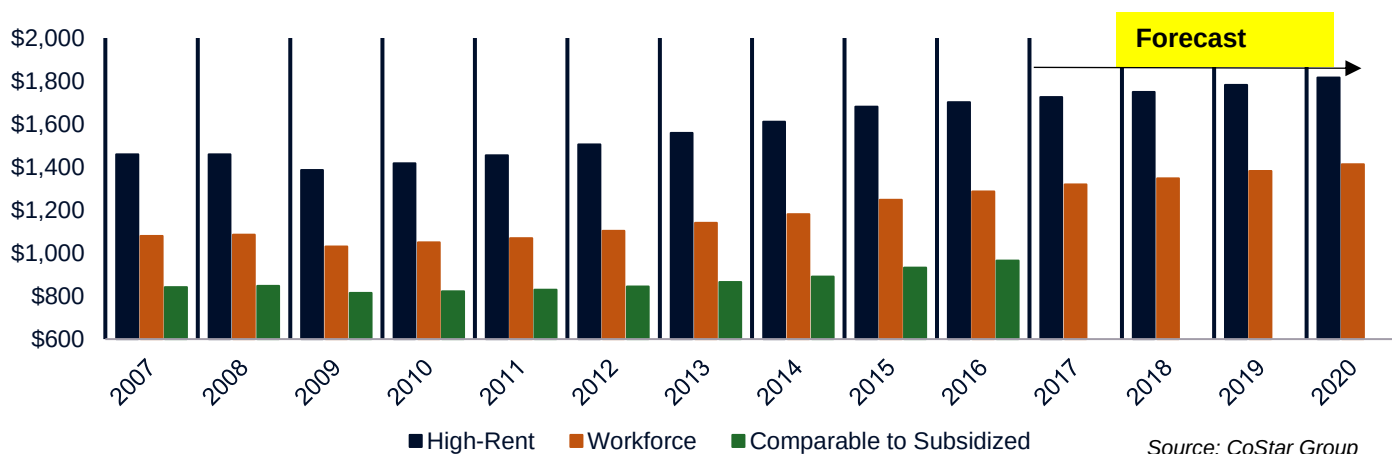


It looks as if this trend is likely to continue. According to data from the Dodge Data & Analytics Construction Pipeline, there are only about 50,000 units of subsidized or mixed income projects underway as January 2017. However, this estimate may be low as subsidized multifamily is not a major property type tracked by Dodge.

Asking Rents Have Also Risen for Affordable Multifamily

While asking rents for all classes of rentals reached a trough in 2009, it appears that rents fell less sharply for more affordable rentals. As shown in the chart below, rents for the Class A segment of rentals, labeled “High-Rent,” fell by just over 5.0 percent from 2007 to 2009 to an estimated \$1,387. By contrast, rents for the Class B/C segment, labeled “Comparable to Subsidized,” fell by only 3.1 percent to an estimated \$815. This phenomenon allowed for a “move up effect” where still-employed renters of all classes were able to move to a higher class of rental. Since 2010, rents have rebounded strongly for all types of rentals, including affordable multifamily.

Estimated Asking Rents by Multifamily Property Type – 2007 - 2020



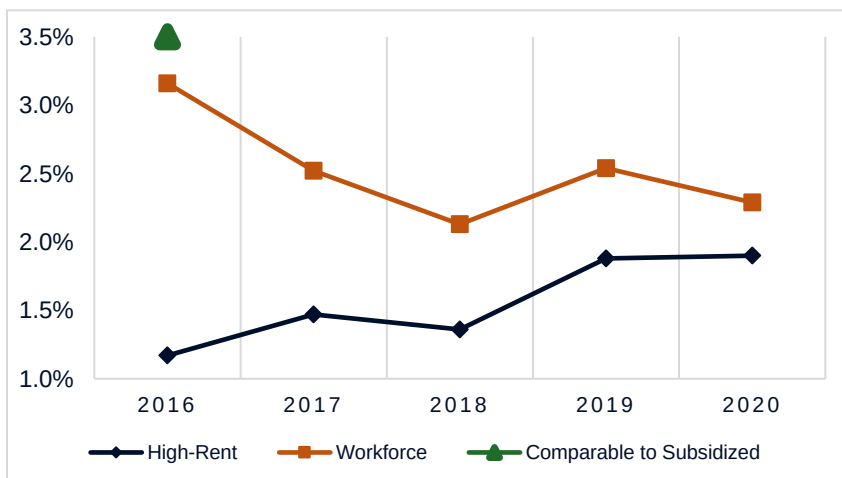
Rent Growth Expected to Ease Slightly

According to CoStar, rent growth was positive for all classes of rentals in 2016, as shown in the adjacent chart. However, rent growth for existing naturally-occurring affordable rentals outpaced growth for existing Class A rental units by over two percent - a significant premium. Rent growth for units labeled as workforce grew by an estimated 3.2 percent in 2016 to end the year at \$1,287. Rent growth for naturally-occurring affordable units, where rents are likely comparable to those for subsidized units, grew by 3.5 percent in 2016 to an estimated \$965. Both segments grew well above the pace of inflation, which rose 2.1 percent in 2016.

The expectation for 2017 is that rent growth in the workforce rental category will moderate but remain quite healthy at 2.5 percent. This would be more than 1.0 percent above the growth experienced by CoStar’s High-Rent segment.

As a result, the onslaught of new supply expected in 2017 is expected to only depress rent growth in the High-Rent Class A segment, keeping rent growth just below 1.5 percent and doing little to improve affordability. In fact, renters will not even benefit from the “move up” effect seen during the recession when rents for the Class A segment fell.

CoStar Rent Growth Forecast 2016 - 2020



Source: CoStar Group

Note: CoStar does not provide projections of two and one star category and therefore no forecast is available here for the Comparable to Subsidized Category.

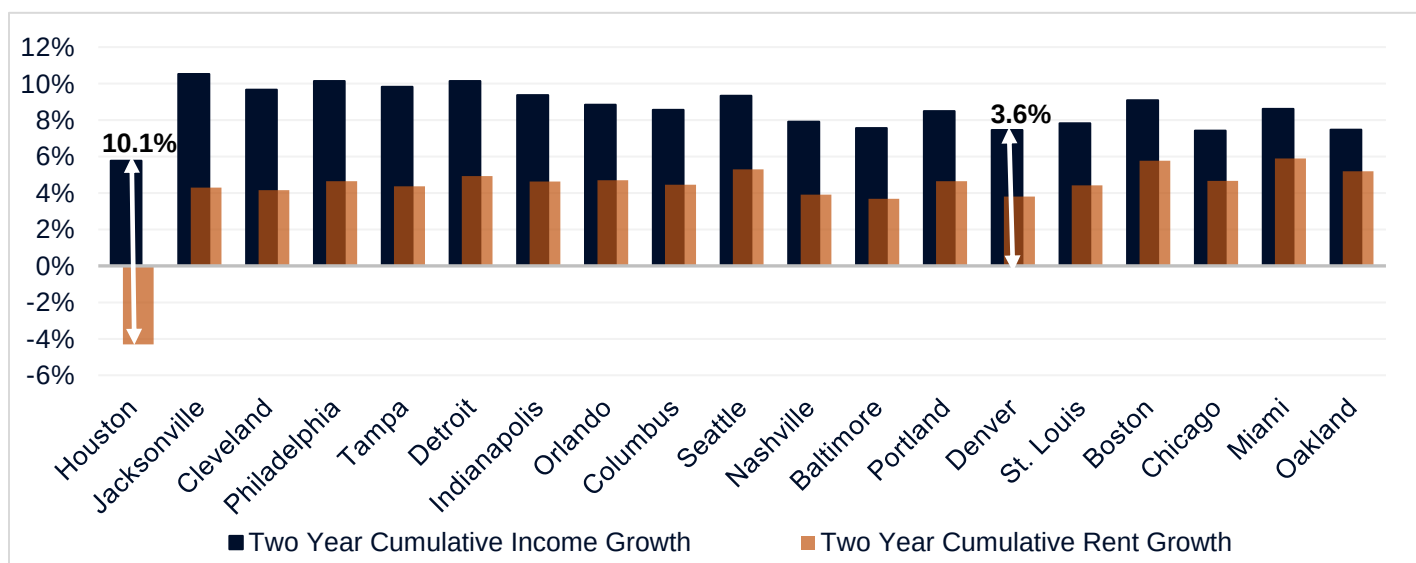


Household Incomes Most Likely Rising Somewhat

Housing affordability is affected by many factors, including the supply of rentals, the demand for rentals, and growth in income and rent. All else being equal, when growth in income outpaces rent growth, rentals become more affordable.

Over the next two years, national household incomes are likely to outpace rents by about 2.1 percent cumulatively, based on Moody's Analytics estimate that median household income will grow by a robust 6.9 percent, which would outpace more normalized rent growth of 4.8 percent, as estimated by CoStar. This would lead to only modest improvement in affordability nationally. However, there are a number of metros where income growth will outpace rent growth by a somewhat wider margin.

Select Metros with Improving Affordability 2017 - 2018



Source: Moody's Analytics, CoStar Group

Improvement in Affordability Will Vary by Metro through 2018

As shown in the chart above, affordability will likely improve most substantially in **Houston** where income growth is projected to outpace rent growth by an estimated 10 percent. **Houston** is expected to have more than 9,500 units delivered this year but is only likely to see demand for about 4,000 multifamily units, leading to a decline in rents.

However, large amounts of new supply do not always guarantee substantial improvement in affordability. For instance, even though **Denver** is in the midst of a massive supply wave with more than 27,000 units delivered since 2012, strong job and population growth coupled with solid household formations have limited the rise in the vacancy rate to just 5.25 percent through the end of 2016, which is on the low side of the historic average. Even with 16,000 additional units underway, Denver's anticipated job growth will likely be strong enough to support the need for 12,000 additional units. As a result, wage growth is likely to outpace rent growth by an estimated 3.6 percent, leading to only a modest improvement in affordability in **Denver**.

Florida Metros Will Likely See Improvement

Rents in some of the Florida metros are considered to be quite affordable by national standards. While rental affordability declined somewhat over the past couple of years, this trend will likely reverse as stronger job growth in many Florida metros coincides with a pickup in new supply. As shown in the chart above, **Jacksonville**, **Tampa**, **Orlando** and **Miami** are likely to see incomes outpace rents on a cumulative basis by at least 3.0 percent over the next two years.

Tampa will likely support some of the strongest improvement in affordability. The metro's economy has received a boost in increased port traffic from the recently expanded Panama Canal. According to Moody's Analytics, the economy is likely to add approximately 65,000 jobs in 2017-2018, with over half of the job growth in mid-wage fields, including construction and healthcare, as well as in some high-wage fields, including finance and technology. As a result, incomes are likely to exceed rents by an estimated 5.5 percent over the next two years.



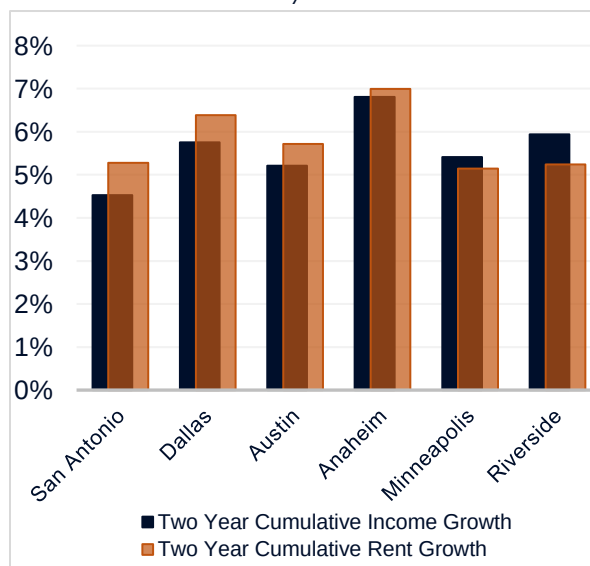
Not All Metros Likely to See Affordability Improvement

There are some metros where affordability will likely stagnate or continue declining. As shown in the chart to the right, the **Anaheim** metro area is expected to continue having rents outpace incomes, albeit only by about 0.7 percent over the next two years. Similarly, there are a number of metros in Texas where affordability is not expected to improve due to the rapid influx of people seeking jobs. **San Antonio**, **Dallas**, and **Austin** are not likely to see any improvement in multifamily affordability over the next two years, despite large amounts of new supply coming online.

Household Income Growth Differs from Wage Growth

Generally, household income growth is forecasted at a metro level, but wage growth is not. While these forecasts can provide useful insight into affordability, it is important to note that income is different than wages. Wages measure earnings from work, while income can include non-work earnings such as interest and dividends. While growth in income will help with rental affordability, many renters rely solely on wages, limiting the predictive power of income forecasts for rental affordability.

Select Metros with Worsening Affordability 2017 - 2018



Source: Moody's Analytics, CoStar Group

2017 Outlook: Wage Growth Should Benefit Affordable Multifamily Housing

Despite the anticipated slowdown in the nation's average rent growth, it is not expected to be much of a benefit to the affordable multifamily segment. Although there has been a substantial amount of new supply delivered, it has been concentrated mostly in 12 metros and consists primarily of Class A units. As a result, Class B/C rent growth may slow, but, because of the current supply/demand imbalance, it is not expected to decline. Instead, strengthening wages are likely to outpace rent growth in many metros, which should contribute to modest improvements in the affordability of multifamily rental housing.

The supply/demand imbalance for all types of affordable housing remains an ongoing issue. According to the recently released *Preview of 2015 Worst Case Housing Needs* report from the U.S. Department of Housing and Urban Development, there were still 2.2 million more renters with worst case housing needs in 2015 than there were just a decade ago. It will take more than one year of modest improvement in affordability to reverse this long-term trend.

Tanya Zahalak
Senior Multifamily Economist

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