The Path Ahead for Multifamily Apartments

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- Thus far, apartments have lived up to their reputation as resilient assets despite a recession of historic proportions.

- Historical correlations between employment and GDP and rent growth indicate that significant distress could lie ahead. But those correlations are irrelevant if the government makes up for lost income from employment, as it did with the CARES Act.

- Therefore, the passage of new support for the unemployed remains an important factor for the future of the apartment industry, especially if the pace of recovery stalls.

- Under our base scenario, which assumes the eventual passage of new legislation that supports the unemployed, but in a reduced amount compared to the CARES Act, the national average rent would decline by a maximum of 4.0% before returning to pre-COVID levels in early 2022.

Despite a Massive Economic Shock, Apartments Continue to Perform

The US economy has experienced a shock of historic proportions in the last six months. Concern over COVID-19 and the measures taken to limit its spread led to the loss of nearly 22 million jobs from February to May, more than 2.5 times the losses during the Great Recession. Some job losses were only temporary – 10.6 million jobs returned in May, June, July, and August – but even as of the end of August, total employment was still down by 11.5 million compared to February. GDP dropped at an annualized pace of -32.9% in Q2 2020, the worst decline since the Great Depression.

For some industries, the impact of COVID may be long-lived. It is hard to imagine the travel industry, including airlines, airports, and hotels, returning to business as normal anytime soon. Restaurants and retail will face unusual challenges as long as the virus remains in circulation. Even the demand for office space may decrease as remote work becomes more accepted.

Amid this “off the chart.” disruption, the apartment industry has fared remarkably well. According to CoStar, the average asking rent across all apartments in the United States fell by just $1, from $1,368 in Q1 2020 to $1,367 in Q2. Effective rents fell by all of $6. Both averages are still above where they were in Q2 2019. Absorption was also positive. Per CoStar, the number of apartment renters increased by 60,000 from Q1 to Q2. While that is a decline compared to the second quarter of the previous three years, when absorption over 100,000 was routine, it is hardly a disaster. In fact, the overall occupancy declined by only 20 basis points, from 93.3% Q1 to 93.1% in Q2. Finally, households continue to pay rent. Through August 20th, 90% of renters
had paid their rent, compared to 92.1% through the same week in August 2019, according to the NMHC rent tracker.\footnote{https://www.nmhc.org/research-insight/nmhc-rent-payment-tracker/}

Figure 1: Quarterly Change in Selected Indicators, Q1 to Q2 2020
(Sources: FRED, CoStar)

However, the overall average hides weakness in certain apartment classes and geographies. Average rents in Class A apartments fell much more than Class B or C apartments in Q2 2020. In some metro areas, including, Charlotte, Nashville, and New York, the rent declines have been steeper in the urban core than in the suburbs. This dynamic likely stems from the desire of some residents to escape densely populated environments, and their declining value proposition given the closures of restaurants, bars, theatres, etc.

Figure 2: Change in Average Rent and Occupancy by Apartment Class, Q1 to Q2 2020
(Source: CoStar)
Correlations between GDP, Employment, and Rent Indicate Potential Distress Ahead

The past performance of apartments in recessions should offer investors in the sector comfort. Nevertheless, the old maxim that past performance is no guarantee of future results still applies. With that in mind, the analysis below offers some insight into potential future performance based on the historical relationship between average rent growth and macro-level economic statistics, including GDP, total employment, and median household income.

Figure 3 presents the relationship between YOY GDP growth and average YOY rent growth since 2001. From 2001 to 2005, there is no correlation but since then, YOY GDP growth appears to lead average YOY rent growth by about 2 quarters. If the relationship were to hold true through this recession, it would imply a substantial reduction in average rent of about 10% over pre-COVID levels that would occur in Q4 2020.

However, while nothing can be ruled out in the current climate, such a decline is unlikely. Even in the worst quarter of the last recession, rents never dipped by more than 1.2% over the previous quarter. This forecast would require a 10% decline in just one quarter. Moreover, most economists are forecasting quarterly GDP growth to turn positive again in Q3 and Q4. The large declines in rents would have to occur even as the economy mounts a recovery.

Employment growth is also correlated with rent growth, as shown in Figure 4. In this case, rent growth appears to lag employment growth.

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2 Note that different data sources report different rates of historical rent growth. Varying methodologies, data collection methods and scope often underlie these differences. The rent series provided by CoStar, and used here, purports to represent the average “same-store” asking rent growth among all multifamily rental properties in the United States. Rent growth within any given metro area or submarket may deviate widely from the national average statistics shown here.
by one quarter. Once again, if this relationship were to hold true, it would mean a large reduction in rent of 11% that would occur in Q3. The fact that both GDP and employment imply a large decline in the near future is worrisome but if such a large decline in Q3 rents were actually in process, the signs would already be apparent.

Figure 5: YOY Change in Total Nonfarm Employment and YOY Rent Growth (Sources: FRED, CoStar, Oxford Economics, Middleburg)

But the Trajectory of Household Incomes is Key

GDP and employment both demonstrate a reasonable historical correlation with rent growth and both imply a substantial rent decline in the near future. Yet that scenario does not seem likely given the current state of the apartment market. If, as we expect, rent declines are not that substantial, it will mean that the historical relationship among these variables must break.

The explanation for such a break lies in household income. Median household income is also correlated with rent growth, as shown in Figure 5.

Figure 5: YOY Change in Median Household Income and YOY Rent Growth (Sources: Oxford Economics and CoStar)
Yet unlike GDP or employment, median household income grew slightly in Q2 2020 according to estimates from Oxford Economics. Moreover, although Oxford Economics projects a slight decline in median household income over the next few quarters, it is a far smaller decline than the past relationship between GDP, employment, and household income would suggest, as shown in Figure 6. In the last recession, declines in GDP and employment were associated with a nearly equivalent decline in household income.

Figure 6: Historical and Projected YOY Growth in Total Nonfarm Employment, Real GDP, and Median Household Income (Source: Oxford Economics)

To be clear, the estimates from Oxford are just that. The statistics behind this household income series come from the American Community Survey. Its official estimates for 2020 will not be released until the third quarter of 2021.

Still, current statistics from the Bureau of Economic Analysis support the notion that the median household income rose in Q2 2020. Aggregate disposable personal income (essentially after-tax income) increased by 9.6% from Q1 to Q2 2020, even though the total compensation of employees fell by 6.8%. The loss in wages was more than made up by an increase in government benefits associated with the CARES Act.

The reported increase in disposable income marks an important contrast to the last recession, when aggregate disposable income fell by 2.8% from its peak in Q2 2008 to its bottom in Q1 2009. Moreover,

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3 Bureau of Economic Analysis, Table 2.1, last revised on August 27, 2020.
it was not until Q1 2010, that disposable income fully recovered. One other noteworthy difference compared to the last recession is the high savings rate. 26% of disposable personal income was saved in Q2 2020, compared to 7.3% in Q4 2019, and just 5.6% in Q2 2008. That means a good portion of the stimulus money was saved.\(^4\)

If Oxford’s forecast is correct, and the historical relationship between median household income and average rent holds, then it would mean a maximum YOY rent decline of less than 1.0%, and a full recovery by Q1 2022.

Considering the scale of the economic damage thus far, this forecast may seem too good to be true for apartment investors. However, there is an advantage to using income as the basis for a forecast. It is more directly related to rents than GDP or employment. While household income, GDP, and employment are usually correlated to some degree, if the correlation were to break, and people lost their job but retained a similar income, they could still pay the rent. For many Americans, that described the situation this summer.

**The Outlook for Household Income Depends on Stimulus**

Given continued stimulus at levels similar to the CARES Act, a forecast of a minimal decline in rents of less than 1.0% over the next year would be reasonable. However, the enhanced unemployment benefits expired at the end of July and no new deal is in sight. The President did issue an “executive memorandum” allowing the use of disaster relief funds for unemployment benefits, which may temporarily bridge some of the gap left by the expiration of the CARES Act benefits. But questions about its details and the capacity of states to implement it limit its near-term impact. Therefore, the overall outlook for stimulus has turned more negative than when Oxford’s income forecast was created at the end of June.

Knowing that, we have modified the forecast for median household income to account for the likelihood of reduced stimulus payments. It falls between Oxford’s forecast, and what one might expect based on the historical relationship between employment and household income growth. This approximates the most likely scenario in our view, which is that Congress eventually reaches a deal on additional support for the unemployed but that it takes some weeks, and reduces benefits in comparison to the CARES Act. Figure 7 shows the forecast in relation to employment growth projected by Oxford Economics.

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\(^4\) Bureau of Economic Analysis, Table 2.1, last revised on August 27, 2020.
Using this forecast of median household income as the basis results in the rent forecast shown in Figure 8. The overall national average rent would decline by a maximum of 4.0% YOY in Q4 2020 before beginning a recovery that returns rents to their pre-COVID levels by the first quarter of 2022. Nevertheless, the details of future stimulus legislation can only be guessed and the range of possible outcomes is wide.

**Conclusion**

The key takeaway is less the forecast, which depends heavily on the details of new legislation, if and when it is passed. Rather, it is the recognition that without the government’s support for household income, the impact of the current recession on the apartment market would be much greater. In the face of such a large loss of employment and GDP, rent declines of 10% were not out of the question. Some analysts made such forecasts early in the crisis.
The lack of new legislation to support the unemployed certainly raises concerns. If the pace of the recovery in employment stalls, a plausible scenario if COVID’s spread accelerates in the fall, and no new stimulus is passed, household incomes will decline and savings will eventually run dry for the unemployed. In that case, substantial rent declines could again be on the table.

Nevertheless, we are hopeful that the economy will continue to heal and that, if household finances deteriorate, the situation will force Congress to reach agreement on assistance to limit the damage, which would extend beyond apartments. Finally, even in a no stimulus scenario, where rents would more closely track GDP and employment, the steep decline in rents would be followed by a steep increase, if the employment and GDP forecasts of Oxford Economics and others are correct.
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