



Selected Economic Impacts on the Multifamily Housing Industry

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Alan Greenspan, ex-Chairman of the Federal Reserve, stated his belief that the current financial crisis occurring in the United States is likely to be judged as the most wrenching economic event since the end of World War II. On the other hand, Mark Zandi, chief economist at Moody's, and other eminent economists have stated policymakers will act in a concerted and aggressive way, stabilizing the financial markets over the next several months, allowing for a brief economic downturn, but that a long and harsh recession will not take place.

Numerous factors have been cited for influencing the current economic situation including record gasoline, natural gas, and electricity prices, the historic weakness of the U.S. dollar, the sub-prime mortgage crisis, the stock market downturn, among others. The bursting of the housing market bubble and ensuing sub-prime mortgage crisis have caused panic in worldwide financial markets and encouraged investors to withdraw their investments in high risk mortgage securities and equities which they have replaced with investments in commodities as "stores of value." This movement of capital has triggered a liquidity crisis in the world financial markets which in turn has created a continuously cascading downward effect on other sectors of the national economy. A liquidity crisis places downward pressure on economic growth because fewer or more expensive loans cause a decrease in investment by businesses and lower consumer spending. Therefore, the purpose of this document is to give a snap shot of the current situation in certain sectors of the U.S. economy and in turn, how developments in those economic sectors may affect the multifamily housing industry both economically and politically.

Housing Market Slump

The U.S. homeownership rate peaked in 2004 at an all time high of 69.2 percent; this was up from 64 % in 1994, which was approximately where the rate had been since 1980. In a corresponding trend between 1997 and 2006, the average American home price increased by 124 percent. This large expansion of homeownership and escalation in home prices was due in part to the creation of the sub-prime loan market and record low interest rates resulting from loose fiscal policy at the Federal Reserve. Fueled by these low interest rates, homeowners used increased property value to refinance homes with even lower interest rates and take out second mortgages which were used to fund consumer spending. This expanding housing bubble abruptly burst in several U.S. markets during late summer 2005, and as of summer 2006 several markets were facing the issues of ballooning inventories, falling prices and sharply reduced sales volumes. Overbuilding during the boom period, increasing foreclosure rates and unwillingness of many homeowners to sell their homes at reduced market prices have significantly increased the supply of owner-occupied housing inventory available. As of January 2008, the average inventory of unsold new homes stands at a 9.8 month supply across the country based on December 2007 sales volume, the highest level since 1981. Further, a record of nearly four million unsold existing homes are available for sale. The bursting of the housing bubble and the resulting increase in home foreclosures were key factors in bringing about the sub-prime mortgage crisis discussed in the below section.

Because multifamily housing rents have not fallen as much as home prices, perhaps the most direct economic effect the apartment industry has seen as a result of the housing bubble burst is the emergence of a shadow rental market. Within this market, single-family and condo units that were formerly owner-occupied are now being occupied by renters. This additional competition not only affects the apartment industry in terms of direct competition for occupancy, but also due to the fact that as residents now have additional rental options, many U.S. markets simply will not bear rent increases.

Taking into account the shadow market effect, analysts have predicted a low 2.2 percent average rent increase for 2008. However, in several areas such as Las Vegas, Phoenix and Miami where there is an overabundant amount of rentable shadow market property, rents can be expected to decline 2 to 3 percent. Due to the negative effects the shadow rental market is having on the multifamily housing industry, one may expect that the industry would support the housing stimulus package President Bush signed into law July 30th. However, that package could turn out to be a double-edged sword for the apartment industry. The housing stimulus package as enacted includes tax credits for the purchase of owner-occupied housing; this will hurt the industry as some renters will chose to purchase a house, however, some of the units purchased will be shadow market properties, thereby benefiting the industry. Therefore, the degree to which this stimulus package may benefit the multifamily housing industry will partially depend on the exact magnitude of the number of current renters who shift from apartment renting to single-family home ownership. Additionally, the industry may benefit from the following provisions of the package: expansion and improvement of the Low-Income Housing Tax Credit program, temporary increases to the tax-exempt private-activity bond cap for multifamily and mortgage revenue bonds, raising the FHA downpayment requirement from 3.0 percent to 3.5 percent and comprehensive GSE reform.

At the state and local government level the housing slump and general economic slowdown has had a major impact on the general revenue streams of 38 states, due to lower real estate transfer and sales tax receipts. Eighteen of these states have announced anticipated budgetary deficits in 2008, while twenty three states have announced anticipated shortfalls for FY 2009. This lost revenue will need to be replaced through other revenue streams. While lawmakers traditionally are loathe to raise taxes, it is unlikely that this fiscal situation can be resolved without some form of tax increase or restructuring. States and localities may choose to follow the examples of Ohio, Michigan and others who have increased or implemented new sales taxes. Of particular interest to the industry are taxes on previously untaxed services such as leasing apartments and apartment management services. In addition to the problems caused by the housing bust, states are also trying to find funding sources for infrastructure and transportation costs. Local governments may seek more taxing authority from the state governments to pay for such things.

Sub-prime Mortgage Crisis

During the housing boom many homebuyers, primarily those with sub-prime credit ratings, took out adjustable-rate mortgages (ARMs) which allowed buyers to purchase owner-occupied housing with low interest rate introductory periods. As the Federal Reserve Bank exercised a monetary contraction policy in 2005, many homeowners were stunned when their ARMs began to reset to much higher rates. As interest rates reset higher many homeowners' monthly mortgage payments jumped far above what they were able to pay. Some homeowners began to default on their mortgages and the cracks in the U.S. housing financial markets began to appear. In March 2007, the United States' sub-prime mortgage industry collapsed due to higher-than-expected home foreclosure rates which had been mounting since 2005. The U.S. mortgage crisis has seen at least 100 mortgage companies shut down, suspend operations or sell off assets since the start of 2007. As of May 2008, financial institutions have recognized sub-prime-related losses or write-downs exceeding \$387 billion. Profits at the 8,533 U.S. banks insured by the FDIC declined from \$35.2 billion in the fourth quarter of 2006 to \$646 million (89 percent) during the fourth quarter of 2007. Because of the global economy, and the huge sub-prime "pool" of mortgages that was bought by investors world wide, the International Monetary Fund (IMF) anticipates that the worldwide losses stemming from the US sub-prime mortgage crisis could run to \$945 billion.

In the period leading up to the sub-prime crisis many mortgage lenders had passed the rights to mortgage payments and related default risk to third-party investors via mortgage-backed securities (MBS). As the housing market slowed, corporate, individual and institutional investors holding MBS faced significant losses as the value of the underlying mortgage assets declined. As a result, investors began moving capital from riskier MBSs and stocks to safer investments, not as likely to lose their value, such as commodities. This mass exodus of capital from the world financial markets is consistent with a credit crunch, when combined with the massive monetary losses of financial institutions this has caused lenders to reduce lending activity or to make loans at higher interest rates. Similarly, the ability of corporations, in particular real estate companies, to obtain funds through the issuance of commercial paper has been affected. For this reason the multifamily housing industry should expect it to be harder and costlier to obtain both short and long term financing at least for the next several months. For some firms this may mean delaying planned projects.

On the political front the government has responded to the sub-prime crisis in several ways. The Treasury Department and the Federal Reserve have implemented several new regulations on the banking industry that require the raising of lending standards. Further, for the first time in its history the Federal Reserve has directly bailed out a Wall Street firm as it financed the buyout of the struggling Bear Stearns. Additionally, many policymakers are touting the housing stimulus

package mentioned above as a means of stemming more home foreclosures. A large piece of the stimulus package is also directly aimed at assisting and reforming Fannie Mae and Freddie Mac, the Government Sponsored Enterprises (GSE) that have seen their finances crash as a result of the subprime crisis. As a positive to our industry, the GSE piece of the legislation does not contain onerous provisions that were included in earlier versions that would have severely restricted the GSEs' ability to purchase multifamily loans.

Energy Crisis

An energy crisis is any bottleneck in the supply of energy resources to an economy. A crisis can develop due to industrial actions like union organized strikes, government embargoes, supply shortages and ageing infrastructure. In terms of energy economics, the single largest factor currently driving high prices is the global supply for such goods as oil, natural gas and electricity in no way matches the current global demand. This is due to the increasing industrialization of previously undeveloped economies such as China, India and Brazil which are consuming massive amounts of energy resources that were previously available for use in the United States. This trend is expected to continue for the foreseeable future until alternative energy sources and green-friendly technology become more readily available. With regards to the energy crisis, the apartment industry is most directly affected by prices in the natural gas and electricity markets.

Many figures in North America have spoken publicly about a North American natural gas crisis including former Secretary of Energy Spencer Abraham and Alan Greenspan. The natural gas crisis is typically described by the increasing price of natural gas in North America over the last few years, because of the decline in indigenous supply, the increase in demand for electricity generation and increased demand in overseas markets. Indigenous supply in the U.S. fell from 20,570,295 MMcf (one million cubic feet) in 2001 to 18,950,734 MMcf in 2005, this caused prices to peak that year at 15.37 per million British Thermal Units, however, prices still remain high when compared to historical data and continue to spike in reaction to changes in global supply and demand. Several policymakers have suggested that a solution to the natural gas crisis is the import of liquid natural gas. However, the recent record low exchange rate for the U.S. dollar has made it relatively expensive to buy foreign natural gas in bulk. For this reason, natural gas prices rose 19 percent in 2007. Further, increased demand from overseas markets such as China and Japan are expected to continue to drive prices higher for the foreseeable future.

In a process parallel to the deregulation of natural gas markets, a retail electric market has developed as a result of end-use customers being able to choose their supplier from competing electricity retailers (utilities traditionally are regarded as "providers of last resort".) However, notwithstanding the favorable light in which market solutions are viewed conceptually, if electricity prices were to move to the levels needed to incentivize new merchant (i.e., market-based) transmission and generation, the costs to consumers would be politically difficult. A separate issue effecting electricity markets is whether consumers face real-time pricing, prices based on the variable wholesale price, or a price that is set in some other way, such as average annual costs. In many markets, consumers do not pay based on the real-time price, and hence have no incentive to reduce demand at times of high (wholesale) prices or to shift their demand to other periods. Thus, the experience with the introduction of wholesale and retail competition has been mixed. Many regional markets have achieved some success and the ongoing trend continues to be towards deregulation and introduction of competition. However, major failures such as the California electricity crisis and the Enron scandal have caused a slow down in the pace of change and in some regions a move towards re-regulation and reduction in competition. This trend is widely regarded as a temporary one against the longer term trend toward more open and competitive markets.

As demand for energy resources continues to soar worldwide and supply of those commodities remains stagnant or declines, the multifamily housing industry should expect energy prices to continue to rise, at least in the short run. Property managers/owners should expect higher energy bills for maintenance of common areas and those firms who do not sub-meter utilities to residents' units will see profit losses due to spikes in utility costs not figured into established rents. Additionally, as energy prices persistently increase, property owners should expect this escalation to exert inflationary pressures on the prices of goods and services throughout the economy in general. This inflationary effect may lead to added expenses for such wide ranging basic apartment industry supplies as paint and landscape maintenance, just to name a few.

Politically, in response to the energy crisis, the principles of alternative energy and sustainable living movements have been gaining popularity. The apartment industry can expect governments to continue to respond to the energy crisis by implementing green/sustainable building standards (possibly requiring the retrofit of green technology), mandating sub-

metering of utilities and imposing energy consumption taxes such as “carbon taxes. Even as the green building movement is nearing a tipping point, the movement and its associated techniques and technologies are still largely in their infancy. This being the case, green technology is still relatively expensive to implement when compared to methods currently being used. Green technologies are likely to remain more costly than standard building technologies for the foreseeable future, and therefore largely unemployed in apartment communities, and will remain so until the concerns of the multifamily housing industry regarding their use are addressed. First and foremost of these concerns is, that many facets of green policy and technology, such as retrofitting, remain impractical to implement from a business perspective or have unexpected negative consequences when the technologies are employed, thereby negating their practical usefulness in apartment communities. Only when these practicality issues are addressed and green technologies become more apartment industry friendly, will multifamily properties begin purchasing green goods in large enough quantities to draw larger amounts of investment capital to their makers to allow for economies of scale to take place in the field thereby lowering prices. Therefore, as more governments begin to adopt mandatory green building policies, the prudent multifamily housing firm will want to budget for these extra expenses until such time as green technology prices drop.

Sprinkler-Based Fire Suppression System Retrofitting

The general downturn in the U.S. economy has been accompanied by a marked slowing in new building construction. This construction slowdown has considerably cut into the number of available job contracts for many local construction unions. One reaction to this decrease in the number of employment opportunities has been the recently resurgent, and well funded, efforts of the United Association of Plumbers and Pipefitters Union and sprinkler system manufacturers to persuade state and local government agencies to mandate sprinkler system retrofits in apartment communities. Statistics prove apartment communities are already safe places to live, however, if the union is successful in getting these mandates passed, the outcome will be costly for the multifamily housing industry. Safe estimates from within the industry place the cost of completing a sprinkler retrofit project for a multi-floor apartment community in the area of \$30 or more per linear foot installed. In 2007, the industry witnessed the Pipefitters’ Union press for a statewide sprinkler retrofit regulation in New Jersey. The New Jersey Apartment Association estimated that in order to complete the required retrofitting the cost to the industry in that state alone was approximately \$2.5 billion. Very few rental markets could bear the rent increases necessary to cover the cost of such a program. Thus, the effect of such retrofit policies in many areas would be a contraction in affordable housing levels as apartment communities would go out of business due to no return on investment. The apartment industry should anticipate that the union will continue to push its retrofit agenda wherever and whenever it senses the opportunity to do so until new construction project starts have returned to normalcy. However, it should be noted that even a return to normal new construction start standards may not guarantee an end to the union’s push for retrofitting, as it knows government mandated sprinkler retrofitting will result in more jobs and clear economic gain for its members.

Conclusion

The apartment industry at this time is stable, with the exception of a few markets scattered across the country; but due to the factors discussed above and the general slowing of the U.S. economy, multifamily housing properties could experience operational difficulties and lower profits while both the government and the market work through current issues. While these conditions will cause short term industry financials to not be as bright as we would like, all is not lost as long-term projections for the industry are very good. Assuming there are no further shocks to the financial system, analysts predict that the credit crunch may begin to ease as early as the end of the summer. This return of liquidity to the market will benefit the multifamily housing industry by allowing consumers and investors to once again begin purchasing the excess supply of owner-occupied housing that is currently comprising the shadow rental market, thereby relieving pressure to keep rents low, as well as lowering interest rates, making it once again more affordable to finance planned projects. All things remaining the same, optimistic analysts are predicting the industry could see a return to normalcy within 9 to 12 months, while others are using an 18 to 24 month timetable. On an even longer timetable the multifamily housing industry may be in the best position it has ever been, as new resident markets could open in the next 5 to 10 years. Such markets will include student and privatized military housing, as well as the retiring Baby Boomer generation as they look to downsize from single-family homes to smaller more easily maintained living spaces. However, it is important for the multifamily housing industry to keep in mind that it only becomes economically feasible for us as an industry to bridge the time gap between the present and the profits of those emerging markets if we are continually able to mobilize our strength in numbers to guarantee that the issues addressed here within are resolved in our favor.

Selected Resources:

The Federal Reserve Board of Governors- www.federalreserve.gov

Federal Energy Regulatory Commission- www.ferc.gov

Energy Information Administration- www.eia.doe.gov

Natural Gas Supply Association- www.naturalgas.org

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