RENTAL HOUSING IN THE EIGHTIES: A DEMOGRAPHIC ANALYSIS AND PROGNOSIS FOR THE FUTURE

by Edward C. Carman, Jr. and David A. Smith

The 1970s represented a turbulent time for the real estate industry: first there was too much money chasing too little real estate; then there was too much real estate chasing too few tenants; then there were too many condos; finally there was no mortgage money.

So much occurred in the '70s that it was easy to lose sight of more fundamental long-term changes in the nature of the real estate business and in the demographics of the United States.

In the 1980s, Americans are feeling the brunt of these changes. The average household is getting smaller. Homes are becoming increasingly difficult to purchase, yet people are paying larger shares of their income for housing. Americans are adjusting their aspirations to owning an attached unit in a multi-family complex rather than a single-family home.

Understanding the demographic changes now occurring is the key to anticipating the responses that they will trigger in the nation's housing markets.

Demographic Analysis

If the 1960s was the decade of the young, then the '80s are the decade of the two-income family and the elderly—two groups which have substantial needs for rental or condominium housing.

Young Adults

The 1950s were the baby boom years. From 1950 through 1965 an unprecedented number of American children were born. Ever since then, this population bulge has been moving like a wave through American society, rewriting mores and economics as it goes.

The first of the baby boom children became adults in 1970; by 1985 the entire generation will be between the ages of 20 and 35. By the end of the decade of the '80s forty-two million Americans will have turned 30—a 31 percent jump from the previous decade.

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With these new adults will come new household formation. Most of these households will have two incomes; most will have fewer children. These people have more money to spend, and they will be searching for acceptable housing. But house prices are out of reach for most young couples, and will stay there as long as interest rates remain high. And as long as budget deficits force the Federal government to borrow hundreds of billions of dollars a year, interest rates will probably remain at record levels.

Amenity Requirements

Even though single-family homes may be unaffordable, Americans will seek housing which provides the amenities and sense of livability of a single-family home. Studies have shown that when it comes to choosing housing, young Americans are particularly sensitive to:

Sense of privacy. To achieve this, apartments should have enclosed or delineated yard space or balconies. Soundproofing will be required to reduce or eliminate noise from neighboring apartments. Rather than long anonymous corridors, apartments should be designed to minimize the number of apartments off each entrance; it is ideal for each apartment to have its own front and back door.

Security. Contrasting with the need for privacy comes a concern for personal security. The apartment should have strong doors, windows, and locks. Buzzer, video or magnetic card identification systems should restrict or monitor access, both to the apartment itself and to the surrounding residential complex.

Landscaping. Though the apartments must be well protected, they must also seek to disguise the size of the complex. Through planned use of extensive greenery, shrubs, trees and flowers, the complex can be given an established, residential feel. Making a rental complex look like a single-family subdivision will add residual value.

Recreational amenities. Multi-family living can provide fringe benefits such as swimming pools, tennis courts, convenient reserved parking, and other recreational facilities. It can also provide a sense of community. These features play a particularly important role in establishing value for future occupant ownership as condominiums or co-operatives.

Energy efficiency. Insulation, storm windows, weatherstripping and efficient heating and cooling systems are virtually mandatory in any new property. Installation of separate utility metering will usually reduce overall fuel consumption by 20 to 30 percent as well as protecting the owners from sudden fluctuations in energy costs. Complexes which have individual metering will command higher resale prices. If energy costs continue to outstrip inflation, conversion will make sense for more and more properties.

Location. Proximity to public places such as schools, employment centers, and churches, and especially to public transportation, reduces the effective living cost of a complex and hence increases expected sale value.

Overall image. A project which carries an air of exclusivity and prestige, largely derived from combination of factors cited, should be a rental market leader.

Anticipated Housing

By the end of the '80s, the population of the United States is expected to increase by twenty million people. Because of the baby boom, the largest age group increase will be reflected in the 25 to 44 year-old bracket. New household formation will be large: approximately 1,500,000 per year, or 15 million for the entire decade.

Of these, roughly three quarters or nearly 10 million households will have no children. Of the remaining quarter, nearly two-thirds will have only one child. In other words, of the new households being formed during the '80s, only one in twelve is expected to have two or more children. *Eleven out of twelve new households will require apartments of two bedrooms or smaller.*

To keep up with the demand, supply must also expand. Yet every year perhaps half a million rental housing units are removed from the supply, usually by deterioration and eventual demolition. During the period from 1950 through 1970, new housing construction averaged one and a half times the rate of household formation, a ratio that has in the past maintained a stable rate of occupancy. Given these relationships, unless 20 to 25 million or so new housing units are built during the decade (or 2,000,000 per year), rental markets will get tighter.

From 1970 through 1978 approximately 1,800,000 new construction units were built each year, roughly 70 percent of which represented construction for owner occupancy (chiefly new houses or new construction condominiums). From 1979 through 1983 that production was cut to 1,400,000 per year, less than 70 percent of the production anticipated to be needed to prevent rental tightening.

Furthermore, during the '70s privately syndicated subsidized housing emerged as a major source of new development. By the end of the decade, it is estimated that 60 percent of the new construction multi-family rental housing had some government involvement. The unprecedented infusion of inexpensive housing, fueled by reduced interest rates (as low as the equivalent of 1 percent) and direct government income subsidies, held back rents in many areas.

Since 1981 the Reagan Administration has eliminated funding for new Section 8 properties (although existing Section 8 properties have continued with their full Section 8 allocation). It is predicted that this decade will produce more new rental households than ever were produced in the country's history. This is a prescription for nationwide rental tightness.

With conventional new construction choked off by high interest rates, and the government bowing out of subsidized housing production, no significant vehicle for the production of new rental housing in the '80s exists.

Elderly

For the last 30 years, the South and West have been the growth areas of the United States, while the Northeast and especially the industrial North Central have suffered population loss. Nearly 75 percent of the increase in population is occurring in the South and West.

Many of these individuals are elderly. Americans are living longer and having fewer children; by 1990 roughly a third of the population will be 50 or older. The gradual increase in the elderly population should continue right through until roughly 2010, when the baby boom generation will turn 55.

The housing needs of elderly people differ radically from those of the nuclear family, yet generally resemble those of young adults. The elderly need less space and fewer bedrooms; most elderly complexes average 80 percent one-bedroom or smaller. The elderly often live on fixed or limited incomes; moderate housing is a must. Insulation plays a key role because the elderly generally prefer higher living temperatures.

Many of the prime residential attractions suitable for young adults are also sought by the elderly. While the need for recreational amenities is less, the desire for a sense of community is even greater; well-managed existing elderly properties provide a full schedule for resident group activities.

Conversions of existing multi-family rental elderly complexes to individual ownership is a logical step. By the end of the decade, all-elderly condominiums or cooperatives probably will start to appear on a much larger scale.

Response

So far, a bleak picture has been painted of more and more Americans competing for a static or possibly dwindling supply of attractive housing. What responses are these changes triggering?

Rent Increases in Real Terms

In the '70s, renters were fortunate. In the first few years of the decade, developers took advantage of cheap debt financing—and even cheaper equity financing available through REITs and similar vehicles—to build more rental housing than the country could then absorb. Vacancy rates reached record highs. These vacancies and the infusion of government subsidized housing held down rents in prime new construction complexes during the latter '70s.

Just as the Treasury department is the bellwether for interest rates, vacancy among attractive new construction complexes sets a ceiling on the rental market. Existing complexes had to mark time as best they could until the desirable complexes filled up.

Once they were full, the desirable complexes faced a second problem: skyrocketing utility costs triggered by the Arab oil embargo of 1974. Most of the housing built in the early '70s featured little insulation and central metering for heat. But when costs rose uncontrollably, while rents were held back by vacancy problems, many properties were squashed in the middle. Subsidized housing suffered along with the rest of the industry.

In the middle '70s rental construction slowed dramatically, and by 1977 the tide was beginning to turn. Owners were finally able to chase the utility increases. Since then rents have increased faster than inflation, yet because of the enormous pit into which real estate fell, the period of catch-up is not complete. And new construction, the traditional market leader, was curtailed by the explosive rise in interest rates starting in 1978.

In order to build a new conventional rental property today, a builder has to charge rents 30 to 40 percent higher than are supported by most marketplaces. It is not surprising that little conventional new construction is taking place, except in those Sunbelt cities experiencing dramatic immigration. But the gap between existing rents and replacement rents has another implication.

Before it will become economical for a potential owner to build a new property, rents must rise 30 to 40 percent in real terms. It is logical to expect that this trend will take place in the decade of the '80s.

Even if inflation remains at 4 to 5 percent per year, the future rents needed to spur new construction would appear to be staggering. The same tenant who paid $400 for a conventional two-bedroom apartment in 1982 might anticipate paying $800 to $1,100 for the same apartment in 1992.

Lowered Expectations

Even though rents are under the replacement cost level, they already represent a disproportionate share of many people's incomes. In the '70s lenders figured their home buyers would pay roughly 25 percent of their income for housing cost; today most banks use 30-40 percent. Housing, like energy, is becoming more expensive.

Two-income families are more easily able to ride with these trends, but single-income families have a difficult time. As a result, during the first years of the decade many people lowered their living standards by doubling up or otherwise sharing living accommodations. In effect, this reduced the rate of household formation, a statistic confirmed in the recent census analyses. In the '70s young people just starting out could aspire to a single apartment. Now they must either share for a prolonged period or live at home. Some families are even doubling up to buy two-family residences where once they would have disdained even to rent.

Reducing expectations may result in some local rental market shrinkage with increases in vacancy: during the recession of 1982-83, this happened in several markets. The phenomenon also occurs with oil: when the price rises, usage drops. But in a very short time people's expectations of what constitutes a fair price is radically adjusted; the same people who complained of shortages when gas was 70¢ a gallon bemoan the "glut" at $1.25 or more.

The new apartments of the future will be smaller. Therefore existing complexes with their generally larger apartments will be relatively more attractive. Of course, these older complexes will face significantly higher heating costs and will have to implement energy-conserving measures. But it seems possible that the moderate-income apartment of today may become the upper-middle-class home of tomorrow.

Potential Rent Control

Every rental owner casts one vote. So does every tenant. But tenants outnumber owners by fifty or a hundred to one, and politicians often listen to votes more than they listen to the issues. Many local political battles over rent control are expected.

Rent control hurts rental properties. Cities like London and New York, which have had prolonged rent control, have a long history of stifled new rental production. Owners have little or no incentive to maintain the property. Tenants become house-locked, unable to move to a non-rent-controlled apartment and clinging to an existing tenancy which is their only way of making ends meet.

It is felt that in the long run rent control does not work: tenants end up paying equivalent rents for inferior property. But the effects of rent control take time to emerge, and a horizon stretching over several years is often beyond the imagination of a local politician. What is worse is that, once implemented, rent control can be political suicide to remove. The effects of sudden decontrol on renters are catastrophic; the natural emigration which might take place over several years can be compressed into six months.

Rent control battles are likely to be fierce and unprincipled. In the long run, however, rent control probably will be discarded because it does nothing to produce housing or even to encourage its preservation and upkeep.

As for national rent control, even if constitutional, it is doubtful that any Republican administration—especially the current administration—would even contemplate such a drastic step. Democratics or liberal Republicans are forced to solve the problem a second way—by increasing supply.

Financing

How will the apartments of the near future be built? In the '70s, cheap fixed-interest-rate mortgages were common. Better still, these mortgages were assumable. Upon sale of the property, the new owner could continue paying the same low interest rate. It seemed like a good idea at the time; after all, the mortgage is nonrecourse, so why have a due-on-sale clause?

When interest rates doubled and tripled from their early '70s levels, the bankers found out why. Suddenly the S & Ls had to pay out 12 to 14 percent for money which was earning them six to eight percent. In fact, the preponderance of fixed-interest-rate mortgages is thought to be the key reason why many S & Ls floundered in the early '80s.

Now, of course, no bank in its right mind would write a long-term low-interest assumable mortgage. But new construction rental housing is generally unfeasible at today's combination of rents and interest rates. Where is the money going to come from? Two sources loom on the horizon:

Pension funds. The many billions of dollars locked up in pension funds have two crucial advantages: they are generally tax-exempt, and they have very long time horizons. They also face a serious investment problem: how to preserve and enhance capital in an unpredictably inflationary market.

Real estate offers an excellent solution. Yet, until recent liberalizations of the law, pension funds were generally excluded from equity or secondary debt positions in real estate. With the removal of these restrictions, a growing trickle of pension fund interest is being observed. It may become a flood.

Foreign investment. Wealthy foreigners have many of the same investment characteristics as pension funds: long time horizons, enormous sums to invest, concern about protection and enhancement of capital during worldwide inflation. Foreign investors can often also structure lower tax costs than domestic investors.

But to these significant reasons a further concern is added: global unrest. In the eyes of foreign investors, the United States remains a haven of capitalism and stability. So they seek tangible United States assets such as oil and gas and real estate. U.S. energy and real estate are inexpensive by global standards. Already the foreigners are buying the glamor properties such as huge office buildings and shopping centers. During the next few years, it is expected they may become more interested in bread-and-butter rental housing.

Joint Venture Financing. High debt service costs have encouraged the development of new financing techniques. Much of the new construction in the Sunbelt has been financed by joint ventures between lenders (often more aggressive savings and loans) and builders. Another technique which gained popularity is the accruing mortgage, where the interest rate, often floating, is several points higher than the payment rate, usually fixed. The two techniques are often combined. Their effect is usually to permit some development in obviously strong rental markets. As rents rise in real terms, vehicles like this will proliferate.

Renewed Government Involvement

A government which cannot house its people will soon be voted out of office. Sooner or later the current policy of almost no involvement in housing production must change in a number of ways:

Income subsidy. The government could revive the Section 8 program and similar vehicles which insulate tenants from rents.

Financing subsidy. The old Section 236 program suffered from some weaknesses which are easily identifiable in retrospect: construction inadequate to deal with long-term expectations; no defense against increases in utility costs; relative lack of concern over management as opposed to construction. A fixed subsidy also protects the government against uncontrollable inflationary income increases and can with proper structuring provide the owner with incentives to minimize costs.

In fact, both the Federal government and several innovative state housing finance agencies have recently enacted differing versions of fixed, relatively shallow subsidy programs precisely as predicted by this article.

Ownership incentives. The Economic Recovery Tax Act of 1981 provided substantial tax incentives to owners of existing housing. During the last few years, phenomenal interest in resyndicating second-user subsidized housing properties with new limited partners developed. Buyers were quick to realize the advantages of purchasing existing housing for a fraction of its replacement cost, and the business developed into one of the dominant forms of real estate tax shelter.

The well-structured resyndication usually: paid the old investors enough to cover their contingent tax liability and hence bring in substantial capital gains revenue to the government; left unaffected the underlying rental character of the property; provided funds for deferred maintenance or capital improvements mandated by higher utility costs; and rewarded good managers who preserved the value of their property.

Moreover, resyndication is "financing-independent." It doesn't require a new infusion of hard-to-find mortgage money since the mortgage is already in place. It serves the government's ends, and the government has a vested interest in improving the quality of housing. Finally, most existing subsidized housing properties carry low acquisition costs. Replacing them might easily cost twice as much. It is far better to upgrade and preserve the existing housing than to embark on an expensive program of demolition and reconstruction.

Unfortunately for the housing industry, the recently enacted Tax Reform Act of 1984 contains provisions which will greatly reduce the volume of resyndications in 1985 and beyond. These provisions, which generally require accrued but unpaid interest to be deducted only in accordance with a market interest rate, and mandate the noteholder to report a matching amount of income, become effective January 1, 1985. Between now and then, there will be a stampede to complete as many transactions as possible.

Conclusion

The decade of the '80s is seeing a vast infusion of young, childless, two-income Americans seeking attractive housing. Housing the elderly will become more important as the proportion of elderly people rises. As time goes on, people will pay more in real terms to get less.

So far in the '80s and for at least the next several years, new construction will not keep up with this inexorable demand. Rents should not only keep pace with inflation but increase in real terms by 30 to 40 percent from 1981 levels. Periodic local rental softness will occur as Americans lower their expectations, but investment yields from existing property should steadily rise.

Properties with relatively smaller units, with energy efficiency and amenities and characteristics of single family homes, will probably do best overall.