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High-End Apartments Facing Greatest Risk Of Oversupply

As rent growth declines and new construction progresses, oversupply is a hot topic in the multifamily industry. Now, fresh data shows the impact of elevated supply could fall heaviest on the high-end properties that make up the bulk of scheduled new deliveries.

There were just fewer than a million units under construction at the end of the third quarter, and 70% of those were considered high-end, according to a CoStar report that found the gap between mid-range and high-end rents is widening.

The rent difference between properties considered four- or five-star and those considered three-star is about $550 per month, or $6,600 a year, much higher than the marginal difference in years past, CoStar found. That could be an issue since developers often deal with oversupply by offering concessions to lure tenants from other complexes, making larger differences more impactful.

High-class building rents nationally average $2,074 per month, so a developer would have to offer at least three free months to attract a tenant from a lower-class building, CoStar reported.

Landlords are already offering concessions on 30% of rental listings, the highest rate in two years, according to a Zillow report from last week.

The trend is being felt in submarkets like Downtown Miami, which saw luxury rents drop 1.1% at the end of the third quarter, while lower-tier rents grew by 1.1%, according to CoStar. Downtown Miami has about 16,708 units under construction or about 57.8% of its inventory. With an average price differential of $540 a month, Miami's nonluxury product is somewhat insulated from the large supply of four- and five-star units coming online, CoStar reported.

Charlotte's South End had 6,592 units, or 59.3% of its inventory, under construction and saw a rent growth decline of 3.1% in the third quarter.

Other submarkets likely to feel a pinch include St. Augustine, Florida, Downtown Austin, and Downtown Atlanta, which all have a construction pipeline representing more than 40% of their inventory. All three markets saw rent growth declines in the third quarter.

The Sun Belt has the largest concentration of units under construction. The markets with the most units being built include Downtown Miami, Downtown Nashville, Frisco/Prosper in Dallas-Fort Worth, Downtown Denver, and Charlotte's South End.

Multifamily REITs are seeing the impact of oversupply and concessions in these areas, according to third-quarter earnings calls. UDR reported its San Francisco and Sun Belt markets being impacted by new supply, with average concessions hovering at about three weeks and ranging up to six weeks free.

UDR expects the concession-heavy dynamic to continue throughout the fourth quarter and into 2024, said Michael Lacy, the company's senior vice president of property operations.

The same submarkets seeing many product deliveries this year will probably see more still in 2024, Camden Property Trust President Keith Oden said.

Economic, Housing and Mortgage Market Outlook - November 2023

Economic Outlook

- U.S. economic growth is expected to decelerate in the fourth quarter of 2023 and remain tepid throughout 2024.
- Slower economic growth will result in slower payroll employment growth and an uptick in the unemployment rate.
- Inflation will continue to moderate but remain above the FOMC's 2% target throughout next year and monetary policy will remain restrictive.

Housing Market Outlook

- Elevated mortgage rates and a slowing economy will present a challenge to the housing market.
- Home sales will remain near current levels and inventory will not increase substantially as the mortgage rate lock-in effect keeps existing homeowners locked into their current residence.
- Favorable demographics will keep the share of first-time homebuyers elevated and with limited inventory, upward pressure on house prices will remain.
- In this scenario, house prices will rise nationally, increasing 5.4% in 2023 and 2.6% in 2024.

Mortgage Market Outlook

- Mortgage origination volumes are expected to remain low throughout 2024 before modestly increasing in 2025.
- Even though house prices have been on the rise, lower sales volume will keep purchase mortgage volumes lower.
- While mortgage rates remain above 6%, there will be very limited refinance activity.
- Overall, total mortgage origination activity will remain low through most of 2024 but start to increase at the end of the year and see modest increases in 2025.

Key takeaways

- The U.S. economy is expected to slow down in the coming quarters.
- Inflation will remain above the Federal Reserve's target for most of 2024.
- Mortgage rates are expected to remain elevated, which will dampen demand for housing.
- House prices are expected to continue to rise but at a slower pace than in recent years.
- Mortgage origination volumes are expected to remain low in the next few years.

Newmark: Spread Between Rent Vs. Own Accelerates

Multifamily expenses increase over 8% year over year, driven by insurance costs.

Renting was significantly more affordable in the third quarter than owning, according to a new report from Newmark. Due to high home prices and interest rates, the spread between homeownership and rental costs grew $994, increasing by 15.4% from the second quarter.

The third quarter also saw demand increase to 91,000 units, rising 12.7% from the second quarter. The second and third quarters, which tend to be the strongest leasing periods of the year, had 171,000 units absorbed compared with the negative 148,000 the prior year. According to Newmark, Southern markets comprised 61% of demand through the third quarter. Texas' Houston, Dallas-Fort Worth, and Austin were the top three markets for nominal demand, combining for 30.3% of demand throughout the nation.

Over 128,000 multifamily units were delivered in the third quarter, the largest quarterly sum on record. Newmark shared that this record is expected to be broken several times over the next few quarters.

Inventory growth at 2.1% is 70 basis points above the long-term average and is forecast to climb to 3.4% throughout the coming year. New supply outpaced demand by 278,000 units as of the third quarter; however, Newmark said this is still a big improvement over what was seen in the first quarter.

According to Newmark, vacancies trended upward for the fifth consecutive quarter, increasing 131 basis points year over year to 5.5%—the highest rate since the first quarter of 2014. While quarterly rent growth increased by 0.5%, year-over-year growth contracted to 0.4%. As of the third quarter, annualized rent growth is at a 10-quarter low.

While growth markets in the Sun Belt have experienced the largest year-over-year declines in rent growth, Northeast and Midwest markets are faring well. Newark, New Jersey, and Cincinnati lead the way for growth at 4.9% and 4.5%, respectively.

Other key takeaways from Newmark's 3Q23 United States Multifamily Capital Markets Report include:

- Renewals have outperformed new lease trade-outs by 430 basis points. In addition, Class C properties have continued to outperform Class A and B communities;

- Year over year, expenses have increased 8.1% for multifamily operators, led by a 25.4% surge in insurance costs. Management and other expenses also saw double-digit increases. Charleston, South Carolina, and Florida's Tampa and Orlando experienced the biggest increases in year-over-year expenses, due in part to insurance growth of 38% or greater;

- Between this year and 2025, $682 billion in multifamily loans will mature. While banks account for 32% of debt maturities in the 2023-to-2032 period, they account for 52% of maturities between 2023 and 2025. Debt funds account for 19% of near-term maturities while only 11% for the full period; and

- The investment sales market saw a 61.7% year-over-year decrease in quarterly sales volume to $30.1 billion. However, multifamily remains the largest share of investment sales of the commercial real estate sector at 32.4% through the third quarter, although higher rates and lower yields have resulted in a 7.3% decrease in market share since 2022.