Urban Enthusiasm

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Long-range economic and development trends suggest a smaller household size and more apartment residents, particularly those who choose to lease downtown.

Homeownership data is trending downward, putting the United States on the cusp of perhaps the biggest change in housing market demand since the end of World War II.

During the second half of the 20th century, homeownership was championed and rose to unprecedented levels. Over the next generation, however, the demand for new rental housing—chiefly in apartment form—will be on par with demand for new-owner housing.

Following is a review of the current housing situation and projections of future demands.

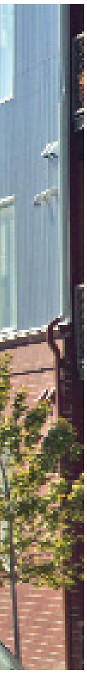
The days of "irrational exuberance" in homeownership are over. The early 21st century saw more new homes constructed during any five-year period than ever before. Between 2003 and 2007, more than 10 million apartment homes were permitted, averaging more than two million annually. Detached units accounted for more than three-quarters of these units, averaging more than 1.5 million units annually—the most ever (see Table 1). According to data from HUD's biennial "American Housing Survey," homeownerships rates climbed from 65 percent to an unprecedented 69 percent from 1995 to 2004.

TABLE 1 Residential Permits, 2003-2006

YEAR	UNITS PERMITTED	DETACHED	DETACHED SHARE
2003	1,889	1,461	77.3%
2004	2,052	1,596	77.8%
2005	2,070	1,613	77.9%
2006	2,155	1,682	78.0%
2007	1,839	1,378	74.9%
Total	10,006	7,731	77.3%
Average	2,001	1,546	77.3%

Source: www.census.gov/const/bpann.pdf accessed July 30, 2008. Figures in thousands.

Reasons for these impressive figures are many, but chief among them may be the subprime loans that encouraged millions of American households to purchase homes that they could not afford. More than 2 million homes may be foreclosed in



(Opposite page) Diamond at Prospect, Greystar, Denver, Colo. (Above left) The Strand, Margolias Realty Group, West Palm Beach, Fla. (Above right) The Uptown Apartments, Forest City Residential, Oakland, Calif.

2008 alone, according to a Q3 2008 report on CNN—the most ever in U.S. history.

The aftermath of the subprime meltdown likely will change the housing market for decades to come. For one, the mix of residential demand is likely to change. Construction of detached units in 2008 is projected at 665,000 homes or nearly a million fewer than the average during the early 2000s. In contrast, construction of units in five-or-more-unit structures (a proxy for rental apartments) will reach approximately 350,000 homes or the average annual rate during the 2000s. Although the supply of detached units will surely increase, it is a relatively unstable element of the residential market. In contrast, rental units are a much more stable element. For this reason, investors appear to prefer apartments compared to other forms of real estate investments.

Lending institutions already have changed their underwriting requirements with the effect that fewer people qualify for home mortgage loans. Soon, the federal government will implement rules that further restrict home mortgages. The likely outcome will be reduced demand for owner-occupied homes and an increased demand for rental homes—mostly apartments.

Other reasons why homeownership may fall include:

- Rising energy prices that will make it more costly to live farther away and also more costly to accommodate the energy demands of detached residential units at low density.
- The appreciation rates for low-density housing will continue to fall, if not become negative, in all but a few metropolitan areas. This will dissuade some households from considering ownership in those areas as an investment.
- As demand for housing shifts toward urban and suburban centers, especially those with transit and other multi-modal options, housing costs will rise because of higher land and construction costs relative to the suburban fringe. This will strain the ability of households to afford new homes, resulting in higher demand for rental units.

Trends to Watch

The apartment market is approaching a so-called dawn of rational repose. Like any housing product, estimating apartment demand is complex and nuanced. Certain simplifying assumptions are made. First, only generalized estimates of demand for apartments will be made of two basic groups: seniors (householders aged 65 and over) and all others. Although the total population grows by 28 percent (82 million people), the senior population nearly doubles (from 37 million to 71 million people), accounting for more than 40 percent of the nation's

TABLE 2 Population by Householder Age Group, 2005-2030

HOUSEHOLDER AGE GROUP	2005	2030	CHANGE	PERCENT	SHARE
All Households	296,507	378,317	81,810	27.6%	
Senior (65+) Households	36,789	70,550	33,762	91.8%	41.3%
Non-Senior Households	259,719	307,766	48,048	18.5%	58.7%

Source: Analysis of Woods & Poole Economics data by Arthur C. Nelson, Metropolitan Research, University of Utah. Figures in thousands.

TABLE 3 Residential Units Occupied by Householder Age Group, 2005-2030

HOUSEHOLDER AGE GROUP	2005	2030	CHANGE	SHARE
All Households	108,871	145,276	36,405	
Senior (65+) Households	22,197	42,568	20,371	56.0%
Non-Senior Households	86,674	102,709	16,035	44.0%

Source: Analysis by Arthur C. Nelson, Metropolitan Research, University of Utah. Figures in thousands.

growth (see Table 2).

Second, persons per household for each group will not change appreciably between 2005 and 2030, which is consistent with some consensus among demographers. Table 3 reports the units to be occupied by each group. Notably, because of their smaller household size, most (56 percent) of the 36 million new occupied housing units will house seniors.

Third, future homeownership rates will fall to their mid-1990 levels—if not to those of prior decades; that is, the long-term tenure split between owners and renters will be about that seen in 1995, which was 65 percent to 35 percent. The rate for seniors will be 78.2 percent to 21.8 percent, and for non-seniors, it will be 61.5 percent to 38.5 percent.

Table 4 illustrates the effect of this assumption on apartment demand. Overall, apartment demand will increase faster than population growth—an increase of 50 percent, compared to 28 percent. The demand for apartments by seniors will more than double, even though a higher percentage of them will own their homes relative to the population as a whole. Non-senior households will absorb the greatest share—about 70 percent of the overall increase in demand.

Table 5 synthesizes these estimations. Between 2005 and 2030, 36.4 million new housing units will be needed to house a growing population. At 46.3 percent, nearly half of this growth—16.8 million units—will be for apartments.

The Trend Toward Urban Living

Where will these new rental units be constructed? Surveys indicate a growing preference for urban living. Roughly half of all households want the opportunity to live in neighborhoods and communities with higher density housing, mix of housing types and household income levels, sidewalks, proximity to stores and restaurants, accessibility to transit options and other "smart growth" features associated with well-designed urban areas. Figure 1 illustrates this.

One reason for this trend is dramatically changing demographics. Between 1960 and 2040, the share of all American households with children will have fallen from nearly one-half to just more than one-quarter. Estimations indicate that between 2000 and 2040, the nation will grow by 61 million households

TABLE 4 Apartment Unit Demand by Householder Age Group, 2005-2030

HOUSEHOLDER AGE GROUP	2005	2030	CHANGE	PERCENT	SHARE
All Households	33,940	50,783	16,843	49.6%	
Senior (65+) Households	4,334	9,277	4,943	114.1%	29.3%
Non-Senior Households	29,606	41,506	11,900	40.2%	70.7%

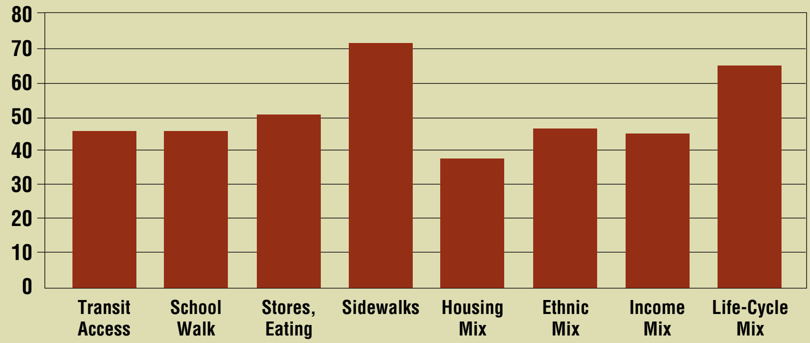
Source: Analysis by Arthur C. Nelson, Metropolitan Research, University of Utah

TABLE 5 Tenure Change, 2005-2030

HOUSEHOLDER AGE GROUP	2005	2030	CHANGE	PERCENT	SHARE
Total Occupied Units	108,871	145,276	36,405	33.4%	
Owner-Occupied Units	74,931	94,493	19,562	26.1%	53.7%
Renter-Occupied Units	33,940	50,783	16,843	49.6%	46.3%

Source: Analysis by Arthur C. Nelson, Metropolitan Research, University of Utah

FIGURE 1



Source: National Association of Realtors and Smart Growth America, "America Community Survey," 2004, adapted by Arthur C. Nelson, Metropolitan Research, University of Utah

The Uptown Apartments,
Forest City Residential, Oakland, Calif.

but only 9 million or just 15 percent of this growth will be households with children.

Put another way, in 2040, there will be 52 million more households without children than in 2000, representing about 85 percent in the net change in households over this period. More than one-third (34 percent) of the growth in households, numbering 21 million, will be single persons. It would seem likely that a sizeable share of single-person households and households without children may prefer something other than a home in a low-density suburb, away from urban centers and with a yard to maintain. Indeed, the American Community Survey, conducted jointly by the National Association of Realtors and Smart Growth America in October 2004, indicates that more than half of all senior households prefer to live in a city or a suburb close to a city (51 percent).

Furthermore, these preferences were seen before the recent, steady rise of gasoline prices, which have more than doubled since then, according to the Energy Information Administration of the U.S. Department of Energy. Given the fixed income nature of senior households and their need to be closer to the services they need as they age, perhaps more would prefer a location in a city or a suburb close to a city today than in 2004.

A few years ago, before the current energy crisis, it was estimated that by 2025, there might be 23 million more residential units on large lots (over 7,000 square feet) than the market demands. This is about 40 percent of the total supply of large lot homes existing in 2005. The current energy crisis, though it may wane from time to time, could further decrease the demand for low-density homes away from urban areas.

Although any projection of future demand for anything is highly speculative, such activity is necessary if the country is to marshal resources to meet future challenges. Those resources include transportation investments, new/upgraded/expanded water and wastewater systems and new investments in a wide range of community facilities from parks and schools to fire stations and libraries.

These investments take 10 to 30 years to plan, finance and develop. The country should know something about the market in 2030 to anticipate public investments to accommodate it. Table 6 reports projection of apartment demand by geographic area.

Table 6 does not report population distributions but instead the distribution of residential demand. "Central cities" are those classified by the census in 2005 (usually urban places of more than 50,000 residents) and suburbs are the balance of areas inside what the Census defines as "metropolitan statistical areas."

The national share of all residential units in 2005 is reported in the American Housing Survey. The distribution projected to 2030 is speculative but based reasonably on emerging demographic trends and somewhat conservative assumptions of the effect of the current energy predicament. That is, one-third of the future residential units will be in central cities, one-half will be in suburbs and the rest will be in non-metropolitan areas.

Non-metropolitan areas will lose share (even as they grow) because of shifting demand to urbanized areas (central cities and suburbs). A more likely scenario is that central cities, as currently configured, may retain their overall share of residential units while higher density suburbs nearby will emerge and become like central cities in most ways except formal census designation. One may conceptualize "central cities" in 2030 as those existing in 2005 plus the ring of close-in suburbs immediately surrounding (or annexed into) them.

What Can Be Done

Will the housing market be allowed to meet this need? The industry continues to work on educating the public—and especially public officials—on the advantages of apartments and leveling the playing field with respect to owner-occupied housing.

Owning versus renting. For decades, information has been fed to households about the long-term investment benefits

TABLE 6 Projected Demand for Apartments by Geography, 2005-2030

HOUSEHOLDER AGE GROUP	NATIONAL RESIDENTIAL UNIT SHARE 2005	NATIONAL RESIDENTIAL UNIT SHARE 2030	RENTER SHARE BASED ON 1995 LEVEL	APARTMENTS 2005	APARTMENTS 2030	TOTAL NEW APARTMENT UNITS 2005-2030	APARTMENT GROWTH PERCENT
Central City	29.2%	33.3%	50.0%	14,526	24,182	9,656	66.5%
Suburb	48.5%	50.0%	28.0%	13,702	20,313	6,611	48.2%
Nonmetropolitan	22.3%	16.7%	26.0%	5,712	6,287	575	10.1%

Source: Arthur C. Nelson, Metropolitan Research, University of Utah. Figures in thousands.

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Meridian at Carlyle, Paradigm Management, Alexandria, Va.

of owning versus renting. However, much of this information was biased and not tailored to individual markets. The industry is making that case that for most Americans in much of the country, the opportunity costs of owning their homes outweigh those of renting.

In about a quarter of metropolitan areas where data are available, homes purchased in 1996 are worth less in 2008 on an inflation-adjusted basis. Only about a third of the metropolitan areas beat the Dow Jones Industrial average. Although the benefits of homeownership are important, for many people, renting may be more financially prudent than buying from a purely investment perspective.

Mobility. For many millions of Americans, homeownership shackles them to locations with lower wages and declining economic opportunities even as they mature and become more economically productive. Renting allows millions to be mobile and be able to move quickly to where economic opportunities emerge. Labor mobility is an important element of a dynamic, efficient national economy.

Investment Stability. Investing in apartments is less risky and provides more dependable rates of return relative to other real estate opportunities—and even the stock market itself. This is reflected by the low capitalization rates of apartments relative to other income-producing investments. The lower the cap rate, the more stable and predictable the investment. For example, data available indicate that cap rates vary from 8.6 for apartments to 9.2 for industrial properties, and 8.9 for office and retail opportunities with an overall average of 9.6, according to assessments made in Q3 2008 by realtyrates.com. Shrewd apartment renters would take their savings from homeownership and invest them in apartment-based real estate investment trusts.

Level the Playing Field

Homeowners enjoy discriminatory financial advantages based on public policy over renters. Current policies essentially create an un-American caste system between owners and renters. The industry has been working to change this system, but inequities remain.

Yet, as the number of renters increase in total and in market share, more pressure can be brought to bear on policymakers to level the playing field. In a competitive housing market, leveling the playing field can give people more choices in housing options, and renters especially may enjoy higher quality housing for the same or lower cost. The rental housing industry has been pursuing such changes as the following:

Homestead exemptions. Most states lower the effective tax rate applied to owner-occupied homes. Lower tax assessments on owner-occupied property thus shift the burden of offsetting reduced income to renters. Because judges are usually homeowners, it is not likely any court will rule homestead exemptions violate equal protection when applied to renters as a class.

However, exemptions could be extended to rental property as well. The overall effect would be to shift property taxes from residential to nonresidential property but at least all residential property would be dealt with fairly.

Proportionate utility rates. Many communities charge higher density, efficiently located property (such as apartments) the same water, sewer, drainage and energy rates as lower-density, inefficiently located property (such as detached homes). Techniques are available to craft proportionate-share utility rates based on density, use, location and other factors and have been advocated by the industry.

Impact fees and related assessments. Many communities charge impact fees on residential units despite the fact that different units have different impacts on the community based on their size, type, location, configuration and other factors. Higher density housing thus tends to subsidize lower density housing. Impact fees and related assessments need to be based on proportionate share principles considering these factors.

Land-use planning and zoning. A multi-pronged approach is needed to change the status quo. One solution could be public education that shows that not only do apartments provide important economic development and social stability benefits to communities, but also that communities with a balance of residential types fare better in the long run fiscally than unbalanced ones.

The challenge is to assure that this new day in residential housing demand is not frustrated and that residents have housing options that meet their needs.

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