SPECIAL REPORT

TD Economics

May 29, 2012

REGIONAL MULTIFAMILY HOUSING: SOUTH ATLANTIC TO OUTSHINE NORTHEAST

Highlights

- As developers respond to increased rental demand, multifamily housing construction is on an upward trajectory across the nation. In this paper we explore the multifamily supply and demand outlook across America's East Coast.
- On the demand side, the South Atlantic's faster population growth will fuel stronger future demand for multifamily housing than the Northeast.
- Meanwhile, and somewhat surprisingly, the South Atlantic also faces a larger supply gap than the Northeast because of the South Atlantic's relatively subdued pace of multifamily construction before the recession and deeper building slump during the recession.
- Overall we find that most East Coast markets will experience strong growth in multifamily housing construction over the next five years as the recession-induced construction slump is reversed, but the greatest opportunities for growth lie in the South Atlantic.

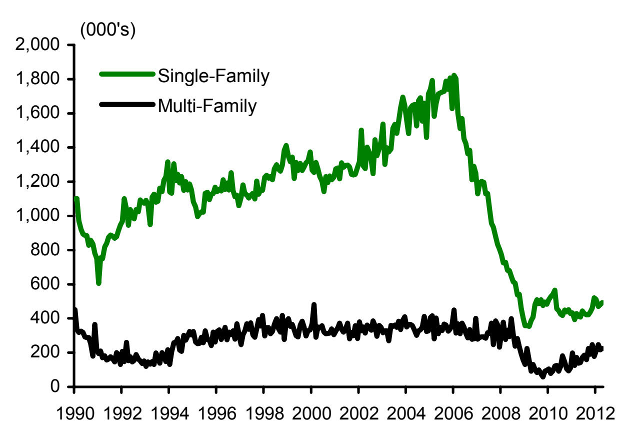
Introduction

Since 2009, multifamily housing has mounted an impressive comeback in an otherwise miserable housing market. Between 2009 and 2011, new multifamily starts rose 59% while single family units declined 2%. Given the economic realities of high unemployment, falling home prices and elevated foreclosures, this shift in housing investment towards rental units is not surprising.

The national story, however, only reveals part of the picture. Housing, by virtue of its immobile nature, depends on local factors. In this paper, we address this reality and explore the opportunities for multifamily housing construction across America's East Coast. We begin by examining demographics, homeownership rates, and the structure of housing markets. Next we cross-reference these demand factors with construction trends and identify markets where the recession has left the biggest multifamily investment gaps.

Our analysis reveals that multifamily development in the South Atlantic faces a brighter future than the Northeast. The South Atlantic will experience stronger demand growth and will also need high levels of multifamily investment to offset inadequate building in the past. In the Northeast, the multifamily recovery still has steam left as developers play catch-up following a period of under-investment. But, the region's slower growing population limits the market's longer term potential.

FIGURE 1: U.S. HOUSING STARTS



Source: Census Bureau

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Overall we expect multifamily housing starts to grow at an annualized pace of 10% in the Northeast and 20% in the South Atlantic over the next five years. The final page of this report includes a table with our five-year forecast for multifamily housing starts.

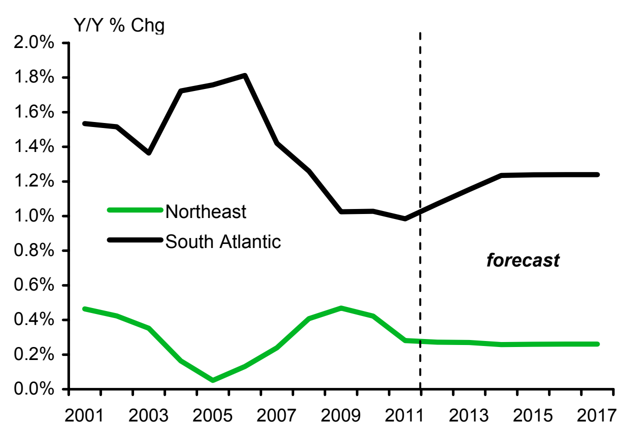
Future Multifamily Demand Will Be Stronger in the South

Future demands for multifamily housing depends on two factors. The first – and most important – is the pace of new household formation in each state. The second relates to preferences and the likelihood that a new household will choose to live in a multifamily housing unit.

Factor #1: Favorable Demographics Drive South Atlantic Demand

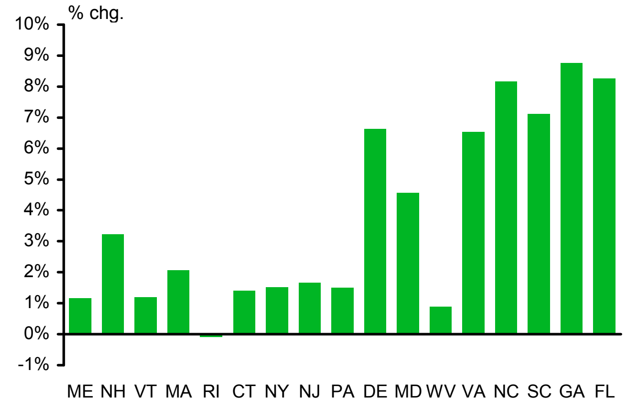
During the recession, the demographic forces underpinning housing demand deteriorated in the South Atlantic, but held steady in the Northeast. There were two reasons for this shift. First, a deeper recession in the South Atlantic left more of the region's population without work, causing the ratio of households to population to fall more than in the Northeast. Second, because of the South's relative economic weakness, the pace of inward migration – which had been the driving force behind the South Atlantic's rapid population expansion earlier in the decade – slowed dramatically. In contrast, the Northeast's relatively stable job market slowed the pace of outward migration and caused population growth to accelerate (see here). As a result, the South Atlantic appears[1] to have sustained a pace of new household formation that was just slightly softer than the

FIGURE 2: POPULATION GROWTH



Source: Census Bureau. Forecasts by TD Economics as at May 2012.

FIGURE 3: PROJECTED HOUSEHOLD GROWTH: 2011-2017



Source: Forecast by TD Economics as at May 2012.

Northeast between 2006 and 2009. This had not happened in recent history, and is unsustainable on account of the South's stronger population growth.

In 2011, as the South Atlantic's job market strengthened so too did its population growth rate. This trend is poised to continue, as more pent-up demand fuels stronger economic growth in the South Atlantic than in the Northeast (see here). Ongoing improvements in the South Atlantic's job market will also gradually reverse the recession-induced declines in the household to population ratio, and support higher household formation rates.

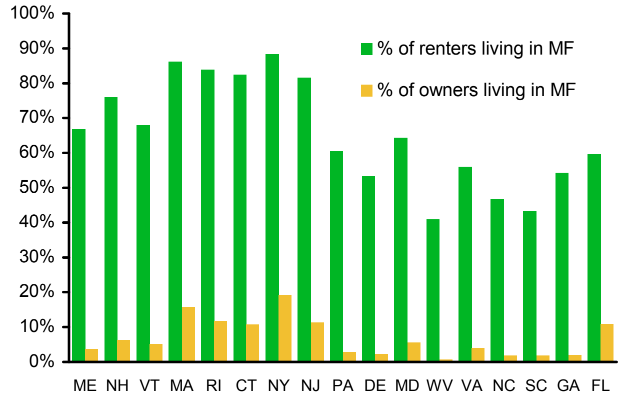
Of course, one cannot paint both regions with a single-brush. In the South Atlantic, household formation will be strongest in Georgia, Florida, and the Carolinas. Meanwhile, Maryland and Virginia will outgrow the Northeast but to a lesser degree. In the Northeast, New England's household formation is poised to slightly outpace the Middle Atlantic.

Factor #2: Declining Homeownership Boosts Multifamily Demand In All States

We now turn our attention towards the likelihood that a given household will live in a multifamily unit. We start by exploring the uplifting effects of declining homeownership on multifamily housing demand. Then we consider what impact converting single-family housing into rental units will have on multifamily demand.

One consequence of falling home prices, job losses and foreclosures has been a precipitous decline in the nation's homeownership rate. Since renters are far more likely than owners to live in multifamily housing, this change has shifted some single-family dwellers into the multifamily market.

FIGURE 4: MULTI-FAMILY LIVING MORE COMMON AMONG RENTERS: 2010



Source: American Community Survey.

There are two factors to consider when assessing the importance of falling homeownership rates on each state: the magnitude of the change and the state's housing structure. Consider New York, where 87% of renters and 20% of owners live in multifamily units. Compare that with South Carolina, where 43% of renters and 3% of owners live in multifamily units. If these ratios stay fixed (we relax this assumption next), then a decline in the homeownership rate will strengthen multifamily demand in New York more than South Carolina.

While the Empire and Palmetto states are the most extreme examples, multifamily demand in the Northeast will generally benefit more from a decline in homeownership than the South Atlantic. Yet despite this (and recognizing the data issue cited in footnote one), because the South Atlantic has suffered a slightly larger decline in its homeownership rate than the Northeast, falling homeownership has had a similar, positive effect on multifamily housing demand across the East Coast since 2006.

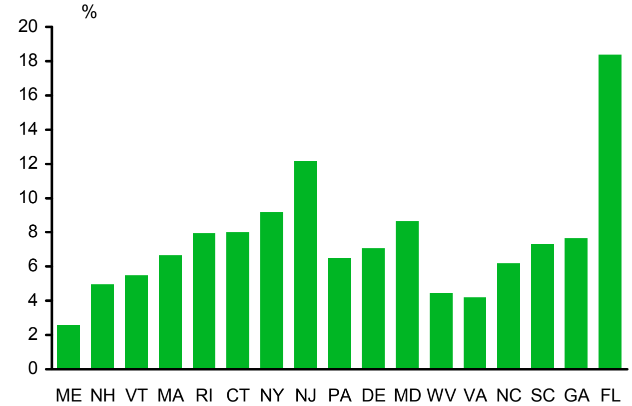
To extend this analysis, we must also account for changes in housing structure across time. Since the housing crash started, renters have made up a growing share of the single-family housing market. This shift makes sense because the foreclosure crisis has left a glut of single-family housing inventory at the same time rental demand is growing. The trend appears to be widespread across the East Coast, and most severe in Florida – the state which has faced the region's deepest economic and foreclosure challenges.

So how are changes in the homeownership rate and underlying housing structure expected to affect multifamily housing demand in the years ahead? Nationally, the homeownership rate is poised to stagnate or trend lower for another year or two, as foreclosure resolution forces more owners to rent. However, stabilizing home prices, improved housing affordability and the impact of an ageing population will all contribute to a gradual improvement in the homeownership rate over the next two to five years.

Most states will mirror this trend, experiencing near-term declines in homeownership, followed by gradual recoveries over the next half decade. Differences from one state to the next will largely be in the volatility of the adjustment. Take Florida for example. Over the next two years, the state's homeownership rate is likely to fall further than anywhere else on the East Coast as its vast foreclosure inventory works through the market. Yet once Florida's foreclosure crisis abates and its population's credit credentials strengthen, job growth and vastly improved housing affordability should support an above average rebound in homeownership. Therefore, states facing the biggest foreclosure challenges and most improved affordability – like Florida, but also New York, New Jersey and Maryland – should experience the biggest swings in homeownership moving forward.

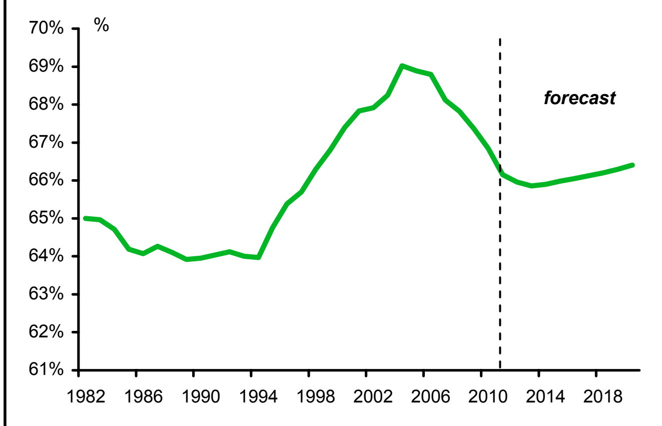
Meanwhile, the redeployment of single-family housing towards rental activity will continue, but is unlikely to last beyond two years. While reduced home prices and extensive single-family housing supply have created a strong incentive to convert single-family housing into rental space, multifamily housing still remains a more efficient way to manage rental activity. Thus, as the existing single-family inventory is absorbed, future rental investment will remain predominately in the multifamily sector. At the state level, areas with the largest outstanding foreclosure supplies will

FIGURE 5: SERIOUSLY DELINQUENT MORTGAGES*



Source: Mortgage Banker's Association, *90+ & Foreclosure.

FIGURE 6: NATIONAL HOMEOWNERSHIP RATE



Source: Census Bureau. Forecasts by TD Economics as at May 2012.

face the biggest near-term adjustments.

In summary, most states will see the share of households living in multifamily units rise over the next two years before gradually tapering off. While multifamily demand in the Northeast will receive a slightly larger boost than the South Atlantic because of the region's underlying housing structure, the difference will be marginal. Indeed, this advantage will be more than offset by the much more powerful force of demographics, which strongly favor the South Atlantic.

Supply Factors Also Favor the South

We now turn to supply factors. Because of the South's foreclosure challenges and excessive pre-recession housing investment, one may be inclined to think the region has less need for multifamily housing investment today than the Northeast. Our analysis, however, suggests otherwise. The South Atlantic experienced less multifamily housing investment than the Northeast before the recession, and since the recession started, the South Atlantic has also suffered a deeper contraction in investment.

As Figure 7 shows, pre-recession housing investment in the South Atlantic was concentrated in the single-family segment of the market. In fact, during the years leading up to the recession, the South Atlantic experienced almost no increase in multifamily housing completions. By contrast, multifamily units drove the Northeast's more subdued building boom.

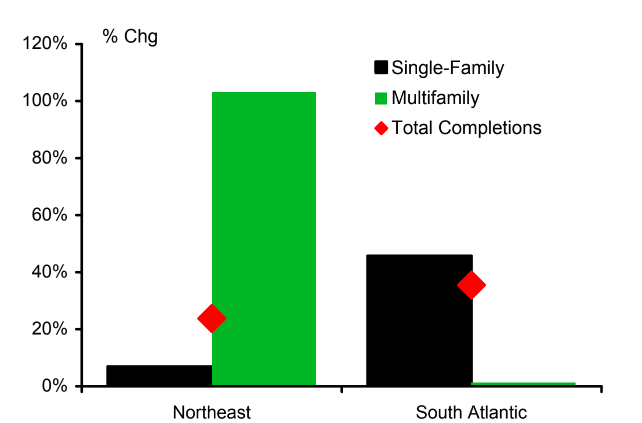
This bodes well for future multifamily housing development in the South Atlantic. Conversion of single-family housing capacity into multifamily will offset some of the South's need for new multifamily investment. But, multifamily and single-family housing are not perfect substitutes for one another. In many South Atlantic metro areas, for example, a large portion of new single-family housing development occurred in suburban markets far from city centers, which have limited attractiveness as rental options. Thus, single-family conversion into rental property will not fully offset the South's need for multifamily investment moving forward.

In addition to its subdued pre-recession multifamily building trend, the South Atlantic has also experienced a more pronounced slump in multifamily investment since the recession started. To measure recent investment trends, we looked at the ratio of multifamily housing starts to multifamily housing stock in each state. To avoid capturing multifamily investment associated with the building boom, we use the ratio's average from 2001 to 2004 as the basis for comparison.

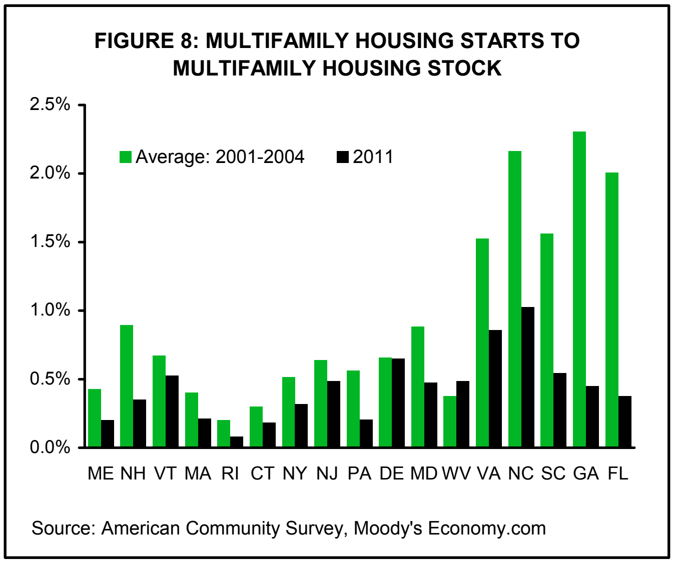
Figure 8 compares each state's ratio today with its 2001 to 2004 level. The chart reveals that South Atlantic states experienced a far more pronounced decline in multifamily housing investment during the recession than the Northeast (other ratios like multifamily starts to population reveal the same thing). It is important to note that Figure 8 overstates current under-investment in the South Atlantic because future population growth will be slower than it was during 2001-04. However, slower population growth will not offset the entire gap. A similar gap emerges if we compare current completions to the demand projections (which assume slower future population growth for the South Atlantic) outlined in the last section.

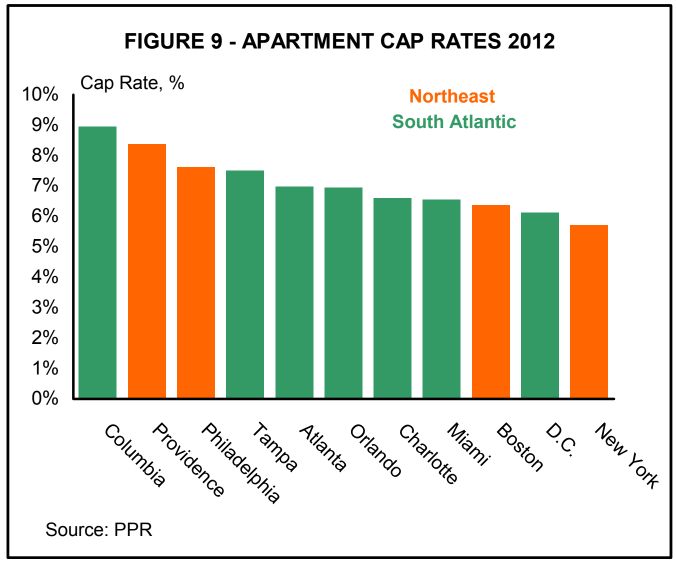
Financial headwinds in the South Atlantic may provide

FIGURE 7: HOUSING COMPLETIONS: 2000 - 2006



Source: Census Bureau, Moody's economy.com





a partial explanation for the region's more pronounced slump in multifamily housing investment since the recession started. 37% of nationwide bank failures since 2008 have occurred in the South Atlantic (compared to just 3% in the Northeast). Given that regional banks play a critical role in financing commercial real estate and property development, limited credit availability may be exacerbating the South's building slump.

Assessing When the Recovery has Gone too Far

The burgeoning multifamily recovery still has plenty of upside in nearly every East Coast market thanks to the big declines in construction activity during the recession. Yet because of the enormous lag times involved in multifamily construction, there is a risk that developers will respond too aggressively to recent rental trends and leave the market saturated with multifamily units a few years down the road.

From a broad perspective, the Northeast market faces the biggest risk of overinvestment. As we've already explained, the region faces softer demand growth and a smaller investment deficit. Yet, in spite of this, Northeast capitalization rates (the premium investors expect to earn on cash invested in real estate) are not higher, and in many cases are lower than in the South Atlantic. This suggests that investors have been more comfortable deploying capital into the Northeast market than into the South.

To date, this has not resulted in a stronger multifamily investment recovery in the Northeast relative to the South. Rather, it appears investors are bidding up the prices of existing properties in key markets like Boston and New York because of their relative economic stability and status as "safe haven" metros. However, if this flow of capital eventually prompts investors to start building more aggressively in the Northeast than in the South Atlantic, it could start to divorce from the fundamental demand drivers and prove unsustainable.

Our table on the final page includes our forecast of multifamily starts within each state. If a state's pace of construction should exceed these levels for a period of several years running, it should serve as a red flag of possible excesses in the market.

Conclusion

Demographics and underinvestment in multifamily housing since the recession started has set the stage for strong multifamily housing construction across the South Atlantic into the foreseeable future. In the Northeast, meanwhile, the future is bright, but less so. After several years of under-investment, stronger multifamily in the Northeast is necessary. However, soft underlying future demand will limit the magnitude of the region's rebound.

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FORECAST TABLE	ME	NH	VT	MA	RI	CT	NY	NJ	PA	DE	MD	WV	VA	NC	SC	GA	FL
Projected Average Demand Growth (Annual Average 2012 - 2016)																	
	0.1%	0.2%	0.1%	0.3%	0.0%	0.1%	0.1%	0.1%	0.0%	0.8%	0.5%	-0.2%	0.9%	1.0%	0.8%	1.2%	1.2%
Population Growth																	
(average 2001-08)	0.5%	0.7%	0.3%	0.2%	0.1%	0.5%	0.1%	0.4%	0.3%	1.5%	0.9%	0.2%	1.2%	1.8%	1.5%	1.8%	1.8%
2012	0.1%	0.3%	0.1%	0.5%	-0.1%	0.2%	0.3%	0.3%	0.2%	0.9%	0.7%	0.2%	1.0%	1.2%	1.0%	1.1%	1.2%
2013	0.1%	0.5%	0.2%	0.4%	0.0%	0.2%	0.3%	0.3%	0.2%	1.0%	0.7%	0.2%	1.0%	1.3%	1.2%	1.4%	1.3%
2014	0.2%	0.5%	0.2%	0.3%	0.0%	0.3%	0.2%	0.3%	0.3%	1.2%	0.8%	0.1%	1.1%	1.4%	1.2%	1.5%	1.4%
2015	0.2%	0.6%	0.2%	0.3%	0.0%	0.3%	0.2%	0.3%	0.3%	1.2%	0.8%	0.1%	1.1%	1.4%	1.2%	1.5%	1.4%
2016	0.2%	0.6%	0.2%	0.3%	0.0%	0.3%	0.2%	0.3%	0.3%	1.2%	0.8%	0.1%	1.1%	1.4%	1.2%	1.5%	1.4%
Homeownership Rate (%)																	
(average 2001-08)	74.6	72.4	71.9	63.3	62.2	71.2	54.9	67.8	73.7	75.9	71.4	78.1	72.9	70.3	75.3	69.6	70.6
2012	73.8	74.1	74.6	65.3	63.1	70.6	53.5	66.2	71.1	74.2	69.4	78.7	67.9	68.3	74.2	66.1	68.8
2013	73.9	74.2	74.7	65.3	63.1	70.7	53.6	66.3	71.1	74.3	69.5	78.8	68.0	68.4	74.3	66.0	68.7
2014	74.0	74.3	74.7	65.4	63.2	70.8	53.7	66.4	71.1	74.4	69.6	78.9	68.1	68.5	74.4	66.2	68.6
2015	74.1	74.5	74.7	65.5	63.2	70.9	53.9	66.7	71.2	74.5	69.8	79.0	68.1	68.6	74.5	66.4	68.8
2016	74.1	74.7	74.8	65.6	63.3	70.9	54.2	66.9	71.4	74.5	70.1	79.0	68.2	68.8	74.7	66.5	69.3
Multifamily Housing Starts (000's)																	
(average 2001-08)	585	926	413	4753	380	1520	23585	8818	5269	645	4661	489	8538	13029	6036	15164	43148
2012	314	606	418	2911	182	1063	14635	6675	2813	540	3304	521	7103	9012	2750	5650	15760
2013	362	672	444	3344	215	1186	16463	7219	3355	621	3768	534	8133	10693	3482	7960	22451
2014	411	740	471	3776	247	1310	18291	7767	3901	705	4238	546	9190	12430	4233	10345	29332
2015	462	811	499	4228	281	1440	20201	8340	4473	794	4734	559	10313	14280	5030	12895	36674
2016	503	870	521	4595	308	1545	21745	8806	4935	868	5143	569	11252	15838	5695	15033	42804
Multifamily Housing Starts Growth (Annual Average 2012 - 2016)																	
	13%	9%	6%	12%	14%	10%	10%	7%	15%	13%	12%	2%	12%	15%	20%	28%	28%

Source: Census Bureau, Moody's Economy.com. All Forecast by TD Economic as at May 2012

Footnotes

1. Our primary source in this report is the American Community Survey (ACS) which offers rich state-level detail on household characteristics and housing inventory. One of the ACS's drawbacks, however, is that 2009 and 2010 data are benchmarked to different decennial censuses and are not directly comparable. As a result, in parts of this report we make claims which appear to be supported by the underlying data, but cannot be verified with 100% certainty.

   Despite this drawback, we remain confident in our forecasts. For one, demographics (which are reliable) are the main input into our projections. Meanwhile, changes in homeownership rates and housing inventory (where we draw most heavily from the ACS) have a more nuanced affect on the results. Finally, while the different benchmarks do obstruct historical analysis, they ensure our forecasts start from a very reliable point.