SPECIAL REPORT
TD Economics

April 28, 2015

RISING APARTMENT CONSTRUCTION TO BE MET WITH CONTINUED RENTAL DEMAND

Highlights

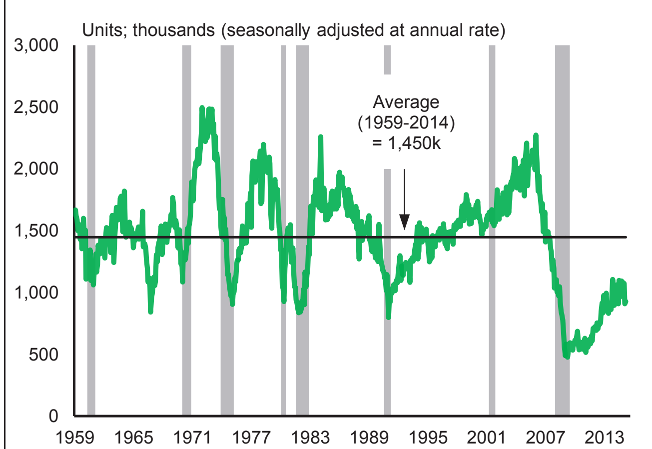
- Housing construction continues to disappoint. At 1 million in 2014, housing starts were more than 30% below their long run average and well below levels consistent with trend household growth. While overall housing construction remains low, multi-family construction has bounced back. In 2014, multi-family starts averaged 355k, the highest level since 1989.
- The increase in multi-family construction is due almost entirely to rising rental construction. Over 92% of the multifamily construction started in 2014 was built for rent – the highest share on record (going back to 1974). In larger metro areas, such as New York and Boston, multifamily housing construction is running at twice its historic average.
- The increase in rental construction has come following several years of strong rental demand that has brought the rental vacancy rate to its lowest level in over twenty years. Rental vacancy rates have also fallen across major metro areas and are below historical averages for the majority of metros in TD Bank's footprint.
- Household growth is likely to continue to rebound over the next few years, but constraints on home-ownership will lift more slowly. As a result, rental demand is likely to remain strong, giving continued support to the rental construction sector.

The recovery in housing construction has been disappointingly weak. In 2014, total housing starts averaged just over 1 million. With the exception of the previous six years, this was the lowest level of housing starts on record going back to 1959. Housing starts are closer to previous housing cycle troughs than to the historical average of 1.45 million (Chart 1).

Nonetheless, not all segments of the market are performing poorly. In 2014, multifamily starts reached 355k, the highest level since 1989. The vast majority – over 92% – of this construction was built for rent (Chart 2). Rental construction has been strong throughout the country, but has been exceptionally robust in the Northeast, where, in 2014, multi-family rental starts reached a historic 41-year high.

The strength in rental supply has raised concerns among investors over the potential for a sharp increase in vacancy rates. However, it must be taken in the context of the overall picture. The dearth of total housing construction relative to trend household formation means that overall housing vacancy rates are likely to remain low and may even continue to decline.

CHART 1: HOUSING STARTS



Source: Census Bureau, TD Economics

James Marple, Senior Economist, 416-982-2557

Rental demand will continue to be supported by robust growth among prime renter cohorts – households between 25 and 34 years old. Eventually many of these households will make the transition to homeownership, but this is likely to be gradual and should coincide with a shift in construction activity towards for-sale properties.

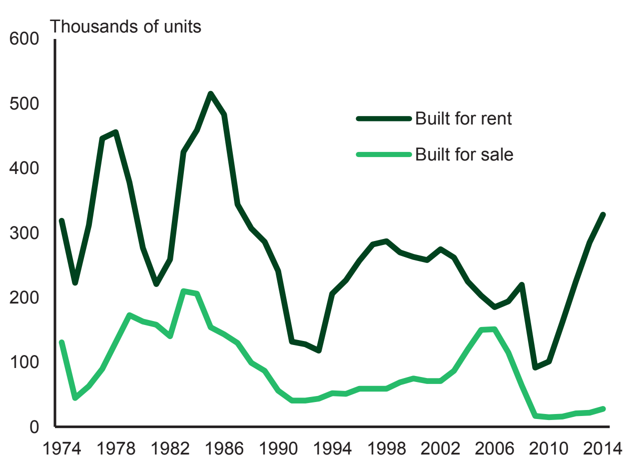
Behind the national picture, regional disparities are likely to emerge. In regions of the country where rental construction has been strongest, some upward pressure on rental vacancy rates is more likely.

Significant multifamily rental construction in the pipeline…

The benefit of housing starts as an economic indicator is that they provide a heads-up both on future economic activity as well as future housing supply. On average, a housing unit that is started today will be completed in about six months. The lag time, however, differs significantly between single-family and multifamily units. A single-family start is typically completed in five to seven months, whereas a multifamily start takes around ten to twelve months. In general, the larger the number of units in the building, the longer it takes time to complete.

Over the last year, multifamily starts have moved in favor of larger buildings that take longer to complete. In 2014, 81% of multifamily starts were in buildings with more than 20 units. The data series only goes back to 1999, but this is the highest ratio recorded. The average length of time from start to completion of a building of this size in 2014 was 13.4 months. Given the increase in starts in 2014, multifamily completions are likely to reach a 25-year high over the next year.

CHART 2: MULTIFAMILY HOUSING STARTS



Source: Census Bureau

Table 1 : Housing construction relative to history

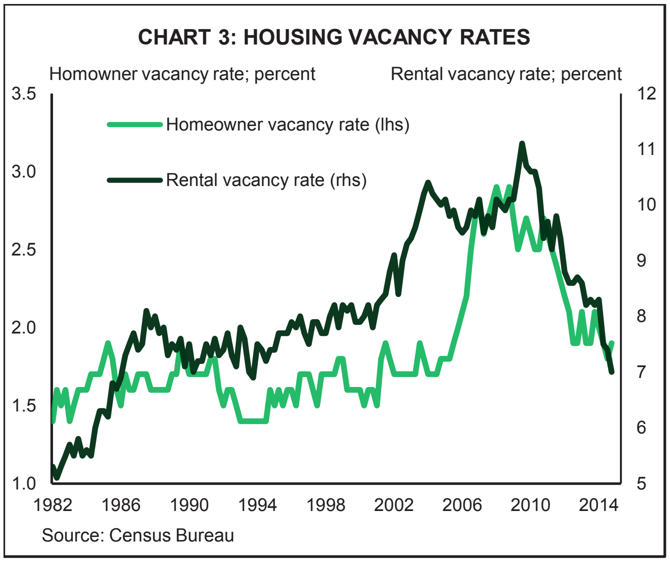
2014 starts % deviation from 1982-2014 average

City	Total starts	Single-family starts	Multifamily starts
Hartford, CT	-67.7	-76.8	-30.0
Providence, RI	-58.2	-59.7	-52.6
New Haven, CT	-53.9	-77.3	14.5
Syracuse, NY	-50.9	-58.7	-8.8
Virginia Beach, VA	-46.2	-48.2	-39.7
Rochester, NY	-45.7	-56.6	**12.9**
Atlanta, GA	-43.8	-51.0	-17.0
Baltimore, MD	-40.4	-51.2	**4.4**
Richmond, VA	-37.9	-47.0	**23.7**
Miami, FL	-36.9	-61.3	-13.4
Tampa, FL	-36.6	-42.8	-22.5
Philadelphia, PA	-34.3	-59.3	**75.4**
Washington, DC	-21.4	-44.4	**58.5**
Bridgeport, CT	-20.0	-42.7	**34.6**
Orlando, FL	-17.3	-28.3	**9.1**
Columbia, SC	-16.8	-16.2	-19.5
Pittsburgh, PA	-10.1	-37.3	**110.9**
Cambridge, MA	-2.0	-36.3	**76.9**
Charlotte, NC	**2.7**	-14.1	**55.0**
Raleigh, NC	**6.7**	-1.5	**36.0**
Boston, MA	**32.3**	-34.7	**134.6**
New York, NY	**57.8**	-47.6	**92.6**
Midwest	-37.4	-47.7	-1.8
West	-30.6	-40.6	-4.9
Northeast	-26.9	-54.7	56.2
South	-21.8	-28.4	-0.6
United States	-27.4	-37.8	4.3

Source: Census Bureau, Moody's Analytics

…largely in urban areas

The surge in multifamily construction has been largely an urban phenomenon and has been most prominent in the largest cities. One way to see the recent strength is to compare it to its historical average. Table 1 does this for total, single-, and multifamily starts across Census regions and major metros within TD's footprint. While single-family starts are below average across metros and Census regions, multifamily starts have pushed above their historical average in the Northeast, and in 14 of the 22 metropolitan divisions included in our analysis. In the Northeast, where multifamily starts are 56.2% above the long-run average, much of the increase has been concentrated in the largest cities. In the Boston and New York metro divisions, multifamily starts are running at around double the historical average. In Boston and New York, as well as Raleigh and Charlotte.



The level of construction relative to history is not a perfect measure, especially at the regional level, where population dynamics are more fluid. In some areas, the relatively low level of construction today reflects the legacy of past overbuilding. In others, current construction levels may reflect greater demographic potential.

The relationship between supply and demand is captured by changes in vacancy. Vacancy rates rose in the aftermath of the housing collapse as the rate of household formation fell below the rate of construction. However, since 2009, household formation has regained the lead and both rental and homeowner vacancy rates have fallen (Chart 3).

Rental vacancy rates have also fallen across metro areas. Table 2 shows rental vacancy rates across Census regions and metro divisions in TD's footprint. Rental vacancy rates are very low in Boston and New York, but they have also been relatively low historically. Rental vacancy rates have fallen the most in Raleigh, Pittsburgh and Charlotte, cities that have also seen a high level of rental construction over the last year.

The concern is for the future evolution of vacancy rates, as starts become completions over the next year. This will depend not only on supply, but also prospects for rental demand. Projecting the number of future renter households is not as clear cut as supply. However, there is good reason to expect demand to keep up. Demographic factors as well as continued constraints on homeownership, especially for younger buyers, suggest that rental demand will remain robust over the next several years. We take this up in the next section.

Table 2: Rental vacancy rates relative to history

City	Rental vacancy rate (2014)	Avg. rental vacancy rate (1982-2014)	2014 diff. from avg. rental vacancy
	Percentage points		
Raleigh, NC	5.7	9.4	-3.8
Pittsburgh, PA	6.0	8.7	-2.7
Charlotte, NC	5.9	8.1	-2.2
New Haven, CT	4.9	7.0	-2.1
Atlanta, GA	8.8	10.6	-1.8
Tampa, FL	8.4	10.3	-1.9
Hartford, CT	6.0	7.8	-1.8
Virginia Beach, VA	6.6	8.2	-1.6
Miami, FL	7.0	8.4	-1.4
Syracuse, NY	8.0	8.6	-0.6
Baltimore, MD	7.4	8.0	-0.6
Washington, DC	6.7	6.9	-0.2
Bridgeport, CT	5.6	5.8	-0.2
New York, NY	4.6	4.8	-0.2
Boston, MA	4.9	5.1	-0.2
Rochester, NY	6.5	6.4	**0.1**
Philadelphia, PA	9.6	9.3	**0.3**
Providence, RI	6.7	6.3	**0.4**
Richmond, VA	11.7	10.4	**1.3**
Columbia, SC	9.7	8.4	**1.3**
Orlando, FL	14.7	11.6	**3.1**
Midwest	8.0	8.4	-0.5
West	5.6	6.8	-1.1
Northeast	6.0	6.0	-0.1
South	9.5	10.0	-0.4
United States	7.5	8.1	-0.5

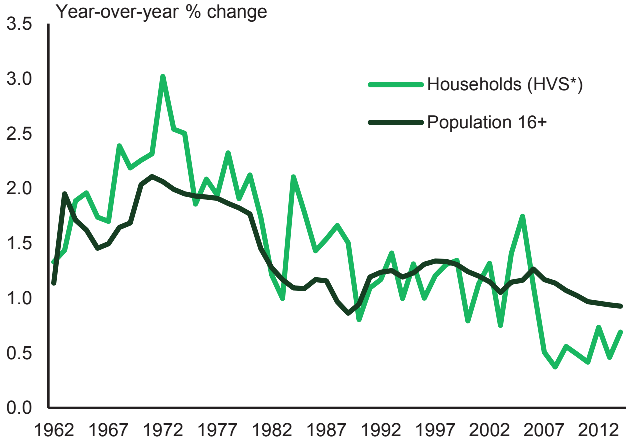
Source: Census Bureau, Moody's Analytics

Household growth will continue to rise

The weakness in single-family construction and the shift to the rental market reflects changes to housing demand that have taken place in the aftermath of the housing crash and subsequent recession. The last several years have been marked by two important trends: a shift away from home-ownership and a decline in the number of new households formed.

The decline in household formation is most evident by comparing the number of households to the adult population. Over the last forty years, households have tended to grow faster than the adult population (in percent terms), leading the ratio of the two – commonly known as the headship rate – to rise. However, over the past five or so years, the opposite has been true (Chart 4). The rate of household growth has fallen to about two-thirds the rate of population

CHART 4: HOUSEHOLD & POPULATION (16+) GROWTH



*Housing vacancy survey. Source: Census Bureau

growth. As a result, instead of 1.2 million or so new households a year, household formation has averaged around 600 thousand a year.

The headship rate declined among all age groups within the population, but was particularly acute for younger cohorts. The largest decline in the headship rate took place among 25-29 year olds, which fell by 5.5 percentage points between 2005 and 2014. Incredibly, the number of households headed by a 25 to 29 year-old fell every year between 2009 and 2013, declining by a total of 424 thousand even as the population within the age group grew by over 500 thousand. This is consistent with a steady rise in the share of young people living in their parent's home. From a low of 10.3% in 2003, the share of people aged 25-34 year olds living with their parents reached an all-time high of 14.7% in 2014 (Chart 5).

The decline in the propensity of young people to form households is a result of a number of factors, some cyclical and some structural in nature. On the cyclical side, the decline in employment is the biggest factor. The employment to population ratio for 25-29 year olds fell six percentage points during the recession and showed no recovery at all for the next two years. Fortunately, it has improved since 2012, but it is still close to four percentage points lower than its peak.

Structural factors include the rise in student debt levels and a trend toward marrying later in life. Student debt has risen swiftly over the past decade. Some of the increase is due to rising enrollment rates, but higher tuition costs have also played a role. These secular trends are unlikely to reverse, but their impact should moderate. The growth in student debt was highest in the earlier years of the decade and has slowed since. New student loan originations peaked in 2010, and have fallen consistently over the past four years. Delinquency rates on student debt peaked in 2013 and fell in 2014.

Importantly, household formation is starting to rise again (see U.S. Homeownership Rate Still Declining But it May Not Be Bad News). According to the Census Bureau, there were 792k households formed in 2014, up from 524k in 2013. However, household formation gained momentum through the year, with 1.3 million households formed in the final quarter. Quarterly data on household growth by age group is not available, but given that the vast majority of these households were renters, many of them were likely younger households.

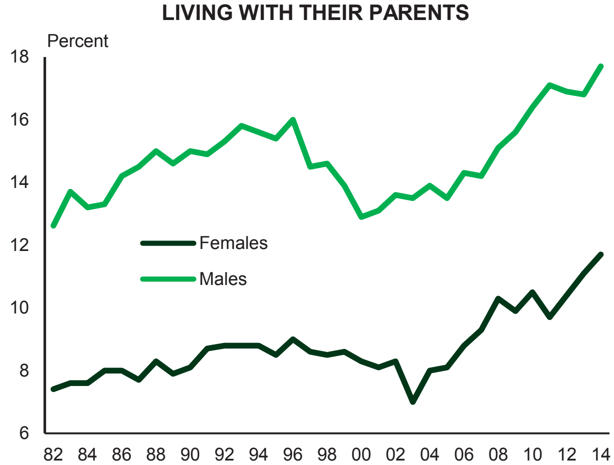
New households are likely to be renters

With household formation rising, the question is how many of them are likely to be renters. As a starting point, the (national) homeownership rate in the fourth quarter of 2014 was 64.5% (Chart 6). If it remains steady, and household growth rebounds to 1.3 million, owner households will grow by around 840 thousand annually and renter households will grow by around 460 thousand.

This, however, would represent a significant acceleration in the growth rate of owner households and a slowdown in renter households. Over the past five years, renter households have grown by 875 thousand a year, while owner households have fallen by 242 thousand annually. The outright decline in owner households was due in large part to foreclosure crisis, which turned many home-owning households into renters (or sent them back to their parents).

The first step is to stem the bleeding. Following eight

CHART 5: PERCENT OF PEOPLE AGED 25 TO 34 LIVING WITH THEIR PARENTS



Source: Census Bureau

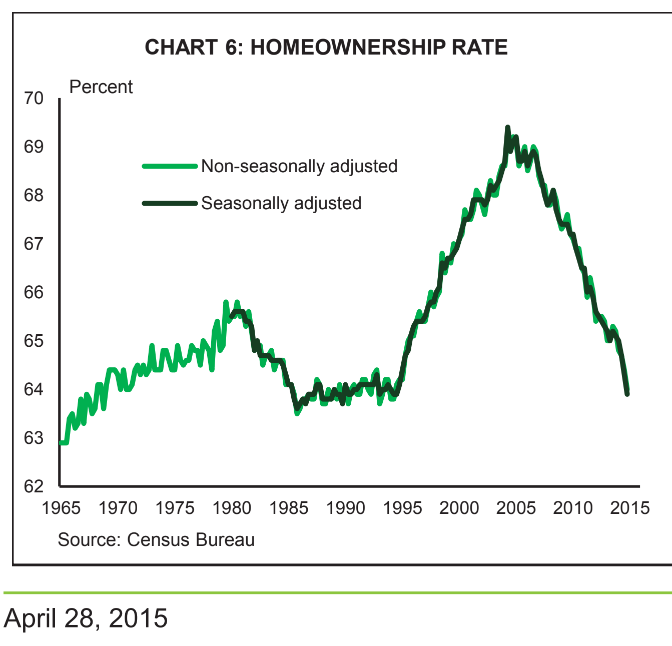
straight years of decline, owner households are likely to see a slow move back to positive growth. However, there are a number of reasons to believe that the rebound in household growth will continue to be weighed toward renters.

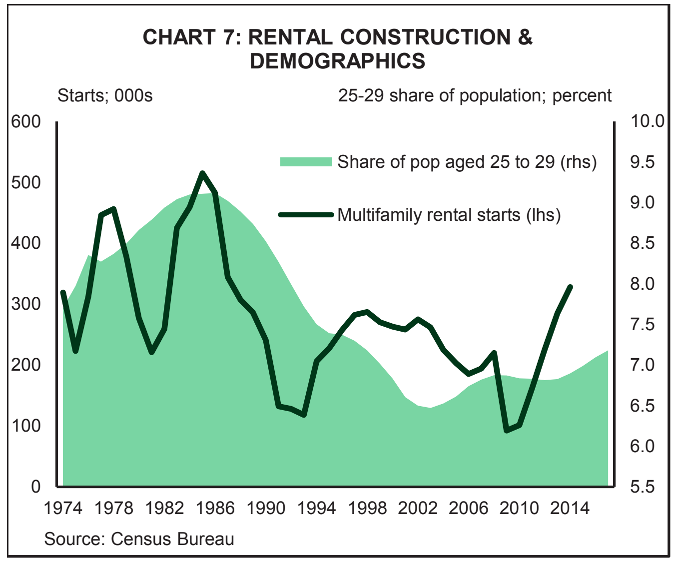
First and foremost, a substantial contributor to the rebound in household growth is likely to come from younger households. Over the next several years, people in their prime rental years – between the ages of 25 and 30 – will be one of the fastest growing segments of the population, expanding by around 500 thousand a year. This will provide a significant base for renter growth. Not coincidentally, the last major surge in rental construction in the mid-1980s took place when this segment of the population was at its highest (Chart 7).

The barriers facing young people in becoming homeowners are likely to diminish slowly over the next several years. Finding a job may be a gateway to starting a new household – moving out from one's parent's home or from a roommate situation – but homeownership requires building a credit history and saving for a down payment. This will not occur overnight, mitigating the risk of an abrupt drop off in rental demand.

Higher risks at the regional level

At the regional level things are a bit murkier. The magnitude of the increase in apartment construction in places like Boston and New York implies a higher threshold for renter demand to keep vacancy rates stable. Population and household growth are harder to predict at the metro level, where projections rely on assumptions on levels of net-migration that can swing more quickly. The good news for cities within TD's footprint is that they are likely to be net beneficiaries of lower energy prices at the expense of cities in the South and Midwest that depend on oil production. As a result, they are likely to see continued improvement in job growth and household formation.





In terms of downside risks to vacancy, rental demand is likely to be stronger in parts of the country where home prices are higher relative to income and rent. Some of the fastest growing cities from a population perspective will be cities in Florida and select cities in the Northeast where affordability remains an issue for prospective first-time buyers. By the same token, homeownership rates may be quicker to rebound in regions of the country where housing is relatively more affordable – cities in North and South Carolina, for example, fit this bill.

Bottom line

Multifamily rental construction has rebounded swiftly over the last several years, rising to its highest level in close to thirty years. As these units are completed over the next year it will lead to a substantial increase in the number of rental units on the market. This increased supply is likely to be met with continued demand. Household formation showed signs of rebounding in 2014 and supported by continued job growth should continue to do so over the next year. With particularly strong growth among younger prime-renter age groups, rental demand is likely to remain robust. Given that overall housing construction is likely to move slowly toward trend household growth of 1.3 million (plus an additional 200 thousand demolitions), the overall vacancy rate will remain low.