Multifamily Supply vs. Demand in an Inflationary World

Increased costs are impacting multifamily construction and operations as apartment demand stays strong.

By Caitlin Sugrue Walter / *National Multifamily Housing Council* and Valerie M. Sargent / *Broadband Communities*

Businesses nationwide have continually been challenged during recent months by the rising cost of labor and materials. This is due in part to ongoing supply chain issues. In addition to these costs, the apartment industry must deal with unique obstacles that impact both operations and construction. Here, we discuss how these costs impact the industry at a time when demand is high and the nation's supply continues to fall short of numbers needed to sustain long-term market demand.

Delays in development timelines can affect everyone from planning and construction teams to service providers that partner with apartment communities to provide broadband services and additional amenities in the lease-up stage and on an ongoing basis. Here are a few things to consider when planning a new development project.

INFLATION PERSISTS, RATES RISE

Inflation is at a 40-year high, and people everywhere are feeling the effects. The Consumer Price Index rose 9.1 percent year over year in June, marking the largest 12-month increase since the end of November 1981. Though the costs of nearly everything, including capital, are rising, inflation does not necessarily translate into rising cap rates; in fact, historically, there has been little correlation between interest rates and cap rates.

Because of the nature of their shorter-term leases, apartments are positioned to re-price rents during inflationary periods to offset rising costs. Accordingly, rising interest rates should leave cap rates unaffected as long as apartments achieve a proportional increase in rent growth.

However, there is still risk that the Federal Reserve will raise short-term rates too aggressively, dampening economic growth and potentially triggering a recession. This would likely have an adverse impact on property values and cause cap rates to rise. Though rent growth has accommodated rising costs thus far, there is a point at which that growth could become unsustainable.

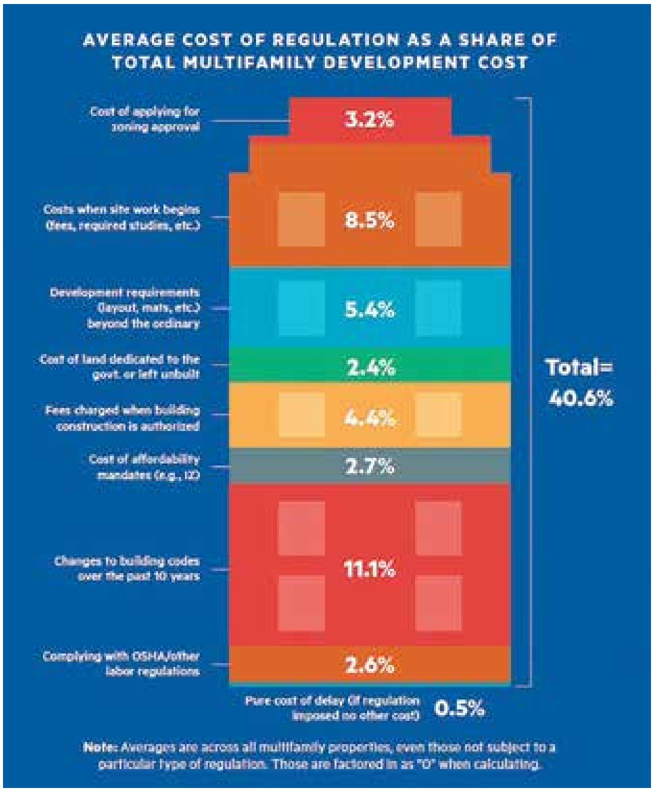
Further complicating matters, the July Quarterly Survey of Apartment Market Conditions (see www.nmhc.org/research-insight/quarterly-survey) found that equity financing and debt financing are much less available. For the deals that do go through, interest rates obviously make borrowing more expensive, which can ultimately contribute to affordability issues for renters as higher rents are the result.

WHAT ARE THE REGULATORY ISSUES?

Costs and hurdles are incurred on both the construction and operations sides that make delivering new developments in a timely manner more complex. In addition to the rising cost of capital and materials, regulatory and legislative impositions on new developments can create speed bumps when building new multifamily developments.

The NMHC-NAHB Cost of Regulations Report found that regulation imposed by all levels of government comprises 40.6 percent of multifamily development costs. Nearly three-quarters (74.5 percent) of survey respondents said they have experienced "not in my backyard" (NIMBY) opposition, which adds 5.6 percent to development costs and delays the completion of these communities by 7.4 months on average.

Other building code requirement changes and affordability mandates make delivering the housing the U.S. so desperately needs more challenging and more costly, especially in areas where addressing the critical shortage of affordable housing is necessary. Many regulations, though well-intentioned, go beyond what is necessary and impose costly mandates



that drive housing costs higher and make building housing, particularly in areas that need it most, more difficult.

CONSTRUCTION COSTS CLIMB

The construction and development sector has not yet fully recovered from pandemic woes. The problems that existed before the pandemic continue to persist and have driven up development costs, creating timeline delays. The NMHC Quarterly Survey of Apartment Market Conditions revealed continued construction delays, materials availability issues and labor issues. This has resulted in longer timelines for delivery of multifamily properties.

In the March 2022 survey, lumber prices had increased 45 percent, and were the only major materials prices to drop (by 5 percent) in June 2022. Others continued to rise and average price changes in June 2022 included increases of 11 percent in exterior finishes and roofing, 12 percent in electrical components, 5 percent in appliances and 10 percent in insulation costs.

Nearly all respondents (97 percent) to the June 2022 survey experienced construction delays. The holdups in starts that were a consistent factor throughout the pandemic have continued, with 85 percent resulting from permitting, entitlement and professional services. The majority of respondents experiencing delays also noted municipalities took between three to six months on building permit approvals. Fifty-eight percent of respondents cited materials sourcing and delivery as the cause for delayed starts. It has been necessary for some developers to make alterations or use alternative pricing/materials due to ongoing shortages of first selection of materials, which adds to timeline delays in many cases.

DEMAND REMAINS STRONG DESPITE CHALLENGES

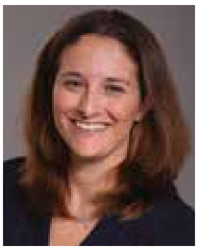
The good news is that apartment demand remains strong. As pandemic uncertainty leveled out, the immense need for apartment homes became even clearer. Even looking within the 150 largest metro areas, vacancy rates remained low in 2021, indicating widespread demand for apartments.

The multifamily industry needs to build 4.3 million units by 2035 to keep up with demand. The U.S. must build 600,000 units to alleviate the existing shortage driving the immediate affordability crisis and rising rents, according to the Executive Summary of U.S. Apartment Demand Through 2035 (see www.nmhc.org/research-insight/research-report/us-apartment-demand-through-2035). The underproduction of housing created higher housing costs, which resulted in a decline of 4.7 million affordable apartments (with monthly rents below $1,000) from 2015 to 2020. The more cost-burdened a household is, the less money it has for amenities such as internet.

New demand for apartments will focus on Florida, Texas and California, where 1.5 million units are needed through 2035. Secondary cities such as Austin, Boise, Las Vegas, Orlando, Phoenix and Raleigh will all grow at twice the national pace, followed by Dallas, Houston, Charleston and Charlotte.

Although developers keep building, they're not meeting the demand, which has serious implications for workforce and underserved households. With a vacancy rate for professionally managed apartments in the first quarter of 2022, more units under development should alleviate some of the pressure longer term.

There is still great opportunity if rising costs and the underproduction of housing can be addressed. The multifamily industry must navigate the many economic and policy obstacles ahead and continue to ensure that supply can keep up with demand in the years ahead. ❖



Caitlin Sugrue Walter, Ph.D., is vice president of research at the National Multifamily Housing Council in Washington, D.C., and can be reached at cwalter@nmhc.org.

Valerie M. Sargent is a multifamily speaker, trainer and executive consultant and is the multifamily news correspondent for ***Broadband Communities****. Contact her at valerie@bbcmag.com. For more information, visit www.nmhc.org, www.bbcmag.com, or www.valeriemsargent.com.*