CAPITAL SQUARE

MULTIFAMILY RENT FLUCTUATION VARIABLES BEYOND INVENTORY GROWTH

November 2023

AN OVERVIEW OF MULTIFAMILY RENT FLUCTUATION VARIABLES BEYOND INVENTORY GROWTH

TAKEAWAYS

- Multifamily inventory increases are correlated with, but not determinative of, rent growth.
- In the short term, operators in these high-supply markets may need to offer higher concessions than have been needed in years, which would significantly impact investor returns.

> Concessions can be significant, volatile and difficult for market research firms to track accurately. As a result, concessions can be underreported in market data, and the true difference between asking rent and effective rent performance could be understated.

The high level of new supply has been a recurring and significant concern in the national multifamily market as owners and managers track performance toward the end of 2023 and budget for 2024. What trends in rent growth can we discern when we look at the country's largest apartment markets that have experienced the greatest and lowest increases in inventory over the past year?

CoStar[1] provides the following data on these markets:

TOP FIVE LARGE APARTMENTS MARKETS' 12-MONTH INVENTORY GROWTH, RANKED BY PERCENT

	12-Month Inventory Growth	12-Month Asking Rent Change	12-Month Effective Rent Change
Raleigh	6.5%	-1.80%	-2.60%
Austin	6.6%	-4.30%	-4.90%
Jacksonville	6.6%	-2.00%	-3.00%
Nashville	7.0%	-1.40%	-2.10%
Sarasota	10.0%	-3.60%	-4.30%

BOTTOM FIVE LARGE APARTMENTS MARKETS' 12-MONTH INVENTORY GROWTH, RANKED BY PERCENT

	12-Month Inventory Growth	12-Month Asking Rent Change	12-Month Effective Rent Change
New Orleans	0.3%	2.70%	2.60%
Tulsa	0.3%	2.60%	2.50%
Fresno	0.4%	3.40%	3.30%
Little Rock	0.5%	2.90%	2.90%
San Francisco	0.7%	-0.50%	-0.40%

The charts above could be summarized by the conclusion that markets that have experienced the highest levels of new supply have also experienced declines in rents, while markets that have had the lowest levels of new supply generally have maintained positive momentum with regard to rents.

While this conclusion is useful, it is also somewhat of a simplification, because other factors such as demand and concessions are fundamental variables also in play.

While there is a correlation between inventory growth and rent growth, demand plays an equally important role in establishing rental rates in a market. Some markets with large inventory growth have been able to maintain positive rent growth where demand has been sufficient to meet much of the new supply. Likewise, some markets with low inventory growth have underperformed in terms of rent growth. Analyzing each market individually and with more metrics, including occupancy trends and absorption rates, enables a more comprehensive understanding.

Furthermore, the markets that have had the highest deliveries responding to resident demand also have among the largest pipelines of properties still under construction that should deliver in the next one to two years, so some of these rent trends may continue in the short term. However, many markets that face short-term challenges from elevated inventory growth are markets with strong long-term economic prospects.

THE IMPACT OF CONCESSIONS CANNOT BE IGNORED

Another observation from these charts and others that reveal similar data is that markets which have experienced large supply increases have only experienced small reductions in asking and effective rents on a percentage basis, generally in the low single digits. The metric of asking rent summarized in these charts doesn't reflect the impact of concessions, whereas effective rents should take concessions into account.

Concessions can be significant, volatile and difficult for market research firms to track accurately. As a result, concessions can be underreported in market data, and the true difference between asking rent and effective rent performance could be understated. Some data may suggest relatively strong rent performance despite significant inventory increases that could be misleading.

We have observed that some lease-up properties have not curtailed concessions fully or at all upon approaching or meeting a stabilized occupancy rate, as was common earlier in this cycle. This could be due to the need to be competitive with other new properties nearby still working through their own lease-ups. We have also observed properties that are not newly constructed – and which should be stabilized – also offering concessions, something we have not commonly seen in the apartment market in recent years.

Compared to rental rates, concessions can be harder to track by market research firms for the following reasons:

- The offered concessions can fluctuate quickly as operators switch the concession term on a weekly or daily basis before the data can be captured. From two weeks up to eight weeks has been common recently.
- Operators may rapidly shift between offering concessions only on specific floorplans versus on all available units.
- Some operators offer significant gift cards instead of, or in addition to, rent concessions.
- Some property websites require a prospect to call or otherwise connect for details on the promotion.
- Shared information that does exist online regarding a concession could also be vague, describing a concession as "up to" a certain amount, for example.
- Some concessions may be offered only in person and not posted online at all, so awareness of these concessions is limited to true prospects who have toured a property and begun discussions regarding a lease.

- Concessions that require an application by a certain deadline are often extended.

The high-inventory growth markets carry an outsized tendency to offer concessions that significantly affect bottom line income. For example, an operator offering a new one-month concession on a 12-month lease would be facing an effective rent reduction of approximately 8%, assuming asking rents are flat. This suggests there could be a much bigger difference between asking rent change and effective rent change for high inventory growth markets than is summarized in commonly shared data, such as the chart above.

IN CONCLUSION

Such a big difference may not be atypical either. We recently surveyed 18 properties in a submarket of Raleigh, North Carolina and found significant concessions. Four properties were under lease-up, and each of these offered a concession between one and two months. Eight of the remaining 14 properties that were not under lease-up, including some originally constructed in the 1980s, also offered a concession in the same range.

Markets with high inventory growth are typically also markets that exhibit strong employment growth and have the best long-term prospects even if the short-term rent trends may be more difficult to forecast. These are among the markets in which we are most interested in acquiring properties despite short term headwinds due to elevated supply levels.

In order to accurately forecast income at the beginning of our hold periods, we need to take into consideration that demand and concessions could play a larger role than some market data may suggest.

Source

1. "Multi-Family National Report: United States," CoStar Group, 2023.

ABOUT CAPITAL SQUARE

Capital Square is a national real estate firm specializing in tax-advantaged real estate investments, including Delaware statutory trusts (DSTs) for Section 1031 exchanges, qualified opportunity zone funds, development funds and a real estate investment trust (REIT). As a vertically integrated company, Capital Square has also become an active developer of mixed-use multifamily and build-for-rent properties in the southeastern U.S. as well as a dedicated property manager through Capital Square Living, which launched in 2023. Since 2012, Capital Square has completed more than $7.8www billion in transaction volume. Capital Square's related entities provide a range of services, including due diligence, acquisition, loan sourcing, property/asset management and disposition, for a growing number of high-net-worth investors, private equity firms, family offices and institutional investors nationwide. Since 2017, Capital Square has been recognized every year by Inc. 5000 as one of the fastest growing companies in the nation. In 2017, 2018, 2020 and 2023 the company was also ranked on Richmond BizSense's list of fastest growing companies in central Virginia. In addition, Capital Square was named a "Top Workplace" by the Richmond Times in 2023. To learn more, visit www.CapitalSq.com.