NATIONAL MULTIFAMILY HOUSING COUNCIL

RESEARCH NOTES NEWSLETTER

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Why Building "Luxury" Apartments Brings Down Rent for All

By Chris Bruen, NMHC Senior Director of Research

The U.S. built 438,500 new apartment units in 2023, according to data from the Census Bureau, up 22.1% from the previous year and marking the highest number of annual completions since 1987. This pace of multifamily deliveries picked up even further in the first quarter of this year to a seasonally adjusted annual rate (SAAR) of 577,000 units. These new units should provide at least some much-needed relief to an undersupplied U.S. housing market in which more than half (55%) of apartment households are cost-burdened (spending more than 30% of their monthly income on rent) and 29% are severely cost-burdened (spending more than half of their income on rent).

But many Americans remain skeptical as to whether these new apartments – which tend to be more expensive than existing units and are often marketed as "luxury" – will aid affordability for households at the lower end of the income spectrum.

In this Research Notes, we examine how increased completions of more expensive Class A and B apartments influenced rental costs for *all* apartments in 2023—including more affordable, Class C units.

Newer Apartments Tend to Be Pricier

Apartments classified as Class A tend to be both higher quality and more expensive than their Class B and Class C counterparts. Class A apartments recorded an effective asking rent of $2,213 per month in 1Q 2024 according to data from from CoStar[1]. Class B apartments rented for $1,671 and Class C apartments for $1,347. Even though nearly all apartment units built in 2023 were classified by CoStar as either Class A (41.3%) or Class B (56.8%), both economic theory and empirical literature suggest that this new supply should have a downward effect on rent growth for all apartments, including Class C. For instance, Myers and Park (2020) found that new apartment construction, even at higher price points, enabled older units to "filter" and house an increasing share of low-income households over time.

Do we see evidence that this recent wave of Class A and B construction has led to lower rent growth among Class C units?

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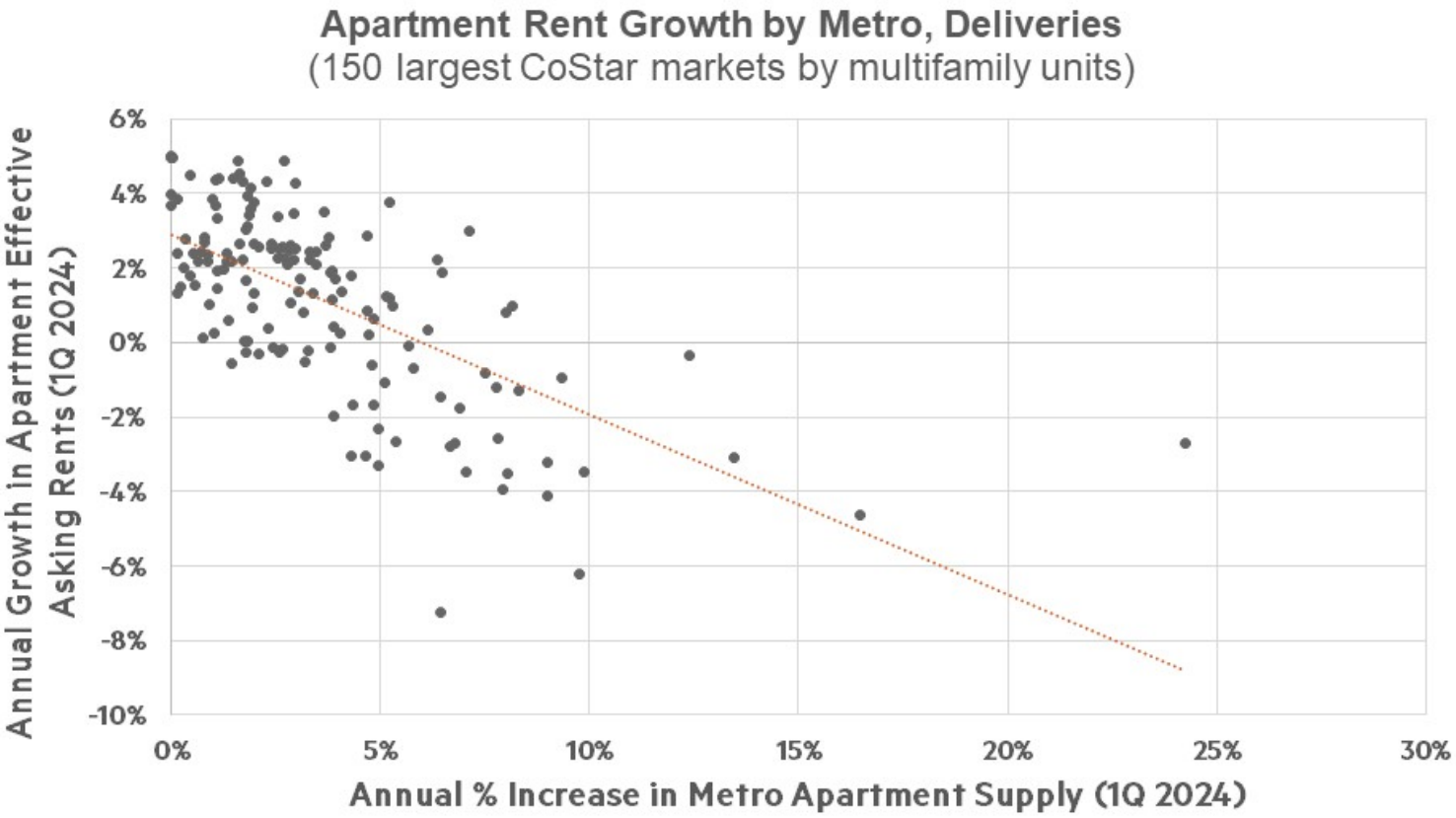
1. CoStar estimate as of 6/10/24

Higher Completions Associated with Lower Rent Growth

In our December Research Notes, we presented Figure 1 below (updated with 1Q 2024 data), which illustrates how markets with higher rates of apartment deliveries over the past year tended to record lower and even negative annual rent growth.

FIGURE1

Annual Apartment Rent Growth by Metro, Annual Deliveries

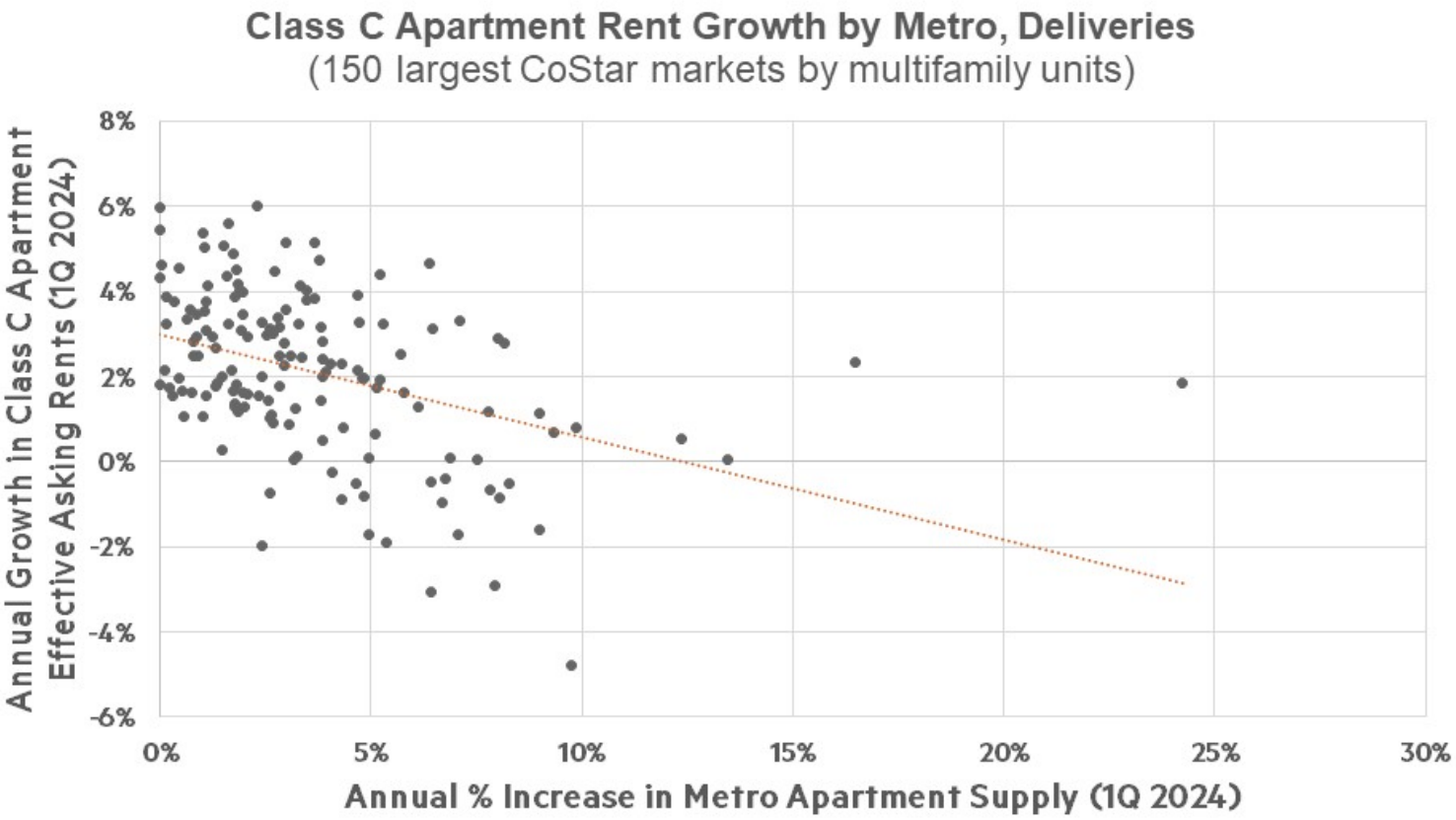


Source: CoStar.

When we look instead at the relationship between apartment deliveries – again, which are nearly all either Class A or Class B units – and Class C rent growth specifically, we still observe a negative, albeit weaker correlation (Figure 2).

FIGURE 2

Class C Annual Apartment Rent Growth by Metro, Deliveries



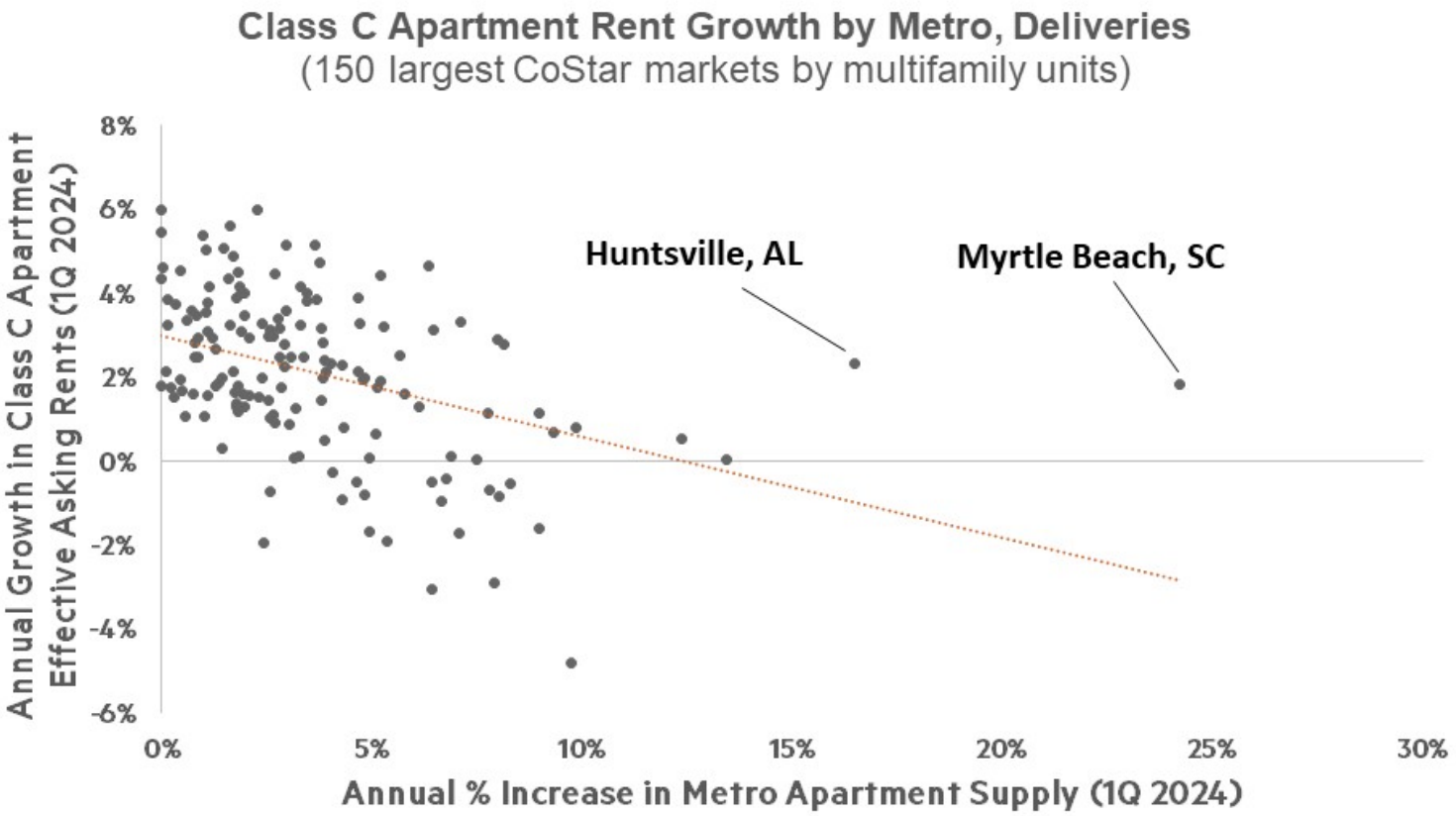
Source: CoStar.

Markets with higher rates of Class A and B deliveries tended to record lower rent growth among Class C units, providing some evidence that construction at the high end promotes affordability among all unit types.

But, because this correlation is somewhat weaker, let's take a closer look at some metros that deviated noticeably from the trendline:

FIGURE 3

Class C Annual Apartment Rent Growth by Metro, Deliveries



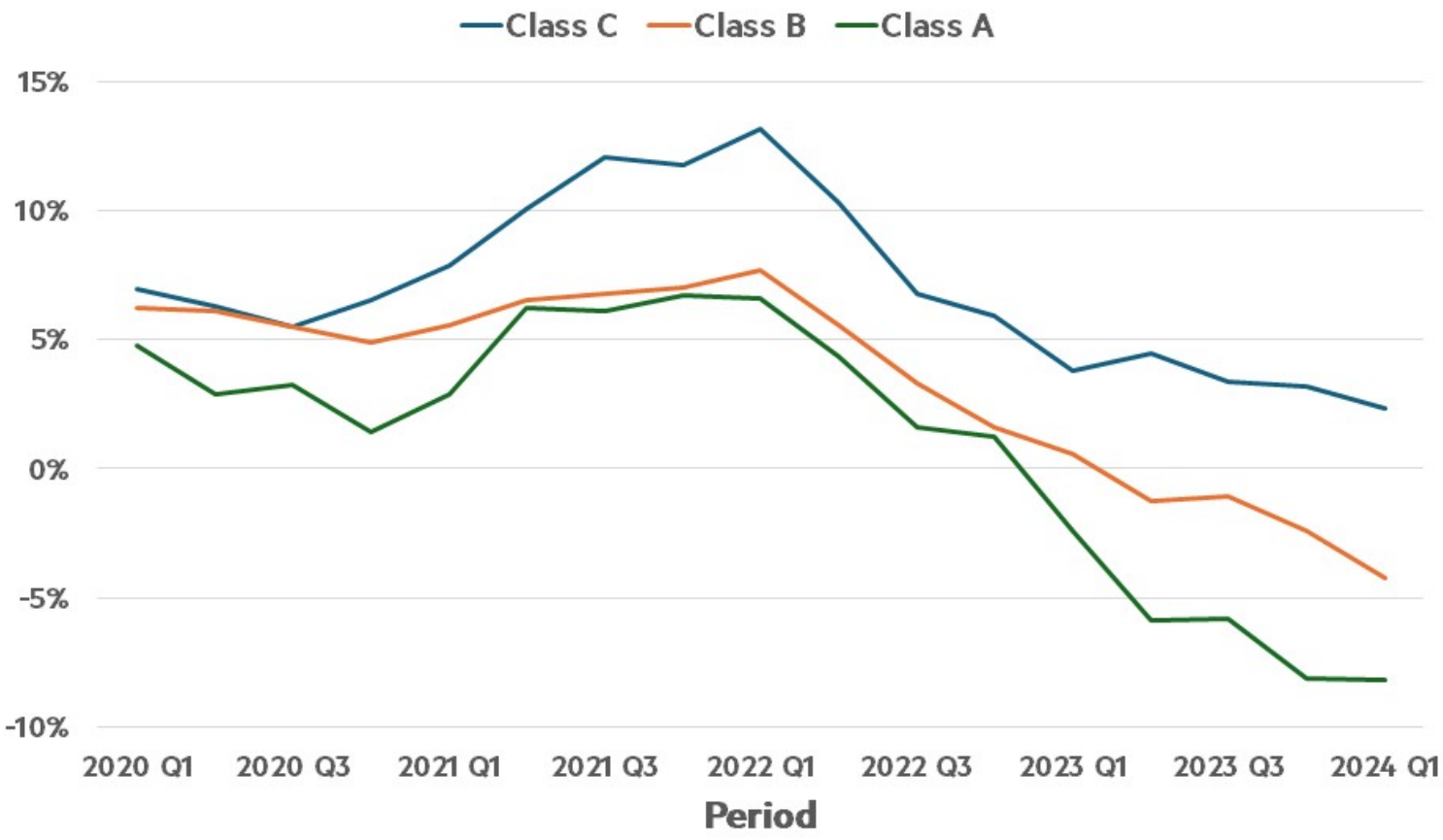
Source: CoStar.

Huntsville, Ala. and Myrtle Beach, S.C. stick out on our chart. Given their level of deliveries over the past year – Huntsville saw its apartment supply increase 16.5% over the past year, while Myrtle Beach recorded a 24.2% expansion – we might have expected their Class C rent growth to be lower. As of 1Q 2024, effective asking rents among Class C apartments rose 2.3% year over year in Huntsville and 1.8% in Myrtle Beach. Contrast these figures with Class A rent growth, which was -8.2% year over year in Huntsville and -2.2% year over year in Myrtle Beach.

Did all this new Class A and B supply not alleviate pricing pressure among Class C units? Figures 4 and 5 below provide a more nuanced picture.

FIGURE 4

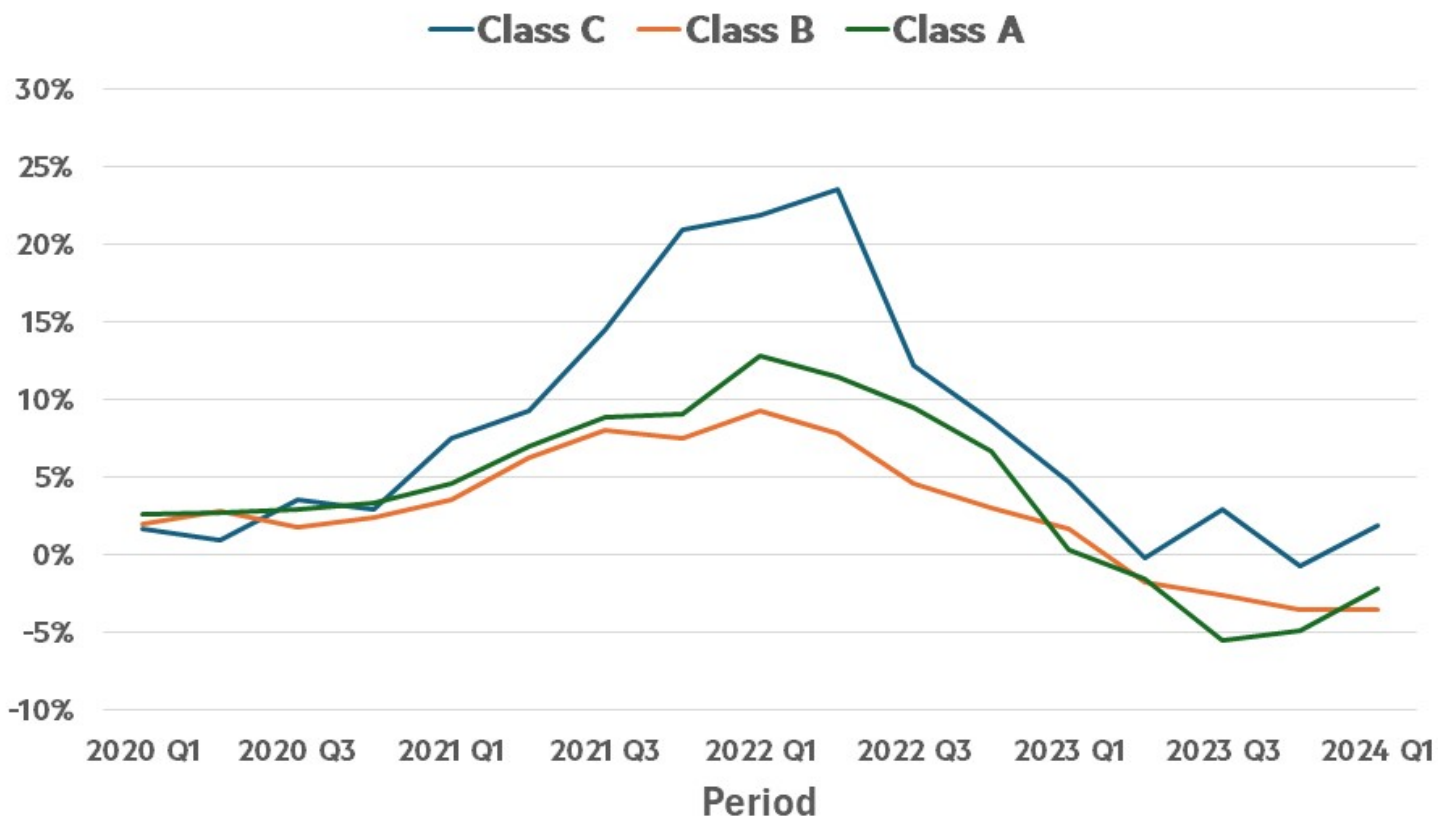
Annual Rent Growth – Huntsville, AL



Source: CoStar.

FIGURE 5

Annual Rent Growth – Myrtle Beach, SC



Source: CoStar.

We can see that rent growth spiked in late 2021/early 2022 for all apartment classes in Huntsville and Myrtle Beach but that this spike was highest for Class C units. Thus, even though Class C units continued to record higher rent growth in 1Q 2024 compared to their Class A and B counterparts, this growth moderated. Specifically, it went down 7.5 percentage points from the 2021 peak in Huntsville and 21.7 percentage points from the peak in Myrtle Beach. In other words, it's likely that the new supply of Class A and B units in these two metros caused rent growth to moderate for all classes, but that Class C units simply had higher rent growth to begin with.

FIGURE 6

Change in Class C Rent Growth (1Q 2022 to 1Q 2024) by Metro, Deliveries

Source: CoStar.

This holds true for other markets as well. Figure 6 above shows that metro areas with higher rates of apartment deliveries between 1Q 2022 and 1Q 2024 tended to record larger decreases in annual, Class C rent growth.

Of course, it is essential to look at apartment supply not just in isolation but also as it relates to apartment *demand.* For instance, Olympia, Wash. delivered 1,200 net new apartment units between 1Q 2023 and 1Q 2024, amounting to a 7.1% increase in the metro's apartment stock. Yet, Olympia absorbed an even greater 1,245 apartment units during this period (this was possible since Olympia's vacancy rate decreased from 10.5% in 1Q 2023 to 9.6% in 1Q 2024). At the opposite end of the spectrum, Fort Myers, Fla. delivered over four times (4.2) more apartment units than it absorbed between 1Q 2023 and 1Q 2024.

Fourteen of CoStar's top 150 apartment markets recorded negative absorptions between 1Q 2023 and 1Q 2024, while four markets – Youngstown, Ohio; Honolulu, Hawaii; College Station, Tex. and Syracuse, N.Y. – recorded zero deliveries.

Absorptions, however, are a very imperfect measure of demand, since the number of apartments absorbed in a market depends not only on demand but also on the number of apartments available to rent. Markets

with a higher number of deliveries will likely have more absorptions simply because they have more apartments to absorb.

What we really want to know is whether the supply and demand conditions for Class A apartments in a market – represented by Class A rent growth – affect the supply and demand conditions for Class C apartments (Class C rent growth).

FIGURE 7

Class C Annual Apartment Rent Growth by Class A Rent Growth, Metro

Source: CoStar.

Figure 7 above illustrates that there is in fact a very strong, positive correlation between Class A rent growth and Class C rent growth among CoStar's top 150 markets. Therefore, even though nearly all new apartment construction consists of higher-end, Class A and B units, the downward effect this new construction has on rent growth should extend to Class C units as well, even after controlling for market demand.

The Takeaway

Apartment deliveries have increased to their highest level since the late 1980s, which has resulted in a significant moderation in rent growth. According to our analysis, this surge in construction – which consists almost entirely of more expensive, Class A and B units – translated to lower rates of rent growth for Class C apartment units as well, providing further evidence of apartment "filtering."

The bottom line: Increased supply (of all kinds) = improved housing affordability.

However, this higher level of deliveries and moderating rent growth is likely to be short lived, since a combination of moderating rent growth, rising operating costs and a rising cost of capital have already led to a sharp pull back in new apartment construction.

- Multifamily permits (5+ units in structure) fell 6.2% to a SAAR of 456,300 in 4Q 2023, according to Census data, a 24.6% decrease from 4Q 2023.

- Starts (5+) edged up 76 basis points (bps) in 4Q 2023 to a SAAR of 396,300, which marked a 27.1 percent decline from the previous year.

Therefore, unless we remove more chronic barriers to supply, we're likely to again find ourselves with increasing housing costs and worsening affordability conditions once this current wave of deliveries subsides.

About Research Notes

Published quarterly, Research Notes offers exclusive, in-depth analysis from NMHC's research team on topics of special interest to apartment industry professionals, from the demographics behind apartment demand to effect of changing economic conditions on the multifamily industry.

Questions

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