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# Research *in* Brief

## *Millennial Mirage: Which Apartment Markets Will Be Most Impacted When Millennial Housing Patterns Prove to Be Not So Different?*

Millennials are on every real estate investor's wish list, especially apartment investors, and for good reason. They are today's largest demographic cohort, at 87 million compared to the 76 million Baby Boomers[1]. Highly educated, with 60% being college educated compared to 46% for their baby boomer parents[2], this makes the Millennial Generation even more attractive.

### MILLENNIALS DRIVING APARTMENT DEMAND

Millennials are now in the prime renting age range of 18-34. In addition, they are getting married later and having children later. While 48% of Baby Boomers were married when they were the same age as Millennials today, only 26% of the current generation are married[3], increasing renter demand. Marriage and children are contributing factors to homeownership decisions, as married 25-34 year olds make up 49% of first time homebuyers while only comprising 30% of renters[4] and homeownership rates are even higher for all households with children, at 61%[5].

Economic factors are further elevating apartment demand as Millennials have struggled disproportionately during the recent economic downturn. Between 2007 and 2013, the number of employed Millennials increased a scant 0.3% while employment among Baby Boomers increased 9%[6]. Additionally, home mortgage debt availability has declined as underwriting standards tightened significantly after the subprime mortgage crisis. While the Fannie Mae and Freddie Mac minimum credit score guideline is 620, 742[7] is the actual average credit score for guaranteed Freddie Mac loans. Add to this record levels of student debt and it gets pretty hard for many Millennials to get past the underwriting for a home loan today.

Among Millennials 25-34, the 2014 homeownership rate was 40.1% compared to the thirty-year average of 45.5%[8], equating to nearly one million fewer 25-34 year olds who are homeowners – a substantial tailwind for renter demand.

### MILLENNIAL APARTMENT DEMAND MIRAGE

While a boon to renter demand today, long-term apartment investors would be wise to examine the sustainability of the factors creating this outsized renter demand. First, while fewer Millennials are getting married today relative to the baby boomer generation at the same age, it doesn't mean they don't want to, as US Census data show 69% of Millennials anticipate being married eventually. Second, while they are also delaying starting families, this too doesn't mean they don't want to have children as 55% of younger Millennials expect to have children in the next five years[9]. Third, despite these demographic delays, 93% of Millennial renters plan to one day own a home[10].

Lastly, the economic factors previously depressing homeownership are also lessening as employment prospects among Millennials are improving while changes to increase the availability of home mortgages are being made. Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency have all loosened lending guidelines in an attempt to facilitate increased mortgage lending activity. Additionally, the minimum down payment required by Fannie Mae and Freddie Mac to avoid mortgage insurance was lowered from 5% to 3%. The impact of these changes will be very real -- the Urban Institute estimates that had lending standards in 2012 been in line with 2001 standards, not even bubble era standards, 1.2 million more home loans would have been made in 2012[11].

There is also a new and powerful economic factor that is changing the rent-versus-buy calculus: rising rental rates. Nationally, rental rates are nearly 10%[12] above the previous cycle highs. While the average mortgage now equals 21.4% of household income, the average rental rate exceeds 30% of income, and these increased rents are starting to have an impact on the Millennial rent-versus-buy decision. In 2014, 32% of homebuyers were Millennials, up from 28% in 2012[13]. Improving employment prospects and loosening credit standards are reversing key economic factors previously driving Millennial rental demand while rising rents are changing the economic balance between renting and buying. Add to this attitudes toward marriage and children that are not so different from previous generations and investors may find today's elevated levels of apartment demand looking more and more like a mirage than an oasis.

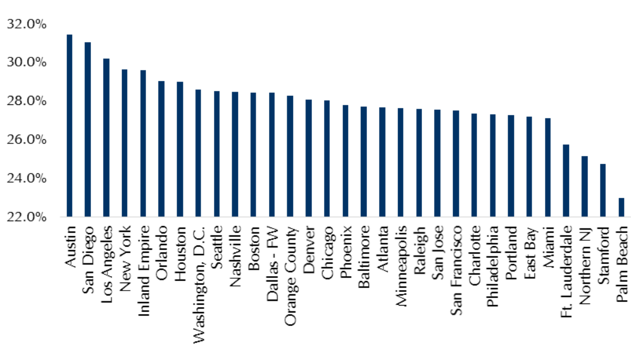
## NATIONAL IMPACT

If homeownership rates return to the thirty-year average, what could be the impact on rental demand? The starting point is approximately one million 25-34 year olds who are likely to become homeowners. However, not all of these individuals are currently renting -- some may be living with their parents or in some other living arrangement in which they are not occupying rental stock. In addition, of those currently renting, some are sharing an apartment, possibly due to marriage or just choosing to have a roommate so there may not be a one-for-one impact. Even if we assume, however, that only half of the one million new homeowners were currently renting, this equates to a five-hundred thousand unit reduction in rental demand, potentially transforming a tailwind into a headwind for apartment demand. The significance of this becomes even more apparent when one considers that the estimated average net absorption for apartments between 2004 and 2014 was 185,000 units per year[14]. Based on these assumptions, rental demand could be reduced by the equivalent of two-and-a-half years of demand. While it is true that the change in homeownership will not occur overnight, the impact will be significant as existing stock will not be reduced overnight either.

## LOCAL IMPACT

Some markets would likely feel the impact much more than others -- markets with elevated levels of Millennials for example would logically be more vulnerable. The following chart shows the percentage of Millennials comprising each market, with above average markets including Austin, Dallas, Denver, Houston, Nashville, and Seattle. These markets are in high demand among investors today precisely because of their elevated levels of Millennials. However, as the generation move into homeownership these elevated levels may put downward pressure on apartment demand.

% Millennials

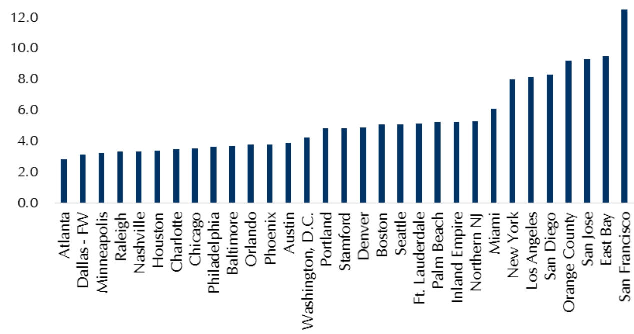



*Source: Costar*

Larger numbers of Millennials are only part of the story in evaluating vulnerable markets. It is one thing to want to buy a home, it is another to be able to afford a home. Markets with higher levels of home affordability may be at the greatest risk as a higher percentage of Millennials will be able to afford home ownership.

Markets offering the highest levels of home affordability include Austin, Dallas, Houston and Nashville, all secondary markets currently in high demand among investors.

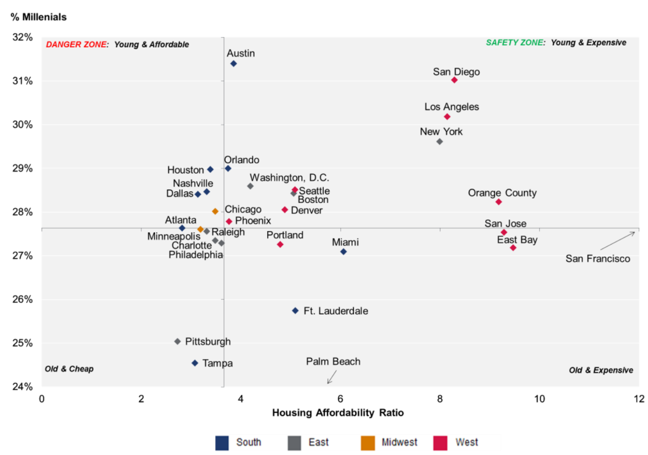
2014 Housing Affordability




*Source: Costar*

Conversely, San Francisco, New York, Los Angeles, San Diego, Orange County, San Jose and the East Bay all have significantly reduced levels of home affordability lessening the impact of Millennials transitioning into homeownership.

When we combine the two factors, we see that markets in the uppermost portion of the chart below have higher levels of Millennials while markets in the leftmost portion have higher levels of home affordability.




*Source: Costar*

Compare for example San Diego with Austin –while both have similar percentages of Millennials, it will be more difficult for 25-34 year olds in San Diego to become homeowners in the near term when compared to Austin's greater housing affordability, reducing the demographic impact. Or consider Houston and Tampa – while both have similar home affordability levels, Houston has significantly higher concentrations of Millennials. Markets in the top left quadrant would likely be hurt the most by an increase in homeownership among 25-34 year olds as these markets are "young and cheap", i.e. they have elevated levels of Millennials and affordable housing. Conversely, markets in the bottom right corner would likely see the least impact as they have comparably older populations and very low levels of home affordability. The prime markets are markets in the top right quadrant, those where concentrations of young renters meet with expensive housing.

Markets currently in high demand among investors that standout as most vulnerable to the effects of an increase in Millennial homeownership include Austin, Dallas, Houston, Nashville and Orlando. Exacerbating this is that these markets on average are forecast to build 26%[15] more supply than demand over the next five years. Increased investor demand and pricing, higher levels of home affordability, and elevated levels of Millennials make these markets especially susceptible to the impact of an increase in homeownership rates. On the other end of the spectrum, San Diego, Los Angeles, New York, Orange County, San Jose, and the San Francisco Bay Area all offer more favorable combinations of home affordability and Millennial concentration levels.

The impact of shifting Millennial housing choices and the move from being renters to ownership will likely have varying effects on apartment demand in the coming decade. Generational shifts are not always easy to evaluate but, like their parents before them, the Millennial wave is hard to ignore. Apartment performance may be less impacted in those markets with larger shares of this cohort combined with lower housing affordability. While these are mostly lower cap rate markets, one can consider the difference in yields as the cost of insuring against a likely increase in Millennial homeownership rates.

[1] "Millennial Generation Is Bigger, More Diverse Than Boomers", CNN Money

[2] "15 Economic Facts about Millennials", The Council of Economic Advisers, 2014

[3] "Millennials in Adulthood", Pew Research Center

[4] "State of the Nation's Housing 2014", Joint Center for Housing Studies of Harvard University

[5] "The Circle of Homeownership", US News & World Report

[6] "40% of Unemployed Workers Are Millennials", MarketWatch

[7] "Fannie Mae, Freddie Mac Reach Deal to Ease Mortgage Lending", LA Times

[8] "Millennials in Adulthood", Pew Research Center

[9] "Millennials Want Houses, Just Like Everybody Else", Bloomberg Business

[10] "Renter Nation Just A Myth: 93% of Millennial Renters Plan to Buy a Home Someday", Forbes

[11] "Fannie Mae, Freddie Mac Reach Deal to Ease Mortgage Lending", LA Times

[12] CoStar

[13] "Rising Rents Are Finally Forcing Millennials to Buy Homes", Bloomberg

[14] American Realty Advisors and CoStar

[15] CoStar

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