# Industry Note: Landlords and the US Rental Housing Industry 2013

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## Abstract

*This industry note employs secondary research in order to explore the rental housing industry in the United States in 2013. This enquiry includes a depiction of the players in the industry, their roles, the industry's value chain, as well as the major forces driving the industry toward or away from profitability and growth (Porter, 1980). This research note presents an overview of the industry (its major factors) as well as business challenges, emerging trends, the landlord mindset, and industry attractiveness. The analysis of the industry concludes that macro analysis indicates that rental markets are still favourable for landlords, projections are less favourable. A cautionary note: rental markets are highly regional and location specific and therefore national trends may not be very useful in determining actual pockets of growth opportunities.*

## *Introduction*

*"Landlords, landlords" moaned Hodgetts as if he had just learned about the death of a dear friend. "How could you possibly entertain the notion of being a landlord? European and American literature is abound[ing] with examples of greedy and miserly landlords. Shakespeare, Dickens, Pushkin, Steinbeck, Alger Jr., the list goes on and on. These writers have sullied the rental profession and anyone who practices it. Why don't we just become money lenders and factory owners for G-d sake and change our names to Fagan and Shylock?" (Sherman and Rowley, 2006, p.48)*

Landlords seemed to have always gotten the brunt of criticism whether it is exemplified in works of literature as typified by Langston Hughes' The Ballad of the Landlord (http://www.poemhunter.com/poem/the-ballad-of-the-landlord/) or the more recent broadway musical (1996) turned film (2005) "Rent". (Rapp, 2006) Yet all disparagement aside, the US rental housing market, a subset of the real estate industry, has always been considered at least a partial bell weather measure of U.S economic performance and therefore a viable business opportunity. That being the case, an understanding of how the rental housing industry works, the players in the industry, their roles, and the industry's value chain is critical in determining what are the industry forces (Porter, 1980) driving the industry toward or away from profitability and growth. This research note presents an overview of the industry (its major factors) as well as business challenges, emerging trends, the landlord mindset, and industry attractiveness.

## *Definition*

Rental housing can be described as a property that is owned by an individual for which a dweller pays a monthly rent to the landlord. The residential real estate market either is a rent-to-own" scheme where tenants' intention might be "to build down payment and a record of payment" in order to eventually buy the property or is a "pure" rental housing scheme where residents' intention is just to rent the property "for a certain period of time at a predetermined price" which is written on a contract (Dubel & Taffin, 2011).

Structures of ownership and management of residential rental property involve "amateur" landlords, large institutional investors and owners, and "social" ownership. "Amateur" landlords are individuals who own a small number of real estate properties and represents the primary segment of the residential real estate. Yet "most residential rental real estate in the United States is controlled by large corporate entities. The third type of ownership structure is 'social' rental housing", which is publicly owned and managed, and serves a targeted segment such as the poor, the elderly and the disabled (Dubel & Taffin, 2011).

**Types of Rental Housing Structures Include:** Single-family houses, which are independent rental properties and occupied by an individual or a few of renters; duplex/townhouses, which are similar to single-family houses in terms of their size and being free-standing; and multi-family dwellings such as apartments, which are comprised of three or more units in the same building depending on their size and condominiums (CTHousingSearch, 2013). See Figure 1 which describes the relationship amongst key players in U.S. housing rental industry.

## *The Major Factors that Affect the Rental Market*

**Affordability**– The younger generation entering the workplace after just having graduated from college and carrying loan debts cannot afford to buy a house in the near future but instead prefer to rent one (Courtis, 2006).

**Interest Rates**- Whether they are high or low, interest rates have a great impact on residential rental market. The higher the interest rate is the less affordable is home ownership and therefore the demand for rental properties increase. Increased demand given a stable supply will increase occupancy rates as well as allow rental rates to climb. High interest rates encourage landlords to sell their properties due to the high mortgage payments also leading landlords to increase their properties' rent prices (Courtis, 2006).

**Supply and Demand**– In any industry, the relationship between supply and demand is one of the key indicators as to how the market performs. For example, in the housing rental market, when there are more rental properties than demand, rental prices will go down. On the other hand, if there are not sufficient properties to meet the high demand, rental prices will increase (Courtis, 2006).

## *Products, Operations and Technology*

Companies operating within the residential rental market rent out properties such as single-family homes, townhouses, multifamily houses and condominiums to residents and also may serve as management of these properties for landlords. Some of these "companies operate as real estate investment trusts (REITs)" (Hoovers, 2013), that is they use money from shareholders to purchase and operate real estate or real estate loans. (Yahoo Dictionary Search) "Examples of the large-scale institutions that perform in the U.S. market include AIMCO Properties, AvalonBay Communities, Equity Residential, and Essex Property Trust" (Hoovers, 2013).

Leasing companies rent properties in several ways: they might possess their own properties which they rent out, they might have properties that rent out for the owners, or they lease properties themselves and then sublease to residents (Hoovers, 2013). Yet with all of these various complex owner-agent relationships "many residential rental properties, especially duplexes and single-family homes, are managed by individual owners" (Hoovers, 2013).

Landlords might collaborate with property management and leasing companies to get assistance with marketing strategies to make sure that their properties are as fully occupied as possible, financing to determine an appropriate lease length and rent value for their properties, building operations to hire and supervise local staff, and provide or arrange appropriate utilities, maintenance, and other building services (Hoovers, 2013). Most of active landlords of residential properties manage their own properties, however, the majority of passive landlords "hire a property manager to operate their buildings" (Hoovers, 2013).

### Marketing

Property management companies play a very important role in retaining quality tenants by communicating with them during their lease term and establishing good relationships. Therefore, residential property leasing companies or landlords might want to collaborate with property management companies in terms of establishing effective marketing strategies (Hoovers, 2013).

The Internet is another important marketing strategy for housing rental companies or landlords. These companies or landlords can use websites to "allow visitors to take virtual tours of properties for rent and allow prospective tenants to examine properties at convenient times and locations" (Hoovers, 2013).

### Values

Property owners or landlords can increase their revenue by providing additional services such as laundry, professional cleaning and concierge service to their tenants. These supplementary services require investing in labour and time to establish and market these ancillary services.

In order to attract more residents, these services become very important especially when poor economic conditions adversely affect the rental market or when the market is very competitive (Hoovers, 2013).

New property management and maintenance technologies enable landlords to reduce their costs and improve their services for their tenants. By adopting these new technologies landlords can make appropriate leasing and maintenance decisions in order to optimize their revenue (Hoovers, 2013).

### *How Do Property Management Companies Provide Value to Landlords?*

- Property management firms screen potential tenants and develop relationships with current tenants. Higher quality tenants, who rent for a long-term and pay rent on time, put less wear and tear on the property, and cause less problems in general (Muela, 2009).
- Decreasing costs and time for legal problems - Since property management companies are knowledgeable about landlord-tenant lawsuits, landlords do not have to take action on the problems related to their tenants. These management companies provide landlords with a careful screening process for their potential tenants, evictions, inspections, safety and property conditions of the property, lease addendums, terminating leases, handling security deposits, and rent collection. Investing in a property management company is much less costly as well as less time consuming than going through a lawsuit process (Muela, 2009).
- Shorter vacancy cycles - Property management companies enable landlords to decrease vacancy time of their properties by improving and preparing the properties for rent in order to maximize the revenue, determining the appropriate rent rate and effectively marketing the properties (Muela, 2009).
- Better tenant retention – management properties decrease tenant turnover rates, which cost landlords in terms of money and time. Tenant turnover process costs landlords cleaning the property, changing the lock, repairing, painting the walls as well as marketing and screening for a new tenant (Muela, 2009).
- Tighter rent collection process – It is important for landlords to collect their rent on time in order to balance and have a sustainable cash flow (Muela, 2009).

### *Business Challenges in Residential Rental Market*

**Profitability Linked To Economic Cycles-** Economic conditions in housing rental industry are one of the key factors that affect the market. In strong economies, consumer behaviors shift from renting to buying, and the opposite in weak economies. Therefore, when there is a growing demand for renting in downturn markets, rent prices go up (Hoovers, 2013).

**Rental Conversions-** In strong economies, it is difficult to convert real estate property to a cash asset, and it is even harder in weak economies. This situation sometimes leads landlords to rent out their properties instead of selling, especially single-family houses. According to Harvard's Joint Center for Housing Studies, single-family homes shifting to rentals doubled from the period 2005 and 2007 and 2007 and 2009 (Hoovers, 2013). However, entering the rental market as a new player raises another challenge for landlords who are competing with existing rental properties for tenants. Potential landlords need to consider this factor before they enter the market (Hoovers, 2013).

**Limited Market Flexibility**- Another challenge that landlords encounter in residential rental market is in a weak economy the landlords might be trapped with falling values of their properties. Inflexible market conditions might lead them to rent out their properties at a price which is less than the current market value (Hoovers, 2013).

**Indoor Air Quality Liability-** In recent years, indoor air quality (IAQ) in property units, especially mold growth, has become an important concern for property owners. Numerous insurance firms have abolished mold coverage from their policies creating a financial liability for landlords (Hoovers, 2013).

### *Emerging Trends in Housing Market*

"Traditionally, the single-family rental market receives its funding from retail or smaller institutional investors" (Hopkins, 2013). Due to the 2008 mortgage crisis, there has been increased inventory of distressed single-family homes accompanied by large drops in their prices. Therefore, it has been more profitable for real estate investors to buy up these properties and turn them into rentals. The shifting tendency of investing towards large-scale investments in single-family homes has become a new trend for the industry.

However, according to Zillows's most recent report, the rate of distressed homes "continued to decline in June with 4.96 out of every 10,000 homes in the country being liquidated through foreclosure" (Gudell, 2013). Due to the limited inventory, the foreclosure resale level remains low nationwide, "making up 9.53% of all sales in June, down 3.6 percentage points from the second quarter of 2012" (Gudell, 2013). Figure 2 and 3 present respectively the number and percentage of homes (out of 10,000) that were foreclosed, specifically Figure 2 addresses the percentage of foreclosure re-sales until June 2013.

Even though constraints started easing in 2013, normal for-sale inventory also shows a low level in most metro areas across the country when compared with the previous year. Limited inventory of foreclosed and normal for-sale homes contribute to support home value appreciation, and because of the increase in home values, investors are slowly exiting the market (Gudell, 2013).

When it comes to multifamily units, since the last quarter of 2009, apartment rentals have increased around 4.5%, and according to Trulia's report, in November, apartment rents have increased 5.5% since the previous November. For this reason, bank owned properties have become more attractive to investors so they can buy these properties at low prices and turn them into rentals (Hopkins, 2013). Figure 4 presents national multifamily rent level and vacancy rate: 2005 through 3rd quarter of 2013.

Another reason that more investors are jumping into the rental market is because of the all-in time low mortgage rates. According to the Associated Press, some homeowners have exploited these low mortgage rates and bought second homes, moved into the new property and then rented out the first property (Associated Press, 2013).

However, with the decline of available inventory, mortgage rates have started increasing "… as the economy recovers and homeownership becomes a realistic option for more consumers" (BD+C, 2013). The multifamily sector has become more questionable as to whether apartment constructions will stop due to the saturation of the market. However, the new rentals that are coming online mostly cater to ultra-high-end customer profile and do not affect the workforce housing where the demand is very intense. Therefore market experts are not expecting multifamily construction to be an issue in the near future (BD+C, 2013).

In 2013 the societal trend driving the housing rental market is that Echo Boomers (Gen Y), especially women, are postponing marriage and forming a household. They place a big importance in their education and career; therefore, this leads them to put having a family and homeownership aside. Birth "rate is at its lowest level in" the U.S. in all time. Approximately 41% of children are born out of marriage according to the Centers for Disease Control/Raymond James research. Consequently, majority of single mothers opt to rent a full amenity apartment in cities rather than buy a home in suburbs (Smith, 2013).

**In Some Markets, Rental Rates Have Seen Double-Digit Numbers So What is Driving Residential Rental Market?**

**Inventory of rental properties** – "According to Harvard University's Joint Center for Housing Studies, the number of available multifamily units declined by an average of 240,000 units" each year between 1999 and 2009 due to the insufficient number of multifamily units that were built in early 2000s and "existing stock aged out of use" (Aho, 2013).

**Foreclosures-** Approximately 3.9 million homeowners who bought a house in 2004 have gone through foreclosures and they have become renters, according to Harvard's center (Aho, 2013).

**Longer Lease Terms** – People have started renting houses for longer terms and wait for economic conditions to improve before they make a purchasing decision. Therefore, the number of renters is increasing (Aho, 2013).

**Unemployment and Stringent Lending Standards** – Due to the banks' tight underwriting standards for mortgages and high down payments, people cannot afford to buy homes even though they want to. Also, the high unemployment rate is another reason that prospective homebuyers are unable to purchase a home (Aho, 2013). High unemployment though does put downward pressure on rental prices.

According to the U.S. Census Bureau, homeownership rate in nationwide was 65.4% at the last quarter of 2012 which is 0.6% below the previous year. Rental vacancy rate nationwide was 8.7% at the fourth quarter of 2012 which was 0.7% below the previous year (Tampa Bay Business Journal, 2013). 56.6% of total residential inventory is comprised of owner-occupied housing properties, while 30% of residential units are renter-occupied at the end of 2012 (Mutikani & Ricci, 2013).

Freddie Mac reported that since 1997 more than one-third of U.S. households have started renting their homes. From 2004 to 2011, 5.4 million more renters have joined the renter population. "Today, 15 million households live in multifamily apartment properties (five or more units) and demand for rental housing is expected to rise for years to come, driven by a range of factors" (Brickman, 2013). Among them:
Demographic trends:

- Baby Boomers no longer desire to be responsible for their properties
- The younger generation does not want to own a house in the near future since they have recently come out of college with a big debt (college loans)
- Echo Boomers (Generation Y) prefer living in urban areas rather than suburbs
- Homeowners who have gone through foreclosure have become renters
- Newcomers to the United States tend to rent before they buy
- Household formation
- "A return to higher credit standards for residential mortgages" (Brickman, 2013), and
- "Attitude changes toward homeownership in light of the single-family housing crisis" (Brickman, 2013).

Figure 5 presents a correlation between rental prices share of core CPI and real rent index for the years 2000 through 2$^{nd}$ quarter of 2013.

Real estate specialists speculate that apartment rentals will experience pent-up demand for the next two decades due to the demand from more than 75 million "echo-boomers and baby- boomers downsizing to smaller units" (Crawford Park, 2013). Also, federal and state housing policies such as mortgage and safety regulations, fees, taxes and inflation rates increase the cost of housing. All these factors drive up the demand for apartment rentals for newcomers to the United States, Gen Y, and baby-boomers. This is especially true for echo-boomers who prefer living in urban areas because of quality of life factors such as availability of all amenities, transportation, schools and universities (Crawford Park, 2013).

In 2013 multifamily property investors place a vast importance in partnership approaches in order to perform in markets with high barriers to entry. Having partnerships enables investors to improve their buildings by renovating and having professional management. In addition, partnerships will enable these investors to maximize their revenue from these rental units (Crawford Park, 2013).

Home construction plays a very important role in the residential rental market due to the limited inventory in the market and a growing demand for rental properties. Therefore, many large and well-known homebuilder companies, such as Lennar Corp. and Toll Brothers Inc. have started entering the rental market, as most Americans prefer living in rented accommodation (Reuters, 2013).

Many households are reluctant to buy a home in such unstable housing markets. They observe that the majority of first-time buyers struggle to pay their mortgage loans and down payments due to the stringent credit policies (Reuters, 2013). These households see renting as a viable solution and wait for an improved housing market (Reuters, 2013). Figure 6 presents current and expected consumer confidence from January 2013 through September 2013.

Small business residential property investors are no longer the trend in the residential rental market. The trend has shifted to large-scale national investors as well as foreign investors who have recognized the growing demand in the U.S. market and started exploiting the low mortgage rates and bank owned foreclosure single-family houses. Foreign firms buy up these single-family houses and turn them into rentals (Whelan, 2013).

"Investors from countries whose currencies are strong can outbid U.S. investors because they also are hoping to make money from foreign-exchange rate fluctuations." For example, for Australians, buying single-family U.S. houses is "really cheap" due to the favourable exchange rates. (Whelan, 2013).

Echo-boomers[1]are the fastest-growing segment of today's workforce and they place significance in being able to be mobile and flexible. Therefore, they opt to live in rental apartments rather than owning a home. Another reason that leads them choosing rental units over homeownership in suburbs is that this generation is interested in environmental sustainability and does not want to deal with long commute every day between job and home (Clark, 2013).

[1]A member of Generation Y, born in the 1980s or 1990s.http://dictionary.reference.com/browse/echo+boomer

According to Zillow's forecast, real estate investors will start exiting the market due to the projected limited inventory, which will cause an increase in home values; regular buyers will then come back to this market. However, it seems that this will not be a long-term trend since mortgage rates will eventually increase relative to the U.S. economic recovery. Increases in home value appreciation however may lead homeowners to sell their properties, enabling the growth of the rental market through increased inventory (Gudell, 2013). Figure 7 presents home value increases and rent appreciation rate for the years 2011 through 2013.

### *Understanding the New Landlord Mind-set*

In order to have a competitive advantage as a differentiator (Porter, 1980), landlords not providing low-cost housing, property-owners need to improve their services. For example, in multifamily dwellings, it is important to provide laundry, mailbox, and concierge services. Also in urban areas echo boomers are looking for availability of amenities so location selection is very important for investors. Furthermore, collaborating with property management companies will improve the services to tenants.

**Services that Improve Landlords' Management and Operational System**

| | |
|---|---|
| Accounting/Bookkeeping software programs | Advertising/Marketing through flyers, real estate websites, and real estate publications |
| Asphalt/ Concrete Services | Associations |
| Attorneys/Legal Services | Bathroom/Kitchen Remodelling |
| Bathtub/Shower Repair | Carpentry/Repair/Carpet Cleaning |
| Chimney Services | Cleaning Services |
| Collection Agencies | Decks, Patios and Fences |
| Doors | Electrical contractors |
| Energy Conversions | Evictions |
| FinancialServices (Banking/Lending/Mortgage) | Fire/Water Damage Restoration |
| Fitness Equipment | Floor Care/Floor Covering |
| Gutter Services | Handyman |
| Hauling | Heating/Cooling |
| Insulation/Weatherization | Insurance |
| Landscaping | Laundry Services |
| Mail Boxes | Movers |
| Mold Detection | Paint/Painters |
| Parking Lot Services | Pest Control |
| Pet Services | Playground Equipment |
| Plumbing/Drain Cleaning | Property Management Software |
| Property Managers | Real Estate Sales |
| Rental/Lease Forms | Restoration/Reconstruction |
| Roofing | Seal Coating |
| Siding/Staffing | Swimming Pool Services |
| Tenant Screening | Utility Billing/Sub-Metering |
| Utility Vehicles | Waste Management |
| Waterproofing/Concrete Repair | Windows/Storm Windows |

### *Industry Attractiveness*

Porter (1980) developed a generally accepted schema for determining industry attractiveness based upon the forces that drive an industry. He identified five different forces that characterize various industry elements and then provided a way of viewing that industry to determine if it is, in fact, the optimal industry in which a firm can sustain a healthy growth pattern and achieve better than average profits. The stronger these competitive forces are within the industry, the greater the overall competitive nature of the industry will be and thus the lower the profitability of that industry. The five major forces that impact industry attractiveness include; 1) the bargaining power of suppliers; 2) the bargaining power of buyers; 3) the level and intensity of inter-competitive rivalry; 4) the existence of substitute produces or services; and 5) the threat of new entrants. (Sherman, Rowley and Armandi, 2006)

### Suppliers

The housing rental market is primarily supplied by construction firms in order to provide raw materials and is also supplied by property management companies, banks, and insurance companies in order to provide services or resources. After the 2008 real estate crisis, many construction workers left their jobs with "builders' ability to respond to the demand [is] being limited by a shortage of labour with basic construction skills and rising prices for some building materials" (Emrath, 2013). "Construction employment is 1 to 2 million jobs below trend levels, which is roughly 1 year of non-farm payroll growth at current levels" (Freddie Mac, 2013). However, as the market is bouncing back, construction workers slowly started coming back. This means that landlords and real estate investor companies will have more options to choose from amongst construction firms. This development provides the industry with an advantageous position over its suppliers since landlords or investors will be able to collaborate with a construction firm which suits their needs and pocketbooks. For instance, "contractors working on rental home renovations can easily source goods from local home improvement stores rather than working through a wholesaler to buy in bulk" (Mac Farland& Smith, 2013).

### Buyers

Recently, there has been a high demand for renting rather than buying in the housing market. Most prospective homebuyers prefer to rent due to their low credit scores and the banks' stringent credit standards, and high unemployment rates. These factors keep prospective homebuyers from taking advantage of low mortgage rates, which has recently started to climb. Also, large investors make big purchases and reduce the inventory of single homes or multifamily houses. This causes home prices go up at a level which individual investors such as "retirees or professionals who are seeking a side income" cannot afford (Mac Farland& Smith, 2013). Figure 9 and 10 present forecasted U.S. economic growth and housing market trends for 2014. Due to a high demand for rental homes and restricted inventory, landlords have more control over tenants in terms of rent rates. The government shutdown of 2013 and rising mortgage rates affected the economy, which was already sluggish, and lowered consumer confidence (Freddie Mac, 2013). This may lead potential buyers to rent rather than purchasing homes, and in this case, landlords are in even more advantageous position.

### Competitive Rivalry

The residential housing market is generally highly competitive and fragmented. "Despite the high costs associated with direct investments into residential rental property, barriers to entry within the industry are generally considered to be low. Smaller non-employer firms dominate the industry" (IBISWorld, 2013). However, over the past year, large institutional investors such as BlackStone Group and Colony Capital have started capturing larger market share and having significant influence on the market (Mac Farland& Smith, 2013). Recently, individual and institutional investors have been making bulk purchases of single homes from the inventory of short sales or foreclosures, and this has turned the market. Low prices of short sales, foreclosures and unsold houses as well as low interest rates attract investors to purchase properties since renting has become more lucrative for investors than selling. However, big purchases from the limited inventory by large investors have restricted the buying ability of small real estate companies and individual investors by "driv[ing] up prices and encourage[ing] new construction" (Mac Farland& Smith, 2013).

In order for real estate investors to gain a competitive advantage, they have to differentiate themselves. For example, "investors looking to attract wealthier renters by offering furnished homes may hire interior designers" (Mac Farland& Smith, 2013). It has been forecasted that large institutional investors who have been making bulk purchases of single-family homes, will steadily exit the market due to the limited inventory of foreclosed homes and increased home value appreciation. Therefore, mid-sized investors might have a better chance to gain competitive position or the large-sized investors might shift their tendency from single-family to multi-family house purchases since apartment constructions has added new inventories to the market. Real estate professionals expect "the U.S. economy to add less than 1 million housing units in 2013 and around 1.15 million in 2014, significantly below normal levels [and] … by the end of 2013, mortgage rates to be around the 4.3 percent level, and head higher in 2014" (Freddie Mac, 2013). Figure 8 presents fixed-rate mortgage (FRM) of 15-yr and 30-yr and adjustable rate mortgage (ARM) of 1-yr and 1-5-yr as of November 2013.

### Substitution

Home ownership is the major substitution for the residential rental market. In the next five years real estate professionals expect more people to be homeowners.

However, for the present, prospective homebuyers tend to rent rather than buy due to the high unemployment rates, low credit scores, and banks' tight credit standards. Demographic factors also have impacted the housing rental market. For instance, the millennial generation does not opt to purchase home because of a desire to be flexible to relocate when they need to. Moreover, the millennial generation chooses to live in urban areas, especially residential areas where the crime rates are low, rather than suburbs due to the easy access to amenities such as transportation, schools, parks and gyms. However in cities the prices of houses are beyond this generation's budget and this situation leads them to rent instead of buy. Furthermore, the baby boomer generation, which have already retired or will retire in near future, also are attracted to renting since they do not want to cope with property related issues such as home maintenance. According to CoreLogic's report, "the factors lifting home prices and sales correlate directly to rental demand, since investors are keen to acquire properties for rental purposes" (Panchuk, 2013).

An alternative substitute to renting is living with others; parents, children, friends or strangers. "Between 2005 and 2011, the proportion of young adults living in their parents' home increased, according to the U.S. Census Bureau. The percentage of men age 25 to 34 living in the home of their parents rose from 14 percent in 2005 to 19 percent in 2011 and from 8 percent to 10 percent over the period for women." (US Census Bureau, 2011) The same can be said for parents living with children, live-in relatives, and cohabitation with strangers. From 2002 to 2007 parents living with children rose 67.2% (2.2 to 2.6 million), other relatives rising 40% (4.8 to 6.8 million) and an 8% increase in non-relatives, including unmarried partners and roommates, to 6.2 million. (Toppo and DeBarros, 2008)

**New Market Entrants - Barriers**

In residential rental market, entry barriers differ based upon the size of institutional investors. In general, real estate "businesses are the most likely to operate without employees in the early stages, so they are able to avoid barriers to entry related to hiring, training, and creating a payroll system" (Gershon, 2013). However, some large private equity investors such as BlackStone Group and Colony Capital have started to make big purchases of single family or multifamily houses and rent them out. If a start up investor enters the market and tries to compete with the large-scale investors, the new entrant needs to consider these dominant real estate companies' current and potential customers and their customers' loyalty to them. Also, these large companies place a huge importance on employee skill and training as well as use of advanced real estate technologies in order to gain a distinct competitive position in the market. Furthermore, government regulations are not considered as high barriers for new market entrants. When it comes to expenses for new startup companies, real estate requires major investment in equipment. Therefore, high startup costs can be a burden for new entrants (Gershon, 2013).

**Results of Five Forces Analysis**

Unstable external environmental factors and industry forces will always affect the rental housing market in different ways. It is therefore interesting to see how the key industry factors change the dynamics of the market and lead to new trends, how they interact with each other, and what kind of business challenges arise from these changes and interactions.

As noted in Table 1 below, the industry has been classified as being between somewhat competitive to competitive with the trend moving towards slightly greater competition based upon the slowly increasing power of suppliers, the greater availability of credit for home purchases and more cohabitation.

**Table 1.Forces Driving the Rental Housing Industry in the US in 2013**

| Force (Power) | Summary Comments | Score |
|---|---|---|
| **Suppliers** | Slightly in favour of the industry coming off of a down market with excess supply. | **2** |
| **Buyers** | High demand yet decreasing with more affordable housing and increasing cohabitation. | **2** |
| **Rivalry** | Competitive yet decreasing with entrance of large investors who capitalize on synergy of size. | **4** |
| **Substitutes** | Home ownership down in the last few years yet increasing as credit markets stabilize | **3** |
| **Entrance Barriers**+ | Low barriers to small scale entry, higher for large scale entry | **4** |
| ***Average*** | | **3.4** |

*1-5 scale where 1 = low competition and 5 = high competition

+ Since entrance barriers decrease competition this scale is inverted.

This preliminary analysis is borne out by recent industry reports which project a rental market bubble based upon increased demand and rental prices in 2013 and beyond.

Vacancy rates for apartment rentals are expected to remain low enough next year to maintain a 'landlord's market' and increasing rents, according to a forecast released Monday by the National Association of Realtors, a trade association. Looking at multifamily housing, NAR expects a vacancy rate of 4% in the fourth quarter of this year to tick down to 3.9% in the fourth quarter of 2013. Rates less than 5% are considered a landlord's market, according to NAR. On average, apartment rent is expected to rise 4.6% in 2013 after a gain of 4.1% this year, according to NAR. (Mantell, 2012)

That trend troubles some experts who fear a bubble in the rental market could be forming. Rental income for investors is growing at an incredible speed, which has attracted even more interested parties looking to capitalize on the shifting dynamics of the housing market. That's spurred a great deal of new construction, with builders scrambling to satisfy the still growing demand for rental properties. (Handley, 2012)

Production of apartments and condominiums gained momentum in the second quarter of 2013, according to the latest Multifamily Production Index (MPI). The index increased nine points to 61, which is the highest reading since its inception in 2003. (National Association of Home Builders, 2013)

We might end up building a lot of product now for what they perceive as current demand or demand for the next couple of years, but if something goes the other way and we relax [home] lending standards, we could have a lot of [rental] vacancies again. (Handley, 2012)

The biggest unknown factor in this equation therefore is the actions of the Federal Reserve relative to the strength of the US economy and overnight/prime lending rates. "Federal Reserve Chairman Ben Bernanke said [Tuesday] that short-term interest rates may stay near zero 'well after' the jobless rate falls below 6.5%, the latest effort by the central bank to assure markets that rates will remain low even as it contemplates pulling back on its $85 billion-a-month bond-buying program. Since last year, the Fed has been saying that it won't raise rates until after the unemployment rate—which was 7.3% in October—falls to 6.5% or lower, as long as inflation remains below 2.5%." (McGrane, November 19, 2013)

## *A Cautionary Note*

Although our macro analysis indicates that rental markets are still favourable for landlords though projected to be less favourable in the future given the forces driving the industry, rental markets are highly regional and location specific and therefore national trends may not be very useful in determining actual pockets of growth opportunities. Viguerieet. al. (2008) argued that a more granular or micro view of markets are necessary in order for businesses to discern real growth opportunities. Investors must drill down to local markets and to individual properties to determine the type of rental (new versus existing; single or multiple dwelling) at a specific site that would yield profitable returns at or above national averages (a benchmark).

For example, Sherman and Rowley (2008) developed a teaching case around a small investor's decision to purchase of a two-family unit for rental purposes in the height of the local rental market in a fairly remote region of the U.S. (Helena, Montana estimated population in 2003 was 26,718; per capita income as of 1999 was slightly over $20,000). Although the purchase price was quite low (around $60,000) and would be paid for by cash and the properties when rented would yield a positive cash flow of about $3000 per year (5% of the purchase price), further investigation noted that the building was quite old (around 60 years old) and subject to frequent repairs (roof, boiler) given the harsh winters in the area. Although not directly mentioned in the case itself, one of these repairs could easily swallow the annual positive cash flow of the property and therefore the risk/reward ratio of this property might be deemed problematic for more risk adverse investors who could not profit from property value accrual. Secondly resale in this market rarely yielded a capital gain as indicated by very stable housing prices over the years.

## Conclusion

The US rental market having been energized by the residential real estate crash of 2008-2009 is now experiencing the potential beginnings of a downswing given the reduction in unemployment, increasing inventory, and more available credit for home purchases. The wild card in this market is the Federal Reserve – an agency that raised overnight lending rates 17 times from the average of 1.13% in 2002 to 5.02% in 2007 yet dropped them to 0.14% in 2012. (Board of Governors Federal Reserve, April 13, 2011)

Only time will tell if the Federal Reserve will actually abide by their 6.5% unemployment target for raising interest rates. If the agency keeps rates low then potential homeowners and landlords will have continued access to inexpensive capital. In theory this would lead to a reducing number of renters while increasing rental inventory - more supply and less demand negatively impacting the industry. However, a change in lending policy could be a boost to the rental industry and swing it in the other direction.

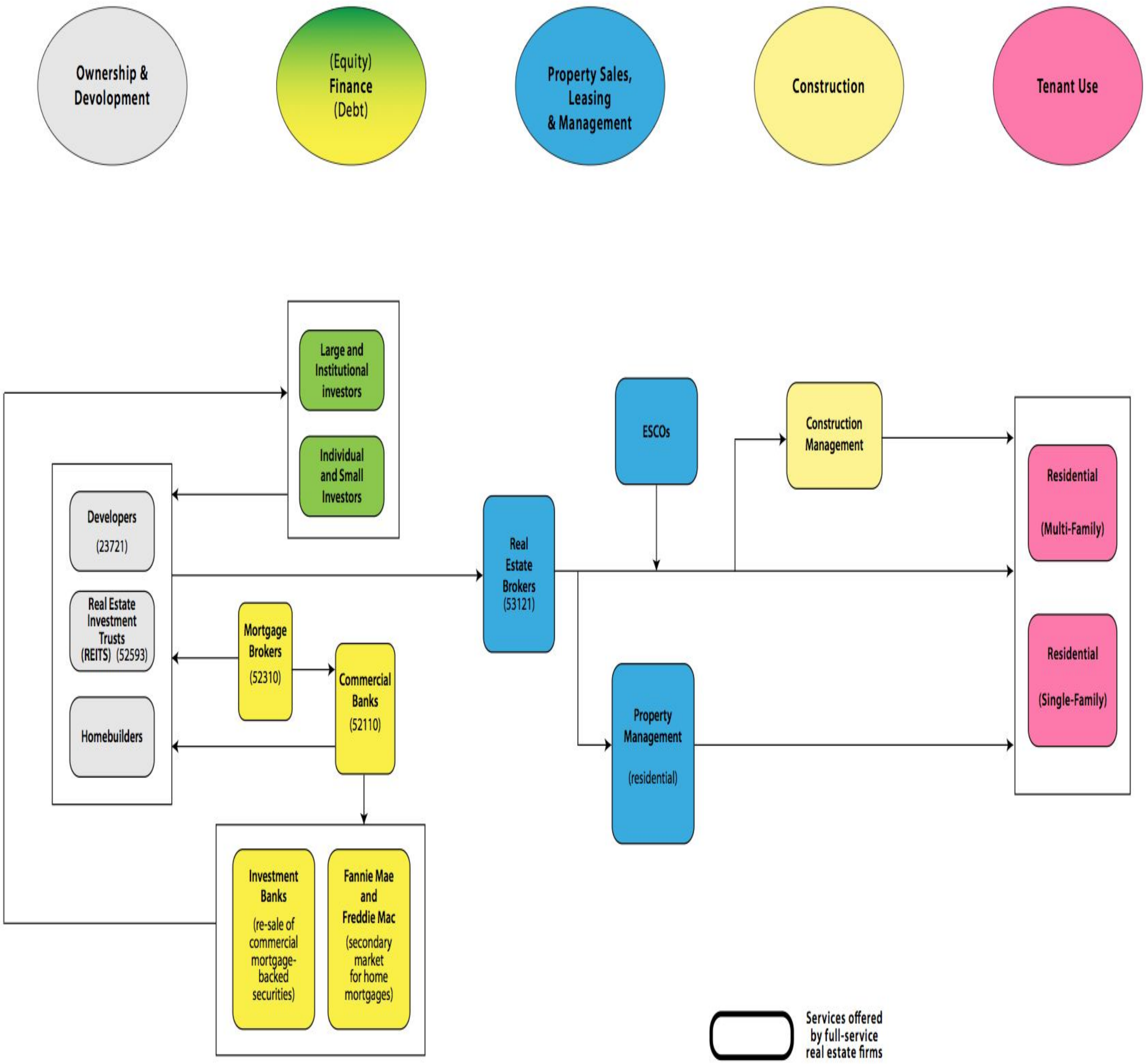


**Figure 1. U.S. Residential Rental Industry Value Chain**

5-digit numbers in parenthesis refer to North American Industry Classification System (NAICS) codes. Adapted from "An Analysis of the U.S. Real Estate Value Chain with Environmental Metrics" by M. Lowe & G. Gereffi, 2008, Retrieved December 31, 2012, from http://www.cggc.duke.edu/environment/valuechainanalysis/ CGGC _RealEstateReport_4-22-08.pdf.

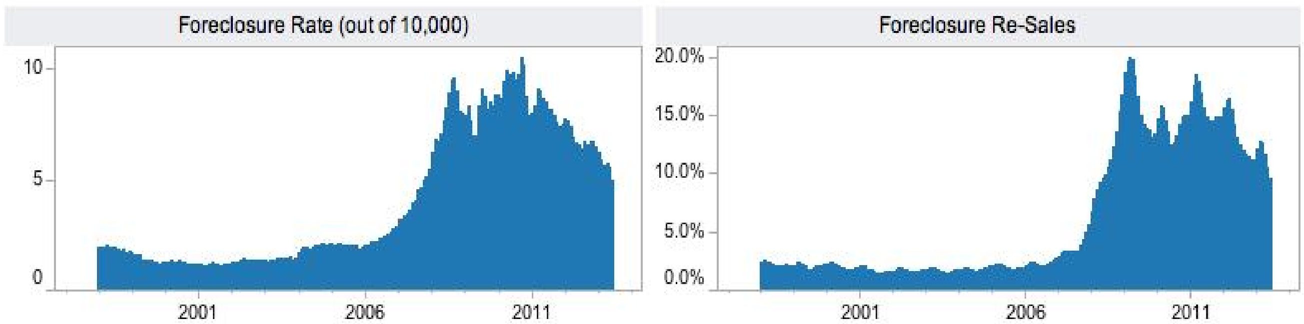


**Figure 2 . U.S. Foreclose Rate & Foreclosure Re-Sales**

Adapted from "Real Estate Research" by Zillow, 2013,Retrieved August 13, 2013, from http://www.zillowblog.com/research/2013/07/22/2013-spring-selling-season-was-hottest-since-2004-as-recovery-accelerates-widens/

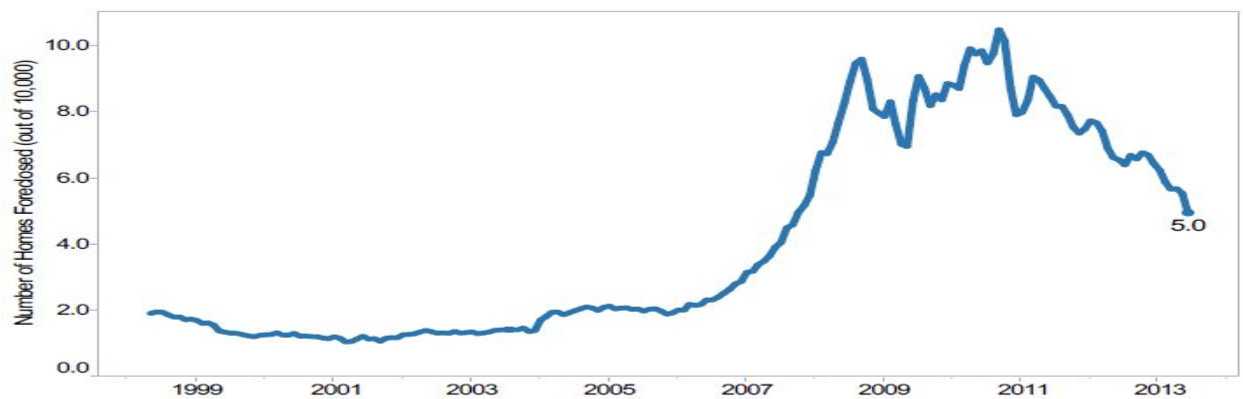


**Figure 3. U.S. Homes Foreclosed**

Adapted from "Real Estate Research" by Zillow, 2013, Retrieved August 13, 2013, from http://www.zillowblog.com/research/2013/07/22/2013-spring-selling-season-was-hottest-since-2004-as-recovery-accelerates-widens/

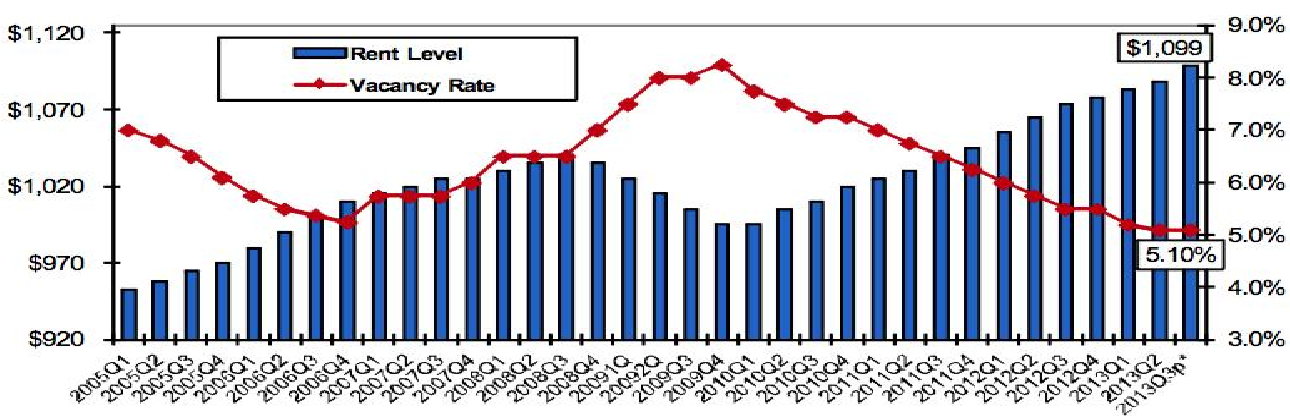


**Figure 4. Estimated National Multifamily Rent Level and Vacancy Rate**

Adapted from "Economic and Strategic Research" by Fannie Mae, 2013, Retrieved November 1, 2013, from http://www.fanniemae.com/resources/file/research/emma/pdf/MF_Market_Commentary_101713.pdf

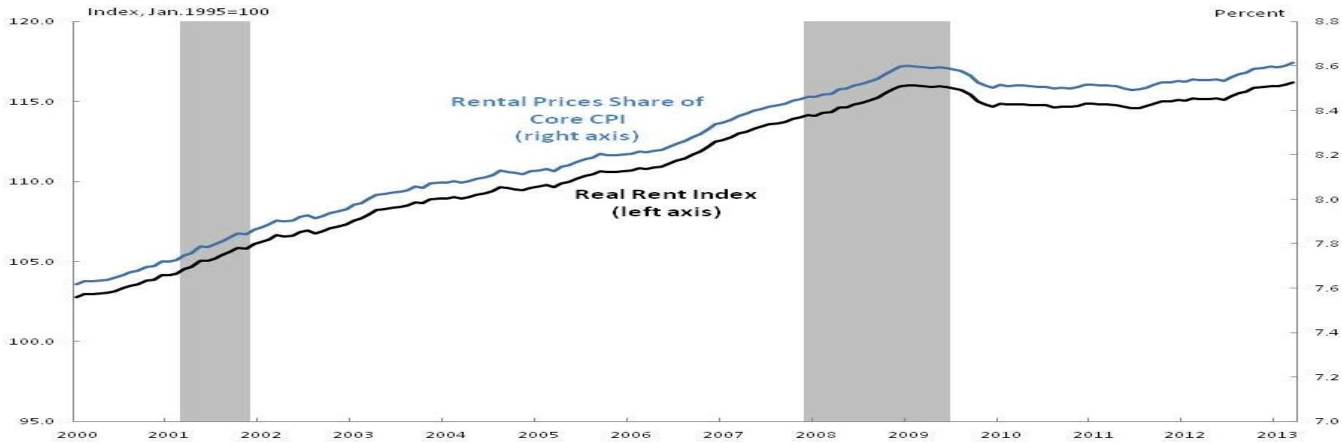


**Figure 5. Two Interpretations of Rental Prices Scaled by Overall Inflation**

Adapted from "National Bureau of Economic Research" by Bureau of Labor Statistics, 2013, Retrieved May 20, 2013, from http://eyeonhousing.wordpress.com/

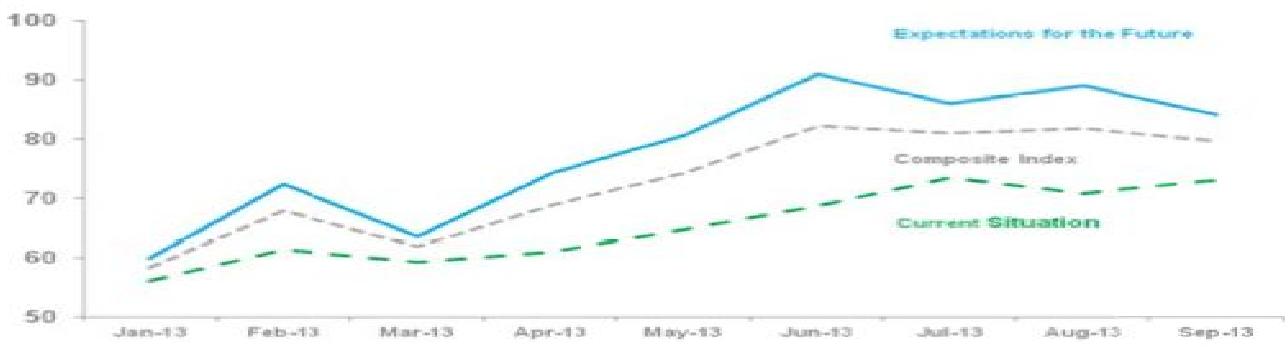


**Figure 6. Consumer Confidence Index**

Adapted from "October 2013 U.S. Economic and Housing Market Outlook" by Freddie Mac, 2013, Retrieved November 1, 2013, from http://www.freddiemac.com/news/finance/docs/Oct_2013_public_outlook.pdf

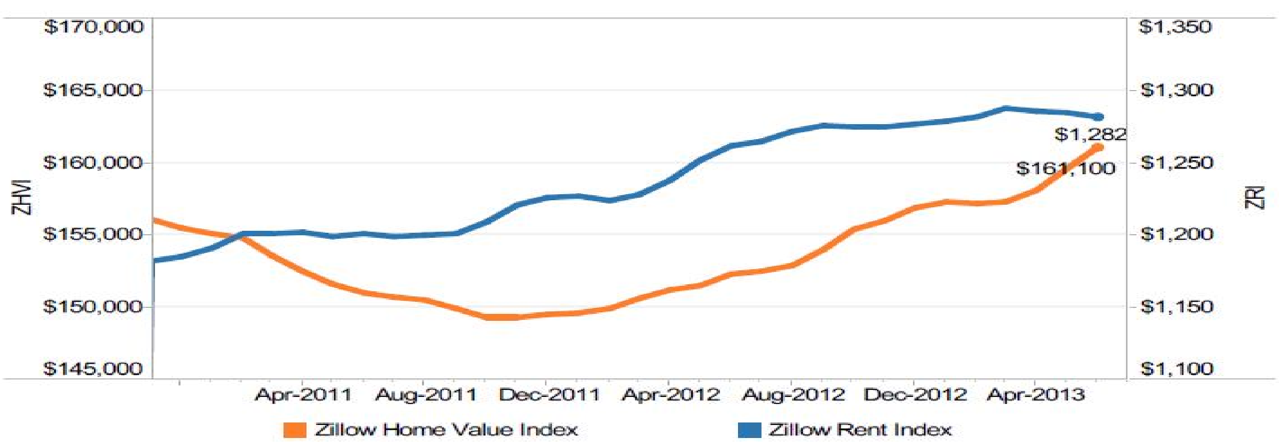


**Figure 7. U.S. Zillow Home Value Index & U.S. Zillow Rent Index**

Adapted from "Real Estate Research" by Zillow, 2013, Retrieved August 13, 2013, from http://www.zillowblog.com/research/2013/07/22/2013-spring-selling-season-was-hottest-since-2004-as-recovery-accelerates-widens/

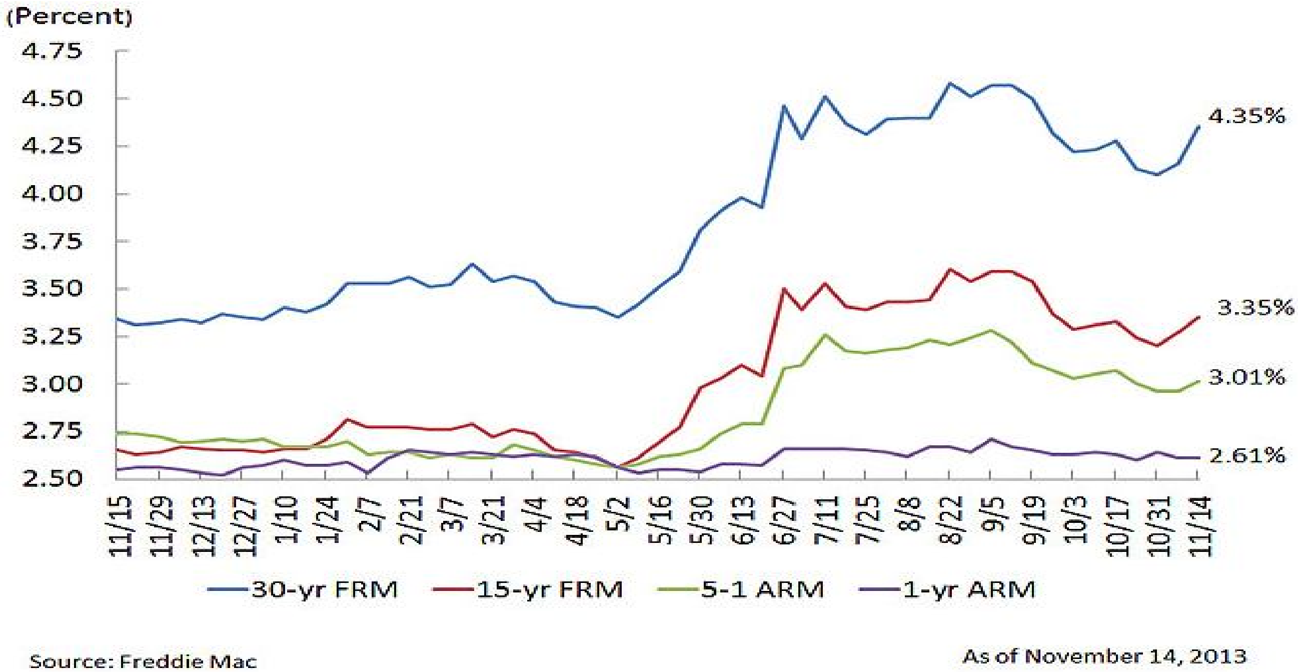


***Figure 8.*****Primary Mortgage Market Survey (U.S. Weekly Averages)**

Adapted from "Economic and Housing Research" by Freddie Mac, 2013, Retrieved November 20, 2013, from http://www.freddiemac.com/news/finance/index.html

| | ------------- 2012 ------------- | | | | ------------- 2013 ------------- | | | | ------------- 2014 ------------- | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 12.1 | 12.2 | 12.3 | 12.4 | 13.1 | 13.2 | 13.3 | 13.4 | 14.1 | 14.2 | 14.3 | 14.4 | 2012 | 2013 | 2014 |
| **Housing Starts and Sales (SAAR, Thous. Units)** | | | | | | | | | | | | | | | |
| Housing Starts | 714 | 741 | 781 | 896 | 957 | 869 | 910 | 975 | 1,085 | 1,165 | 1,250 | 1,328 | 781 | 928 | 1,207 |
| Single-Family (1 Unit) | 486 | 517 | 547 | 597 | 630 | 598 | 620 | 655 | 760 | 840 | 920 | 985 | 535 | 626 | 876 |
| *Percent Change: Year-over-Year* | | | | | | | | | | | | | 24.3% | 16.9% | 40.0% |
| Multifamily (2+ Units) | 228 | 224 | 235 | 299 | 328 | 270 | 290 | 320 | 325 | 325 | 330 | 343 | 245 | 302 | 331 |
| New Single-Family Home Sales | 351 | 360 | 376 | 386 | 449 | 443 | 413 | 435 | 506 | 562 | 619 | 664 | 368 | 435 | 588 |
| *Percent Change: Year-over-Year* | | | | | | | | | | | | | 20.3% | 18.2% | 35.2% |
| Total Existing Home Sales (Single-Family, Condos and Co-Ops) | 4,497 | 4,510 | 4,740 | 4,897 | 4,943 | 5,063 | 5,397 | 5,114 | 5,191 | 5,226 | 5,268 | 5,356 | 4,660 | 5,130 | 5,260 |
| *Percent Change: Year-over-Year* | | | | | | | | | | | | | 9.4% | 10.1% | 2.5% |
| Total Home Sales (New + Existing) | 4,848 | 4,870 | 5,116 | 5,283 | 5,392 | 5,506 | 5,810 | 5,549 | 5,697 | 5,788 | 5,887 | 6,020 | 5,028 | 5,564 | 5,848 |
| *Percent Change: Year-over-Year* | | | | | | | | | | | | | 10.1% | 10.7% | 5.1% |
| **Home Prices (NSA, Thous. $)** | | | | | | | | | | | | | | | |
| Median New | 234 | 236 | 248 | 250 | 258 | 267 | 263 | 275 | 283 | 286 | 280 | 292 | 245 | 266 | 285 |
| Median Total Existing | 158 | 181 | 184 | 179 | 176 | 203 | 208 | 197 | 193 | 218 | 221 | 209 | 177 | 196 | 210 |
| FHFA Purchase-Only Index (Percent Change: Quarterly YoY, Annual Q4/Q4) | 0.6% | 3.5% | 4.1% | 5.5% | 7.0% | 7.3% | 7.6% | 8.3% | 7.8% | 6.1% | 6.1% | 5.9% | 5.5% | 8.3% | 5.9% |
| **Mortgage Rates (Percent)** | | | | | | | | | | | | | | | |
| 30-Year Fixed Rate Mortgage | 3.9 | 3.8 | 3.5 | 3.4 | 3.5 | 3.7 | 4.4 | 4.4 | 4.6 | 4.7 | 4.9 | 5.0 | 3.7 | 4.0 | 4.8 |
| 5-Year Adjustable Rate Mortgage | 2.8 | 2.8 | 2.8 | 2.7 | 2.6 | 2.7 | 3.2 | 3.2 | 3.4 | 3.6 | 3.8 | 4.0 | 2.8 | 2.9 | 3.7 |
| 1-Year Adjustable Rate Mortgage | 2.8 | 2.8 | 2.7 | 2.6 | 2.6 | 2.6 | 2.7 | 2.7 | 2.8 | 3.0 | 3.2 | 3.3 | 2.7 | 2.6 | 3.1 |
| **Single-Family Mortgage Originations (NSA, Bil. $, 1-4 Units)** | | | | | | | | | | | | | | | |
| Mortgage Originations | 434 | 543 | 596 | 581 | 430 | 554 | 457 | 387 | 308 | 370 | 358 | 322 | 2,153 | 1,827 | 1,358 |
| Purchase | 111 | 176 | 171 | 156 | 121 | 196 | 208 | 171 | 149 | 229 | 227 | 204 | 613 | 695 | 808 |
| Refinance | 323 | 367 | 425 | 425 | 309 | 359 | 249 | 215 | 159 | 141 | 131 | 118 | 1,540 | 1,132 | 550 |
| Refinance Share (%) | 74% | 68% | 71% | 73% | 72% | 65% | 55% | 56% | 52% | 38% | 37% | 37% | 72% | 62% | 40% |
| Liquidations | 500 | 583 | 665 | 574 | 461 | 580 | 497 | 368 | 289 | 315 | 295 | 264 | 2,323 | 1,906 | 1,162 |
| **Mortgage Debt Outstanding (NSA, Bil. $)** | | | | | | | | | | | | | | | |
| MDO Single-Family First Lien (1-4 Units) | 9,263 | 9,222 | 9,153 | 9,160 | 9,128 | 9,103 | 9,062 | 9,081 | 9,101 | 9,156 | 9,219 | 9,277 | 9,160 | 9,081 | 9,277 |
| *Percent Change: Quarterly Annualized Rate, Annual Q4/Q4* | -2.8% | -1.7% | -3.0% | 0.3% | -1.4% | -1.1% | -1.8% | 0.9% | 0.8% | 2.4% | 2.8% | 2.5% | -1.8% | -0.9% | 2.2% |
| MDO Total Single-Family (1-4 Units) | 10,094 | 10,035 | 9,943 | 9,929 | 9,876 | 9,833 | 9,784 | 9,799 | 9,815 | 9,869 | 9,932 | 9,989 | 9,929 | 9,799 | 9,989 |
| *Percent Change: Quarterly Annualized Rate, Annual Q4/Q4* | -3.4% | -2.3% | -3.6% | -0.6% | -2.1% | -1.7% | -2.0% | 0.6% | 0.6% | 2.2% | 2.6% | 2.3% | -2.5% | -1.3% | 1.9% |
| Adjustable Rate Mortgage Share of Conventional Mortgage Applications (%) | 6% | 6% | 5% | 4% | 5% | 6% | 7% | 8% | 9% | 10% | 11% | 11% | 5% | 7% | 10% |

October 10, 2013

Note: Interest rate forecasts are based on rates from September 30, 2013.

Note: All mortgage originations data are Fannie Mae estimates as there is no universal source for market-wide originations data.
2012 mortgage originations were revised as part of an annual benchmark to the Home Mortgage Disclosure Act (HMDA)

Note: Unshaded areas denote actuals. Shaded areas denote forecasts.

Sources: Actuals: Census Bureau, National Association of REALTORS®, Federal Housing Finance Agency, Freddie Mac, Federal Reserve Board. Forecasts: Fannie Mae Economic & Strategic Research

*Opinions, analyses, estimates, forecasts, and other views of Fannie Mae's Economic & Strategic Research (ESR) group included in these materials should not be construed as indicating Fannie Mae's business prospects or expected results, are based on a number of assumptions, and are subject to change without notice. How this information affects Fannie Mae will depend on many factors. Although the ESR group bases its opinions, analyses, estimates, forecasts, and other views on information it considers reliable, it does not guarantee that the information provided in these materials is accurate, current or suitable for any particular purpose. Changes in the assumptions or the information underlying these views could produce materially different results. The analyses, opinions, estimates, forecasts, and other views published by the ESR group represent the views of that group as of the date indicated and do not necessarily represent the views of Fannie Mae or its management.*

**Figure 9. Housing Forecast: October 2013**

Adapted from "Economic and StrategicResearch" by Fannie Mae, 2013, Retrieved November 1, 2013, from http://www.fanniemae.com/resources/file/research/emma/pdf/Housing_Forecast_101713.pdf

Revised 10/17/2013

| Indicator | 2012 Q3 | 2012 Q4 | 2013 Q1 | 2013 Q2 | 2013 Q3 | 2013 Q4 | 2014 Q1 | 2014 Q2 | 2014 Q3 | 2014 Q4 | Annual Totals 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP (%) | 2.8 | 0.1 | 1.1 | 2.5 | 2.0 | 2.1 | 2.8 | 3.0 | 3.0 | 3.2 | -0.2 | 2.8 | 2.0 | 2.0 | 1.9 | 3.0 |
| Consumer Prices (%) a. | 2.1 | 2.2 | 1.4 | 0.0 | 2.5 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 1.5 | 1.4 | 3.0 | 1.8 | 1.5 | 2.0 |
| Unemployment Rate (%) b. | 8.0 | 7.8 | 7.7 | 7.6 | 7.4 | 7.3 | 7.2 | 7.1 | 6.9 | 6.8 | 9.3 | 9.6 | 8.9 | 8.1 | 7.5 | 7.0 |
| 30-Year Fixed Mtg. Rate (%) b. | 3.6 | 3.4 | 3.5 | 3.7 | 4.4 | 4.3 | 4.4 | 4.7 | 4.9 | 5.1 | 5.0 | 4.7 | 4.5 | 3.7 | 4.0 | 4.8 |
| 1-Year Treas. Indexed ARM Rate (%) b. | 2.7 | 2.6 | 2.6 | 2.6 | 2.7 | 2.7 | 2.7 | 2.8 | 2.8 | 2.9 | 4.7 | 3.8 | 3.0 | 2.7 | 2.7 | 2.8 |
| 10-Year Const. Mat. Treas. Rate (%) b. | 1.6 | 1.7 | 2.0 | 2.0 | 2.7 | 2.6 | 2.8 | 3.0 | 3.3 | 3.5 | 3.3 | 3.2 | 2.8 | 1.8 | 2.3 | 3.2 |
| 1-Year Const. Mat. Treas. Rate (%) b. | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 | 0.2 | 0.3 | 0.5 | 0.3 | 0.2 | 0.2 | 0.1 | 0.2 |

| Indicator | 2012 Q3 | 2012 Q4 | 2013 Q1 | 2013 Q2 | 2013 Q3 | 2013 Q4 | 2014 Q1 | 2014 Q2 | 2014 Q3 | 2014 Q4 | Annual Totals 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Housing Starts c. | 0.78 | 0.90 | 0.96 | 0.87 | 0.90 | 0.95 | 1.05 | 1.10 | 1.20 | 1.25 | 0.55 | 0.59 | 0.61 | 0.78 | 0.92 | 1.15 |
| Total Home Sales d. | 5.12 | 5.28 | 5.39 | 5.50 | 5.80 | 5.65 | 5.70 | 5.80 | 5.90 | 6.00 | 4.72 | 4.51 | 4.57 | 5.03 | 5.59 | 5.85 |
| FMHPI House Price Appreciation (%) e. | 1.1 | 0.1 | 2.7 | 5.2 | 0.9 | 0.0 | 1.0 | 2.5 | 2.0 | 0.4 | -2.3 | -5.0 | -3.3 | 5.9 | 9.0 | 6.0 |
| S&P/Case-Shiller® Home Price Index (%) f. | 2.1 | -0.4 | 1.1 | 7.1 | 1.5 | 0.0 | 1.1 | 3.1 | 1.5 | 0.2 | -2.5 | -3.8 | -3.7 | 7.2 | 9.9 | 6.0 |
| 1-4 Family Mortgage Originations g. | | | | | | | | | | | | | | | | |
| Conventional | $471 | $495 | $440 | $461 | $315 | $275 | $306 | $362 | $258 | $194 | $1,549 | $1,300 | $1,206 | $1,750 | $1,491 | $1,120 |
| FHA & VA | $97 | $105 | $100 | $99 | $85 | $75 | $77 | $91 | $64 | $48 | $451 | $377 | $294 | $380 | $359 | $280 |
| Total | $568 | $600 | $540 | $560 | $400 | $350 | $383 | $453 | $322 | $242 | $2,000 | $1,677 | $1,500 | $2,130 | $1,850 | $1,400 |
| ARM Share (%) h. | 8 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 3 | 5 | 11 | 10 | 10 | 14 |
| Refinancing Share - Applications (%) i. | 82 | 83 | 79 | 73 | 64 | 45 | 45 | 40 | 40 | 35 | 70 | 76 | 75 | 81 | 68 | 41 |
| Refinancing Share - Originations (%) j. | 69 | 73 | 75 | 70 | 55 | 40 | 45 | 40 | 40 | 35 | 68 | 67 | 64 | 70 | 63 | 41 |
| Residential Mortgage Debt (%) k. | -3.0 | -0.1 | -1.8 | -1.2 | 1.5 | 0.5 | 1.0 | 2.0 | 3.0 | 4.0 | -1.6 | -4.2 | -2.2 | -2.1 | -0.3 | 2.5 |

Note: Quarterly and annual forecasts (or estimates) are shown in shaded areas; totals may not add due to rounding; quarterly data expressed as annual rates.
Annual forecast data are averages of quarterly values; annual historical data are reported as Q4 over Q4.

a. Calculations based on quarterly average of monthly index levels; index levels based on the seasonally-adjusted, all-urban consumer price index.
b. Quarterly average of monthly unemployment rates (seasonally-adjusted); Quarterly average of monthly interest rates.
c. Millions of housing units; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
d. Millions of housing units; total sales are the sum of new and existing single-family homes;quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
e. Quarterly growth rate of Freddie Mac's House Price Index (FMHPI); not seasonally-adjusted; Dec.to-Dec. for yearly data.
f. National composite index (quarterly growth rate); not seasonally-adjusted; Q4-to-Q4 for yearly data.
g. Billions of dollars (not seasonally-adjusted).
h. Federal Housing Finance Agency (FHFA); quarterly averages of monthly shares of number of loans of conventional, home-purchase mortgage closings (not seasonally-adjusted).
i. Primary Mortgage Market Survey®; quarterly averages of monthly shares of all single-family mortgage applications (not seasonally-adjusted).
j. Home Mortgage Disclosure Act for all single-family mortgages (not seasonally-adjusted); Annual share is dollar-weighted average of quarterly shares.
k. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages(not seasonally-adjusted, annual rate).

Prepared by Office of the Chief Economist and reflects views as of 10/17/2013 (MAS); Send comments and questions to chief_economist@freddiemac.com.

*Opinions, estimates, forecasts and other views contained in this document are those of Freddie Mac's Office of the Chief Economist, do not necessarily represent the views of Freddie Mac or its management, should not be construed as indicating Freddie Mac's business prospects or expected results, and are subject to change without notice. Although the Office of the Chief Economist attempts to provide reliable, useful information, it does not guarantee that the information is accurate, current or suitable for any particular purpose. The information is therefore provided on an "as is" basis, with no warranties of any kind whatsoever.*



**Figure 10. October 2013 Economic and Housing Market Outlook**

Adapted from "October 2013 U.S. Economic & Housing Market Outlook" by Freddie Mac, 2013, Retrieved November 1, 2013, http://www.freddiemac.com/news/finance/docs/Oct_2013_public_outlook.pdf

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