The Interplay Between Market-Rate and Affordable Housing Rents

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The growing number of households that are rent-burdened has put a spotlight on housing costs and led policymakers to implement programs intended to produce more affordable housing. The federal tax bill signed into law this spring, for example, permanently increases funding for the Low Income Housing Tax Credit (LIHTC) program by 12%, which will provide $14 billion of tax credits annually to be allocated among the states annually. The Opportunity Zone program, which provides tax incentives to build housing in low-income areas, also was extended and revamped.

Because the need for housing that is affordable to low- and middle-income families is so great, it is important that the allocated funds be spent wisely. One way to increase efficiency is to use data to ensure that projects are delivered to locations with both strong demand and less robust competition from market-rate properties.

While that sounds simple, the competitiveness between market-rate and fully- affordable housing (defined by Yardi Matrix as properties where at least 90% of units have income restrictions tied to subsidies) vary across cities and even within individual metros. Based on a review of Yardi Matrix's national database that encompasses 120,000 multifamily properties (26,000 fully affordable) with 23 million units (3.5 million fully affordable), a comparison of rents at -market-rate to fully-affordable housing helps us to draw a few main conclusions:

- In some metros, a large percentage of market-rate property advertised rents are competitive with fully affordable housing property rents, while in others there is very little competition between the two.
- Within each metro, the level of competitiveness varies by submarket, depending on factors such as the cost of market-rate rents, the amount of supply, the age of the multifamily stock, and the income of residents within each immediate area.
- The level of competitiveness is a key component in affordable housing performance. The occupancy rates of fully affordable properties are generally higher in metros in which market-rate rents are less competitive with affordable rents.

Why Is This Analysis Relevant?

Market-rate properties that are competitive with affordable properties serve overlapping income groups and may compete for the same tenants. We define competitiveness using an affordability index developed by Matrix, which is based on the federal calculation of Area Median Income (AMI). We determine the AMI level at which rents are considered "affordable" based on the government's standard that housing costs should not exceed 30% of gross household income. When rents at market-rate and fully affordable properties are "affordable" to households earning similar incomes (<10% difference in AMI), we deem that to be competitive. The full methodology is in the appendix at the end of the report.

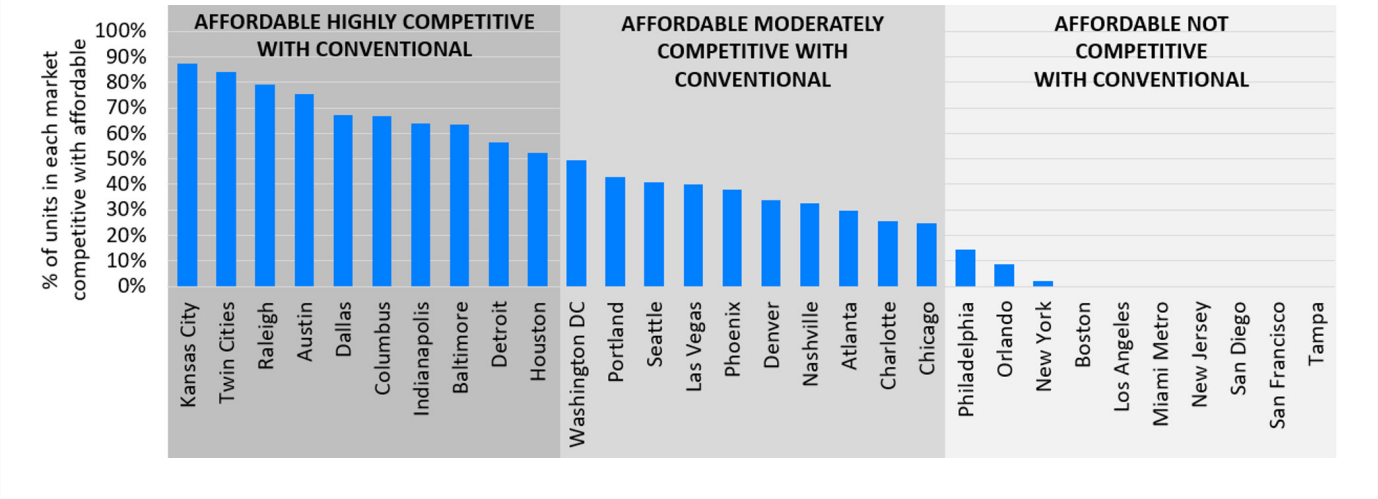
Why Competitiveness Varies by Metro

The Matrix methodology for assessing competitiveness between market-rate and affordable properties finds a wide range of outcomes at the metro level. Among the top-30 U.S. metros:

The Interplay Between Market-Rate and Affordable Housing Rents (cont.)

- One-third are highly competitive, with at least 50% of conventional units competing with fully affordable housing.
- Another third is moderately competitive, with 25% to 50% of market-rate units in competition, and
- The remaining third has less than 25% in competition (including seven metros with zero competitiveness). While each metro has its own unique drivers, there are a few factors that correlate to the competitiveness between market-rate and affordable multifamily.

FIGURE 1
Percentage of Market-Rate Stock in Competition with Fully Affordable Developments based on AMI%



Source: Yardi Matrix

Market-Rate Vs. Affordable

One key factor influencing competitiveness is the absolute level of market rents. In metros where average advertised rents exceed $2,500 (New York City, San Francisco, Los Angeles, Miami, San Diego, Boston, and New Jersey) market-rate properties rarely compete with affordable housing. In contrast, metros with average rents below $1,500 (Las Vegas, Columbus, Houston, Detroit, Kansas City, and Indianapolis) tend to show moderate to high levels of competitiveness.

Nationally, the average market-rate rent is $1,754, which is 31.2% higher than the $1,337 average maximum allowable rent of fully affordable properties. However, the difference varies greatly by market. Miami's average $2,586 market-rate rents are 82.1% higher than the $1,420 fully affordable average, and Los Angeles's $2,653 market-rate average is 70.5% higher than the $1,556 affordable average.

On the other end of the spectrum, in some metros the difference in rents between market-rate and affordable units is minimal. For example, the average market-rate rent in Austin is $1,553, or 4.8% less than the average $1,631 average maximum allowable rent at affordable units. In the Twin Cities, the average $1,590 market-rate rent is only 3.3% higher than the $1,539 average affordable rent, while in Indianapolis, the $1,302 market-rate average is only 5.5% higher than the $1,234 affordable average.

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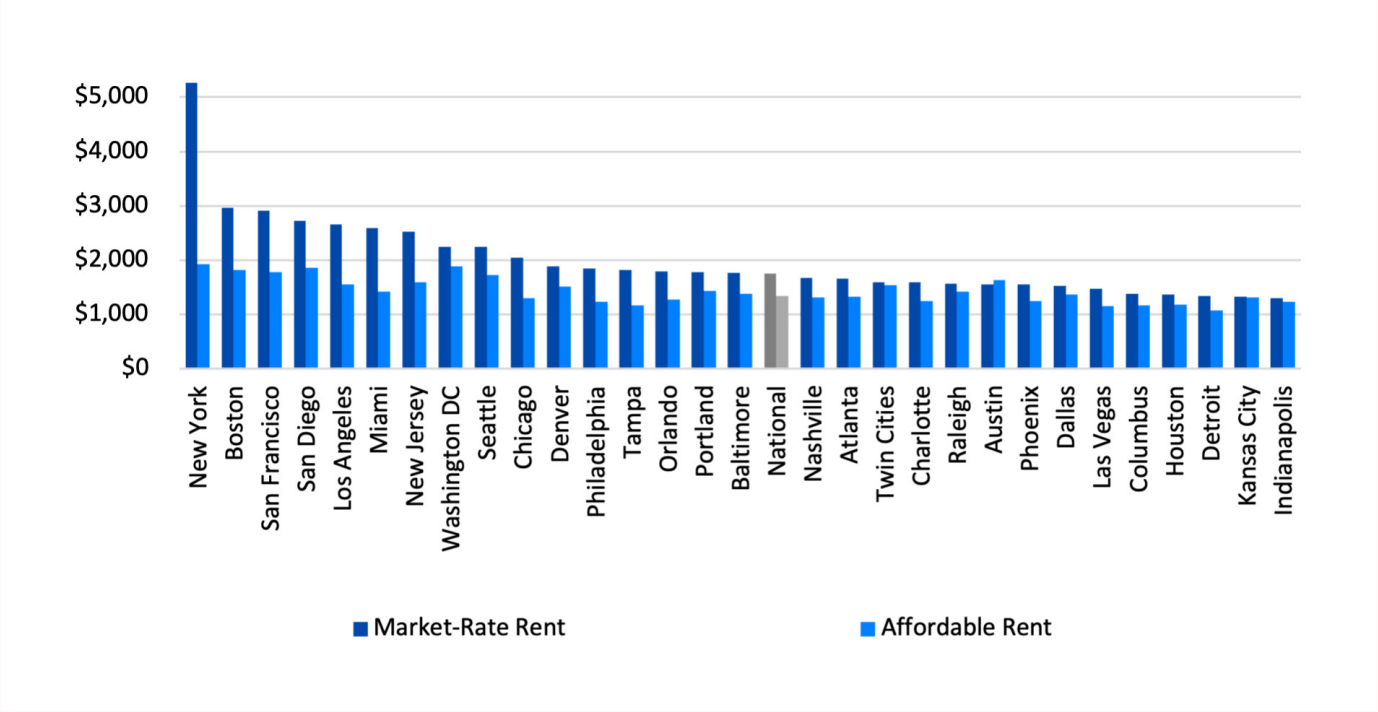
FIGURE 2
Market-Rate vs Fully Affordable Rents



Analyzing Supply Growth

Another correlation is the amount of supply growth. Markets such as Austin and Dallas, which are among the leaders in annual apartment deliveries, have fostered a competitive environment for owners. Austin has added roughly 25% to multifamily stock over the last three years, leading the average market-rate advertised rent to drop by 13%. Consequently, in Austin, multifamily properties in all but the highest end of the luxury scale are competitive in price to fully affordable properties.

On the other end of the spectrum, in markets such as New York City, Los Angeles, San Diego and Philadelphia, which trail the national average in deliveries as a percentage of stock, most market-rate apartments are not competitive with fully affordable properties. To be sure, some of the factors overlap, as the lack of supply growth contributes to the overall expense of market-rate rents.

A third correlating factor is the age of multifamily stock within a metro. Our competitiveness methodology groups market-rate properties in each metro into four quality categories (from high to low):

- Discretionary,
- Upper mid-range,
- Low mid-range and
- Workforce.

New construction is concentrated in higher-end luxury segments, so metros with a larger percentage of apartment stock built over the last 10-20 years usually have a higher proportion of luxury market-rate apartments that are not competitive with affordable units. An example includes Miami, where 59% of market-rate stock is in the two highest quality categories (discretionary and upper mid-range).

The Interplay Between Market-Rate and Affordable Housing Rents (cont.)

Conversely, some metros have a large percentage of market-rate apartment stock that was built decades ago and now are classified in the lower-quality scale categories. These units tend to be more competitive with affordable units due to lower rents that come from age, property quality, and (sometimes) deteriorating neighborhoods. One market example of this phenomenon is Detroit, where half of the total market-rate stock is classified by Matrix as workforce, the lowest quality level. Those workforce units in Detroit are deemed competitive with fully affordable housing. Another example is Baltimore, where 56% of total market-rate stock is in the two lowest quality levels -- low mid-range and workforce. Those properties are deemed competitive with affordable units.

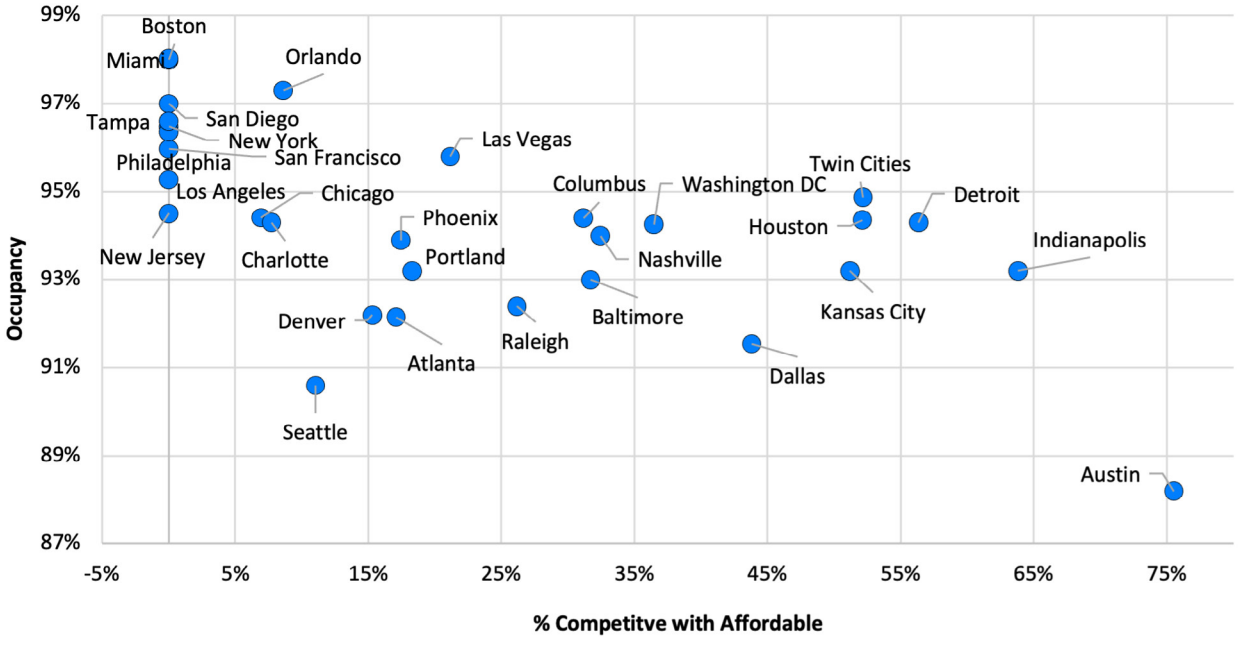
Competitiveness is important because it correlates to demand for affordable housing. A rule of thumb is that renters are more likely to choose to live in a market-rate property if rents are within 10% of affordable housing rents. That is critical at a time when a growing number of renter households across the country pay more than 30% of their income on rents, fueling demand for lower-cost units and lower-cost markets.

Matrix Expert occupancy rate data confirm the link between competitiveness and performance. Metros in the Matrix top-30 with high advertised rents and low competitiveness scores recorded occupancy rates of 95.0% or more in fully affordable properties. The average occupancy rate was 97.0% or higher in fully affordable units in less competitive markets such as Miami, Boston, Orlando, and San Diego.

The converse is true as well. The fully-affordable occupancy rate is only 88% in Austin, where three quarters of market-rate properties are competitive with fully-affordable units due to the rapid supply growth in both segments. Metros with high competitiveness scores and rents below the national average generally record fully affordable occupancy rates between 93% and 94%.

FIGURE 3

% of Conventional Stock in Competition with Affordable based on Rent Premiums



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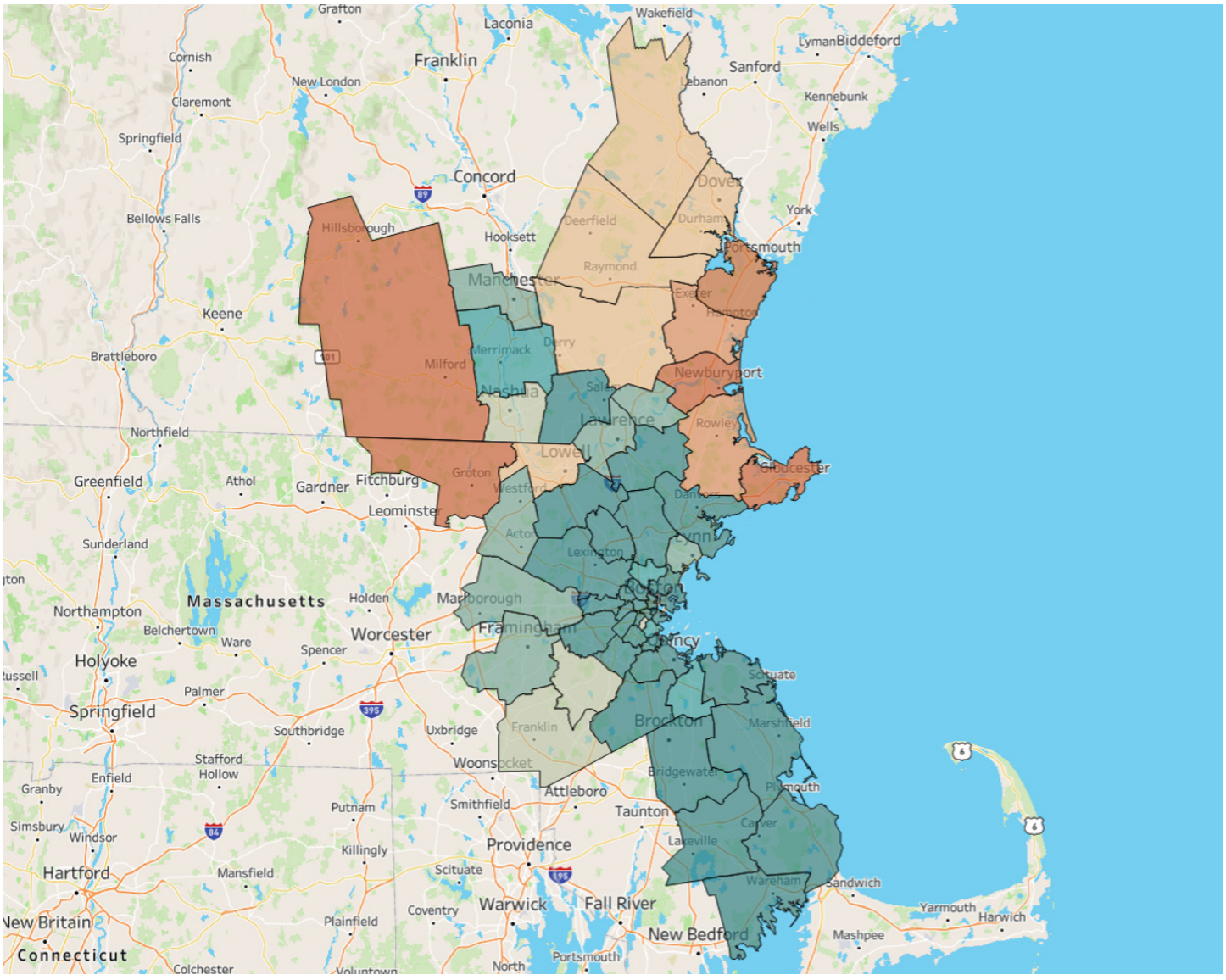
Competitiveness Submarket Analysis

Our metro-level analysis has established a wide variation between metros regarding competitiveness. A deeper review of each market reveals that there is a similar variation within each metro. In other words, competitiveness between market-rate and fully-affordable properties is not consistent within metros. That makes it incumbent on affordable housing developers to underwrite submarkets where they plan to build.

Studying the submarkets of a few metros with different competitive profiles provides context. Boston has a 0% metro-level competitive score, meaning very few market-rate properties are competitive with affordable. Looking at the competitive landscape by submarket, we find markets near the city center are less competitive with affordable, while submarkets at the edge of the metro are more competitive.



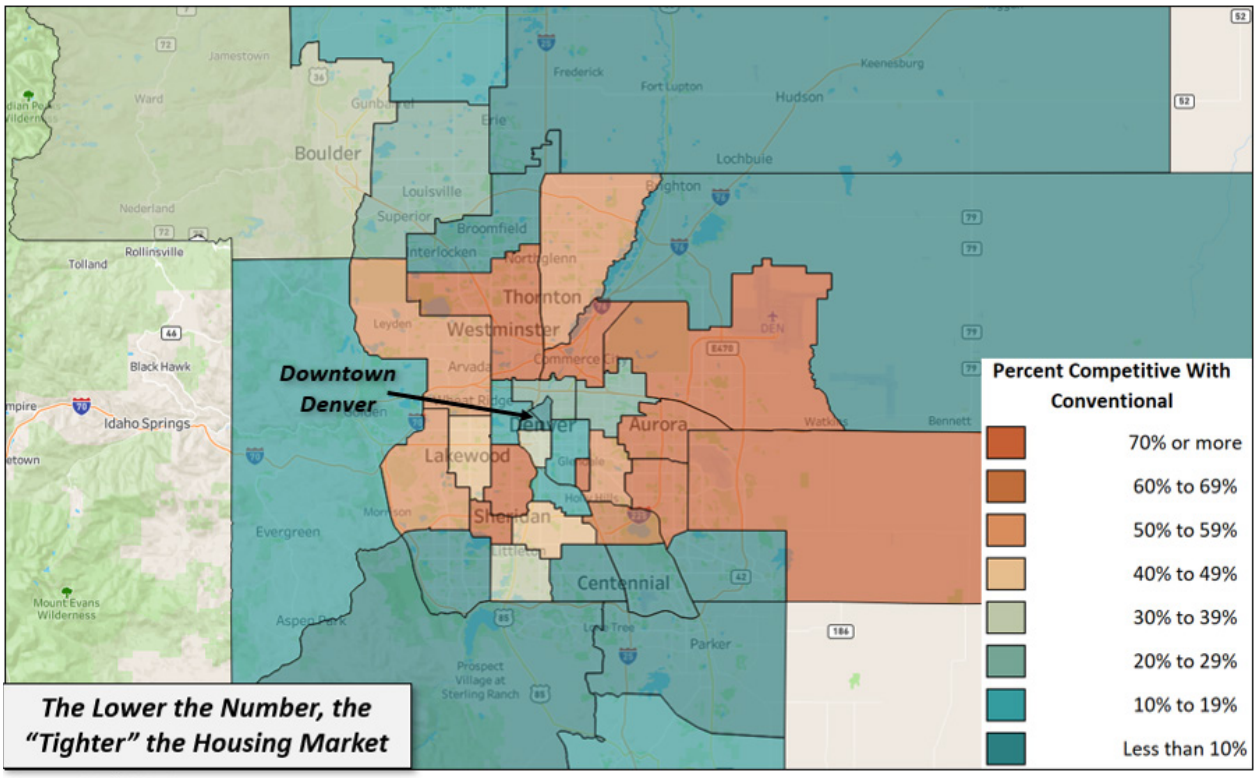
The Interplay Between Market-Rate and Affordable Housing Rents (cont.)

Boston's average maximum allowable rent in fully affordable properties is $1,819 per month, well above the $1,337 national affordable housing average, owing to the high income of Boston households. Despite that, market-rate apartments in high-end downtown and inner-ring submarkets such as Cambridge and Somerville are not competitive with affordable properties as advertised rents average more than $3,000.

The story, however, is different in the outer suburbs to the north such as Amesbury/Newburyport, or Townsend, which have higher competitiveness scores. Although the $1,700-plus average fully-affordable rent is still above the national average in those submarkets, rents in market-rate apartment stock are much less pricey due to the long commute to the city center and the age of much of the apartment stock. In Amesbury, for example, more than 40% of the stock is classified at the workforce-quality level.

Denver lies in the middle of the competitiveness scale, with one-third of market-rate units deemed competitive with fully affordable. Denver's less competitive submarkets are located in the downtown and outer suburbs, where the average market-rate rent in higher quality types tops $2,500. That's well above the average affordable rent of roughly $1,300 due to the lower AMI of households in those submarkets.

FIGURE 4
The Lower the Number, the "Tighter" the Housing Market

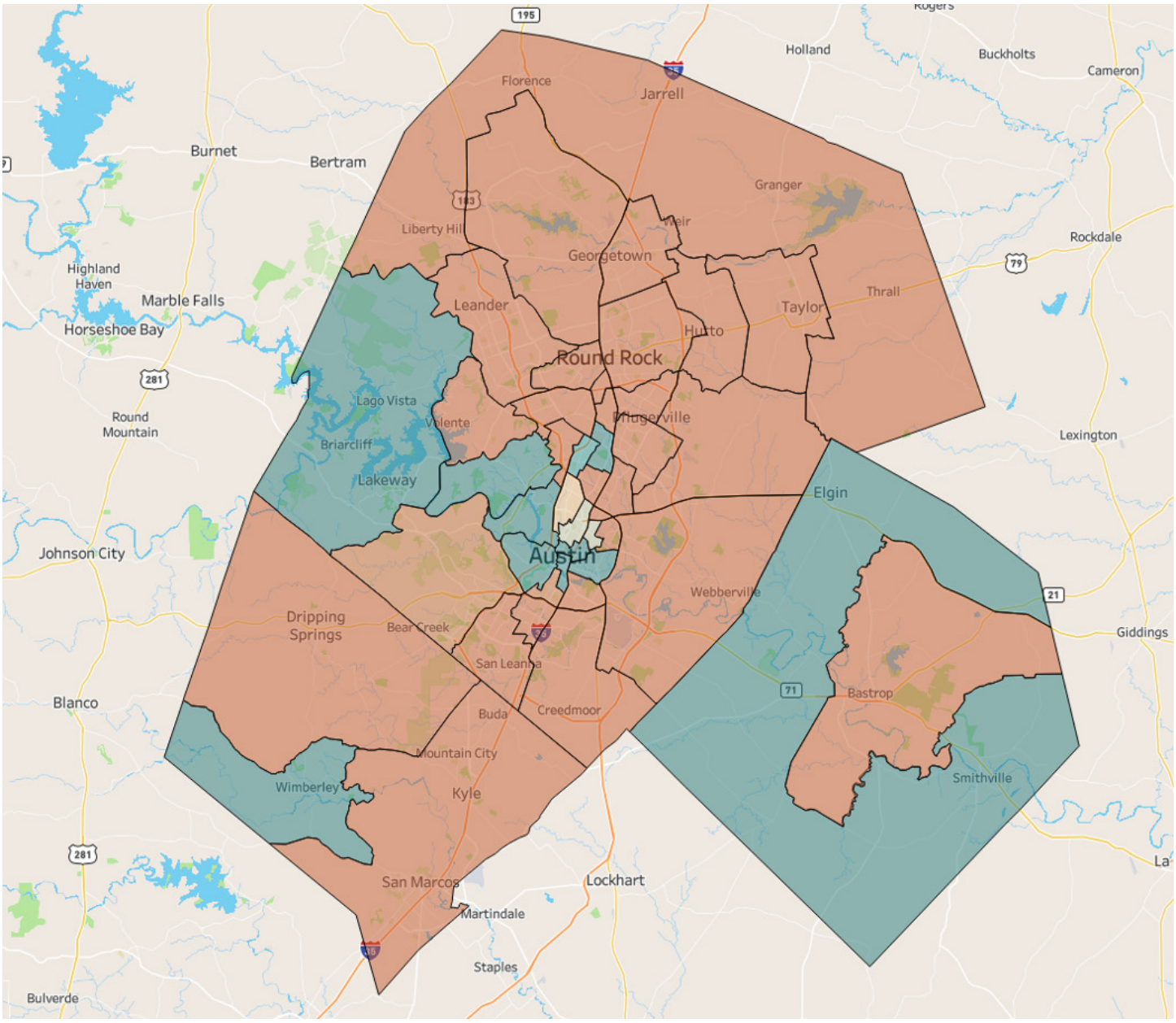


Source: Yardi Matrix

The Interplay Between Market-Rate and Affordable Housing Rents (cont.)

A contrast occurs in Denver's higher-end suburbs such as Lakewood, Aurora, and Cherry Creek, where household incomes are higher, leading to higher rents in fully-affordable units. In those submarkets, the average rent in fully-affordable apartments is between $1,500 and $1,800, but most of the apartment stock is newer and higher quality with rents averaging more than $2,000 per month.

Austin, as noted, is among the most competitive markets. In large swaths of the suburbs, market-rate properties are highly competitive because the influx of supply in recent years has led advertised rents to fall. However, there are pockets of less competitive submarkets such as the downtown or the West End where the spate of new luxury market-rate units has raised the average rent relative to affordable apartment stock.



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Competitiveness Key to Affordable Development

Although the affordable housing construction market is set to enjoy increased funding thanks to the increase in LIHTC and hundreds of other state and local programs to incentivize development, significant challenges exist. Because construction and financing costs have risen in recent years, and the value of tax credits has declined, each dollar deployed for affordable housing builds fewer units.

Another issue is that affordable properties, on average, cost more to build per unit than market-rate housing. Why? One reason is that many jurisdictions place extra regulatory requirements on affordable housing, such as high environmental standards and requiring more expensive union labor. Another factor is that affordable developments have higher soft costs such as legal and consulting fees because projects increasingly require developers to layer subsidies and grants into their financing, which requires that more parties be involved in these transactions.

A recent study by the Boston mayor's office found that large public development projects (50,000 square feet or more) cost $624 per square foot to build, more than 50% more than the $406 per square foot for private developments.

> **"Affordable housing consistently costs more to build across housing typologies and does not capture the same economies of scale as the private market," the report said. "Key driving differences include divergent incentive models, higher soft costs, and longer development periods."**

The upshot is that to ensure that dollars are spent wisely and serve the purpose for which they are intended, affordable-housing developers must analyze every relevant factor, including – and especially – metrics such as the competitiveness of the submarkets in which they build.

Appendix

The methodology for the Matrix competitiveness index is explained here.

The four property quality types that are embedded in Matrix are:

- Discretionary equivalent to A+, A apartments).
- Upper Mid-Range (A-, B+).
- Low Mid-Range (B, B-).
- Workforce - Upper (C+, C).

For each metro, we calculated the average advertised rent in each of the quality segments and the share of apartment units comprised by each quality segment. To use Austin as an example, the average fully affordable maximum rent is $1,631 (10% of stock in the metro), while the advertised averages in the market-rate segments are:

- $1,915 for Discretionary, which comprises 22% of stock in the metro.
- $1,659 for Upper Mid-Range, which comprises 46% of stock in the metro.
- $1,296 for Low Mid-Range, which comprises 17% of stock in the metro.
- $1,190 for Workforce – Upper, which comprises 5% of stock in the metro.

Using the government's definition of "affordability" (when housing costs consume 30% or more of household income), we calculated the percentage of area median income it would take to "afford" the rent in each quality segment before they become cost burdened. In the example of Austin:

- Households that earn 68% of the AMI could afford the average rent of a Discretionary property.
- Households that earn 58% of the AMI could afford the average rent of an Upper Mid-Range property.
- Households that earn 46% of the AMI could afford the average rent of a Lower Mid-Range property.
- Households that earn 44% of the AMI could afford the average rent of a Workforce – Upper property.
- Households that earn 58% of the AMI could afford the average rent of a Fully Affordable property.

Housing quality categories were deemed "competitive" with fully affordable when the percentage of households that could afford the average rent for market-rate units fell below 10% of the same calculation for fully-affordable units. We further credited all of the properties within the quality category to be competitive with affordable. To use the Austin example, Upper Mid-Range (46% of total stock), Low Mid-Range (17%), and Workforce–Upper (5%) were all considered competitive with affordable. Totaling the percentage of stock in those categories, we determined that 68% of multifamily properties in Austin are competitive with fully affordable units.