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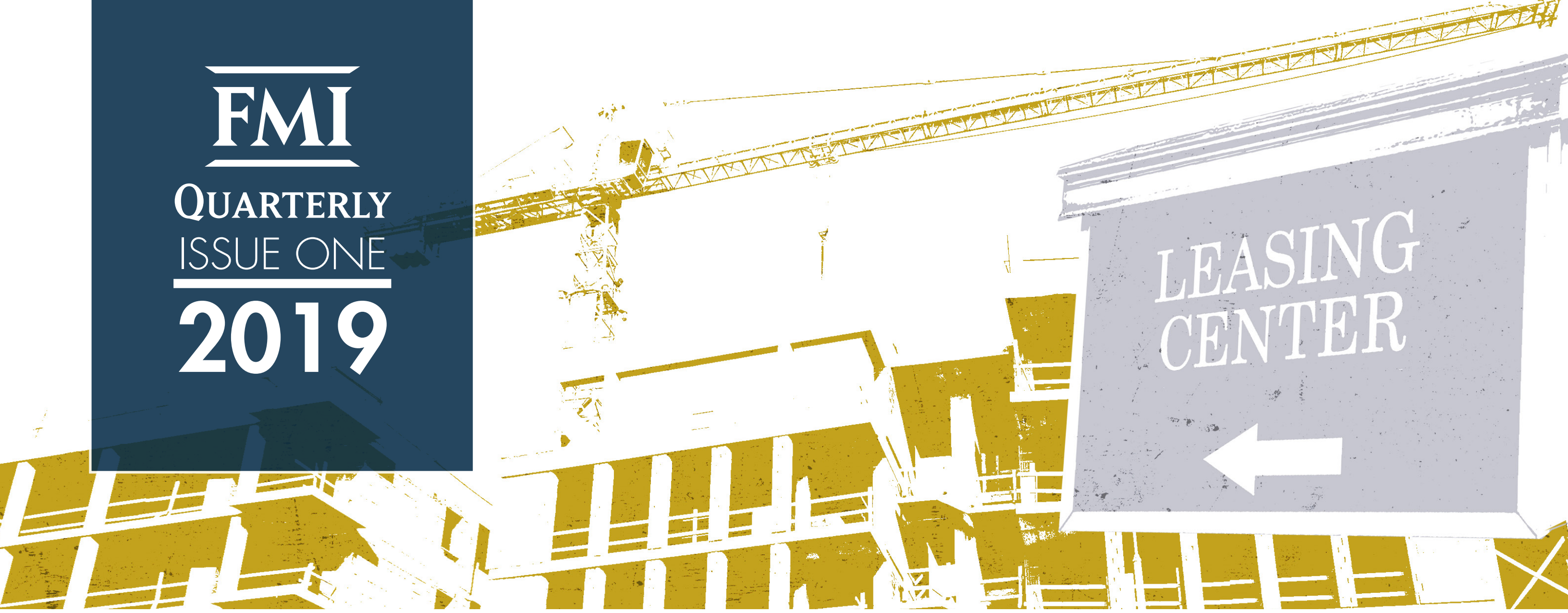

The Multifamily Boom: How Much Longer Can It Go On?

By Jay Bowman

Because the time to fix a leaking roof is when the sun is shining, multifamily contractors should be shoring up their cash reserves and diversifying now rather than later.

Ever since the Great Recession ended, the multifamily sector has been on a tear. In fact, no other segment of the construction industry can match its expansion. From a spending perspective, multifamily construction spending put in place has increased at a compound annual growth rate (CAGR) of 18% over the last 10 years. That's the highest among all construction segments and three times the rate of growth in total construction spending put in place.

The multifamily segment has clearly benefited from sociodemographic trends, most notably the fact that the largest cohort of the U.S. population—the millennials—began entering the workforce in large numbers in 2010. This younger generation tends to favor urban environments and rent-by-choice housing, both of which have helped strengthen demand for multifamily housing.

These and other trends have buoyed the financial returns on multifamily developments and properties, which continue to draw interest from a broad range of stakeholders. In this article, we explore the likelihood of an economic downturn, explain the impacts that past downturns have had on multifamily construction, and provide recommendations on how to start diversifying now rather than later.

How Much Longer Can It Continue?

It's no secret that multifamily contractors have been on quite a ride over the past several years. However, there are signs that we may be nearing the end of the road of double-digit growth for the multifamily sector. And when the road *does* end for multifamily construction, the ditch will be deeper than it would be for any other construction segment. Engineering and construction (E&C) firms that have all their eggs in the multifamily segment should start preparing now to either ride out the downturn or diversify their options (or a bit of both).

Right now, a lot of E&C firms are asking themselves just how much longer the multifamily boom can continue. Not everyone agrees on the answer to that question. Those who believe multifamily building construction should continue at or near the current pace point to several positive trends, including:

- Occupancy rates remain high and are expected to average near 95% this year.
- With near-full occupancy, rents are expected to grow at 2.5%, which is half a point above the target inflation rate of 2%.
- With supply and demand in perceived balance, developers plan to deliver 337,000 new apartment units this year, up from 320,000 units in 2018, marking the sixth straight year for 300,000-plus units.

The pessimists don't buy into these facts and figures, and instead point out the inconsistencies in the supply and demand equation as signs that the multifamily boom could be winding down. Yes, occupancy rates are high, they say, but the sociodemographic trends that fueled demand for multifamily buildings may now be turning against it. Consider, for example, that the oldest millennials are now approaching the average age of the first-time homebuyer (29.7 years old, according to Ellie Mae).

There are other factors at work here, including:

- According to the Urban Land Institute's "Top 20 Emerging Markets" report, 55% of new residents over the last five years have relocated to suburban homes (a trend that's pushing up vacancies in some markets).
- From 2015 to 2017, 40 of the 75 largest metropolitan markets (MSAs) in the U.S. witnessed an increase in vacancy by an average of almost 1.5 percentage points.
- Rents may be up in the aggregate but are flattening in some markets. For example, 63 of the 95 largest cities in the U.S. experienced rent appreciation below the 2% inflation target last year.
- Finally, the multifamily segment hit several "peaks" in 2015, including the number of multifamily units started for rent and the number of multifamily units started for buildings with 20 or more units.

Exactly where the multifamily market is headed in 2019 depends on various factors, with geographic location being one of the key determining variables. E&C firms working in Los Angeles, Miami, San Francisco or Washington, for example, may not notice much change in the market this year. However, firms focused on Houston, Nashville or San Antonio may start to see a slowdown.

Preparing for the Worst

When recessions hit, they tend to have major impacts on the multifamily sector. By one measure, more than 75% of economists recently surveyed by the National Association for Business Economics (NABE) expect a recession within the next three years, with about 10% of them foreshadowing a recession in 2019; 42% expecting one in 2020; and 25% predicting that one will rear its head in 2021. Whether the next recession is as severe as the Great Recession remains to be seen, but even a slight downturn can significantly impact the multifamily segment, which usually suffers more than most other construction segments during these periods. Here's the proof:

- In the two to three years following each of the past three recessions, the number of multifamily units started declined by more than 50%.
- In 2009 alone, the decline was almost 60%.
- From 2006 to 2010, construction spending put in place in the multifamily segment declined by more than two-thirds.
- FMI's construction spending for put in place pinpoints 2018 as the most recent peak year for multifamily construction spending for the U.S. and predicts an 8% decline over the next two years.

These numbers, and the hints of a possible recession coming around the next corner, should be prompting those in the multifamily industry to think ahead and ask themselves just how prepared they are for the potential of a greater than 50% decline in construction spending or project opportunities.

Diversify Now Rather Than Later

As history has taught us, most companies in the multifamily segment probably ***aren't*** prepared for a downturn and will wind up suffering much worse than companies that strengthened their cash and working capital positions in advance—or that diversified their options by expanding into adjacent segments.

The problem is that diversification doesn't happen overnight. In fact, FMI's research reveals that diversification takes an average of 18 months from the time of entry to positive financial performance. Should the next recession occur within the next two years, and if diversification is an attractive and/or possible option, it's time to start putting those wheels in motion now.

When it comes to diversification, there are two roads that companies can take: market diversification and segment diversification. Here's a look at each option and how it works:

Market diversification is similar to "taking the show on the road." The multifamily contractor that adopts a market diversification strategy remains committed to building apartments, condominiums and so forth, but it does that in a new city or state.

When considering a market diversification strategy, the most important questions to answer are related to addressable opportunity and owner procurement practices and preferences. An "addressable" opportunity is the share or volume of spending that represents the types of projects the contractor is best at. Often, this is defined by project value, but it may also include product type (e.g., midrise, podium, etc.).

Contractors that enter new, unfamiliar markets are almost guaranteed to fail if they don't have a deep knowledge of owner procurement practices and preferences. Contractors should ask themselves questions like:

- How satisfied are owners with the current contractor community?
- Are owners likely to consider a new contractor?
- What most influences contractor selections?

If these questions cannot be answered, avoid market diversification.

Segment diversification finds the contractor remaining in its existing market(s) but expanding its services into new building or owner types. Contractors commonly choose segments to diversify into on a superficial basis. For example, a multifamily contractor may see student housing or patient bed towers as sharing many similarities with apartments.

Now, this assumption isn't completely false, but more often than not, the owners of these buildings do not equate their projects to "just another type of apartment." It is reasonable for a contractor to diversify in this manner, but we suggest a slightly different tack when considering a segment diversification strategy. Rather than looking for similar product types, the contractor should ask what benefits or value it provides that goes beyond just the product. For example, is the contractor schedule-driven? Or does it have an expertise in high-end finishes?

Effectively articulating a value proposition can increase an owner's willingness to buy what the contractor is selling. When a contractor diversifies based on owners' receptivity to a given value proposition, that company's success often surpasses that of the contractor that took the "safe route" and simply expanded into other like-kind projects.

It's a Matter of "When," Not "If"

Whether it happens during 2019 or sometime in the future, an economic downturn is definitely in the cards. It's just the nature of the beast when you're operating in a cyclical economy. The choice is yours at this point: Either continue to make hay while the sun is shining or take the preventive steps now to make sure your multifamily construction business can sustain itself through the next recession (and beyond).

Because recessions have been tougher on multifamily contractors versus any other type of E&C firm, it's important to evaluate your position and preparedness for the next recession now versus later. If, for example, market or segment diversifications are options, start the process today. Remember that most diversification options take 18 months to begin to bear fruit. As the adage goes, "The time to fix a leaking roof is when the sun is shining."

Jay Bowman is the managing director of research with FMI. Jay assists a broad range of stakeholders in the construction industry, from program managers and general contractors to specialty trades and materials producers, with the identification and assessment of the risks influencing the strategic and tactical decisions they face. He can be reached at ***jbowman@fminet.com***.

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