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State of the Market 46: Renter Nation

By David A. Smith

Five years into the Great Recession, America has become a renter nation – and for an emerging generation of young adults, it will be rental, not homeownership, that is their path to jobs, family, and personal success.

For many Americans, this will mean rethinking how we view our living accommodations and what we think a home is for. America's leadership – developers, capital providers, and policy makers – will need to innovate on and expand the types and quantity of good affordable rental housing; to invent new tenure forms and configurations for multi-household housing; to remake America's growing cities; and to reshuffle national spending priorities.

Huge opportunities lie ahead, once we let go of the notion that the road to family wealth and happiness always goes through homeownership.

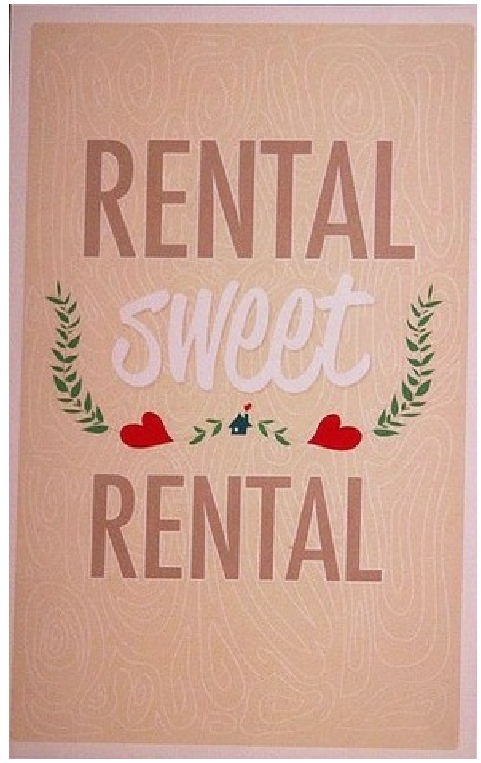
By the way, much of this is happening now; even as home prices languish, rents are rebounding.

Owned homes as an asset class: consumption versus investment

For most of us, a home is a *consumption* asset – something we use for our quality of life, like our car, laptop computer, or cell phone. Yet an owned home is also an *investment* asset – something we expect to generate economic benefits for us.

People desire owning a home because they see it as a bundle of six benefits:

1. ***Physical safety of valuables and loved ones***. "A man's home is his castle."
2. ***Security of tenure***, the knowledge that you will not be thrown onto the street tomorrow.



As American as saving money and starting a family

3. ***Controllable occupancy cost***, to enable you to budget your household spending.
4. ***Improvability***, so that one's own sweat and ingenuity and stewardship are rewarded.
5. ***Equity liquidity***, to tap it for starting new businesses, children's education, or retirement income.
6. ***Wealth-building***, a personal forced savings with the promise of a return higher than inflation.

These six benefits form a hierarchy of needs: we want the next one only after we have satisfied all the ones ahead of it, and if forced to choose, people will give them up in reverse order: wealth-building first, physical safety last.

So powerful are people's drives for the psychological security of a home that they willingly encumber themselves with the largest and longest financial commitment

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they will ever make in their lives. People will sign themselves up for thirty or more years of monthly payments, at a monthly commitment that always make us gulp, *and* for that privilege scrounging up a huge sum of cash as a down payment.

At the same time, home ownership via a mortgage represents a gigantic sacrifice in future optionality. Even when the market is working well, homes are a difficult asset to sell. Aside from a slow process with high search and transaction costs, it entails two other burdens unlike any other asset: (1) you have to move your place of living, and (2) you have to find and secure a new place to live. That's a lot of disruption, which many of us internalize and forget about because we sell or buy homes rarely.

The golden age of American homeownership: 1945-2005

Throughout most of recorded human history, owned homes were purely consumption assets; nobody expected to get rich simply by buying a place and living in it. One might resell a home, but seldom for more than one paid for it.

Then came the golden age of American homeownership: six decades of economic and demographic boom that will never be repeated. From 1945 through 2005, economic growth and demographic pressure (the Baby Boom), coupled with America's gradual urbanization, led homes to improve in every dimension imaginable. Homes got bigger, they got better, they got technologically more complicated, and they became more valuable in real (inflated-adjusted) terms.

For Americans who came to adulthood in that interval, a home was the best possible investment. Nobody had to choose in the hierarchy of benefits: almost everyone who bought a home got all six of these benefits: there was always someone to buy our homes from us when we were done consuming them. Sheer good luck deluded two whole generations of us into misperceiving what a home was for, and of unwittingly passing on these articles of faith to our children's generation.

The Golden Age of American Homeownership was a period of unusual predictability and strength of growth, and so home buying became all upside and no downside. Those days are gone and they're not coming back.

Housing and the Millennial generation: different priorities, different resources

Until 2007, we told young adults that homeownership was a no-brainer. It was a person's economic escalator – just climb on and effortlessly rise. We now know we were wrong.

In housing, young adults don't value the same things their parents do – and nor should they. They are busily exploring adulthood, speedily making and remaking life decisions: priorities, cities, jobs, interests, and partners. They also lack cash. Of the bundle of housing benefits offered by home ownership, they value only the first three – safety, security of tenure, and controllable occupancy cost. The others are merely nice-to-have.

We also told young people that education was good; more education was better; and any education would somehow pay off, so they should borrow to buy it. We were wrong about that too. The only thing less valuable than an overleveraged house is an overpriced education. The house can at least keep the rain off; the education can have a forward value of zero.

Today, the young adults we would like to be buying homes have mortgaged $1 trillion of their future earning power by buying college educations many of which have minimal prospective incremental earning value. Facing this bleak prospect, they are generally deferring marriage and certainly deferring home purchase.

Rental as the Millennials' optimal housing choice

Millennials are the new arrivals in renter nation; they are the latent demand for long-term quality urban rental housing. For them, cities are where the money is, where the jobs are, and where it's worth living in smaller spaces. All of that implies consuming quality housing; none of it implies investing in it.

Compared with homeownership, rental offers the same must-have benefits – physical safety, security of tenure (a lease), and controllable occupancy cost – and a different set of nice-to-have benefits:

1. ***Minimal cash assets required***. A month or two's security deposit is the maximum; many markets require less cash than that.
2. ***A tenure young adults can attain***. Rental eviction is much faster and cheaper than foreclosure, so landlords rent to people who would fail homeownership credit checks.
3. ***Mobility and convenience, both macro and micro***. With rental, not only can you move from one city to another, you can (and do) move within a city, to be closer to your job; that becomes more valuable as commuting becomes more expensive.
4. ***Availability***. With the exception of supply-constrained environments paying the high price of curtailing or obstructing development, America has a bounty of quality market-rate rental housing at all price points.[1] People who move in search of better jobs can readily find market rentals.
5. ***Flexibility of consumption***. A rental tenure average roughly 1½ years, about one-sixth the average homeownership tenure; if your household configuration is changing rapidly, rental's consumption flexibility is a big plus.
6. ***Minimal responsibility***. Homeowners have chores; renters call the landlord.

These benefits particular to rental outweigh homeownership's particular benefits for younger adults still forming their careers and families. Then, as they increase their earnings, they'll *consume* more housing, but won't necessarily *invest* in more housing. They may even be contented renters all their lives – as were many American middle-class households in the twentieth century before World War II, and as Germany and the Netherlands have today.

Capitalizing on the growth of renter nation

In an Age of Uncertainty, rental's virtues – mobility, economy, and optionality – have higher value than homeownership's costs. The renter nation offers opportunities and challenges: private participants should be developing or redeveloping and financing properties with that vision, and public policy makers.

Apartments will be the new form of residential innovation. Over the last half century, American housing has become more vertical (more floors per acre), larger (more units per building), more specialized, and more technological (more systems per property). Housing has become less a construction and more of an engineered nexus of services related to urban living – where people will accept smaller living spaces if they are better designed for living. That also suits people still forming personal relationships. The more we create smaller living spaces with shared facilities, even if it's no more than roommates sharing bathrooms and kitchens, the less people need to be married to inhabit them.

Shifting ownership from a personal obligation of each household to a professional service households can rent will mean that being a landlord requires increasing professionalism and increasing scale – hence the growing market share held by REITs, management companies, and other service aggregators.

Policy makers will shift resources into rental. We don't need to subsidize new construction of homes to own, especially when Detroit, Cleveland, and half a dozen other cities are mothballing or demolishing

[1] In many parts of urban America, *affordable* housing is scarce, because the price of market-rate housing rises as the city's economy grows. That makes affordability a chronic ongoing need that private markets will never address purely on their own; it requires conscious government policy and incentives.

excess single-family inventory. For that matter, second homes and vacation homes add nothing to household formation and can hardly make an effective policy case today. Historically, these political cows have been sacred; we'll see if they are much longer.

Rental, the new American dream

The Millennial generation's inability or unwillingness to consume new housing is retarding the economy, slowing down household formation, and eroding America's cities and our national competitiveness – and most importantly, poorly serving the next generation of adult Americans. Hence, in a renter nation:

- The range of physical configurations available via professionally managed long-term rental will continue to expand. Large owners and managers can not only contain costs, they can distribute risk, and that in turn means lower costs.
- Developers, owners, and managers able to deliver quality rental experiences with both scale of units (for cost efficiency) and personalized touch (for service customization) will rapidly gain market share.
- We'll see new forms of residential leases. Longer leases with CPI-derived escalators, common in commercial real estate, may once again flourish in apartments. Or leases that allow for an in-property transfer (smaller to larger apartment, say) may become a tenure model as familiar as earnout mortgages are in financing.
- Smart owners will play up a campus-style range of configurations, and tie that to loyalty bonuses for intra-property moves, so when you have a child, the owner lets you move up to the next larger apartment on an intra-lease basis.
- Property managers with large, multi-city portfolios will offer an 'in-universe placement service,' whereby the manager will find your next apartment for you, absorb the packing and moving costs, and seamlessly transfer your lease from Property 1 to Property 2.

In terms of national policy, we need to embrace a rise in the rate of permanently affordable rentership. Expanding quality rental, not another spate of subdivision homebuilding, will faster and better revive our wheezing economy. Ergo:

- We will have found ways to repurpose hundreds of thousands of unsold condos into workforce housing rentals.
- In supply-constrained urban areas, we will be developing true workforce housing (rents higher than LIHTC, lower than normal market) and will have eliminated its resource gap.
- Permanent affordable rental housing will be seen as a fully acceptable adult-living tenure option and recognized as an essential element of urban infrastructure – the secret sauce to make cities and their economies grow new jobs.

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