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After the fall: Opportunities in the Chicago housing market

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It is hard to envision development opportunities in the current state of the housing market. Plunging home values, rising foreclosure rates, stagnant home sales and the continuing economic recession have created one of the worst housing market crises in history. The Chicago area has experienced its share of pain, with housing values declining by 16 percent from its peak and the pace of new home sales declining over 80 percent.

The rental market, which is strongly influenced by the labor market, has also been affected by the rising unemployment levels in the region. The big question in everyone's mind is: When will the housing market bottom out and start recovering? But from the point of view of a housing developer or communities planning for the future, an equally critical question is: What type of new housing developments should be planned for in the next five to ten years?

To predict the nature of the future housing market we recommend going back to the basics. The housing market is intrinsically complicated, with multiple unpredictable variables influencing its health, including mortgage interest rates, the availability of credit, loan underwriting practices, unemployment rates, and consumer perception. These factors tend to push the market to the extremes: just as the availability of easy credit and lax underwriting standards contributed to the past housing boom, the credit freeze, increasing unemployment rates and declines in consumer confidence have resulted in a steep drop in home prices and sales.

However, at a more fundamental level, housing demand is driven by household growth and associated shifts in demographic segments. According to the Chicago Metropolitan Agency for Planning (CMAP), the six-county Chicago region is expected to add over 720,000 net new households by 2030 at an average rate of 24,000 households a year. New households create a demand for additional housing units; the age of householders and their stage of life typically determine associated preferences for housing product types. Householders are not equally distributed among age groups. The size of generations and their aging with time determines the number of households in various stages of life, which in turn directly affects the demand for various housing products in a particular time period.

GENERATIONAL WAVES

Since the 1980s, the post-war baby boom generation (people born between 1946 and 1964) has dominated the housing market. Because the boomer generation is over one and a half times as large as the preceding pre-war generation, its associated shifts in housing preferences (as it has gone through different life stages) has had quite a dramatic impact on the housing market. As baby boomers entered the job market and the prime rental housing age group of 20- to 35-years-old, they contributed to the 1980s rental housing boom. As they entered family life as middle-aged householders of 35 to 54 years of age, they fueled the surge in single-family housing demand from the late '90s until the recent housing bust. In addition to cheap credit and subprime lending practices that artificially inflated demand, the recent boom in single-family home construction was driven by the middle-aged boomers with the financial capacity to buy new and larger homes.

Now the baby boomers have started entering the empty nester age group, and this cohort is expected to increase by 275,000 households in the next 10 years (Figure 1).

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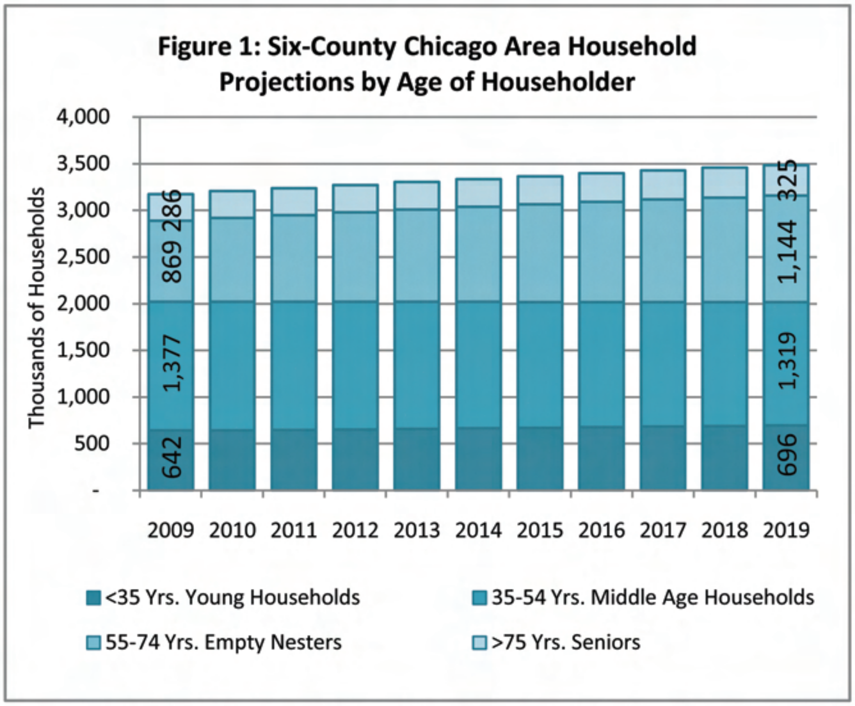
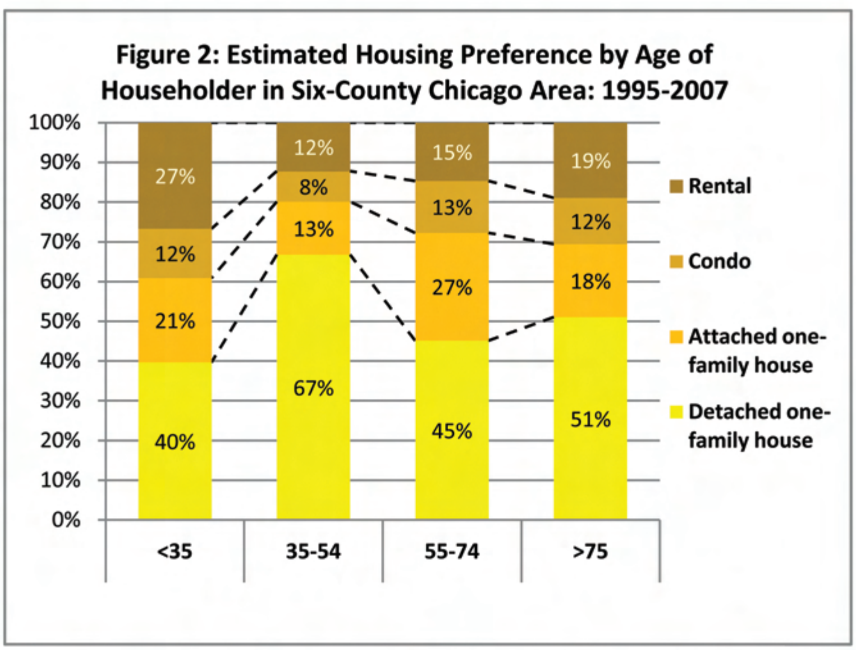


Source: Woods and Poole Inc., Census 2000 and S. B. Friedman & Company.

This growth will be the most significant demographic shift in terms of net household change relative to all other cohorts. Historical census data (1995-2007) on empty nester buyer preferences for new homes in the Chicago region supports the anecdotal theory that empty nesters seek to "trade down" their larger single-family homes in favor of maintenance-free living in townhomes and condominiums. In the past 12 years, 27 percent and 13 percent of all new homes purchased by empty nesters were townhomes and condominiums, respectively, reflecting a greater propensity to own such product than any other age cohort (Figure 2).



Source: American Community Survey 2007, Census 2000 and S. B. Friedman & Company.

However, as with households of all age cohorts, empty nester households have the greatest preference for single-family homes and, therefore, the boomers may continue to provide limited support for the single-family market.

While the boomers will continue to impact the housing market because of their sheer size, they are entering a phase in life that is characterized by lower household mobility rates. Younger households

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have a greater tendency to move as they are trying to establish their careers and find a suitable long-term residence, but as they age they tend to settle down and exhibit a lower propensity for change. Therefore, the boomers are unlikely to be the primary drivers of the housing market in the future as they have been in the past.

Successive generational waves will continue to result in future swings in the demand for various housing products, but these impacts will be less significant because the populations of these generations are not as appreciably different from the boomers. The immediately successive Generation X (born roughly between 1965 and 1983), or the "baby bust" generation, is less than 15 percent smaller than the baby boomer generation. The rental housing market did experience a significant slowdown with weak rent growth and relatively little new market-rate rental construction activity through the 1990s and early '00s as this generation entered the prime rental age. However, this trend was exacerbated by the surge in homeownership facilitated by new mortgage products (such as ARM financing) and lending practices.

Now this generation is between 25 and 44 years old and has already made significant investments in the recent for-sale housing boom. Over the next ten years, as this relatively smaller generation squarely moves into middle age, it will result in a decline of approximately 58,000 households in the 35-to-54-year-old age cohort. Census data shows that this cohort has the greatest propensity for "trade-up" single-family homes, and over a third of all households in this age cohort chose this product type in the past 12 years. Both the decline in households in the middle-age cohort and the fact that the current housing downturn has created a significant over-supply of single-family homes suggest that demand for single-family homes will wane over the next 10 years.

Generation Y (born roughly between 1984 and 2002) – the children of the baby boomers – is a key latent force starting to emerge in the housing market. The size of this generation is nearly equal to the baby boomer generation, and over the next ten years they will continue to mature into young adults, enter the job market and form approximately 54,000 more households under age 35 than the current base of 642,000 households in this age cohort. Rental housing and starter homes will be the predominant preference for these young householders.

THE OPPORTUNITIES

In light of these changing demographic patterns, several conclusions can be drawn regarding the future potential of the various housing market components over the next ten years.

1. Expect starter home buyers and renters to lead the housing recovery. Over the next five years, Generation Y households will jumpstart the housing market as they seek affordable starter and rental homes as young, mobile adults. A tax credit of up to $8,000 for first-time home buyers in the recently passed economic stimulus bill provides a significant incentive that should bolster starter home sales. Generation Y households not ready for homeownership will instead look to rent, contributing to the revival of rental housing demand. In the past 10-15 years, conversions of apartments to condominiums and limited new rental developments have reduced the supply of rental housing in the region.

The apartments and starter homes being freed up by the smaller Generation X will not be adequate to meet the demand of this larger succeeding generation, leading to the demand for new construction housing. Starter homes could include compact single-family homes on small lots, townhouses and condominiums, with affordability being a key component. Location will be critical for new rental housing as proximity and convenient access to major job centers will be the driving force behind rental housing demand. Selected communities may compete for and become attractive to these new buyers by providing services and facilities that welcome young families.

2. Use caution when developing single-family subdivisions. Single-family housing remains the dominant housing choice for all age groups, but the core demand segment – 35-to-54-year-old householders (Generation X) – is projected to decline. Additionally, the oversupply of homes from the recent housing boom and the foreclosed homes due to the current downturn will need to be absorbed before demand for new homes can come back. New single-family development will also face stiffer competition from the resale market, particularly from boomers trying to sell their large homes. These factors will contribute to a sluggish single-family market over the next ten years. While the boomers could generate demand for new homes as they look to move to smaller, lower maintenance single-family homes, it could be limited by their ability to resell their existing, larger homes.

To expand their customer base and boost absorption, developers could include a mix of home designs aimed at multiple age and income levels within a single subdivision rather than focusing only on family households as in the past. Developers of existing, unsold subdivisions that are caught in the downturn could reposition their developments by seeking entitlements to rezone for a mix of small to mid-size lots and adding other product types such as townhomes and condominiums.

3. Condominiums and townhomes in mixed-use centers are still a good bet. The growing young and empty nester households will revive the demand for condominiums and townhomes over the next ten years. Many in these age groups are attracted to the dynamic lifestyle in mixed-use centers that have a range of shopping, dining and entertainment options.

Downtown Chicago, with its world-class recreational and cultural amenities, will continue to draw homebuyers from the entire Chicago region. While the sales pace in the downtown market has declined by over 65 percent from its peak of nearly 4,400 units in 2005, construction of new condominium buildings has also come to a virtual standstill (data from Appraisal Research Counselors).

With relatively few new units in the pipeline, the existing 4,700 units of unsold inventory are likely to be absorbed within two to three years, even at the pre-boom absorption rate of approximately 2,500 units per year. Therefore, once the economy recovers and the existing inventory starts getting absorbed, there will be opportunities for downtown condominium development. Sales are expected to pick up slowly, however, because investors and second home buyers will not provide the boost in sales as seen in the boom period. While land may be a constraint in the traditional downtown area, a southward expansion along the lakefront will continue to expand the downtown condominium market, just as the South Loop has done in the past ten years. The potential selection of Chicago for the 2016 Olympics will serve as a catalyst for the next wave of expansion and new development in the downtown area.

Condominium and townhome development will also experience a revival within established and emerging suburban downtowns. As suburban communities continue to seek to reposition and energize their downtowns, developers will find opportunities to capitalize on the young and empty nester households that desire vibrancy and a sense of place in a relatively lower density environment with a small-town feel. Depending on the scale, community sentiment and land prices, there may be opportunities for both condominium development and townhomes. Townhomes will be the preferred development choice in smaller scale town centers and locations where land prices are not high enough to require higher density condominium development and associated structured parking.

4. Go Green. “Green” homes, or homes that are energy efficient and environmentally friendly, will be one of the defining trends in the future. As people, especially younger generations, become increasingly conscious of the environmental impact of their lifestyle choices and green building technologies and products become more economical, green homes and developments will become a mainstream feature of the housing industry.

Several multi-family high-rise developments in the region, such as Kinzie Street Apartments and Aqua in Chicago and Winthrop Club in Evanston, are seeking LEED certification and are actively marketing this feature as an added building amenity. LEED-ND (Neighborhood Development) is currently in the pilot stages and is expected to come online later this year. New residential developments that acquire LEED certification will be able to distinguish themselves in the market place.

Stephen B. Friedman is president of S. B. Friedman & Company, and Ranadip Bose is a senior project manager.

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