Segmentation and Returns on Rental Housing

Abstract

This paper studies rents and landlords' returns across the quality distribution of the U.S. multifamily rental market. We establish three facts: since the Great Recession, (i) asking rents grew more on low-quality properties; (ii) realized internal rates of return rose more in the low-quality segment; and (iii) the vast majority of new rental housing entered the top of the quality distribution. We present a model of a segmented rental market to show that these facts are related. In the model, high-quality buildings require more capital per unit, so fixed land costs and zoning quantity caps tilt construction toward the high tier. High-quality buildings feed the low-quality housing stock by filtering down as they age, but this filtering is partly offset by redevelopment of low-quality buildings into high-quality buildings in response to demand growth. The model predicts that construction is more responsive to demand shocks at the high end, moderating the high-end rent response relative at that at the low-end. We test these predictions with city-level responses to labor demand shocks. Low-quality rents and returns respond more, and controlling for outsized high-end new supply, itself an outcome of the shock, absorbs about 60 percent of the differential. Fit to tier-level price and construction levels and to the reduced-form construction responses to demand shocks, the model reproduces around a third of the cross-city differential in untargeted price responses to those shocks. In counterfactuals, uniform upzoning and an inclusionary set-aside with a density bonus both stem the outsized response of low-end rents to demand shocks.

Benjamin Keys
The Wharton School, University of Pennsylvania