Recommended Practices for Determining Demand


Introduction

The National Council of Housing Market Analysts (NCHMA) has separate definitions of overall market demand and project specific demand. Market demand is the total number of households in a defined market area that would potentially move into any new or renovated housing units. Market demand is not project specific and covers all renter households and income levels. Components of demand vary and can include household growth; turnover, substandard dwelling units, rent over-burdened households, and demolished housing units.

Project specific demand is the total number of households in a defined market area that would potentially move into the proposed new or renovated housing units. These households must be of the appropriate age, income, tenure and size for the specific proposed development. The components used to estimate the demand for a specific project are similar to those used to estimate overall market-area demand.

An analysis of a proposed rental project should evaluate both overall market demand and project-specific demand. It should evaluate the demographic; employment, construction and absorption trends, as well as projected changes in supply and demand to determine the number of units are needed to achieve market equilibrium. The analysis also should determine if there is sufficient support within the proposed development’s primary market area (PMA) to support the planned development, as well as any other comparable units in the development pipeline.

A project-specific demand analysis should estimate the number of income-qualified renter households within the planned development’s income range. The project-specific demand conclusion should not only indicate whether a market area has a sufficient number of income-qualified households to fill the proposed units. It also should discuss the impact of its proposed units on existing rental communities in the market area. In addition, it should consider how effectively a planned project can compete for tenants and address the planned development’s ability to achieve stabilized occupancy at its proposed rents.
A. Factors to Consider in Analyzing Demand

**Household Growth:** Sufficient housing units should be available to accommodate existing households, newly forming households and in-migrating households. If the market area’s existing housing stock does not have an adequate supply of units, construction of new units is necessary to accommodate household growth.

**Units in Pipeline:** Projects that are planned or under construction will increase the existing supply and may affect market equilibrium. The units in the pipeline include the off-line units that will be renovated and returned to the market, unstabilized projects that are in lease-up, projects that are under construction, and planned projects that will enter the market before the proposed development is completed and fully occupied.

**Vacancy Rates:** Rental markets with high vacancy rates may reflect an oversupply of available housing. The overall health of the rental market may impact the ability of a proposed development to reach stabilization, despite favorable capture rates and properly positioned rents.

**Substandard Housing Conditions:** Below average unit conditions, obsolete unit designs, or shortages of certain unit types can produce a pent-up demand for new units to replace existing housing units. Renters who are dissatisfied with their current living conditions may be potential tenants for newer units that better suit their needs.

**Unit Replacement:** Units can be removed from the rental inventory for a number of reasons, including natural disaster, eminent domain, condemnation, abandonment, demolition, unit consolidation, and conversion to owner-occupied units or non-residential uses. Replacement of existing units can be a major cause for residential construction, especially in established communities with limited vacant land available for development.

**Absorption Levels:** A market area’s performance in adding and filling additional units is often a better gauge of its ability to accommodate additional units than household growth statistics, especially in an area with a stable or declining population or an aging housing stock that does not satisfy needs or expectations of current residents.

**Market Balance:** Demand for new units comes from household growth as well as from pent-up demand from households who lack available, affordable housing and/or inhabit substandard housing. Pent-up demand is often reflected by very low vacancy rates at existing rental properties. If the number of new units that are planned or under construction exceeds the PMA’s historic rental housing absorption levels or its projected levels of renter household growth, the completion of all the units in the development pipeline could temporarily oversaturate the market and produce rising vacancy levels and declining rents.

**Market Segmentation:** Household growth, job growth, and residential construction do not necessarily occur evenly throughout all income ranges. The need for additional units can be limited to specific price ranges or market niches.

**Number of Potential Income Qualified Households:** The primary market area, in nearly all cases, must contain a sufficient number of households who meet the occupancy restrictions of a proposed project. If it does not, a proposed project will not succeed unless it can attract households from supplemental sources, such as homeowners who sell their homes and become renters or local employees who live outside the primary market area.
**Unit Distribution:** Demand, as measured by both the number of potential qualified renters and reported occupancy rates within the primary market area, can vary significantly by unit type.

**AMI Distribution:** A planned project may have a small percentage of units targeted to a very high or very low-income group. In such cases, measuring the number of income-qualified households within the entire target income band can severely overstate the number of potential income-qualified renters.

**Turnover:** Not all income-qualified tenants will consider moving into a project. Empirical data on the percentage of market area tenants who move during a given period can give a more realistic estimate of how many existing market area tenants will be seeking a different unit during a planned project’s lease-up period.

**Affordability:** LIHTC projects are targeted to low and moderate-income households who must pay a specific rent that is not based on their incomes. Unless a planned project has project-based rental assistance or a tenant has a Housing Choice Voucher, each tenant must have sufficient income to pay the proposed rents. In many cases, tenants who pay an excessive amount of their income for rent do not have enough income to pay the rents at the planned project.

**Housing Choice Vouchers:** If the planned project’s rents will be under the Housing Payment Standards, vouchers can be a source of supplemental demand. Voucher support for income-restricted units can be substantial in communities where prevailing rents far exceed Housing Payment Standards, units do not meet Housing Quality Standards, landlords of existing properties do not participate in the voucher program, and/or housing authorities have unused vouchers.

**Market Saturation:** If the primary market area already has units that serve a large percentage of the planned project’s target income group, there may not be enough unserved households to fill another planned tax credit project without adversely impacting the occupancy levels of existing LIHTC projects.

**Location:** A site’s adjacent land uses, access, visibility, neighborhood characteristics and/or surrounding land uses may attract or prevent renters from moving to the site.

**Proposed Rents:** Demand estimates indicate the number of households able to pay the proposed rents, not their willingness to do so. If the proposed rents do not offer a value commensurate with the project’s location, design, unit size, and amenities, income qualified households may not lease the proposed units.

**B. Red Flags**

**Inappropriate Market Area:** The size and socio-economic composition of a market area greatly influences demand calculations. A market area that is too large will overstate demand for a proposed development. An unrealistically small market area may either understate demand by underestimating the number of potential, income-qualified residents or overstate demand by excluding competitive existing or planned projects that are just outside the defined market area.

**Sole Reliance on Capture Rates:** A capture rate only measures the ratio of the total units proposed to the number of income qualified households in the market area. It does not take into account whether the other existing or approved projects adequately serve the proposed project’s target income group. A capture rate also does not consider if there is demand for additional units at the target rent and income levels.
**Use of Threshold Criteria:** While capture and penetration rates are certainly an important measure of the strength of proposed development, determination of a project's viability should not be based solely on one number. A low capture or penetration rate does not automatically equate to demand for the proposed development. Conversely, a higher capture rate or penetration may be acceptable if the project is properly positioned or the market area is experiencing or about to experience rapid growth.

**Project Level Capture and/or Penetration Rates:** For projects that have an uneven unit mix (such as four one bedroom, 32 two bedroom, and 36 three-bedroom units) or AMI distribution (such as four 30% AMI and 72 60% AMI units), the use of aggregate capture or penetration rates can result in a misleadingly high estimate of the number of income qualified residents.

**Limited number of units of a specific type or AMI level:** Including a few units of a specific unit type or AMI level can allow a project to appeal to a broader income range. If the analysis does not consider whether there are sufficient households to fill each unit type at each proposed AMI or rent level, the demand conclusions may not be an accurate indicator of whether a proposed project’s unit mix and occupancy restrictions are suitable for the market area.

**Reliance of rent over-burdened households as a measurement of demand:** Rent overburden indicates that either households do not have sufficient income to afford private rental housing or that they have elected to spend a greater share of their income for rent. Rent overburdened households are concentrated at the lowest income ranges. Unless a project has project-based rental assistance or rents at the lowest AMI levels, it will not necessarily attract rent over-burdened tenants.

**Tenant-based Housing Choice Vouchers:** The availability of Housing Choice Vouchers or the waiting lists for Housing Choice Vouchers are generally not accurate measures of demand for a proposed rental community. Little correlation, if any, exists between the demand for vouchers, which allow tenants to pay rents based on their incomes, and 60% LIHTC units, which require all tenants to pay a specific rent. Vouchers are often left unused because tenants cannot find units that satisfy the program’s rent and housing quality requirements. At best, a discussion of Housing Choice Vouchers should be anecdotal.

**Use of census data to measure substandard housing:** State demand models that include census-based substandard housing measures (usually inadequate plumbing facilities and overcrowded conditions) often do not completely capture the quality of the housing stock in a given market area. However, there is generally a correlation between the percentage of households residing in these housing units and the condition of a market area’s rental stock. Urban market areas will often have high substandard percentages, while emerging suburban and exurban markets have low substandard percentages. Thus, states that use substandard housing measures find that additional rental units are more difficult to justify in newer areas.

**No discussion of pipeline in demand analysis:** Units planned or under construction can alter the market area’s rent and vacancy levels of different unit types. If the number of units within the market area’s development pipeline exceeds short-term new construction needs, the market area may experience oversaturation, which might impair the market feasibility of the planned project.

**Underperforming LIHTC projects:** If LIHTC units, particularly those that have the same occupancy restrictions as the planned project, are experiencing higher vacancy rates that the overall market, there may be less demand for the planned project than indicated by a capture rate or penetration model.
Conversely, higher vacancy rates may be limited to a specific project with design flaws or management deficiencies that is causing it to underperform in an otherwise healthy market.

**D. Recommended Practices for Analyzing Demand**

**Capture Rate:** Calculate the project’s overall capture rate, as well as the capture rate for each unit type by proposed income targeting.

**Penetration Rate:** Calculate the penetration rate. Discuss whether there are enough unserved income- and size-qualified households to fill the proposed project without creating an adverse impact on the occupancy levels of comparable existing projects.

**Anticipated Additions to Housing Stock:** Discuss the implications of any future changes in the rental housing stock within the market area upon the long-term and short-term feasibility of the proposed project.

**Unit Replacement:** Where applicable, discuss the impact of physical depreciation, functional obsolescence, or a declining demand for a particular unit type within the market area on the demand for the proposed project.

**Absorption Levels:** Define and justify the absorption period and absorption rate for the subject property, considering the proposed unit mix and rent structure. The absorption forecast should consider the market area’s historic ability to add and fill additional units, the performance of directly comparable properties, and the indicated capture and penetration rates. If a project’s expected lease-up period will exceed its planned lease terms, the projected absorption rate should consider turnover by initial tenants.

**Overall Market Demand:** Discuss the additional number of units needed within the market area between the effective date of the report and the planned project’s anticipated completion date. The overall demand estimate should consider the market area’s existing vacancy levels, anticipated household growth rates, unit replacement needs, and project’s that are planned and under construction. The analysis should determine if there is sufficient demand to support the proposed project.

**Housing Choice Vouchers:** Evaluate need for voucher support or HUD contracts, if applicable.

**Market Balance:** Evaluate a planned development’s impact on overall rental occupancy rates. This analysis should include all units, as well as those in the planned development’s target rent and income ranges.

**Market Position:** Discuss how effectively a planned development’s location, design, size, unit mix, and income distribution matches market area need. Recommend changes to project design, unit mix and occupancy restrictions that would improve the planned development’s ability to attract and retain tenants.