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Investing in the future

How institutional capital is addressing the global housing shortage

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EXPERT COMMENTARY

The housing affordability crisis is providing abundant opportunities for investors in the 'essential housing' sector, says Todd Williams, chief investment officer at Grubb Properties

America is getting squeezed in the middle

Today in the US, younger generations face a serious housing crisis. For decades to come, young professionals will continue to face issues of housing affordability. They do not have sufficient income and savings for luxury rentals or to purchase single-family homes, while also making too much to qualify for subsidized housing.

As a result, essential housing – moderately priced apartments in urban areas close to public transportation and employment opportunities – is in high demand. This missing middle multifamily asset class represents a significant market opportunity. Answering this growing need with efficiently and well-managed properties at scale can create both a stable revenue stream and substantial upside potential from well-timed real estate asset divestments.

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Capitalizing on this opportunity will require a sophisticated, multi-pronged strategy – one that would include data-driven location selection, cost-effective acquisition and development, smart use of land, energy-efficient designs, attentive property management and more.

The missing middle

Housing has been materially under-built for the past 15 years, and the US housing shortage is projected to last another five to 10 years, according to reports by consumer financial services company Bankrate. This lack of supply has led to high housing prices, and for many, renting continues to be more economical than buying a home. The spread between monthly homeownership and rental costs expanded to more than $1,000 per month in the fourth quarter of 2023, as reported in brokerage Newmark's *US Multifamily Capital Markets Report*. This leaves many renters by necessity without a tangible path to homeownership and ultimately to economic stability and mobility.

Even so, rents have grown rapidly over the past few years, although some high-growth markets are currently seeing flattening of rent growth thanks to the addition of post-pandemic new supply. Yet a powerful demographic wave of Millennial and Gen Z working professionals is likely to continue driving demand for multifamily housing. The US birth rate peaked in 2007, and Gen Z (currently aged 15-29) is the only generation adding renter households as they enter the workforce, according to the Joint Center for Housing Studies. But they, like many others, are rent-burdened: 58 percent of Gen Z renters spend more than 30 percent of their income on housing, reports American news site Axios.

The available stock of middle-segment multifamily rental properties does not match this market demand and developers remain focused on building high-end or luxury apartments targeting upper-middle to high-income rents. Nearly 2 million new apartment units were delivered between 2020 and 2023, largely in high-growth markets. Of those new units, more than 75 percent were considered to be high-end or luxury.

Over the next three years, nearly 1 million additional apartment units are forecasted to be delivered, and 98 percent of the units projected to be delivered in 2029 are luxury apartments. With this addition, luxury units will make up nearly 35 percent of total market inventory – up from just 26 percent in 2020, according to data from global commercial real estate research and analytics firm CoStar. We foresee that the slowing of overall supply will not keep up with demand, and in addition, the supply that is being delivered is too concentrated in the luxury segment.

Rents continue to increase faster than personal income, climbing 61 percent since 2000 compared to 11 percent for wages, according to data from the US Census Bureau. Today, the renter's dollar does not go nearly as far as it did in 2000. Analysis by Moody's shows that more than half of Americans spend 30 percent or more of their income on rent, meaning they qualify as rent-burdened, and nearly half of all rent-burdened households are in the median-income category, according to a *DSNews* article from October. And in Grubb Properties' *2023 State of the Young American Renter Survey*, when respondents were asked to rank five economic concerns, 33 percent put rental increases at the top of the list.

"This essential housing asset class is positively differentiated and well positioned to help with our nation's housing crisis while providing investors with access to the generational market opportunities ahead"

Essential housing

All this adds up to a critical need for moderately-priced housing that is designed to meet the needs of this emerging demographic – in other words, housing in the missing middle.

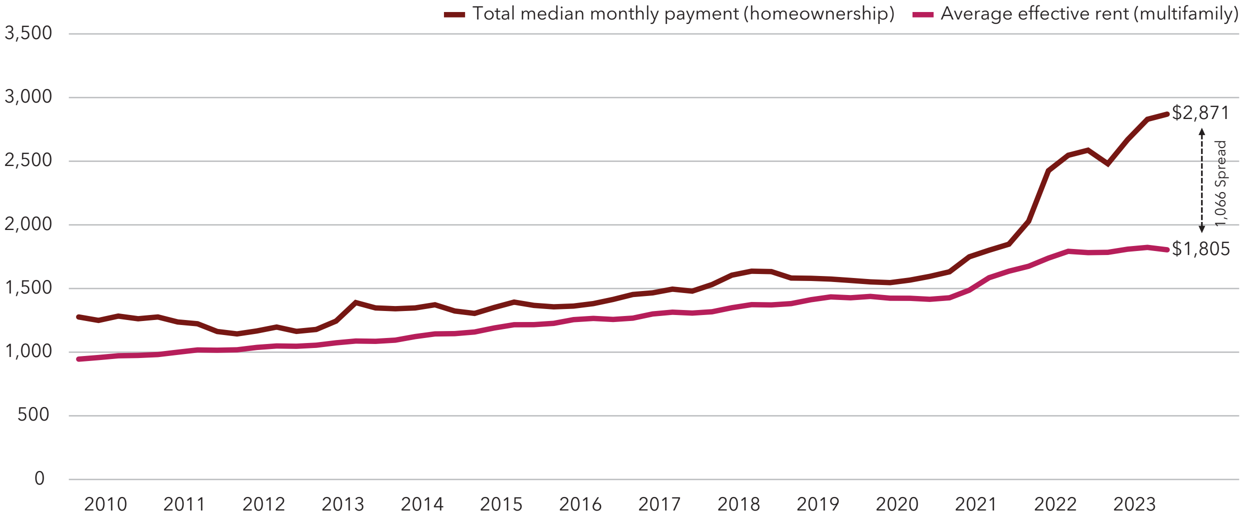
We term this asset class serving middle-income workers 'essential housing' – quality multifamily rental options in resilient and high-growth urban markets that can make an important impact on the housing shortage. As we define it, essential housing is for households earning 60 percent or more of the area median income (AMI), above the cut-off for public housing subsidies, but less than 140 percent of AMI.

This essential housing asset class is positively differentiated and well positioned to help with our nation's housing crisis while providing investors with access to the generational market opportunities ahead.

We aim to locate our essential housing communities near large, stable employment centers such as hospitals, biotech and innovation hubs, state governments or large research universities. We have observed that our Millennial and Gen Z renters highly value proximity to workplaces and community amenities. We also prioritize locations near transit options, including bike paths, mass transit and greenways, and build amenities to enable and encourage the use of transit alternatives. For example, our Link Apartments NoDa 36th community in Charlotte, North Carolina, is adjacent to a light rail station that connects directly to uptown Charlotte, is near a popular greenway and is in the heart of one of the city's most walkable communities.

Creating essential housing assets can be done through both cost-effective acquisition – including purchasing existing distressed luxury projects to be repositioned – as well as development, utilizing smart

Home ownership and renting costs are moving further apart ($)



Source: Newmark United States Multifamily Capital Markets Report, Q4 23

design, efficient use of square footage, construction efficiencies and other creative techniques to drive down cost, generate non-tenant revenue or subsidies and to reduce recurring operating expenses such as utility costs. It also should include property management that elevates resident satisfaction and retention, decreasing turn costs and making the community a more enjoyable place to live.

61%

Growth in multifamily asking rents from 2000-23

11%

Growth in median household income during that period

Source: CoStar, US Census Bureau

Finding the opportunities

Investors looking to participate in the essential housing market should consider several criteria when evaluating opportunities.

First, assess whether the market has strong demographics and if the product aligns with the current and foreseeable market demand. There is a margin of safety to projects driven by resilient demographic demand rather than being dependent on an increasingly narrow segment of the population with high relative incomes.

Second, check if the multifamily portfolio is diversified and scalable, and if it includes both stabilized communities as well as projects readying for lease-up and others in the development pipeline. Portfolios located in a variety of markets, such as high-barrier-to-entry and housing-starved gateway cities, as well as high-growth markets with limited new construction that is priced to be accessible to essential workers, will often perform better.

Third, evaluate whether the portfolio has long-term stability and growth drivers, for instance, properties in areas located near major urban centers with resilient or counter-cyclical employment.

And finally, a portfolio should have a path to stabilization. Investors should know the longer-term commitment and plan to establish and drive sustainable high occupancy rates and low resident turnover at the communities. These metrics lead directly to elevated net operating income and ultimately to higher asset valuations.

The essential housing opportunity exists across the US, with a variety of potential execution strategies depending on local market conditions. Some examples of the platforms on which to build a productive portfolio include:

- Urban infill development locations in high-growth US markets with transit options and major counter-cyclical employment anchors such as research universities and medical centers.
- High-barrier-to-entry gateway markets such as New York City, Los Angeles, Denver and Northern California's Bay Area that have experienced housing challenges.
- Distressed luxury apartment development projects in both market types that can be acquired at a significant discount to replacement cost. Elevated interest rates, oversupply and overleveraged developers provide a window of opportunity to buy and reposition some of these projects as amenity-rich essential housing.

With the significant supply and demand imbalance for US value-based housing continuing to grow, essential housing can play an important role in addressing part of America's housing affordability crisis while providing a compelling opportunity for real estate investors. ■