Middle-Income Housing Post-Covid-19 Even More Essential

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Executive Summary

The Praedium Group and SitusAMC Insights have jointly produced this report, which focuses on the outlook of the US apartment market, with an emphasis on middle-income multifamily housing and renters earning $60,000-$90,000 per year, roughly 90-150% of National Median Income. We believe that strong demand for middle-income housing is fueled by several long-term economic and demographic trends and a beneficial supply/demand dynamic, providing attractive growth prospects in this sector of the multifamily market.

- Propensity to Rent Among Millennials and Baby Boomers, and the Rising Population of Gen Z – Demographic shifts are fueling long term apartment demand, as Gen Z, millennials and baby boomers all enter notable renting ages and show a higher preference for renting over ownership. At present, a record number of young adults 18-29 years old are living at home – a number that jumped to 52% in 2020 during the pandemic – representing a potentially huge pool of pent-up demand for middle-income housing.

- Deteriorating Attainability of Single-Family Housing – Though some households may seek more space amid the pandemic, homebuying conditions remain difficult for middle-income and first-time buyers. Home price gains have outpaced wage growth for years, and with for-sale inventory near all-time lows as construction costs surge, prices rose a record 17.2% year-over-year in March. Rising costs have made the construction of "starter homes" as affordable price points challenging. The decline in affordability of single-family homes continues to curb potential homebuyers. Coupled with stricter lending standards and dwindling mortgage availability this past cycle, many middle-income households will be prevented from potential homeownership, shifting additional demand towards renting.

- Substantial Middle-Income Housing Renter Pool – Middle-income renters, defined as households earning approximately $60,000 to $90,000 (or roughly 90-150% of National Median Income), account for a considerable segment of rental demand. With substantial barriers to homeownership still in place, many in this considerable portion of the population will turn towards the more affordable rents of middle-income housing.

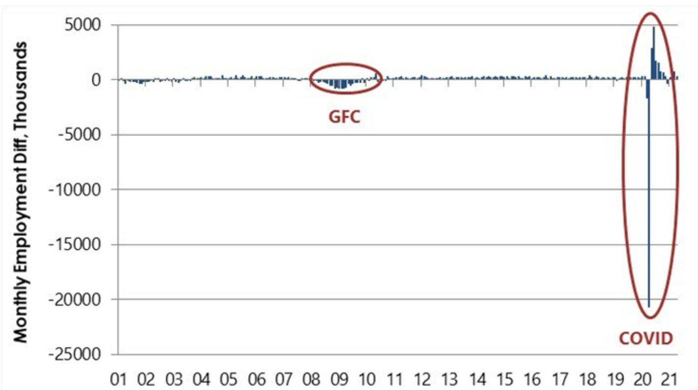
- Lack of Newly Built Supply in Middle-Income Housing – Middle-income multifamily housing demand has been driven by many demographic factors this cycle, but newly built supply additions are minimal, keeping vacancy rates for Middle and lower income apartments in the mid-3% range for several years. While vacancies have seen an uptick during the pandemic, they remain below 4% and more than 300 bps lower than luxury apartments. As land, labor and construction costs have dramatically escalated for many years, multifamily developers need to achieve luxury rents for projects to be economically feasible and are overwhelmingly building at the high-end of the market. As a result, luxury apartment inventory has also grown more than 45% in the last decade, compared to less than 2% growth in Class B & C inventory. Although the demand for affordable and lower-rent multifamily housing has been evident, rising cost structures make it more difficult for investors and developers to build new units with non-luxury rents. Costs have increased substantially from both a labor and materials perspective over many years, and pandemic disruption has caused some material costs to boom, keeping the focus of developers on luxury housing over middle-income housing.

For purposes of this discussion, Class A housing targeting high-income renters is referred to as "luxury;" Class B multifamily housing which targets middle-income renters is referred to as "middle-income housing;" and Class C housing is termed "lower-income housing."

Economic & Demographic Background

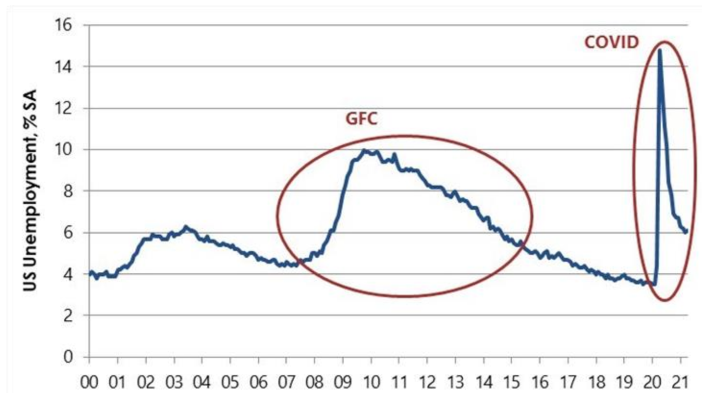
The record-long economic expansion came to a sharp halt with the Covid-19 crisis, causing record drops across various economic indicators. The labor market lost over 22 million jobs while unemployment swelled to nearly 15%, some 500 bps above prior financial crisis peaks. While the economic recovery has cooled after an initial burst and some challenges should be expected, there are reasons for broader optimism in a strong recovery. Covid-19 vaccines were developed very quickly and have proven to be highly effective so far, and as vaccination rates continue to climb while positive cases slow, this progress signals a reopening of the economy on the horizon. The labor market continues to improve, already recovering over 14 million of the more than 22 million jobs lost, while unemployment has fallen 870 bps from its peak to 6.1%. The April jobs report underwhelmed relative to expectations, highlighting some of the bumpiness that should be expected over the course of this recovery, but the focus should be on the fact that the labor market continues to add jobs.

Of 22+ Million Jobs Lost at Pandemic Onset, Over 14 Million Have Been Added Back



Sources: BLS, SitusAMC Insights

Unemployment Recovering from Record High in Modern Times



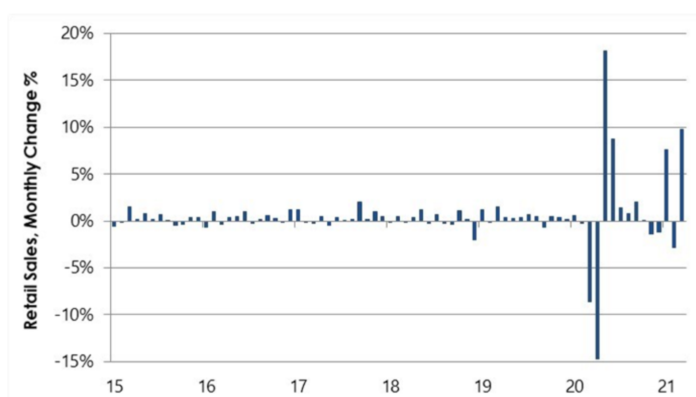
Sources: BLS, SitusAMC Insights

The Fed's industrial production index similarly rebounded but remains 3.4% shy of its pre-pandemic level. The ISM's index of national factory activity soared to its highest level in nearly 40 years, while manufacturing survey measures including the Philadelphia Fed and Empire State Manufacturing surveys have surpassed pre-pandemic levels, though manufacturers report labor shortages as they struggle to keep pace with pent-up consumer demand. Retail sales have reflected this pent-up demand with a substantial bounce back, most recently jumping 9.7% in March as Americans spent their latest stimulus checks.

Industrial Production Has Rebounded

Sources: Federal Reserve, SitusAMC Insights

Retail Sales Have Recovered to New Highs



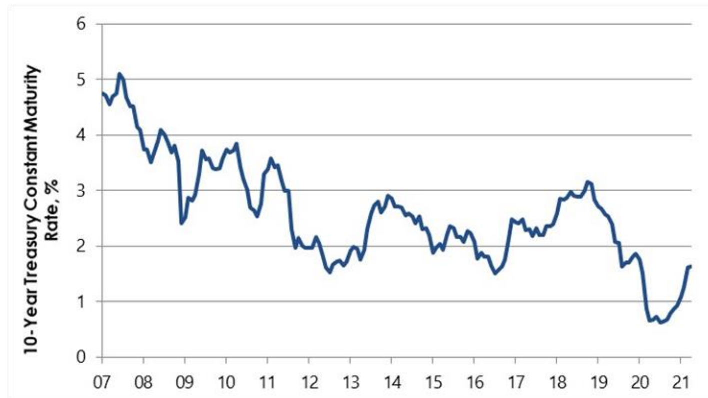
Sources: US Census Bureau, SitusAMC Insights

Stocks initially fell off a cliff when the pandemic hit, with the Dow and S&P both falling some 20% in March alone. However, both have come storming back to all-time highs with year-over-year growth now in the 45-50% range, reflecting investor optimism in the recovery. The 10-Year Treasury rate initially fell to record lows but has since bounced back to pre-pandemic levels, albeit still at a relatively low level historically while hovering around 1.6% from March to early May. While the Fed has acknowledged rising inflation amid improving economic conditions, officials insist interest rates will remain near zero for the foreseeable future.

Stock Market Initially Tumbled but Now Surging to All-Time Highs

Sources: S&P Dow Jones Indices LLC, SitusAMC Insights

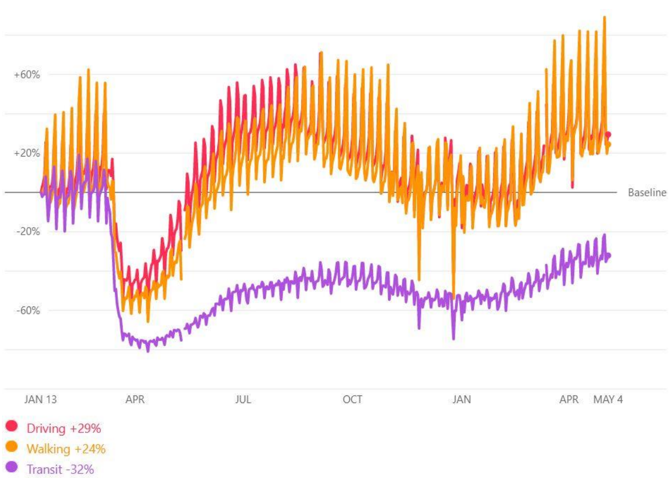
10-Year Treasury Fell to Record Low but Has Since Advanced to Pre-Pandemic Levels



Sources: Federal Reserve, SitusAMC Insights

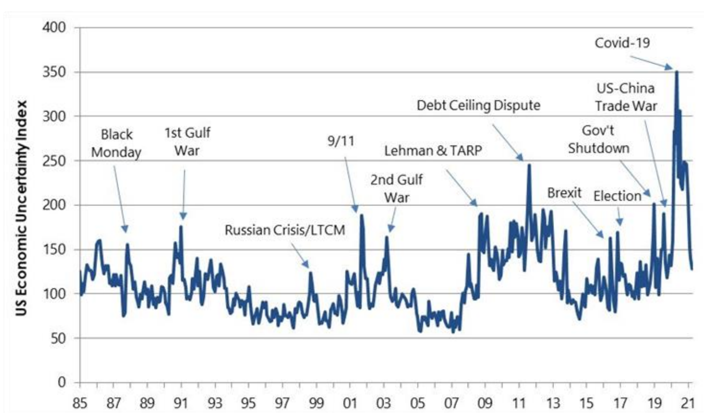
Additional data points suggest everyday life and sentiment are on the mend. According to location data from Apple, US mobility via transit is improving but remains below pre-pandemic levels, an indicator that activity has yet to fully return to pre-Covid levels. However, driving and walking have improved from pre-pandemic levels, and are trending on par or better than last summer's post-lockdown surge. The US is also seeing much stronger gains in driving mobility (+29% vs. January 2020 baseline) compared to European counterparts including the UK (+7%), Italy (-1%), and Germany (-4%). The US Economic Uncertainty Index, which has captured the impact of various crises over several decades, has made a substantial retreat from its all-time peak a year ago. The index remains elevated compared to its baseline in recent years, suggesting some lingering uncertainty as everyday life across the country has yet to fully return to pre-pandemic normalcy, but the index's sharp decline reflects optimism as vaccination rates increase and the economy reopens.

Mobility Continues to Improve, Supporting Recovery



Sources: Apple, SitusAMC Insights

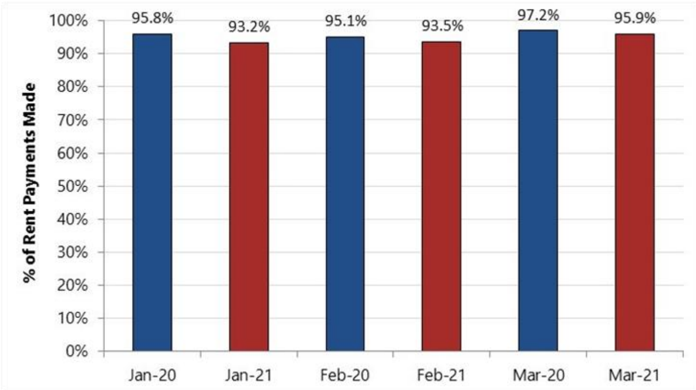
Uncertainty Has Receded from Record High Level



Sources: Economic Policy Uncertainty, SitusAMC Insights

Despite the economic shock brought on by Covid-19, apartment rent payments have held up relatively well per the NMHC's Rent Payment Tracker, which collects data on 11.1-11.6 million apartments each month. Apartment rent payment rates have yet to dip below 93% in 2020-21, and through March 2021, payment rates were within 300 bps of their pre-pandemic rates from a year ago. Existing home sales popped after an incredible 30% slide in three months, as delayed transactions and pent-up demand eventually lifted sales to their highest level since 2006. Sales have tapered off since peaking in October, with historically low inventory limiting transactions, but they remain above previous cycle highs.

Apartment Full or Partial Rent Payments Have Held Up Relatively Well



Sources: NMHC, SitusAMC Insights

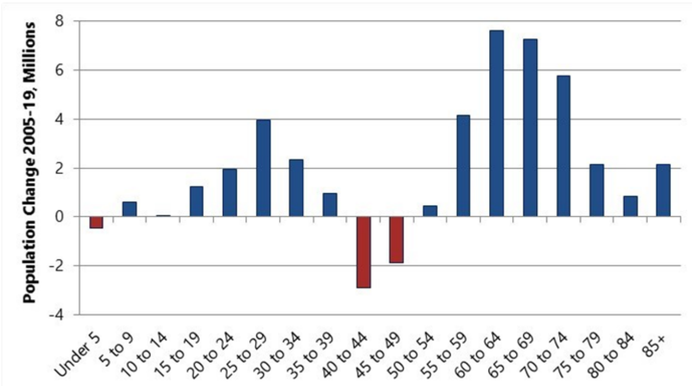
Existing Home Sales Plummeted Before Rebounding to Highest Level Since 2006

Sources: NAR, SitusAMC Insights

While home sales have exploded, conditions for homebuyers are rapidly eroding. Historically tight inventory amid the surge in sales is causing prices to skyrocket, most recently rising a record 17.2% year-over-year in March to a new all-time high. While economic conditions are improving and mortgage rates remain favorable, soaring prices are squeezing affordability for buyers. Stringent lending standards are also keeping many potential buyers at bay, even if some are seeking more space in the aftermath of the pandemic. These strict and increasingly unaffordable conditions could limit the pool of potential buyers, notably first-time buyers and middle- to low-income workers.

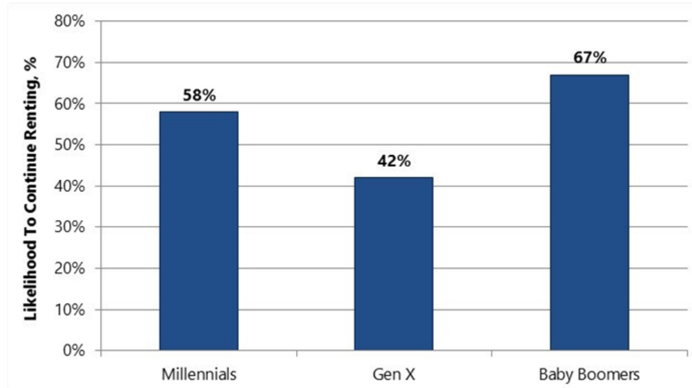
Despite the economic uncertainty brought on by the pandemic, longer term demographic trends have still aligned to drive future rental demand. Gen Z, millennials and baby boomers are the three most prominent generations dominating housing demand, as age groups from 20-39 and 55-74 have seen the largest population gains since 2005. These age groups are notable renting ages; people both enter the workforce and begin renting, as well as retire and look to downsize. Not only are Gen Z, millennials and baby boomers hitting notable renting ages, survey data indicates they prefer renting compared to other generational cohorts. While worth noting this is pre-pandemic survey data, any potential shifts in sentiment would also have to overcome rising hurdles to homeownership. More recent survey data from Apartment List showed that the number of millennials who expect to always rent has increased from 10.7% in 2018 to 12.3% in 2019 to 18.2% in 2020, evidencing a structural and not cyclical shift in behavior among this age cohort. These demographic trends and generational preferences will continue to account for heavy rental demand in the coming years.

Notable Renting-Age Cohorts Seeing the Fastest Population Growth



Sources: US Census Bureau, SitusAMC Insights

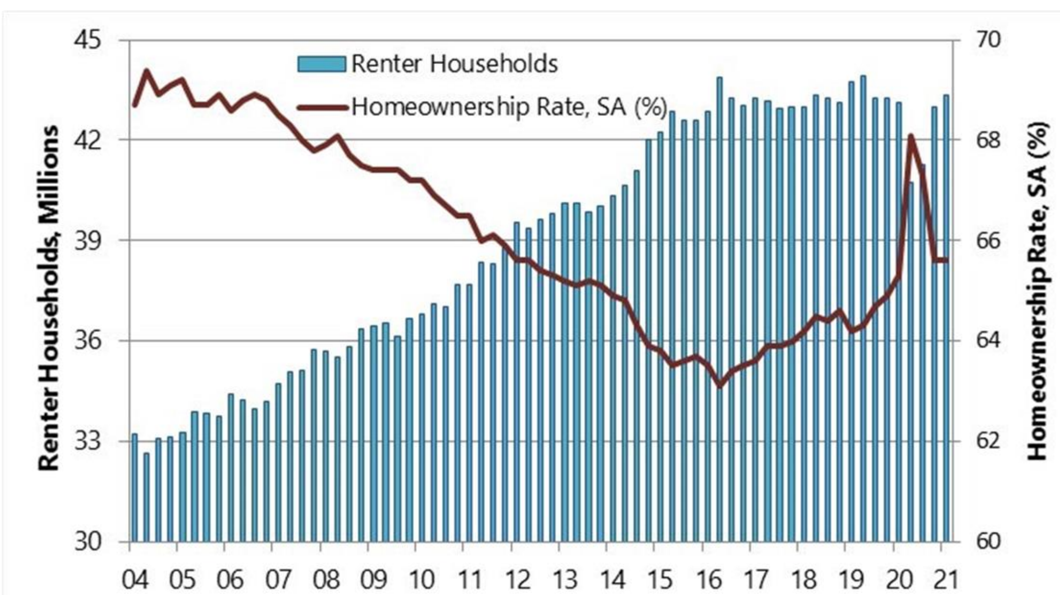
Millennials and Baby Boomers Have Shown a Greater Preference for Renting Than Gen X



Sources: Freddie Mac, SitusAMC Insights

With these demographic trends developing, renter households rose some 30% between 2004-16 as homeownership plunged in the aftermath of the housing bust and facilitated a shift from owning to renting. After bottoming out at 63.1% in 2016, homeownership began to drift higher and stunt renter household growth but remained relatively low from a historical perspective. Amid the pandemic, homeownership surged to 68.1% in 2Q20, its highest level since 2008, but quickly retreated to the mid-65% range. Renter households similarly dropped but quickly returned to pre-pandemic levels, rising 6.4% over three quarters and surpassing 43.3 million in 1Q21. Though homeownership sits higher than its rate through much of the past cycle, potential homebuyers are now facing an all-time shortage of homes for sale, record-high price growth, and historically strict lending standards, which could all work to suppress the homeownership rate and keep many middle-income households renting.

A Pandemic Spike in Homeownership Has Reversed Course, Lifting Renter Households Back Near All-Time Highs

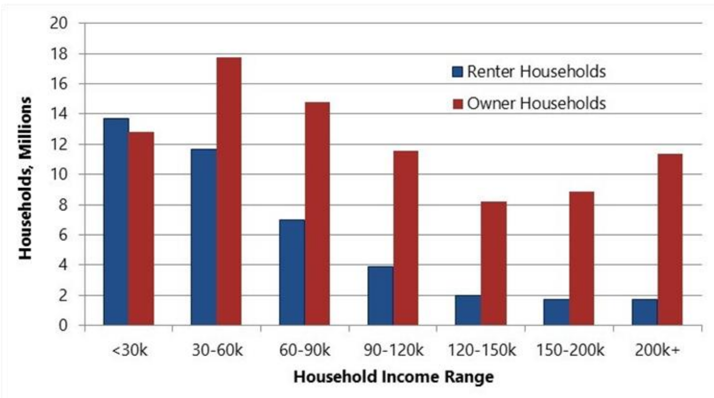


Sources: US Census Bureau, SitusAMC Insights

Middle-Income Rental Demand

Broader apartment demand has been fueled by numerous factors, but middle-income housing demand has been particularly robust. Middle-income housing renters, focused on households earning between $60,000 and $90,000, or approximately 90% to 150% of the national median income, represent a considerable share of renters that are driven to more affordable middle-income housing apartments rather than upscale luxury apartments. In 2019 there were nearly 7 million US households with $60-90k income, accounting for significantly more renter households than higher income bands that showed a greater propensity for homeownership. The SitusAMC Insights Apartment Affordability Index calculates rental affordability where 100 = affordable and a higher score indicates greater affordability. This index reflects how Class B & C apartments are considerably more affordable than Class A for households with $60-90k in income, with Class A apartments even measuring unaffordable for $60k households.

Households with 60-90k Income Account for More Renters Than Higher Income Bands



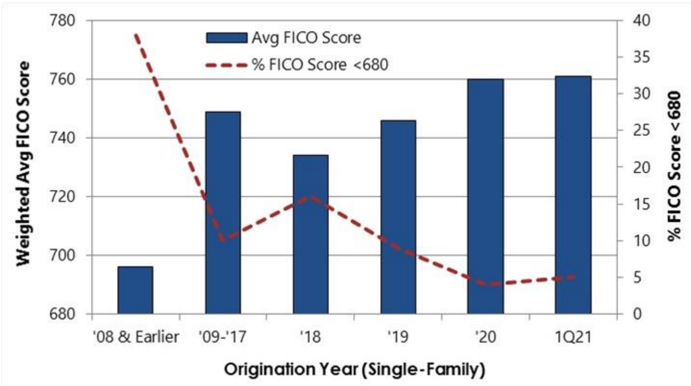
Sources: US Census Bureau, SitusAMC Insights

Affordability a Key Issue for Renters

Sources: Reis, SitusAMC Insights

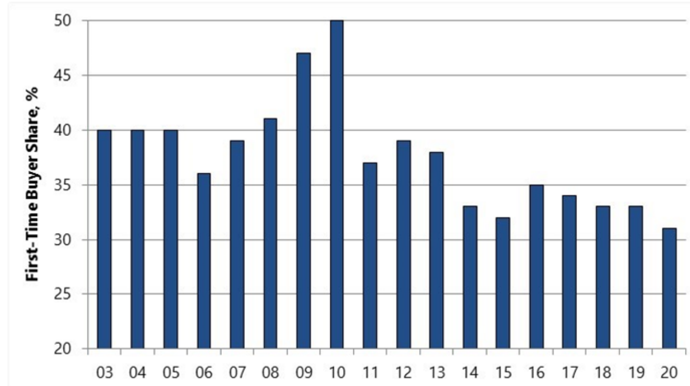
This class of renter is becoming more prominent due to both demographic shifts and limitations encountered by such middle-income households in the purchase of homes, such as stricter lending standards and savings for down payment, which remain major obstacles to many potential buyers. Mortgage lending standards remain significantly tighter in the aftermath of the housing bust and have even tightened further in recent years. According to Fannie Mae data on conventional single-family mortgages, weighted average FICO credit scores have now risen above 760 as of 1Q21, an all-time high well above the sub-700 standard for originations before 2009, and still a notable climb from the 746 average across 2009-17. The share of FICO scores below 690 has similarly tumbled from a whopping 38% before 2009 to 10% across 2009-17 and 5% in 1Q21. Mortgage availability has also plunged according to the Mortgage Bankers Association's index (MCAI), which fell off a cliff during the pandemic and remains more than 30% below its year-ago level and some 85% below its 2006 peak.

Mortgage Lending Standards Remain Tight



Sources: Fannie Mae, SitusAMC Insights

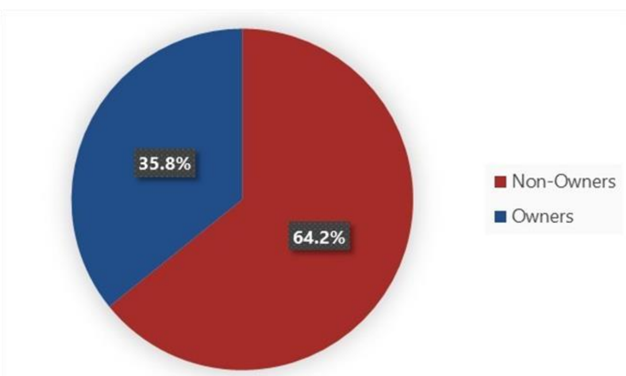
First-Time Homebuyers Remain Subdued



Sources: NAR, SitusAMC Insights

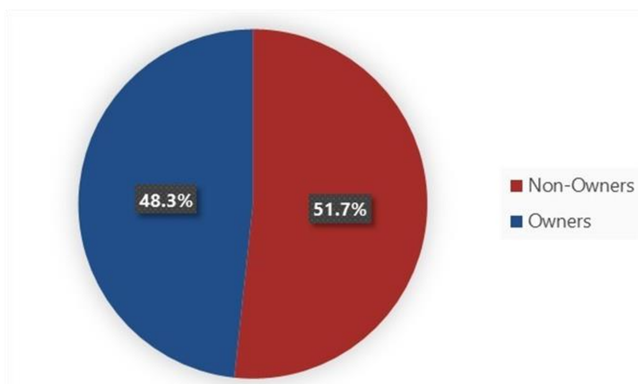
Stringent lending standards and tight mortgage availability have limited potential first-time homebuyers. Despite a pandemic-induced spike in home sales, the share of home sales to first-time buyers fell to 31% in 2020 per the NAR, the lowest level since 1987. Even if there was a desire for more space, many potential buyers remain burdened by lending conditions and economic hardship. The share of first-time buyers has been suppressed ever since the housing bust, a historical discrepancy reflected in generational differences. Per the Stanford Center on Longevity, prior to the pandemic millennial homeownership at age 30 was just 35.8% compared to a whopping 48.3% for baby boomers at age 30, highlighting how middle-income housing demand is further shifting from buying to renting.

Homeownership Among Millennials at Age 30



Sources: Stanford Center on Longevity, US Census Bureau, SitusAMC Insights

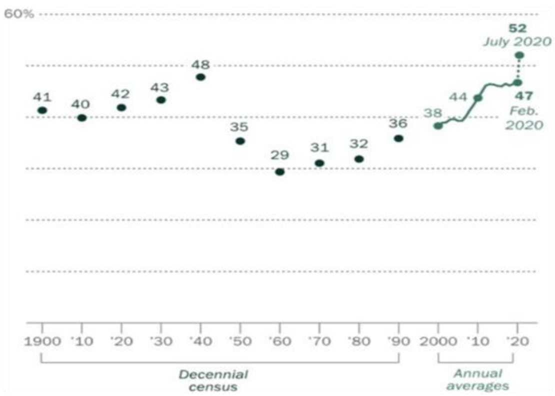
Homeownership Among Baby Boomers at Age 30



Sources: Stanford Center on Longevity, US Census Bureau, SitusAMC Insights

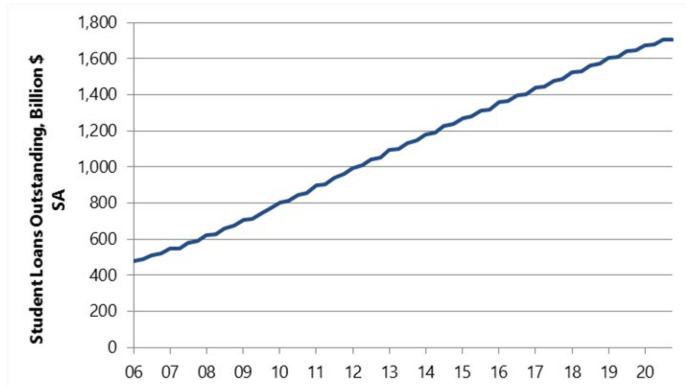
The number of 18-29-year-olds living with their parents surged in the aftermath of the financial crisis and remained stubbornly high above 45% for a decade. Amid the pandemic this rate jumped 500 bps to 52% in July 2020, an all-time high. As the economy continues to pick up steam, this elevated rate represents a pool of potential new renters as conditions improve and young adults begin moving out of their parents' homes. While the pandemic may prompt some to seek more living space, the housing market remaining unfavorable for first-time buyers, forcing many of these future household formations to become renters. It is also likely that there may be a greater focus on saving up rainy-day funds in the aftermath of the pandemic, with many households seeking flexibility in living arrangements over long-term financial commitments. Meanwhile student debt continues to soar, doubling over the past decade to more than $1.7 trillion. While President Biden has expressed support for some student loan forgiveness up to $10,000 per borrower, attempts to cancel more per borrower are undergoing internal review, and no specific plans have been introduced. This massive burden continues to stymie many potential homebuyers, and even if some level of relief does come to fruition, the recession likely stunted many household budgets and potential down payments. Coupled with still strict lending standards, the harsh reality is that many millennial households will be forced to continue renting.

More Than Half of 18-29-Year-Olds Now Live with Their Parents



Sources: Pew Research Center, US Census Bureau

Student Debt Doubled Over the Past Decade, Limiting the Home Buying Potential for Many

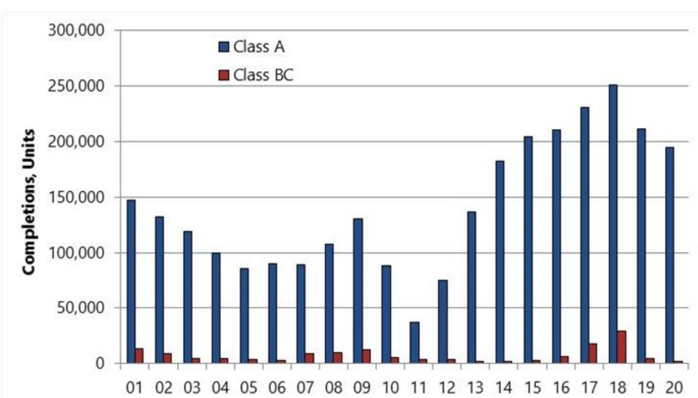


Sources: Federal Reserve, SitusAMC Insights

Class Cut Fundamentals

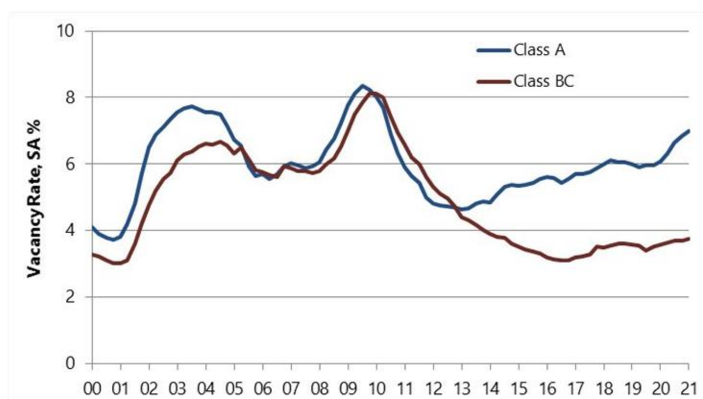
Fundamentals for luxury and middle/lower-income properties have seen diverging trends for several years now. Much of this can be traced to apartment construction, where developers have focused mostly on luxury buildings for decades. Even though construction has tapered off the past two years, accelerating completions for much of the past decade have flooded the market with luxury units, sending luxury vacancies well above Class B & C. Since bottoming out at 4.6% in 2013, luxury vacancies have now risen to 7% in 1Q21, including a 90 bps year-over-year jump amid the pandemic. Meanwhile Class B & C vacancies remain below their 2013 levels, rising just 20 bps over the past year to a seasonally adjusted 3.8% in the first quarter.

Class A Completions Have Far Surpassed Newly Built Class B & C Supply



Sources: Reis, SitusAMC Insights

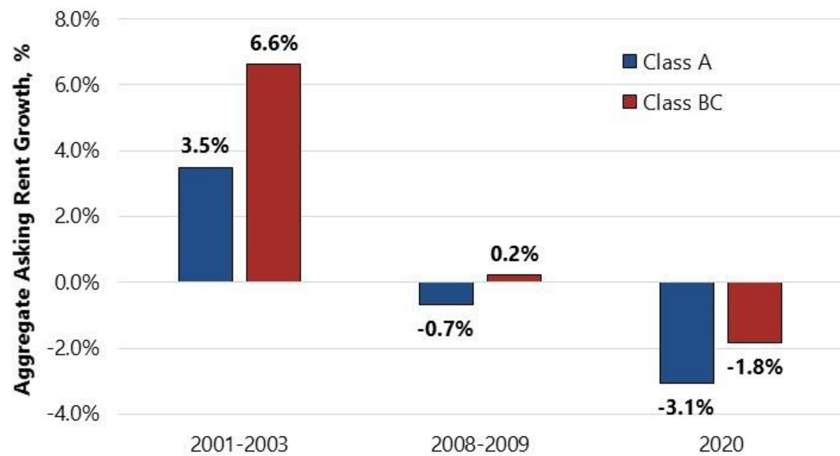
Class A Vacancies Trending Further Above Class B & C Apartments



Sources: Reis, SitusAMC Insights

Middle- and lower-income apartment rents have also outperformed luxury in downturns over the past two decades, showing greater resilience during downturns. Class B & C apartment rents grew an aggregate 6.6% during the 2001-2003 downturn, outpacing 3.5% luxury growth. Both class cuts performed worse during the 2008-2009 financial crisis, but Class B & C apartment rents managed to eke out marginal growth while Class A rents contracted. This trend continued in the latest downturn, as both class cuts saw rents decline amid the sharp downturn in 2020, though Class A contracted 3.1% compared to 1.8% for Class B & C. Although middle- and lower-income apartment rental rate performance here is viewed as a single group, we believe that during disruptions in the overall economy, middle-income housing fare better than that of lower income properties, due to the inherent credit risk of the tenant profile of lower-income properties. The pandemic has also had a more profound effect on low wage workers, with the FRBNY finding low wage workers (<$30k) saw the steepest decline in employment between February and April 2020 at more than a third, and as of January 2021 remained the 14% below pre-pandemic levels, the lowest of any wage group. This further suggests that middle-income properties would outperform lower-income properties in this downturn.

Class B & C Apartment Rent Growth Outpaced Class A in Each of the Last Three Downturns

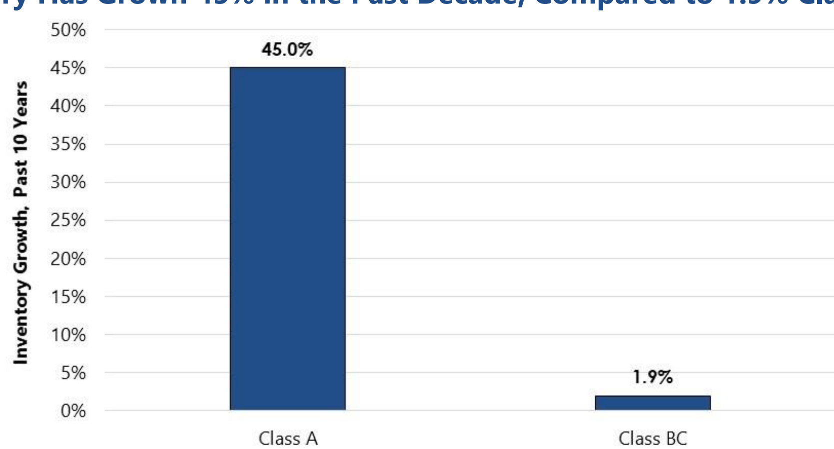


Sources: Reis, SitusAMC Insights

Class Cut Development Trends

New apartment construction in the 21st century has favored luxury units for high-income renters over more affordable units for middle-income renters. With multifamily developers increasingly pressured to focus on luxury buildings in order to turn a profit, Class A inventory has risen a massive 45% over the past decade per Reis. Meanwhile, Class B & C inventory has risen less than 2% over the same time. While Class B & C inventory has grown slowly over the past decade, renter households have increased 15% over that time, solidifying demand for middle-income rentals.

Class A Inventory Has Grown 45% in the Past Decade, Compared to 1.9% Class B & C Growth

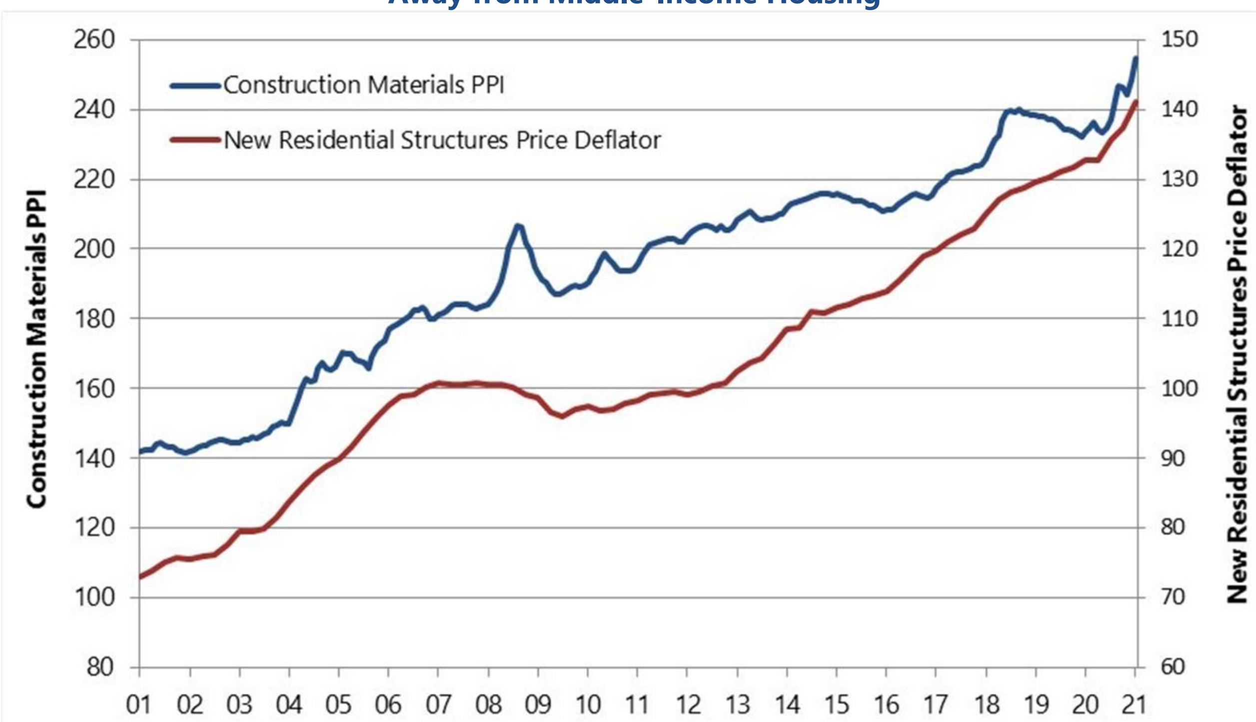


Sources: Reis, SitusAMC Insights

Construction Costs

Apartment inventory trends have been heavily influenced by construction costs for decades. Rising costs of materials and labor have pressured multifamily developers, forcing many to rely on building luxury units to meet profitability benchmarks. The result has been a flood of new luxury units to the market and a lack of more affordable units aimed at middle-income renters, a trend that has been reflected in class cut data. The construction materials producer price index was plateauing prior to the pandemic after many years of growth but began to surge over the back half of 2020. The construction materials PPI is now at an all-time high as of April 2021, rising 18% in less than a year and nearly 40% over the past decade. The new residential structures price deflator has consistently risen for many years and surged even further during the pandemic, now up 6.3% year-over-year in 1Q21 and nearly 50% from its 2009 trough. Supply shortages arising from trade and manufacturing disruption due to the current health crisis have caused some materials costs to surge of late. For instance, the producer price index for cold rolled steel, hot rolled steel, and softwood lumber are each at all-time highs after year-over-year gains ranging from 66%-83%. As production still ramps up in the aftermath of the pandemic, outsized demand may keep many material costs elevated in the short term.

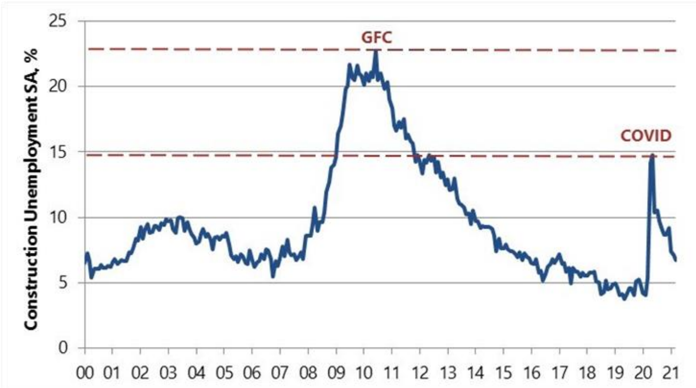
Construction Input Costs Have Risen Substantially Over the Past Two Decades, Steering Developers Away from Middle-Income Housing



Sources: BLS, BEA, SitusAMC Insights

In addition to substantial materials costs, labor costs are also pressuring development budgets. Construction unemployment surged to a seasonally adjusted 14.8% in May 2020, rising more than 1000 bps over three months, but maxed out well below the 22.7% peak in the aftermath of the housing bust. The sector rate has since begun a quick turnaround, falling more than 800 bps in less than a year to a seasonally-adjusted 6.7% in March. The temporary spike in unemployment has had little impact on construction wages, which continued rising through the pandemic as expected. In fact, average hourly earnings rose 2.9% in 2020, matching their pre-pandemic 2019 gain. With construction wages rising more than 2% every year from 2014-20, these persistent gains continue to put pressure on overall construction costs.

Construction Unemployment Tumbled Since Covid Peak, Never Approached Housing Bust Highs



Sources: BLS, SitusAMC Insights

Construction Wages Have Grown Considerably Over the Past 15 Years, Rising Through Downturns

Sources: BLS, SitusAMC Insights

Conclusion

As the economy continues its recovery from the pandemic shock, several market dynamics should continue to support middle-income housing in the long and short term. Key factors include: (1) a growing cohort of middle-income renters; (2) rising homebuying costs creating barriers to middle-income homeownership; (3) increased interest in renting among different generations, and (4) construction trends less focused on middle-income rental supply. Middle-income rental housing has outperformed luxury during the pandemic just as it has during previous downturns, showing greater resiliency during economic disruption. It is our belief that economic factors and demographic trends may help middle-income multifamily assets maintain stability during – and recover faster after – the economic disruption.

Notes