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REAL ESTATE

Opportunities in Moderate Income Rental Housing

Introduction

Over the past several decades, the residential rental sector has grown from relative obscurity to become one of the largest and most important institutional investment asset classes. The sector offers a wide range of investment options, including:

- Risk profiles – as low risk as first-lien mortgages to as high risk as ground-up development.
- Housing formats – from class-A high-rise apartment to manufactured housing communities, and everything in-between.
- Geographies – institutional residential investors are now active in over 50 cities across the U.S.

In recent years, investors have also begun considering how the income profiles of residents could shape investment strategies. Looking at strategic opportunities in the sector, we believe Moderate-Income Rental Housing offers attractive long-term risk-adjusted returns while supporting the need for more affordable housing in the U.S.

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What is Moderate Income Rental Housing?

Rental housing has traditionally been segmented into two income-related categories: [1] market-rate rental housing and [2] government subsidized rental housing.

For market-rate housing, rent for new leases is set by the landlord and governed only by prevailing supply and demand conditions in the market without restrictions.

Subsidized housing is a generic term covering all federal, state, or local government programs that reduce the cost of housing, typically for low- or moderate-income residents. This can include government-owned public housing, Section 8 (vouchers provided by the government that reduce the cost of privately owned housing), Low Income Housing Tax Credits that encourage investors to own or build housing for low- or moderate-income residents, among other programs. Owners of subsidized housing are typically required to charge rents that serve residents earning less than 60% of area median income.[1]

In addition to these two traditional groups, a new category is emerging. For the purposes of this analysis, we will refer to this category as "Moderate Income Rental Housing", or MIRH. Additional colloquializations include "workforce housing", "non-subsidized affordable housing", "class B/C apartments", among others.

While there is not a single authoritative definition, MIRH typically focuses on market-rent housing intended for moderate income residents, filling a gap between typical subsidized housing that explicitly limits costs to low-or-moderate income renters, and traditional market rate housing that has typically focused on middle-or-upper income renters. Importantly, renters in the MIRH category might exceed income limits for subsidized housing but may also stretch to afford typical market rate rentals.

Our definition of MIRH has two components. First, MIRH is market-rate housing that caters to residents earning between 60% and 120% of local area median income. Formats could include a range of options such as mid-or-high-rise apartments, garden apartments, manufactured housing, or single-family rentals. Second, the rent is offered at a rate that is between 20% and 40% of the renters' monthly gross income.

A Few Words on Rent Control…

In the interest of disambiguating rental housing terminology, it is worth briefly mentioning "rent control / rent stabilization". These laws generally put a limit on annual rent increases and outline tenant eviction protections. One example of a rent control law is AB 1482, or the "California Tenant Protection Act", which passed in 2019 and went into effect on January 1, 2020. AB 1482 restricts the allowable annual rent increase for all California multifamily rental units to 5% plus a local cost-of-living adjustment of no more than 5%, for a maximum annual rent increase of 10%.[2]

Rent control laws vary widely by city, and, generally speaking, are uncommon outside of New York, Oregon, and California (which we estimate account for 25% of the rental housing universe).[3] However, one common theme among municipalities that employ rent control is to specify older buildings under the purview of rent control legislation. For example, AB 1482 only applies to buildings 15 years old or older. Because MIRH may be more likely to be older vintage housing, it may also be more likely to be subject to rent control.

Mitigating this risk to MIRH is the fact that rent increase limits are typically much higher than what MIRH investors would underwrite over a holding period. Sticking with the AB 1482 example, few investors would underwrite more than 10% rent growth per year. Risks from rent control are more applicable to Class B to Class A conversions, where significant unit upgrades are made with the intention of materially increasing rents and targeting higher-income households. “B-to-A conversions” fall outside of the MIRH strategy, which aims to keep rents at an affordable level, and could be better described as a “buy and hold” or core strategy than a value-add strategy.

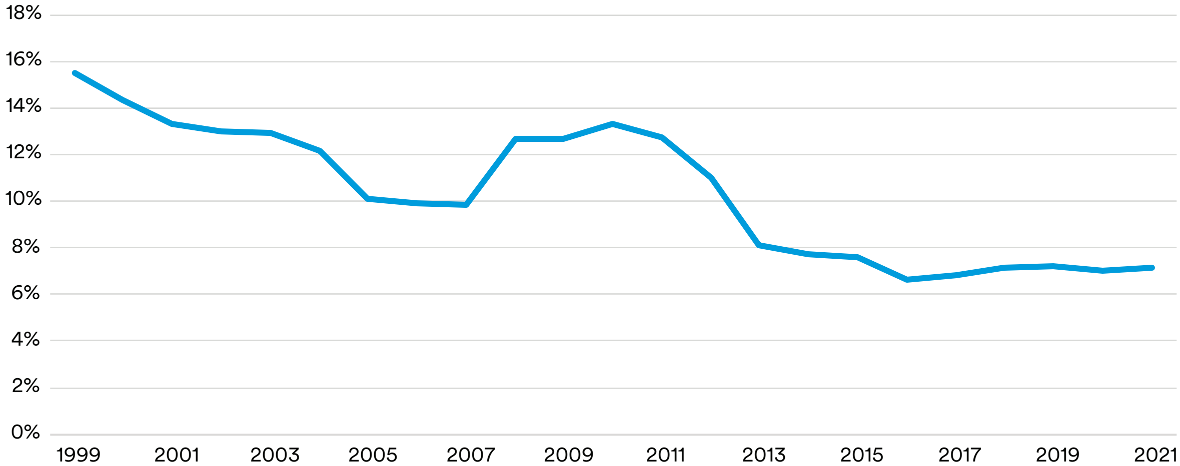
Over-demanded and Under-supplied

Housing supply shortfalls and a widening wealth gap in the U.S. are creating positive conditions for MIRH performance.

As we outlined in our recent report The Future of Housing, housing supply growth has been tepid for much of the last decade. Between 2010 and 2020, nearly 10 million new households were formed, but only 4 million net new housing units were delivered in the U.S. This was primarily due to fallout following the Global Financial Crisis when many homebuilders were shuttered.

Among the housing units that have been built, most have been geared for higher income households. Construction of moderately sized and affordable homes has rapidly declined over the past 30 years. In the single-family space, for example, homes below 1,400 square feet made up 16% of all new construction in 1999 but made up just 7% of construction in 2021 (exhibit 1). A similar trend is observable in the multifamily sector.

Exhibit 1 | Moderately Sized Homes (<1,400 sf) as Share of Total Single Family Construction



Source: MIM, Census. September 2022.

Due to a number of factors including rising income inequality in the U.S., a large pool of rental properties have gone mostly unnoticed by the institutional investor community. Orlando serves as an instructive example.

Median household income in Orlando averages roughly $70,000. A family earning the median income would need to spend less than $1,600 on rent to avoid the categorization of rent burdened. Apartment properties in Orlando that were completed over the last 10 years rent for an average of $2,100 today (with 2- or 3-bedroom units suitable for families renting for closer to $2,300). This rent level is at least 25% above what would be considered an affordable level for the median income household, and implies most newly constructed market-rate housing is out of reach for many residents.[4]

Taken together, we believe a deep pool of renter demand coupled with a limited supply growth creates a strong investment case for MIRH.

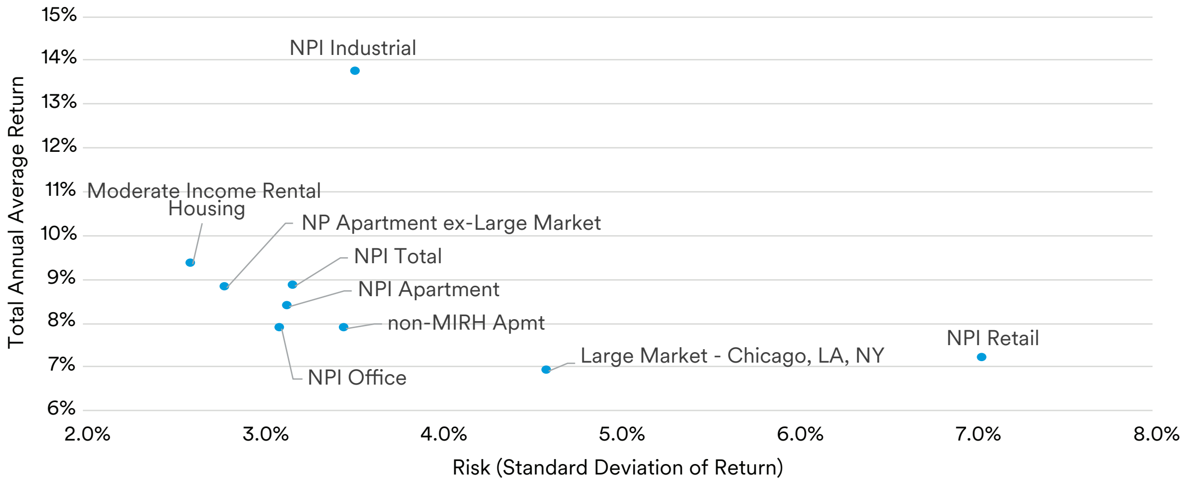
Attractive Risk-adjusted Returns

Given specific definitions of MIRH do not exist, historical investment performance is unavailable in as robust of a manner as other property types or sub-types. Still, we believe the evidence that does exist suggests strong risk-adjusted returns.

One relevant study was produced by Mark Roberts and Jake Wegmann from Southern Methodist University and the University of Texas at Austin. The study reviewed data from the National Council of Real Estate Investment Fiduciaries (NCREIF) and considered the performance over time of apartment properties that are affordable to residents earning 80% of area median income.

The study was able to show that between 2011 and 2021, MIRH produced absolute returns that out-performed all core property types except for the industrial sector, with the lowest level of volatility (exhibit 2).

Exhibit 2 | NCREIF Property Sector Risk and Return



Source: Jacob Wegmann and Mark Roberts using data from Bloomberg, NCREIF
10 Years as of 2Q2021

Several factors could explain this outperformance, including:

- Limited new construction coupled with attractive demand conditions, as outlined above.
- Moderate income renters may be renters by necessity, not renters by choice. As such, this category does not compete with the for-sale housing market. This could lead to both higher rent growth and lower volatility.
- Renters in this category may move less frequently, which could lead to lower turnover costs and vacancy volatility.

We expect industry definitions of MIRH to continue to evolve, and to solidify. Indeed, as of this writing, NCREIF has coordinated a task force to set firmer guidelines. Growing transparency of returns will shed more light on performance, but preliminary evidence makes a compelling investment case.

Geographic Strategies

As we outlined above, developers have been unwilling to construct housing accessible to moderate income earners. The rising cost of construction is one potential culprit. We estimate new residential construction costs a minimum of $200 per square foot. Assuming a 1,500 square foot 2-bedroom apartment, a 4% cap rate, and 100 bps development profit, the lowest possible rent for newly developed housing is $2,100, generally out of reach for those earning 60% to 120% of median U.S. household income.[5]

As a result, and absent legislative change that lowers construction costs, the primary source of new MIRH supply is older housing stock that is functional, but no longer in competition with newly developed residences. This can inform market targeting strategies for MIRH investments.

Markets where a significant portion of the housing stock is newly constructed likely have a shortage of MIRH and could produce better MIRH rent growth. Examples include Austin, where the average age of housing units is 26 years, Orlando (30 years), Phoenix (31 years), Atlanta (31 years), and Charlotte (31 years).

Examples of markets with a larger stock of competitive MIRH supply (which could lead to relatively lower rent growth) include New York (64 years), Boston (61 years), Philadelphia (58 years), San Francisco (56 years), and Los Angeles (55 years).[6]

This is a somewhat counterintuitive result since many of the markets with newer housing stock are considered lower cost of living markets. However, given the influx of higher wage earners to low-cost of living markets and rapid rent growth over the past several years, many markets across the U.S. sunbelt find themselves in significant need of affordable market rate housing for renters earning at or modestly below area median income.

Risks to MIRH

Challenges to the outlook for moderate income rental housing performance mainly center around the political outlook. Housing has been a politically sensitive topic for decades, and the category of renters that underpin this strategy is increasingly in the regulatory spotlight at the federal, state, and local level, rightfully so. Legislation that restricts rent growth or causes an acceleration in supply growth for moderate income housing could cause us to re-visit our views. However, given the current gridlocked political climate, we believe the U.S. may be a decade or more away from offering an adequate amount of housing to low- and moderate-income renters.

Conclusion

We expect favorable performance to persist for rental housing geared for moderate-income residents, who are facing worsening wealth inequality and limited supply of attractive and affordable professionally managed housing options.

In addition to the positive outlook for fundamentals, best estimates of performance history imply moderate income rental housing has been an outperforming property type in recent years. We expect that as industry definitions solidify, and transparency improves, more institutional investors will allocate capital to this strategy, which could cause yields to compress in the medium-term.

Lastly, while we believe the investment case is strong, MIRH has the added benefit of increasing the sustainability of a community by supplying housing for some of its most critical members. These include teachers, police officers, healthcare workers, sanitation workers, and others. In our view, neglecting the housing needs of these groups is already having negative consequences for some metropolitan areas[7], and this could expand if affordability continues to worsen. MIRH therefore has the benefit of potentially helping investors improve the sustainability component of their ESG goals, while also offering investments with attractive returns, in our view.

Endnotes

[1] https://archives.huduser.gov/portal/glossary/glossary_all.html

[2] https://sfrb.org/article/summary-ab-1482-california-tenant-protection-act-2019

[3] MIM, NCREIF. October 2022.

[4] MIM, CoStar, Census. October 2022.

[5] MIM, NCREIF, Census. October 2022.

[6] Census American Community Survey. October 2022.

[7] https://www.miamitodaynews.com/2022/07/19/new-council-to-help-hospitals-universities-deal-with-nursing-shortage/ “A lot of nurses can’t even find affordable housing to come here and work, graduate from [a university] be able to work and live there.” -Florida representative Marie Woodson.

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