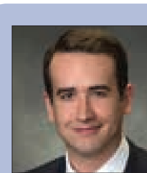
MetLife Real Estate

Multifamily soldiers on



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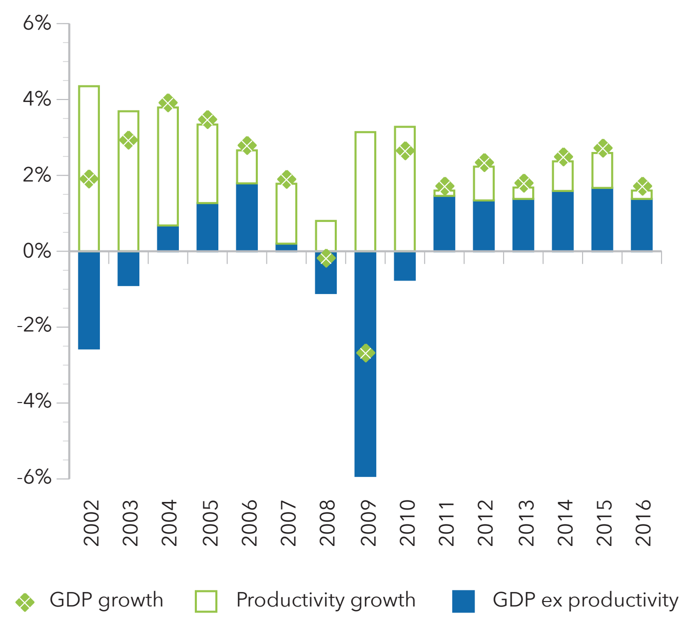
The severity of the Great Recession, and its unexpected nature, left a lasting impression on a generation of real estate investors. They remain watchful for any signs of the next downturn, and many have been reluctant to adopt a broadly positive view of the market. Even in 2014, when the economy was growing rapidly and supply growth remained low, market sentiment was overwhelmingly cautious. Despite consistently positive fundamental conditions in recent years, the industry's caution has resulted in one property type or another falling out of favor far more easily than it would have in the past. In some specific markets concern has been warranted, but we believe that, in general, the market's reaction has been too often governed by failures to recognize structural changes. In no sector are the market's misconceptions more evident than multifamily.

At the beginning of 2016, real estate investors were benefiting from a strong labor market that was producing 225,000 new jobs per month.[1] As it had historically, this level of job growth was supporting strong multifamily demand growth. On the supply side, however, the picture looked concerning. Multifamily supply growth, peaking in 2017, was expected to equal nearly 4.0 percent of existing stock, a pace more than double the historical average.[2] The last time this level of supply growth occurred was in 2000, when it was followed by three years of declining rents in the wake of the bursting of the dot-com bubble.[3] Based on this prior experience and concerns for near-term economic growth, the market expected record levels of supply additions in 2016 and 2017 to result in rising vacancy and falling rents. What went unrecognized, however, was both the strength and durability of multifamily demand.

GDP and productivity growth



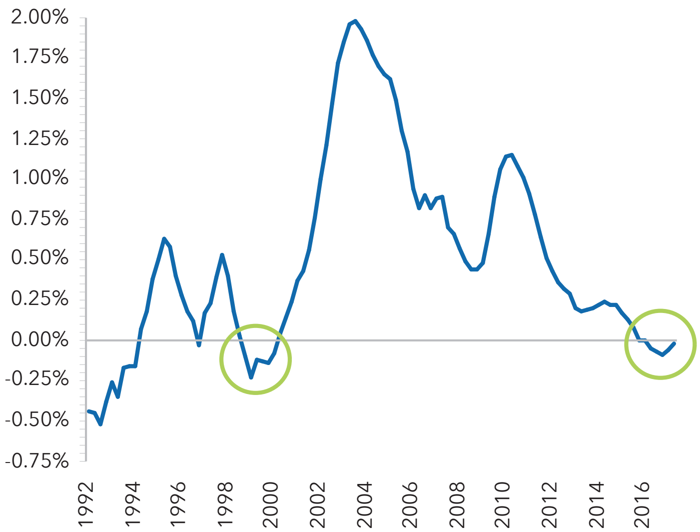
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics

While not expressly expecting a recession, many investors remained downbeat about overall economic prospects due to what was perceived as persistently weak GDP growth of 2.0 percent to 2.5 percent annually. Historical experience had conditioned many investors to view GDP growth below 3.0 percent as relatively weak and incapable of producing strong real estate demand growth. That belief, however, failed to recognize the degree to which the drivers of GDP growth had changed during the current economic cycle.

In the late 1990s and mid-2000s, economic growth was driven by one factor above all: productivity. Productivity, the measure of economic output per worker, grew rapidly during these periods because of the broad adoption of personal computers and the internet. By contrast, productivity growth during the current cycle has been extremely weak (see "GDP and productivity growth"). Productivity, however, does not occupy space; people and goods do. In that regard, the current cycle has delivered in spades. Since bottoming in early 2010, total employment has risen by more than 17.5 million.[4] On top of this impressive total, government surveys indicate a near-record 6.0 million jobs remain to be filled.[5] While the pace of employment growth has slowed to approximately 173,000 per month, this level has continued to produce strong multifamily demand growth.[6] The focus, therefore, should not be placed on topline GDP, but rather on its non-productivity drivers, including the labor market, demographics and consumer spending. Demographic change, in particular, is an area where the market may have most missed the mark when evaluating the durability of multifamily demand.

Historically, a disproportionate amount of multifamily demand has come from the 20–34 age group. As renters age, advance

Office cap rates minus apartment cap rates



Sources: MetLife Investment Management, NCREIF

in their careers, marry and have children, they gradually acquire the savings necessary to make down payments and the desire to own a home. While surveys indicate many Millennials (born from 1983 to 2001) also desire to eventually own a home, their circumstances suggest ownership may occur at a much later age than it did for their parents. Burdened by average student loan debt of $35,000, and unable to realize the efficiencies of cohabitation due to later marriage, many Millennials are struggling to save enough to purchase their first homes.[7] Moreover, they are feeling little near-term pressure to do so, as later marriage typically translates into having children later. School-age children are one of the primary motivators for moving from multifamily units in the urban core to single-family homes in suburbs boasting stronger schools. As a result of Millennials' constrained finances and their reduced pressure to purchase homes, we believe the prime rental age group has expanded from 20–34 to 20–37.

In addition to the Millennial Generation's delayed need to purchase homes, the cohort drives multifamily demand through its sheer size. At more than 83 million, there are 11 percent more Millennials than members of Generation X.[8] Many members of Gen X figure into the multifamily story, as well. During the housing boom of the mid-2000s, the national homeownership rate climbed to a high of 69 percent, largely driven by homebuyers from Gen X. Having lost their down payments to foreclosure during the subsequent housing bust, many of these buyers will now remain in the rental pool for far longer than they have historically. With their eldest children long out of the house, the oldest Baby Boomers are now also re-entering the rental market after downsizing from large suburban homes. Across the demographic spectrum, indicators continue to suggest structurally higher multifamily demand.

The degree to which the market has underestimated multifamily demand growth can be seen by examining the capital markets. For the first time since the late 1990s, multifamily cap rates are higher than those of office (see "Office cap rates minus apartment cap rates"). While this dynamic is partially driven by foreign capital, which flows disproportionately to the office sector, and reasonably founded expectations of strong office NOI growth, it also assumes relatively weak NOI growth on the part of multifamily. From a historical perspective, even without the knowledge we possess of the strength and durability of multifamily demand, this is a bold assumption to make. On a five-year rolling basis, office NOI growth has outperformed multifamily NOI growth during only one period since 1986: the late 1990s.[9] After being fueled by the dot-com boom, the office sector quickly gave up that growth as the bubble burst.

Today, arguably more than two years after it fell out of favor with many investors, the multifamily sector continues to perform well. Solid demand growth buoyed by a strong labor market and structural demographic changes have left vacancy only marginally higher, despite the strongest supply growth in multiple cycles. Apart from rare exceptions across markets, multifamily rent growth has remained positive and NOI growth has remained strong. With supply growth set to decline substantially during the next two years, the sector's near-term prospects appear bright. We believe that in their attempt to avoid a similar fate to the real estate investors of 2007, many investors today continue to overlook significant structural changes in the economy and real estate market. As a result, they may be committing a classic error by trying to once again "fight the last war." All the while, the multifamily sector soldiers on.

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[1] Bureau of Labor Statistics, December 2017.
[2] CBRE Econometric Advisors.
[3] Ibid.
[4] Bureau of Labor Statistics, December 2017.
[5] Ibid.
[6] Ibid.
[7] *The Wall Street Journal*, May 2015.
[8] U.S. Census Bureau, December 2017.
[9] National Council of Real Estate Investment Fiduciaries, December 2017.