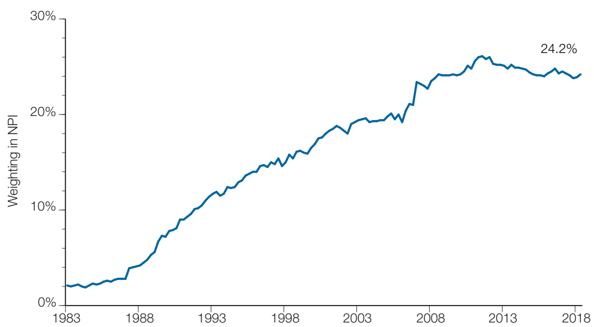
Clarion Partners

Renter Nation: U.S. Socioeconomics Drive Multifamily Housing Demand

State of U.S. Housing Market: Increasingly a Renter Nation

The U.S. rental housing market has seen a significant run-up in demand. A major and unprecedented structural shift has occurred due to a variety of demographic and socioeconomic factors. Real estate investment managers' allocations to institutional-quality multifamily product have risen given the ongoing strength in property fundamentals (Figure 1). The sector is viewed as having a steady income stream with rents that adjust with inflation annually. In the coming years, the current conditions will offer new opportunities in professionally managed rental housing across different formats, generations and geographies. Clarion Partners believes that renters, both by choice and by necessity, will continue to escalate the demand for rental housing.

Figure 1: Multifamily's Share of NPI Over Three Decades



Source: NCREIF, Clarion Partners Investment Research, Q2 2018. Note: NPI = NCREIF Property Index.

Favorable Demographics and Socioeconomics Driving Demand

All forms of U.S. housing report low availability and high pricing amid a strengthening economy and rising household formation. Over the next decade, the United States is poised to add more than 10 million new households, which will benefit both owner- and renter-occupied housing.[1]

Demographics

The recent expansion of the multifamily market has been driven by renter households across the six largest living U.S. generations. In 2018, total housing units (or households) reached 120 million — about 77 million owner and 43 million renter households (now approximately 65 percent and 35 percent).[2] Today the homeownership rate across all ages is near historic lows. In the future, for-sale housing may make a greater recovery; however, a full return to the prior peak homeownership rate is not anticipated.

Recent and Future Rental Household Formation. In the past 10 years, the number of new renter households rose by nearly 10 million, significantly outpacing the owner segment, which reported minimal growth. We expect steady growth in renter households to continue in the future. Industry estimates anticipate another 500,000 new rental households per annum through 2025.[3]

Changing Lifestyles Lead to a Surge in Single Renter Households of All Ages. Over the past decade, the single population rose by a whopping 15 million above married individuals. The shift in independent living is attributed to lifestyle changes in both younger and older U.S. households. More young adults are postponing marriage, while older adults divorce more frequently.[4] All have led to a rise in apartment living, generally a more manageable expense and flexible living arrangement than a single-family home.[5]

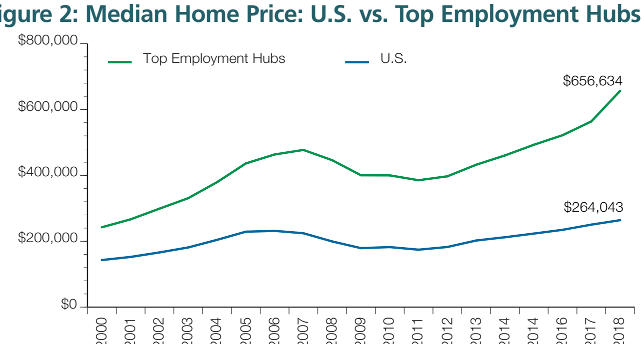
Socioeconomics

Today the cost of living is one of the most significant challenges facing many cities across the nation. As U.S. housing prices have surged, wealth and income gains have been modest for most people. These combined circumstances have led to the recent surge in rental housing demand.[6] Nationwide, it is now cheaper to rent than buy in more than half of all counties.[7]

Highest For-Sale and Rental-Housing Prices in Top Employment Hubs

For-sale housing. The acceleration in for-sale housing appreciation is pronounced in the top U.S. employment hubs, with a high concentration of office-using jobs (Figure 2). Over the long term, a well-paid and educated workforce has generally been linked to expensive real estate. Outsized pricing gains have been reported in San Francisco, Los Angeles, New York City, Seattle and Boston, where there are nodes centered around thriving industries.

Figure 2: Median Home Price: U.S. vs. Top Employment Hubs

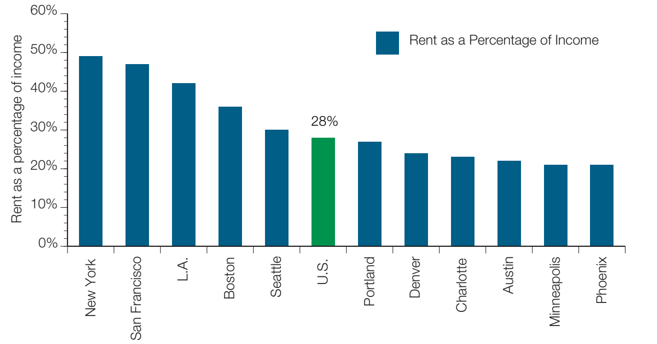


Sources: CoreLogic Inc., National Association of Realtors, Q2 2018. Notes: (1) Seasonally adjusted data from existing homes. (2) Top employment hubs include Washington, D.C., Boston, New York City, San Francisco, Los Angeles and Seattle

Rental Housing. Currently, 24 percent of U.S. renter households (about 20 million) spend more than 50 percent of annual income on housing.[8] Across some U.S. cities, rent-to-income ratios are well above the U.S. average (Figure 3). The Department of Housing and Urban Development (HUD) identifies households spending more than 30 percent of income on housing as cost burdened.[9]

Large Generational Financial Differences. The primary renter base comprises largely young adults. This group holds the smallest share of U.S. net worth and has seen income growth fall significantly short of apartment rent escalations over the past

Figure 3: U.S Rent-to-Income Ratios by Selected Metro



Sources: CBRE-EA, Q2 2018; U.S. Census Bureau, Q2 2018. Note: Most recent median household income data as of 2016. Multifamily rents are net effective.

decade. Consequently, the wealth disparity by age has widened, and the financial demands of homeownership (e.g., saving for down payment) are out of reach for many, so much so that about 30 percent of millennials (24 million) currently live with family.[10]

Record Student Debt a Huge Challenge for First-Time Homeowners. Student-loan debt is a unique problem to the United States and, in particular, the millennial generation, now standing at $1.5 trillion. The average student-loan debt for the class of 2017 was $39,400, up 6 percent year over year. Today, the average net worth of younger millennials is negative. A home mortgage requires top-tier credit and conservative debt-to-income ratios. The current system for rating credit and qualifying for a home loan may continue to be restrictive. Consequently, first-time buyers now represent only 30 percent of all sales, down from the long-term average of 39 percent.[11]

Rental Housing: Demand Outpacing Supply

In this real estate cycle, total absorption has outpaced overall completions. The sharp expansion of new rental housing has been met with high ongoing demand. Across the entire rental housing universe (totaling approximately 43 million units), there are 28.9 million multi-unit apartments and 13.2 million single-family homes.[12] Institutional-quality multi-unit rentals represent only 15 million total rental units.[13] Professionally managed multifamily is still a relatively small share of overall inventory. Clarion Partners believes that there is still a scalable opportunity in institutional-quality housing investment.

The recent growth in rental stock has been most pronounced in the class A and single-family segments.

Class A Boom in Big Cities. In the past decade, millions of high-quality class A rental units have delivered in the biggest U.S. cities. Much of this new inventory has targeted higher income professionals and is located in high-rise buildings in downtowns or urban neighborhoods. Today just under half of all renter households reside in principal cities — the main core of metropolitan areas.[14] These areas also tend to be the costliest and generally have large young-and-single professional populations, yet many renter-by-choice millennials pay a premium for a "live, work, play" lifestyle.

Growing Popularity of the Sun Belt. Relatively less expensive cities in the Sun Belt have high domestic migration from both millennials and older adults. These regions tend to have more low- and mid-rise rental housing. Much of the future new household growth may be in the South.[15] Several metros and regions, such as Austin, Dallas, Atlanta, Denver and South Florida, are experiencing faster-than-average employment and population growth.

The Rise of Single-Family Rental Homes. Less than one-third of rental households are living in detached, single-family homes; however, this segment has reported considerable growth (up by 4 million since 2006).[16] Recently, suburban household growth has picked up, offering the lure of larger living space, superior schools and a better environment for older millennials.

In select markets, we see a sizeable opportunity in these multifamily housing segments:

Class A in Largest and Most Expensive Metros. With the acute cost of housing in the largest and most expensive metros, there is an ongoing opportunity to develop and invest in class A rentals in these markets. The ongoing savings crisis among younger adults is likely to sustain a large stream of demand for entry-level rental housing therein.

Renovate Well-Located Class B Apartments to Class A. Existing class B properties in strong submarkets and path-of-growth neighborhoods are prime for redevelopment. There is a tremendous amount of aged inventory in urban downtowns and premier suburbs still in need of renovation.

Investment Outlook

Given the current U.S. socioeconomic environment, there is rising interest in high-quality rentals across all price points and regions. The composition of rental households is a broad cross-section of categories that will demand a well-diversified inventory. Clarion Partners recommends an investment strategy targeting mainly professionally managed, high-quality multifamily in and around both the largest and most expensive U.S. metropolitan areas. We believe there is still a significant opportunity to improve the quality of the nation's rental housing stock, as well as create more dynamic mixed-use living communities. The growing renter-cohort groups of both renters by necessity and renters by choice will offer a steady tenant base for many years ahead.

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[1,15] John Burns Real Estate Consulting. *Demographic Strategies for Real Estate.* 2016. Note: Based on 2016 to 2025. [2,3,4,9,12,14,16] JCHS. *Nearly Half of American Renters Are Cost Burdened.* December 2017. Note: Data as of year-end 2016. [5] Pew Research Center. *Led by Baby Boomers, Divorce Rates Climb for America's 50+ Population.* March 2017. [6](1) S&P CoreLogic Case-Shiller Home Price index. Q2 2018. (2) CBRE-EA. Q2 2018. [7] National Association of Realtors. Q2 2018. [8] U.S. Census Bureau. Q2 2018. [10] U.S. Census Bureau. *Jobs, Marriage and Kids Come Later in Life.* August 2017. [11] National Association of Realtors. Q2 2018. [13] CBRE-EA. Q2 2018.