Principal Asset Management℠

RESILIENT HOUSING:

Greater demand, lower risk, recession resistant

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The U.S. residential rental market has demonstrated remarkable strength since the pandemic. All types of housing, including traditional multifamily, single-family rental, and manufactured housing, have exhibited strong occupancies, collections, and rent growth. Furthermore, all price points, from luxury to lower end, and locations, both urban to suburban, are experiencing success in these key operating metrics.

Since second quarter 2021, publicly traded multifamily Real Estate Investment Trusts (REITs) have exhibited portfolio occupancy above 96% and collections over 98%. Since third quarter 2021, REITs annual rent growth has exceeded 10%—and the market continues to expect reasonably strong adjusted funds from operations (AFFO) and same store net operating income (NOI) growth. Accordingly, the broader sector has benefitted from the collective tailwinds of exceptional demand from strong household formation and more muted supply.

While these last two years have indeed been the “salad years” for all housing, when assessing performance over a longer horizon there is greater disparity in the performance between residential property types and locations. Additionally, future demographic and societal trends may position some housing types to perform better than others.

Impact of demand, design, operations, and supply

At Principal Real Estate, we view a “Resilient Housing” strategy as one that could produce attractive risk-adjusted returns on a sustained basis, including outperforming most other property sectors in the event of a recession. In our definition, characteristics of a resilient strategy entail:

- Targeting properties in suburban areas charging rents in between $1,250-$2,250 per month
- Residential housing for renters representing households earning 80%-120% of area median income (AMI)
- Rental obligation between 20%-35% of income
- Value-oriented Class A and Class B apartments and single-family rentals driven by structural demand drivers

While there is no exact return benchmark that has captured the Resilient strategy, the “Garden apartment” sub-index within the greater NCREIF index is a close proxy, as most garden properties have traits consistent with those outlined above. Exhibit 1 shows the historic annualized returns and Sharpe ratios of the Garden Index along with a comparison to its high-rise counterpart.

EXHIBIT 1: Garden property total returns compared to high-rise property subset

	1-year	3-year	5-year	7-year	10-year
Garden total return	32.79%	16.47%	13.38%	12.52%	12.24%
High-rise total return	20.19%	8.38%	6.92%	6.85%	7.84%
Delta - total return	12.60%	8.08%	6.46%	5.67%	4.40%
Garden Sharpe ratio (*)	7.655	2.553	2.309	2.462	2.808
High-rise Sharpe ratio (*)	6.694	1.656	1.451	1.649	2.235
Delta - Sharpe ratio	0.961	0.896	0.858	0.813	0.573

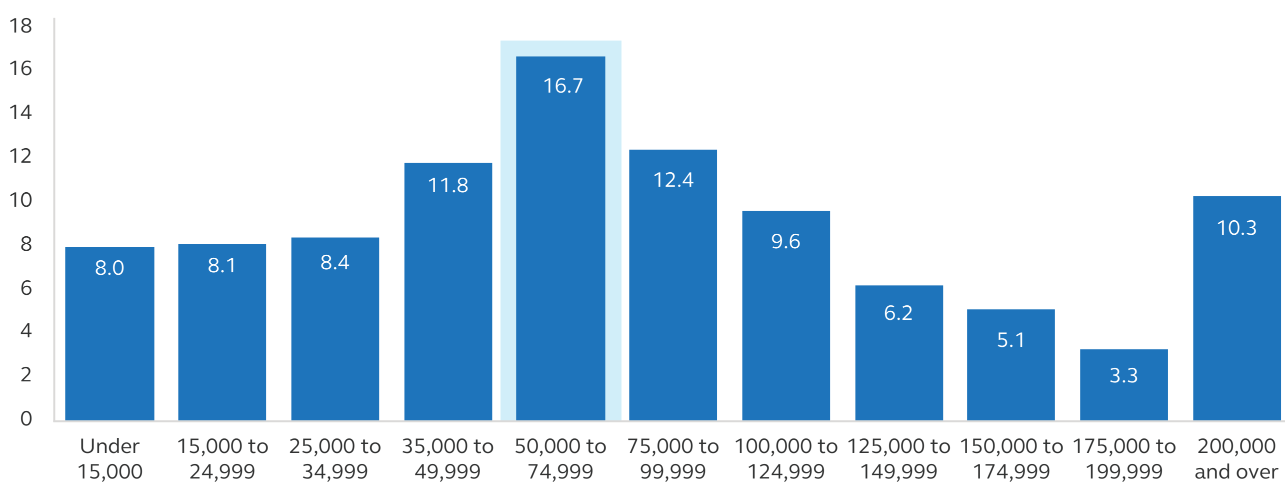
Source: NCREIF, Q2 2022
*The risk adjusted metric, "Sharpe ratio", measures the excess return over risk free rates divided by the standard deviation. With the Sharpe ratio, a larger number reflects a better risk adjusted return.

The data illustrates attractive absolute and risk adjusted return performance in the garden subset. Why has this been the case? The answers for the historic, and likely continuation, of this outperformance are multi-faceted and touch upon elements of demand, design, operations, and supply.

Demand

From a demand perspective, the Resilient subset captures the greatest amount of wage earners, and these earners have gravitated to properties charging between $1,000-$1,999 per month. Exhibit 2 highlights the percentage of households by income category.

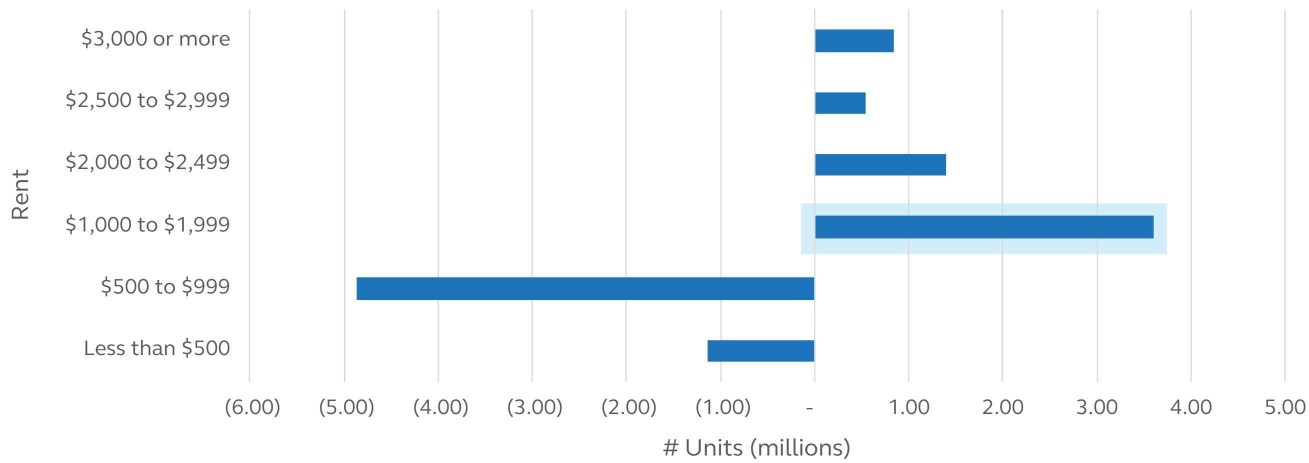
EXHIBIT 2: U.S. household income distribution, annual household income in U.S. dollars



Source: Census Bureau Current Population Survey (ASEC), Principal Real Estate, 2021. CPS ACEC data represent calendar year 2020, the latest available.

Using increments of $25,000 in household income, the category between $50,000 - $74,999 represents the greatest single cohort of wage earners (16.7%). When applying the market custom of rent being no more than 30% of income, this $50,000-$74,999 cohort can afford rents ranging from $1,250-$1,875 per month. If the largest amount wage earners can afford rents between $1,250-$1,875, does it stand to reason properties charging these rents would generate the greatest demand? Exhibit 3 clearly captures this dynamic. The results follow the expected correlation: those units charging $1,000-$1,900 demonstrated the greatest change in demand where such units were in sync with the largest percentage of wage earners.

EXHIBIT 3: Change in occupied units, 2016-2022

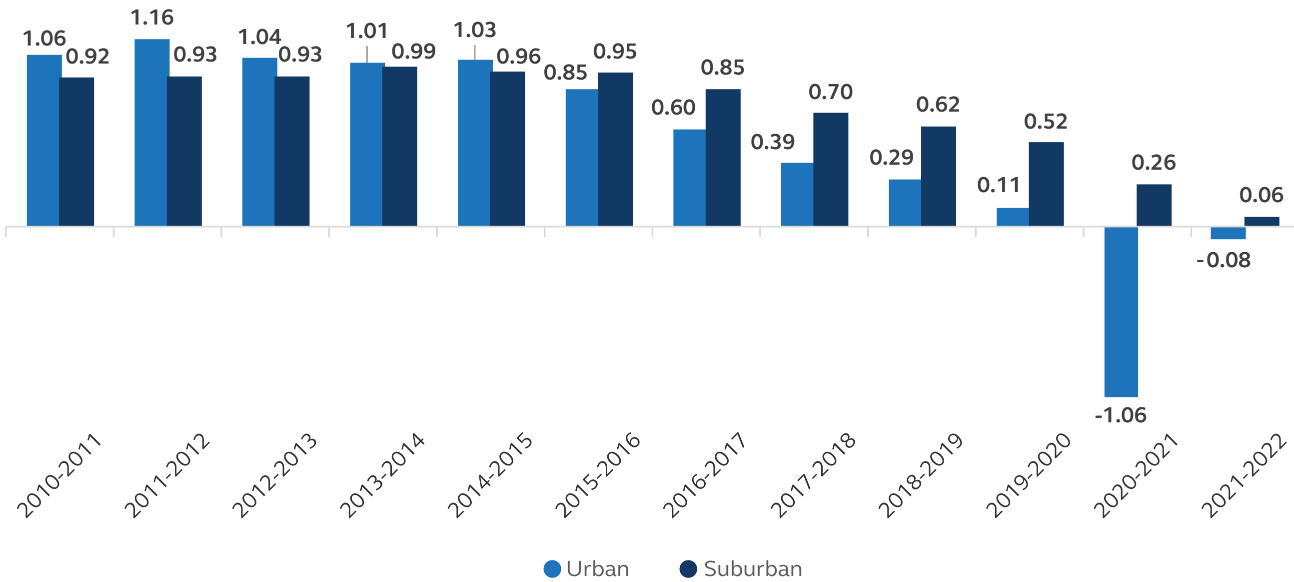


Source: Census Bureau Current Population Survey (ASEC), Principal Real Estate., Q3 2022. CPS ACEC data represent calendar year 2020, the latest available.

In addition to the simple correlation where the greatest level of wage earners will generate the greatest demand, there have been other demographic and societal trends that further accelerated the demand of resilient housing in suburban areas. Much has been written about the impact of the COVID-19 pandemic and the migration to the suburbs. A myriad of reasons explains this migration, including greater ability to work from home, health concerns decreasing the utilization of public transportation, desire for more space and outdoor areas, select concerns for safety and schools, and general cost considerations. While the pandemic accelerated a sizable shift to the suburbs, this dynamic had already been underway for some time. Exhibit 4 provides the growth rates of suburban and urban areas since 2010. Contrary to conventional wisdom that the migration is a more recent event, the trend of greater growth in the suburbs has been occurring since 2015. With many of the structural drivers still in place, such as work from home, safety, cost, tax, schools, etc., this trend is likely to continue.

EXHIBIT 4: Primary cities and suburbs within major metropolitan areas

Annual growth, 2010-2022



Source: William H. Frey analysis of Census estimates, July 2010 to July 2011, data 2021-2022 from Placer.ai.
Note: Primary cities are consistent with a Brookings typology that includes the metropolitan areas largest city and up to two additional cities with a population exceeding 100,000. Major metropolitan areas are the 56 areas with populations exceeding one million.

Operations and design

Turning to some operational and design elements, the Resilient subset has other features that have amplified performance on the margin. In general, a garden project will have larger units, more balconies, more two- and three-bedroom unit types, and provide more pet-friendly outdoor areas than is common in urban apartments. These characteristics were valued during the pandemic and should continue to be coveted. In addition, the Resilient sector operates with lower operating expenses. On average, annual expenses per unit on a garden multifamily property will be $7,000 per unit less than what is common on a high-rise multifamily property. Importantly, the fixed or non-controllable component (notably utilities and taxes) are elevated in high-rise assets and the risk of rising taxes in many urban areas, given challenged finances, is more pronounced. Assets with higher and more volatile expenses that are more fixed in nature lead to greater vulnerability in NOI in situations where top line revenue is reduced.

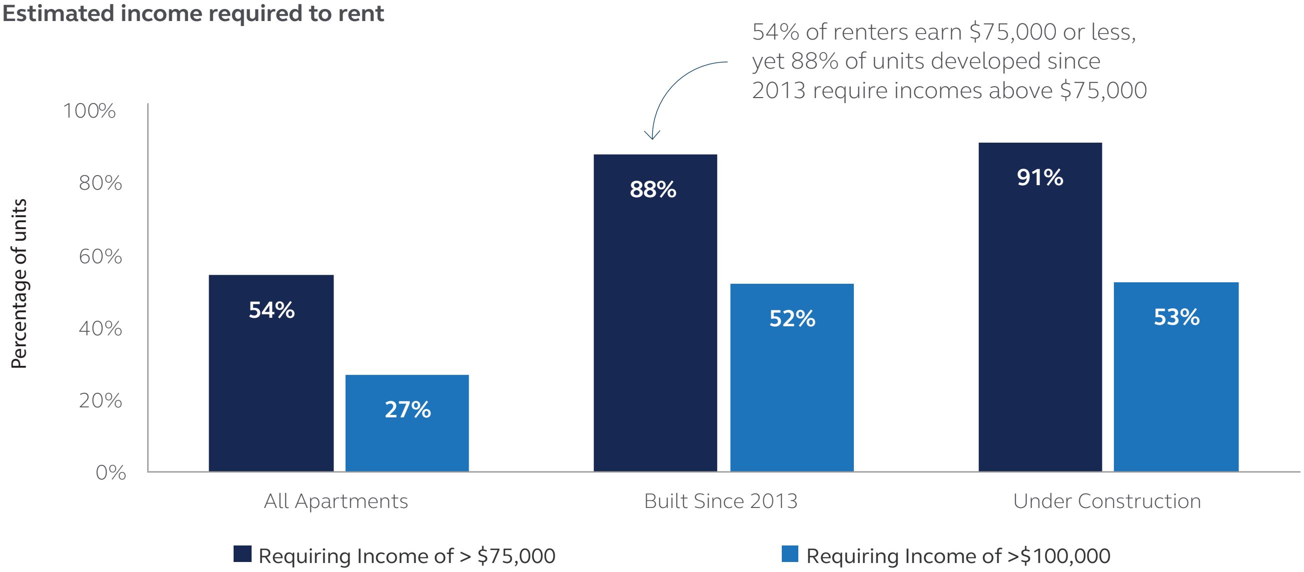
Supply

Regarding supply, Exhibit 5 shows that over the last nine years, there has been a much larger share of properties developed for households with income levels above $100,000 than those below. Reasons for this trend include rising construction costs, necessitating greater rents for proformas to pencil, and abundant capital pursuing "in style" investment themes of urban "infill" or "Transit Oriented Development" strategies. Ironically, notwithstanding its favorable private market investment performance during the 2014-2018 period when these stylistic strategies were popular, Garden apartments were often referred to as "Commodity suburban." With the passage of time, and an ever-larger outperformance of the garden subset, investors have focused less on themes or labels and more on operations and performance. This greater focus on investment performance has accelerated capital appetite to the sector. In 2021, over 80% of transactions were in non-gateway markets, the largest on record.[1]

[1] NCREIF, Newmark Residential, Real Capital Analytics

EXHIBIT 5: Construction since 2013

Estimated income required to rent

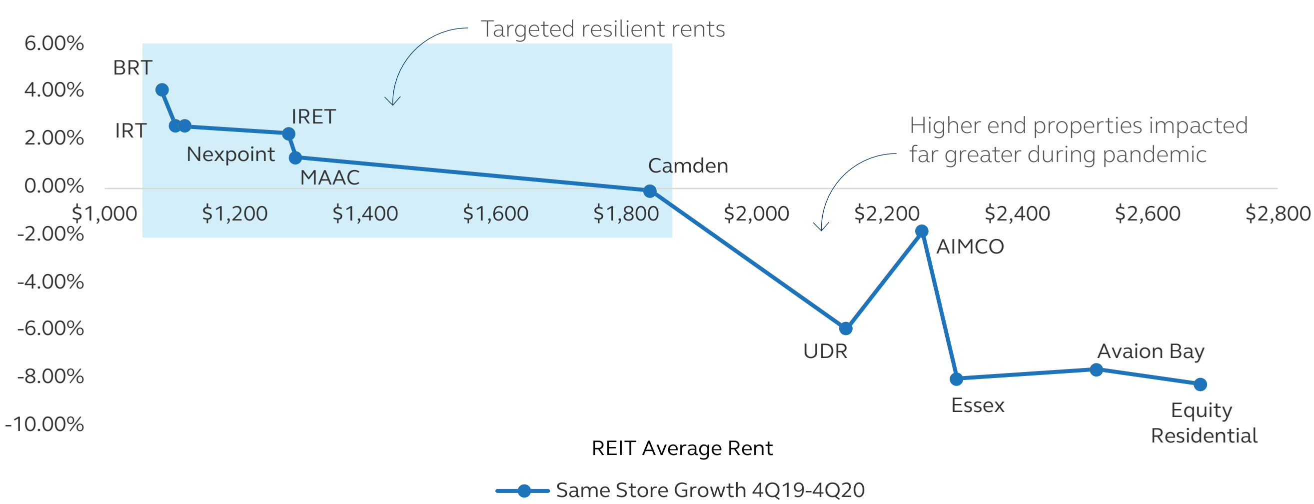


Source: Source: CoStar Portfolio Strategy, 2Q 2022

While suburban properties charging between $1,000-$1,900 per month have been the beneficiary of greater demand and less supply, why exactly are they more resilient? Admittedly, the term "resilient" may be esoteric to some and carry a different meaning among industry participants. One characteristic to qualify as "resilient" that should be universally sanctioned is attractive performance during recessionary periods. Historic NCREIF and public market data can shed insight on this topic. During the recession resulting from the Global Financial Crisis (GFC), the garden component exhibited a 7% lower value decline and returned to its previous peak valuation level three months sooner than high-rise.[2] When reviewing how the publicly traded multifamily REITs performed during the pandemic induced recession, Exhibit 6 shows that those REITs that charged rents under $2,000 per month had positive revenue growth, but those above did not. Both data points highlight less impact from challenged economic scenarios.

EXHIBIT 6: Multifamily REIT rent vs. same store growth, 3Q 2020

Average rent per unit per month on overall portfolio of properties



Source: REIT 4Q20 Financials. AIMCO data is 3Q20 data (4Q20 data release is delayed). REITs included: BRT Apartments Corp.; IRT = Independence Realty Trust, Inc.; NexPoint Residential Trust; Camden Property Trust; United Dominion Realty Trust, Inc.; Essex Property Trust, United Dominion Realty Trust, Inc.; Aimco = Apartment Income REIT Corp.; AvalonBay Communities, Inc.; Equity Residential. Past performance does not guarantee future results. No investment decision should be made upon it. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security.

[2] Source: NCREIF, Q1 2008 – Q1 2012

CONCLUSION

Although the broader multifamily market in the U.S. has exhibited strength for several years including the latter stages of the pandemic period, partially due to strong demand amidst very low unemployment rates, a case can be made that the subset referred to as "Resilient Housing" has not only outperformed other multifamily on a risk-adjusted basis, but we believe is also well-positioned to do so going forward as market conditions become more volatile.

While this doesn't mean that the multifamily sector, including Resilient Housing will be immune from recessionary impacts, investing in property sectors with strong fundamentals, granular and durable income streams, and the ability to exhibit strong same store NOI growth potentially could see less impacts than other sectors. As such, a Resilient Housing strategy appears well-positioned for inclusion in a client portfolio.

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