Asset Management

March 2021

Real Assets

THE WORKFORCE HOUSING SWEET SPOT PREVAILS IN US CRE INVESTING

By Martha Peyton, PhD
Managing Director, Applied Research

Beyond borders

For institutional and professional investor use only.

Aegon Asset Management is the global investment management brand of Aegon N.V. See disclosures for more detail.

The workforce housing sweet spot prevails in US CRE investing

With the pandemic recession still underway, apartments remain an attractive sector and recent studies show many institutional investors are looking to add them to their portfolios. Those looking to invest in this particular sector should take into account market locations, property quality slices and individual properties that address their return-risk requirements. At Aegon Asset Management, we focus on middle-market workforce apartments which exhibit strong and durable demand-supply drivers and offer opportunity for value-add strategies that can generate incremental return. More immediately, we believe such investments have the potential to offer an ongoing cyclical defense related to the enormous numbers of renter-by-necessity households.

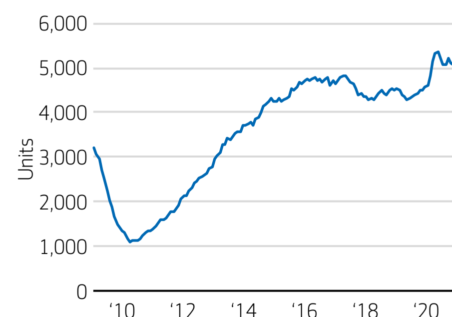
Apartments, along with industrial, are the preferred sectors in 2021 for investors in US property, according to the Pension Real Estate Association, Investment Intentions Survey.[1]

The case for apartments is well-documented and well-supported by data from a variety of sources. In the US, apartments have offered investment returns averaging 8.6% over the ten years ending December 31, 2020.[2] Returns are driven in part by strong demographic forces, most notably the maturation of the millennial generation born between 1981 and 1996. In 2019, this generation overtook boomers as the largest adult population cohort in the US numbering 72.1 million.[3] Gen Z, defined as those born in 1997 and later is even larger, with the oldest reaching 24 in 2021.[4]

Millennials are a renter generation despite strides toward homeownership as older millennials have matured, gotten married and become parents. The oldest millennials achieved a 58% homeownership rate in 2020 up from 46% five years earlier. But even at 58%, they lag the 66% homeownership rate that their age group enjoyed in 2000. Younger millennials are similarly behind their age group's homeownership rate in 2020.[5] Altogether, 48% of millennial households were homeowners in 2020 according to Apartment List, leaving 52% as renters.[6] Tight home mortgage requirements implemented following the last recession, student debt burdens, older marriage and child-bearing, and slow wage growth are often cited contributors to the low rate of homeownership among millennials. Not only are millennials predominantly renters, but prior to the pandemic, they were renters who preferred downtowns and who were helping to revitalize many of them which in turn helped to attract empty-nester boomer renters as well.[7]

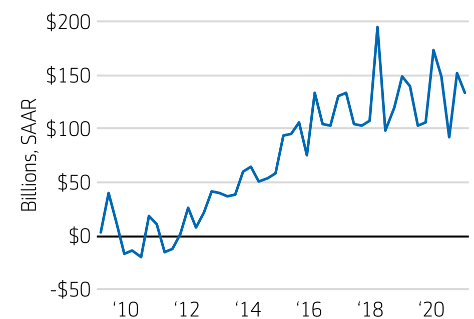
Demand has fueled apartment construction (Exhibit 1) in recent years, largely in downtown high-rises. Since 2009, new stock has increased by over 3 million units amounting to 17.2% of the total stock and has provided plentiful opportunity for investors.[8] Abundant mortgage debt, shown in Exhibit 2 has supported both apartment construction and investment. These demand-supply attributes explain why the apartment sector in its entirety has been a sweet spot for US commercial real estate (CRE) investing and why investors are hungry for more.

Exhibit 1: Trailing 12-month multifamily starts



Source: US Census Bureau, as of December 2020.

Exhibit 2: Multifamily flow of funds

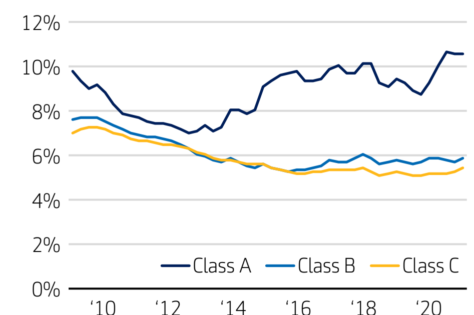


Source: US Federal Reserve, as of third quarter 2020.

Middle-market apartments are especially sweet

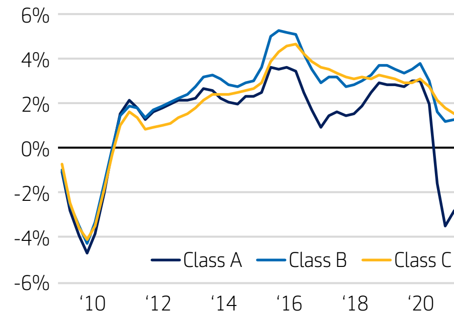
Middle-market rentals which accommodate the workforce are B-class apartments; they are generally older and have lower rents than new stock, but they offer higher quality space and amenities compared with the lowest grade C-class apartments. Over the current cycle, B-class apartments have been producing lower vacancy rates (Exhibit 3) and higher rent growth (Exhibit 4) compared with more expensive A-class stock.

Exhibit 3: Multifamily vacancy by property class



Source: CoStar Realty Information, Inc., as of December 31, 2020.

Exhibit 4: Multifamily effective rent growth by property class



Source: CoStar Realty Information, Inc., as of December 31, 2020.

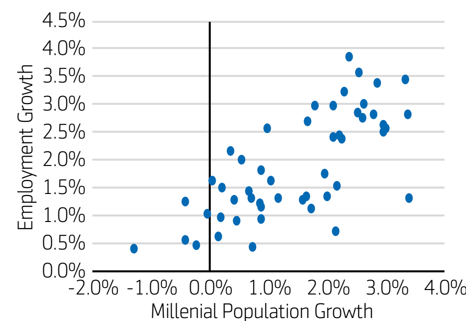
Their superior performance reflects essentially fixed supply as construction is concentrated in the higher-rent segment which more easily compensates for construction and land costs. At the same time, demand for B-class apartments is robust given the income constraints of many renters. Pre-Covid-19 data show that 46% of renter households are "rent burdened" spending more than 30% of their income on rent.[9] Due to Covid-related lockdowns, many lost income or jobs requiring dipping into savings to cover expenses. With savings gone, home ownership moves further out of reach for effected households. Additionally, with ongoing slow growth in wages, the bulk of renters are likely to remain renters by necessity for the foreseeable future. Perversely, future economic downturns which slow income and wage growth further might even contribute to stronger demand for middle market apartments making them a vehicle for defensive investing.

Performance prospects vary widely by market

In general, the first step in building a portfolio of middle-market workforce apartments is selecting metro areas that offer relatively more attractive prospects for rent growth. Dispersion of rent growth across US geographies is enormous. Over the five years ending in 2020, B-class apartment growth in the fifty most populous metros averaged 5.36% in the strongest ten and 1.35% in the weakest ten.[8] Metro location matters!

Our analysis of the drivers of metro area rent growth points to several statistically significant factors with employment growth, population growth of millennials, and single-family home prices as the most powerful. These factors drive the demand side of workforce housing. They are correlated to each other in that job growth attracts population especially of younger single people which stimulates single-family home prices (Exhibit 5).

Exhibit 5: Five-year growth (2014-2019)



Source: US Census Bureau, US Bureau of Labor Statistics, 2019.

The supply side also requires scrutiny. Some metros are more abundantly supplied with workforce housing thus placing relatively less burden on renters. Such metros have shown weaker rent growth and will likely continue to do so. Supply of relatively more affordable single-family homes for ownership also affects rent growth. Investors are well-advised to pay attention to these supply and demand factors along with metro area size which is a proxy for liquidity. Liquidity refers to the capacity to buy and sell properties throughout the real estate cycle at "willing buyer-willing seller" prices.

Applying these analytical results, we focus on the 50 largest US metro areas; each is larger than one million in population. Among these metros, 17 stand out as particularly attractive for workforce apartment investments. They can be described as ***economically and demographically strong with relatively expensive single-family stock***. They are shown in aggregate in Exhibit 6 along with their distinguishing characteristics.

Exhibit 6: Main metrics by US, top 50 metros, and 17 target markets

Metrics	National	Average top 50 metros	Average of 17 target markets
Population growth (5-yr avg)[10]	0.62%	0.90%	1.11%
Population growth 25-34 yr old (5yr avg)[10]	1.12%	1.42%	1.83%
Med HH income/med home price[11]	22.17%	23.17%	17.37%
Employment growth (5-yr avg)[12]	1.60%	1.90%	2.50%
Vacancy rate A or 4 & 5 star[8]	10.51%	10.35%	10.65%
Vacancy rate B or 3 star[8]	5.81%	6.10%	5.71%
Effective Rent Growth A or 4 & 5 star (5-yr avg)[8]	1.12%	1.57%	1.73%
Effective Rent Growth B or 3 star (5-yr avg)[8]	2.89%	3.21%	3.43%
B or 3 star stock as % of total stock[8]	40.65%	41.09%	36.56%

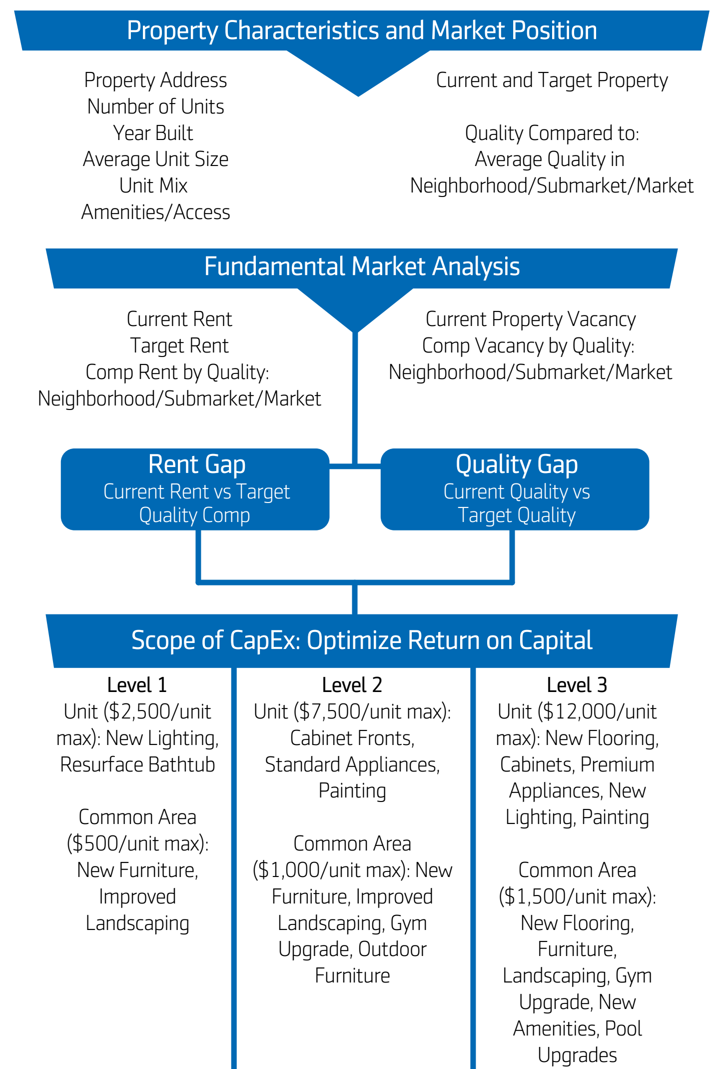
Selecting properties

Within the targeted metro areas, selecting properties with relatively stronger investment performance prospects is the next challenge. Rent growth over time reflects the force of demand propelled by jobs and population, but there is a limit. Rent growth for B-class stock above the inflation rate requires that tenant incomes grow more strongly than the even the pre-Covid economic environment could support. Remember that these metros have concentrations of rent-burdened households. Investing in properties with cash flows generated solely by current rents and inflation-like rent growth may be adequate as "core" assets, but we believe there is opportunity for more potential return available.

Most B-class apartments are now 20 to 30-years-old. Some have been refurbished and updated others have not. The latter especially represent potential value-adding opportunities for investors willing to take on the incremental risk. Our approach to selecting value-add properties weighs and mitigates that risk.

Focusing on the target metros is the first line of risk control in that it takes advantage of relatively stronger demand-supply drivers of rent growth. Selecting properties within those metros is a separate analytic process involving careful examination of the competitive positioning of prospective investments and their neighborhoods. This examination requires both data collection and analysis as well as on-the-ground real estate savvy. As shown in Exhibit 7, our approach includes an examination of a standard selection of property and neighborhood characteristics overlaid with visits to the property, its competitors, and walks through the neighborhood. This examination produces a view of the current competitiveness of the property in its neighborhood market and potential value-add opportunity.

Exhibit 7: Aegon Asset Management property evaluation approach



The sweet spot for value-add occurs when property rents are below neighborhood highs for B-class apartments and where improvements can garner similar higher rents. The challenge is to maintain rents that are affordable in the context of the neighborhood competitive set. Improvements to both individual units and common space are typical value-add activities, but property management improvements are sometimes value generators as well. We recommend considering rent gaps alongside various standard packages of potential capital improvements. The goal is to produce a step-up in rent and an attractive return on capital invested. In addition, the capital investment should offset physical depreciation and prolong the quality-life of the property.

In our experience, investments that match our criteria typically generate a step-up in rent as improvements are completed and units leased. Prior to the pandemic, this usually involved a one-to-two-year time frame. Rent growth thereafter commonly reverts to the market trend for properties of similar quality. Incremental return of 200-400 basis points versus core apartments is our typical goal. Further upside is possible if exit cap rates are favorably affected by the prolonged quality-life of the property. Challenges to achieving these results are largely related to managing the improvement process on budget and on time. For this, we rely on expert local partners.

Aftermath of the pandemic

Looking forward, we believe the investment characteristics of workforce apartments are especially well-suited to address the uncertainties accompanying recovery from the pandemic and associated recession. Fixed supply and renter-by-necessity demand underpin cash flow prospects that are less vulnerable to recovery uncertainties than those of other property sectors. Focus on metro markets that are enjoying relatively robust growth in millennial population reinforces defensiveness further because demographic trends are more structural than cyclical. We believe investors can incorporate additional resiliency by diversifying holdings across several metros with differing employment compositions. Historical correlations of employment growth in target metros are an important element in informing portfolio construction.

Despite our best efforts, it is analytically impossible to predict accurately the onset of the timing and strength of the US economy in the aftermath of the pandemic and effects on CRE performance. We believe the best defense for investors is to position their portfolios against distress, and workforce apartments are one tool to consider.

References

[1]Pension Real Estate Association, Investment Intentions Survey, 2021

[2]National Council of Real Estate Investment Fiduciaries (NCREIF), December 31, 2020

[3]Pew Research Center, Millennials overtake Baby Boomers as America's largest generation, April 28, 2020

[4]US Census Bureau, 2017 National Population Projections, April 7, 2020

[5]US Census Bureau, Homeownership Rates by Age of Householder, December 31, 2020

[6]Apartment List. Apartment List's 2021 Millennial Homeownership Report, February 9, 2021

[7]H. Lee, 'Millennials and the Future Urban Landscape' Housing Perspectives, Harvard Joint Center for Housing Studies, November 1, 2018

[8]CoStar Realty Information, Inc., December 31, 2020

[9]Joint Center for Housing Studies of Harvard University, The State of the Nation's Housing, 2020

[10]US Census Bureau, Moody's Analytics, 2019.

[11]US Census Bureau, National Association of Realtors, Moody's Analytics, Aegon Real Assets US, Q3 2020.

[12]US Bureau of Labor Statistics (CES), Moody's Analytics, Q4 2019.

Disclosures

Unless otherwise noted, the information in this document has been derived from sources believed to be accurate at the time of publication.

This material is provided by Aegon Asset Management (Aegon AM) as general information and is intended exclusively for institutional and wholesale investors, as well as professional clients (as defined by local laws and regulation) and other Aegon AM stakeholders.

This document is for informational purposes only in connection with the marketing and advertising of products and services, and is not investment research, advice or a recommendation. It shall not constitute an offer to sell or the solicitation to buy any investment nor shall any offer of products or services be made to any person in any jurisdiction where unlawful or unauthorized. Any opinions, estimates, or forecasts expressed are the current views of the author(s) at the time of publication and are subject to change without notice. The research taken into account in this document may or may not have been used for or be consistent with all Aegon AM investment strategies. References to securities, asset classes and financial markets are included for illustrative purposes only and should not be relied upon to assist or inform the making of any investment decisions. It has not been prepared in accordance with any legal requirements designed to promote the independence of investment research, and may have been acted upon by Aegon AM and Aegon AM staff for their own purposes.

The information contained in this material does not take into account any investor's investment objectives, particular needs, or financial situation. It should not be considered a comprehensive statement on any matter and should not be relied upon as such. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to any particular investor. Reliance upon information in this material is at the sole discretion of the recipient. Investors should consult their investment professional prior to making an investment decision. Aegon AM is under no obligation, expressed or implied, to update the information contained herein. Neither Aegon AM nor any of its affiliated entities are undertaking to provide impartial investment advice or give advice in a fiduciary capacity for purposes of any applicable US federal or state law or regulation. By receiving this communication, you agree with the intended purpose described above.

Past performance is not a guide to future performance. All investments contain risk and may lose value. This document contains "forward-looking statements" which are based on Aegon AM's beliefs, as well as on a number of assumptions concerning future events, based on information currently available. These statements involve certain risks, uncertainties and assumptions which are difficult to predict. Consequently, such statements cannot be guarantees of future performance, and actual outcomes and returns may differ materially from statements set forth herein.

The following Aegon affiliates are collectively referred to herein as Aegon Asset Management: Aegon USA Investment Management, LLC (Aegon AM US), Aegon USA Realty Advisors, LLC (Aegon RA), Aegon Asset Management UK plc (Aegon AM UK), and Aegon Investment Management B.V. (Aegon AM NL). Each of these Aegon Asset Management entities is a wholly owned subsidiary of Aegon N.V. In addition, the following wholly or partially owned affiliates may also conduct certain business activities under the Aegon Asset Management brand: Aegon Asset Management (Asia) Limited (Aegon AM Asia).

Aegon AM UK is authorised and regulated by the Financial Conduct Authority (FRN: 144267) and is additionally a registered investment adviser with the United States (US) Securities and Exchange Commission (SEC). Aegon AM US and Aegon RA are both US SEC registered investment advisers. Aegon AM US is also registered as a Commodity Trading Advisor (CTA) with the Commodity Figures Trading Commission (CFTC) and is a member of the National Futures Association (NFA). Aegon AM NL is registered with the Netherlands Authority for the Financial Markets as a licensed fund management company and on the basis of its fund management license is also authorized to provide individual portfolio management and advisory services in certain jurisdictions. Aegon AM NL has also entered into a participating affiliate arrangement with Aegon AM US. Aegon AM Asia is regulated by the Securities and Futures Commission of Hong Kong (CE No. AVR688) to carry out regulated activities in Dealing in Securities (Type 1) and Advising on Securities (Type 4).

©2021 Aegon Asset Management or its affiliates. All rights reserved.

Adtrax: 3472281.2GBL