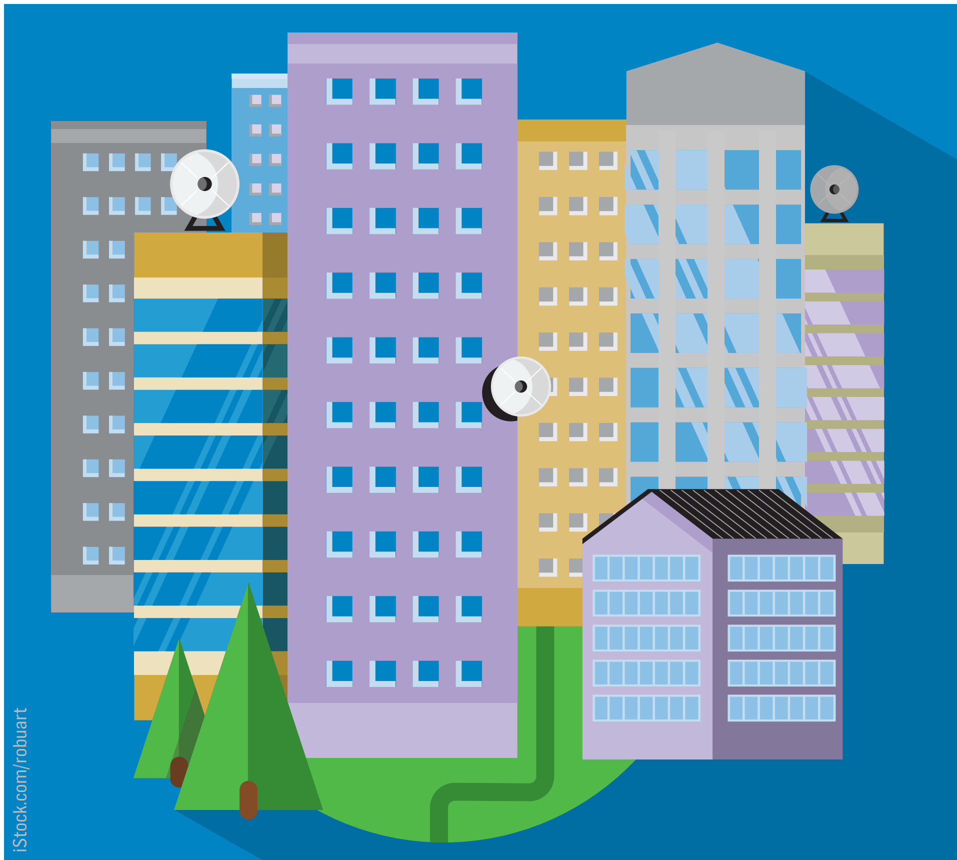
The Endurance of US RENTAL housing investments



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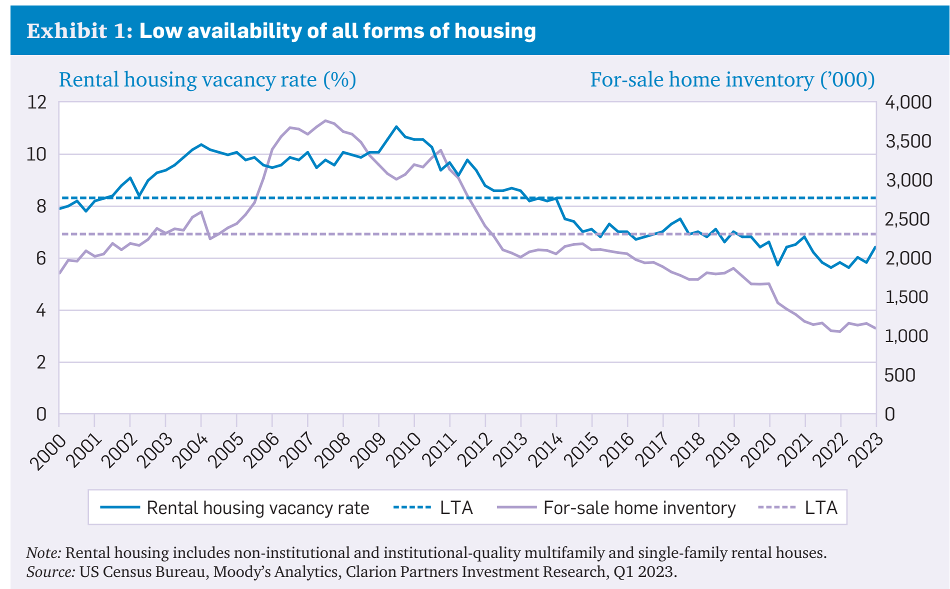
Macroeconomic, demographic and financial factors will continue to buoy US housing rentals, especially in the Sun Belt and suburbs, making them an attractive proposition for investors.

By Tim Wang & Julia Laumont, Clarion Partners

[1] Rosen Consulting Group, Housing is Critical Infrastructure: Social and Economic Benefits of Building More Housing, Rosen Consulting Group, June 2021.

Over the past decade, US multifamily has been among the most highly sought-after sectors by institutional real estate investors due to its necessity characteristic, the underlying strength of property-level fundamentals and high risk-adjusted total returns. It has become an integral part of commercial real estate investment portfolios with a weighting of 29.2% in the NCREIF Open-end Diversified Core Equity Index (ODCE) in Q1 2023. Clarion Partners believes that well-located, high-quality rental housing will continue to be a strong performer over the long term due to a variety of macroeconomic, demographic and financial factors.

Exhibit 1: Low availability of all forms of housing



Note: Rental housing includes non-institutional and institutional-quality multifamily and single-family rental houses.
Source: US Census Bureau, Moody's Analytics, Clarion Partners Investment Research, Q1 2023.

Macroeconomic drivers sustaining demand

We are optimistic about the outlook for US multifamily in 2023 and beyond due to two macroeconomic factors:

1. The national housing shortage

Following a decade of underbuilding, there continues to be a national housing shortage. Both the US for-sale housing inventory and rental housing vacancy rate have remained near a two-decade low in recent years (see Exhibit 1). Based on the difference between household formation and housing completions, we estimate a shortfall of 3.2 million housing units, which includes 1.2 million owner households and 2 million renter households; this is consistent with Realtor.com's estimated shortages ranging between 2.5 million and 3.7 million housing units.

This approximation jumps to 6.8 million when also taking into account the loss of existing units due to demolition, natural disasters or functional obsolescence.[1] The deficit is even more pronounced in the low and middle markets, as much of the new construction targets the high-end segment.

2. Favorable demographics

The increasingly onerous cost of owning a home has led many in all age groups to remain in the renter cohort, sometimes by choice. While the overall US homeownership rate hovers near the long-term average, the rate among first-time buyers is at an historical low. It is also well below the US average in the Northeast and West regions, especially in major markets where the cost of living is very high.

While more millennials (72 million strong) are buying homes, Gen Z (70 million), which has started to enter the workforce, will remain in the renter cohort for the next decade or so. Furthermore, more Gen X-ers and Baby Boomers (138 million combined), traditionally homeowners, are choosing to rent for lifestyle reasons.

> "Following a decade of underbuilding, there continues to be a national housing shortage."

Additional key factors likely to sustain future rental housing fundamentals include strong ongoing job and wage growth, elevated construction and replacement costs, and tighter lending conditions for new construction, which will likely suppress future new supply.

Financial headwinds

However, several acute for-sale housing affordability challenge persists.

US for-sale housing affordability is at an all-time low

In 2022, the median US home price climbed to a new high, but US for-sale

[2] Joint Center for Housing Studies at Harvard University, The State of the Nation's Housing 2023, Joint Center for Housing Studies at Harvard University, June 2023.

housing affordability reached an all-time low (see Exhibit 2). Even as residential mortgage rates surged to the highest point since 2002, home prices have remained near record levels across many US markets, and financing costs to purchase have more than doubled in the last year (see Exhibit 2). This has created steady demand for professionally managed rental housing across a wide range of US metros.

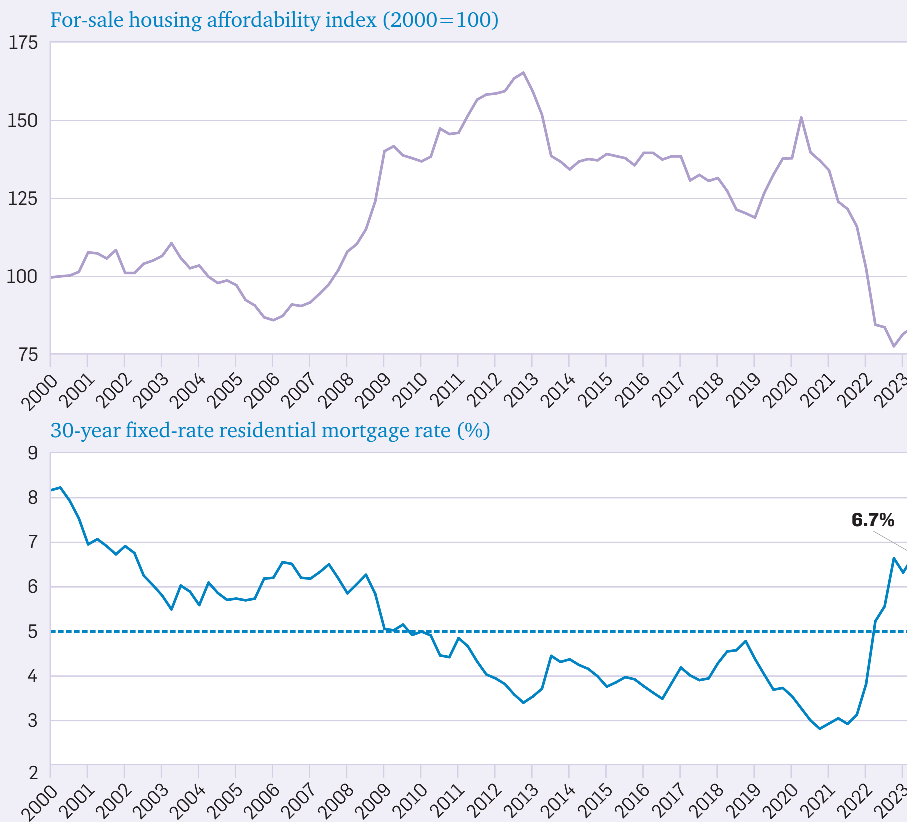
US for-sale housing price surge

Over the past decade, the US median home price has almost doubled, from $195,000 to $383,000. Housing prices in many secondary markets in the South and West regions approached new highs, with a few rivalling the level of some high-cost major markets. However, overall home prices are still significantly lower in much of the Sun Belt. In this time period, the national average income grew by 40%.

Many US counties report a home price above the national median

Of the 50 largest metropolitan statistical areas, 30 now have median home prices above that of the nation, which has climbed from 24 in 2013. This has led to a greater demand for high-quality Class A and B rental housing in more metros.

Exhibit 2: US for-sale housing affordability has worsened



Note: For-sale housing affordability index based on Moody's Analytics model that factors in three variables: 30-year fixed rate mortgage commitment rate — national, FHFA purchase-only home price index and median household income.
Source: Moody's Analytics, Clarion Partners Investment Research, June 2023.

Rise in cost-burdened households

In recent years, there has been a rise in total cost-burdened households, which pay more than 30% of their monthly income on housing costs. Of 130 million US households, over 30% are now cost-burdened, representing the highest rate on record. The share of severely cost burdened households — those paying over 50% of monthly income on housing costs — is significant for both renter and owner households.[2]

Ongoing shift to the Sun Belt and suburbs

Higher for-sale housing costs have led to greater residential mobility and shifted the geography of housing demand. Recent domestic migration and population growth trends have continued to heavily favor the Sun Belt and suburbs, which has had a significant impact on CRE demand overall in these areas.

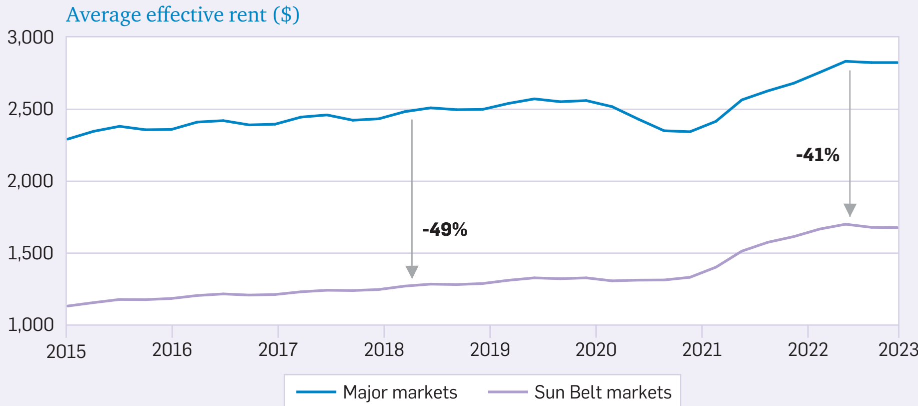
Sun Belt lure

During the pandemic, Sun Belt markets saw a surge in net in-migration, often at the expense of major markets. Looking ahead, the Sun Belt boom is expected to continue given the relative cost of living, quality of life and job opportunity. Overall, the Sun Belt markets' rental housing costs still offer a sizable discount relative to the six major markets at about 40% (see Exhibit 3). Over the next five years, the top markets for population and employment growth are largely forecast to be in Texas, Florida, North Carolina, Nevada, Utah, Arizona and Tennessee (see Exhibit 4).

Suburban boom

With a robust inflow of Gen Z and millennials into the central business districts (CBDs) of major markets, we

Exhibit 3: Sun Belt apartments offer a 40% discount to major markets



Note: Six major markets include New York, Boston, San Francisco, Los Angeles, Washington DC and Chicago.
Sun Belt markets include Miami, West Palm Beach, Nashville, Dallas, Austin, Charlotte, Raleigh, Tampa, Jacksonville, Phoenix, Orlando, Fort Worth, Houston, Salt Lake City and Las Vegas.
Source: CBRE-EA, Q1 2023.

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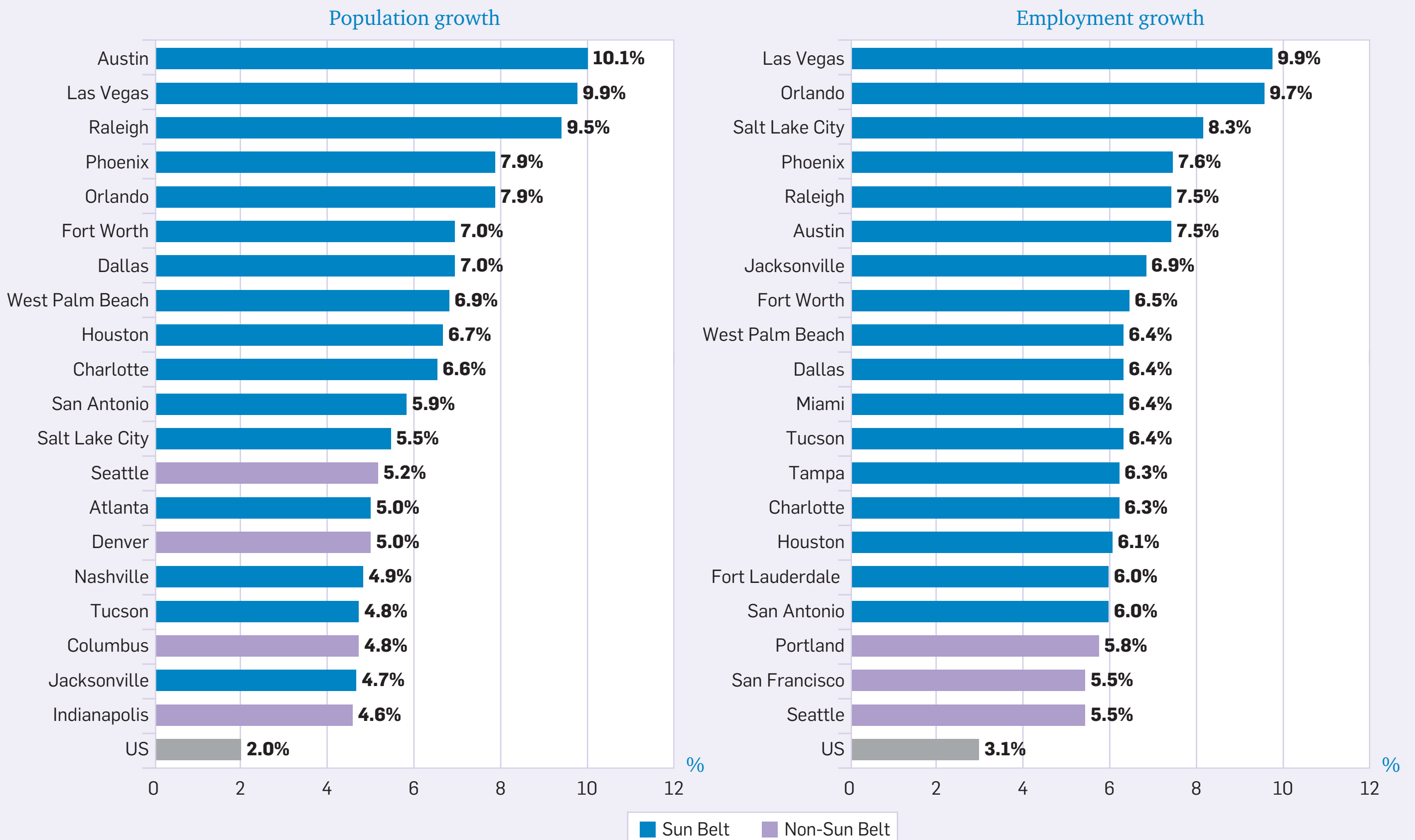
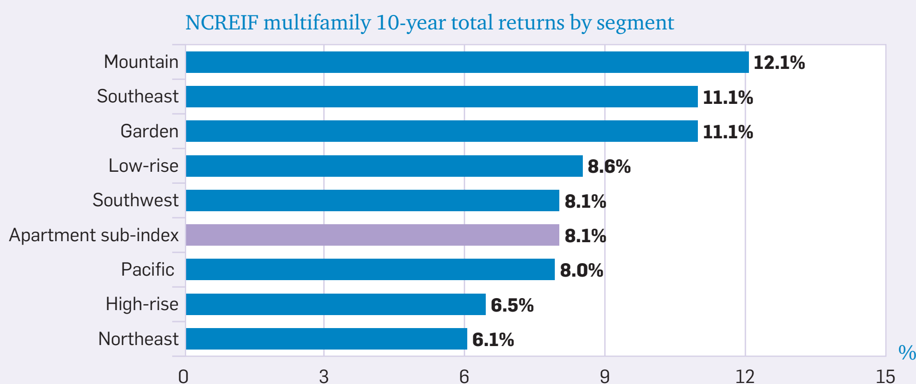
Exhibit 4: Sun Belt markets are strongest for total population and job growth (2023F–2028F)



Note: Calculation used forecast data from Q2 2022 to Q4 2027.
Source: Moody's Analytics, Clarion Partners Investment Research, Q1 2023.

> Multifamily investments can potentially serve as a hedge against rising inflation.

Exhibit 5: Mountain, Southeast and garden apartments have performed strongly



Source: NCREIF Property Index, Clarion Partners Investment Research, Q1 2023.

expect steady demand there as well in the years ahead. However, as millennials reach middle age, cost pressures mount and growth industries are more diversified by region, we expect strong rent growth performance in the urban fringe and suburbs to persist. From 2015 to 2023, the average annual rent growth in the suburbs was double that of urban areas as more young adults migrated to the suburbs to have families enjoy more living space and access public schools.

Strong multifamily investment performance

Over the past decade, the NCREIF Property Index multifamily subindex (stabilized and unlevered) has performed very well (see Exhibit 5). The short- and long-term total returns have also indicated strong outperformance in the Mountain, Southeast and Southwest regions, along with the two lower-density multifamily formats — garden-style and low-rise apartments. Given the recent population, migration and job growth trends, we believe that commercial real estate investors should align investment strategies accordingly in the future.

Going forward, we believe there are several other considerations to bear in mind as a multifamily investor:

- *Political risks* (i.e., rent control, environmental risks and policies);
- *High-growth industry clusters* (i.e., tech, life sciences and health care);
- *High cost of living,* including food, electricity, transportation and caregiving; and,
- *Endurance of remote and hybrid work;* physical office occupancy now averages about 50% of pre-Covid levels, which may influence future living arrangements.

New supply levels in 2022 and 2023 may increase the historically low rental housing vacancy rate. We expect rental demand to remain strong given the acute housing shortage theme.

We are cautiously optimistic about the long-term outlook for professionally managed rental housing income growth and appreciation given the worsening affordability in the for-sale housing market. Last but not least, landlords can adjust rent more quickly than in other sectors. Therefore, multifamily investments can potentially serve as a hedge against rising inflation, a desirable characteristic in today's reflationary environment.

Investment focus

Over the past decade, US rental housing fundamentals have remained very healthy overall. US multifamily rents are at all-time highs, and most markets report vacancy rates under 5%. Furthermore, all major markets reported positive rent growth in 2022. Clarion Partners is focused on the following acquisition and development investment strategies:

- Top submarkets of Sun Belt metros with a concentration of high-growth industries, strong population growth and a low cost of living;
- High-quality class A and B apartments in top suburban and urban fringe submarkets of major and secondary markets; and,
- Targeting renters by choice in top lifestyle markets/submarkets. ◆

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