RETHINKING DEMAND IN MULTIFAMILY REAL ESTATE: AN EVOLVING PARADIGM

Quintin E. Primo III
Dori Nolan
Jason Lewis

The traditional drivers of demand in the multifamily housing market have produced strong sector fundamentals for more than 30 years.

Factors such as healthy US job growth, rising income levels, and favorable demographics have all contributed to the resiliency and attractiveness of the property type as an investment vehicle for institutional investors.

But will these same drivers continue to produce a halo effect over the multifamily market? Certainly, the "new normal"—characterized by persistently high unemployment, low interest rates, and sluggish growth—if realized, would not on balance appear to be beneficial for real estate assets of any type, including multifamily. Are there other secular trends that will override these challenging economic factors, such as the browning and graying of America—the disproportionate growth of minority and elderly populations? In addition to the economy and demographics, are there technological or other factors that will affect the needs and space demands of end users?

This article seeks to briefly address these and other questions with respect to market demand, and considers the implications for multifamily investment portfolio construction and risk.

In summary, we believe that demand for multifamily housing will continue to be robust and that this property type can play an important role in a prudently managed investment portfolio, offering high risk-adjusted returns.

What Will Be the Major Demand Drivers For Multifamily Over the Next Five To Ten Years?

Job Growth Is Still Important

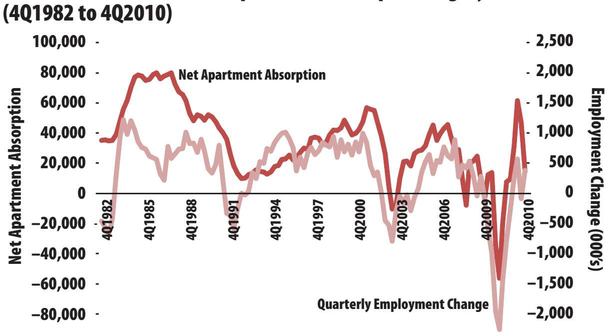
Job growth is still critically important and a primary driver of demand. Employment gains during the most recent recovery have been erratic, yet apartment vacancies nationally have now fallen below 7%, reflecting growing demand and constrained supply. Property and Portfolio Research (PPR) estimates a historical correlation between job formation and apartment demand at 0.67, confirming that as new jobs are created, apartment demand improves as well (Exhibit 1).

The US economy is still grappling with a number of thorny issues. The recovery is therefore likely to be uneven and prolonged, with full employment not achieved until 2015 or 2016, and even then, unemployment will remain at new normal levels that are higher than the country has historically experienced. But with US corporations flush with cash, cheap currency, and banks again beginning to lend, the long-term employment outlook is positive. Thus, we believe the jobs picture will inevitably firm and favorably impact the multifamily sector in 2011 and beyond.

Homeowners Are Becoming Renters

The extremely weak homeownership market that has plagued the economy since 2007 will take years to recover and reverse the dramatic declines in value that destroyed so many Americans' dreams of financial security. The home as a storehouse of value has been replaced by the ugly image of foreclosures and underwater mortgages along with lender and real estate agent misconduct that consumers won't soon forget.

Exhibit 1: Job Growth and Apartment Absorption Highly Correlated (4Q1982 to 4Q2010)

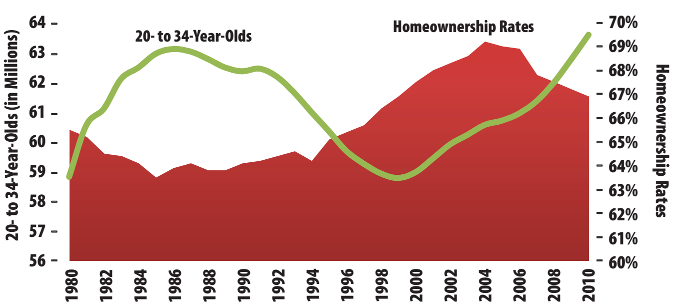


Sources: Bureau of Labor Statistics, PPR, Capri

Reflecting this new reality, the drop in the homeownership rate from a peak of 69% in 2004 to 67% currently has resulted in 3 million new renters entering the market, only a portion of whom have been absorbed by the shadow rental market of detached homes and condominiums. This trend has been heightened by the tightening of underwriting criteria for single-family mortgages—resulting from higher capital standards imposed on lenders and new mortgage securitization requirements—that will limit mortgage availability to consumers for the foreseeable future.

The psychology of the American consumer regarding housing ownership has therefore changed significantly. The stigma previously attached to renting has been dispelled, which could have a profound impact on the country's propensity to rent. Further limitations on the deductibility of mortgage interest as the federal government struggles to address budget deficits could easily accelerate this trend.

Exhibit 2: Homeownership Rates and Growth of Echo Boomers



Source: US Census Data

Demographic Trends Portend Growth

Demographic drivers such as population growth, immigration, and the resettlement of families that doubled up during the recession are projected to lead to the formation of 850,000 US households per year from 2011 to 2015. As compared to other developed countries, the US enjoys healthy and resilient population growth of roughly 1% per year along with a youthful base.

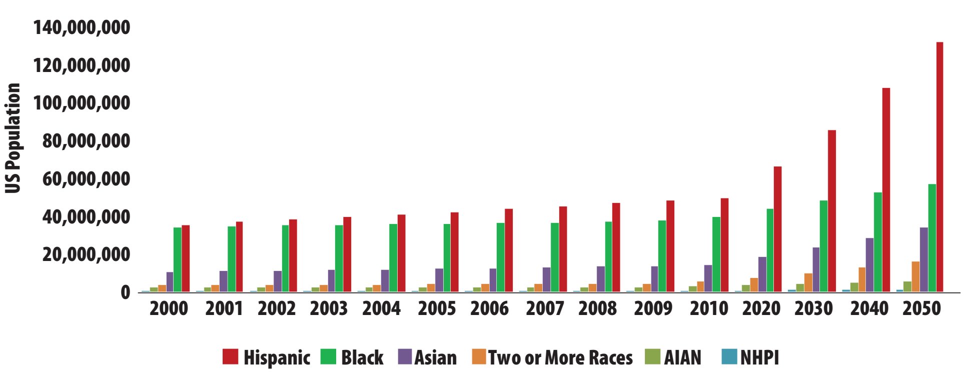
■ Impact of the Echo Boomers

Over the next five to ten years, America's relative youthfulness should continue as a key driver of multifamily demand. The 20- to 34-year-old sector of the population, classified as echo boomers, numbers almost 70 million, has a high propensity to rent, and represents the ideal apartment tenant profile. This age cohort is also growing rapidly (Exhibit 2). The proportion of echo boomers to total US population is expected to reach a cyclical peak at approximately 21% in late 2012. Equally compelling is that for households headed by an individual under age 35, the homeownership rate dropped to 39% in the second quarter of 2010, 400 basis points from its 2005 peak.

■ The Browning of America

Relatively higher birth rates among minorities and continued immigration will cause the non-white population in the United States to surge through the middle of the century. The US Census Bureau esti-

Exhibit 3: Historical and Projected US Population by Minority Group



Note: Census Abbreviations: Black = Black or African American; AIAN = American Indian and Alaska Native; NHPI = Native Hawaiian and Other Pacific Islander

Sources: US Census Bureau, Capri

mates that 95% of the 157 million projected increase in US population from 2000 through 2050 will be among minorities. By far, the fastest-growing group will be Hispanic Americans, causing this cohort to become an increasingly significant portion of renter demand (Exhibit 3).

Importantly, the rapid expansion of the Hispanic community is not simply an urban phenomenon. A recent Chicago Community Trust–funded study on the migration patterns of Latinos found that more Hispanics now live outside the city of Chicago than within. The most recent Chicago census data further confirms that Hispanic migration to the suburbs continues. Affordable housing, closer access to service-industry employment, and other factors have fueled this trend.

These demographic trends will invariably impact the composition of future renter demand. Those owners who show sensitivity to, and creatively address, cultural differences and preferences among expanding minority groups are expected to capture greater market share through understanding of the needs of their residents.

Urbanization

The "new urbanism" in American cities offers industry and economic clustering, transit orientation, efficient delivery of city services, and vibrant educational, cultural, and health-care institutions as well as extensive retail, restaurant, and other amenities. These attributes create strong demand among young professionals to work downtown and to increasingly live in areas undergoing urban renewal and gentrification. Such benefits also beckon well-off empty nesters to relocate from the suburbs. Both demographic groups will continue to be key elements of urban multifamily demand for the foreseeable future.

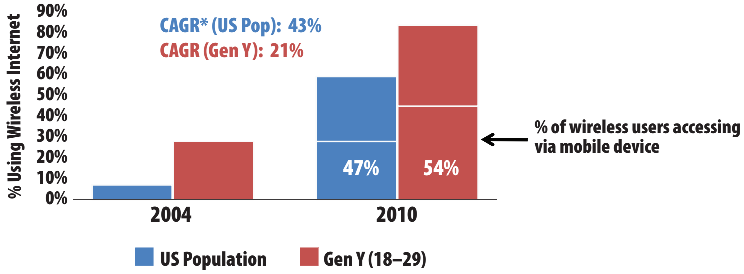
The need and demand for affordable housing within major American cities, however, remains of critical importance. Using Chicago again as an example, a joint report by ULI and the MacArthur Foundation indicates Cook County is expected to lose up to 78,000 units of affordable housing in the next ten years, yet demand will *increase* by 185,000 units, thus causing a troubling affordable housing gap. Maintaining socioeconomic diversity is in cities' (and investors') best interests and is a core strength of the American urban landscape.

The Graying of America

At the beginning of 2011, our first baby boomers turned 65. Over the next decade, the 76 million people born from 1946 through 1964 will flow through America's demographic pipeline, not only creating new sources of demand but also challenging conventional wisdom in the multifamily industry. Traditionally, older Americans have been an afterthought for multifamily owners more focused on the prime age cohorts with the highest propensity to rent. However, the 55- to 75-year-old age-group (forecast to increase to 20% of the US population by 2030) is now too large to ignore, bringing with it both opportunities and challenges.

Better educated, healthier, and more sophisticated than any previous generation in American history, these graying baby boomers will represent an increasingly large portion of multifamily demand, but their tastes and needs will differ from those of other renters. As America's first knowledge generation, they will be attracted to lifestyles and locations that provide opportunities for continued learning, recreation, and health-care security. Properties and locations, particularly in urban areas, that recognize these needs will benefit accordingly.

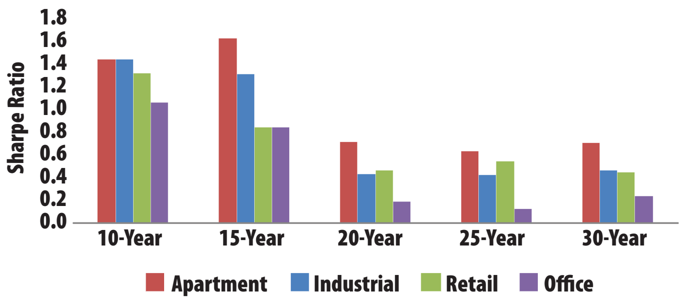
Exhibit 4: Wireless Internet Usage Is Growing Rapidly



* CAGR: compound annual growth rate

Sources: "The Current State of Wireless Internet Use," PEW Internet and American Life Project; Capri

Exhibit 5: Risk-Adjusted Returns by Property Type (as of 4Q2008)



Sources: NCREIF, Torto Wheaton Research, Capri

Technology Will Impact Consumer Consumption Patterns and Property Design

Changes in technology will impact how renters, or consumers, utilize space as well as their overall demand for it. Today, for instance, the stand-alone business center is becoming obsolete as technology migrates to laptops, wireless connectivity, and "the cloud" as sophisticated consumers expect and demand powerful connectivity throughout the living environment.

Information technology will continue to evolve; communication is rapidly moving away from traditional desktop Internet access to smart phones, tablets, and other mobile, handheld devices (Exhibit 4). Since 2008 alone, iPad, iPhone, and iPod Touch Internet subscriptions have more than tripled. Consumers will increasingly conduct their lives through these new technologies and will expect their interface with multifamily owners to correspond accordingly.

Facebook along with other forms of social media additionally characterize how potential renters are communicating and interacting. Craigslist has become the number one source of traffic for many apartment communities nationwide. Search engine optimization and the ability to successfully maneuver through cyberspace have begun to define apartment marketing strategies as well. A targeted strategy around efficient utilization of digital and social media to attract, interact with, and retain renters will become paramount in apartment owners' competitive positioning.

The role of hybrid and electric vehicle alternatives will also become increasingly important, supported by both consumer demand and government subsidies and mandates. Multifamily properties will need to respond with design changes, incorporating charging stations, more efficient space striping, and bays for car sharing. These features will become more prevalent and amenities that sophisticated consumers will value.

In addition to technology, multifamily demand will be impacted by changing patterns of consumption in other respects. For example, environmental sustainability has become a core value for a broad range of Americans. Thus, sustainability in design and property operations—features such as energy efficiency, recycling capabilities, LEED certification, and smoke-free environments—are now important consumer considerations, not just fringe benefits, and their significance is certain to increase in the future.

How Is a Multifamily Portfolio Best Constructed and What Are The Possible Risks?

As this article suggests, future demand for multifamily properties is likely to be robust, but we believe it will continue to evolve in character. Job growth is still very important to net absorption, but when compared with other institutional property types, multifamily demand will be particularly impacted by the powerful demographic trends, technology, and other factors discussed herein.

Over the past 30 years, apartments have provided the highest risk-adjusted return of any property type, due largely to the sector's resiliency, strong demand drivers, and ability to quickly react to improving market conditions (Exhibit 5).

To ensure this outperformance continues, thoughtful construction of a multifamily portfolio will be important. Certainly, the strategies deployed by investors should reflect their own specific investment objectives—the role commercial real estate plays in their overall portfolios, the need for income and/or appreciation, the willingness to leverage, as well as a host of other factors unique to each investor. Nevertheless, we suggest several broad themes in multifamily portfolio construction that reflect our view of the evolving paradigm in the marketplace.

1. We recommend a strong bias toward larger urban markets such as New York, Washington DC, Chicago, Los Angeles, San Francisco, Houston, and others. These urban areas represent "clusters of excellence" exhibiting higher barriers to entry and the greatest market liquidity. We would overweight in these types of major metro markets 100%.

2. The portfolio should be strategically constructed to reflect evolving demographics, especially the growth of minorities and older consumers. This should be incorporated in areas such as asset selection, property design, and marketing. In joint venturing with owners or developers, investors should consider the diversity of the sponsor's investment and property management staff to assess their commitment to these growing markets. Locations in close proximity to transportation, employment, education, and health-care centers remain essential to capturing demand.

3. Consider ground-up apartment development and value-added strategies. There is no better way to ensure that a product will not be obsolete in five to ten years with respect to technology, changing consumption patterns, and other considerations. In addition, higher total returns can be generated as compared with an increasingly competitive acquisition market. We recommend that up to 20% of the portfolio be dedicated to these more opportunistic strategies in targeted markets.

4. Stay geographically diversified. While we are biased toward coastal markets, investors should never put all their eggs in any one regional or geographic basket.

5. Given the need and demand for affordable housing, consider adding this or a mixed-income element to the portfolio. There are many investment options offering safe, market-rate returns to investors. An added benefit is that these investments should have a lower return correlation to market-rate housing given the unmet yet expanding demand for affordable housing. We recommend investing between 5% and 10% of the multifamily portfolio in this sector.

What are the prospective risks to such a portfolio? Beyond broad economic, systemic, and demand/supply variables, the focus on income-producing assets in urban markets exposes the portfolio to the risks of aging American cities—high labor costs, deteriorating infrastructure, declining tax bases, rising social costs, and a host of other factors. Especially in the face of increasing global competition to the economy, cities must evolve to a new paradigm to realize the prospects of the new urbanism. In addition, macro considerations such as the affordability of single-family homes and the future of the housing finance industry, now largely dominated by Fannie Mae and Freddie Mac, will come into play.

Even with these broad portfolio risks, we believe that the secular outlook for US multifamily investments is excellent. As the demand drivers for this property type continue to evolve, prudent investors in this sector should be rewarded with stable, resilient return performance. ■

Quintin E. Primo III is Chairman and CEO, Dori Nolan is Principal, and Jason Lewis is Vice President of Capri Capital Partners, LLC.