American Realty Advisors

2018 Spring Newsletter

Green Shoots of Opportunity in Multi-Family Housing

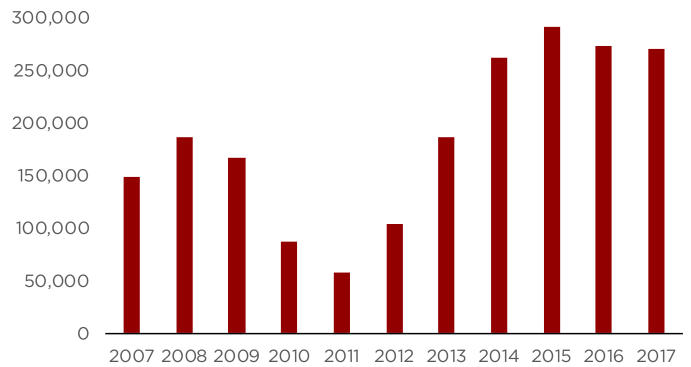
Christopher Macke
Managing Director,
Research & Strategy
cmacke@aracapital.com

Stanley L. Iezman
Chairman & CEO
siezman@aracapital.com

Intro

We recommend gradually increasing tactical allocations to core multi-family housing (MFH) at this time for two reasons. First, after a period of robust construction activity, the sector is now beginning to overcome supply-induced torpor. Second, being later in the economic cycle, it is prudent to consider how property sectors performed during recent downturns as well as how quickly they recovered. MFH performed above average during downturns and recovered more quickly. While we recommend increasing MFH exposure, there is significant variation across markets and even within markets requiring a high degree of selectivity and discipline in acquisitions. Just as importantly, there are both structural and cyclical tailwinds and headwinds that impact geographic and other considerations in crafting a MFH acquisition strategy going forward.

> MFH Units Delivered (4/5 Star)



Source: ARA Research; CoStar Data

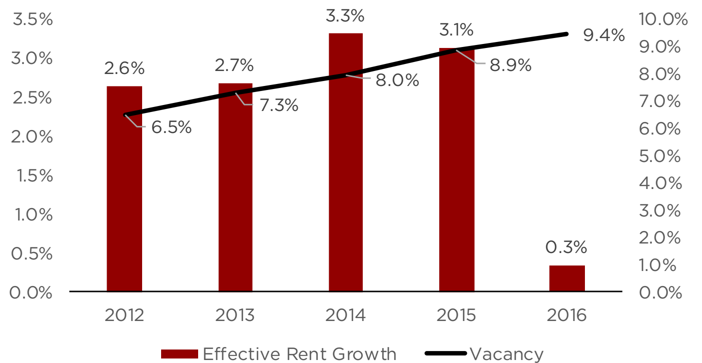
I. Supply, Supply, Supply

Surviving the Supply Wave

During 2015, we anticipated the significant increase in multi-family supply and the resulting softness in fundamentals and returns. Acting on this, we lowered our allocation to multi-family over the next few years and increased allocations to industrial. Both decisions have worked out well.

The last three years saw nearly 1.1M high-end units delivered and, not surprisingly, even with extraordinary demand driven by lower homeownership rates and the sheer size of the Millennial generation, property fundamentals buckled in 2016 and vacancy rates increased by nearly 300 bps from a cycle low of 6.5% to 9.4%.

> Multi-Family Housing Deliveries



Source: ARA Research; CoStar Data

This impacted returns, which declined significantly beginning in 2016 and continuing into 2017, resulting in the lowest returns in 2017 across property sectors.

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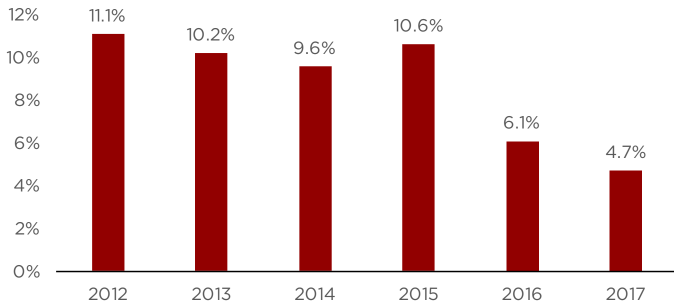
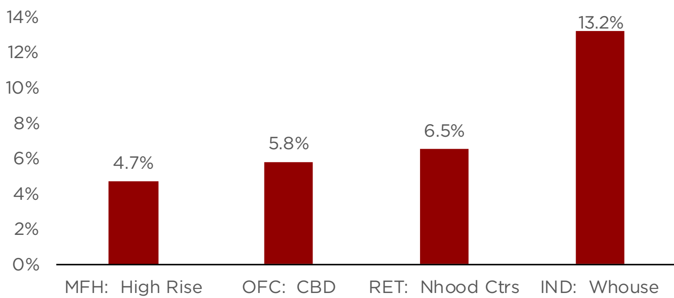
> Returns



Source: ARA Research; NCREIF Data

> Returns

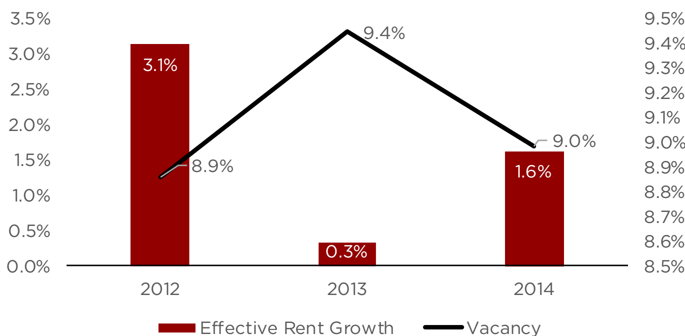


Source: ARA Research; NCREIF Data

Turning the Corner

Multi-family property fundamentals appear, however, to be turning the corner. 2016 was a cyclical trough followed by both vacancy and rent growth improving in 2017 due to a combination of moderating supply and increasing demand.

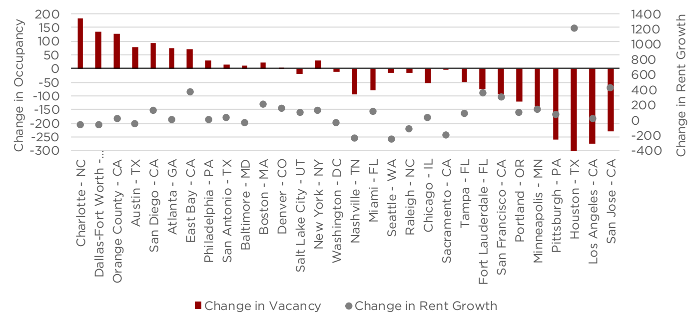
> Property Fundamentals



Source: ARA Research; CoStar Data

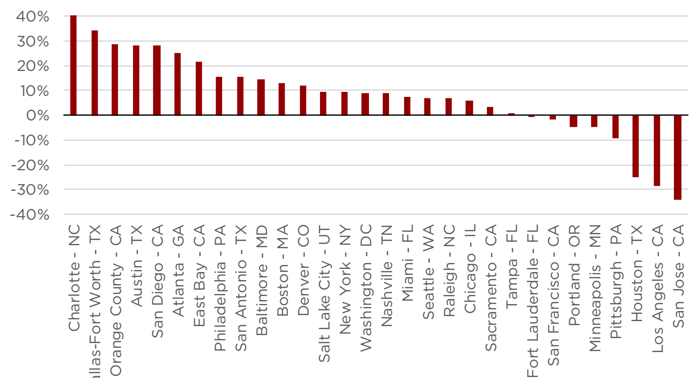
With the property fundamentals recovery in the early stages, the improvement in vacancy and rent growth has varied widely across markets. Looking at a subset of 30 markets, nearly half experienced vacancy increases in 2017 and approximately one-third experienced lower rent growth in 2017 than in 2016 reflecting the wide variation in supply relative to demand across markets.

> YOY Change in Vacancy



Source: ARA Research; CoStar Data

> Over/Under Supply (2017)



Source: ARA Research; CoStar Data

The variation extends to submarkets as well. In Los Angeles, West Hollywood and Hollywood each saw a more than 200 basis point year-over-year increase in vacancy rate and have double digit vacancy rates. Conversely, the Pasadena and Beverly Hills/Century City submarket vacancies declined year-over-year.

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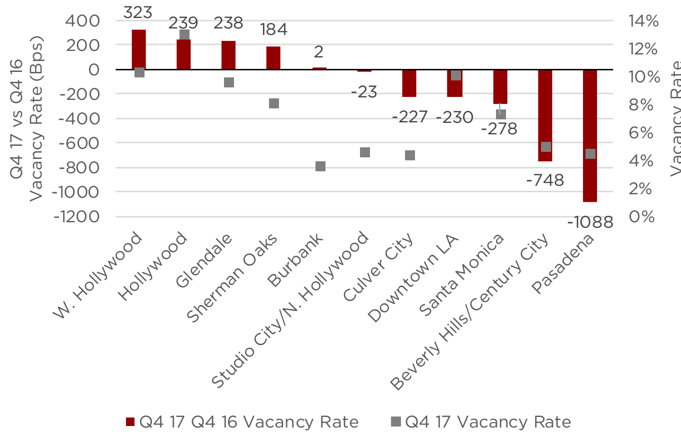
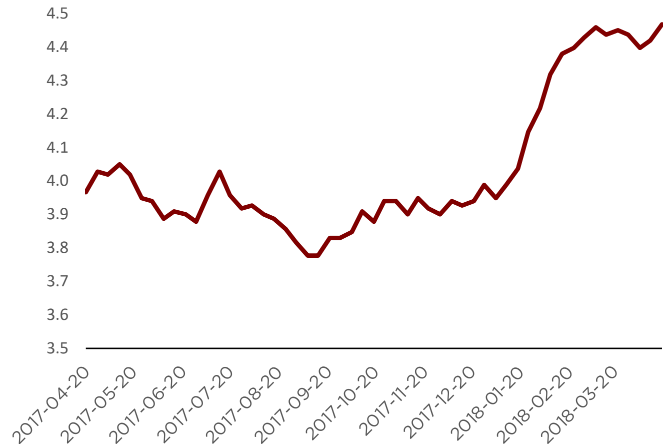
> **YOY Change in Vacancy (Bps) and Vacancy Level**



Source: ARA Research; CoStar Data

> **30-Year Fixed Rate Mortgage Rate (%)**



Source: ARA Research; St. Louis Federal Reserve Data

II. Outlook

Demand Drivers

Demand drivers paint a mixed picture going forward with the previously elevated demand tailwinds coming from Millennials and low homeownership rates moderating going forward, while other factors including decreasing home affordability in many markets, the negative impact of tax reform on homeownership and its positive impact on disposable income providing increasing tailwinds to drive future demand.

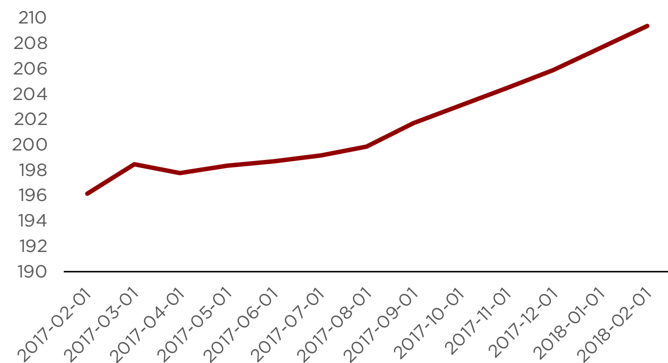
Housing Affordability - Increasing tailwind

Rising mortgage rates combined with rising prices will further lower housing affordability. This will make homeownership more expensive creating an increasing tailwind to multi-family demand.

During the last six months, the average 30-year fixed rate mortgage increased 64 basis points with further increases expected as long-term Treasury rates continue to rise.

During the last six months, home prices increased at a 7.6% annualized pace: not surprisingly, home affordability declined at an 8.7% annualized pace.

> **Case-Shiller Home Price Index**



Source: ARA Research; St. Louis Federal Reserve Data

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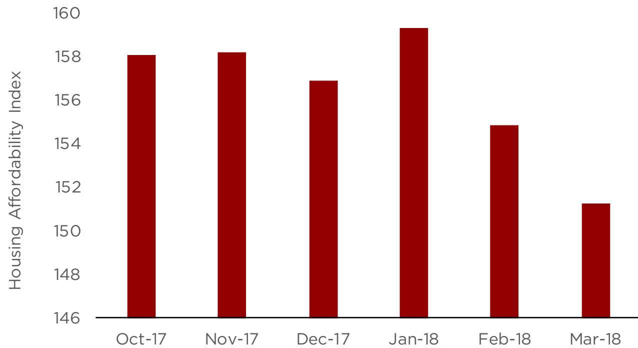
> Housing Affordability



Source: ARA Research; St. Louis Federal Reserve Data

Single family inventory levels in relation to home sales activity are at nearly half the long-term average adding additional upward pricing pressures reducing affordability further.

> Months Supply of Existing Single-Family Home on Market

Source: ARA Research; Moody's Data

Tax Reform - New tailwind

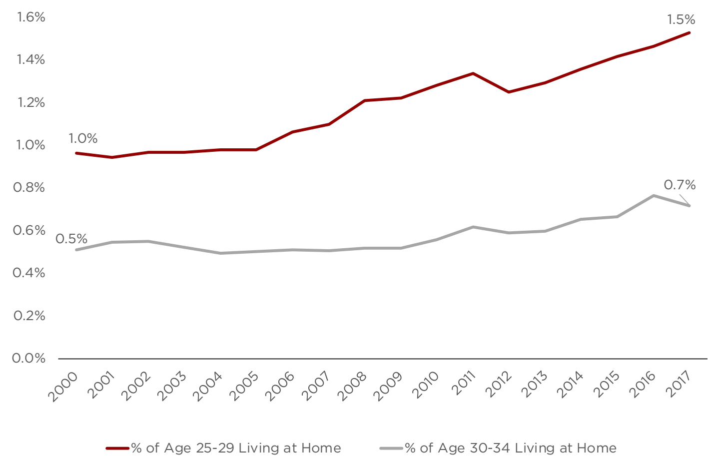
The new tax bill changed the economics of owning versus renting by doubling the personal exemption and lowering the cap on mortgage interest deduction reducing the tax benefits of owning versus renting. Reduced personal income tax rates increased disposable income levels providing additional consumption capacity allowing for greater expenditures on shelter providing a boost to rent growth potential. Collectively, we expect these to increase MFH demand.

Millennials – Mixed tailwind

The current percentage of Millennials living at home as a percentage of total U.S. population is 50% greater than in 2000, and this is most pronounced in younger Millennials (25-29). If this percentage were to revert to 2000 levels, this would result in an additional 2.4 million 25 to 34-year-old Millennials seeking external housing.

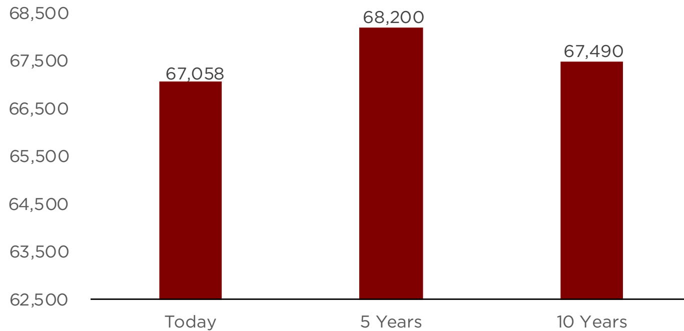
Conversely, over the next five years, the 20 to 34-year-old prime renting age segment is forecast to first increase and then decline ending up approximately 500,000 larger in ten years than today's level. Without immigration, in five years the 20 to 34-year-old age segment would be approximately 800,000 lower than today's level and approximately 3 million lower in ten years than today's level.

> 25-34 Year Old Millennials Living at Home as a Percentage of Total Population



Source: ARA Research; Census Bureau Data

> 20-34 Year Old Population Change

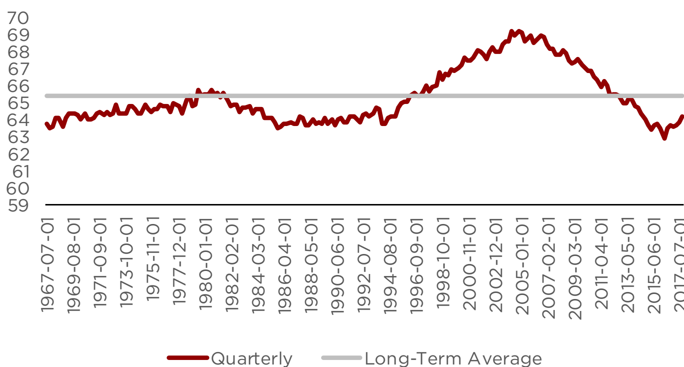


Source: ARA Research; Moody's Data

Homeownership Rate – Decreasing tailwind

Declining homeownership rates have been a strong boost for multi-family demand for many years with the rate below the long-term average for the past five years. Although there have been recent increases that are lessening this tailwind, tax reform and decreasing home affordability will stem this tide somewhat, especially in high housing affordability markets.

> Homeownership Rate (%)



Source: ARA Research; St. Louis Federal Reserve Data

Supply Drivers

A combination of rising costs and downward pressure on rent growth is expected to lead to an eventual decline in multi-family supply. This will occur at varied rates across markets and submarkets, largely driven by the current health of individual market and submarket property fundamentals with those having elevated vacancy generally seeing greater declines in the near-term.

Land and Construction Costs – Increasing headwind

Construction costs continue to increase at a rapid pace, driven by rising labor costs resulting from labor supply shortages and increased material costs due to elevated demand and higher commodity costs.

Financing Costs – Increasing headwind

While to date lenders have somewhat absorbed the cost of rising interest rates through spread compression, rising rates will eventually force lenders to increase their rates. Additionally, as lenders continue to moderate their MFH construction and development lending activity, borrowers will increasingly use more expensive debt fund capital and greater amounts of equity, shifting the composition of their capital stacks and increasing the cost of the project financing costs. This will negatively impact project economics and make it more difficult for new projects to meet required return hurdles.

Return Performance

Multi-family was second only to retail in its average return performance during the last three economic downturns and it outperformed all other property sectors during the early stages of the following recoveries. Given our outlook for improving property fundamentals and multi-family supply tapering, we expect the sector to again perform above average during the next downturn and the early stages of the subsequent recovery.

Average Annual Returns		
	Downturns	**Early Recoveries**
Apartment	1.5%	13.6%
Industrial	-0.9%	12.0%
Office	-3.6%	10.9%
Retail	3.3%	11.4%

Source: ARA Research; NCREIF Data

Downturns			
	1992-1993	2001-2003	2008-2009
Apartment	5.1%	8.7%	-12.9%
Industrial	-2.6%	7.8%	-12.4%
Office	-6.1%	4.8%	-13.8%
Retail	1.2%	12.0%	-7.7%

Source: ARA Research; NCREIF Data

Early Recoveries			
	1994-1996	2004-2005	2010-2012
Apartment	11.3%	16.1%	14.2%
Industrial	10.7%	15.3%	11.1%
Office	7.9%	14.9%	11.2%
Retail	4.9%	20.0%	12.1%

Source: ARA Research; NCREIF Data

III. Investment Strategy

While property fundamentals are expected to strengthen and the sector has been a proven late cycle winner, investing in multi-family now is not foolproof. Key factors including significant variation in property fundamentals across markets and submarkets and the effect of aging Millennials need to be carefully considered.

Property Fundamentals

With a material variation in fundamentals across and within markets, we implemented a proprietary method for evaluating near-term submarket property fundamentals dynamics. This enables us to segment submarkets into those currently having favorable fundamentals from submarkets with challenging current fundamentals but signs of opportunities, and to tactically respond before the consensus recognizes the likely recovery. This enables us to optimize capital allocation generating the best return prospects.

Aging Millennials

The aging of Millennials is both a risk and opportunity.

On the risk side, as Millennials age and move toward cohabitation and children, their propensity to own will increase and this will have an effect on multi-family demand. As we wrote previously in , “Millennial Mirage: While Markets Will Be Most Impacted”, high housing affordability markets with relatively high percentages of Millennials such as Nashville, Houston and Orlando are most vulnerable to the aging effect with increased homeownership rates. Conversely, low housing affordability markets such as San Francisco, the East Bay, San Jose and Los Angeles will be less impacted as Millennials will find it more challenging to transform their desire for homeownership into actual ownership in these markets. These markets offer opportunities to capitalize on those seeking better schools and more room, while opting to remain renters due to financial constraints. We have identified the first ring submarkets in these markets that are proximate to the urban core and having the good schools some aging Millennials will be seeking as well as specific assets in those submarkets. These are target acquisitions in those markets intended to capitalize on the portion of aging Millennials seeking locations having good schools. Awareness of the risks posed by aging Millennials to high housing affordability market demand and the opportunities created in low housing affordability markets underpins our proactive Millennial MFH investment strategy.

IV. Epilogue

We believe multi-family fundamentals are set to begin strengthening, albeit in fits and starts. With the sector being a demonstrated above average performer during economic downturns and early stages of recoveries, this suggests an increased tactical allocation to multi-family will be beneficial. One however must be skillful, as factors including uneven fundamentals across markets and the choices of aging Millennials will impact returns. Investors accounting for these factors when crafting their MFH investment strategy will have an advantage in the marketplace.

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INSTITUTIONAL CAPITAL MANAGEMENT

515 S. Flower St.
49th Floor
Los Angeles, CA 90071

T 213.233.5700
F 213.233.5705

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