Working the middle: Opportunities in ESSENTIAL housing

With investors increasingly focused on the positive societal impacts of their investments, manager strategies centered around solving housing-related issues are gaining momentum.

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Cities across the United States have long grappled with how best to tackle increasing housing unaffordability for many of their residents, to varying degrees of success. The ensuing economic fallout from the coronavirus and wider discussions on equality have brought back into focus the critical importance of equitable policies for all sociodemographic groups in providing basic necessities, including quality housing.

Much of the existing commentary on the affordable housing space has been centered around the potential investment opportunities arising from coordination with state and local municipalities to leverage tax credits or subsidies to supply much-needed low-cost housing to the community; significantly less has been dedicated to addressing and solving for what some have coined the 'missing middle' — that is, those renters who can neither qualify for affordable or subsidized housing in the traditional sense, nor afford the

[1] Chris Salviati, 2019 Cost Burden Report: Half of Renter Households Struggle with Affordability, *Apartment List*, October 8, 2019.
[2] Severely burdened households are households paying in excess of 50% of income to housing as defined by the Department of Housing and Urban Development (HUD).

luxury housing that has represented the majority of new projects that have been delivered during the most recent economic cycle (after the 2009 Global Financial Crisis).

What is essential housing?

There is a myriad of labels used to describe any housing that is not 'market rate.' These descriptors — affordable, attainable, low income, workforce, Section 8, rent protected, essential — are often used interchangeably, muddling the nuances of the sector. So, what do we mean when we talk about essential housing, and how does it differ from some of the more well-known housing types?

Perhaps the best way to contextualize the gamut of for-rent housing in the United States is to think of it as a spectrum, moving from those properties owned and operated by governmental housing authorities and fully subsidized on the left, to the most expensive Class A+ market-rate apartments on the right (see Exhibit 1). Units that cater to households making more than 80% of an area's median income (AMI) that are above the cutoff for governmental subsidy, but do not qualify for or cannot reasonably afford the new luxury product, are what we've designated as the 'essential gap.' It is this gap that has, and continues to be, woefully undersupplied, but also creates an opportunity for the socially minded investment manager.

Demand and (lack of) supply

Data from Apartment List[1] suggests that there are over 9.3 million households nationwide moderately rent burdened (with an equally large number considered to be severely rent burdened[2]) that need more affordable and accessible housing relative to their incomes. The next logical question might then be, 'why isn't there enough housing that is within reach for these households?'

The short answer is that the demolition of outdated units to make way for new luxury multifamily construction or different uses entirely, value-add repositioning of older product to drive rents that are no longer attainable, and lack of purpose-built attainable housing all contribute to the shortage of available housing for this cohort. By rough estimates, nearly 200,000 Class B/C apartments have been demolished in the last 20 years. At the same time, the ability for investors to earn a sufficient return on development of buildings with lower per-unit rents has been increasingly challenged given rising land and construction costs, discouraging much new supply.

Challenges for investment managers

The lack of suitable supply represents both the opportunity and the challenge of essential housing for investors. From a fundamentals' perspective, the combination of limited supply and elevated demand is the basis of any compelling investment thesis. But how does one go about acquiring or building this type of product at sufficient scale to justify a targeted product offering?

As we alluded to, many 'obvious' candidates for such a strategy are also prime targets for value-add capital that can afford to pay more on the expectation of higher returns post-renovation, handily beating out a core-like, income-oriented essential housing

Exhibit 1: For-rent housing spectrum

Public housing	Low-income housing tax credits	Essential gap	Class A+
Characteristics: • Owned & operated by government agencies • Limited to low-income families & individuals, the elderly and persons with disabilities • Properties range from single-family houses to high-rise apartment complexes	*Characteristics:* • In exchange for tax credits, properties must meet affordable rent requirements for at least 30 years • Typically privately owned • Can apply to mixed-income housing or 100% affordable	*What is it?* • Units that are financially viable for households making between 80%–120% of AMI, usually market-rate Class A-/B/C properties *Why is it missing?* • These units are prime targets for value-add renovations, pushing rents into unaffordable ranges for these tenants	*Characteristics:* • Highest absolute per-month rent costs • Not subsidized • Typically privately owned • May require tenants to make 40x the rent

Greatest household economic burden ⟷ Least household economic burden

Source: American Realty Advisors based on data from Cushman and Wakefield's Global Occupier Metrics Dashboard as of May 2020.

Case study: Dissecting the lack of supply

At first glance, imagining that a household making 80%–120% of AMI would have difficulty finding housing in a reasonably affordable place to live, like Miami, is hard to fathom. Yet the aggregate figures mask the true lack of supply.

According to the recently revised HUD Income Limits for fiscal year 2020, the median income for Miami-Dade County was $59,100. This means a household making between $47,280 and $70,920 fall within our 80%–120% of AMI range. At the 30% rent-to-income ratio, this means households can afford to pay between $1,180 and $1,800 in rent monthly.

There are approximately 101,000 market-rate multifamily units in Miami-Dade County whose effective rents fall within $1,180–$1,800 to service the approximately 202,000 households whose incomes align with the 80%–120% parameters.

Yet this 2:1 household-to-unit ratio doesn't account for other factors that further reduce the amount of supply, namely:

1. ***The number of units vacant at any given time in this price range.*** There have been, on average, less than 4% of these units vacant in any given quarter over the last 20 years.
2. ***The distance to primary employment nodes.*** The units that are vacant and available for occupancy are strewn across the county. While many are within driving distance to major employment nodes, nearly 20% are in locationally disadvantaged areas. According to the Center for Neighborhood Technology, a more comprehensive view of affordability combines both the cost of housing and cost of transportation, suggesting properties that are geographically further out actually exacerbate affordability pressure. And this says nothing as to the availability of other essential amenities such as grocery stores, childcare and the like.
3. ***The propensity for rents to rise.*** The units identified reflect a pool of accessible apartments to the households making 80% of AMI today and reflects a moment in time. A change in ownership strategy that results in a value-add renovation program with the objective of increasing rents could bring these rents to an unattainable level, thus reducing the amount of available options even further.

program whose strategy is to maintain the existing affordability profile of the asset.

Thus, investment managers may need to go beyond the most obvious markets or locations within primary markets to offset some of these pressures and create a viable pipeline. Because there is virtually no metro in the country that isn't faced with affordability concerns, managers may be compelled to venture into secondary and tertiary markets to find suitable opportunities with better going-in yields. Moreover, because essential housing assets tend to stay well-leased throughout economic cycles and offer a stable, income-oriented return profile, there is less exit liquidity risk venturing beyond primary markets for this type of strategy than perhaps for other property types. This is particularly true for open-end essential housing structures whose modus operandi is to acquire and hold long term.

There is also the operational element to consider. One of the reasons institutional managers have not, to date, ventured into the essential- or middle-income housing segment with the same gusto as other opportunities is the inefficiencies of scale. Existing properties that fit the bill are generally smaller in size (100 to 200 units, with average per-unit costs of +/–$150,000 per unit compared to +/–$250,000 per unit for Class A), requiring a measured aggregation strategy in order to compile sizable enough portfolios to really achieve operational efficiencies. The upside, of course, is that there tends to be lesser competition for these smaller deals.

Strategies that elect to leverage a development component may also be viable, though will require creative approaches to cost management, floor plan and space optimization, and amenities. This could include the use of modular or prefab construction, standardized and re-usable building plans, and pared-back amenities to offset hard construction costs. Moreover, with a lower turnover ratio from longer-tenured residents, future capex needs may be reduced, serving to at least partially offset higher initial costs to develop.

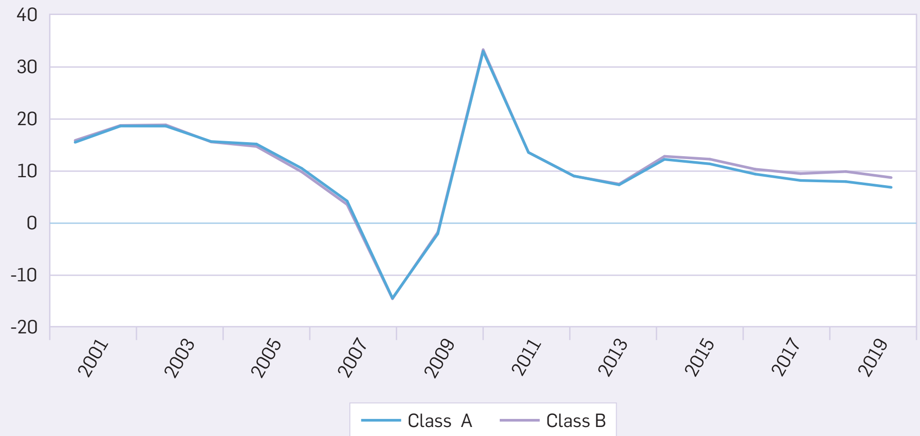
Investor expectations of an essential housing allocation

Because a commitment to essential housing is a commitment to conserving the affordability of units, investment managers should position their offerings

Exhibit 2: Class B return profile

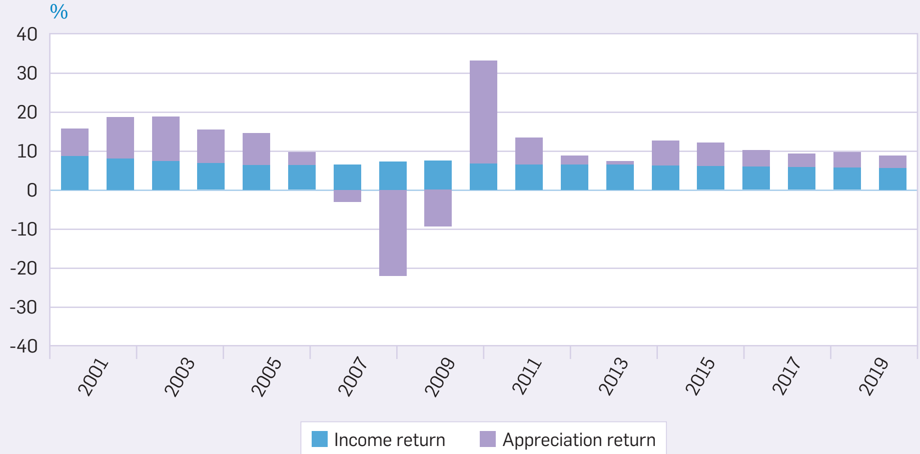
Total returns, Class A and Class B apartments, national, 2001–19

%



Income component of Class B total returns, 2001–19

%



Note: CoStar's total teturn data is a proprietary estimate of the total nominal return on unleveraged property investments and is based on derived transaction returns. Income returns are calculated based on the change in average cap rates for actual sale transactions, while appreciation returns reflect the percent change in price value net of capital expenditures.
Source: American Realty Advisors based on data from CoStar as of August 2020.

to potential investors as having core-like returns with added upside through higher going-in yields. According to data from CoStar, cap rates for Class B properties nationally (a frequently used and appropriate proxy for essential housing) as of Q2 2020 offered a 120-basis point spread above Class A, and have achieved stronger total returns over the last seven years (see Exhibit 2).

Over the last 19 years, 64% of Class B multifamily returns have been derived from income, with the remainder attributed to appreciation. What's even more impressive is that despite representing the lion's share of the total returns, the income component is responsible for just 8% of annualized volatility — this suggests that a focus on the resilient and stable nature of the income returns is a prudent one for fundraising.

Conclusion

With individuals' homes currently serving as their residence, their workplace and their social sphere, the coronavirus has re-emphasized the necessity of accessible housing for all. Yet to date, the availability of appropriately priced housing for middle-income renters has been woefully inadequate to satisfy the level of demand.

Part of the reason there has been limited inertia in solving for this segment is the challenges associated with acquiring it — simply put, it is harder to compete on pricing for marketed opportunities against buyers whose strategies envision higher rental rates after a renovation program.

Yet given the increasing appetite from institutional capital for strategies that allow them to do well by doing good, forward-focused institutional managers who endeavor to navigate the complexities and answer the call have an opportunity to do both.

For those investors to whom achieving a stable, income-oriented return while simultaneously satisfying their ESG agenda is appealing, an essential housing strategy may be best suited to achieve those goals. It requires adopting an approach with a long-term view dedicated to maintaining affordability of market-rate essential housing across the country. ◆

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