INVESTMENT MANAGEMENT

The Millennial Effect: Urban Demand Drives Multifamily Fundamentals

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Author

Alexander J. Snyder, CFA
Senior Analyst

CenterSquare
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Scan the skyline of nearly any major city, and you're likely to see cranes hard at work pulling up the steel bones of a new apartment building. Supply has been on the rise, and some have speculated that this increase in volume points to a bubble in the multifamily sector. However, we believe the supply we are observing represents a rational response to a fundamental demographic shift in where people want to live. Led primarily by the Millennial generation and downsizing Baby Boomers, demand for higher-end apartments in metropolitan locations has been robust across all markets. Demand for rentals should continue to soak up new inventory as young professionals strike out on their own and more seniors retire to an urban lifestyle. On the supply side, though apartment construction has risen, it is still only average as a percent of existing inventory, and overall housing construction is actually still below average historical measures. What is new, is that the mix of single-family and multifamily housing has skewed in favor of apartments, causing cranes to be seen in city centers while suburban land lots remain grassy. While new supply should bring a healthy moderation to rent growth, we believe multifamily has the potential to post attractive returns even as increased supply comes online in 2017 and beyond.

Coming of Age

An urbanization trend has taken root in major metropolitan areas across the United States, one that we believe will allow multifamily assets to continue experiencing solid fundamentals at least through 2016 and probably beyond. Household formation has remained healthy, spiking at the end of 2014 and continuing at a strong pace throughout 2015. Additionally, since the depth of the real estate-led financial crisis, multifamily homes have garnered a larger percentage of total U.S. households in comparison to single-family, whose starts have remained subdued.

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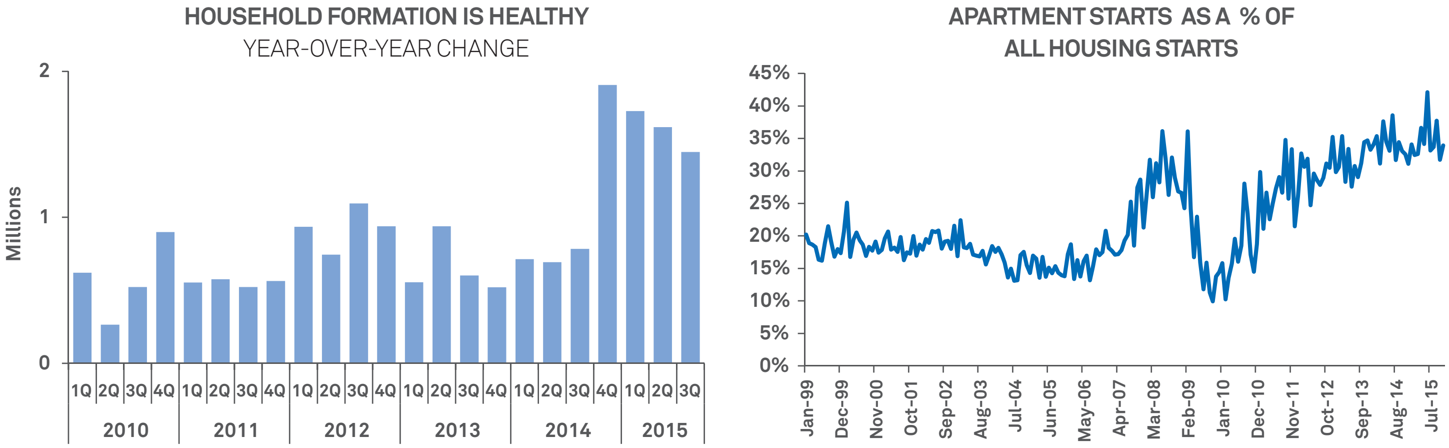
Figure 1: Housing Snapshots



Source: U.S. Census Bureau, as of November 2015.

> In 1970, the estimated median age for a first marriage for men was 23, and for women, 21. In 2015, that median age rose to 29 and 27, respectively.[2]

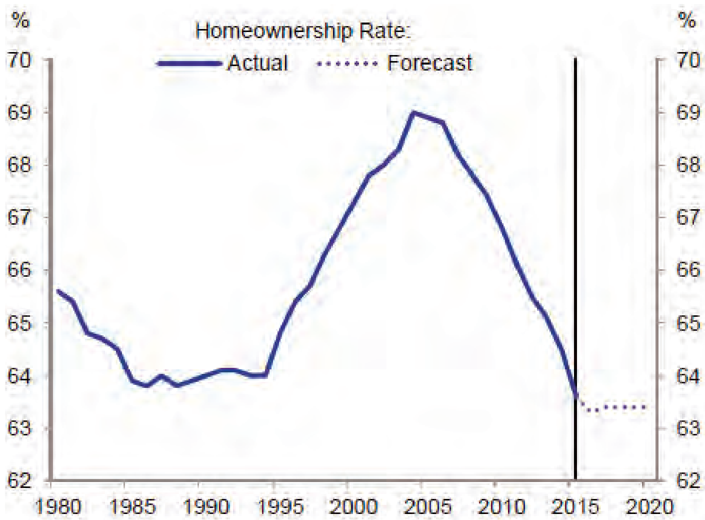
This shift is due in large part to the Millennial generation—77 million 18-to-36 year olds representing 24% of the U.S. population[1] —who have shunned suburbs for city centers, creating strong multifamily demand in most urban cores throughout the U.S. This is true for nearly all major cities, though coastal markets such as San Francisco, Los Angeles, and New York City have seen particularly noticeable benefits. Millennials are choosing to rent and rent longer in urban centers out of both necessity—graduates with record high student debt levels have trouble saving up for down payments—and choice, as Millennials delay standard life transitions such as marriage, having kids and home buying. This extension of life before marriage and children allows for a more transitory lifestyle, one that apartment landlords are all too happy to help provide.

The plunging home ownership rate has been an easy source of new renters for apartment owners, as approximately 9.1 million households have become renters since 2004.[3] The big question is how long that trend will continue. After 2 years of unabated declines in the homeownership rate, 3Q15 saw a small uptick, led by Millennials. However, one data point does not a pattern make; it is notable that this is only the first upward trajectory and that even if the trend continues, the extensive Millennial generation still provides a deep renter pool for the coming years.

In fact, the percentage of young adults between the ages of 26-34 still living with their parents has dramatically increased over the past decade, as the percent of these types of unbundled households hit nearly 15% in 2014, an almost 5% increase since 2002 and nearly 3% above the historical average.[4] As households unbundle, it is likely a large percentage of these Millennials will choose to rent rather than purchase (either by necessity or desire), and will act as a continued source of new renters for multifamily landlords. This should offset any potential detriment from increased home buying.

1 "Millennials Prefer Cities to Suburbs, Subways to Driveways," nielson.com, March 4, 2014.
2 U.S. Bureau of the Census, March 2015.
3 U.S. Bureau of the Census, Raymond James Research, January 8, 2016.
4 BEA, BLS, Census and Green Street Advisors, November 13, 2015.

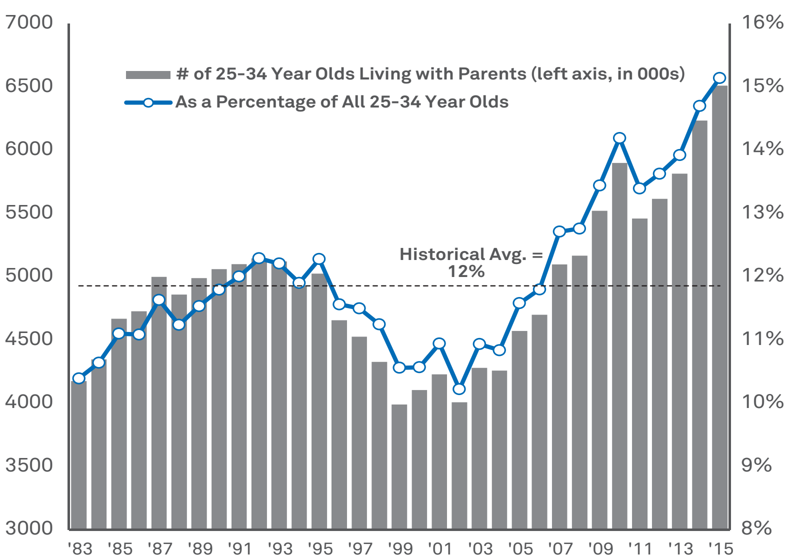
Figure 2: Homeownership Rate



Source: Goldman Sachs Global Investment Research, as of November 2015.

For the first time since the 1920s, growth in U.S. cities is rising faster than growth outside the city center.[1]

Figure 3: Young Adults Living With Parents



Source: BEA, BLS, Census, and Green Street Advisors, as of November 2015.

The transitory, low-maintenance, high energy lifestyle of urban living hasn't appealed only to the young. Empty nesters are choosing in record numbers to take care of less and do more, and in so doing they are selling single-family homes in the suburbs to move into the city, reducing square footage, domestic upkeep, and commuting time, and increasing proximity to urban offerings such as restaurants and entertainment. Typically able to afford higher quality, higher rent units, this older generation added nearly 100,000 renters to the multifamily market per year from 2010 to 2013,[5] a trajectory that we believe will continue over the coming decades, further amplifying the urbanization trend.

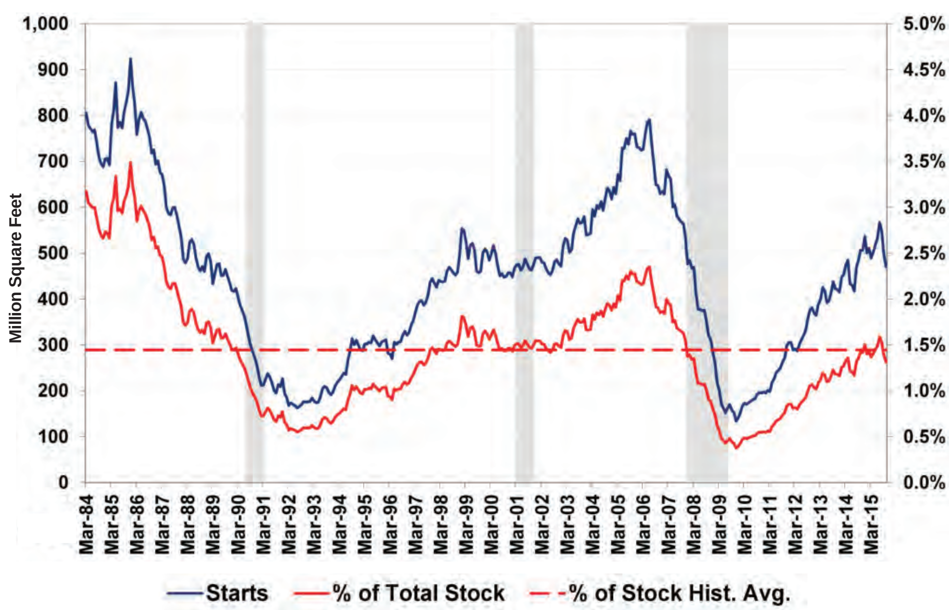
5 "Empty Nesters Flock to Apartment Living", multifamilyexecutive.com, November 19, 2014; Axiometrics, Inc.

Renters by Choice

Desire alone is not enough to fuel this shift and affordability is at the core of many multifamily sector bear arguments. Burdened with rising rent and dropping real household incomes, the bottom three quintiles of the population—renters by necessity—are strapped and typically occupy aging, existing multifamily structures. However, the upper two quintiles of income earners have seen a rise in median real income, and it is these top earners—renters by choice—that have been targeted by the vast majority of urban apartment developers. Wage growth and a lifestyle with fewer financial obligations (i.e., young professionals with no children or seniors with adult children) have continued to feed demand for newly built Class A units. This allows developers to charge top rent, which helps underwrite expensive land, labor, and construction costs. Although high in absolute terms, the supply of multifamily homes is fairly average as a percent of stock, and we would reiterate that supply is further offset by a lack of single-family home construction competing as a destination for new household formations.

Note that supply, as always, has to be put in the context of demand. Beyond any demographic shifts, much of what drives apartment demand is the job market. Nationally, the average ratio of jobs to new supply (a proxy for the level of potential demand relative to availability) historically is 6.7x. Currently, the market stands at 10x. To hit the historical 6.7x mark, monthly jobs would need to drop to about 180,000 a month through the summer of 2016, a decline we do not anticipate. With jobs at the recent run rate of 250,000 a month and given the current supply outlook, the ratio would still stay high at 8.7x through the summer of 2016.[6] This expected job growth, with the addition of aforementioned demographic trends and the expansive pool of potential renters, leads us to believe demand for higher quality apartments will continue to absorb new supply.

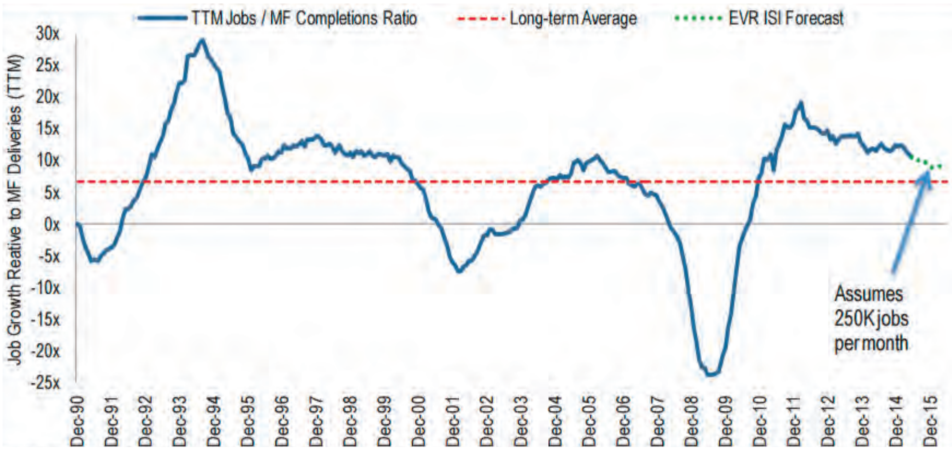
Figure 4: Multifamily Supply as a % of Existing Stock



Source: Citigroup Global Markets, as of November 2015.

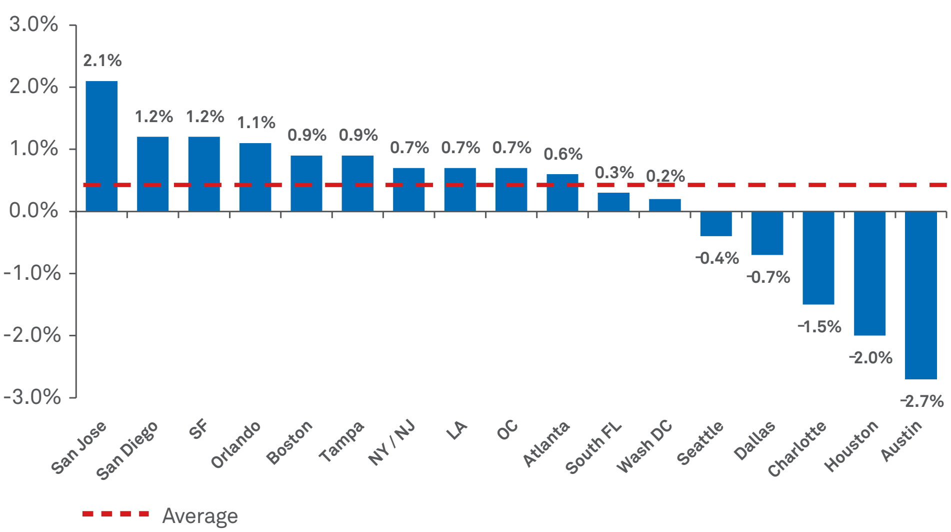
6 Evercore ISI Real Estate Research, BLS, Census, November 12, 2015.

Figure 5: Supply in Context



Source: Evercore ISI Real Estate Research, BLS, Census, as of November 2015.

Figure 6: Net Demand as % of Stock (Next 12 months)



Source: Evercore ISI Real Estate Research, Moody's, MPF Research, Costar, as of November 2015.

Coastal Craze

Regionally, coastal metropolitan areas have exhibited the healthiest urbanization story, and this robust demand has led to construction in these markets. The common justification of both lenders and equity investors of new development is that urban cores will likely see the greatest population and job growth in the coming years and decades, coupled with constrained supply due to unavailable developable land. This is especially important after the Great Recession caused thousands of newly built homes far outside of major cities to stand vacant for years, inducing banks with a strong desire to lend money to projects in locations that will (at least in theory) always have demand. Investing in urban cores feels safe, and it has been one of the main reasons much of the new development has occurred there. The tandem pull precipitating urban development is construction costs: they have risen so far beyond inflation over the last few years that often only Class A assets with high rents can pay back the cost of development.

Current trends are nearly replicating the activity of the 10-year multifamily bull market of the 1990s.

In California, the supply versus demand imbalance in housing is particularly acute. This is due to both the high demand stemming from a multi-year wave of tech related jobs, and the extreme restrictions and unpopularity of adding any new supply—nobody currently living in Santa Monica wants a new high rise denting their uninterrupted skyline. Simple economics dictate that to successfully change the demand/supply imbalance in these areas, accompanying revisions to constraints on new construction must be enacted. Given that we don't believe politicians or existing residents will rationalize this anytime soon, it portends California will continue to be one of the nation's strongest rental markets.

However, select geographic markets are not fairing as well, due largely to regionally-specific issues. For example, weakness in energy-driven Houston stems from the plummeting price of oil and subsequent oversupply in the multifamily sector. Some markets without natural land constraints are seeing cracks as well. Charlotte and Austin, despite being strong economic markets, have managed to build past their blistering near-term demand. The Seattle market is a bit tenuous, as it is reaching parity and may be at risk for overbuilding, dependent on predicted versus actual local job growth (mainly from Amazon) in the short- and medium-term.

Outlook

We believe 2016 will see apartment fundamentals moderate slightly from the strong pace set in 2015 and continue to normalize towards a long-term average in 2017 and beyond. However, it is our belief that—absent a recession—fundamentals of multifamily values assets will not "correct", as new supply coming online in most metropolitan markets has been justified by strong demand. Some areas, such as Texas and Charlotte, may see marginal downward trajectories due to regional imbalances, but we believe that the vast majority of metropolitan centers will provide strong fundamentals in the near and medium term. Steady job growth, an absence of overall new home supply in most markets, and the living preferences of a milestone delayed Millennial generation and downsizing Baby Boomers should all contribute to a solid fundamental picture for multifamily in 2016 and beyond.

About the Author

Alexander J. Snyder, CFA Senior Analyst

Mr. Snyder is a Senior Analyst for CenterSquare Investment Management's real estate securities group. Mr. Snyder joined the firm in 2015 and supports the portfolio management team, conducting full investment analyses and valuations for the securities within his U.S. REIT coverage universe. Mr. Snyder was also a member of CenterSquare's real estate securities investment team earlier in his career, holding positions as Analyst and Senior Analyst from 2008 to 2011. Prior to joining CenterSquare in 2015, Mr. Snyder was an Associate with Morgan Properties in Philadelphia, specializing in acquisitions, asset management and financing. Prior to that role, Mr. Snyder was a Real Estate Finance Consultant for Caras Real Estate & Old Sawmill District in Missoula, MT, and an Acquisitions & Asset Management Associate at Rubenstein Partners in Philadelphia. Mr. Snyder holds a B.A. in Economics from the University of Pennsylvania with a Minor in Mathematics.

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