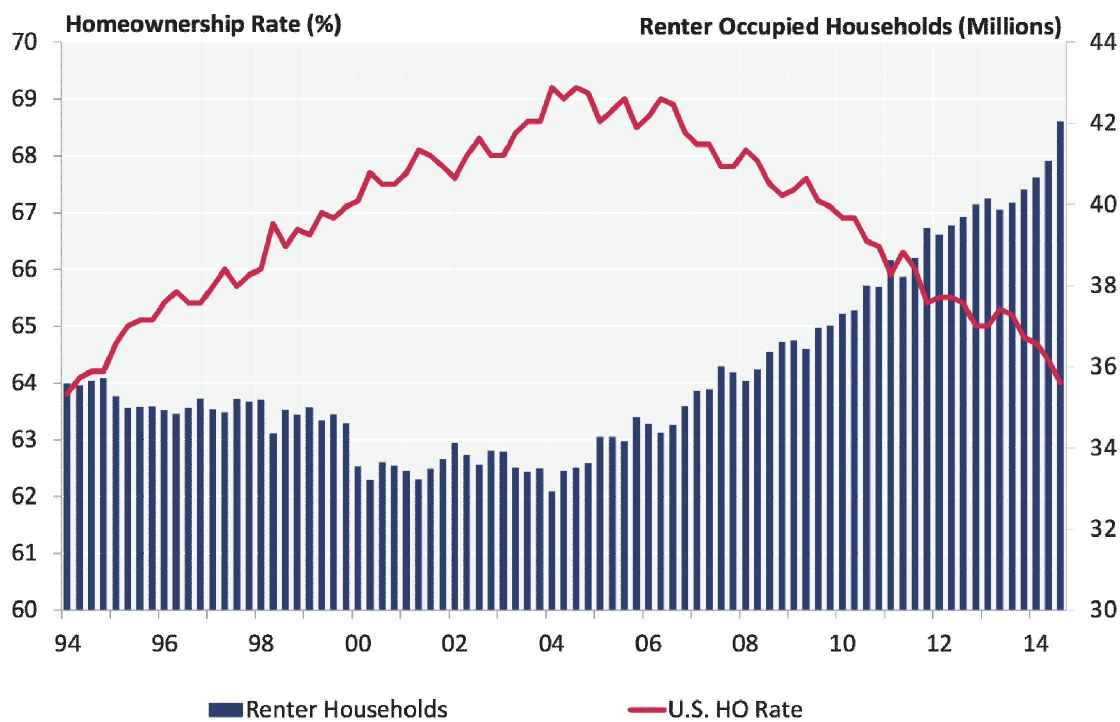
PCCP Market Commentary

Will Multifamily Continue to Perform?

Third Quarter 2015

On June 6, American Pharoah, a thoroughbred racehorse, made history by winning the Triple Crown. This horse is performing at levels that no other horse has reached in 37 years. Now the ownership team is faced with a dilemma: can American Pharoah continue to perform, or is it time to take all of the chips off the table? Just like American Pharoah's dilemma, we wonder whether the multifamily sector can continue to perform at its record-breaking levels. Over the past few years, multifamily, especially newly constructed, core product has been the all-star asset class for yield-seeking investors. Had-been and would-be homeowners, unable to afford a down payment or obtain financing, had no alternative but to rent. Demand boomed and created an attractive rent premium, followed by a development premium that has resulted in a wave of new class-A supply. However, rental rates are now outstripping wage growth, giving rise to questions of affordability. We believe that demand is going to continue to drive the multifamily markets, but at this point in the cycle, our opinion is that slow and steady growth assumptions will ultimately win the race for return.

We do not see demand for rentals abating over the foreseeable future. Most of the dynamics that have driven the multifamily market over the past several years – a burgeoning renter pool, lagging household formation, surging student debt and tight credit standards – continue to support the multifamily investment thesis. Homeownership in the U.S. has plummeted from its peak of 69.2% in 4Q04, to 63.7% in 1Q15[1].



Sources: Moody's Analytics; U.S. Census Bureau; CoStar Portfolio Strategy *As of 15Q1*

[1] Moody's Analytics; U.S. Census Bureau; CoStar Portfolio Strategy

According to a recent study by the Urban Institute, this rate is expected to continue falling, and is predicted to reach 61% in 2030[2]. The prime renting cohort, those aged 20 – 34, has swelled by four million over the last five years. Though the rate at which the millennial cohort grows is beginning to slow, by the end of 2019, another 1.5 million potential renters will be added to these ranks[3]. The latter part of this group (30 – 34 year olds), those who would be expected to transition into homeowners by now, are continuing to trend toward renting as they age. Homeownership in this cohort has hovered around 55% from 1980 – 2007, and has since trended downward to 44% in 2013[4]. One can surmise that delayed family formation, student debt burdens, and tight lending standards are keeping most of this cohort in rentals.

Positive trends in the job market coupled with the inability to buy should also equate to continued expansion in the multifamily sector. The prime rental cohort (20-34-year olds) saw hiring exceed 720,000 over the past 12 months[5]. The average pace over the past two years has been the highest absolute level of job growth in this category since the 1980s when the baby boomers were entering the work force en masse.

From our perspective, as the job market improves, affordability is going to remain an issue. Despite positive job growth, median household income has grown by a paltry 2.0%[6] since 2011. During the same time, rental growth in the U.S. has grown by an average of 3.3%annually. In fact, in only 11 of CoStar's top-54 U.S. markets did income growth outpace rental rate growth. Approximately 48% of recently delivered units require an income of at least $75,000, and 20% require an income of at least $100,000[7]. However, the average income within the 20-34 year old cohort, which comprises the bulk of job growth today, is $35,288[8]. In 2013, new deliveries in the top-5 markets witnessed a 16% pop in asking rents[9], but the markets proved these figures were not sustainable as the growth rate subsequently dropped to 2% in 2014.

We have no doubt that the demand for multifamily will continue, but we are tempered in our expectations that rental growth can continue to outpace income growth. We are much more interested in class-B opportunities in major metropolitan areas that can perform in a tepid rental growth market, rather than in newly constructed class-A that relies on double-digit rent growth over the hold period to deliver targeted returns. Class-B apartments located in tight rental markets should appeal to a broad swath of renters. When the opportunity to add value presents itself, perhaps through refurbishment, consistent returns can be manufactured even in a frothy metropolitan market. In our opinion, it is time to put American Pharoah to pasture as we're in the multifamily game for the long run.

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[2] Urban Institute, *"Headship and Homeownership: What Does the Future Hold?"* June 2015.
[3] U.S. Census Bureau; Moody's Analytics
[4] Urban Institute, *"Headship and Homeownership: What Does the Future Hold?"* June 2015.
[5] Bureau of Labor Statistics
[6] CoStar, Bureau of Labor Statistics
[7] CoStar; assumes an income:rent ratio of 28%.
[8] Bureau of Labor Statistics
[9] CoStar