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dialogues

CO-INVESTMENTS: *the* fourth pillar *of* incentives

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Taking a pulse on DC capital flows into real estate solutions

Meeting the need for middle-income workforce housing

A young talent speaks out on attracting and retaining the next gen

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NAREIM dialogues

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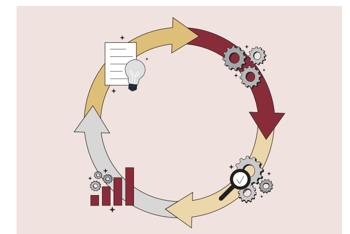

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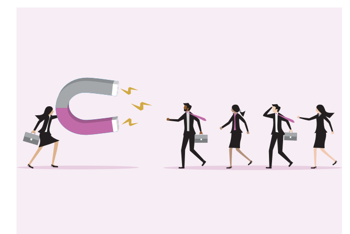


What young talents want
Jackie Siegmund

Housing the workforce

The workforce housing segment faces a severe undersupply of attainable and quality rental housing. Investors would be wise to take notice.

By Ken Munkacy,
Vincent DiSalvo,
Justin Hoogerheyde and
Jed Daniel,
Kingbird Investment Management

America's housing shortage is a result of a confluence of factors that started with, and have since accelerated from, the 2008–2009 Global Financial Crisis; specifically demand growth spurred by the formation of smaller and non-family households and relative supply dilution resulting from onerous regulations, growing construction costs and labor shortages. While these obstacles constrain supply growth across all income categories, workforce targeted housing has been the most affected, despite the pressing nationwide need for housing suitable to this demographic.

Workforce renters, defined as those earning between $45,000 and $75,000 annually, are among the households most impacted by America's undersupplied housing market. They typically live in rental properties that sit in the middle of the price and quality spectrum — their rents are below luxury rates but above what is considered 'affordable.' New luxury housing is often out of reach for this cohort, but, at the same time, these renters' incomes are often too high to qualify for government supported/regulated affordable housing.

The average workforce renter is employed in the retail, manufacturing, logistics, healthcare or education sectors, and can be often classified as lower-middle class. This cohort represents the largest segment of the renting population, comprising 26.3% of renter households — yet the supply of affordable and quality rental housing available to them is insufficient.

Rising rents and the waterfall effect

The current supply of affordable and quality rental housing does not adequately satisfy the workforce cohort's growing need. As new housing production has lagged household formation, workforce vacancy rates have declined to record lows and workforce rents have grown much more rapidly than incomes, at an average annual pace of 4.2x that of the median renter's income.[1]

These vacancy declines and rent increases create a 'waterfall effect' in which renters with higher incomes push workforce renters out of apartments they could previously afford, and into

[1] CoStar, S&P/Case Shiller, National Multifamily Housing Council and US Census Bureau.

subpar housing product that neither reflects their lifestyles nor meets their needs. As a result of this phenomenon, an estimated 34.8% of units that are both affordable and available to workforce renters are of subpar quality, according to ACS PUMS data.

This workforce housing shortfall is worsened by apartment builders' preference for developing luxury product. Since 2010, builders have delivered approximately 3.3 million apartment units across the US, 2.9 million of which (87%) were luxury apartments. Only 432,000 units, or 13%, were affordable to workforce households, per CoStar data.

Because of the confluence of these factors, as of Q2 2022, the workforce housing vacancy rate was 4.3%, compared to a luxury housing vacancy rate of 7% (CoStar). And, as of 2020, ACS PUMS shows that an estimated 30% of workforce renters were cost burdened, up from 18.4% in 2001 (see Exhibit 1).

Between the high cost of construction and a lack of government policy interventions to subsidize new development and rents, an increase in workforce housing supply that matches demand is unlikely under current conditions. This will exacerbate the existing shortage, driving vacancies even lower and rents even higher, although at more moderate rates than occurred due to the Covid-19 pandemic.

An area of opportunity for investors

From an investor's perspective, workforce housing rentals represent a sustainable and resilient investment opportunity. Vacancy rates are historically lower and rent growth is historically higher for apartments in this category than in luxury units. As of Q2 2022, the workforce vacancy rate was 4.3% vs. luxury's 7.0%. This is indicative of the asymmetric demand for workforce priced product.

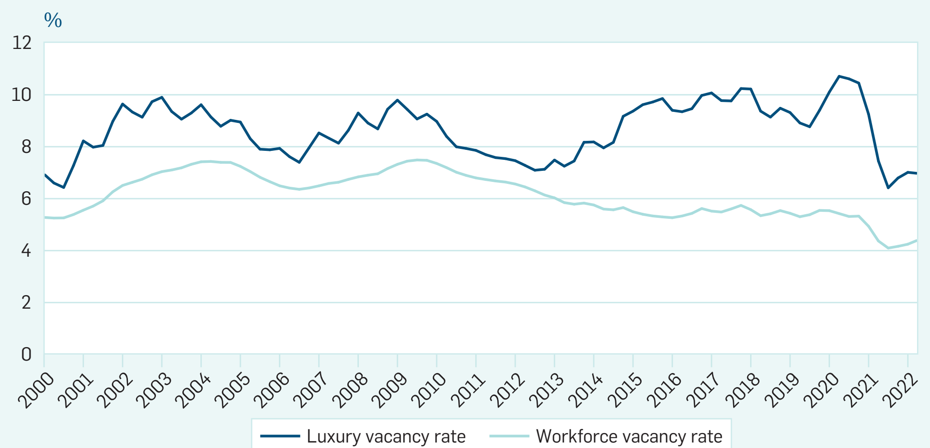
Profile for investors

Due to the low vacancy rates induced by the housing shortfall, workforce housing rents have risen faster than the overall average. As a result, this sector is an ideal target for capital allocation within a well-diversified investment portfolio, as it sits at the center of the risk/return spectrum of private real estate investing. Workforce investments are shielded from economic downturns, as budget-conscious renters will move from luxury to workforce units, maintaining demand during shocks.

Further, workforce properties are less expensive to build and buy than luxury assets, leading to higher yields — properties catering to the workforce cohort typically feature mid-tier amenities (e.g., small clubhouses, pools and playgrounds, less advanced appliances, lower-quality flooring and counters, etc.) and are often located outside of markets' urban cores, but within a reasonable commuting distance to job centers.

Investments in workforce housing rentals can improve cash distributions and enhance capital values for investors. The workforce housing investment return profile has characteristics of both bond investments, through its cash distributions, and stock investments, through its capital appreciation. These cash distributions have the added benefit of inflation protection; given the short time frames associated with apartment leases, owners can adjust rents with inflation annually, a feature that is often unavailable in the longer leases typical of warehouse, office and retail properties. Funds focused on value-add workforce housing returned an average net IRR of 16.4% between 2009 and 2019, compared to an average yield of 10.7% for core/core-plus luxury housing funds, according to Preqin data.

Exhibit 1: Workforce housing vacancy rates have been tightening more than luxury housing vacancy rates



Source: CoStar.

> “The lack of supply relative to demand in the workforce housing segment has created a fundamentals-driven opportunity for investment in this housing class.”

Workforce housing is also resilient: during the 2020–2021 Covid-19 pandemic, luxury rents declined in three out of four quarters, while workforce rent growth remained positive according to CoStar data.

The lack of supply relative to demand in the workforce housing segment has created a fundamentals-driven opportunity for investment in this housing class. This significant housing shortage has driven home prices out of reach for many households, pushing them to rent; thereby driving multifamily rents higher and vacancies lower. This dynamic, in effect, creates a margin of safety for multifamily real estate asset values, creating resiliency in the sector despite the current short-term central bank-imposed volatility and market dislocation.

These phenomena enable durable cash distributions and sustainable capital value appreciation, which, in turn, enhances returns to investors. According to an analysis of Preqin data, private real estate funds focused on workforce rental housing returned an average net IRR of 16.4% between 2009 and 2019, versus an average net IRR of just 10.7% for funds focused on luxury housing.

Our investment approach

While the national story is evident, we take a data-driven approach and target only regions, markets and submarkets with workforce housing shortages, diverse economies and job growth in stable sectors like tech, healthcare and government. Kingbird utilizes a proprietary market research dashboard that aggregates over 100 variables across all markets in the US to track their economic performance and housing needs on an absolute and relative basis, giving us unique, centralized insight into markets.

We have allocated capital to Austin, Texas, where Samsung is building a new $17 billion microchip plant that will bring 4,500 new jobs. This plant is within a 30- to 40-minute drive to two Kingbird properties. In Columbus, where we have made several investments, Intel is developing a new $20 billion microchip facility with 3,000 jobs. Dallas, Huntsville, New York City and Los Angeles — all Kingbird markets — are also launching significant new projects in fields such as technology, infrastructure, media, defense and aerospace, which will create new jobs and accelerate demand for workforce rental housing within commuting distance.

Each of these markets is growing rapidly from an employment and population standpoint, relative to their housing supply, resulting in market-specific expressions of the broader housing shortage. People want to live and work in these cities, but they lack sufficient housing to meet these needs. This has pushed lower income renters further and further from city centers as they are priced out of existing supply.

We have taken a dual approach to workforce investment, developing new workforce assets in target markets where new development is economically feasible and repositioning existing assets through renovations, rebranding and constructing higher-quality rent rolls where it is not. Both approaches have the net effect of increasing the supply of workforce housing, simultaneously alleviating some of the pressure on the cohort while taking advantage of the evident need for more workforce housing in order to produce superior risk-adjusted returns. The ability to address the workforce housing shortage through either new development or value-add repositioning allows us to work around or bypass the issues cited above.

The US housing shortage is a chronic, complex problem for which there is no quick or easy solution. Persistent demand for multifamily housing that is affordable to the workforce renter segment represents an opportunity to diversify investment portfolios by investing in an alternative asset class offering cash distributions, enhanced capital values and attractive returns. ◆

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