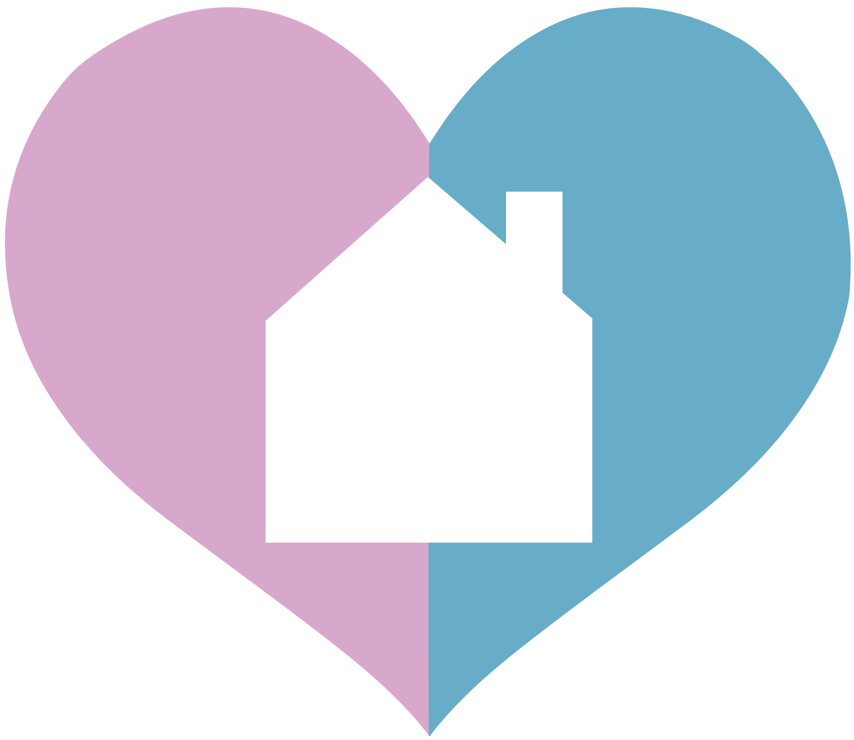
ESSENTIAL HOUSING



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The US is facing an unprecedented housing crisis as the current housing market is 5.24 million homes short of what is needed to meet demand.[1] Much of that shortfall is in the moderately priced rental housing segment. This gap in "essential housing" is caused by both a demand issue, resulting from a long-lasting shift in demographics, and a constraint in supply caused by the rapidly rising costs to build housing.

Multifamily housing historically has been an effective hedge against inflation compared with other commercial real estate asset classes. Lease terms are generally shorter and more favorable, which gives investors the opportunity to reprice rents as prices increase. But when inflation rises, so too does the cost of living, pushing housing further out of reach for many hard-working citizens. Essential housing is well-placed to benefit from accelerating demand as inflation pushes rents higher.

The US is in the middle of one of the biggest housing crises that the country has ever seen. A more resilient approach to housing will be critical as inflation pushes rents ever-higher.

WHAT IS ESSENTIAL HOUSING?

For this article, we can define essential housing as product for households earning more than 60% of an area's median income (AMI), putting these households above the cutoff for a public housing subsidy, but less than 140% of that AMI, putting them below the threshold to afford luxury housing. Under this definition, essential housing should serve about 41 million households in the US, offering working professionals an affordable, quality housing option in urban markets.

Essential housing is not to be confused with workforce housing, which largely serves middle-income working families through existing rental product. Workforce housing often has a greater number of configurations, with 2–4 bedrooms, and is typically located in suburban areas close to schools. While this is a critically important component of the US housing stock, these unit configurations and locations largely don't fit the needs of young people entering the workforce today. Essential housing is also not luxury housing, which targets those earning above 140% of the AMI, and which is currently saturating the market in most cities. The Wall Street Journal found that 80% of the 371,000 new rental apartments expected to be built in 2020 were luxury properties.[2]

One issue driving the shortage in essential housing is the growing demographic demand from the large millennial and Gen Z generations who are already in or about to enter the workforce. Given that peak births occurred in 2007 (making that population 15 years old in 2022), this demographic force is expected to last at least another decade. In addition to this overall demand, there is also pent-up demand for housing among this population: in February 2020, largely before the COVID-19 pandemic came to the US, 47% of 18–29-year-olds were living with at least one parent, according to the Pew Research Center.[3] In 2020, the impact of the pandemic only created more pent-up demand and pushed more than 52% of this age group to be living at home.

Despite this demand, housing supply has remained at historic lows because of the cost challenges in building new housing. Several factors contributing to the rise in cost are:

Rising land costs. Between 2012 and 2017, the value of land used for single-family housing in the US rose almost four times faster than inflation. As a result, the median price per acre of land under existing single-family homes rose 27%.[4] In 2019, the median land value of a quarter-acre lot occupied by an existing single-family home was a staggering 60% higher than it was in 2012.[5] This land trend suggests that land costs play a key role in the runup in home prices, with no relief in sight.

Rising construction costs. Another significant challenge is the unprecedented inflation in construction costs, something that has affected the entire housing industry. The Turner Building Cost Index found the ten-year average compound annual growth for construction costs is 3.95%—approximately 25% higher than the average wage growth over the same time period.

Pandemic ripple effects. Supply chain problems are interfering with the cost and availability of construction inputs such as lumber, concrete, steel, and many fixtures needed to complete new builds. For example, lumber, which normally fluctuates between US$200 and US$500 per thousand-board-feet, reached a record high price of US$1,700 per thousand-board-feet in April 2021 and has continued to vary significantly. This rise in lumber prices caused the price of an average new single-family home to increase by nearly $18,600 as of January 2022, according to the National Association of Home Builders.[6]

Housing costs have outpaced wage and inflation growth for some time. With the coronavirus pandemic and related economic contractions, it's expected this trend will accelerate precipitously, putting housing out of reach for an even larger swath of younger, employed Americans.

This economic pressure will expand the "missing middle" renters who don't qualify for subsidized housing but cannot afford the luxury housing that is the majority of new construction. For example, Trulia recently found that teachers could afford less than 20% of the homes for sale in 11 of 55 major US metro areas studied. The essential housing gap leaves the "missing middle" without a tangible path to homeownership and, ultimately, to economic stability and mobility. The Financial Times recently found that in 2020, many millennials, now in their 30s, own just 3% of all household wealth. Comparatively, baby boomers had 21% of household wealth when they reached their late 30s in the 1990s.[7]

This "missing middle" population needs quality housing that they can afford in locations that work for them—making essential housing even more essential at this exact moment in time.

Although the essential housing gap is a considerable problem, it also presents a significant opportunity for investors to be part of what we believe to be one of the most resilient asset classes, where there is little competition.

HOW DO WE TACKLE THE PROBLEM?

There is an achievable solution to the housing gap that serves all stakeholders: investors, potential residents, and our broader community. For example, Grubb Properties enacts this solution through our Link Apartments℠ brand, which is focused on intelligent design and resident amenities to provide a lower cost, urban infill living opportunity.

In developing Link Apartments℠, Grubb Properties has focused on two key differentiators: location and price point. We choose urban locations that are near community amenities, transit options, and major counter-cyclical employment anchors such as research universities and medical centers. We also target rents that are affordable to residents earning 60-140% of area median income.

How are we able to achieve those prices in these target locations, where virtually no other multifamily product is being developed at this price segment? We drive value through a variety of proven proprietary methods, such as innovative site acquisition, shared parking, tax incentives, grants, and more. For example, we focus on just six highly efficient floor plan types that we replicate across all our communities. This is unique in the industry, where the standard is often more than 25 unit-types.

We also rely on our 59-year-history and deep experience in both multifamily office investment to help with innovative site selection, which helps us reduce costs. For example, in many markets we acquire office buildings in urban infill locations with acres of surface parking. We then develop a community on that land, including a parking garage that is shared between the office tenant and the new residents. This strategy saves on construction costs and provides a steady non-tenant revenue stream.

We also look at sustainability and ESG principles as investment tools that can drive down the recurring cost of utilities for our residents, further enhancing affordability. Our most recent community earned a National Green Building Standard (NGBS) Silver designation. Our 2021 combined GRESB Sustainability Benchmark improved 19% over our 2020 score, while our 2021 GRESB Sustainability Benchmark Development Score is 81 out of 100, above the global average.

Focusing on the customer delivers both a better resident experience and the returns investors expect through a truly differentiated product that addresses a major market gap.

WHAT IS THE BENEFIT FOR INVESTORS?

For the investor, essential housing provides a stronger margin of safety than building luxury apartments, because essential housing is driven by demographics rather than by how well the economy is performing at any given moment. The large millennial and Gen Z populations are already facing a housing shortage, and the cost pressures constraining the supply are only going to intensify over the next few years.

By targeting the missing middle population, essential housing can reach a larger audience that is drastically underserved by most of the product being built today. This provides an opportunity for investors to participate in a resilient, risk-mitigated strategy, with little competing product in urban markets throughout the US.

Essential housing is desperately needed in both gateway markets and high growth cities and can be an appealing product for investors looking to enter those markets. Gateway markets like Los Angeles, the Bay Area, and New York City have experienced decades of housing challenges, and the problem is worsening.

The pandemic created a unique opportunity for developers to enter these resilient markets at a discount as people temporarily shifted from high-density cities to lower-density ones. This short-term shift in demand for housing created buying opportunities for sites in these dense markets, lowering the cost and availability of one of the most critical inputs: land.

High-growth markets, by definition, have a high demand for housing that is driving construction costs up even further. These cities, such as Charlotte and Atlanta, are struggling to build enough housing, and the housing they are building is mostly luxury and therefore unaffordable to many of their residents.

While fast growth makes these markets challenging, Grubb Properties is often able to deploy techniques to drive down our effective cost, such as sourcing land for free through our commercial division or negotiating tax abatements in exchange for moderate-priced housing, among other creative methods. This allows for a diversification of markets in an investor's portfolio, and an opportunity to invest in some of the most resilient markets with economies and job centers that perform well even during economic downturns.

The growing need for essential housing ultimately fuels our belief that providing essential housing is not just a smart policy and a good investment strategy—it's also a moral imperative.

ABOUT THE AUTHOR

Todd Williams is the Chief Investment Officer at Grubb Properties and is responsible for leading the company's private equity real estate investment programs and institutional joint ventures, including the development, launch and fundraising for discretionary funds that provide equity capital for the company's real estate investments.

NOTES

[1] "Report: America is Short 5.24M Homes," Realtor Magazine, updated September 17, 2021, magazine.realtor/daily-news/2021/09/17/report-america-is-short-524m-homes, accessed April 29, 2022.

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[3] Catherine E. Schoichet, "52% of Young Adults in the US are Living with Their Parents. That's the Highest Share Since the Great Depression," CNN, updated September 4, 2020, cnn.com/2020/09/04/us/children-living-with-parents-pandemic-pew/index, accessed April 29, 2022.

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[6] "Latest Wave of Rising Lumber Prices Adds More than $18,600 to the Price of a New Home," National Association of Home Builders, updated January 4, 2022, nahb.org/blog/2022/01/latest-wave-of-rising-lumber-prices-adds-more-than-18600-to-the-price-of-a-new-home, accessed April 29, 2022.

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REVIEWER RESPONSE

What stands out here is a view of essential housing that specifically carves out middle-income working families. Per data from the Harvard JCHS tabulations of the US Census Bureau ACS (which, understandably, is reported on a considerable lag), roughly half of moderately cost-burdened renter households were over the age of 45 in 2019. This suggests the other half is under the age of 45, and perhaps that is the subset the authors are focused on here, but to expand the conversation, it would be insightful to understand why their approach is to focus solely on a portion of the larger cost-burdened pie.

The authors also seem to infer that luxury apartments aren't driven by demographics. It could be argued that the rise and relative successes of luxury properties in the most recent cycle were precisely due to demographics—namely, millennials moving to the urban cores. Instead, one could argue that essential apartments are more insulated from economic cycle risk because there is always someone to backfill a more affordably priced apartment in a downcycle.

One thought inspired by this article, perhaps for further exploration in a different conversation, was the mention of tax abatements from local municipalities as a mechanism for securing below-market land. In the example given in this article, it would be interesting to see what percentage of their Link Apartment deals were subsidized in this way, and if there's a risk that budget deficits at the local level could stymie this funding avenue in the future.

– Sabrina Unger
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