Duraleigh Woods Apartments - Raleigh, NC

The fourth in a series of reports from ASB on the impacts of the global pandemic on real estate investing and markets.

The Favorable Outlook for Workforce Housing

Introduction. COVID-19 has profoundly altered the way most Americans shop, work, and socialize. The pandemic has also shuffled America's housing choices. With shelter-in-place restrictions both constraining social interaction and requiring many office workers to work from home, never in modern history have housing arrangements been more complicated and integral to nearly every aspect of our lives. One housing category that has thrived during the pandemic is workforce housing. In this paper, we will define workforce housing and discuss why it has done well during the pandemic and what factors exist that position it to remain an attractive multifamily sub-sector for years to come.

Workforce Housing Defined. The Urban Land Institute defines workforce housing as affordable for households earning between 60 and 120 percent of area median income (AMI), while affordability is generally characterized as paying no more than 30% of household income on a residence. In less technical terms, workforce housing is market rate housing rented by middle-income earners — social workers, teachers, healthcare workers, and government workers, as distinguished from low-income housing which is typically rent controlled or subsidized often with vouchers or tax credits. In the Washington D.C. metro area where AMI is $106,500, workforce housing options fall in a range of monthly rents between $1,600 and $3,200. Comparatively, in the Raleigh, NC metro area workforce rents fall between $1,200 and $2,500.

Workforce housing is generally comprised of Class B apartments. According to CoStar there are 3.1 million Class A units, 6.7 million Class B units, and 7.7 million Class C units, making up the 17.5 million multifamily units nationally. The defining characteristic of workforce housing is affordability. Many rental communities typically derive this affordability from either less prominent locations outside the urban core or from slightly older vintage housing, or both. Workforce housing communities tend to be lower density and more suburban where low-rise, walk-up, garden-style attributes are common. Older vintage construction typically translates into larger units and a greater concentration of two- and three-bedroom unit types.

Workforce Housing in a Pandemic. Workforce apartment communities attracted strong demand during the pandemic as renters-by-necessity sought larger, more affordable units in lower density submarkets. These attributes helped financially vulnerable households meet space needs for children and parents to learn and work from home more efficiently and comfortably.

Additionally, a portion of demand for workforce communities came from households migrating out of urban cores. The value proposition of paying higher rent in and around urban centers was undermined by the pandemic as workers discontinued their commutes to nearby offices and were unable to frequent shuttered urban amenities — bars, restaurants and entertainment venues. In fact, NCREIF data shows that in 2020 workforce housing dramatically outperformed urban core apartments, which also suffered softening fundamentals from oversupply.

Taking high-rise as a proxy for urban apartments and garden-style as a proxy for workforce, vacancy rates in high-rise communities increased by 300 basis points, ten times higher than the 30-basis point increase experienced by garden-style apartments. During the same period, garden-style apartments outperformed high-rise urban apartments by nearly 500 basis points on a total return basis.

In fact, the pandemic only helped accelerate long-term demand for workforce apartments, which has been growing steadily over the last real estate cycle. Since the Great Recession, new apartment supply has concentrated at the top of the market just as middle-income households face growing pressures on household finances. As a result, increased demand and lack of new supply has steadily strengthened fundamentals and helped increase workforce housing rents and investment returns. Notably, garden-style apartments achieved a 15-year total annualized return 220 basis points above high-rise apartments, and outperformed the office, retail, and hospitality sectors during this same period, indicative of workforce's long-term outperformance.

Limited New Supply and Growing Demand Should Drive Strong Rent Growth. Due to the vintage of many workforce housing properties, obsolescence naturally reduces inventory. CBRE estimates that 100,000 units are removed from inventory annually, most of which are workforce and affordable units. In addition, many older properties, particularly in urban-infill locations, have been redeveloped into new Class A units or have been renovated, which sometimes push rents outside of the affordable range. Although most Class B redevelopment strategies can be considered workforce, elevated capital costs chasing redevelopment multifamily deals has increased the rents developers need to earn, pricing out many renters. As for new supply, over the past decade inventory of Class A units has increased 168% compared to just 16% for Class B units.[1] Moreover, construction of Class A units today represents 11% of inventory while Class B represents just 3%. As older supply is taken out of inventory or repurposed, renovations push some rents outside of the affordable range, and development continues to concentrate at higher rents, supply dynamics continue to tighten.

Growing Financial Vulnerability for Middle-Income Earners. Wage stagnancy in America has been a long-term problem particularly for middle-income workers. Between 2000 and 2018, earners in the 90th and 75th percentile have experienced 16% and 12% aggregate inflation-adjusted increases in wages, respectively, compared to only 5% for median income workers.[2] At the same time, ballooning student loan debt has significantly outpaced inflation, undermining disposable income and savings for renters, particularly those in their twenties. Between 2001 and 2019, the inflation-adjusted median student loan increased by an aggregate 90% or a compounded rate of 3.6% per year.[3] Rising healthcare costs also challenge households. In the decade ending in 2018, the cumulative growth in healthcare costs borne by employees outpaced wages by more than 2.5 times.[4] In addition, rising divorce rates and evolving social norms have resulted in a doubling of the share of single person households from approximately 14% to 28% of all households over the past six decades. The unwinding and insolvency of private and public pension plans also means that many retirees will face ongoing financial challenges without the long-term support of employers. Taken together, these trends highlight the growing financial strain experienced by many American families. Not surprisingly, the share of cost-burdened renters — defined as paying more than 30% of income on rent, increased from approximately 40% in 2001 to 47% by 2018.[5]


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Demographic Tailwinds for Workforce Housing. Ongoing demographic shifts also point to strong future demand for affordable workforce housing. Millennials, born between 1981 and 1996, fueled the urban apartment boom over the past decade and are now positioned to do the same for workforce and suburban housing. Aging millennials are expected to increase the 30- to 49-year-old demographic cohort by 10.3 million people through 2035.[6] As millennials enter these prime family formation years, affordable space for growing families, family-friendly amenities and high-quality school systems are priorities that should help fuel demand for workforce housing, particularly for larger two- and three-bedroom units. These forces already are playing out in explosive growth of the single-family home rental market. Considering that institutionally owned single family homes comprise less than 1% of the for-rent housing market and tend to carry premium rents, the demand for affordable, family-friendly middle-income rental housing will likely continue to exceed supply.

Aging baby boomers are expected to increase the 65- to 79-year-old population cohort by 11.2 million people over the next 15 years.[7] Unfortunately, in the wake of the pandemic, 42% of people now in their fifties are not likely to be financially ready for retirement at age 60,[8] i.e., are at risk of lowering their standard of living after retirement. They may be forced to postpone retirement, delaying migration to retirement destinations, and instead age in place. This dynamic is well underway – the typical U.S. homeowner remains in place for 13 years as of 2020 up from just 8.7 years a decade ago.[9] As a result, those would be movers now aging in place stifle the supply of for-sale housing, particularly family-friendly options in suburban locations increasingly preferred by millennial renters as they marry and have children. This dynamic further constrains inventory and maintains pressure on elevated prices, locking renters out of the ownership market and supporting continued demand for rental apartments.

Workforce Housing Investment Risks. Despite strong demographic and financial tailwinds, there are important investment risks to consider. Given the older vintage of workforce assets, capital expenditures tend to be higher to deal with deferred maintenance issues. The repair or replacement of major items such as roofs in addition to aesthetic and functional upgrades to landscaping and amenity areas required to stay competitive typically result in higher capital costs over time. As a result, buyers of workforce investments need to carefully underwrite a property's physical condition to accurately project capex. In addition to capital risk, workforce housing investments also face greater policy risk. Housing affordability remains a top concern for millions of Americans and rent regulation measures by way of state and local ballot initiatives continue to surface around the country. In 2020, a ballot initiative passed in Portland, Maine will implement a cap on most rent increases. Other such legislation has been proposed by municipalities from California to New York with varying success. In most instances, these policies disproportionately impact more affordable Class B and C multifamily investments.

Conclusion. According to a Freddie Mac study, the United States has experienced a sustained housing shortage totaling 3.8 million units as of 2020, due in large part to declining single-family home construction. This shortage ensures excess demand and helps maintain strong housing fundamentals. On-going fiscal challenges price many out of homeownership, creating demand for middle-income workforce housing investments. At the same time, affordable family housing is inherently more challenging to deliver just as millions of millennials are entering child rearing years over the next decade. These factors will combine to help drive NOI growth for multifamily investments, serving as a long-term hedge against inflation and a source of attractive risk-adjusted performance. As a result, the appetite for multifamily investments among institutional investors remains robust. Allocations to the apartment sector have increased meaningfully among the universe of core, private, direct investment funds in the NFI-ODCE Index. For these investment funds totaling more than $224 billion in market cap — apartment allocations over the past 20 years have increased by more than six hundred basis points to 24.6% as of the first quarter of 2021. Expect growth in apartment investments and particularly workforce housing allocations to continue among ODCE Funds.

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