Flash Research Report

US Multifamily – Fed rate hikes and the rise & rise of rents

July 2022



SPIRE CAPITAL

Global private markets for private investors

Background

Spire Capital selectively searches global private markets in line with key investment themes. We conduct due diligence, create customised access vehicles and invest in the "sweet spot" of the chosen theme. As a firm, we have proudly been ‘democratising’ private markets for Australian private investors for over a decade. This means offering clients and their advisors the opportunity to invest alongside us in customised feeder funds that have been optimised (tax structuring, cost, administration and reporting) for Australian investors. With as little as AUD 20,000 (underlying investments are normally USD10m minimum), local investors can complement traditional asset class exposures like listed equities/property and bonds with allocations to global private markets across real estate, private equity, venture capital, infrastructure, debt and agriculture. Opportunities are offered via funds, co-investments, secondaries and are integrated into portfolio administration and reporting systems including full tax reporting. To facilitate liquidity for investors, Spire has recently introduced a bi-annual ‘trading window’ (managed by PrimaryMarkets) to enable units in closed-end/illiquid Spire Funds to be traded.

Investment Partners

ADM Capital | Bridge Investment Group | Bradford Castle Partners | Brookfield | Cortland | EQT | evp_ | Oaktree | Valterra Partners

Spire Capital Investment Committee

Matthew Cook, F Fin
Director
Head of Funds Management

- Founder and equity partner in Spire Capital with primary responsibility for funds management, structuring and business management
- 29 years in the industry, and previous directorships with Knight Frank and Denison Capital
- Bachelor of Business (Land Economy) and Graduate Diploma in Applied Finance. Fellow of FINSIA (Financial Services Institute of Australasia)
- Member of Spire Capital Investment Committee

Dale Holmes
Director
Head of Investor Relations

- Director and equity partner in Spire Capital with primary responsibility for capital raising and investor relations
- 24 years in industry. Commenced in 1989 with AXA with senior roles more recently as General Manger MLC Alliances (2000-2004) and IPAC as Practice Manager (1995-2000).
- Former and founding CEO of the Greater Western Sydney Giants AFL team, prior to that he was the GM of the Australian Football League in NSW/ACT and a member of the AFL National Executive team.
- Bachelor of Economics.
- Member of Spire Capital Investment Committee

Stuart Haigh
Director
Head of Investments

- Director and equity partner in Spire Capital with primary responsibility for investment research, partner development and assessing co-investments
- 20 years in industry. Formerly with Partners Group working in deal teams and capital raising across Sydney, Zug & London (private equity, real estate, credit and infrastructure). Prior time at MLC Private Equity & NAB Asset Management
- Honours in Agricultural Economics (University of Sydney), Advanced Diploma of Financial Services from Deakin University and post-graduate studies in International Business at Harvard University in Boston
- Member of Spire Capital Investment Committee

US Multifamily – Fed rate hikes and the rise & rise of rents

Introduction

Since 2010, Spire Capital ('Spire') has continually invested in the US Multifamily sector (debt and equity) in selected growth cities ('sun-belt' states) and suburban locations (Class B/+ product), catering to renters seeking quality, affordable rental housing at a 20-30% rent to income ratio.

Over the 12 years, Spire has invested in excess of AUD 600m on behalf of principal + client commitments and has proudly executed with longstanding partners, Bridge Investment Group ('Bridge') and Cortland. The period has delivered outsized returns for investors, as a structural undersupply of housing, strong demand for quality/affordable apartments and supportive monetary conditions have combined for 20%+ net IRR's[0] across all Bridge and Cortland vintages.

This Flash Report has been written to consolidate on how US Multifamily is tracking coming out of the COVID-19 pandemic and how the sector is positioned as the US Federal Reserve ('Fed') continues to hike rates.

Recap on the US multifamily sector

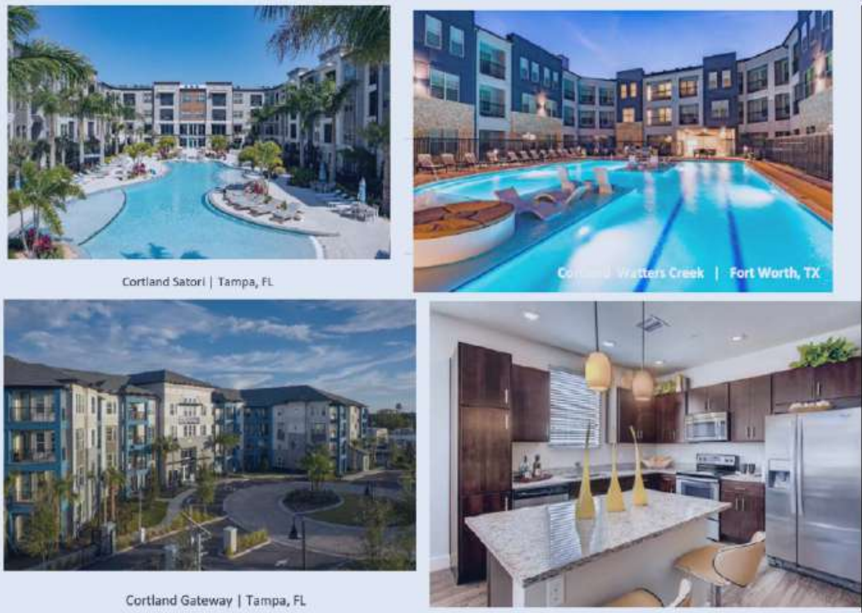
The US multifamily real estate market has grown to be the largest and most liquid commercial real estate market in the US. The market is comprised of 23.5m apartments spanning USD 5.2tn in value[1], with an annual average transaction volume[2] of USD 169bn.

The sector is highly attractive for investment, given its highly efficient capital markets contain equity participants including REITs, sovereign wealth funds, asset managers, family offices and debt participants, including the semi-government agencies (Freddie Mac, Fannie Mae), insurance companies and banks. The market has an extraordinarily fragmented opportunity set, with the largest apartment owner holding less than 0.5% market share, i.e., Starwood Capital Group owns 115k of the 23.5m apartments in the sector[1].

The highly diverse mix of tenants (typically 300+ per community), steady occupancy (B+ Multifamily apartment stock has been 92%-95% occupied over the last 21 years[3]) combined with short-duration leases (i.e., 12 months) provide broadly diversified, highly resilient cash-flows. The cash-flows from rents are driven by local supply/demand fundamentals for each sub-market and contribute to the national inflation number. 'Shelter Inflation' has a c.33% weighting in the CPI basket in the US and is comprised of rents (1/3 of the weighting) and home prices (2/3 of the weighting)[3].

The strong fundamentals, portfolio attributes and performance continue to attract institutional money from around the world as allocators of real estate capital see the sector as a true safe-haven amongst other sectors under cyclical and structural pressure (e.g., retail, office and hotels). According to Colliers International[3], foreign investors poured USD 21bn into US multifamily properties in CY2021 (a 30% increase on the previous year), much of this directed at the high-growth Sun-Belt markets. Colliers are reporting that foreign investors have shifted the focus from "big, shiny office buildings", stating that "some of those investors who skewed toward office are seeing the growth opportunities in industrial and multifamily, and they're diversifying". Bridge have noted this trend also, stating that 'beds and sheds' are seen as highly attractive to investors seeking defensive allocations.

The continued growth in capital flows creates additional liquidity, while the 'weight of money' supports valuation. For Spire's chosen partners – Bridge and Cortland - this provides additional exit optionality, as the bulk of capital flows are looking for core assets, which Bridge and Cortland are creating through buy, improve, sell initiatives.



Cortland Satori | Tampa, FL

Cortland Gateway | Tampa, FL

Class B/+ Multifamily

Typically located outside of the urban core on 20+ acres and priced at a sizable discount to Class A rents.

Generous on-site amenities including gyms, grilling stations, pools, dog parks, business centres, and/or clubhouses.

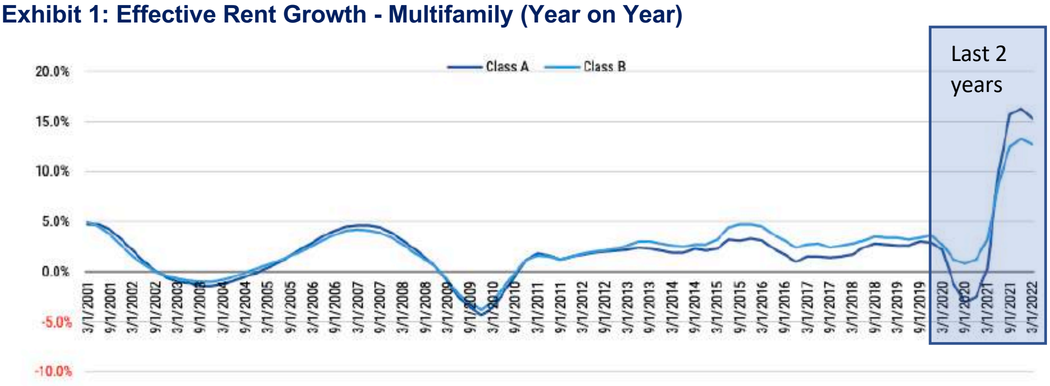
Suburban product typically built as "garden style" with four stories or less with surface parking.

'Fed rate hikes are now working to push homeownership even further out of reach for potential US homebuyers. This is prolonging rentership for would-be buyers and pushing more households into rentals, which are already structurally over-occupied'

How has US housing performed post pandemic?

The post pandemic period has been characterised by rapid Rent Growth and soaring home prices, making the cost of shelter in the US less affordable across the board. This has applied to both Class-A and Spire's preferred segment – Class-B.

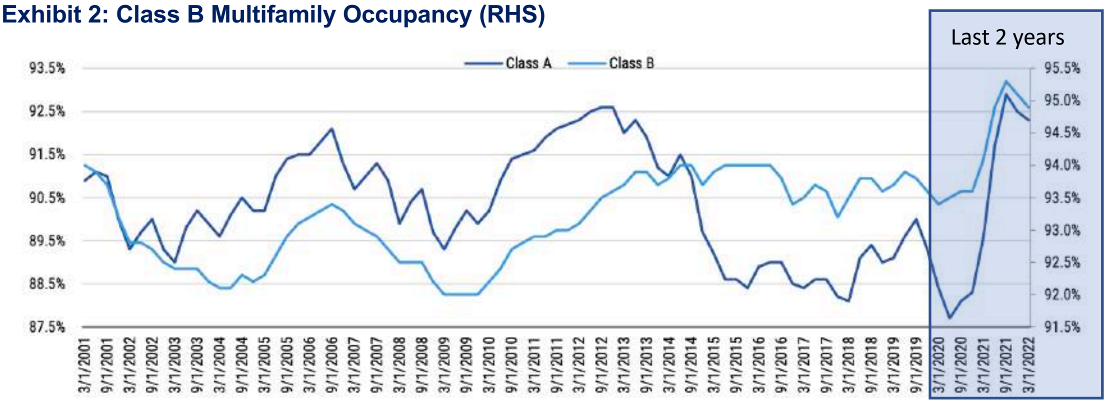
Exhibit 1: Effective Rent Growth - Multifamily (Year on Year)



Source: CoStar, Morgan Stanley Research

Over the last 20 years, Class-B Rent Growth has proven to be less volatile (relative to Class-A) and maintained a positive number through the recent pandemic. With long-term rent growth averaging 3%, the current environment of 13%+ is truly extraordinary.

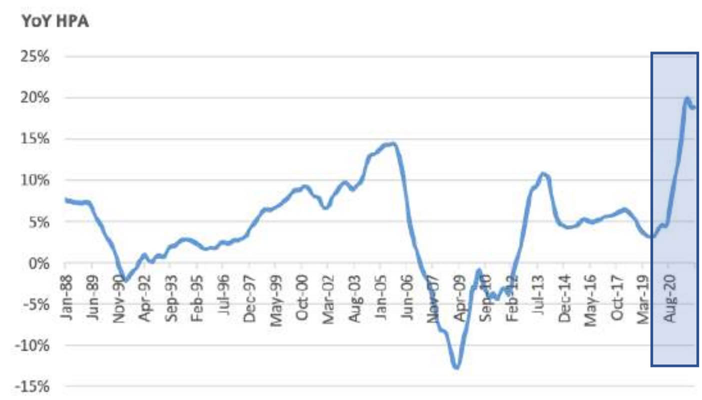
Exhibit 2: Class B Multifamily Occupancy (RHS)



Source: CoStar, Morgan Stanley Research

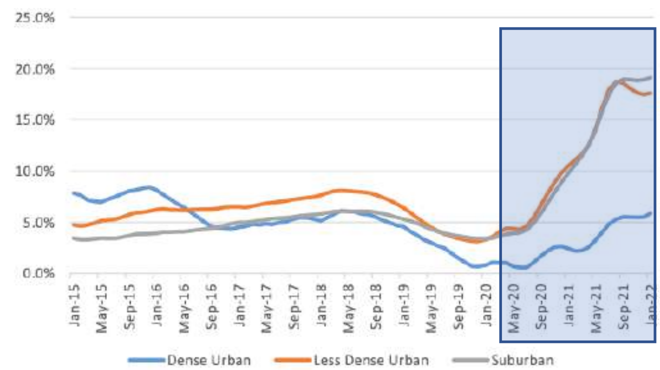
In addition, Class-B occupancy has traded in a tighter range (relative to Class-A) over the last 20 years (92%-95%) with current occupancy within 0.5% of all-time highs.

Exhibit 3: Home Prices (Year on Year)



Source: Case-Shiller, Morgan Stanley Research

Exhibit 4: Price appreciation by density



Source: Zillow, Morgan Stanley Research

Fed rate hikes are now working to push homeownership even further out of reach for potential homebuyers. This is prolonging rentership for would-be buyers and pushing more households into rentals, which are already structurally over-occupied. More on this later.

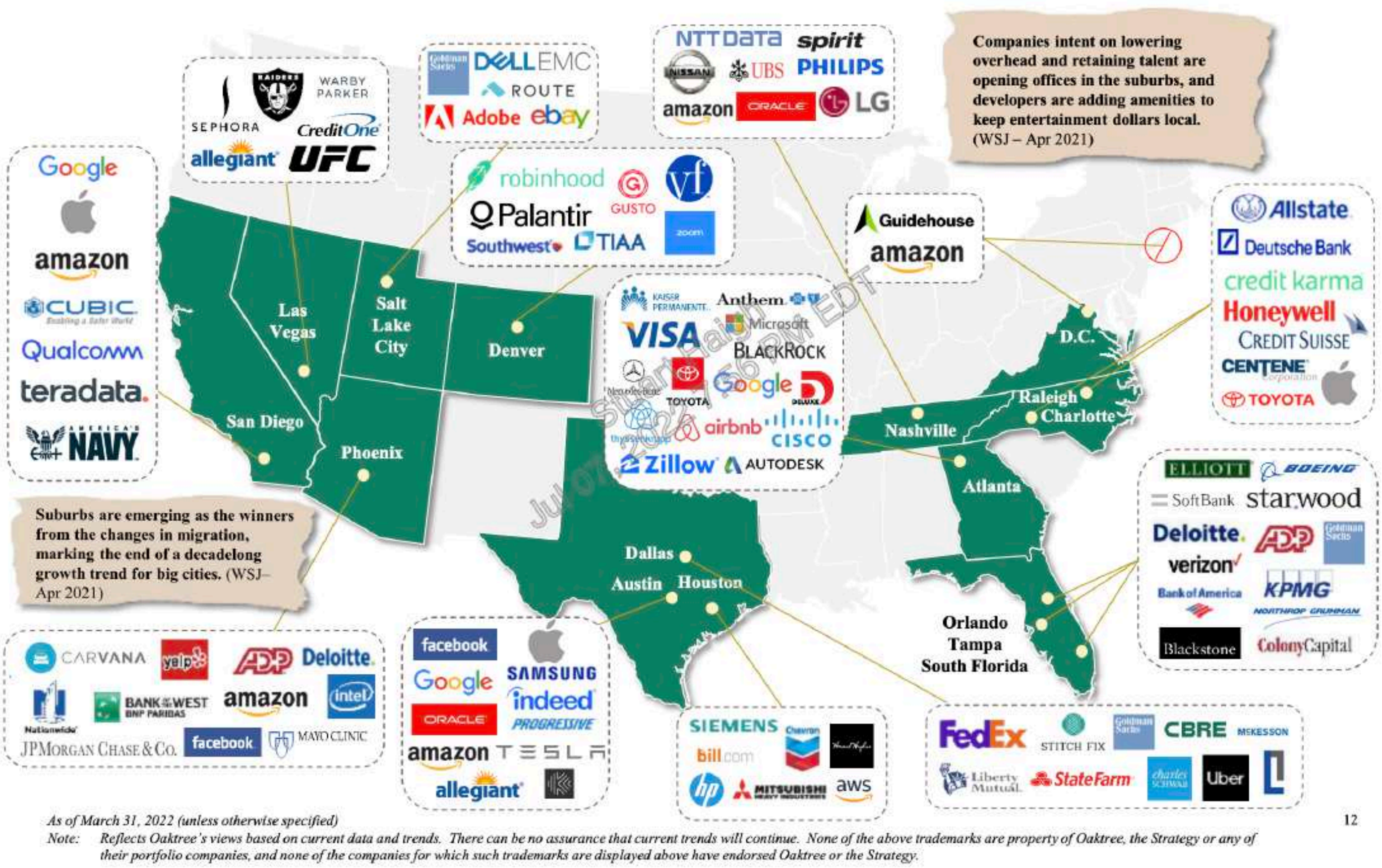
Is supply responding to the demand?

The surging rents and house prices have been fundamentally driven by an undersupply of residential housing, with occupancy levels for B-Class multifamily at the aforementioned near-record high level (i.e., 95% vs, the long-term average of 93%3). While there is consensus on the extent of the undersupply (i.e., significant), there is a wide variance across industry participants regarding estimates of the actual number of housing unit shortages:

- Cortland – 1.1m[6]
- Bridge Investment Group – 2.4m[7]
- Morgan Stanley – 1.5m to 5m[4]
- NCRIEF, Freddie Mac – 3.8m[5]

At the national level, Cortland believes the US is now past 'peak undersupply' pointing to continued housing completions and low population growth. This said, the national level is a relatively low-resolution view of the picture, given the multispeed nature of the US economy across states and cities. Underlying sub-markets (Municipal Statistical Areas ('MSA')) have their own idiosyncrasies and exhibit large variances in population and economic growth relative to the national average. A key driver of the variance is migration levels, as American corporates and workers relocate to lower tax states (e.g., Texas), warmer climates, more space, better value for money/affordability and generally energetic cities.

Exhibit 5: Growing Corporate Expansions and relocations to Sun-belt states



Source: Oaktree Capital Management[12]

Exhibit 6 shows the extent of the supply-demand imbalance across cities targeted by Cortland by looking at the 'migration to unit delivery ratio'. For example, Orlando, FL is expected to have 6.3 people migrating to the city for every apartment over the next 2 years - see exhibit below. Other key beneficiaries of net migration include Tampa, Charlotte, Phoenix, Atlanta, Dallas and little-known Boise, Idaho - expected to have 10.8 new migrants for every apartment over the next 2 years.

Exhibit 6: Migration-to-unit Delivery Ratio (next 2 years)

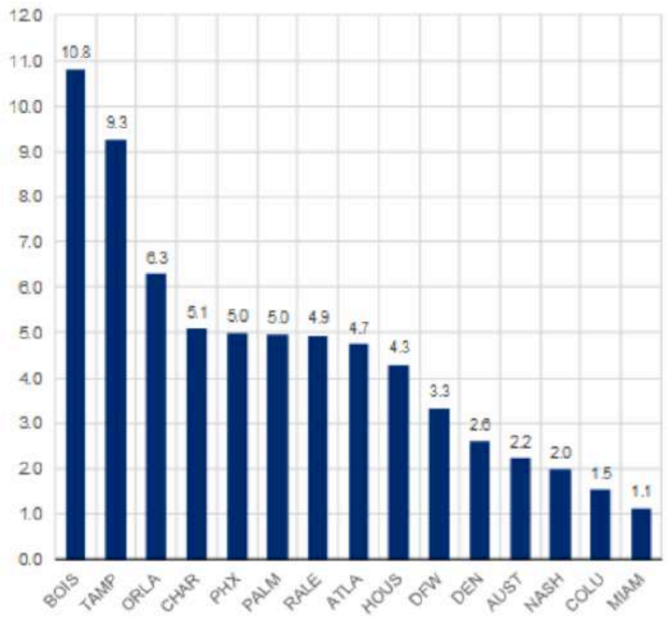
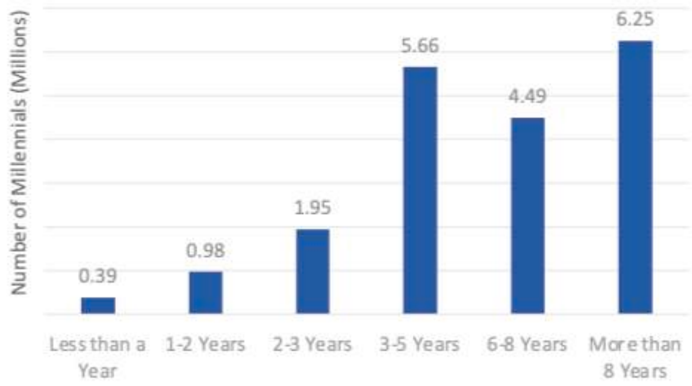


Exhibit 7: Delays in homeownership due to student debt

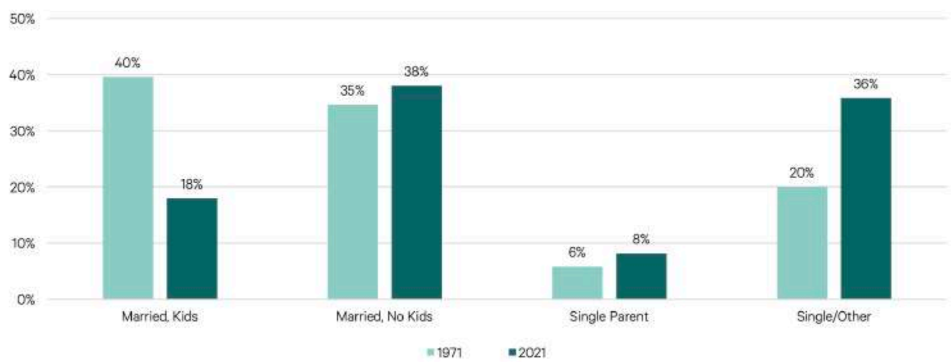


Source: Cortland. 1 U.S. Census Bureau and U.S. Department of Housing and Urban Development, Median Sales Price of Houses Sold for the United States [MSPUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MSPUS, February 24, 2022.

In addition to the population growth tail-winds outlined above, the secular trend towards renting continues to gather steam. According to Cortland research, nearly 11 million millennials expect to delay homeownership by six years or more, due to student debt alone. A further 5.7 million expect to delay homeownership at least three to five years, due to student debt alone[8].

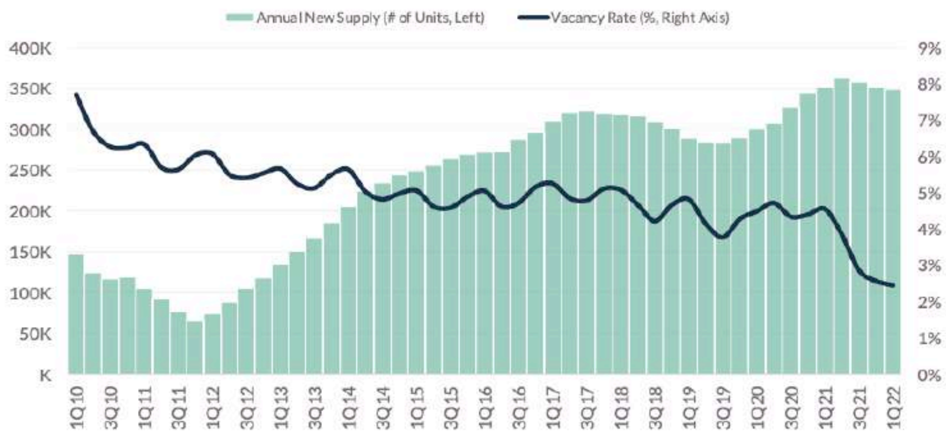
Another factor driving long term demand is the shifting composition of US households over the last 40 years. Over this period, the number of households characterised as 'married, kids' has more than halved (see Exhibit 8). At the same time, the 'single/other' category has almost doubled from 20% to 36%. This shift is reflected in popular culture, with the high rating television show of old, *Married with Children*, being superseded by *Modern Family*. This long-term trend has a meaningful impact on housing demand as a more fragmented population base seek highly amenitised multifamily apartments as a home.

Exhibit 8: Shifting household composition – proportion of household composition, 1971 vs 2021[0]



To reinforce above points, data from RealPage11 shows that demand growth is clearly outpacing the supply response, with Exhibit 9 challenging the conventional economic wisdom that says increasing supply should lead to decreasing occupancy (increasing vacancy). Exhibit 9 shows the progressive ratcheting of supply of new apartment units (green bars) being overwhelmed by a structural decline in vacancy rates (black line). Put simply, demand is overpowering supply.

Exhibit 9: U.S. Apartment supply relative to demand (vacancy rate) – supply not keeping pace with demand



Source: RealPage Inc

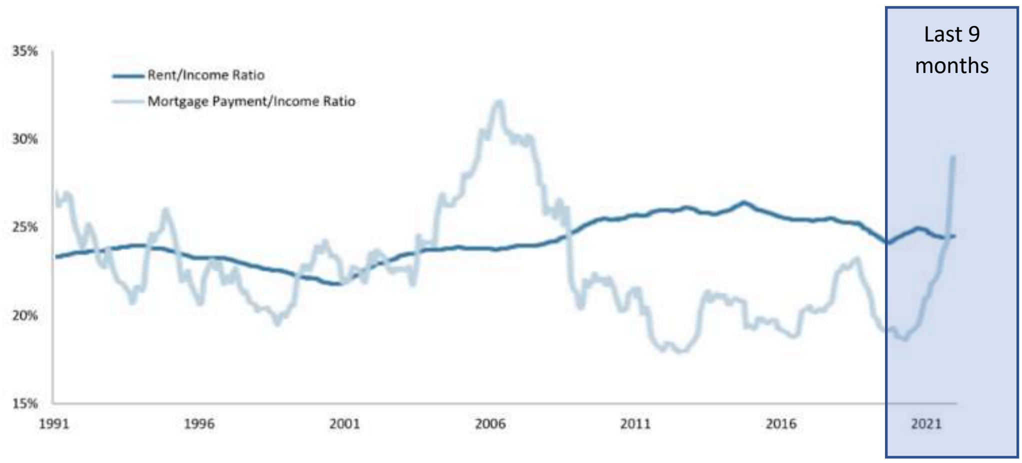
What has the supply/demand imbalance and run up in prices done to affordability?

As foreshadowed, recent home price appreciation and Fed rate hikes add to the challenge of saving for a down payment and securing a home loan. The brings into focus affordability. Morgan Stanley's latest research piece[4] on residential real estate makes a key point on this:

"An inability to afford a home or qualify for a mortgage will push more households toward rentals at a time when occupancy rates are already historically high and rents are climbing at a record pace. This will in turn erode households' ability to save for a down payment, keeping them as rental demand for longer, providing more upward pressure on rents and thus shelter inflation."

As per the below exhibit, the cost of ownership (measured by mortgage payment to income ratio) has risen to nearly 30% of income, well outpacing the cost of renting at less than 25% (measured by rent to household income).

Exhibit 10: U.S. Housing and Rental Affordably Ratio



Source: Goldman Sachs as of June 8, 2022

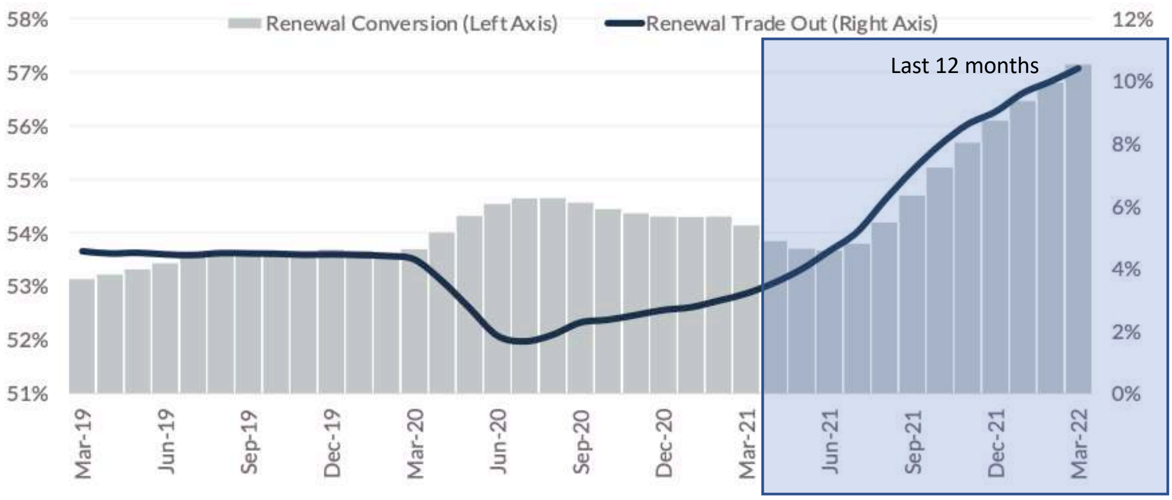
Indeed, the impact of Fed rate hikes for those seeking to transition from renting to buying in the US are meaningful. For a would-be buyer of a home, 30-year mortgage rates have moved from ~2.75% to ~5.75% on the back of recent Fed rate hikes (see below exhibit). This combined with a 20% increase in home prices in the last 12 months is simply crowding out would-be buyers from securing a home. The upshot is that multifamily tenants will stay in place for longer, working to further exacerbate the supply/demand imbalance foreshadowed earlier in this paper.

Exhibit 11: 30 Year Fixed Rate Mortgage – Average in the U.S.

Source: Freddie Mac[9]

Exhibit 12 shows the acceleration in tenants staying put ('renewal conversion' - grey bars). This number has moved from 53% to 57% over the last 9 months. Meanwhile, more tenants staying put has worked to add additional pressure to rents for new tenants moving into the community ('Renewal Trade Out' - black line) with new tenants now paying 10%+ more than departing ones.

Exhibit 12: LHS Tenants staying longer – Renewals have moved from 53% to 57% in last 12 months



Source: RealPage Inc

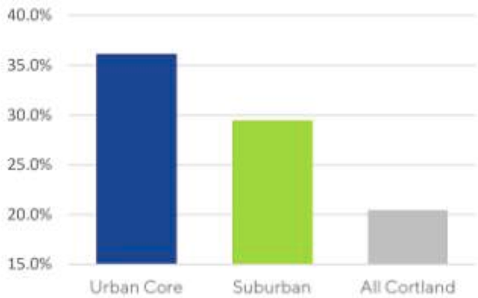
Not surprisingly, this bodes well for continued rent growth, provided tenants have the capacity to absorb the increases. This then poses the next question.

Is there an affordability 'sweet-spot' for investment?

Rent inflation is one of many drivers of broader inflation in the US. Surging energy and food prices, combined with shelter inflation, have pushed year-on-year inflation in the US to 8.6%[9] as at the end of May 2022. Meanwhile, wages growth is not keeping pace with inflation, creating budgetary pressures for many US households. With this, the tenant rent-to-income ratio becomes a key metric to understand how much 'headroom' multifamily operators have to drive rents. The below exhibit highlights that urban core apartments (typically A-Class) have a ratio of 35%+ relative to suburban apartments having <30%. Exhibit 10 shows the current mortgage payment/income ratio for homeowners of 30%, meaning urban core tenants not only have less headroom to absorb rent increases, they are also more susceptible to jumping into home ownership (assuming they can raise the down payment and secure debt financing).

Cortland has a laser focus on rent-to-income ratio and continues to successfully manage assets to a c.20% rent-to-income ratio. Average rents across Cortland's portfolios are ~$1,650/month or ~$20k per year. This means an average household income of $100k. At this level, tenants are usually professionals, so they are less sensitive to retail/hospitality industries that have not only been hit by Covid-19, but also remain vulnerable to a consumer-led recession. Similarly, Bridge is focussed on rent-to-income ratios and manages assets to a <25% ratio.

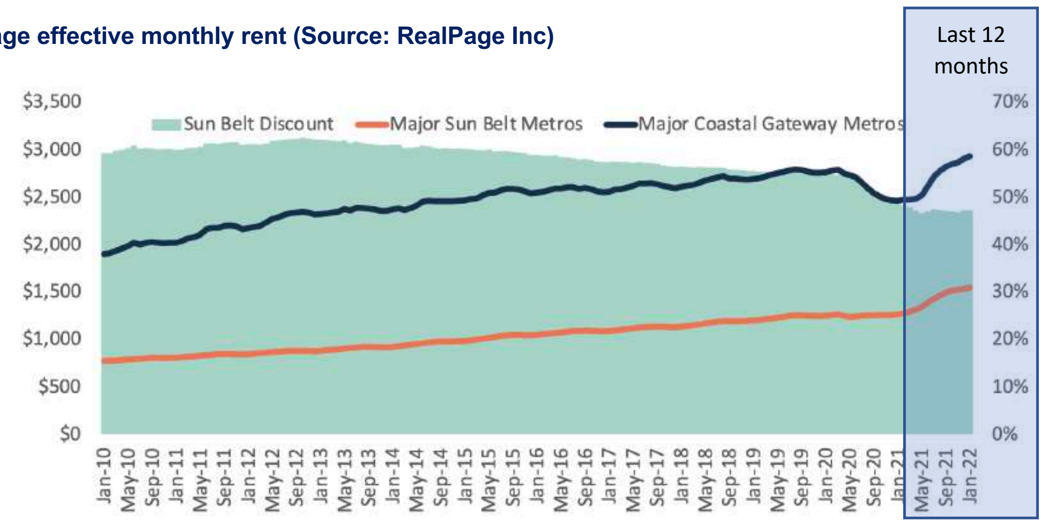
Exhibit 13: Rent to Pre-Tax Income by Jurisdiction



Source: Cortland. Ratio of monthly effective rent to monthly pre-tax income. Average across submarkets classified as 'Urban Core' and 'Suburban' in Cortland markets

Another dimenson to consider in assessing affordability is the difference in absolute rent costs between tenants moving from major gateway coastal cities to the high-growth cities in the sun-belt targeted by Bridge and Cortland. Exhibit 14 shows avearge rents per month for sun-belt cities have increased through $1,500 in recent months. This compares to $3000 for major coastal gateway cities, meaning that tenants can still halve rental costs (i.e., 50% 'sun-belt discount') by moving interstate to the sun-belt. This is in-addition to commonly saving on taxes. While this has come down from a 60% discount, it is still a meaningful difference in a world where households and corporate employers look to optimise cost bases in the face of growing budgetary pressures (fed rate hikes, broad based inflation).

Exhibit 14: Average effective monthly rent (Source: RealPage Inc)



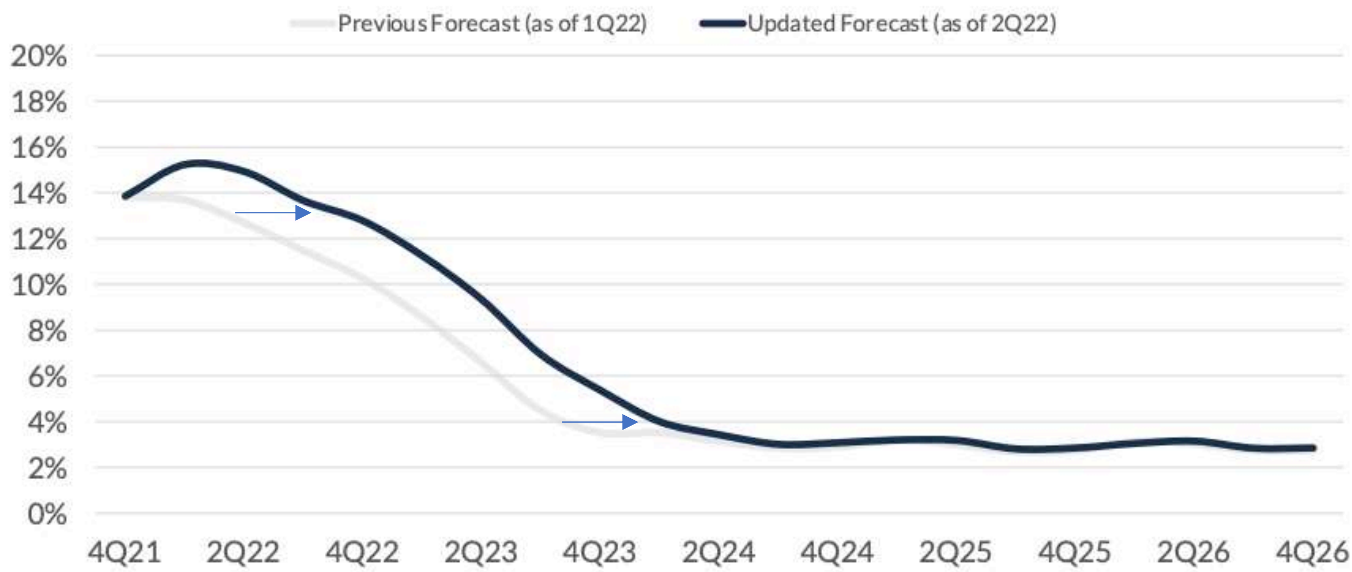
Outlook for rent growth

As the aforementioned factors combine (unaffordable housing, undersupplied multifamily sector, record high occupancy, compelling resident proposition), it would follow that rent growth forecasts be reviewed upwards. With this, industry thinktank RealPage analytics have revised rent growth forecasts –

"*An unseasonably strong 1st quarter, paired with continued strength from previous quarters, resulted in a near-term rent growth upgrade through 2022 & 2023*"

The below exhibit pushes out record-level rent growth for a further 12 months, with the number eventually normalising in mid 2024 (i.e., 2 years from today).

Exhibit 15: Rent Growth forecast[10]



Source: RealPage Inc

How does Rent Growth translate to Net Operating Income Growth?

The continued 'outsized' Rent Growth bodes well for Net Operating Income (NOI) growth. Leading managers like Bridge and Cortland operate properties at 50% margins with tight expense growth management (i.e., ~5% per annum). The upshot is that NOI growth is positioned to grow much faster than Rent Growth. To illustrate, we can take the RealPage forecast above which works out to be an average rent growth of 10% over the next 2 years, or 21% point to point over the 4 quarters. If we assume that expenses are 50% of incoming rents and grow at 5% per annum, we arrive at forecasted NOI growth of 32% point to point over the next 2 years.

	Year 1	Year 3	Change
Rent (growing at 10%)	100	121	21%
Expenses (growing at 5%)	50	55	10%
Net Operating Income (NOI)	50	66	**32%**

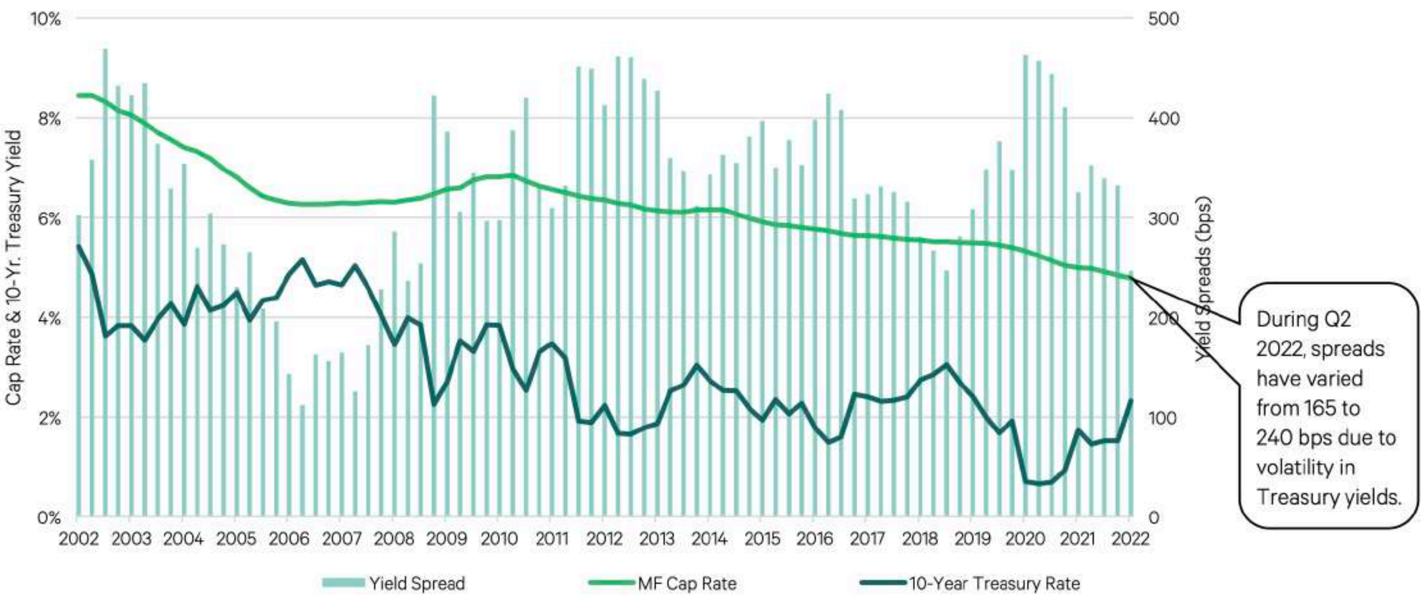
A 2-year outlook has been isolated because the next 2 years are important in the context of the Fed's hiking cycle. While a possible 32% increase in NOI is an exciting proposition ('and by no means a promise' says the Spire Compliance Team), it needs to be viewed in parallel with rates moving further up, and hence, cap rate expansion potentially working against valuations.

Final word on cap rates

Historically, US Multifamily cap rates have not been particularly sensitive to movements in the 10-year US Treasuries, demonstrated by a large variance in the spread over the 20 years (i.e., 110 to 460bpts). This said, it is instructive to check-in on spreads as a measure of the 'buffer' against cap rate expansion. With recent spread compression and continued Fed rate hikes expected, it is a reasonable to assume that cap rates may at some stage expand (in spite of weight of money seeking to get set).

With this, we can then return attention to NOI Growth as the next line of defence or 'buffer' for cap rate expansion hurting valuations. Entry cap rates in the sun-belt and mountain west regions of the US (Bridge and Cortland's target markets) are currently sitting around [4.00%]. With this as the starting point, and assuming the Fed thinks in 0.25% increments (i.e., hiking cycle to be 0.25% at a time), we can assert that each rate hike will require a 6.25% increase in NOI to keep the valuation in check (on the assumption the valuation is simply derived from NOI divided by cap rate). This relationship/sensitivity between cap rate expansion and required NOI growth can then be applied to the aforementioned 32% NOI Growth forecast. 32% divided by 6.25% is 5. This means, there is theoretically enough NOI Growth forecasted to withstand 5 hikes or a 125bpts increase in cap rates over the next 2 years.

Exhibit 16: U.S. Multifamily Cap Rate vs 10 Year US Treasury



Source: Bridge Investment Group[0]

Conclusion

On the back of a decade of strong performance, US multifamily real estate remains a highly attractive real estate sector, given the structural supply-demand imbalance and the relative rent affordability born out of booming house prices and recent Fed rate hikes. B-Class product, in high-growth cities, has proven time and again its resilience through stress, owing to a diverse tenant base and a highly valuable/affordable proposition offered to long-term renters. The Fed can't do anything about the supply shortage, and the market can't do much about it in the near term either, paving the way for what Morgan Stanley Research describes as a 'vicious cycle'[4];

"An already unaffordable housing market will become even less affordable for prospective homeowners. These affordability pressures combined with a lack of supply will force households into the rental market where structurally low vacancy rates are already sending rents skyward. Those rising rents will erode households' ability to save for a down payment, pushing the prospect of homeownership further into the future and keeping pressure on rents."

As a consequence, the sector continues to be propelled forward by **the rise and rise of rents**. While the prospect of cap rate expansion lingers, forecasted outsized rent and NOI growth provide a powerful buffer for valuations – potentially prolonging outsized returns.

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About Spire Capital

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