10 Reasons to Invest in U.S. Apartments

Executive Summary

Apartment properties have long played an important role in the U.S. commercial real estate investment world. Their role in commercial real estate investment activity gained importance following the collapse in home prices after the Global Financial Crisis, as homeownership rates declined precipitously from record levels. Additionally, recent demographic shifts, including the emergence of the Millennial generation into prime renting age, have supported strong growth in apartment demand.

Even before recent changes, all types of investor groups have long been attracted to the sector, from small private buyers to public REITs and large institutional players, domestic and international.

Particularly for institutional investors, apartment properties have served as a cornerstone of any diversified portfolio of commercial real estate assets. In addition to diversification, the apartment sector is compelling for a wide variety of reasons, including that apartments have historically provided high and stable cash flow yields compared to other commercial real estate sectors.

Now, as the U.S. economic expansion matures, we believe that apartments offer defensive performance characteristics should economic growth slow. Those investors who are wary of possible interest rate increases and higher inflation are likely to benefit from apartment investments as part of their portfolio, as apartment supply and demand have historically adjusted quickly to changing market conditions, and apartment rents have kept pace with inflation.

In this paper, we explore 10 reasons apartment investments remain compelling in today's market environment.

#1 Demographics Continue to Favor Renting

The prime renter age group – 20-34 years old – is still increasing in size.

While the "Millennial" group is getting older, the majority of Millennials remain likely to rent. Millennials (individuals turning 24-39 in 2018), especially younger ones, are still in stages of life when people traditionally rent, while the significant "Gen Z" generation is just entering rental market behind the Millennials.

Homeownership rates remain well below levels witnessed prior to the last recession.

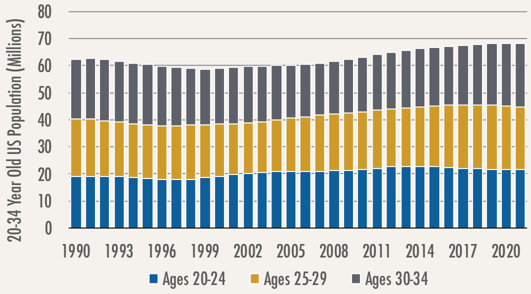
Homeownership rates could rise slightly from the current 64% due to more Millennials moving into life stages that favor homeownership. However, we expect any upward movement to remain quite modest. We are unlikely to see a return to the peak homeownership level of 69% achieved in 2006 during the credit-fueled boom that drove homeownership to record levels.

Homeownership rates among 25- to 29-year-olds was 32% in 2017 and 46% for 30- to 34-year-olds, levels well below the national average of 64%.

By its large size, the Baby Boom generation will continue to be a significant source of apartment demand.

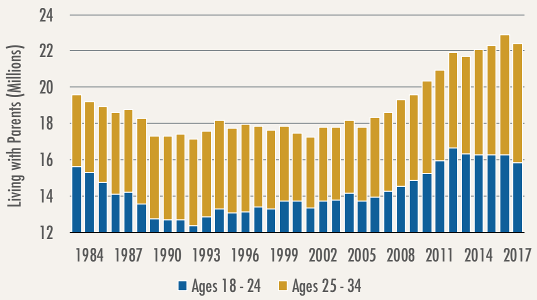
Due to lifestyle changes and "downsizing," many older households no longer have the need for large space requirements and therefore may opt for apartments and other independent living rental housing.

Figure 1:
20- to 34-Year-Old Population Still Increasing

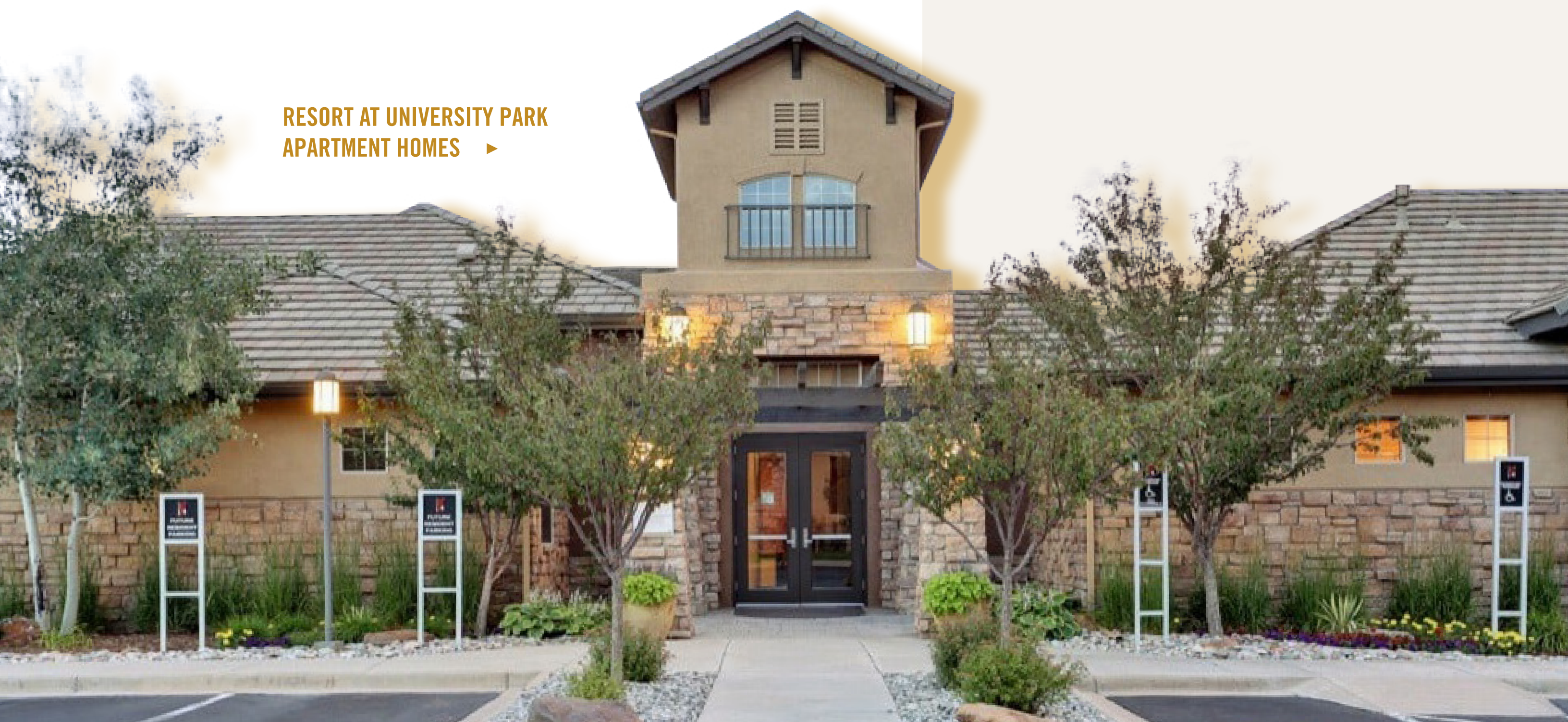


Source: Moody's Analytics, CBRE Research

Figure 2:
18- to 34-Year-Old Population Living at Home



Source: U.S. Census Bureau, CBRE Research



RESORT AT UNIVERSITY PARK APARTMENT HOMES ►

#2 There is Significant Pent-Up Demand for Apartments

The number of young adults living at home has continued to increase.

The increase began to accelerate during the depths of the Great Recession, as scores of new graduates faced weak job prospects.

This "boomerang" effect persists to this day. In 2016, the number of 18- to 34-year-olds in the U.S. reached a new peak at more than 22.9 million — an increase of over 4.5 million from 10 years ago. As the economy moves toward full employment and wages increase, it is anticipated this "pent up demand" could translate into over 3 million to 4 million additional renters. This is quite a significant amount of potential demand, especially since new annual apartment supply averages close to 325,000 units overall.

#3 Barriers to Homeownership are High

Younger households are burdened with high levels of student debt.

According to the Federal Reserve Bank of New York, student loan balances held by those aged 30 and younger have ballooned by more than one-third over the past 10 years. The ability of these households to service debt *and* a mortgage is limited and serves as a strong constraint on saving for a down payment and homeownership. In addition, student loan debt as a percentage of total household debt is approaching 10% – almost double the rate from a decade earlier.

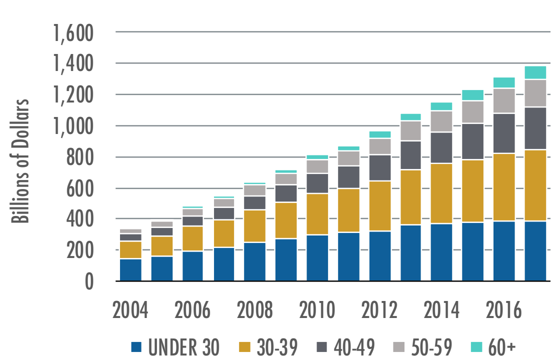
Housing affordability has declined, especially for first-time home buyers.

The National Association of Realtors' first-time homebuyer affordability index has declined over the past two years, despite an increase in qualifying income for first-time home buyers. Incomes have grown alongside mortgage rates and prices for entry-level homes, and starter home prices are up 9.7% nationally since 2015.

Renting is more cost effective.

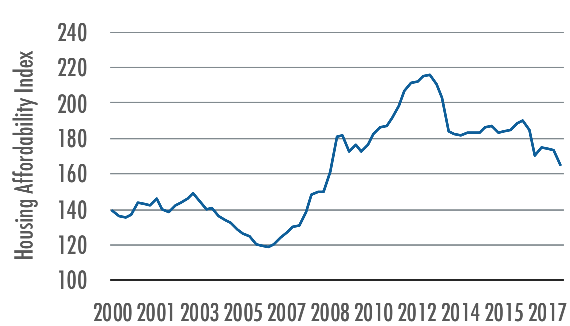
With rising mortgage rates and home prices, the cost calculation for buying versus renting tips increasingly in favor of renting.

Figure 3: Total Student Loan Balance by Age Group



Source: Federal Reserve Bank of New York, CBRE Research

Figure 4: Housing Affordability Index



Source: Federal Reserve Bank of New York, CBRE Research

#4 Lifestyle Changes Support Apartment Demand

Many younger adults like the flexibility renting offers for geographic mobility and the freedom to change residences when new job opportunities or other life changes dictate intracity or intercity moves.

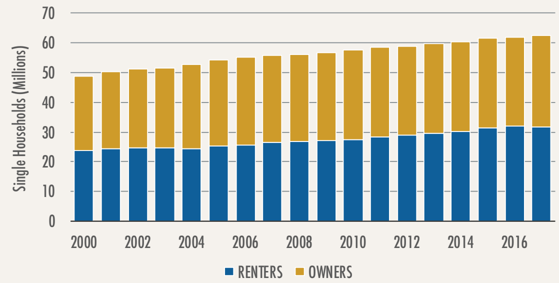
Some younger households are choosing to stay in multifamily housing as a lifestyle choice — not out of economic necessity or because they haven't reached a stage in life that favors homeownership.

Social changes are also having a strong effect on multifamily demand:

- In addition to deferred marriages, the overall number of single, never married, and divorced households has steadily increased over time.
- The average age of first marriage in the U.S. has risen to 29.5 years old for men and 27.4 years old for women, both up two years from 10 years ago.
- For the first time in history, the birth rate for women ages 30- to 34-years-old was higher than the rate for women ages 25- to 29-years-old.

These changes translate into more single-person households, which tend to have a much lower homeownership rate (currently 50.9% vs. 64% overall). The number of single, renter households has increased by 2.3 million over the past four years, and renters now account for almost 27% of all households. (Figure 5)

Figure 5: Single, Renter Households Increasing



Source: Bureau of the Census, CBRE Research

#5 Apartment Construction has Been Concentrated in Class A "Renter by Choice" Product

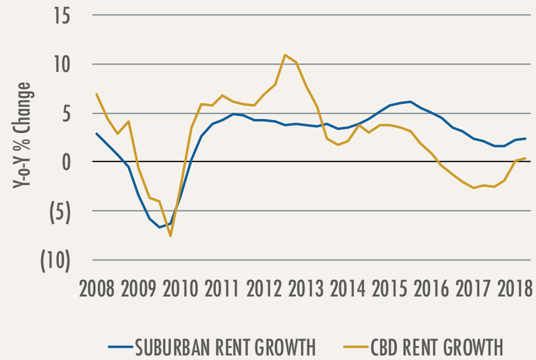
In recent years, a large share of new apartments have been constructed in downtown or central business district (CBD) areas of the major "Gateway" markets.

Much of the recent new apartment construction reflected demand from young workers who desire prime locations and markets.

However, developers have largely overlooked prime suburban areas. As a result, suburban rent and occupancy performance has outperformed downtown areas. (Figure 6)

There is limited new development activity targeted toward the more moderate income "renters by necessity," who are a stable source of demand and less likely to shift toward homeownership.

Figure 6: Suburban Rent Growth Stronger than CBD Since 2013



Source: CBRE Economic Advisors

#6 Apartments Have Strong Investment Characteristics

Apartments have many favorable investment characteristics that contribute to outperformance and high cash flow yields over the cycle.

Apartments have a short leasing cycle of one year, compared to four to seven years for other major property types. Leasing changes more rapidly in response to the market cycle and shifts in demand and demographic factors. Supply also adjusts more quickly to changes in the market cycle, as building development periods are shorter, allowing the market to reach equilibrium more quickly in response to rising rents and occupancies.

Apartments tend to have lower capital expenditure requirements and lack the tenant improvement and leasing commission requirements of other property types. Therefore, a higher proportion of net operating income is distributable as cash flow. (Figure 7) Cash flow yields are generally higher and more stable than other property types over the long run. (Figure 8)

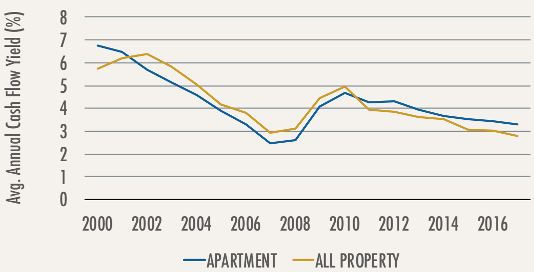
Investment liquidity is strong, as more investors see the benefits of high-quality investments in apartments. New capital sources, including foreign investors, have played an increasingly prominent role, while institutional investors have steadily increased their allocations toward apartments. On the debt side, the federal agencies — Fannie Mae and Freddie Mac — continue to play an important role in enhancing liquidity and providing loan price competition.

Figure 7:
Percentage of NOI Distributed as Cash Flow

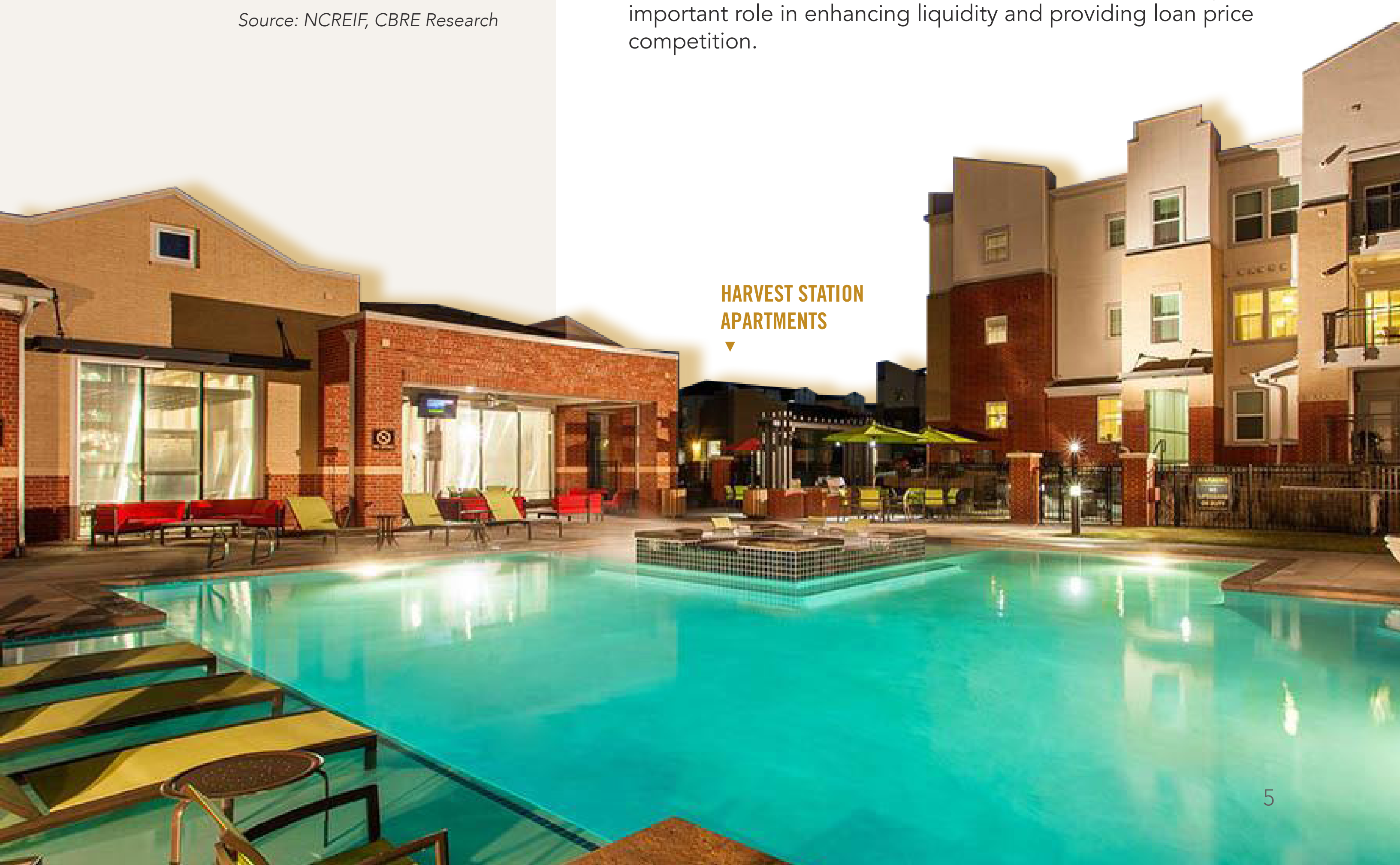
APARTMENT	76.6%
HOTEL	61.0%
INDUSTRIAL	68.6%
OFFICE	58.0%
RETAIL	73.6%

Source: NCREIF, CBRE Research

Figure 8:
Apartment Cash Flow Yields Outpacing All Property



Source: NCREIF, CBRE Research



HARVEST STATION APARTMENTS

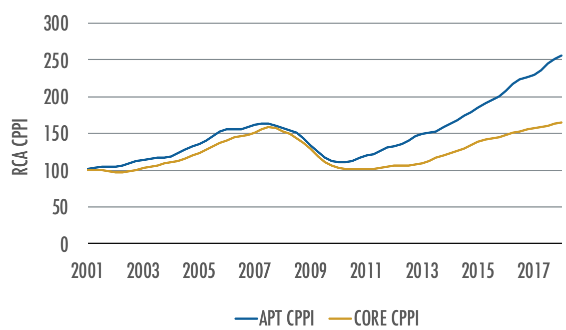
#7 Apartments Tend to Outperform in Economic Downturns, Providing a Defensive Investment Strategy for Investors

The U.S. economy is considered by some analysts to be in a late stage of its economic cycle. The Federal Reserve has enacted several short-term interest rate increases over the past year and is reducing its holdings of longer-term Treasury and mortgage securities. As a result, monetary policy is likely to become less accommodative. With prospects for an upward shift in the yield curve, there are implications for economic growth and valuations.

During past recessions, the duration and severity of the downturn in apartments was lower than other property types, as the sector is less sensitive to changes in economic activity. Apartment fundamentals also tend to recover faster as the economy emerges from recession. Over the most recent economic cycle, apartment values declined less and recovered more quickly.

According to the Real Capital Analytics' Commercial Property Price Index (CPPI), a widely-used benchmark of property values, apartment values fell 32.2% during the global financial crisis, and it took 47 months to recover the loss. Core commercial property, on the other hand, fell 36.6% and it took 78 months for full recovery.

Figure 9: Apartment vs. Core Commercial CPPI



Source: Real Capital Analytics (RCA), NCREIF, CBRE Research

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#8 Apartments are Likely to Perform Well in Either a Stable or Rising Interest Rate Environment

If interest rates remain low, apartment investors are likely to continue to benefit from low financing costs.

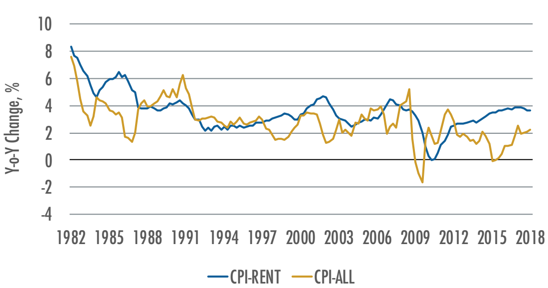
Because of the agencies' low-cost provision of debt capital, along with lenders' perceptions of apartment sector's stability, financing rates for apartments have been lower than other commercial property types over time. According to Real Capital Analytics, apartments have benefited from financing rates that averaged more than 48 basis points lower than commercial property over the last 10 years.

Apartment investors may also benefit from higher interest rates — especially if the increase in rates is due to rising inflation — as apartments will serve as an effective inflation hedge.

There are two effects of rising inflation on apartment market performance:

- Property effects – A rise in inflation will lead to higher asset replacement costs. This in turn restricts new supply, since higher rents are required to spur additional development. Over the long term, apartment rents have tended to outpace overall inflation rates. (Figure 10)
- Financial effects – Higher mortgage rates tend to result in lower housing affordability and more rental demand. While household formations tend to fall during recessions and periods of weak economic growth and rising interest rates, the effect on apartment demand is offset by lower homeownership rates.

Figure 10: Rental CPI Growth vs. All CPI Growth



Source: Moody's Analytics, Bureau of Labor Statistics, CBRE Research

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#9 Tax Reform Makes Renting More Attractive

Recent federal tax reform will likely have a positive impact on the apartment market.

CBRE-Econometric Advisors recently completed a study that indicates the tax benefits of renting vs. buying a home will increase in 29 of the 35 largest U.S. markets. Limitations on state and local tax deductions, as well as the loss of the mortgage interest deduction on home purchases of $750,000 or more, will marginally impact the cost of housing in high-cost markets and have negligible impact on population flows.

The new tax plan's increased standard deduction of $24,000 for a married couple provides renters in many more markets with benefits previously enjoyed only by homeowners.

Prior to tax reform, only 15 of the 35 U.S. markets with a population of 2 million or more had seen a greater benefit from the standard deduction than from the specific itemized deductions from homeownership. With the new tax law's increased standard deduction, that total has increased to 29 of the 35 largest U.S. markets, including major cities like Miami, Philadelphia, Chicago, Denver, Seattle, and Washington D.C.

The overall impact of tax reform on the U.S. economy should be positive, but the duration of that impact is uncertain given its late-cycle timing and uncertainty about whether corporate tax savings will be sufficiently reinvested to support job growth.

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#10 Well-Located Suburbs Offer Investment Value

There are good reasons to favor apartment investments in select, well-located, suburban areas with quality transit, amenities, and school systems.

Most recent apartment construction activity has been concentrated in core CBDs in the largest markets. While construction has increased, it remains much more limited in suburban markets. (Figure 11)

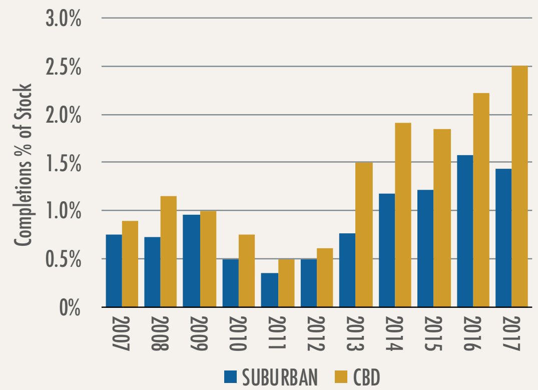
As result of this trend, suburban apartment rents have outperformed. Part of the shift in rent growth is also due to lower affordability in the core CBD markets, which has limited the extent that developers can increase rents.

Investors continue to acquire apartments at more favorable initial acquisition yields, or cap rates, in the suburbs. According to the CBRE Cap Rate Survey, the national average suburban, Class B cap rate is 5.41%, while the comparable cap rate for infill locations is 5.14%. Although spreads between suburban and CBD cap rates have compressed in recent years, the suburbs appear to offer relative value. This is especially true when viewed against the backdrop of a stronger rent growth outlook.

The investment thesis is also strengthened by potential demographic shifts that may favor the suburbs. As Millennials age and begin to have families, they are likely to place a premium on suburban locations with strong schools. This should boost demand for apartments in such locations, as homeownership may remain out of reach for many of these households.

Recent construction activity has been focused on smaller urban units, especially studios and one-bedrooms, to accommodate the growth in single-person households and young workers. We would expect demand to shift to more larger units as the formation of households with young families increases. This would likely provide an opportunity for new suburban construction as well as upgrading older properties.

Figure 11: Suburban Properties & Developments Offer Better Value



Source: Moody's Analytics, Bureau of Labor Statistics, CBRE Research

THE QUARTERS AT TOWSON TOWN CENTER