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WEALTH SOLUTIONS

Three Reasons Apartments Remain Attractive in 2023

With the U.S. Federal Reserve tightening monetary policy to tame the highest inflation in four decades and rent growth normalizing back to historic averages, some investors are wondering if the investment opportunity is closing in multifamily real estate.

However, we believe there are three reasons why investors should remain confident that the long-term investment case for the apartment rental market remains intact: 1) **Affordability:** Higher mortgage rates and low for-sale inventory favor renting; 2) **Demographics:** Young people are delaying buying homes because homes are not affordable and they are already in debt; 3) **Supply:** Inflation is increasing construction costs which, in turn, discourages new building.

① **Affordability:** The undersupply of affordable, for-sale housing, coupled with higher interest rates and mortgage costs makes it more difficult to afford a home purchase, exacerbating an already tough environment (**Figure 1**). Since the 2007-2009 Global Financial Crisis (GFC), new home construction slowed and never kept pace with demand, especially in years when labor markets were tight. Now with the U.S. economy forecast to slow, that deficit of building will likely persist as inflation drives up input costs, making new projects too risky for many homebuilders. This is squeezing potential new homeowners: The sticker price of homes-for-sale remains high while the monthly cost to buy a home (as a percentage of income) continues to rise. This is not an easy problem to fix, creating a meaningful tailwind for rental homes and apartments.

Figure 1: U.S. Housing Affordability for First-Time Homebuyers at all-Time Lows

Housing Affordability Index – First-Time Homebuyers

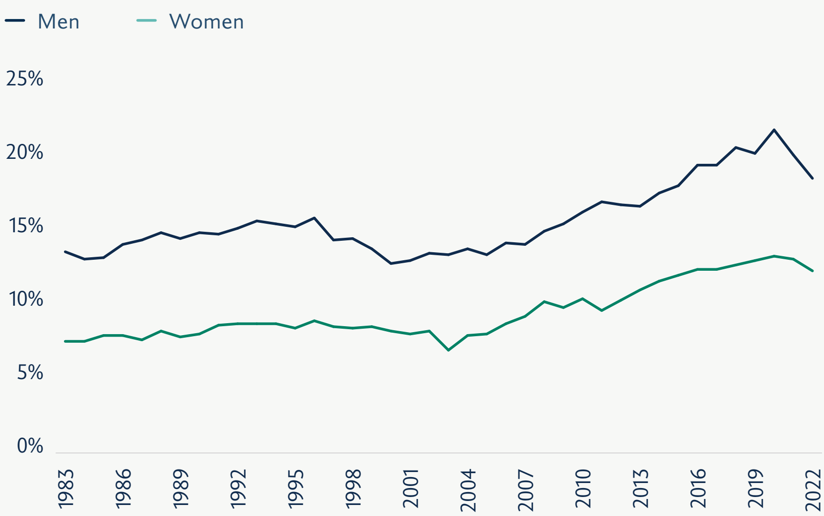
Source: Bloomberg, National Association of Realtors, as of September 30, 2022.
Note: Index measures ability of renters to afford a first-time home purchase. A value of 100 or greater indicates a typical first-time buyer can afford a typical starter home under existing financial conditions with a 10% down payment.

② **Demographics**: Growing household formations and shifting preferences are boosting demand for renting. In the United States, after steadily increasing after the GFC, the number of young adults living at home is beginning to decline (**Figure 2**), which supports household formations. However, at the same time, the age of the typical first-time buyer has reached an all-time high of 36. Taken together, we think this is supportive of strong future apartment demand. As a result, the age of the typical first-time buyer has reached an all-time high of 36, National Association of Realtors data shows.

Figure 2: Affordability Forcing More Young Adults to Rent Rather Than Buy

Lowest Number of Young Adults at Home Since 2015 ...

Percentage of people 25-34 living at home



... but Many are Delaying Home Purchase

Home buyer characteristics

Share of first-time buyers

26%

Lowest on record

Typical first-time buyers

36 years old

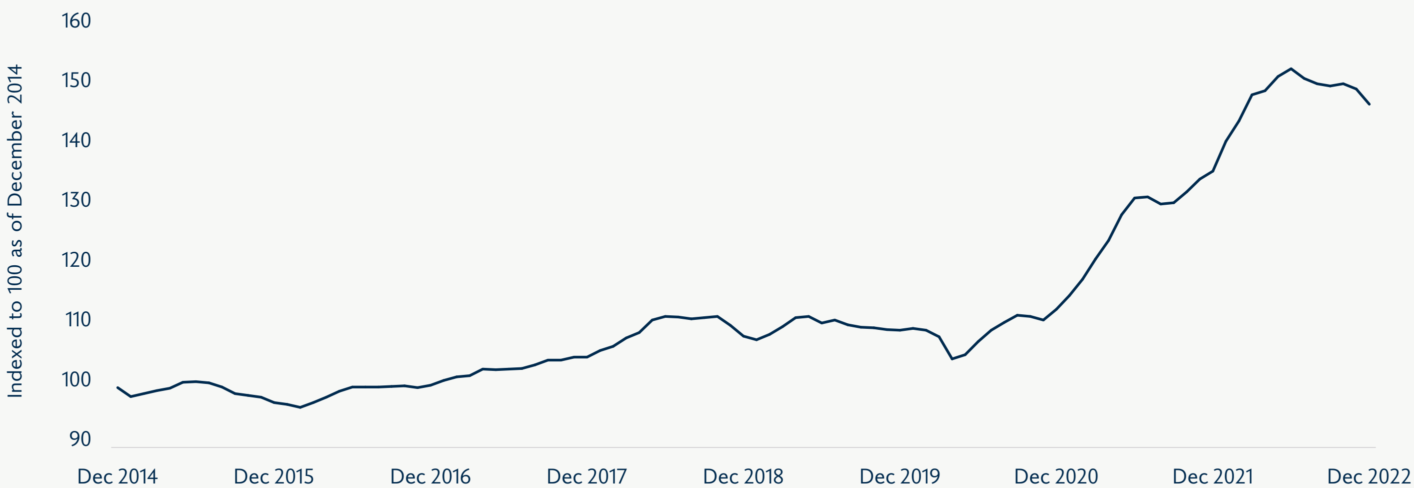
All-time high

Source: National Association of Realtors, U.S. Census Bureau, as of November 2022.
Note: Historical analysis does not guarantee future results.

③ **Supply:** Overall we expect the outlook for new supply to remain tight. Certain markets are experiencing elevated new supply relative to overall available inventory. This could result in near-term declines in asset values and help create some attractive long-term buying opportunities. Overall, however, today's high input costs (**Figure 3**) significantly disincentivize new developments, limiting future supply. Unfavorable economics for developers, coupled with the significant time it takes to put rental housing into production, we expect that future supply will remain tight, offering a tailwind for apartment landlords.

Figure 3: Apartment Construction Costs Have Spiked

Producer Price Index Shows Cost of Multifamily Residential Construction Goods Rising



Source: U.S. Bureau of Labor Statistics, as of December 31, 2022.
Note: Chart shows PPI by Commodity: Input to Industries: Net Inputs to Multifamily Residential Construction Goods (Index Dec 2014=100)

It's easy for investors to think that a slowing economy and rising mortgage rates will cause a housing crash, making real estate an unappealing investment. However, economics and demographics suggest that an allocation to real estate still makes sense. In these circumstances, we favor high-quality, multifamily properties that can produce long-term, stable cash flows as a result of being in markets benefitting from population growth, with an affluent renter base, located near premier employers. That may be a contrarian view, but as Brookfield Chief Executive Bruce Flatt says, "Being contrarian and not being where the crowd is going is hard to do, but (can be) the most lucrative if accomplished."

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