AN ANALYSIS OF ECONOMIC CONSISTENCY OF CLASS A RENTERS

White Oak Partners Research Team | September 2022

- *Higher average education levels among class A renters provide job security during an economic downturn.*
- *Average rent-to-income ratios of 5x allow residents to absorb cost increases in an inflationary environment.*
- *Consistently high occupancy and exceptionally low credit loss allow core-plus assets to continue to provide resilient cash flows even during adverse economic conditions.*
- *While industrial output decreases, retail spending declines and offices lose occupancy during a recession, people always need a place to live.*

Historically, multifamily housing has been a top performing investment across all real estate sectors during both periods of growth and recession. Multifamily rental rates outperformed office and industrial sectors in the 2001 recession and outperformed all major property sectors, including office, industrial and retail, during the 2008-2009 recession.[1] Class A housing, defined as a property within the top 20% of asking rents, has been resilient during economic downturns and has delivered consistent cash flows regardless of economic conditions. Job resiliency, strong rent coverage ratios and above-average education levels differentiate the class A rental cohort from lower tier (class B and C) apartment renters. Both upside potential and downside protection make core-plus multifamily an attractive investment, especially in uncertain market conditions.

EDUCATION AND EMPLOYMENT

Higher income levels combined with an above-average rate of college degrees contribute to higher resiliency among class A renters during an economic downturn. Core-plus assets had the lowest vacancy rate across apartment types during the global financial crisis.[1] As class A renters currently average a rent-to-income ratio of 5x[2], they can typically weather market downturns better than their class B and class C counterparts. Additionally, because jobs requiring bachelor's degrees are typically more specialized and thus harder to replace, they often remain in demand during a recession, which leads to fewer job losses. The global financial crisis in 2008 perfectly demonstrated the job security higher education provides. People bachelor's degrees and above only experienced about a 3% uptick in unemployment, whereas other education levels saw anywhere from 6-10% rise in unemployment levels.[3] Due to this increased job security, class A apartments retain strong occupancy and collections throughout recessions and continue to provide consistent cash flows to investors.

STRONG RENT TO INCOME RATIOS

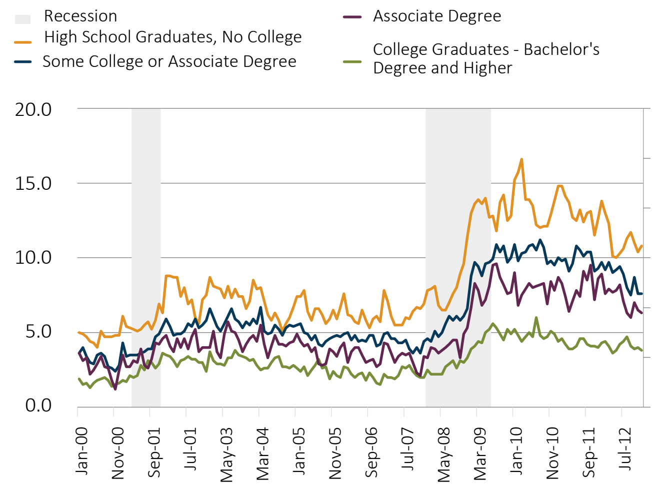
Due to the high income and job resiliency among class A residents, credit loss is far less of a risk even during economic downturns. Since the start of the Covid-19 pandemic, class A renters have seen wage growth that has kept pace or exceeded rent increases. According to RealPage, the average class A renter is now making $135,000, up almost 35% since the onset of the pandemic.[2] Despite being in the top 20% of asking rents and experiencing disproportionate rent growth over the past years, the average core-plus renter is still qualifying at five times income. Increased discretionary income coupled with resilient employment allow class A residents greater ability to make their monthly rent payments. The same cannot be said for class B and class C residents. A cost burdened renter is defined as someone contributing 30% or more of their income to rent. In 2018, 79% of renters earning $30,000 or less were cost burdened. Of those making between $30,000 and $45,000, 55.7% were cost burdened. Of renters that would qualify for class B, earning between $45,000 and $74,999, 27% were cost burdened. Comparatively, among those making more than $75,000, enough to qualify for class A, only 6.4% were cost burdened.[4] Very healthy rent-to-income ratios among core-plus residents may likely continue to allow for rent increases even when rental growth among other apartment classes is slowing.

While the overall job market continues to see wage growth since the onset of the pandemic, class C has lagged behind. Despite strong employment demand, service and hospitality workers, who are primarily class C residents, were hit the hardest during the onset of the pandemic. Because of this initial drop in employment, class C renters experienced less wage growth than both class A and class B renters. Household incomes among new class C renters increased 17% between March 2020 and June 2022. In comparison, class A and class B incomes rose by 21% and 25%, respectively, over the same time period.[5] While year-over-year rent growth among class C apartments has been far above-average, it has yet to close the gap between higher income residents due to lesser wage growth.

CLASS A IN AN INFLATIONARY ENVIRONMENT

Average class A rent coverage of five-to-one allows residents to absorb increased rent growth and general price increases better than their class B and class C counterparts. According to recent Harvard data, rent combined with energy and commute costs account for almost two thirds of monthly income of an average renter making less than $30,000 a year and 40% of

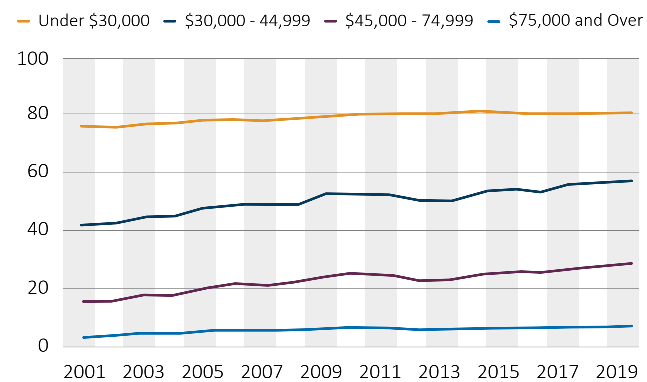
UNEMPLOYMENT RATE BY EDUCATION LEVEL 2000-2012 (FRED)



Source: White Oak Partners

HIGHER INCOME RENTERS CONTINUE TO HAVE HEALTHY RENT-TO-INCOME RATIOS

Share of Households with Cost Burdens (Percent)

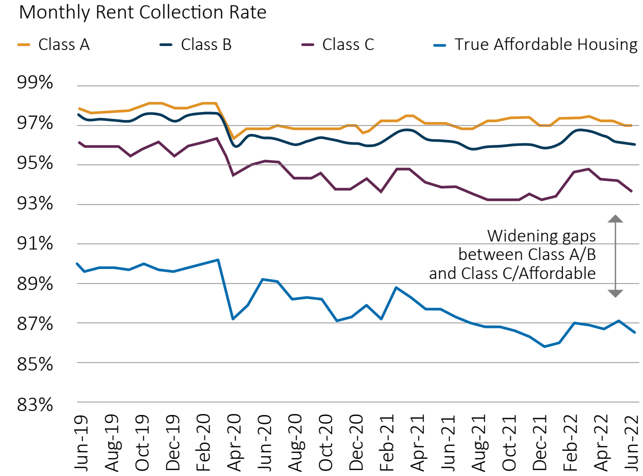


Notes: Incomes are adjusted for inflation using CPI-U for All Items. Cost-burdened households pay more than 30% of income for housing.

Sources: JCHS tabulations of US Census Bureau, American Community Survey 1-Year Estimates.

RENT COLLECTION TRENDS VARY SIGNIFICANTLY BY APARTMENT ASSET CLASS

Monthly Rent Collection Rate



Sources: RealPage

those making $30,000-$45,000.[4] These expenses don't include food, often one of the biggest household expenditures. Those making more than $75,000 average 20% of their income on these expenses combined.[4] Energy and food costs are particularly sensitive to inflation, leaving much less room for rent growth outside of class A. In July, prices for electricity rose 1.6% month-over-month. At the same time, food prices increased 1.1%, marking the seventh consecutive month of price increases greater than 0.9%.[6] As expenses continue to rise, lower income renters are at a far greater risk of late or missed rent payments. Rising household expenses also limit the ability for apartment owners to increase rents as residents are unable to absorb rent hikes. This trend is playing out in the current inflationary market. In the 12 months leading up to July 2022, food prices increased 10.9%, while energy prices are up almost 33%.[6]

Monthly rent collections among class C apartments have been in decline since the onset of the pandemic and this trend has likely accelerated with rising expenses. According to the most recent RealPage collection data, collections among class C residents fell to 93.7% year-over-year in July compared to 97% among class A properties.[5] The difference in collection rates over the past year has widened, indicating inflationary pressures are weighing more heavily on lower tier apartment complexes.

RENT GROWTH

Historically, rents among core-plus assets have remained strong despite adverse economic conditions. During the Global Financial Crisis, class A rents among professionally managed apartments declined just 4% to 4.5%. Rents began growing again in late 2010 and accelerated further in 2011. Apartment occupancy fell just 4% during this time, with class A properties dropping from 96% to 92%. In both 2001 and 2008, class A saw steeper initial drops in rent growth; however, strong occupancy and collections offset this decline.[1]

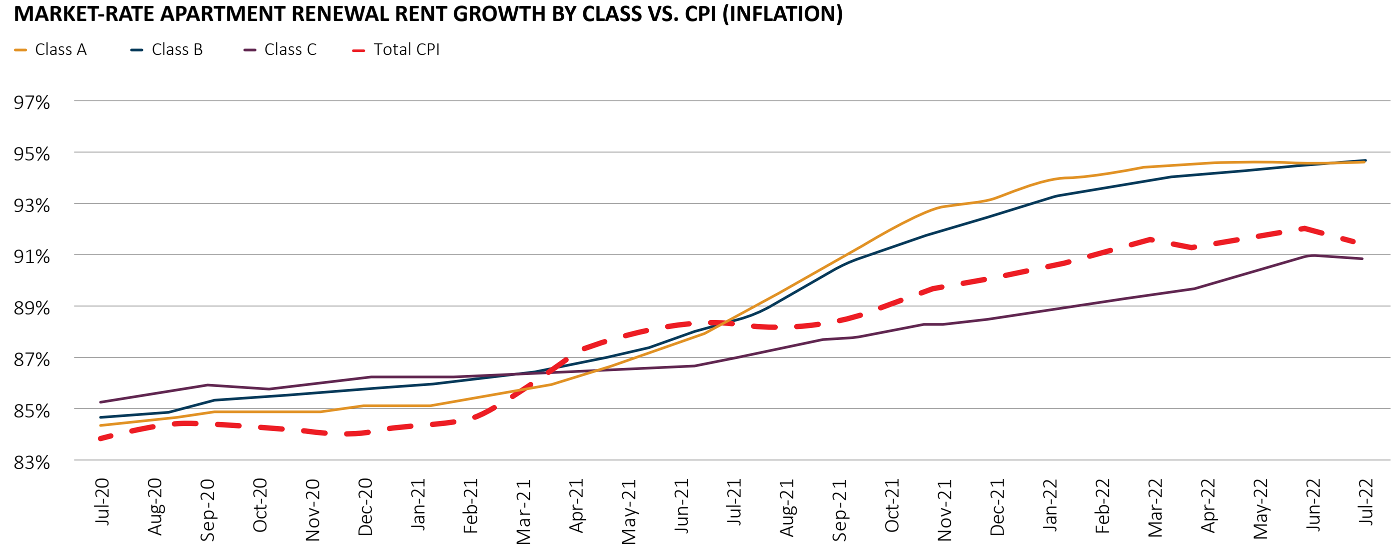
The effect of inflation on rent growth can already be seen within class C apartments. While class A and class B apartments have seen unprecedented rent growth post pandemic, class C is lagging behind.[5] Because class C renters spend a higher portion of their income on rent, the possibility of rent increases is limited. Class C owners are at a higher risk of vacancy and credit loss when rents increase. This has caused inflation to outpace rent growth among class C properties, which is in contrast to class A and B properties that have seen rent growth outpacing inflation.

While class A rents decreased during the 2001 economic downturn, rent growth among class A properties quickly recovered, surpassing other apartment classes in 2004. Core-plus rent growth retained this top spot for much of the following decade.[7] Despite the Global Financial Crisis upending the real estate market, class A apartments only had three quarters of negative rent growth during the height of the recession. In 2009, rent growth was much more pronounced in class A properties than other asset classes, driven by strong employment numbers among white collar professions. During a recession, it is commonly thought that class A renters move down the quality spectrum to stretch their income. While this is likely true for some residents, class A properties saw the strongest rent growth and only had three quarters of decline in 2009.[7]

Since the Global Financial Crisis, most apartment completions have been Class A. Despite unprecedented construction, demand for apartments still outstrips supply. In Q1 2022, a record 700,000 units were leased despite only 335,000 new units being delivered.[8] The fundamental undersupply of the housing market will likely continue to drive strong rent growth for the foreseeable future due to rising interest rates and construction costs. According to CBRE, construction costs will be up 14.1% by year end 2022.[9] While apartment projects currently under construction may continue, developers will likely be hesitant to take on new projects, which will further limit supply.

The strong single family housing market has also helped propel rent growth among core-plus assets. More stringent lending requirements (resulting from the Great Financial Crisis) and increasing property costs have led to many high-income residents being unable to afford a home in a location they

MARKET-RATE APARTMENT RENEWAL RENT GROWTH BY CLASS VS. CPI (INFLATION)



Sources: RealPage

want. As a result, many people are choosing to remain renters longer in order to live in more desirable areas and have access to better schools without the costs of home ownership. The national median sales price of a single-family home surpassed $440,000 in Q2 2022, representing a 15% increase year over year.[10] Due to supply chain issues and increasing construction costs, new single family home construction is not likely to meet demand, further driving up the cost of home ownership.

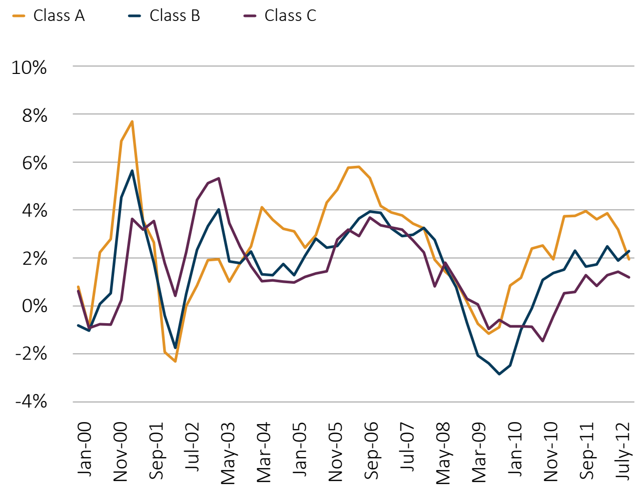
HIGH OCCUPANCY

Vacancy increased across all multifamily classes during the Global Financial Crisis and the 2001 recession. Class C housing was most affected as lower income residents have less of a financial cushion to weather an economic downturn. Going into the 2001 recession, occupancy rates were consistent across asset classes. As the downturn progressed, vacancy increased linearly across all classes of multifamily. After a slight recovery in 2002, occupancy began to diverge between classes in early 2003. Despite vacancy increasing roughly 2.4% during the 2001 recession, Class A apartments emerged with the strongest occupancy among multifamily properties. Class A retained strong occupancy all the way through the Global Financial Crisis, hitting a low of 93.3% during 2009. Occupancy quickly recovered, hitting 95.5% less than two years later. Class C occupancy remained roughly 100 basis points lower than both class A and B. This trend continued going into the 2008 recession with occupancy in A and B assets mostly even.[7] The effects of both economic downturns weighed more on lower income renters, thereby creating a divergence in occupancy rates that can still be seen today. The high occupancy among class A properties allow cash flows to remain resilient in economic downturns.

CONCLUSION

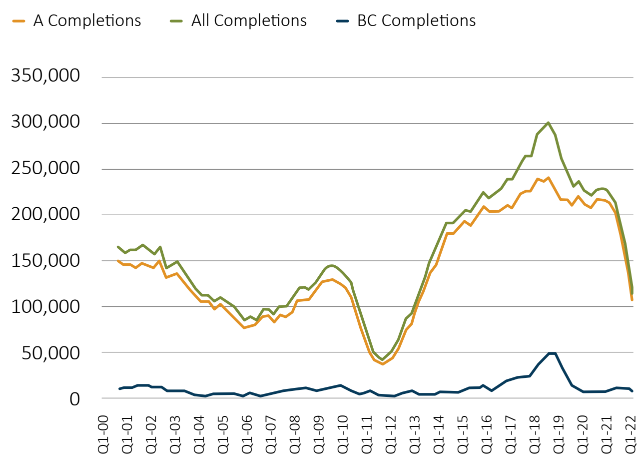
The strength of the class A rental cohort gives core-plus assets the unique characteristic of both capturing upside potential and providing downside protection. In times of recovery and growth, class A properties have experienced impressive rent increases. In a recessionary environment, class A properties historically have continued providing consistent cash flows to investors. Residents' above-average educational attainment results in strong employment resiliency and incomes even during economic downturns. Additionally, more than five times average income-to-rent ratios insulate class A residents from inflationary price increases. The resident demographic makes Class A multifamily a safer investment than other real estate classes, even during severe recessions like the Global Financial Crisis.

NATIONAL RENT GROWTH (2000-2012)



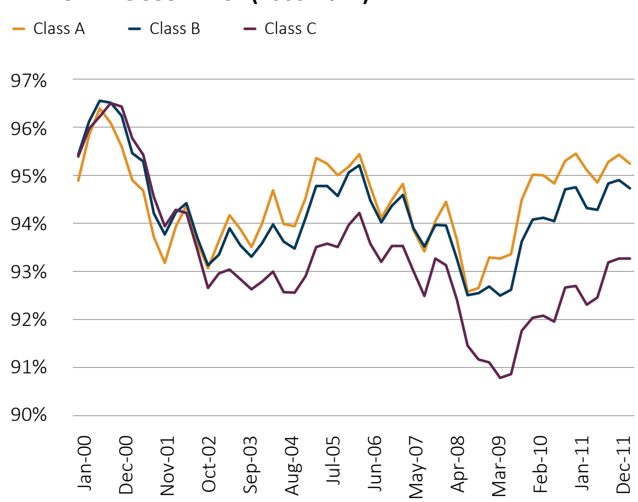
Sources: RealPage

MULTIFAMILY COMPLETIONS
(Rolling 12-month Sum)



Sources: Moody's Analytics

NATIONAL OCCUPANCY (2000-2012)



Sources: RealPage

Sources:
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11. Harvard University
12. RealPage Analytics
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CONTACT US

MICHAEL MENZER
Chief Executive Officer
mmenzer@whiteoakpartners.com
614-741-7790

JAMES CRAMER
Partner, President
jcramer@whiteoakpartners.com
614-741-7797

ANDREW CARR
Partner, Head of Capital Markets
acarr@whiteoakpartners.com
614-741-7736

BENJAMIN BARNES
Partner, Chief Real Estate Officer
bbarnes@whiteoakpartners.com
614-741-4628

4960 E. Dublin Granville Road,
Suite 500
Westerville, OH 43081

whiteoakpartners.com

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