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MULTIFAMILY IN AN INFLATIONARY ENVIRONMENT

White Oak Partners Research Team | July 2021

As inflationary pressures in the economy today increase the cost of products like building materials and newly built properties, real estate remains a desired asset class because of the inflationary hedge attribute of net operating income (NOI) growth outpacing cap rate expansion. Multifamily housing is a needs-based asset class, which is a key differentiator compared to other real estate asset classes. The favorable outlook of suburban housing due to demographic-driven demand remains a tailwind that is projected to continue to drive NOI growth over the longer term. This edition of WOP Insights provides context to the several ways that multifamily investments generate superior risk-adjusted returns in a high growth, inflationary environment.

STRUCTURAL ADVANTAGES

Multifamily is well positioned to outperform in an inflationary environment due to the combination of a lease structure (typically one year) with a staggered expiration schedule, the tendency of resident incomes to rise during inflationary periods, and the availability and range of debt options provided by the Federal Housing Finance Agency (FHFA) and other lenders. The lease structure commonly used at multifamily communities limits vacancy risk as only a portion of the leases expire at the same time, which allows for supply and demand to remain in balance. The multifamily lease structure also allows organic rent growth to be harvested in a high growth environment. The combination of vacancy risk protection and organic rent growth allows multifamily assets to outperform other commercial asset types throughout the economic cycle, which is especially important in an inflationary enviornment.

Wages typically grow during periods of inflation, and the increasing wages make it easier for residents to absorb inflationary cost increases like rent growth. Housing further differentiates itself from alternative investment types due to needs-based demand drivers and the mission-driven treatment from lenders, such as the FHFA. Support from the federal government for multifamily lending provides access to capital that is unavailable for other property types. The depth of the pool of lenders allows owners to refinance and avoid selling at an inopportune time due to loan maturity.

DEMOGRAPHIC DEMAND DRIVERS

Housing is a needs-based asset class and the current housing market is undersupplied in many parts of the country, especially in cities with fast-growing economies and populations—which make up the majority of White Oak Partners' target markets. The need for housing today is growing due to generational demographics as the number of Millennials that are reaching prime household formation now and over the next several years increases. While the prime household formation age groups (20 to 44 years of age) grew over the past 10 years, new housing was added at a lower rate than the 1.5 million per year long-term average according to the National Association of Realtors (NAR). This demographic-supported demand for housing has caused sharp price increases for single-family homes and that has made it harder for first-time home buyers to enter the market. As for-sale housing becomes less attainable, demand for suburban multifamily housing increases as would-be home buyers are priced out of the market. The housing market dynamics that have made a home purchase increasingly more difficult, combined with the demographic need for housing, provide support for outsized future rental growth and, as a result, strong investor returns.

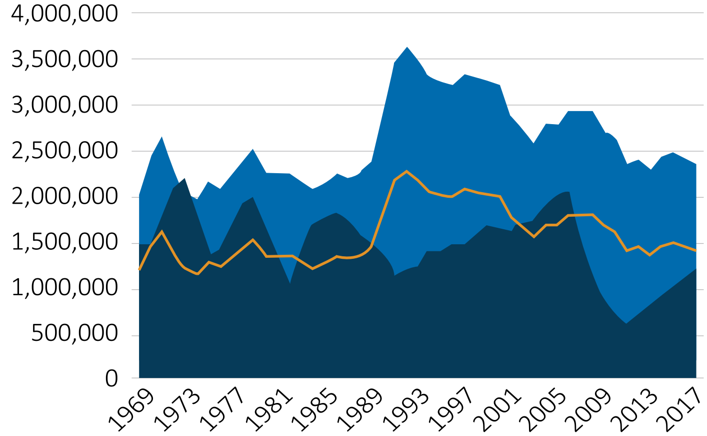
UNDERWRITING DURING PERIODS OF INFLATION

Multifamily investment serves as an inflationary hedge with the ability to generate NOI growth to offset a potential rise in cap rates. The range of debt options provides the ability to lock in long-term debt, which is a benefit that is greatly enhanced by the increasing cost of capital in an inflationary environment. As an income-producing asset, the desirability of multifamily increases to investors as the share of total return commonly generated from NOI growth increases during periods of inflation. Conventional wisdom suggests that cap rates expand in inflationary environments. However, due to increasing investor interest in the asset class, cap rates have the potential to remain relatively low, offering investors additional upside. The attribution analysis to the right highlights the components of return for a typical multifamily investment by White Oak Partners.

PAYOFF

Multifamily is well-positioned in an inflationary environment due to structural advantages like relatively short lease terms, staggered lease expirations, and a wide range of debt options. These factors allow multifamily investors to capture organic rent growth associated with inflation while harvesting the benefits of favorable debt. The needs-based nature of housing provides the opportunity for continued NOI growth due to the imbalance between supply and demand. The structural advantages and demand drivers of multifamily real estate can provide superior risk-adjusted returns to investors, especially in properties located in the most desirable suburbs of growing markets.

CHANGE IN POPULATION AND HOUSING COMPLETIONS



Source: U.S. Census Bureau, Moody's Analytics, Freddie Mac

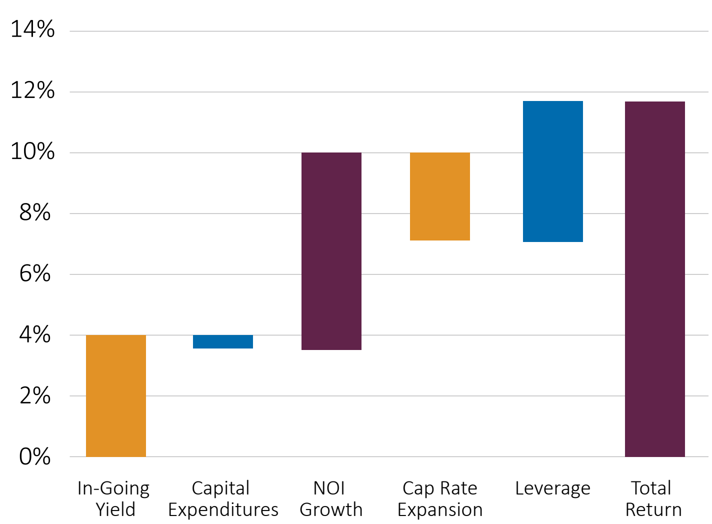
COMPONENTS OF RETURN

IN-GOING YIELD	NOI GROWTH	CAP RATE EXPANSION
4.0% Unlevered	6.0% Unlevered	(2.7%) Unlevered

DEBT	TOTAL RETURN
4.5%	11.8%

Based on 4% in-going cap, 4.75% NOI CAGR growth, 75bps expansion in cape rate, 55% LTC, term I/O, 2.75% rate

ATTRIBUTION ANALYSIS



Source: WOP Underwriting

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