- *The data suggests Class B and value-added assets are impacted more severely by new construction than Class A apartment communities.*
- *Construction slowdown in the Sunbelt signals a future shortage of multifamily properties.*
- *Capital markets favor multifamily over other real asset classes due to the necessity-based aspect of housing. Allocations to multifamily within real estate investments are expected to increase, which may limit cap rate expansion.*
- *Operators with boots on the ground expertise in local markets are best positioned to manage through waves of elevated supply and lease-ups.*

2023 A YEAR IN REVIEW

# KEY DRIVERS SHAPING FUTURE INVESTMENT STRATEGY

*White Oak Partners Research Team | February 2024*

## 2023 RECAP

Multifamily fundamentals are heavily influenced by the volume of new supply. The multifamily market experienced a year of moderate rent growth amidst high levels of new unit additions and a challenging debt environment. Multifamily rents grew modestly at 1.1% in 2023, while the broader U.S. economy has exceeded expectations despite negative sentiment, volatile interest rates, and stubborn inflation.[1] Job creation has remained robust, which propped up the American consumer—a key driver of economic activity. Wages continue to grow above historic levels, which has helped multifamily generate consistent income returns.

Developers brought a much-needed wave of supply into the U.S. housing market in 2023. Single-family homes remain expensive compared to renting, primarily due to homeowners locking in attractive mortgage rates prior to the Fed's tightening cycle. As a result, for-sale inventory is historically low, driving up the competition for apartment communities in desirable suburban locations. New multifamily construction predominately followed demand throughout the Sunbelt, where migration has been the strongest.

Despite the ongoing need for housing, interest rate increases have impacted developers' ability to make new builds pencil. Construction start data suggests that many Sunbelt markets will have minimal new supply after the current wave delivers, with expectations that multifamily supply/demand fundamentals will be similar to the pre-pandemic market conditions.[1] Institutional appetite for quality multifamily assets will likely help suppress cap rate expansion over the next several years, putting multifamily in a favorable position as capital markets thaw.

As the White Oak Research Team evaluates economic and multifamily data from 2023, key tailwinds and macroeconomic risks must be considered. In this Insight Piece, White Oak will outline economic trends that drive investment strategy in 2024 and beyond.

## KEY DRIVER #1: RESIDENT FOCUS

Resident economic health is a key driver of White Oak's investment decisions—especially in an environment where cap rates broadly trade at similar levels across multifamily vintages and investment strategies. The American consumer has remained resilient throughout the rate hiking cycle and period of inflationary pressures. The COVID-19 pandemic spurred a shift in consumer spending, most notably by introducing a wave of Federal stimulus. However, the withdrawal of government assistance has not meaningfully impacted consumer expenditures as many Americans continued to spend either through wage gains or credit cards, similar to pre-pandemic spending habits. The increase in credit card debt is a key risk to monitor, but delinquencies are low at 3% nationally, demonstrating healthy household balance sheets.[2]

Further risks to monitor include delinquencies on auto loans; by the end of 2023, the percentage of subprime borrowers 60 days past their auto loan payments reached 6%, the highest level since 1996.[3] The rise in missed payments can be attributed to both higher financing rates and increased vehicle prices. The delinquency rate for prime borrowers is diminished to just 0.28% during the same period, further representing a strength of household finances for those higher on the income scale.[3]

While inflationary pressures are broadly trending downward, inflation indexes continue to be above the 20-year average, and the stickiness of price increases across goods and services puts more pressure on moderate-to-low-income households. Reduced discretionary income makes it harder to adjust to cost increases, placing more credit risk on lower-income residents typically renting workforce housing.

There is always a risk of a broad economic decline following a period of rate increases. Despite headlines suggesting an outsized risk of a "white-collar recession," data indicates that many white-collar workers are able to find new jobs quickly in this environment, evidenced by stable unemployment insurance (UI) claims during periods of layoffs in white-collar industries over the past four quarters. In fact, UI claims throughout 2023 are at similar levels to pre-pandemic market conditions.[4]

## KEY DRIVER #2: ASSET CLASS FUNDAMENTALS

New supply was the primary influence on multifamily performance in 2023. With 2024 shaping up to deliver a similar number of units to the market, we can look to 2023 data to inform how new unit deliveries may impact different multifamily asset classes. The U.S. saw nearly 440k units delivered throughout the calendar year.[1] The link between new supply and rental growth is well-defined and confirms the clear winners in 2023 were low-supply markets (Figure 2).

**FIGURE 1**
**Labor Market at Glance: Pre-Pandemic vs. Today**

| | 2019 (Pre-Pandemic) | 2023 |
|---|---|---|
| **UI Claims Monthly Average (Not Seasonally Adjusted)** | 1.7M | 1.76M |
| **Labor Force Participation Rate (Year-End)** | 63.3% | 62.5% |
| **Rent-to-Income Ratio (U.S. Median, Year-End)** | 21.7% | 22.8% |

*Sources: U.S. Department of Labor, St. Louis Fed, RealPage*

**FIGURE 2**
**Impact of New Supply on Rent Growth**

| % of Existing Market Delivered (2023) | # of Markets | YoY Rent Change (as of Nov. 2023) |
|---|---|---|
| 5% | 10 | -2.8% |
| 4% - 5% | 9 | -2.4% |
| 3% - 4% | 10 | -1.4% |
| 2% - 3% | 25 | 0.1% |
| 1% - 2% | 48 | 1.7% |
| <1% | 48 | 2.2% |

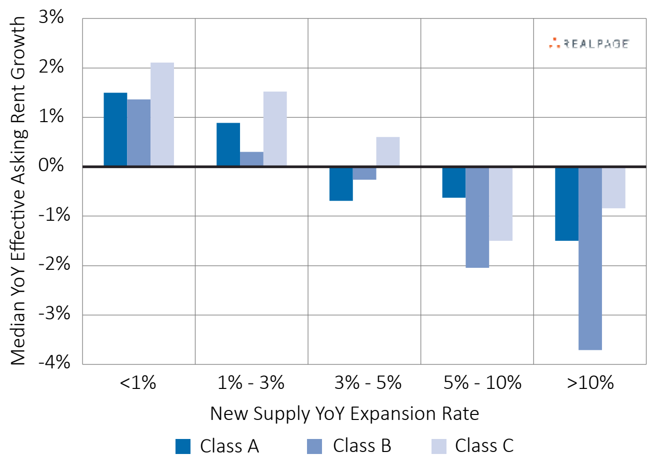
*Sources: RealPage, Q4 2024*

However, there is more nuance beyond headline supply and demand data points. Markets like Dallas and Tampa have daunting headline numbers, but several submarkets remain insulated from new supply pressures, thus outperforming the broader market. This emphasizes a fundamental based, bottom-up approach to asset and location selection. Further, there is a strong bifurcation between the impact of new supply on assets across the quality spectrum.

Developers continue to favor constructing high-end, Class A apartment communities due to resilient resident demand for luxury apartment communities. Most of the 440k units delivered in 2023 have rents at or near the top of the market. Rent growth moderation and lease-up competition brought concessions to many markets. Market expectations throughout 2023 assumed that stabilized and pre-stabilized Class A communities would be the most impacted asset type due to elevated lease-up competition at the top of the market. However, the data suggests that Class B was the most impacted, as concessions on brand-new units compressed effective rent to levels that competed with Class B units.[5] The negative impact on Class B assets becomes more apparent in submarkets with higher levels of supply (Figure3).

**FIGURE 3**

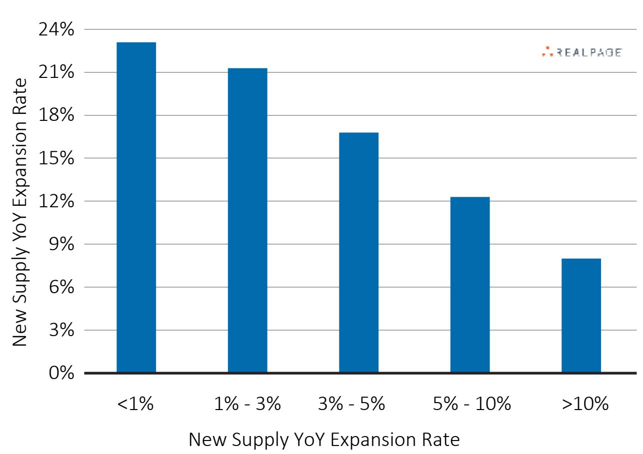
**Median Submarket Rent Growth by New Supply Expansion Rate, September 2023**




*Source: RealPage, Q3 2023*

**FIGURE 4**

**New Construction Rent Gap With Class B by New Supply Expansion Rate, September 2023**




*Source: RealPage, Q3 2023*

The limited impact on luxury, top-of-the-market multifamily demonstrates that some residents are leveraging lease-up competition and recent wage gains by moving from Class B units into higher-quality new construction. In high supply submarkets—where net inventory growth exceeds 10%—the rent premium that new construction has over Class B rents fell to just 8%, compared to the 2022 average spread of 27% between stabilized Class A and B units (Figure 4).[5] Value-add strategies which rely on rent premiums risk driving residents into newly constructed Class A apartments, creating an outsized risk of re-tenanting older vintage assets.

Despite evidence of Class B renters moving up the quality spectrum into more expensive units, rent-to-income ratios remain low in the luxury Class A apartment space at just 22%, suggesting that demographic fundamentals continue to support luxury multifamily assets.[6] Class B apartments provided a necessary discount to top-of-the-market construction during 2021-2022. Now that discount is disappearing, resident incomes are stable, propped up by tight labor market conditions. Further, Class A fundamentals remain favorable due to barriers to acquiring single-family homes, which will lengthen the renter's life cycle.

## KEY DRIVER #3: MARKET SELECTION

New multifamily supply was predominately concentrated in Sunbelt markets throughout 2023 as developers followed where demand was strongest. Migration into the Sunbelt accelerated throughout the COVID-19 pandemic and remains the preferred region for domestic migration.

The top ten MSAs for population growth throughout 2021-2022 are all Sunbelt markets, dominated by cities in Texas and Florida (Census). All ten were among the fastest growing cities in the decade leading up to the pandemic. Additional multifamily units were needed to house growing populations throughout the "Smile States," especially as single-family homes remain unaffordable. The monthly cost of the median home in the U.S. increased by 111% since the start of the pandemic.[7] Costs increased much faster in desirable suburban locations, fueling performance in multifamily assets that provide residents with similar lifestyles to suburban homeownership.

New deliveries are expected to remain at levels similar to 2023 for many Sunbelt markets.[1] However, construction starts are falling rapidly. RealPage estimates that total construction starts declined by an average of 40% in 2023 across the country, and many Sunbelt markets saw a decline of over 50%.[8] Long-term supply/demand fundamentals appear strong, and multifamily performance is poised to benefit from limited supply in the medium-to-long term.

In addition to fast-growing markets throughout the southeastern U.S., many midwestern cities are achieving robust performance primarily due to limited new multifamily supply. Growing employment opportunities and high barriers to homeownership suggest enhanced investor interest.

## KEY DRIVER #4: CAPITAL MARKETS: MULTIFAMILY AS AN ASSET CLASS

Today's macroeconomic environment has created fundamental challenges in certain asset classes, like office. However, where the economic landscape creates structural challenges for other assets, it creates opportunity in multifamily. Strong fundamentals are propped up by a resilient resident base who cannot afford home prices in desirable suburban neighborhoods, and the current volatility in treasury/debt markets combined with upcoming debt maturities are pushing developers and owners alike to sell quality assets to de-risk their holdings. There is not a wide-scale trend of transactions fueled by motivated sellers, but there are select opportunities that support long-term investment strategies.

Housing remains a stable and favorable asset class for both foreign and domestic investors, with multifamily serving as the most efficient method of deploying capital in the housing space on a risk-adjusted basis. The outsized risks in other asset classes push even more capital into multifamily as institutions rebalance portfolios away from office allocations. Capital flows into the multifamily sector will likely compress cap rates in the medium-to-long term. Additionally, the stability of the U.S. economy appears attractive to investors looking to diversify away from global holdings and geopolitical risk.

Low inventory in the for-sale market will be a tailwind to multifamily performance in the coming years. Suburban multifamily, in particular, should benefit, as the largest generation (Millennials) enters their prime earning and family formation ages. This demographic trend will fuel demand for low-density suburban assets in locations where purchasing a home is not attainable for those earning 120%-180% of area median income. Strong schools, resident safety, employment opportunities, and proximity to lifestyle drivers inform micro-location selection within attractive and growing Sunbelt markets.

Additionally, demographic trends, rent-to-income ratios, inflationary pressures, and the present risk of an economic downturn place more risk on the Class B resident—a risk that has not necessarily become apparent in asset pricing in the Class B and value-add markets as cap rates are at similar levels for both Core and Value-Add assets.

## CONCLUSION

Multifamily data suggests long-term supply/demand fundamentals will remain strong in growing markets with diverse local economies and in-demand lifestyle drivers. The current wave of new supply paired with challenges in debt markets provides a unique opportunity to acquire best-in-class multifamily product at or below replacement cost in attractive and growing cities with solid long-term fundamentals.

Class A renters are educated and affluent households, likely substituting the "American Dream" of homeownership with luxury multifamily communities due to elevated homeownership costs. This continues to act as a tailwind to the multifamily market as the challenges to homeownership appear likely to persist due to the shortage of roughly 3.8 million housing units.[9] Additionally, the demographic makeup of these residents helps insulate them from the risks of an economic downturn as educated workers face lower unemployment rates than most blue-collar workers –even during challenging economic times. Please see the White Oak Insight Piece, The Economic Resiliency of Class A for more details.

The state of the single-family home market should continue to act as a tailwind to Class A multifamily. Residents in their prime earning years may prioritize lifestyle and location over building equity in undesirable areas due to low for-sale inventory and uncertainty in the mortgage rate market. Elevated home values appear sticky given the pressure to sell single-family homes is diminished as most homeowners hold attractive fixed rate debt compared to current market conditions.

Long-term supply/demand fundamentals make medium and long-term investment strategies attractive at today's valuations. Debt market volatility creates a window of opportunity to acquire luxury multifamily properties that are backed by strong demand in sought-after markets.

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*[1] RealPage Analytics*
*[2] Delinquency Rate on Credit Card Loans, All Commercial Banks (DRCCLACBS) | FRED | St. Louis Fed (stlouisfed.org)*
*[3] Delinquency Rates At Highest Levels In Almost 30 Years | Bankrate*
*[4] Report r539cy, Employment & Training Administration (ETA) - U.S. Department of Labor (doleta.gov)*
*[5] Supply Surge Softens Class B Assets | RealPage Analytics Blog*
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*[7] 2024 Multifamily Outlook (freddiemac.com)*
*[8] New Census Data Likely Overstating Starts | RealPage Analytics Blog*
*[9] Housing Supply: A Growing Deficit - Freddie Mac*

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