THE CASE FOR WORKFORCE HOUSING

A Market Perspective

NOVEMBER 2018

CBRE

CBRE RESEARCH

WHY WORKFORCE HOUSING?

THE APPEAL

- **Demand**: Market demand is very strong for market-rate multifamily workforce housing—rental communities that are affordable for low- to-median-income families. Limited wage growth over the past decade has contributed to the high number of workforce housing renters.
- **Supply**: New supply is extremely limited, with little new workforce housing being built in recent years. Multifamily product aging into price ranges that are affordable for workforce housing renters has been modest at best.
- **Market Performance**: Workforce housing has outperformed higher-end multifamily for the past four years, with vacancy rates that are below and rent growth that is above the market-wide averages.
- **Investment Returns**: NCREIF returns for garden multifamily—a key component of workforce housing—are considerably higher than the all multifamily average.

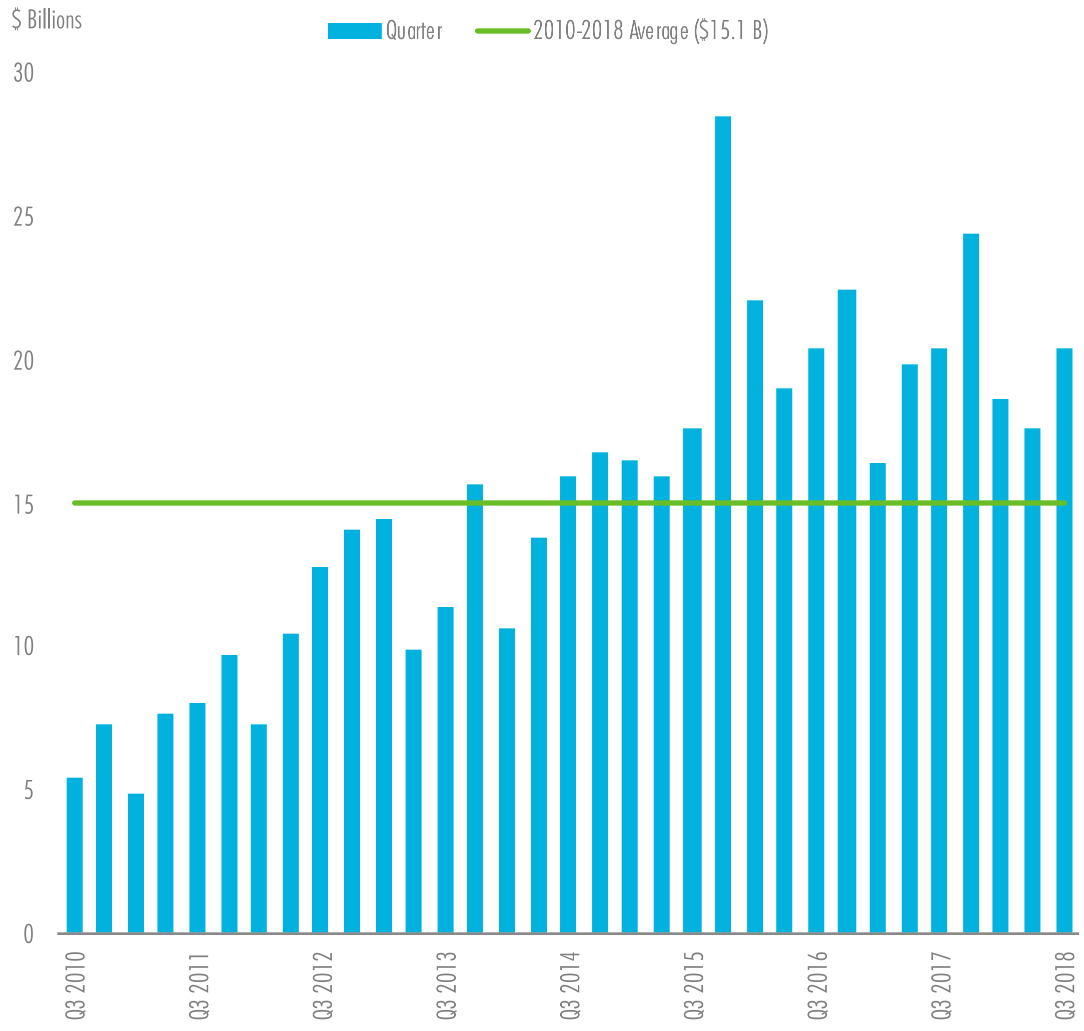
OTHER CONSIDERATIONS

- **Rent Growth**: Housing affordability is a growing concern, and residents in workforce housing pay a relatively high proportion of their income in rent. This circumstance could lead to increased government regulation, such as rent control, which could adversely impact investment in workforce housing.
- **Downcycle Risk**: Historically, Class B and C multifamily has underperformed higher-quality multifamily during economic downturns due to lower levels of household formation and renters' financial stress.
- **Housing Programs**: Other policies plus public and private programs that help to create new workforce housing or maintain the affordability of existing workforce housing could moderate the supply/demand imbalance, if they were to become widespread.

WORKFORCE HOUSING IN THE MULTIFAMILY WORLD

- Workforce housing has outperformed the overall multifamily market in recent years with relatively low vacancy rates and above-average rent growth.
- The healthy market performance has attracted significant investment interest and activity. Nearly $375 billion has been pumped into the workforce housing market over the past five years—51.3% of the total for all multifamily assets. Moreover, the capital has increasingly come from unlikely sources, including institutional and cross-border investors (often indirectly via funds).
- One of the key questions in the marketplace today is whether investment in workforce housing still makes sense. To answer this, CBRE Research has analyzed the property market fundamentals of workforce housing and how well it is performing vis-a-vis other types of multifamily housing. This report addresses factors behind the demand and supply trends, and identifies which metro markets are currently outperforming national trends.
- The report also identifies risks to workforce housing investment, including demand's sensitivity to economic downturns and the prospect for future rent growth amid growing concerns about housing affordability. Other risks include potential rent control regulations and widespread expansion of public and public/private workforce housing programs.
- Despite the risks, workforce housing has very strong supply/demand fundamentals that give the sector a solid foundation to provide continued good investment returns.

Figure 1: U.S. Multifamily Workforce Housing Investment



Source: CBRE Research, Real Capital Analytics, Q3 2018. Investment of garden-style properties built in 2003 or earlier.

WHAT IS WORKFORCE HOUSING ????????

Most industry participants define workforce housing as that in which families earning 60% to 100% of area median income (AMI) live. Often the upper end of the range is extended to 120% of AMI, especially in higher-cost metros. Using the nation's 2017 median income of $60,336, the 60%-to-100% range of AMI roughly equates to between $36,200 and $60,300.

Workforce housing does not include government-sponsored affordable housing, which predominantly caters to families earning below 60% of AMI. There are also programs for families earning 60% to 120% of AMI, but they have some type of rent and/or income restrictions. This report focuses on market-rate workforce housing, which represents the majority of the product.

Workforce housing is not entirely multifamily; it also includes single-family housing. Nevertheless, multifamily represents the predominant investment opportunity for the workforce housing sector, and market-rate multifamily housing is the focus of this report. References to workforce housing in this report are references to the multifamily sector.

Multifamily workforce housing is a combination of Class B and Class C product. Some Class B properties would not qualify, but using classes is a frequent and adequate approach.

Workforce housing is composed of mostly older (pre-2000s product) and mostly suburban garden-style communities. Renters in these communities are often "renters by necessity" vs. "renters by choice."

SUPPLY DYNAMICS

Approximately 12 Million Multifamily Workforce Housing Units Nationwide

- There are approximately 12 million multifamily workforce housing units in the 66 major metros tracked by CBRE Econometric Advisors (CBRE EA). The estimate is derived from CBRE EA's total 14.9 million units for all types of multifamily housing and their class breakout of 20% Class A, 60% Class B and 20% Class C.
- Not all Class B communities are considered workforce housing. However, CBRE EA does not track most properties with less than 50 units, many of which could be considered workforce housing assets.
- A more comprehensive full national count would, of course, be higher. CBRE EA's database covers most of the 1+ million population metros, but only a handful of metros with less than 1 million population. The multifamily inventory in smaller metros tends to be older and more moderately priced.

Minimal Additions to Workforce Housing Inventory

The creation of workforce housing normally occurs through product aging (sometimes referred to as "naturally occurring affordable housing" or NOAH) and sometimes through changes in neighborhood appeal, rather than through new development.

The most recent cycle is no different. Nearly all the new inventory is at the top end of the quality and rent spectrum, and minimal new workforce product has been built. Developers and industry leaders have sought ways to deliver less costly multifamily housing, but few market-rate solutions have been found.

Over the past decade, a small amount of new workforce housing has been built, although the exact total is difficult to determine. Most of it has come from inclusionary housing policies that require developers to set aside a certain number of workforce housing units in any new development or contribute financially to the creation of workforce housing offsite. While an important contribution to the workforce housing supply, these new units represent only a small amount of workforce housing today.

At this point in the cycle, much of the multifamily development activity has shifted from urban core to "greenfield" suburban. Garden-style multifamily construction is increasing. However, even for the new garden product in less expensive metros, the development economics are still a challenge. For example, the lowest construction cost for garden development in the South and Southeast is around $165,000 per unit. Even at this construction price, rents are still too high for most workforce housing families.

Natural Creation of Workforce Housing Slower in This Cycle

Obsolescence is reducing workforce housing inventory. The multifamily industry traditionally removes more than 100,000 units per year due to obsolescence, and these are predominantly workforce and affordable housing units. The large amount of supply added in the 1960s and 1970s is likely contributing to higher obsolescence than in previous cycles.

Many older apartment communities have been demolished to accommodate the development of new Class A properties during this cycle. In prior cycles, nearly all development occurred on previously undeveloped sites. The value-add investment and redevelopment activity has increased the rents and decreased the affordability of a large portion of older

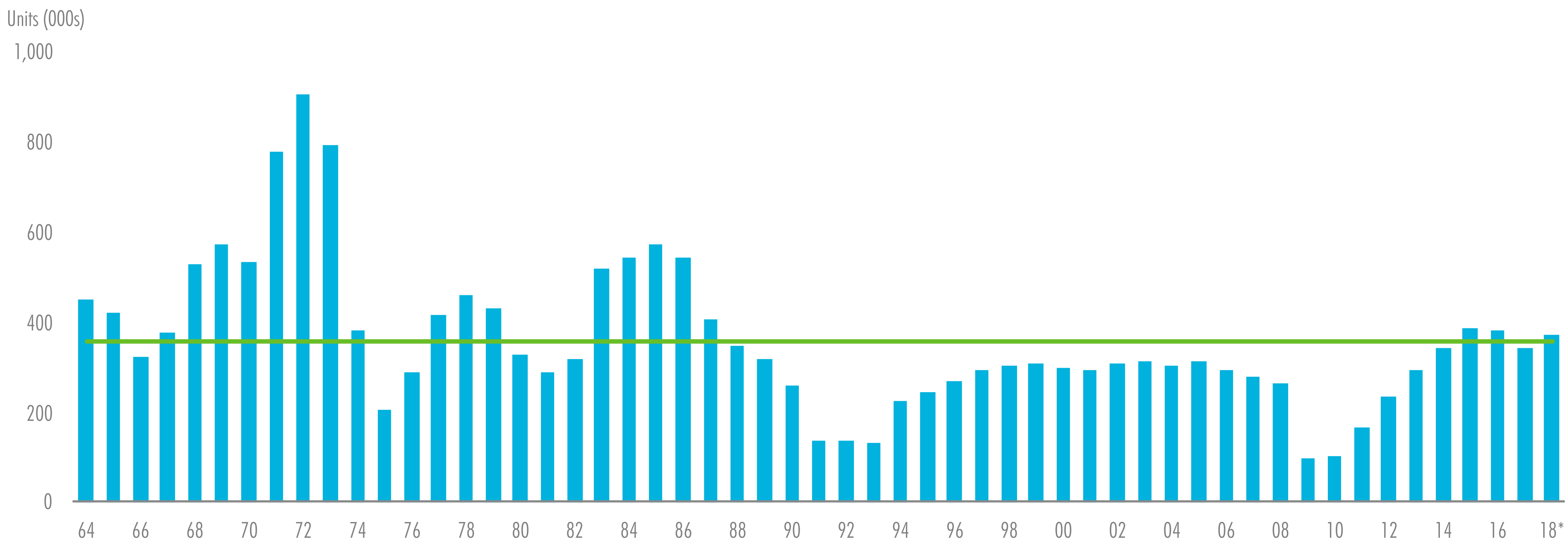
multifamily inventory. While most of this value-added product can still be considered workforce housing, some has been upgraded enough to lift units into Class A-/B+ status, and to lift rent levels beyond affordability for many workforce housing renters.

The redevelopment of older housing units, however, has been tremendously valuable to the multifamily sector. The work has helped to correct deferred maintenance and provide better-quality and updated housing units to many workforce housing renters. The physical improvement of older multifamily housing properties have also made them more attractive to investors.

The organic creation of more moderately-priced multifamily units has been slower this cycle than in previous ones. This likely will continue over the near term due to the abundant value-add activity and the much higher-quality product built in the 2010s, including mid-rise and high-rise developments.

The amount of inventory that will age into workforce housing is smaller than in previous cycles. The number of multifamily assets built in the 2000s exceeded that of the prior decade but was less than the production of the 1970s and 1980s as shown on Figure 2.

Figure 2: U.S. Multifamily Starts, 1964 to 2018



*2018 is average annual seasonally-adjusted figure for January through September. Includes for-sale multifamily. Green horizontal line = historical annual average of 359,300 units.

Source: CBRE Research, U.S. Census Bureau, Q3 2018.

Figure 3: Five Trends Impacting Existing Workforce Housing Supply This Cycle

1. GENERAL OBSOLESCENCE

Older properties removed for a variety of reasons. Not unique to this cycle, but possibly enhanced due to abundance of 1960s and 1970s product.

2. SITE REDEVELOPMENT

Properties scrapped for ground-up development of new Class A communities. Particularly driven by urban in-fill development, gentrification of older neighborhoods.

3. VALUE-ADD UPGRADING

Some properties upgraded enough to move out of price range of most workforce housing renters.

4. NOAH PROCESS SLOWER

Organic creation of workforce housing slower this cycle due to large volume of value-add activity and the high quality product that has been built in past decade.

5. AVAILABLE OLDER STOCK SOMEWHAT LIMITED

Amount of 2000s product kept pace with late 1990s, but the first half of 2010s produced lower levels of new supply ("feedstock" for future workforce housing).

Source: CBRE Research, Q3 2018.

DEMAND: SIZE OF RENTER BASE

The number of single-family and multifamily workforce renter households totaled roughly 13.5 million in 2017, according to the U.S. Census Bureau. These households are represented in the orange and yellow slices of the Figure 4 pie chart.

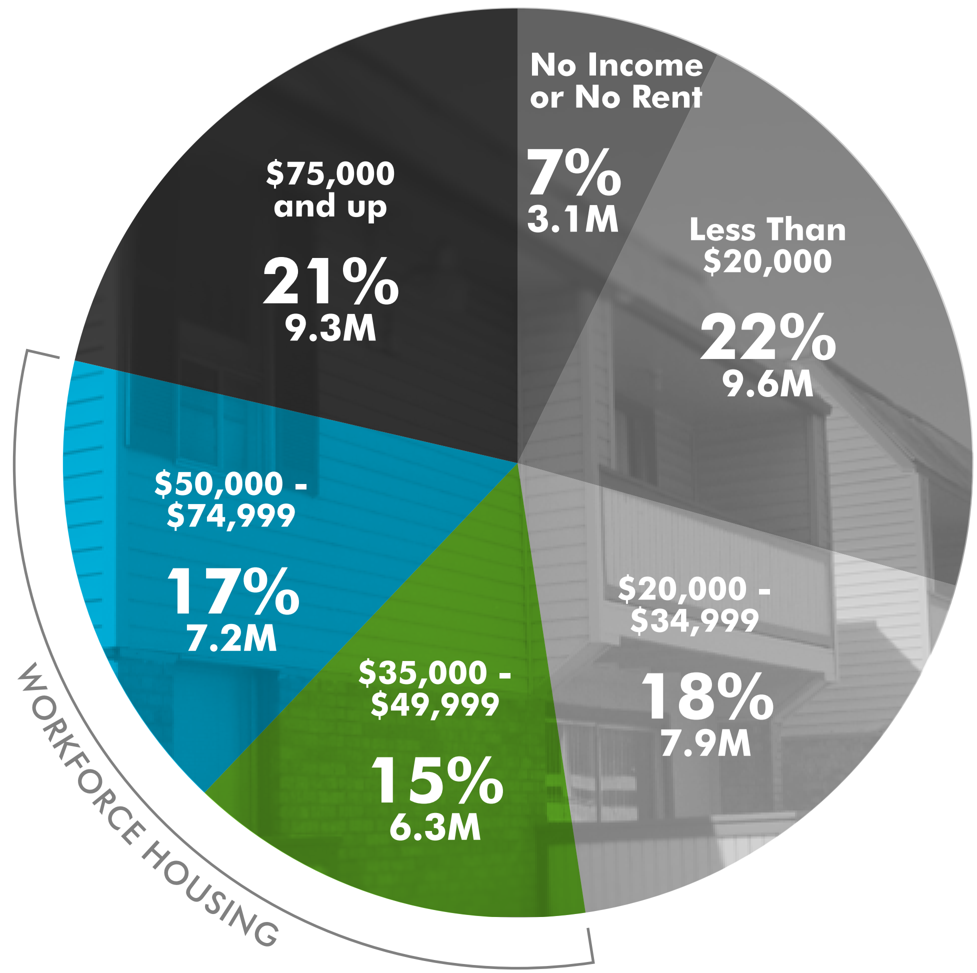
Demand for workforce housing is not limited to individuals and families whose incomes are in the 60%-to-100% AMI range. Higher-income households often choose more affordable housing for a variety of financial and non-financial reasons (i.e., paying off student debt, saving to buy a house, proximity to family and employment, etc.).

At the lower end of the income scale, many families that qualify for affordable housing, earning 60% or less of AMI, end up in workforce housing since there is a critical shortage of affordable housing.

Most individuals and families in workforce housing do not have the financial means for homeownership. Some will in the future, certainly, especially if they are young and getting started in careers, but the majority are truly “renters by necessity” and stay in workforce housing.

Single-family rental housing is an alternative for some individuals and families in multifamily workforce housing. However, lack of transparency in availability, as well as rising rents (average 4.2% year-over-year increase since 2015 for securitized portfolios), makes single-family renting an option only for a small portion of multifamily renters.

Figure 4: U.S. Renter Households by Income Ranges



The workforce housing categories are the green and blue slices, representing approximately 58% to 123% of U.S. median income of $60,336.

Source: CBRE Research, U.S. Census Bureau, American Community Survey, 2017 data released Q3 2018. Households based on renter housing units. Includes both single-family and multifamily units. The Census reported a total of 43.4 million renter households in 2017.

Similarly, most workforce housing renters have a hard time moving up the quality spectrum to Class A and B+ units. The average differential in rent between Class A and Class B product as of Q2 was $777 per month or 47%. While the percentage difference has edged down over the past five years (with Class B and Class C rent growth outpacing Class A), the dollar differential is near its highest level in this real estate cycle.

Since the last recession, multifamily rents have increased by 3.6% per year on average, while wages have grown only 2.2%. Single-family median home prices have increased 6.5% per year since the recession, thus making it more difficult for middle-income and lower-middle-income earners to buy homes.

Limited alternative options for workforce housing renters means very strong and sustained demand for workforce housing apartments. As a result, workforce housing should hold up better during the next economic downturn than it did during past recessions.

During past downturns, Class A product outperformed Class B and C due to the greater financial vulnerability of renters in lower-priced communities. This dynamic is not totally going away, but the current market trends mean fewer choices for workforce housing renters, thereby mitigating some of the downside risk for investors.

Figure 5: Summary of Market Performance by Category, Q2 2018

CATEGORY		EFFECTIVE RENTS		VACANCY	
		RENT	Y-o-Y CHANGE (%)	Q2 2018 (%)	Y-o-Y CHANGE (BPS)
Total	Sum of Markets	1,685	2.0	4.7	10
Class	Class A	2,440	2.2	5.1	0
	Class B	1,663	1.8	4.6	10
	Class C	1,021	3.0	4.2	30
Submarket Type	Urban	2,459	0.3	4.7	-10
	Suburban	1,492	2.4	4.6	10
Structure Type	High-Rise	1,974	1.2	5.3	20
	Garden	1,204	3.3	5.0	10
Year Built	2000s/2010s	1,612	2.6	5.2	-10
	1990s	1,360	3.0	5.1	10
	1980s	1,257	3.3	4.8	0
	1970s	1,182	3.5	4.8	30
	1960s	1,183	3.0	4.8	40

Most categories do not include all units tracked by CBRE EA. Note that the "data cuts" are based on different sample weightings; therefore the statistics do not totally match with the sum of markets statistics or with other data cuts.

Source: CBRE Research, CBRE Econometric Advisors, Q2 2018.

WORKFORCE HOUSING MARKET PERFORMANCE

Market Performance by Class

Traditional measures of market performance—particularly rent growth and vacancy—indicate that workforce housing is performing better than higher-end multifamily housing and better than in most previous years.

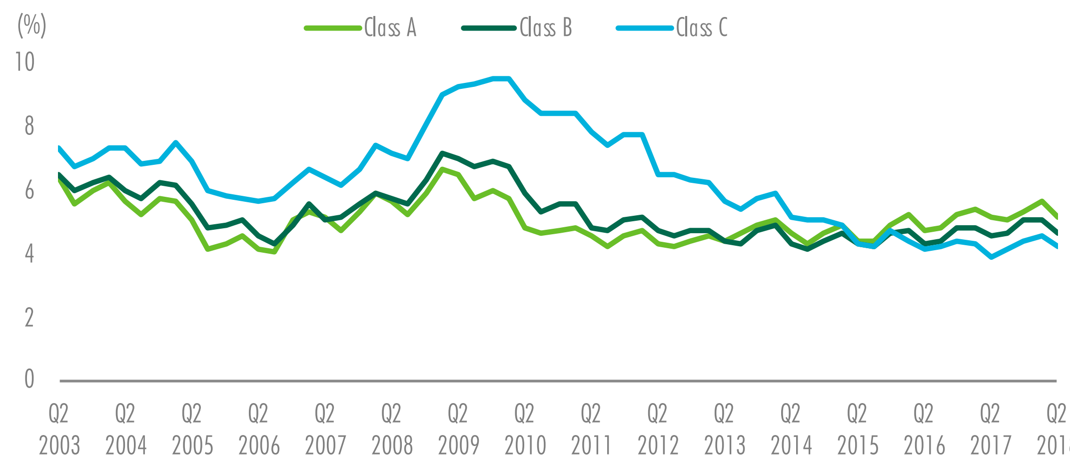
With respect to performance by class, Class C is outperforming Class A in both vacancy and rent growth. Class B is essentially on par with Class A for rent growth, but has lower vacancy rates than Class A.

Vacancy rates for all three classes converged in 2015. Since then, both Class B and Class C vacancy rates have fallen below that of Class A. As of Q2, Class C vacancy was 4.2%, near its long-term low of 3.9% in Q2 2017. Class B's 4.6% vacancy is one-half point above its long-term low of 4.1%, but well under the long-term average of 5.3%. In contrast, Class A's Q2 rate of 5.1% was at its long-term average and 1 point above its low (4.0%) in Q3 2006.

Class C's Q2 year-over-year rent growth of 3% was higher than Class A and Class B and above its long-term average of 2.5%. In contrast, Class A's 2.2% and Class B's 1.8% year-over-year rent increases were both below their respective long-term averages.

A closer look at the history of Class B rents is useful since a large portion of workforce housing falls within this sector. The greatest rent gains occurred from 2014 to 2016 and have cooled since then. Class C rent growth also was particularly robust during the same period and has held up better in 2017 and 2018.

Figure 6: Historical Multifamily Vacancy by Class



Class A represents the top 20% of communities based on average property rent; Class C represents the bottom 20%.

Source: CBRE Research, CBRE Econometric Advisors, Q2 2018.

Figure 7: Historical Multifamily Rent Change Year-over-Year by Class

Class A represents the top 20% of communities based on average property rent; Class C represents the bottom 20%.

Source: CBRE Research, CBRE Econometric Advisors, Q2 2018.

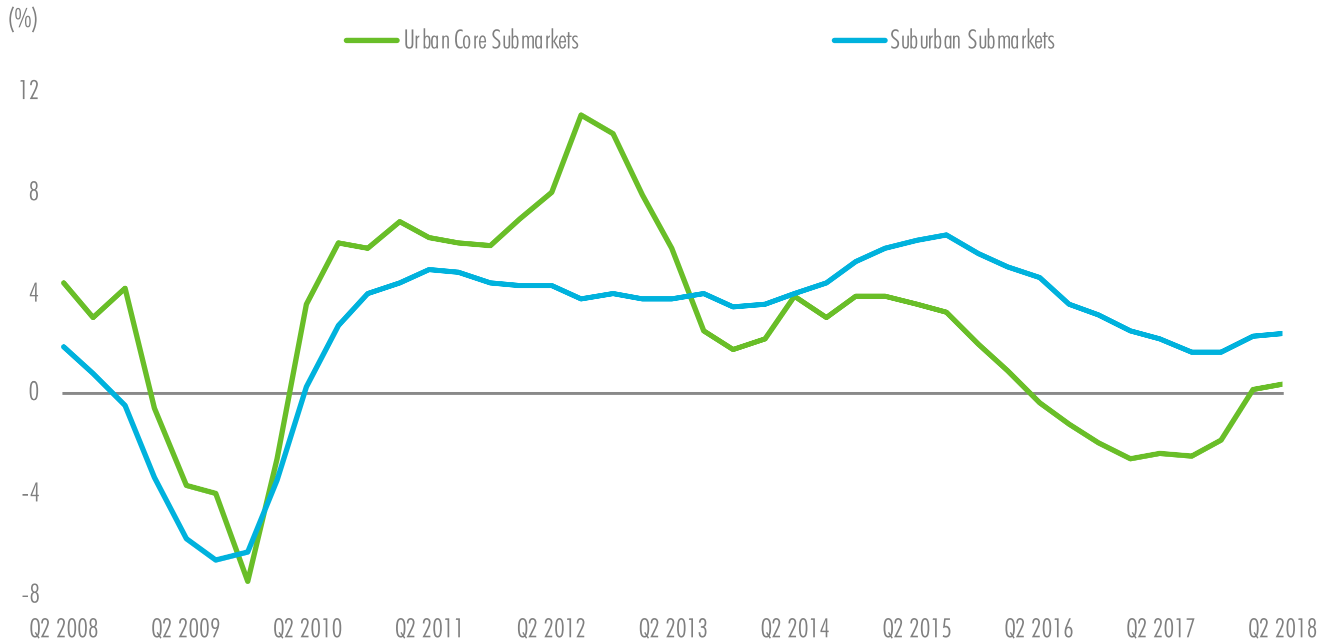
Like the performance differences by class, older product has been outperforming newer product. Multifamily units built between 1960 and 1990 had an overall vacancy rate of 4.8% in Q2 vs. a low-5% rate for units built thereafter, according to CBRE EA.

Similarly, effective rent growth for older multifamily product—especially that of the 1970s and 1980s—is above that of newer product.

Suburban Rent Growth Outpacing Urban

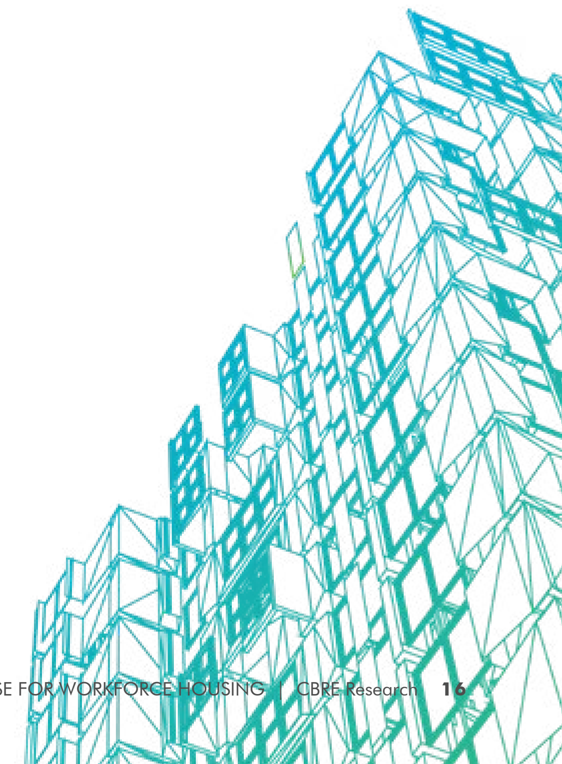
A second market segmentation provides another lens into the outperformance of workforce housing: urban core submarkets vs. suburban submarkets. Some urban product is workforce housing and some suburban is higher end, but workforce housing is a significant portion of existing suburban inventory.

Figure 8: Urban - Suburban Rent Change Year-over-Year



Suburban submarkets are those not contiguous with the urban core submarkets.

Source: CBRE Research, CBRE Econometric Advisors, Q2 2018.



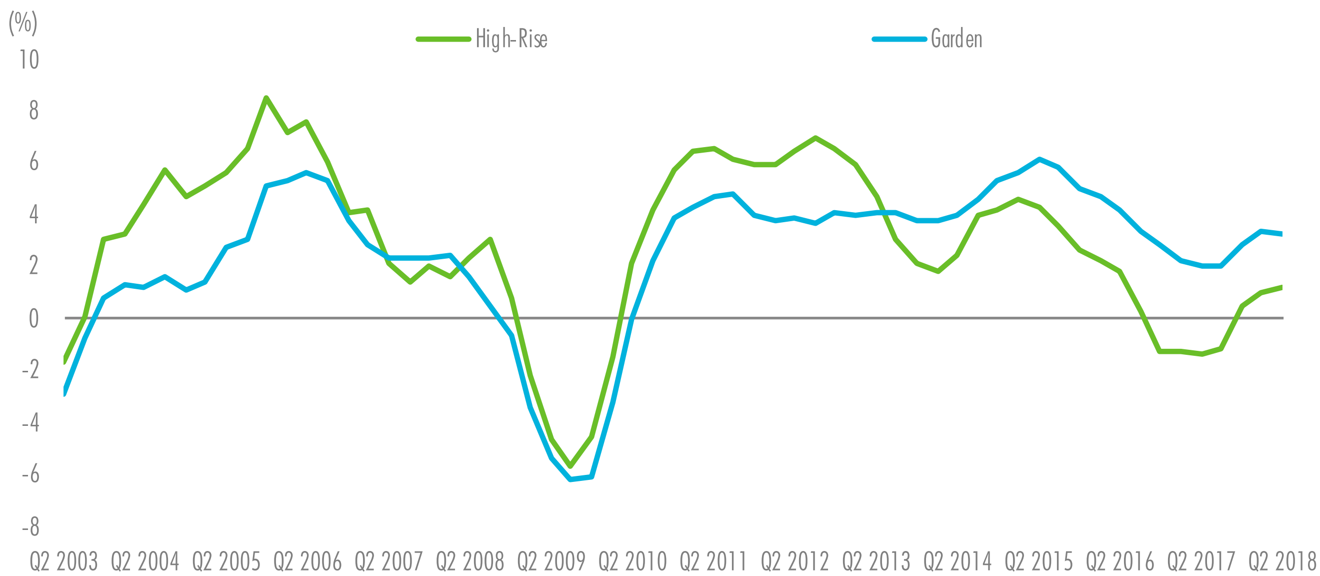
As of Q2 2018, vacancy rates are comparable: 4.6% for suburban and 4.7% for urban core submarkets. However, suburban rent growth of 2.4% year-over-year is healthier than urban core's flat 0.3%. For the entire post-recession period, average annual rent increases for suburban multifamily have been higher than urban: 4.0% vs. 3.1%.

Suburban assets have enjoyed higher rent increases than urban since late 2013, when new supply began to impact the urban core submarkets. However, suburban rent growth has moderated in the past few years.

Garden Assets Enjoy Lower Vacancy & Higher Rental Increases

Market data for garden product vs. high-rise assets reveals the stronger performance of garden product over the past five years (since Q3 2015), with garden's five-year average rent gain at 3.8% vs. 1.6% for high-rise. For the year ending Q2 2018, garden multifamily has achieved an average national rent increase of 3.3% vs. 1.2% for high-rise product.

Figure 9: Garden/High-Rise Multifamily Rent Change Year-over-Year



Class A represents the top 20% of communities based on average property rent; Class C represents the bottom 20%.

Source: CBRE Research, CBRE Econometric Advisors, Q2 2018.

Garden product vacancy was slightly under the high-rise average as of Q2. This is a statement in itself, since garden product maintained a higher vacancy over the 2002-2014 period and then was on par with high-rise from 2015 through 2017. Over the 2002-2018 period, garden vacancy averaged 6.2%, 1 point higher than the high-rise average.

Garden Product Enjoys Higher Investment Returns

Current return values from the NCREIF Property Index (NPI) also provide a view of workforce housing investment performance and confirm the sector's investment appeal. The Q3 one-year returns for garden assets averaged 9.25%, nearly double the high-rise return of 4.87%. For garden assets, both the appreciation and the income returns were favorable. The biggest difference between garden and high-rise is appreciation. NCREIF's appreciation return for high-rise assets has been at low, though stable, levels over the past two years.

As of Q3, among all 16 property sector subtypes, garden apartments had the fifth highest one-year return after all of industrial's four subtypes.

Over the past 20 years, one-year returns for high-rise assets averaged a healthy 10.09%, just slightly ahead of garden's 9.94%. Over the period, however, garden returns experienced much less volatility as indicated by the standard deviation calculations.

Figure 10: NCREIF Returns

MULTIFAMILY SUBTYPE	CURRENT ONE-YEAR RETURN			20-YEAR HISTORY	
	TOTAL RETURN (%)	INCOME RETURN (%)	APPRECIATION RETURN (%)	AVERAGE TOTAL RETURN (%)	STANDARD DEVIATION (%)
High-Rise	4.87	3.97	0.88	10.09	10.03
Garden	9.25	5.00	4.10	9.94	7.79
Low-Rise	7.17	4.31	2.78	9.73	8.36
All Types	6.35	4.30	1.98	9.55	8.38

High-rise is defined as 4+ stories. 20-year history based on one-year total returns from Q3 1998 through Q3 2018. The low-rise category is quite small. Garden is the best surrogate in this database for workforce housing.

Source: CBRE Research, NCREIF, Q2 2018.

LEADING METROS & LOCATIONAL CONSIDERATIONS

Workforce housing is generally performing well across all metros and submarkets. Yet, there are some broad patterns to geographic variations in performance.

The markets with the highest workforce housing rent growth (using Class B multifamily housing as a proxy) are predominantly higher growth metros. Orlando and Las Vegas led the country, both with 7% rent increases for the year ending Q2. Another nine metros have growth rates of 4% or above.

Cyclical market behavior should also be considered. In the past, workforce housing metrics have been more volatile in markets where demand and supply have varied considerably (more boom/bust-type markets). But past cyclical behavior may not be an indicator of future cycles given the shortage of workforce housing today.

Nearly all submarket types and locations are benefitting from workforce housing's strong market conditions. Nevertheless, locational characteristics partly govern value.

As with all multifamily assets, proximity to employment centers, especially expanding ones, is favored. Access to good public transportation and/or highway systems adds to asset value. Other considerations are proximity to good schools and location in safe neighborhoods. Some workforce housing is in high-crime areas—a risk that investors may not want to assume. Moreover, in many apartment communities with lower rents (especially Class C), there often is a higher resident credit risk, posing operational and financial challenges.

Figure 11: Leading Metros for Class B Rent Growth, Q2 2018

	METRO	RENT GROWTH Y-o-Y (%)	VACANCY	
			Q2 2018 (%)	Y-o-Y CHG (BPS)
1	Orlando	7.4	4.2	13
2	Las Vegas	7.2	4.5	-38
3	Jacksonville	5.9	4.6	-33
4	Columbus	5.2	3.6	-42
5	Tampa	5.1	4.3	-58
6	Phoenix	4.9	4.8	-20
7	Houston	4.8	6.3	-107
8	Inland Empire	4.4	3.4	-16
9	Atlanta	4.4	5.5	5
10	San Diego	4.0	4.2	18
11	San Jose	4.0	3.7	-67
12	Los Angeles	3.9	4.2	6
13	Minneapolis	3.8	3.1	56
14	Indianapolis	3.8	5.7	-8
15	Sacramento	3.6	4.4	59
16	Salt Lake City	3.5	4.2	-7
17	Detroit	3.5	3.6	-5
18	Providence	3.4	3.0	-31
19	Ft. Worth	3.4	4.7	32
20	Ft. Lauderdale	3.2	4.9	-110
21	Pittsburgh	3.1	4.2	-183

Based on 50 metros with 50,000+ units in Class B inventory.

Source: CBRE Research, CBRE Econometric Advisors, Q2 2018.

WORKFORCE HOUSING RISKS

Housing Affordability & Renters' Ability to Absorb Rent Increases

Even with strong property fundamentals, the current market environment poses a few risks to workforce housing that could limit demand and/or owners' pricing power in the near future or in a recession.

Demand for workforce housing may slow, as rent growth has been outpacing income growth for most of the past decade. This has given rise to much discussion about housing affordability or lack thereof.

So far, the depth of demand has kept this risk on the back burner. If individual renters cannot afford rent increases and leave workforce housing for other options, their apartments have been readily filled by new residents. Still, housing affordability remains a real problem that workforce housing owners and investors cannot ignore.

More than one-third of workforce renter households (both multifamily and single-family renters) were considered "rent burdened" last year in that their rent payments represented 30% or more of their incomes. For renter households in the lower portion of the workforce housing range (earning $35,000 to $49,999), 48% paid 30% or more of their incomes on rent.

The percentages of workforce housing renters paying 30% or more of their incomes on rent have been rising as well. More than 35% of them did so last year, compared to less than 21% in 2006. If the data were

Figure 12: Rent-to-Income Levels by Income Category, 2017 - Percentages of Total Renter Households

	PERCENTAGE PAID ON RENT (OF TOTAL MULTIFAMILY RENTERS)			
INCOME RANGE	<20%	20%-29%	30%+	TOTAL
Less Than $20,000	0.6	2.0	19.5	22.1
$20,000 - $34,999	1.0	3.2	14.1	18.3
$35,000 - $49,999	2.2	5.4	6.9	14.5
$50,000 - $74,999	5.8	6.7	4.0	16.5
$75,000 and up	14.6	5.4	1.4	21.4
No Income and/or No Rent	-	-	-	7.2
Total	24.1	22.7	46.0	100.0

	PERCENTAGE PAID ON RENT (WITHIN INCOME RANGE)			
INCOME RANGE	<20%	20%-29%	30%+	TOTAL
Less Than $20,000	2.5	9.1	88.4	100.0
$20,000 - $34,999	5.4	17.6	77.0	100.0
$35,000 - $49,999	15.1	37.2	47.7	100.0
$50,000 - $74,999	35.2	40.4	24.4	100.0
$75,000 and up	68.2	25.3	6.6	100.0
Total	24.1	22.7	46.0	

The income ranges of $35,000 to $49,999 and $50,000 to $74,999 most closely approximate workforce housing families.

Source: CBRE Research, U.S. Census Bureau (American Community Survey), 2017 data released Q3 2018.

adjusted for inflation, the increase would be even more pronounced.

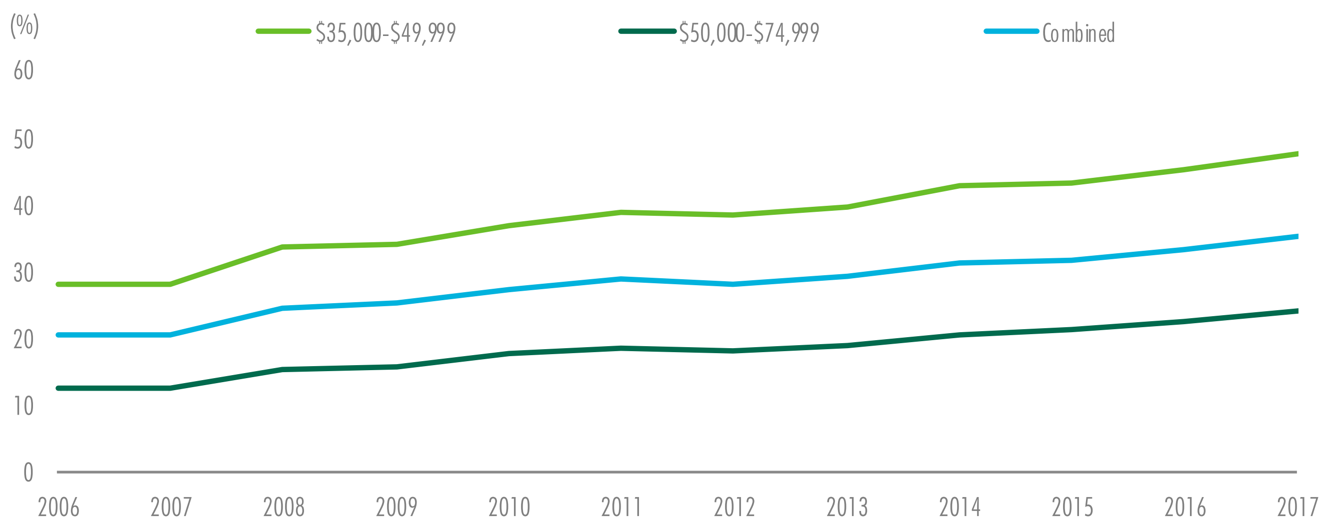
The challenge that some households have in keeping up with rent increases is apparent in some parts of the marketplace (e.g., contributing to slower lease-ups of renovated units in value-add assets).

Household Formation Slows During Recessions

In recessionary periods, household formation declines and housing demand falls. Consequently, demand for workforce housing could fall when the next economic downturn occurs, as individuals and families seek alternative housing arrangements such as living with relatives and doubling up with roommates to save on housing costs. Additionally, young adults delay moving out of their childhood homes, and immigration rates fall as job opportunities dissipate.

The reduced level of household formation during and immediately following the last recession was particularly strong. Household growth fell from 1.34 million households in 2007 to only 286,000 in 2010. Class C vacancy rose to more than 9% and Class B to more than 7%, while Class A peaked at just 6.8%.

Figure 13: Historical Percentage of Workforce Housing Renters Paying 30%+ of Income on Rent



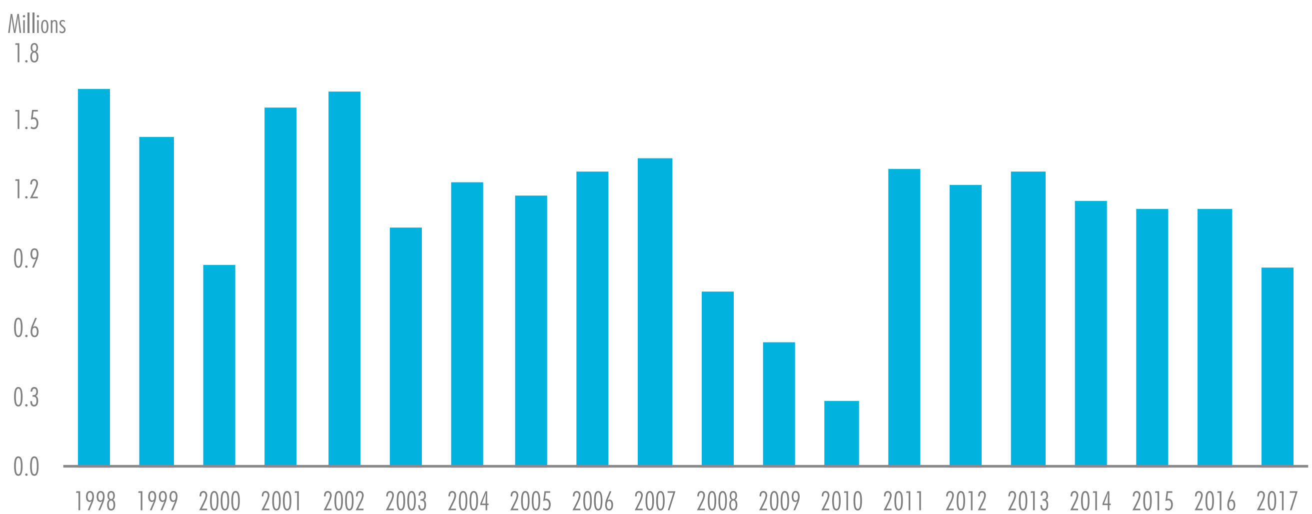
Source: CBRE Research, U.S. Census Bureau (American Community Survey), 2017 data published Q3 2018.

Renters of Class B and especially Class C assets are often less financially secure and more sensitive to rent increases. Many do not have the financial wherewithal to stay in their apartments if their income is reduced significantly. Moreover, many of them are in professions more sensitive to economic downturns.

The strength of today's workforce housing market, coupled with limited housing alternatives, should mitigate the impact of the next recession. Several factors are in play. As already discussed, the workforce housing market is currently undersupplied. In addition, the gap between Class A and Class B rents is large. As of Q2, the average Class A monthly rent was $777 or 47% higher than Class B. Downturns can bring enough concessions to Class A apartment renters that attract those from Class B communities. However, flight-to-quality trends should be less pronounced in the next downturn due to the substantial rent differential between older product and the newer Class A inventory.

Additionally, most economists believe that the next recession will be much milder than the last. Therefore, the recessionary reduction of household formation and of multifamily demand should be much less severe.

Figure 14: U.S. Household Growth Past 20 Years



Source: CBRE Research, U.S. Census Bureau (American Community Survey), 2017 data published Q3 2018.

Rent Control Policies Could Affect Rent Growth

Rent control is not common in the U.S. but has gained momentum in high-cost cities. With not enough affordable housing (housing for families that make less than 60% of AMI) to meet demand and with a tight supply of workforce housing, policy makers are seeking solutions to control housing costs and help meet the housing needs of lower- and middle-income Americans.

Economists generally believe that rent control ultimately is counterproductive to solving the affordable housing problem. Rent control makes markets less attractive for investment in and development of new multifamily housing, thereby leading to an availability shortage and ultimately to higher rents.

Nevertheless, rent control discussions and proposed legislation have been occurring more frequently in many parts of the country, including California, Washington, Oregon, Illinois and Washington, D.C. Rent control generally limits the amount of rent increases on units at the time of renewal, as well as when the unit is vacated and re-leased.

VALUE-ADD STRATEGY MORE AT RISK FROM AFFORDABILITY CONCERNS

Of the two principal workforce housing investment strategies—stabilized and value-add—the affordability issue may present a greater risk to the highly popular value-add, which depends on significant rent increases for success. In lower-priced markets, monthly rent increases tend to range between $75 and $100, while in higher-priced markets they average in the $100-to-$200 range.

Investors have been attracted to value-add opportunities for the higher yield potential post renovation—not only compared to stabilized assets of the same vintage, but also to other types of multifamily such as core.

Pricing for assets with value-add potential reflects the popularity of the strategy. CBRE's recently released North America Cap Rate Survey H1 2018 revealed that expected returns on cost for value-add acquisitions remained at very low levels: 5.95% for infill assets and 6.27% for suburban. The low expected returns on cost clearly reflected the competitive buying landscape, the strong appetite for this investment type and the acceptance of moderate returns.

Despite the financial stress on some renter households today and the broad affordability concerns, the odds of value-add buyers obtaining the rent growth needed to justify the investment are still very good.

Investment in stabilized workforce housing assets is also supported by market fundamentals and carries less risk from an affordability standpoint. The strategy focus is on current income and income durability; owners do not obtain large NOI increases from rent growth, but gain steady income coupled with moderate rent growth.

Like value-add investing, stabilized workforce housing investment is expensive from a historical perspective given the low cap rate pricing of Class B and C acquisitions. CBRE's H1 2018 Cap Rate Survey reported that infill Class B and C cap rates were averaging 5.14% and 5.87%, respectively. For suburban assets, Class B and Class C cap rates were 5.41% and 6.24%. All of these rates represented the lowest levels since CBRE began the semiannual cap rate surveys in 2009. The spreads between Class A and B and between Class B and C cap rates were also very tight. Class A cap rates were 4.65% and 4.94% for infill and suburban assets, translating into Class A-B spreads of only 49 and 47 basis points for infill and suburban assets, respectively.

Buying stabilized workforce housing is an attractive strategy for longer-term holders. Today's investment marketplace is generally less competitive for stabilized product than for value-add, and therefore offers better pricing for buyers. However, sellers favor the pricing they can achieve from value-add buyers, who typically outbid stabilized asset buyers.

For both value-add and stabilized asset workforce investment there are two other major considerations. Replacement costs for all types of housing are rising steadily. This perspective helps to justify the high prices (low cap rate pricing) of workforce housing assets.

However, on the negative side, a notable risk to the success of workforce housing investment is underestimating operating costs, as well as the necessary capital expenditures needed to maintain older multifamily communities. Older properties often have higher expense ratios. Buyers familiar with just Class A assets may have an operational learning curve.

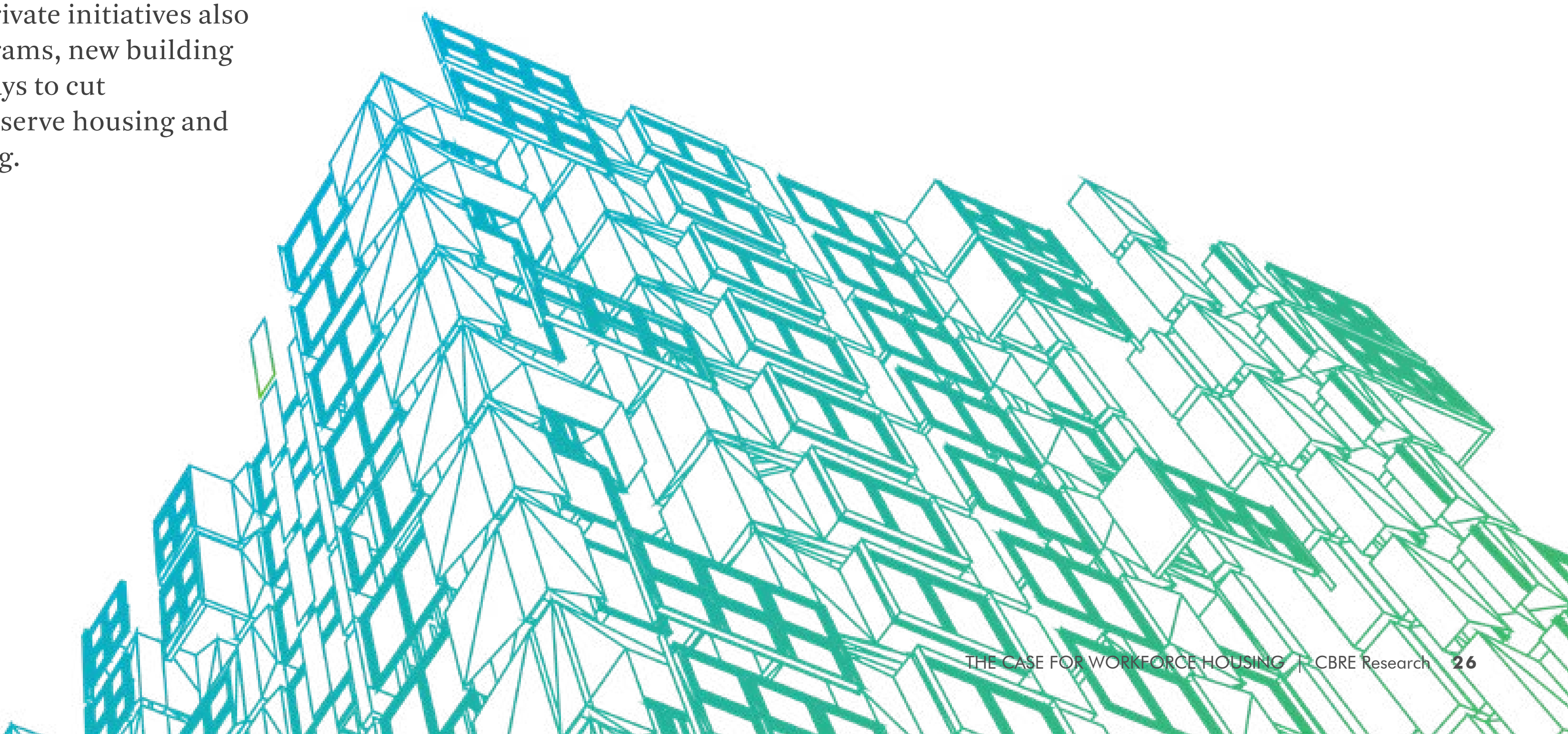
Efforts to Improve Workforce Housing Availability Could Impact Market Balance

Throughout the U.S., at all levels of government and even in private industry, there are numerous existing and proposed programs to help improve housing options for lower-middle-income and middle-income families. These varied programs are over and above the affordable housing programs specifically targeted for aiding families making less than 60% of AMI.

Public initiatives range from proposed changes to federal housing policies down to land use regulations and inclusionary housing policies at the local level. Public and private initiatives also include new financing programs, new building methods and many more ways to cut development costs, help preserve housing and help families pay for housing.

The wide variety of housing programs are mostly positive for the housing industry and for broad societal goals of providing enough safe and affordable housing for all Americans. They also offer many opportunities for developers and investors.

Paradoxically, however, if the publicly- and privately-led housing programs in place and under discussion throughout the U.S. became widespread, they could reduce the current supply-demand imbalance that is causing workforce housing rent growth. However, no matter the success of many of the programs, near-term solutions to building and preserving affordable housing will only alleviate rent stress at the margins.



CONCLUSIONS

Workforce housing has been outperforming the broader multifamily market for several years, and likely will continue to do so over the near term. Market metrics, such as lower vacancy rates and higher rent growth, provide statistical proof of the sector's superior performance and a compelling argument for continued investment in it.

The past decade has produced only minimal new supply, and demand remains very high due in part to lack of alternative housing options. Returns are moderate in today's highly competitive investment marketplace, but workforce housing investment — both for value-add and stabilized assets—remains a very attractive strategy.

The marketplace is not without risks. Workforce housing affordability and renters' ability to pay higher rents have begun to create some resistance to rent increases and may limit them further in the future. In past recessions, Class B and C multifamily housing vacancy rates and rents have fluctuated more than those of Class A. Proposed rent control policies, if enacted, could adversely affect investment in this sector. The wide array of public and private programs focused on trying to improve housing affordability may improve the supply/demand situation for renters at the expense of owners.

Yet, as a whole, given the market environment, workforce housing is favorably positioned in the multifamily housing world and should continue to be an attractive investment strategy.

CONTACTS

Brian McAuliffe
President
Capital Markets
+1 312 935 1891
brian.mcauliffe@cbre.com

Peter Donovan
Executive Managing Director
Capital Markets, Multifamily
+1 617 217 6035
peter.donovan@cbre.com

Mitchell Kiffe
Senior Managing Director |
Co-Head of National Production
Capital Markets, Multifamily
+1 703 905 0249
mitchell.kiffe@cbre.com

Spencer G. Levy
Chairman of Americas Research and
Senior Economic Advisor
+1 617 912 5236
spencer.levy@cbre.com
Follow Spencer on Twitter: @SpencerGLevy

Jeanette I. Rice CRE®
Americas Head of Multifamily Research
+1 214 979 6169
jeanette.rice@cbre.com
Follow Jeanette on Twitter: @RiceJeanette