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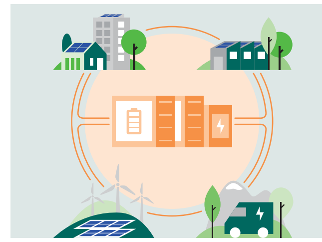
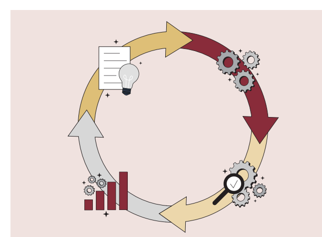
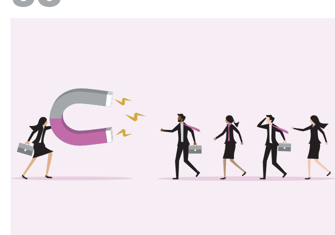






Serving *the* middle

The growing pool of middle-income earners, rising barriers to home ownership, and historically low supply make "Attainable A" multifamily housing an attractive proposition. However, construction costs, labor supply, regulations, and NIMBYism are challenges.

By Jamil Harkness, Bailard, Inc.

In the largest 40 metropolitan areas of the US, roughly one-third of the multifamily housing inventory (comprising 20 or more units) is made up of "Class A" units. Within this category, the more expensive "Trophy Luxury A" and "Luxury A" units represent 11% (480,000 units) and 52% (2.3 million units) of the available inventory, respectively. The lower cost end of the spectrum, which constitutes 37% of the total (1.7 million units) and represents the second largest segment, is composed of "Attainable A" properties.

According to data obtained from CoStar, multifamily supply and demand dynamics at the end of 2022 favor "Attainable A" properties over other "Class A" categories. Despite a general slowdown in resident demand across all segments and geographies in the past year, the vacancy rate for "Attainable A" only increased by 100 basis points, reaching 6.4% by year-end 2022. In contrast, the vacancy rate for "Trophy Luxury A" and "Luxury A" properties increased by 120 bps and 110 bps, ending the year at 8.7% and 9.2% vacancy, respectively.

Rent data showed a similar trend. Rents for "Attainable A" increased 3% year-over-year in 2022, with average asking rent for all unit types within this segment reaching $1,726 per month. Comparatively, average asking rent for "Trophy Luxury A" and "Luxury A" hit $3,425 and $2,250 per month, representing 2.6% and 2.3% rent growth, respectively, lagging "Attainable A".

We believe that "Attainable A" multifamily properties offer the best value to renters within the "Class A" universe, providing high-quality residential options to millions of renters who either cannot afford, or do not wish to live in "Trophy Luxury A" or "Luxury A" apartments. Moreover, we opine that this multifamily investment approach presents the opportunity to construct "Class A" apartments in a suburban locale at a fraction of the cost of developing luxury "Class A" apartments in densely populated urban cores or urban infill nodes, providing compelling risk-adjusted returns.

Defining "Attainable A"

The Bailard Real Estate team defines "Attainable A" as high-quality, well-amenitized, recent-vintage, moderately priced multifamily properties generally located in close-in suburban markets.

Based on this definition, these properties are typically garden style or low-rise wood-frame construction. “Attainable A” differs from “Trophy Luxury A” and “Luxury A” in several respects, including design, materials, finishes, amenities, and locational attributes (see Exhibit 1).

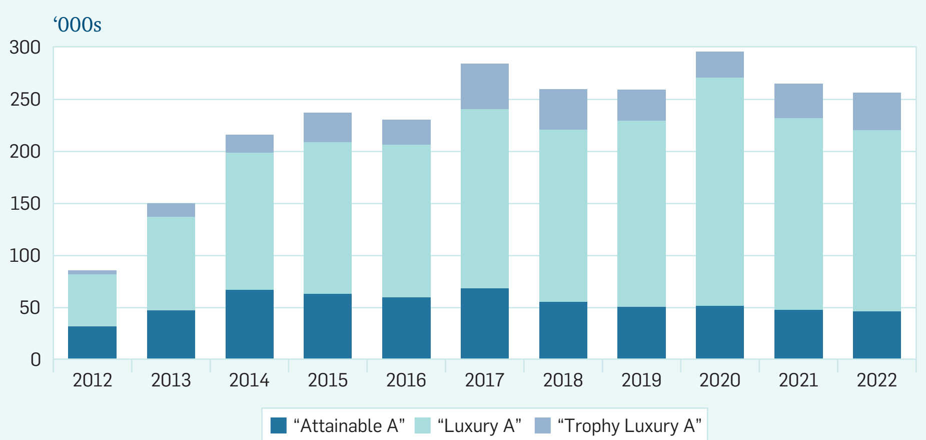
“Attainable A” multifamily is often a good fit for middle-income renters by necessity. Pew Research defines middle-income earners as individuals who make between 75% and 170% of the median income. According to the Bureau of Labor Statistics, median income for an individual in 2022 was $54,132. Therefore, target renters for “Attainable A” are those who earn an annual income of $40,600 to $95,000.

Data obtained from CoStar indicates “Trophy Luxury A” and “Luxury A” one-bedroom apartments in urban or infill neighborhoods average $3,000 and $2,100 per month, respectively, making them unaffordable for most middle-income individuals. However, an “Attainable A” one-bedroom apartment in a first-ring suburban market rents for approximately $1,440 per month, a discount of 51% and 33% to “Trophy Luxury A” and “Luxury A” rents. To qualify using the traditional “35% of salary” rent affordability metric, $49,000 per year is needed for “Attainable A”, while $102,000 and $75,000 per year at minimum are needed for “Trophy Luxury A” and “Luxury A” properties.

Exhibit 1: Characteristics of “Class A” multifamily properties

Bailard Real Estate definition	
“Trophy Luxury A”	• Architecturally distinctive • Highest-quality materials (stone, wood, glass, and metal) • High ceilings (9'+) • High-speed elevatoring • Highest-quality fixtures, hardware, and appliances • Amenities: Clubroom, fitness center, business center, pool, valet, pet park, etc. • Primarily urban and infill neighborhoods
“Luxury A”	• High-quality materials (stone, wood, glass, and metal) • High ceilings (9'+) • High-quality fixtures, hardware, and appliances • Amenities: Clubroom, fitness center, business center, pool, valet, pet park, etc. • Located in urban infill and close-in suburban neighborhoods
“Attainable A”	• High-quality, durable materials • Predominantly “walk-up” and low-rise with hydraulic elevators • Good quality finishes (wall-to-wall carpeting and hardwood laminate flooring, granite and manufactured stone counters, balcony/patio, in-unit washer/dryer) • Site amenities: Clubhouse, fitness center, business center, pool and pet park • Primarily in urban and first-ring suburban markets

Exhibit 2: Only 18% of “Class A” completions in 2022 were “Attainable A” properties



Source: CoStar, 2022.

The case for “Attainable A”

Over the past decade, the 40 largest metropolitan areas have seen a total of 2.9 million completed multifamily units. “Class A” apartments, across all segments, accounted for the majority of new deliveries, comprising 2.5 million units or 86% of the total. However, combined “Luxury A” apartments totaled 1.9 million units, with only 587,000 “Attainable A” apartments constructed. As a result, middle-income Americans face a restriction in the supply of affordable “Class A” housing options, as shown in Exhibit 2.

Despite the limited number of “Attainable A” apartments completed in the last ten years, the middle-income renter pool remains sizable. Middle-income renters account for 54.3% of US renters and the majority fall within the 22 to 45 age group, which comprises Gen Z, millennials, and Gen X. Almost half, 49.6%, either live alone or with roommates. This economic cohort holds a variety of occupations including: carpenters, plumbers, firefighters, police officers, office managers, nurses,

[1] https://fred.stlouisfed.org/series/ASPNHSUS , https://fred.stlouisfed.org/series/MORTGAGE30US, CBRE-EA.
[2] The return on cost represents the investment's returns, net of joint venture partner fees, and investment-level leverage. As such, fund-level fees and expenses are not included in the calculations.

teachers, sales associates, marketing managers, surgical technologists, IT professionals, project managers, and real estate agents.

In fact, the proportion of middle-income earners in the US has remained stable at around 51% of all workers, vs. 52% in 2012. However, due to employment and population growth, the absolute number of full-time working earners has substantially increased in the past decade. Our analysis, using data from the Census Bureau and Pew Research, suggests that across the 40 largest metropolitan areas, 3.5 million new middle-income earners were added to the workforce over the past decade, as depicted in Exhibit 3. Given the sheer size of the pool of working adults in the middle-income bracket, which is growing and constantly being "refreshed" by new (and younger) workers entering the labor force, "Attainable A" product is well-positioned to reap the benefits as an attractive and affordable housing option.

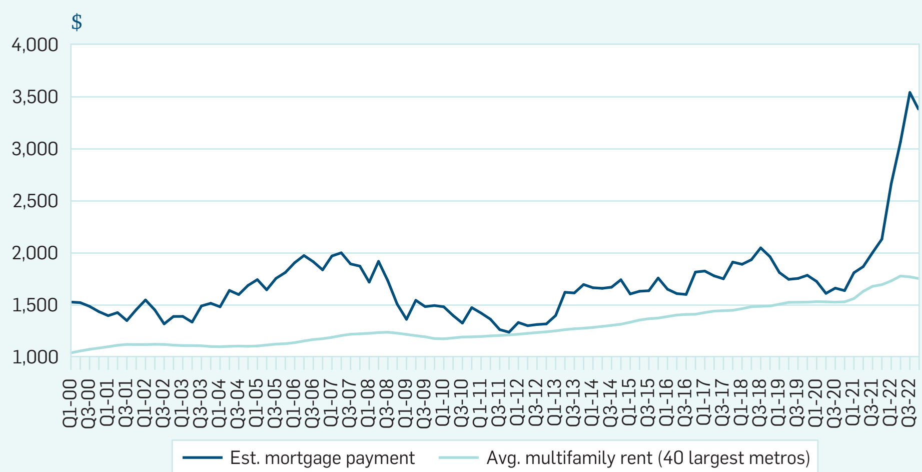
Another crucial factor which has recently expanded the growing renter pool, especially for those in the middle, is the declining affordability of single-family homes. Due to the recent increases in interest rates, the average 30-year mortgage rate reached 6.5% in Q4 2022, up from 2.7% in 2020.[1] Average home prices have also increased dramatically (33%) over that same two-year period, from $403,900 to $535,800. Assuming a 90% loan-to-cost, 30-year amortizing mortgage, the average monthly mortgage payment is $1,570 higher than average multifamily rents. The widening rent vs. own gap is illustrated in Exhibit 4. Of late, the pool of renters is expanding beyond middle-income earners to higher-income earners who may have previously considered buying a home but can no longer afford to do so.

Exhibit 3: The absolute growth in middle-income earners has outpaced other earners in the largest 40 metros

Year	# of full-time, year-round workers with earnings (in millions)	# of low-income earners (in millions)	# of middle-income earners (in millions)	# of high-income earners (in millions)
2011	51.8	12.9	**26.9**	11.9
2021	59.7	14.9	**30.4**	14.3
Change	7.9	2.0	**3.5**	2.4

Source: US Census Bureau, American Community Survey, Pew Research, 2022.

Exhibit 4: The obstacles to buying a home are growing, thus widening the rent-to-own gap



Source: US Census Bureau, CoStar Group, Bailard Research, 2022.

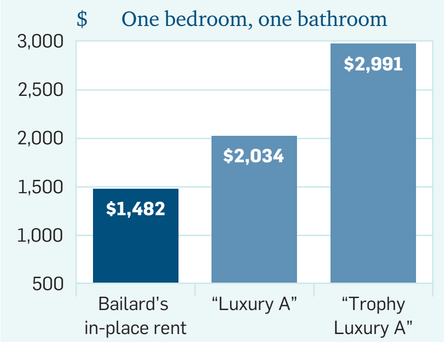
Develop or buy?

"Attainable A" properties are often located in suburban locations. With limited land in both the core and infill micro-markets in many metropolitan areas, multifamily development in those nodes tend to be vertical, dense, and expensive. Because zoning and land-use restrictions in many suburban markets limit the height of most properties, including residential buildings, garden-style, and other low-rise multifamily projects are the norm.

When deciding to develop or buy a property, factors like market dynamics, capital costs, and regulations must be vetted. Generally, if buying an existing property costs materially more than developing a new one, developing is the preferred choice. Bailard Real Estate's 271-unit apartment in suburban Austin is an example of a development that generated a return on cost of 6.6%; 250 bps higher than what Bailard could have achieved by purchasing an existing stabilized asset of similar quality in a comparable location at the prevailing capitalization rate.[2]

The rental rates for Bailard's suburban Austin development are significantly lower than other "Class A" properties, as demonstrated in Exhibit 5. Using the

Exhibit 5: "Attainable A" rents are much more affordable in Austin, Texas



Source: CoStar, Bailard Research, 2022.

standard "35% of salary renter affordability" metric, a resident of Bailard's project would need to earn $50,800 per year to qualify, compared to $70,000 per year for "Luxury A" and $102,500 per year for "Trophy Luxury A".

In weighing the considerations of building in suburban markets vs. urban centers, several elements are either neutral or stand out in favor of suburban locations, including:

- Business friendliness (including tax and regulatory burdens)
- Population characteristics
  - Suburban household count (affected by population and job growth)
  - Educational levels
- Micro-market factors
  - Accessibility
  - Visibility
  - Proximity to amenities and shopping
  - Safety and security (both perceived and actual)
  - Quality of schools
- Return metrics and alternative investment pricing
- Affordability considerations (including cost of living and rent-to-income ratio)

In assessing the criteria listed above, the Bailard Real Estate team identified a number of markets within each of NCREIF's four geographical regions across the US which "check the box" on most or all of the factors enumerated, and are attractive targets for "Attainable A" development (see Exhibit 6).

Risks

Although we believe the investment case for "Attainable A" is strong, several barriers to entry limit additions to supply. First, "not in my backyard" (NIMBY)ism remains a significant deterrent to multifamily builders and developers. Homeowners fear that certain multifamily developments could bring undesirable impacts (i.e., traffic, congestion, strain on public services, etc.), and also potentially depress surrounding home property values. This can result in significant public opposition, and/or more regulatory burdens that prevent building new homes in areas that sorely need them.

Second, elevated construction costs due to inflated commodity prices, higher labor costs, increased costs for planning, permitting, and approvals, and the higher cost of capital (i.e., construction loans and equity) can stand in the way of new multifamily developments getting built. According to CBRE Research, construction costs increased by 14.5% in

Exhibit 6: Representative "Attainable A" markets

West	Midwest	South	East
Denver	Cincinnati	Atlanta	Charleston
Phoenix	Columbus	Austin	Charlotte
Portland	Kansas City	Dallas	Philadelphia
Sacramento	Milwaukee	Houston	Raleigh-Durham
Salt Lake City		Orlando	
Seattle		San Antonio	

Source: Bailard Research, 2022.

[3] *2022 US Construction Cost Trends*, CBRE, July 2022.
[4] *2022 US Construction Cost Trends*, CBRE, July 2022.

2022 (vs. 2.8% per year average in the prior 10 years), primarily due to increases in hard and land costs which account for 60% to 80% of total construction costs.[3]

Third, local zoning and regulations remain resistant to new multifamily projects in favor of single-family housing in nearly every state across the country. As a result, many multifamily builders encounter higher burdens, including a broad range of fees and other requirements imposed at different stages of the construction process.

Last, but not least, labor availability has the potential to curtail housing development, in general, and multifamily construction in particular, as the workforce is not expanding at the rate necessary to meet demand. According to CBRE Research, construction employers are struggling to hire and retain crews; job openings increased by 11.3% while construction worker unemployment ended the year at 3.5% (the lowest since Q4 2019).[4] Labor shortages is a problem even if other construction costs remain in line.

Conclusion

The "Attainable A" product segment will continue to be a solid performer due to population/demographic trends, favorable supply/demand dynamics, and the unfavorable affordability challenges for single-family home ownership. This reality will help keep multifamily assets at the top of investors' list of preferred property types. Furthermore, more cost-efficient, less dense suburban markets are primed to continue to benefit from longer-term secular trends. Given the expected growth of the target renter pool across the country, the need for housing, especially affordable housing, is more acute than ever. ◆

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