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In Challenging Economic Times, Workforce Housing is the Right Product for Multifamily Investors

Even in the face of significant economic headwinds, multifamily properties that cater to working-class Americans remain a reliable source of attainable housing that may provide attractive and historically steady returns for investors.

KEY POINTS

1. Workforce housing is generally defined as multifamily housing for families earning 60% to 120% of an area's median income.

2. Workforce housing is not "Affordable Housing," where rents are subsidized with government assistance.

3. Workforce housing today can offer real estate investors three key benefits relative to investments in Class-A or "value-add" properties: reliable renter demand, stability, and competitive returns.

4. Comparatively strong returns in recent workforce housing investments are especially appealing in periods of high interest rates and high inflation.

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The luxury end of the real estate market often gets the most attention from the media and investors. High-end apartments are glamorous and, in the best economic circumstances, can attract premium rents. But, we are far from optimal economic times, and from an investment standpoint, workforce housing as a subsegment of the multifamily housing market is perhaps more compelling than ever.

For investors who want diversified real estate portfolios, Revitate Cherry Tree sees three key potential benefits to having an allocation to workforce housing. But before examining those, however, let's first establish what does - and doesn't - constitute workforce housing.

Workforce Housing Defined

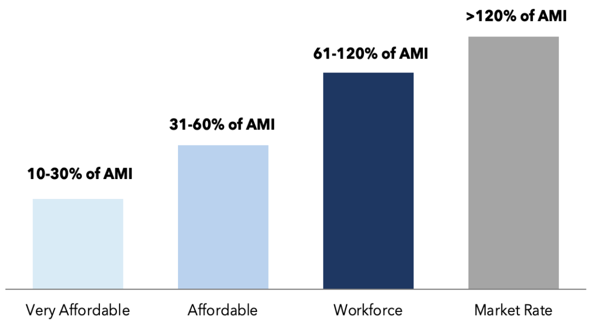
Workforce housing is generally defined as housing that serves families earning 60% to 120% of an area's median income (AMI). In 2021, the median income in the United States was $45,760.[1] With that national average, this segment of the real estate market provides housing for families with incomes of $27,456 to $45,760, and up to $54,912 in higher-cost cities.

In essence, this category of housing caters to working-class Americans, generally employed by local governments or in industries like health care, manufacturing, logistics, and education.

Given the high cost of housing in the United States and the fact that wage gains have not kept pace with cost-of-living increases, many of the families in workforce housing cannot afford to own homes. They are renters by necessity, not by choice, and that usually translates into longer-term lease agreements.

Contrary to some perceptions, workforce housing does not include government-sponsored "Affordable" housing. These properties, commonly referred to as Section 8 housing, cater predominantly to families earning less than 60% of AMI. While workforce housing can include properties that have rent controls or some income-eligibility requirements for tenancy, most of workforce housing has market-rate rents. The discussion here focuses on this segment.

Figure 1: Housing Category Spectrum



Source: U.S. Dept. of Housing and Urban Development, 2017

With regard to the real estate industry's classifications, workforce housing constitutes Class B and Class C properties. Class A properties are the luxury residences that most working-class Americans cannot afford.

Many of the Class B and C properties were constructed before the year 2000 and are garden-style apartments. This style of residence became particularly appealing during the pandemic, given that their large green areas and separate entrances enable tenants to maintain social distancing.

Three Benefits of Workforce Housing

In the current market environment, we think workforce housing offers investors three key benefits relative to luxury properties, and especially to more risk-intensive categories of value-add multifamily housing, which are the properties that need major renovations and updates to be able to generate better rental income.

Benefit 1: Reliable Renter Demand

There are approximately 12 million multifamily workforce housing units across the 66 major metropolitan areas in the United States.[2] In recent years, there has not been much new supply of this type of housing for a variety of reasons.

Supply in this segment of the market can increase through a process known as **NOAH**, or "**naturally occurring affordable housing**." Properties that might have been built as luxury residences become less desirable over time, either as a result of their age or because their location no longer holds the appeal among higher-income earners that it once did. Both factors can make it more difficult for landlords to charge premium rents, and for that reason the housing can become affordable for working-class renters.

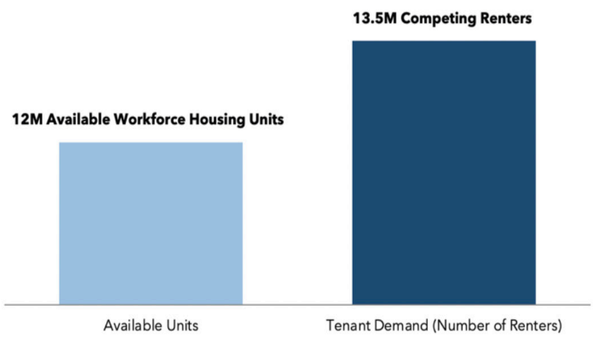
In recent years, though, NOAH hasn't played out as it once did. First, older properties are being taken out of the market at a higher-than-normal rate. Typically, the multifamily industry removes about 100,000 units per year simply because their age has rendered them obsolete. But the obsolescence rate has increased in recent years, in part because there was such as surge in multifamily housing construction in the 1970s and 1980s.

As these properties have been demolished, developers have been replacing them with Class A properties that working-class Americans usually cannot afford. Even the Class C properties that are being renovated are often upgraded to accommodate the luxury market, and their rents are beyond the reach of working-class tenants. **The Wall Street Journal noted that in 2020, 80% of the new supply of rental units came from luxury developments.**[3]

Often the only new workforce housing that is being built comes as a result of inclusionary housing policies that require developers to set aside a certain number of units that will be affordable for middle-income tenants. But these units still present only a small portion of the workforce housing available today.

For developers, the economics make it difficult to build workforce housing. Building materials and land prices have increased dramatically over the past decade. To earn a profit after that level of construction expense, property owners often must charge rents above what middle-income households can afford.

Figure 2: Housing Supply-Demand Imbalance



Source: CBRE, 2018.

On the demand side, there are about **13.5 million tenants competing for the 12 million available workforce units.**[4] That tenant population is the estimated number of Americans with yearly earnings in the range of 60% to 120% of AMI. It is important to note that middle-income earners are not the only potential tenants for workforce housing today. Given the high costs of home ownership and the limited supply of homes to buy, more renters by choice are also looking for apartments with affordable rents, where they can live for a few years while saving money to buy a home.

The advent of higher mortgage rates in 2022 and fears of recession, even if a major economic slowdown does not materialize, have **further increased the demand for reasonably-priced** rental units.

While the supply-demand imbalance in housing creates a challenge for families looking for homes, it does increase the appeal of this segment of the real estate market for property owners and investors. These properties are better positioned today to find and maintain long-term tenants at rents that are attractive for the owners and investors.

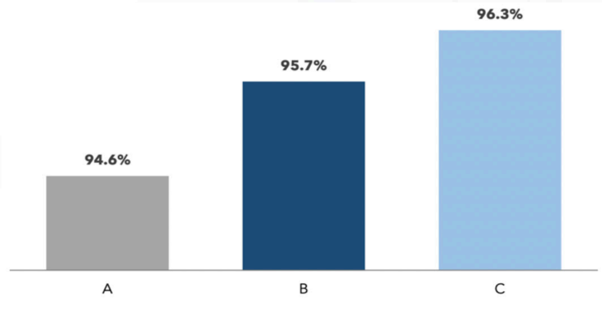
Benefit 2: More Stability and Less Risk

Workforce housing, in our view, currently offers more stability than the luxury end of the market and less risk than the value-add end.

Unlike value-add strategies which rely on a capital rehabilitation plan of the property, workforce housing property owners and investors have historically been able to count on **predictable and steady rental income** from day one due in great part to stable occupancy levels.

As Figure 3 shows, Class B and Class C housing have recently had higher occupancy rates than Class A properties.

Figure 3: Occupancy Rates by Product Type



Source: CoStar, 2022.

With rising interest rates, record home prices, and the increased cost of a traditional mortgage, home ownership is likely to become even more unattainable for working-class Americans. That will likely translate into sustained, if not increasing, demand for attainable rental homes in the foreseeable future.

At Revitate Cherry Tree, we focus on workforce housing properties that do not require major restorations and have high occupancy rates at acquisition. With a solid base of existing tenants, these consistently cash flow for owners and investors from day one of ownership. We also find that the returns these properties generate can be **enhanced by the operational efficiencies** that a sophisticated and experienced operator brings.

Workforce housing presents considerably fewer risks as well. With value-add properties that require major renovations, there is a delay in cash flow generation while the upgrading work is being done. Once the improvements have been made, there is also no guarantee that a property will attract the levels of rents that deliver a reasonable return on the investment that has been made to refurbish it.

Benefit 3: Competitive Returns

Finally, investors seeking the stability of workforce housing do not necessarily have to sacrifice on return. On the contrary, workforce housing can typically offer comparable, and in some cases, more attractive risk-adjusted returns to other multifamily property types.

Revitate Cherry Tree sees early evidence of the performance potential in **three Midwest workforce housing communities** we've already acquired. As detailed in Figure 4, occupancy and renewal rates are very high. Moreover, with inflation hovering at 8% in 2022, there have also been far fewer income-generating investments today that can deliver a real yield.

Figure 4: Recent Performance of Workforce Housing: Profile of three recent Revitate Cherry Tree Multifamily Fund acquisitions.

	RevCT Property 1	RevCT Property 2	RevCT Property 3
Occupancy Trend			
Current	98.6%	93.8%	94.1%
30-Day Trend	100.0%	94.6%	94.1%
Renewals			
Life to Date (LTD)*	81.0%	60.9%	73.2%
Average Rent (LTD)			
Actual (In-Place)	$889	$921	$1,232
Pro Forma	$887	$855	$1,170
Delta	0.2%	7.7%	5.3%

Source: Company data.

Conclusion: The Right Product at the Right Time

To use a baseball analogy, luxury and value-add properties are now a bit like the home run hitters who have high strikeout ratios. The rewards can be high, but so too are the risks. **Workforce housing is like the reliable singles and doubles hitter with a high batting average.**

In today's environment, that reliability is especially important. Given that workforce housing has high occupancy rates and can deliver reliable income without major upfront costs, it presents much less risk. With today's lack of housing supply and strong demand, as the pool of renters has increased for a variety of reasons, the rental income that workforce housing can generate will likely remain reliably stable for the foreseeable future.

All of these appealing characteristics are demonstrated in the returns workforce housing has been able to generate. This type of housing may not garner the attention that new luxury projects or major property renovations can generate, but, in our view, this oft-overlooked segment of the market may be the one of the most worthy of investors' attention.

References

[1] USAFacts.

[2] "The Case for Workforce Housing," CBRE Research, November 2018.

[3] "Aiming at Wealthy Renters, Developers Build More Luxury Apartments Than They Have in Decades," The Wall Street Journal, 1/15/20.

[4] 2017 U.S. Census Bureau, 2017 CBRE Economic Advisors Data, and CBRE | A Case for Workforce Housing, a Market Perspective, 2017.

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