Principal Real Estate

Principal Asset Management℠

LIVING SECTOR SERIES | PART III

U.S. single-family rentals

ARTHUR JONES
Senior Director,
Global Research

JD STEHWIEN
Senior Analyst,
Global Research

In the third part of our *Living Sector Series*, we focus our attention on single-family rentals, which is one of our highest conviction strategies within the real estate asset class today. Once synonymous with home ownership, the single-family market underwent an evolution following the Global Financial Crisis (GFC) due to shifts in economic and demographic dynamics, which changed the way individuals and households think about housing.

In the decade following the GFC, it also became apparent that younger generations of would-be homebuyers did not have the financial wherewithal to purchase homes as prior generations. As institutional investors have increasingly taken note and expanded their focus on the residential sector, single-family rental homes have become more prominent within the U.S. housing landscape and offer several interesting tactical and strategic opportunities for investors.

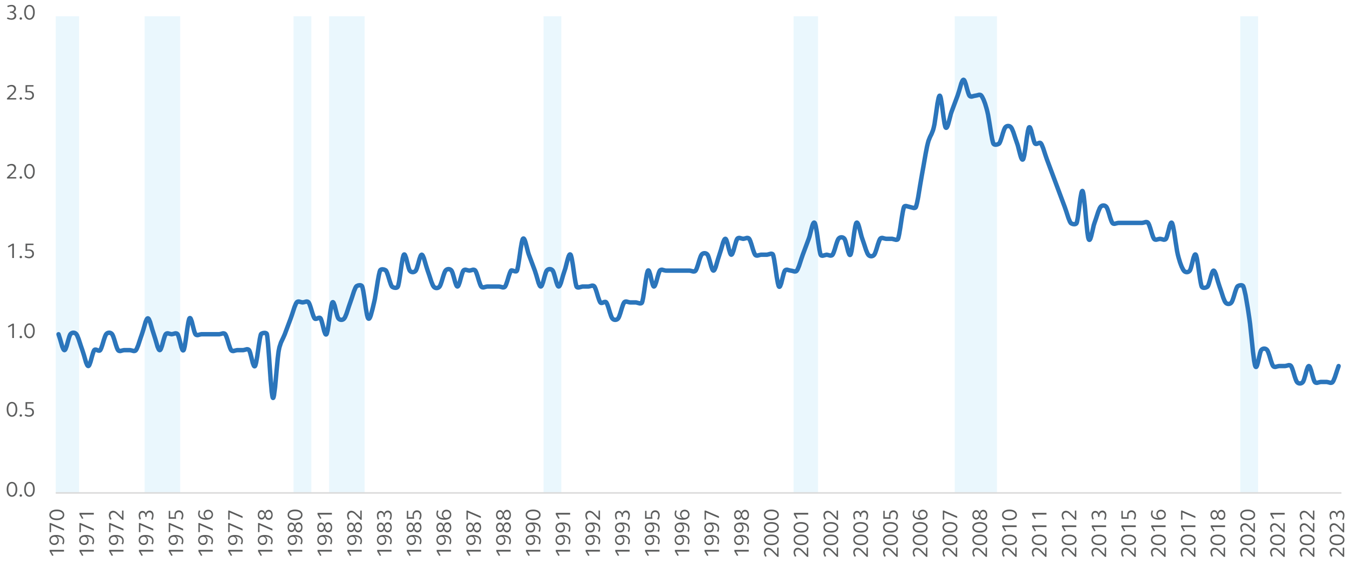
In this paper, we will focus on the dynamics of the U.S. housing market as it relates to the single-family rental sector, with an emphasis on the shift in housing affordability, which we believe is a key to sustained and broad-based demand.

Emergence of single-family rentals

The Global Financial Crisis (GFC) was the most transformative economic event in the post-World War II era. The financial meltdown and implosion of balance sheets in the U.S., and across the globe, pushed the economy into a deep recession that reverberated throughout the housing sector. A primary catalyst for the recession, the housing sector suffered swift and severe consequences. Home values fell by 25.4% between 2006 and 2011, according to the S&P CoreLogic Case-Shiller U.S. National Home Price Index. During the recession, the economy lost nearly 9 million jobs, with the labor market failing to return to full employment until 2017. Moreover, tight credit conditions hampered both the housing recovery and the ability of developers to build enough housing to keep pace with the nation's population growth. Insufficient growth of the nation's housing stock since the GFC has contributed to bringing vacancy to a generational low today (see Exhibit 1).

EXHIBIT 1: Single-family homeowner vacancy near a 45-year low

Single-family homeowner vacancy rate, %



Source: Moody's Analytics, Census Bureau, Principal Real Estate, Q4 2023

During the period following the GFC, it is estimated that roughly 10.5 million four-year degrees were conferred.[1] New graduates entered a labor market with conditions far more formidable than those of prior generations, which hindered their ability to accumulate wealth during a critical period in their careers. As a result, many Millennials have found it challenging—even today—to accumulate enough savings to purchase a home.

[1] USAFacts: https://usafacts.org/faq, National Center for Education Statistics, Table 318.20

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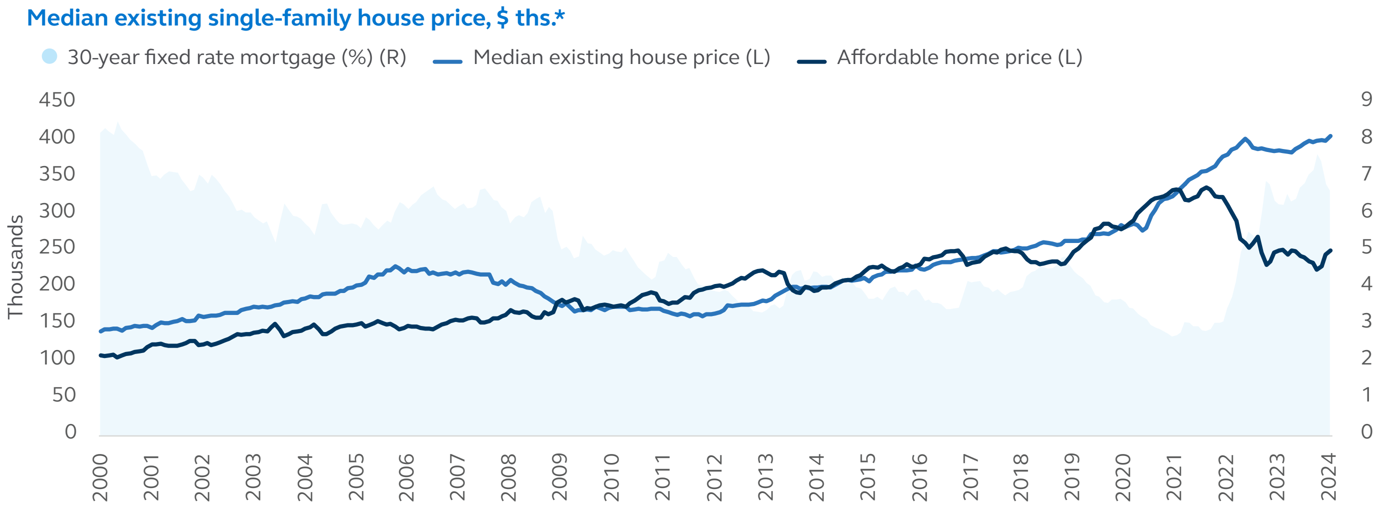
The situation has become even more acute following the COVID-19 pandemic, when low interest rates and a lack of single-family development following the GFC caused a spike in home prices, further eroding affordability in the single-family for-purchase market. Today, as interest rates have normalized and single-family prices are once again rising, purchasing a home is well beyond the financial wherewithal of most households. The median price of an existing single-family home is $405,635, while the median household spending 30% of their income on a mortgage payment can only afford a home that costs $250,771 (see Exhibit 2).[2]

EXHIBIT 2: Single-family (for purchase) housing affordability remains at an all-time low



* Assumes 30% monthly budget for affordable housing, per HUD. Down payment of 7%, deducting monthly utility, property tax, and home owners insurance.
Source: National Association of Realtors, Moody's Analytics, Principal Real Estate, January 2024.

[2] Includes monthly tax and insurance payments of $426 per month.

The general lack of single-family housing affordability combined with economic headwinds has prevented many younger households from making first-time home purchases, particularly Millennials and Generation Z, as they begin to form families of their own. Millennial-headed households (ages 28 to 43) had a homeownership rate of just 53% in 2022 compared with 59% for the same age cohort in 2001, according to data from the American Community Survey. This decline in home ownership has resulted in an additional 1.5 million households that are priced out of the for-purchase market; thus, are potential single-family renters.

Single-family opportunity

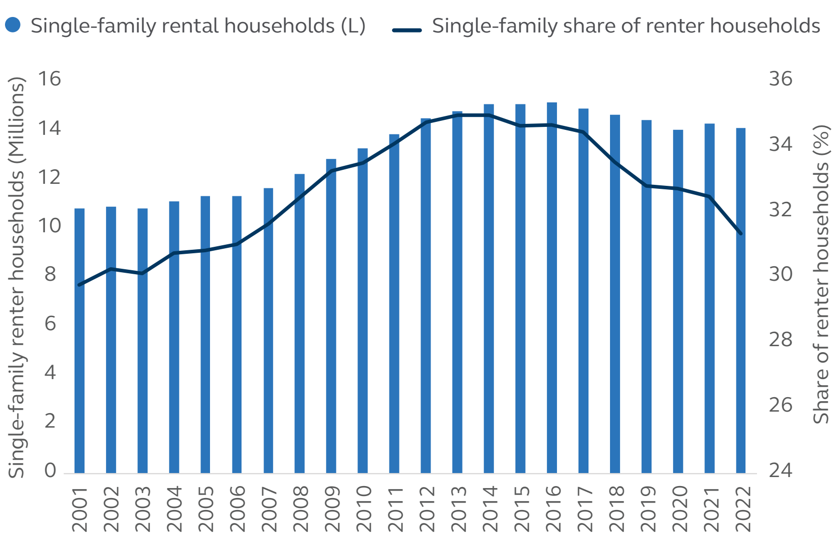
As a result of economic and demographic shifts over the past decade and a half, housing affordability in the U.S. is one of the most pressing issues facing both policymakers and households today. While there is no easy answer to this problem, market dislocations and inefficiencies often breed creative solutions and potential opportunities for real estate developers and investors; we believe that the current housing market situation is no different. As mentioned in previous reports in this series, we view the residential sector as one with immense and diverse growth opportunities, and one of the most exciting of these is the single-family rental sector.

While single-family rentals are a relatively new and emerging sector for institutional investors, they have long been an important part of the residential for-rent market. In 2001, 10.8 million renters lived in single-family homes, just under 30% of all renters. Following the GFC, the number of single-family renters peaked at 15.1 million in 2016. Despite recent declines since that peak, there are still 3.2 million more single-family renters in the U.S. today than in 2001 (see Exhibit 3).

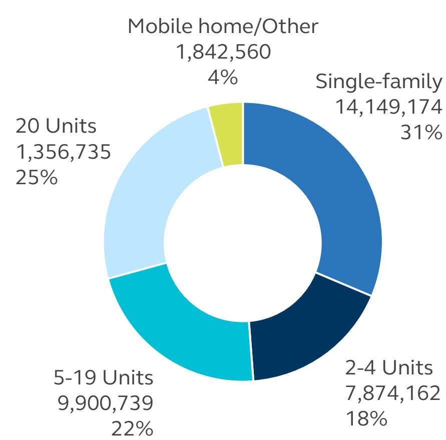
Today, there are 45 million renter households in the U.S., according to the Census Bureau, and of those households, 14.2 million, or 31%, live in single-family rental homes. We believe, for investors who are looking to diversify their residential portfolios beyond traditional apartment rentals, this presents a significant opportunity to take advantage of the structural demand for housing in an increasingly competitive market.

EXHIBIT 3: Single-family homes have long been an important part of the residential rental universe.

Single-family rental households



Distribution of U.S. rental housing



Source: IPUMS ACS (1-Year Sample), University of Minnesota, www.ipums.org, Principal Real Estate, 2022

Single-family renter profile

	Single-family home renter	Single-family home owner	Multi-family home renter
Median age	43	56	40
Median family size	3	3	2
Average income	$74,365.09	$124,718.11	$62,531.61
% With children	30.2%	31.4%	21.5%
% With a bachelor's degree	26.2%	43.8%	34.5%
% Living with a partner	59.4%	78.5%	43.4%
% Single income households	37.4%	39.5%	53.4%

Source: IPUMS ACS (1-Year Sample), University of Minnesota, www.ipums.org, Principal Real Estate, 2022.

The relative demographics outlined in the table above help us understand the needs of a family who would be interested in signing a lease in the single-family rental market. Renters of single-family homes tend to be older than multi-family renters, and far younger than homeowners, which supports our thesis that the sector caters to households who are outgrowing their current apartment rentals. Single-family renters are also 16% more likely to be living with a partner and more likely to have a child living at home.

One of the largest differences between Americans who own their home and those who rent is simple—household income. In the single-family market, those who own their property make 67.1% more per year compared to renters. Additionally, we estimate that homeowners pay approximately $2,900 monthly, based on the median existing-home price of $405,625 and prevailing mortgage rates. On the other hand, single-family rentals average $2,216 a month, including taxes and not requiring a down payment.[3] This creates a significant affordability gap where families who need to upgrade are unable to afford a home of their own. We believe that single-family rentals can fill the gap at a price point that is comparable, or more favorable, to renting a traditional apartment.

[3] Assumes an interest rate of 6.64% and a down payment of 7%. Includes monthly tax and insurance costs, based on a national average, of $426. As of December 2023.

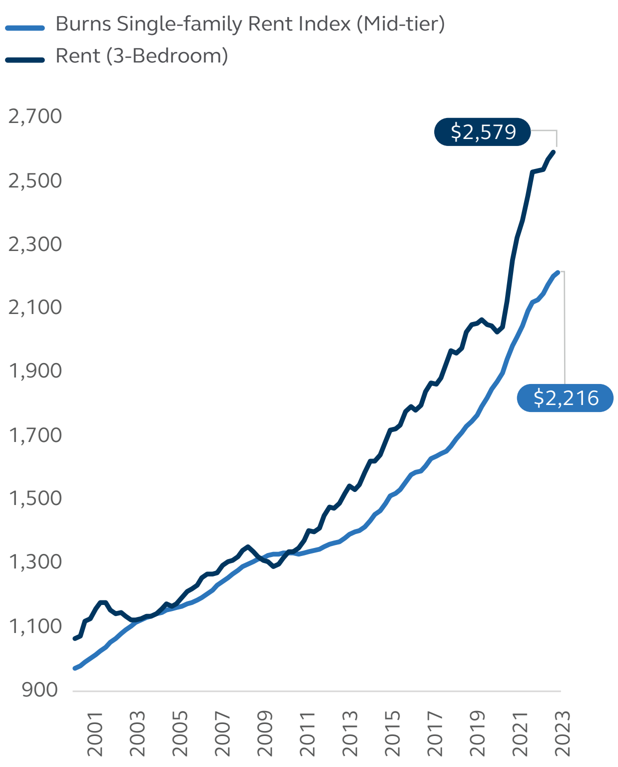
Can single-family rentals help bridge the affordability gap?

The issue of housing affordability is not solely related to the single-family for-purchase market. The traditional apartment market, as we discussed in our previous report, has experienced rapid rental growth in the years following the pandemic. While household earnings grew at a healthy pace during the past four years, they failed to keep pace with outsized rental growth. Between 2020 and 2022 (the last year historical income data are available from the Census Bureau), apartment rents grew by 21% while household income grew by just 15%, suggesting that renter households have become increasingly burdened by housings costs.

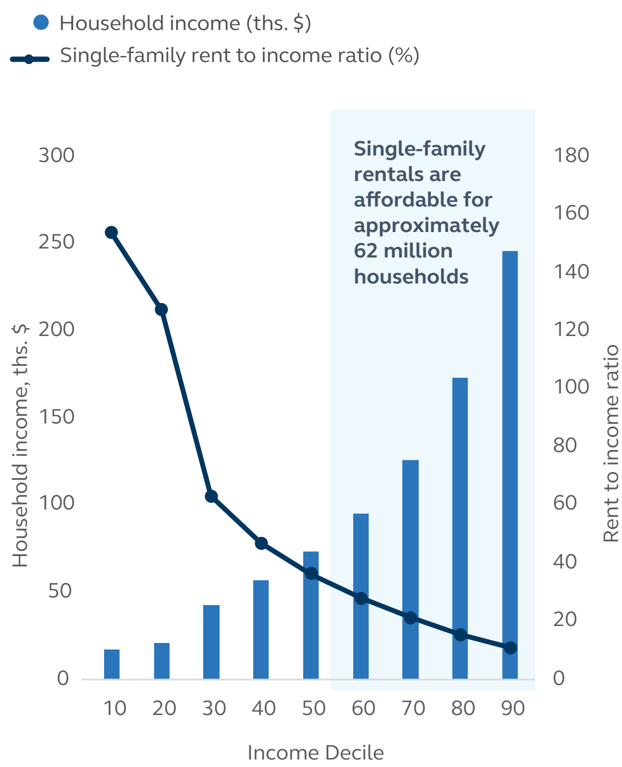
While single-family rentals are not often thought of in the same vein as affordable housing, they do provide a viable entry point relative to both single-family purchases and traditional rentals. Comparing rental trends from John Burns Consulting and CBRE, we show that mid-tier single-family rentals offer a significant discount to a comparable traditional three-bedroom rental unit. A mid-tier single-family unit rents for $2,216 per month compared with $2,579 for a three-bedroom apartment. The rental rate for single-family rentals would allow landlords to target households with incomes of $88,650 and higher. While this figure is above the national median income, it is well within the means of nearly 45% of the income distribution in the U.S., or approximately 62 million households (see Exhibit 4).

EXHIBIT 4: SFR offers an attractive price point relative to traditional apartments

Single-family and apartment rents, monthly $/unit



Household income and single-family affordability



Source: CBRE EA, John Burns Consulting, IPUMS ACS (1-Year Sample), University of Minnesota, www.ipums.org, Principal Real Estate, Q4 2023

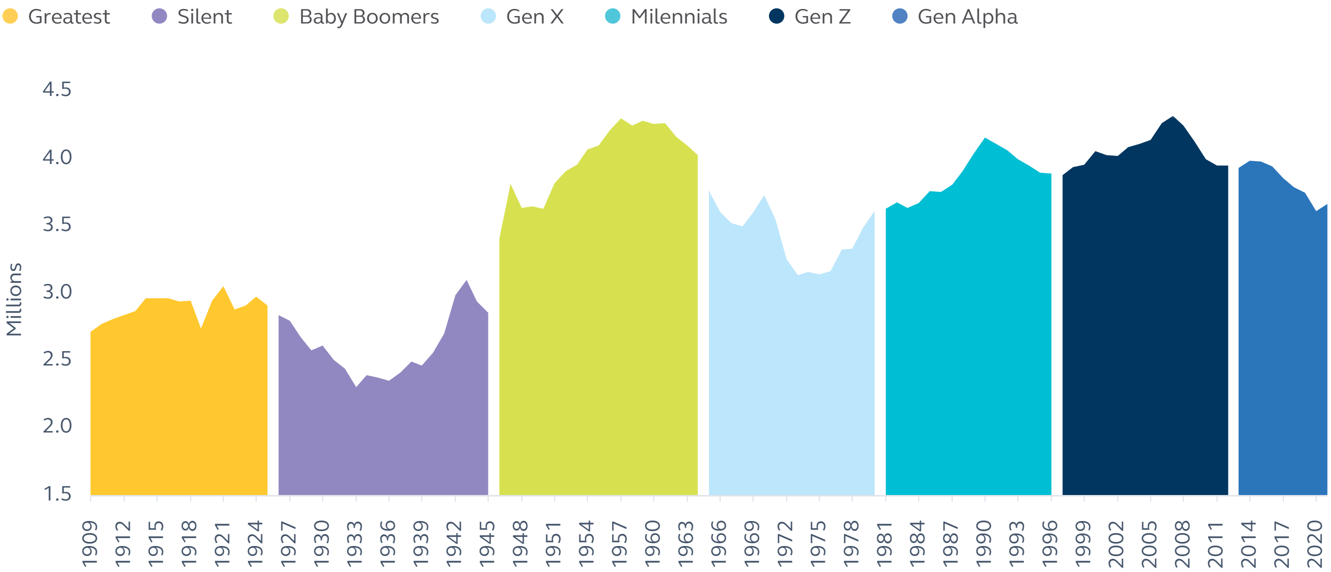
Demand

Demand for housing is directly derived from population growth and household formation. While it is well documented that the U.S. population base is aging and thus growing more slowly, this does not mean the demand for certain segments of the residential sector will languish. As discussed earlier, the residential sector remains highly underserved, and with affordability in the for-purchase market at an all-time low, the demand for rentals—especially single-family—will remain high.

Today, Millennials are the dominant demographic group, numbering 77 million and accounting for 23% of the U.S. population and have surpassed Baby Boomers in prominence. Generation Z, those born between 1997 and 2012, are a close second, accounting for roughly 20% of the total population. They are also beginning to contribute meaningfully to the prime renter age population cohort and will soon be starting families and contributing to single-family demand as they outgrow apartment living, as Millennials have already (see Exhibit 5).

EXHIBIT 5: SFR will continue to draw from a large demographic base

Birth by generation



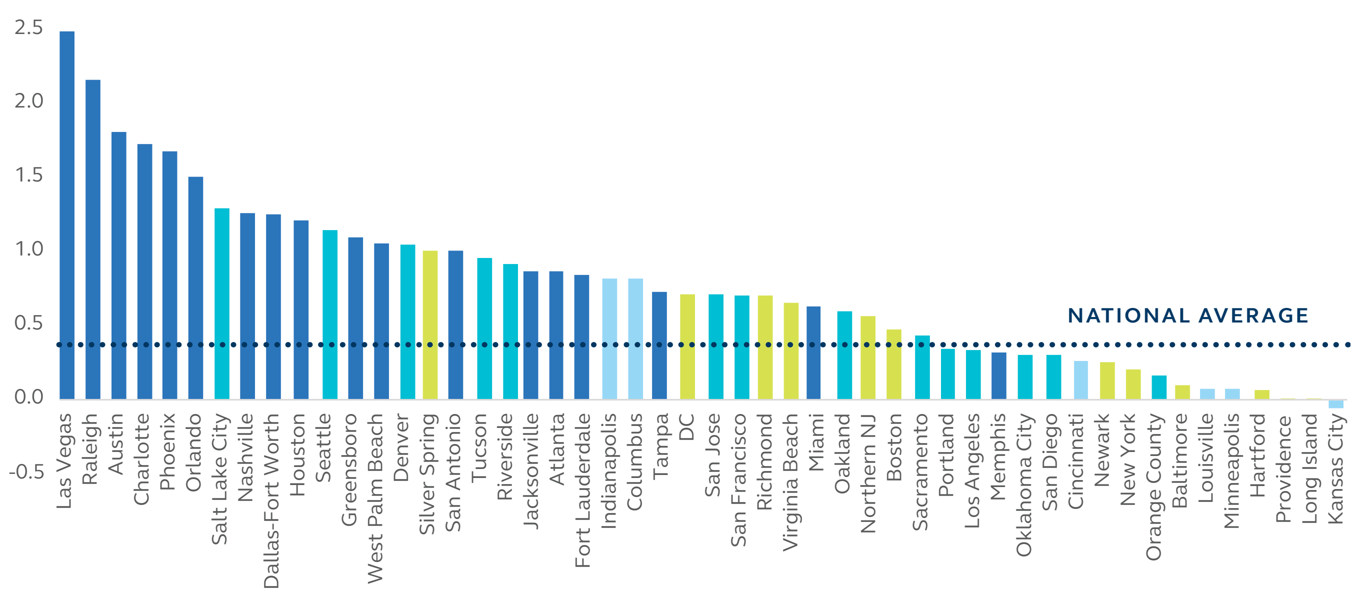
Source: U.S. Centers for Disease Control and Prevention (CDC): Table 1 - Births and birth rates by race and Hispanic origin, 2021

In pursuit of single-family rental opportunities, we believe that investors should continue to focus their efforts on high-growth demographic regions where increases in business activity, favorable costs of living and doing business, and amenities will continue to attract positive net in-migration. Population growth over two decades has favored metro areas in the U.S. South and West regions, which we believe will continue. Moreover, we believe that renter-age population growth in these regions will continue to outpace the national average, as this age cohort remains more mobile and tends to be more likely to migrate because of new employment opportunities (see Exhibit 6). Markets in the South and West regions are also less land-constrained than larger global coastal gateway cities in the West and Northeast regions, allowing for suburban development of single-family build-for-rent communities.

EXHIBIT 6: We continue to favor sunbelt markets due to favorable demographics

Forecasted prime renter age population growth by Metro

2023-2028 ann. % chg



Source: Census Bureau, Moody's Analytics, Principal Real Estate, Q4 2023

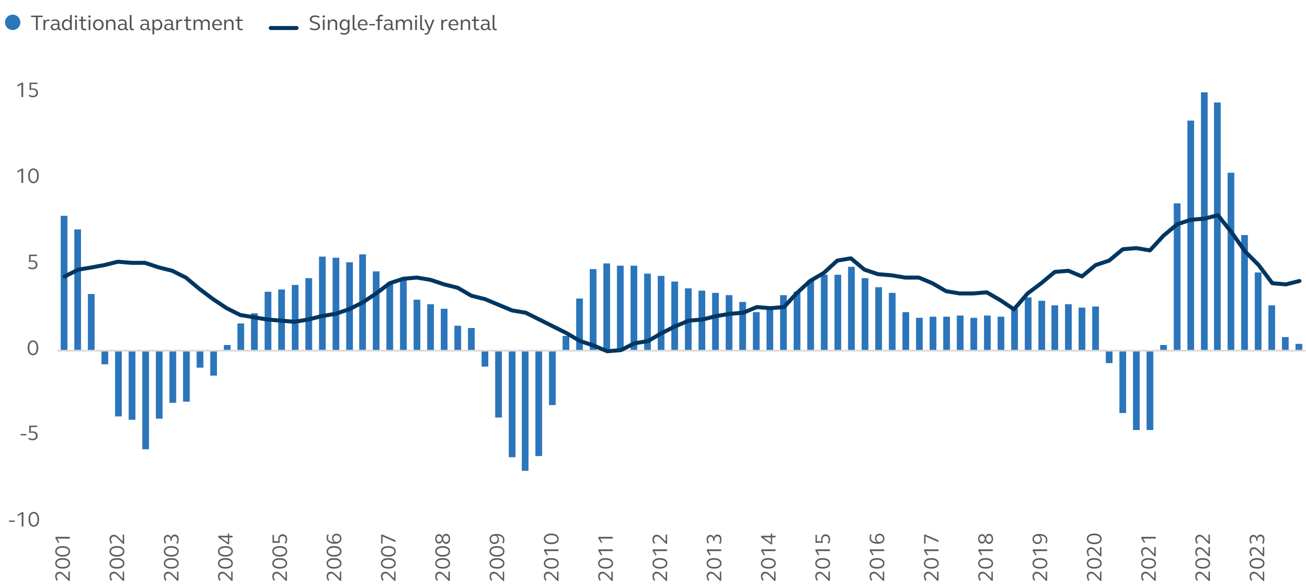
Performance

Obscuring from the volatility in multifamily rents through the pandemic, the single-family rental sector has performed well on both a relative and absolute basis. With occupancy rates consistently in the mid to high 90% range for single-family homes, the pendulum of pricing power remains with landlords. Rent growth over the past year has averaged 4% at a time when traditional multifamily units have experienced flat to negative shifts in rents. Leasing rates following move-outs for multifamily assets have generally seen negative rental inflation and only modest increases on renewals, which has prevented broader rent declines but resulted in weak performance over the past 12 months.

Over the longer term, single-family rental growth has remained remarkably stable, showing both lower volatility and on average higher rent growth than traditional apartments (see Exhibit 7). Since 2004, for example, traditional apartment rent growth has averaged 2.6%, while single-family rent growth over the same period was 3.3%. Part of the stability of the sector stems from its ability to perform well on a relative basis through downturns, which typically coincide with periods of overdevelopment in the apartment sector. Lower volatility, more stable occupancy rates, and rent growth within the single-family sector translates into positive NOI growth for investors and has resulted in stronger investment performance.

EXHIBIT 7: SFR offers healthy and stable income growth potential

Rent growth, yoy % chg.



Source: CBRE EA, John Burns Consulting, Q4 2023

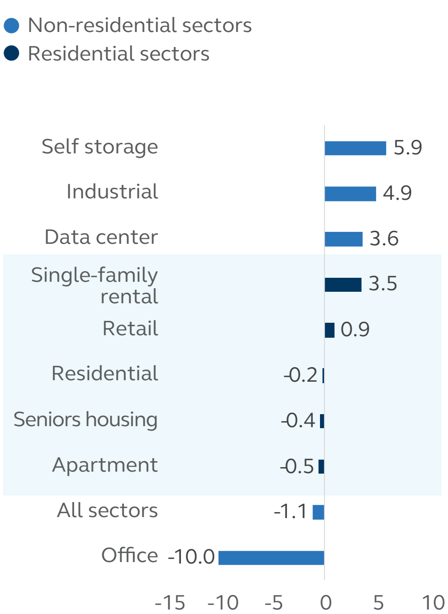
While the sector remains somewhat new to private investors and benchmarks have been scarce for private equity, NCREIF's new property classifications now break out alternative property sectors, including single-family rentals. Early returns from the new index align with market fundamentals, showing that single-family rentals have not only outperformed the broader residential sector benchmark, but have also measured up favorably across all property types over the past two years. Based on the NCREIF Index, single-family rentals have posted an average annual return of 3.5% since 2021, which trails only self-storage, industrial, and data centers over the same period (see Exhibit 8).

From a pricing perspective, Green Street's Commercial Property Price Index (CPPI) offers a more comprehensive and historically complete measure of the single-family rental sector, which is based on pricing in both private and public quadrants. It is well documented that listed REITs have a more balanced sector allocation across both traditional private sectors and emerging alternative sectors, such as single-family rentals. Since 2019, the single-family rental sector has outperformed other major sectors, including industrial, with capital values increasing by 9.9% on an average annual basis, based on repeat sales. In the past 12 months, the index suggests that the sector saw pricing increase by 6.8% at a time when other major sectors experienced a decline in values.

EXHIBIT 8: Single-family rentals have outperformed in a challenging environment

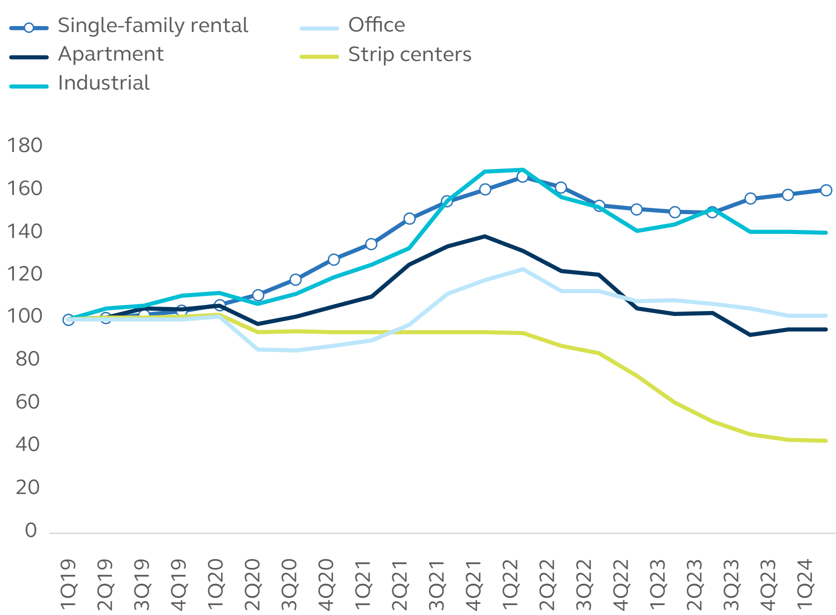
NPI Plus sector total returns

2-yr annualized total return (%)



Green Street CPPI

Index (Q1 2019 = 100)



Source: NCREIF NPI Plus Index, Green Street CPPI, Principal Real Estate, Q4 2023.

Conclusions

The single-family rental sector remains one of our top high-conviction strategies from both a tactical and long-term perspective. The stability exhibited by the sector during the recent corrective phase in broader real estate markets is impressive. It is our view, the sector is supported by favorable demographics and market fundamentals, which have prevented the overdevelopment experienced in the apartment market. Single-family investors and developers can take advantage of housing dislocations that are the product of an underserved residential market and overpricing in the single-family-for-purchase market. These forces have created demand for new and innovative housing solutions that better align with socio-economic trends that have emerged in the decade and a half since the GFC. While capital market headwinds make it difficult to access debt capital for new development, we believe that well-capitalized investors with dry power will be able to execute strategies that will yield healthy returns on newer vintage build-to-rent communities, as well as on acquisitions of existing assets.

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