The Investment Case for Workforce Housing

Gill Torren, Privcap:
Today, we're joined by Cathy Marcus and Lee Menifee of PGIM Real Estate. Welcome to Privcap. We're going to talk about real estate investment opportunities and some of the insights that the PGIM Real Estate team has into this asset class. Lee, tell us about some of the notable trends that PGIM Real Estate's research has uncovered in the U.S. real estate.

Lee Menifee, PGIM Real Estate:
I’ll start with the biggest picture, and that's really shifting demographics. Within shifting demographics, one of the most interesting things we're seeing is growth at either end of the adult age spectrum, so a lot more older people and also a big bulge of people in their 20's and going into their 30's.

While that is probably pretty well acknowledged, what's interesting about it is that as you dig deeper in that, you find that a lot of other things that have pretty direct investment implications, some things that we really haven't been that involved in before.

The growth in millennials and people in their 20s and 30s supported a lot of apartment demand, and actually, a common misperception is that all the demand is in urban areas and in Class A apartments. That's true—this cycle has actually been very good for demand of that type of apartment—but that's only one segment of the population being served.

Torren: Interesting. What about some of the insights into lower income demographics? It's not an exaggeration to say that the U.S. is having an affordable housing crisis. As of 2000, about 36% of renters paid more than 30% of their income on rent. Today, that's jumped to 50%; half of renters are paying more than half of their income in rent. There's a whole segment of the population that isn't necessarily being served by this Class A urban apartment, and there's the opportunity to invest in some other areas.

Cathy, what are some of the investment strategies that have come out of PGIM's research findings? Let's start with the lower income demographic.

Cathy Marcus, PGIM Real Estate:
Sure. As Lee mentioned, a lot of the recent development in the U.S. has
been around these Class A (or A-plus or AA or whatever we're calling them), very luxury-type apartment projects that are really tailored to the young professional.

For the past 10 years, the U.S. has been so focused on huge amenity packages and quartz countertops and [questions like] “Should we have a golf simulator or should we have a saltwater pool?” and really forgotten about all of the people who are living in apartments because that's the only place where they can live. What they're really looking for is good enough product; they don't need a golf simulator. They're looking for well-maintained product in good locations and well managed, institutionally managed, professionally managed places where they can feel safe and feel like it's a place where maybe they can stay for a long time.

We've really recognized this trend through Lee's group and their work, and we have been out acquiring more of what we're calling “workforce housing.” These tend to be Class B, maybe B-minus projects around the country, often garden-style apartments, maybe less in the urban centers.

There are a lot of these types of projects in the southeast and the southwest as well. Some of them could be really workforce housing just because of their age or because of the relative rents that can be charged there.

Several of our strategies have made some pretty big investments in these. Some of the strategy is a bit more value add-oriented, in that maybe the idea is to come in and do some cosmetic work, or maybe fix up some amenities or, in some cases, even address deferred maintenance. That's really been a big focus of ours, and we've acquired probably about 20,000 units with that strategy recently.

**Torren:** Is the fact that the renter is more sticky that changes the management style of the real estate?

**Marcus:** The great pitfall for investors like us is to have the discipline to keep this product affordable, and to not come in and try to turn it cosmetically into an A project. Because that's a great strategy, it's just a very different strategy. It's not the strategy that we're after. And you can't raise the rents several hundred dollars a month and think that you're not going to have that level of turnover.

Lee, tell us a bit more about what you've learned about workforce demographics.

**Menifee:** One of the things to think about when you think about the renters, by necessity, is where are people going to be living in 10 years? Let's go back to the more affluent renters in their 20's currently renting Class A
apartments. A lot of them are going to be homeowners 10 years from now. A lot of the renters, by necessity, aren't necessarily going to be homeowners. You really have this embedded group of people who are just looking for places to live that are clean and dependable and all the things that Cathy described. They're not likely to be quite as mobile as other parts of the population.

San Francisco and New York obviously stand out as being very unaffordable. You have places like Orlando and Phoenix, where more than 45% of renters pay more than 30% of their income on rent. There are opportunities there to provide affordable housing as well in markets that don't necessarily show up where people normally think of as being unaffordable markets.