# PERE

# Residential

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## How one asset class is proving its resilience

KEYNOTE INTERVIEW

# Residential demand still deep and diversified

*While economic recovery after covid-19 may take longer than previously anticipated, The Resmark Companies' chief investment officer Ziv Cohen says the shortage of housing units in the US won't diminish*

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**Q What makes residential development primed for future success?**

Residential real estate is predominantly a needs-based asset class. Everybody, at the end of the day, needs some type of shelter. That need increases each year: according to the Joint Center for Housing Studies of Harvard University, 1.4 million new households are formed annually.

In the aftermath of the global financial crisis, the new housing supply diminished dramatically. Residential housing construction in the US never fully recovered and many homebuilders and multifamily developers were severely affected – to the extent that this has evolved into a housing supply crisis. To put it in perspective, despite significant population and job growth, housing development from 2010-19 is 40 percent of the average housing development per decade for the past three decades.

Estimates by various research groups indicate that the US housing market is undersupplied by as many as four million units. Covid-19 and the resulting market turmoil are likely to widen this housing shortage. Economic, structural, regulatory and bureaucratic constraints will continue to provide headwinds and limit residential supply – such as local jurisdictions limiting entitlement of new housing units, putting substantial constraints on the product that can be built and regulating how those units are going to get built.

Meanwhile, from a demand standpoint, three key demographic trends will provide the residential sector with depth in product demand and ample buyer diversification: baby boomers are looking to downsize and pursue a more carefree lifestyle; millennials that have been predominantly renting are becoming homeowners; and the sizable generation Z is now entering the rental market and is expected to dominate the market in the coming years.

Overall, we believe that investments in the residential sector are set for long-term success.

## Q Is that true for all US markets?

Not really. Not all US markets are created equal, as the supply/demand drivers do vary by market. Approximately 29 states are experiencing housing deficits, while the other 21 are actually oversupplied, according to Freddie Mac. This goes to show how vast the deficit is in the undersupplied states.

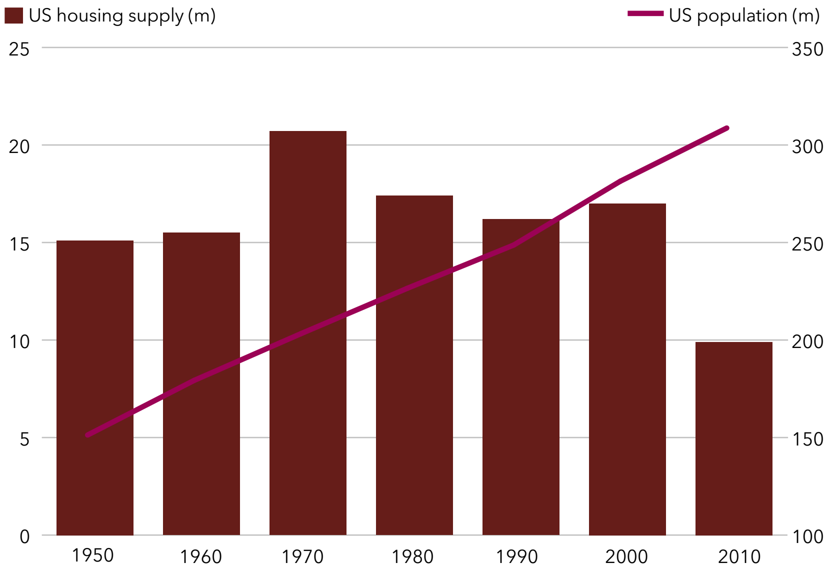
As a residential-focused firm, it is critical that we dive into sub-markets and micro-markets to see the local picture. Our approach is research-driven with a 'boots-on-the-ground' mentality. We stay current with local market trends, consumer preferences and supply/demand imbalances and favor states that are undersupplied.

There are two kinds of markets we focus on: primary established and secondary growth. Primary established markets demonstrate high costs of homeownership, high barriers to new supply due to land constraints and government restrictions, substantial job growth in high-paying industries such as technology, healthcare, higher education, professional services and entertainment, and consistent positive household formations.

These include many of the coastal and gateway markets in California, Washington, Oregon, Washington DC and Pennsylvania. Not surprisingly, these states contain the nation's highest performing cities according to the Milken Institute, and also the largest housing deficits.

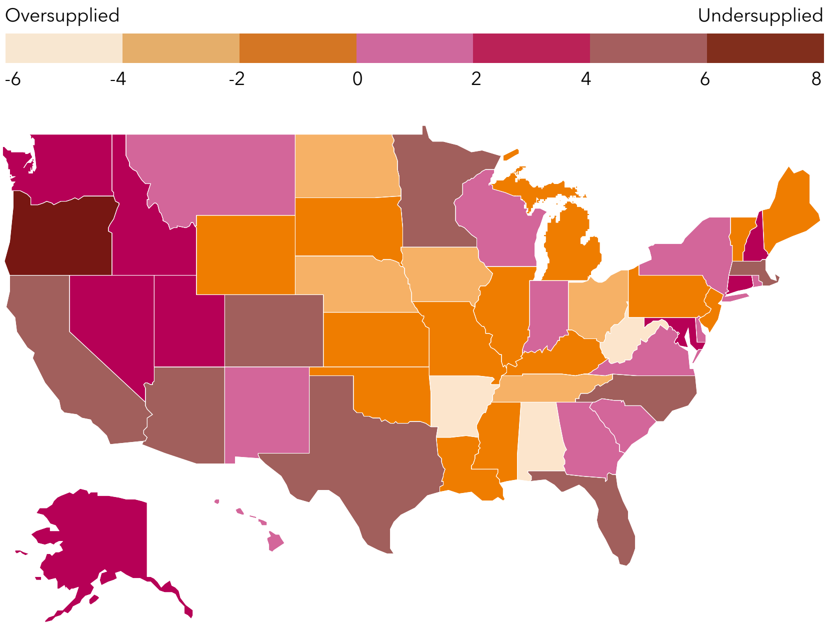
Secondary growth markets allow for greater affordable residential alternatives, convenient access to the regional employment centers via multiple commute options, and demonstrate exponential growth in in-migration. Many of the markets in Arizona, Nevada, Colorado, Utah and Texas reflect these characteristics. Overall, we favor markets that are close to employment, retail, entertainment and transportation – giving a vibrant dynamic to that community, which in turn drives a greater propensity to buy or rent.

**US new housing supply has fallen markedly since 2000 even as the population has risen**




Source: US Census Bureau

**US housing deficits: Shortages as a proportion of each state's housing stocks vary widely (%)**




Source: Freddie Mac

## Q How has the coronavirus pandemic affected the sector?

Mainstream 2020 forecasts, prior to covid-19, projected a stable and slow-growing US economy, which is a positive backdrop for residential development. Yet now, the global economy is facing a significant threat as a result of the virus, which has triggered heightened uncertainty and volatility around the globe. The economic disruptions due to the various containment measures and attempts to flatten the curve cannot be quantified at this time, so it is prudent to brace for a significant covid-19-triggered impact.

The most staggering statistic has been unemployment, with nearly 40 million Americans filing for unemployment after just 10 weeks of covid-19-related shutdowns. The longer it takes to contain the virus, the deeper the economic impact and the more likely it is that the US will enter a recession. The US government has taken multiple steps to balance out the impact, including reducing rates and infusing liquidity into the capital markets.

As it relates specifically to residential development – both for-sale housing and for-rent multifamily – we are seeing limited construction shutdown as residential development is deemed essential in most jurisdictions. Delays have been primarily due to operational complications with respect to inspections, permits, and various other administrative processes.

Land acquisition transaction volume is down significantly as homebuilders and multifamily developers face uncertainty in their economic underwriting, and landowners who have staying power are reluctant to market their properties during this time. In the for-sale housing market, we have seen substantially reduced visitor traffic and limited new home sales, elevated yet contained contract cancellations, some price concessions and reductions, but also reduced sales backlog as units under contract continue to close consistently. In May, we observed improvement in these metrics.

The for-rent multifamily market is facing reduced leasing activity, negative or flat rent growth, and increased vacancy. April collections, however, beat expectations, and May collections were outpacing April's across product classes.

*"The US housing market is undersupplied by as many as four million units. Covid-19 and the resulting market turmoil is likely to widen this housing shortage"*

**Q What are the implications of the current market on new opportunities in the residential development space?**

We anticipate that public homebuilders will continue to build their cash positions by closing on escrows in their backlog and restricting land acquisitions, in addition to likely exploring joint ventures for existing assets, land sales, land banks, model home sale/leasebacks, and other means to generate liquidity. Smaller private homebuilders will potentially face challenges as they do not have the same financial staying power as their public counterparts, are more leveraged, and typically rely on private investors and commercial banks to finance their projects.

In the for-rent multifamily development space, land repricing is anticipated in the short to medium term. In addition, development and construction costs are anticipated to trend downward as fewer projects are consummated. Development yields are likely to expand in the short to medium term.

While this environment is poised to delay future completions, it will also provide attractive asset pricing and create opportunity for those firms who have access to liquidity. I believe that the combined effect of these factors is likely to make residential development an even more attractive asset class post-covid-19.

**Q How do you view risk in your portfolio, and how has that changed in today's environment?**

We have always managed risk by maintaining disciplined investment practices through selectivity and proactivity. Risk mitigation and downside protection are at the forefront of our underwriting, due diligence, and asset management processes and are even more critical in today's environment. We are constantly evaluating and re-evaluating risk in order to design solutions to mitigate it – this is where discipline and creativity meet.

In addition to our extensive in-house experience, we have worked with extremely experienced, skilled, and well capitalized residential developers for the past 25 years. Our investment process is an aggregation of best practices, and is honed to conservatively contemplate risk. This has allowed us to develop a reputation as a thoughtful and reliable joint venture partner.

Every down market, however, brings its own challenges and this one is no exception – it is important that we proactively evaluate our models, size up any added risks, and ascertain which markets will experience the most robust economic recovery. ■