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Investcorp Real Estate North America Market Update: Multifamily & Industrial – Continued Strength and Opportunity

Arium Royal Palm, Royal Palm Beach, Florida

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Rosemont Grayson, Atlanta, Georgia

Introduction

The outlook for the United States multifamily and industrial sectors is bright.

Driven by the persistent need for housing, multifamily investments show durability even through times of economic volatility. Both the Global Financial Crisis and the COVID-19 pandemic have been clear examples of the asset classes' resilience. Multifamily properties will continue to benefit from favorable supply-demand dynamics in the years ahead. A significant shortage of homes and unaffordable housing prices will keep millions of households in the rental market. And supportive demographic trends, including a growing cohort of young professionals, will drive strong demand for the rental market, particularly in the Sunbelt region.

The rapid growth of e-commerce will continue to fuel demand for distribution centers and fulfillment hubs to cater to online shopping needs. The resurgence of manufacturing activities in the United States, bolstered by favorable government policies and reshoring initiatives, is further boosting demand for industrial space. Increasing focus on supply-chain resilience and the rise of sameday and next-day delivery expectations means that the demand for last mile warehouse centers will be particularly strong near urban areas with good transit infrastructure, higher population densities and better migration prospects. While new industrial property supply will continue entering the market, exceptionally strong demand will keep vacancy rates for industrial properties well below pre-pandemic levels.

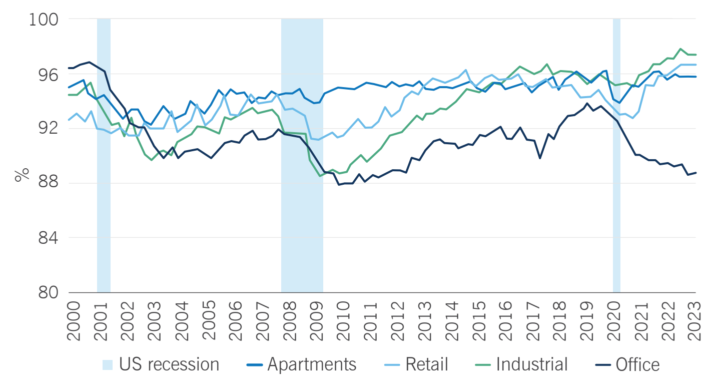
This paper explores the drivers and outlook for apartments and industrial property in the United States in further detail.

Apartments

Multifamily property has become a key part of the institutional investment landscape in the United States and will remain a front-running investment choice.

The attractiveness of Multifamily property can be seen in their occupancy rates. Apartments have historically had the highest occupancy rates compared to other property types, averaging 95% between 2000 and 2023. Apartment occupancy rates have also been the most stable of all asset classes over this time period, with a standard deviation of 0.9% between 2000 and 2023. This compares with a deviation of 2.0% for office properties. (See Figure 1).[1]

Figure 1. **Occupancy rates by type of REIT**



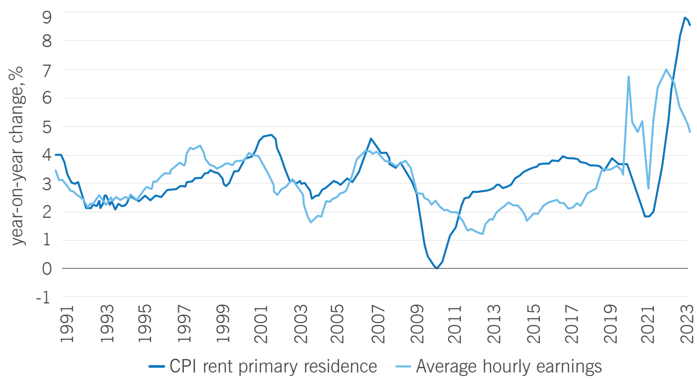
Sources: Capital Economics and NAREIT

Apartments have out-performed other property types in terms of rental growth. Over the last decade, apartment rents have grown at an average annual rate of 4.8%, double the growth rates for office over the same period. What's more, the sector has been the best-performing property type during recessions, with demand remaining relatively strong and rents recovering faster than other sectors.

Rental growth for apartments has also far outpaced average inflation over the past two decades, making the asset class well positioned to respond to price pressures. It offers the best inflation-hedging characteristics of the main sectors due to the link between demand and earnings. (See Figure 2).

[1] Note: Standard deviation is a measure of the average distance from the mean of a series over time. A smaller standard deviation means there is less variation over time.

Figure 2. **Rental growth and earnings**



Sources: Capital Economics and Refinitiv

Demand

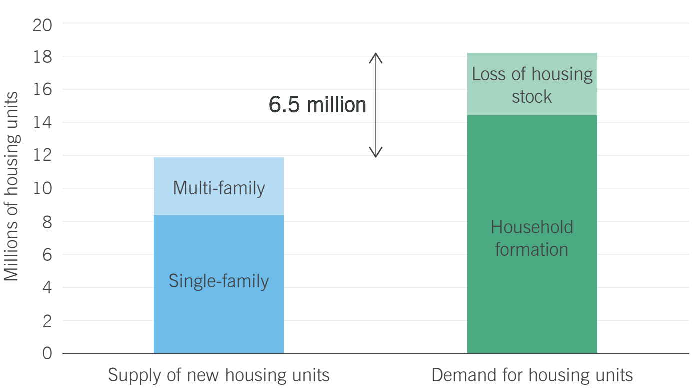
Despite some macro financial headwinds in the near-term, the multifamily market remains on solid footing, and we expect demand to remain robust.

A key driver of future demand for apartments is the stretched housing market.

First, demand has outpaced supply for well over the last decade. Homebuilding has fallen short since the onset of the Global Financial Crisis, exacerbated by zoning regulations, a lack of skilled labor and a lack of available land. Between 2012 and 2022, 11.9 million new homes were built. This includes 8.5 million single-family homes and 3.4 million multifamily homes. Yet over this same time period, 14.6 million new households formed, leaving a shortage of 2.7 million homes.

Further compounding this shortage is that, over time, housing stock gradually depreciates and therefore must be replaced. Estimates from the US Census Bureau indicate that the US housing market needs to add approximately 350,000 units per year to replace lost units.[2] From 2012 through 2022, this has amounted to a loss of roughly 3.8 million housing units. In all, this means that demand for housing has outpaced supply to the tune of 6.5 million homes over the last decade. Lack of homes for sale will support rental demand, and lead to a steady rise in rental households over the coming years. (See Figure 3).

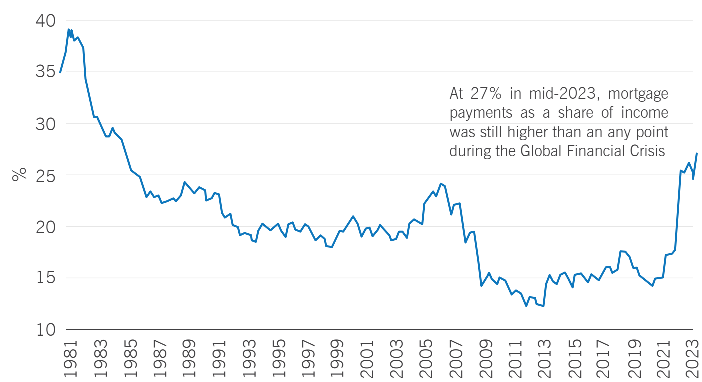
Figure 3. **Supply and demand for housing, 2012 to 2022**



Sources: Capital Economics and US Census Bureau

Second, housing is overvalued by historical standards, and rapidly rising mortgage rates are making homeownership increasingly unaffordable. At 27% in mid-2023, mortgage payments for a median-priced home as a share of median family income were still higher than at any point during the Global Financial Crisis. (See Figure 4). Recent research from Freddie Mac estimated that roughly 15 million mortgage-ready households have been priced out of a home due to rising interest rates.[3] With homeownership set to remain largely inaccessible to large swathes of the population for some time to come, this will be supportive for the rental market.

Figure 4. **Mortgage payments as share of income**



Sources: Capital Economics and Refinitiv

In many parts of the country, it is currently more expensive to own a home than to rent. And while rents have been rising as well, rising homeownership costs have accelerated at a much faster rate. In Miami, for example, house price growth was 15 percentage points higher than rental growth over the past year. The gap was 14 percentage points in Tampa and 13 percentage points in both Atlanta and Phoenix. (See Figure 5). Rental demand should therefore be particularly strong in these Sunbelt markets in the coming year.

2 https://www.freddiemac.com/research/insight/20181205-major-challenge-to-u.s.-housing-supply#

3 https://www.freddiemac.com/research/insight/20221121-do-rising-interest-rates-price-out-mortgage-ready

Figure 5. **House price growth vs rental price growth, 2021 to 2022**

Metro Area	House Price Growth (y/y%)*	Rental Growth (y/y%)**	Difference (%pts)
West Palm Beach / Boca Raton	24.7	5.6	19.1
Fort Lauderdale	23.8	5.6	18.2
Miami	20.8	5.6	15.2
Tampa	25.0	10.6	14.4
Atlanta	18.5	5.7	12.8
Phoenix	19.0	6.3	12.7
Riverside-San Bernardino	16.0	4.4	11.6
Anaheim	13.7	2.1	11.5
Seattle	11.6	2.1	9.5
Denver	12.8	5.1	7.7
Los Angeles / Long Beach	9.7	2.1	7.6
Dallas	19.1	11.9	7.2
St. Louis	11.0	4.1	6.9
Fort Worth - Arlington	18.6	11.9	6.7
Baltimore	9.6	3.4	6.2
Philadelphia	9.4	3.3	6.0
Houston	12.8	7.0	5.8
Detroit	10.5	4.7	5.7
Chicago	9.8	4.5	5.4
New York / Jersey City	10.5	5.7	4.8
Boston	9.8	5.8	4.0
Minneapolis	7.8	5.3	2.4
San Francisco	6.3	6.4	-0.1
San Diego	13.2	15.9	-2.7
Washington	7.2	12.2	-5.0

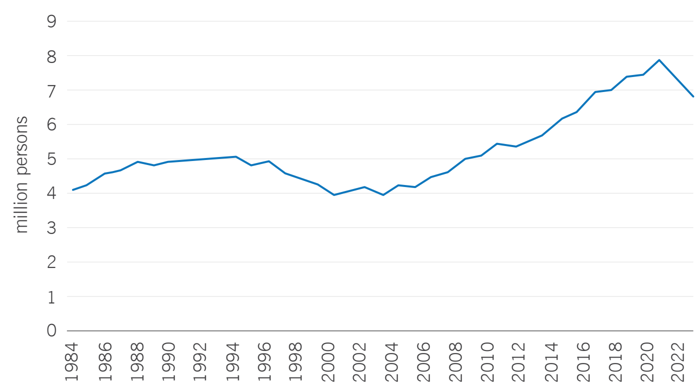
* House prices are a measure of single-family homes.
** Rental growth is the CPI for owner occupied rents.
Sources: Capital Economics, Bureau of Labor Statistics and Federal Housing Finance Agency.

Young adults will continue to drive multifamily demand. They are the most likely of all age groups to rent, with heads of households ages 35 or younger comprising 34% of all renters, compared with 19% of all homeowners. Roughly 16% of adults aged 25 to 34 lived at home with their parents in 2022. This amounts to just under seven million people, and 1.5 million more than were living at home a decade ago. We have already seen some of this cohort move out, as the economy re-opened after the pandemic, with around 600,000 fewer adults living with their parents in 2022 compared to 2021. (See Figure 6). However, with many more still living at home compared with levels in the past, they represent a large number of potential renters.

The rising cost of homeownership, student debt and lifestyle preferences are all factors explaining why millennials are opting to rent rather than own. Since many millennials are relatively early on in their careers, this cohort is also more likely to look to B grade apartments, which tend to be more affordable.

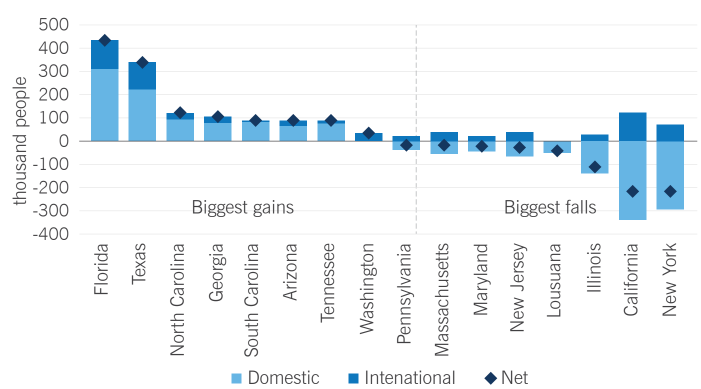
The Sunbelt region will be a particular beneficiary of increased demand from millennials. There has been an accelerated population shift to these States in recent years, with a wave of domestic migration to Florida and Texas. (See Figure 7). The population aged 25 to 35 is projected to see the largest increases to the Sunbelt area over the next decade, particularly compared to coastal states. Employment growth has also been strongest in the South, with Austin, Dallas and Houston recording growth rates exceeding 4% earlier this year. Other metros such as Orlando, San Antonio and Tampa also reported similarly rapid employment growth. And we continue to think the Sunbelt will outperform other markets in the years ahead, given the strong employment outlook for the region.

Figure 6. **Young adults (aged 25-34) living with parents**



Sources: Capital Economics and US Census Bureau

Figure 7. **US migration by State, July 2021 to July 2022**



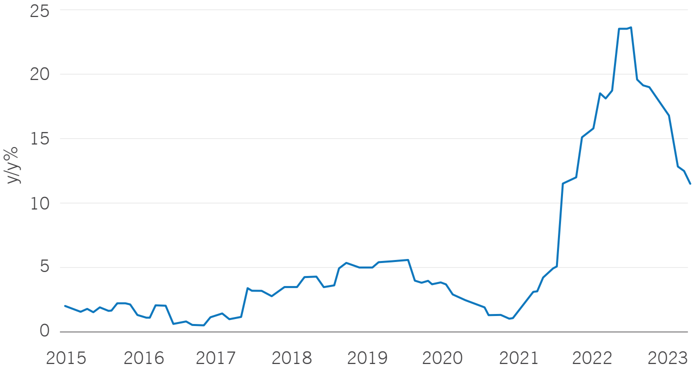
Sources: Capital Economics and Refinitiv

Supply

On the supply side, attractive returns for developers have kept multifamily starts above historic levels this year. The Census Bureau reported multifamily starts of 555,000 annualized earlier this year, up almost 40% on the 10-year average. However, completions have been struggling to keep up with starts as rising input costs have led to delays. According to the National Multifamily Housing Council's quarterly construction survey of members in June, persistent construction and permitting delays, less available construction labor and onerous project requirements being imposed by local governments have put a damper on apartment development. (See Figure 8).

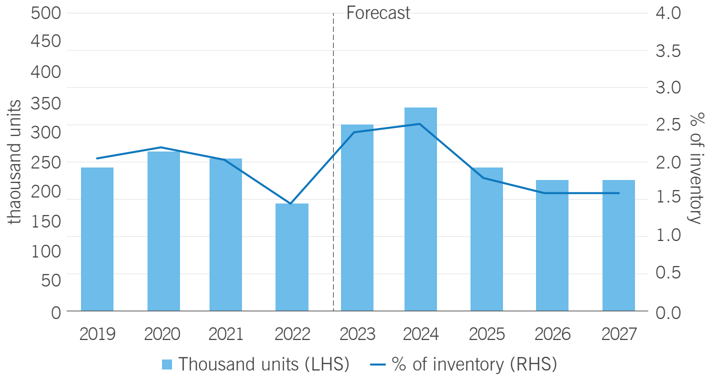
The longer lag between starts and completions means that the number of apartments under construction has stayed close to record highs. Earlier this year, apartments under construction sat above 950,000, which is narrowly below the peak seen in 1973. Given the congested construction pipeline, completions will be especially strong this year and next. We expect them to average 300,000, or roughly 2.5% of inventory, in both 2023 and 2024. Thereafter we expect deliveries to slow, averaging below 2.0% of stock between 2025 and 2027. Elevated interest rates will create headwinds for multifamily construction pipelines through higher borrowing costs and more stringent lending conditions, making it harder for developers to secure financing for their projects. (See Figure 9).

Figure 8. **Non-residential construction costs**



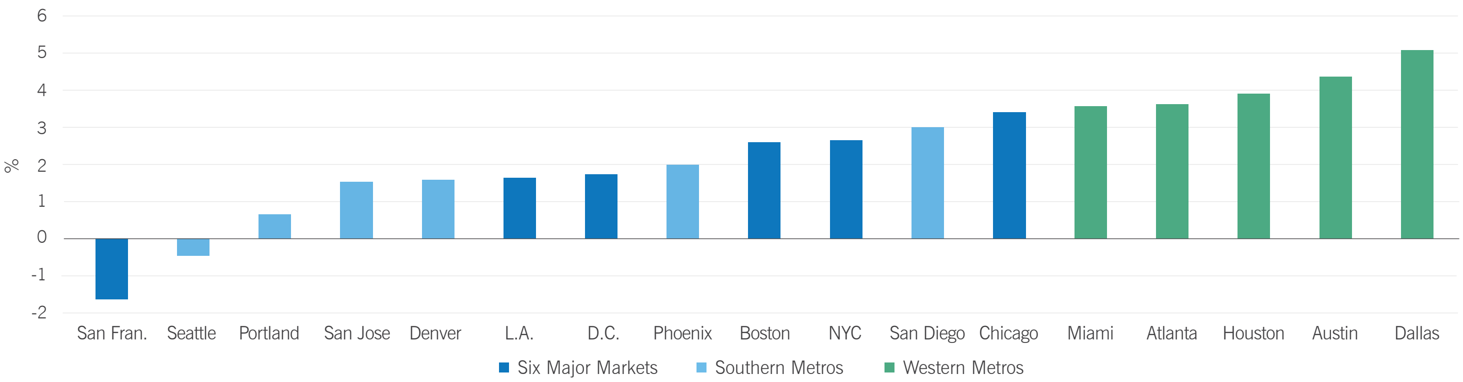
Sources: Capital Economics and US Bureau of Labor Statistics

Figure 9. **Apartment completions**



Sources: Capital Economics and REIS

Figure 10. **Total returns forecast (% cumulative, 2023-2027)**



Source: Capital Economics

Looking ahead, we anticipate multifamily starts will begin to trend downward as higher interest rates and soaring costs of labor position many projects as unprofitable. Some developers are also slowing construction and delaying projects presumably because of the volume of new supply constructed in recent months. Additionally, building permits have dropped back in recent months, which is consistent with our expectation for lower completions from 2025 onward. Lower supply in the medium-term will enhance the existing multifamily stock and keep occupancy rates elevated.

Mid-term Outlook

With more supply coming into the market, we think the operating environment will soften slightly going forward. However, an improvement in rental affordability and a more supportive economic backdrop as the Fed begins to loosen monetary policy will help to spur employment growth and support occupier demand from 2024 onward. As such, we expect a sharp rebound in absorption rates of around 2% in 2024, and a pick-up in rental growth of roughly 3% per annum, which is similar to pre-pandemic levels.

Cap rates have started to rise slightly this year, re-opening the gap between apartment yields and the 10-year Treasury yield. That said, apartment yields began to rise earlier than other sectors, which is why we expect a more muted rise compared to other sectors. With yields rising, capital values may soften somewhat in the near-term. Yet by 2025, rent rises and a stabilization in yields will take capital value growth back into positive territory, averaging 3% per annum between 2025 and 2027. Lastly, the expected precipitous drop in new supply between 2025 and 2027 would create a very favorable environment for landlords, therefore creating an opportunity for outsized rent growth and healthy occupancy.

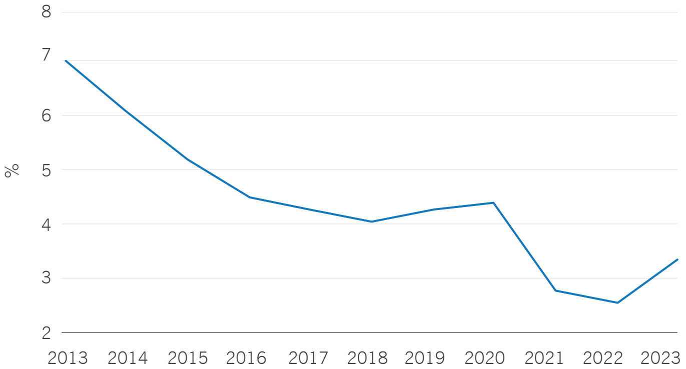
There will be a growing differentiation between southern and western markets in the years to come. This is due to the relatively high rents and cost of living in many western metros, which will persuade residents to seek out cheaper alternatives, predominantly in the Southern United States. That will mean rent growth is strongest in southern metros, with Dallas, Miami and Atlanta faring well over the next five years. With rental growth being the key driver of capital growth in the years ahead, southern metros will dominate the rankings for total returns between 2023 and 2027. (See Figure 10).

Industrial

The industrial property market has emerged as a highly attractive investment option. The confluence of factors such as the e-commerce boom, supply chain shifts and limited supply have resulted in exceptionally strong performance in recent years. High demand has seen vacancy rates trend downwards and fall to a record low of 3.0% in 2022. This has resulted in a rapid acceleration in rental growth, with annual asking rents climbing over 20% in 2022. (See Figures 11 and 12).

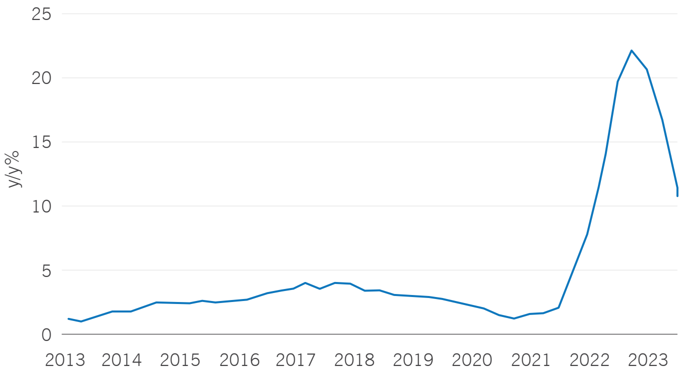
The resilience of the industrial property market during recent economic downturns has also bolstered its appeal. Industrial properties tend to perform well even during recessions, as they are essential for maintaining supply chains and logistics operations, making them a stable investment option during uncertain times. Industrial real estate demand has outperformed the economy for the past decade due to these factors. The fundamental drivers behind this activity show no sign of abating, and we expect this strength to continue in the years ahead.

Figure 11. **US industrial vacancy rates (%)**



Sources: Capital Economics and CBRE

Figure 12. **US industrial asking rents (y/y%)**



Sources: Capital Economics and REIS

Las Vegas Infill Industrial Portfolio, Las Vegas, Nevada

Demand

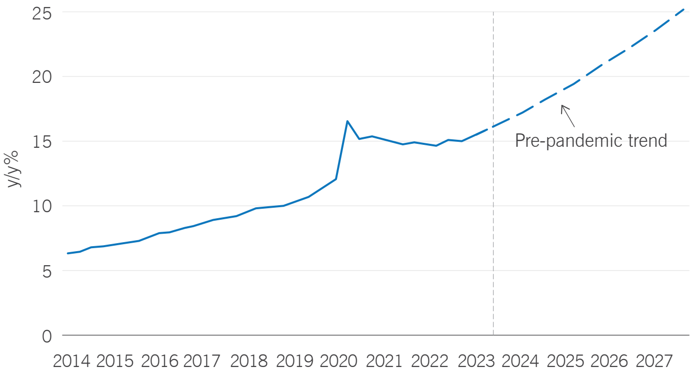
The industrial sector has performed well since the 2008 Global Financial Crisis, with rents growing steadily. The arrival of COVID-19 prompted a series of virus-related restrictions on activity which caused major disruptions to supply chains, encouraging retailers to increase their stock buffers. This forced many consumers to shift their spending from in-store to online and from services to goods, impacting the growth of distribution networks across the US.

While online as a share of total retail sales has fallen back from its lockdown peak, it remains above its pre-virus level and is expected to trend higher in the future. (See Figure 13). Total e-commerce sales as a share of total retail spending remained flat over the past two years at around 15%, largely due to a faster increase in total retail spending. As such, e-commerce has continued to gain momentum in absolute terms.

Looking ahead, underlying trends in e-commerce growth remain intact. Demographic tailwinds, including young digitally savvy consumers, will remain a key engine for online sales growth. Improvements in technology, digital payments and supply chain capabilities will further drive changes in consumer behavior. Furthermore, at 15% share of total retail sales, the US e-commerce market is still relatively underpenetrated compared to its peers, leaving room for large catch-up growth. (South Korea and the United Kingdom, for example, have penetration rates above 30%.[4]) (See Figure 14).

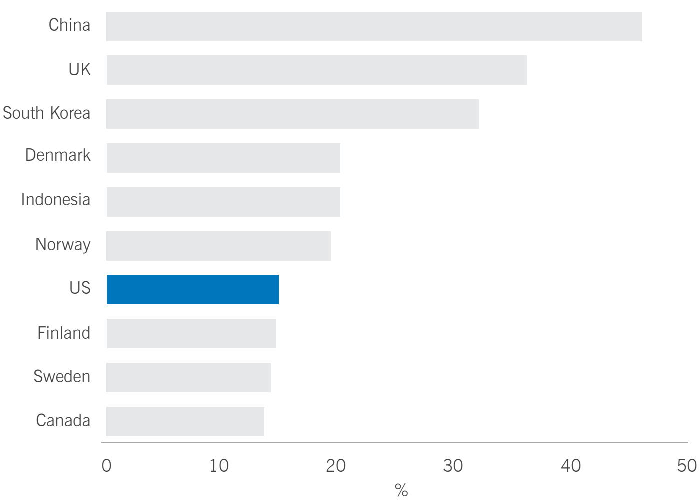
[4] https://www.insiderintelligence.com/content/countries-retail-ecommerce

Figure 13. **E-commerce share of total retail sales**



Source: Capital Economics and Refinitiv

Figure 14. **Top 10 countries by share of e-commerce**

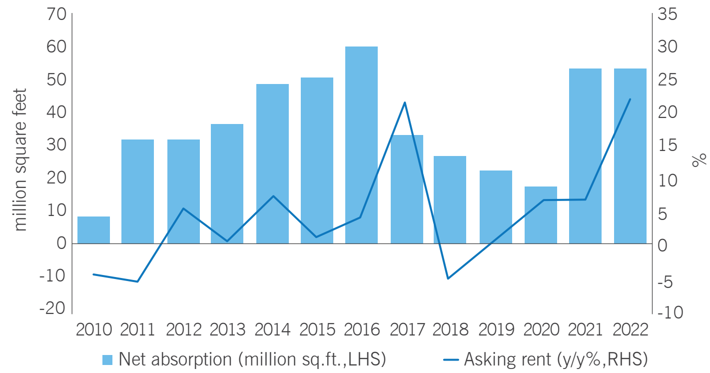


Source: Capital Economics and eMarketer

Industrial demand will be further supported in the future years by government incentives to return manufacturing operations back to the US. Manufacturing construction spending in the States has boomed over the last two years. Between 2015 and 2019, the average amount spent on manufacturing construction was roughly $77 billion a month. By contrast, since March 2021, the average monthly spend has been $112 billion. This sharp rise has not been reflected in other sectors. It is unlikely that rising building costs have affected manufacturing substantially more than other sub-sectors, as they do not include capital costs.

This acceleration in spending has therefore likely been driven by firms' reshoring production due to global supply chain disruptions, rising tensions with China and favorable government incentives. The pandemic exposed the vulnerability of the automotive and technology industry to supply bottlenecks, which has encouraged companies to onshore operations to prevent future interruptions. Firms were further incentivized as the Biden administration passed

Figure 15. **Manufacturing property growth in demand**



Sources: Capital Economics and US Census Bureau

legislation over the last year to improve US competitiveness and strengthen security against China. These acts included over $50 billion towards domestic semiconductor manufacturing over the next ten years and another $50 billion towards green technologies such as electric vehicle batteries.

This has fed into sharp growth in demand for manufacturing property and annual asking rents growing by 23% in 2022 (See Figure 15). Government incentives will ensure absorption remains elevated in the coming years, as $200 billion of private sector investment has already been announced towards semiconductor production over the next decade. We expect this to continue to drive strong rental growth, particularly given vacancy rates are already low. The Sunbelt stands to benefit the most, with over $90 billion being directed towards the construction of new facilities in Arizona and Texas alone.

At the metro level, demand for industrial property in the US will be driven by five key factors: 1) the absolute cost of rent; 2) the cost of rent relative to nearby markets; 3) location (i.e. proximity to population, seaports and transit infrastructure); 4) supply pipeline; and 5) vacancy rates.

First, in terms of absolute cost of rent, firms will aim to minimize their costs, including the rents they pay on warehouse space. Given the surge in rents seen in recent years, warehouses have become much more expensive. We therefore expect affordability to increasingly enter firms' decision-making processes as they look to expand their footprint. That said, rent is a very small percentage of the firm's total cost structure and so affordability to pay the higher rent levels is not an issue.

Second, while the absolute cost of rent captures the attractiveness of cheaper markets, it does not tell the full story around rents. Firms should focus on how expensive an industrial market is compared to its nearby alternatives. For example, we consider Los Angeles, Riverside, San Diego and Phoenix to be competing markets. They all have rent levels higher than the national average which could put off some firms from operating there. But others

250 West Nyack, New York/New Jersey

will still need access to these markets. In this case, what drives the firm's decision is how cheap each market's rents are compared to nearby markets.

We think this is one reason why demand has been so strong in Phoenix, for instance. Goods arriving at the ports of Los Angeles and Long Beach have increasingly travelled straight to Phoenix instead. We expect this trend to continue over the coming years, with firms looking for more affordable distribution hubs, particularly while their vacancy rates are at or close to historic lows.

Third, market location will remain at the forefront of industrial firms' decision-making processes when choosing where to expand. Locational factors, such as proximity to seaports and cargo-handling airports or access to rail and road infrastructure, are vital in driving industrial demand. Additionally, locations with higher population densities and better migration prospects will be attractive. Indeed, many companies are adopting Amazon-like same-day and next-day delivery services, and Amazon itself recently announced the need to double its facilities in order to continue providing such competitive services. As such, locations near large consumer bases will be attractive for last mile assets.

Lastly, new supply will also affect vacancy rates and therefore play a role in determining rental growth.

Supply

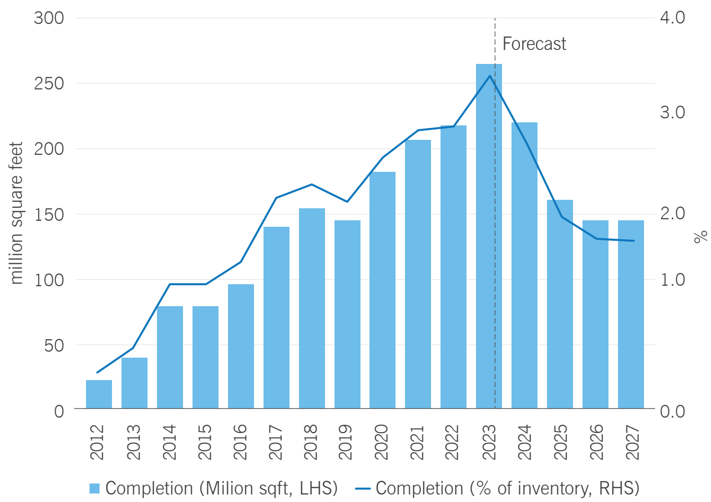
It typically takes a year to build a warehousing unit. Developers responded strongly to the surge in demand and rents during 2021 and 2022. As a result, warehousing completions reached record highs during the latter, and despite increased supply, vacancy rates fell; thanks to the continued strength of demand, the size of the drop (at nearly 3.0 percentage points) was greater than most analysts expected.

Completions will be higher still in 2023. Brokers reported between 630 to 685 million square feet of industrial space under construction at the end of Q4 2022. Given the annual lag between starts and completions, we expect an inventory growth of around 3.4% this year. (See Figure 16). Yet even with higher supply coming in the near-term, demand is expected to keep pace, supporting occupancy rates and rents.

Looking ahead, there is evidence that new supply is cooling. CBRE reported that under-construction projects declined in Q1 2023, the first time in over four years.[5] We expect this to be the start of a weaker supply trend over the next year or two, as higher interest rates and more conservative lending practices render borrowing, particularly for speculative development, more expensive and less easy to secure. Additionally, construction costs have risen by roughly 40% since June 2021, making construction less tenable. (See Figure 17).

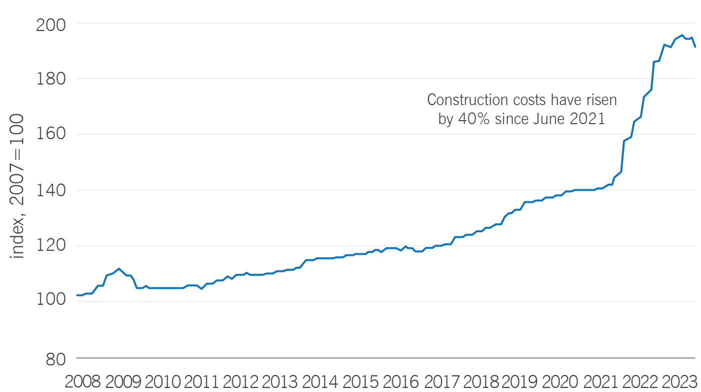
With industrial values easing and developers facing higher costs, we believe completions will slow from 2024 through at least 2027. (See Figure 16). Reduced future supply will help support low vacancy rates and healthy rental growth in the years ahead.

Figure 16. **Distribution warehouse completions**



Sources: Capital Economics and REIS

Figure 17. **Cost of industrial building construction**



Sources: Capital Economics and US Bureau of Labor Statistics

[5] https://www.cbre.com/insights/figures/q1-2023-us-industrial-figures

Mid-term Outlook

Despite the slowing momentum of the incredibly strong growth we've seen over the past two years, the outlook for industrial property remains bright. With demand still exceptionally strong, we believe vacancies will rise only slightly on the national level due to new supply in the market, increasing by 20 basis points to roughly 4.5% this year. We expect vacancy rates to remain between 4.5% and 5.0% over the next five years, which is well below pre-pandemic levels.

As a result of modestly rising vacancy, we believe that annual rental growth will remain extremely strong this year but will drop from record highs to a still very healthy around 6% to 7% year-on-year, with a more gradual easing to roughly 4% by end-2024. This will leave rental growth elevated relative to the pre-pandemic norms, with the Sunbelt region and port markets faring particularly well, however, all markets will ultimately benefit from the long-term systematic changes that will benefit the industrial sector for many years to come.

Cap rates have already risen at a national level since their trough in Q2 2022, and they may have a bit further to climb in order to re-assert the appropriate yield gaps to bond yields. As such, capital values may stay relatively muted in the near-term, except where extremely strong rental rate/operating income growth exists, which will offset upward cap rate pressures. As yields stabilize and rental growth is sustained, capital values will begin to grow again due to the strong demand growth in the sector. This represents a systematic change for the industry and should, in the medium and long term, benefit industrial valuations.

Conclusion

Underpinned by strong fundamentals, we believe that both the multifamily and industrial real estate sectors are expected to thrive in the years ahead, presenting attractive opportunities for investors.

Favorable supply-demand dynamics will be supportive of both sectors. An undersupply of housing will see apartment demand continue to outpace supply, supporting rents for some time to come. The rise of e-commerce and need for efficient supply chains will keep demand for industrial properties strong.

Overall, based on our analysis, these sectors are poised to see sustained growth, supported by strong demographic trends, evolving consumer behavior and a resilient economy.

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