

INVESTMENT RESEARCH

WILL THE 2020s BE THE DECADE OF U.S. SUBURBAN RENTAL DEMAND?

October 2020

Introduction

The global financial crisis was followed by a shift in U.S. housing demand that favored urban housing, particularly in rentals. Declining incomes, rising foreclosures and restrained bank lending forced many homeowners to rent and delayed the home-buying plans of many potential owners. The accompanying surge in demand for urban-housing was also driven by millennials — a large cohort of younger workers born between 1981 and 1996 — entering the workforce, who preferred an urban live–work–play environment.

Fast-forward to today, and the drivers of housing demand no longer overwhelmingly favor urban locations. For one, the COVID-19 pandemic has diminished the relative benefits of urban housing and increased the adoption of work-from-home arrangements. Second, and most important, the underlying demographic profile of the United States has shifted. The large, millennial cohort that bolstered demand for urban housing post-global financial crisis are now entering their 30s, and if history is a guide, is expected to increasingly prioritize such features as space and proximity to schools.

For those reasons, housing demand is set to favor suburban locations in the near term and during the next decade. Both multifamily and single-family rental properties should benefit from that suburban demand shift, which supports investment strategies focused on the acquisition, development and redevelopment of suburban rental housing.

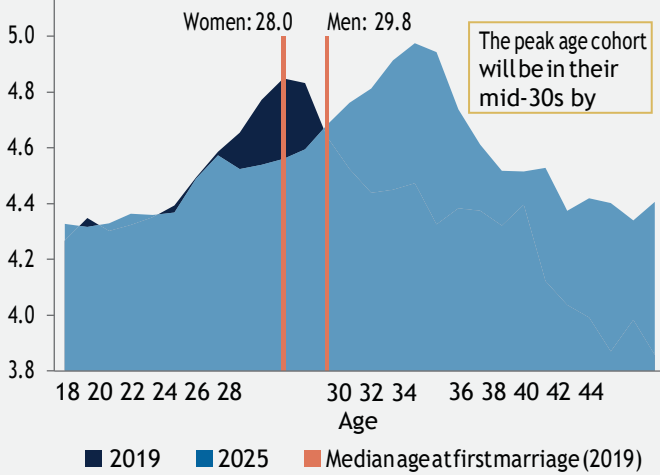
Demographic Shifts Provide Suburban Tailwind

Given the size of the cohort, the millennials' changing lifestyle preferences will have a pronounced impact on demand for certain locations and types of housing. The aging of the millennial population into their mid-30s is set to provide a tailwind for suburban demand as more and more young couples move out of urban areas in search of larger accommodations and better school districts in which to start and grow their families.

In 2019, the most common age in the United States was 28, close to the median age for first marriage for men (29.8) and women (28.0). As shown in Exhibit 1, by 2025, the most-populous age range will be in their mid-30s, many of whom will have had children or be close to starting a family.

Exhibit 1

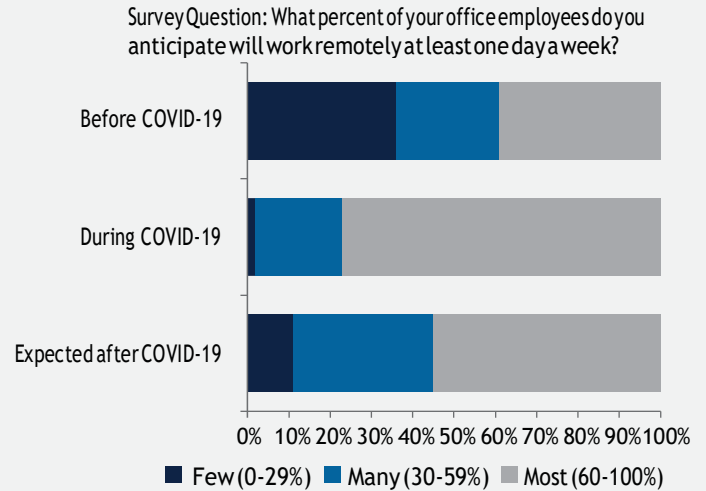
2019 vs. 2025 Population By Age (Mil)



Sources: Census Bureau, PGIM Real Estate. As of October 2020.

Exhibit 2

Anticipated Increase in Work-From-Home Arrangements



Sources: PwC, PGIM Real Estate. As of October 2020.

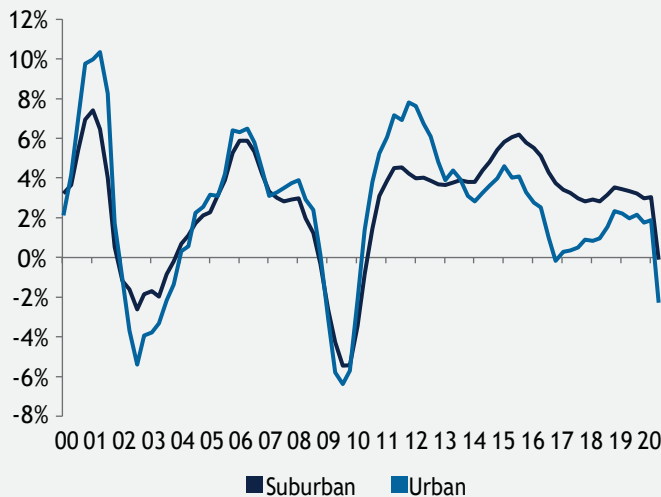
The desire for the additional living space found in the suburbs will coincide with what may be an increased acceptance of flexible working arrangements in the post-pandemic world. As seen in Exhibit 2, many employees' forced adoption of work-from-home arrangements during the current pandemic is expected to result in remote working becoming a more common and accepted practice. The office environment is not anticipated to become obsolete, nor is full-time remote working expected to become adopted en masse, but being able to work from home more regularly may make a longer commute from the suburbs more palatable.

Urban Fundamentals Affected More During This Downturn

Entering 2020, suburban-apartment-income growth had already been outpacing urban for six years. Rents in urban submarkets had been growing more slowly than in suburban submarkets since 2014 (Exhibit 3). Demand remained high, but it was counterbalanced by elevated construction activity, as shown in Exhibit 4.

Exhibit 3

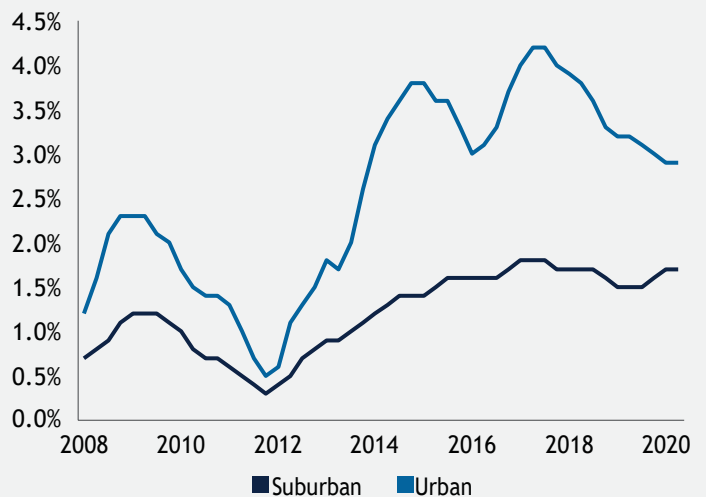
Apartment Effective Rent Growth (Trailing 12-Month)



Sources: RealPage, PGIM Real Estate. As of October 2020.

Exhibit 4

Urban vs Suburban Apartment Inventory Growth

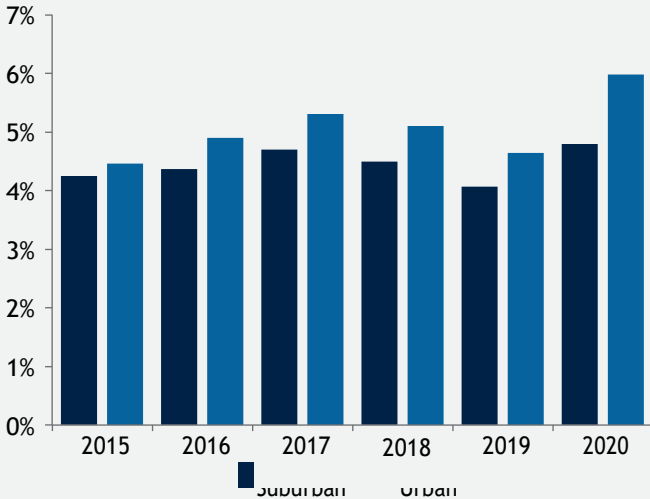


Sources: RealPage, PGIM Real Estate. As of October 2020.

Urban locations have also been faring worse in 2020 because the attributes that renters find most appealing — such as proximity to workplaces, restaurants, entertainment and, ultimately, other people —lose considerable luster during a pandemic. In the major metros we track, rents for units located in urban submarkets fell 2.4% during the second quarter, and vacancies spiked to their highest level since 2009 (Exhibit 5). Suburban submarkets have also been affected, but less severely so far.

Exhibit 5

Apartment Second Quarter Vacancy Rate



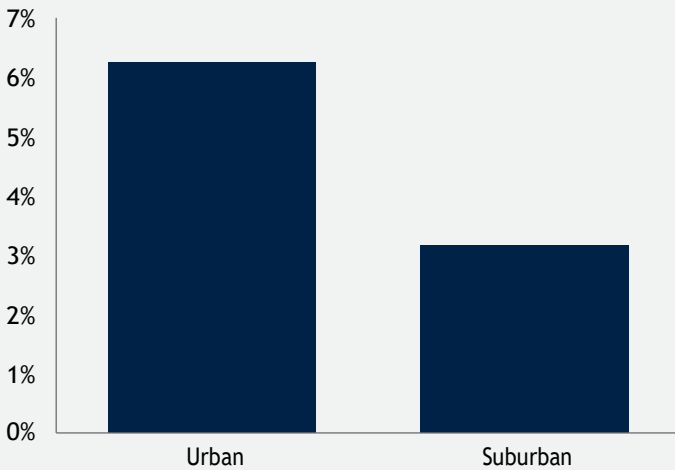
Sources: RealPage, PGIM Real Estate. As of October 2020.

Supply Growth Lower in the Suburbs

Supply growth in suburban submarkets continues to be more contained than in urban locations. As seen in Exhibit 6, urban supply pipelines remain full, which should continue to weigh on rents. Although land may be scarcer in urban areas, barriers to development are often lower. There is actually a slightly negative correlation between population density and measures of land regulation.¹

Exhibit 6

Apartment Units Under Construction, As % Of Inventory



Sources: RealPage, PGIM Real Estate. As of October 2020.

¹ Joseph Gyourko, Albert Saiz and Anita A. Summers. “A New Measure of the Local Regulatory Environment for Housing Markets: The Wharton Residential Land Use Regulatory Index.” Wharton, University of Pennsylvania, working paper #558.

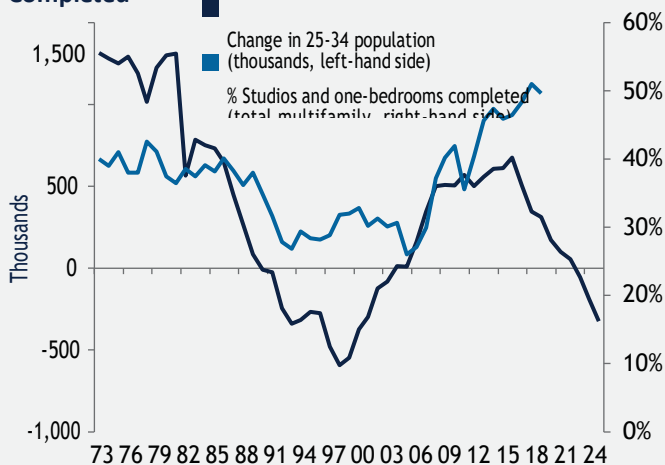
In contrast, many suburban locations with highly rated public school systems have high supply barriers in the forms of zoning restrictions and local homeowners' opposition to densification. Moreover, local wealth is positively correlated with land-use regulation measures. Given that public school systems rely heavily on local property taxes, many attractive suburban locations with well-funded public schools also have the highest barriers to development.

Unit-Type Preferences Also Set to Shift

A shift in unit type preferences will also likely coincide with the shift in demand to the suburbs. As shown in Exhibit 7, over the course of the most recent cycle, the percentage of studios and one-bedroom units in newly completed buildings rose significantly, from less than 30% of all units completed in 2006 to 50% in 2019. With the bulk of the millennial population in their mid- to late-20s for much of that span, the unit mix suited the demand.

Exhibit 7

Change in Age 25-34 Population vs. Unit Types Completed



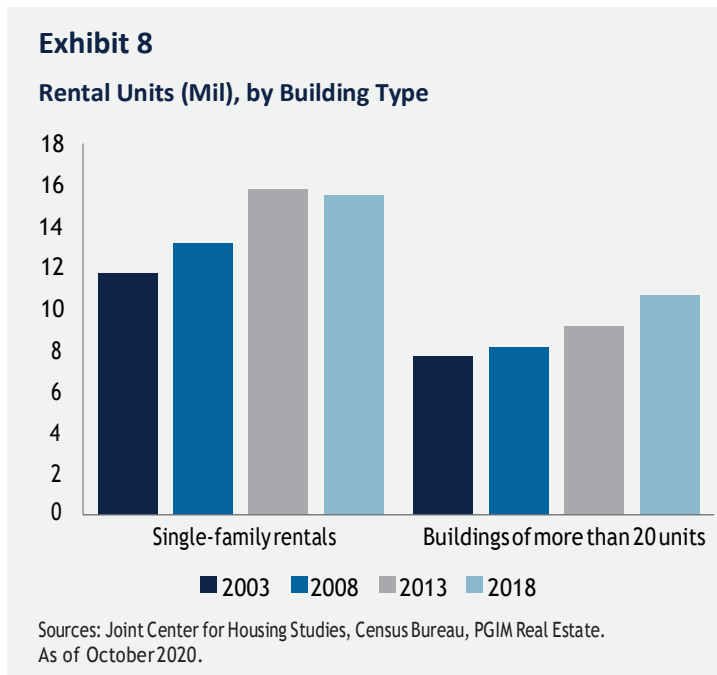
Sources: Moody's Analytics, Census Bureau, PGIM Real Estate. As of October 2020.

Nonetheless, a preponderance of studio apartments and one-bedroom units is unlikely to meet the changing lifestyle needs of millennials in search of more space and accommodations suitable for families. Instead, there will likely be a growing preference for two- and three-bedroom units, which are usually built in suburban submarkets. As such, there will be opportunities to either develop or redevelop rentals with larger units or intentionally design properties that preserve the option to cost-efficiently shift unit mixes over time.

Single-Family Rentals to Benefit From Suburban Shift

Single-family rentals, having held up relatively well so far in the current downturn, will benefit from the same shifts in demand — perhaps to a greater extent. CoreLogic reported year-over-year single-family-rental growth of 1.4% in June 2020, indicating a slowdown from recent trends but better than the 1% rent decline for national apartment rents during the same time frame.

Supply conditions, too, should remain supportive of income growth. As shown in Exhibit 8, single-family rental inventory fell 1.5% between 2013 and 2018, as many were converted to owner-occupied units. This was in contrast to larger apartment buildings, whose inventories increased 17% during the same span.



Though home foreclosures typically rise during recessions — thereby opening up opportunities for some conversions to rentals — inventory is unlikely to increase to the same degree as observed in the years following the global financial crisis. This should keep supply relatively tight, helping support strong occupancies and rental growth.

Rising Homeownership a Headwind, but Affordability Concerns Persist

A key risk to the outlook for suburban rental housing will be the extent to which homeownership continues to rise during the next decade. The homeownership rate has been steadily increasing over the past five years from a cyclical trough of 63.1% in 2016 to 65.3% in early 2020. Nonetheless, most renters still view affordability as a significant hurdle to homeownership. A 2019 survey of renters from Freddie Mac found that 84% believed renting to be a more affordable option than owning — a figure that has trended upward during the past several years. Even for those who do eventually become homeowners, suburban rentals may still serve as attractive transitional options.

Concluding Remarks

Years from now, the COVID-19 pandemic and accompanying recession may be viewed as sparks that ignited renewed demand for suburban living. However, the shift toward the suburbs was already occurring, pandemic or not, because of the changing lifestyle demands of an aging millennial cohort. Accelerated adoption of more flexible work-from-home arrangements should give a boost to suburban living, but the demographics were already pointing in that direction.

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