REDWOOD CAPITAL GROUP

Work Force Housing Investment Theme

David J. Carlson
Managing Partner

There are a number of indispensable variables that position the multi-family sector for continued strength over the next decade. Upon further examination of these variables a distinct trend emerges that underscores the thematic approach Redwood has taken towards the sector. We target Class B, suburban product that houses the essential workers within a particular community. We see this demographic underpinning mid-to-long term performance of the sector due to supportable trends in household formation, demographic trends, job growth, supply dynamics and affordability. This memo provides a snapshot of why we think workforce housing is an attractive, alpha generating investment not only in comparison to its sector's benchmark indices but also to that of other types of commercial real estate.

Defining Workforce Housing

Workforce housing is a term that has typically been employed by municipal government, city planners, and political action organizations concerned with housing policy or advocacy. Yet it is gaining importance with multifamily investors, operators and developers. And the increased frequency of the term heard through the multi-family sector is for good reason.

Rising rental rates over the last 5 years have created a shrinking supply of affordable workforce housing in cities across the United States. As more Class A suburban and urban core properties push rents higher and higher there is less room for the essential workers to find quality housing.

The term 'workforce housing' typically sparks images of firefighters, teachers, law enforcement professionals, nurses and others who are overqualified for affordable housing yet can't afford the average market-rate apartment. Or more broadly, workforce housing may be targeted more generally at certain income levels regardless of type of employment, with definitions ranging from 50% to 120% of Area Median Income (AMI). To be sure, with the economic turmoil over the past decade, Redwood has found that the core of qualified workforce Americans has widened significantly. Expenses for necessities are rising daily, yet take-home pay is only recently starting to accelerate. With these factors in mind, Redwood takes the definition a step further to include workers in all forms of retail trade, construction, manufacturing, back office employees and even a portion of "white collar" employees such as administrative assistants and office managers. Regardless of which definition one advocates, it is our opinion that these additional types of workers are also "essential" to overall economic prosperity and stability of any community.

Of further interest to note are various research reports available from the Urban Land Institute which point out that investments in the preservation of existing workforce and affordable housing result in higher financial yields than investing in new construction; they cite research from the U.S. Department of Housing and Urban Development indicating that preservation of existing units costs 30 percent to 50 percent less than developing new units. Moreover, it notes that preservation is more beneficial from a social standpoint, since it contributes to neighborhood and community stability.

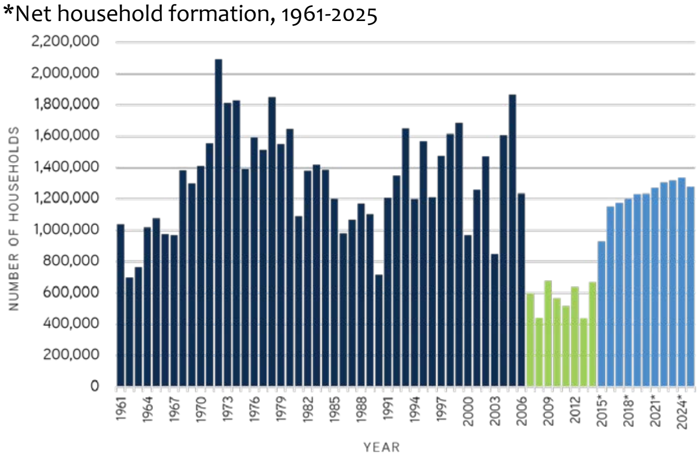
Further still, J. Ronald Terwilliger, chairman of the Terwilliger Center for Housing, noted that there is tremendous demand for affordable rentals, which has soared in the post recession years due to wage stagnation, tougher home purchasing requirements, and lingering financial stress. "The lower- and middle-income workers who are the lifeblood of local economies across the country have limited and declining options for affordable and rehabilitated homes near their jobs, which hurts them as well as employers," Terwilliger said.

The need for more affordable and rehabilitated housing for a greater number of working-class Americans is no longer something we can ignore. We will outline in this memo that investment into this niche of the multifamily sector provides not only significant socioeconomic benefit but also attractive risk adjusted returns. The following analysis provides support that our thematic approach is readily achievable.

<u>Demographic Attributes</u>

According to a demographic study by ULI and Terwilliger Center, housing rental rates will continue to surge over the long term. ***"Although a few overbuilt submarkets (mainly urban) garner much of today's attention, 7.3 million of the 12.5 million net new households created over the next decade will rent."*** In addition, the study predicts the suburban migration will continue. "The increase in population of those in their 20's over the last decade will most certainly result in a surge in population in their 30's over the next decade." And the benefactor of this population surge when young families are formed is the more affordable suburban market in pro-growth states.

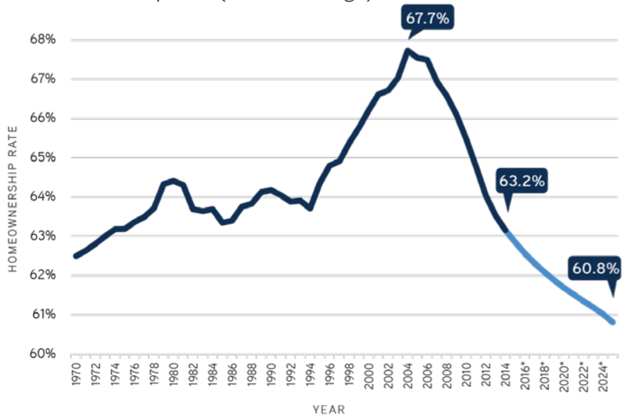
*Net household formation, 1961-2025



Sources: U.S. Census Bureau; John Burns Real Estate Consulting LLC calculations and projections using Census Bureau data.
**projection*

Additional demographic dynamics favor suburban workforce rentals as depicted in the chart on the following page. ***The plunge in homeownership from 2005 to 2015 has been a monumental shift in demand for apartments. In fact, the ULI and Terwilliger report projects that the rate will reach 60.8% in 2025, the lowest rate since the 1950's***. This will translate to sustained long term rental demand.

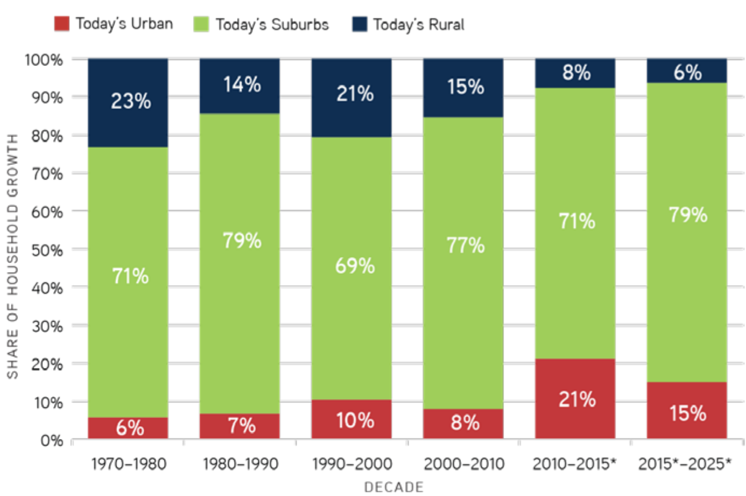
* Homeownership Rate (annual Average)



Source: John Burns Real Estate Consulting LLC calculations using U.S. Census Bureau data.
**projection*

Of additional interest are emerging suburban trends. The suburbs are certainly less celebrated than urban neighborhoods yet they actually tend to be more diversified and house the lion's share of the population. Between 2000 and 2015, among the top 50 metro areas the suburbs have accounted for 91% of the population growth and 84% of the household formation according to the Urban Land Institute. ***Moreover, during the next decade, a staggering 79 percent of household growth is projected to occur in the suburbs***. Suburbs of all kinds will absorb the coming wave of household creation as those born in 1980s and 1990s get a later start to forming families. It is projected that they will turn to the suburbs, where housing is more affordable and the schools are customarily better.

*Share of household growth by decade.



Source: John Burns Real Estate Consulting LLC calculations using U.S. Census Bureau data.
**projection*

Much of this suburban household formation will be generated by the Millennials, the nations most diverse and highly educated generational cohort. The data surrounding this generation is remarkably beneficial for suburban multi-family. ***At 83 million strong, the Millennials comprise the largest percentage of the US population at 26%.*** And like previous generations, the majority is expected to return to the suburbs by the 2020's, fueling increased demand for affordable apartments, particularly given their propensity to avoid homeownership. Already approximately 68% of Millennials between the ages of 20 and 34 rent versus own. ***And at present 23 million of them still live with their parents, exceeding the historical proportion by 19 percent***. This pent up generational demand will be unleashed as current positive job creation trends drives the young-adult unemployment rate downward, creating opportunities for this generation to move out on their own.

Moreover, Millennials love apartments. ***The generation has been dubbed "Generation Rent" and is expected to continue driving apartment demand through 2024.*** While some experts assert Millennials are in fact interested in homeownership, they are too laden with debt to pursue it. And in addition, Millennials are renting longer than previous generations and many are doing so simply as a lifestyle choice. This generation is more interested in experiences rather that materialism. Renting affords them the flexibility that homeownership simply cannot.

It is worth noting that demographic trends are not all driven by the younger cohorts. Many Baby Boomers are downsizing from homes to the maintenance free lifestyle of apartments. And candidly some of the families who lost their homes during the recession continue to rent with no plans to return to homeownership. ***The number of people over 55 years old in apartments has increased by 200,000 households in the past decade, while home ownership levels have steadily fallen***. The phase being "maintenance free."

As a result of these tremendously influential trends, apartment occupancy levels have risen and rents have increased. Nationally, average rents have climbed by more than 21 percent since 2010, with the largest increase of 4.6 percent in 2015, according to a REIS Report. Current demographic tendencies favor multi-family and they tend to favor suburbs.

<u>Rent Growth Attributes</u>

The talks of the sector being in the proverbial "ninth inning" are unfounded. The cycle's expansion has been lengthy but the underlining dynamics support a healthy run for the mid to long term. As of the end of 2016, annual rent growth exceeded 5.0 percent annual gain for six of the last seven quarters. Projections for 2017 point to a 4 percent gain, exceeding the long term average of 3.3 percent.

When Redwood breaks down the data an interesting trend emerges. Significant performance variances emerge based upon neighborhood and asset class. That is, luxury assets in urban locations, as well as limited suburban locations with outsized deliveries, will face the most risk in 2017 and 2018. ***Conversely, Class B and C assets will continue to outperform. This niche is exactly what Redwood has targeted***.

We investigated historical data provided by REIS and found persuasive support of our inclination for suburban work force housing.

The data from REIS depicts the compounded average growth rate of inventory (units) and gross revenue per unit as well as the weighted average vacancy for both Class A and Class B/C rental units from 2000-2016. The data included a national overview as well as a regional overview for the West, Southwest, Midwest and Southeast regions of the U.S.

The overall narrative is very positive. For example, the national chart demonstrates that over the last 16 years, the number of Class A rental units grew more rapidly than the number of Class B/C rental units. Specifically, the compounded average growth rate of Class A rental units over the last 16 years is 2.6% nationwide while the number of Class B/C rental units actually slightly declined (0.1%) over this same period. ***Meanwhile, despite this differential in inventory growth trend, the Class A vacancy rate has grown more rapidly than Class B/C vacancy rate while the gross revenue per unit growth rate for Class B/C units has kept on pace with the gross revenue per unit growth rate of Class A units***. And remarkably these positive national trends are generally represented across each of the four major geographic regions (Southeastern, Midwest, Southwest and West).

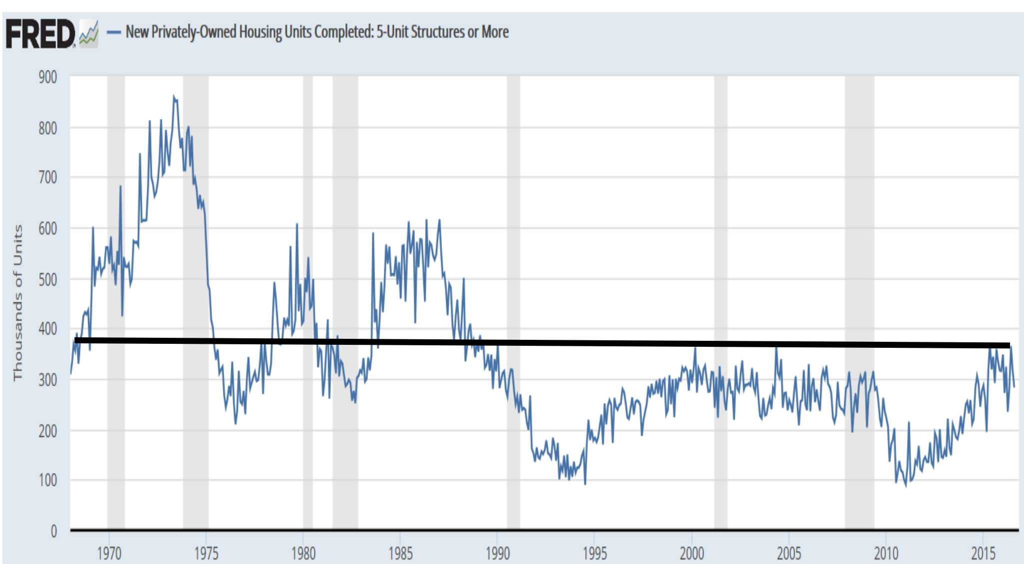
Additionally, according to the industry publication National Real Estate Investor, apartment rents are growing most rapidly in suburban working class submarkets that apartment developers have traditionally avoided. "With a handful of exceptions, the neighborhoods posting the strongest rent growth don't have much ongoing construction," says Greg Willett, chief economist for Real Page and MPF Research. "These are suburban areas." And in fact, they are also often working- class areas with older, less expensive housing. ***It is exactly this older suburban housing stock in need of rehabilitation that Redwood continually targets.***

In contrast, it is interesting to note that rents are growing much more slowly in the urban, core markets where the rents are already significantly elevated. "The heavily supplied, urban cores have seen the weakest rent growth," says John Affleck, international economist for CoStar Group. "The high income tenants in these areas can consider home ownership, and then play off the abundant new product, one against the other, for the best deals."

Based upon the data at hand, it is abundantly clear that Class B/C suburban product offers the most attractive investment alternative within the sector.

Supply Attributes

According to Marcus & Millichap, while apartment development has reached a milestone of 320,000 units in 2016, development is largely concentrated in 10 major metros and further concentrated in urban settings. It is also important to put things into historical perspective. ***According to Federal Reserve Economic Data, multifamily development remains below the long-term average of 341,000 units.*** Given that the lion share of new development in 2015 and 2016, as well as that projected for 2017, is condensed into urban submarkets, it is evident that rehabilitated suburban work force housing is positioned well to withstand the additional supply.



Source: Federal Reserve Economic Data

Equally as compelling is that fact that by 4Q 2016 the national vacancy rate reached 3.5%, the tightest level since 2000. This underscores the significant demand for apartments and further substantiates the conclusion that absorption remains healthy in the face of new supply.

And, according to the CBRE US Real Estate Market Outlook for 2017, suburban markets are generally less affected by strong supply trends. ***The report claims that Class B and C multifamily communities will out perform relatively well in 2017 given that they do not compete with the high-end and high-priced new product.*** We agree. It is a simple observation, really. Would you expect that a nurse or a hotel front desk clerk who works within a few miles of his or hers employer and has children happily situated in a highly rated suburban school to rush downtown to rent an alternative apartment simply because it has a hotel-like lounge or glamorous fitness center, not to mention likely $300 to $700 more a month in rent? No. You would not. The same can be said for the majority of the suburban workforce that Redwood targets.

The report goes on to tout the emergence of what they call the "quiet giants" …the suburban multifamily markets. ***The report suggests that urban infill neighborhoods have the highest concentration of development and will experience the greatest negative impact from supply, with rent growth rates that are markedly slower than suburban metro averages***.

When investment professionals in our industry suggest that the multifamily market is primed for a downturn, they're typically focused on these concentrations of urban high-rise properties, which conceivably could run into problems. In 2015, 75 percent of all large new apartment properties across the country were high-end luxury developments; the vast majority of them concentrated in urban work/live/play neighborhoods. By way of example, in the Midwest 73 percent of apartments were luxury units, according to an analysis of Yardi Matrix data compiled by Rent Café, which went on to observe that this tilt continued in 2016. Interestingly, some midwestern cities—Kansas City and Milwaukee among them—gained no new apartments outside the urban core.

In other markets like Chicago and Minneapolis, suburban development has been very limited. A Colliers report on Minneapolis/St. Paul includes a breakdown of development by submarket, which reveals that the vast majority of new projects in the past four years have been confined to downtown Minneapolis and the Uptown/St. Louis Park submarket. The fact is that most of these suburban submarkets have added fewer than 1,000 units during that time.

New urban luxury apartments in recent years have attracted upscale renters with a range of amenities that rival resort properties: rooftop terraces with poolside bars, social gathering areas with food and drink options, fully equipped business centers, concierge services, and so on. Now, suburban renters can enjoy many of the same on-site amenities, albeit on a more modest scale. ***Redwood rehabilitates it's assets in such a manner that our residents can experience a wonderful outdoor entertainment area or a technological advanced business / internet café but not at the expense of outrageous downtown rental rates.***

Another argument is that new construction is at its fastest pace in a decade and the sector is therefore overheated. There is fault in that logic. It stems from the fact that multifamily starts were at a historical low point for several years during the Great Recession yet demand increased steadily. We are simply catching up to historical norms not reaching a tipping point to a downturn. In fact, the 283,000 units that came on line in 2015 fell short of the 49-year average of 341,000 units, according to Federal Reserve Economic data analyzed by Marquette University. (Reference the chart above).

Another report written by Marcus & Millichap estimates that 1.3 million new households will have been created in 2016, translating to net absorption of 300,000 apartment units in the 12 months ending in September. As noted earlier in this memo, the national vacancy rate stands at 3.5 percent, the lowest since 2000. And first-time homebuyers are in short supply due in part to stringent lending requirements and a lack of entry-level homes for sale, the report stated.

The conclusion here is that the sector, and particularly suburban work force housing, is not in danger of an eminent downturn. Quite the contrary, the dynamics favor Redwood's targeting niche.

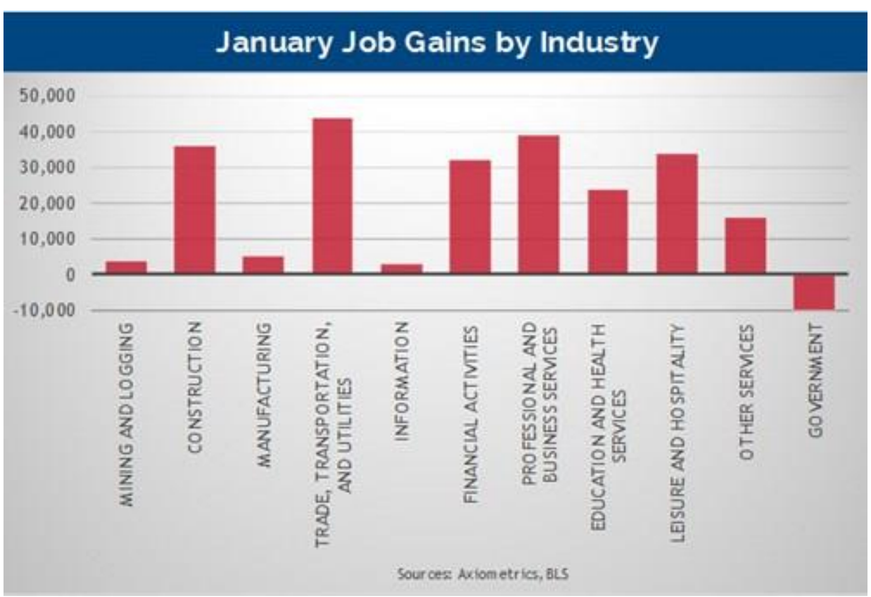
Employment Attributes.

The economy is now well positioned for growth over the next few years as wage growth has accelerated and we have obtained full employment. This will drive consumer consumption and demand for housing will benefit. The modest but steady pace of compensation gains over the last few years has finally appeared in the most recent US Census. ***Median household income rose 5.2% over the trailing 12 months from 3Q 2016. This is the largest upward movement since 1967.***

The U.S. economy continued to expand at a moderate pace in Q4 2016. Employment rose by a respectable 495,000 jobs and brought the unemployment rate down to 4.6% from 4.9%. For the year, the total employment gain was 2.2 million. Another welcome sign for the economy was December's favorable year-over-year wage growth rate of 2.9%. Furthermore, notwithstanding that the Q4 GDP growth rate was lower than expected at 1.9%, it was primarily due to anomalies in trade activity rather than significant slowing in either consumer spending or business investment. The average second half 2016 level of 2.7% is more indicative of the year-end economic climate and is well above the performance of recent years.

To be sure, expectations for the U.S. economy in 2017 are positive, with most GDP projections in the 2.2% to 2.3% range. Cleary, stronger economic growth in the U.S. economy bodes well for multifamily demand.

What's of particular interest to Redwood is the uptick in employment growth in what we consider the "essential workforce". The chart below outlines which sectors have enjoyed healthy job growth. As detailed in the footnotes on the following page, the sectors that provide the jobs for our targeted resident are exactly the ones experiencing acceleration such as retail trade, construction and leisure & hospitality.



- The Trade, Transportation & Utilities super sector was led by retail trade. The clothing stores subsector added 18,300, while electronics and appliance stores (+7,600), other general merchandise stores (+7,200) and furniture and home furnishing stores (+6,000) experienced strong gains, and wholesale trade added 3,000.

- Construction hiring bounced back sharply in January. The construction of buildings subsector added 12,900 jobs, while specialty trade contractors added another 16,000.

- Leisure & Hospitality's net gain came primarily from 29,900 new jobs in the food services sector, while arts, entertainment and recreation added 9,100 jobs.

Another interesting trend has emerged. ***According to CBRE's U.S. outlook for 2017, more people are leaving the urban core for the suburbs than vice versa***. "Broad-based migration to the suburbs has helped fuel strong rent and occupancy growth in suburban apartment markets, particularly in recent years. The percentage of markets with annual suburban rent growth exceeding the respective annual urban rent growth by more than 100 bps has consistently increased—from 22% in Q2 2012 to 63% in Q3 2016. For most of the past two years, the suburbs have significantly outperformed urban cores in more than half of these markets—a pattern that we haven't seen in the past."

"With strong development pipelines squarely focused on downtown Class-A product, lack of affordability is expected to remain a challenge for the overall apartment market, especially in the more urban areas. As such, the shift toward the suburbs is projected to continue, and suburban apartment markets will likely continue to perform well relative to urban cores."

Moreover, according to an article in the Wall Street Journal on December 3, 2016 "big cites may be getting all the attention, but the suburbs are holding their own in the battle for population and young earners." ***Research shows that suburbs are continuing to outpace urban areas for overall population growth, demographic diversity and even younger residents.***

According to the study mentioned in the article by ULI and the Terwilliger Center for Housing, the suburban areas surrounding the 50 largest metropolitan statistical areas ("MSA") make up not only 79% of the population of those MSA's but also accounted for 91% of population growth. ***The article also noted "as of 2014, about two-thirds of jobs in the 50 largest MSA's were in the suburbs.*** To be sure, there has been a reversal in the migration of employment in recent years. While urban employment grew at 8% and suburban growth remained stagnant between 2005 and 2010, the last few years have seen 9% growth in the suburbs compared to a deceleration to 6% in urban areas.

Summary

It is critical for people to have the option to live near where they work, particularly those types of workers who are most essential to the local economy. Vital employees include teachers, emergency service workers, nurses, construction workers and retail clerks, many of whom find that most urban and some suburban multi-family properties are simply priced beyond their reach. This is especially true in the urban cores where land and development costs are extremely high, resulting in rental rates that are beyond their reach. When people can afford to live closer to their jobs, entire communities reap the benefits. Commute times and traffic congestion ease, neighborhoods are more diverse and provide the opportunity for families to live and grow in one place over time, and economies strengthen by helping employers attract and retain essential workers. ***Redwood believes it's investment and rehabilitation strategy is a counterbalance to this frustrating trend facing a large percentage of the workforce. Our strategy provides affordable rehabilitated homes for this contingent of essential employees.*** And the data behind the demand for this type of housing underscores our thematic approach.

And despite the limited challenges it currently faces, the sector has many gleaming bright spots. Firstly, Millennials love apartments. The generation has been dubbed Generation Rent and is expected to continue driving apartment demand through 2024. Some experts may assert that Millennials are interested in homeownership, but the fact is that they are too laden with debt to pursue it. And data shows that a large contingent would rather rent given the lifestyle flexibility it provides versus the heavy anchor that comes with owning a home, not to mention unexpected maintenance expenses. Sure, their interest in owning a home will become more apparent as they continue to age, pay off debt, get married and start families — but this is still a long way off for the majority of the generation. Secondly, job growth in the working class sector is quite healthy and is facilitating their ability to afford the moderate rent premiums Redwood is implementing on our value add deals. Thirdly, supply is concentrated mostly in urban markets while the high barrier to entry suburban markets that Redwood targets have largely been left alone. Suburban markets are experiencing healthy rent growth, vigorous absorption and generally low vacancy rates.

In sum, Redwood Capital Group's investment strategy is to buy well-located suburban apartment properties in need of cosmetic upgrades, and bring them up to near luxury status with new interior finishes and amenity packages rarely seen in garden apartment communities. A recent example is our acquisition of The Reserve at Hoffman Estates, a 642-unit property in Chicago's northwest suburbs. We upgraded interiors with espresso cabinetry, black appliances and other features common in luxury units but rarely seen in mid-market properties. The 30-year-old property already had two outdoor pools, and we added a hot tub, sundeck and barbeque grills to pool areas. Other new amenities include a cyber café, a dog park and an upgraded fitness center. The Reserve's amenities may not surpass those of the many uber luxury high-rises in downtown Chicago, but at less than half the cost in rent it's a highly attractive alternative for working class residents.

As suburban apartment investors, Redwood has found many such value-add opportunities across the country. ***Compared to urban luxury properties, there are fewer institutional investment competitors, so going-in cap rates are moderately more attractive, and in many cases, there are supply constraining barriers to entry such as zoning restrictions and public resistance***. This is in contrast to many urban markets where development has essentially been encouraged by cash strapped cities. And in many instances, the suburbs present a limited number of nearby alternative properties with the same level of amenities and unit features post renovation. This is in contrast to urban properties where a renter can simply walk down the street to the next one in line.

Redwood's thematic approach to work force housing accomplishes multiple objectives. For one, based upon market research, the investment is well justified and appropriately generates healthy risk adjusted returns. And further, the approach addresses a meaningful socioeconomic issue in affordable housing. We are creating a place for these essential workers to experience living in a rehabilitated and modernized home along with facilitating a sense of community as a result of well "amenitized" common areas. The "essential workers" deserve clean, affordable and modernized homes. Redwood accomplishes that we each investment we make.

David J. Carlson is managing partner and co-founder of Redwood Capital Group, a multifamily property investment management firm based in Chicago, IL. Redwood currently owns and operates about 37 apartment properties across the Midwest, southeast and southwest, totaling nearly 11,000 units valued at more than $1.3 billion.