

FALL
2024

OVERSUPPLIED?



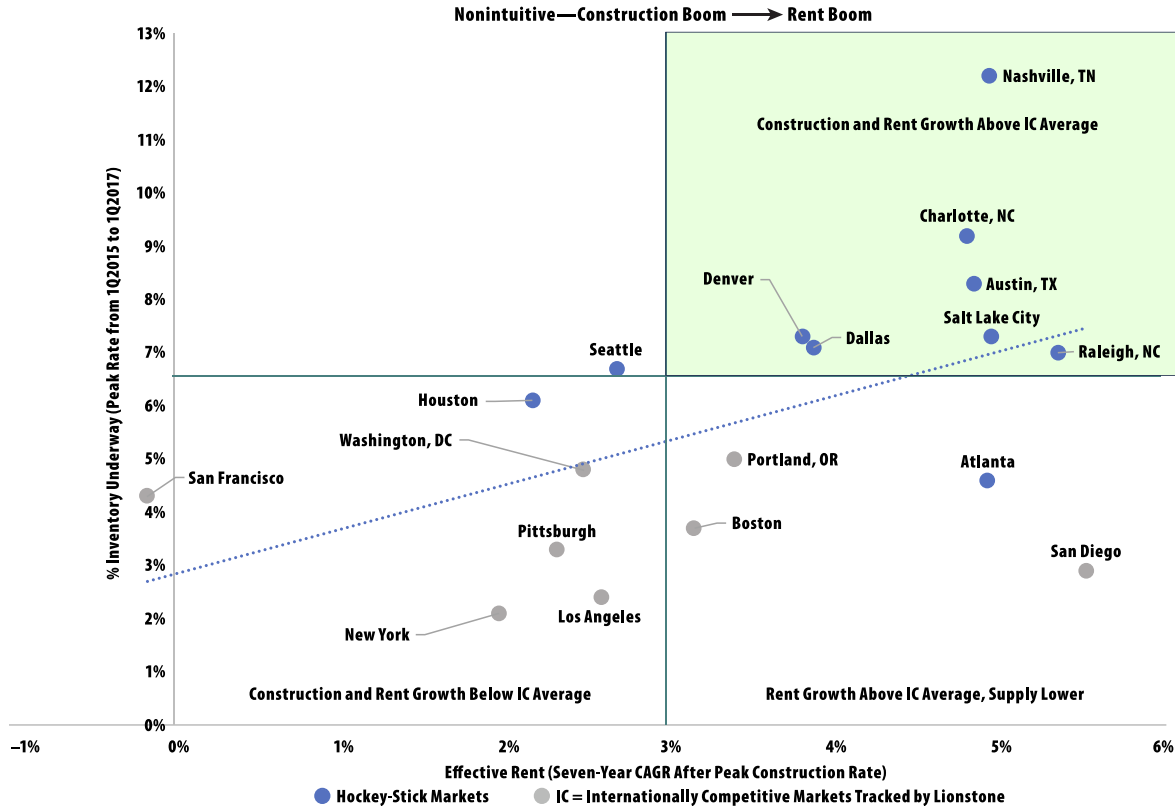
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Investors are concerned about the impact of oversupply in some property types on total returns, notably multifamily, and certainly in the near term, rents appear to be suffering where supply is highest. But are investors missing the total return forest for the excess construction trees? Lionstone’s research indicates that, while supply is important, long-term rent growth may be more correlated with household income growth than inventory growth over an investment cycle. As a result, forecasting household income growth at the metro and neighborhood levels appears to be an attractive way to position a portfolio for income gains over private equity ownership periods, which typically span five to ten years.

The Supply Side

While past results are no guarantee of future returns, it is interesting to see what happened the last time this apartment oversupply occurred (Exhibit 1). The biggest rent growth winners, those in green, for the seven years following peak supply growth in the last construction cycle (2015–2017) were cities with the worst bouts of oversupply. Almost all the “hockey-stick” markets (broadly lying from Seattle, down through the Rockies, into Texas, and over through the Carolinas) are in this high-supply, high-rent-growth quadrant.

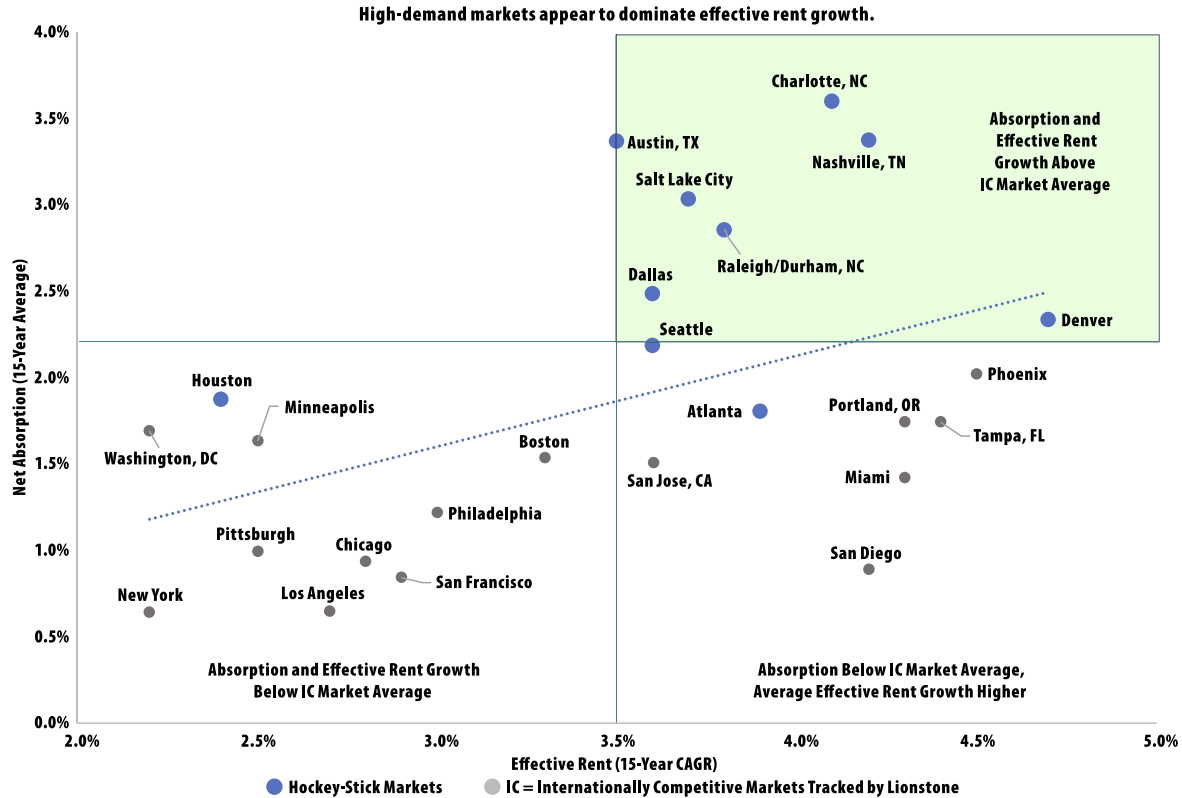
Exhibit 1: Peak Construction Versus Rent Growth



Source: RealPage; 1Q2024

Note: Information and opinions provided by third parties have been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. The information is not intended to be used as the sole basis for investment decisions, nor should it be construed as advice designed to meet the particular needs of an individual investor.

Exhibit 2: Apartments—Absorption Versus Effective Rent Growth (2008–2023)



Source: RealPage; 1Q2024

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Barriers to new supply did not appear to grow rents. New York, San Francisco, and Los Angeles were all in the bottom left quadrant, where the rent growth and supply were lowest.

Some might ask whether high-supply markets from the last cycle were bailed out by pandemic-induced migration. The flip side of that question may be, Will there be enough demand growth in high-barrier coastal markets to drive their rent growth in the future? To examine both those questions, I use a longer historical lookback on low-barrier versus high-barrier markets.

The Demand Side

Metropolitan areas with high demand growth generally outperformed on rent growth (Exhibit 2). Importantly, the time period shown here goes back to 2008, so this

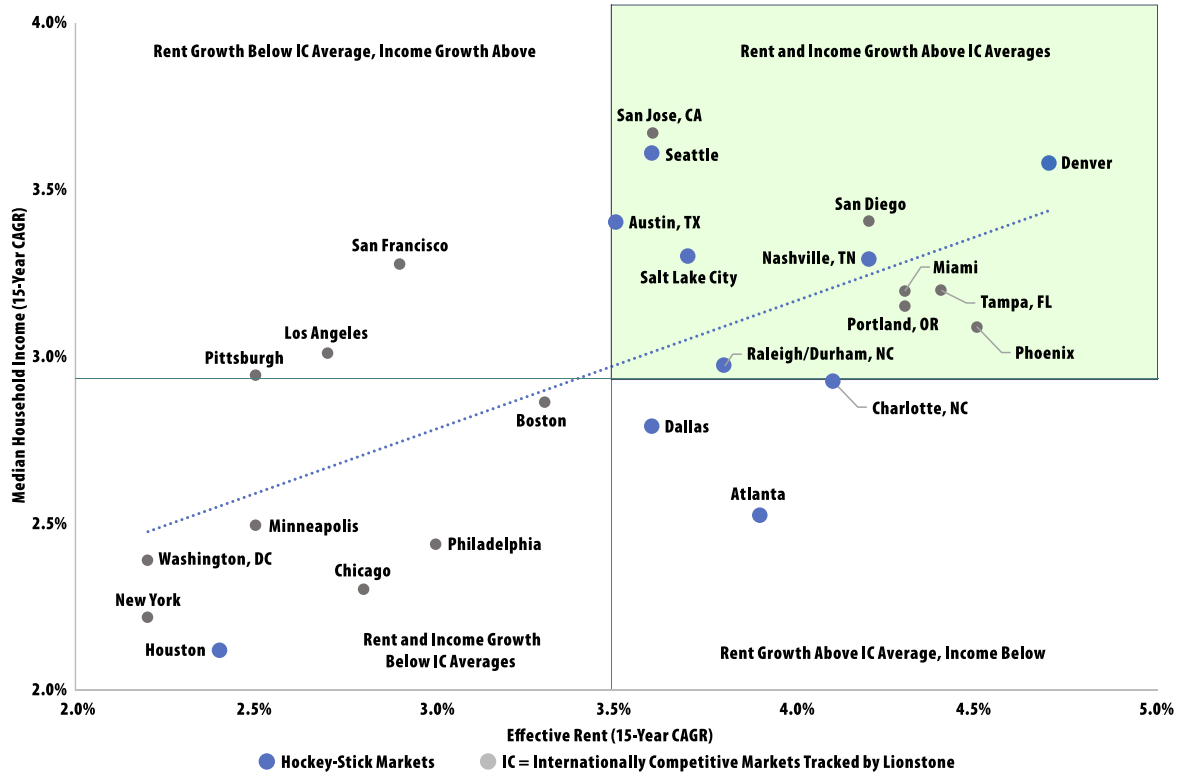
demonstrated rent growth does not appear to be merely a post-pandemic pop but rather a longer-term trend.

Again, the high-barrier markets (New York, Los Angeles, and others) mostly dwelled in the low-rent-growth, low-demand-growth cellar in the lower left.

Why? Here are two reasons to consider. A secular undersupply of housing in the US may support absorption in all markets, regardless of whether they have barriers to supply. More important, there is a virtuous circle in the hockey-stick markets: building apartments serves the needs of growing populations of people, who usually migrate to metros for jobs, and employers grow operations in these cities to access ambitious migrants and because low-barrier markets may be easier places in which to grow a business. Austin, TX; Raleigh, NC; and Seattle all appear to fit this description.

Exhibit 3: Apartments—Income Versus Effective Rent Growth (2008–2023)

Effective rent growth appears driven by household income growth, not barriers to supply.



Sources: RealPage, CoStar; 1Q2024

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Demand = (Bodies × Dollars)

Ultimately, rent growth is mostly about household income growth. Cities where median households had strong earnings growth generally outperformed in rent growth. All but one of the hockey-stick markets posted above-average rent growth since 2008, not just since the beginning of the pandemic (Exhibit 3).

Admittedly, a few metros do not fit the pattern. Household incomes grew at an above-average pace, but rent growth was below average in the upper-left quadrant, which includes San Francisco and Los Angeles. All these metros had below-average population growth. Metros in the lower-right quadrant posted above-average rent growth but below-average household income growth and had, you guessed it, above-average population gains. Lionstone believes metros with both

population and household income growth are the best bets for long-term rent growth.

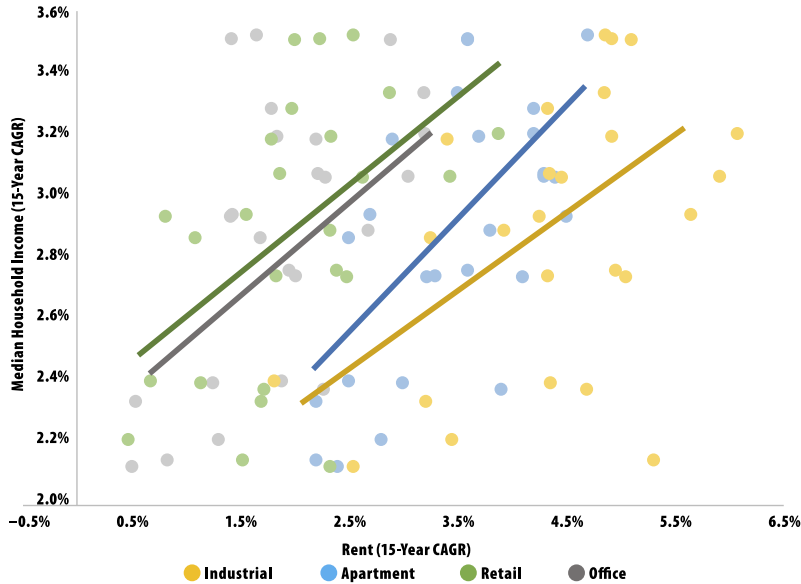
Application Across Property Types

Interestingly, this same relationship between rents and medial household income growth at the metro level appears to hold for retail, office, and even industrial property types, as shown in Exhibit 4.

Asset-Level Application

There may be three primary challenges to employing this income-growth-based investment thesis. First, not all locations in a metro have average income growth. So investors should be cognizant of neighborhood-level income trends such as gentrification, migration, and demographics including education, and household

Exhibit 4: Income Versus Rent Growth Across Property Types



Sources: CoStar, RealPage; as of 2Q2024

structures (age, number of children, etc.) and how changes in each impact household incomes and population growth. Second, geography applies to each property type's success. For a retail strip center, it might be a ten-minute drive time and the type of complementary property uses nearby. Third, investors should be careful in their use of historical data and backtesting to inform their future views. Backtesting and historical trends are useful, but there may be little profit in predicting 2018.

Rather, a differentiated, proprietary, forward look on the drivers of success may be more gainful.

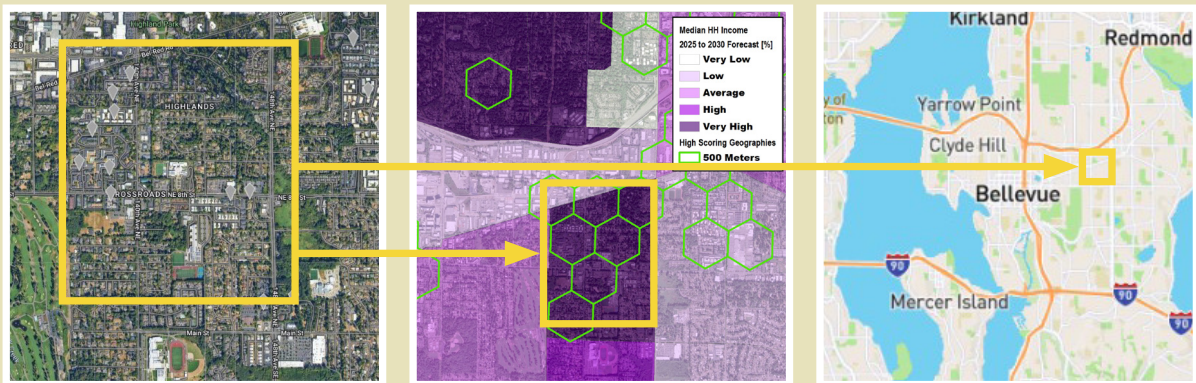
Fortunately, such analysis is much more possible today than it has ever been. Advances in data (both third party and proprietary) and analytics, such as machine learning and the people who facilitate it, enable investors to leverage and employ more information into insight than ever before. As a result, investors can take a view on future income and population dynamics at geographies that can correspond to their unique property types and strategies.

So near-term oversupply? Sure, it's worth worrying about, but private equity investors need to take a longer, more granular view than that. ■

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Bellevue-Redmond Corridor (Seattle Metro)



Sources: Lionstone Research, CoStar, as of October 2024