VIRTUS
REAL ESTATE CAPITAL

Affordability Series
Volume 3

The Case for Local Investment in Middle-Income Rental Housing

THE CASE FOR LOCAL INVESTMENT IN MIDDLE-INCOME RENTAL HOUSING

In this whitepaper, we contextualize the challenges rapidly growing cities face due to the lack of existing affordable housing and often substandard transit infrastructure. This third volume in the Virtus Affordability series is updated for the post-COVID environment and makes a case for public investment in this problem, whose fundamental drivers and societal effects are discussed in Volume 1 and Volume 2.

Most existing policy to date has understandably focused on worthy issues like extremely low-income renters and neighborhood preservation at the micro level. Meanwhile, rental housing for the median income renter has skyrocketed in nominal price and share of gross income.

The rental housing crisis affects not just extremely low-income families that have always required social assistance but also the growing cohort of "middle class poor" who face uphill struggles in the modern economy and housing. The emergence of a national rental "housing crisis" has placed a burden on family formation, economic growth, and upward mobility for many residents today. At Virtus, we believe there is a compelling social equity rationale for assisting median income renters and a clear return on investment in the form of more resilient and diverse communities that have room to grow, not just make rent.

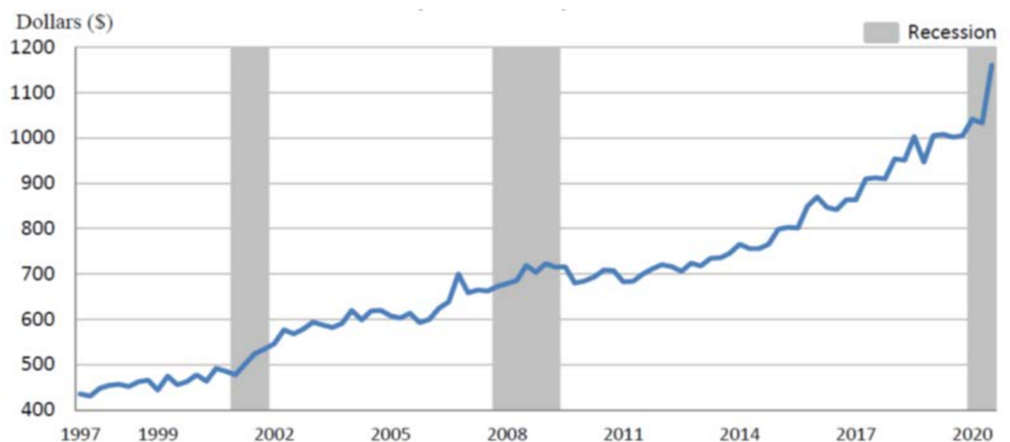
As such, assisting this demographic is not simply "doing good" for renters but rather making crucial investments in economic development that, if avoided, will otherwise lead to stagnation across entire communities. We discuss each general topic in greater detail below, but in general, we believe the emerging paradigm for city governments must include:

- **Recognizing and Defining the Problem, Including its Full Scope**
- **Expanding their Focus to Include "Middle-Class Poor" Renters**
- **Investing in their Future Rather Than Just Pay for the Past**
- **Establishing and Guiding Visions before Others Do**
- **Acting Like Creators / Stakeholders, not only Neutral Regulators**

THE POST-COVID ECONOMY UNMASKS THE PRE-COVID HOUSING CRISIS

One of the most dramatic aspects to come out of the COVID-19 pandemic has been a seeming flight of population, business, and capital out of dense gateway markets like New York, and San Francisco and into medium-sized "growth" markets. However, like many COVID-19 stories (such as the centrality of e-commerce in 2020), what has actually occurred is an acceleration of preexisting trends that the pandemic supercharged. The list of cities benefiting from post-COVID migration patterns is neither novel nor surprising; places like Austin, Dallas, Denver, and Nashville have topped population growth rankings for decades. Even before the pandemic, these same cities were attracting economic development away from gateway metros. It is generally noted such cities are "cheaper," at least by the standards of coastal-based firms attracted by lower taxes and cost of living that these metros offer. However, within their own regions, these growth hubs are often seen as relatively expensive for the same reason they attract corporate relocations: they are dense with highly educated populations, already have existing business infrastructure, and are culturally dynamic enough to draw people for lifestyle alone. Indeed, much like a gentrifying neighborhood, these gentrifying cities have seen immense (and self-reinforcing) growth in population and jobs, but the benefits of that growth do not always accrue widely to existing populations.

Figure 1: Median Rent on Vacant Units, 1997-2020



Source: US Census Bureau, Current Population Survey. October 27, 2020
Recession data: National Bureau of Economic Research

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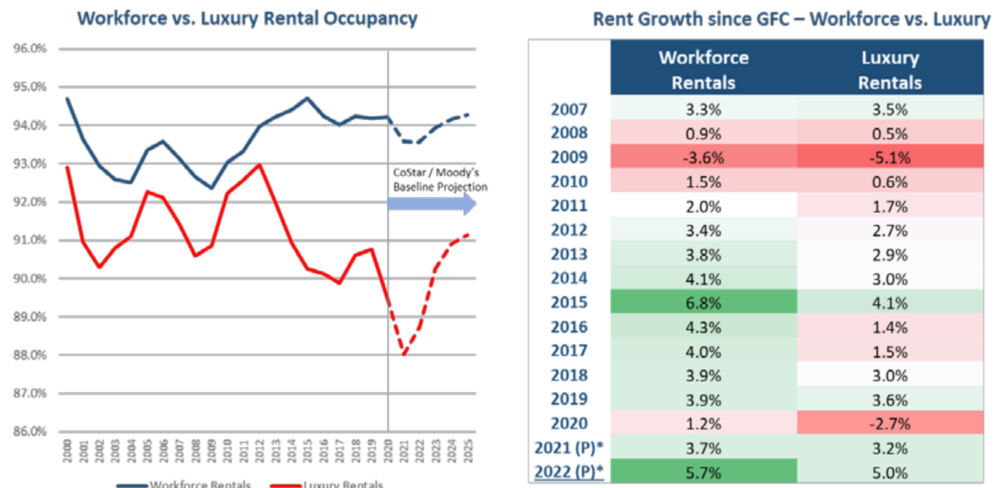
One obvious example has been the diverging rent trends between luxury rentals and "workforce housing." Both gateway and growth markets saw declining rents in major city centers during 2020, as downtown luxury rentals were already facing new supply pressures before lock downs made high-density urban living less attractive. This made much of 2020 a great time for a renter to sign a lease on a new Class-A apartment, whether she was staying in California or relocating for a new job. However, those bargains have not been available in less upscale neighborhoods where rent has gone up…during a year that has experienced the largest ever historical draw down in terms of both GDP and employment. This is yet another instance where post-COVID reality is an accelerated version of pre-COVID trends; workforce housing has consistently shown tighter vacancies, steeper rent growth, and generally different market behavior than Class-A luxury rentals over multiple business cycles and climates.

Figure 2: Workforce Housing vs Luxury Rentals



Rent Growth since GFC – Workforce vs. Luxury

	Workforce Rentals	Luxury Rentals
2007	3.3%	3.5%
2008	0.9%	0.5%
2009	-3.6%	-5.1%
2010	1.5%	0.6%
2011	2.0%	1.7%
2012	3.4%	2.7%
2013	3.8%	2.9%
2014	4.1%	3.0%
2015	6.8%	4.1%
2016	4.3%	1.4%
2017	4.0%	1.5%
2018	3.9%	3.0%
2019	3.9%	3.6%
2020	1.2%	-2.7%
2021 (P)*	3.7%	3.2%
2022 (P)*	5.7%	5.0%

Source: CoStar Analytics, data sourced 1Q2021
Workforce Rentals defined as 3-Star units, Luxury inventory as 4-5 Star units. (P) denotes a CoStar projection

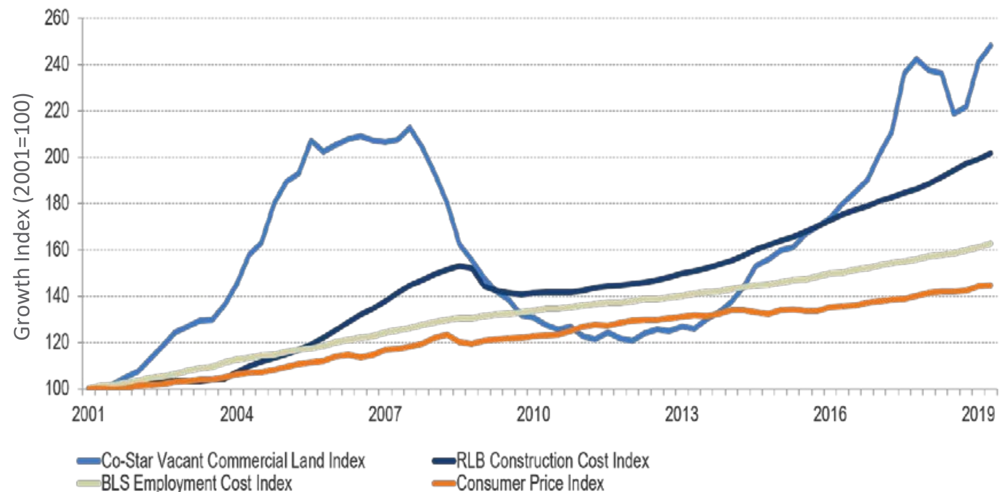
Still, the economic destruction of this pandemic hit working-class households harder than it did more affluent white-collar employees whose workplaces could pivot to telecommuting—so why did rents fall in luxury-oriented submarkets while rising in working class neighborhoods? The answer is largely in how constrained such rental markets are in all senses—constrained geographically in where they can be located (due to restrictive zoning), constrained in supply (due to construction costs), and thus constrained in high rent (due to low supply vs demand).

Finally, with the added economic uncertainty of a downturn, rental markets are also "constrained" upwardly in demand, as fewer and fewer households have the savings or economic standing to achieve homeownership. In sum, renters in major urban growth centers are trapped in a situation where their current cities are job magnets, which further swells demand on a limited stock of rental housing affordable by the middle-income that has not kept pace with other forms of urban growth.

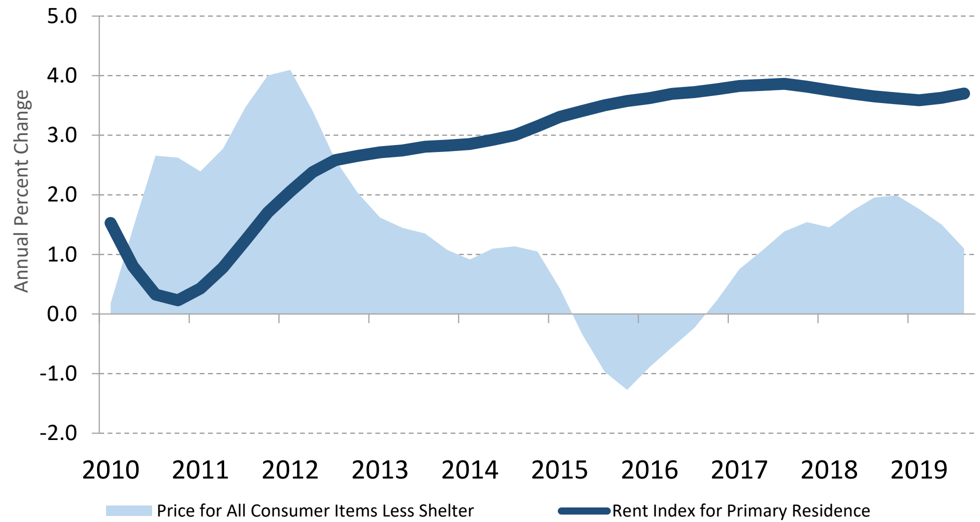
RECOGNIZING AND DEFINING THE PROBLEM, INCLUDING ITS FULL SCOPE

This situation where topline economic growth makes things worse for renters has a growing list of cities assessing a rental housing "crisis," an unpleasant word generally reserved for places like San Francisco. However, the emerging picture is that of American cities falling along a continuum of "growth and a housing crisis" or stagnation. In other words, **if your metro is blessed with outsized economic growth, there is likely an equally outsized burden on the typical renter.** Call it whatever you like; the housing crisis in American cities deepens across business cycles and will not go away without bold and different action.

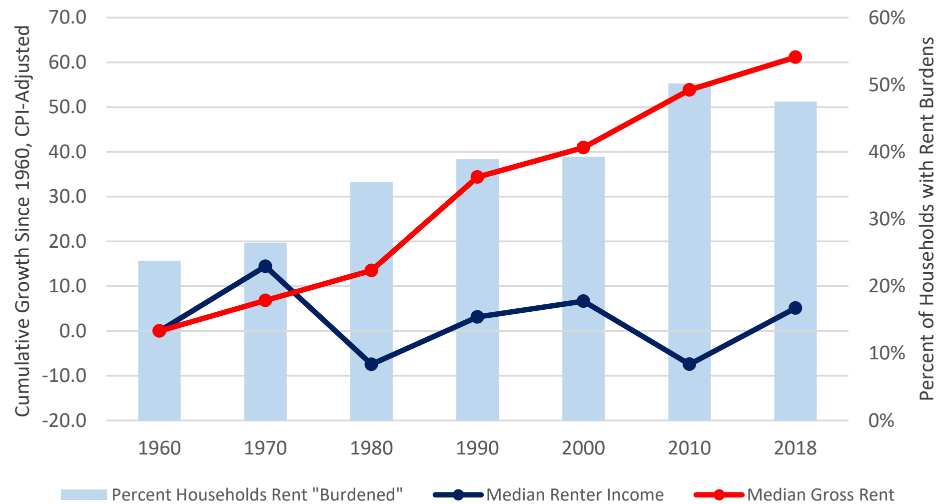
Figure 3: Land / Construction Costs Outpace Inflation



Source: Harvard JCHS tabulations of CoStar Vacant Commercial Land Index; RLB Construction Cost Index; and US Bureau of Labor Statistics (BLS), Consumer Price Index for All Urban Consumers and Employment Cost Index.



Source: Harvard JCHS tabulations of CoStar Vacant Commercial Land Index; RLB Construction Cost Index; and US Bureau of Labor Statistics (BLS), Consumer Price Index for All Urban Consumers and Employment Cost Index.



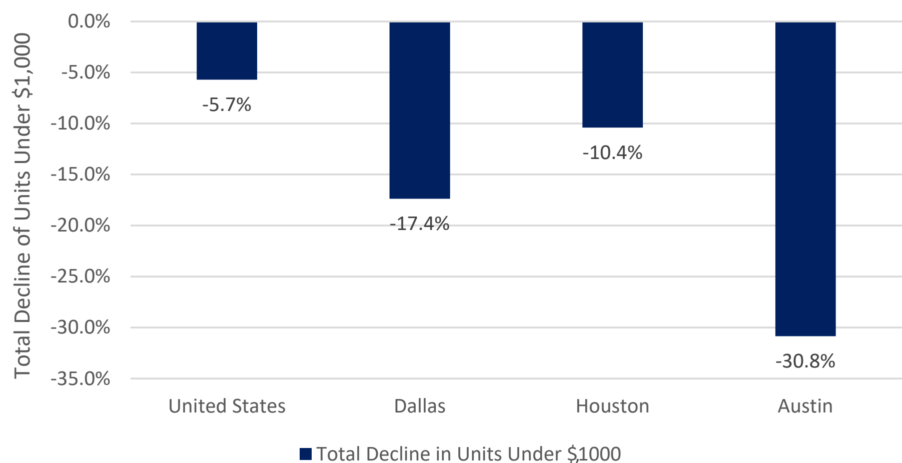
Source: JCHS tabulations of the US Census Bureau, 1960–1990 Decennial Census and 2000–2016 American Community Surveys. Rents and incomes are adjusted for inflation using the CPI-U for all items

The root problem is simple to diagnose, if not solve: wages have stagnated, development costs have risen, and public policy has not effectively countered this dislocation. If any of this is surprising, there are various reasons this issue has been able to fly under the radar for so long:

1. **The Problem is Historical and Cumulative**. Unlike most economic "shocks," the underproduction of affordable rental housing is a process that has accrued over decades, across different political visions, and in both expanding and contracting environments. Zoning laws have either practically or explicitly confined such housing to small pockets—often older areas with historically high minority populations. Moreover, wholesale density increases are extremely rare or confined to overlays, deepening the association between urban development, gentrification, and displacement. The result is that rental housing is under produced on a national scale, and especially in economically attractive markets or neighborhoods.

   The problem can persist even in relative building booms. Notably, 2019 was a historically high year for multifamily rental construction, seeing the largest nominal increase since 1985. However, after nearly 40 years of population growth, that total figure is a much lower relative percentage of both inventory and population than it was decades ago. Further, this is before considering how many of those units merely replaced previous ones, rather than added to the total stock of housing. Framed another way, the nation has neglected its rental housing stock since at least the early 1980s. The Harvard Joint Center for Housing Studies has documented this "net" erosion of affordable housing annually. Importantly, the current economic cycle saw a decline in moderate-income availability, not merely in the lowest quality units. This trend is even more pronounced in growth markets and in states like Texas and Colorado.

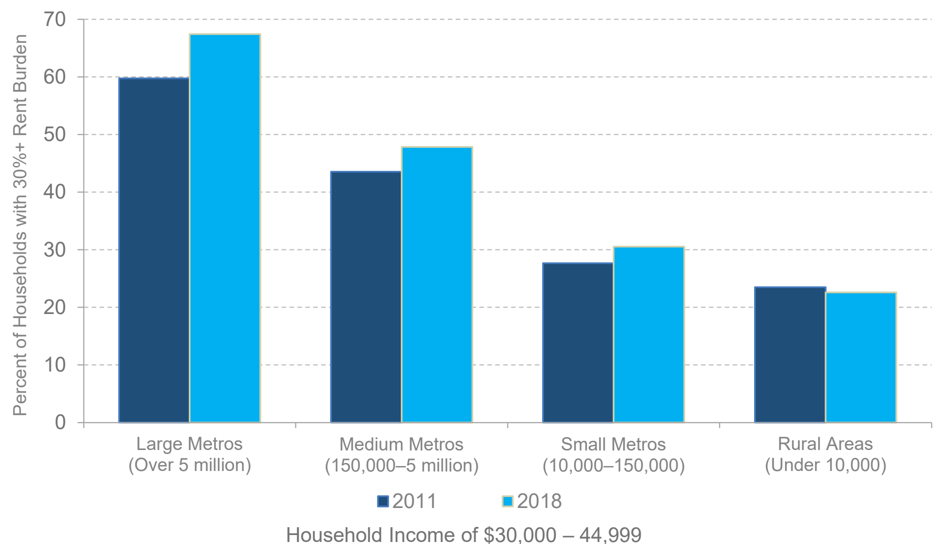
Figure 6: Declining Stock of Affordable Units in High Growth Texas Markets



Source: Harvard Joint Center for Housing Studies, America's Rental Housing 2020

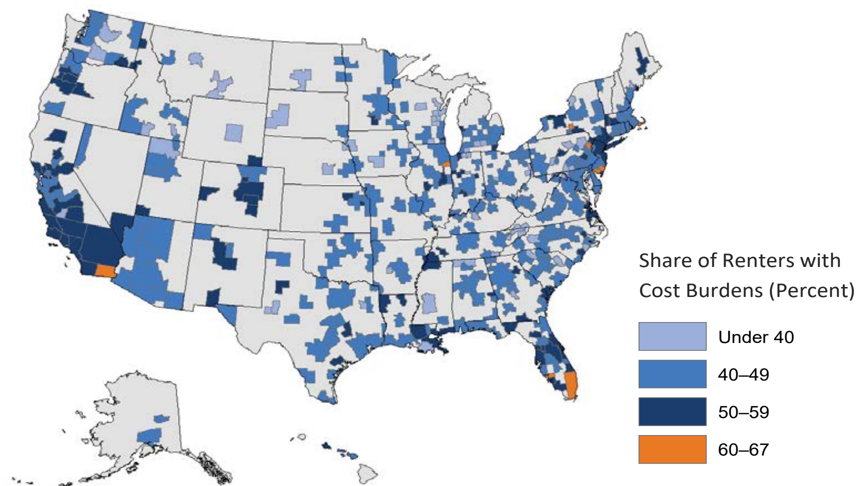
2. **We have slowly lost touch with ideal spending rates.** Since the problem has grown gradually, it has been easy to ignore the uninterrupted rise of rent burdens. Typically, renter households with a "moderate" rent burden are paying over 30% of gross income for housing, and extremely burdened households are paying over 50%. These standards originated in prior decades when a 30% rent burden was considered the upper limit of sound household budgeting. The reality is that a 30% rent burden has gone from being a rarity to a new normal in most economically dynamic areas.

Figure 7: Rent Burdens are Highest in Large Metros



Source: Harvard JCHS tabulations of US Census Bureau, American Community Survey One-Year Estimates

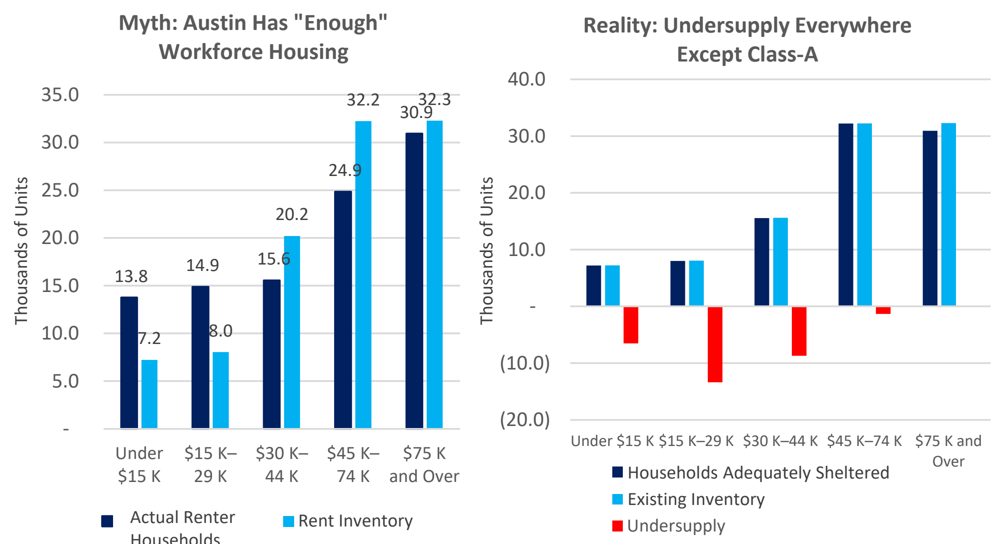
Figure 8: Nearly Half of Metro Renters are Cost Burdened



Source: Harvard JCHS tabulations of US Census Bureau, American Community Survey 1-Year Estimates

Even many sophisticated city managers are surprised by this fact because they are used to seeing housing burden figures that include homeowners, who are both more numerous and have much lower housing burdens. Looking more closely, what lies beneath is an emerging "middle-class poor" of professions that used to offer more accessible paths to homeownership — teachers, firefighters, police officers, and nurses. **This is also one source of the claim that cities like Austin have "enough" housing affordable to typical renters; it assumes that households who technically CAN pay rent totaling upward 50% of gross income SHOULD be doing so.** The ideal measure of a housing stock's sufficiency is not merely whether most everyone "fits" somewhere but whether there is enough competitive slack in the inventory such that renters have any negotiating power. This exists only for relatively affluent renters.

Figure 9: Inadequate Rental Supply Across Incomes



Source: Harvard Joint Center for Housing Studies, America's Rental Housing 2020, Appendix Data Tables

3. **Renters are spending that money and time driving instead.** When accounting for combined housing and transit costs, lower-barrier cities become comparable to higher-barrier cities with higher nominal housing costs. For instance, the combined housing and transportation burden of San Antonio is a higher percentage of median-income than that of Washington, DC, despite vastly higher nominal housing costs. The difference is the DC Metro's extensive public transportation. It is often the case that cities that refuse to innovate on the housing creation side will only pay for it on infrastructure overhead, as any commuters stuck in the doldrums of highway renovations can attest. Importantly, such measurements do not account for the opportunity cost of growing transit times, nor do they account for the vastly greater environmental impact of auto-intensive sprawl development, both of which make existing growth patterns seem even more short-sighted and unsustainable.

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4. **Renters' needs are hidden within the political process.** First, the response orientation of public entities means the important is often overwhelmed by the urgent. Missing middle housing has been a "perma-important" issues, but rarely urgent until recently. In addition, existing advocacy pathways favor homeowners and special neighborhood interests, which have created anti-growth, anti-development coalitions in many cases.

   While the public face of this coalition may be marginalized voices from gentrifying neighborhoods, the underlying power is often entrenched and affluent homeowner blocks doing their utmost to ensure "undesirable" uses and tenants do not become neighbors. Such voices often have an outsized impact as voters, and special influences give them a louder voice than renters. This has arguably led to the "one size fits all" approach to housing that overproduces single family residences and under produces other solutions. In sum, while the individual issues these coalitions support are often laudable (artistic character, anti-gentrification), the collective result of their efforts has been to oppose **adding** net housing instead of merely upgrading it, especially in crucial areas. This, in turn, has made the housing and infrastructure issues mentioned above even worse. This pattern has been studied by researchers across political aisles, concluding that both entire metros and individual municipalities with restrictive zoning create excess costs that they then pass on to renters[1].

Figure 10: Research Across Political Aisles Confirms the Effect of Land Regulation on Housing Costs

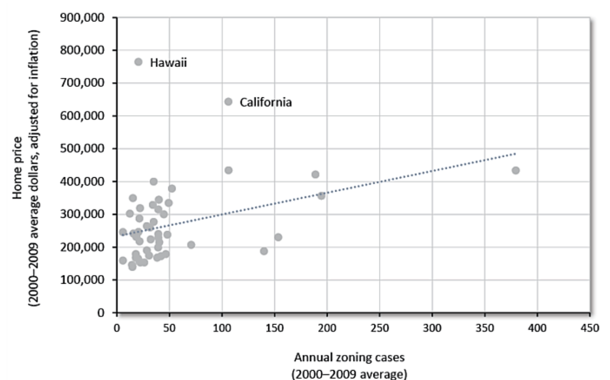
How Land-Use Regulation Undermines Affordable Housing

- ***Sanford Ikeda and Emily Washington, Mercatus***

"In effect, local governments exceed their "zoning budgets," imposing restrictions in excess of what their own planners and politicians declare to be the optimal amount of regulation, because land-use regulation procedure causes them to ignore the long-term effects of individual zoning decisions."

More Regulation is Highly Correlated with Higher Housing Prices

- **Vanessa Brown Calder, Cato Institute**



Sources: https://www.cato.org/publications/policy-analysis/zoning-land-use-planning-housing-affordability
https://www.mercatus.org/system/files/Ikeda-Land-Use-Regulation.pdf

1. https://www.cato.org/publications/policy-analysis/zoning-land-use-planning-housing-affordability
https://www.mercatus.org/system/files/Ikeda-Land-Use-Regulation.pdf

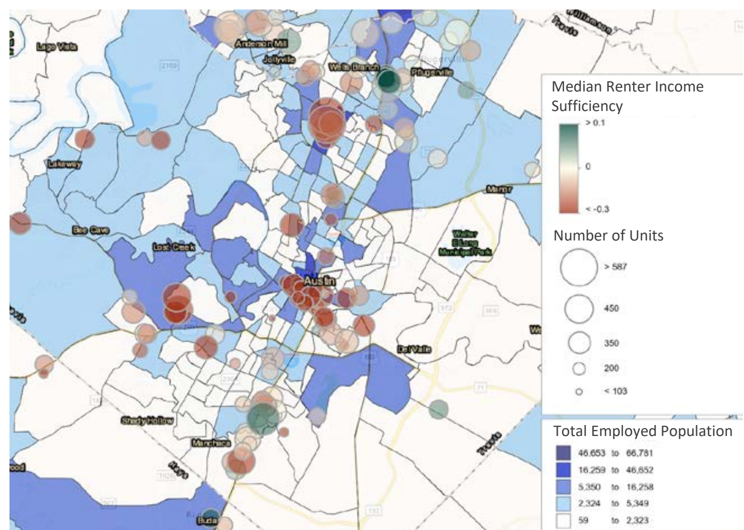
This crisis is universal among American cities, but the individual responses to it will widen outcomes at the highest levels because housing is so central and impactful. While the first victims of the housing crisis are middle-class and below renters, eventually it constrains future growth and imposes externalities across an entire economy—as is evident in late-stage cities like San Francisco, which is beset by both chronic homelessness and an inability to provide affordable housing to working-class renters.

In our last Affordability whitepaper, Virtus drew connections between higher housing costs and the social problems that generally travel alongside them. The pain starts with renter households overpaying, leading to lower savings rates and greater financial insecurity. This discourages household investments like continuing education, moving easily for jobs, or saving to purchase homes—all major life milestones that are being delayed, which leads to depressed family formation rates. Eventually, these social issues accumulate at a higher level. The housing crisis displaces jobs from the communities they serve; this creates social homogeneity and likely reduces the personal connection and investment that workers like teachers or first responders have for their communities. Eventually, the only place to add market-rate housing is at the city fringe (since it has become impossible to meaningfully add density in many inner ring areas). This, in turn, creates sprawl that eats up productivity and simply allocates high housing burdens into transportation. At this point, the system will create outsized infrastructure needs if existing sprawl growth patterns are left unchecked. Over decades the passive trend has been a tragedy of the commons in which the tax base continually retreats outward while imposing increased infrastructure burdens on the center due to surrounding sprawl. It is less surprising that cities have failed to build adequate rental housing, considering this struggle to maintain infrastructure. Austin's development patterns geographically bear out this pattern; not only has the existing construction wave been concentrated in luxury rentals, but it has also been concentrated chiefly at the center and edges of the city.

Figure 11: Recent Development is Unaffordable

Austin Market Rate Projects Added Since 2000

Red Dots Denote New Projects Unaffordable to Median Renters



Source: CoStar Analytics and American Community Survey data, Virtus visualizations via Esri ArcGIS.

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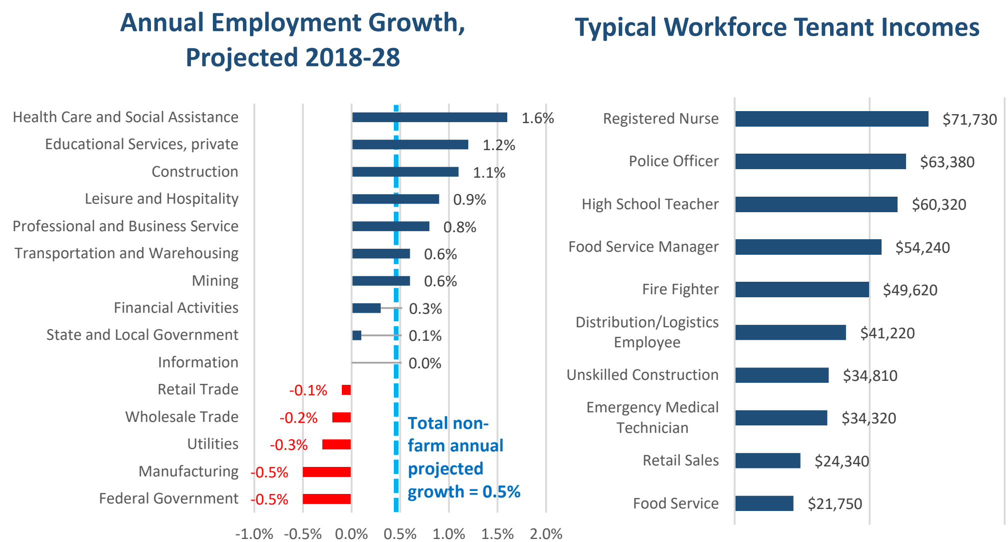
REACHING THE "MIDDLE-CLASS POOR" IS KEY TO SOLVING THE ISSUE

Most housing policy has been squarely focused on only the most impoverished constituents for over half a century, and during this singular focus, the housing crisis has grown larger. The concept of full-time working households needing assistance would have been profoundly alien to past regulators of an economy where even blue-collar workers could be on a path to homeownership. **This is also why the difference between an unsubsidized rent totaling just under $1,000 per month is radically different from subsidized rent around $600 per month nominally.** At face value, the difference is just a few hundred dollars, but subsidized rents cover a completely different cohort—one much more likely to be elderly, disabled, or otherwise out of the labor force. Meanwhile, **working** households cannot qualify for federal benefits (despite having extreme gross income rent burdens). This distinction is also lost in conversations where "market-rate" housing is synonymous with Class-A luxury rentals. In fact, most working renter households fall into the "missing middle" where existing subsidies are not accessible to them, but neither are the prices on new market-rate construction. This refusal to acknowledge households in between the "low income" and "luxury" cohorts results in the myth that there is "enough" market-rate housing compared to low-income housing. Proponents of this view will often produce graphs like Figure 8, showing a greater imbalance of low-income units and "enough" higher-income units. However, this abstract view neglects the spillover of excess households into units they can "afford" but only at unsustainable rent burdens. A more accurate picture of the same data from Harvard JCHS shows that rental housing is only adequately supplied for households making above $75,000 annually.

This more comprehensive view of renter household incentives suggests that lessening housing burdens is as much about keeping urban economies healthy enough for growth, rather than a purely humanitarian "charity" endeavor. Robust infrastructure, attractive housing, and an educated populace are not luxuries, but basic resources in the increasingly competitive "market" of urban development, as was evidenced in Amazon's near-theatrical HQ2 selection process during 2018. Not every firm can (or desires to) force metros to vaunt their qualities to potential entrants, but even the smallest business undergoes a similar process when seeking a location. This process also plays out at the micro level within metros, as individual municipalities compete to attract corporate relocations drawn to the entire region's growth. Places that want to avoid competing on who can stoop lowest in corporate giveaways would do well to offer superior infrastructure—including affordable and attractive places to house employees.

This sets up another conclusion — **cities need to extend the range of their housing investment efforts to include the populations employers are concerned about and not just those that have historically been the focus of federal subsidies.** We have had decades of state and federal policy solely focused on Extremely Low Income ("ELI") renters. Worthwhile programs like Low Income Housing Tax Credits ("LIHTC"), Section 8, and others that have built or maintained thousands of units for genuinely impoverished families. However, much like increasing the stock of luxury rentals has not helped typical renters, these programs have failed to improve the building stock of market product for median-income renters. Arguably such programs were never meant to shift entire urban housing markets. Still, we nonetheless find ourselves in a situation where the existing affordable housing toolkit is much smaller in both size and scope than the problem itself.

Figure 12: Most Projected Job Growth is Grey Collar



Source (both): Bureau of Labor Statistics National Wage Data by Area and Occupation, 2019 Release

Size is easiest to discuss first; these programs are smaller in footprint than most realize, especially due to the outsized role such entitlements take in political discussions. The greatest source of federal housing assistance is not for renters but rather homeowners, in the form of the Earned Income Housing Tax Credit on mortgages. Even after tax reform, these costs will total $400 billion over the next five years, compared to the entirety of renter-based housing subsidies at roughly $72 billion. That's a 6-to-1 ratio, despite renters having much lower median incomes and theoretically standing to benefit from greater assistance. The message here is clear: governments are perfectly happy to subsidize middle-class households when we believe there is a compelling "return" on the dollars.

These programs were not intended to subsidize affluent homeowners versus renters; rather, rental housing was formerly seen as simply transitory. The next step is to see grey collar renter households—again, a cohort comprised of teachers, first responders, etc.—as equally crucial and worthy of public investment. **This is also why local programs built centrally around homeownership are likely to remain niche and minor in their impact: they serve the wrong cohort.** Serving the full range of families in need requires an "expanded toolkit" of strategies for investing in housing infrastructure.

INVEST IN THE FUTURE RATHER THAN JUST PAY FOR THE PAST

At the macro level, the value of helping renter households becomes more apparent. But how does an expanded toolkit that can solve the problem look like? What does it do? It is unavoidable that cities will need to take initiative in establishing a vision independent of federal standards, including direct investment in their communities. We use the word "invest" very literally: unlike programs that merely soften existing problems, the most innovative city programs are chiefly designed to create additional housing, not merely preserve or subsidize existing offerings. This is true partly due to the problem's size relative to federal funds, but also because federal programs are better suited for addressing acute problems rather than maximizing the competitive advantages of a region. Federal programs serve only the lowest income bands, do not produce enough housing, and do not effectively control the placement or character of housing.

Beyond this, strategies that are beneficial in one metro may not be in another. For instance, a land-poor city like Seattle will have radically different needs than a land-rich metro like Houston. In the latter, nominal housing costs are less an issue than infrastructure and accessibility. Even programs tied to specific demographic areas like Opportunity Zones or New Market Tax Credits are frequently too broad in mandate or bureaucratic in nature to turn around specific areas. Many have noted that Opportunity Zones are chiefly funneling capital to already attractive areas that happened to be designated by the OZ program rather than more distressed or capital-starved areas. In short, cities that want autonomy in guiding their master plans will need to take a proactive attitude, including considering direct public investment in projects whose purpose and location fit local economic development goals.

At Virtus, we believe the most accretive city-level programs will be those addressing the missing middle of renters because this cohort is least served by existing programs and has a greater return on public investment. This cohort is also better matched with private capital that, in many cases, simply needs gap funding or minor variances to make the difference between an unaffordable market rate "luxury" product and true workforce housing.

This latter aspect—unlocking private capital that would not otherwise participate in affordable housing efforts—has the potential to create much more value for each public dollar spent. In short, better visions will require public investment—partly because cities are best poised to understand their own needs, and to control the funds controls the vision.

IF CITY LEADERS DON'T ESTABLISH A VISION, OTHERS WILL

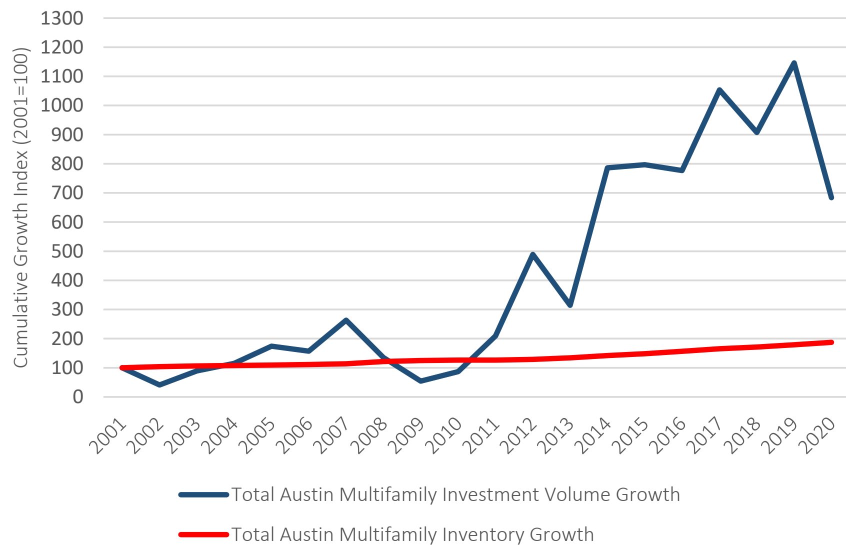
When cities remain passive and let existing incentives and policies play out, the result is "more of the same." One major reason for this is that private investment is inevitable in dynamic economies. Whether they like it or not, cities like Austin and Denver attract not only population and business but outside capital investment. In such climates, individual real estate investment firms are relatively powerless to enforce "natural" affordability, since their lower valuations on properties for sale will always be outbid by other firms who want to make the "best and highest use" for a given asset. Thus, when cities shun investment in moderate-income affordability, private capital that could be allocated toward the creation of housing is instead deployed to acquire existing units and raise rents on them (with or without improving them). This trend is evident in seeing the groundswell of investment in Austin. In 2001, CoStar Analytics tracked roughly $246 million of multifamily investment transactions in the metro—a figure that would grow over 10x to $2.8 billion by 2019. Over the same period, the entire inventory of multifamily rentals in Austin did not quite double, growing from 124,000 to 234,000 units. While Austin has certainly seen heightened development, this vantage point shows the scope of a missed opportunity to divert capital toward more socially beneficial uses. A more proactive economic development framework could divert both acquisitions of existing units, as well as development of luxury-only units, toward workforce housing projects that increased rental inventory instead of just rent.

This alternative paradigm is one where cities are also positive, creative forces alongside the private sector—defining and incentivizing what CAN be done, in addition to regulating what cannot. This means not only formulating master plans but actively seeking sites and partners that follow through on planning documents. Many of the paths to success involve easing up, rather than increasing, restrictions; Transit Overlay Districts ("TOD") can act as concentrated laboratories to make major concessions on either density or parking ratios that would be riskier to apply across a metro. Another place to think more creatively is in Area Median Income ("AMI") bands for tenant qualifications. It has become gospel that projects with income bands above 80% or even 60% of AMI are not truly "affordable" projects. Again, we believe this distinction looks increasingly semantic in areas where even market-rate rental housing is severely under supplied and overpriced. Within the existing "zero-sum" framework, projects with higher AMI bands are taking away share from projects with lower

AMI bands.

In contrast, we encourage cities to instead think marginally. Given any individual parcel, would it be preferable to consist entirely of market-rate housing, or would a 100% AMI limit be acceptable in an area that has little market rate supply in that range? This is an important question because public servants and service industry employees who work in central urban areas increasingly cannot afford to live anywhere close to them. Although Virtus focuses most of its efforts on providing housing to median renter incomes in the 50% to 80% AMI range, median income renters can also be defined above this, including the more widely adopted

Figure 13: Multifamily Investment vs. Inventory Growth



Source (both): CoStar Analytics, data exported 1Q2021

range of 80% to 120% AMI.

CITIES SHOULD ACT MORE LIKE DEVELOPERS, NOT JUST NEUTRAL REGULATORS

The more city governments tap into their creative potential, the more they connect with a tradition of innovation we have increasingly forgotten. Recent decades saw failures of public housing, leading to skepticism of the positive (vs. restrictive) potential of cities. To be sure, cities are not always good at executing master plans, but this means such efforts need greater focus, not less. To do so, communities need to follow through proactively to the end, not merely stopping at infrastructure. Urban history is full of such partnerships exceeding the potential that private developers alone could have—from the early imposition of Manhattan's grid when it was still farmland; to Haussman's master planning that produced the modern

form of Paris; all the way to modern examples like Curitiba, whose experiments developed the Bus Rapid Transit strategy.

In short, there is ample evidence from the past that massive future-proofing planning efforts are properly the role of local governments, and all such successful models have depended on their resolve and investment. The fact that cities often fail at going solo does not mean they should relinquish their role in master planning. Instead, they must partner with domain experts to realize a mutual vision. This will unlock vast amounts of private capital more tailored to reaching the missing middle. Depending on the financing mechanism chosen, cities may receive direct financial benefit from investing alongside private developers. Even if other mechanisms are chosen, there will still be broader social returns.

Public investment in affordable housing keeps cities competitive, with both populace and infrastructure having increased room to grow and innovate rather than merely stay housed.

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ABOUT VIRTUS

Virtus Real Estate Capital, founded in 2003, is a hands-on, data-driven, curious investor that delivers compelling outcomes from cycle-resilient investments for all stakeholders. Through thoughtful evolution and resilience in challenging times, Virtus has purposefully worked to foster thriving communities that empower people to live better lives. Over the last 18 years, it has acquired 251 properties for a combined acquisition value of over $4.6 billion, and has fully realized 181 property investments. With a strong and established track record, Virtus has proven to be successful in all phases of the market cycle. For more information, please visit virtusre.com.

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