Investing in a Rental Nation
The Millennial Impact on Real Estate

David Snow, Privcap:
We're joined today by Peter Ciganik of GTIS Partners, Andrew Jacobs of Metropolitan (a subsidiary of The Carlyle Group) and Michael Schwartz of RSM. Gentlemen, welcome to Privcap today. Thanks for being here.

Unison: Thank you.

Snow: We've got a hot topic: we're going to talk about the impact that the millennial demographic is going to have on real estate. Millennials are the largest generation in U.S. history. They have already started to leave their parents' homes and they're establishing themselves as independent residents and even starting families. Where are they going and how is this impacting the real estate opportunity? Starting with a question for Peter: have you seen real estate implications [due to] the fact that many of these millennials want to live in certain cities and not in the suburbs, but in downtown areas?

Peter Ciganik, GTIS Partners:
We certainly have. Over the last decade or so, urban downtowns have really vitalized in a number of gateway cities and I think that's largely demographically driven. This is the largest generation, as you say, and their peak year now is about 26 years old. In that age, they have finished their studies or college and have found their first jobs. That was tough going with the recession, but now they're in their first well-paying jobs and are able to set up their own households.

Of course, those households will first be rental. These guys are young and they enjoy the cultural and fun part of the city as a necessity, of course. They're renting—they cannot own at this point because of credit issues, down payment issues and so forth. We've definitely seen a big influx into urban downtowns. There is a question now, though, of whether that wave is peaking with them becoming older. [They're] in their late 20s, early 30s—the time when you actually set up a household and have your first kid. We can come back to that, but we are now actually starting to see a shift from that toward a more suburban movement where they're still renters, but they are moving to the suburbs because of schools and more space. They're renting houses, which is an interesting area for us. As an investment firm, we've been active in that.

Andrew Jacobs, Metropolitan Real Estate:

The term "live, work, play" has been used for some time now, which I think succinctly says what they're looking for, which is the ability to be pedestrian friendly and the ability to walk out of your apartment. Maybe if you don't walk to work, at least hop on mass transit to go to work and not have to use a car. Then, of course, all the ancillary retail that would also support their lifestyle.

The term "24-hour city" has been an important metric as well for some time. Obviously, [that's] cities where there's a lot going on around the clock; now, that's morphed into 18-hour cities. The evolution of this urbanization has gone not just to the New Yorks but also to the Philadelphias and the smaller cities that are also seeing this urban concentration.

Snow: Michael, what have you seen among your clients as far as an investment thesis built on the idea that parts of cities once considered not very livable are now getting flooded with younger people who enjoy the density and the amenities?

Michael Schwartz, RSM US LLP:

Even within the 24-hour cities, the outlying areas, because it's gotten so cost prohibitive. For example, you're seeing a lot of development in San Francisco—where the market is just priced itself crazy—development and an influx of people into the East Bay area, residential in Oakland. You wouldn't have considered living there 15 years ago and our clients have invested both in the office with the work environment there. Silicon Valley is so expensive.

In New York, you're seeing Brooklyn and even Queens now. We have a client that's investing in multifamily and residential in Queens right now. Then, also to Andrew's point, the 18-hour cities where we're seeing an influx of people who generally don't want to live in the gateway cities because of, again, price. They're moving to cities such as Columbus, Madison, Raleigh and Nashville.

Snow: In these 18-hour cities, is there a sense among some private equity real estate investors that there's more upside and that places like New York and San Francisco are just at the top?

Jacobs: While I absolutely believe in the urbanization of secondary cities and 18-hour cities, clearly as investors, we're staring where we as an industry in search of yield need to go to these secondary cities, especially if you're a high-yield, higher-return, higher-target return investor.

Schwartz: Yes. When you're getting five cap rates or even less out in the Bay Area and New York and you're getting six-and-a-half to seven in some of these other cities, you're going to go there.

Jacobs: I mean, San Franciscans and New Yorkers—young ones—are spending half of their income or more in rent. They can't spend more. The wage inflation isn't there to support higher rents, so the peak that Michael mentioned—we absolutely see it.

Snow: A big question going forward: as these millennials begin to establish families and have kids, will they continue to live in the cities or will they do what many previous generations have done, which is to go out to the suburbs, where they can get more space and the schools are good? What are the bets of smart money in real estate?

Ciganik: What's more important than providing something for your kid in terms of education that's [high] quality? Unfortunately, downtown and public schools in a lot of these places have been underfunded for years now with the challenges of public education and the tax base is still out there in the suburbs.

So, what's happening is that a lot of them, when they have their first or second kid, are literally forced to in some way to actually move out. I think they would prefer to live downtown and, if they could, they would rent or buy. But how many people can actually buy a condo in New York and then send your kids to a private school? Not that many. So, moving to a place where schools are good and space is affordable becomes the choice and the option. As I mentioned, a lot of them still cannot buy a house as their parents would have, so they're renting. We've seen single-family rentals, which is leasing homes, to be the fastest-growing area over the last five years.

A lot of apartment managers cite statistics that we've become a renter nation and it is true that eight million new rental units have been filled over the last five or so years, since the recession. But five of those eight are single-family rental homes rather than high-rise apartments. It's now 36% of the total housing stock and it's the fastest growing and the largest in the last few years.

Schwartz: Fannie Mae believes in that, too, because they just recently announced that they're guaranteeing, I believe, a $1-billion debt fund of Blackstone, the largest owner of rental homes around the country, including in Las Vegas, where they acquired so many homes in 2008 and '09.

Jacobs: Some developers, with a lot of foresight, in my opinion, have actually started to develop in the suburbs transit-oriented communities. It's a relatively close-in suburb. The community is built adjacent to a regional transit line, which can take the residents directly into the CBD or into the downtown and back. I think [it's] a very interesting hybrid—we'll see if it catches on.

Snow: If the trend holds for millennials to go to the suburbs eventually and they indeed are buying homes at a lower rate than previous generations, that would argue that institutional ownership of for-rent single-family homes will continue to rise. What inning do you think we're in as far as that as a burgeoning food group within the broader real estate investment landscape?

Ciganik: I think we're pretty much at the very beginning. There are about 15 million rental homes out there, but most are owned by moms and pops—people who move and have a house that they don't want to sell, so they rent it out. About 250,000 to 280,000 of these homes are owned by institutions. We own almost 4,000 of them, which is a tiny fraction of the total. Less than 2% are institutionally owned, but it's growing fast. It's actually growing faster than the multifamily REITs back in the early 1990s. And there are many parallels.

If you remember back, the RTC, when they brought multifamily properties to market with the collapse of the S&Ls—it parallels what happened to houses in 2008 and '09. There was a big distress and houses were selling cheap, just like apartments in the early '90s. Institutional investors seeing the potential in the yield came in and amassed properties at a scale that then enabled them to actually make it properly managed and institutional.

Snow: One final observation about demand for real estate in cities, which is that millennials aren't the only ones who want to live in a convenient downtown area. You have 10,000 baby boomers retiring every day in the U.S. Many of them want to downsize their homes and live in cities, so they're moving from the suburbs to multifamily housing.

Jacobs: It's a really good point. I grew up in the suburbs and my parents grew up in the suburbs and their parents grew up out there. And where do they live now? They live in center city.

Schwartz: The baby boomers age where we're going to see that only continue, too.

Snow: [They] might be moving into the city and a millennial with a brand-new baby moves into the house they vacated, which is now owned by Blackstone.

Schwartz: Yes, correct. Right.