CIO CONVERSATION SERIES

CARY STREET PARTNERS

Episode 5

SINGLE-FAMILY HOME PRICES, EVERYBODY'S BUSINESS

Tom Herrick: Welcome to the CIO Conversation Series, I'm Tom Herrick, Cary Street Partners Chief Investment Officer. On this episode, we're holding an open house for a conversation about real estate, walking through what is arguably the hottest sector around.

Steve Shigekawa: We're coming out of the pandemic. There's stimulus in the economy, low interest rates, and so we're seeing really strong demand for housing.

Tom Herrick: My guest today is Steve Shigekawa, a Managing Director at Neuberger Berman. This is a research driven firm that is one of Cary Street's most trusted, strategic partners. Steve has spent nearly three decades in the business, including the past 19 at Neuberger, where today he leads the real estate securities group. He's built wide ranging expertise across the entire real estate and spectrum, from office to infrastructure to apartments and more. But our conversation today will focus on one thing: the strengths and dynamics of the single-family housing market. Steve and I will get to the foundational issues in single-family housing, including why it's hot right now and how long that might last. We'll take a regional perspective, look at the potential trend of corporate versus individual ownership, and set our sights on where the sector is headed in the future. Is it still the hit or miss, boom or bubble market we've seen in the past? We'll open the door to those questions and more.

Steve Shigekawa, thank you for being here.

Steve Shigekawa: Thanks for having me, Tom. Looking forward to our chat.

Tom Herrick: So we're recording this the third week of June, and this is a time when home prices are still trending up and in the news every night, just about, a sustained rise over the last year during a pandemic lockdown wherein some prices were spiking like crazy. It's not uncommon to hear of above asking price bidding wars and things like that going on. So maybe we could begin, Steve, just with kind of your picture of what the market looks like right now before we start getting into some more granular questions.

Steve Shigekawa: Sure, you know I think you're right on with your comments. You know, the pandemic really accelerated some of the trends that we were seeing previously. People were working from home, they're looking for more space, and so that demand was really enhancing demand for single-family homes. You know, today we're in an economic recovery. We're coming out of the pandemic. There's stimulus in the economy, low interest rates, and so we're seeing really strong demand for housing, you know, paired up with that limited supply. So that's really what the housing market is looking like today.

Tom Herrick: The question I get a lot is, is this a replay of 2006, 2008 ending that particular housing bubble or assent in a great financial crisis?

Steve Shigekawa: You know, I wouldn't say it's the same. I mean, there were different things happening during the global financial crisis, as we all remember. You know, that was coming in a period of deregulation in the banking industry. There was very loose underwriting in terms of getting mortgages. And then we saw new products, whether subprime or Alt-A, really adding to that demand for housing. You know, today's market is a little bit different – the banking industry is much healthier. We're seeing a long-term supply shortage, paired with recovering demand coming out of an economic recession driven by the pandemic.

Tom Herrick: So the prior move, you know, I guess you would characterize that as being driven more by I mean, we call it lax underwriting. Is that a fair way to characterize it?

Steve Shigekawa: Yeah, I think that's the way to think about it, especially if we all recall was subprime mortgage and the securitization of those mortgages. It really was the start of the problem, in terms of that bursting of the housing bubble during the global financial crisis.

Tom Herrick: So you referenced supply and that's kind of what I'd like to get into first. You know, cause a really smart, prominent developer friend of mine told me about 20 years ago that housing, particularly affordable housing, single-family housing was going to be supply-constrained for quite awhile. What are the factors driving that lack of supply?

Steve Shigekawa: Yeah, you know, your friend was absolutely right. Recently Freddie Mac put out a report saying that there's a housing shortage in the U.S., that's 3.8 million homes. The National Association of Realtors also reported, their number was even larger, it was five and a half to 6.8 million homes. And if you think about that, you know, 2006 was the peak year in terms of construction that at 1.7 million homes per year. And just in 2020, there was only 1.3 million homes, new homes being built. So if you were to try to backfill that shortage by building let's say, two million homes per year, that's going to take 10 years. That supply shortage is the primary factor that we're looking at. But there are other things to think about as well, I mean, because of the pandemic there's been labor shortages recently, higher material costs. And then we also have regulation that has impacted housing as well.

Tom Herrick: It seems like the labor issues have been around a while. Maybe they've gotten worse over the last year, but it seems like there's been a shortage of the building trades, you know, for a decade now. And you reference regulatory issues – is that more of a regional focus? We always hear about the obvious example being California. Maybe you could comment on that to some degree, how the regulatory environment plays into this.

Steve Shigekawa: Sure, you know California is the toughest market in terms of the regulatory environment and zoning restrictions. You know, when you think about NIMBY-ism, Not In My Backyard, you know that's widespread in coastal California. And so that really makes it difficult to build in that market. You also have a shortage of land, that adds to it and then that's pushing up prices. You know, you talked about labor. There has been a shortage of skilled trade workers and it has been added because of the pandemic. I mean, the pandemic really disrupted, you know, a lot of things that we think of as sort of a normal functioning market. You think about the manufacturing shutdowns during the pandemic, supply chain bottlenecks, you know, that's all impacting that shortage.

Tom Herrick: Is the shortage all on one end or the other, or is it just across the board? You know, I hear a lot about it and, you know, from sort of the entry level, affordable part of the single-family market. But does it reach the high end as well? Because I sure don't see a lack of bidding wars among expensive homes either.

Steve Shigekawa: Yeah, I think that if you look at this current situation, there's a shortage across all regions and all price points. But most pressure is on the entry level market. If you think about that entry level market and the amount of supply, you know, we've been building fewer and fewer entry level homes as a percentage of the homes that we are building. And so if you think about that, just adding to the problem. But the shortages are really across all regions. For sure there's more homes being built in the south and the West because of outmigration from the Northeast and the Midwest, but there's shortages in all of the markets.

Tom Herrick: What about the way, you know we hear in the media all the time, particularly related to the pandemic, that people are moving out of cities or moving to the suburbs. Is that actually occurring? I guess is the first thing, and is that a permanent feature of the housing market? I guess, is a better question.

Steve Shigekawa: Well, in some markets, and I think most of the headlines that you see are talking about cities like New York and San Francisco, where because of the pandemic, you know, people were moving. They wanted more space. Those are densely populated urban markets. And so people were moving out of their apartments and trying to find more space because of the pandemic. And they were also working from home, and so if they could go to a larger living arrangement, it just made that a little bit easier. And so the pandemic really just kind of magnified some of those trends. But I think more importantly is thinking about the demographics in the country and what that is pointing towards. And the millennials, you know, that's the largest demographic in the U.S. and they're aging and starting to be at that point where, you know, they're going to be starting families. I think that's going to be a more important trend. And that has, you know, that's going to take a little while.

Tom Herrick: So that family formation in the demographic bubble is more of a permanent feature than a pandemic-induced conversation?

Steve Shigekawa: I think so. I mean, in New York, employees are just starting to return to the office. And I think in the fall is when you sort of see this consensus building, is that large corporations are having their employees come back into the office. And many of those people that left the city are coming back. And we're seeing that in rental rates of apartments and we're seeing that in, you know, just transportation patterns. So people will come back to those cities. There are reasons that they live in those cities because it's close to their office, but it's also close to entertainment, it's close to activities. And so we think that the urban market, you know, there is going to be that return. But you're right, more importantly, we're looking at the millennial generation as they're shifting to, you know, getting to that point where they're starting families.

Tom Herrick: So, you know, since we're talking about generations and generational change, I sense there's a definite mentality amongst that millennial generation, you know, regarding, just questioning homeownership in general. Maybe that's the scar tissue after the financial crisis. Is that playing into markets right now?

Steve Shigekawa: You know, I think it is. I mean, the millennial generation, they saw the previous generations. And in previous generations, the view was, you know, when you get married and start a family, you buy a home and it's a great investment and your home value will continue to appreciate. And that's a good thing to be doing. I think the financial crisis, you know, showed people that, you know, home values go down and that may not be the best thing to do. And so renting becomes more appealing. And I think for that millennial generation, they're looking for the flexibility in terms of their living arrangements, their working arrangements. But they're getting to the point where, you know, they're starting to form families. And when you form a family, you're looking for more space, you're looking for good schools. And so there is that migration from urban to suburban.

Tom Herrick: You know, in general, as we've seen in other asset classes, millennials seem to be trending towards being a little more cautious, I guess is a good way to put it. Not out of the market, but certainly a little more cautious. In my generation, homeownership was just a given. It was the first thing you did was buy a house, if you could. As soon as you could, you bought a house. It was a one-way street, one way bet all the time. We're seeing, it seems like we're seeing, like I said, just a much more cautious attitude out of that generation. And this is a topic that I'd like to talk more about, you know. Historically in single-family homes, you know, the rental market has been a very sort of hit or miss, mom or pop market, you know, it hasn’t been a corporate market. Publicly owned corporations haven’t owned single-family homes and run that as a business per say, to any significant degree. Is that changing? And is that a factor in today's market?

Steve Shigekawa: It is. Coming out of the financial crisis, large institutions, you know, private equity, and other institutions bought homes through the foreclosure process, and they accumulated portfolios of single-family homes coming out of the housing bust and with the purpose of renting them. But the single-family rental market, it's a fragmented market, you're right about being hit or miss, but it's a large market. You know, there's more than 16 million homes in the country that are rented. And that was even before large institutions came into this. And so it really has been a mom and pop type business. It's oftentimes challenging to find rentals. And so institutions have come in and there's an opportunity, you know, to have scale, to implement new technology in terms of the leasing process, the acquisition process, and then also having a lower cost of capital. So, you know, we think that you're going to see institutional ownership of single-family rentals continue to grow. And it will be, it could be similar in size to the multifamily market in terms of publicly traded real estate companies.

Tom Herrick: And so to be clear, you're describing much more in place, permanent public corporations, real estate investment trusts, that, you know, this will be a business model for them going forward. Is that accurate?

Steve Shigekawa: It is accurate. Coming out of the financial crisis, there was, you know, some thought it was a good trade. You would rent them temporarily and then you would sell them when home prices recover. Other investors believed it was a long-term business and a single-family rental market, the opportunity is there in terms of growing that business as long as you can implement efficiencies. You know, there was a lot of questions as to whether you could manage a portfolio of homes spread out all over a city versus an apartment building where all of your units are under one roof. Over the past decade, these companies have become very efficient in terms of owning and renting these single-family homes.

Tom Herrick: What does their buying process look like? I mean, I can't imagine public corporations are going on like home tours with realtors and, you know, things like that. You know, they must be doing this in a – it's a little bit overused word, institutional – but an institutional process, a corporate process, as opposed to, you know, what I would do with my wife, which is tour a home, and you know look at various features and decor differently than the next person might.

Steve Shigekawa: Yeah, and today these buyers, they're looking at all different avenues of acquiring assets. So it could be, you know, coming out of the financial crisis, it was through the foreclosure process, buying portfolios of distressed mortgages and taking ownership of the underlying homes. But it's also buying on the MLS, on the normal listings. But these institutions have created, developed the technology where they can buy the single-family homes really within seconds of a listing, as long as it meets the criteria that they're looking for. It could be a home with three bedrooms, two baths in a suburb that has good schools, no swimming pool, because it's more maintenance. But if it meets its criteria, they're going to immediately bid, and they have an efficient view of what pricing is. And so but they utilize all different avenues, some are buying directly from builders, some are building themselves purpose built rental, single-family homes.

Tom Herrick: Intuitively, this has to be creating what I guess I would call a displacement factor of some sort in the market right now with all this buying activity going on, it's additional buyers, is what I'm saying. Is there data that supports that?

Steve Shigekawa: Well, I think sometimes the headline, it shows that. And so to a degree, you're right that you have these large institutions that are competing with families that are looking for a home, and they may be pushing up prices. And so that narrative, you know, is one thing, but I think when you look at the scale, you know, I mentioned that the single-family rental market is about 16 million homes. All of these institutional ownership owners combined own about 300,000 homes. That's less than two percent of the market. So the single-family rental homes have been in existence even before these institutions were there. But the institutions have, you know, made it more efficient. You know, today you can look at renting a single-family home just as easily as you can rent an apartment. And there's demand, you know, we talked about millennials and their preference, you know, renting versus buying. So it's satisfying that demand. And also these institutions, you know, helped with the recovery in housing coming out of the financial crisis.

Tom Herrick: So, Steve, for investors that are in our audience, how would they participate in, you know, institutional ownership of single-family housing? What are the vehicles for doing that?

Steve Shigekawa: There's several ways to participate in the housing market generally. There are public companies that own apartments, single-family rentals, manufactured housing. There are public homebuilders and timber companies as well that are also tied to the housing market. Within the single-family rental business, there's both public and private companies that are growing their portfolios in terms of the single-family rental market, specifically.

Tom Herrick: Looking forward, pivoting a little bit towards a future outlook. Maybe you could comment on, you know, what your outlook is going forward, particularly around the affordability issue, which seems like it would be the driver here.

Steve Shigekawa: You know, we have a positive outlook. You know, we're at the start of an economic recovery. We're seeing strong GDP growth. The job market is improving. There is stimulus, both monetary and fiscal stimulus in the system. Interest rates continue to be low. And so I think you'll start to see, you know, some of the imbalance ease as builders start to build more homes. But we have a positive outlook for housing over a multi-year period.

Tom Herrick: Do rates become an issue? You know, we've seen mortgage rates move up a little bit here recently, but I think a 30-year is still something around three and a quarter roughly, which doesn't seem to be an affordability problem to me at three and a quarter. But is there a tipping point, I guess what I'm trying to determine here where that is a problem?

Steve Shigekawa: Well, you know, you're right, mortgage rates are very low today. But just for reference, if you go back to 2002 to 2006, this is as the housing market was really accelerating during the last cycle. Mortgage rates were in the five to six percent range. In 2007, they got to about six and a half percent. So being at three and a quarter today, I think that there's runway in terms of even if interest rates or mortgage rates were to go up, you know, you would still see good demand for buying single-family homes.

Tom Herrick: A question we hear a lot is, and this is a tricky one, is, you know, I'm trying to buy, but there's bidding wars. You know, there's 10 bids for a house all over asking price. How far do I go? I mean, as a consumer, a buyer there in that sort of environment. Am I participating in a frothy market? You know, these are the forms of the questions that come at us. Is the best advice maybe to stick to some affordability metrics, in your opinion?

Steve Shigekawa: Yeah, I think buyers should be you know, they have to be patient and they have to recognize that there's a little bit of a bottleneck in the housing market right now, partially driven by the pandemic. But you'll start to see more supply come to the market. But you're right, you know, we would suggest people to stay disciplined as it relates to affordability. You know, and interest rates, they're low today and we expect them to continue to be low in the near future. And then there's also the ability today to consider renting as well as buying a single-family home.

Tom Herrick: Steve, thanks for sharing your insights. It's been great speaking with you today.

Steve Shigekawa: Well, thank you for having me, I appreciate it.

Tom Herrick: That was Steve Shigekawa, Managing Director and Real Estate Portfolio Manager at Neuberger Berman. Thanks again to Steve and to all our friends at Neuberger for making it happen, and of course, thank you for listening.

We'll be back next month with more thought leadership as we strive to maintain Cary Street's higher standard on the airwaves. We're already at work on episodes covering other important questions and pocketbook issues that are front of mind for investors. Next month, in fact, we'll look at the commodities market with Brad Klein of CoreCommodity Management. We hope you'll join us for what should be a really interesting conversation. In the meantime, for more information, please visit our website at CaryStreetPartners.com. And as always, subscribe, share the show, and send us your feedback, too. We'd love to know what you think. I'm Tom Herrick, talk to you next time.