Real estate markets

The Demographics of the Housing Market

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- We believe the housing market remains in a very oversupplied and fragile state.
- Those calling for a rapid recovery are not considering the myriad demographic forces that, in our opinion, will inhibit significant new demand for the foreseeable future.
- The multifamily industry should be a direct beneficiary of these forces over the next 3-5 years.

Over the past several months, a number of "experts" have begun calling for a sharp rebound in the housing market. Two of the most common phrases uttered by the bullish camp are:

"Housing is poised for a V-shaped recovery"

"There is significant pent-up demand for housing"

We believe the significant excesses that developed during the bubble period of 2002-2006 will take many years to work through, particularly in light of high unemployment and underemployment rates. As such we do not believe housing is poised for a V-shaped recovery. However, the question of significant pent-up demand for housing bears examination. We do not dispute that there are a number of potential home buyers who were patient and fiscally prudent during the housing bubble and are eager to take advantage of depressed prices. However, there are two essential required components for "significant" pent-up demand: money and potential buyers. Regarding the money side of the issue, Loan Performance estimates that from the late 2005/early 2006 peak housing values declined approximately *USD 5.5 trillion*. Combining this with the tightening of mortgage underwriting standards and First American Core Logic's estimate that approximately 23% of the homes in the country *with a mortgage* have negative equity, our skepticism for the availability of capital amongst the average homeowner becomes understandable. The potential buyer side of the equation, although more difficult to quantify, yields equally troubling results when one considers the demographic forces facing the housing market. These forces are discussed in this report.

On the bright side, we believe these headwinds have created other investment opportunities. The structural and demographic issues weighing against the housing market should translate into substantial gains for the multifamily industry over the next 3-5 years.

The Demographics of Housing

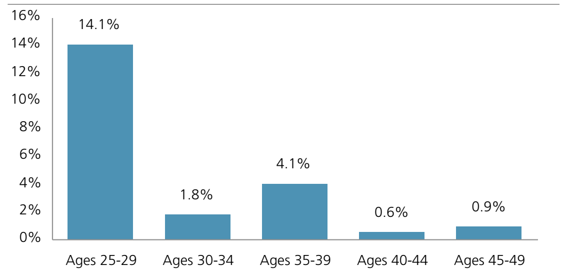
Who bought the houses during the bubble?
As can be seen in Chart 1, the 25-29 year old demographic (demo) accounted for the largest growth in homeownership during the bubble years by almost a factor of four times. Historically this demo would most likely have purchased their first home in their late 20s to early 30s. Much of that was pulled forward to younger buyers given the near unlimited access to cheap capital. A significant portion of these buyers have either been foreclosed upon, are in serious delinquency, have lost significant money in the downturn or have been dissuaded from homeownership by the poor experiences of their peers (or some combination thereof). Whatever the experience, we believe a number of these potential first-time buyers will not currently pursue the ownership route.

The dynamics of the aging population
Chart 2 highlights the past and projected growth rates for the major age demos for the past and current decade. As the chart indicates, the 18-34 year old demo, historically the first time home buyer, has a growth rate that is projected to decline by almost 500 basis points to 2.2%. The 35-50 year old demo, historically the first and second move-up buyer, has a negative growth rate. The age demo with the highest projected growth rate by a factor of five times is the 65+ year olds. Historically this demo has had a high degree of homeownership, including the purchase of second/vacation properties. We believe that the combination of the housing bubble burst with the recent financial crisis severely impaired the balance sheets and retirement plans of a substantial portion of this demo. If this is correct, it is reasonable to expect that this demo does not represent a significant demand driver for second/vacation homes for the next several years.

Higher education – a double-edged sword
Chart 3 highlights the college enrollment trends for both the 18-19 year old and 25-29 year old demos. Our focus is specifically on the 25-29 year old demo (historically the first time buyer) where the percent enrolled in college has grown from 11.4% to 13.2% between 2000 and 2008 (the latest available data). Although we applaud furthering the education of all our citizens, there is a negative implication for housing. We believe many of the 2.9 million implied 25-29 year olds in higher education are likely to leave college/graduate school with significant levels of debt. This will likely make it much tougher for a majority of these graduates to be able to purchase a home in the near term (except of course for those who receive family assistance).

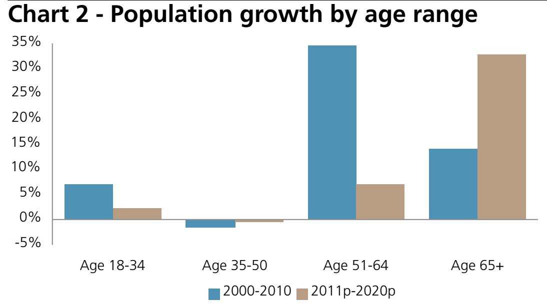
Do we need more big houses (or a lot more houses at all)?
As can be seen in Chart 4, the number of persons per household (PPHH) has been steadily declining since 1955 and is down 22.2% to approximately 2.6 PPHH. At a minimum we believe this argues against the "McMansion" trend of the bubble period and towards significant-

Chart 1 - Homeownership growth by age range
1Q 2000 - 3Q 2006



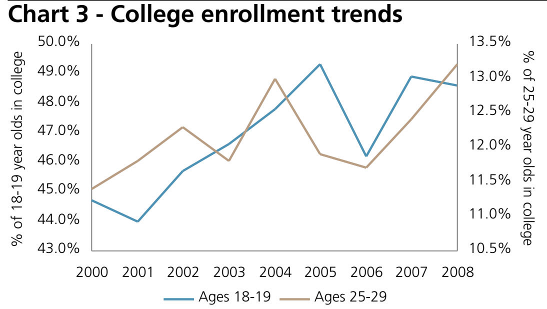
Source: U.S. Census

Chart 2 - Population growth by age range



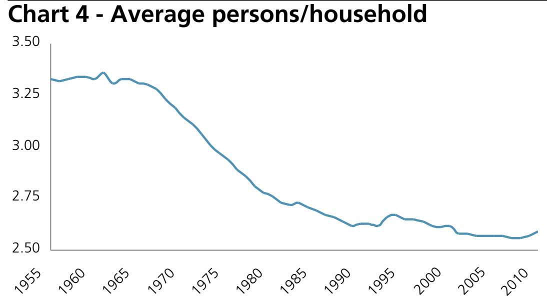
Source: U.S. Census

Chart 3 - College enrollment trends



Source: U.S. Census

Chart 4 - Average persons/household



Source: U.S. Census

ly smaller homes. It could also portend a need for less single-family homes as debt-laden consumer seek more affordable shelter.

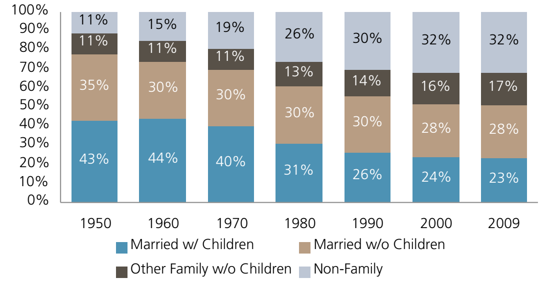
Household composition trends – decidedly housing unfriendly
Chart 5 highlights the trend in household (HH) composition from 1950 to 2009. As the chart indicates, married with children HHs and married without children HHs have declined from 43% and 35% to 23% and 25% respectively while HHs with non-family members has grown from 11% to 32%. We believe this trend away from the "nuclear family" potentially argues against a growth in homeownership.

Homeownership rates – a declining trend
Depending upon one's measurement period, homeownership rates in the U.S. have averaged between 64%-65% (Chart 6). Homeownership rates peaked at 69.2% and currently sit at 66.5%. Should homeownership rates follow the path of other asset class bubbles (gold, technology…) we believe there is a strong chance that homeownership will, at a minimum, mean revert to long-term averages (if not decline further). Should homeownership rates simply mean revert, based on 112.4 million U.S. households, this would imply negative housing demand of 1.68 million single-family houses. Each 1% decline in homeownership beyond 65% would equate to an *additional* 1.12 million excess single family homes.

Implications of income and unemployment disparities
According to the Bureau of Labor Statistics, the U.S. unemployment rate is 9%. However, as can be seen in Chart 7, when viewed by income decile, the unemployment rate increases precipitously as incomes decline. Given that the median home price in the U.S ranges between USD 160,000-170,000 depending upon geographic mix, we believe the rapidly increasing unemployment rates at lower income levels could restrict housing demand, particularly given the tightening of lending standards.

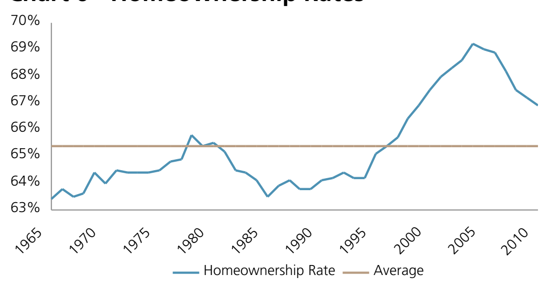
The silver lining to the dark cloud
As we wrote in our 8 September 2010 note entitled *Housing's Pain is Multifamily's Gain*, we believe the significant headwinds facing the single family housing market, including the demographic factors discussed above, are very positive for the demand for multifamily (MF) housing. Combining this with the dearth of new MF supply over the past four years (Chart 8) we believe the supply/demand fundamentals of the multifamily business will be strong for a number of years.

Chart 5 - Household composition trends



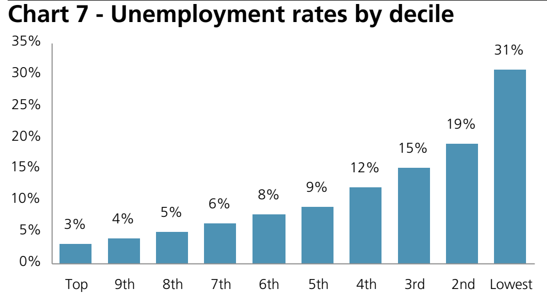
Source: U.S. Census

Chart 6 - Homeownership Rates



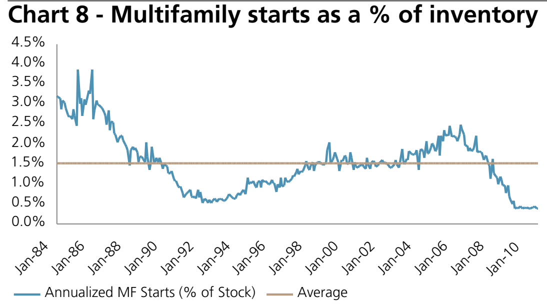
Source: U.S. Census

Chart 7 - Unemployment rates by decile



Source: BLS

Chart 8 - Multifamily starts as a % of inventory



Source: U.S. Census

Appendix

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