REALM

Micro Units Investment Thesis

October 9th, 2023

Terms:

Micro Unit: Typically, units less than 400 SF. In some areas like Texas, units up to 500 SF are considered micro units. National micro unit data in this document is based on units less than 400 SF.

Low-Cost Housing: Units with monthly rent under $1,000.

Thesis:

Investment in Low-Cost Micro Unit Housing (LCMUH), especially in low vacancy markets, provides the opportunity for better risk-adjusted returns than typical multifamily.

Supporting Claims:

Risk

1.) LCMUH is lower risk than typical multifamily because of more favorable supply/demand dynamics.

2.) LCMUH is lower risk than typical multifamily because properties can be acquired at a more attractive basis.

Return

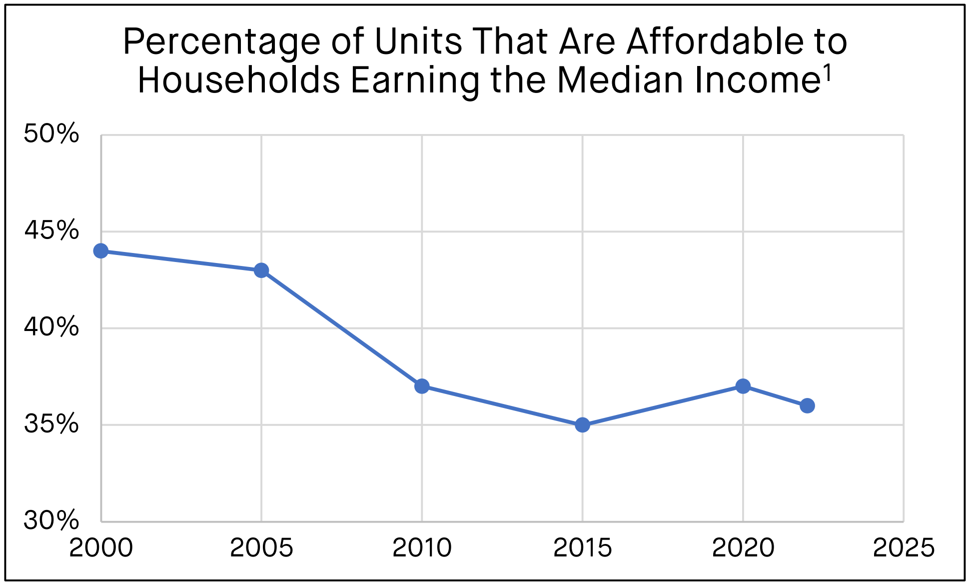
3.) LCMUH will provide better returns than typical multifamily due to subsidized lower interest rate financing.

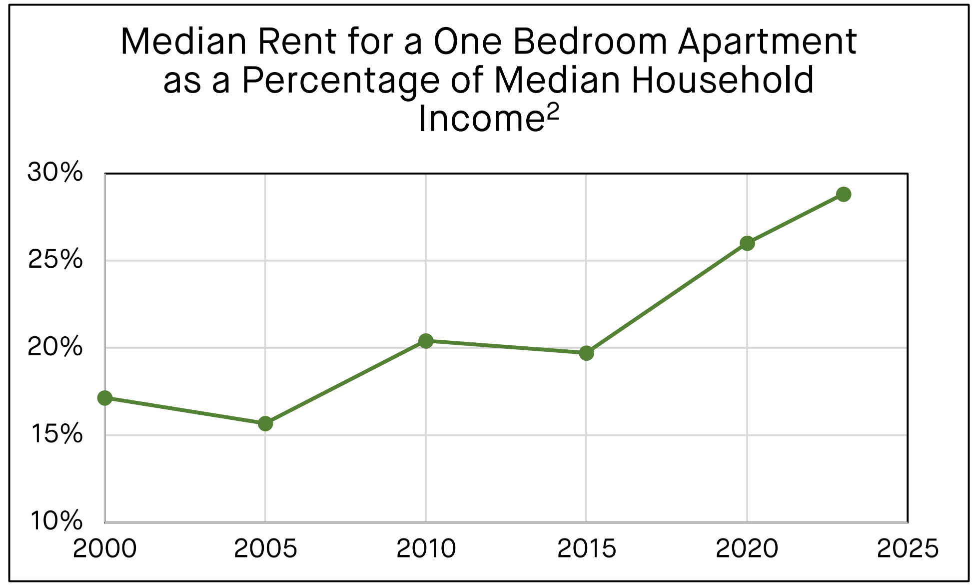
4.) LCMUH will provide better returns than typical multifamily due to impending cap rate compression.

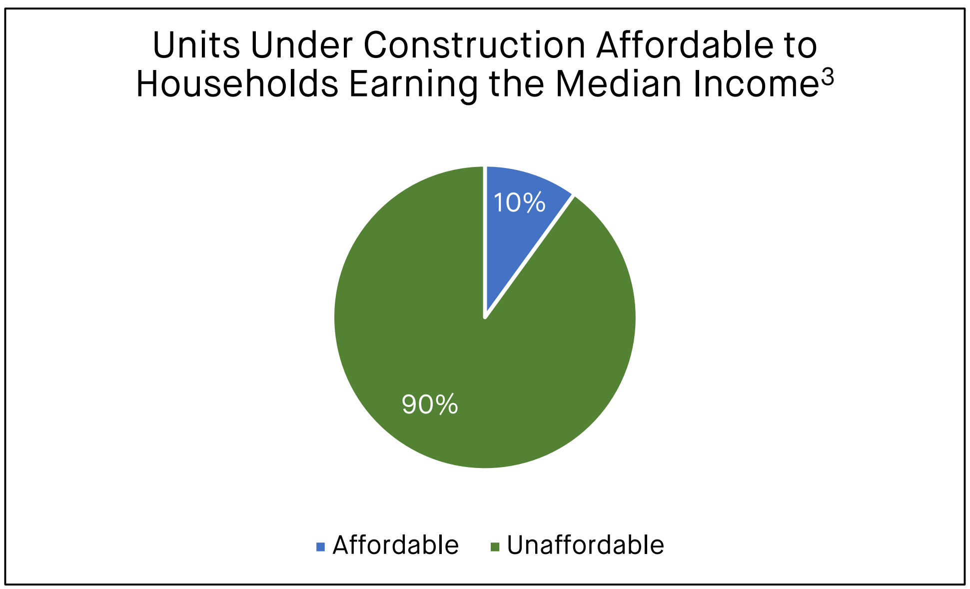
More Favorable Supply/Demand Dynamics

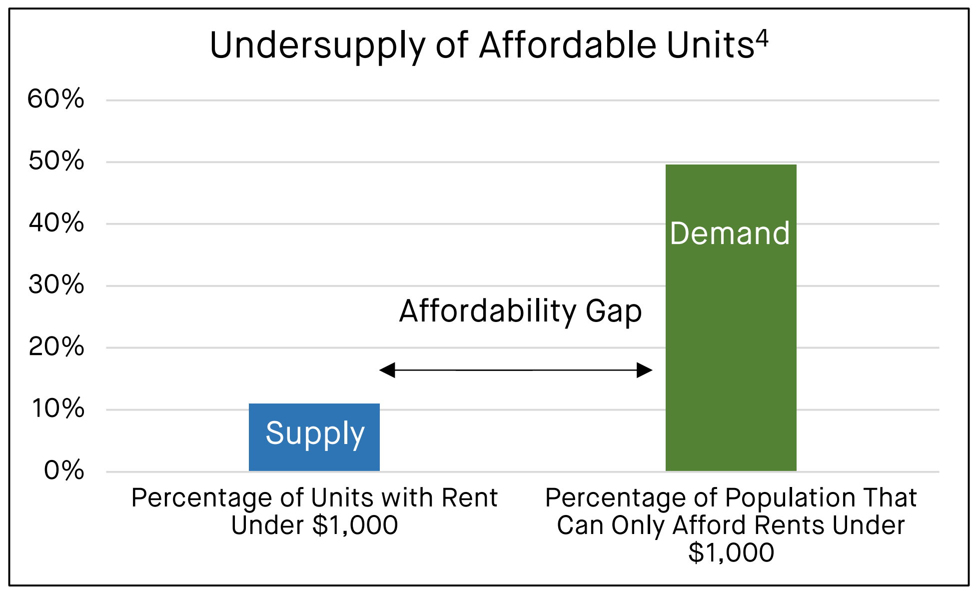
Supply is Limited

As the cost of housing continues to rise dramatically, affordable units make up an increasingly small share of multifamily inventory in the U.S. In the charts below, "affordable" is defined as rent that requires no more than 30% of income.



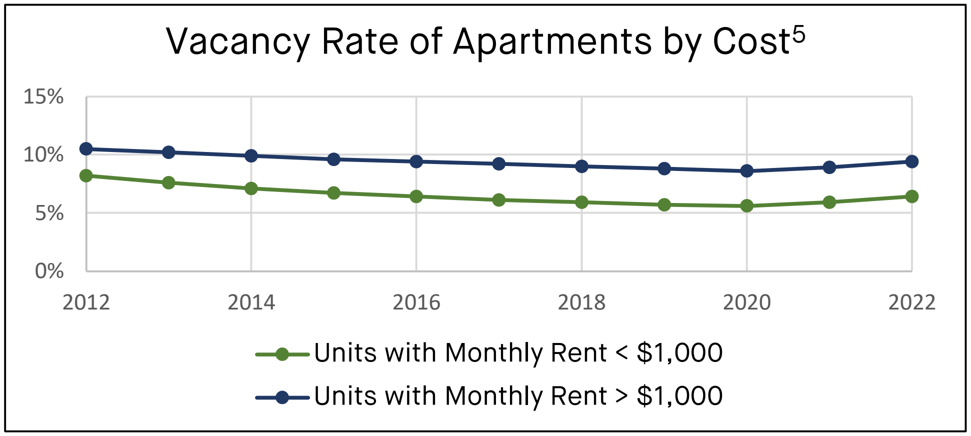




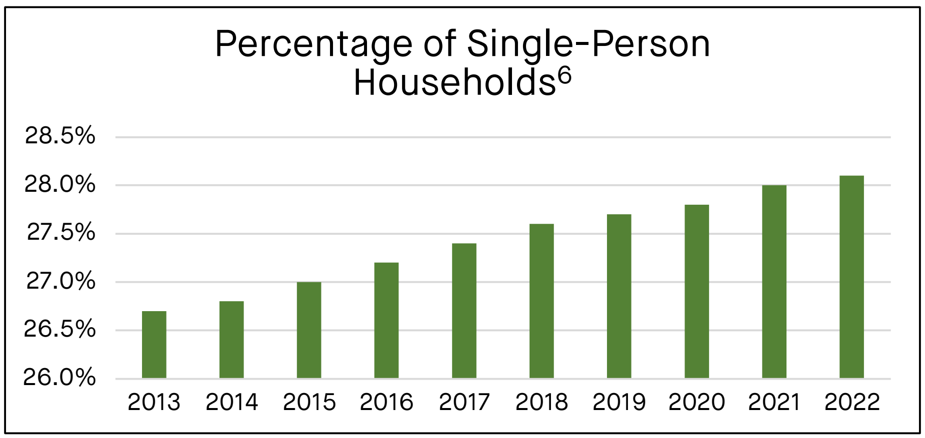


More Favorable Supply/Demand Dynamics

Demand is Strong and Growing

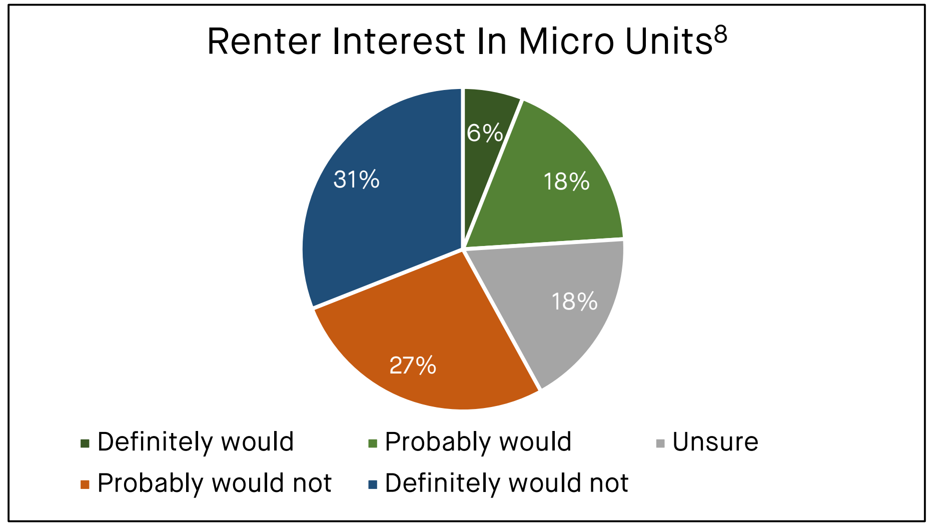


<u>Demand for low-cost housing is consistently higher than demand for more expensive housing.</u> This difference is especially pronounced in more urban areas.



The number of single person households has been steadily increasing for decades. With 131 million households in 2022, even a 0.1% change is an additional 131,000 single person households. Demographics are shifting in favor of smaller units.

Although 24% of renters would be open to living in a micro unit, They make up only about 1% of units in the US. The popularity of micro units has also increased significantly since the survey below was conducted by ULI in 2015. A 2021 survey by Apartment List[7] found that 42% of renters would consider living in a micro unit.



Additional Data Points

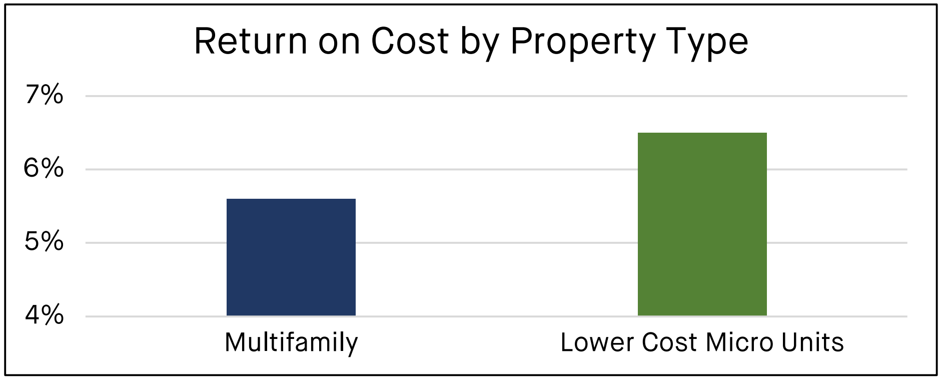
- The number of people who are rent-burdened (paying more than 30% of their income on rent) has increased by 5 million since 2019. About 50% of renter-occupied households are spending over 30% of their income on rent[9].

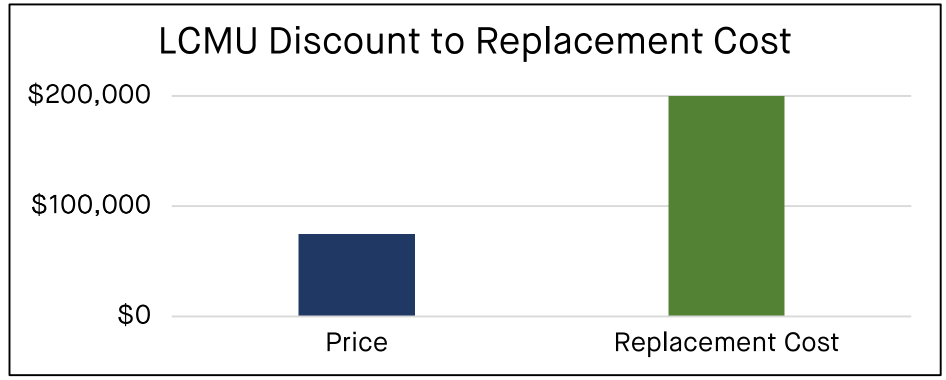
- The difference in SF between a micro unit and typical unit is shrinking. The average size of a newly built apartment in 2022 was 887 square feet, down from 941 square feet in 2013[10].

Attractive Basis

The stabilized return on cost for LCMU's is consistently greater than 6.5%. This is especially attractive when compared to the market cap rate for multifamily at 5.6%[11]. When buying stabilized units, this difference requires the buyer to take on no additional risk from the renovation and leasing process. This makes LCMU's appealing to opportunistic investors as well as those seeking stable, cash-flowing assets.

The conversion of existing hospitality properties into LCMU's provides the opportunity to make acquisitions at a greater discount to replacement cost. National market sale price per unit is currently $237K, compared to the average development cost per unit of $350K. In the case of LCMU's, REALM is able to acquire properties for $75K per unit when the replacement cost of those same units is estimated to be $200K per unit[12].





Low Interest Rate Agency Financing

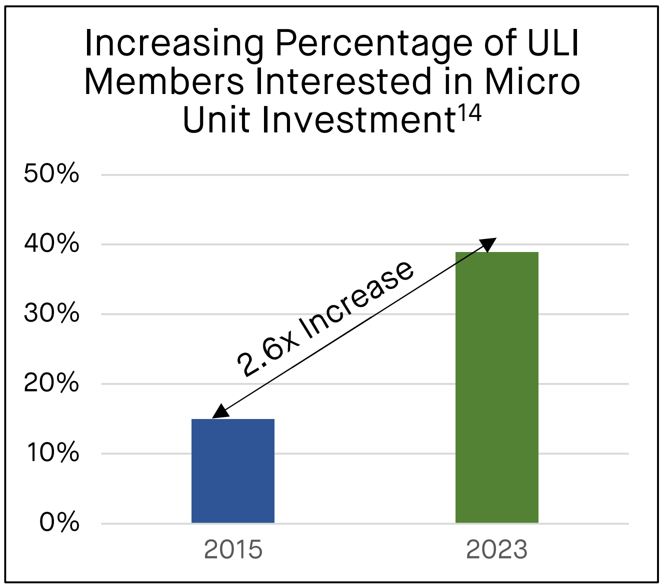
Until very recently, returns for investments into LCMU's have been less appealing due to the inability to obtain agency financing. However, agency financing is just now becoming available for these investments. Additionally, banks and agencies are incentivized to provide more favorable debt terms to providers of affordable housing due to the societal benefits. Reductions in interest rates range from 40-80 bps, which can have a significant impact on returns. The differences illustrated below are based on an example $10M acquisition with interest-only financing at 60% LTC over a 2-year hold period.

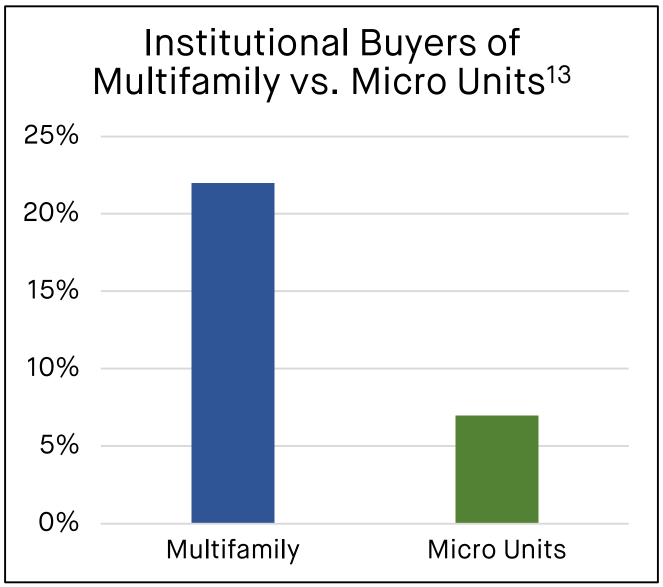
	No Debt	Market Debt	50-bps Rate Discount Debt
Equity Multiple:	1.3x	1.5x	1.6x
IRR:	14.6%	25.3%	26.0%
Profit:	3,028,571	2,188,571	2,248,571

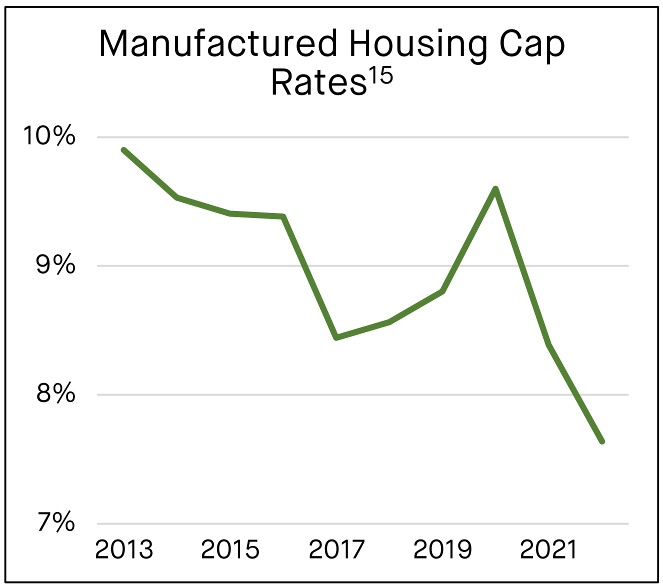
Expected Cap Rate Compression

As the amount of institutional capital in the LCMU market increases, buyer demand is expected to rise significantly, resulting in cap rate compression. Institutional capital is still limited in the micro unit space for multiple reasons. One reason is the novelty of the asset type, and there is limited evidence of successful projects in this space being done at scale. However, due to the favorable supply/demand dynamics of this market, that is likely to change. The Urban Land Institute conducted a survey of its members in 2015 and found that 15% of respondents were interested in micro units. This same study was conducted in 2023 and found that 39% of respondents were interested in investing in micro units, a 24% increase in 8 years. As the market becomes more competitive, cap rates are expected to compress

Investors have also been hesitant given this inability to obtain agency financing on these acquisitions. Until Q3 2023, limited agency financing had been available for conversions from hospitality to micro unit multifamily. This lack of financing results in less attractive returns and consequently, limited interest by institutional investors. Now that agency financing is becoming attainable for such projects, the investment of institutional capital is likely to increase rapidly. Such influxes of capital have historically resulted in cap rate compression, driving up property values. The charts below illustrate the limited amount of institutional capital active in micro unit acquisitions relative to all multifamily acquisitions. The difference is even more pronounced in LCMU properties. A similar phenomenon has already taken place in the manufactured housing sector, where comparatively high cash flows and growing demand led to a wave of investment that significantly compressed cap rates, as illustrated in the graph below.





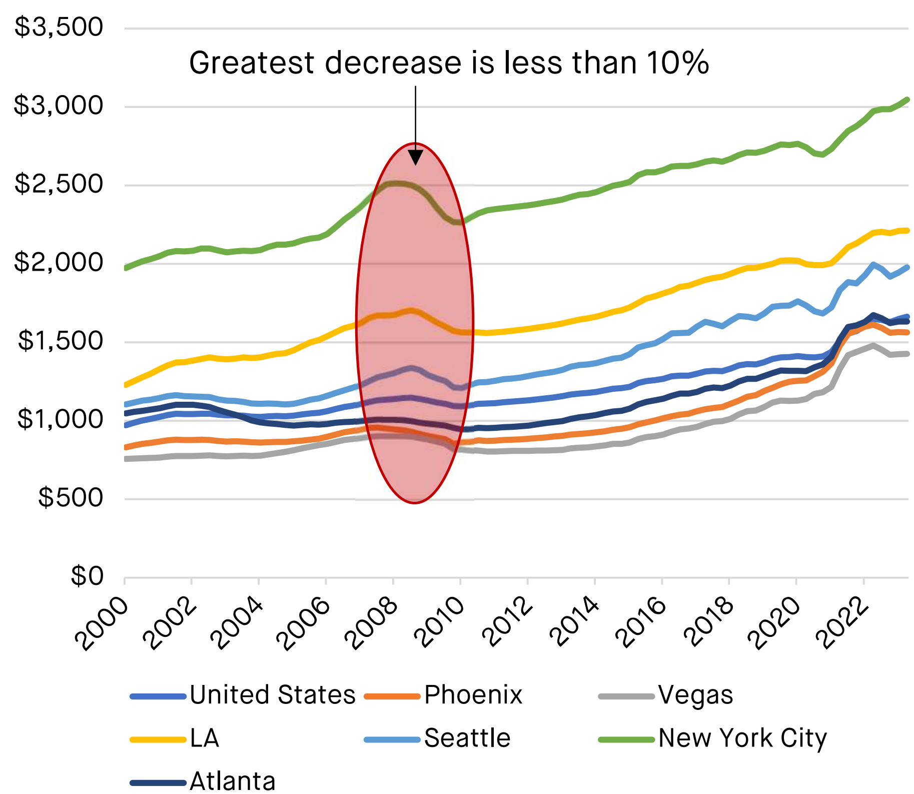


GK0

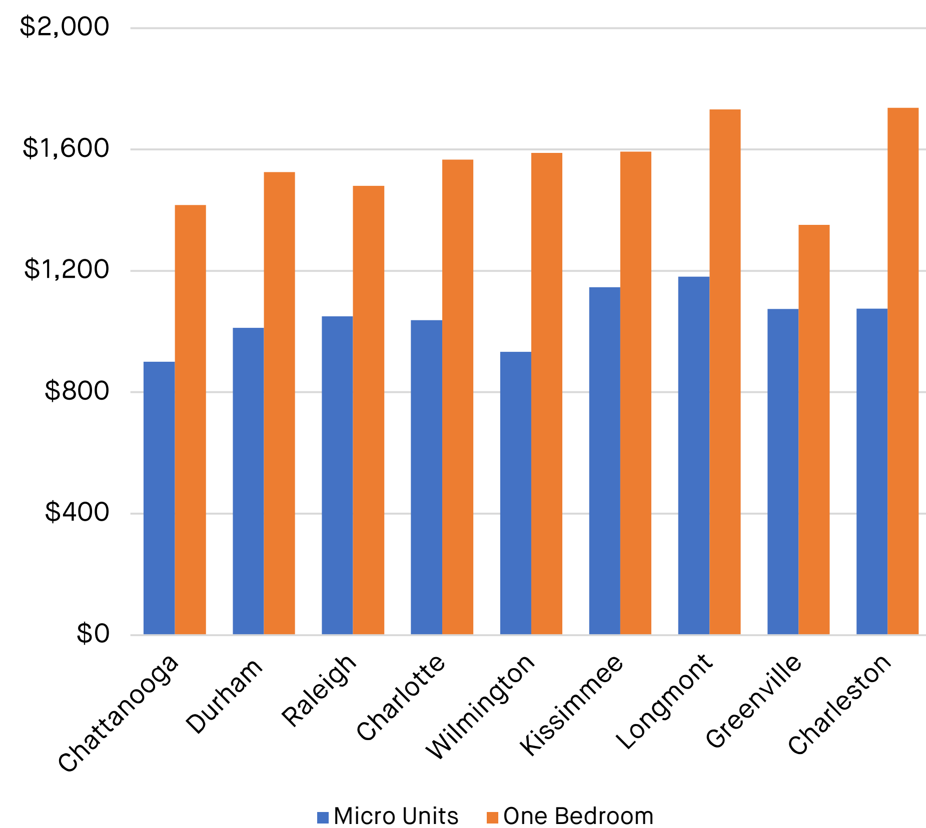
Multifamily Oversupply Risk

One risk associated with LCMU's is the potential for falling rents caused by multifamily oversupply to allow newer/nicer properties to compete in price. In this scenario, rents for higher quality apartments would become much closer to the rents for LCMU's. As a result, landlords would have to either charge less rent or see their units vacated by tenants moving into higher quality spaces. However, the data suggests this scenario is highly unlikely. As shown in the graph below, even during the 2008 recession in the most sensitive markets, effective rent per unit did not drop by more than 10%. If this significant drop in rents were to occur today, the vast majority of units would still be well outside the price range of LCMU's.

Effective Rent per Unit by Market Over Time[16]



Micro Unit Rent Discount Compared to One-Bedrooms[17]



Slide 7

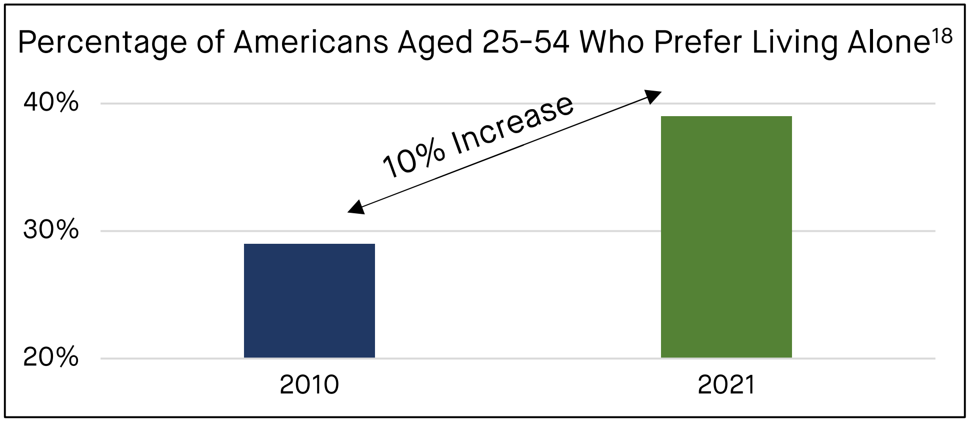
GK0 TK wants studio rents and micro unit rents. We don't have micro unit rents.

Gavin King, 2023-09-14T20:01:59.074

Additional Risks and Mitigants

Co-Living Spaces and Shared Housing Options

Another risk of LCMUH is the competition posed by co-living spaces and the option of renters to share a house or larger apartment with roommates. However, a large percentage of renters would prefer to live without roommates, and this preference is only becoming more popular as evidenced by the graph to the right.



Rapidly Increasing Supply of Micro Units

The American Census Bureau estimates that the inventory of micro units in the US increased by 200% between 2014 and 2021, while the inventory of all multifamily increased only 18%. Although this trend of deliveries is expected to continue, nearly all of these newly constructed units are not low-cost. The majority of this development is high end units in markets like Seattle and New York City.

Limited Historical Data

Because micro units have only become popular in recent years, it is difficult to reliably compart their performance to other asset types across real estate cycles. However, this type of data is less relevant to investments in *low-cost* micro units since data on low-cost units is very accessible and reassuring. Regardless of the asset type, more affordable housing properties have consistently performed better than more expensive ones, as illustrated in pervious slides.

Conclusion

Lower-Cost Micro Unit Housing provides the opportunity for risk-adjusted returns that outperform competing asset types. Supply is expected to remain limited because the development cost of newly built properties cannot allow for rents at this price point. At the same time, demand will likely remain high as micro units are the only affordable option for a large percentage of Americans who want to live alone. Investment in LCMU's is especially attractive in the short term before cap rate compression occurs as the market responds to newly obtainable agency financing.

Sources

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[2]U.S. Census Bureau
[3]Harvard Joint Center for Housing Studies' State of the Nation's Housing 2023 report - https://www.jchs.harvard.edu/state-nations-housing-2023
[4]U.S. Census Bureau
[5]National Low Income Housing Coalition
[6]U.S. Census Bureau
[7]Apartment List " Micro-Units and Micro-Apartments: What Are They?" - https://www.apartmentlist.com/renter-life/micro-apartments
[8]Urban Land Institute "The Macro View on Micro Units" - https://uli.org/wp-content/uploads/ULI-Documents/MicroUnit_full_rev_2015.pdf
[9]US Census Bureau American Community Survey
[10]RentCafe.com
[11]Costar Multifamily Market Data
[12]Costar Multifamily Market Data & REALM Estimates
[13]Costar Multifamily Market Data
[14]Urban Land Institute "The Macro View on Micro Units" - https://uli.org/wp-content/uploads/ULI-Documents/MicroUnit_full_rev_2015.pdf
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