

SEA CHANGES

The term “sea change” originated with William Shakespeare in 1610 and referred to “a change brought about by the sea.” This archaic definition has given way to modern, more expansive versions, such as “a profound or notable transformation” or “a change from accepted or traditional forms.” Three sea changes of this variety now shape the real estate industry: 1) remote work; 2) single-family housing as an investment vehicle; and 3) surging interest rates.

Remote work is here to stay. What many thought was simply a hangover from the COVID pandemic has been warmly embraced by Millennials and the generation to follow. Given the sheer size of the Millennial generation (72.1 million) and its current age range (27 to 41), it is no surprise that employers are forced to adapt. Hybrid work models, downsized offices, and enhanced work environments are the result. So are rising vacancy rates and sharply reduced space absorption. Two concerns stand out. The obvious one is what to do with surplus office space. Market and economic forces will dictate adaptive reuse and redevelopment options. The bigger question is the social and psychological impact of at-home work instead of daily interaction with co-workers. What happens to interpersonal communication, which has already been comprised by the Internet? Does social isolation worsen due to diminished opportunities to connect with others? These are lofty questions, but they are real issues.

A second shift well under way is the emergence of single-family housing as an investment asset class. This trend began following the Great Recession when house prices tanked and investors took advantage. In the first quarter of 2022, 43% of all house sales in metro Atlanta were to investors, according to Core Logic, Inc. This partly explains the 19.4% rise in the median house price from May 2021 to May 2022 reported by the Atlanta Realtors Association. The abundance of capital flowing into the single-family housing market has elevated prices in much the same way that subprime mortgages injected undue stimulus. A related trend is the proliferation of build-to-rent single-family housing communities. Higher rental rates, together with difficulties qualifying for a mortgage, have fostered growth of this product type.

The third sea change is the recent surge in interest rates after many years of low-cost debt. A simple barometer is the 30-year mortgage rate, which averaged 5.74% as of July 1, 2022. This figure stood at 3.37% a year earlier, indicating a 70% increase. The implications are endless for the real estate industry: 1) greatly increases the cost of home ownership and ability to qualify for a mortgage; 2) places upward pressure on capitalization rates; and 3) raises the cash-on-cost hurdle rate for income-property development. Another victim is the U.S. government's debt service burden now that the national debt exceeds \$30 trillion, having doubled in the last 10 years. Given that the annual inflation rate now exceeds 9% and the Federal Reserve is committing to restoring the 2% target rate, interest rates are sure to continue rising.

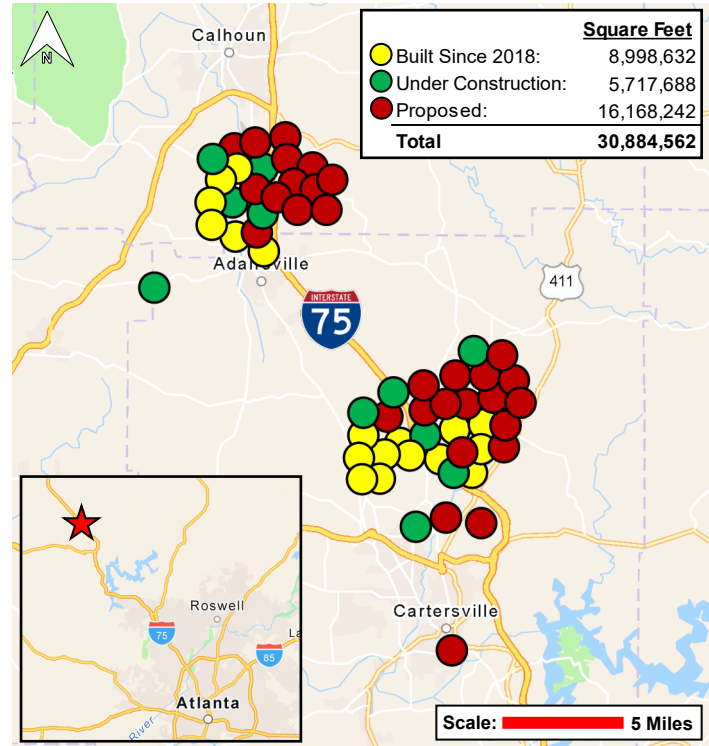
In summary, three sea changes currently grip the real estate industry. These represent profound transformations from traditional norms, demanding adjustments in investment approach and strategy. Pain will be inflicted, but change creates opportunity. Those nimble enough to adapt will benefit.

INDUSTRIAL EXPLOSION - INTERSTATE 75 NORTH CORRIDOR

Industrial development is booming along the Interstate 75 corridor in Bartow and Gordon counties. Almost nine million square feet of industrial space has delivered since 2018 and another 21.9 million square feet were under construction or proposed as of May 2022. This is a dramatic change from past development cycles when this corridor was largely overlooked. Most of the recent development has been warehouse and distribution facilities. Factors driving the current surge include:

- ❖ A close-in location on Interstate 75 with available sites that have utilities and entitlements.
- ❖ A strong labor pool.
- ❖ Proximity to the Appalachian Regional Port in Murray County, which opened in 2018.

The uptick in industrial development is creating new jobs in Gordon and Bartow counties and the need for more housing. Multifamily developers have responded, particularly in Bartow County, where 921 units were under construction and another 1,731 units were proposed as of May 2022.



MONTHLY HOUSING COSTS - RENT VS. OWN

Even with the recent spike in mortgage rates, the monthly cost of owning a condominium in Atlanta's urban core compares favorably to the monthly cost of renting a Class A apartment. When monthly rents approach \$2.75 per square foot, the net effective cost of ownership is actually less than renting, as illustrated by the model below.

COST TO RENT (Assumes 1,000 Square Foot Unit)

| | | | |
|-------------------------------------|----------------|----------------|----------------|
| Monthly Rent Per Square Foot | \$2.25 | \$2.50 | \$2.75 |
| Rent | \$2,250 | \$2,500 | \$2,750 |
| COST TO RENT | \$2,250 | \$2,500 | \$2,750 |

COST TO OWN (Assumes 1,000 Square Foot Unit)

| | | | |
|--------------------------------------|----------------|----------------|----------------|
| Home Price Per Square Foot | \$400 | \$400 | \$400 |
| Purchase Price | \$400,000 | \$400,000 | \$400,000 |
| MORTGAGE PAYMENT | \$2,110 | \$2,110 | \$2,110 |
| Plus: Taxes, Insurance, and HOA Dues | \$950 | \$950 | \$950 |
| PRE-TAX COST TO OWN | \$3,060 | \$3,060 | \$3,060 |
| Less: Tax Savings | (\$663) | (\$663) | (\$663) |
| AFTER-TAX COST TO OWN | \$2,397 | \$2,397 | \$2,397 |

COMPARISON

| | | | |
|--|--------------|----------------|----------------|
| CASH COST OF OWNERSHIP | \$147 | (\$103) | (\$353) |
| Plus: Opportunity Cost of Down Payment | \$167 | \$167 | \$167 |
| NET EFFECTIVE MONTHLY COST OF OWNERSHIP | \$314 | \$64 | (\$186) |

Note: Cost to own assumes a home price of \$400 per square foot, HOA dues of \$0.30 per square foot, and a 90% LTV, 30-year, 5.7% fixed-rate mortgage (rate based on week ending June 30 via Freddie Mac). Opportunity cost assumes a potential 5% annual return on down payment. A unit size of 1,000 square feet is assumed.

To monitor key economic and housing indicators, please visit our website. As always, your thoughts and feedback are encouraged.

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