Labor Pains... and Opportunity

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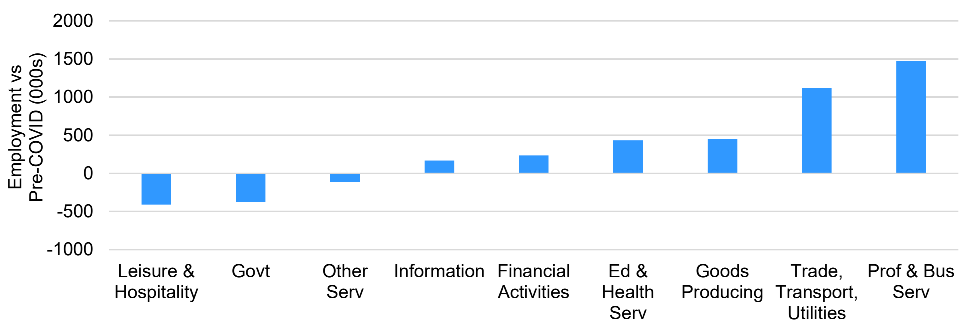
While there is consensus that we are past peak inflation and the broader U.S. economy is showing some major cracks, the labor market continues to exhibit signs of strength. Ironically, this steadfastness has been the primary driver of the Federal Reserve's monetary tightening policy, which has been a painful condition for the markets over the last year. However, the labor market is showing signs of loosening, which, if continued, would add to the easing of inflationary pressures across the economy. While employment supply and demand factors may not immediately come to mind when considering real estate investment, the current labor situation can shed a light on areas of opportunity for investors in the asset class.

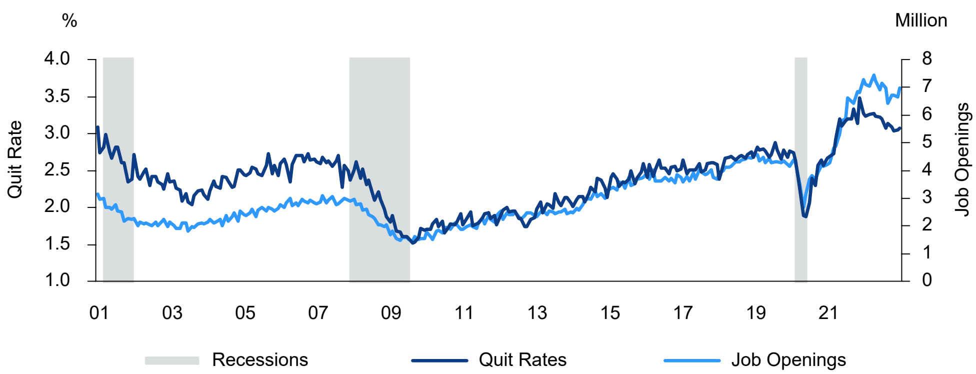
Employment in the services industry has been the slowest to recover post-COVID (Figure 1). To address the difficulty in hiring and retaining workers, companies have increased pay levels, contributing meaningfully to services-related wage inflation over the last year. Yet, this dynamic has changed recently. Based on the latest set of labor reports, the quit rate for the services industry has receded closer to 2019 levels (Figure 2), leading to lower job openings in these sectors.

Figure 1: Current Employment vs. Pre-COVID by Sector



Source: Bureau of Labor Statistics, February 1, 2023, Pre-COVID time period is February 2020.

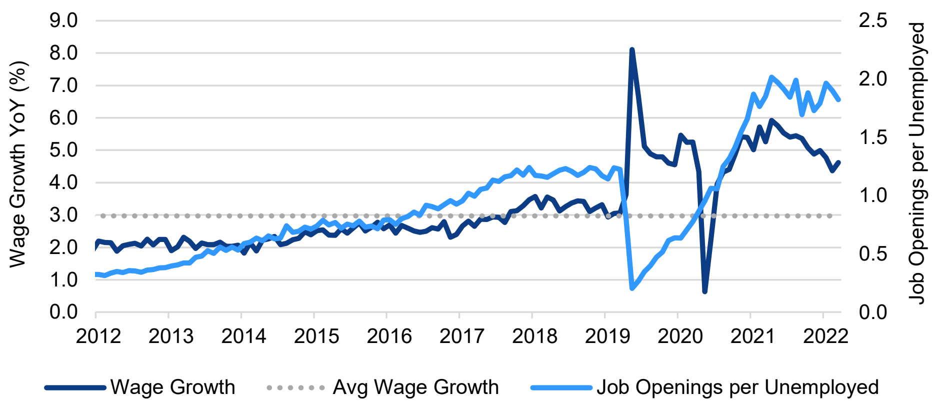
Figure 2: Services Industries* Weighted Average Quit Rate



Source: Bureau of Labor Statistics, National Bureau of Economic Research, Empirical Research Partners Analysis, February 1, 2023.
* Information, financial activities, professional and business services, education and health services, leisure and hospitality and other services.

We're seeing this scenario in real estate as well with the labor market cooling across operationally intensive sectors (i.e., cold storage, healthcare). These businesses are having an easier time finding workers without being held hostage to the same aggressive wage inflation that occurred in 2022. Their numbers suggest the market is returning to a more normalized 3% annual increase. Yet, despite this easing and ongoing layoff announcements across sectors, the market is still the victim of a meaningful labor supply shortage and above-average wage inflation (Figure 3).

Figure 3: YoY Wage Growth and Job Openings



Source: Bureau of Labor Statistics, February 1, 2023.

How can this be? It's becoming increasingly evident that the shortage of labor we have in this country – which today sits at 4.9 million workers – is a structural issue. The labor supply has been impacted by restrictive immigration policies (up to 2 million workers are missing from our labor markets as a function[1]) and accelerated retirements from the labor force (2.5 million workers retired during the pandemic with 1.5 million being early retirements[2]). For companies to increase their productivity in the face of these labor shortages, necessity-based innovation will be key. This thesis is particularly interesting because it highlights investible opportunities.

In the commercial real estate space, it is worth paying attention to management teams that are focused on innovation and have already made strides to reduce dependencies on labor for productivity. A prime example of this shift in the REIT space is rental residential. The best apartment REITs have already spent considerable resources to develop technologies that allow them to operate apartment buildings in a very low-touch yet high-service way. To wit, contactless leasing and self-touring create tremendous efficiencies. Leasing associates no longer have to spend hours walking potential residents through the apartment building. This innovation either eliminates the need for a full-time employee or allows the said employee to spend time on more productive work. It also allows for multiple tours to occur at once. We can surmise that such advances have helped keep labor inflation in check for apartment REITs throughout these challenging times. We can expect future modernizations to contribute to strong margin control in the face of a slowing growth environment.

It's also worth paying attention to other real estate sectors where similar innovations are poised to occur, presenting a massive opportunity for efficiency gains. Healthcare is a prime example, especially areas like senior housing or skilled nursing facilities, where labor constraints have only been exacerbated by COVID. To date, we haven't seen the innovation desperately needed in this space, but by necessity it is coming. Even more obvious opportunities like digitizing records or electronically tracking nurses as they move through the facility are innovations that could lead to major operating efficiencies. For labor-intensive sectors whose margins have been under pressure and will remain so in the low-growth environment that we're now entering, the time to innovate has never been more opportunistic. It is here we are watching and waiting with considerable interest.

[1] https://www.businessinsider.com/immigration-could-solve-labor-shortage-3-million-missing-workers-trump-2021-11
[2] https://www.businessinsider.com/labor-shortage-millions-retired-early-pandemic-not-going-back-2021-11

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