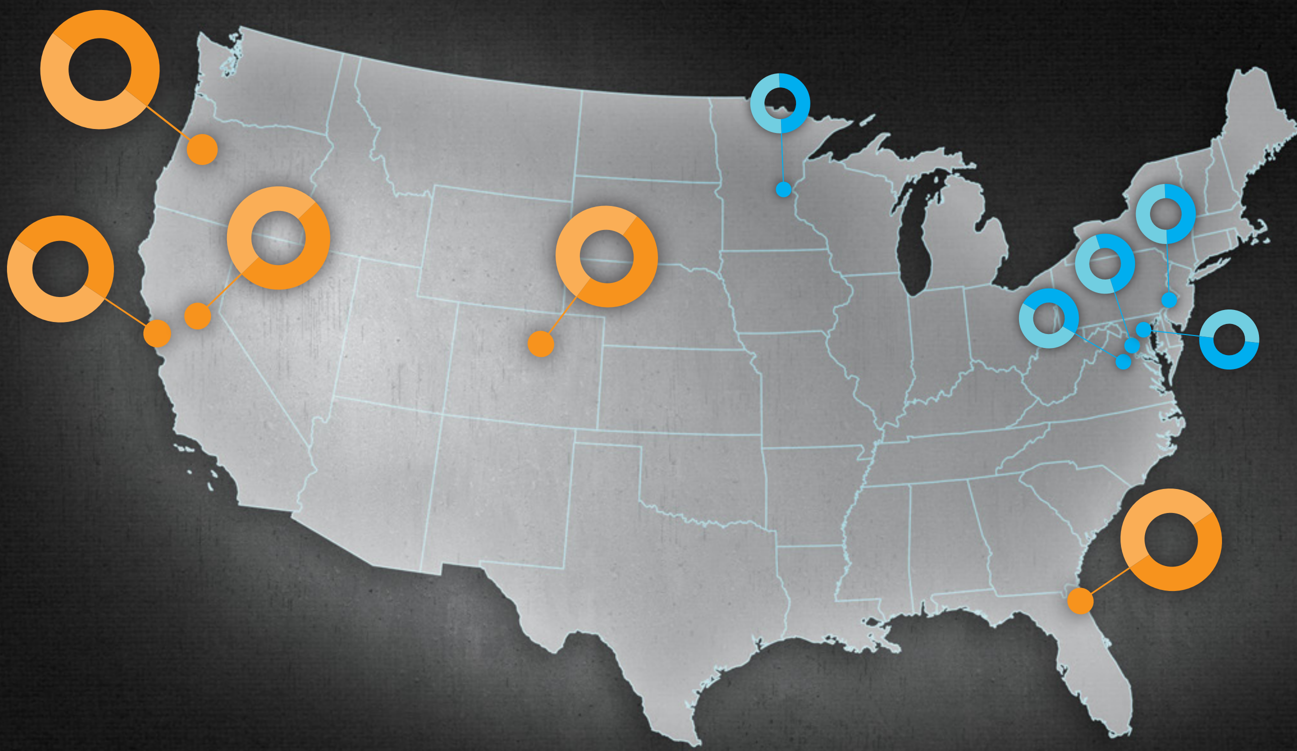
YARDI® Matrix

US Multifamily Outlook

Summer 2015



A Business Services & Healthcare Lead Job Growth

B Boomers Highlight Apartment Demand

C Absorption Up & Rents Growing

Market Analysis

Summer, 2015

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Photo by Nikada/iStockphoto.com

Executive Summary

The multifamily market has been performing so well for so long that it feels like it is entering a bubble phase. Time will tell, of course, but the cycle might have some legs left. No doubt the outsized gains in rents and property values will have to level off eventually, as the rate of increase in many metros far exceeds the growth in the economy and wages. Even so, in our view demand for apartments will continue to be above-trend for at least the next couple of years. Strong demographic headwinds and healthy job growth will enable the market to keep rolling along and prevent any type of serious downturn, even if it returns to a more sustainable level of growth.

Demand for apartments will be underpinned by another year of 2 million-plus new jobs, the above-trend household formations of Millennials and the ongoing move of Baby Boomers into urban apartments.

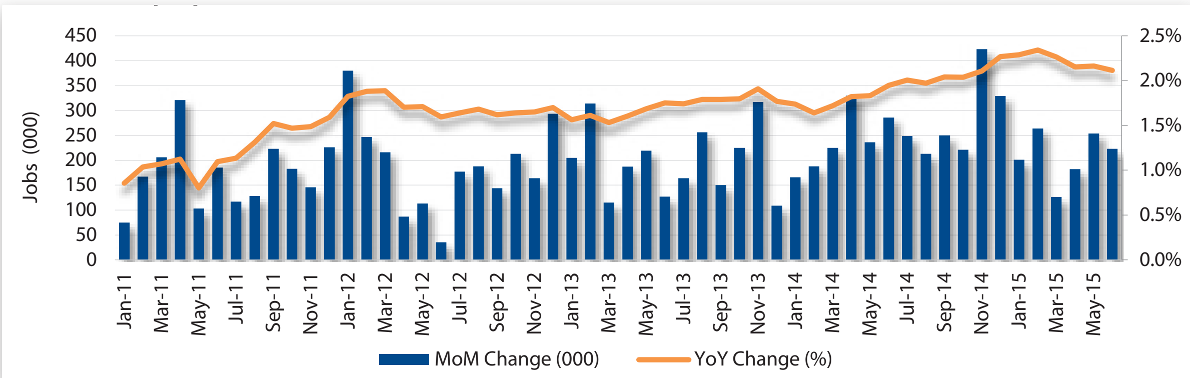
Our forecast at the beginning of the year for solid 5% rent growth seems almost too conservative now, as rents have grown by 6.2% over the first half with no slowdown in sight.

Even though the employment situation is not ideal – the worker participation rate remains too low and wage growth remains too weak – all in all there could be worse scenarios for commercial real estate. As good as the total growth numbers and unemployment rate look, the job market is not strong enough to push interest rates meaningfully higher, which is good news because real estate has benefited from the low-rate environment. Low rates help keep commercial real estate attractive to investors, who continue to load up on multifamily properties. As the cycle stretches over time, capital is increasingly trickling from primary to secondary and tertiary markets and from stable to value-add assets.

Economic Overview

The U.S. economy has bounced back from a weak first quarter, continuing its slow-but-steady path. Second-quarter GDP is expected to rebound from the -0.2% showing in the first quarter. Although the quarterly numbers have been inconsistent, year-over-year growth has consistently been about 2.5% to 3.0%, and is likely to remain in that range going forward.

Employment Growth



Source: Yardi®Matrix

Through six months, job growth was on pace for 2.5 million jobs for the year, a slight decline from 2014, but solid numbers nonetheless. The growth was led by professional and business services (672,000 year-over-year through June), education and health services (571,000) and trade, transportation and utilities (539,000). Financial activities also grew by 159,000, up 2.0% year-over-year. The numbers indicate fairly broad-based growth, with robust increases in segments with above-average wages (such as professional and business services, healthcare and financial activities) and in lower-paying segments (leisure and hospitality added 425,000 jobs and retail trade added 300,000). Travel-related spending continues to post impressive gains, as hotel revenue per available room (RevPAR) rose 7% in the first half, the sixth straight year of buoyant RevPAR gains.

One area that is bleeding jobs is mining, which lost 49,000 jobs year-over-year through June, while support services for mining lost 39,000 jobs. Oil prices rebounded from a six-year low of $47.45 in January to $62.50 in May, but they remain well below the $100-per-barrell rate that was normal in recent years. While there is room for oil prices to rise, we don't see major changes in the near future. The slowing economic growth in Asia and Europe will put a lid on global demand, while rising production in the U.S. and the lifting of sanctions in Iran are potential increases to global supply. Eventually prices will rally, as global demand increases and some sources of supply are shut down by the low prices, but that isn't likely to happen for another couple of years.

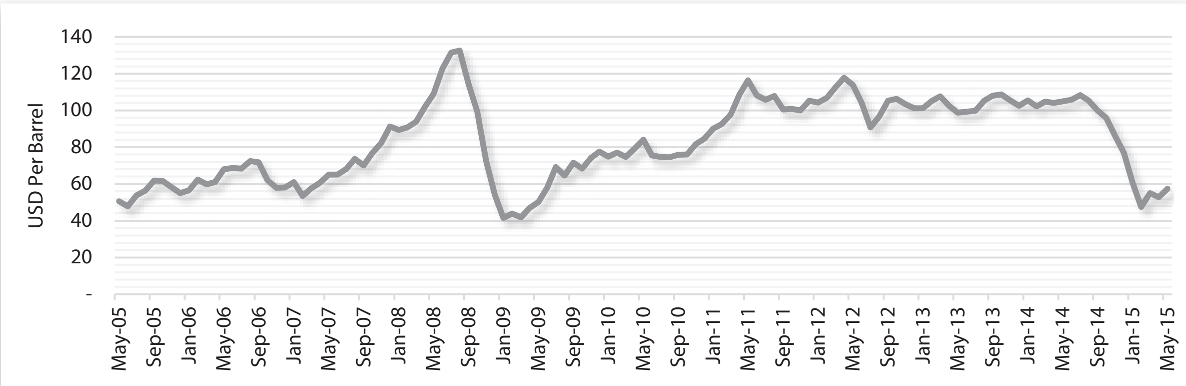
Employment Growth by Sector

	% Share	YoY Change (000)	YoY Change (%)
Prof & Business Services	13.8%	672	3.5%
Education & Health Services	15.4%	571	2.7%
Trade, Transport & Utilities	18.9%	539	2.0%
Leisure & Hospitality	10.6%	425	2.9%
Retail Trade	11.0%	300	1.9%
Manufacturing	8.6%	161	1.3%
Financial Activities	5.7%	159	2.0%
Government	15.4%	55	0.3%
Mining & Logging	0.6%	(49)	-5.5%

Source: Yardi®Matrix

Low oil prices will dampen growth in states such as Texas, Louisiana, Oklahoma and western Pennsylvania, but the overall impact to the economy has been limited. Larger energy-concentrated metros such as Dallas and Houston have made sure to diversify their economies since the 1980s, so the reduction in jobs caused by less drilling and exploration may be painful but not devastating.

Oil Price per Barrel



Source: www.indexmundi.com

Lower energy costs brought predictions of a spike in consumer spending, but that has not yet materialized. Typically, lower energy costs filter into the economy on a lagging basis, as it takes a while for savings to build up in consumers' pockets, but to date there has not been much evidence of a bump in consumer spending. Real personal consumption has risen at a 3% rate through the first half of 2015, which is solid but not spectacular. One standout is auto sales, which are up to a 17-million-per-year rate, making a full rebound from the recession. That's good news not only for Detroit but the entire Midwest, which encompasses a large number of manufacturing industries that service the auto sector.

Photo: Shutterstock

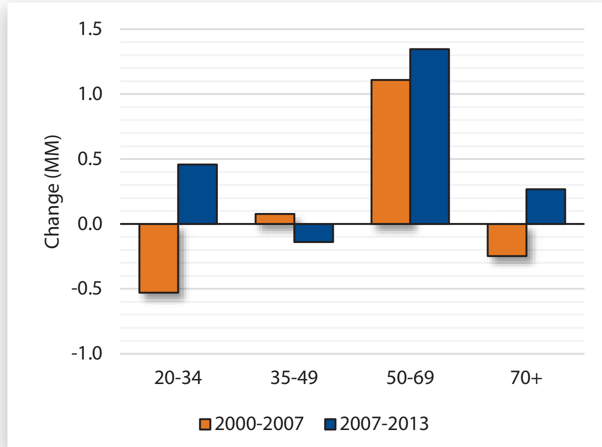
The direction of interest rates remains of key interest for the real estate market, but Federal Reserve Chief Janet Yellin has made it clear that rates will rise slowly and gradually as long as wage growth remains tepid. That has calmed fears of any spikes in interest rates before next year. Hourly and weekly earnings are rising at a 2% annual rate, which is progress but not enough to create robust growth or to generate concerns about inflation. Considering the 5.2% unemployment rate as of June is getting close to the historical standard for full employment, we would expect to see more pressure on wages. There is anecdotal evidence from a number of large companies that are voluntarily raising wages in order to prevent worker defections, but the data remains inconclusive in terms of serious wage growth.

Demand Drivers

There are many reasons to be optimistic about the demand for apartments over the next few years, some of which are eminently familiar. Particularly well known is the story of the rising number of household formations from the growing number of Millennials, and the generation's move to urban locations. Demographic data shows that compared to prior decades, a greater number of 20- to 34-year-olds are single, living with parents or living in apartments with a roommate that is not a spouse.

That these themes are familiar don't make them less true. The Millennial generation – at 75 million the largest demographic group in the U.S. – will keep growing into the prime renter age of 20-34 years old for a few more years. As their employment prospects improve, household formations will accelerate as more move from their parents' homes and away from roommates. Millennials are not as eager as prior generations in buying a home, and many can't afford the credit in any case, which means that a greater share of households they form will live in apartments.

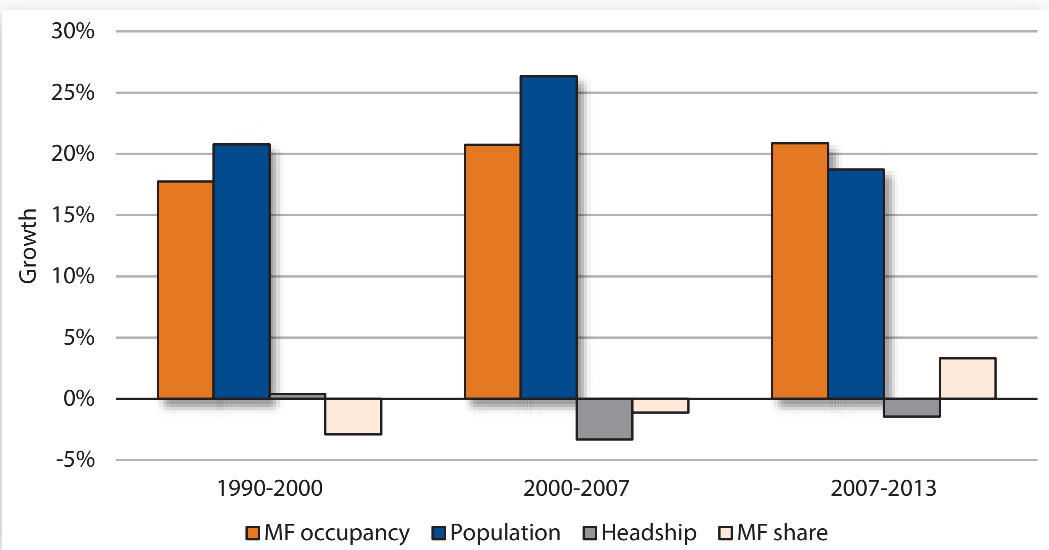
Change in Occupied Multifamily Units



Source: Census Bureau, Jordan Rappaport, Federal Reserve Bank of Kansas City

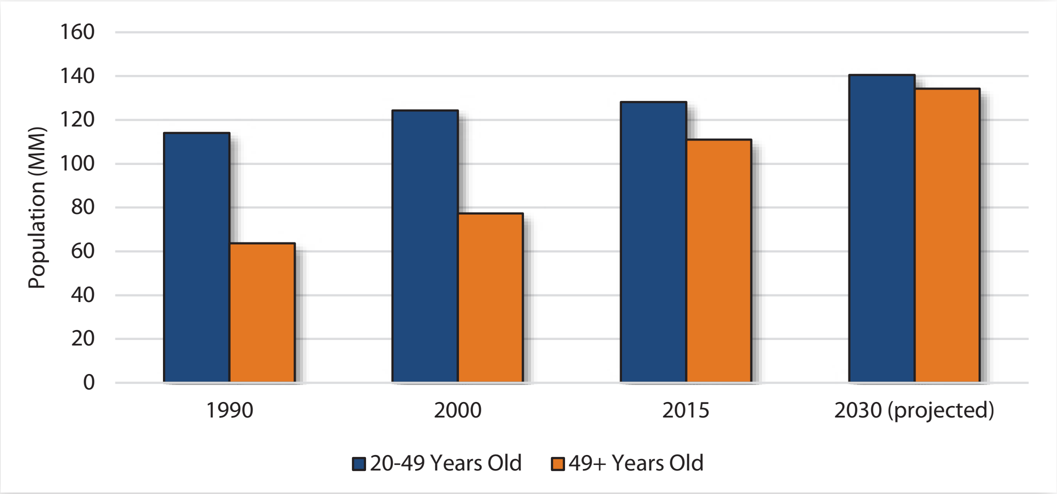
However, there is another growing demographic that is driving demand for multifamily properties at the other end of the age scale. Retiring Baby Boomers are increasingly moving into apartments, a trend that is helping fuel the rise of the urban apartment phenomenon as much or more than the Millennial story. A study by the Kansas City Federal Reserve using Census Bureau data found that there was a 1.3 million increase in households headed by individuals ages 50-69 (generally the Baby Boom generation) in multifamily properties between 2007 and 2013. When factoring in the entire population over age 50, an additional 1.6 million households occupied multifamily units during that time. Meanwhile, the 20- to 34-year-old population increased multifamily occupancy by only 458,000 between 2007 and 2013, and multifamily occupancy shrank by 140,000 for the 35- to 49-year-old population.

Growth Decomposition of Adults Aged 50-69 Years



Source: Census Bureau, Jordan Rappaport, Federal Reserve Bank of Kansas City

Projected Population 20 to 49+ Years Old



Source: Census Bureau, Jordan Rappaport, Federal Reserve Bank of Kansas City

The Kansas City fed study demonstrated a decided trend toward renting for individuals ages 50 and up, which are growing as a demographic group. Between 1990 and 2007, the share of the 50- to 69-year-old population that rented was less than the overall percentage of the population. In other words, people of that age were more likely to own homes than rent. However, between 2007 and 2013, that dynamic flipped, and the share of renters in that age cohort (20.9%) was greater than its share of the population as a whole (18.7%).

No doubt there are a host of factors involved, but boomers may have different goals for retirement than preceding generations. Boomers – especially those that are well-off – are living and staying active longer than those of the same age in past generations. One possibility is that rather than retiring to quiet rural locations when they sell suburban homes and downsize, a growing number of empty nesters are seeking urban locations where they can enjoy theater, restaurants, sports and more. Plus, rather than retiring to far-away locations, they are maintaining primary or secondary apartments within proximity to their children and grandchildren. That would help explain demand for high-priced luxury apartments that are proliferating in urban locations but seem to be priced out of reach of the Millennial generation.

The importance of this trend is exacerbated by the fact that the older generation is growing at a faster rate than the younger cohort. Over the next 15 years, the 50+ population is projected by the Census Bureau to grow by 20%, to 134 million in 2030 from 112 million today. Meanwhile, the 20- to 50-year-old cohort is projected to grow by 9%, to 140 million in 2030 from 128 million today. Put another way, the 50+ population will grow by 23 million, almost double the 24- to 49-year-old population growth of 12 million.

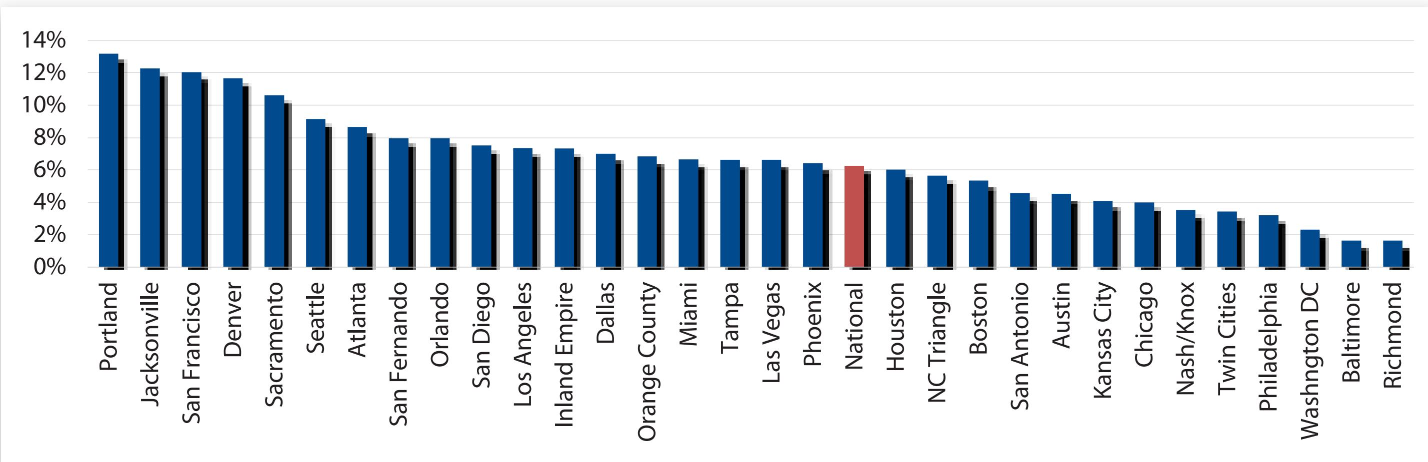
Photo by svetikd/iStockphoto.com

Rent Growth

Rents continue to accelerate at an impressive rate. During the second quarter of 2015, the average rent in the 100 markets surveyed by Yardi Matrix grew by 6.2%, to $1,138, up from $1,071 in the year-earlier period. Year-over-year increases hit double-digits in the top five markets: Portland (13.2%), Jacksonville (12.3%), San Francisco (12.0%), Denver (11.7%) and Sacramento (10.6%), while Seattle (9.1%) was just shy of that mark. On the other end of the spectrum, growth was less than 3% in only three of our top 30 markets: Richmond (1.6%), Baltimore (1.6%) and Washington DC (2.3%) and was between 3-4% in only three markets: Philadelphia (3.2%), Twin Cities (3.4%) and Nashville/Knoxville (3.5%).

The ongoing dynamic growth in the technology-driven cities in the western region raises the question of the sustainability of the increases. The prodigious amount of venture capital being thrown at technology start-ups stirs memories of the tech bubble popping in the early 2000s. The resulting failure of tech firms led to a sharp uptick in office vacancies and left many highly educated workers unemployed, which had implications for all property types, especially apartments and retail. If the same dynamic is at work today, the booming markets such as San Francisco, Portland and Denver could be in for a shock.

Rent Growth 2Q15 vs. 2Q14



Source: Yardi®Matrix

While we believe that the technology industry could be in line for a correction, it's not likely that the correction will be as steep as it was 15 years ago. For one thing, technology is much more integrated into the lives of consumers than it was before the last crash, which means that it encompasses a bigger share of the economy. Virtually everyone has smart phones and multiple computers and tablets; as people's lives are more entwined with devices, they are unlikely to do without and likely to keep upgrading. What's more, although tech firms are trading at expensive multiples, they are far from the giddy and unsustainable highs of the last bubble.

Demand for apartments is driven not only by the proliferation of high-paying jobs, but also the fact that those markets have made themselves into enticing environments through amenities, transportation, parks and more, As such, demand is not likely to collapse, even in the face of a hiccup in a major industry. Still, investors should keep an eye on the tech industry and assume that rent growth at some point in the not-too-distant future will return to levels more in line with wages and inflation.

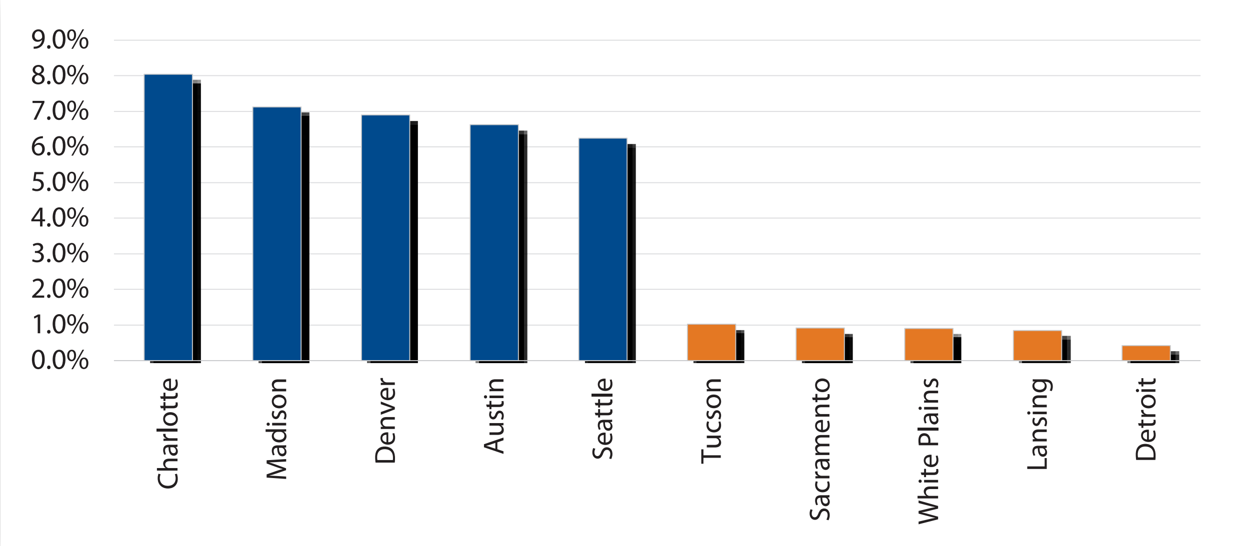
Supply Snapshot

Responding to strong demand for housing, high occupancy rates and record-high prices, U.S. multifamily supply is soaring in 2015. Yardi Matrix's database finds that 356,000 units that will be completed this year in the 100 markets it surveys, adding 3.3% to total stock. Markets with the most new supply as a percentage of stock in 2015 are: Charlotte (8.0%), Madison, Wisc. (7.1%), Denver (6.9%), Austin (6.7%) and Seattle (6.2%). The amount of new supply in 2015 is the highest since before the credit crisis, but it represents a return to the pre-recession average. The prior four years saw an average of less than 140,000 units added each year, so in many respects the supply is making up for the previous shortfall in development.

The sharp increase in supply raises legitimate concerns about overdevelopment, but it would take more than a year or two of robust supply increases to produce a significant increase in vacancy rates. For one thing, some of the construction stems from pent-up demand that was suppressed during the recession. Household formations, which were unusually low for several years, topped 2 million in 2014 and are expected to remain strong in coming years. Another reason, as discussed earlier in the report, is that Americans age 50 and up increasingly are moving into apartments, a trend that is likely to drive demand in the coming decade.

Photo by Mr_Twister/iStockphoto.com

Completions as a Percentage of Total Stock by Market (Top/Bottom 5)

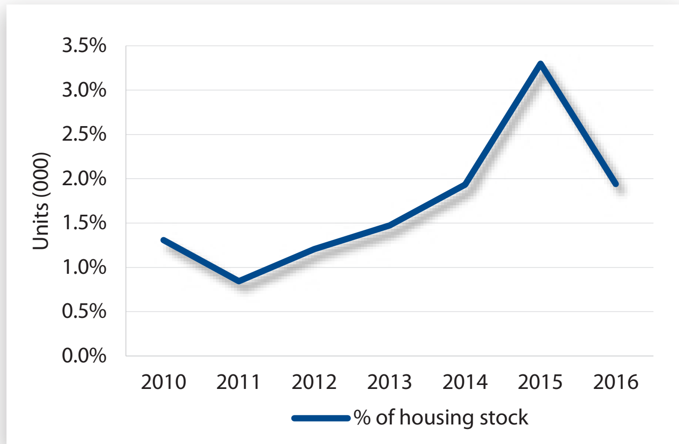


Source: Yardi®Matrix

Apartment supply also should be taken into context with single-family housing construction, which has not recovered from the recession in the same way as multifamily. Between 1994 and 2008, an average of 321,000 multifamily units were built each year, according to the Census Bureau, not much different from the current years' additions. On the other hand, the story for single-family housing is much different. An average of 1.3 million single-family homes was added to stock annually between 1994 and 2008, but the current average is roughly half that number. There is an overall need for housing as the population grows. Multifamily construction comprises a greater share of total housing starts, but that makes sense given declining homeownership rates and social trends that favor renting rather than owning.

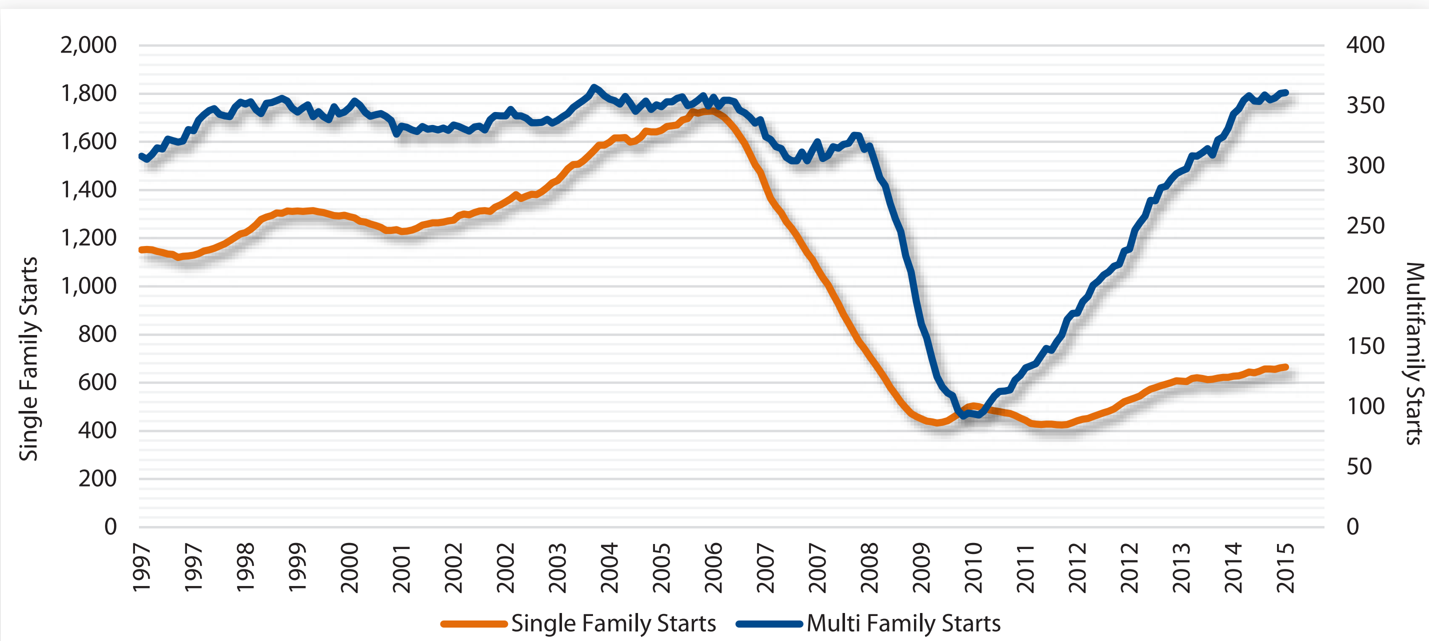
To be sure, some markets are in danger of being oversupplied. Currently, 516,000 units are under construction in markets surveyed by Yardi Matrix and a total of 1.1 million are in some form of planning, so supply is likely to remain strong for several years. Also, 212,000 units out of the 516,000 under construction are in lease-up. However, we believe on a national level absorption will remain in line with supply unless there is some combination of multiple years of oversupply and/or an economic event that reduces demand growth.

Supply as a Percentage of Total Stock



Source: Yardi®Matrix

Housing Starts (as of May 2015)

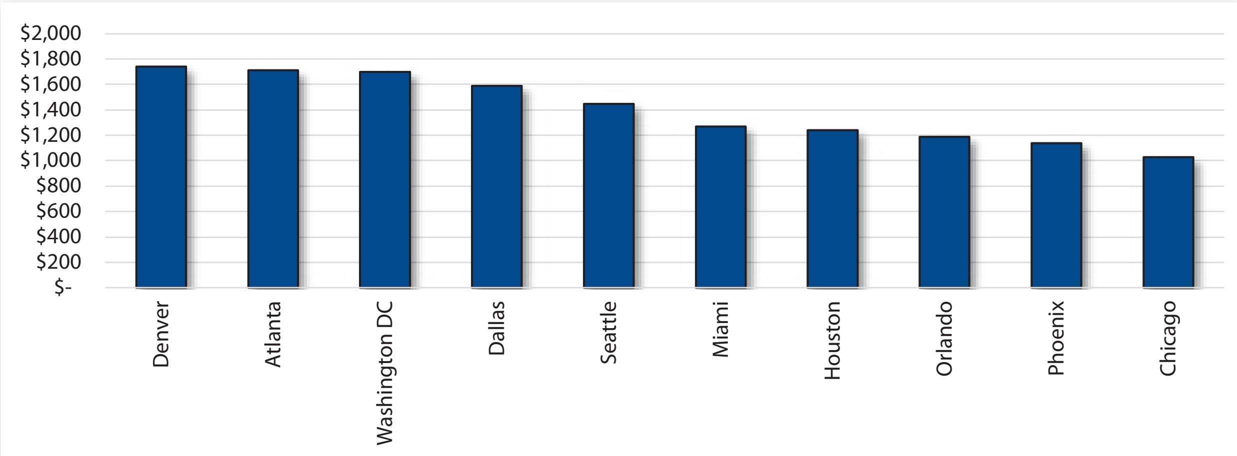


Source: US Census Bureau, Haver Analytics

Capital Markets

Transaction activity remains elevated, supported by availability of debt. During the first half of 2015, multifamily sales totaled $30.1 billion, which puts the market on pace to top the $58.3 billion of deals closed in 2014. The top 10 markets in terms of volume were all above $1 billion, led by Denver ($1.7 billion, Atlanta ($1.7 billion), Washington DC ($1.7 billion), Dallas ($1.6 billion) and Seattle ($1.4 billion).

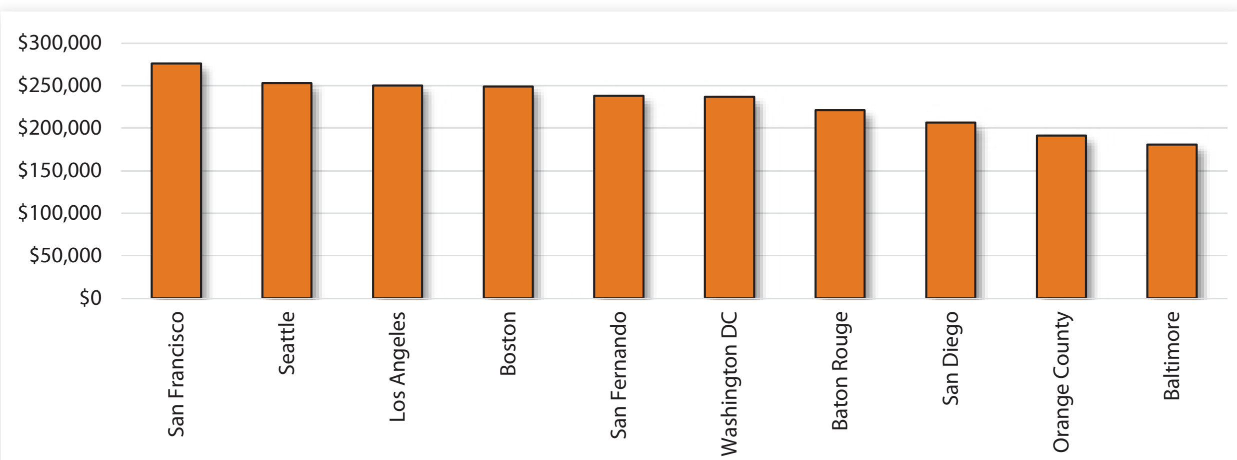
Top Ten Markets for Transaction Volume



Source: Yardi®Matrix

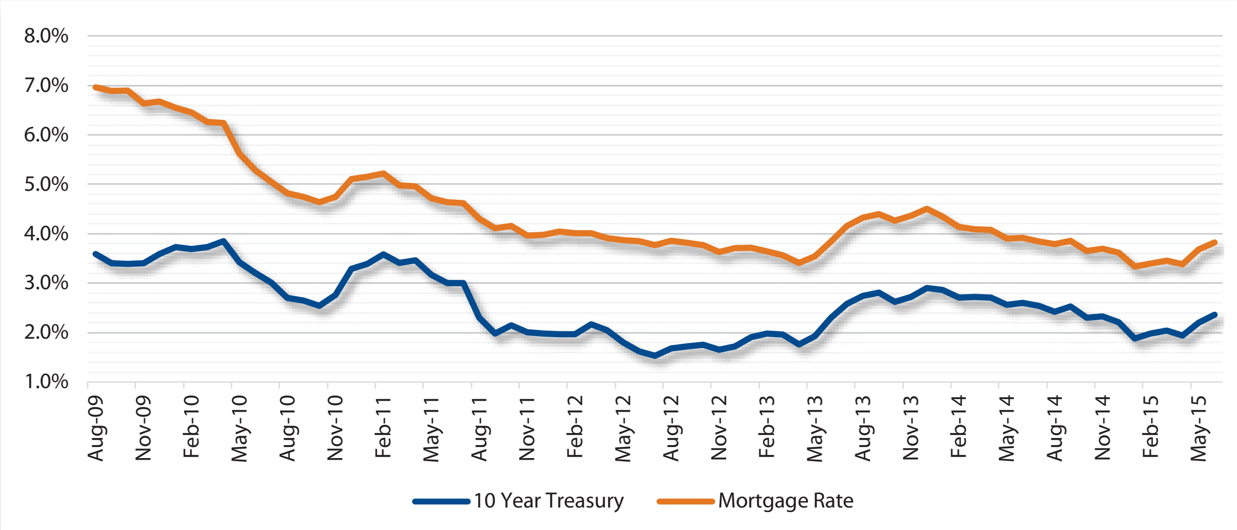
Continued hearty investor demand is pushing prices higher as well. Nationally, the average price per unit rose to $112,000 during the first half, a 10.2% increase from the $101,000 average in 2014 and a 75% increase over the trough pricing in 2009. On a metro level, San Francisco had the highest price-per-unit at $276,000, followed by Seattle ($252,000), Boston ($250,000), Los Angeles ($249,000) and Washington ($237,000). Acquisition yields remain at all-time lows, between 3.75% and 5% for class A properties in top markets, 5% to 6% for most class B properties and 6.5% to 8% for class C assets and tertiary markets.

Top Ten Markets for Price per Unit



Source: Yardi®Matrix

US Treasury Rates and Life Company Multifamily Mortgage Rates



Source: Trepp, Commercial Mortgage Alert

Photo of Denver by gcosoveanu/iStockphoto.com

Debt availability continues to be strong, as lenders are looking to lock in multifamily properties. Life companies are offering spreads of less than 150 basis points over the 10-year Treasury rate for high-quality apartment properties. As a result, class A properties can get financed at with interest rates of 3.75% to 4.25%. Interest rates are 25-50 basis points more for class B properties and secondary markets and higher yet for transitional assets and tertiary markets.

After burning through their combined $60 billion allotment by mid-year, Fannie Mae and Freddie Mac were granted another $15 billion apiece to lend in 2015. Having limited allocations prompted the agencies to increase rates for borrowers to 4.0% to 4.5%, in line with CMBS levels but a little higher than insurers. However, the government-sponsored lenders are focusing their limited lending dollars on financing properties that have an affordable housing component, which is in line with their mission to support affordable housing. As a result, the agencies are likely to be less active in the higher-quality apartment segment for the rest of the year. That may result in slightly higher loan costs for borrowers over the rest of the year, even though CMBS programs and banks are actively competing for business.

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Definitions

Lifestyle households (renters by choice) have wealth sufficient to own, but have chosen to rent.

Discretionary households, most typically a retired couple, or single professional, have chosen the flexibility associated with renting over the obligations of ownership.

Renter By Necessity households span a range. In descending order, household types can be:

- *A young professional double-income-no kids, household* with substantial income, but without wealth needed to acquire a home or condominium;
- *Students*, who also may span a range of income capability, extending from affluent, to barely getting by;
- *Lower middle-income* ("gray collar") households composed of: Office workers; policemen; firemen; technical workers, teachers…
- *Blue collar households*, who may barely meet rent demands each month, and who likely pay a disproportionate share of their income toward rent.
- *Subsidized households*, who pay a percentage of household income in rent, with the balance of rent paid through a governmental agency subsidy. Subsidized households, while typically low-income, may extend as well to middle-income households in some high-cost markets, such as New York City.
- *Military households*, subject to frequency of relocation.

These differences can weigh heavily in determining a property's ability to attract specific renter market segments. The five-star resort serves a very different market than the down-and-outer motel. Apartments are distinguished similarly, but distinctions are often not clearly definitive without investigation. The Context® rating eliminates that requirement, designating property market positions as:

Market Position	Improvements Ratings
Discretionary	A+ / A
High Mid-Range	A- / B+
Low Mid-Range	B / B-
Workforce	C+ / C / C- / D

The value in application of Context® is that standardized data provides consistency; information is more meaningful because there is less uncertainty. The user can move faster, more efficiently, with more accurate end results.

The Pierce-Eislen Context® rating is not intended as a final word concerning a property's status—either improvements or location. Rather, the result provides reasonable consistency for comparing one property with another through reference to a consistently applied standard.

To learn more about Yardi®Matrix and subscribing, please visit www.yardimatrix.com or call Ron Brock, Jr at 480-663-1149 x2404.