ApartmentResearch
MARKET REPORT

Marcus & Millichap

Philadelphia Metro Area ***First Quarter 2015***

Multifamily Market Stays Warm in Frigid First Quarter

Tenants filed into additional apartments in the Philadelphia metro in the first quarter, nudging down vacancy and enabling operators to raise rents. Beyond this year's opening period, the prospects for further strengthening in property operations in 2015 appear strong. Indexes of regional economic activity reveal optimism over near-term business conditions and plans to add more workers in the months ahead. Other commercial property sectors are also giving a lift to rental housing demand. More than 1 million square feet of net absorption was recorded in the office sector last year, and a nearly identical amount of retail space was occupied as new stores opened. Against this background of growing demand drivers, Philadelphia is in the midst of a construction cycle that may be seen as a response to growing rental housing demand and shifting housing preferences away from ownership. From another perspective, the recent and expected additions to rental stock may be merely catch-up to upgrade stock after limited building during and immediately following the recession.

Deal flow and dollar volume grew substantially last year, although weather-related disruptions likely restrained activity during the first three months of this year. About two-thirds of deals in the market last year comprised properties priced from $1 million to $10 million, and this segment of the market promises to be the center of activity again in 2015. Although the market's strong performance and the growing economy are encouraging many owners to hold, listings may nonetheless increase as owners seek to transact while investors' appetites are largely unsatisfied. Accordingly, many small investors who have been unable to purchase will find more opportunities to tap widely available debt financing and make deals in the months ahead. At the upper end of the market, additional sales of properties selling for more than $20 million in 2014 and early this year signal the presence of institutions and other large investors. This contingent will likely remain active over the remainder of 2015 due to the steady performance profile of local properties and higher prices in other regional metros.

2015 Annual Apartment Forecast

1.1% increase in total employment

Employment: Local employers will create 31,000 positions in 2015, falling shy of last year's exceptionally robust gain of 45,400 positions. Improving employment opportunities will help retain many graduates of the area's colleges and universities.

4,800 units will be completed

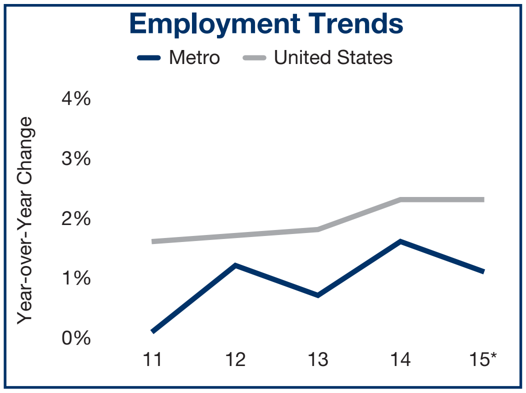
Construction: Projects consisting of 4,800 units will come online this year, marking an increase from 2,316 rentals in 2014. This year, nearly 1,700 units will come online in the Downtown Philadelphia and Southwest Philadelphia submarkets.

20 basis point decrease in vacancy

Vacancy: Strengthening job growth will create new demand and trim the vacancy rate 20 basis points in 2015 to 4.5 percent, the lowest year-end level in eight years. Nearly 5,000 rentals were absorbed last year, causing the vacancy rate to tumble 80 basis points.

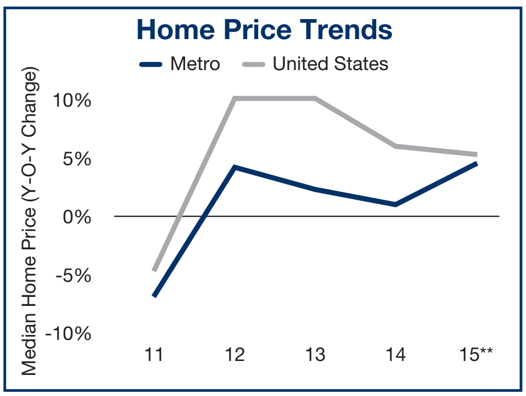
3.0% increase in effective rents

Rents: The average rent will advance 3 percent during 2015 to $1,190 per month, matching the rate of growth recorded in 2014. Since the average rent bottomed in 2009, an increase of 16 percent has occurred.



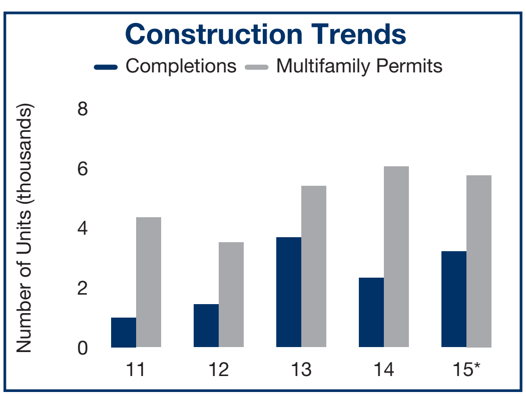
Economy

- Employers in the metro were on track to add 5,000 jobs in the first quarter as prospects continued to improve for many businesses, especially in the service sector. As a result of the hiring during the period, 45,700 jobs were created over the past year, a 1.7 percent rate of growth.
- Local healthcare providers and testing facilities are growing and added nearly 12,000 workers since the first quarter last year. Other degreed fields, such as financial services, and professional and business services, are also expanding, creating a combined 8,000 positions during the past 12 months. Manufacturing employment, though, declined over the past year and additional jobs were trimmed in the first three months of 2015.
- An upswing in multifamily construction supported the addition of 1,500 construction jobs over the past year. Some layoffs occurred in the first quarter, however, as harsh weather delayed some projects.
- **Outlook:** Employers in the metro will add 31,000 jobs in 2015 as healthcare and other private service-providing businesses expand.



Housing and Demographics

- Builders completed 8,600 units of single-family and multifamily housing since the first quarter last year, a 4 percent increase from the prior 12 months. Multifamily completions accounted for 35 percent of the total, more than two times the long-term average.
- An improving local economy and the addition of hundreds of units of new rental housing are supporting a respectable pace of household creation. Roughly 10,400 households were formed over the past 12 months, compared with 7,600 new households in the preceding year.
- The homeownership rate in the metro decreased from more than 69 percent to approximately 67 percent since the start of 2014. The median price of an existing single-family residence of $229,000 in the first quarter is affordable to households with incomes of $55,600 annually.
- **Outlook:** Single-family homes are affordable to a considerable number of households in the metro. However, many other households are selecting multifamily rentals as a lifestyle choice, forming a strong base of consistent demand for apartment operators.



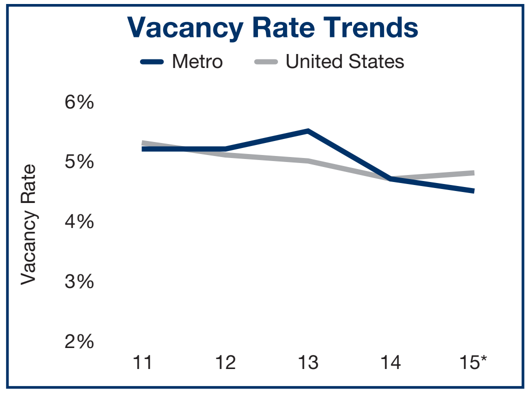
Construction

- Multifamily developers remain active. In the past 12 months, projects containing 3,100 rentals were delivered in the market; nearly 3,600 units were completed during the year ending in the first quarter 2014.
- Roughly 1,000 rentals were delivered in the first three months of this year. The total includes 353 units in several market-rate projects in the Downtown Philadelphia submarket and more than 150 apartments in special purpose and age-restricted rentals throughout the metro.
- More than 3,500 apartments are under construction and slated for completion yet this year, while an additional 2,400 rentals are on track to come online next year. Permit issuance, though, will fall to about 5,500 units.
- **Outlook:** In 2015, developers will place in service 4,800 units. The total includes nearly 4,000 market-rate apartments.

*Forecast
** Trailing 12-month period through 1Q

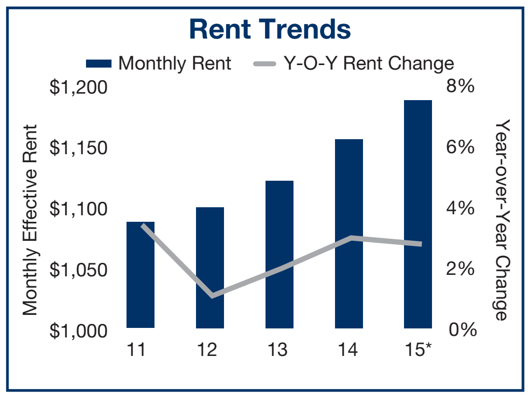
Vacancy

- Tenants moved into approximately 2,000 units in the first quarter this year to reduce the vacancy rate 30 basis points to 4.4 percent. Over the past 12 months, steady rental housing demand sliced the vacancy rate 50 basis points.
- Generally, newer properties have maintained relatively tight vacancy. Across the metro, vacancy in buildings constructed since 2000 was 6.0 percent in the first quarter, marking a rise of 40 basis points that reflects an increase in supply, not a drop in demand. In Center City, vacancy in recent vintage properties was approximately 7 percent at the end of March.
- Properties built in the 1970s, the mainstay of the local market, are also performing respectably. The vacancy rate in this segment fell 70 basis points from the first quarter last year to 4.0 percent. Additional growth in service-sector payrolls will generate new demand for older rental housing throughout the metro this year.
- **Outlook:** A spate of deliveries in the third quarter will temporarily push up vacancy before it dips to 4.5 percent at year end, a decline of 20 basis points from the prior year.



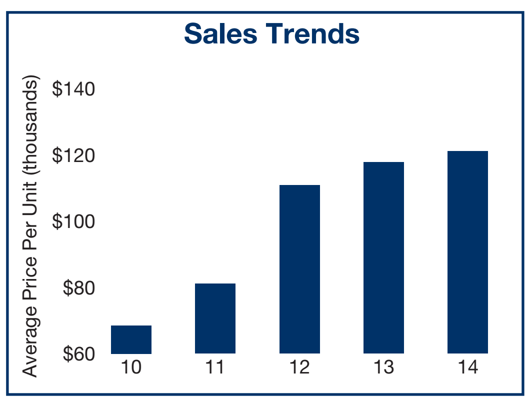
Rents

- The average rent in the metro rose 0.9 percent in the first three months of this year, to $1,164 per month. A 3.0 percent gain occurred since the first quarter last year, representing an acceleration from the 1.4 percent increase in the preceding year.
- Concessions are not used extensively in the market. Fewer than 4 percent of rental units employ leasing incentives, including less than 3 percent of apartments built since 2000 in the Downtown Philadelphia submarket. The average concession there is roughly one month of free rent.
- Vacancy in South Jersey submarkets tightened to the low-4 percent range in the first quarter as demand growth outpaced a small increase in rental stock. The average rent rose 2.6 percent last year to $1,056 per month and advanced 1.0 percent in the first three months of this year. Nearly 700 units are slated for delivery in 2015 and may require use of incentives during lease-up.
- **Outlook:** The average rent in the entire metro will advance 3 percent in 2015 to $1,190 per month to mark the sixth consecutive annual increase.



Sales Trends

- A large jump in the number of sales of more than $20 million underpinned a 40 percent increase in transaction velocity last year. Sales of properties in the $1 million to $10 million tranche, meanwhile, climbed about 35 percent.
- The additional deals at the upper end of the market drove a 50 percent rise in dollar volume during 2014. Overall, properties sold during the year carried an average price of $121,100 per unit, a nominal increase from the average price in the prior year, but 10 percent above the pre-downturn peak.
- Cap rates start in the low-5 percent range for Class A properties or buildings in highly urbanized areas of the metro, and extend higher than 7.5 percent for Class C assets in secondary submarkets.
- **Outlook:** The metro's stalwart reputation as a place where investors can realize stable income growth and the potential for modest appreciation will support a heightened level of transactions throughout 2015.



*Forecast
Sources: CoStar Group, Inc.; Real Capital Analytics

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The Federal Reserve recently indicated that it may raise its short-term lending benchmark anytime after its April meeting. The timing of the first increase in the Fed funds rate rests upon the central bank's confidence that inflation will move back to its target 2 percent rate over the medium term. For this to occur, the labor market must tighten further and wage growth must accelerate. Against the prospect of an inevitable rise in interest rates, investors remain highly motivated to purchase multifamily assets and debt providers continue to compete for market share while also maintaining discipline.
- Nationwide apartment vacancy dropped 30 basis points year over year to 5 percent in the first quarter. Completions are on track to reach 250,000 units in 2015, the high¬est yearly total in two decades. For the entire year, U.S. vacancy will rise 10 basis points to 4.8 percent, while the average rent will advance 3.4 percent.
- Fannie Mae and Freddie Mac continue to underwrite five-, seven- and 10-year acquisition loans and offer maximum leverage of 80 percent in most major markets. Interest rates vary for full leverage loans from about 3.85 percent at the low end of a short maturity loan to a range of 4.0 percent to 4.2 percent for 10-year debt of more than $3 million. Debt service coverage ratios remain virtually unchanged from late last year, at 1.2X.
- Investor demand for mortgage-backed bonds will sustain a high level of conduit lending in 2015, while large banks will also expand their exposure to the sector. CMBS debt is issued from 4.0 percent to 4.25 percent, with leverage in a tight range from 75 percent to 80 percent. The application of interest-only financing for a portion of the term is generating interest from borrowers. Large banks, meanwhile, can offer slightly lower rates on 10-year debt and offer financing for shorter maturities. Life companies are also active, but selective, in the multifamily segment.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rent	Y-O-Y % Change
1	Chester County	3.7%	-40	$1,340	2.7%
2	Bucks County	3.8%	-40	$1,082	3.5%
3	Gloucester County	3.9%	60	$931	0.2%
4	Southwest Philadelphia	4.0%	-30	$1,285	3.7%
5	Norristown/Upper Merion/Lower Merion	4.1%	0	$1,282	3.0%
6	Burlington County	4.3%	-10	$1,089	2.2%
7	Delaware County	4.5%	-80	$1,070	4.9%
8	Outer Wilmington	4.5%	-100	$986	2.9%
9	North Montgomery County	4.6%	-20	$1,222	5.0%
10	Newark	4.7%	10	$1,061	4.0%
11	Northwest Philadelphia	4.7%	70	$1,290	4.8%
12	Downtown Philadelphia	4.8%	-140	$2,041	2.7%
13	Lower Camden County	5.1%	-130	$972	0.7%
14	Camden/Cherry Hill	5.2%	-40	$1,196	0.3%
15	Northeast Philadelphia	5.5%	40	$935	3.4%
16	Central Wilmington	6.0%	-80	$1,080	1.3%

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