ApartmentResearch

MARKET REPORT

Marcus & Millichap

Philadelphia Metro Area ***Third Quarter 2015***

Philadelphia Operations Improve as Investors Ante Up

The outlook of the Philadelphia apartment market remains bright as rising employment fosters stable economic growth, which in turn is strengthening apartment operations. Total employment is on the cusp of recovering all the jobs lost during the recession. These favorable conditions are boosting demand for apartments and rapidly improving performance throughout the metro, motivating developers to begin new multifamily projects. Builders are focusing their attention in Center City where nearly 25 percent of this year's deliveries will be placed into service. Demand is especially strong here due in part to the increasing popularity of living in the urban core among young professionals and baby boomers. The lack of developable in-fill locations in the area is prompting builders to convert office spaces into apartments. For example, the Avenue of the Arts office building is being transformed to a 217-unit apartment complex. Despite rising inventory marketwide, absorption continues to surpass supply. In the second quarter, vacancy in every submarket fell within a narrow range of 3 and 7 percent, and average rents are posting modest gains.

Demand for apartment assets in the Philadelphia metro is far outpacing the supply of for-sale inventory, as strong property operations are encouraging owners to hold onto their assets. Limited availability of listings is creating competition among buyers; thus, adequately priced properties receive multiple offers over a short time period. The robust demand is pushing property values higher. At the top of the market, some institutional-grade apartment buildings in Center City are beginning to sell at record-high prices and cap rates in the low-5 percent range. Opportunistic sellers are taking advantage of these conditions, resulting in accelerated transaction velocity. Cap rates remain compressed in the metro, though they are often higher than other metros in the Northeast, attracting yield-driven buyers. Overall, first-year returns average in the mid-5 to high-6 percent range.

2015 Annual Apartment Forecast

1.2% increase in total employment

Employment: Employers in the Philadelphia metro will boost hiring 1.2 percent this year, adding 35,000 jobs. In 2014, staffing increased 1.6 percent and the unemployment rate contracted 130 basis points.

3,600 units will be completed

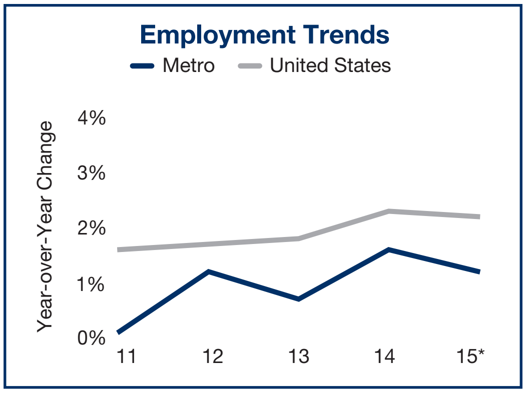
Construction: Developers are on track to complete 3,600 units in 2015, increasing total apartment inventory 1.4 percent. Last year, 2,400 rentals were delivered.

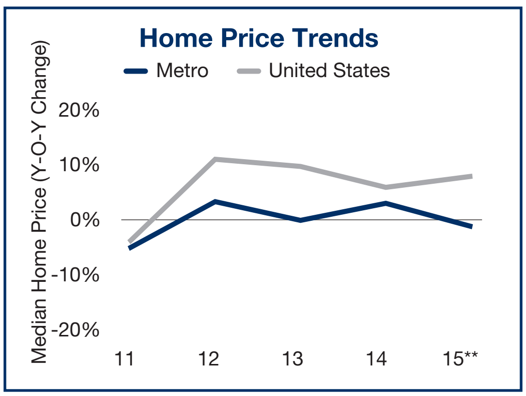
10 basis point decrease in vacancy

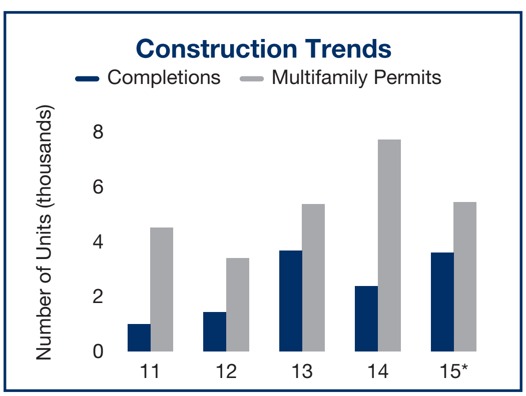
Vacancy: The expanded construction pipeline will slow the vacancy decline this year as the rate recedes 10 basis points to 4.5 percent, on net absorption of 5,300 units. In 2014, average vacancy fell 90 basis points.

3.6% increase in effective rents

Rents: Strong rental demand will foster a 3.6 percent gain in average effective rents to $1,195 per month, up nearly 11 percent from the pre-recession high. Last year, rents rose 3.2 percent.







** Forecast*

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

Economy

- Year over year in the second quarter, employers in the Philadelphia metro increased headcounts 0.8 percent, or 23,300 jobs. Weak hiring in the first quarter held employment gains down from the same period last year, when 35,800 positions were added.
- The strongest gains were in the education and health services, and the trade, transportation and utilities sectors, which added 12,100 and 7,500 workers, respectively. The construction sector was the fastest-growing segment, boosting employment by 6.5 percent.
- The unemployment rate fell 40 basis points over the past year to 5.7 percent; in the previous 12-month period, unemployment plunged 140 basis points. The rate has declined 330 basis points since peaking in the first half of 2010.
- **Outlook:** Employers in the Philadelphia metro will accelerate hiring 1.2 percent this year, or 35,000 jobs. In 2014, staffing increased 1.6 percent.

Housing and Demographics

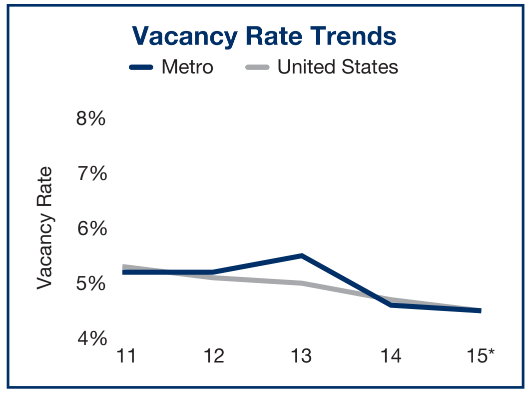
- The total number of households in the metro advanced 0.6 percent in the 12-month period ending in the second quarter as 13,400 new households were formed. Over the same span last year 6,600 households were created.
- Single-family home completions were down 0.6 percent during the past year with only about 6,000 single-family residences brought online, far less than the pre-recession average. However, the homebuilding market is picking up. Developers poured slabs on 7,800 new homes and permits for an additional 7,800 were issued over the same period.
- The median price of a single-family home in the Philadelphia metro dipped slightly year over year in the first quarter to just shy of $200 per square foot. The mortgage payment for a median-priced home is nearly $600 less than the effective rent for an apartment built since 2000, though the model assumes a 20 percent down payment, which is out of reach for many renters.
- **Outlook:** A rise in interest rates will place mortgage payments out of reach of more renters, augmenting demand for apartments.

Construction

- The past year ending in June, developers placed into service 2,500 apartments, nudging up apartment stock 0.7 percent. Over the previous annual time period 3,900 units were completed.
- Construction was heaviest in the Center City Philadelphia submarket where more than 700 units were delivered. Nearly 400 rentals were brought online in the Northeast Philadelphia submarket. In the Center City Philadelphia submarket and University City area, there are roughly 2,100 and 1,250 underway, respectively.
- The largest apartment project underway is Parc Plymouth Meeting in Plymouth Meeting. The complex will be composed of 398 luxury rentals. Amenities include an outdoor pool and cabanas, business center, fitness center and pet salon. Construction of the project is expected to wrap up in the fourth quarter of this year.
- **Outlook:** Developers are on track to complete 3,600 units in 2015, increasing total apartment inventory 1.4 percent. Last year 2,400 rentals were delivered.

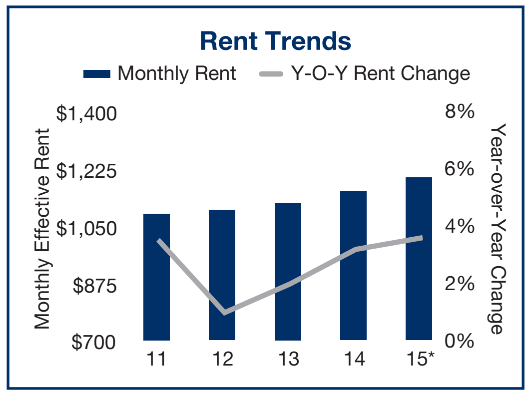
Vacancy

- Average vacancy in the second quarter was down 10 basis points to 4.4 percent year over year on net absorption of 2,700 units. During the corresponding span last year, the rate fell 60 basis points.
- Vacancy is tightest in Delaware County at 3.1 percent, after falling 90 basis points in the past four quarters. The largest vacancy improvement was recorded in the Lower Camden County submarket.
- In northern Delaware, average vacancy inched up 10 basis points to 5.0 percent over the past year. Meanwhile, in southern New Jersey vacancy dipped 60 basis points to 4.7 percent. Vacancy fell 80 basis points in northern Delaware and 90 basis points in southern New Jersey in the previous year.
- **Outlook:** The expanded construction pipeline will slow the vacancy decline this year as the rate recedes 10 basis points to 4.5 percent on net absorption of 5,300 units. In 2014, average vacancy fell 90 basis points.



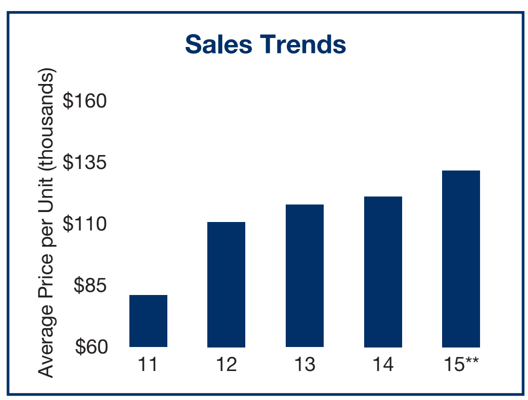
Rents

- The average effective rent in the Philadelphia metro rose 3.1 percent to $1,183 per month in the year ending in June, continuing the trend of steady rent growth that began in 2009. In the previous annual time period ending in June, rents increased 2.2 percent.
- Average effective rents are growing the fastest in the Northwest Philadelphia submarket. This submarket recorded a 5.3 percent year-over-year gain, rising to $1,287 per month. Average effective rents in the Center City Philadelphia, Central Wilmington and Gloucester County submarkets each grew more than 4.0 percent.
- Tight vacancy has limited the need for the use of concessions to attract tenants in the metro. Approximately 4.5 percent of professionally managed complexes were offering concessions in the second quarter, down from 6.6 percent a year earlier. The average incentive equates to roughly three weeks worth of free rent.
- **Outlook:** Strong rental demand will foster a 3.6 percent gain in average effective rents to $1,195 per month, nearly 11 percent above the pre-recession high. In 2014, rents rose 3.2 percent.



Sales Trends

- Attractive yields continue to lure investors to the Philadelphia metro. During the 12-month period ending midyear, transaction velocity jumped 12 percent. Sales of smaller buildings with fewer than 20 units comprised the largest segment of listings; however, transactions of properties with more than 100 units surged 40 percent over the past year.
- Prices for assets with more than 100 units averaged roughly $130,000 per unit, though those in Center City and Chester County could easily trade above the $200,000 per door threshold.
- Smaller properties in Center City can generate cap rates in the low-5 percent bracket. Larger, stabilized Class B properties with more than 100 units in suburban areas average in the low- to mid-6 percent range.
- **Outlook:** The pending rise in interest rates will motivate more opportunistic sellers to list properties, primarily those who are looking to trade up.



** Forecast*
*** Trailing 12 months through 2Q*
Sources: CoStar Group, Inc.; Real Capital Analytics

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Capital Markets

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

- Despite volatility surrounding economic growth in China and Greece's status in the eurozone, the yield on the 10-year U.S. Treasury is trading near 2.25 percent. Economic data is showing improvement following weak first quarter GDP, with market participants now positioning for the December meeting as the most likely starting point for an interest rate hike. The latest comments from Federal Reserve Chairwoman Janet Yellen, however, indicate that the exact moment is still data-dependent.
- The Federal Open Market Committee has committed to a policy of "lower for longer" as it assuages fears that the first interest rate increase will disrupt the recovery. The first policy rate change is expected to be just 25 basis points, and measures will remain accommodative for some time.
- Agency lenders are underwriting 10-year multifamily loans ranging between 4.3 and 4.7 percent with average LTVs from 55 to 75 percent. Portfolio lenders are offering similar loan-to-value ratios with interest rates between 3.85 and 4.50 percent as underwriters have become more competitive in an effort to do business. Floating bridge loans for stabilized assets will require LTVs of 70 percent and price with a spread between 250 and 425 basis points over LIBOR, while value-add transactions will be underwritten at 80 percent LTV (60 to 65 percent of cost) with a 300- to 475-basis-point spread.
- Total CMBS issuance is expected to top 2014 levels this year as $100 billion to $125 billion is underwritten. A wave of pre-crisis loans will start to come due over the next few years, prompting refinancing as current owners renegotiate the capital structure of their assets. Through April, $35.8 billion in CMBS had been originated, underscoring the availability of credit as credit unions, insurance companies and alternative asset managers expanded their offerings.

Local Highlights

- Late last year, Subaru announced that it will be relocating its North American headquarters from Cherry Hill to Camden. The automaker will be building a 250,000-square-foot building where it will house 500 employees; it is set to be completed by the beginning of 2017.
- FMC Tower at Cira Center South is underway in University City. The 690-foot-tall mixed-use tower will incorporate 622,000 square feet of office, 268 apartments and 10,000 square feet of ground-floor retail. Construction of the project is expected to wrap up in mid-2016.
- Lockheed Martin's former facility in Newtown was recently purchased by pharmaceutical company KVK. Lockheed will continue vacating the campus through the end of the year and KVK will begin occupancy in January. The pharmaceutical company has yet to announce the total number of jobs it will bring to the area.

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