Marcus & Millichap

Multifamily Research
Market Report

Philadelphia Metro Area

First Quarter 2016

Philadelphia Apartment Sector in Full Swing, Displaying Familiar Vigor

Jobs, new households driving rental demand; economic outlook positive. Riding positive economic trends and an elevated tempo of household creation, the apartment sector in the Philadelphia metro has settled into a pattern of producing solid results for property owners. Marketwide rents are increasing modestly and consistently, while vacancy will likely fluctuate within a tight range this year. Exceptional demand-side dynamics persist in the market as several years of job growth have created a large pipeline of current and potential renters. A recent survey of service-sector businesses, which employ more than 80 percent of the workers in the metro, indicates an upbeat outlook for near-term growth in this vital segment of the local economy. Against the backdrop of rising rental housing demand, developers are preparing to introduce a substantial number of new apartments in the market this year. Recently delivered complexes have leased up well, barely disturbing marketwide trends, although the focus on higher-end rentals may be overlooking unfulfilled demand from specific demographic groups or income levels.

Small private capital driving investment market, sustaining deal flow in 2016. Flows of debt and equity continue to create a vibrant investment climate and are supporting a modest pace of transactions thus far in 2016. Last year, much of the buying occurred in the $1 million to $10 million price tranche as small private capital tapped competitive debt providers to make deals. Well-located, stabilized assets in this segment retain wide appeal, though investors also seek slightly underperforming properties that can be upgraded as a means to unlock new value. Many larger players are also active in the market; more than one in five complexes sold last year priced at more than $20 million, a slightly higher proportion than in the prior year. First-year returns in this portion of the market are typically in the 5 percent region, forming the lower end of the range in the entire market. In general, keen demand has lifted prices to a new peak during the current economic cycle and the opportunity to capture higher prices and realize return objectives will encourage additional listings in 2016. Redevelopment-oriented groups, meanwhile, will continue to focus on creative reuse projects in the urban core.

2016 Multifamily Forecast

1.5% increase in total employment

Employment:

Employers in the Philadelphia metro will create 44,000 jobs in 2016. More than 48,000 positions were added last year behind strong growth in healthcare and construction.

5,400 units will be completed

Construction:

Fueled by the ongoing accumulation of rental stock in Center City, developers will complete 5,400 mostly market-rate rentals this year. Approximately 3,200 units were completed in 2015.

30 basis point increase in vacancy

Vacancy:

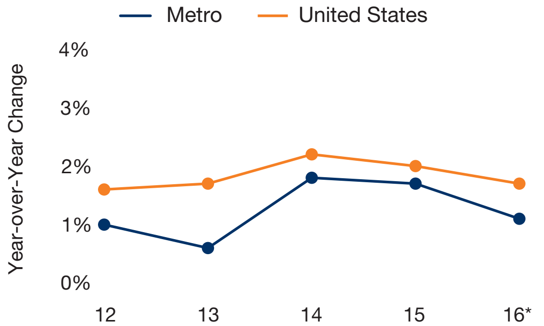
Completions will exceed an increase in occupied units in 2016, generating a 30-basis-point rise in vacancy to 4.6 percent and erasing last year's decline.

3.1% increase in effective rents

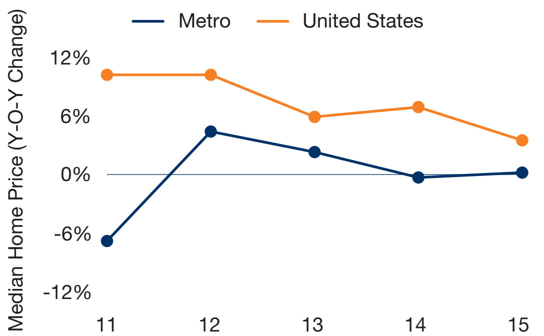
Rents:

Consistent rent growth remains a hallmark of the local market. This year, the average rent in the metro will increase 3.1 percent to $1,221 per month, outpacing last year's gain of 2.6 percent.

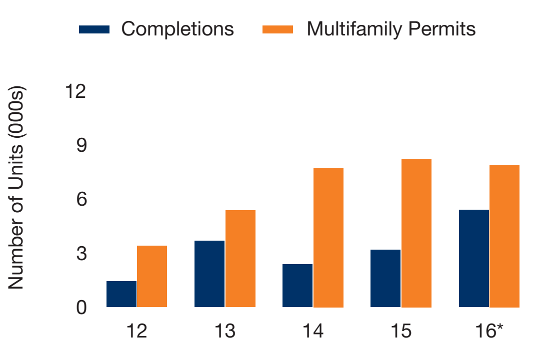
Employment Trends



Home Price Trends



Construction Trends



* Forecast

Economy

- Employers in the Philadelphia metro created 48,200 jobs in 2015, including 19,800 new posts in the final three months of the year alone. With the job additions last year, employment in the metro now exceeds its pre-recession peak by approximately 27,000 positions.
- Growing medical practices and diagnostic facilities generated a gain of 14,300 healthcare jobs last year, while trade employment also grew. Expanding payrolls at retail and wholesale establishments, and in warehouse and distribution businesses, underpinned a gain of 3,100 trade, transportation and utilities jobs during 2015. Construction firms also made 8,900 new hires.
- In 2015, payrolls in suburban Bucks, Chester and Montgomery counties expanded 1.5 percent, or by approximately 14,700 workers, during the year to exceed the gain posted in 2014. Service-sector businesses, including retail, food and beverage establishments, and hotels, led the increase in employment during 2015.

Outlook: Additional growth at service-sector establishments will support a gain of 44,000 jobs in the Philadelphia metro this year, marking a slight moderation from the pace of hiring in 2015.

Housing and Demographics

- The growing local economy has spurred a faster pace of household creation. Over the past 12 months, roughly 21,000 households were formed, outpacing the gain of 7,100 households in the prior year.
- Single-family homebuilders continue to step up production to meet rising demand. More than 6,400 single-family residences were completed in the metro during the past 12 months, marking a gain of 21 percent over the preceding year. Approximately 8,500 homes are slated for completion this year.
- Sales of existing single-family residences have been steady. The median price of homes sold over the past year was roughly $219,000, about the same as the median price one year ago.

Outlook: Household creation will increasingly pressure developers to keep pace with rising demand, sparking further gains in single-family building and in the multifamily sphere.

Construction

- The pace of construction in the multifamily segment remains elevated. Developers pulled permits to build 8,200 units of multifamily housing during 2015, a 7 percent increase from one year earlier.
- A surge in deliveries in the final quarter of 2015 lifted completions of multifamily rentals to nearly 3,200 units last year, outpacing the 2,400 apartments placed in service during the prior year. Among the more than 1,200 rentals completed in the fourth quarter, the 3737 Chestnut and 3601 Market high-rises brought a combined 639 market-rate units.
- Center City remains the hub of development, with nearly 2,100 units on tap in 2016 and a smaller quantity scheduled to come online next year. Within the suburbs, three projects with 843 apartments are rising in Chester County, while 370 rentals are progressing toward completion in South Jersey.

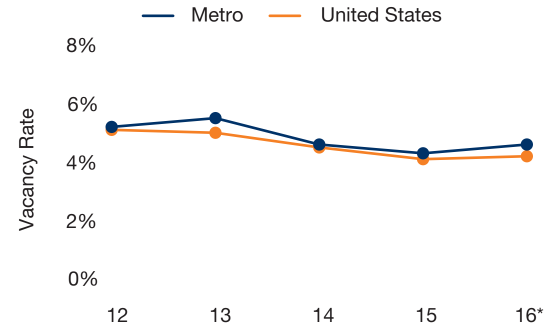
Outlook: Developers will deliver 5,400 rentals this year, the highest annual total this century.

Vacancy

- Tenants occupied an additional 4,100 apartments during 2015, trimming the vacancy rate in the metro 30 basis points to 4.3 percent. Approximately 2,500 rentals were under construction in the first quarter this year, which could place upward pressure on the vacancy rate during the period.
- The vacancy rate at complexes built since 2000 was unchanged last year, but ranges slightly higher than the figure for all properties, ending 2015 at 4.9 percent. More seasoned properties are also faring well. The oldest rental buildings in the metro, comprising properties built prior to 1980, registered vacancy of around 4 percent in 2015, down from the mid-4 percent band one year earlier.
- Vacancy in the Center City submarket plunged 90 basis points last year to 3.7 percent despite the addition of 716 units during the year. Rentals built since 2000 performed especially well, registering a vacancy rate of 4.1 percent at year end, down from 6.9 percent at the end of 2014.

Outlook: The vacancy rate in the metro will rise 30 basis points this year to a still-tight 4.6 percent behind net absorption of nearly 4,100 units.

Vacancy Rate Trends

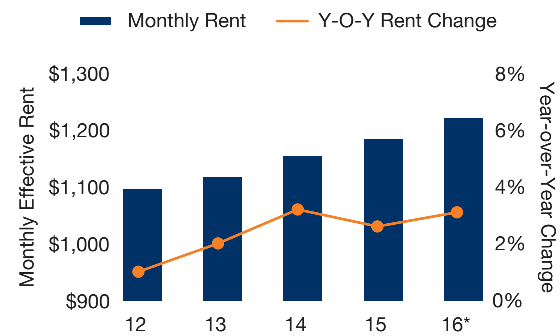


Rents

- Tightening vacancy enabled property owners to raise the average rent in the metro 2.6 percent last year to $1,184 per month. In the preceding year, an increase of 3.2 percent was recorded.
- Leasing incentives are employed sparingly, affecting less than 3 percent of existing units in the metro. In the infrequent instances where they are used, concessions average approximately one month of free rent.
- The introduction of hundreds of new, typically higher-priced rentals has enabled operators of older properties to reprice their offerings. Rentals built in the 1990s, for example, rented for an average $1,281 per month in 2015, representing a 3.4 percent bump from the preceding year.

Outlook: This year, the average rent in the metro will increase 3.1 percent to $1,221 per month. Concession use may rise periodically and temporarily as new units come online but will remain at a minimal level overall.

Rent Trends

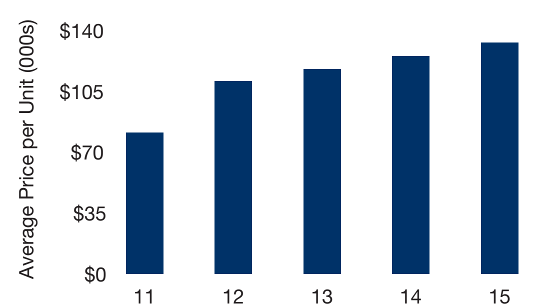


Sales Trends

- Keen interest in local properties persists. Transaction velocity jumped more than 20 percent last year, led by a surge in buying in the $1 million to $10 million tranche and additional sales of high-end complexes. Total dollar volume in the market also climbed substantially.
- The average price of properties sold in the metro in 2015 was $132,900 per unit, or 6 percent more than the average price posted in the preceding year. Strengthening asset performance, accessible debt markets and motivated equity sources have converged to drive up the average price more than 90 percent since the bottom of the market was touched in 2010.
- While the average cap rate in all deals shrunk to the high-6 percent range last year, the range is rather broad. In the $1 million to $10 million segment, for example, first-year returns in the 7 percent band are the norm, but properties sold at prices starting at $20 million can command cap rates 200 basis points lower.

Outlook: Property owners will continue to consider whether to shorten prospective holding periods to list and strike deals while exceptional liquidity persists and values continue to test new highs.

Sales Trends



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

Capital Markets

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

- Following the first interest rate increase since 2008, the Federal Reserve has promised a measured, patient approach to future rate hikes. Recently, the mixed picture of U.S. economic data has given several members of the bank's monetary policy committee reason to pause. Robust labor market indicators present positive evidence of continued expansion, while manufacturing and inflation expectations have weakened due to the stronger dollar. As a result, the central bank will likely weigh the balance of data over the coming months before enacting additional rate hikes.
- Multifamily housing trends have continued to accelerate over the past year, with the national vacancy rate falling 40 basis points to 4.1 percent. Meanwhile, development remains considerable, although generally limited to primary markets; deliveries in 2015 exceeded 230,000 units for the second straight year, the highest annual total since 2000. However, despite the incredible pace of construction, net absorption surpassed supply growth, supporting a 5.6 percent climb in average effective rental rates.
- Fannie Mae and Freddie Mac are underwriting five-, seven- and 10-year commercial property loans with maximum leverage of 80 percent. Interest rates for these loans will range from 3.7 percent to 4.2 percent, depending on loan structure and maturity, for loans above $3 million. Portfolio lenders, including commercial banks and life insurance companies, offer debt at 65 to 75 percent loan to value on 10-year terms at 3.60 to 4.25 percent. Floating-rate terms typically carry a maximum LTV of 65 percent for stabilized properties, while pricing at a 250- to 425-basis-point spread above Libor. CMBS issuance topped $100 billion last year, but wider spreads have curtailed activity thus far in 2016.

Local Highlights

- The daytime population in submarkets adjacent to Center City will increase this year and provide a potential new source of rental housing demand for new rentals in the vicinity. Developers are wrapping up construction of the 575,000-square-foot FMC Tower office building at 30th and Walnut streets; a midyear completion date is targeted.
- The Northeast Philadelphia submarket continues to undergo a significant updating of rental stock. More than 900 rentals have been placed in service since 2010, and market-rate projects containing an additional 500 apartments are slated for completion this year. Tenant demand remains strong, with the vacancy rate ending last year at 4.6 percent, close to the marketwide level.
- The Camden/Cherry Hill submarket in South Jersey was slow to find traction early in the current cycle but has gained momentum in the past two years. During the past 12 months, rising demand drove down the submarket vacancy rate 100 basis points to 4.0 percent. The vacancy rate in one-bedroom rentals, a common choice for new households, sits even lower at 3.5 percent.
- Employers in New Castle County created about 7,900 jobs in 2015, marking a 2.2 percent expansion in payrolls that exceeded the metrowide rate of growth. Despite the potential lift to housing demand, vacancy in the Central Wilmington submarket rose 40 basis points to 6.2 percent, but the average rent advanced 4.3 percent to $1,108 per month.

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