Marcus & Millichap

The Multifamily Outlook

Summer 2016

Sixth Year of Job Growth Sustains Household Formation, Restrains Apartment Vacancy Amid Supply Influx

Hiring in the first five months of 2016 drove total U.S. employment 5.5 million jobs above the pre-recession peak despite a disappointing number in May's first report. This number is expected to be revised higher due to the resolution of the Verizon strike, and therefore the pace of robust demand for rental housing will remain consistent with the past six years. New renters will continue to flow into the apartment market evident by the further decline of the unemployment rate to 6 percent among individuals age 20 to 34, as this segment has a high propensity to rent.

A wave of new apartments came online in many metros during the first quarter this year, placing upward pressure on vacancy rates in many markets and supporting a minor uptick in the U.S. vacancy rate. Even as risks of overdevelopment in a limited number of metros push some local vacancy rates higher, the broader effects of elevated construction volume on the nationwide vacancy rate will remain minimal.

The single-family housing market offers increasing appeal to renters as low mortgage rates and easing credit standards entice more prospective buyers. However, first-time buyer activity has remained suppressed, with the percentage of first-time homeowners in the low-30 percent range, down nearly 10 percent from prior to the recession. Over the past 10 years, the home ownership rate for households under 35 declined from 43 percent to 35 percent. As millennials continue to delay marriage, first-home purchases will remain below historical levels. This shift will support a robust renter pool over the coming years.

Rent growth will remain the primary force upholding property valuations in the near term as vacancy moderates near current levels. Investor interest remains unfulfilled amid bright performance prospects, helping to lift the average price and hold the national average cap rate to the low-5 percent range in the first quarter.

Demographic trends underpin the positive outlook for apartment operations. The vast population from age 20 to 34 has continued to exhibit a high propensity to rent and this age cohort remains a primary target segment for apartment owners and developers in the near term.

Multifamily 2016 Outlook

285,000 units will be completed

Construction:
The period of substantial building will extend into its third year during 2016 with the completion of 285,000 units, the highest annual level in the current cycle.

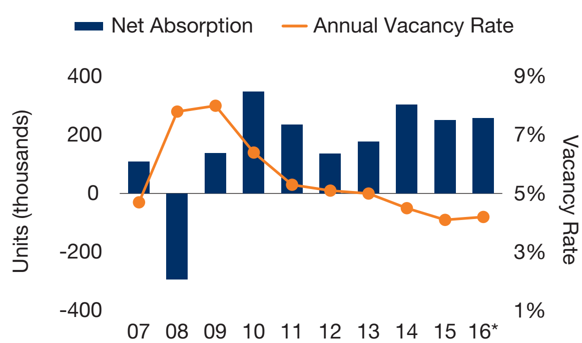
10 basis point increase in vacancy

Vacancy:
During 2016, the vacancy rate will rise nominally to 4.2 percent behind net absorption of nearly 260,000 units, exceeding the total posted last year.

4.5% increase in effective rents

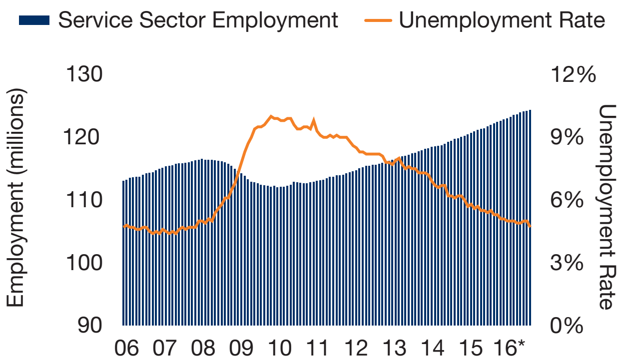
Rents:
In 2016, the average effective rent will increase 4.5 percent, marking a moderation from last year's robust 5.9 percent rate of growth.

Demand Trends Remain Positive

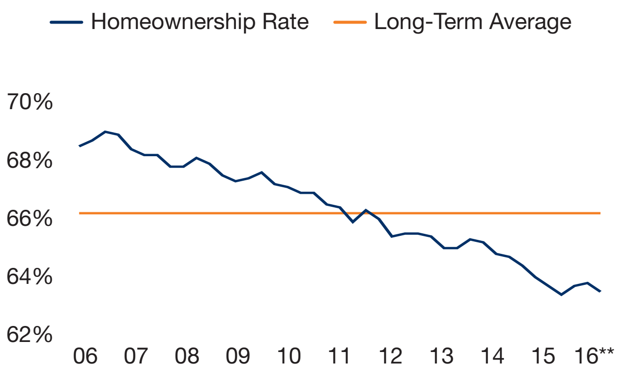


* Forecast

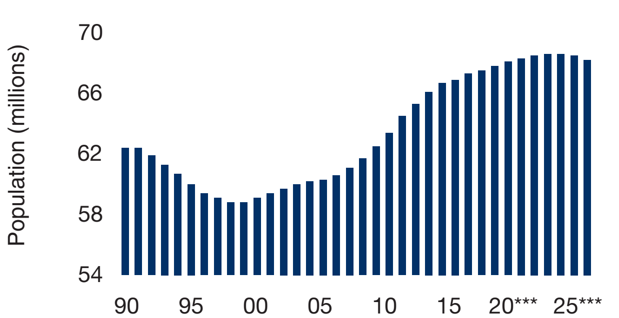
Employment Trends



Homeownership Rate Down Sharply



U.S. Population 20-34 Years Old



* Through May
** Through 1Q
*** Forecast

Economy

Service-sector industries continue to raise U.S. payrolls well above the pre-downturn peak. Job creation in industries including healthcare and retail is providing the types of positions that drive demand for Class B/C apartments, where vacancy remains tight. Fields that typically offer higher pay are also making significant contributions. Professional and business services employment, which includes higher-paying posts in fields that require degrees, added 129,000 jobs in the first five months of the year. New hires in this sector continue to provide a large pool of prospective renters for Class A rentals. Growth prospects are bright, with job openings recently rising to an all-time high and hiring rates climbing. Generally, consistent monthly job gains have compressed the total unemployment rate to 4.7 percent and are lifting wages. The unemployment rate continues to tighten in the prime renter cohort group, which comprises individuals age 20 to 34. After peaking at more than 12 percent six years ago, the unemployment rate for the group has plunged to roughly half that level in April, encouraging the creation of new households.

Single-family home demand has remained buoyant, yet has been largely supported by an immense investor base as builders shy away from constructing starter homes due to heightened construction costs and tight margins. As a result, potential would-be home buyers have been forced to pursue purchases of existing residences, prompting tight housing inventory and rising prices amid limited new construction. Additionally, many millennials are overwhelmingly favoring urban environments where home prices are well above the metro average, providing a solid renter base in core submarkets. These changes will continue to support an outsize renter pool, boosting multifamily operations over the coming years.

Millennials continue to substantially influence the rental market. Roughly 66 million citizens are age 20 to 34, with the total millennial cohort population exceeding the baby boomers. Whether to retain greater mobility to pursue jobs or an aversion to homeownership, the millennial generation continues to display an elevated propensity to rent compared to other segments of the U.S. population. Approximately two-thirds of millennials rent, and many tend to favor urban locations over suburban living. Potential lifestyle changes, including family formation, may ultimately trigger higher homeownership rates.

Outlook: U.S. employers remain on pace to hire 2.1 million workers in 2016, while incomes will continue to grow modestly. The stable labor market and emergence of the millennials as a collective economic force will drive consumption trends and support GDP growth in the 2 percent range.

Performance Trends

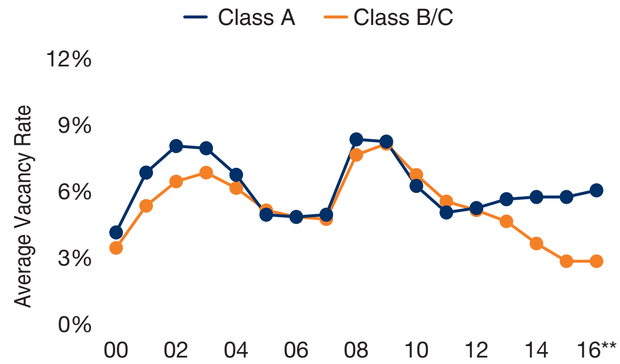
Respectable economic growth maintained sound conditions in the U.S. apartment sector in the first quarter. The national vacancy rate ticked up 10 basis points to a still-tight 4.2 percent in the first three months of 2016, an increase that was not unexpected due to significant completions. The delivery of these new rentals continues to pressure the Class A segment in several markets, generating an increase in vacancy of 30 basis points in the first quarter to 6.0 percent. Class B/C vacancy was unchanged at 2.8 percent, and the gap between the vacancy rate in the sector's upper and lower tiers expanded to its largest level this century. Overall, tenants occupied an additional 38,000 rentals in the first quarter, a respectable showing for an off-peak period of leasing. Elevated levels of absorption persisted in the first quarter in several metros, including those with a significant concentration of technology employment. Austin, San Jose and Seattle-Tacoma each posted high levels of demand during the quarter, although only San Jose registered a drop in the vacancy rate.

Nationwide, more than 59,000 new apartments were put in service during the first three months of the year. Property openings will accelerate during the second and third quarters as prime leasing season opens to greet recent college grads entering the workforce. Most of the metros with large completion totals in the first quarter also posted an increase in vacancy rates as absorption lagged. Bucking the trend, vacancy decreased 10 basis points in Los Angeles during the period, and vacancy also slipped 10 basis points in Miami-Dade despite the addition of more than 2,100 rentals. Development will slow as construction financing requirements have tightened significantly with banks increasing equity requirements.

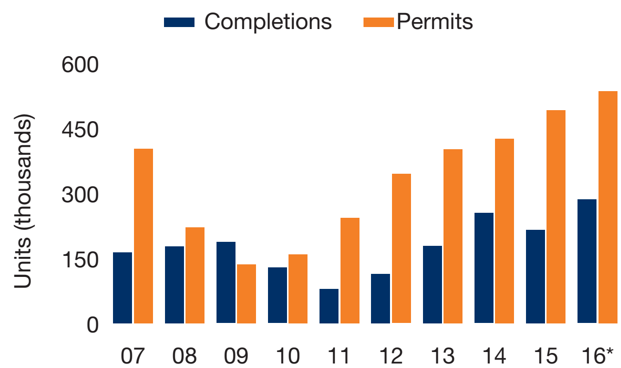
The national apartment sector continues to record increases in the average rent in excess of the rate of inflation, underpinning real growth in property revenue. The gain in the first quarter of 2016 leaves the average rent nationwide 5.9 percent above the level recorded one year ago and is greater than the 5.5 percent gain recorded for all of 2015. Tight vacancy will enable many property owners to continue to push rents at a healthy pace in the coming months. Potential headwinds to maintaining the current rate of growth persist, however, and include competition from new supply and a potential increase in the migration from rentals to homeownership related to easing mortgage underwriting and low interest rates.

Outlook: The second quarter began auspiciously, with reported lease renewal rates running at more than 50 percent, in line with the pace of the preceding quarters. For the entire year, additional growth in demand will closely mirror completions, triggering a nominal rise in vacancy to 4.2 percent. The long-term average national vacancy rate is 5.3 percent.

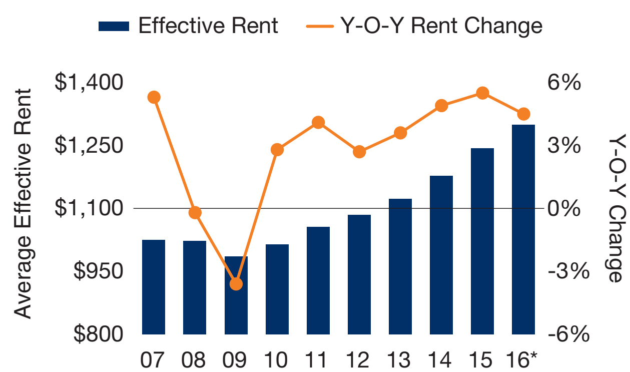
Vacancy Rate by Class



Multifamily Construction Trends

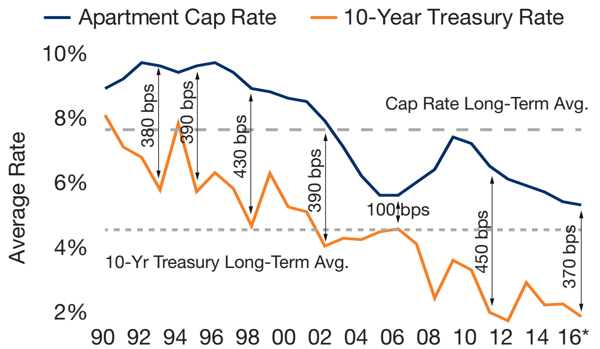


Rent Growth Robust

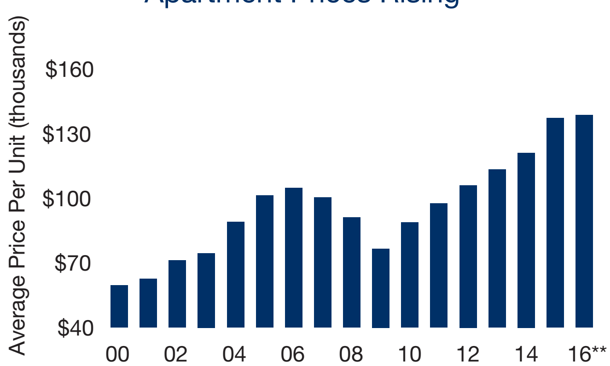


* Forecast
** Through 1Q

Apartment Cap Rate Trends



Apartment Prices Rising



* Through June
** Trailing 12 months 1Q

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Capital Markets

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

The U.S. economy maintained an uneven pattern of growth in the first half of 2016. Recent data showing a slower rate of job growth and subdued increases in wages will likely encourage the Federal Reserve to adopt a more measured approach to monetary policy and extend its timeline for raising its benchmark rate.

Fannie Mae and Freddie Mac offer fixed-rate 10-year loans at up to 80 percent LTV and pricing between the high-3 percent range and the low-4 percent range, depending on deal size, market and asset quality. Portfolio lenders will typically require LTVs closer to 65 percent. Floating bridge loans are typically underwritten at approximately 80 percent LTV, and pricing generally starts at 250 basis points over Libor for recourse and 450 basis points over Libor for non-recourse transactions.

Outlook: Foreign economic trends and events could potentially create temporary volatility in global markets during the second half of 2016. As markets absorb these actions, a migration of capital into the safe haven of U.S. government bonds will maintain the yield on the 10-year U.S. Treasury within a tight range.

Sales Trends

Accessible acquisition debt, low interest rates and the steady flow of equity supported a modest pace of growth in transaction activity during the first quarter. Gains were visible in institutional and private investor segments, but a combination of limited listing inventory and increased caution levels restrained activity growth.

Private capital deployed in assets pricing from $1 million to $10 million continues to comprise a vast majority of all apartments sold, reflecting the greater availability of acquisition debt. Primary markets generally post the highest deal volume, but an intensifying search for yield continues to support more extensive searches for assets in secondary and tertiary markets.

Cap rates continue to compress between primary and tertiary markets as tight vacancy and steady rent growth push up prices. The gap between first-year returns in the top tier and tertiary markets remains well above the tight levels posted at the peak of the last cycle, creating potential opportunities for investors.