

# Multifamily Research Market Report

Fourth Quarter 2016

Philadelphia Metro Area

## Steady Economy Widens Pool of Renters; Construction Booming

**Rents jump amid healthy job market and tight vacancy.** The Philadelphia apartment market is poised for another solid year as the expanding local economy intensifies demand for apartments, enabling rent hikes and keeping vacancy low amid a flood of development. Multifamily construction will reach record levels this year, though much of the building is localized to select submarkets. Center City and King of Prussia remain the primary recipients of new supply, much of which is upper-tier space. The upswing in construction may result in some temporary vacancy softening while new space takes time to lease up. Additionally, these areas may see heightened concession usage in the coming months as competition among operators intensifies. Overall, the strong labor market coupled with an acceleration of

household formation will bolster underlying tenant demand, spurring substantial rent growth. This year, the metro will achieve the greatest annual rent increase since the recession with lease rates on pace to reach historic highs.

**Buyers scour the market for deals amid a small inventory of listings.** Capital flows into the stable Philadelphia multifamily market as investors seek predictability and cash flow while interest rates stay attractive. The metro's strong property fundamentals together with a steady economic outlook have kept buyer demand elevated. It is not unusual for well-priced deals to receive over 10 offers as investors pounce on available properties amid limited listing activity. The main factor keeping sellers on the sidelines

remains concerns about capital redeployment. Those who do sell often transfer their equity to the triple net-leased market, buy up into bigger apartments or cash out. Moving forward, the pool of sellers may widen as property owners look to take advantage of the perfect storm of low interest rates, high valuations and intense buyer demand. Pricing is well above pre-recession levels and cap rates are highly compressed. Class B deals will typically fetch cap rates that average in the low-6 percent band while Class C assets trade in the low-7 percent range or above. Potential risk factors facing the market in the coming years remain interest rate volatility and tax uncertainty. If cap rates or interest rates jump in the near future, owners may see an erosion of property values.

## 2016 Multifamily Forecast

1.9% increase  
in total employment



### Employment:

The workforce will expand 1.9 percent this year through the creation of 54,000 jobs. A gain of 1.7 percent came in 2015, led by gains in the education and health services sector as well as the construction sector.

5,900 units  
will be completed



### Construction:

The market is poised for the strongest year of construction since 2000. Following the completion of nearly 3,230 units in 2015, builders will deliver 5,900 rentals this year. Much of the development is focused on the Center City and King of Prussia areas.

0 basis point  
change in vacancy



### Vacancy:

Positive net absorption of 4,200 units drove a 30-basis-point decrease last year. In 2016, the metrowide vacancy rate will show little movement, remaining at 4.3 percent.

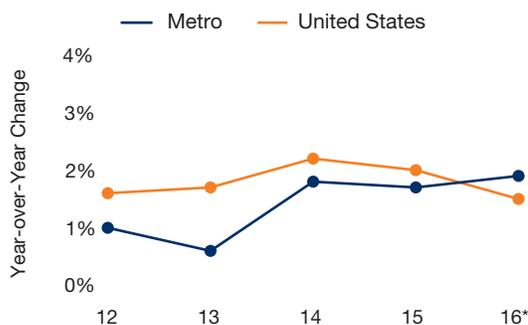
5.4% increase  
in effective rents



### Rents:

Tight market conditions coupled with a surge of high-end development enabled strong rent growth. Following a 2.6 percent increase last year, the average effective rent climbed 5.4 percent annually to \$1,248 per month.

### Employment Trends

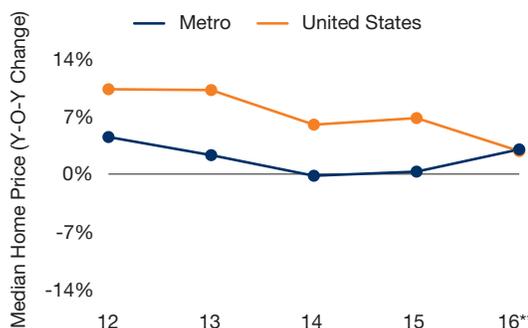


## Economy

- Employers continue to expand. Over the 12 months ending in the third quarter, 55,400 positions were created in the metro, outpacing the gain of 41,100 jobs in the preceding 12-month span.
- Professional and business services employers hired more than 16,700 workers in the past year, an increase of 3.7 percent. Meanwhile, the leisure and hospitality as well as the education and health services sector expanded by 8,000 jobs each.
- Healthy economic growth lifted the median household income 3.1 percent in the past 12 months to more than \$68,100 per year. Current income levels rest nearly 19 percent higher than the national rate.

**Outlook:** Local employers will create 54,000 positions this year, the highest total in any calendar year since 2000. In 2015, Philadelphia companies hired roughly 48,200 workers.

### Home Price Trends

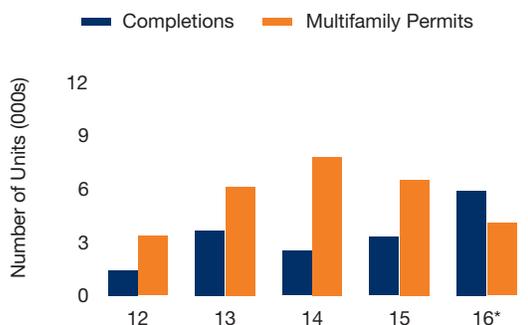


## Housing and Demographics

- Multifamily permitting slipped in the past year, down 35 percent year over year. Single-family issuance on the other hand rose 9 percent on more than 6,800 new permits.
- The median price of an existing single-family residence was \$223,100 in September, up 5.4 percent from one year ago. After accounting for a downpayment, taxes and insurance, this translates into a monthly mortgage obligation of \$1,341, nearly \$100 greater than the average monthly rent.
- More than 13,000 households were created in the last 12 months, an acceleration from the 11,700 formed in the prior annual period. Steady household formation coupled with an expanding population base will supply Philadelphia apartment operators with a widening pool of potential tenants.

**Outlook:** Though homeownership is attainable for many metro residents, the multifamily market will remain strong as many young professionals choose the convenience of renting over owning a home.

### Construction Trends



## Construction

- Developers completed more than 4,800 units since September 2015, the greatest four-quarter period of construction since 2006. In the third quarter alone, builders finalized 1,400 rentals, the second-strongest quarter of development of the current expansion.
- Construction was focused on the University City area, which received approximately 1,020 units in the past year. Center City was also highly targeted with builders completing 860 apartments during the same period.
- The pipeline has widened considerably moving forward. There are nearly 9,000 rentals underway throughout the metro with completion dates stretching through 2018. The Norristown/Upper Merion/Lower Merion and Center City submarkets alone account for 5,400 units of in-process inventory.

**Outlook:** Following the completion of 3,230 units in 2015, developers will bring another 5,900 rentals to market this year, the strongest year of apartment construction since 2000.

\* Forecast  
\*\* Trailing 12 months through 3Q

## Vacancy

- More than 7,000 units of net absorption drove the metrowide vacancy rate down 80 basis points year over year to 3.5 percent in September. This represents the lowest vacancy since mid-2007.
- A supply influx in Center City is causing some temporary softening, though vacancy remains low. The vacancy rate rose 40 basis points over the last three months to 4.3 percent in the third quarter. The Northeast Philadelphia area is the tightest submarket in the metro with vacancy down 220 basis points in the past year to 2.4 percent.
- Vacancy for Class A properties rose 110 basis points in the past year to 6.2 percent in the third quarter. Middle- and lower-tier complexes saw rates slide 90 basis points to 3.2 percent and 220 basis points to 1.9 percent, respectively.

**Outlook:** Positive net absorption of approximately 4,200 units enabled a vacancy contraction of 30 basis points in 2015. The Philadelphia vacancy rate will remain at 4.3 percent this year.

## Rents

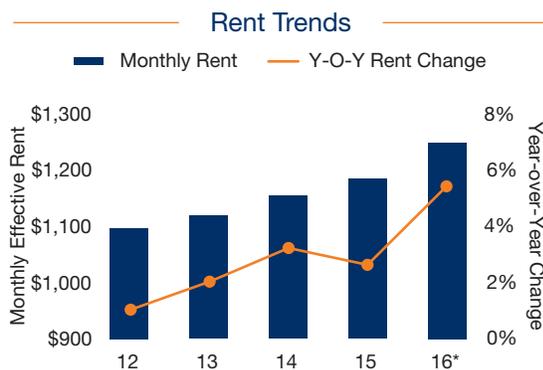
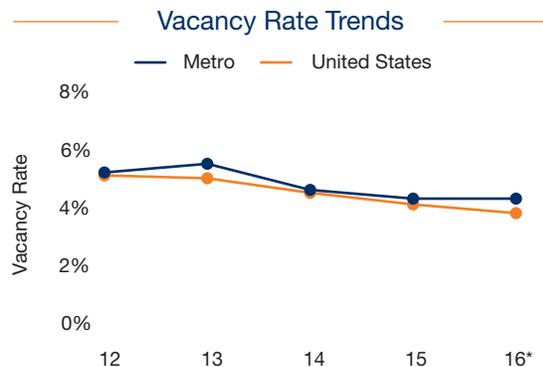
- Tight conditions across the metro encouraged strong rent growth during the last year, with the average lease rate advancing 3.9 percent to \$1,235 per month at the end of the third quarter. A 2.9 percent uptick was posted in the prior annual period.
- The number of properties deploying concessions was just 3.8 percent in the third quarter, down from 21.4 percent five years ago. Not only is total concession usage scarce, but the size of concessions is waning. The average discount equated to about three weeks of free rent in September, down from four weeks a year earlier.
- Center City boasts the most expensive rents throughout the Greater Philadelphia metro, averaging \$2,158 per month in the third quarter. The Southwest Philadelphia area, which includes University City down to the Philadelphia International Airport, recorded the greatest rent hike among all submarkets, surging 12.8 percent year over year to \$1,466 per month.

**Outlook:** This year, the average rent in the metro will increase 5.4 percent to \$1,248 per month, the strongest year of rent growth since mid-2007. A rent gain of 2.6 percent was registered in 2015.

## Sales Trends

- Transaction volume over the past two years has been robust as buyers heavily targeted urban areas such as Center City and University City. The only limiting factor impacting future deal flow remained the inventory of available listings.
- Intense buyer demand pushed valuations well beyond that registered at the pre-recession peak. The average sale price over the last 12 months was \$128,600 per unit, 16 percent greater than 2007 levels.
- The metrowide average cap rate was flat in the last 12 months, remaining in the high-6 percent range. Class B properties have yields that average roughly 50 basis points lower.

**Outlook:** Investors will heavily pursue value-add deals where capital infusions of \$5,000 to \$10,000 per room can typically result in a rent increase of \$75 to \$100 per month depending on the submarket.



\* Forecast  
 \*\* Trailing 12 months through 3Q  
 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 initial reading of third quarter GDP of 2.9 percent and consistent growth in employment are fanning expectations that the Federal Reserve will raise its benchmark short-term lending rate at its December meeting. Other economic data showing steady improvement in the housing market and the stabilization of oil prices around \$50 per barrel offer signals that the U.S. economy is growing at a sustainable pace.
- Increasing rental housing demand underpinned a decline in the U.S. apartment vacancy rate of 60 basis points to 3.5 percent year to date through the third quarter, the lowest level this cycle. Apartment builders have responded to growing demand and favorable demographic trends by ramping up construction. Completions will rise to 320,000 units this year and peak in 2017.
- Capital markets remain highly competitive, offering an assortment of fixed-rate products available through commercial banks, life-insurance companies, CMBS and agency lenders. Fannie Mae and Freddie Mac are underwriting loans of 10 years at maximum leverage of 80 percent. Rates will typically reside in the high-3 to low-4 percent range, depending on underwriting criteria. Portfolio lenders will also price in this vicinity but will typically require loan-to-value ratios in the 65 to 75 percent band. Floating-rate bridge loans and financing for asset repositioning are typically underwritten with LTVs 70 to 75 percent of stabilized value (80 to 85 percent of cost) and price 300 basis points above Libor for recourse deals and extending to 450 basis points above Libor for non-recourse transactions.

## Local Highlights

- The two most significant completions of the past year came from the Norristown/Upper Merion/Lower Merion submarket. The Parc, the larger of the two, totals 398 units and is located in Plymouth Meeting at the intersection of I-476 and I-276. The amenities package includes a yoga room, outdoor fire pit and a 11,000-square-foot clubhouse. The second project, The Courts at Spring Mill Station, was delivered in late 2015 and brought 385 apartments to the Conshohocken area.
- Five Below, a young-adult themed discount store, announced plans to relocate its corporate headquarters to the east end of Center City. The discount chain signed a lease to occupy 153,600 square feet at the Lits Building and will operate a flagship storefront on the ground floor. Moves like these will draw working professionals to the urban core, bolstering demand for apartments in the surrounding area.
- The largest multifamily project underway is Indigo 301. The complex will bring 363 units to the heavily developed King of Prussia area upon completion later this year. Indigo 301 offers a host of amenities including a dog run and pet spa, golf simulator and yoga studio.