Marcus & Millichap

Multifamily Research Market Report

First Quarter 2018

Philadelphia Metro Area

Construction Focuses on Center City, Aiding Other Neighborhoods

Rental demand has been high as more downtown units are expected to come online. Jobs that were added last year, many related to healthcare and hospitality, drew more people to Philadelphia. More households formed, supporting a level of net absorption that surpassed record-setting construction in 2017. Much of that development was in Center City, where the influx of 1,600 units last year pushed the submarket's vacancy rate up 20 basis points. The vibrant downtown area of Philadelphia, which has vacancy of 4.8 percent, is still attracting apartment tenants, but the addition of 2,600 units in 2018 could cause vacancy to tick up further. As these new units take time to lease, the share of properties offering concessions there is likely to rise, tempering rent growth in the immediate term.

Less construction means more vacancy contraction in areas where the rate is already low. As more of the development pipeline concentrates downtown, other parts of Philadelphia will see fewer deliveries, including submarkets like Gloucester County where vacancy is below 4 percent. No completions this year will enable the area's vacancy rate to drop even further, prompting continued rent growth above the market average. An absence of construction in Bucks and Montgomery counties will have similar effects on their vacancy rates and effective rent values.

Multifamily 2018 Outlook

5,400 units will be completed

Construction: Overall development will slow in 2018, even as certain areas see increased completions. About half of arrivals are going to Center City, more than in 2017.

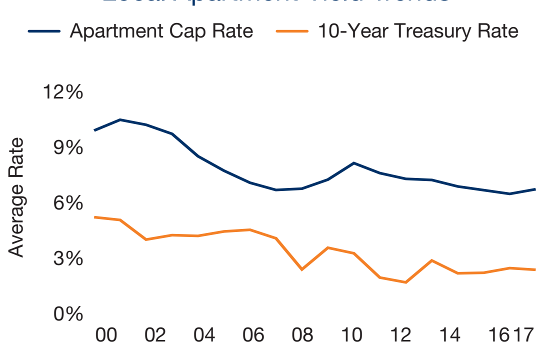
30 basis point increase in vacancy

Vacancy: Following a peak year for deliveries, additional construction will overshadow demand, pushing vacancy up to 4.7 percent in 2018.

2.5% increase in effective rents

Rents: Growth in the average effective rent stays near the five-year average as the rate rises to $1,295 per month.

Local Apartment Yield Trends

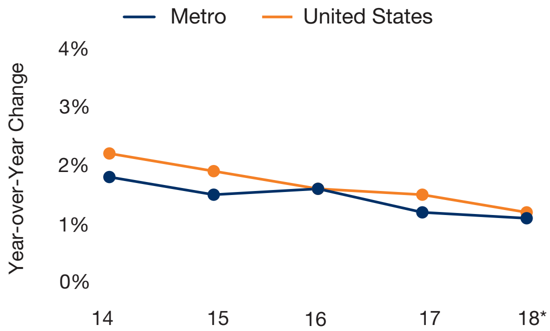


Sources: CoStar Group, Inc.; Real Capital Analytics

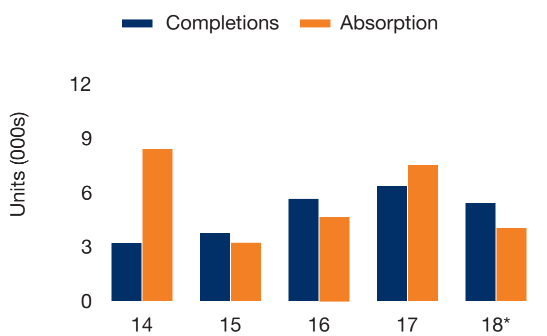
Investment Trends

- The city of Philadelphia's favorable outlook, influenced by recent corporate expansions and a collection of well-regarded universities, continues to draw investors to the market. Fewer listings are prompting an increase in syndicate activity among the buyer pool as investors pull capital to finalize deals, contributing to a general appreciation in sales prices.
- Not just a target for developers, Center City was also a focus of investors in 2017. Most transactions involved Class C buildings, with a handful of trades of Class A and B properties. Yields in the area generally range from 5 to mid-6 percent depending on the type of asset. Given the appeal of the downtown location, Class C complexes typically trade there at yields 100 basis points below their average for the entire market.
- Buyers may find more opportunities, particularly regarding value-add strategies, in the transitioning North Philadelphia neighborhood of Fishtown.

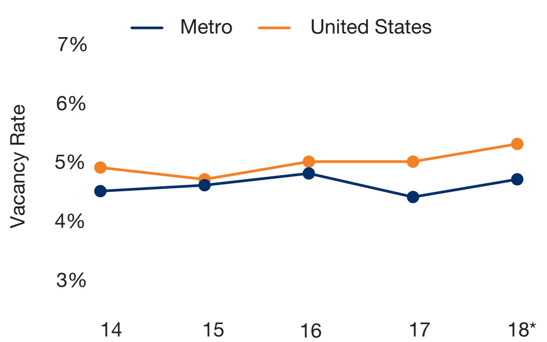
Employment Trends



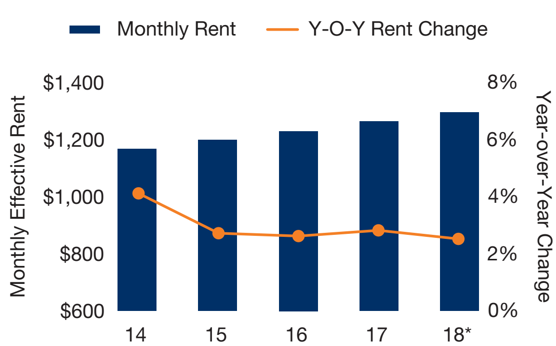
Completions and Absorption



Vacancy Rate Trends



Rent Trends



* Forecast

4Q17 – 12-MONTH PERIOD

EMPLOYMENT:

1.2% increase in total employment Y-O-Y

- Jobs gained in accommodations and food services, as well as in healthcare and education, made up 25,800 of the 33,500 positions filled over the past year.
- Philadelphia's unemployment rate dropped below 5 percent for the first time since early 2008, but it is still 60 basis points above the national level.

CONSTRUCTION:

6,300 units completed Y-O-Y

- The number of new arrivals expanded by 12 percent in 2017 as completions reached a new high.
- Southwest Philadelphia, the Norristown/Merion area and Center City all welcomed over 1,000 units each last year. While that marked an increase year over year for each submarket, the greatest jump was in Southwest Philadelphia, which only had 153 arrivals in 2016.

VACANCY:

40 basis point decrease in vacancy Y-O-Y

- Over 7,500 units were absorbed last year, prompting the vacancy rate to decline to 4.4 percent.
- Vacancy dropped 170 basis points in the northwestern and southwestern parts of Philadelphia, tied for the largest decline of any submarket. This held true even as more units opened in the southwestern area last year than in the previous six combined.

RENTS:

2.8% increase in effective rents Y-O-Y

- Average effective rent rose to $1,263 per month, improving by a wider margin than in 2016 when the rate of appreciation was 2.6 percent.
- Notable rent growth occurred on the New Jersey side of the metro over the past year, with gains near or at 6 percent in Gloucester and Burlington counties. Southwest Philadelphia also recorded a rise in rents of 6.3 percent.

DEMOGRAPHIC HIGHLIGHTS

FIVE-YEAR POPULATION GROWTH*
36,100

4Q17 POPULATION AGE 20-34
(Percent of total population)
Metro 21%
U.S. 21%

4Q17 MEDIAN HOUSEHOLD INCOME
Metro $69,144
U.S. Median $58,714

FIVE-YEAR HOUSEHOLD GROWTH*
85,000

POPULATION OF AGE 25+
PERCENT WITH BACHELOR'S DEGREE+**
Metro 34%
U.S. Average 29%

4Q17 TOTAL HOUSEHOLDS
36% Rent
64% Own

* 2017-2022

**2016

SUBMARKET TRENDS

Lowest Vacancy Rates 4Q17

Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
Northeast Philadelphia	3.1%	-30	$1,020	3.4%
Southwest Philadelphia	3.3%	-170	$1,440	6.3%
Bucks County	3.8%	-60	$1,179	2.3%
Gloucester County	3.9%	0	$1,173	5.9%
Burlington County	4.2%	0	$1,237	6.0%
Delaware County	4.3%	20	$1,051	-0.8%
Norristown/Upper Merion/ Lower Merion	4.3%	-70	$1,361	0.3%
Chester County	4.4%	-40	$1,414	2.4%
Northwest Philadelphia	4.4%	-170	$1,330	-3.1%
Lower Camden County	4.5%	60	$1,046	0.4%
Overall Metro	**4.4%**	**-40**	**$1,263**	**2.8%**

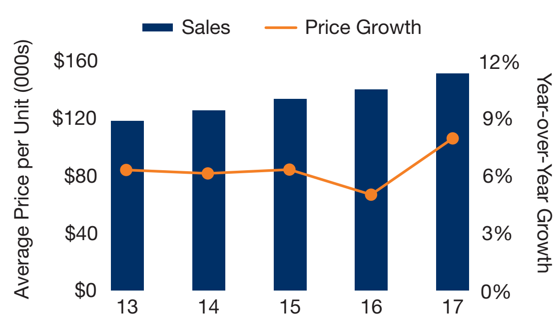
SALES TRENDS

Healthy Competition Among Buyers Facilitates Price Growth Amid Widening Cap Rates

- During 2017, transaction volume expanded by 25 percent and the average price of a unit moved up 8 percent. Buyers continued to compete for all asset classes, with more deals completed year over year for A, B, and C property types.
- The average cap rate in the market rose by 30 basis points, now resting at 6.8 percent.

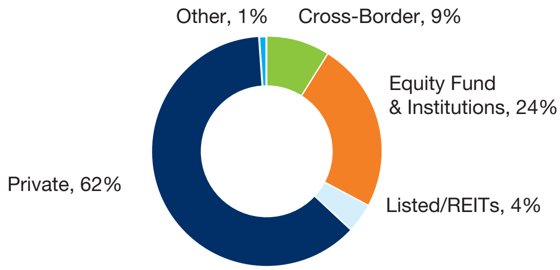
Outlook: Moving into 2018, the lack of listings is driving up demand, pushing sale prices up further. Early trading activity is dispersed, but multiple sales have closed in Navy Yard, Northern Liberties and University City.

Sales Trends

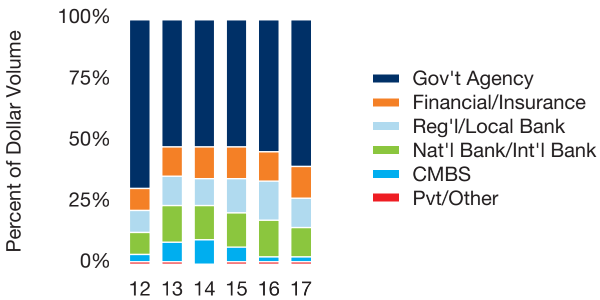


Pricing trend sources: CoStar Group, Inc.; Real Capital Analytics

2017 Apartment Acquisitions By Buyer Type



Apartment Mortgage Originations By Lender



Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

CAPITAL MARKETS

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

- **Fed raises benchmark interest rate, plots path for additional increases.** The Federal Reserve increased the federal funds rate by 25 basis points, lifting the overnight lending rate to 1.5 percent. While the Fed noted that the inflation outlook had moderated in recent months, an upgraded economic forecast factoring in recent tax cuts and a rollback in regulation strengthened growth projections for the next two years. As a result, the Fed has guided toward two additional rate hikes this year, while setting the stage for as many as four increases in 2019.
- **Lending costs rise alongside Fed rate increase.** As the Federal Reserve lifts interest rates, lenders will face a rising cost of capital, which may lead to higher lending rates for investors. However, in an effort to compete for loan demand, lenders may also choose to absorb a portion of the cost increases. While higher borrowing costs may prompt buyers to seek higher cap rates, the positive economic outlook should provide rent growth that outpaces inflation over the coming year. As a result, sellers remain committed to higher asking prices, which has begun to widen an expectation gap as property performance and demand trends remain positive.
- **The capital markets environment continues to be highly competitive.** Government agencies continue to consume the largest share, just slightly over 50 percent, of the apartment lending market. National and regional banks control approximately a quarter of the market. Global markets and foreign central banks are keeping pressure down on long-term interest rates. Pricing resides in the 4 percent realm with maximum leverage of 75 percent. Portfolio lenders will typically require loan-to-value ratios closer to 70 percent with interest rates in the high-3 to mid-4 percent range. The passage of tax reform and rising fiscal stimulus will keep the U.S. economy growing strongly and rental demand will remain high with the national apartment vacancy rate at 5 percent at the end of 2017.

National Multi Housing Group

Visit www.NationalMultiHousingGroup.com

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Price: $250

Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; National Association of Realtors; Moody's Analytics; Real Capital Analytics; RealPage Inc.; TWR/Dodge Pipeline; U.S. Census Bureau