Marcus & Millichap

Multifamily Research Market Report

Fourth Quarter 2018

Philadelphia Metro Area

Property Performance in Northeast Philadelphia Draws Investors

Vacancy declines and rents rise in Northeast Philadelphia due partly to subdued construction. A faster pace of hiring compared with 2017 supports continued in-migration and household formations in Philadelphia, lifting an already-high level of rental demand. Net absorptions in excess of supply additions drop the vacancy rate to 4 percent for the first time in 12 years, raising rents by more than last year. Availability is tightest in Northeast Philadelphia, the metro's second-largest apartment submarket. A lack of substantial new completions over the past five years directs demand to existing stock and keeps vacancy low, prompting above-market rent gains in that time.

Developers target familiar areas. Center City, the Norristown/Merion area, and Wilmington continue to see the largest share of deliveries. That includes two projects, each with over 300 units, arriving by year end. While demand for rentals remains high, the rapid pace of completions in the urban core is starting to weigh on property fundamentals there. Effective rents will stay about flat in Center City as vacancy rises 50 basis points. This is especially the case for Class A product, which is facing the most competition from construction and rentals in neighboring areas.

Multifamily 2018 Forecast

4,600 units will be completed

Construction: Deliveries slow to their lowest level in three years, with over 40 percent of arrivals heading toward Center City. In 2017 5,200 units were completed.

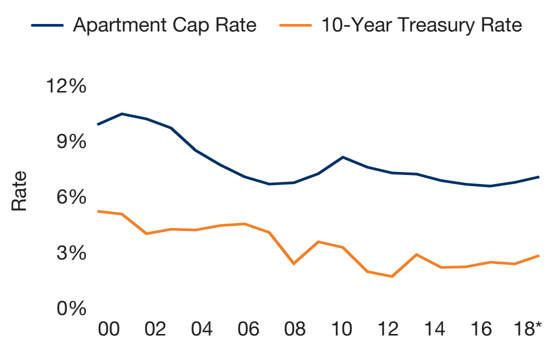
40 basis point decrease in vacancy

Vacancy: The net absorption of units surpasses 5,000 for the second year in a row, dropping metro vacancy to 4 percent following a 40-basis-point decline last year.

3.4% increase in effective rents

Rents: The average effective rent rises in 2018 to $1,298 per month. Last year, an advance of 2.7 percent occurred.

Local Apartment Yield Trends

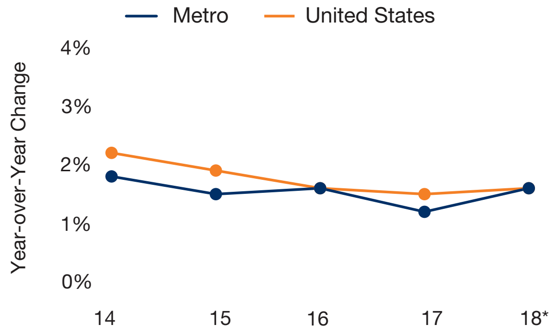


* Cap rate trailing 12-month average through 3Q; Treasury rate as of Sept. 28
Sources: CoStar Group, Inc.; Real Capital Analytics

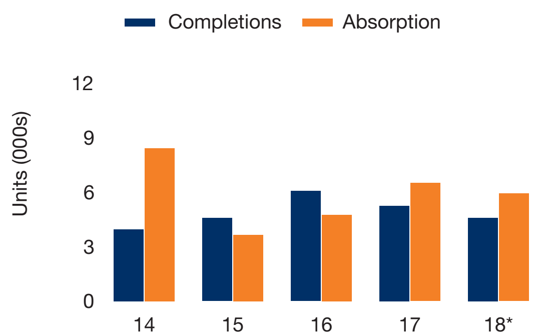
Investment Trends

- Sales velocity improved in the Fairmount/Northern Liberties area of Philadelphia over the 12-month period ending in September. Properties recently sold there tended to be older and smaller than the market average, but they offer a compelling location near the market's urban core. Cap rates ranged from mid-6 to above 9 percent at an average sale price of $262,000 per unit.
- Investors interested in Class B properties looked toward Northeast Philadelphia. A range of post-2010-built assets with fewer than 50 units changed hands in Fishtown, Brewerytown, and surrounding neighborhoods. These new or stabilized assets benefit from shifting demographics and proximity to downtown, commanding an average sale price of $275,000 per unit and a below-market average initial return of high-5 percent.
- Value-add oriented investors are acquiring assets in Center City at an average sale price below that of some submarkets to the north. The generally older structures offer opportunities for higher rents with successful conversions to Class B quality.

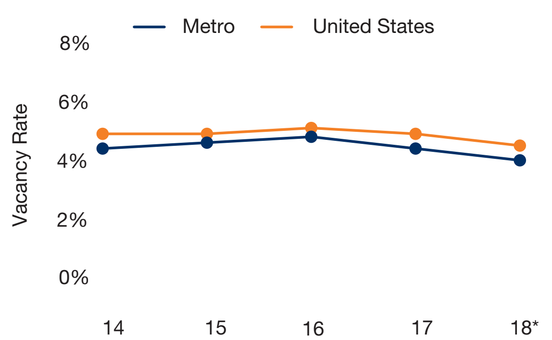
Employment Trends



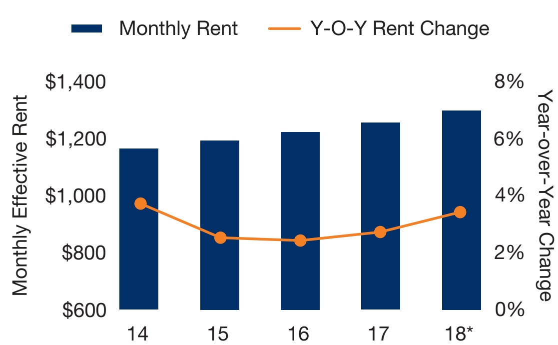
Completions and Absorption



Vacancy Rate Trends



Rent Trends



* Forecast

3Q18 – 12-MONTH PERIOD

EMPLOYMENT:

1.6% increase in total employment Y-O-Y

- The pace of hiring quickened year over year in September as roughly 45,800 positions were added. Increased job creation contributed to a 70-basis-point decline in the unemployment rate to 4.0 percent, a 17-year low.
- Employment growth was most prevalent in the professional and business services as well as education and healthcare services sectors, adding a total 26,000 jobs.

CONSTRUCTION:

4,900 units completed Y-O-Y

- Approximately 1,000 fewer units were completed during the 12-month period ending in September than over the previous yearlong period. In that span developers maintained their focus on the Center City submarket.
- More than 7,300 units are underway with completion dates scheduled through the first half of 2021. The largest 2019 delivery is the 539-unit Hamilton downtown.

VACANCY:

60 basis point decrease in vacancy Y-O-Y

- Demand in excess of supply additions drove triple-digit vacancy declines in Wilmington and Northwest Philadelphia over the past year, contributing to the fall of the metrowide rate to 3.7 percent.
- The removal of almost 400 existing units over the past four quarters pushed vacancy below 3 percent in Gloucester County. No completions in 2019 will keep availability low.

RENTS:

4.3% increase in effective rents Y-O-Y

- As vacancy fell to its lowest level since 2006, rent growth accelerated, bringing the average effective rate to $1,313 per month in September.
- Rents improved the most over the 12 months before October in Southwest Philadelphia. The average effective monthly payment in the downtown-adjacent submarket jumped 12.6 percent to $1,550 per unit.

DEMOGRAPHIC HIGHLIGHTS

3Q18 MEDIAN HOUSEHOLD INCOME

Metro $72,846

U.S. Median $61,789

3Q18 AFFORDABILITY GAP

Renting is $272 Per Month Lower

Average Effective Rent vs. Mortgage Payment*

MULTIFAMILY (5+ Units) PERMITS❖

5,870 1H 2018

4.6% Compared with 1H 2014-2017

3Q18 MEDIAN HOME PRICE

Metro $228,675

U.S. Median $260,016

FIVE-YEAR HOUSEHOLD GROWTH**

79,000 or 0.7% Annual Growth

U.S. 1.2% Annual Growth

SINGLE-FAMILY PERMITS❖

6,932 1H 2018

0.2% Compared with 1H 2014-2017

*Mortgage payments based on quarterly median home price with a 30-year fixed-rate conventional mortgage, 90% LTV, taxes, insurance and PMI. **2017-2022 ❖Annualized Rate

SUBMARKET TRENDS

Lowest Vacancy Rates 3Q18

Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
Northeast Philadelphia	2.5%	-90	$1,053	2.2%
Gloucester County	2.8%	-40	$1,178	0.2%
Bucks County	3.1%	-40	$1,215	3.1%
Delaware County	3.1%	-70	$1,077	3.2%
Northwest Philadelphia	3.2%	-130	$1,350	2.6%
Burlington County	3.4%	-50	$1,244	1.6%
Lower Camden County	3.6%	-60	$1,071	4.0%
Outer Wilmington	3.6%	-130	$1,121	1.8%
North Montgomery County	4.0%	-90	$1,362	4.8%
Central Wilmington	4.1%	-210	$1,175	4.9%
Overall Metro	**3.7%**	**-60**	**$1,313**	**3.0%**

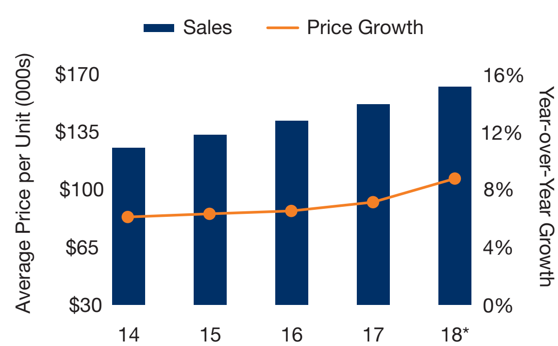
SALES TRENDS

Investment Landscape Stays Competitive Even As Rising Interest Rates Affect Some Deals

- Over the past 24 months, sales velocity has remained elevated compared with previous years. Strong demand fueled a 9 percent increase in the average sale price to $162,000 per unit. The average cap rate rose 40 basis points to 7.1 percent during that span.
- The average sale price for Class B assets improved at a greater rate than for Class A or C properties, due in part to the sale of more contemporary assets.

Outlook: Throughout Philadelphia sizable rent gains and extremely tight vacancies will keep private investors targeting apartments, particularly in submarkets with a large inventory of $1 million to $10 million stock.

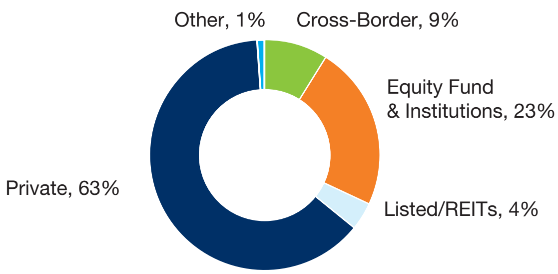
Sales Trends



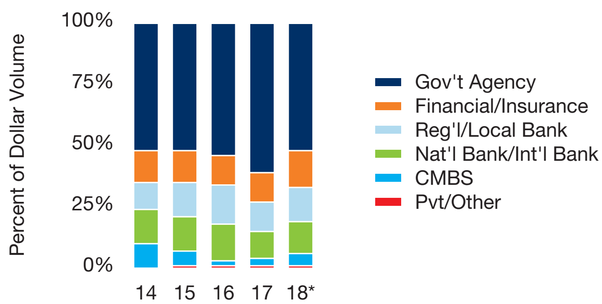
* Trailing 12 months through 3Q18

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

3Q18 Apartment Acquisitions By Buyer Type



Apartment Mortgage Originations By Lender



* Through 2Q
Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

CAPITAL MARKETS

By DAVID G. SHILLINGTON, President, Marcus & Millichap Capital Corporation

- **Fed pushes overnight lending rate higher, cites economic strength in case for additional increases.** The Federal Reserve increased the federal funds rate by 25 basis points in late September, lifting the Fed funds rate to 2 percent. Remarks from the Fed highlight a robust economy, spurred by accommodative fiscal stimulus, while inflation remains broadly in line with expectations. Provided the economy continues to perform as expected, the Fed is likely to increase rates in December, as well as up to three times next year.
- **Benchmark interest rates, lending costs push higher post-Fed meeting.** After the Federal Reserve lifted overnight rates and maintained a positive economic outlook, long-term interest rates have pushed higher. The 10-Year Treasury yield has quickly traded toward the 3.25 percent range, which is prompting lenders to pass on the increased cost to borrowers. However, fierce competition for loans is also leading to some cost absorption among lenders. While greater borrowing costs may prompt buyers to seek higher cap rates, strong economic performance should enable rent growth above inflation. As a result, sellers remain committed to higher asking prices, which is widening an expectation gap as property performance and demand trends remain positive.
- **The capital markets environment continues to be highly competitive.** Government agencies remain the largest source of funds, commanding slightly over 50 percent market share. National and regional banks control approximately a quarter of the market. Pricing resides in the high-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 low-5 percent range. The passage of tax reform and rising fiscal stimulus will keep the U.S. economy growing, underpinning strong rental demand and supporting a national apartment vacancy rate of 4.6 percent at the end of 2018.

National Multi Housing Group

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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