

Vacancies Tighten in Third Quarter Despite Elevated Completions; Investors Broaden Acquisition Criteria

Household formation reinvigorated, intensifies multifamily demand. Job creation remains solid, though the pace of growth has moderated somewhat as qualified workers have become increasingly scarce. Total employment now stands 6.2 million jobs above the prior peak of 2008 and confidence in the economy remains sound. The steady hiring momentum this cycle has boosted household formation, with 1.3 million new households projected in 2016, the strongest pace since 2002. For the apartment sector, this has translated to net absorption of more than 300,000 units during the 12 months ending in the third quarter.

Apartment development still on upswing. Completions will total 320,000 units this year, the greatest addition since the 1980s. Most of the development is concentrated in 10 major metros. Despite the accelerated pace of construction, the national vacancy rate reached 3.5 percent in the third quarter, the tightest level since 2000. A significant slate of deliveries in the fourth quarter will likely elevate vacancy as new units come online during the seasonal down cycle, but lease-ups should accelerate in the first quarter of 2017.

Homebuying remains a trend to watch. At the national level, home prices have recovered to their pre-recession peak, though transactions have been restrained. The limited available inventory, particularly at entry-level price points, together with stringent lending requirements and high down-payment thresholds have held back first-time home buyers. The most significant obstacle to homeownership has likely been a trend among young adults to delay marriage and family formation. The median age for marrying now stands at 28.2 years, up from 23.4 years in 1980.

Construction and redevelopment pressuring Class A properties. The dramatic increase of apartment construction over the last few years together with additional redevelopment has begun to pressure Class A apartment performance, particularly in submarkets with substantial pipelines. Nationwide, Class A vacancy rose by 30 basis points in the last 12 months. Many of the new builds have begun to offer greater concessions, especially in markets where deliveries have reached their highest points in years including San Francisco, San Jose, and New York City. Concessions have been effective in luring tenants from Class B properties, resulting in modest vacancy increases in these assets.

Multifamily 2016 Outlook

320,000 units

will be completed



Construction:

Elevated development extends into its third year with the completion of 320,000 units expected in 2016.

30 basis point

decline in vacancy



Vacancy:

Vacancy will close 2016 at 3.8 percent with the absorption of 354,000 units.

4.5% increase

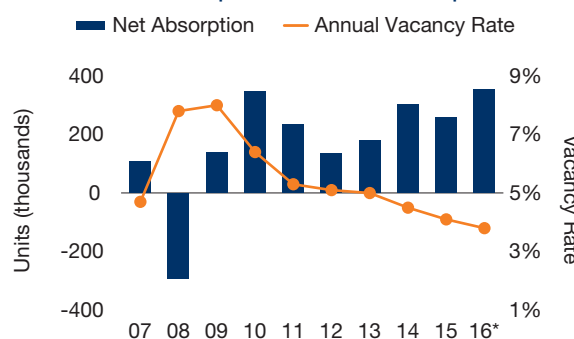
in effective rents



Rents:

The forecasted national average effective rent gain of 4.5 percent is solid, but local market performance will have increased variance.

Demand Outpaces New Development



* Forecast

Economy

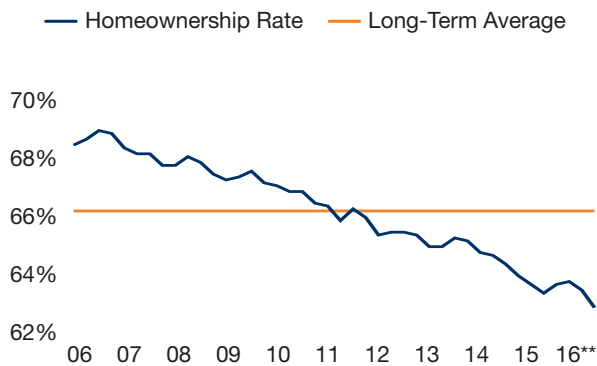
Economy Maintains Full-Employment 72 Months Of Job Gains and Counting



Maturing expansion evolving from job creation to wealth creation.

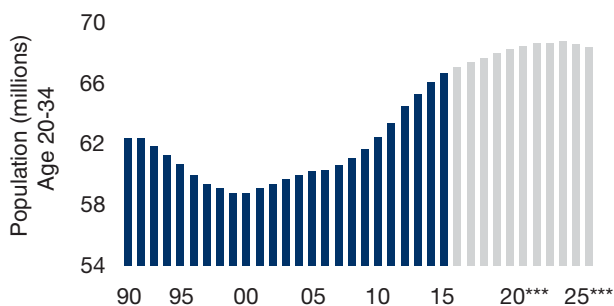
The addition of 15 million jobs since employers resumed hiring following the recession makes this cycle the second strongest on record. The steady 5.0 percent unemployment rate has boosted wage growth, lifting it to 2.6 percent over the last year. With 5.9 million open job positions, the most on record, the economy will continue to add jobs at a moderate pace. However, qualified staff will become increasingly difficult to acquire, elevating recruiting competition. Already several major corporations including JPMorgan Chase and Starbucks have announced wage increases to recruit and retain qualified workers. The modest but steady pace of compensation gains over the last few years finally appeared in a Census survey showing the median household income rising 5.2 percent during the past year, the largest upward movement since 1967.

Homeownership Rate Down Sharply



Growth likely to recover momentum. The economy grew at a modest 1 percent pace in the first half of 2016, down from 2.3 percent last year. However, steady consumption supported by rising wages and a slight increase in exports should bolster output in the second half. Should the third quarter results align with expectations, and steady job and wage growth persist, the Fed will likely raise rates at its December meeting. However, the central bank has repeatedly demonstrated a reluctance to move rates during periods of volatility. The election outcome could raise uncertainty, particularly with the federal budget and debt ceiling coming up for renewal.

Millennial Population Entering Prime Renter Years



Millennials still renting, for now. Approximately 68 percent of the millennials between 20-34 years old, reside in rental households. With job formation reducing the unemployment rate for this generation to 6.1 percent from a peak of 12.5 percent in 2010, household formation should rise. At present, 23 million millennials still live with their parents, exceeding the historical proportion by 19 percent. This pent-up demand will be released as job creation pressures the young adult unemployment rate and creates opportunities for this generation to move out on their own.

Outlook: The economy is well positioned for growth over the next several quarters as employment and wage growth support consumption and demand for housing. Several risks could emerge and create modest turbulence in coming months, however. If Congress fails to pass a budget and raise the debt ceiling in a timely manner, volatility on the financial markets could disrupt the cycle. Considering a longer horizon, inflation could begin to creep up as wages strengthen and begin to add pressure to the economy.

* Through 3Q

** Through 2Q

*** Forecast

Performance Trends

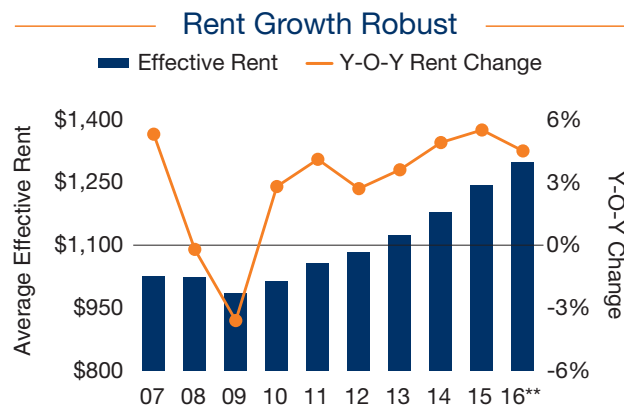
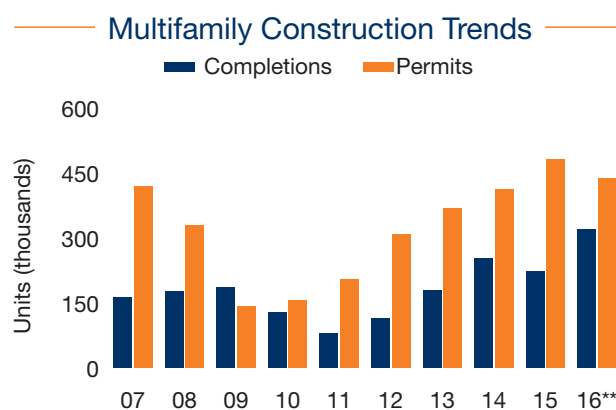
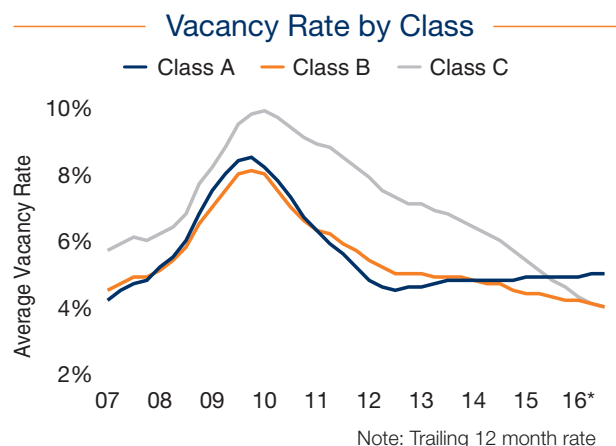
Third quarter performance outpaced expectations.

The national vacancy rate contracted 30 basis points from one year ago to a 10-year low of 3.5 percent in the third quarter, as net absorption outpaced a significant wave of new supply. Demand was strong in the Class B sector, where vacancy dipped 20 basis points, and in the Class C segment, which posted 40-basis-point decline. Homeownership rates have fallen steadily since the recession, fueling lease renewals over the past few quarters and maintaining tight vacancy levels. In the third quarter, vacancy declined significantly in numerous major markets including Atlanta, Chicago, Dallas/Fort Worth and San Francisco.

Deliveries brisk in the third quarter. The completion of 100,000 apartments in the third quarter was sizable but still fell short of overall demand. However, the highly amenitized Class A segment is beginning to face challenges as the newly developed supply competes with a growing inventory of recently updated older Class A stock. Looking forward, deliveries will jump to 120,000 units in the fourth quarter before culminating at the cyclical peak in 2017. After next year, the development pipeline should thin considerably amid stricter underwriting guidelines for construction loans.

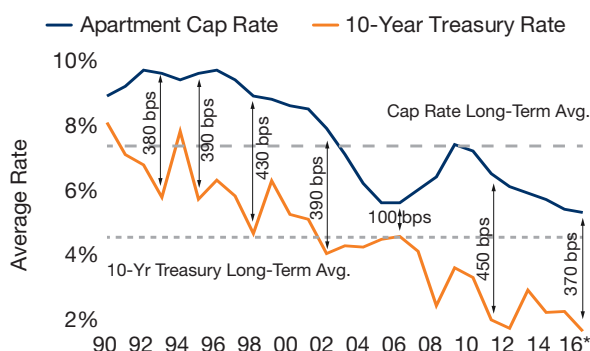
Rent growth remarkably sturdy. Despite the length of the apartment cycle expansion, average rent growth remains particularly robust, exceeding a 5.0 percent annual gain for five of the last six quarters. The current pace of 4.1 percent annual growth in the third quarter was modestly slower but remains well ahead of the 3.3 percent long-term average. Numerous markets have generated exceptional rent gains over the last year, led by Sacramento's 11.6 percent increase. The Inland Empire, Seattle and Portland also posted strong momentum. A wave of completions in San Francisco, San Jose and New York, however, has expanded competition for renters ahead of the typically lower demand winter months. As a result, these markets have experienced modest downward pressure on effective rents in recent months.

Outlook: In the coming year, a variety of both supply and demand characteristics could decelerate effective rent growth on a macro basis, but the outlook still points to an increase in the 4 percent range. Market dynamics will become more tactical, with significant performance variances emerging by neighborhood and asset class. Top-tier properties in submarkets with significant development face the most risk in the next year, while lower tier assets and properties in metros that do not have sizable development pipelines will continue to outperform.

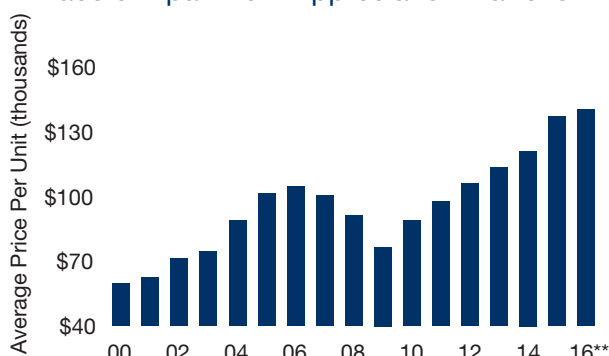


* Through 3Q
** Forecast

Yield Spread Gives Investors Latitude



Pace of Apartment Appreciation Flattens



* Through September

** Trailing 12 months 2Q

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President
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Treasuries stable; probable Fed move in December.

The U.S. economy generated slow growth in the first half of the year giving the Federal Reserve breathing room to hold off an increase of its benchmark lending rate at its September meeting. Expectations that the economy will accelerate in the second half, together with gains in wage growth and sturdy, if unremarkable hiring, raise the probability that the central bank will boost rates at its December meeting. Following the steep drop in Treasury Rates after the Brexit, the ten-year treasury bounced back to the 1.7 percent range where it has remained.

CMBS reviving in wake of rule changes. The first CMBS offerings to comply with the new Dodd-Frank risk retention regulations were issued during the third quarter and elicited strong interest from bond investors. Greater certainty in the mortgage bond market will make CMBS a viable financing option for commercial property owners and investors.

Outlook: The ongoing migration of capital into the safe haven of U.S. government debt, particularly by international investors, will likely keep the yield on the 10-year U.S. Treasury range-bound in the coming months. Liquidity, particularly for multifamily investments, remains strong, but development capital has tightened.

Sales Trends

Buyers remain cautiously active. Following six years of dramatic gains, transaction velocity growth has flattened this year to align with last year's record-setting pace. Financial market turbulence over the course of the last 18 months, together with uncertainty centered on weak international economies and the pending election, have raised caution and opened a modest gap in buyer and seller expectations. Although the pace of appreciation has eased, strong performance trends have bolstered values, raising the price per unit 34 percent above the prior peak set in 2006.

Investors look beyond the core to bolster yields. The average apartment cap rate has held steady in the low 5 percent range, led by flattened yield trends in primary markets. The pursuit of higher returns, however, has boosted investor activity in secondary and tertiary markets as well as in outlying areas of major metros. As a result, yields outside the core have continued to compress at a steady but modest pace. Considering the cost of capital has remained exceptionally low, yield spreads continue to offer sufficient opportunity to sustain sales. In recent surveys, apartment investors have reiterated their optimism, with nearly two-thirds indicating they believe values will increase by a healthy 6.6 percent in the next year.