Marcus & Millichap

The Apartment Outlook

Midyear 2018

Tax Law Reinforces Apartment Housing Demand as Rising Interest Rates Dampen Homeownership Outlook

Economy gets a boost from tax reform. Economic growth surpassed 4 percent in the second quarter, lifted by strengthened consumption and business investment. The new tax law has stimulated the economy by increasing after-tax earnings and pushing consumer and business confidence to near-record levels. This combination has sparked elevated spending and accelerated job creation. Through the first half of 2018, the economy added over 1.3 million jobs, driving unemployment below 4 percent and boosting wage growth to 2.7 percent, its highest level since the onset of the recession. As a result, personal disposable income has grown by 5.4 percent over the last year, dramatically outpacing the 3.5 percent average growth rate over the past 10 years. The combination of low unemployment and more disposable income has translated into particularly strong consumption. Through the summer, core retail sales growth surged to 5.6 percent, well ahead of the 10-year average of 3.1 percent.

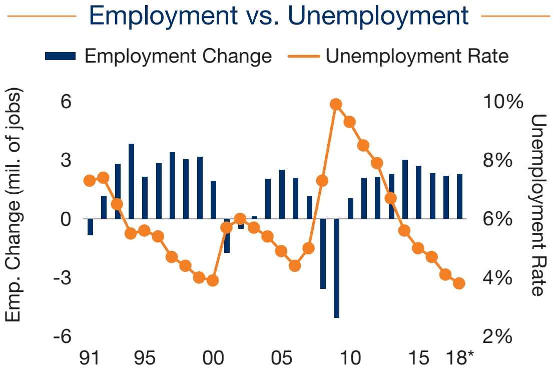
Rising inflation and higher interest rates could cool momentum. Accelerated growth brings with it some new challenges. Core inflation has nudged upward to 2.3 percent, raising caution at the Federal Reserve. To rein in inflationary pressure, the Fed has already signaled that it will tighten monetary policy by raising the overnight rate a total of four times in 2018; this will push up short-term interest rates. The challenge for the Fed is that long-term interest rates have been range bound, with the 10-year rate hovering near 3 percent for the last six months. Unless the Fed can push long-term rates up, its monetary tightening policies could invert the yield curve, raising short-term Treasury yields above long-term Treasuries. An inverted yield curve is a commonly perceived sign of an impending recession, raising the risk of a slowing economic outlook.

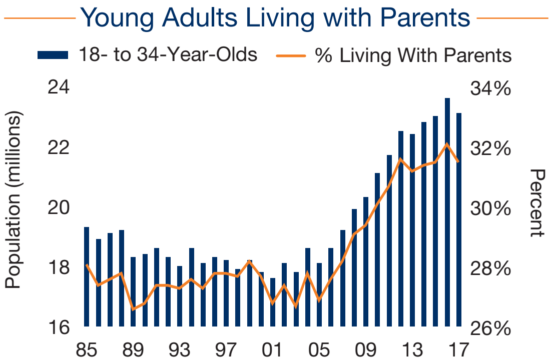
Tax rules favor rental lifestyle. The recent tax reform added two provisions that could impede first-time homebuyers. Under the new tax law, the standard deduction has doubled to $24,000 for married couples ($12,000 for individuals), pushing the threshold home price to benefit from itemized deductions to the $400,000 range for married couples. This, in conjunction with a limitation on the deductibility of state and local taxes, including property tax, could restrain home purchases, which have already slowed in the first six months of the year. Rising interest rates in conjunction with steady home price appreciation have also lifted the monthly mortgage payment for a median-priced home more than $130 in the first half of the year. The rise has pushed the monthly payment more than $300 above the average monthly rent for an apartment. The widening affordability gap, still-stringent home-loan underwriting standards and the limited availability of entry-level homes remain an impediment to first-time homebuyers.

Accelerated household formation outpacing new construction. The economic boost has aligned with the wave of millennials in their 20s moving into their first residence. The influx of demand has drawn down the available housing supply over the past few years. While both single-family and multifamily developers are set to increase construction this year, elevating total housing deliveries by 7.5 percent, housing demand will increase by an estimated 19 percent. Though developers have delivered apartments at a record pace over the past five years, single-family construction remains half of its 2006 level. Based on a lack of entry-level housing options, rising prices and new tax rules that remove some homeownership benefits, the apartment sector could experience a substantive lift in demand in the near future.

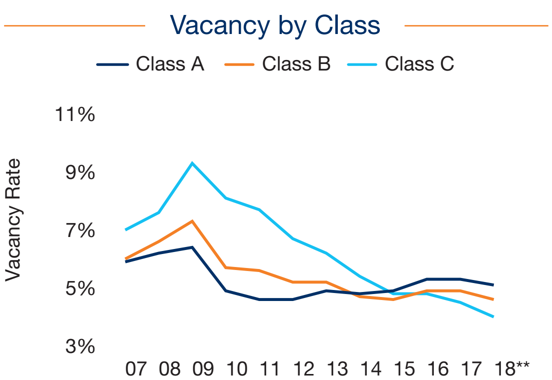
Executive Summary

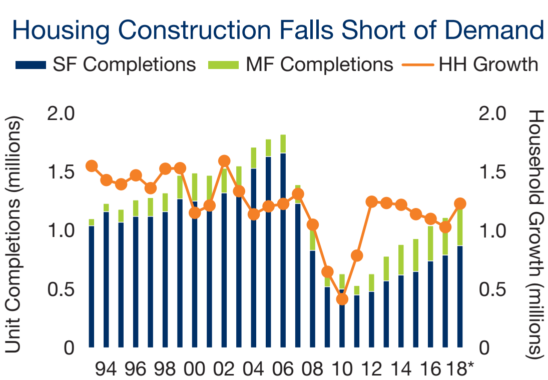
- Rising mortgage interest rates have significantly widened the affordability gap between renting and owning. Both are weighing on single-family home sales and in combination with stringent underwriting standards and a low supply of entry-level homes, apartment demand stays strong as residents extend stays.
- Many demographic drivers are impacting apartment demand, including the number of 18- to 34-year-olds living with their parents, the rise in single-person households, and growing diversity among the millennial generation.
- High-level of construction activity the past few years has heighten concern regarding oversupply. Yet, demand has kept pace with inventory growth over the past five years and apartment vacancy remains near a cyclical low first achieved in mid-2015.
- Various parts of the country have rent-control laws in place that limit apartment rent advances. Today, there are states or cities where voters or the city council are considering amending existing laws to allow additional rent-control measures.
- Secondary and tertiary markets are dominating sales activity, claiming more than 50 percent of trades and dollar volume since 2016.





Note: Unmarried college students living in dormitories are counted as living in their parents' home.





* Forecast ** 2Q2018

Tax Reform Brings Significant Changes For Real Estate Investment

Retention of key real estate tax provisions just scratches the surface. The new tax law kept three of the most important rules for real estate investors: tax deferred exchanges, real estate depreciation and the mortgage interest deduction. Beyond this, the new rules deliver a host of important changes that could reshape investor strategies. Three important changes investors should consult their accountants about include:

- **20 percent pass-through deduction:** For active investors using a pass-through entity such as an LLC, the new 20 percent pass-through deduction will boost after-tax yields. This new deduction has a variety of restrictions based on income and asset base but offers substantive upside for those who qualify.

- **Bonus depreciation:** This temporary provision will phase out after 2023, but it enables investors to immediately expense personal property in real estate assets acquired after Sept. 27, 2017, boosting immediate cash flow. A Cost Segregation Study enables investors to identify the deductible components.

- **Restrictions on business interest deductions:** Companies that have loans on purchased locations they operate from have historically been able to deduct the interest on their real estate. Under the new rules, companies with average annual gross receipts of $25 million or more face limits on their overall interest deductions. The new rule can make the sale-leaseback of locations more beneficial for companies from a tax standpoint because leases remain a deductible expense.

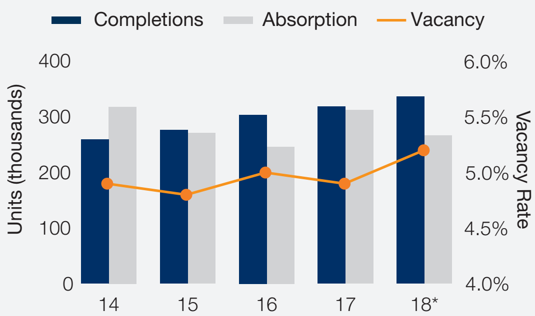
Demographic Trends Driving Demand

Apartment demand strong; paces construction pipeline. Oversupply risks have brought some caution to investors as construction has heightened over the past few years. Demand has kept pace with inventory growth over the past five years and apartment vacancy of 4.6 percent in the second quarter remained near a cyclical low of 4.5 percent first achieved in mid-2015. Class C apartment vacancy has tightened 160 basis points over the past five years to 4.0 percent, while new stock coming online has softened the Class A rate, which reached 5.1 percent in the second quarter. Low vacancy has kept overall rent growth steady between 3 and 4 percent over the past two years as rents increased across all property classes. The pace of growth has been strongest among Class C assets in the past four quarters and for the first time in more than 10 years. The annual advance for Class C outpaced rises for both Class A and Class B properties.

Shifts in demographic trends and household composition shape future housing demand. In addition to increased barriers to homeownership, many demographic drivers are impacting household growth and several benefit apartment demand. The number of 18- to 34-year-olds living with their parents, the rise in single-person households and growing diversity among the millennial generation are all positive drivers for apartment properties. Each of these groups has a higher propensity to rent than purchase a home. These shifts from the norm of prior generations sustain strong demand for rentals across all property classes. While housing needs have increased and are set to rise further, housing construction has fallen short of demand since 2011. Residential construction, including both single-family and multifamily starts, is beginning to flatten near the historical norm, signaling the current housing shortage will worsen alongside an increased need for housing.

Apartment Absorption Strong as Completions Set to Rise in 2018

Supply and Demand



U.S. VACANCY:

30 basis point Y-O-Y increase

Healthy apartment demand keeps vacancy near historical low. The absorption of more than 265,000 units this year remains on par with the previous five-year average but falls short of anticipated supply additions this year, pushing up the forecasted overall apartment vacancy to 5.2 percent.

U.S. CONSTRUCTION:

335,000 units completed Y-O-Y

Apartment deliveries reach the highest level in more than 25 years. During 2018, annual stock additions reach above 300,000 units for a third consecutive year as robust development throughout several major metropolitan areas continues.

U.S. RENT:

3.1% Y-O-Y increase

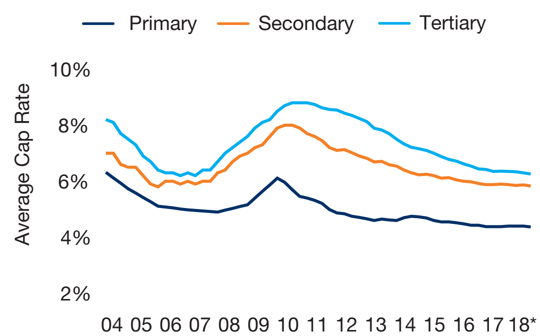
Average effective rent rises for ninth straight year. Tightening vacancy over the past few years had resulted in few properties offering leasing incentives. Pending deliveries could put some pressure on owners to increase concession use this year, slowing rent growth as the national average reaching $1,330 per month.

* Forecast
Sources: Marcus & Millichap Research Services; RealPage, Inc.

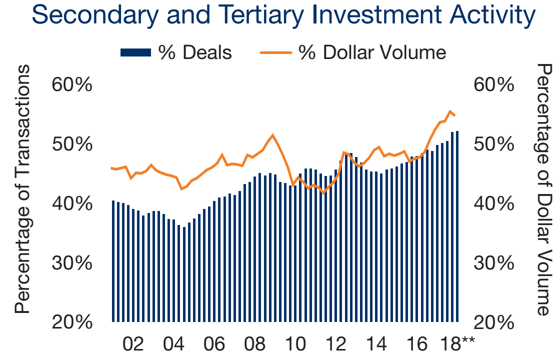
2018 Investment Outlook

- **Healthy operations keep capital flowing into properties.** Low vacancy and stable rent growth remain attractive to buyers, luring new investors to the segment. These same qualities have buyers adjusting expected future returns from earlier in the business cycle, thus widening the gap between buyer and seller expectations. Investors seeking significant upside will have to amend expectations as opportunities for rapid appreciation are dwindling.
- **Investors' interest in secondary and tertiary markets increases.** Due to limited inventory in primary markets and growing demand for rentals in smaller markets, capital has moved to tertiary markets for elevated yields. The increased competitive bidding occurring now in all markets has placed downward pressure on first-year returns, with the strongest decline in tertiary markets as more investors seek assets in these locations. Here, returns have fallen 160 basis points, averaging 6.3 percent in the second quarter. The decline has slashed the spread between primary and tertiary markets from nearly 300 basis points in 2012 to 140 basis points at midyear.
- **Calls for rent control in some markets trigger concerns.** Parts of California, Maryland, New Jersey and New York, as well as the District of Columbia, have rent-control laws in place that limit apartment rent advances. Steep increases in rental rates in many metropolitan areas with no current rent-control laws has prompted a push by some for legislation that would limit rent growth in these areas. In markets where rent control is being considered by voters or city councils, investors should use caution when evaluating their investment strategies.

Cap Rate Trends by Market



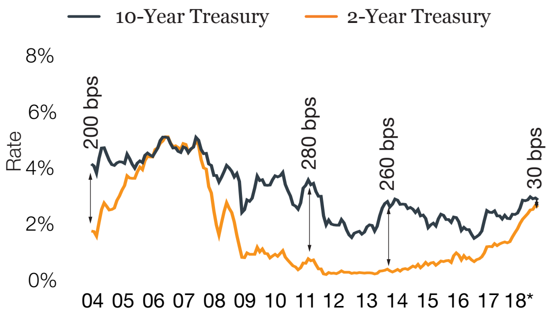
Secondary and Tertiary Investment Activity



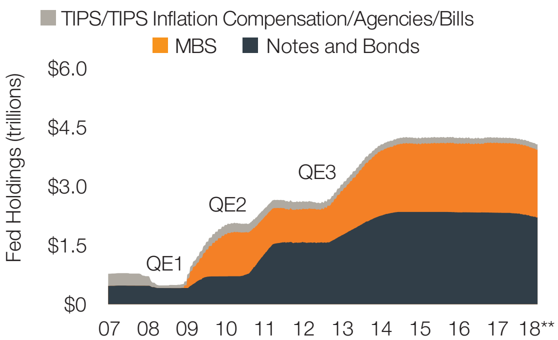
* Through 1Q2018
** Through 2Q2018

U.S. Capital Markets

10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens



Fed Balance Sheet Normalization



* As of Aug. 17
** Through July 20

Lenders Pursue Deals as Capital Plentiful; Caution Enforcing Underwriting

Fed watchful as economic surge raises inflationary pressure. Strengthened hiring amid exceptionally low unemployment levels has boosted wage growth, placing upward pressure on inflation. Amid this trend coupled with rising trade protectionism and tariffs, the Federal Reserve appears determined to head off inflation risk by continuing its quarterly increases of the overnight rate. These actions are lifting short-term interest rates while the 10-year Treasury rate remains range bound near 3.0 percent. Should the 10-year remain steadfast, Fed tightening could create an inverted yield curve in which short-term rates rise above long-term rates. Although this event has preceded every recession of the past 50 years, many economists suggest such an inversion this year could be an exception to the rule. Because of distortions caused by regulatory changes and quantitative easing, this inversion could be different. Nonetheless, the Fed's stated path does raise recessionary risk levels because it could weigh on confidence levels and restrain spending by consumers and businesses, thus slowing economic growth.

2018 Capital Markets Outlook

- **10-Year Treasury still "sticky" at 3 percent.** After surging at the beginning of the year, the 10-year Treasury has been range-bound near 3.0 percent. To create some headroom for its escalation of short-term rates, the Fed has tried to exert upward pressure on long-term interest rates by unwinding its balance sheet. This quantitative tightening has had little influence, particularly as foreign investors have enjoyed a yield premium relative to their native 10-year rates.
- **Potential rapid interest rate escalation a downside risk.** Although capital remains plentiful, lending could tighten quickly for a short period if interest rates rise rapidly. As experienced in late 2016 when the 10-year rose by more than 80 basis points in 60 days, and again at the beginning of 2018 when there was a 60-basis-point surge, market liquidity could tighten if rates jump. Considering this has happened twice in the last two years, borrowers will likely benefit by taking a cautious approach with their lenders and lock in financing quickly.

National Multifamily Group

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