Apartment Demand Surges to New Peak; Investors Target Widening Range of Opportunities

Fed takes action to extend economic growth cycle. Sturdy underlying fundamentals continue to support domestic growth, expanding the economy by 2.1 percent in the second quarter, but headwinds are emerging. Growth has moderated over the past several months and some international forces are weighing on momentum, prompting the Fed to cut the overnight rate by 25 basis points at the end of July, in an effort to extend the economic runway. This modest cut may have fallen short of what was needed to offset the escalating trade war and financial market turbulence as the 10-year/two-year yield curve briefly inverted recently. This commonly perceived signal of an impending recession has the potential to increase uncertainty and work against the positive economic forces such as steady job creation, low inflation, sound wage growth and elevated consumer confidence. In addition, sustained recruiting demand has resulted in a 20 percent surplus of job openings relative to job seekers, enabling many people with weaker skills and education to find work. Reflective of this, organizations are becoming increasingly competitive in their recruiting efforts, opening additional locations to tap new labor pools and boosting compensation packages to attract new staff members and retain existing workers. This has provided a bump to household and disposable income levels nationwide.

Uncertainty restraining some growth drivers. Though economic optimism remains elevated, consumption and corporate investment have moderated relative to 2018. Unresolved trade talks, slowing international economies and the hangover from elevated interest rates last year continue to pressure domestic markets, prompting some consumers and businesses to act more cautiously until additional clarity emerges. These factors have restrained leasing activity for some property types in several markets during the first half of this year, but a recovery could be sparked by lower interest rates. Still, the recently inverted yield curve and uncertainty surrounding trade will weigh on the outlook.

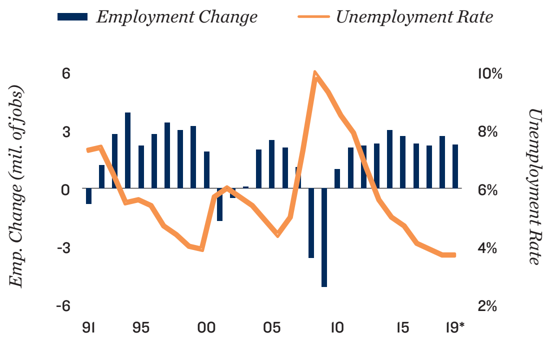
Law makers focus on housing affordability. The tight job market has accelerated household formation, sparking an extended period of price and rent appreciation and reducing housing affordability in many markets. Legislative measures in several states are being taken to restrain rent growth through regulation. These measures will restrict market forces and investors' ability to create value in rental housing. Rent control will also exacerbate the tight housing market by inhibiting new development. Cash flows may be more stable under rental statutes as tenant turnover can be reduced, but growth potential can be dramatically limited, weighing on valuations and prompting owners to reconsider investment strategies. Oregon led the nation by creating the first statewide rent-control law in February this year, while New York recently implemented the Housing Stability and Tenant Protection Act of 2019. The New York act removes the ability to transfer stabilized units to market rates and puts limits on the amount owners can raise rents to pay for capital improvements. Additionally, California and some other states continue to push toward of local and statewide rental regulations to tackle affordability issues.

Evolving lifestyles prompt developers to rethink strategies. While the millennial generation remains the key age cohort for apartment renters, older generations are emerging as a quickly growing renter segment. Empty nesters are beginning to downsize from suburban single-family homes into urban lifestyle apartments as wide-ranging amenities and increased walkability serve as primary drivers. Homeownership among the 55-64 and 65-plus age cohorts have decreased by roughly 2 percent each over the past five years — declining faster than younger age groups. Less maintenance and closer proximity to employment and entertainment hubs boost the appeal of urban living. Increased demand for two- and three-bedroom apartments has resulted from this trend as many older renters prefer larger spaces that can accommodate home offices and guest rooms for visiting family members. Vacancy for these apartment types were pushed to the lowest levels in nearly two decades at the end of the second quarter, posting 3.9 percent for two-bedroom units and 4.8 percent for three-bedroom units.

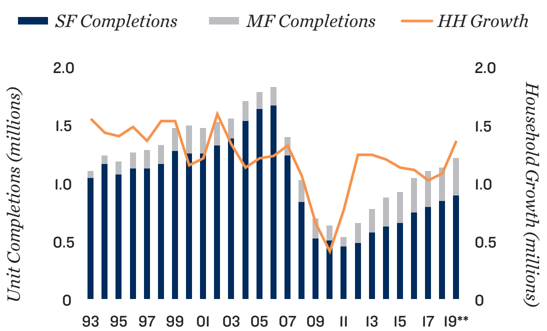
Executive Summary

- The economy remains on solid footing, supported by sustained employment growth. With job openings vastly outnumbering job seekers, those typically hard-pressed to find work are securing employment, generating additional households as more people are able to move out on their own.
- Rent control remains at the center of housing discussions, encouraging legislators from a variety of states to propose rent reformation to boost housing affordability. While these regulations may solve issues in the short term, they can have severe longer-term effects.
- Apartment developers have long catered to younger generations; however, they are now shifting their focus, including more amenities and altering layouts to accommodate older generations who are making the transition to urban life.
- Absorption registered its highest level in nearly 30 years in the second quarter as more than 180,000 units were absorbed. This kept rent growth in the upper-4 percent range on an annual basis in the second quarter, pushing the average effective rent to nearly $1,400 per month.
- High pricing and tight yields have many investors rethinking their strategies as the cycle extends. Many buyers are expanding their search parameters to include secondary and tertiary markets, where cap rates are generally stronger and more assets are available.

Employment vs. Unemployment

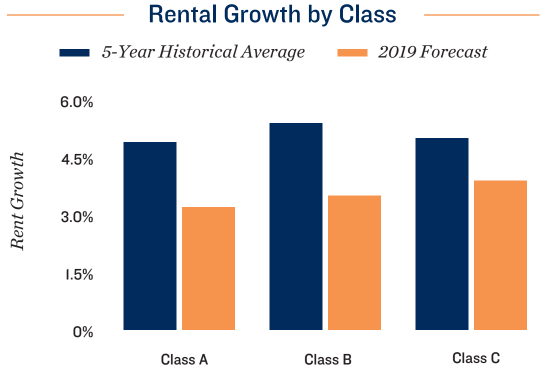


Housing Construction Falls Short of Demand



Vacancy by Class

Rental Growth by Class



** Employment change trailing 12 months through July; Unemployment rate as of July*

*** Forecast*

Millennials Key to Apartment Outlook

Suburban real estate may be biggest winner of evolving millennial lifestyles. The millennial cohort will have a transformative impact on real estate markets as this generation approaches a new life stage. Many millennials are beginning to form families after delaying marriage until their late 20s or early 30s. Family formation will increase the appeal of suburban neighborhoods as more moderate housing costs and proximity to quality schools becomes increasingly important. Suburban housing demand will be bolstered in the coming years as a result of this lifestyle shift, putting further pressure on apartment vacancy rates and producing even stronger demand for entry-level single-family homes. Corporations are taking note of this, setting up campuses in suburban employment hubs in many primary metros, bringing jobs to the growing talent pools. Additional suburban retail, particularly in proximity to office properties, will be developed to create live-work-play hubs that support the migration to the suburbs.

Household Formation Boosting Leasing Activity

Developers still trying to keep pace with demand. Deliveries will surpass 300,000 for the second time this cycle as builders feverishly bring new units to market. Average annual completions sit about 40 percent higher than last cycle's pace, illustrating a contrasting dynamic relative to other property types during the same periods. New York will lead development efforts, adding 37,000 new apartments this year, while Dallas posts the next highest total at 26,000 units. Though primary markets will comprise the eight most construction-heavy metros, a number of secondary and tertiary cities will witness increased development as economic growth flows inland from large gateway cities. Many smaller metros are experiencing expanded urban renewal efforts as some companies relocate from the suburbs to downtown buildings, seeking to capitalize on urban millennial populations. Detroit and Indianapolis offer prime examples, each recording a substantial uptick in construction activity this year.

Tight labor market ballooning apartment demand. A record-high 182,000 units were absorbed in the second quarter, pushing the 2019 absorption total to roughly 200,000 and putting the apartment market in position to finish the year strongly. Exceptional leasing activity will keep the national vacancy rate tight, hovering in the low- to mid-4 percent range as widespread demand maintains momentum across all asset classes. Class C units will continue to experience the tightest conditions — with vacancy in the mid-3 percent band — as low unemployment enables those with fewer skills and less education to find work and create new households. Broader demand trends continue to squeeze the Class B market tighter, pushing vacancy down 70 basis points to 4.1 percent since last June, while Class A vacancy dropped 60 basis points to 4.7 percent during the same span.

Rents benefiting from tight unemployment. Rent growth remained strong over the past year, with Class B and C apartments witnessing 5.1 percent and 5.0 percent increases, respectively. Elevated household formation is putting significant pressure on workforce-housing availability, tightening vacancy rates to near 20-year lows. Class A rents also posted strong growth, climbing 4.2 percent during the past year. The Class A national average effective rent sits at $1,827 per month, nearly $500 above Class B and almost $800 higher than Class C apartments. Growth rates in all classes are receiving additional support as developers struggle to keep pace with demand amid the shortage of construction workers, rising construction costs and tightened lending.

Investors Redefine Strategies As Cycle Matures

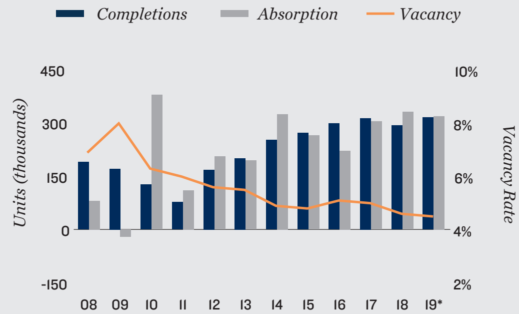
2019 Forecast

U.S. CONSTRUCTION:

315,000 units completed Y-O-Y

- Completions are scheduled to hit the highest mark in more than 25 years, adding to the over 1.4 million units completed in the past five years. Primary markets will dominate construction headlines this year.

Apartment Supply and Demand



U.S. RENT

4.1% Y-O-Y increase

- This year's rent growth will come in below 2018's increase of 4.9 percent as the average effective rent rises to $1,402 per month. While Class B and C will likely lead gains, Class A will also post strong growth rates.

U.S. VACANCY

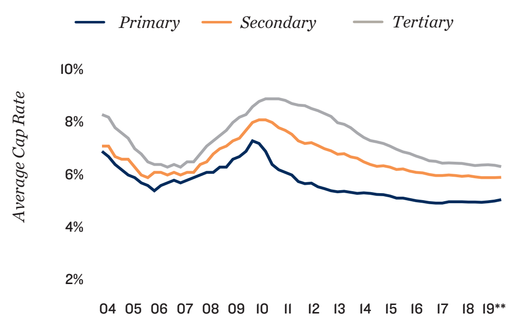
10 basis point Y-O-Y decrease

- Record-setting absorption in the second quarter will support another decrease to the national vacancy measure, nudging it down to 4.5 percent by year end. This will support the ninth vacancy reduction in the past 10 years.

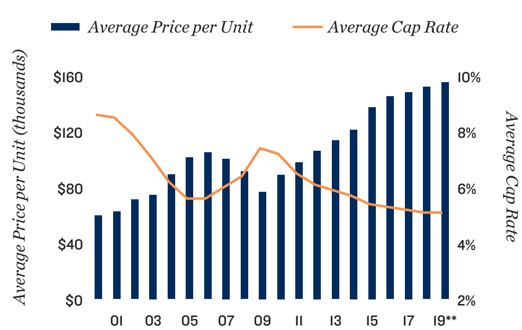
2019 INVESTMENT OUTLOOK

- **Buyers zero in on smaller cities.** Limited available assets and quickly climbing prices in primary markets have many investors diverting their attention to secondary and tertiary metros, where more opportunities may be found. Many Midwest markets are seeing increased trading activity with yields up to 250 basis points above large coastal markets and roughly 150 basis points higher than the national average cap rate of 5.1 percent. Metros including Columbus, Minneapolis and St. Louis have witnessed transaction velocity more than double over the past five years.
- **Suburbs attract new wave of buyers.** New supply risk continues to grow in urban areas, encouraging more investors to expand their search parameters to include suburban neighborhoods. Roughly 28 percent of the nation's apartment completions occur in downtown areas, up 10 percent over the past decade. The share of suburban apartment transactions has been trending up since 2010 from about 74 percent to approximately 83 percent of that total at the end of 2018.
- **Investors closely monitor rent control.** Rent control remains a hot topic as the nation's housing shortage puts additional upward pressure on rental rates. An increasing number of legislative proposals to put a ceiling on rents or regulate rent growth in some cities and states is creating uncertainty for apartment investors, weighing on investment strategies and potentially causing them to look elsewhere for opportunities.

Cap Rate Trends by Market



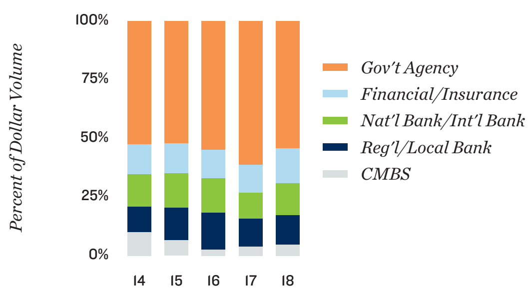
Price and Cap Rate Trends



* Forecast
** Trailing 12 months through 2Q
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

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

Apartment Mortgage Originations By Lender



** Through Aug. 14*
Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

Fed Breathes More Life Into Economy; Capital Sources Show More Flexibility as Interest Rates Decline

Fed efforts to extend economic runway facing increased headwinds. The Federal Reserve's decisive action, including their rate drop in July, will support the economic growth cycle but may be outweighed by the escalating trade war. Uncertainty and caution increased following the Aug. 1 announcement that additional tariffs would be levied, sparking a flight to safety and the recent inversion of the 10-year and two-year Treasurys. Though the Fed's 25-basis-point reduction of the overnight rate and early end to quantitative tightening could pose some inflationary risk, the Fed has communicated a willingness to let the economy "run hot" in an effort to spur growth. Should core inflation rise above 2 percent, it will not be seen as an immediate risk. Falling interest rates, a byproduct of the trade war and the Fed's efforts to boost the economy, will bolster leveraged yields for investors. With the yield on the 10-year Treasury now down 70 basis points from the cycle peak last October and at their lowest level since the record-low set in 2016, investment options that may not have penciled even 30 days ago have been reinvigorated. This should help moderate the buyer/seller expectation gap that widened earlier in the year.

Abundant liquidity balances conservative underwriting. Debt financing for apartment assets remains strong, supported by myriad lenders. However, Fannie Mae and Freddie Mac, two mainstay apartment capital sources, will moderate activity in the second half of the year as they reach their lending caps on market rate assets for the year. The Government Sponsored Enterprises will remain active lenders for "uncapped business" including environmentally-sustainable and affordable housing properties. A wide range of local, regional and national banks, pension funds, insurance companies and CMBS sources will remain very active. All have responded to the falling interest rate climate by reducing mortgage rates, but lender spreads have widened as the 10-year Treasury rate has fallen. Given the downward pressure on interest rates, lender caution has risen, particularly for construction loans. Though lending is still available for these types of projects, investors may need to blend mezzanine debt with other capital sources until they prove out their concepts and substantially fill units. For stabilized existing assets in most major markets, financing remains plentiful.

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