Yardi® Matrix

U.S. Multifamily Outlook

Winter 2019

Strong Performance In an Aging Cycle

**South, West Lead
Nation in Rent Growth**

**Construction Hitches
Push Supply into 2019**

**Investors Look
To Place Equity, Debt**

Market Analysis
Winter 2019

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Still Room to Run for Multifamily, Despite Prolonged Cycle

■ Although the recovery is starting to show signs of strain and market players are increasingly gaming out downside scenarios, 2019 should be another good year for the multifamily industry. Demand is expected to stay healthy as long as job growth remains positive and young adults and retirees choose apartments.

■ The economy is showing signs of strain and stock market volatility demonstrates heightened concern about the economy among investors, but job growth and consumer spending are likely to remain healthy. GDP might not approach 3% again, but neither do we see it slowing below 2%.

■ We foresee another year of moderate rent increases in the 2.5% to 3.0% range nationally, led by metros in the South and West with strong in-migration and job growth. Some of the greatest gains will come from fast-growing tertiary markets such as Tacoma, Colorado Springs and Reno. New York City rents will be relatively flat again, but no metro will see negative growth.

■ We expect roughly 300,000 deliveries nationally in 2019, the fourth straight year at that level. Although rents will be tested in some metros by a spate of deliveries, recent experience has shown that supply will be absorbed when demand is there.

■ Investors just can't quit commercial real estate. As the economic cycle ages, investors are increasing allocations to safer asset types, which means a larger portion of CRE dollars moving into multifamily and industrial.
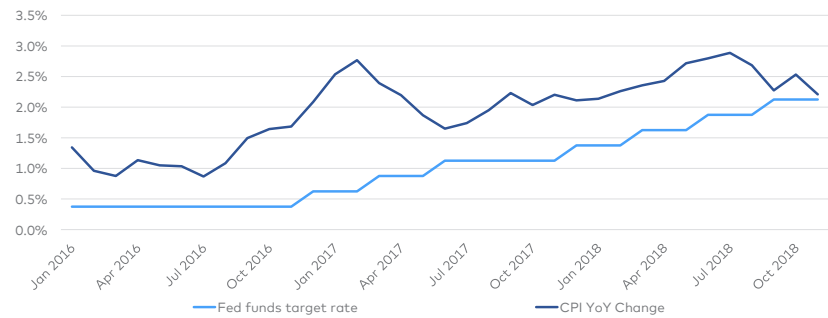
Economic Outlook

For economists and real estate investors alike, most of 2018 was a surprisingly strong year, as fundamentals received a boost from 2017 tax reform, corporate profits improved, and until the fourth quarter the global economic picture was positive. However, as the shine wears off the historic tax cuts and the trade war between the United States and China deepens, cracks in the economic armor will likely begin to show in 2019.

Fed Funds Rate Approaching YoY Inflation

Source: Moody's Analytics, Federal Reserve, Bureau of Labor Statistics

Despite a slower-than-expected month of November, employment gains remained well over 200,000 per month in 2018 and the labor market continues to tighten. The challenge in 2019 for most employers will be finding candidates to fill their vacant positions, as job openings outnumber unemployment by roughly one million. Unemployment remains at a 50-year low and could continue to fall even if new hiring is scaled back in 2019.

Given the tightness of the labor market, wage inflation will be the key metric to watch throughout 2019. For the first time this cycle, wages grew 3% or more starting in late 2018, and wage growth is expected to continue its upward momentum.

The Federal Reserve has been put in an awkward position by President Trump's criticism of its decision to increase interest rates and tighten monetary policy. The increases to the federal funds target rate have been in line with the Fed's dual mandate to maintain price stability and strength in the employment market. In December, however, as global economic tensions rose, Fed

Chair Jerome Powell indicated that the fed funds target rate was very close to neutral, and expectations for 2019 were revised downward to two rate hikes, from three.

Throughout the current tightening cycle, which began in December 2015, the Fed has been overly transparent and direct with its intention to raise rates. As a result, markets have been able to account for expected increases, and major stock and bond indices have been mostly stable. However, as the fed funds rate rose above inflation for the first time in 2018 and the fear of a global slowdown driven by tariffs increased, volatility flooded into the markets in the fourth quarter of 2018. That volatility will likely continue into 2019 as markets digest a flattening yield curve, a government shutdown and continued trade rhetoric in Washington.

While these crosswinds may lead to more economic turbulence in 2019, the overall economic picture does not look bleak. Consumer confidence remains strong, but continued divergence between the present situation index and the expectation index implies weaker long-term confidence. We expect GDP to return to the cycle average, which

2018 GDP Outperformed Long Run Average
(Annualized GDP Growth per Quarter)
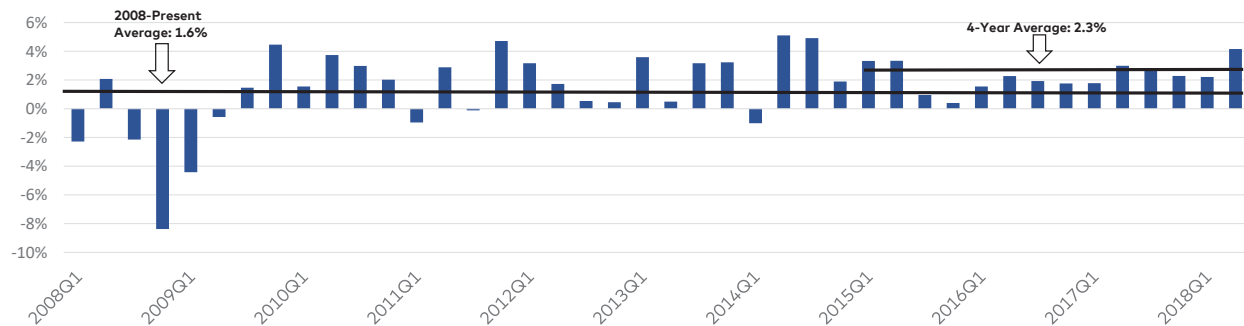
Sources: Bureau of Economic Analysis

is closer to 2%, in 2019. Real estate has prospered in the environment of moderate growth, so that's not necessarily a bad thing as the cycle begins its second decade.

Growth will likely be sector specific, as industries including agriculture and manufacturing stand to feel the strongest negative impacts of a trade war. Trade, transportation and utilities may also suffer from falling oil prices that are searching for a bottom after peaking above $75 per barrel in early October. On December 24, oil prices fell below $43 per barrel; they may continue to fall on concerns of slowing global demand. Growth should continue in the hospitality, health care and technology sectors as corporate profits expand and investment in health services increases.

Growth will also be regionally focused, as employment gains continue to be dominated by secondary markets in southern and western states. The likes of Florida, Texas, Tennessee, North Carolina, Arizona, and Nevada are

attracting corporations and residents seeking a cheaper cost of living. Houston (118,000) and Dallas (109,000) led the nation in year-over-year absolute job growth through November. Orlando, Austin (both 4.4%) and Houston (3.9%) led major metros in year-over-year percentage growth.

Companies are tapping into educated workforces in secondary markets, where the cost of living is dramatically less than in gateway markets. Despite the headline-grabbing Amazon decision to establish its HQ2 in New York and Washington, D.C., the overall trend of corporate relocations and expansions has been to secondary markets in the South and West.

We expect 2019 will bring slower levels of growth and softening fundamentals, but overall the economy remains healthy. Yet the potential for a downturn exists if trade tensions heighten and global growth falls. The tightening of the yield curve is a warning sign, especially if the curve inverts at some point.

Rent Growth Trends

Fresh off another year marked by steady improvement, the rental sector looks to extend what is already a prolonged market cycle. With year-over-year growth crossing the 3.0% mark nationally in 2018—slightly above initial expectations—the multifamily sector showed that it still has some legs going into 2019. We expect rents to continue to rise in 2019, at a rate of 2.8%, marking another year of consistent improvement.

The market is underpinned by strong demand based on household formation that tops one million annually and positive employment growth. The number of young adult households is continuing to rise, families are remaining renters longer than they did in the past, and some retirees that sell homes with expensive property tax burdens are turning into renters.

Rent growth is strongest in late-cycle markets such as Las Vegas, Phoenix and Orlando, where employment and demographic growth are well above trend. Growth is likely to continue there at some of the highest rates in 2019, with rent appreciation projected at or near the 4.0% mark for all three metros. Spillover markets, where renters have flocked to avoid the high rental costs of high-priced urban centers—such as the Inland Empire, Winston-Salem and Colorado Springs—saw rents rise at some of the highest rates in 2018 and will continue to do so this year. Meanwhile, East Coast markets have largely remained stable, although with household creation being dominated by the Western and Southern regions, growth will top out for most Eastern metros in the 1.5 to 2.0% range.

Technology-driven markets in the Western U.S. have surged again, leading Seattle, San Francisco, San Diego and San Jose to above-average rent growth during the second half

Metros	2019 Rent Forecast % Change	YoY Change December 2018
National–All Markets	2.8%	3.2%
Sacramento	6.5%	4.4%
Tacoma	5.8%	4.6%
Salt Lake City	4.6%	4.5%
Inland Empire	4.5%	5.5%
Dallas	4.3%	2.4%
Orlando	4.0%	4.4%
Las Vegas	4.0%	7.3%
Colorado Springs	4.0%	2.4%
Seattle	4.0%	2.9%
Los Angeles	4.0%	4.2%
Phoenix	3.9%	6.5%
Tucson	3.7%	4.4%
Twin Cities	3.6%	3.3%
Columbus	3.6%	2.8%
Orange County	3.5%	2.2%
White Plains	3.5%	2.7%
Northern New Jersey	3.5%	1.9%
San Diego	3.4%	4.5%
Raleigh	3.4%	3.0%
Denver	3.4%	3.3%
Atlanta	3.3%	5.3%
Jacksonville	3.3%	5.5%
Tampa–St. Petersburg	3.3%	3.1%
Indianapolis	3.2%	3.1%
Long Island	3.2%	2.6%

Source: Yardi Matrix

of 2018. Continued economic improvement in these markets and good demand for Lifestyle-rated assets continue to push rents, as outside talent is still attracted there. With rentals still representing the bulk of household creation in these cities, rent hikes are likely to continue. However, an already cost-burdened renter community is facing even more strain, which could lead to further exacerbation of affordability issues. This trend is already pushing growth in markets near the major tech hubs, as well as those aspiring to attract a higher influx of tech talent, such as San Diego, Salt Lake City and Austin.

Denver and Raleigh are two growing technology hubs where high delivery numbers have moderated rent growth, keeping improvement below the national average in 2018. While apartment deliveries in Raleigh will likely regress to the mean in 2019, down to about 3,000 units, completions in Denver show no signs of letting up, as more than 10,000 units are slated for delivery this year. With the appeal of more affordable rent rates and wide job availability in high-paying sectors still strong in both markets, we expect rent growth to top 3.0% in 2019.

U.S. Rent Growth (YoY Change)

Source: Yardi Matrix
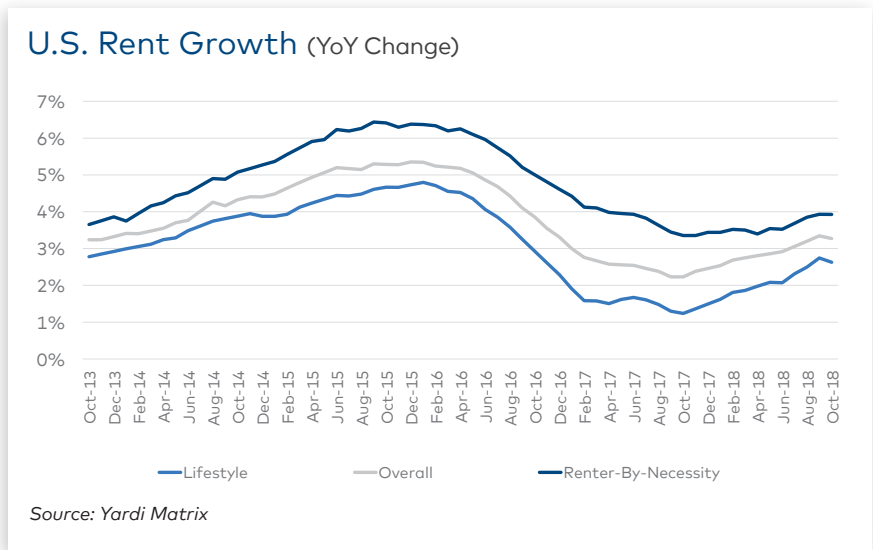
Supply

Development activity will remain strong in 2019. We expect deliveries to come in at about 300,000 units this year, 2.2% of total current stock and largely in line with 2018 totals. This will mark the fourth year in a row of completions in the 300,000 units range, which is entirely appropriate given the strong demand that we expect to continue for another few years.

Growth in supply has hit a few roadblocks. The shortage of skilled labor as unemployment dips below 4% is an issue. Labor is increasingly harder to find and more expensive. Developers are also facing increases in the cost of land, particularly in urban submarkets, and building materials due to tariffs. That makes it more difficult to underwrite new projects at rent levels that are affordable.

One consequence of these issues is that it has smoothed the schedule of deliveries somewhat. Instead of a big bump of new supply in 2018 and 2019 and then a decline in 2020 and beyond, the delivery schedule is likely to remain closer to 300,000.

Another factor boosting multifamily development is that it is taking up a larger share of total housing construction. Single-family construction is lagging, in part because rising costs make it difficult for developers to build at entry-level price points, which are in more demand than large suburban homes. With a wider availability of rentals and fewer costs attached to renting, that dynamic is likely to continue. Millennials, which now represent the largest population cohort in the labor force, are starting to buy their first homes, but affordability is a problem due to student loans and rising mortgage rates. Their propensity for technology- and entertainment-driven markets is effectively pricing some of them out of homebuying.

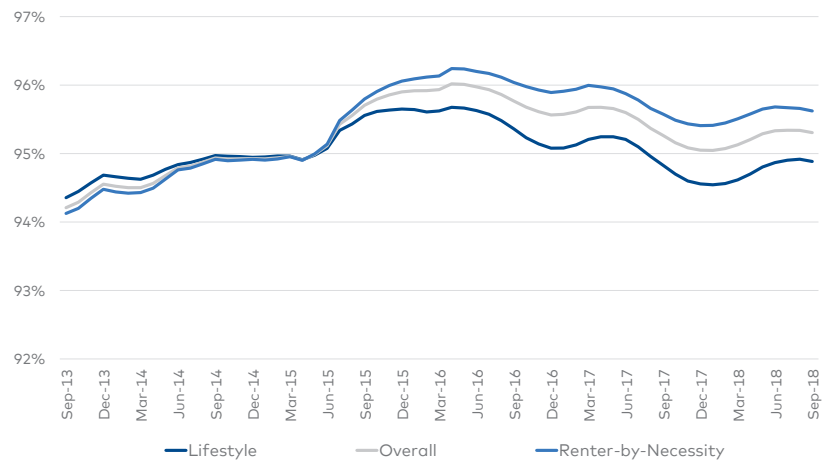| Metros	2019 Forecast Completions	2019 Completions % Change
National–All Markets	298,722	2.2%
Dallas	22,410	3.0%
Miami	16,320	5.5%
Seattle	12,450	5.1%
Washington, D.C.	12,270	2.3%
New York City	12,150	2.2%
Austin	11,730	4.9%
Los Angeles	10,980	2.6%
Denver	10,620	3.9%
Chicago	10,470	3.1%
New Jersey–Northern	9,150	4.2%
Atlanta	8,970	2.0%
San Francisco	8,280	3.3%
Boston	8,250	3.6%
Charlotte	7,680	4.4%
Phoenix	7,620	2.5%
Portland	6,900	4.5%
Twin Cities	6,570	3.2%
Houston	6,150	1.0%
Orlando	6,000	2.8%
Nashville	5,820	4.3%
San Jose	5,820	4.6%
San Antonio	5,490	2.8%
Philadelphia	5,460	1.9%
San Diego	4,230	2.3%
Columbus	4,080	2.4%

Source: Yardi Matrix

High-growth metros continue to drive new supply, with the most growth in Sunbelt and Western U.S. markets. Dallas (22,410 units expected in 2019), Miami (16,320 units) and Seattle (12,450 units) are projected to lead deliveries this year. Pipelines are also robust in Washington, D.C. (12,270 units) and New York City (12,150 units), although the delivery rate as a percentage of stock will essentially be in line with national trends. Rent growth will be limited in both markets in 2019, although Amazon's HQ2 project is likely to create an increase in demand in those markets in the mid- to long term.

Miami (5.5%), Seattle (5.1%) and Austin (11,730 units, 4.9% growth) lead major metros in growth as a percentage of stock. San Jose (4.6%), Portland (4.5%), Nashville (4.3%) and Northern New Jersey (4.2%) also are forecast to add more than 4% to stock numbers.

After slipping in late 2017 and early 2018, the average occupancy rate in stabilized properties has bounced back. With deliveries through that interval being slightly slower than expected, the rate reached 95.3% as of October 2018—which represents a 10-basis-point increase year-over-year.

National Occupancy

Source: Yardi Matrix

Historical and Forecast Completions

Source: Yardi Matrix

Despite strong occupancy rates, developers overwhelmingly continue to focus on building luxury Lifestyle assets, creating an occupancy gap with less expensive Renter-by-Necessity (RBN) units. Nationally, occupancy rates were 95.6% in RBN and 94.9% in Lifestyle.
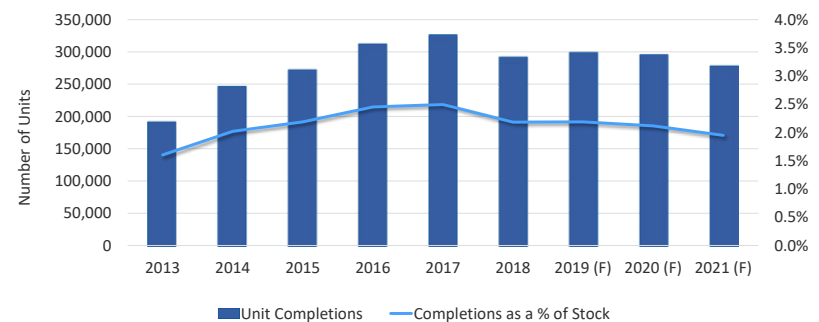
Capital Markets

There is no obvious crack in the so-called "Wall of Capital" that has supported the commercial real estate industry for nearly a decade. Prices remain firm as equity capital continues to pour into the industry, and all major sources of debt capital are actively seeking business.

That said, a sense of nervousness is developing, despite strong fundamental performance, as the economic cycle closes in on a full decade. Property yields have likely bottomed out and concerns about rising interest rates and weakening economic growth have led to a slowdown in commercial mortgage originations, particularly in out-of-favor asset types.

Nervousness is reflected in the volatility in the capital markets. The stock market reacted to economic and political news with unusually large swings in the fourth quarter, and the bond market has also gyrated more than usual. The 10-year Treasury rate increased steadily after bottoming out at just over 2.0% in September 2017 and has been bouncing around the 3.0% range.

Rising rates don't necessarily spell bad news for acquisition yields, but investors are concerned that cap rates are at historic lows and the economy seems more likely to soften than to accelerate over the next 12 to 18 months. The increase in the 10-year Treasury has been offset by rising property rents, a 40- to 50-basis-point tightening of mortgage spreads that mitigates the impact on borrowers, and the ongoing excess of capital looking to buy commercial properties. However, if any of those factors weaken—for example, an increase in loan spreads or reduced

2018 Sales Volume Flat, Price per Unit Continues to Rise
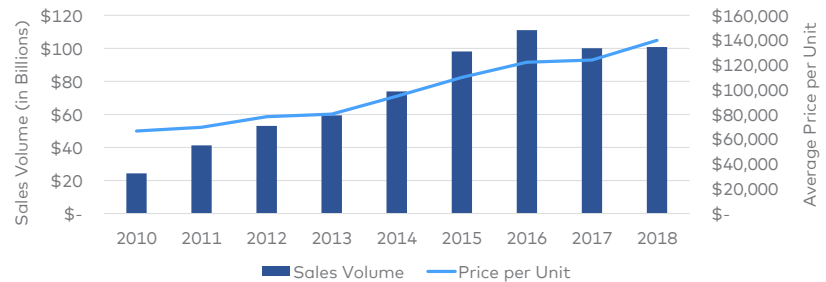
Source: Yardi Matrix

property performance—that could lead to softening of cap rates.

The sense of caution among investors is playing out by segment. Demand for in-favor asset types multifamily and industrial is much stronger than for less-favorable hotel, retail and office properties. Transaction volume was roughly level in 2018, but anecdotally, sellers are getting fewer bids and buyers are seeking to price in the fact that rent growth is likely to moderate as the economy slows in coming years.

Tightening loan spreads reflect the healthy appetite among lenders to book loans, but the Mortgage Bankers Association (MBA) reported that commercial mortgage originations in 3Q18 fell 7% from the same quarter a year ago. The biggest drop came from CMBS, which fell 53% year-over-year, and commercial banks, which originated 22% less than a year ago, according to the MBA's survey. Life companies and the government-sponsored enterprise (GSE) multifamily lenders posted slight increases in lending.

The decline in lending is more a reflection of demand than supply. No major source of debt capital is pulling back, and the number of debt opportunity funds is on the rise. Both total CRE

($3.3 trillion) and multifamily ($1.3 trillion) mortgage debt outstanding as of 3Q18 are at all-time highs, according to MBA.

Lenders are acting much differently at this stage of the cycle than they were in the last cycle, when loan terms became ever more aggressive until the market collapsed. Today, lenders are competing hard on pricing, offering more interest-only periods and easing some covenants, but are keeping leverage at 60 to 70% and requiring borrowers to have significant equity stakes. Whether that will be enough to prevent a wave of defaults when the next downturn occurs is not clear, but debt sources will have less capital at risk this time around.

Lenders are also discriminating among property types to make their portfolios as recession-proof as possible. Demand for industrial and multifamily—property types that are expected to retain strong demand in upcoming years no matter how the economy performs—is insatiable, while there are fewer lenders that want to add holdings in asset classes that have a less certain fundamentals outlook. MBA reports that loan volume in the third quarter declined 55% year-over-year for health care properties, while retail (28%), hotel (19%)

Mortgage Bankers Association Index
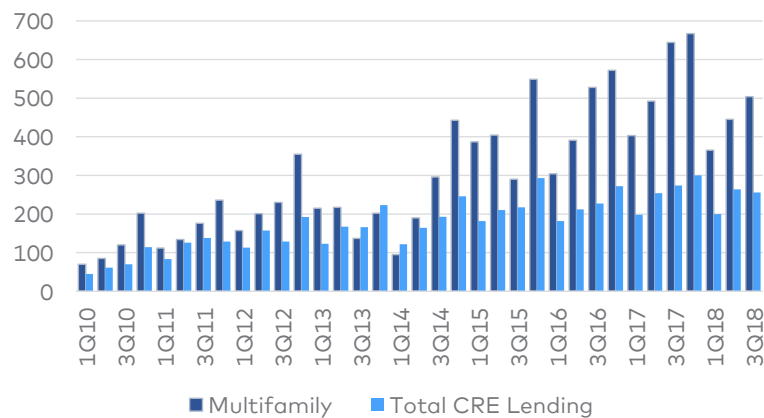
Source: Mortgage Bankers Association

and office (17%) also fell. Meanwhile, the volume of loans backed by multifamily and industrial properties each rose by 19%.

Another year of uncertainty surrounds Fannie Mae and Freddie Mac. With Congress split between a Democratic House of Representatives and Republican Senate, the odds are long that legislation to reform the GSEs will get passed. However, the Trump administration's proposal to appoint Vice President Mike Pence's chief economist, Mark Calabria, as head of the Federal Housing Finance Agency to oversee the GSEs could be a sign that their mandates will be shrunk. Calabria has long been a critic of the agencies and has been a vocal advocate of ending conservatorship.

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Definitions

Lifestyle households (renters by choice) have wealth sufficient to own but have chosen to rent. Discretionary households, most typically a retired couple or single professional, have chosen the flexibility associated with renting over the obligations of ownership.

Renter-by-Necessity households span a range. In descending order, household types can be:

■ A young-professional, double-income-no-kids household with substantial income but without wealth needed to acquire a home or condominium;

■ Students, who also may span a range of income capability, extending from affluent to barely getting by;

■ Lower-middle-income ("gray-collar") households, composed of office workers, policemen, firemen, technical workers, teachers, etc.;

■ Blue-collar households, which may barely meet rent demands each month and likely pay a disproportionate share of their income toward rent;

■ Subsidized households, which pay a percentage of household income in rent, with the balance of rent paid through a governmental agency subsidy. Subsidized households, while typically low income, may extend to middle-income households in some high-cost markets, such as New York City;

■ Military households, subject to frequency of relocation.

These differences can weigh heavily in determining a property's ability to attract specific renter market segments. The five-star resort serves a very different market than the down-and-outer motel. Apartments are distinguished similarly, but distinctions are often not clearly definitive without investigation. The Yardi® Matrix Context rating eliminates that requirement, designating property market positions as:

Market Position	Improvements Ratings
Discretionary	A+ / A
High Mid-Range	A- / B+
Low Mid-Range	B / B-
Workforce	C+ / C / C- / D

The value in application of the Yardi® Matrix Context rating is that standardized data provides consistency; information is more meaningful because there is less uncertainty. The user can move faster and more efficiently, with more accurate end results.

The Yardi® Matrix Context rating is not intended as a final word concerning a property's status—either improvements or location. Rather, the result provides reasonable consistency for comparing one property with another through reference to a consistently applied standard.

To learn more about Yardi® Matrix and subscribing, please visit www.yardimatrix.com or call Ron Brock, Jr., at 480-663-1149 x2404.

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