Yardi® Matrix

U.S. Multifamily Outlook

Summer 2019

Strong Fundamentals Support Lasting Growth

Rent Gains Show No Signs of Letup

Investor Appetite Boosts Capital Markets

Labor Shortage Hinders Completions

Market Analysis

Summer 2019

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Still Room to Run for Multifamily, Despite Prolonged Cycle

- At mid-year 2019, the multifamily market is continuing its strong fundamental performance with prospects for the next few years remaining bullish. Rent growth has stabilized at just over 3%, and we expect a 2.6% increase for the full year—the seventh straight year above the 2.5% long-term average.

- Rent growth is led by metros in the Southwest and South with fast-growing economies and relatively affordable housing, but strong gains are being recorded in most metros across the country. The healthy economy and employment market, along with demographic and social factors, are creating healthy demand for apartments.

- Although growth remains steady, there are concerns about the U.S. economy as the strong and steady growth trajectory of the last few years has begun to show some cracks. Trade tensions, slowing global growth and an inverted Treasury yield curve may be starting to outweigh healthy employment, steady energy prices and continued growth of the technology industry.

- Supply nationally has increased by about 300,000 units annually, and we expect that to continue for another couple years. There are 600,000 units under construction but, with the construction labor shortage, the units are taking longer from start to finish.

- Capital markets are supportive of a healthy market. Investor demand for U.S. apartments is robust, as the sector is seen as a safe haven in an increasingly uncertain environment. The 100-basis point drop in the 10-year Treasury yield also restores a high premium over borrowing costs. Demand for debt is so high that agency lenders are burning through their allocations and other lenders are picking up any slack.

Economic Outlook

Spread Between 3-Mo and 10-Year Treasury

Source: Federal Reserve

The U.S. economy sits on shaky ground as we pass the halfway mark of 2019. The strong and steady growth trajectory of the last few years has begun to show some cracks. Trade tensions, slowing global growth and an inverted Treasury yield curve may be starting to outweigh the healthy employment, stable energy markets and continued growth of the technology industry.

Low inflation and an inverted yield curve prompted the Federal Reserve to drop its Fed Funds Target Rate for the first time since 2008, and another rate decrease is expected to come before year-end. The question, however, is whether dropping short-term interest rates will stimulate the U.S. economy, or will it be "too little, too late" to provide a jumpstart. Given that rates have been low for a long time, a 25-basis point cut in rates might not have a large impact on business spending.

After strong GDP growth in 2018 (2.9%) and the first quarter of 2019 (3.2% annualized), economic growth slowed to 2.1% on an annualized basis with the first read of second quarter GDP. We expect the slowing trend to continue, and the economy will likely expand around 2% for the year.

Another dark cloud looming on the horizon is U.S. trade policy with China. Since President Donald Trump removed the U.S. from the Trans-Pacific Partnership and escalated rhetoric surrounding trade tariffs, global financial markets have been unsteady. The president's strategy is to talk tough and impose tariffs to bring other countries to the bargaining table on trade deals, but the tariffs have increased costs for U.S. businesses and consumers and have had limited effect on negotiations. The long expansion continues nonetheless, built on strong fundamentals. But the warning signs for slowing growth are not lost on bond investors.

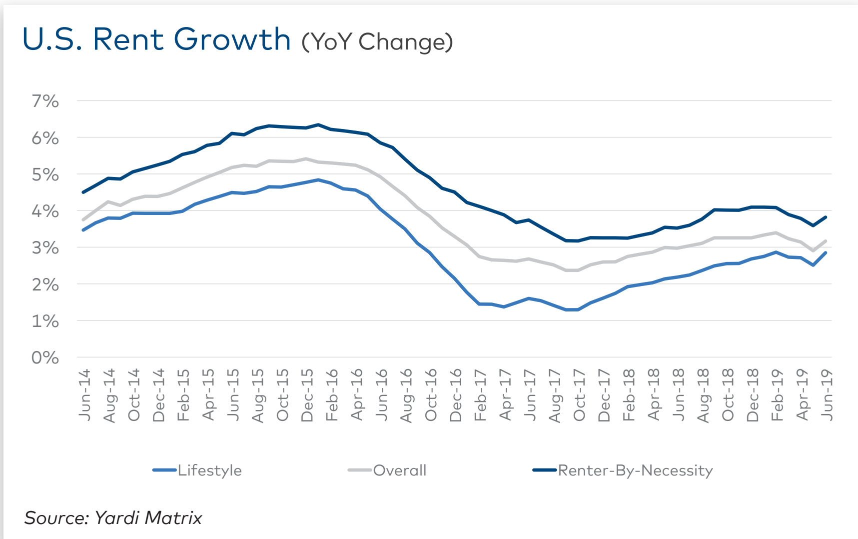
The saving grace for the U.S. economy continues to be the labor market. New job formation, low unemployment and steadily increasing wages provide stability and support to an otherwise unsettled economic situation. As of June, U.S. employers have added jobs in 105 consecutive months, by far the longest expansion in the post WWII era. Unemployment sits near 50-year lows at 3.7% and, with such a significant number of job openings, candidates that in previous cycles remained on the sidelines are being pulled into the labor force. Minorities, older workers and individuals with criminal records are entering the labor market in large quantities as employers cannot be as selective or discriminatory as they have been in years past. All indications point to additional employment growth, as workforce participation increases and job formation remains hot.

The likelihood of a recession in the next two years is small. While asset prices have increased to all-time highs, there is no clear bubble waiting to burst and sink the economy. Given the unemployment rate and the lack of significant leverage in commercial real estate, an economic downturn will probably not have as big of an impact on multifamily as the Great Recession.

With robust demographic fundamentals providing a tailwind to the multifamily industry, apartment owners will likely be able to weather the oncoming economic storm. Demand for class B and C apartments will increase as economic fundamentals wane. Class A properties may feel more pain, but demand for apartments will remain strong across asset classes.

Rent Growth Trends

Multifamily rent growth got out of the gate slowly in 2019, leading the industry to wonder if the above-average increase streak would end in 2019. But since rent growth resumed second quarter, the answer seems to be "no."



Through mid-year, rents are up 2.6% year-to-date and 3.3% year-over-year. The market now looks poised to further extend what has been an already protracted cycle, with rent growth unwavering in a large swath of markets. As of mid-year, only a handful of markets saw increases of 2.5% or less. We expect normal seasonal leveling of rent growth in the second half but a full-year increase of 2.6%, or 10 basis points above the 2.5% long-term average.

By class, apartments aimed at the middle and lower end of the spectrum continue to lead in rent growth. New supply is heavily concentrated in the Lifestyle segment in most markets, while the strongest demand is in the working-class Renter-by-Necessity segment. As a result, rents in the segment have risen 3.8% year-over-year, while Lifestyle rents saw improvement top out at 2.9%. Moving forward, the supply-constrained Renter-by-Necessity segment will likely continue to lead gains, as the pipeline continues to tilt towards upscale rentals.

Demand should remain strong for the foreseeable future due to the healthy employment market and demographic trends. Employment growth has shifted down a gear in 2019 from its lofty post-2010 average of 200,000 new jobs/month, but movement is still positive across sectors, pushing unemployment further below the 4.0% mark. Continued job gains have also spurred increases in household formation, and—amid heightened home prices and high ownership barriers in most major metros—an increasing share of that growth is going to rentals.

Affordability remains a sticky point. With U.S. apartment rents averaging $1,465 as of June, the result is a cost-burdened renter cohort, which accelerates the migration from high-cost metros in the Northeast and Midwest to the Southwest and Southeast. Rapidly growing metros include Las Vegas, Dallas, Austin, Orlando, Phoenix, and the Inland Empire—their populations have increased at least 300% since 1970, per U.S. Census data. Rent growth also outpaces older, core markets.

Late-cycle conditions in these markets continue to drive rent growth through 2019's mid-point and onward. Las Vegas (8.4%) and Phoenix (8.1%) have surged more than expected, while the momentum has helped push rents to new highs in smaller markets in their respective states—Reno (3.5%) and Tucson (6.1%).

Tacoma (5.7%), Albuquerque (5.5%), Sacramento (5.3%) and Colorado Springs (5.1%) are all small markets benefitting from proximity to expanding tech markets facing rising affordability issues. These markets added a combined 1,300 units through June, putting more upward pressure on rents and the overall occupancy rate in stabilized assets—all had rates above 95.0% as of May.

Houston and Miami were the only two major metros with below-1.0% rent growth year-over-year—at 0.8% and 0.9%. Houston's multifamily market faced strong barriers to growth post-energy crisis, but recovery after Hurricane Harvey alleviated those issues, resulting in a short-term spike in occupancy and rents. Both are slowly regressing back to the mean. Meanwhile, the bulk of Miami's multifamily growth is occurring in its condominiums, as a global gateway for outside capital.

Metros	2019 Rent Forecast % Change	YoY Change June 2019
National–All Markets	2.6%	3.0%
Las Vegas	5.4%	8.4%
Phoenix	5.3%	8.1%
Tucson	5.1%	6.1%
Tacoma	4.9%	5.7%
Winston–Salem	4.7%	4.8%
Colorado Springs	4.3%	5.1%
Long Island	4.3%	5.1%
Jacksonville	4.1%	4.1%
Nashville	4.1%	4.1%
Southwest Florida Coast	4.1%	1.0%
Raleigh	4.0%	4.4%
Orlando	4.0%	3.0%
Milwaukee	4.0%	3.4%
Twin Cities	4.0%	4.0%
Seattle	3.9%	3.1%
Memphis	3.8%	3.6%
Sacramento	3.8%	5.3%
Austin	3.7%	4.9%
Inland Empire	3.6%	4.2%
St. Louis	3.6%	2.4%
Louisville	3.6%	3.4%
Knoxville	3.6%	3.6%
Columbus	3.6%	2.6%
Tampa–St. Petersburg	3.5%	3.1%
Los Angeles	3.5%	3.2%

Source: Yardi Matrix

Supply

U.S. multifamily deliveries topped 105,000 units by mid-year and just under 300,000 units are expected to be added for the full year. With roughly 600,000 units under construction, we expect that the string of years in the range of 300,000 deliveries will continue through 2020 at least. Some 1.3 million multifamily units were added between 2015 and 2018.

New construction is fueled by strong demand as roughly 1 million households are being formed annually. Occupancy rates of stabilized properties dropped from multi-decade highs of 96% in late 2017 and early 2018, but the current rate of 95.0% indicates that most of the new product is being filled and occupancy is only a problem in a handful of metros. The absorption of new units is also evidenced by consistent rent growth in the 3% range.

Inventory growth might have spiked even higher previously but is being held back by the construction labor shortage, which is extending the time it takes to complete projects. Construction delays have resulted in deliveries spread across years, allowing the market to absorb incoming supply and keep rent and occupancy rates at strong levels. The average occupancy rate in stabilized properties has bounced back to 95.0% as of May, after a dip below that mark last winter, and is down by just 20 basis points year-over-year.

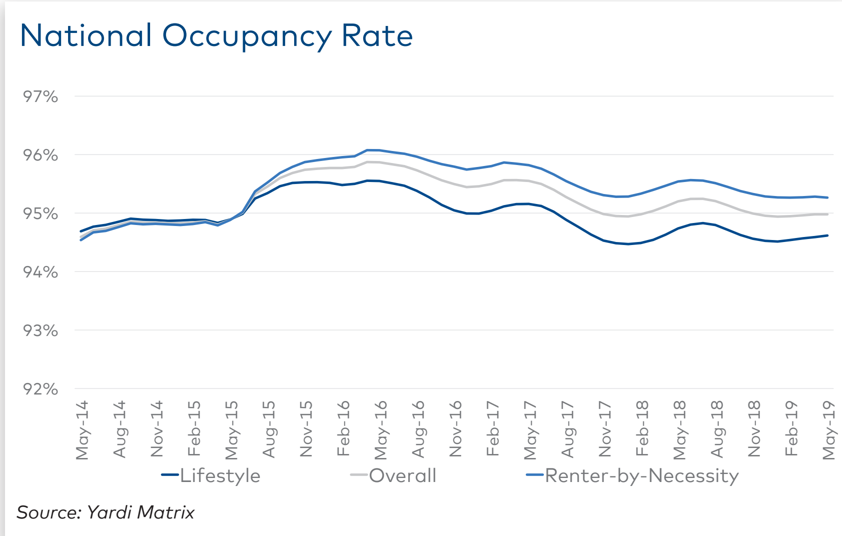
Construction financing has also been a limiting factor, though probably a slight one at this point. Some commercial banks have cut back on financing new supply, but private equity lenders have stepped up and are actively financing new deals.

Dallas (23,711 units), Seattle (16,385), Miami (16,176), Austin (13,545) and Washington, D.C.,

Metros	2019 Forecast Completions	2019 Completions % Change
National–All Markets	265,000	1.9%
Dallas	19,110	2.6%
Seattle	13,056	5.4%
Miami	12,695	4.4%
Austin	10,640	4.6%
Washington, D.C.	9,679	1.9%
Atlanta	8,867	2.1%
Phoenix	8,597	2.9%
Los Angeles	8,262	2.0%
Denver	8,169	3.1%
New York City	7,631	1.4%
Chicago	7,321	2.2%
San Jose	7,299	5.9%
Houston	6,704	1.1%
Charlotte	6,275	3.7%
Boston	6,198	2.8%
New Jersey–Northern	5,378	2.5%
Orlando	5,118	2.4%
Portland	4,560	3.0%
Raleigh	4,554	3.0%
San Francisco	4,534	1.8%
Nashville	4,183	3.2%
Tampa–St. Petersburg	3,843	1.8%
Columbus	3,827	2.3%
Twin Cities	3,726	1.8%
Salt Lake City	3,423	3.5%

Source: Yardi Matrix

(11,721) lead the way for expected deliveries in 2019. Tech-driven markets are on the up and up. Seattle, Austin, Denver and San Jose all ranked in the top tier by both actual number of units and percentage of stock, highlighting the appeal of the sector, especially with the Millennial cohort. That segment of the population is also more likely to stay on as renters for a longer time in upscale areas near the market's core or important intellectual nodes.



The result is a propensity for developing Lifestyle assets, which can temper the high costs of construction with higher returns. Significant wage increases in office-using employment sectors and the solid performance of manufacturing in some markets in the South have resulted in strong demand for high-end rentals, keeping rent growth in the Lifestyle segment positive despite the supply imbalance between upscale and blue collar-aimed multifamily assets.

Although rents in Albuquerque have overperformed throughout the year, developers have been slow to add projects to the pipeline. Other markets with solid rent growth that have been largely underserved are Long Island, Knoxville, and Sacramento. These markets have become a haven for renters looking to commute to strong employment centers with prohibitive rental rates.

Capital Markets

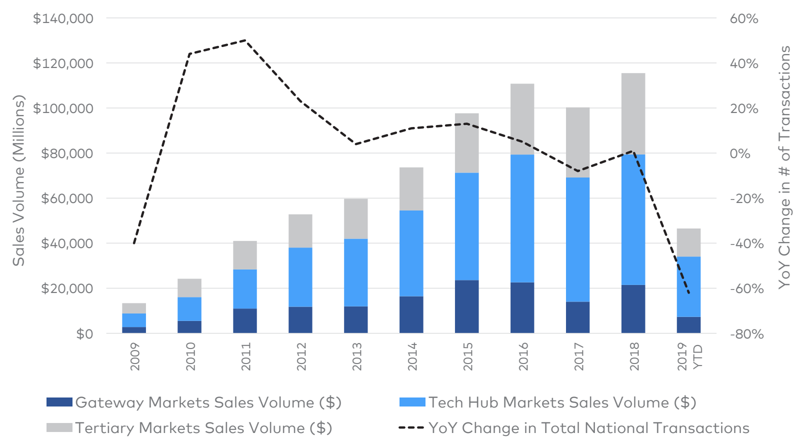
Multifamily continues to benefit from healthy capital markets conditions. The appreciation in property values has moderated, but prices continue to rise. Despite questions about the future direction of the government-sponsored enterprises (GSEs), multifamily debt outstanding hits new highs every quarter.

The unexpected decline in interest rates is a mixed blessing. Commercial real estate tends to thrive in low-interest rate environments, but the drop portends pessimism about the economy from a major part of the financial markets. Nonetheless, one of the reasons that multifamily is so liquid is that investors believe that performance will remain strong for an extended period and that it is uniquely positioned to remain stable even if there is an unexpected negative change in economic conditions.

Transaction volume for multifamily reached a cycle high of $115 billion in 2018, a signal that demand is not diminishing, even at this late stage of the economic cycle. A large amount of capital is seeking to invest in commercial real estate, and even if some drops out because of fears about the economy or pricing, there remains a huge amount of dry powder willing to step in.

That has helped maintain acquisition yields at historic lows, despite the gyrations in interest rates over the last nine months. Although some acquisition activity fell through, yields of completed deals barely blinked when the 10-year Treasury topped 3.2% in the fourth quarter of 2018 and they have remained steady as the rate fell to 2.0 percent in June. We expect that the restored premium between the risk-free rate and multifamily acquisition yields will help maintain capital flows to the segment.

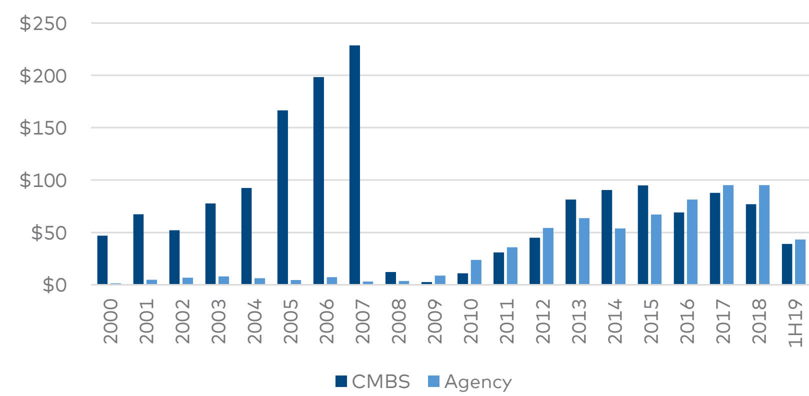
Sales Volume by Market Type



Source: Yardi Matrix

Opportunity Zones might provide another source of transaction activity for the market. The 2017 law gives a tax break to investors in properties in designated low-income zip codes. Fundraising for funds has increased substantially this year, as more than 300 funds are raising upwards of $50 billion to invest. We would expect Opportunity Zone deal flow to increase in the second half.

CMBS, Agency Bond Issuance



Source: Commercial Mortgage Alert

After years of all talk and little action with the GSEs, the Trump administration does appear to be on the verge of doing something to reduce the footprint of Fannie Mae and Freddie Mac. It is unlikely for legislation changing the mission of Fannie and Freddie to pass before the 2020 election, but the new Federal Housing Finance Agency director, Mark Calabria, is expected to impose administrative limits on the agencies. It is not clear what that will entail, but the agencies' lending caps on market- rate properties could be reduced from the current level of $35 billion per year. The agencies also do a substantial amount of lending outside the caps on properties that meet prescribed thresholds for affordability and action on energy improvement. That part of their mission is less likely to be changed.

The argument for keeping the GSEs strong is to preserve housing market liquidity in the event of a downturn. Today, though, there is no shortage of lenders willing to step in if the agencies' wings are clipped. Banks and CMBS in particular have the capacity and the desire to increase lending in the multifamily arena. Debt funds and lenders funded through collateralized loan obligations are also a growing part of the market for financing transitional properties and new construction.

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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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