Institutional Property Advisors

A Marcus & Millichap Company

Institutional Apartment

January 2012 RESEARCH REPORT

2012 Annual Forecast

Apartment

1.5% employment increase

118% construction increase

40-basis-point vacancy decrease

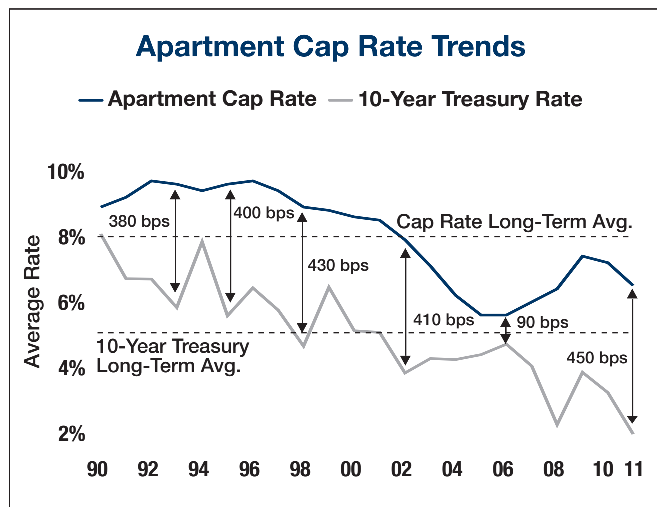
3.8% asking rent increase

4.8% effective rent increase

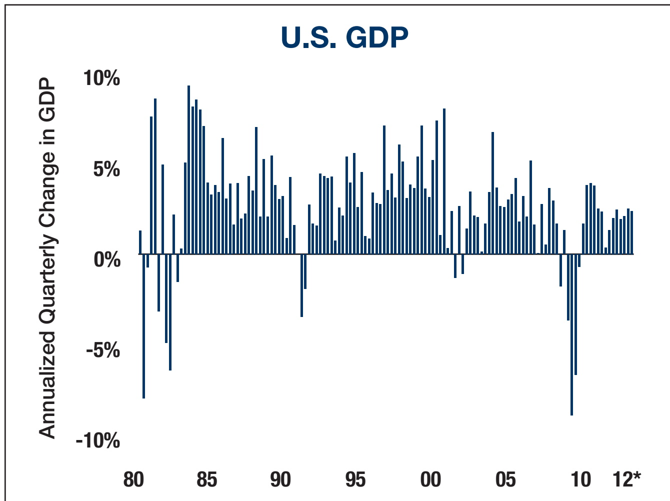
Robust Demand Overshadows Construction Pipeline; Apartments Push into Full Expansion

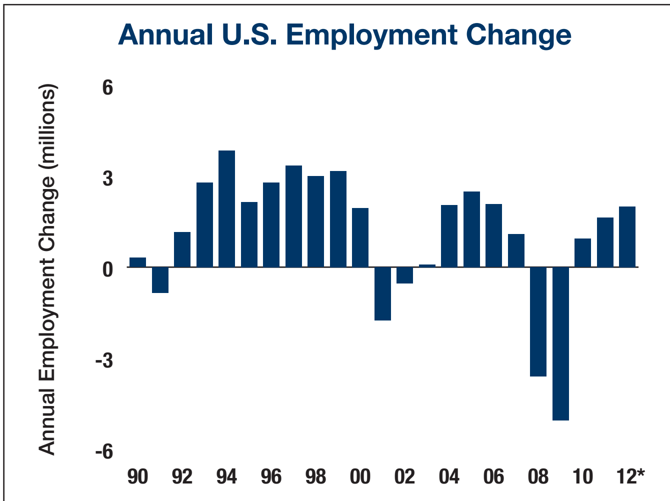
The apartment recovery cycle began as early as 2009 in some markets, with demand reversing from negative territory and moving well ahead of expectations and all other property types. The speed and sharpness of the apartment recovery across most U.S. markets belied the severity of the employment downturn in the last recession. Property performance improved meaningfully throughout 2010 before transitioning from recovery to full expansion mode in 2011, when all markets posted vacancy decreases and effective rent growth. The relatively moderate pace of economic recovery thus far has not deterred neither private nor institutional investors from continuing to direct generous amounts of capital toward apartment property acquisitions. Although strong demand for apartment properties compresses both going-in returns and internal rates of return, cash yields relative to the risk-free rate remain attractive to investors. The widely held view is that robust demographic trends and tighter space fundamentals will also support strong apartment performance over the next several years.

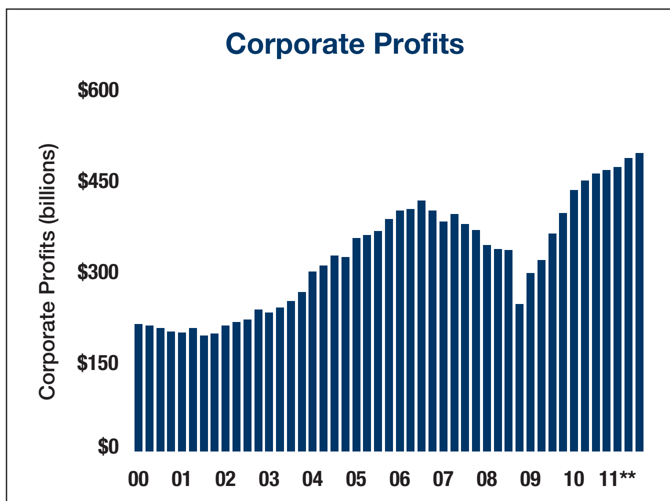
Four major factors drove demand for top-tier assets in preferred markets at the onset of recovery: asset pricing below replacement cost; a limited buyer pool; a significant gap in interest rates relative to cap rates; and the prospect of stronger property revenues and values derived from significant rent and occupancy gains. By the end of the first half of 2011, owners of Class A assets had already reaped many of the benefits of operational improvements. Cap rate compression in this product tier narrowed the interest rate arbitrage and an expanded buyer pool pushed pricing within reach of replacement cost in some markets.



During the second half of 2011, a pause in transactions occurred in the top-tier segment against a backdrop of significant macro-level economic and political pressures, such as the eurozone financial crisis and U.S. political stalemate, as well as a hint of deal fatigue. In addition, capital availability hit a snag when equity sources briefly receded in response to capital market volatility. Buyer pools have since thinned out and cap rates for this segment have increased 25 to 50 basis points, but institutional investors still demand core assets in preferred markets and those transactions remain highly desirable and competitive. The lull in sales should fade as the year progresses and as economic data continues to post upside results. Allocations to commercial real estate, apartments in particular, should remain intact, generating more sales throughout 2012, although investors remain cautious about the magnitude of rent and occupancy gains still to be achieved.







*Forecast
**Through 3Q

Economy Faces Marathon Recovery

The absence of a defining driver in GDP growth, government cutbacks, and skittish consumer and business confidence often overshadowed the incremental gains propelling U.S. economic growth throughout 2011. This miscue resulted in modest employment growth and low wage and income growth. In perspective, the private sector has added 3.2 million jobs since the employment trough, representing a recovery of 36 percent of the jobs lost in the peak-to-trough period of January 2008 to February 2010. The unemployment rate fell 90 basis points over the last year to 8.5 percent in December, marking a significant decline. In addition, retail sales eclipsed the pre-recession level, corporate profits moved 19 percent higher than the third-quarter 2006 peak, and exports comprised 13 percent to GDP. While GDP growth measured well below the historical trend at 1.7 percent in 2011, holiday retail sales exceeded expectations. Meanwhile, fixed residential investment surprised to the upside with a surge in home renovations, multifamily starts, and a modest gain in single-family home starts.

Numerous challenges that could undermine the U.S. economic recovery will persist in 2012, including the pervasive political stalemate and indecision. The eurozone financial crisis presents another risk, as the potential for a mild eurozone recession could stall productivity. The pace of export growth may contract if eurozone countries slip into recession, muting strength in corporate profits. Emerging markets could support global trade and absorb some of the slack, but certainly not all of it. The biggest obstacle to growth, however, remains the climate of uncertainty, which both attenuates consumer demand and impairs progress in job gains, leaving the economy vulnerable.

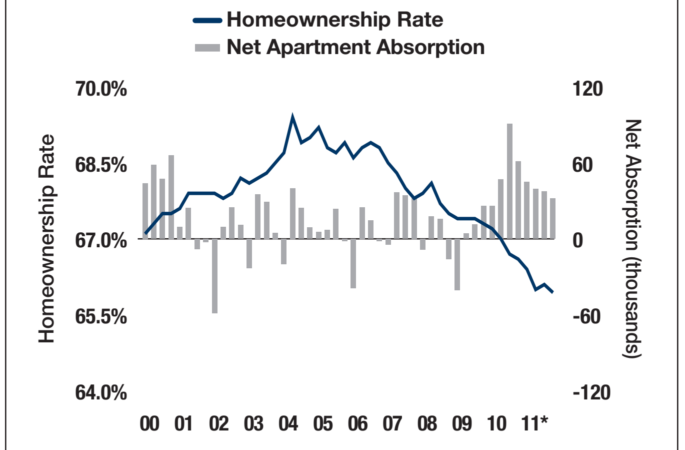
The upward trend in economic indicators supports prospects for a marathon-like recovery and moderate growth. Manufacturing and expansion in new orders suggest stronger productivity over the next year. GDP should strengthen to 2.2 percent in 2012, based on stronger consumer spending and business fixed investment. It is expected to remain a pillar of growth, both in capital equipment and, increasingly, non-residential structures as fundamentals improve. Modest employment growth will prevail until GDP returns to its 3.2 percent historical average, but the U.S. economy is forecast to add 2 million jobs this year, outpacing 2011. Improved business confidence should transition a significant portion of robust hiring in temporary job placements to permanent jobs.

Diverse Forces Sustain Apartment Absorption

The third year of positive momentum advanced the U.S. apartment sector squarely into the expansion phase of the real estate cycle. Remarkable apartment performance over the past two years offered proof of the sustainability of the apartment sector recovery and the resiliency of solid apartment investments. Looking forward, the sector's maturity along the real estate cycle raises new questions regarding:

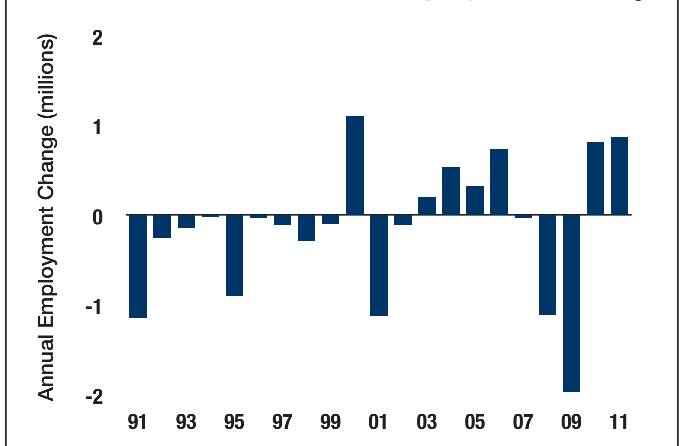
- Sources and strength of future demand
- Affordability and Class A rent growth relative to incomes
- Markets suitable for light value-add investments
- Effects of a new development cycle
- Expectations for exit cap rates

Early into the recovery, a dominant source of demand for rental housing derived from the displacement of both former homeowners and renters of investor-owned homes, which ultimately fell into foreclosure. The homeownership rate measured 66.1 percent as of the third quarter of 2011, marking a reduction of 160 basis points over the past three years. The shift in tenure alone produced an increase of nearly 2.4 million renter-occupied households, a stark contrast to the decline of nearly 800,000 owner-occupied homes. More recently, employment gains in the 20- to 34-year-old prime renter cohort captured a 71 percent share of the 1.7 million jobs created from 2010 and through October 2011. The release of pent-up demand from "bundled up" households provided a significant boost to apartment demand. Combined net absorption over the past two years totalled more than 378,000 units, outpacing by nearly three times the 137,000 units delivered. The national vacancy rate plummeted 260 basis points to 5.4 percent in a two-year period, despite below-average employment growth.

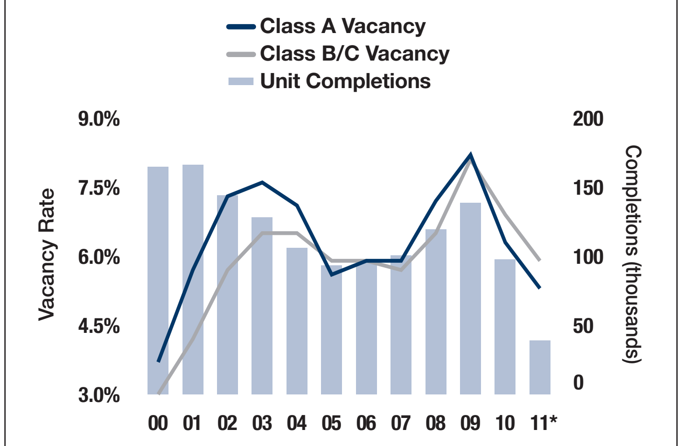


Class A Leads Recovery; Others Follow

Despite the broad-based national recovery, not all apartment properties or markets recorded stellar gains. Superior performance linked first to markets with strong ties to the trade, technology, energy and health and education sectors, and second to the age and quality of the properties. The vacancy spread between Class A and B/C properties narrowed recently to 50 basis points at a national level, posting 5.1 and 5.6 percent vacancy, respectively. Class B/C properties lagged Class A performance and recovery, posting negative net absorption in eight of the 10 years prior to the recovery. Class B/C properties turned a corner in 2010, recording positive net absorption equal to about half the rate of Class A net absorption and posting gains on par with Class A product in 2011. Class A and B/C vacancy have recovered by 310 and 250 basis points from peak, respectively.



The difference between Class A and B/C product is most apparent at both extremes of high and low barrier-to-entry markets. Class A product maintains a highly favorable vacancy differential in low barrier-to-entry markets, such as Atlanta, Houston and Phoenix. Heavy development in these markets during the last construction cycle has created a surplus of options for renters, with many of them opting for top-tier units offered with healthy concessions. Meanwhile, Class B vacancy rates are significantly lower than Class A in perennially low vacancy, high barrier-to-entry markets, such as San Diego, Los Angeles, Boston and San Francisco. Key factors supporting properties in higher-barrier markets include, high home prices, steep construction costs, and generally higher rents. On a national basis, revenues for Class A product outpaced Class B/C, increasing an average of 4.4 and 3.5 percent annually for the past two years, respectively. The price to build in high barrier-to-entry markets is cost and time prohibitive, but they serve a large household base that rents by necessity, making them excellent candidates for light value-added investments.



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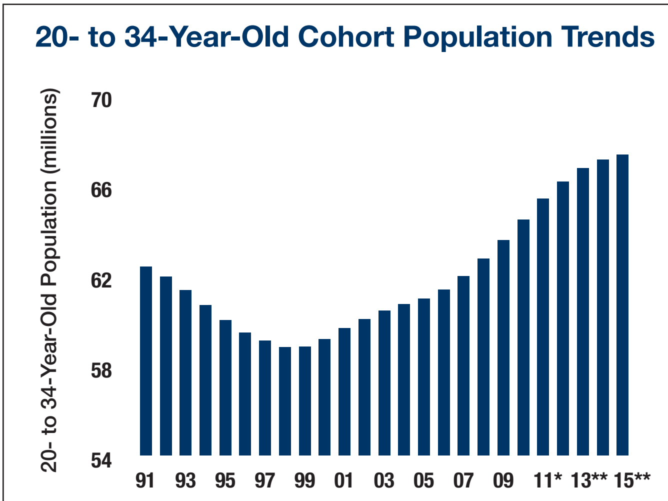

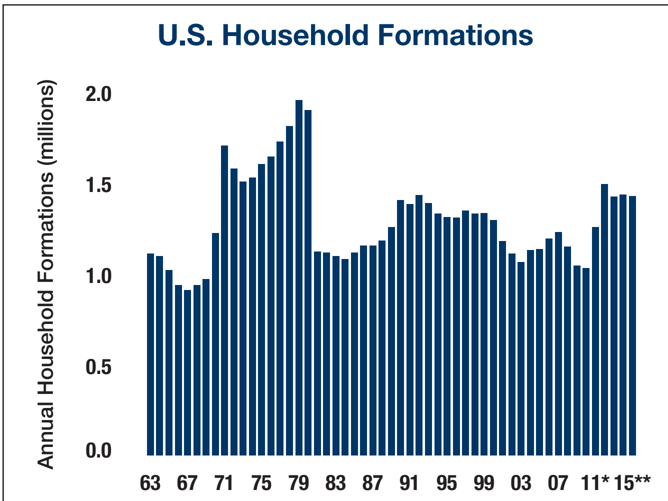

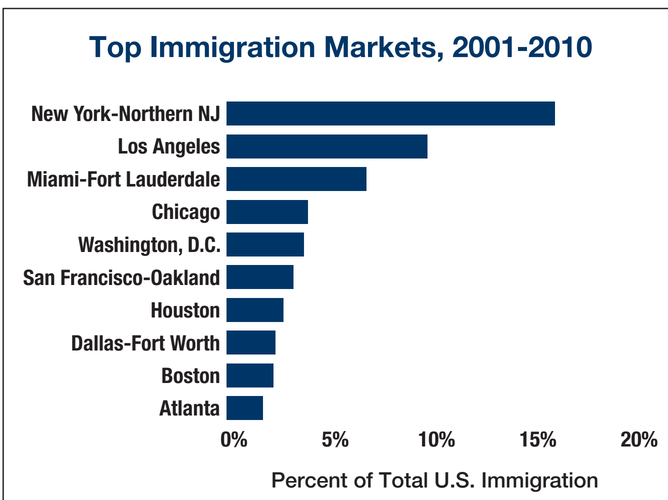

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Multiple Demand Drivers Converge; Apartments Enter Expansionary Phase

The progression of echo boomers reaching prime renter years will expand the 20- to 34-year-old age cohort by approximately 3.2 million over five years. Higher levels of employment and household formations are requisite to sustain superior apartment performance over the next decade, with demographic trends and immigration underpinning demand. Employment growth of approximately 2 million is forecast for 2012, before accelerating meaningfully into 2013 and peaking at an estimated 4.1 million in 2014. Payroll expansion in 2014 is expected to reach the fastest pace since 1994.

Household formations declined sharply in the latter years of the 2000s, likely suppressed by the recession, high unemployment, and low immigration levels. As the recession took hold, immigration slowed to the lowest levels in 30 years and stricter government immigration policies may dampen future inflows. Immigration implies an immediate need for rental housing and thus provides critical support for apartment demand. New household formations are forecast to move off recent lows and increase by 29 percent to an annual average of 1.2 to 1.4 million between 2010 and 2015. These estimates are dependent on immigration, but represent conservative assumptions of immigration levels over the next few years. According to some studies, immigrants are forecast to contribute over 40 percent of net household formations between 2010 and 2020, a stunning rise from an estimated 15 percent contribution in the 1980s. Immigrants are expected to continue to play a key role in the traditional immigration gateway states, such as New York, New Jersey, Illinois, California and Florida. Arizona, Georgia and Texas are the three fastest-growing states for immigration. Demand for entry-level rental housing will remain an important driver in both mainstay and emerging gateway markets.

In addition to the rapid population increase in the 20- to 34-year-olds, the 55-plus age cohort will provide another powerful element of apartment demand over the next five years. As baby boomers progress into their retirement years, rental demand will rise while approximately 20 percent of these households choose or need to rent in the next decade, totaling as many as 2.6 million households. Stabilizing home prices and stronger buyer demand for homes will enable many baby boomers to sell their homes, releasing equity and boosting absorption of apartment units, particularly in Sun Belt states.

The wave of echo boomers, immigrants, retiring baby boomers, and the sharp rise in non-traditional households will exert tremendous influence on demand for all types of housing, but particularly for apartments. Current forecasts suggest that the period from 2007-2014 represents a peak cycle of growth in the 20- to 34-year-old segment of the population. As they enter the workplace in greater numbers, they will likely become the largest contributors to apartment demand.

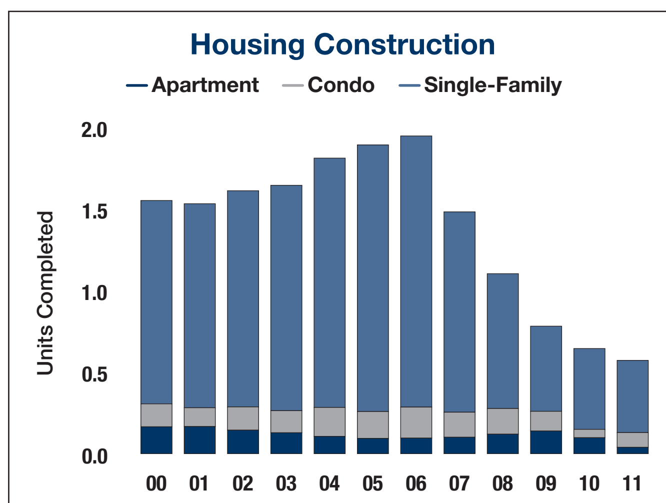
Supply Falls Short; Developers Ramping Up

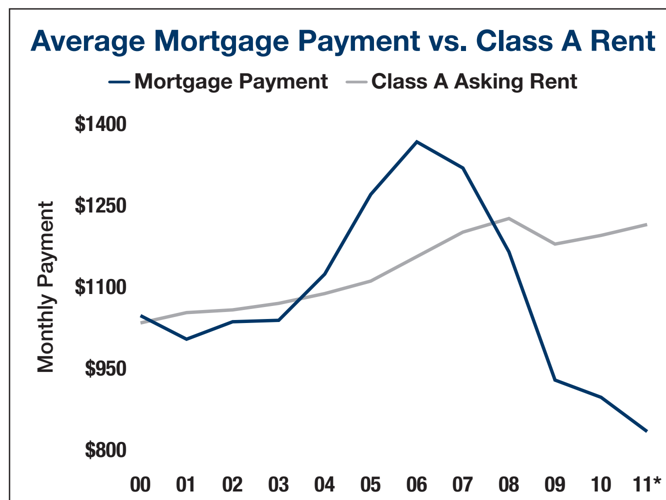
New construction remains less than one percent of inventory, well below the 2.2 percent long-term trend. Completions are forecast to total nearly 85,000 units in 2012, more than double the number delivered in 2011, but still falling short of the 120,000 units forecast for demand. Another decisive decline in vacancy of 40 basis points to 5.0 percent will lift overall effective rent growth 4.8 percent in 2012. Low vacancy will fuel solid rent gains in core markets in 2012, but perhaps not with the same magnitude as the last two years.

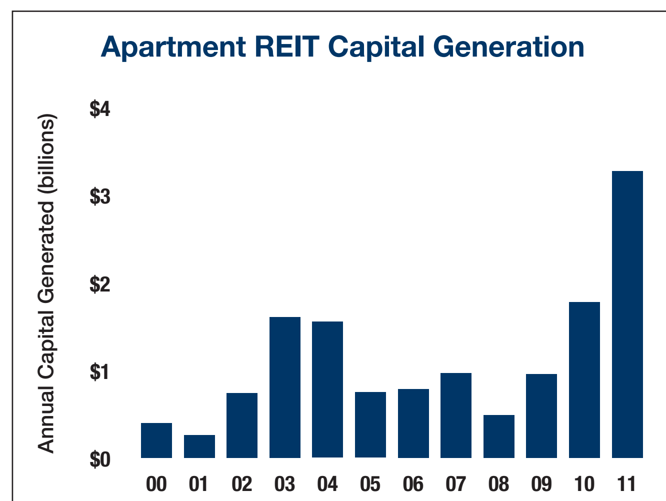
A 26 percent decline in the median home price from the 2006 peak to the year-end 2011 price of $164,600, with a 200-basis-point drop in the fixed interest rate for a 30-year mortgage, results in a spike in affordability that is hard for apartment investors to ignore. Today's median-priced home at current interest rates yields an $830 monthly mortgage payment, 40 percent lower than the $1,389 mortgage payment in 2006. Using traditional financing standards, the minimum income needed to make a mortgage payment has fallen by 40 percent since 2006, significantly boosting the number of households that meet the income requirements. However, the significant down payment and financing hurdles keep homeownership out of reach for many renters.

The rise in recovering apartment rents in tandem with falling home values has resulted in a negative bias to Class A rents in some markets, with a differential of more than $400 compared with a monthly mortgage payment on a national level. This affects more affordable markets that often incorporate depressed home prices in far-flung submarkets that generally would not be a fair comparison to apartment rentals. Although the low-interest-rate environment and approaching trough in home prices will attract some affluent renters to homeownership, the current mindset of many renters appears biased toward renting. First-time homebuyers typically account for 40 percent of existing home sales, but have fallen to 35 percent as of November 2011. Until the labor markets and incomes firm, strict underwriting criteria and a strong preference for mobility will keep rental housing in demand.

Well-capitalized REITS with ramped up pipelines, and developers partnered with a variety of new institutional and private equity sources, will lead the multifamily acquisition and development cycle in 2012. Real Estate REITS issued a record $37.5 billion in shares in 2011, reflecting a 32 percent increase over last year. Multifamily permits increased nearly 91 percent to an annualized 295,000 units as of November 2011, measured on a year-over-year basis, and starts should accelerate meaningfully by mid-year 2012. Actual deliveries should require another 12 to 18 months in lower barrier-to-entry markets and much longer for supply-constrained markets. A two-to-three-year window still exists before pockets of supply imbalance begin to emerge. Infill locations near transportation, business, retail, entertainment and cultural venues increasingly comprise a greater share of new supply, which elevates construction cost but fetch a premium in the market. Investors may view infill, high-density submarkets in traditionally low-barrier markets as having similar characteristics to high barrier-to-entry markets but priced at a discount.







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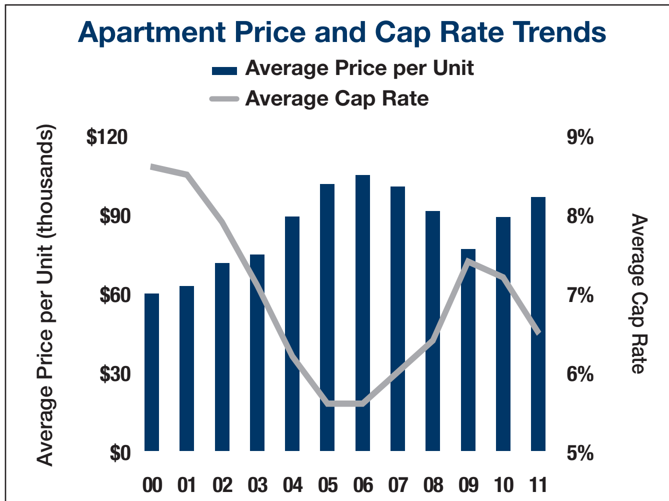
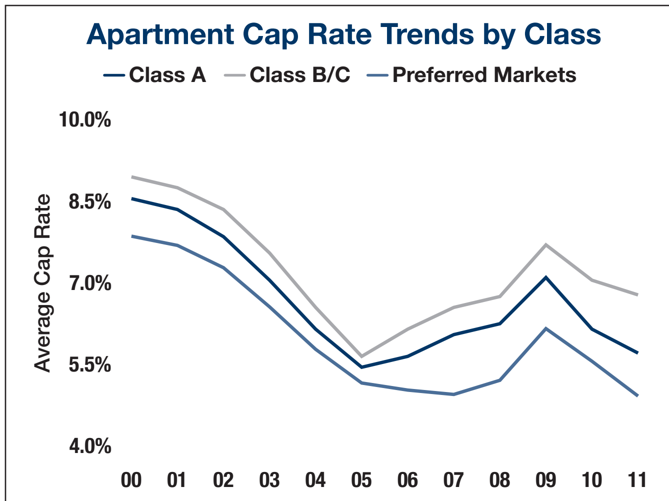
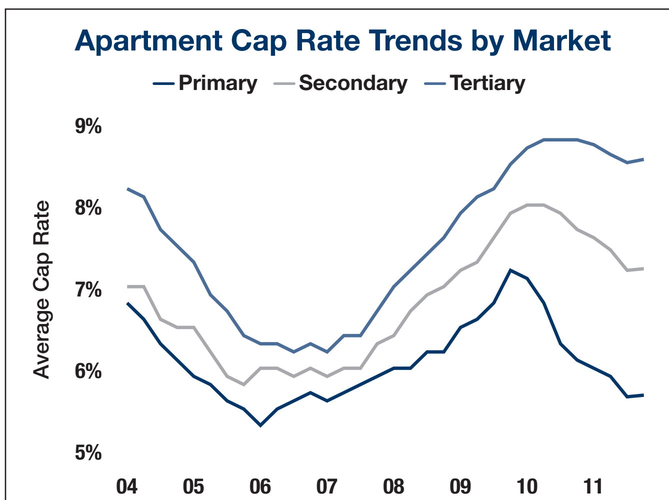






Yield Pursuit Expands Acquisition Targets

The maturation of the apartment investment market over the past 15 years influenced a lower point for cap rates. The average cap rate for apartments in the early-2000s was between 8 and 9 percent, steadily trending down since the early 1990s. This was not only a result of lower interest rates, but also because of the acceptance of apartments as an investment class by institutional and international investors. Further, the advent of apartment REITS and evolution of national data reporting services improved transparency in the industry, further reducing perceived risk.

Increasingly, institutional investors are seeking well-located Class A- and B+ assets in primary markets in need of minor updating and top assets in secondary markets. Stabilized Class B assets with light value-add potential in preferred markets, offering at least a 100-basis-point cap rate spread to Class A assets are also in favor. Investor concerns linger regarding the sustained ability to raise Class B rents, given the lower demographic profile of the residents. These renters often report lower levels of educational attainment and income when compared with residents of Class A units, which often house higher-earning young adults and renters by choice. Class A properties, however, can be vulnerable to residents vacating for home purchases or moving to new construction at discounted, lease up rents. Class B residents tend to be subject to more wage and employment pressure, and price sensitivity. Historically, revenues per unit averaged about 3 percent for both product types, with the exception of the period of 2001 to 2003. Class A revenues weakened relative to Class B/C during this time, before outpacing Class B/C revenues, following the most recent recession.

Demand and pricing for core apartment assets in preferred markets turned aggressive with surprising speed in 2010, ahead of improved property fundamentals, and continuing throughout 2011. Preferred markets typically have higher-cost housing and consistently generate a high level of apartment demand by necessity, offering greater protection from both demand and supply-side risks. While operations can reverse quickly in an economic downturn, resulting in highly volatile cash flow, the structurally lower vacancy rates enable a shorter recovery period. In addition, fewer competing assets available for sale safeguards asset values, resulting in higher appreciation returns and lower perceived risk.

Conversely, markets with low barriers to entry often carry significantly higher demand and supply-side risk, but capture a greater proportion of job and population growth, offering opportunities to rapidly grow occupancy and NOIs in an economic upswing. Buyers could pay more for Class A apartment properties and maintain a reasonable spread over the risk-free rate, which widened to 432 basis points at the end of last year, the largest gap in at least 20 years. Even investments in preferred markets maintained a spread of 252 basis points relative to the 10-year treasury. Significant portfolio transactions boosted apartment sales in the $20 million-plus segment, which approached $38 billion in 2011, reflecting a 43 percent increase over last year and 60 percent of all sales. For a longer-term perspective on apartment sales

trends in the $20 million-plus segment, consider that the average apartment price per unit increased for 12 consecutive years starting in 1994, eventually peaking near $126,000 in 2007. This represents a 10.7 percent average annual increase over the 14-year period and a 5.4 percent average cap rate at peak. Prices contracted nearly 35 percent from peak-to-trough in 2009; however, strong sales momentum in this tier has since lifted the average sale price by 60 percent from the trough to the current $131,500 per unit. In comparison, apartment NOIs rose approximately 16 to 17 percent in 2010 and 2011 combined. In addition, cap rates recompressed by 161 basis points to 5.5 percent. Gateway markets including New York, Washington, D.C., Los Angeles, San Francisco, Houston, Dallas and Chicago dominated investments.

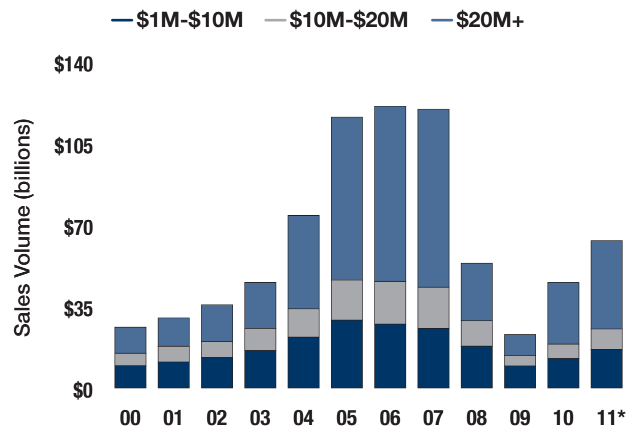
"Preferred" apartment investment markets are generally defined by structural characteristics inherent to coastal markets: A large population base, healthy immigration, geographic and policy constraints on supply, strong market fundamentals, stable incomes, high home prices and rents.

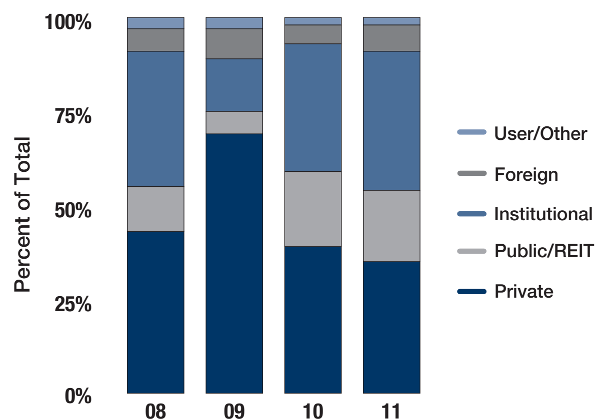
For purposes of this discussion, preferred markets include:

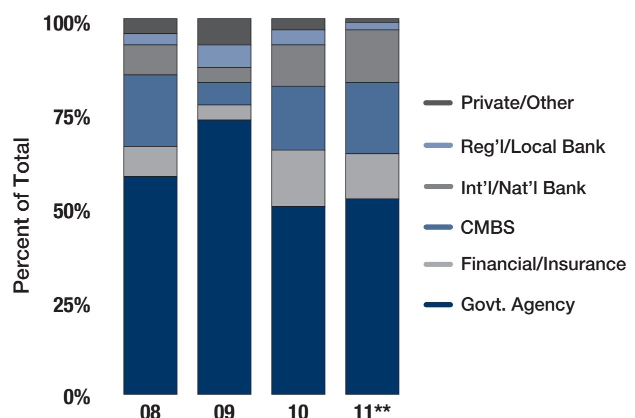
- New York
- Washington, D.C.
- Boston
- San Diego
- Los Angeles
- Orange County
- San Jose
- San Francisco
- Seattle

The composition of apartment buyers in the $20 million-plus tier shifted from the 2009 trough. Equity funds more than tripled their share of acquisitions, while public and institutional investors' share more than doubled. As of year-end 2011, private buyers maintained the largest share of acquisitions at 34 percent, yet this reflects a contraction from 67 percent in 2009. Public and institutional investors combined for a 38 percent share, followed by equity funds at 18 percent. Foreign investment fell to 7 percent from 8 percent, but appears to be rising since the anticipated correction in core property values never materialized.

With recent transactions biased toward core, top-tier markets, and best-in-class assets, stronger operational performance and low-cost debt have broadened buyer demand. Furthermore, yield compression will lead to more sales of Class B and B- properties. Greater sales velocity in a broader spectrum of asset quality and markets in 2012 will create more reliable value estimates and lend support to market pricing in the lower tiers and secondary markets. The cap rate spread for mid-tier assets located in tertiary markets is approximately 300 basis points higher than primary markets at 5.6 percent, with secondary markets ranging within that spread. This arbitrage offers attractive return spreads when viewed with properly assessed risks and a more than five-year investment horizon. Older, Class B renovation candidates located near employment nodes and transit hubs will present worthy investment opportunities in good primary and secondary markets.







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Apartment Total Returns Eclipse Alternatives

Apartments have shown far greater resiliency in holding their values during market downturns. The negative change in appreciation over the peak-to-trough cycle for apartments is roughly one-half to one-third less severe compared with the office, industrial, and retail sectors. Furthermore, comparative statistics offer evidence that apartment values recover in a fraction of the time historically required by other sectors. The sector currently posts the strongest return performance among property types, posting an overall return of 3.6 percent for the third quarter of 2011 and an annualized overall return of 18.6 percent, comprised of a 12.5 percent appreciation return and 5.6 percent income return. Until just recently, apartments were the only property type to have capital appreciation driven by both cap rate compression and NOI growth.

When compared with the volatility of other asset classes, the real estate sector is poised to receive increased investments for its stable cash flows and appreciation. These factors have broadened the appeal of apartment investment beyond traditional private investors and REITs to include sovereign funds, equity groups, and other institutions. This, in turn, enhanced liquidity, particularly for major institutional properties. Apartments offer low space market volatility and therefore the highest risk-adjusted returns. The apartment sector typically performs best in a rising interest rate environment and stands to benefit from the unique demographic trends forecast for the next decade.

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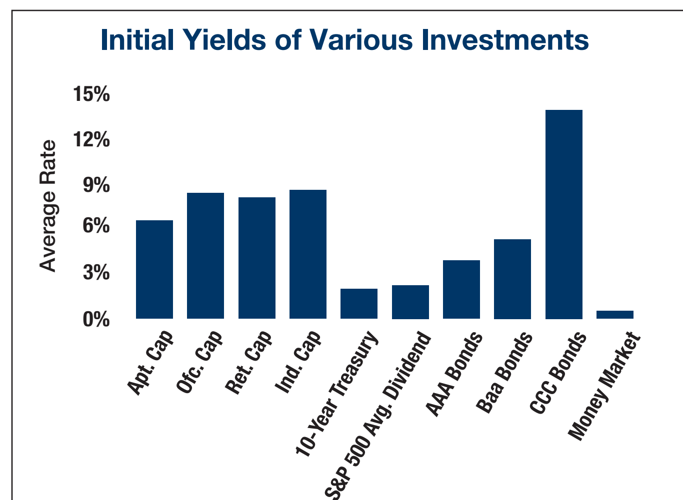

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