Yardi® Matrix

U.S. Multifamily Outlook

Winter 2018

Sustainable Pace?

Investors Benefit From Tax Plan, Cost of Debt

Apartment Deliveries To Hit Cycle Peak

Continued Demand Drives Growth in Rents

Market Analysis

Winter 2018

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A Year of Moderate Growth

After several years of sizzling improvements in fundamentals, 2017 was a year of retrenchment in the multifamily market. Rent growth cooled amid robust development, and occupancy levels—although still solid—began to trend down in some metros. The question heading into 2018 is whether the market has passed its peak and is headed for a correction or whether the sector's bull run has more steam left in it. Our view is that there is some growth left—though it will be tepid for the next 18 to 24 months.

On a big-picture basis, demand for multifamily shows no signs of slowing. The number of Millennials in the prime 20-to-34-year-old renter cohort will keep growing, while retirees will continue to downsize. Forecasts call for household growth of roughly one million per year for the next few years, and although housing is recovering, rental demand will be fueled by urbanization and other social trends such as fewer cars on the road.

Economy: We expect another year of moderate economic growth, with potential upside from the recently passed tax reform bill that will lower tax rates and encourage corporate investment. It likely will take at least a couple of quarters before the impact is felt, though. Job growth could slow as the labor market nears full employment, but should remain healthy.

Rents: Rent growth decelerated significantly in 2017, and we expect moderate increases in the 2% range nationally. Growth will be kept in check by the increases in supply, especially in luxury properties, and the lack of affordability in high-cost metros such as New York and the Bay Area. Demand will remain high in the Sunbelt and growing markets in the West and Southwest.

Supply: We forecast 360,000 deliveries in 2018, which would mark a peak for the cycle and would be up from roughly 300,000 new units that came online in 2017. We expected more deliveries last year, but the shortage of construction workers slowed down the delivery pipeline by lengthening the construction period. The delays do have an upside, giving owners more time to absorb the heavy pipeline.

Capital Markets: There is some healthy caution being interjected into the equity and debt markets, but capital forces remain robust. Property sales have declined slightly for two straight years as buyers start to question how long the positive fundamentals cycle will last, but there is no shortage of capital for appropriately priced assets. Debt availability remains as strong as ever, led by Fannie Mae and Freddie Mac, which could hit another year of record lending.

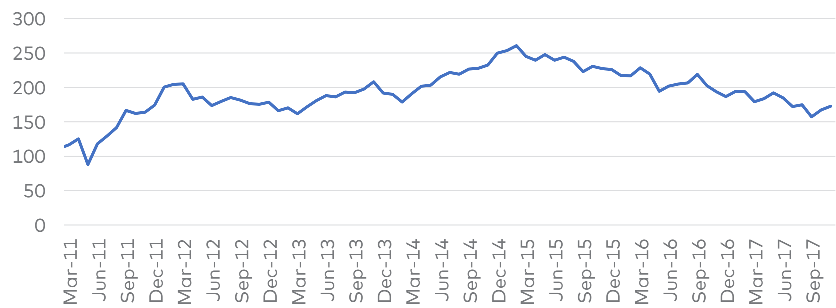
Economic Outlook

Economic fundamentals remain stable as employment continues its steady pace, despite the anticipated deceleration of new job growth as the labor market nears full employment. The economy produced 174,000 new jobs per month year-to-date through November, down slightly from the 187,000 created in 2016.

Inflation remains tame and below expectations, even though the economy has been bolstered by two consecutive quarters of 3%-plus GDP growth. If fourth-quarter GDP proves to have increased by another 3%, it would mark the first time in the current cycle that the economy will have achieved three straight quarters at that level of growth.

Another key metric is pushing the economy forward, as well. Consumer confidence remains at peak levels, reaching 129.5 in November, a 17-year high. Americans are even more confident in the current economy, as the present situation index, which makes up roughly 40% of the consumer confidence index and focuses on consumers' short-term views of the economy, reached 153.9.

Trailing 12 Month Average Job Formation (in thousands)



Source: Bureau of Labor Statistics

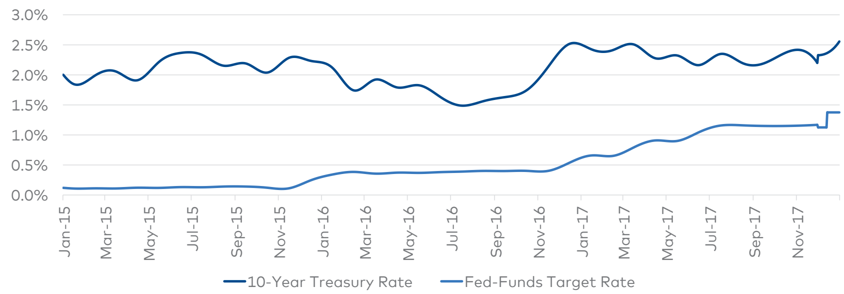
We anticipate that growth in 2018 will exceed 2017's performance. Major segments of the economy—such as housing, autos, manufacturing and commercial real estate—are healthy, and there is no segment that appears so ripe as to be the next bubble about to burst. Meanwhile, the economy should get a shot in the arm from the stimulus created by the recently enacted tax reform. Although the historical record is somewhat mixed in terms of the correlation between tax cuts and economic growth, corporations are likely to invest some of their lower tax billets into productive uses, and consumers will use lower personal tax rates to spend on consumer goods.

The new tax laws are especially favorable for commercial real estate. Reducing the corporate tax to 21% from 35% will benefit major players in the real estate industry, from banks and lenders to REITs and large institutional property owners. Tax rates for income earned by pass-through entities such as LLCs and LLPs will be eligible to deduct 20% of their income. The initial concern over items such as the treatment of the 1031 exchange tax deferral has also been mitigated, as the legislation will not change the current system.

In addition to a boost from the tax bill, real estate investors should continue to experience historically low costs of debt, despite the steady interest rate increases from the Fed over the past 24 months. At the end of 2017, the 10-year Treasury rate fluctuated around 2.5%, similar to where it began the year, after having fallen to a 2017 low of 2.01% in September.

Jerome Powell will replace Janet Yellen as chairman of the Federal Reserve in February, but despite the changing leadership, indications are that the Fed will continue its monetary tightening as well as its balance-sheet contraction. The Fed in December raised overnight interest rates to 1.5%. There are legitimate concerns that rising rates will increase the cost of mortgage debt and acquisition yields, but the slow and orderly increase in rates has so far been shrugged off by the commercial real estate market. At some point, higher rates will translate into pain for the market, but we expect that the impact in 2018 will continue to be minimal if property performance is steady.

10-Year Treasury Rate vs. Fed Funds Target Rate



Sources: Federal Reserve, U.S. Department of the Treasury

Long-term rates, which track more closely to inflation expectations and international demand for U.S. Treasuries, may increase, but at a slower pace than short-term rates. If interest rate trajectories continue, a flat or inverted yield curve may pose a significant threat to the real estate market and the macro economy.

The U.S. economy is poised to begin 2018 on a strong note. While the tax bill may stimulate the economy, and specifically the real estate economy, the added growth will likely be small. But unemployment of 4%, rising housing and equity markets, and slow but steady wage increases have many Americans confident about the current state of the economy. Long-term issues related to the national debt, overheated financial markets and geopolitical risks may bring about the next economic downturn, but the near decade-long expansion will likely continue in 2018.

Rent Growth and Occupancy

We expect that fundamentals will weaken only slightly in 2018, and thus rents will continue their moderate rate of growth. Our forecast of a 2.5% increase in rents in 2018 is on par with the rate of growth in 2017.

Demand drivers will remain healthy. Overall job growth continues to impress, and the growing Millennial cohort is contributing significant numbers to household creation. However, supply is the biggest headwind. Apartment deliveries will hit a cycle peak of 360,000 in 2018, outstripping demand and prompting the occupancy rate to slide, albeit slowly. The average occupancy rate of stabilized properties declined 40 basis points in 2017 to 95.3%. As we expect a new cycle high in deliveries this year, that rate will likely continue to drop, tempering rent growth.

Metros	2018 Rent Forecast % Change	YoY Change 2017 Indexed Rents November 2017
National	2.5%	2.4%
Sacramento	7.2%	8.0%
Colorado Springs	6.5%	5.5%
Phoenix	5.0%	3.5%
Inland Empire	4.9%	4.4%
Salt Lake City	4.9%	4.1%
Las Vegas	4.8%	5.8%
Seattle	4.8%	3.1%
Los Angeles	4.7%	3.7%
Orlando	4.5%	5.1%
Dallas	4.4%	2.6%
Columbus	4.3%	3.4%
San Fernando Valley	4.2%	4.7%
Jacksonville	4.1%	4.9%
Tampa–St Petersburg	3.7%	3.1%
Atlanta	3.7%	2.5%
Twin Cities	3.7%	3.9%
Raleigh	3.5%	1.6%
Long Island	3.5%	3.1%
San Diego	3.5%	4.3%
Tucson	3.5%	4.8%

Source: Yardi Matrix

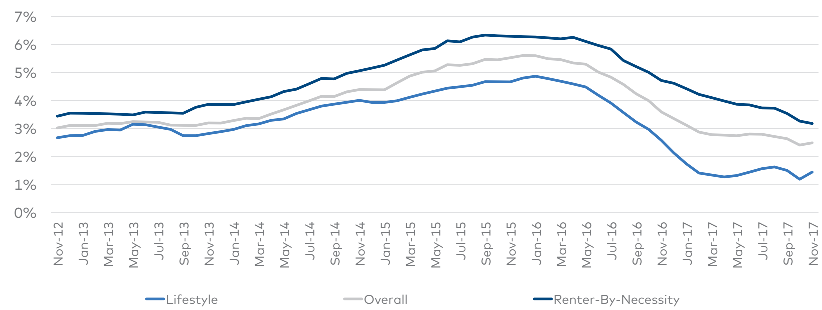
The increase in deliveries will be felt most in metros with the highest rate of increase—such as Nashville, Austin, Seattle and Charlotte—and in large coastal markets such as New York City where affordability is already a serious issue. The slowdown in delivery that took place last year offered traditionally supply-constrained markets a further push in growth, and gave markets with concerns about overbuilding some room to breathe.

Markets with above-trend increases are those with healthy employment gains, rapidly diversifying economies and growing populations. Other markets will continue to rely on the spillover effect—due to their proximity to popular technology and lifestyle centers that are highly in demand and plagued by affordability issues—to sustain growth.

Sacramento is projected to lead metros in rent growth in 2018. We forecast a 7.2% increase due to low inventory growth and demand from a stable and growing job market, as well as the city's proximity to the Bay Area. Other western metros expected to see high rates of growth include Colorado Springs (6.5%), Phoenix (5.0%), the Inland Empire (4.9%) and Salt Lake City (4.9%)—all either relatively affordable markets with growing technology-driven industries or located near major urban centers with significant affordability woes.

Following an uptick in crude oil prices and growing demand following the events of Hurricane Harvey, Houston rents have battled back, finding a road to growth by the end of 2017. The damaging of roughly 45,000 apartments in the metro has led to quick absorption of vacant units, in a market plagued by an occupancy rate of about 93%. Strengthening fundamentals and expectations that the local job market could expand by 70,000 jobs in 2018 are poised to get the rent growth rate to 2.3% this year.

U.S. Rent Growth (YoY Change)



Source: Yardi Matrix

Rents are expected to grow at the slowest rates in Oklahoma City (0.8%), Washington, D.C. (1.3%), New Orleans (1.4%), Portland (1.5%) and Baltimore (1.5%). Inventory expansion in markets like the District and Portland has caught up to occupancy and rent growth rates, as the increased availability of space is moderating improvement. Meanwhile, the only major metro where rents are expected to contract in 2018 is New York City. Manhattan is set to add multifamily units at one of the fastest rates in the nation, which, coupled with very high rents, will yield some slippage.

Supply

Multifamily development activity remains high and should hit the peak of the current cycle in 2018. We expect that 360,000 new units will be delivered in 2018, an increase in total stock of 2.8% and a 20% increase over deliveries in 2017.

With demand for apartments robust, developers have moved into high gear in recent years. Roughly 600,000 units were under construction nationwide as of the fourth quarter of 2017. We originally expected that 360,000 units would be completed in 2017, but the shortage of construction workers has slowed down the number of deliveries. The average start-to-finish time for projects increased to 22 months as of the third quarter of 2017 from 16.5 months in the third quarter of 2013, according to Yardi Matrix's database. Through three quarters in 2017, about 220,000 units were delivered nationally, up 2.3%.

Metros	Total Inventory as of 12/17	2018 Forecast Completions	2018 Completions % Change
National–All Markets	12,987,933	360,000	2.8%
Dallas	704,191	22,158	3.1%
Manhattan	543,945	21,768	4.0%
Denver	246,296	15,661	6.4%
Houston	623,369	14,334	2.3%
Miami	270,823	13,483	5.0%
Los Angeles	407,785	12,472	3.1%
Seattle	291,315	12,362	4.2%
Washington	505,144	11,249	2.2%
Atlanta	422,154	10,231	2.4%
San Antonio	185,509	9,385	5.1%
Austin	215,380	8,603	4.0%
Charlotte	160,683	8,165	5.1%
Chicago	328,954	8,018	2.4%
Nashville	122,069	7,562	6.2%
Phoenix	292,137	7,495	2.6%
Tampa	203,714	7,291	3.6%
Twin Cities	197,209	6,888	3.5%
Boston	213,065	6,887	3.2%
Orlando	201,532	6,450	3.2%
San Francisco	246,554	5,893	2.4%

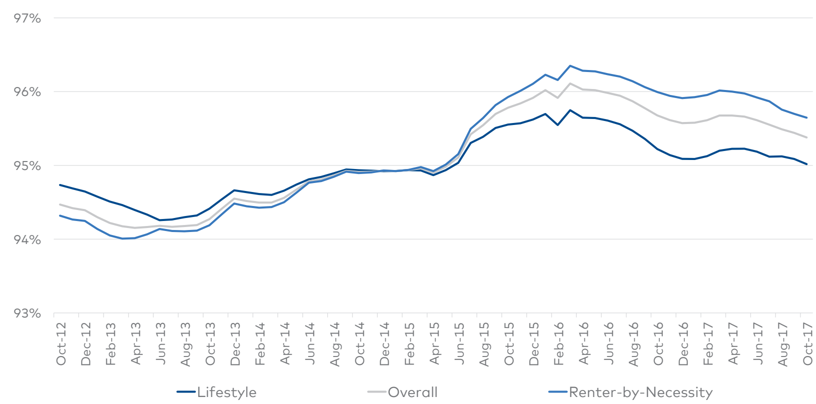
Source: Yardi Matrix

We expect that deliveries will peak in 2018, since starts have been slow. The number of new multifamily permits was down by 8% year-over-year through November. The growth in supply remains healthy, but some developers and lenders are starting to exercise caution in the face of rising vacancy rates, a slowdown in rent growth and regulations aimed at putting the brakes on construction lending. This year will likely mark a pickup in completions, as units under construction are finished up, along with the already in-place pipeline for 2018. This will likely result in a new cycle high for deliveries to occur this year, while 2019 will mark the start of a more moderate rate of completion.

The recent surge in Lifestyle-segment units has posed a challenge for rent growth in most markets, with improvement rates declining throughout the better part of last year. While the below-expectations number of deliveries has had a role in maintaining rent growth in markets where overbuilding had become a problem, 2018 will pose a new challenge for those metros.

Supply improvements will be focused on growing markets, with 143,000 completions slated in the top 10 markets. The Dallas Metroplex is once again set to lead all major markets for completions, with 22,000 deliveries forecast in 2018. The metro added roughly 90,000 new jobs in 2017, and its rapidly expanding economy continues to fuel demand for rentals. Manhattan follows with 21,768 units. The market's notorious weighting in condos, co-ops and townhomes is making way for a surge in the development of rentals on the island. Other markets with large pipelines include Denver (15,600), Houston (14,300), Miami (13,500), Los Angeles (12,500) and Seattle (12,400).

National Occupancy



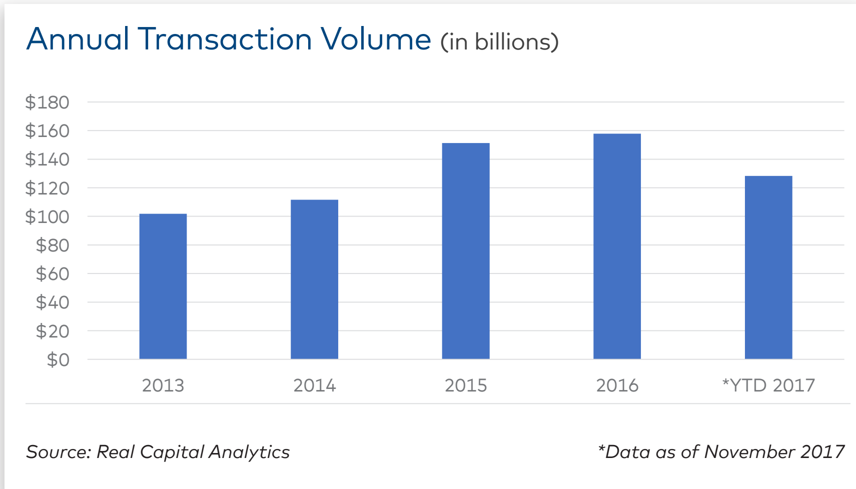
Source: Yardi Matrix

Markets with the biggest percentage increase in total stock include Charleston (6.8%), Denver (6.4%) and Nashville (6.2%). Last year's best-performing market for rent growth, Sacramento, will continue its restricted rate of inventory expansion in 2018, with only 1,093 units scheduled for completion, 0.9% of existing stock. Another California metro with high regulatory barriers, the Inland Empire, also will see stock grow at less than 1% in 2018. Midwest metros Detroit (0.4%), Cleveland (1.3%), Cincinnati and St. Louis (both 1.4%) can expect to see tepid growth in inventory.

Capital Markets

How much steam is left in the recovery is the main issue that preoccupies the real estate capital markets. On the surface, the good times continue to roll. Property values and total mortgage volume have reached all-time highs, and the economy is expected—at the very least—to maintain its moderate level of growth. Some expect growth to increase because of the stimulative effect of tax cuts.

Both equity and debt capital remains abundant in the market. Multifamily is still a popular investment class due to its sterling performance—the segment has had several years of above-trend rent growth, high occupancy rates and extremely low levels of distress. Even if the rate of growth cools off, multifamily should be a safe investment over the next few years.



That said, the length and depth of the recovery in commercial real estate also have led capital forces to exhibit signs of nervousness. Property transactions have declined from cycle highs, as buyers are being a bit more cautious and sellers are not willing to budge from high valuations while property fundamentals remain strong. That has led to less competition in some transactions and a stalemate in others, which has resulted in an approximate drop of 10% in deal flow.

Through November 2017, apartment property sales were $126.7 billion, down 7.8% year-over-year from 2016, which was the cycle peak, according to Real Capital Analytics. Crossborder acquisitions, led in 2017 by investors from Canada and Singapore, have fallen from a 2015 peak but remain elevated. Ongoing low acquisition yields have kept REITs quiet, but all major sources of U.S. capital are active. Despite the cooling of transaction activity, the amount of capital in the sector remains elevated.

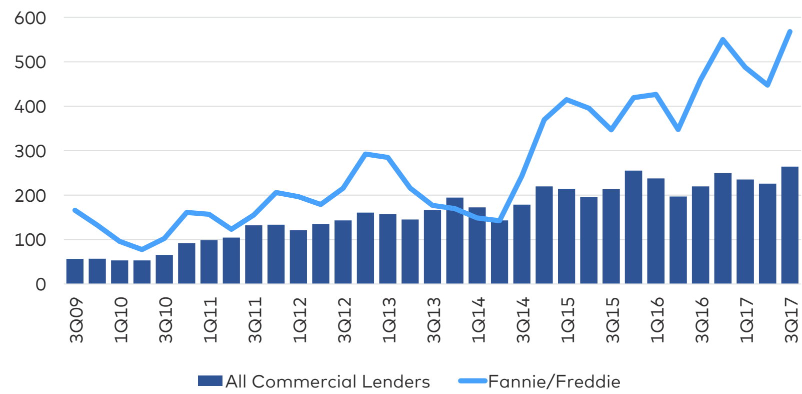
Lending on commercial properties continues to be healthy, as overall commercial mortgage debt rose by $45 billion year-over-year, a 1.5% increase to $3.1 trillion in the third quarter of 2017. Multifamily mortgage debt rose at an even faster rate, up $24.9 billion, or 2.1%, to $1.2 trillion.

Multifamily lending growth was led again by the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, which originated roughly $70 billion apiece in 2017. The agencies lent to near the limit of their $36.5 billion caps and were also active in programs for loans on small-balance properties, affordable housing and "green" assets.

There will be changes in the GSEs in 2018, but just how extensive is not clear. Their caps will drop to $35 billion in 2018 as the Federal Housing Finance Authority expects demand for loans to fall slightly. Another minor change involves the green lending programs. To qualify, property owners must show 25% reductions in either water or electricity usage, where in the past they could combine reductions from the two utilities.

In the bigger picture, reform of the GSEs will again be on the table in 2018, though what will happen remains a mystery, as there is little consensus on policy and federal agencies such as the FHFA that oversee the GSEs will have new leadership. Without a lot of alternate options, the odds are that the GSEs' structure will largely remain intact.

Mortgage Bankers Association Index



Source: Mortgage Bankers Association

Other major lender types are robust. Insurers will maintain their share. Large banks will be more cautious about construction lending and are likely to focus more on permanent lending. Local and regional banks and alternative lenders are being more active in financing new construction. Private debt funds will step into the space vacated by banks in the transitional-loan segment.

The CMBS market got through its first year under risk-retention unscathed. Fears that issuers would be unwilling to comply with the regulation, or that there would be no demand for junior bonds, proved unwarranted. The market did undergo some changes, however, as the requirement that issuers hold a 5% portion of deals did tilt the playing field toward large banks, prompting some smaller lending operations to drop out of the market. CMBS volume was $96 billion in 2017, up 26%, according to "Commercial Mortgage Alert," although volume is likely to shrink in 2018, as demand could be weak. Transaction activity is not likely to grow, and refinancings may decline due to the end of the maturity wave from 2006-07 loans.

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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.

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