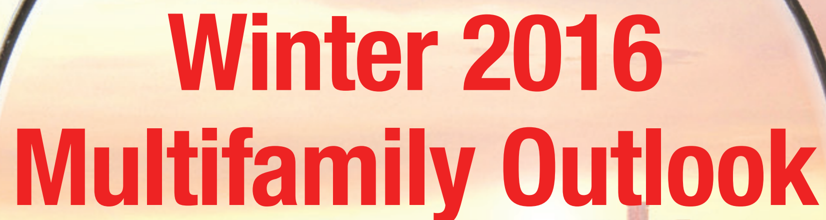
YARDI® Matrix

Rent Growth Encore?
What's in Store for 2016



Job Gains Highlight Steady Economy

Boomers, Millennials Drive Demand

Forecast: West, South Metros to Lead

Market Analysis
Winter 2016

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Overview

After a couple of fat years in which apartment rent growth soared beyond 6% nationally, the big question for the market is: Can it last?

Over the long haul, the answer is "No," of course. But in the meantime, 2016 should be a year of solid rent growth, without the froth of 2015. Yardi Matrix projects 4.6% rent growth nationally, led by many of the hot markets that produced outsize increases in 2015. While the forecast represents a deceleration from the 6.5% gain recorded in 2015, rent growth will, nonetheless, outpace the eight-year average of 2.8%, satisfying most property owners. Several factors support our forecast:

Economic Expansion: More of the same may not be the most exciting theme, but most signs point to another year of moderate growth. During 2016, forecasts call for U.S. GDP growth of approximately 2.5% and the creation of roughly 2.5 million jobs, on par with gains recorded since the recovery began in 2010. Key economic segments including housing, auto sales and consumer spending are improving. However, headwinds persist. In addition to tepid wage growth and weakness in

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the mining industry, the dollar remains strong, which will continue to hamper export activity. Furthermore, the financial markets will have to come to grips with rising interest rates, even if the increases are modest, and potential weakness in emerging markets brought about by low commodity prices.

Strong Renter Demand: The multifamily market will benefit from demographic and social trends in 2016 and beyond. The large Millennial and Baby Boomer generations—at opposite ends of the age spectrum—will be central to sizable upticks in renter demand. Through the end of this decade, Millennials will continue to advance into what's traditionally been considered the prime renter-age cohort, while improving job prospects support an uptick in household formation. Boomers, on the other hand, are not only living longer than previous generations but are increasingly likely to rent, for reasons of finance and convenience.

Moderate Supply Growth: Apartment completions across the 111 markets Yardi Matrix tracks will total 335,000 units, representing a 2.9% increase in existing stock. New supply may appear elevated compared to the years following the recession, but new stock is needed given the robust amount of demand from household formations, the exceptionally high occupancy rates in most metros and the growing problem of affordability.

Healthy Capital Markets: The flood of capital into U.S. multifamily real estate shows no signs of lessening, especially in the wake of recent multibillion-dollar acquisitions by large private equity funds. Debt will remain available from a variety of lending sources, though new regulations and a likely uptick in interest rates could raise borrowing costs. Underwriting standards have loosened a little, but are nowhere near frothy 2007 levels.

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Economic Outlook

Another year of moderate economic growth with favorable demographic trends appears on tap for 2016. We expect U.S. GDP growth to hover in the mid-2% range through 2016, with employment gains averaging around 200,000 jobs per month. There are risks, however: further economic slowing in China and emerging markets, a recession in Europe, spreading conflict in the Middle East and rising interest rates, which could roil the financial markets.

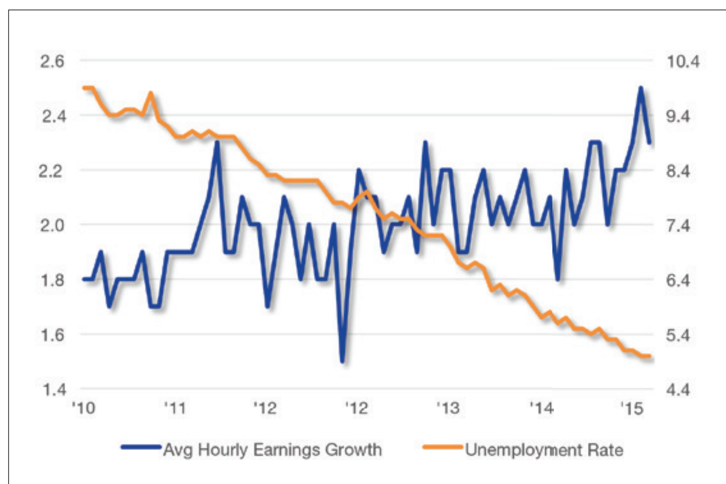
Year to date through November, roughly 2.3 million jobs were created nationwide, or slightly more than 200,000 per month. The rate of job growth has been remarkably consistent since the recovery began. Since January 2010, the economy has generated 12.1 million new jobs, or 206,000 per month. Nothing on the horizon appears likely to significantly impact the pace of near-term growth.

What's more, the economy is fast approaching full employment, which typically supports wage growth. Not only has the unemployment rate fallen below 5% for the first time since April 2008 but the U6 underemployment rate, a broad measure of labor underutilization, recently slipped into the single digits, down from its recessionary peak of 17 percent. Although what constitutes full employment can be debated, the reduction of slack in the labor market points toward wage inflation, which ultimately enables tenants to afford higher rents.

Another reason for optimism is the strength exhibited by a broad range of economic segments. Unlike growth driven by the tech boom of the late 1990s or the housing boom of the mid-2000s, today's economy is riding a broad range of segments:

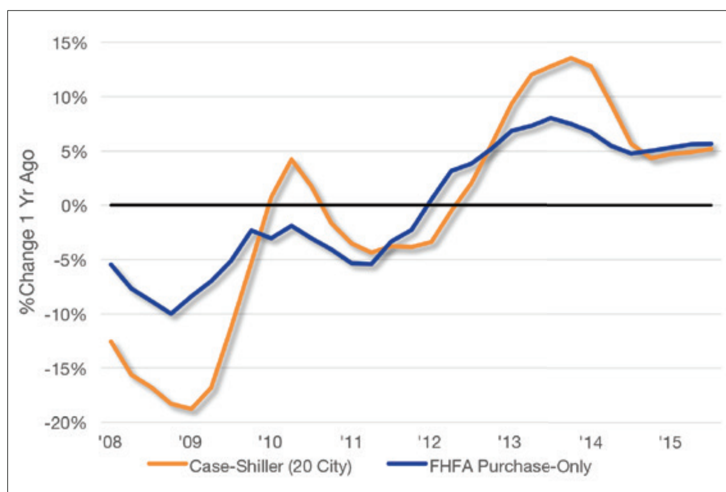
- The housing markets are gradually returning to life, with prices and construction rising steadily, if not vigorously, in some markets. Home prices were up 6.3% year-over-year through November, according to CoreLogic, which forecasts 5% growth in the year ahead as demand increases and inventories of vacant foreclosed homes are almost depleted.
- Construction of single-family homes remains well below historic norms, though, as developers focus on

Wage Growth vs. Unemployment Rate



Source: U.S. Bureau of Labor Statistics

Higher House Prices and Consumer Spending

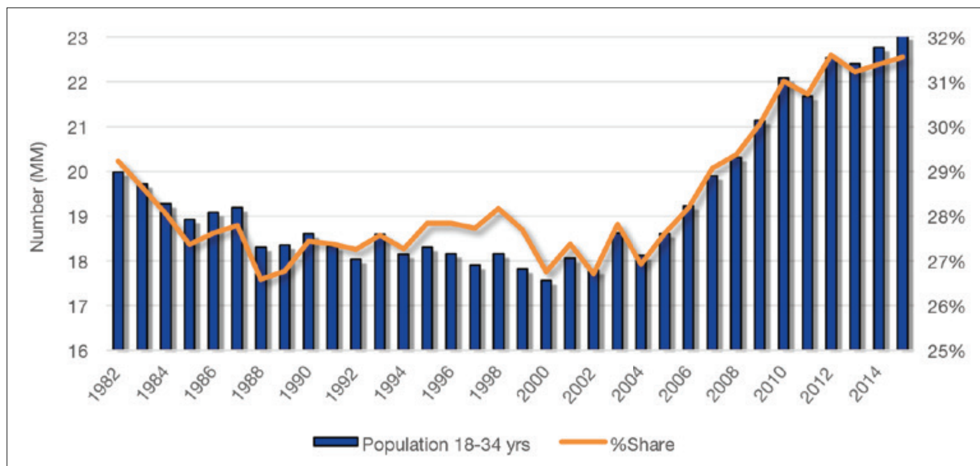


Source: Case Schiller, U.S. Census Bureau

multifamily and living units targeted at niche segments, such as senior housing. Furthermore, banks remain fairly conservative about extending credit to developers.

- Overall, development activity has accelerated, supporting the creation of 259,000 construction jobs over the past 12 months. While single-family housing has lagged, commercial development—particularly multifamily and industrial—has accelerated. A large share of activity in the industrial sector can be attributed to significant demand from retailers for modern logistics properties, which allow for the most efficient and cost-effective distribution of goods to their brick-and-mortar stores and/or directly to consumers. In the office sector, more than 100 million square feet is under construction, although most is concentrated in a few top markets, including New York, Houston, Seattle and the Silicon Valley.
- Oil prices fell below $40 per barrel in December with OPEC's decision to maintain production in spite of weaker global demand, and few analysts expect them to rise much in the near term, which is good news for U.S. households and apartment operators. Lower prices at the pump may not have driven a notable uptick in consumer spending but have allowed households to afford higher apartment rents and contributed to increased personal savings.
- Lower gasoline prices have helped to boost automobile sales, which topped 18 million units in 2015, led by increased sales of trucks and SUVs. This resurgence bodes particularly well for Detroit and should produce a much-needed ripple effect through the remainder of the Midwest and South. Related businesses, such as parts manufacturers and distributors, also benefit from higher sales of cars and trucks.
- Consumer spending is growing modestly. Sentiment surveys are mixed, as consumers feel more confident about household finances, lower gas prices and the improving labor market but remain nervous about tepid wage growth. Areas of strength in the retail sector include general merchandise, sporting goods and grocery stores as well as restaurants, while the furniture and building supply segments remain weak. Inflation has been muted due to low gas prices and the strong dollar, which is keeping the price of imported goods in check.
- Household formation is set to rise for the rest of the decade due to the growing number of Millennials in the 20- to 34-year age segment and the recovery of the job market. We expect household formation to average more than 1 million annually over the next several years, producing robust demand for housing.

Percentage Share of Young Adults* Living at Home



*Source: National Multi Housing Council   *"Young adults" defined as 20 to 34 years old.*

Photo by jackstudio/iStockphoto.com

This somewhat rosy scenario is not without risks, chief among them the impact of rising interest rates. After six years at zero, the Federal Open Market Committee raised the federal funds rate 25 basis points in December. The action reflects the FOMC's confidence in the U.S. economy, and was long anticipated by the market. However, the timing and amount of future rate hikes will remain highly debated and holds the potential to create volatility in the financial markets, which could translate into uncertainty among corporate decision-makers.

Another risk is the global economy. The slowdown in China and the emerging markets, along with continued weakness in Europe, might not derail the U.S. economy but could chip into the pace of growth. China has been hit by slower growth and an uptick in leverage across sectors, and the attempt to rein in debt could exacerbate the economic impact. Other emerging markets have been hard hit by the drop in commodity prices and the weakness of this major trading partner.

The continued slump in oil prices may be a net positive for the U.S. economy, but it puts a damper on growth in Texas, Oklahoma, Louisiana, North Dakota and parts of Pennsylvania, among other places. Over the past 12 months, these states have accounted for a disproportionate share of the 124,000 mining and logging jobs lost nationwide.

The potential for exogenous shocks to the economy also should not be overlooked. Recent terror attacks in Paris and California demonstrate the growing influence of radical elements and potential for disruption in major cities. Meanwhile, the threat of a government shutdown has reduced over the past few years, but budget negotiations between the Democratic administration and GOP-led Congress remain a struggle.

Another trend to be watched is the structural nature of lower inflation. It may not just be a hangover from the recession but a product of the confluence of various trends, including technology, the aging population and low energy prices. Technology improves productivity and makes it easier to live and work in low-cost areas. An aging population forms fewer households, has more people on fixed incomes and spends less on consumer goods. Meanwhile, lower energy prices translate into reduced production and transportation costs, which filter through the economy.

Robust Supply Growth, Redux

Growth in multifamily supply will remain strong in 2016. Across the 111 markets tracked by Yardi Matrix, 335,000 units are slated for completion next year, a 10.7% increase over the 303,000 new units delivered in 2015. As a percentage of stock, 2016 will add 2.9% to total supply, up from 2.7% in 2015. Deliveries are concentrated in top metros, with the top 10 accounting for 153,000 units (46% of total supply), the top 15 accounting for 180,000 units (54%) and the top 20 accounting for 206,000 units (61%).

Leading the delivery of new units will be Texas markets Houston (23,500) and Dallas (22,500), which combined with Austin (10,900) encompass nearly 57,000 units in the Lone Star state. Other markets adding huge inventories in 2016 include Washington, D.C. (16,000), the North Carolina Triangle (15,400), Miami (14,000), San Francisco (13,900), Los Angeles (12,500), Atlanta (12,100), Seattle (12,000) and Denver (10,400). As a percentage of supply, leaders among metros include Nashville/Knoxville (6.4%), Seattle (5.5%), Miami and the North Carolina Triangle (5.4%), Austin (5.3%), Los Angeles (4.8%) and Denver (4.4%).

	2016 (est)		2015	
Matrix Monthly 30	**Completions**	**Completions % Stock**	**Completions % Stock**	**Completions**
Houston	23,526	3.9%	3.4%	20,080
Dallas	22,481	3.3%	2.8%	18,757
Washington, DC	16,041	3.3%	3.2%	15,145
NC Triangle	15,429	5.4%	5.6%	14,980
Miami	14,028	5.4%	4.0%	9,855
San Francisco	13,866	3.9%	3.7%	12,762
Los Angeles	12,538	4.8%	2.3%	5,685
Atlanta	12,145	2.9%	2.6%	10,468
Seattle	11,979	5.5%	5.3%	10,793
Austin	10,895	5.3%	4.8%	9,447
Denver	10,390	4.4%	5.6%	12,717
Nash/Knox	9,523	6.4%	3.4%	4,762
Phoenix	9,408	3.3%	2.2%	6,052
Chicago	7,513	2.4%	2.1%	6,508
Boston	6,895	2.7%	3.6%	8,789
Orlando	5,997	3.1%	2.9%	5,386
San Antonio	5,409	3.0%	3.1%	5,421
Philadelphia	4,922	1.8%	1.7%	4,405
Kansas City	4,736	3.3%	2.2%	3,047
San Diego	4,671	2.6%	2.1%	3,593
Portland	4,371	3.2%	4.2%	5,537
Tampa	4,305	2.2%	2.3%	4,431
Orange County	4,051	2.1%	2.8%	5,250
Twin Cities	4,036	2.1%	2.9%	5,439
Baltimore	2,799	1.3%	1.4%	2,902
Inland Empire	2,467	1.7%	1.2%	1,778
Richmond	2,260	1.1%	2.1%	4,302
Las Vegas	2,083	1.3%	1.7%	2,789
Jacksonville	1,582	1.7%	2.2%	2,054
Sacramento	1,019	0.8%	1.0%	1,192

Source: Yardi© Matrix

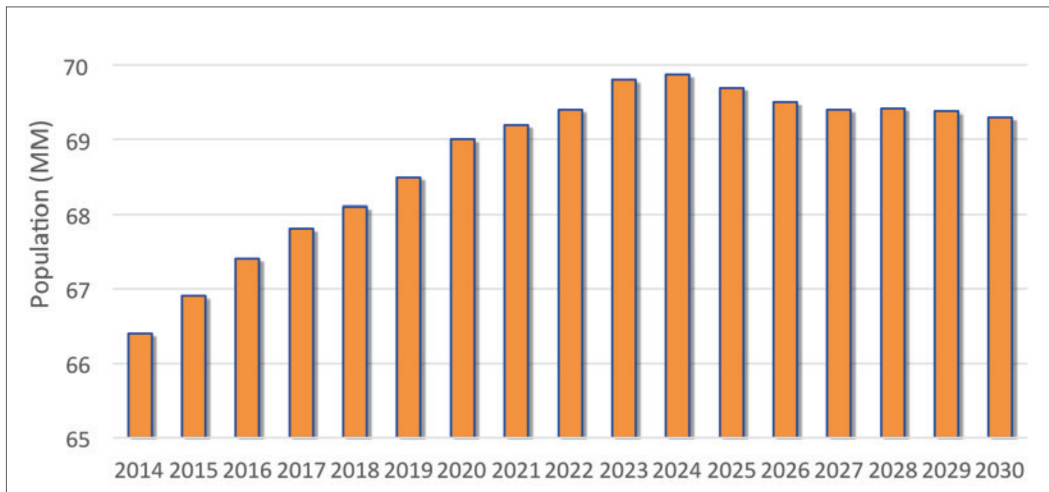
Although the supply numbers look frothy in some markets, especially after accelerated construction during the past few years, demand is expected to keep pace. The sector is coming off a period of historically low supply growth, which began in 2010 and endured through the better part of 2013. Furthermore, supply-side concerns are dimished by today's historically high occupancy rates and expectations for strong renter demand, the result of elevated household formation and reduced homeownership rates.

Photo by NYCstocker/iStockphoto.com

Most of the metros with the highest new supply—including Dallas, Houston, Miami, San Francisco and Seattle—benefit from one or more of the following trends: a steady influx of young professionals, low housing affordability, exceptionally tight apartment market conditions and above-average job creation. As a result, it would take more than a year or two of rapid supply growth before conditions softened enough for landlords to lose their upper hand in rent negotiations.

In fact, the long-term trend demonstrates the need for consistent supply growth. Population growth, the declining homeownership rate and the increase in the number of renters in the large Millennial and Baby Boomer generations demonstrate that somewhere between 300,000 and 600,000 new multifamily units will be needed to meet demand over the next decade. In that light, the current supply trend will merely serve to keep up with the demand, although the balance does differ in each market.

Population of 20-34 Year Olds in the United States



Sources: U.S. Census Bureau, Fannie Mae

West, South to Lead Rent Growth Again

We anticipate another strong year for rent growth, even if it is unlikely to match 2015's 6.5% gain. Last year's growth was fueled by a handful of Western markets, including Portland, San Francisco, Sacramento and Seattle. Conditions in all of those markets will remain favorable in 2016, but there are signs that affordability is becoming an issue at the high end of the rent spectrum and the rate of increases will moderate.

2016 Forecast

Market	Rent Growth Forecast 2016	Job Growth
Denver	11.2%	2.6%
San Francisco	11.0%	2.5%
Portland	9.0%	1.8%
Sacramento	8.8%	2.4%
Austin	8.0%	2.3%
Seattle	7.2%	2.3%
NC Triangle	7.1%	3.1%
Dallas	7.0%	2.7%
Atlanta	6.8%	3.3%
San Diego	6.5%	2.3%
Orlando	6.4%	3.9%
Jacksonville	5.6%	3.1%
Inland Empire	5.4%	2.3%
Phoenix	5.4%	4.1%
Orange County	5.3%	2.3%
Houston	4.7%	1.2%
National	4.6%	1.8%
Tampa	4.4%	3.0%
Nashville/Knox	4.2%	2.7%
Los Angeles	4.2%	2.3%
Boston	4.2%	1.5%
Las Vegas	4.1%	3.7%
Miami	3.9%	3.2%
Kansas City	3.5%	2.5%
Baltimore	2.3%	0.9%
Chicago	1.9%	2.0%
San Antonio	1.5%	2.2%
Philadelphia	1.3%	2.3%
Washington, DC	0.8%	1.4%
Twin Cities	0.0%	2.2%
Richmond	0.0%	3.2%

Source: Yardi Matrix

Three cities that topped the rankings in 2015 also boast the strongest rent growth forecasts for 2016: Denver (11.2%), San Francisco (11%) and Portland (9%). All of these metros are home to intellectual hubs led by technology firms and offer the jobs, lifestyle amenities and climate that attract Millennials. The top five is rounded out by Sacramento (8.8%) and Austin (8%), which will repeat strong gains made in 2014. Austin is thriving as a haven for young, highly educated workers, which enables property owners to fill units despite a huge increase in supply (5.1% in 2016). Sacramento is benefiting from its proximity to markets with strong rent gains and the dearth of new supply, which has produced an extremely tight rental market despite relatively weak demand.

Similar to 2015, markets across the West and South should generate above-trend rent gains next year. Western markets expected to post some of the most robust rent growth include Seattle (7.2%), San Diego (6.5%), the Inland Empire (5.4%), Phoenix (5.4%) and Orange County (5.3%). Southern markets forecast to rise above the U.S. average include the North Carolina Triangle (7.2%), Dallas (7%), Atlanta (6.8%), Orlando (6.4%) and Jacksonville (5.6%).

The news isn't as good for the Mid-Atlantic, Northeast and Midwest, regions that have generally underperformed in recent years, due to ongoing population and job growth shifts to the West and South. Of the 111 markets forecast by Yardi Matrix, Richmond and the Twin Cities form the bottom of the top 30, with expectations for essentially flat rents in 2016. Washington, D.C., ranks 27th, with an uptick of 0.8% anticipated next year. Washington's problem isn't demand: The job market is strong and the population is rising. However, the metro will be inundated with new supply as developers deliver approximately 8.000 units, adding 3.7% to the local apartment stock. Other Mid-Atlantic and Midwest metros with projected below-trend rent growth include Philadelphia (1.3%), Chicago (1.9%), Baltimore (2.3%) and Kansas City (3.5%).

Rent growth is slowing in Houston, but the low energy prices are most impacting demand for office space. Retail employment has grown in 2015, as the city continues to attract new residents. The metro's economy has become more diverse, but given the drop in energy-related jobs and large amount of new supply, rent growth is likely to moderate.

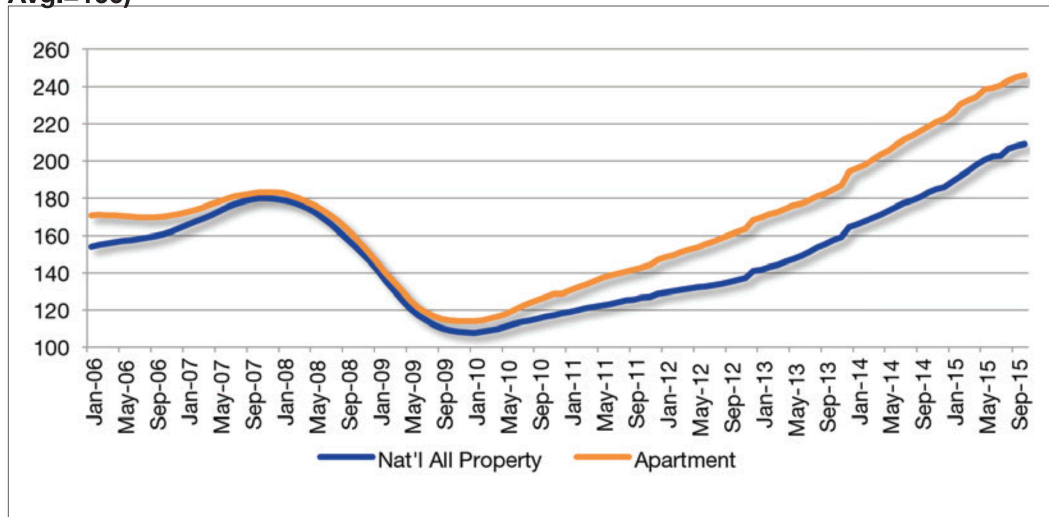
Wall of Capital (Markets)

The wave of capital into commercial and multifamily real estate has been a big story for several years, and 2016 should be no different. In fact, the influence of institutional capital sources just keeps growing, as evidenced by the spate of large-scale mergers and acquisitions. Recent examples include:

- Lone Star Funds acquired Rochester, N.Y.-based REIT Home Properties and its nearly 42,000-unit portfolio for $7.6 billion in October.
- A Blackstone Group partnership purchased the 11,250-unit Stuyvesant Town-Peter Cooper Village in Manhattan for $5.3 billion and a 10,000-unit portfolio of properties in core markets from a fund managed by Greystar Partners for $2 billion.
- Partnerships controlled by Starwood Capital Group paid $5.4 billion for 72 properties owned by Equity Residential and $1.9 billion for a portfolio of properties in southern states from Landmark Apartment Trust.

These deals indicate that the biggest and most sophisticated investors in commercial real estate are betting on the multifamily sector over the long term. Given that other capital sources traditionally mimic the activities of the Blackstones and Starwoods of the world, it would seem safe to say that there is not likely to be a shortage of equity capital in the sector anytime soon. Additionally, even though the U.S. economy is growing relatively slowly, the economic volatility in Europe, Asia and emerging markets and global conflicts in the Middle East (among other places) will keep driving foreign investors to the U.S. as a safe haven.

Moody's/Real Capital Analytics Commercial Property Price Index (2001 4Q Avg.=100)



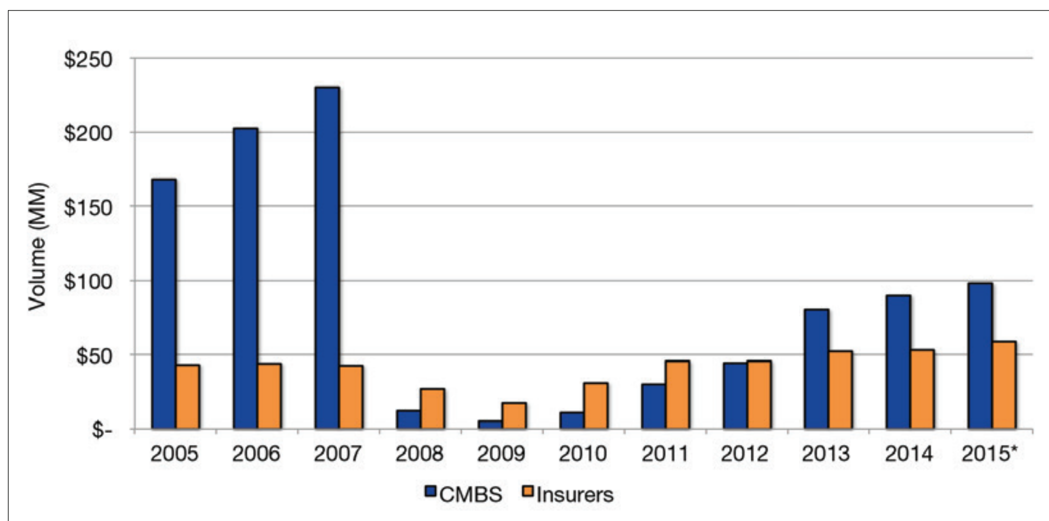
Sources: Moody's Investors Service, Real Capital Analytics Inc.

The M&A activity and influx of capital from global sources are helping transaction volume reach record levels. Through the third quarter of 2015, $95.8 billion worth of apartments changed hands, according to Real Capital Analytics Inc., putting the market on pace to top the $111.9 billion sold in 2014. Meanwhile, initial yields for apartments dropped to 5.8% nationally in the fourth quarter and to 3-4% for properties in gateway markets. If anything, the high prices are a disincentive to sales because they make it hard for buyers and sellers to reach an agreement.

The debt market also continues to be strong, led by Fannie Mae and Freddie Mac. Both of the government-backed mortgage agencies had strong years in 2015 and are set for an encore in 2016. The agencies have $30 billion allotments, but properties that fall under certain categories—such as affordable, small-balance, manufactured and workforce housing—do not count against the cap. All in all, each agency is likely to lend upwards of $45 billion in 2016, and the focus on affordability, rehabilitations and properties in tertiary markets will increase liquidity in segments that have not been well served by the banking community in recent years.

Other major lending sources—including life companies, commercial banks and CMBS—will be active again in 2016. The competition is leading to a slight loosening of standards, and lenders are increasing leverage and the amount of interest-only debt, but the market is still avoiding the worst practices of 2007, such as pro-forma underwriting.

Annual Mortgage Volume



Sources: Trepp, American Council of Life Insurers **Estimated*

Securitization programs may have a problem competing on pricing, as CMBS spreads widened late in 2015 as the market prepared for the impact of regulatory changes designed to reduce leverage and limit trading. For example, restrictions on trading bonds for profits has created a disincentive for banks to buy securities in a market-making function, which reduces liquidity and lowers bond prices. CMBS issuers are also preparing for a "risk-retention" regulation going into effect in 2017 that requires them to either hold a 5% strip of bonds they sell or sell to a qualified B-piece investor that will have to hold the bonds for five years. That will also reduce market liquidity, which could impact prices.

Changes to regulations in 2015 are having an effect on construction and acquisition lending. The rules, implemented as part of the Basel 3 regime require banks to hold more capital reserves for construction, acquisition and redevelopment loans. The reserves are particularly onerous if the borrower doesn't put up at least 15% equity. The rule is intended to reduce leverage. While prudently sized loans are good for the market over the long run, the increased capital costs will lead to higher loan coupons, likely by 20 to 50 basis points. And some banks will take themselves out of the space entirely and be replaced by specialty lending institutions operated by private equity.

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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 Context® rating eliminates that requirement, designating property market positions as:

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

The value in application of Context® 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 Pierce-Eislen 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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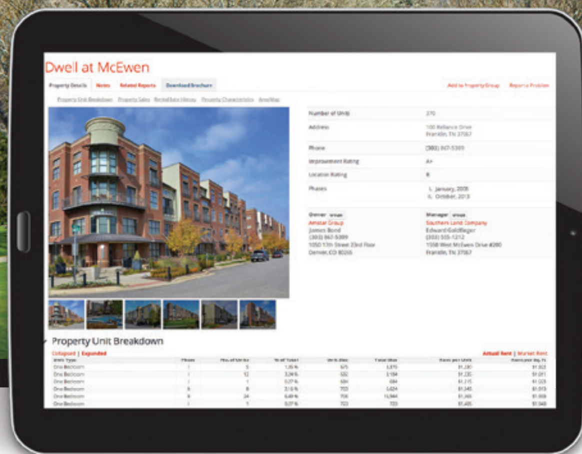

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