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2017 Multifamily Outlook: Return to Balance

A BERKSHIRE RESEARCH VIEWPOINT

February 2017

Berkshire

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2017 MULTIFAMILY INDICATORS

	Expectation	Momentum	Berkshire View
ECONOMY & HOUSING			
Job Growth	▼	**Moderating**	As the economy reaches full employment, the pace of expansion will moderate
Income Growth	▲	**Expanding**	With the labor market tightening, the income trend is improving
Household Growth	▲	**Expanding**	Renters are still driving much of the improvement in broader housing demand
Home Price Growth	▼	**Moderating**	Affordability of homeownership will continue declining supporting rents in most areas despite slowing appreciation of home prices
MULTIFAMILY FUNDAMENTALS			
Demand Growth	▼	**Moderating**	Pent up demand in the broader rental market remains a near-term tailwind despite slowing job growth
Supply Growth	▲	**Expanding**	Supply risk is rising but still relatively concentrated in the luxury segment
Vacancy Rate	▲	**Bottoming**	Vacancy rates should have moderate increases in most markets but remain near long-term average levels
Rent Growth	▼	**Moderating**	Slower effective rent growth in line with consumer price inflation is expected
CAPITAL FLOWS & PRICING			
Sales Volume	▼	**Moderating**	Apartment sales should remain healthy, supported by new product as well as maturing debt
Cap Rates	▲	**Bottoming**	Cap rates are likely to stabilize and potentially edge slightly higher as risk premiums begin to widen
Property Price Growth	▼	**Moderating**	After a period of record-breaking appreciation, the pace is likely to taper off

Note:

The direction of the arrows reflects expected change in a given indicator compared to the prior year (orange color denotes potential for a more direct negative impact on operational performance and property appreciation).

OUTLOOK SCORECARD

	2017 Expectation		2016 Actual		2016 Expectation		Cycle
	Direction	Value	Direction	Value	Direction	Value	Momentum
ECONOMY & HOUSING							
Job Growth	▼	1.9 mil.	▼	2.3 mil.	▼	2.5 mil.	Moderating
Income Growth	▲	3.0%	▲	2.5%	▲	3.0%	Expanding
Household Growth	▲	1.1 mil.	▲	0.9 mil.	▲	1.2 mil.	Expanding
Home Price Growth	▼	4.5%	▼	5.5%	▼	5.0%	Moderating
MULTIFAMILY FUNDAMENTALS							
Demand Growth	▼	1.0%	▼	1.2%	▼	1.1%	Moderating
Supply Growth	▲	1.7%	▲	1.6%	▲	1.6%	Expanding
Vacancy Rate	▲	+70 bps	▲	+40 bps	▲	+50 bps	Bottoming
Rent Growth	▼	2.0%	▼	2.3%	▼	2.5%	Moderating
CAPITAL FLOWS & PRICING							
Sales Volume	▼	$120 bil.	▼	$158 bil.	▼	$120 bil.	Moderating
Cap Rate	▲	0-10 bps	▼	-10 bps	▼	-5 bps	Bottoming
Property Price Growth	▼	3%	▼	13%	▼	5%	Moderating

Notes:

The direction of the arrows reflects expected or actual change in a given indicator compared to the prior year (orange color denotes potential for a more direct negative impact on operational performance and property appreciation).

The vacancy rate for Berkshire Group's target markets is expected to increase from an average annual rate of 4.7% in 2016 to 5.5% in 2017.

The cap rate for Berkshire Group's target markets is expected to increase from an average annual rate of 4.5% in 2016 to 4.6% in 2017.

EXECUTIVE SUMMARY

The 2017 outlook for the U.S. multifamily market performance remains positive. Real estate fundamentals should return to more balanced conditions with greater differentiation in performance across markets and various types of properties that usually characterize this phase of expansion. Despite the recent increases in new supply, apartment vacancy rates should remain near historical norms across the country, with some exceptions, as demand continues to expand at a strong pace supported by robust growth in employment and renter households.

2016 was expected to be another year of opportunity for investors and the market performed as predicted. Apartment prices set new records and the sector led commercial property sales and gained shares in institutional real estate portfolios. The current expansion in fundamentals was also expected to start showing signs of maturing in 2016 with most markets experiencing stabilization in occupancy rates and moderating rent growth, which has also come to pass.

U.S. apartment prices are expected to rise again this year, although not as much as in 2016. While underlying property income growth in apartments might have passed its peak, the sector still offers relative stability, long-term value and better protection against the risk of rising inflation amid uncertainty surrounding other asset classes. Demographic tailwinds supporting apartment demand remain strong and continue to serve as a source of upside potential and factor into prolonging the current cycle.

As in 2016, there remain a number of risks in 2017 mainly due to geo-political uncertainty in the U.S. and abroad. Depending on their scope and pace of implementation, business-friendly policies of the new administration could potentially boost economic growth as early as the second half of this year and change the market’s trajectory for 2018 and beyond. However, regulatory and political uncertainty, both domestically and globally, could slow investment decisions, affecting job growth and sales activity and trigger stock market turbulence.

While property operational performance is largely a function of market-specific demand/supply fundamentals, real estate pricing is greatly impacted by factors that are shaped globally such as capital flows, availability of debt, interest rates and risk premiums. From this perspective, 2017 is likely to be a year when macroeconomic and capital market dynamics will have the potential to impact real estate pricing and returns more than local job or wage growth. Given the likelihood of elevated volatility, Berkshire believes that U.S. apartments will continue to attract investor demand and gain appreciation as long-term focus wins over concerns regarding moderating income growth. Furthermore, potential volatility around macroeconomic issues could spur more opportunistic investment in 2017, especially considering the higher volumes of new deliveries and maturing debt relative to last year.

KEY FACTORS IN THE ECONOMY AND HOUSING

The multifamily outlook is shaped by numerous factors including growth in total employment and income, as well as broader housing market trends including total housing demand growth and composition. These factors are, in turn, shaped by households' propensities towards owning versus renting. In 2016, the U.S. economy and housing have performed in line with the expectations of healthy, although somewhat slower growth. These trends should continue in 2017, but with more reasons for both downside risk and upside potential.

As a result of the U.S. elections in November, the Republican Party now has control of the White House, House of Representatives and Senate, creating a path that could potentially lessen legislative gridlock and expedite policymaking. Business confidence has risen on the expectation that potential policy changes such as corporate tax reform, financial deregulation and a repeal of the Affordable Care Act could boost growth, prolonging both economic expansion and the real estate cycle.

Uncertainty remains regarding other key policy areas including government spending, foreign trade or immigration and their effects on inflation and interest rates, which could potentially delay investment decisions. However, given the broader global risks, capital is expected to continue favoring income-producing real assets, including U.S. commercial real estate and apartment properties.

Employment Growth

The U.S. labor market continued to expand in 2016, adding 2.3 million jobs, a more moderate pace compared to 2.8 million in 2015. In both years, job growth was primarily in the professional and business services sectors as well as in the health and education sectors. The trend towards moderation is expected to continue in 2017, with the baseline scenario calling for 1.3% job growth nationally, or 1.9 million jobs, which should help generate a net absorption of about 300,000 units, equivalent to 1.3% of the existing apartment inventory.

Wage Growth

With the labor market nearing full employment, wage growth gained momentum throughout 2016. This trend is expected to continue in 2017, which will support rent growth and help mitigate affordability concerns for the apartment sector as a whole. Regional labor markets where the current unemployment rates are particularly low by historical standards, including Los Angeles, San Francisco and San Jose, can expect stronger wage growth. Considering that apartment occupancy in most markets is close to full capacity, local wage growth will be an increasingly more important driver of apartment rent growth.

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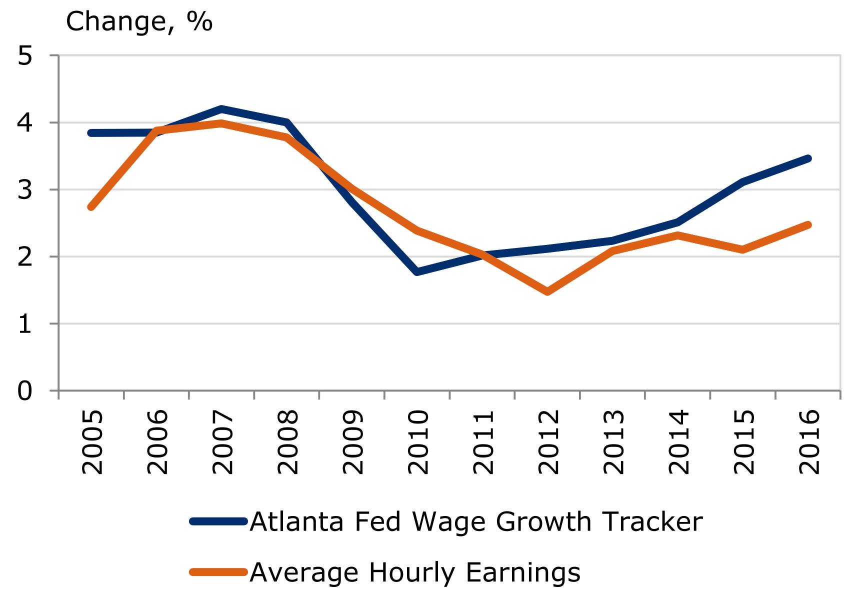
Wage Growth Trends are Improving

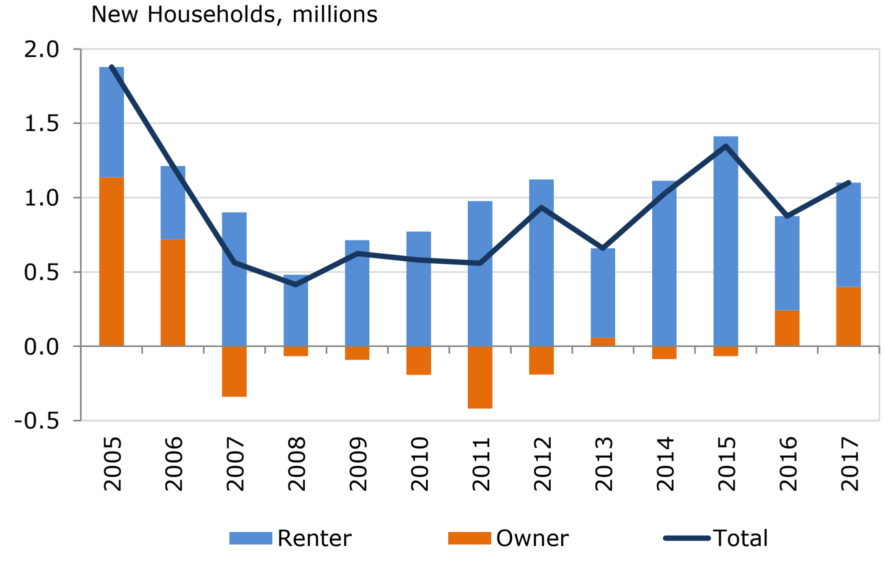


Sources: Federal Reserve, Berkshire Group Research.

Household Growth

Total household growth weakened mainly in the first half of 2016, with an average annual gain of 879,000 compared to 1.35 million in 2015. Unlike in 2015 when all of the gain in total households was accounted for by renters, 2016 had the first modest increase in owner households in a decade, even as the homeownership rate dropped slightly. Despite some loss of momentum in 2016, renter households still grew by more than 600,000, well above the long-term average of approximately 400,000. In 2017, the total number of households is expected to grow by 1.1 million, with the rental market accounting for over half of this gain as the homeownership rate remains flat or continues to edge down.

Renters Continue to Drive Total Household Growth



Sources: Census Bureau, Berkshire Group Research

With much of new multifamily product concentrated in the luxury segment, rent growth in this tier of the market is expected to lag relative to the broader market.

New Housing Supply Growth

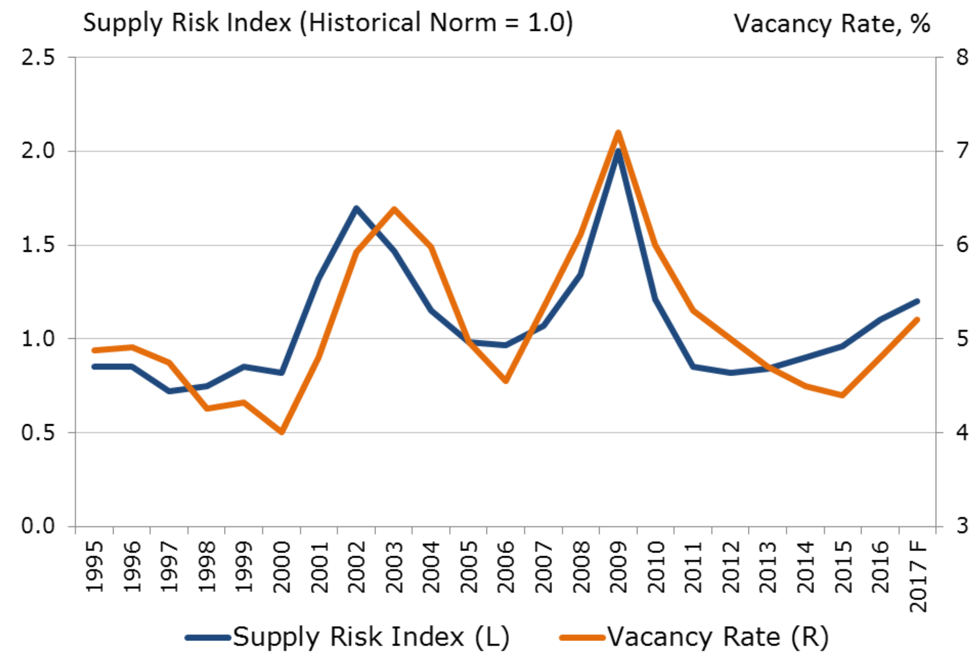
Total housing completions continued to increase in 2016, rising to 1.06 million units from 968,000 in 2015, with virtually all of the gain in the single-family sector. Multifamily completions increased only slightly, from 310,000 to 314,000 units. Accounting for demolitions, effective growth in total housing supply growth has slightly lagged demand and the overall housing vacancy rate has remained steady as a result.

Based on the current level of starts, new housing completions are expected to increase to about 1.17 million units in 2017, with about 360,000 units delivered in the multifamily segment. Given the shortage of rental supply that exists at the moment and the outlook for solid job and household growth, only a slight increase in supply risk can be expected nationally.

Last year, the market experienced further tightening of standards for lenders providing financing for new multifamily development. If lender underwriting for new construction remains conservative, this should further constrain new supply and mitigate the risk of slower growth in jobs and apartment demand that is currently projected to take place in 2018 and beyond.

In most of Berkshire's target markets, new deliveries will only have a moderate effect on fundamentals, bringing occupancy and rent growth more in line with historical norms rather than pushing them into a severe contraction. With much of new multifamily product concentrated in the luxury segment, rent growth in this tier of the market is expected to lag relative to the broader market. Depending on the market, the luxury segment is defined as the top 5% to 10% of the property rent distributions in a market.

Vacancy Rate is Approaching Historical Norm



** A proprietary metric developed by Berkshire Group Research to evaluate relative supply risks across market. The index takes into account growth in stock relative to growth in employment and compares the current difference between the two to the historical averages for each metro area. An index above 1.0 indicates rising supply risk and upward pressure on the vacancy rate.*

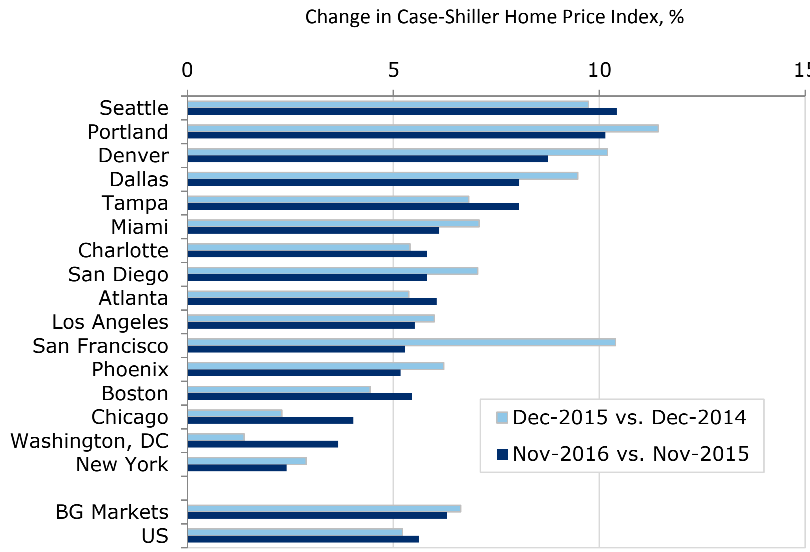
Sources: Axiometrics, Bureau of the Census, Bureau of Labor Statistics, Berkshire Group Research.

The pace of home price appreciation has slowed in most major markets relative to last year and, therefore, the boost to rents is not expected to be as strong as in 2016.

Home Price Growth

Despite weak owner demand, home prices continue to climb because the supply of homes for sale remains low relative to actual sales. Strong year-over-year home price appreciation reported in Seattle, Portland, Denver, Tampa and Dallas is contributing to strong rent growth for these markets, and higher home prices should continue to put upward pressure on rents in 2017. Rising home prices in these and other markets, along with higher mortgage rates, will further reduce the affordability of homeownership and stimulate rental demand. The pace of home price appreciation has slowed in most major markets relative to last year and, therefore, the boost to rents is not expected to be as strong as in 2016.

Rising Home Prices Support Rent Growth in 2017



The S&P/Case-Shiller Home Price Indices are the leading measures of U.S. residential real estate prices, tracking changes in the value of single-family homes both nationally as well as in 20 metropolitan areas. The indices measure changes in home prices given a constant level of quality; changes in the types and sizes of houses or changes in the physical characteristics of houses are specifically excluded from the calculations to avoid incorrectly affecting the index value[1].

Sources: S&P/Case-Shiller, Berkshire Group Research.

As long as interest rates rise in line with the expectations of stronger economic growth, the impact on the pricing of core institutional-quality apartment assets should be small, due to the offsetting effect of property income and investor demand.

Interest Rates

The 10-year Treasury rate continued to drop through much of 2016 but has surged since the U.S. Presidential election in November, mainly due to the expectation of rising inflation. As a result, the quarterly average 10-year Treasury rate increased from 1.56% in Q3 2016 to 2.13% in Q4 2016 and averaged 2.41% in January 2017. Present expectations of stronger economic growth and higher inflation are suggesting that the 10-year Treasury rate will move towards 3.00% by the second half of 2017.

As long as the short-term and long-term interest rates and the multifamily borrowing spreads rise in line with the expectations of stronger economic growth, the impact on the pricing of core institutional-quality apartment assets should be small due to the offsetting effect of property income and investor demand. However, a potential increase in borrowing rates could affect pricing for buyers, especially those pursuing value-add acquisitions.

Rising rates should create more investment opportunities as a significant volume of multifamily loans will be maturing in 2017, contributing to an increased activity in sales, re-financings and recapitalizations. For homeowners, even a slight increase in mortgage

[1] S&P/Case-Shiller Home Price Indices Methodology, February 2015.

rates, especially when combined with rising home prices, property taxes and other costs such as insurance premiums, will keep pushing affordability lower, thus supporting rental demand.

MULTIFAMILY MARKET IMPLICATIONS

Vacancy and Rent Growth Trends

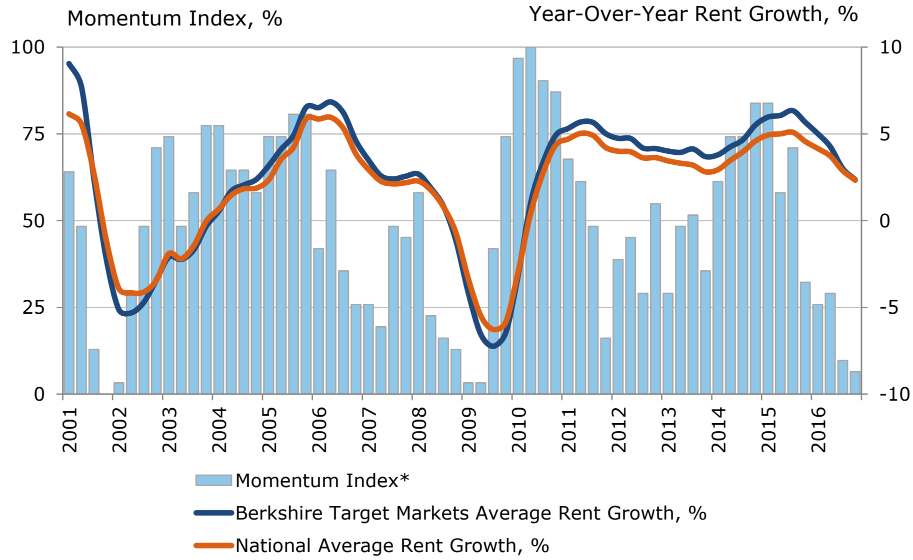
After six years of expansion, the multifamily market started to show signs of maturing towards the end of 2016. The average vacancy rate across Berkshire's 31 target markets increased from 4.5% in Q4 2015 to 4.9% in Q4 2016, with the average annual rate rising from 4.3% in 2015 to 4.7% in 2016 but remaining well below the 15-year average of 5.5%. Given the current projections for slower job growth and higher volume of new apartment completions, the average vacancy rate could potentially increase by another 50-100 basis points in 2017, bringing it line with the historical norm.

Average market vacancy rates in 2016 were below long-term averages in all of the target markets except Baltimore, San Francisco and San Jose. New supply is likely to keep upward pressure on vacancy rates in these markets as well as in Houston, Nashville and West Palm Beach through much of 2017. Markets where 2016 vacancy rates were particularly tight relative to the long-term averages included Charlotte, Dallas, Fort Worth, Orlando and Phoenix, providing not only a basis for stronger near-term rent growth, but also potential for a new wave of supply and subsequent moderation beyond the immediate horizon.

Effective rent growth across target markets slowed to an average of 2.3% in 2016 compared to 5.7% in 2015 but is consistent with the long-term average. There was a widening variation in effective rent growth trends last year. Markets with declining rents included Houston, San Francisco, San Jose, Oakland and New York. The strongest effective rent growth of 4.5% and higher was reported in Seattle, Fort Worth, Phoenix, Atlanta, Orange County and Raleigh.

Effective rent growth could potentially slow to an average of 2.0% across target markets. Overall, a combination of moderate vacancy increases and continuing rent growth should support positive operational performance in 2017.

Rent Growth Momentum Waned at the End of 2016



** Share of target markets where rent growth is improving relative to a year ago*
Sources: Axiometrics, Berkshire Group Research.

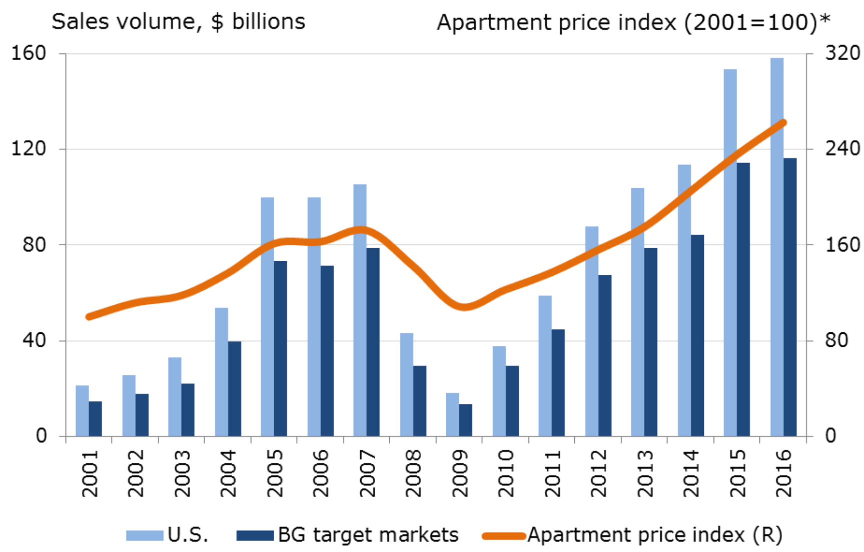
Apartments had higher transaction activity than any other major property sector in 2016, and the share of total sales (based on dollar volume) increased to 32% from 28% in 2015.

Capital Flows & Pricing

Unlike all other major real estate sectors, investment in apartments continued to increase in 2016 setting a new record with sales volume of $158 billion compared to $153 billion in 2015. Over 7,800 apartment properties, totaling about 1.2 million units, sold nationally, with secondary and tertiary markets continuing to gain investor interest. Apartments had higher transaction activity than any other major property sector in 2016, and the share of total sales (based on dollar volume) increased to 32% from 28% in 2015.

Strong market fundamentals and investor demand continue to push apartment prices to new records, with the Moody’s/RCA CPPI index up 11.4% from the prior year as of December 2016. While the pace of price appreciation is slower than the 14.8% gain in 2015, it is still quite robust by historical standards and notably stronger compared to other major property sectors. This positive momentum is likely to continue through 2017. Based on near-term income growth and cap rates across targeted markets, there should be attractive opportunities in 2017 for buying existing apartment properties in areas outside of the central urban core of primary markets and for well-located, high-quality product in secondary markets.

Apartment Prices Set New Records in 2016



** The Moody's/RCA Commercial Property Price Index (CPPI) based on repeat-sales transactions.*
Sources: Real Capital Analytics, Berkshire Group Research.

Apartment fundamentals and investment performance are expected to remain healthy in 2017 supported by growth in the economy, employment, incomes and home prices.

Overall Multifamily Outlook

Apartment fundamentals and investment performance are expected to remain healthy in 2017 supported by growth in the economy, employment, incomes and home prices. Given the new geo-political landscape, the outlook has both upside potential and downside risk, mainly from capital markets rather than operating income.

The U.S. economy should continue to expand in 2017 with multifamily rents and property values edging higher. Overall, 2017 is expected to be a positive but potentially more volatile year for multifamily operational performance and pricing, with greater differentiation across markets and types of product. Similar to 2016, the market should present new investment opportunities resulting from higher volumes of maturing multifamily debt and recently completed product.

Disclaimer

Gleb Nechayev,
Senior Vice President, Head of Economic & Market Research

Mr. Nechayev leads the development of original real estate research at Berkshire Group. He is a recognized real estate economist specializing in multifamily markets, with nearly two decades of industry experience counseling institutional and private clients. Mr. Nechayev holds a Masters in City Planning from the Massachusetts Institute of Technology, and is a graduate of the National Economic University of Kiev, Ukraine. He is a member of both the Urban Land Institute and National Multifamily Housing Council.

Berkshire

One Beacon Street, 24th Floor
Boston, MA 02108

T 617.646.2302
F 617.646.2370

www.berkshire-group.com