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2016 Multifamily Outlook: Another Year of Opportunity

A BERKSHIRE RESEARCH VIEWPOINT

February 2016

Berkshire

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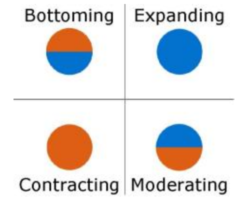
2016 MULTIFAMILY INDICATORS



	2016 Momentum	Berkshire View
Economy & Housing		
Job Growth		As the U.S. economy reaches full employment, the pace of expansion moderates
Income Growth		The tightening labor market is likely to boost wages which remained subdued until now
Household Growth		Renters are still driving much of the improvement in broader housing demand
Home Price Growth		Affordability of homeownership will continue declining supporting rents in most areas
Multifamily Fundamentals		
Demand Growth		Pent up demand in the broader rental market remains a near-term tailwind
Supply Growth		Supply risk is rising but still relatively concentrated in a few markets and submarkets including urban core
Vacancy Rate		Vacancy rates will see moderate increases in most markets but remain near the long-term average levels
Rent Growth		Slower, but still robust, effective rent growth above historical norms and consumer price inflation is expected
Capital Flows & Pricing		
Sales Volume		Apartment sales should remain healthy supported by new product as well as maturing debt
Cap Rates		Cap rates are likely to stabilize and potentially edge slightly higher as risk premiums begin to widen
Property Price Growth		After a period of record-breaking appreciation the pace is likely to taper off

EXECUTIVE SUMMARY

As the U.S. multifamily market enters its fifth year of expansion, Berkshire Group remains cautiously optimistic that 2016 will turn out to be another solid year for the sector's fundamentals and investment performance. In addition to long-term demographic tailwinds, multifamily occupancy and rents should continue to benefit from solid job growth, rising wages, improving household trends and lower affordability of homeownership. In most parts of the nation there remains tangible pent-up rental demand, which should help absorb much of the new multifamily product scheduled for completion this year.

While multifamily property values are at record levels, they can still be driven higher not only by solid growth in underlying property income, but also by investor demand for the relatively stable performance that apartment assets in the U.S. offer amid mounting global uncertainty and rising risks of recession. In fact, more robust economic growth in the U.S. relative to other advanced countries bodes well for the nation's commercial real estate pricing in general, despite the Federal Reserve's indication of a gradual monetary tightening and the prospect of rising long-term interest rates.

However, the outlook is not without risks, which have become more pronounced since the beginning of the year. Potential missteps in the implementation of monetary policy, rapid appreciation of the U.S. dollar, a greater-than-expected slow-down in China, further drops in energy prices, and geo-political tensions can create significant volatility in the financial markets and affect capital market liquidity. From this perspective, the ability to actively manage real estate through a potential downturn can be an important mitigating factor and a competitive advantage.

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, which are in turn shaped by households' propensities towards owning versus renting.

Employment Growth

The labor market fully recovered its losses from the recession in the spring of 2014 and has been in expansion mode ever since, adding 2.9 million jobs in 2014 and 2.7 million jobs in 2015. This growth has been driven primarily by the professional and business services sectors. The trend is expected to continue, adding a projected 2.5 million jobs in 2016, which should push the unemployment rate below 5.0%, consistent with full employment. Because job growth is one of the key drivers of multifamily demand and occupancy rates, 2016 is likely to be another good year for multifamily fundamentals.

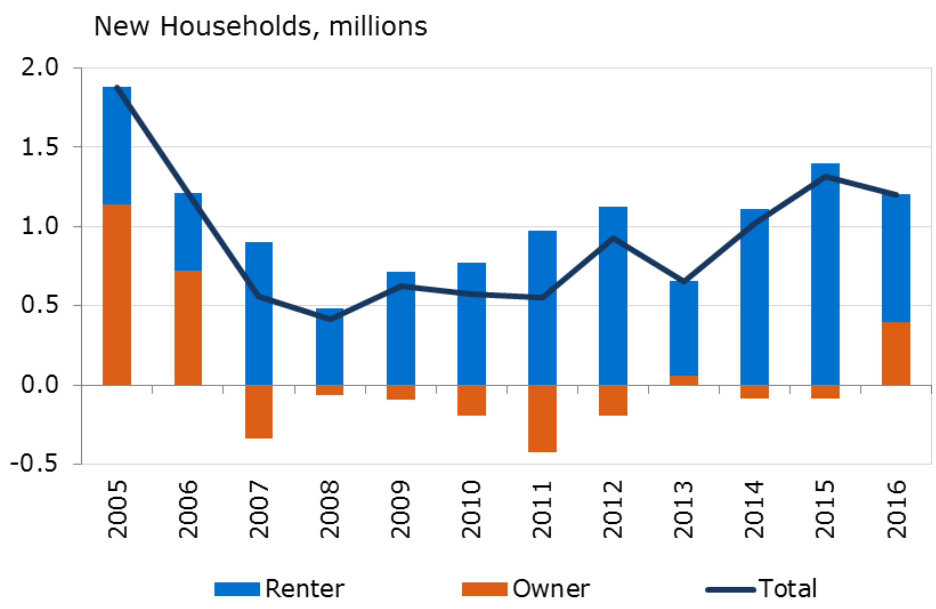
Wage Growth

The tightening labor market is likely to boost wage growth, which remained subdued until recently. Average hourly earnings grew by just 2.0% in 2015 but should move into the 3.0% to 3.5% range in 2016 as businesses begin to experience a shortage of skilled labor. Recognizing this prospect, the number of U.S. companies expecting to raise compensation is now the highest since 2005. This strengthening trend of income growth should provide a tailwind to multifamily rents across markets, even as more new households that can qualify for mortgages may purchase homes.

Household Growth

Last year, total household growth in the U.S. surged for the first time since the housing bubble burst. Throughout much of the recovery since 2010, the overall household formation, or effective change in the nation's housing demand (the number of occupied units), remained somewhat depressed, averaging less than 700,000 households per year. Total household growth is improving and has surpassed 1.3 million in 2015 with all of the gain derived from rental households as the homeownership rate continued to edge down. In 2016, total household growth is expected to increase by 1.2 million largely due to steadily improving labor market conditions for younger adults. Similar to 2015, the rental market is likely to be the primary beneficiary of this trend, gaining up to 800,000 households, while the homeownership rate is expected to remain flat or even edge down slightly due to still elevated foreclosures and the slow return of first time buyers to the market.

Renters Likely to Drive Total Household Growth in 2016



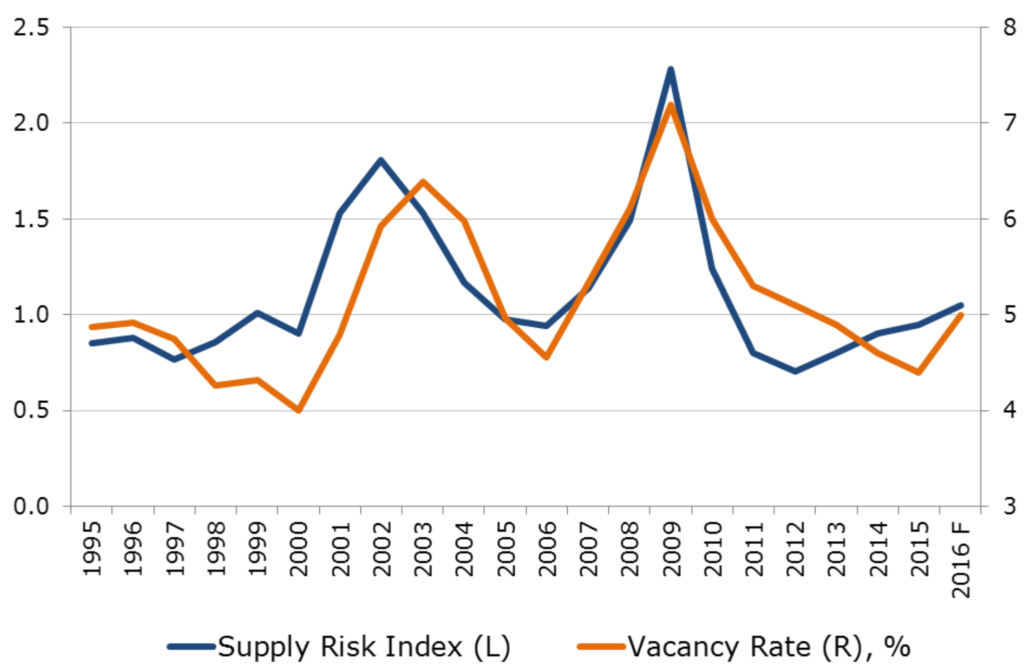
Sources: Census Bureau, Berkshire Group Research

New Housing Supply Growth

Total housing completions continued to increase in 2015, rising to 960,000 units from 880,000 in 2014, with much of the increase in the multifamily sector. In spite of the increase, new housing supply is still falling short of demand, especially when factoring in removals from stock due to demolitions. In assessing housing permits, which lead completions by approximately a year, new supply is expected to continue to lag total household growth, growing by about 1.1 million units in 2016.

Last year's increase in multifamily starts has prompted some concern over rising supply risk in the segment in most markets around the country. Multifamily starts in projects with five units or more increased from 340,000 in 2014 to 390,000 in 2015, slightly above the 50-year average of 360,000. So far, high supply risk is still limited to a handful of our target markets (including Nashville, Houston and Austin) and is expected to have a moderate impact on average occupancy and rent growth in 2016. Due to the considerable cumulative shortage of rental supply that formed over the last decade and the current levels of completions, it is likely to take another year to fill the gap and bring occupancy rates back to historical norms in most areas. Because much of new multifamily product is represented by luxury product concentrated in urban core submarkets, rent growth is likely to slow down sooner in this segment.

Supply Risk Index* is Still Low but Keeps Edging Up



** 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 indicates rising supply risk and upward pressure on the vacancy rate.*

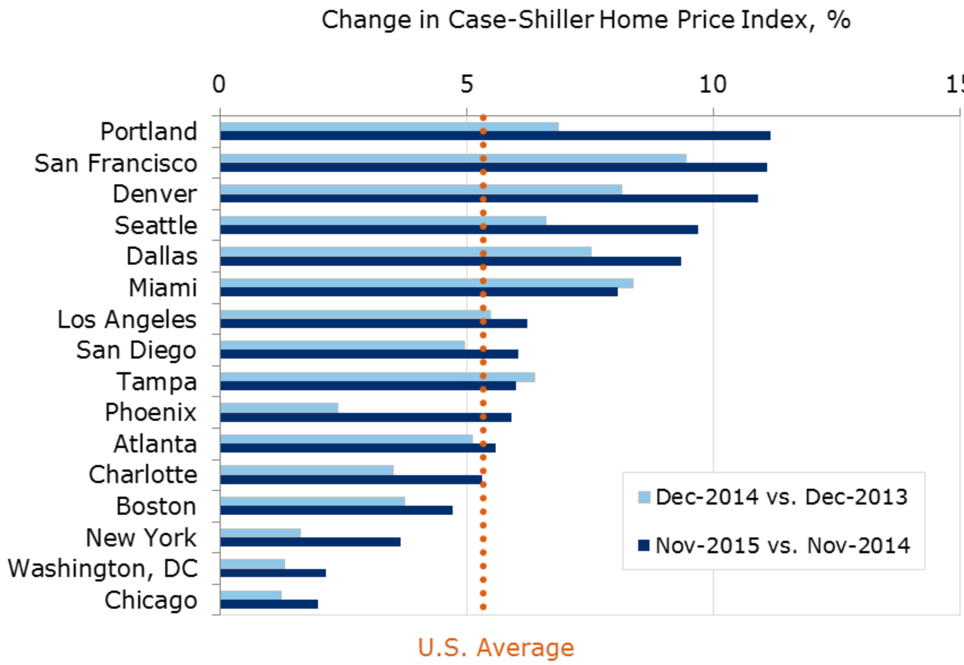
Sources: Axiometrics, Bureau of the Census, Bureau of Labor Statistics, Berkshire Group Research.

Home Price Growth

Despite weak owner demand, home prices continue to climb because the supply of homes for sale remains low relative to the actual sales. Rents have led home prices during the economic recovery but rising home prices are now becoming a tailwind for rents. Among Berkshire's target markets, variation in home prices over the last two years have contributed to nearly a 70% variation in rent growth. For example, strong growth in home prices reported in San Francisco, Denver, Portland, Dallas and Seattle has contributed to strong momentum in apartment rents for these markets, and higher home prices should continue to put upward pressure on rents in 2016.

A combination of rising home prices and mortgage rates will further reduce the affordability of homeownership, which, in some markets, is already low both in relation to incomes as well as rents. Concurrently, rapid increases in rents over the last five years have made the costs of buying a home competitive in many areas. Households that have ample savings for a down payment and are able to qualify for a loan may be more likely to buy. Overall, stabilization in homeownership and a continued increase in home prices remain a net positive for multifamily in 2016.

Rising Home Price Support Rent Growth in 2016



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.

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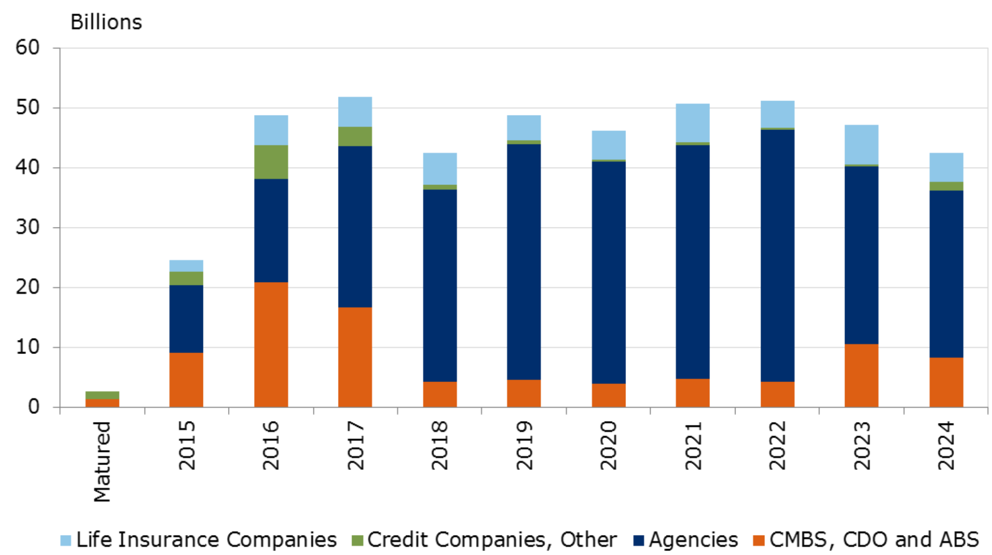
[1] S&P/Case-Shiller Home Price Indices Methodology, February 2015.

Interest Rates

With the U.S. labor market approaching full employment and wage inflation beginning to pick up, the Fed is likely to stay its course and gradually raise the federal funds rate. What matters to commercial real estate pricing (cap rates) is if and how this policy might impact the long-term interest rates as well as the shape of the yield curve. While the actual effects are expected to be relatively minor in the near term, some unique investment opportunities are expected to emerge as a significant volume of multifamily loans will be coming due in 2016, contributing to an increased activity in sales, re-financings and recapitalizations. For homeownership, even a slight increase in mortgage rates, especially when combined with rising home prices and property taxes, will push affordability lower, keeping many potential buyers on the sidelines and turning more households towards rental housing.

Multifamily Maturities by Lender: 2015-2024*



**$141.1 billion in maturities expected after 2024*

Source: MBA Loan Maturity Survey YE 2014

Oil Prices Remain a Wild Card in the Outlook

Oil prices finished last year sharply down. In January 2016, West Texas Intermediate fell to about $30 per barrel, about 36% below the prior year and 72% below the last peak in June, 2014. The magnitude of the current decline in oil prices is comparable to the supply-driven drop in 1985-1986 and the demand-driven drop in 2008-2009. The reasons behind the current drop in oil prices are not as clearly defined as in the two prior periods due to the influence of both supply-side and demand-side factors. This more complex market dynamic makes it difficult to not only evaluate the impact of this correction on the broader economy, but also to predict when oil prices will stabilize and begin increasing. Low oil prices have clearly benefited consumers' budgets but have not translated into stronger economic growth as consumers have chosen to save or pay down debt rather than increase spending. Accordingly, the oil price correction has, thus far, had a neutral or only moderately positive effect on the broader economy.

A prolonged period of low oil prices does carry tangible risks for the producers and exporters of oil as well as for financial firms invested in the energy sector. The last two occurrences of severe oil price declines were followed by fairly quick and sharp upward corrections and, if this pattern is repeated, oil prices should begin stabilizing in 2016. This expectation is supported by the futures market, which is currently pricing a return to $50 per barrel in 2016. While the futures market usually is a more accurate predictor of prices, it was proven wrong in 2015. If oil prices do not begin to recover in 2016 as expected, the downside risk is likely to outweigh any upside potential and affect job growth in markets with higher exposure to oil-related industries.

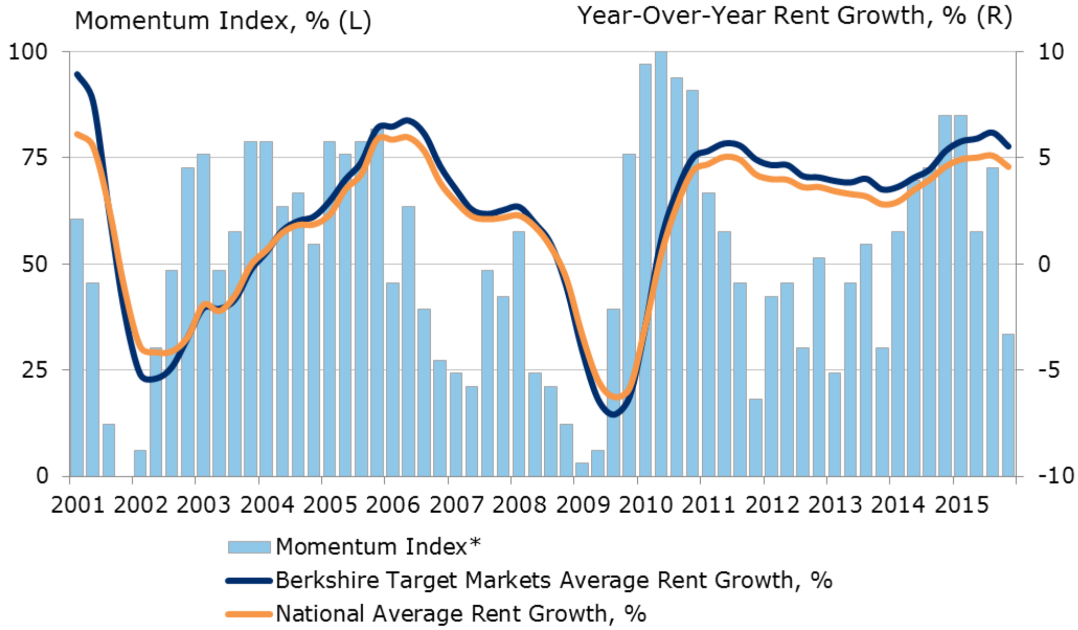
MULTIFAMILY MARKET IMPLICATIONS

Vacancy and Rent Growth Trends

The multifamily market has entered 2016 on solid ground. The average vacancy rate across Berkshire target markets is currently 4.4% compared to the 15-year average of 5.7%. The vacancy rates remain below historical averages in all but three of the target markets and continue to drop on a year-over-year basis. Markets where the current vacancy rate is particularly tight relative to the historical norms include Phoenix, Denver, Durham, Orlando, Charlotte, Raleigh, Dallas and Fort Worth. Even with rising new supply, only moderate increases in vacancy rates, in the range of 50 to 75 basis points, are expected in 2016.

Meanwhile, effective rent growth also remains quite solid averaging over 6.0% per year across Berkshire target markets and over 5.0% nationally in 2015, compared to 2.0%-2.5% over the last 15 years. Rent growth continued to accelerate in most markets through much of last year and was particularly strong in Portland, Oakland, San Francisco, San Jose, Denver and San Diego. However, it will be difficult for these markets to keep their current pace of rent growth in 2016 without more substantial improvements in local market income trends. Signs of moderating growth clearly emerged in the fourth quarter of 2015. In most markets, slower but still robust effective rent growth above historical norms and consumer price inflation is expected. Overall, the combination of moderate vacancy increases and continuing rent growth should support positive operational performance in 2016.

Rent Growth Momentum Slowed at the End of 2015



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

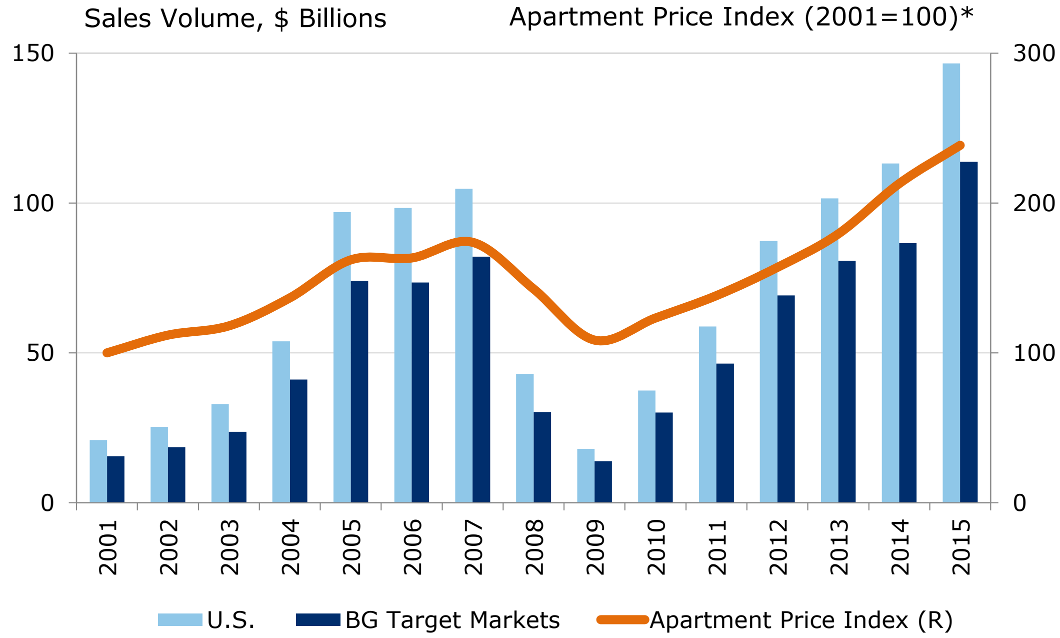
Capital Flows & Pricing

Last year set new records for apartment investment, with institutional sales approaching $145 billion, up from $113 billion in 2014 and more than twice the annual volume averaged over the prior 15 years. Close to 8,000 apartment properties, totaling over one million units, sold nationally with secondary and tertiary markets continuing to gain investor interest.

It is expected that 2016 will be another good year for apartment sales driven in part by a tangible increase in newly-built product as well as maturing multifamily debt. Moreover, foreign pension plans received relief from the 35-year-old tax imposed under FIRPTA (Foreign Investment in Real Property Tax Act of 1980) in December 2015, which could stimulate more foreign investment in U.S. real estate. Foreign investment in U.S. apartments, and core assets more specifically, could be a direct beneficiary. Even without this tax change, cross-border capital in U.S. apartments has doubled since 2010 and now accounts for more than 10.0% of total acquisitions.

Strong market fundamentals and investor demand keep pushing apartment prices to new records, with the Moody's/RCA CPPI index up 12.0% from a year ago as of November 2015. While the pace of price appreciation is slower than the post-recovery record of 19.0% in 2014, it is still quite robust by historical standards and the positive momentum is likely to continue in 2016. Looking at near-term income growth and cap rates across targeted locations, there are attractive opportunities in 2016 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 Sales and Prices Set Records in 2015



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

Overall Multifamily Outlook

Apartment fundamentals and investment performance are expected to remain healthy in 2016 supported by growth in the economy, employment, incomes and home prices. With the current economic and capital markets environment, a number of tangible downside risks to the outlook must also be recognized including lower than expected oil prices, economic weakness in China, and global geo-political instability. While the apartment sector is not immune to these risks, it is better prepared than other property sectors to withstand potential shocks given the strong demographic tailwinds supporting rental demand.

Berkshire's baseline view is that the U.S. economy will continue to expand in 2016 with multifamily rents and property values edging higher. Overall, 2016 should to be a positive but potentially more volatile year for multifamily operational performance and present many new investment opportunities stemming from higher volumes of maturing multifamily debt and recently completed product.

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Gleb Nechayev,
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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.

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