

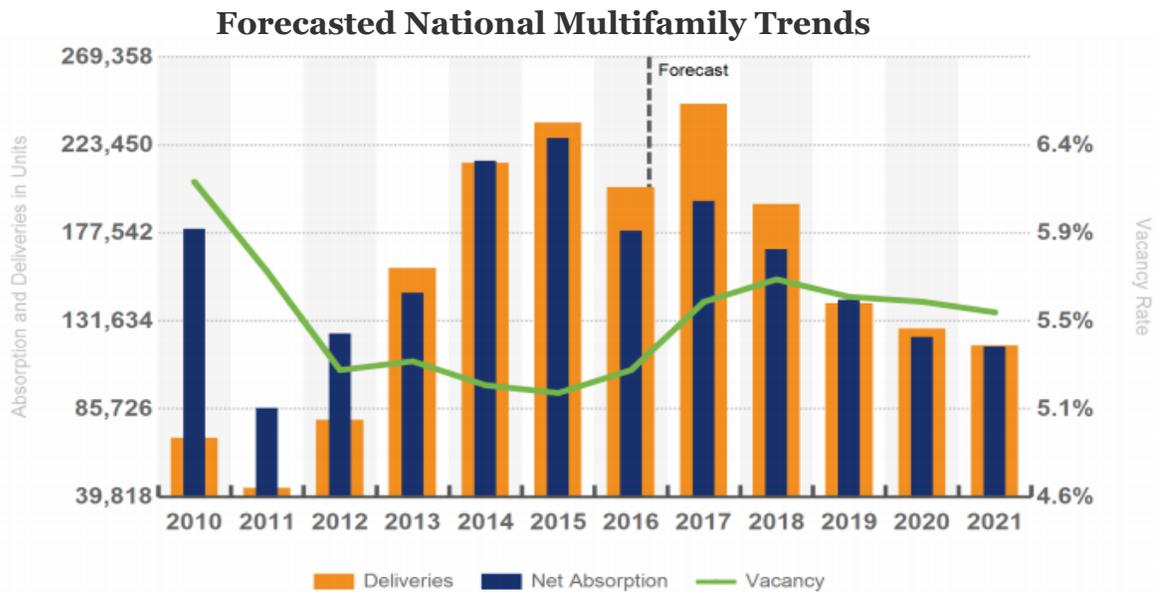


Multifamily Market Commentary – January 2017

2017 Multifamily Market Outlook – Reduced Speed Ahead

The U.S. multifamily sector has had a solid six-year run, with increasing rent growth and declining vacancies. Key fundamentals have propelled the multifamily sector over the past few years: favorable demographic trends, continued job growth, and increasing renter household formations. There are 83 million Millennials, making them the nation’s largest population cohort, according to the Census Bureau, and this is the cohort that is expected to continue driving demand for multifamily over the next five years.

Momentum will likely slow down in 2017 due to elevated levels of new supply and moderating job growth. As a result, the national vacancy rate is expected to increase, and rent growth will remain positive but grow at a lower and more normalized pace. Overall, the outlook for the multifamily sector should remain fairly stable in 2017.



Source: CoStar

Net Absorption – Positive but Slowing

Demand for multifamily rental units remained stable throughout 2016. Net absorption likely totaled at least +179,000 units absorbed, compared to an estimated +187,500 units absorbed in 2015, according to Reis, Inc. Expect net absorption in 2017 to remain positive, although at a much lower level than last year, possibly falling to fewer than +160,000 units absorbed, according to Reis. Over the next few years, net absorption is expected to decelerate but remain positive, as seen in the chart above.



Vacancy Levels Rising

The national multifamily vacancy rate is expected to rise in 2017, primarily due to the onslaught of new supply expected to complete and come online over the next 12 to 24 months. Since most of this new supply is concentrated in a limited number of submarkets – within only 12 metro areas – supply is expected to outpace demand, pushing the national vacancy rate upward, as illustrated in the chart on the previous page. This anticipated trend should be short-lived, however, due to the combination of ongoing favorable demographic forecasts and favorable future job growth projections.

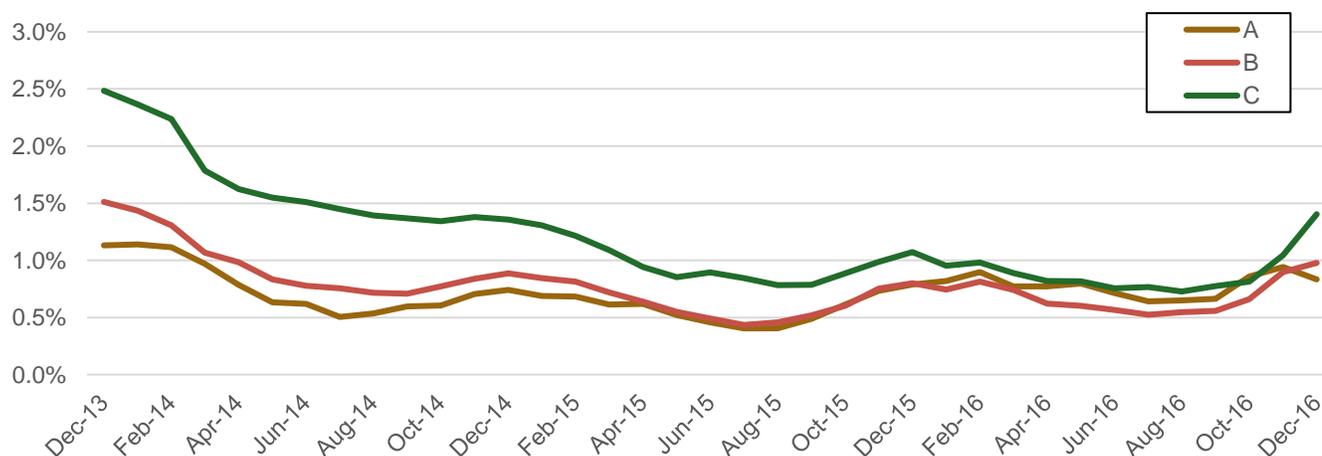
Indeed, the Fannie Mae Multifamily Economic and Market Research team is anticipating that the U.S. multifamily vacancy rate will increase to 5.5 percent during the early part of 2017 – from 5.25 percent as of the fourth quarter of 2016 – and could end the year at about 6.0 percent. This would return the national vacancy rate to a more normalized level.

Rent Growth Expected to Ease Slightly

Rent growth was positive in 2016 but is estimated to have ended the year at about 2.5 percent, above the pace of inflation, which grew 1.7 percent year-over-year as of the end of November. There has been above average rent growth since 2011, and the fourth quarter of 2016 was the first occurrence of zero rent growth. The expectation for 2017 is that rent growth will once again be positive but is likely to moderate from 2016's overall pace to about 2.0 percent.

As seen in the chart below, multifamily concessions for all property classes remain at very low levels. This suggests that supply and demand have been out of balance for some time now. As more and more new supply comes online this year, national concession rates are expected to increase, more dramatically in certain metros. For example, although the New York metro concession rate of 1.1 percent seems unremarkable, in actuality it more than doubled in the 12 months ending in the third quarter of 2016, according to data from Axiometrics.

National Multifamily Concession Rate by Class



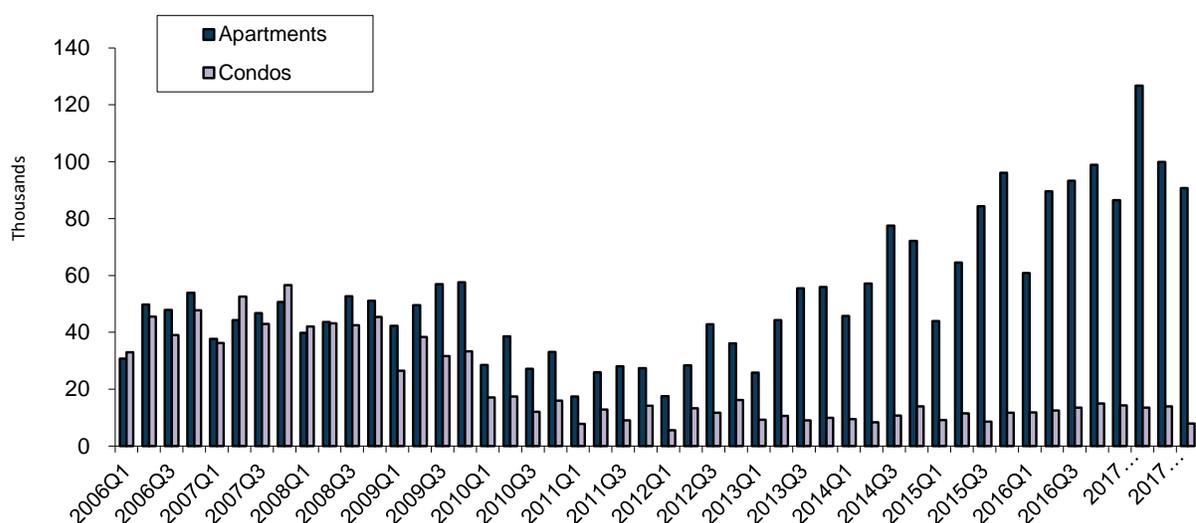
Source: Axiometrics



Multifamily New Supply – Coming Home to Roost

As seen in the chart below, the amount of multifamily new construction remains elevated, with deliveries expected to peak in 2017. According to the Dodge Data & Analytics Construction Pipeline – which distinguishes between multifamily properties consisting of either apartment or condo units – about 343,000 apartment units were completed in 2016, with another 400,000 units expected to come online in 2017. More concerning, most of this new supply is believed to consist of class A units, which command the highest rent levels.

Multifamily New Construction



NOTE: Pipeline data is not an actual forecast of activity; it is a monitor of activity reported to date. As more projects are planned and tracked, figures in future periods might go up.

Source: Dodge Data & Analytics, January 2017 – Metros with 5,000 or more units underway or completed.

**Anticipated delivery date.*

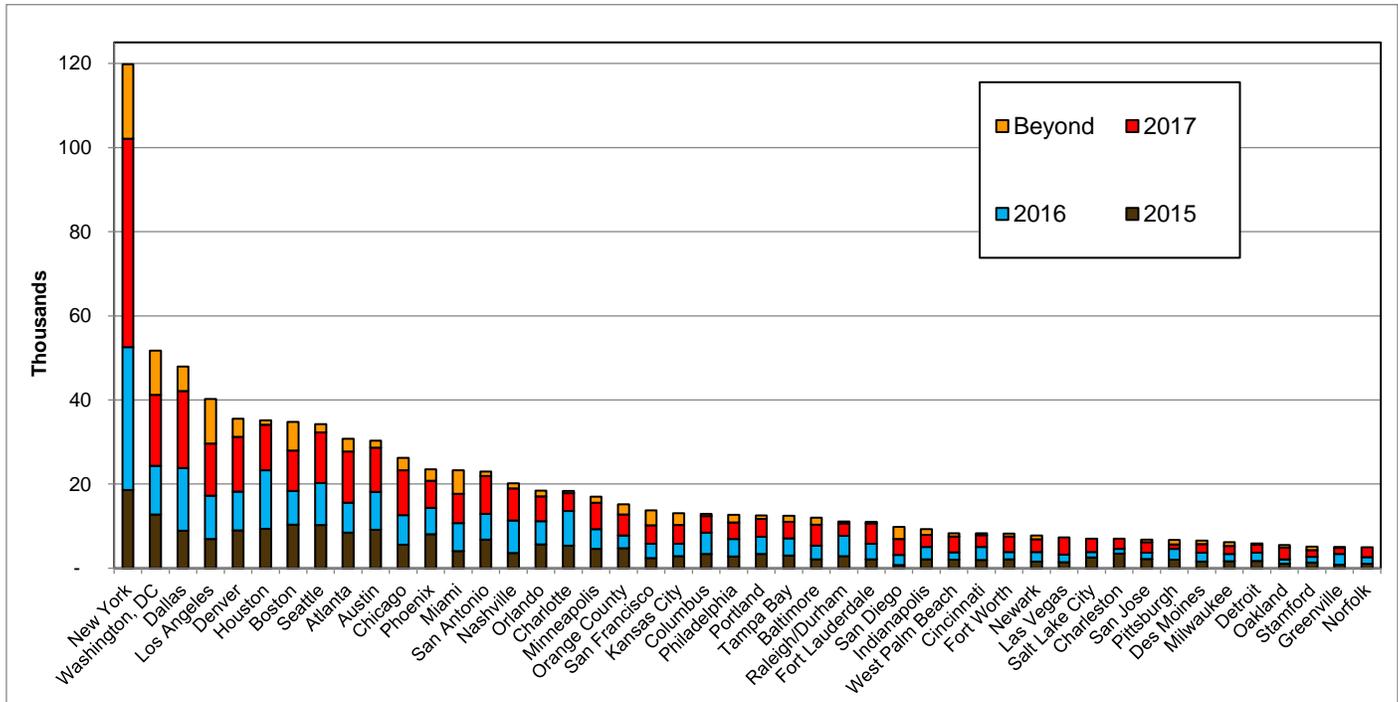
Location, Location, Location

At a national level, the prediction of 400,000 new multifamily units is not unreasonable. Job growth is expected to come in at 1.4 percent, according to Moody's Analytics, which works out to an estimated addition of 2.0 million new jobs in 2017. Based on that level of job growth, theoretically multifamily rental demand could be in the range of about 400,000 units.

The reason that level of multifamily rental demand is not likely to occur is because much of the new supply is primarily concentrated in only 12 metros (as seen in the chart on the following page) and most of that is further concentrated in certain submarkets. The estimated amount of national job growth, and its anticipated accompanying demand, is not going to be concentrated in just those 12 metros, which is why supply is expected to outpace demand in many of these metros over the next 12 to 24 months.



Multifamily Apartment Units Underway – Select Metros



NOTE: Pipeline data is not an actual forecast of activity; it is a monitor of activity reported to date. As more projects are planned and tracked, figures in future periods might go up.

Source: Dodge Data & Analytics, January 2017 – Metros with 5,000 or more units underway or completed.

*Anticipated delivery date.

A Looming Jobs and Supply Mismatch

Although all of the nation’s major metros are expected to see positive job growth this year, not all metros will experience the same level of employment growth, as illustrated in the two charts on the following page. Although Moody’s Analytics’ baseline forecast for 2017 anticipates a national employment growth rate of 1.4 percent, there are a number of metros that will be below the national estimate, including Houston, New York, and Boston. These are all metros with a large amount of new supply on the horizon.

Houston is expected to have more than 9,500 units deliver this year and Boston is not far behind at about 9,200 units. New York is expecting the lion’s share of new supply, with more than 43,000 units expected in just 2017. As a result, all three of these metros are expected to see diminished or even negative rent growth this coming year due to too much supply and not enough job growth.

For example, Houston is likely to see demand for only about 4,000 multifamily units. Boston’s demand is projected to be fewer than 1,500 units. And although the New York metro is the nation’s largest multifamily rental market, its anticipated job growth is likely to produce demand for only about 26,000 units – and that is an optimistic estimate.

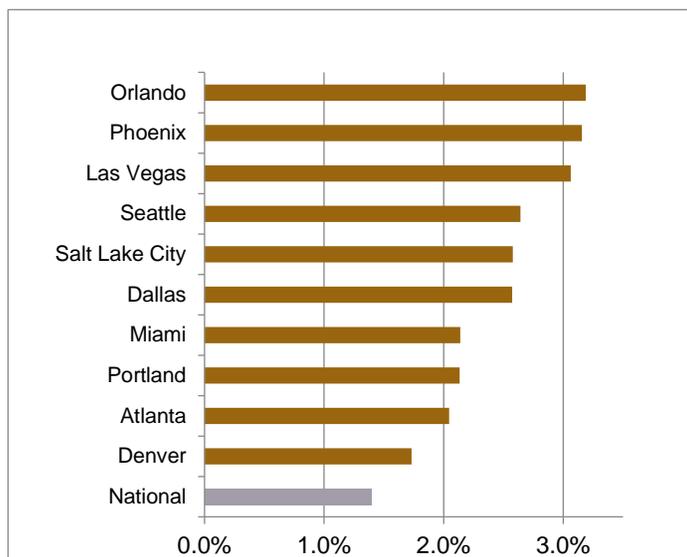


Other Metros Possibly Undersupplied

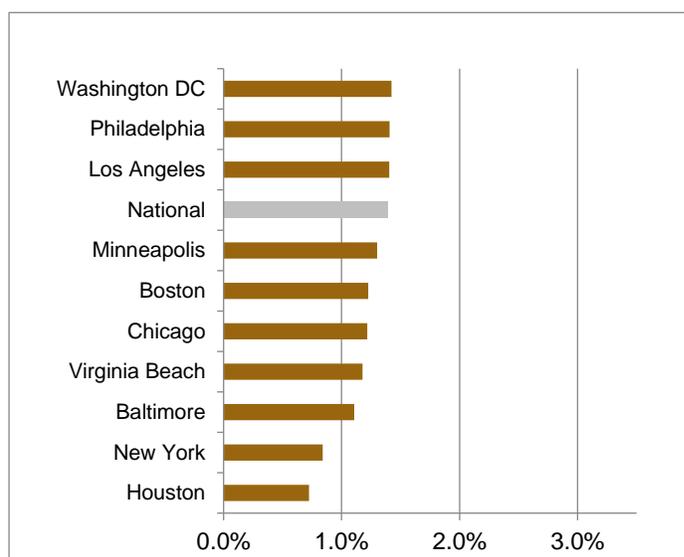
Job growth in other metros is expected to fare better, as seen below. Some of the Florida metros, including Orlando and Miami, will far surpass the national average. Dallas, one of the Texas metros not dependent upon the oil and gas sector, is expected to see 2.6 percent job growth due to continued expansion in its professional services, healthcare, and transportation sectors.

Orlando and Phoenix are both poised once again to see some of the best job growth in the nation, at an anticipated 3.2 percent, also thanks to growth in the professional services, healthcare, and tourism sectors. Yet both metros are likely to be undersupplied. Orlando is expected to see about 39,000 new jobs in 2017, resulting in possible demand for about 7,800 multifamily units, but only 5,300 units are expected to deliver this year. Phoenix is also likely undersupplied. It is expected to have about 63,000 new jobs in 2017, resulting in possible demand for about 12,000 multifamily units, but only 6,200 units are expected to come online this year.

Select Markets with Higher Expected 2017 Employment Growth



Select Markets with Lower Expected 2017 Employment Growth



Source: Moody's

Cap Rates Expected to Rise – but Not Skyrocket

The 10-year Treasury has risen more than 100 basis points over the past six months, and, as a result, it is expected that commercial real estate capitalization rates will start climbing as well, multifamily included. With multifamily cap rates currently at historically low levels – an estimated 5.4 percent at the end of third quarter 2016, according to Real Capital Analytics – it would seem that they have nowhere to go but up. The only question is how high and how fast rates will rise.

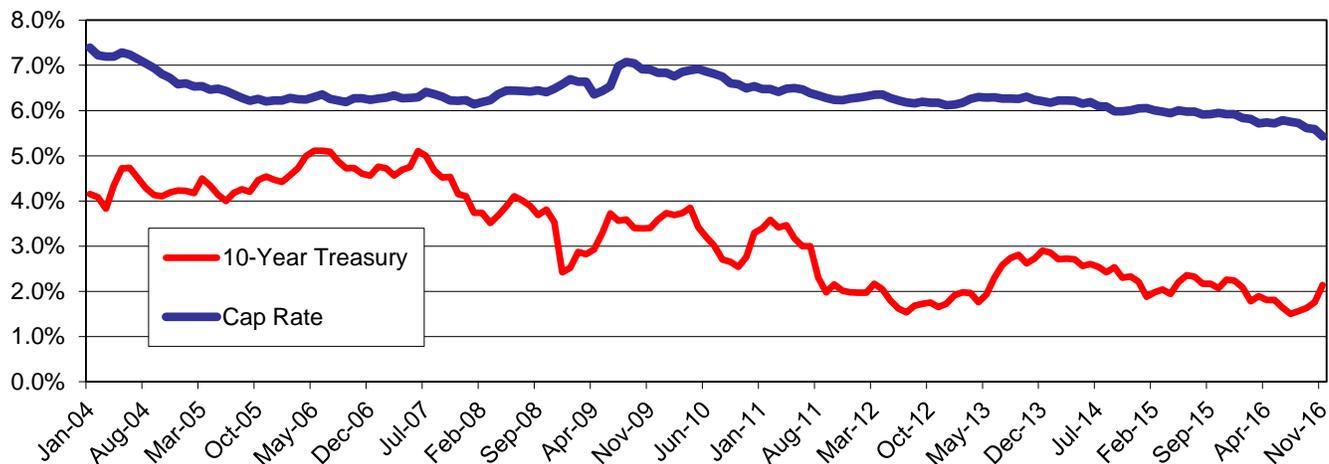
Multifamily cap rates have been drifting downward all year due to an influx of capital flows and investor demand. With interest rates now rising, it seems likely that investors might turn their attention away from the multifamily sector in a search for yield. This should help relieve the pressure on cap rates that resulted from too many investors pursuing the same properties in the same places.

As a result, the projection is that multifamily cap rates could rise to 6.0 percent by the end of the year. Keep in mind, even if cap rates reach 6.0 percent in 2017, the 10-year Treasury is forecasted to average 2.6 percent for the year, which would



create a healthy spread of 340 basis points. In fact, that is the same amount of spread that existed as of November 2016, according to Real Capital Analytics.

Treasurys and Multifamily Cap Rates



Source: Real Capital Analytics, and Federal Reserve, Selected Interest Rates H.15, per Moody's Analytics

2017 Outlook: Reduced Speed Ahead

The outlook for the multifamily sector in 2017 is positive but more subdued than years past. As a result, multifamily mortgage origination volume levels are expected to slow down, in line with the sector's market outlook.

The amount of new supply expected to come online this year is mostly located in 12 metros where job growth is expected to slow down and outpace demand. While there should be job growth spurring continued rental household formations, there is no denying that this concentrated amount of supply – consisting primarily of class A units – will likely cause a disruption in underlying fundamentals. Rising vacancy levels and reduced or negative rent growth could occur in certain submarkets, which would likely negatively affect the overall metro trend in the nation's oversupplied metros.

It is important to keep in mind that this slowdown is expected to be short-lived, occurring over the next 12 to 24 months. After that time, it is expected that the multifamily sector's underlying fundamentals will improve as new supply slows and stable job growth and demographic trends continue, resulting in increased demand.



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