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Commercial Real Estate Advisors®

APARTMENT Market Outlook

As the first sector to emerge from its recessionary slump, the apartment market has posted several years of intensive investment and rent growth, and continues to offer widespread potential for further gains. Investors must be cognizant of rising inventory levels, however, and the potential for declining rents in submarkets where construction is getting too far ahead of demand. Investors have good reason to expect further increases in demand as job growth enables more working-age adults to form new households. Millennials have shown a greater preference to rent than previous generations, with some studies indicating that more than half of U.S. residents in this group are renters, compared with about a third of adults across age groups. For this reason, communities experiencing pronounced in-migration by Millennials stand to create renter demand faster than those markets that are simply growing their populations. Because young professionals as a group are more amenable to moving to new communities than their predecessors, Millennial populations may expand quickly in cities with healthy employment growth. Many Baby Boomers, too, are trading single-family homes for urban apartments as they approach retirement age. Both groups are contributing to an urbanization trend in which renters prefer to live, work, dine and spend their leisure time in central neighborhoods or downtown districts. Not limited to major cities, the urban dynamic reflects an interest in walkable neighborhoods with mixed uses and excellent amenities. In some markets like Houston, downtown conversions and new construction has saturated some core submarkets with high-end space, while the new inventory has influenced the market to push up rents at existing properties. This has set the stage for value-add plays that target mid-range renters, who may be feeling priced out of the new rental stock. Regardless of the market, investors must keep a weather eye on the development pipeline to avoid flooding the market, as Las Vegas is in danger of doing this year with its ten-fold increase in units nearing completion.

AUSTIN, TEXAS

Texas's capital city increased its population by another 2.5 percent in 2013, making it the fastest-growing large city in America. That growth will generate more renter demand than the 17,700 apartments under construction in 2014 can satisfy, particularly in a market where median single-family home prices are rising beyond the reach of average wage earners. Apartment vacancy is less than 5 percent despite the addition of 5,400 units in 2013. Nearly half of apartment completions in 2014, or 4,500 units, will be in the Central Business District, where asking rents approaching $3 per square foot are more than double the market average. Aside from the pending surge in down-town supply, completions of non-CBD apartments will lag the rapidly increasing demand for market-rate apartments, fostering rent growth and creating opportunities for value appreciation at existing properties.

10 APARTMENT MARKETS TO WATCH

- AUSTIN
- BOSTON
- DALLAS
- DENVER
- HOUSTON
- KANSAS CITY
- LAS VEGAS
- PORTLAND
- RALEIGH AND THE RESEARCH TRIANGLE
- TUCSON

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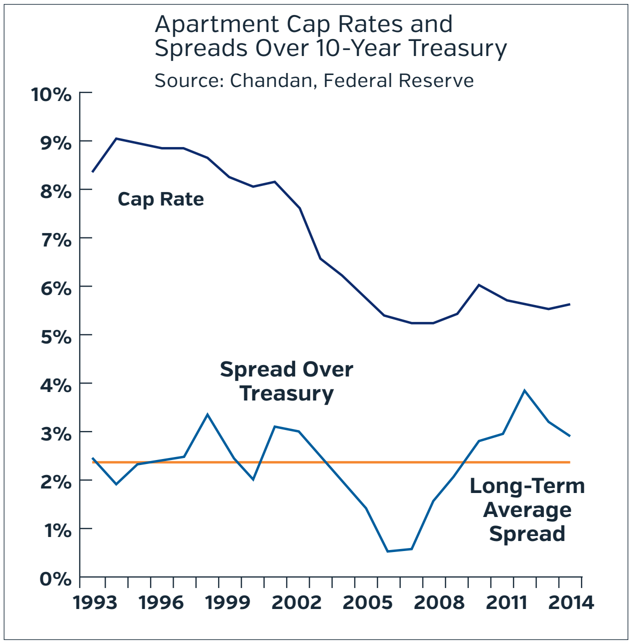
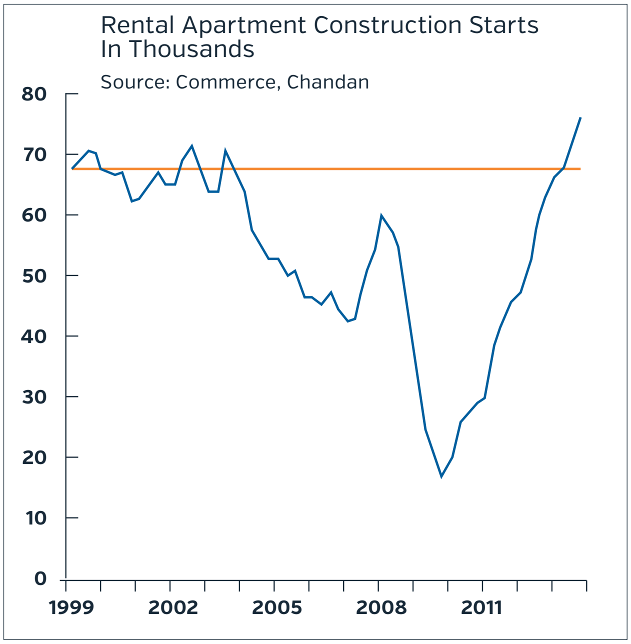
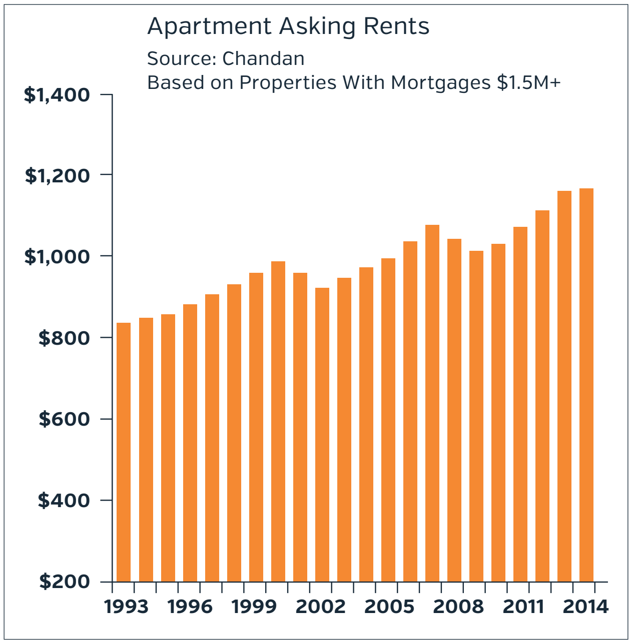
Key Apartment Market Trends in 2014

Rising interest rates are putting pressure on apartment cap rates, which are already considerably narrower than for other property types. By early 2014, the spread between apartment cap rate and the Treasury yield was approaching its long-term average. As interest rates head higher, apartment appreciation will depend more on income.



Apartment rent growth has slowed in many markets as new inventory has come online, alleviating the supply shortfall. The slow pace of renting Americans' income gains and the improving housing market are also factors tempering new demand. Nonetheless, the long-term outlook for renting remains strong, a permanent legacy of the housing crisis.





The impact of new inventory on occupancy and rental rates will persist. As of early 2014, rental construction starts had surpassed their long-term average level. Most markets will absorb the new space without rents falling significantly for older properties. However, pockets of overbuilding are a factor in some of the most popular investment markets.

BOSTON, MASSACHUSETTS

Boston's position as a top multifamily investment market (just behind New York and San Francisco) has pushed asset pricing to record highs and made construction an attractive alternative for investors. Local builders and institutional developers from around the country are cranking out new multifamily product here at the rate of about 4,000 units per year. That is well behind the pace of new household formation, which will be nearer to 7,000 annually over the next several years here. A falling vacancy rate, currently near 4 percent, has sparked spectacular rent growth of 20 percent or more over the past five years, although rents may plateau as new projects deliver large blocks of space and add vacancy. Much of the new construction is taking the form of large urban towers, answering the demands of well-paid, highly educated young knowledge workers attracted to Boston's 24-hour culture.

DALLAS, TEXAS

Combine low taxes, mild winters and a business-friendly climate with Dallas' central location relative to both U.S. coasts, and it's easy to see why this North Texas metro is enjoying annual economic growth of more than 3.5 percent. Reports early this year that logistics technology firm Omnitracs Inc. may bring as many as 1,000 jobs to the Dallas central business district simply added to the list of more than 50 major employers that have relocated to the metro area in the past two years, adding jobs and fueling population growth that will top 2 percent in 2014 alone. Renters in the Dallas-Fort Worth metro absorbed more than 16,600 apartment units in 2013, more than any other U.S. market, yet average vacancy of approximately 5.5 percent is well below the 10-year historical average of around 8 percent. While these fundamentals suggest good development prospects, the metro is also turning out apartments far faster than any other major market, completing nearly 13,000 units in 2013. That new supply could temporarily hamper rent growth in some submarkets.

DENVER, COLORADO

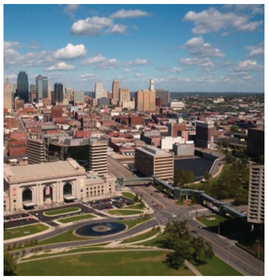
Denver will add nearly 50,000 jobs in 2014, with much of the growth occurring in high-paying energy, financial services, health care and bioscience industries. Employment growth of almost 4 percent in 2013 and a similar gain expected this year make Denver one of the nation's fastest-growing job markets. Multifamily rent grew at a remarkable 6 percent in 2013. The addition of 10,000 new units this year will expand the apartment inventory by more than 3 percent, however, enough to slow annual rent growth to a more modest 4 percent. Nearly half of the apartments under construction are in the central business district, where the renovated Union Station is set to open later this year. Existing and planned light rail lines offer development opportunities, as well as value-add plays for investors able to upgrade and reposition existing, older properties in these growth corridors.

MARKETS TO WATCH

NOT THE LARGEST or the most actively contested markets, the 2014 Apartment Markets to Watch are each at an important juncture that presents unique opportunities for investment. Together, they reflect the diversity of trends that is driving the economy and commercial real estate performance in markets across the country.

HOUSTON, TEXAS

Houston's multifamily market has been on a two-year high–and lenders are ready to take it down a notch. Construction will add nearly 11,000 units in the Energy City by the end of 2014, more than 6,000 of which will be in a handful of high-end urban submarkets, growing inventory in those neighborhoods by more than 6 percent. With the remaining 5,000 or so units to be completed elsewhere in the city, however, the overall vacancy rate of about 6 percent is unlikely to shift appreciably until 2015 or beyond, and remains low for this market. Houston's appetite for apartments is growing nearly twice as fast as the pace of construction, which is expected to add 10,000 units annually in 2015 and 2016. Nevertheless, some lenders concerned over the recent volume of development in Houston have tightened underwriting for construction loans, which could create a competitive advantage for investors with other sources of capital.



KANSAS CITY, MISSOURI

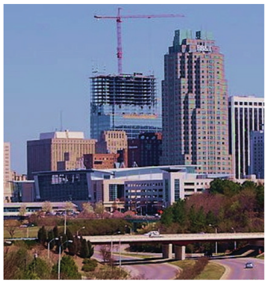
The arrival of Google Fiber has been a catalyst for start-up companies and business relocations to Kansas City. Job growth, which measured 1.3 percent in 2013, will jump to 1.8 percent this year and add more than 18,000 new positions to the metro economy. The market is on an aggressive development track that could add as many as 3,500 multifamily units in each of the next two years. The vacancy rate, which began 2014 around 5.5 percent, could reach 6 percent after this year's new apartment projects come online. Annual rental rate growth will accelerate to more than 3 percent this year. Outsized demand for high-end urban apartments has sparked several interesting conversions of older commercial buildings. Multifamily cap rates have compressed slightly but averaged more than 8 percent in 2013, offering attractive returns for investors seeking an alternative to first-tier markets.

LAS VEGAS, NEVADA

Apartment developers are playing a game of chance in Las Vegas. Encouraged by the first increase in average rents since the Great Recession and a recent improvement in the vacancy rate, projects in the pipeline could deliver as many as 3,000 multifamily units in 2014, a tenfold increase from the previous year. Granted, the local population will increase by 2.7 percent this year alone, making it one of the fastest growing U.S. cities. Yet this market must dig itself out of a deeper housing hole than most, and still has a ways to go. The apartment vacancy rate of 9 percent is more than 10 basis points above the historical average. Average rents have only recovered to 80 percent of the pre-recession peak, and thousands of single-family homes remain on the rental market. The nascent recovery merits some development but is unlikely to float all boats in 2014.

PORTLAND, OREGON

Multifamily construction has ramped up gradually in Portland, enabling landlords to grow rents even as new supply comes closer to matching the demand for apartments. After two years of adding some 2,000 multifamily units annually to the local inventory, and with a vacancy rate falling to near 3 percent, developers have stepped up the pace and will likely deliver 3,000 apartments in 2014. That accelerated construction activity will be enough to stabilize the vacancy rate and slow rent growth at existing properties. Portland's enviable quality of life, including outdoor attractions and an expanding cluster of amenities catering to an urban lifestyle, continues to support outpaced job growth. Technology employers, and the service industry jobs that grow around the technology workforce, will help Portland to add about 30,000 jobs in 2014, similar to 2013's employment growth. With only modest rent growth likely as apartment construction gains momentum, Portland offers opportunities for income investors, and some value-add plays remain for investors willing to invest in significant property upgrades.



RALEIGH AND THE RESEARCH TRIANGLE, NORTH CAROLINA

The seat of North Carolina's state government and home to more than 170 companies in the nearby technology hub of Research Triangle Park, Raleigh grew by more than 2.1 percent in 2013 and expanded its job count at an even faster rate of 2.44 percent. Knowledge-based employers and the stream of graduates from area universities have fostered a highly educated workforce, with nearly half of working-age residents holding a college degree, and that labor pool is attracting more employers and accelerating the market's population growth. A recent reduction in North Carolina's corporate tax rate will add to the market's attractions for employers. Multifamily vacancy contracted in 2013 to less than 4 percent, and although more than 12,700 apartments in the construction pipeline may temporarily slow rent growth, the market's long-term growth prospects will bring rents on track to increase between 2 percent and 3 percent annually through 2018.

TUCSON, ARIZONA

This Arizona market offers stable fundamentals, including a vacancy rate that has been rooted between 9 percent and 10 percent since mid-2011, and rental rates that have inched up steadily for more than a year. While the city's population growth of 1.9 percent since the end of 2012 was overshadowed by a number of faster-growing markets, Tucson's population of Millennials (ages 20-34) has rocketed up by nearly 11 percent since 2008, three times the national average. The rate of household formation will more than double in 2014 to approximately 1.8 percent, propelled by job gains that promise to drive down unemployment from the current 7 percent to 6.5 percent or lower. With steadily improving fundamentals in the forecast and asset prices that haven't yet entered the rapid escalation that comes with competitive bidding, Tucson offers enticing acquisition opportunities and value-add plays. Development may be more appropriate for the northern submarkets, where average vacancy is less than 7 percent.

IT'S A DIFFERENT WORLD OUT THERE.

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