

ApartmentResearch

MARKET REPORT

Marcus & Millichap

Philadelphia Metro Area

Second Quarter 2014

Unwavering Philadelphia Grabs Investors' Attention

Projected hiring across an array of established industries and favorable demographic trends will hold the Philadelphia apartment market on a course of steady property performance in 2014. A harsh winter hindered the local economy early this year, but job growth was nonetheless sufficient to drive hundreds of residents into apartments. Vacancy in the metro has resided in a tight band from the high-4 to mid-5 percent range for the past three years, a trend that will persist through year-end 2014. Greater job opportunities in the local economy will raise the probability of retaining many recent graduates of local colleges and universities, thereby expanding the pool of potential renters. Entrants into the rental housing sector will find some new complexes to select from. After an average 1,300 units were delivered annually over the preceding 10 years, Philadelphia is experiencing its version of a construction boom. More than 6,000 rentals will come online between last year and the end of 2014, a modest level relative to the size of the market.

While the strong performance of the apartment sector continues, the hesitancy of many owners to list properties for sale despite favorable operations and high investor demand contributed to a drop in transactions over the past year. Property owners that attempt to monetize recent gains in NOIs through a sale typically find a receptive audience of potential buyers and often generate multiple bids, placing upward pressure on values. In the city of Philadelphia, higher prices and lower yields on Center City properties are encouraging investors to broaden their searches to surrounding neighborhoods where quality assets, multiple demand drivers and the opportunity to capture higher yields exist. Cap rates for Class B and Class C assets in Philadelphia neighborhoods start at approximately 6 percent but can vary depending on location. In addition to existing rental properties, heightened rental housing demand is sparking interest in conversions and redevelopments. This trend will continue to develop in areas such as Center City and in up-and-coming South Philadelphia neighborhoods.

2014 Annual Apartment Forecast



Employment: Following a slow first quarter, the pace of hiring will pick up over the remainder of 2014. For the entire year, payrolls in the metro will expand 1.2 percent through the addition of 32,000 workers. In 2013, 12,400 jobs were created.



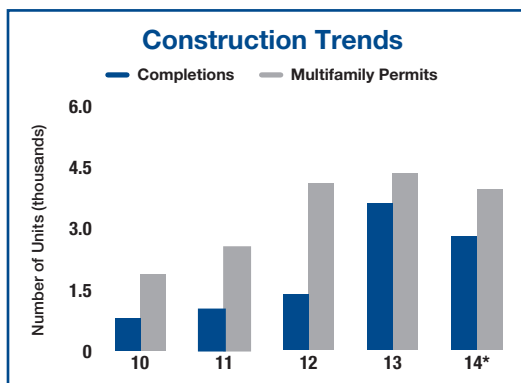
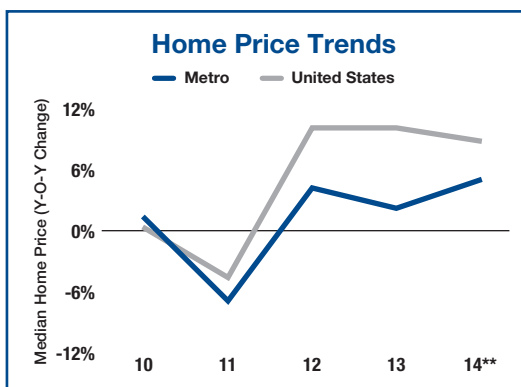
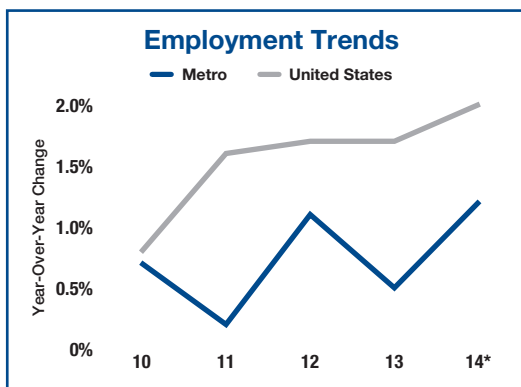
Construction: Developers will bring online 2,800 units this year, including 653 units in Center City and 264 rentals in the University City submarkets. More than 3,600 apartments were delivered metrowide in 2013.



Vacancy: Growing demand and strong absorption of new rentals will trim vacancy 30 basis points in 2014 to 5.2 percent, erasing last year's 30 basis-point rise.



Rents: The average rent in the market will advance 3.4 percent to \$1,159 per month during 2014, outpacing last year's gain of 2.0 percent.



*Forecast

** Trailing 12-month period through 1Q

Economy

- Employers put 7,700 additional workers on payrolls during the past 12 months, including 3,800 new hires in the first quarter this year. The unemployment rate slid 160 basis points over the past year to 6.5 percent.
- Professional and business services, a wide-ranging employment sector that includes degreed office-using professions, grew by 3,400 jobs since the first quarter last year. Most of the increase occurred in the first three months of 2014, when 2,600 positions were created.
- After weighing on employment trends since the recession started, construction payrolls continue to recover. Building trades added 4,000 jobs over the past year, including 600 jobs in the first quarter despite brutal weather that likely stalled many projects.
- **Outlook:** Employers in the Philadelphia metro will create 32,000 jobs in 2014, the highest annual total since the recession ended.

Housing and Demographics

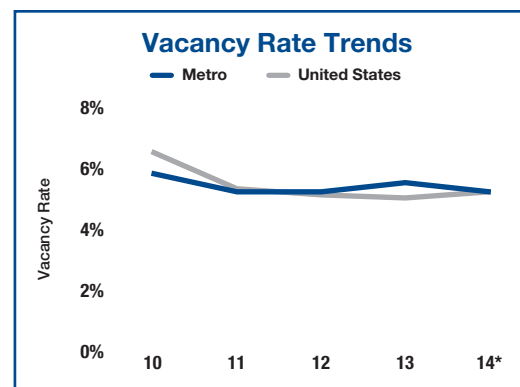
- Although weather slowed transactions in the first quarter, sales of existing single-family residences nonetheless rose 13 percent over the past 12 months. The median price climbed 5 percent during the period, to \$221,400.
- Home building continues to rise from post-recession lows. Over the past 12 months, single-family starts inched up 3 percent to roughly 5,900 units.
- Improving job opportunities are spawning a considerable number of new households in the metro. This year, nearly 14,000 new households are projected, following a gain of 9,900 households in 2013.
- **Outlook:** Household creation will generate new housing demand. High downpayment requirements and tight mortgage underwriting will discourage home purchases by younger households and maintain a large pool of prospective renters.

Construction

- Developers delivered 3,500 units during the 12 months ending in the first quarter, expanding rental stock a modest 1 percent. In the prior year, 1,100 rentals came online in the metro.
- In the first quarter, developers brought online the 232-unit Madison New Britain in Bucks County. Two market-rate projects with an aggregate 60 apartments were also completed in the Downtown Philadelphia submarket: 19th & Fairmount and the Wharton Street Lofts.
- Across the metro, work continues on more than 4,400 apartments. Nearly 2,000 units are underway in the urban core, in the Downtown Philadelphia and University City submarkets, while suburban building is greatest in the Norristown/Upper Merion/Lower Merion submarket. More than 900 units are under construction there, including 517 rentals scheduled for completion during 2014.
- **Outlook:** Builders are on track to complete 2,800 units this year, comprising primarily market-rate units. Multifamily permit issuance will ease slightly, to 3,900 units.

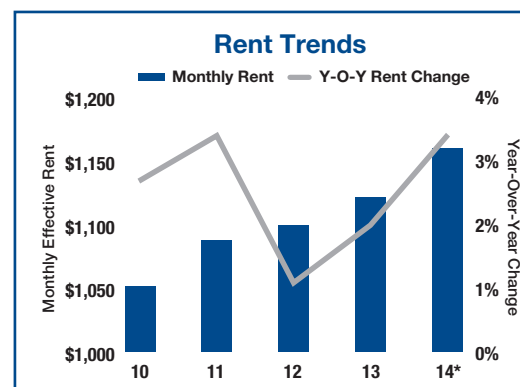
Vacancy

- Renters moved into an additional 2,500 apartments in the first quarter, slashing vacancy 60 basis points to 4.9 percent. The vacancy rate has decreased 50 basis points since the first quarter last year.
- More than 1,000 rentals came online in the Downtown Philadelphia submarket over the past year, pushing up the vacancy rate 330 basis points during that time to 6.2 percent. The first quarter, however, was rather strong, as net absorption of 472 units slashed vacancy 130 basis points.
- No apartments were delivered in South Jersey in the first three months of this year, but tenants occupied an additional 610 apartments, generating a 90 basis-point drop in vacancy to 5.1 percent. Demand was also strong in the Central Wilmington submarket, where the vacancy rate fell 50 basis points in the first quarter to 6.0 percent.
- **Outlook:** This year, the vacancy rate in the metro will fall 30 basis points to 5.2 percent, matching the lowest year-end level of the past three years.



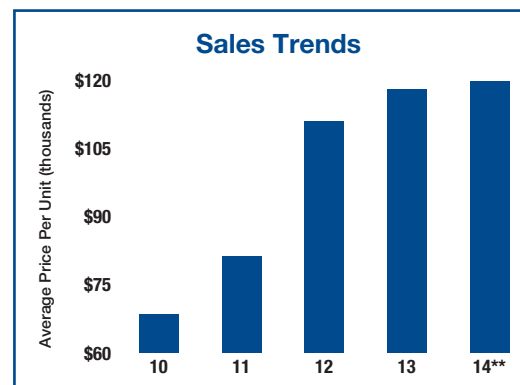
Rents

- Following a nominal increase in the final quarter of 2013, the average rent in the metro rose 1 percent in the first three months of 2014, to \$1,132 per month. On a year-over-year basis, the average rent is up 1.4 percent.
- Rents grew faster in South Jersey over the past 12 months. Since the first quarter last year, the average rent in that section of the metro advanced 3.6 percent to \$1,057 per month. A 2 percent gain was recorded in the first quarter of this year alone.
- Concessions are used sparingly across the market and sit at a minimal level. At the end of the first quarter, the average concession was 6.9 percent of the average rent, a level equivalent to more than three weeks of free rent.
- **Outlook:** The average effective rent will increase 3.4 percent in 2014 to \$1,159 per month while concessions will ease further because of tight vacancy.



Sales Trends**

- Limited listings contributed to a decline in transaction velocity over the past 12 months. Dollar volume also slid but remains at a significant level, exceeding the totals in 2010 and 2011 combined.
- Properties selling for \$1 million to \$10 million accounted for about 65 percent of all deals over the past 12 months, roughly the same proportion as in the preceding year. During the same span, assets trading for more than \$20 million represented 14 percent of all transactions, marking a slight drop from the prior period.
- Assets sold over the past year carried an average price of \$119,600 per unit, representing a slight increase from one year before and a continuation of an upward trend in pricing. Cap rates in city neighborhoods start at approximately 6 percent.
- **Outlook:** With the local economy growing and properties performing at a characteristically steady pace, equity and debt capital will continue to pursue transactions in the months ahead.



*Forecast
 **Trailing 12-month period
 Sources: CoStar Group, Inc.; Real Capital Analytics

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The U.S. economy is tracking a solid recovery that is supporting a robust multifamily sector. Assessing positive developments in the labor and housing markets, and the resiliency of the U.S. consumer, the Federal Reserve recently voted to reduce its monthly bond purchases by an additional \$10 billion. The yield on the 10-year U.S. Treasury has remained in the mid-2 percent range throughout the second quarter.
- Nationwide apartment vacancy was flat in the first quarter at 5 percent as demand growth virtually offset the completion of more than 45,000 apartments. Completions are on track to reach 215,000 rentals in 2014, the highest yearly total in several years. For the entire year, U.S. vacancy will rise 20 basis points to 5.2 percent, while the average rent will advance 2.6 percent.
- Fannie Mae and Freddie Mac are underwriting terms of five, seven and 10 years and offer maximum leverage of 80 percent. Interest rates currently range from about 3.5 percent at the low end of a short maturity loan to 4.5 percent for 10-year debt on loans of more than \$3 million. For loans greater than \$15 million, interest rates are 12 to 15 basis points less across the maturities, and for financing of less than \$3 million, interest rates rise from 20 basis points to 30 basis points.
- Conduits are more active and are considering a wide range of markets and asset quality. CMBS loans are generally written at rates varying from 4.5 percent to 5 percent and leverage up to 75 percent and, in limited instances, 80 percent. Other active sources of apartment lending include commercial banks and life-insurance companies, and specialty providers of bridge and mezzanine financing.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rent	Y-O-Y % Change
1	Gloucester County	3.3%	-290	\$929	1.1%
2	Northwest Philadelphia	4.0%	-90	\$1,231	-2.0%
3	Chester County	4.1%	80	\$1,305	1.9%
4	Norristown/Upper Merion/Lower Merion	4.1%	-190	\$1,245	1.8%
5	Bucks County	4.2%	-70	\$1,045	2.0%
6	University City	4.3%	-130	\$1,239	1.1%
7	Burlington County	4.4%	-90	\$1,065	5.0%
8	Newark, Delaware	4.6%	-100	\$1,021	0.4%
9	North Montgomery County	4.8%	-110	\$1,164	-0.6%
10	Northeast Philadelphia	5.1%	120	\$904	0.8%
11	Delaware County	5.3%	50	\$1,020	0.0%
12	Outer Wilmington	5.5%	-20	\$958	1.3%
13	Camden/Cherry Hill	5.6%	-160	\$1,192	1.5%
14	Central Wilmington	6.0%	-10	\$1,066	4.3%
15	Downtown Philadelphia	6.2%	330	\$1,988	0.4%
16	Lower Camden County	6.4%	-120	\$965	5.8%