

# ApartmentResearch

MARKET REPORT

Marcus & Millichap

Philadelphia Metro Area

Fourth Quarter 2014

## Philadelphia's Stability Draws First-Time Apartment Buyers

Stable growth in the Philadelphia economy continues to drive household formation and apartment demand as employers increase payrolls throughout the metro. Millennials are drawn to the conveniences of urban living in downtown Philadelphia and University City, fostering demand for apartments in these areas. Developers are responding optimistically to the heightened need for rental units by ramping up new projects. One of the largest projects is the East Market Redevelopment Project in Center City that will revamp the city block from 11th to 12th streets and Market to Chestnut. Rising development in downtown Philadelphia, though, has temporarily outpaced demand, raising the vacancy rate. Condo construction is also coming back in core areas; however, many projects underway are high-end residences, which are beyond the affordability of many renters. Housing demand is rising in suburban areas, and builders are being drawn farther into the suburbs. Higher rents commanded by new units in the core and limited availability of rentals in the suburbs are driving rent growth in the market, with concessions becoming less prevalent.

Strong operations, healthy net operating income and more attractive returns than other major northeast markets are luring investors to the Philadelphia metro. Apartment listings, though, remain limited and competition among buyers is pushing prices higher. First- and second-time private buyers from New York City and Northern New Jersey are also being drawn by the metro's comparatively affordable prices and higher yields. These investors are taking advantage of low-cost financing and targeting Class B/C assets in suburban areas such as Montgomery County and Delaware County. Meanwhile, more seasoned investors are picking up older, well-located properties in prime submarkets. Institutions are looking for new top-tier assets in Class A locations like Center City and University City. These buyers are also looking in higher-end suburban locations such as Main Line, King of Prussia and Malvern, where cap rates can dip below 5 percent.

## 2014 Annual Apartment Forecast



**Employment:** This year employers are on track to bolster payrolls with an additional 21,000 workers, a year-over-year increase of 0.8 percent. Meanwhile the unemployment rate is expected to dip below 6 percent by year end. In 2013, total employment rose 0.5 percent.



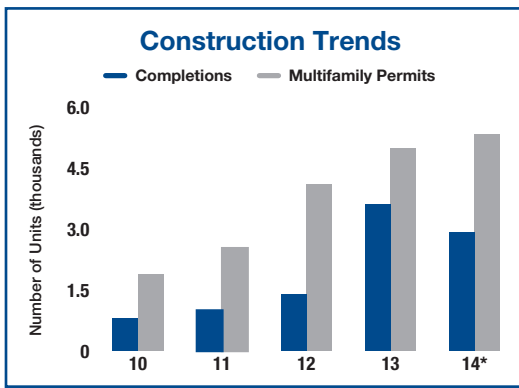
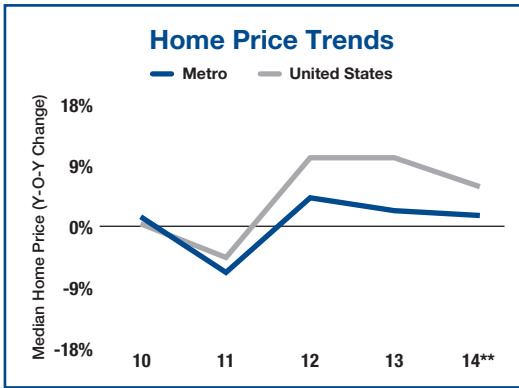
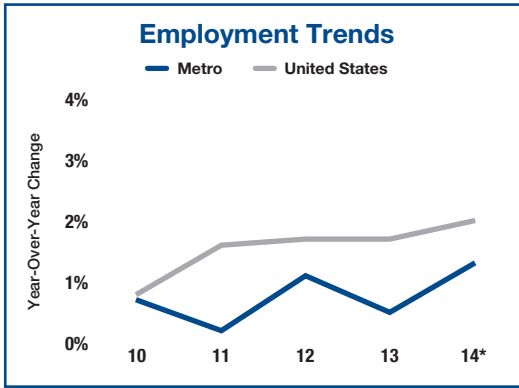
**Construction:** Developers are poised to increase rental stock 0.8 percent in 2014 with 2,900 units scheduled for completion. In 2015, 3,200 new rentals will come online. Last year 3,600 apartments were placed into service.



**Vacancy:** Despite an anticipated 30-basis point rise in the fourth quarter, the vacancy rate will decline 70 basis points this year to 4.8 percent on net absorption in excess of 5,000 units. Last year, vacancy rose 30 basis points.



**Rents:** In 2014 rising demand for rentals will lift effective rents to \$1,159 per month, a 3.4 percent annual increase, after a 2.0 percent jump last year.



\* Forecast  
 \*\* Trailing 12 months through 3Q

## Economy

- In the first three quarters of the year employers in the Philadelphia metro boosted hiring 0.7 percent with the creation of 19,900 positions, outpacing job growth of 18,100 positions in the same span last year.
- Year-to-date employment gains were led by the professional and business services and the trade, transportation and utilities sectors, which added 7,800 and 7,900 positions, respectively. The government sector posted the largest losses in the metro, shedding roughly 6,600 workers.
- The unemployment rate fell 80 basis points to 6.2 percent during the first nine months of the year. Over the same period last year the rate declined 70 basis points.
- **Outlook:** This year employers are on track to add 21,000 workers to payrolls, a year-over-year increase of 0.8 percent. In 2013, total employment inched up 0.5 percent.

## Housing and Demographics

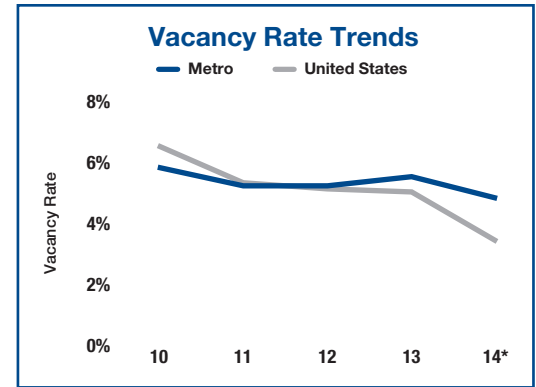
- Over the past year, sales of existing single-family homes declined 9 percent. Nonetheless, the median existing home price rose 1 percent to \$220,700. Home construction is slowing down with completions slightly lower than last year's pace of 5,900 homes. Housing starts were also down 19 percent.
- The mortgage payment on a median-priced home, assuming traditional financing, was \$1,207 per month in the third quarter. Meanwhile, the average rent for an apartment built since 2000 was over \$400 more per month, restricting rent growth in suburban areas where there is a higher inventory of single-family housing.
- Household formation rose 0.5 percent in the past 12 months with more than 11,000 households created in the metro. These new households are made up of mostly young professionals who are more likely to rent apartments than buying a single-family home or condo.
- **Outlook:** The rising cost of homeownership and future rises in interest rates will motivate many new households to rent.

## Construction

- In the year ending in the third quarter developers placed nearly 3,600 rentals into service, increasing inventory 1 percent. During the same period last year 2,000 units were delivered.
- Construction is heavily concentrated in the Downtown Philadelphia submarket. In the past year, more than 1,000 rentals were completed and an additional 1,800 are underway. Development is on the rise in the Southwest Philadelphia submarket, primarily near University City, where 1,300 units are being built.
- There are nearly 6,000 units underway across the metro. The largest of these is the 398-unit luxury complex Parc in Plymouth Meeting. The complex is scheduled for delivery in the fourth quarter of 2015. An additional 1,500 rentals are in the planning pipeline, though few projects have start dates.
- **Outlook:** Developers are positioned to increase rental stock 0.8 percent in 2014 with 2,900 units scheduled for completion.

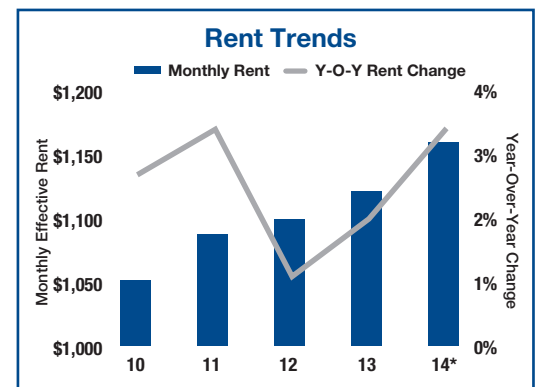
## Vacancy

- Vacancy in the third quarter fell 20 basis points over the prior year to 4.5 percent. During the corresponding period last year vacancy rose 10 basis points.
- In the Chester County submarket, vacancy declined 90 basis points year over year to 2.3 percent, the lowest rate in the market. However, vacancy will likely increase in the coming year as nearly 500 units are expected to be delivered in the submarket.
- Elevated construction outpaced demand in the Downtown Philadelphia submarket, pushing vacancy up 20 basis points to 5.1 percent. Vacancy in the Southwest Philadelphia submarket recorded one of the biggest declines in the market, falling 100 basis points to 4.4 percent.
- **Outlook:** Despite an anticipated 30-basis point rise in the fourth quarter the vacancy rate will decline 70 basis points this year to 4.8 percent. Last year, vacancy rose 30 basis points.



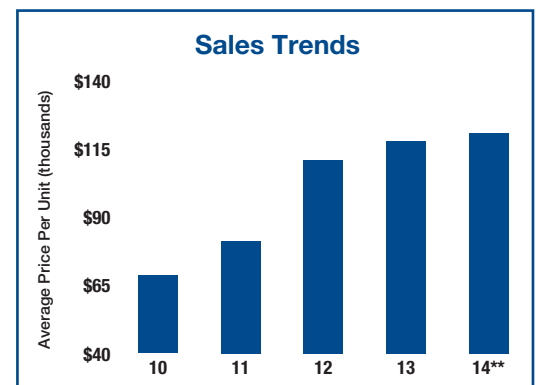
## Rents

- High occupancy and low competition from the new for-sale housing market enabled operators to lift average effective rents 3.2 percent to \$1,155 per month in the annual period ending in the third quarter. In the corresponding period last year effective rents rose 1.3 percent.
- Elevated rents charged by new luxury units in the Downtown submarket and strong tenant demand for rentals drove up effective rents 2.6 percent to \$2,004 per month. Effective rents in the Lower Camden County, Outer Wilmington, Gloucester County and Northeast Philadelphia submarkets were all below \$1,000 per month.
- Average effective rents in South Jersey rose 3.4 percent in the past year to \$1,077 per month. In Northern Delaware, operators lifted rents 3.3 percent to \$1,035 per month.
- **Outlook:** This year, rising demand for rentals will lift effective rents to \$1,159 per month, a 3.4 percent annual increase.



## Sales Trends\*\*

- Transaction velocity edged up slightly in the past year, pushing total dollar volume over \$1 billion. Listings in South Jersey are attracting increased investor attention as prices continue to rise west of the Delaware River.
- Properties that were built pre-1980s in suburban submarkets traded at roughly \$80,000 per unit in the 12-month period ending in the third quarter. Meanwhile, prices for newer properties in downtown Philadelphia and University City averaged above \$350,000 per month.
- Initial yields for Class A assets in the urban core often dipped down into the mid-4 to low-5 percent range while smaller residential buildings in the area traded in the mid-5 to mid-6 percent bracket.
- **Outlook:** Newly built properties in Center City and University City will present new opportunities for institutional investors. Stability in the Philadelphia market will sustain a liquid investment market.



\* Forecast  
 \*\* Trailing 12 months through 3Q  
 Sources: CoStar Group, Inc.; Real Capital Analytics

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## Capital Markets

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

- Nationwide apartment vacancy held in the low-4 percent range through the third quarter as job growth and rising household formation continue to stimulate rental housing demand amid a cycle of increasing apartment construction. Long-term interest rates, meanwhile, remain low, as slowing economic growth in some regions of the world has supported a strong flight-to-safety flow of capital into the 10-year U.S. Treasury.
- The Federal Reserve was widely expected to complete its monthly bond purchases during the fourth quarter. The combination of the Fed's action and gathering economic momentum raises the prospects that the central bank will start lifting short-term interest rates in 2015. Once rates begin to rise, the impact on commercial real estate may be nominal. Historically, cap rates have not moved in step with interest rates.
- Fannie Mae and Freddie Mac continue to underwrite five-, seven- and 10-year acquisition loans and offer maximum leverage of 80 percent in most markets. Interest rates vary from about 3.5 percent at the low end of a short maturity loan to a range of 4.0 to 4.5 percent for 10-year debt of more than \$5 million. Debt service coverage ratios remain virtually unchanged from earlier this year, at 1.2X. New agency capital has also emerged in the form of the Freddie Mac Small Balance program, which caps loan amounts at \$5 million.
- Conduits are increasingly active in the multifamily sphere, providing borrowers with 10-year terms. CMBS loans are typically issued at rates varying from 4.3 percent to 5 percent and leverage from 75 percent to 80 percent. The application of interest-only financing for a portion of the term is gaining ground in this financing segment. Other active sources of apartment lending include commercial banks and life-insurance companies.

## Local Highlights

- Holtec International, a power-plant supplier, announced plans to build a new facility along the Delaware waterfront in Camden. The company plans to add approximately 3,000 jobs at the location over the next nine years.
- Moe's Southwest Grill is rolling out aggressive expansion plans in the Philadelphia market. The Atlanta-based restaurant chain will be opening six new locations every year for the next five years. The first eatery was opened in Doylestown early in the second quarter. Each new store is expected to create around 45 jobs.
- The pharmaceutical company AmerisourceBergen will be adding 185 positions over the next three years to its local operations. To accommodate the additional personnel, the firm will be renovating the 70,000-square foot Millennium III building in Conshohocken. The expansion is scheduled to be completed by the end of this year.
- Early in the fourth quarter work began on the first phase of the East Market Redevelopment Project. The initial phase will include demolition of many existing buildings from Market to Chestnut and 11th to 12th streets. It will also have a tower with 160,000 square feet of retail space and 322 apartments, and a 200,000-square foot court building will be renovated for future commercial uses.