

Investment Activity Picks Up as Buyers Seek Higher Yields

Multifamily sector maintains strength in face of headwinds.

Rising employment numbers and a boost to the median income are placing Philadelphia’s economy on firm footing for another year of steady growth. Expansion of the workforce has translated into more households being formed in the metro, though such a large delivery of top-tier rentals has extended lease-up of new complexes. Despite short-term fluctuations of property metrics, demand drivers in the market remain stable and continue to support the increase in development. The metro is home to an evolving startup and tech environment along with corporate giants that are growing their footprint and adding more workers, ensuring stable rental demand in the face of a supply influx.

Downtown luxury units dominate the pipeline. Center City has led the multifamily boom in Philadelphia, appealing to residents with higher incomes in the area as many rentals fall in the luxury category. More than 5,000 units have been constructed here so far this decade. The six largest projects under construction are rising in Center City, led by the 360-unit Franklin Tower, which is anticipated to open by year end. An influx of higher-priced units will keep demand for more affordable rentals in Gloucester County and Northeast Philadelphia stout, holding vacancy low.

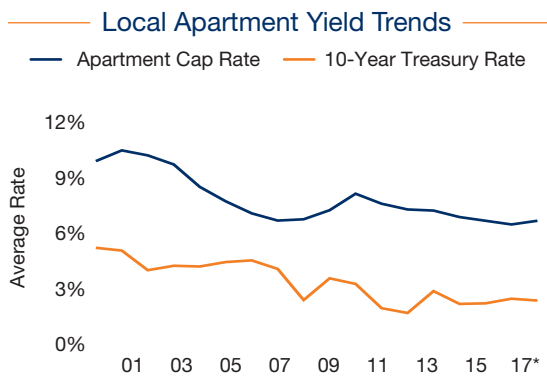
Multifamily 2017 Outlook

- 5,400 units will be completed

Construction: Development will reach a new high for the current cycle this year, pushing deliveries past the 5,100 units completed in 2016.
- 90 basis point increase in vacancy

Vacancy: Net absorption takes a large drop this year, pushing the vacancy rate up to 4.8 percent, erasing a 40-basis-point drop posted last year.
- 5.3% increase in effective rents

Rents: Rent growth persists despite a rise in vacancy, bringing the average effective rent to \$1,300 per month at year end. A 4.3 percent rise occurred in 2016.

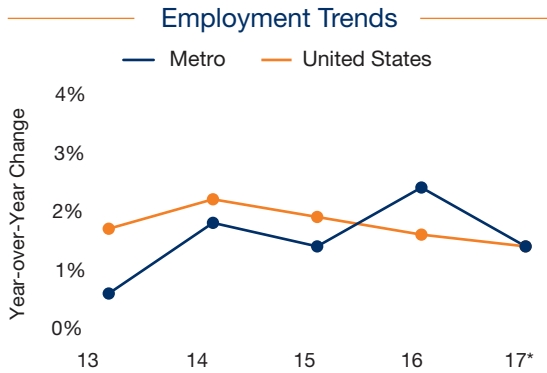


Investment Trends

- Yield-driven buyers are finding assets that match investment criteria across Philadelphia, driving up interest for the shrinking number of listings. Properties are sitting on the market for longer than they were in recent years, though, as buyers are performing ever-greater due diligence.
- Investors are being priced out of the Center City area as competition spikes, pushing private investors to search for assets in outlying neighborhoods. North of the downtown corridor, properties can trade with a going-in cap rate that is up to 100 basis points higher than comparable complexes to the south.
- Robust construction activity has kept institutional investors in play. They made up roughly 45 percent of transaction volume so far this year. First-year yields for these newer properties average in the low-5 to low-6 percent area once stabilized.

* Cap rates trailing 12 months through 3Q17; 10-year Treasury rate through Oct. 20. Sources: CoStar Group, Inc.; Real Capital Analytics

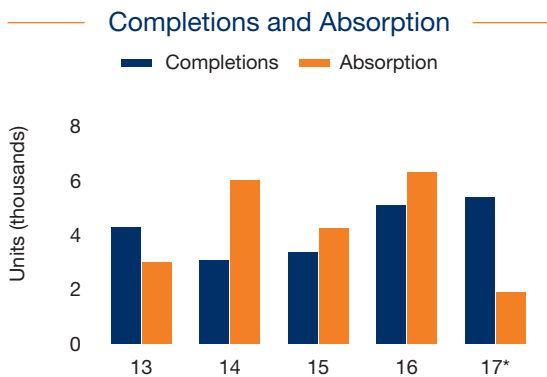
3Q17 – 12-MONTH PERIOD



EMPLOYMENT:

1.7% increase in total employment Y-O-Y

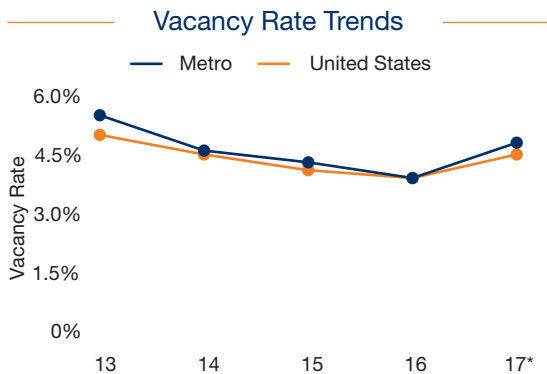
- Led by the professional and business services sector, which created 13,500 jobs during the past 12 months, the workforce expanded by 48,300 workers. Leisure and hospitality was also a major contributor with an additional 12,400 workers on company payrolls.
- The jobless rate fell 40 basis points over the year to end the third quarter at 4.7 percent.



CONSTRUCTION:

4,900 units completed Y-O-Y

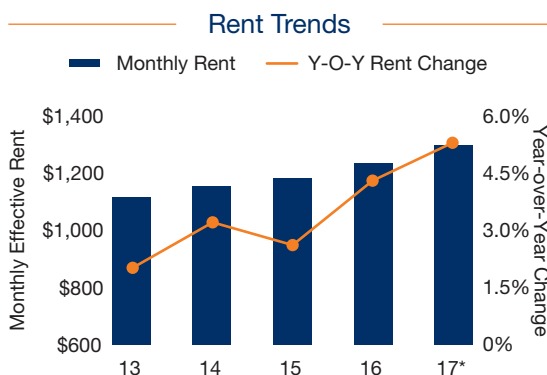
- Deliveries over the year ended in the third quarter were nearly on par with the 5,030 units brought into service over the prior yearlong period.
- The largest project completed over the past year was Indigo 301, a 363-unit market-rate complex located in King of Prussia. Riverworks in Phoenixville was the next largest with 349 units.



VACANCY:

140 basis point increase in vacancy Y-O-Y

- Net absorption over the past year fell to negative 740 units, raising the vacancy rate to 4.9 percent to end the third quarter, the highest rate since early 2014.
- Rental demand was greatest in Southwest Philadelphia as 490 units were absorbed over the year. The vacancy rate dropped 10 basis points to 8.6 percent; it was the only submarket to reduce vacancy.



RENTS:

4.5% increase in effective rents Y-O-Y

- Rental growth maintained an upward trajectory in the face of rising vacancy, climbing to \$1,290 per month and outpacing the 3.9 percent rise of a year ago.
- Rent gains were led by the Southwest Philadelphia submarket, where rent rose 12 percent from the third quarter of 2016 and advanced to \$1,642 per month. Northeast Philadelphia followed, up 8.8 percent to \$1,064 monthly.

* Forecast

DEMOGRAPHIC HIGHLIGHTS



FIVE-YEAR POPULATION GROWTH*

37,000



3Q17 POPULATION AGE 20-34
(Percent of total population)

Metro 21%

U.S. 21%



3Q17 MEDIAN HOUSEHOLD INCOME

Metro \$73,477

U.S. Median \$58,218



FIVE-YEAR HOUSEHOLD GROWTH*

85,000



POPULATION OF AGE 25+
PERCENT WITH BACHELOR DEGREE+**

Metro 34%

U.S. Average 29%

2Q17 TOTAL HOUSEHOLDS



33% Rent



67% Own

* 2017-2022

**2016

SUBMARKET TRENDS

Lowest Vacancy Rates 3Q17

Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
Gloucester County	2.8%	160	\$1,092	7.8%
Bucks County	3.3%	50	\$1,166	2.2%
Northeast Philadelphia	3.3%	90	\$1,064	8.8%
Delaware County	3.4%	10	\$1,194	2.8%
Burlington County	3.6%	110	\$1,203	3.1%
Camden/Cherry Hill	4.0%	20	\$1,268	1.3%
Lower Camden County	4.0%	140	\$1,033	0.5%
Newark	4.0%	0	\$1,112	2.4%
Northwest Philadelphia	4.8%	220	\$1,355	1.2%
Central Wilmington	5.0%	150	\$1,139	2.6%
Outer Wilmington	5.1%	200	\$1,074	5.5%
Overall Metro	4.9%	140	\$1,290	4.5%

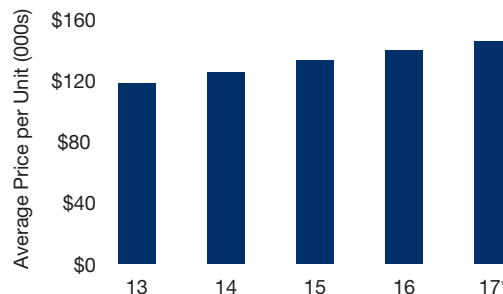
SALES TRENDS

Investment Activity Intensifies as Apartment Market Transforms Philadelphia

- Transaction velocity jumped 30 percent over the past four quarters from the prior period. Investors focused heavily on the Center City submarket, growing deal flow threefold.
- The average price per unit reached \$145,400 over the past year, up 5 percent. Going-in cap rates fell in the upper-6 percent band, marking a 10-basis-point rise.

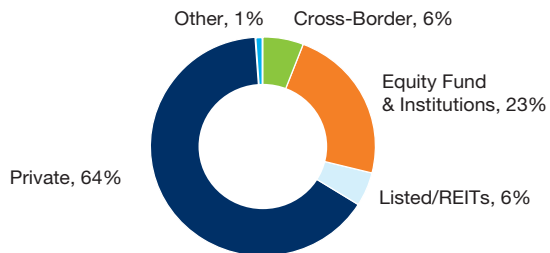
Outlook: Redevelopment efforts will maintain institutional attention in the downtown corridors while private investors will look for greater affordability in the immediate suburban areas.

Pricing Trends

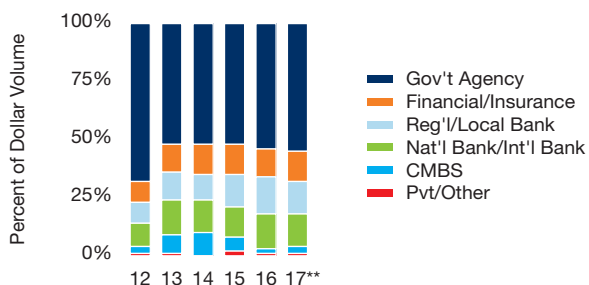


* Trailing 12 months through 3Q17
Pricing trend sources: CoStar Group, Inc.; Real Capital Analytics

Apartment Acquisitions
By Buyer Type*



Apartment Mortgage Originations
By Lender



* Trailing 12 months through 2Q17
 ** Through first half 2017
 Include sales \$2.5 million and greater
 Sources: CoStar Group, Inc.; Real Capital Analytics

CAPITAL MARKETS

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

- Monetary policy in transition.** Despite the Fed raising its benchmark short-term rate three times in seven months and signaling another rise before the end of the year, long-term rates have remained stable. The yield on the 10-year U.S. Treasury bond remained in the low- to mid-2 percent range throughout the third quarter of 2017. The Federal Reserve wants to normalize monetary policy and, in addition to raising its funds (or overnight lending) rate, has announced it will begin to taper its balance sheet by allowing an initial \$10 billion in securities to mature without reinvestment. By reducing its acquisitions of securities, 10-year Treasury rates should drift upward, thereby widening the spread between short- and long-term rates.
- Increase in interest rates over the course of the year, pushing up the cost of capital.** While commercial real estate fundamentals remain strong, rising costs associated with debt financing will tighten the spread between cap rates and lending benchmarks. This environment could weigh on transaction activity as investors evaluate their yield options. Cap rates have remained relatively stable over the last year, but upward movement in Treasury rates has amplified the expectation gap between buyers and sellers.
- The capital markets environment continues to be highly competitive.** Government agencies continue to consume the lion's share, just slightly over 50 percent, of the apartment lending market. National and regional banks control approximately a quarter of the market. Growing uncertainty about federal policy and global geopolitical concerns are keeping long-term interest rates down with pricing residing in the 4 percent realm with maximum leverage of 80 percent. Portfolio lenders will typically require loan-to-value ratios closer to 75 percent with interest rates in the high-3 to mid-4 percent range. As uncertainty remains regarding the possibility of tax policy revision, rental demand remains strong with the national apartment vacancy at 4.5 percent.

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; National Association of Realtors; Moody's Analytics; Real Capital Analytics; MPF Research; TWR/Dodge Pipeline; U.S. Census Bureau