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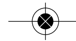
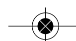


2011 Apartment Forecast By the Numbers

Is It Getting Better?

BY JEFFREY LEE



After facing a maelstrom of tight credit, job loss and weak housing demand in 2009, many in the apartment industry are understandably tentative as they enter 2011. Improved demographic demand coupled with virtually no new supply would seem to point to a profitable year to come for many apartment providers. But not every owner has such a rosy outlook. While trophy properties with strong performance continue to gain value as investors look for sure bets, apartment communities with weaker performance may still face challenges finding financing or attention from investors. And while demographic trends are pointing in a positive direction, disappointing job growth in 2011 could derail improvements in rent growth and occupancy.

Just how improved will the apartment market be in 2011? A number of established economists and research firms in the apartment industry offered their takes, painting a picture of slow but steady progress for the national economy, employment, apartment fundamentals and financing—as long as that progress isn't wiped out by a double-dip recession.

"This reflects some optimism about an improving job market," he says. "It may take individuals anywhere from six to nine months to find a job, but that is far better than the situation in early to mid-2009, when the nation was shedding hundreds of thousands of jobs per month.

"In other words, pent-up demand from renters tired of living with their families or roommates may be driving these results. Another factor seems to be flat or declining trends in house prices and mortgage rates. There is an incentive to sign 12-month leases for an apartment rental, versus committing to a home and a 30-year mortgage, particularly if home prices and mortgage rates are expected to stay low," Calanog says.

Apartments will gain a disproportionate share of new housing demand for other reasons, as well. "Between 2005 and 2009, the number of 18- to 34-year-olds living at home increased by 2.2 million, the highest level recorded in over 25 years," according to Marcus & Millichap. "Based on expectations that strict mortgage standards and elevated downpayment requirements will persist for several years to come, most young adults will head for the renter pool."

Loan servicers should continue to step up the pace in dealing with non-performing mortgages, Willett notes. "That throws

Economists predict a steady recovery for the apartment industry as a whole, but not all apartment owners will be swept up in the growth.

Job Growth Likely

The U.S. economy overall should improve in 2011. Pent-up consumer and business demand will begin to release next year and drive a stabilized recovery, with GDP growth at around 3 percent, according to Marcus & Millichap Research Services' economic outlook.

The consumer sector may still remain a drag on the economy, however, the firm says. Consumers continue to be strapped by tight credit, and the extended downturn has lead many households to pay down debt and increase savings rather than spending disposable income on goods and services.

Job production will likely remain limited and, importantly, inconsistent from month to month, according to Greg Willett, Vice President, Research and Analysis for apartment research firm MPF Research. While the onus of the recovery is on businesses, they first must regain confidence before they undertake more substantive hiring.

On the other hand, young adult hiring in 2010 has been the best since 1984, indicating substantial new household formation, notes Ron Witten, President of multifamily market advisory firm Witten Advisors.

So despite lackluster economic growth and continuing uncertainty in the labor markets, households appear to be returning in droves to the rental market and signing leases, says Victor Calanog, Director of Research for research firm Reis.

more owners who haven't been paying their way out there looking for other alternatives," he says. "Additional households who have been renting single-family homes that will go through the foreclosure process will be displaced, and lots of those households do end up back in apartments."

However, Calanog notes, if the rate of job creation remains disappointing through 2011, it is likely that strong numbers from apartment rentals may moderate.

Despite persistent weakness in consumer and business confidence, the risk of a double-dip recession remains unlikely, predicts Marcus & Millichap, and employment growth should strengthen next year to near 2 percent.

Demographic Delight in Store

For apartment operators, the favorable demographic trends lead to an optimistic outlook for next year. With virtually no new completions on the market, demand growth should drive occupancy significantly.

Entering Q4, occupancy is up to 93.9 percent after hovering around 92 percent through most of 2009, according to Willett. Q3 effective rents are up 1.2 percent quarterly and year-over-year, with particularly strong performance from the Midwest and the Carolinas, Willett reports.

Reis found similar improvement, with national vacancy falling from 7.8 percent to 7.1 percent, one of the sharpest drops in vacancy

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Best Bets for Investing

Real estate experts responding to the Emerging Trends in Real Estate 2011 study, conducted by PwC US and the Urban Land Institute, cited several "best bets" for investors and developers next year.

Temper Expectations. Buy well-leased core assets and look for 6 percent to 7 percent cash flows.

Lock in Leverage. Mortgage rates can't get much lower, and cyclical bottom is the optimum time to leverage properties in order to magnify future value gains as property fundamentals ameliorate.

Provide Debt and Recap Equity. Players who fill the gap on assets with lowered cost bases can obtain excellent risk-adjusted returns up and down the capital stack, including mezzanine debt and preferred equity, if not loan-to-own opportunities.

Focus on Global Gateways and 24-Hour Markets. Everybody wants to be in the primary coastal cities with international airport hubs.

Favor Infill Over Fringe. The "move back in" trend gains force as twenty-something Echo Boomers want to experience more vibrant urban areas and aging Baby Boomer parents look for greater convenience in downscaled lifestyles.

Patience Is a Virtue. Transaction activity will increase and more value-add and distressed deals will appear.

Buy or Hold REITs. Survey respondents expect solid, cash-flowing returns.

Buy Land. It won't get any cheaper than now, but prepare to wait for the right development opportunity.

Exercise Caution on Distressed Loan Pools. They could be a recipe for disaster if you don't underwrite the assets properly.

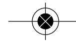
on record, and asking and effective rents rising by 0.5 percent and 0.6 percent respectively, about the same pace relative to Q2.

The consensus view is that rents should bounce back strongly in 2011. Witten Advisors predicts rents up 4.5 percent in 2011 as operators become aggressive in raising rents with little fear of losing customers to other housing options.

As demand picks up, occupancy should rise above the 95 percent mark, up 1 to 1.5 percentage points, according to MPF.

Shifting Investment Strategies

For developers, owners and investors, the big question at this



time last year was how lenders would manage their apartment portfolios. Would they continue to extend maturing loans, or would they demand repayment or sizable paydowns?

The answer, so far, seems to be a healthy mix of both. Servicers are extending more loans for deals that have life and can eventually repay, while foreclosing on others that have very little chance of repaying, either due to poor markets, physical conditions or bad sponsors.

That policy appears to be working, according to Mike Kelly of Caldera Asset Management. Tightening rent rolls and competitive debt markets will help many deals that were under water at the end of 2009 to be able to return some equity.

"There is an incentive to sign 12-month leases for an apartment rental, versus committing to a home and a 30-year mortgage, particularly if home prices and mortgage rates are expected to stay low."

Victor Calanog, *Director of Research,* Reis

Investors have begun to accept that the wave of deeply discounted, distressed opportunities they were expecting has not panned out. That capital, however, is now turning its focus to

10 Markets to Watch

Participants in the Emerging Trends in Real Estate 2011 survey believe the 24-hour cities will always dominate and outshine secondary markets.

This year, the top markets selected by survey respondents offer no surprises. Washington, D.C., pulls away from the pack, followed by San Francisco, Boston and Seattle, as the pre-eminent gateway cities. Houston and Denver solidify rankings, and respondents show faith in Southern California's resiliency, despite recent setbacks.

While ratings improved for markets from coast to coast over 2010's results, the gap between top and bottom continues to widen. More than 60 percent of surveyed cities still fall below "fair" ratings for commercial and multifamily housing investment prospects. Following is a snapshot of the top 10 markets ranked by survey respondents:

Washington, D.C. Never far from the top, the nation's capital will hold onto its top ranking as long as the economy labors. The federal government never downsizes, while lobbyists and consultants swarm legislators and agencies hoping to influence or stop regulatory changes. All the activity cushions property markets and attracts investors. No market benefits more from core buyers' recent flight to quality, driving prices back up.

New York. TARP and Fed funds directed at banks helped financial markets and eased job cuts, triggering the biggest ratings jump for New York. Apartment rents rebound along with coop/condo prices, which registered only minor drops in top neighborhoods.

San Francisco. The country's most volatile 24-hour market, the City by the Bay now offers investors excellent near-market-bottom buying opportunities, particularly in apartments and hotels. The market also sidesteps some of its state's fiscal mess, performing better than Southern California. Tech and life science industries flourish around top-flight universities (Stanford, UC Berkeley), help attract brainpower, and sustain expensive regional living standards.

Austin. A smaller Texas market that scores high ratings. Survey participants note, "Everyone wants to live in Austin." As the state capital and home to a major university (hook 'em, Horns), Austin is one of the few cities in the Sunbelt with growth restrictions.

Boston. This venerable 24-hour city registers high marks for livability, controlled development, and a highly educated labor force, but lacks economic vibrancy. Apartment rents will track back up as expensive for-sale housing keeps tenant demand high for multifamily units.

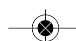
Seattle gets a boost from in-migration to the area, adding 160,000 new residents since the recession.

San Jose aligns with San Francisco gateway benefits, including a flourishing tech and life sciences industry.

Houston is expected to emerge stronger from the recession than most cities, creating more real estate demand.

Los Angeles remains an attractive location with Southern California serving as the most important gateway to the Pacific Rim and Latin America.

San Diego tracks closely to Los Angeles with its desirable climate.



stabilized assets, according to Marcus & Millichap. Competition for deals has increased and cap rates have started to contract for higher-quality properties. On average, cap rates dropped 10 basis points this year to 7.3 percent, while per-unit prices rose 9 percent to $83,600, the firm found.

Along with that improvement in pricing, investors are tempering their real estate return expectations, according to the Emerging Trends in Real Estate 2011 report released in October by PwC US and the Urban Land Institute. Investors anticipate high-single-digit returns for core properties and mid-teen returns for higher-risk investments.

"Investors have begun and will continue to target those markets where the prospects for job creation are stronger," says Mitch Roschelle, Partner, US Real Estate Advisory Practice Leader, PwC. "This is why we see this flight-to-quality trend of late in the real estate industry, and this is a factor contributing to the lowering of cap rates in some recent transactions in certain large, coastal cities."

Debt Markets Loosening

The report also predicts that debt markets will thaw further in 2011 as banks continue to strengthen balance sheets, take their losses and step up lending, resulting in higher transaction volumes. Borrowers are expected to have improved chances to obtain refinancing if they own relatively well-leased, cash-flowing properties. But overleveraged owners dealing with high vacancies and rolling down rents may face more uncertain prospects in the credit markets, including the increasing likelihood of foreclosure.

"Real estate market participants continue to see a gulf between buyers and sellers; however, there is an expectation that the bid-ask spread will begin to close in 2011 as selling sentiment improves dramatically from last year's all-time survey lows and buyers temper expectations for giant discounts," says ULI Senior Resident Fellow for Real Estate Finance Stephen Blank. "Investors with cash could have excellent opportunities to seize market bottom plays by recapitalizing cash-starved owners or buying foreclosed assets."

Caldera's Kelly predicts the government agencies Fannie Mae and Freddie Mac will continue to lead the debt markets. Freddie Mac's Capital Markets Execution product has become a staple in many new acquisitions, and Fannie Mae should come on strong as its Delegated Underwriting and Servicing (DUS) lenders become more aggressive.

Longer term, the White House faces a Jan. 31 deadline to present its plan for reforming Fannie Mae and Freddie Mac, and Congress has indicated that GSE reform will be their first major initiative for the new Congress next year.

At a recent industry event, U.S. Department of Housing and Urban Development (HUD) Secretary Shaun Donovan pledged that the Administration is "fully committed to not just making sure that multifamily is part of the debate, but that it is part of the solution."

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Greg Willett, *Research and Analysis,* MPF Research

Will Cap Rates, Taxes Jump?

While recent trends offer a great deal to keep the apartment industry optimistic about the future, there are also a number of unanswered questions, Kelly says.

- If Freddie and Fannie consolidate or change styles, what happens to the apartment market? Will cap rates jump?
- Owners have seen cap rates improving, but many of these sales have been newer properties in prime markets. Can they expect the same for B and C properties, or is the apartment industry entering a world of "haves" and "have nots?"
- Effective rent growth looked strong in 2010, but residents who signed a lease with concessions are now coming up for renewal. Will they be willing to accept increases of 5 percent or more in their effective rent?
- What about expenses—particularly taxes? Could they go up faster than multifamily housing operators expect?

While industry experts and researchers can make forecasts about the year ahead, their predictions only go so far. Finding the answers to these questions and more will make 2011 a fascinating year to watch.

Jeffrey Lee is NAA's Manager of Communications and can be reached at 703/797-0647 or jeffreylee@naahq.org.

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