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UPDATE ON THE MULTIFAMILY INDUSTRY

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2010 MID-YEAR REVIEW AND FORECAST UPDATE EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The Economy

- The “Great Recession” was unusually long in duration and severe, both in terms of declining output and employment. It was the worst U.S. downturn in the post-War period by nearly every measure.
- To date, the recovery was weak by historical standards and exhibited unusual and disconcerting slowing in its fourth quarter (2Q10). Because the market disequilibria that produced it are not fully resolved, the recovery is likely to continue to fall short of historical norms through 2011, although a “double-dip” recession remains a low probability event.
- Payroll job creation will average about 100,000 jobs per month in 2H10, accelerating to 125,000 to 150,000 jobs per month in 2011 and 2012. The risks in the short term are largely to the downside.
- This level of employment growth is sufficient to reduce the rate of unemployment, but only at a leisurely pace. Existing and prospective tenants will remain anxious about employment security and will manifest this concern in their leasing and household formation behavior.

National Apartment Market Performance

- The Great Recession had a measurable negative impact on the household formation behavior of Americans aged 20 to 29 years, commonly referred to as the “renter cohort” or generationally as “Gen Y.”
- The number of households headed by renter cohort individuals declined by 480,000 (-3.1%) during the recession, even as the size of Gen Y increased by 2.3%. The two demographic trends gave rise to tremendous pent-up demand for housing independence among this group.
- Improved job prospects in the first half 2010 allowed a portion of this pent-up demand to be unleashed, contributing to the strongest apartment absorption recorded in ten years and the first meaningful broad based rent increases observed since early 2008. Reis report that average occupancy increased 20 basis points to 92.2% and average asking and effective rents advanced 0.5% and 0.9%, respectively, from December to June.

- **RED Research** estimate that untapped demand for rental apartments in major metropolitan areas among Gen Y individuals ranges from 100,000 to 125,000 units, boding well for intermediate term apartment market performance.
- Reis forecasts call for an 160 bps increase in average occupancy (to 93.8%) by YE2014, accompanied by 2.7% annual effective rent growth.
- **RED Research** are of the view that the Reis forecasts do not incorporate the impact of unsatisfied demand among Gen Y households, causing the estimates to be moderately conservatively biased.

Metropolitan Apartment Market Performance

- First half occupancy gains were strongest in the (non-California) West, Florida and Southeast regions, where gains averaged 40 to 60 bps. Conversely, progress in most California and Washington-to-Boston corridor markets was modest.
- By contrast, rent increases were steepest in the Mid-Atlantic and Northeast regions, which posted 1.2% to 1.9% average gains December to June.
- Following a typical path, apartment demand in the “growth” markets rebounded earlier in the up-economy cycle than the high-cost barrier protected coastal markets and the slow-growth Midwest. Technology centers (Denver, Portland, Raleigh and San Jose) also posted impressive gains.
- Markets with technology-, finance- and government-oriented economies chalked down the largest average rent increases. A group of Sunbelt growth markets also showed good speed out of the recovery gates, including Houston, Nashville and San Antonio.
- The weakest income trends were recorded by Midwest commodity markets and the “growth” segment economically-dependent on construction and leisure travel; notably Las Vegas, Orlando and Phoenix. Los Angeles was conspicuous among the under-performing group.

Multifamily Property Market Trends

- Activity in the property markets during the first six months of 2010 were in line with levels observed during the July – December 2009 period. The role played by distressed assets, however, was smaller.
- Cap rates fell measurably in the spring. Real Capital Analytics estimate that the average initial property yield fell 20 bps from December to June and 40 bps from June 2009 to June 2010 to 6.8%.

- Institutional investors appeared to gear up acquisition efforts during the summer months. Anecdotal evidence suggests that cap rates applicable to trophy properties in the top metro areas declined 50 to 75 bps over the course of a few weeks.

Expected RED 50 Metropolitan Investment Total Returns

- The improved property performance outlook over-balanced the observed increase in property valuations; pushing average estimates of expected five-year, unlevered total returns for the **RED 50** markets from 6.7% in February to 7.4% in August.
- **RCR** expect dynamic growth markets favored for expansion by small businesses and entrepreneurs to offer the strongest potential for high total returns. Five markets set themselves apart in this regard: San Antonio; Fort Lauderdale; Charlotte; Austin and Indianapolis. Houston, Dallas and Salt Lake also score well with respect to expected total returns.
- Conversely, the federal government-centric markets and the gateway metropolises (Boston, Los Angeles, New York and San Francisco) rank in the bottom quartile of the **RED 50** in regard to expected total returns, largely due to Reis forecasts of tepid rent growth. **RCR** view the Washington, D.C. area as overpriced on a relative value basis, but are of the mind that Reis rent forecasts for the gateway metropolises are biased negatively.

The Impact of the “Gen Y” Demographic Cohort on Prospective Apartment Demand

- Some industry analysts predict an impending apartment “shortage” due to growing demand from the Gen Y demographic cohort and the current dearth of apartment construction.
- A close examination of the demographic data suggests that the expansion of the “renter cohort” of individuals aged 20 to 29 years because of the maturation of Gen Y will have only a modest impact on net apartment demand over the next decade. Moreover, it is unlikely that the dearth of apartment construction will be a long-lived phenomenon if the economic recovery proves strong enough to catalyze energetic apartment leasing among this group.
- Rather, it is the existing pent-up demand for apartments among Gen Y that will materially impact metropolitan apartment markets. The release of this unsatisfied desire for independent living arrangements will be manifested over the next two years, assuming the recovery supports the trend, causing realized apartment absorption to materially exceed Reis projections. After 2012, demographic factors will be largely neutral for the apartment industry.