INSTITUTIONAL INSIGHTS

MULTIFAMILY MARKET INTELLIGENCE

IPA | INSTITUTIONAL PROPERTY ADVISORS

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Multifamily Update

August 2022

Six Key Takeaways from Today's U.S. Apartment Market Performance

As we move into the second half of 2022, it is a good time to pause and take stock of the U.S. apartment sector results posted during recent months, and to perhaps tweak the performance expectations anticipated for the rest of the year.

Here are six key trends that will play significant roles in shaping near-term apartment industry financials.

Renter Demand is Returning to a More Normal Level

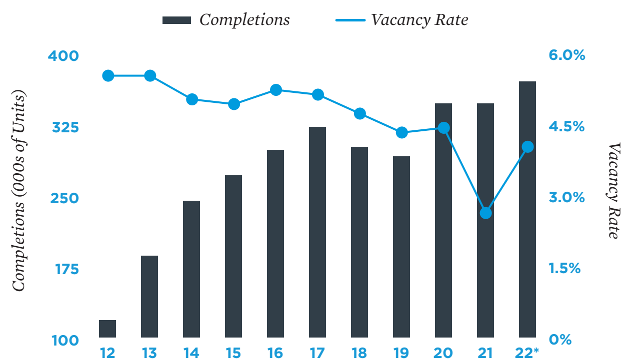
On net, renter demand for apartments came in at a sluggish volume of fewer than 50,000 units in the first half of 2022. While it was clearly going to be impossible to sustain 2021's annual absorption pace of more than 600,00 units, it is now going to be challenging to achieve an annual demand level typical of the late 2010s as net absorption for 2022 is likely to land near 100,000 rentals by year-end.

Some of the traditional key drivers of apartment demand are still positive influences. Monthly job additions continue to come in well north of 400,000 positions, and loss of renters to purchase has been curtailed by the combination of rising home prices and higher mortgage interest rates. However, the pace of new household formation seems to be taking a hit, due to concerns over inflation and the question of whether a recession is imminent.

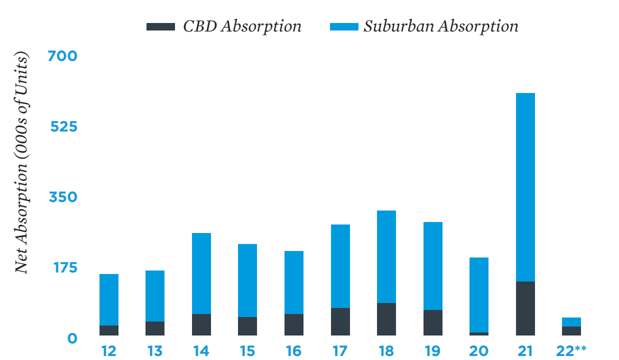
Household composition of those signing new leases for apartments is an under-the-radar metric to monitor during the next few months. Some property owners and operators are beginning to report an uptick in the share of demand coming from roommate households. Solo renters fueled an unusually large share of 2020-2021 demand, and now some of those individuals cannot afford to live alone when prices have climbed so much. More roommate households translate to lesser total demand, at least in the near term.

Product availability by price point is another factor to consider when thinking about demand capacity in 2022's last half. While completions will add to the luxury apartment stock offered for lease, there's minimal room to accommodate more renters in already jam-packed Class B and C properties.

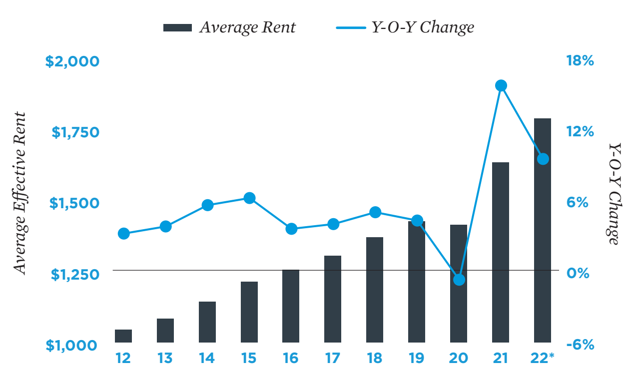
Multifamily Supply & Availability Trends



Absorption Slows in 1H 2022 After Surge

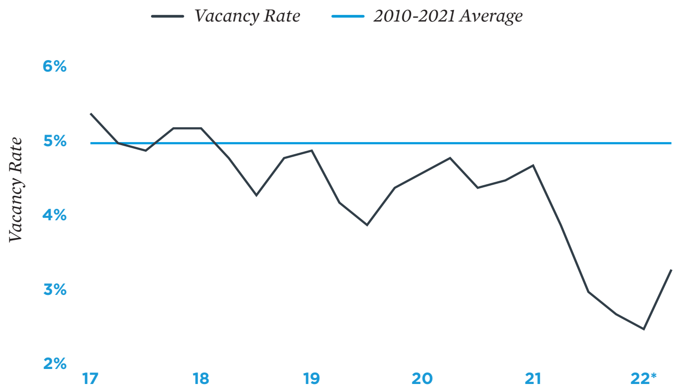


Multifamily Rent Trends

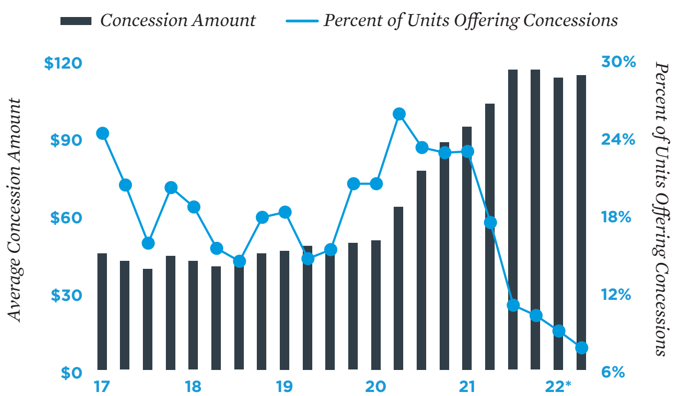


** Forecast ** Year-to-date through 2Q*
Source: IPA Research Services; RealPage, Inc.

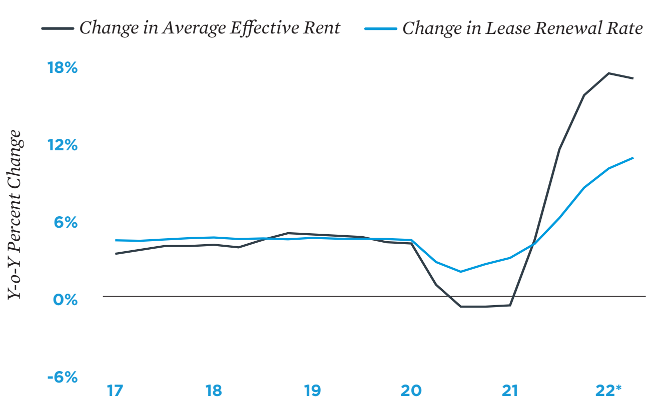
Below Average Vacancy Continues



Concession Use Trending Down



Lease Renewal Rates Rising



* Through 2Q
Source: IPA Research Services; RealPage, Inc.

Vacancy Uptick is Only Mildly Slowing Rent Growth so Far

With apartment demand falling a little short of expectations in 2022's initial half, vacancy is moving up slightly faster than was anticipated. The second quarter vacancy figure for the nation as a whole registers at 3.2 percent, up from the record low of 2.4 percent set in the first quarter. However, vacancy today remains under the historical norm of about 5 percent, allowing rent increases to continue.

U.S. average monthly rent of $1,736 in the second quarter was up 16.9 percent from the year-ago level. The pace of annual rent growth does appear to have moved past peak in some of the hottest Sun Belt and Mountain/Desert region metros, but rents are not backtracking anywhere so far. Rent growth should cool more rapidly in 2022's second half, but annual increases at a level that's close to double digits is still expected.

An under-the-radar metric to watch is how rent roll clean-up will impact unit availability and, in turn, rent positioning. While the number of missed rent payments did not spike over the past couple years in most professionally managed apartment communities, a little bad debt is normal. With eviction bans now expired in most locations, the turnover of units occupied by non-paying households could result in higher vacancy that is, in this case, beneficial for property owners and operators.

Movement in renter incomes is another metric. For households signing move-in leases in professionally managed apartment properties during the first half of 2022, typical household income was up to roughly $74,000, rising from approximately $62,000 in the pre-pandemic days of early 2020.

Renewal Lease Revenue Helps Mitigate Spiking Expenses

Renewal lease revenue growth is helping mitigate spiking expenses. High inflation carries through to push up apartment operating costs, including staffing expenses and the cost of materials. Furthermore, property values that are way above pre-pandemic levels translate to higher property taxes, and insurance costs have skyrocketed in most cases.

The good news is that budgets continue to work for the most part because of the larger-than-normal revenue bumps coming from renewal leases. Year-to-date renewal lease rent hikes are averaging right at 10 percent, roughly double the renewal lease price increase typically seen in the past.

The metric to monitor here is the ability to hang onto existing renters when leases expire. Roughly 57 percent of households who had leases reach their conclusion in the first half of 2022 opted to stay in place, rather than move. That resident retention figure is in line with the all-time high, despite the rent increases that must be digested.

Building Activity Trending Up, but Still Challenging Completing New Properties

The moderating apartment demand experienced thus far in 2022 has not significantly hurt the market, in part because new property deliveries are falling short of expectations as well. Continuing construction delays held completions to roughly 162,000 units during the initial six months of the year, suggesting that it will be tough for annual new supply to reach the total of just over 400,000 units that had been slated to finish coming into this year.

Ongoing apartment construction at the beginning of the third quarter totals 857,000 units, up 20 percent on a year-over-year basis. In addition to the properties where physical building is in process, there's quite a bit of additional future supply right at the starting gate. Properties authorized by building permit during the year-ending June totaled 666,000 units, up 28 percent year-over-year.

Given that housing of every type is undersupplied across most of the country right now, big-picture overbuilding seems nearly impossible. However, construction activity can obviously get too aggressive in select metros and neighborhoods. Spots vulnerable to overheating construction include Phoenix, Austin and most metros in Florida.

Select small towns that benefited from a wave of in-migration in the work-from-anywhere environment also have significant apartment construction beginning to happen now. Many of these locations are actually anticipated to prosper over the long term, but increased construction could be problematic if newcomer households cannot be retained.

Living in Urban Cores Has Rebounded, Despite Slow Office Return

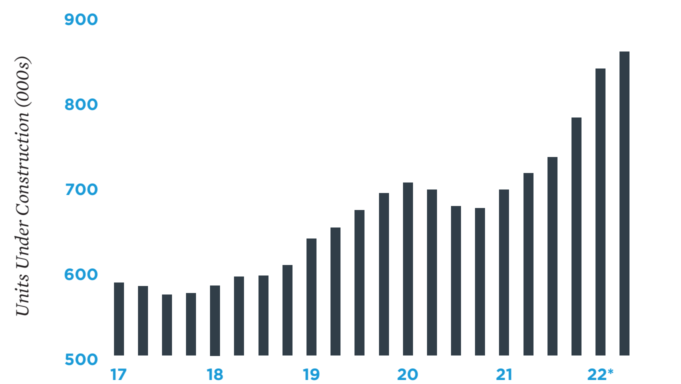
While the best apartment sector performances on the neighborhood level continue to register in the suburbs, there is momentum that is exceeding previous expectations in most of the country's urban core locations.

After downtown apartment vacancy surged to 6.3 percent during the early days of the COVID-19 pandemic, renters did not stay away from the urban core for very long. Downtown vacancy as of 2022's second quarter was limited to just 3.7 percent, actually below the availability figure seen pre-pandemic.

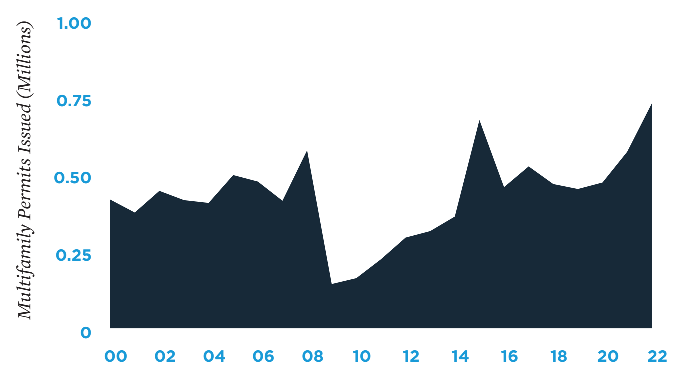
The comeback for urban core apartment demand is in striking contrast to downtown office usage that remains far less than ideal. Thus, some renters — especially young renters — are opting for urban apartments for their general lifestyle appeal, not merely for their convenience to work.

Given that downtown apartment occupancy has already recovered in all but a handful of neighborhoods across the country, the return-to-office push that presumably lies ahead at some point in time does not necessarily seem likely to drastically impact relative apartment property performances between downtown and the suburbs.

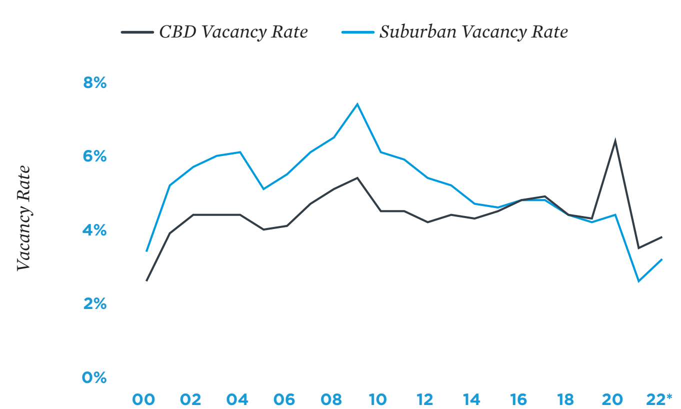
Active Construction Pipeline Climbing



Multifamily Permitting Activity Elevated



Vacancy Historically Low Across Settings



** Through 2Q; Permits reported on seasonally adjusted annualized basis as of June of each year*

Sources: IPA Research Services; Moody's Analytics; RealPage, Inc.; U.S. Census Bureau

Capital Markets Disruption to Investment Should Become More Apparent

Rapidly rising interest rates have altered the apartment investment picture, but the shift in both transaction activity and sales pricing occurred too recently to derail the performance statistics posted for the initial half of the year. Continued robust results achieved as of midyear were sustained by deals that had begun 60 to 120 days prior to the end of the second quarter.

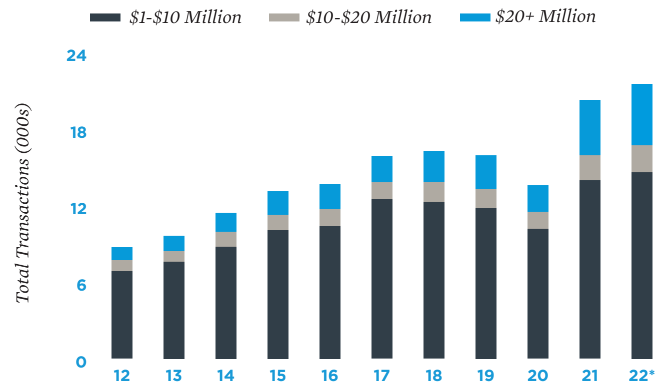
Diving into the specifics that are currently available, the apartment trading activity reported for 2022's first half was up 15 percent over the same period last year. The nation's typical sales price reached $202,000 per unit, up a comparable 15 percent on an annual basis.

Most entities that have been active apartment buyers over the past few years continue to actively seek out additional assets to purchase. However, there is some misalignment between seller and buyer pricing expectations, resulting in a shrinking pool of offers per deal.

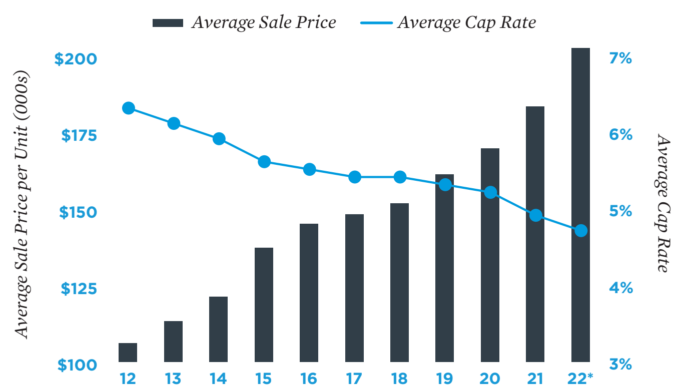
There is more fall-out in demand for value-add properties than for core luxury product, so the flight-to-quality is holding average pricing higher than would otherwise be the case.

A decline in momentum in third quarter 2022 statistics could manifest for investment activity. The activity outlook at year-end is less certain. Sales volumes normally spike during the fourth quarter, as investors rush to meet already set capital deployment goals. However, it seems unlikely that factors making trades hard to get across the finish line right now are going to look much better in the immediate future.

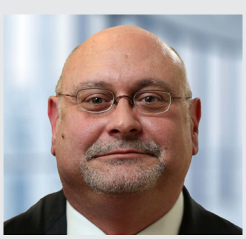
High End Trading Picks Up Notably in '21 & '22



Multifamily Sale Price & Cap Rate Trends



** Through 2Q; trailing 12-months through 2Q for transactions*
Source: IPA Research Services; CoStar Group, Inc.; RealPage, Inc.



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Sources: IPA Research Services; Bureau of Labor Statistics; CoStar Group, Inc; Moody's Analytics; Mortgage Bankers Association; National Association of Home Builders; National Association of Realtors; Real Capital Analytics; RealPage, Inc.; U.S. Census Bureau