

BEYOND THE GLOBAL HEALTH CRISIS

IPA INSTITUTIONAL PROPERTY ADVISORS

Special Report
Multifamily

Summer 2020

The Resilience of Multifamily Will Be Tested by the Shock of COVID-19; Robust Underlying Dynamics Underpin an Optimistic Long-Term Perspective

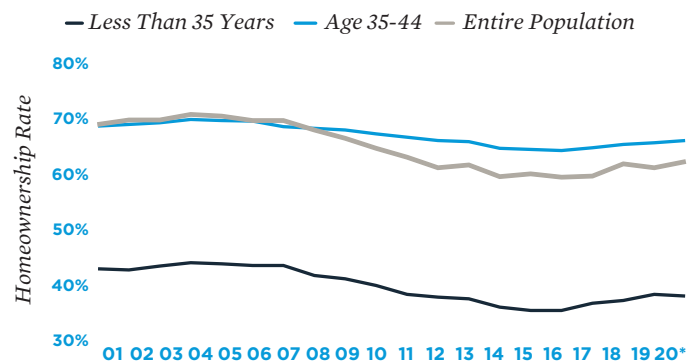
Well-established multifamily fundamentals support a rebound on the horizon. The underlying dynamics of the apartment industry remain sound despite current challenges. One of the key drivers behind rental housing, 20-34 age cohort, which makes up roughly one-fifth of the population, will continue to have a high propensity to rent. The affordability gap between renting and owning remains substantial, exacerbated by the situation at hand, making renting a more viable option for many. Furthermore, the young population continues to put on hold transitions such as marriage and having children which have traditionally been the catalyst to homeownership. These robust underlying demand drivers will support the multifamily sector through the headwinds. Once the disruption of the pandemic ceases, healthy multifamily demand combined with a decline in deliveries should create a quick rebound in overall market conditions.

Turbulence will be felt within the industry in the near term. The wide-reaching economic disturbance will lead to a temporary decline in household formation as young people delay moving out on their own. In addition, some tenants that are now unemployed may not have sufficient savings to meet expenses such as rent payments after the \$600 per week federal pandemic unemployment compensation ends on July 31st. Class C properties face the steepest hurdles in the short term, with their tenant base already making monthly rent payments at significantly lower levels compared to other property types. The economic effects on multifamily demand will also impact mid-tier and upper-tier properties as corporations freeze hiring, pause raises, and in some cases rescind job offers to recent college graduates. Absorption will most likely lag behind historical averages for the upcoming summer leasing season.

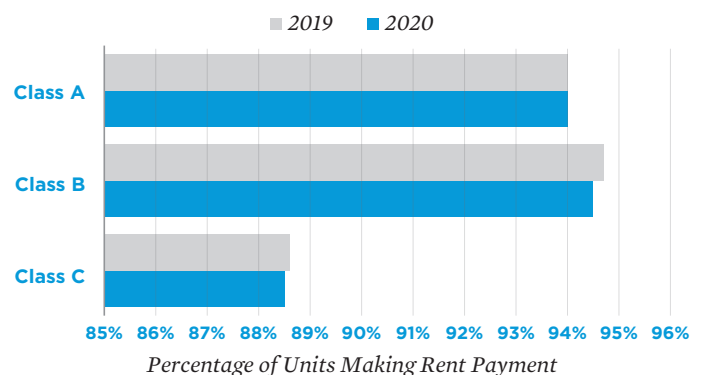
Efficiencies discovered during the pandemic could become lasting changes. Societal trends and contact-less precautions will likely carry on beyond the end of the pandemic. Owners and developers can benefit from these changes by being more innovative in their offerings. Properties with touch-less entry systems and efficient e-commerce and food delivery, could witness higher demand levels. Design concepts may favor larger units that include home office space rather than large common areas that have been trendy within the industry over the past few years. However, it will be costly for existing owners to adapt to these changes, particularly

if it becomes a requirement to install contact-less features to remain competitive in the marketplace. Potential cost savings could arise from operational changes made since the beginning of the pandemic. For example, many property management firms have shifted to virtual tours, video chats and self-guided tours. These new leasing tools may cut operating expenses if proven to be as effective as a full-service physical leasing staff.

Younger Demographic Delaying Homeownership



June Rent Collections



* Through first quarter
Sources: IPA Research Services; Real Page, Inc.; US Census

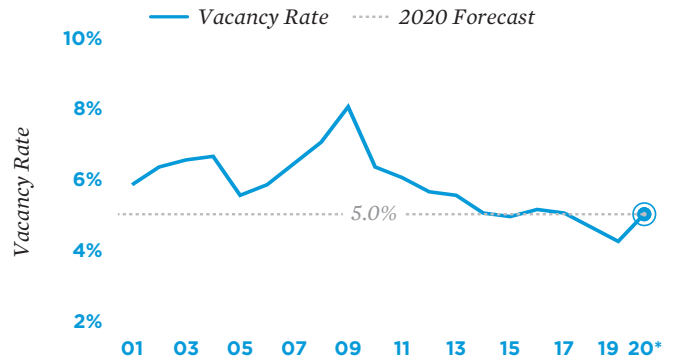
Multifamily Fundamentals Face Hurdles; Construction Delays Will Cushion Vacancy

Vacancy picture will be cloudy through second half of year. The average vacancies across Class A, B, and C apartments entered the year at nearly 20-year lows, providing some cushion against vacancy rates rising to the levels recorded during the financial crisis. However, the national vacancy rate will rise by end of year due to lagging absorption. Additionally, the expiration of eviction moratoriums could facilitate a temporary surge in vacancy, assuming that courts can process the requests efficiently. From that point forward, units should begin to be backfilled as the economic recovery in the second half of the year begins in earnest. It is also likely that the vacancy rate reported in the second quarter will not reveal the true economic vacancy. Eviction moratoriums could allow tenants to occupy units without paying rent, essentially making that unit vacant in the eyes of an owner, but not physically vacant in the second quarter statistics.

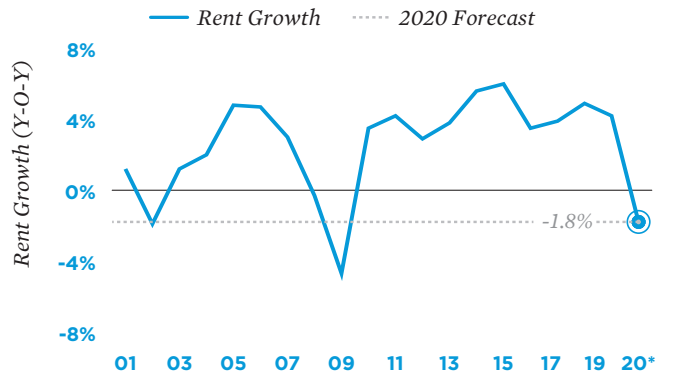
Rent growth uncertain, but renewals will benefit landlords. Expanded federal unemployment benefits last into July and should provide financial support for unemployed renters in the short term. This has most likely prevented a significant decline in vacancy and possible rapid decline in asking rents. Furthermore, many owners have paused rent increases and offered renewals at flat rates to maintain occupancy. Nevertheless, a pause in rent growth will be temporary and may set the stage for outsized gains over the next few years as rents should once again benefit from the overall undersupply of housing. Owners should also benefit from an increasing number of lease renewals, which should help stabilize revenue.

Developers reporting delays, muting 2020 deliveries. In the most recent IPA Developer Impact and Sentiment survey, over 50 percent of respondents thought that projects would be delayed by three to six months. Multifamily construction wasn't deemed essential employment in numerous states which accounts for a large number of the postponed deliveries. Furthermore, measures taken to reduce workers' risk of exposure to COVID-19 could contribute to further delays pushing more delivery dates for projections under construction into next year. Taking these potential delays into account, the number of deliveries in 2020 could be reduced by 30%, to 232,000 units. Lower deliveries this year when absorption will be challenged due to the pandemic, should benefit overall market conditions by reducing vacancy pressure, especially for Class A properties. Given the strong likelihood that demand for multifamily will rebound in 2021, the market will be in a much better position to absorb the projects pushed into next year for completion.

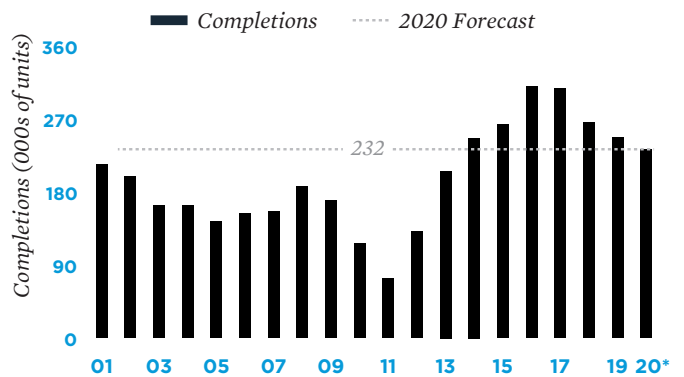
Rebounding Absorption Cushions Vacancy by Year-End



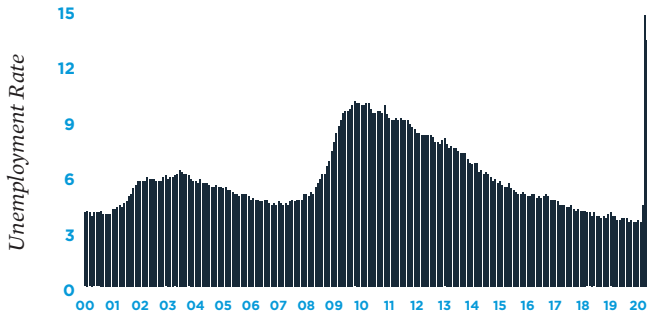
Rent Growth to Turn Negative for First Time Since the Great Recession



Pandemic Pause Slows Deliveries



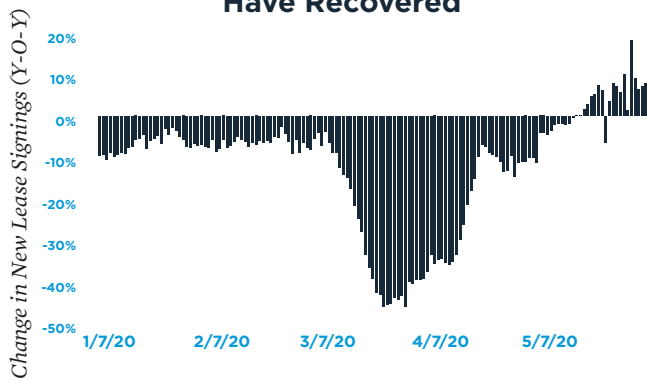
Unemployment Rate Spikes Above Great Recession Peak



Signs of Economic Optimism Appear and Pent-Up Demand Slowly Comes to Market

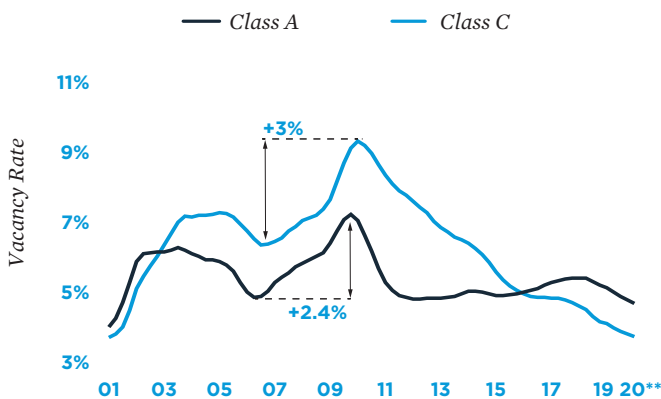
First sign of possible economic recovery. The economy looked bleak in March and April as job losses of 22.1 million spiked the unemployment rate to 14.7 percent, but positive news from the labor market is lifting spirits. In May and June, 7.5 million jobs were added and the unemployment rate dropped to 11.1 percent. Two months of record breaking employment growth coupled with declines in continuing unemployment claims are positive signs for the economy starting its comeback. The \$2.4 trillion CARES Act appears to have buoyed the economy, but its impact will fade significantly by August if not amended. By then, enhanced unemployment benefits will have ended plus State and local tax revenues will be languishing. To prevent a double dip recession, Congress will need to consider extending and expanding assistance before its summer recess.

New Lease Signings Have Recovered



Pent-up demand beginning to be released. Once the pandemic hit and states announced stay at home orders, people who have been planning to relocate, have had to put these plans on hold. As states have lifted restrictions and begun to re-open their economies, individuals felt safer and have begun taking advantage of the opportunity to move. This trend can be seen in new lease signing data as new leases dropped dramatically in March when state economies were closed. At the beginning of May, however, new leases began exceeding levels from a year ago. As the economic recovery gains momentum, further pent-up demand may be released in 2021. The timing of the pandemic impacted the disbursement of recent college graduates into the labor force. Young adults have a high propensity to rent and as employment opportunities rise with the economic recovery, look for a potential quick rebound in multifamily absorption. A similar rebound was witnessed in the first year of recovery from the Great Recession.

Class C More at Risk During a Recession



Fundamentals across classes poised to see divergence. Historically there has been a very strong correlation between the unemployment rate and Class C vacancy. In the late stages of the expansion, Class C vacancy declined to the lowest of the three classes. However, with unemployment surging over the past three months, Class C vacancy will rise above A and B assets. The population with the least educational attainment has been the most impacted since the pandemic hit. For workers above 25 years old with only high school education, the unemployment rate has ballooned from 4.4% in March to 15.3% in May. For those with a college degree or higher the rate jumped from 2.5% to 7.4% over the same period. This is not to say that employment losses won't impact all property types, but college educated tenants in Class A assets, appear to be the most insulated from the direct impact of the economic downturn. If this in turn allows Class A properties to maintain higher occupancy by the end of the year, luxury rents could rebound faster compared to the other classes.

* Unemployed through June
 ** as of 1Q 20
 Sources: IPA Research Services; Real Page, Inc.; BLS

Capital Accumulates on the Sidelines as Investors Search for Pricing Clarity; Private Buyers Look to Bolster Their Portfolios Amid Less Competition

Investors will have to rediscover asset values. A disconnect between buyers and sellers will continue to subdue deal flow in the short term. Post-COVID-19 underwriting remains difficult as the speed and depth of the downturn has hampered all rent forecasts. The lack of clarity has made valuations difficult. Some owners still view their assets in the light of pre-pandemic pricing while some buyers are expecting large discounts due to the current uncertainty. As the economy begins to normalize and quarterly data on fundamentals becomes available, the bid/ask spread should tighten as valuation clarity becomes more discernible. Capital that has been on the sidelines over the course of the crisis, will move back onto the playing field with renewed pricing transparency and underwriting clarity grounded in near term operating results.

Long-term buyers see a window of opportunity. Many institutional investment groups have paused acquisition and development activities until uncertainty dissipates. This is allowing private investors with a long-term mindset to aggressively pursue assets. The long-term outlook for multifamily remains sound and despite the short-term hurdles, quality assets that come to market will lure plenty of bids. Private investors lead transaction activity coming out of the Great Recession and appear poised to repeat that same feat in the current marketplace. The availability of attractively priced debt coupled with limited sales inventory have buoyed the anemic transaction activity over the past 45 days. Transaction pipelines are overflowing; setting the stage for pricing data points and investor sentiment transparency during the second half of 2020.

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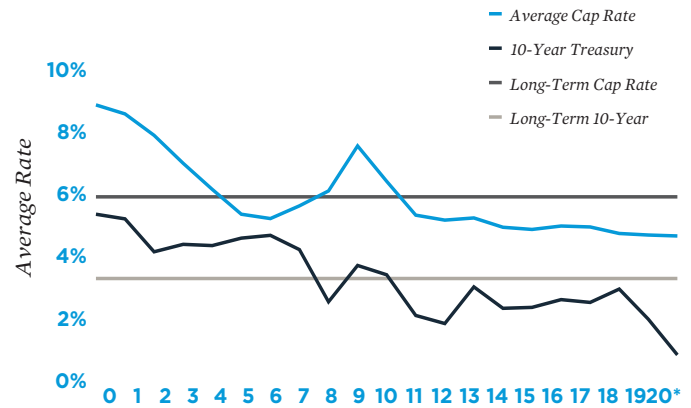
Price: \$1,500

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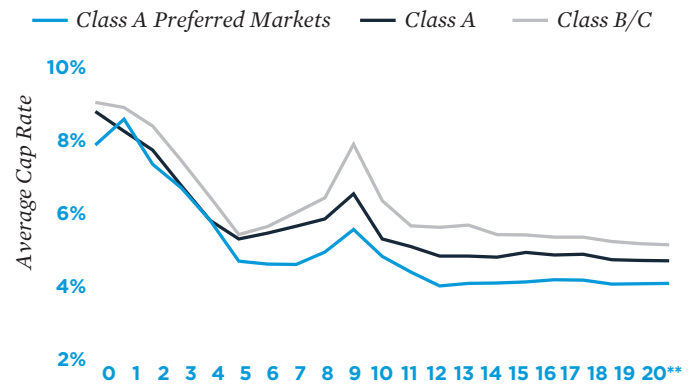
Sources: IPA Research Services; BLS; CoStar Group, Inc.; Real Capital Analytics; RealPage, Inc.; U.S. Census Bureau

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Cap Rates vs 10-Year*



Historical Cap Rates**



* Through June 18
Includes sales \$20 million and greater
Sources: IPA Research Services, CoStar Group, Inc., Real Capital Analytics, Federal Reserve

** Through 1Q
Includes sales \$20 million and greater
Assumes properties less than 10 years old at time of sales to be Class A, properties older than 10 years assumed to be Class B/C
Preferred Markets Include: NY, DC, BOS, SD, LA, OC, SJ, SF, SEA
Sources: IPA Research Services, CoStar Group, Inc., Real Capital Analytics