2014 Forecast

New Deliveries New Direction?

While apartment completions will rise meaningfully in 2014, multifamily starts will move in the opposite direction.

BY GREG WILLETT

After the U.S. apartment market logged another very healthy performance in 2013, look for most key metrics to come in at fairly similar levels in 2014. However, some modest adjustments are on the way, mainly reflecting the impact that will come when we receive substantial deliveries for the first time in several years. Across the 100 largest metros in the country, scheduled completions climb to about 231,000 units in 2014. That delivery volume compares to roughly 187,000 units brought to market in 2014 and a mere 78,000 units that came on stream when construction finishes bottomed in 2011.

Apartment demand anticipated for 2014 aligns with the upcoming delivery volume fairly well, but the presence of this sizable block of product moving through the initial leasing process means that overall occupancy should slide a bit.

MPF Research's forecast calls for occupancy to dip 40 to 50 basis points. That adjustment still will leave the market in healthy shape, as occupancy has been hovering at the 95 percent mark for two-and-a-half years. The specific rate as of Q3 2013 was 95.4 percent.

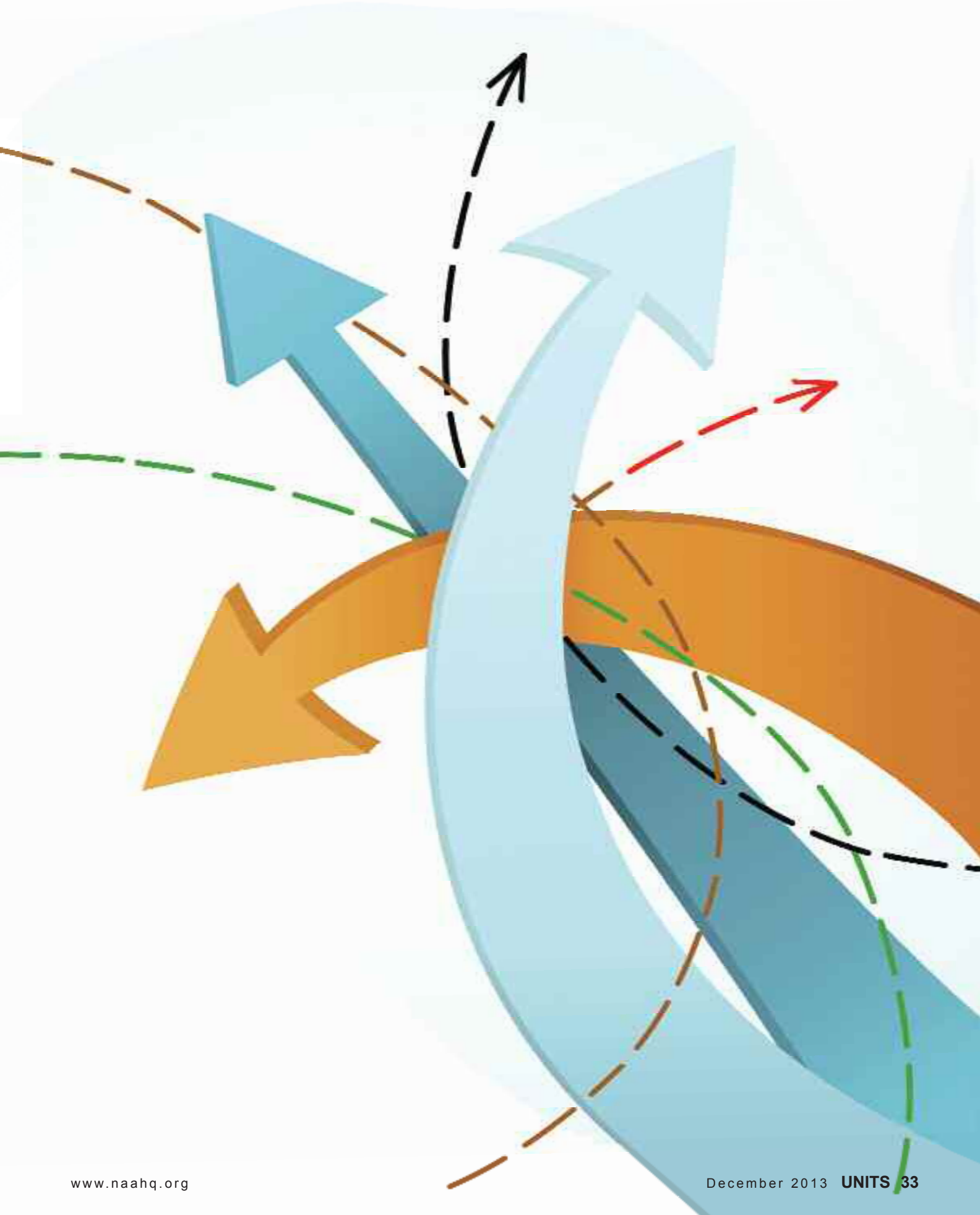
MPF Research expects that effective rents for new leases will grow 2.5 percent to 2.8 percent in 2014, off mildly from the 3.2 percent annual rent growth pace recorded as of Q3 2013 but still a number that lines up with or slightly exceeds the likely consumer price inflation level.

Notable Product and Neighborhood Variations

Digging deeper into what's happening in the apartment sector, it's important to realize that performance by product niche is diverging.

There should be sizable variation in results among top-tier properties and their middle-market and bottom-end counterparts during the coming year or two. Across many metros, those product segment differences will echo through to shifts in momentum by neighborhood (urban core versus suburban). In turn, owners and operators have different priorities and concerns by product sector and neighborhood.

Let's begin at the top end of the product spectrum, where the leasing environment should be competitive during the near term. To date, demand has been



Apartment Construction Leaders	Units Under Construction	Near-Term Inventory Growth
Raleigh/Durham	9,510	7.6%
Austin	13,958	7.3%
Charlotte	7,666	6.1%
Charleston	1,895	4.7%
Orlando	6,941	4.5%
Bridgeport/Stamford	2,035	4.4%
San Jose	6,584	4.4%
Washington D.C.	22,479	4.3%
Denver/Boulder	11,017	4.2%
Dallas	20,397	4.1%
Seattle	3,551	4.1%

Source: MPF Research

Key Markets Likely to Outperform the U.S. Norm For Revenue Growth in 2014

Revenue Growth Includes Changes in Both Occupancy and Rent

	Expected Growth
Oakland	5.3%
Portland	4.8%
San Francisco	4.8%
San Jose	4.7%
Miami	3.9%
Houston	3.5%
Baltimore	3.2%
Denver/Boulder	3.2%
Seattle	3.2%
Los Angeles	3.0%
Orange County	3.0%
Salt Lake City	3.0%
West Palm Beach	3.0%

Source: MPF Research

2014 Class A Rent Growth 2.5%

strong for new properties, with lease-up rates and achieved rents generally running ahead of pro forma targets. However, to some extent, absorption has been boosted by demand for new, upscale product that built up during the period when completions were so scarce.

That pent-up demand volume probably doesn't run very deep, as the sluggish overall economy hasn't allowed the addition of big numbers of high-income renter households in most metros during the past few years. Thus, as we move along the delivery cycle, look for the lease-up pace in individual properties to slow somewhat, not just because there will be more product available but also because we'll gradually shrink the pool of households who likely are additional prospects for this product niche.

Within the existing top-tier stock, there is some loss of residents to new completions as well as a few move-outs for home purchase. Those existing upper-end communities thus far haven't had trouble back-filling any vacancies, so occupancy hasn't moved meaningfully.

However, the resident churn that has emerged has dampened pricing power to some degree. Annual rent growth in existing class A projects has slowed to about 2.5 percent, versus the increases near 3.5 percent recorded in middle-market and bottom-tier communities. That slowdown in rent growth for the top segment of the product segment likely will become more pronounced as more new supply is finished in 2014. Furthermore, because so many of 2014's scheduled completions are found in the urban core, the slowing of rent growth in and around downtown markets should show up in a big way.

Potential 2014 Effective Rent Growth 2.8%

Turning to middle-market and bottom-tier communities, those properties now are very, very full in most metros. Residents of those projects typically can't afford the rents at the top-of-the-market options—whether existing or new product—and they generally can't afford home purchase either.

Owners and operators of class B and C apartments, then, aren't particularly concerned about demand during 2014: They know their stocks will be jam-packed in most cases. That tight occupancy outlook bodes well for rent growth potential in the middle-market and bottom-tier inventories, but we are reaching the stage of the market cycle where we have to start thinking about resident affordability challenges in those units.

Job production in recent years hasn't been strong enough to generate much wage growth. That means that pushing rents too aggressively in

50 bps Occupancy Dip in 2014

the middle and lower segments of the apartment market at some point could lead residents to combine households, shifting the demand dynamics at the more-affordable end of the rental housing spectrum.

As with top-tier product, there are neighborhood-level performance implications that come with the expectations for the class B and class C product slices. A lot of these properties are in the first-ring suburbs, particularly in Sun Belt metros.

Starts Likely Have Peaked

While apartment completions will rise meaningfully in 2014, MPF Research anticipates that starts will move in the opposite direction.

Although a large block of product remains in the planning stages across most markets, rising costs for construction materials and labor are making it tougher to get new apartment construction deals actually going.

Furthermore, it wouldn't be surprising to see some equity capital sources take a wait-and-see attitude on additional starts, letting projects already underway prove up their results to justify more investment. The potential for somewhat higher interest rates in the near term is another factor that could slow new building initiations.

Finally, limited site availability will come into play as an influence on near-term starts. Many of the properties that will complete in 2014 actually are on legacy sites that were created during the last building cycle and then briefly went dormant during the Great Recession. We're really just getting started in generating additional sites for this construction cycle, and that takes time.

Increased completions during 2014 certainly could come into play shaping transaction volumes overall, as well as their locational focus. With high-end properties in the coastal markets that institutional investors tend to prefer hard to come by and available only at prices perhaps challenging to justify, the share of total activity has been increasing for class B and C properties in those coastal cities and for the better-quality communities in secondary and tertiary markets.

In general, that pattern appears likely to continue, as investors will chase yield. But, at the same time, near-term deliveries will bring another round of high-end communities to the coastal markets, and it wouldn't be surprising to see those new completions begin to change hands very quickly.

While 2014's overall apartment market momentum probably won't quite match the results seen over the past couple of years, expectations still are very positive. Just because it won't be the best year ever doesn't mean it will be a bad year! And what really stands out about the apartment market cycle that we're in now is the potential sustainability of very solid performances year after year for a much longer total period than we've registered during past cycles. We're truly playing the long game this time.

Greg Willett is Vice President of Market Research for MPF, a division of RealPage.