Marcus & Millichap
RESEARCH SERVICES

Special Report
MULTI-FAMILY

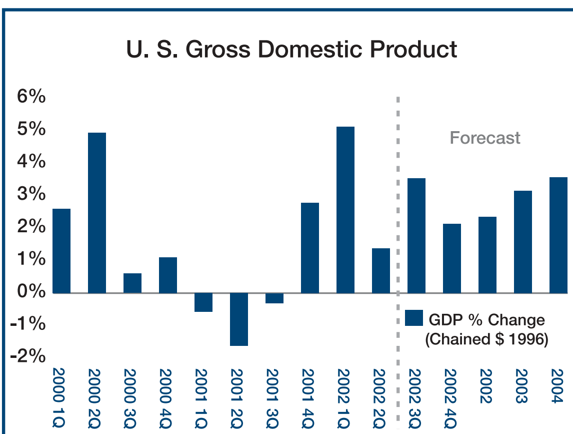
Autumn 2002

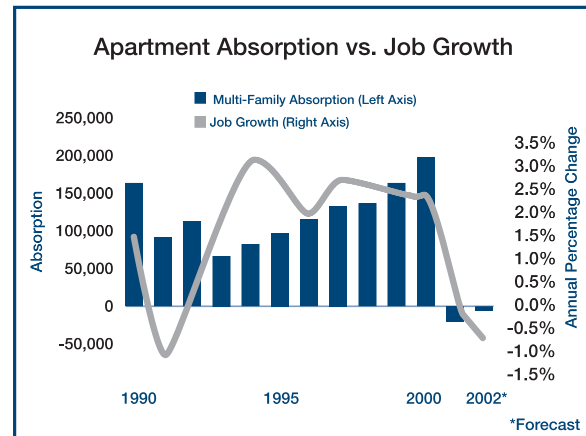
Economic Recovery to Overcome Headwinds, Bumps Expected

The U.S. economy has exceeded the most optimistic expectations in light of the post-bubble recession of 2001 and the negative economic impact of the 9/11 tragedies. Thanks in no small part to aggressive interest rate reductions and business inventory correction, the economy has performed remarkably well, but it faces numerous challenges.

The recession was among the mildest in terms of job losses and reduced output, but the "profit recession" was among the most severe ever for U.S. companies. Accounting scandals, global financial and economic weakness, the threat of war and loss of investor confidence have exacerbated the business downturn, delaying much-needed hiring and capital expenditures. In recent months manufacturing has lost steam, and growth expectations for 2002 and 2003 have been lowered.

Consumers, the main pillar of the economy through the downturn, are showing signs of weakness. The threat of a consumer pull-back before the business recovery kicks in has increased the risk of another downturn. However, several core areas of strength should work to avoid this scenario. Beyond the current soft spot, the makings of a new expansion cycle are in place.





Absorption on the Mend, Investor Demand at All-Time High

The recessionary drain on renter demand was exacerbated by historically low mortgage rates and the resulting rise in homeownership. After three quarters of negative net absorption totaling approximately 100,000 units, demand turned positive in the second quarter of this year. However, it will be some time before sizable absorption and strong rent growth return to most markets.

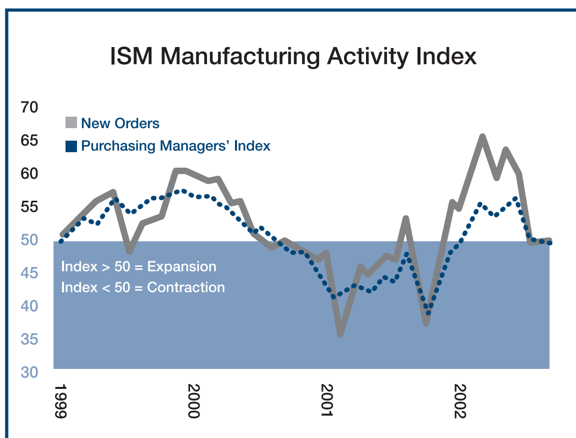
Overbuilding has been less of a factor than in previous downturns, but in the high-end category, where the majority of new projects is concentrated, an oversupply situation exists in some markets. Construction starts will contract for the next two years, setting the stage for a recovery in vacancy, which is expected to reach 6.3 percent this year from a low of 3.8 percent in 2000.

Demand for apartment properties by institutional and private investors continues to outpace available inventory, even in weaker markets, pushing up prices. On a risk-adjusted basis, lower apartment yields are still competitive and will continue to attract investors. As the economy recovers and interest rates move up, the market will shift, justifying caution in underwriting transactions.

U.S. Economy

Mild Recession, Tentative Recovery

The recession of 2001 was among the mildest on record. Gross Domestic Product (GDP) declined 0.6 percent compared to an average decline of 2.3 percent in all recessions since 1950. Employment losses totaled 1.3 percent, in comparison to an average of 2.8 percent in previous recessions.

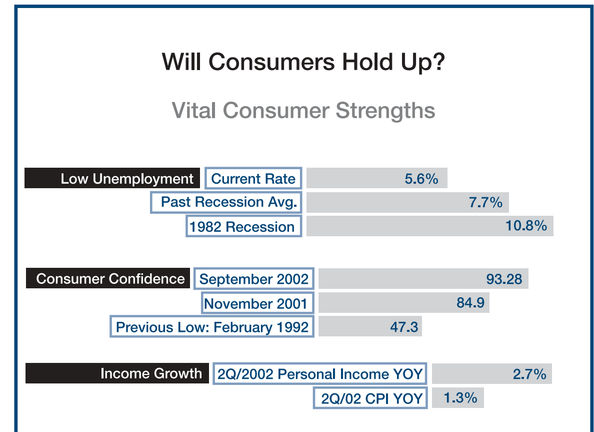


The economy, however, remains vulnerable to additional shocks. Consumer spending may be waning as reflected in weak retail sales in September. Lagging corporate profits, volatility in equity markets and a weak corporate bond market are also primary concerns. Risk factors to the recovery include:

- Possibility of war and its impact on energy prices and consumer sentiment
- Potential for global financial crises
- Global economic weakness, making the U.S. the primary growth engine despite its widening trade deficit
- Low capacity utilization and lack of pent-up consumer demand, leading to additional layoffs

Four underlying drivers should help avoid another downturn:

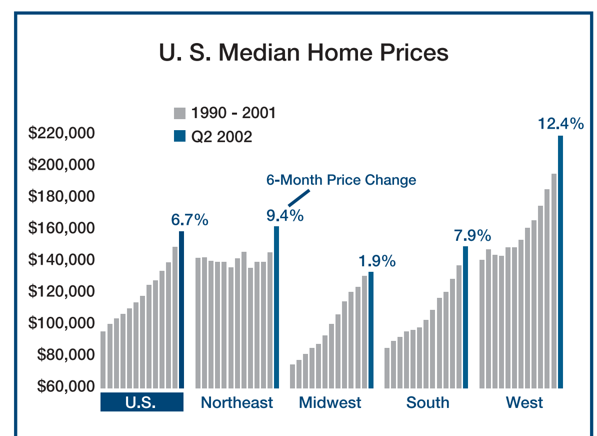
- Unemployment remains at a healthy level. Although the rate may rise in the coming months, at 5.6 percent it is well below the recession average of 7.7 percent.
- Consumer confidence has fallen in the last three months, but remains well above the previous low point in 1992.
- Personal income growth is still outpacing inflation.



- The record-setting housing market may cool, but the overall strength of this sector, which is fueling another record year of refinancing, will help sustain the recovery.

Stage Set for Next Growth Cycle

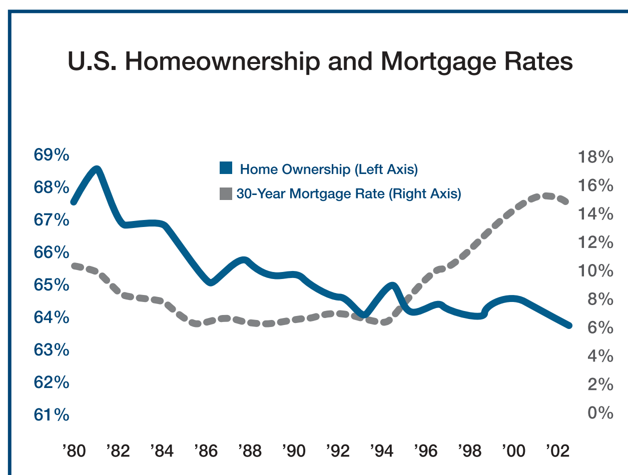
Barring additional shocks, a number of positive underlying factors will provide the foundation for a new growth cycle. Business inventories were liquidated last year at the fastest rate on record, clearing the way for additional production. Growth in productivity is still outpacing labor cost increases, supporting a profit recovery. The weak recovery has delayed interest rate increases, and tame inflation will moderate tightening when the time comes. Government spending is likely to remain strong if not expand further. The economy is simply missing the spark



necessary to jumpstart growth, which depends on sustained improvement in corporate profits.

Apartments Not Immune, but Resistant to Downturn

The past 12 months proved to be the most painful for many apartment owners since the recession of 1990-91. The national vacancy rate nearly doubled from its 2000 low and several years of solid rent growth turned into concessions in most markets at what felt like lightning speed. Real estate performance is relative, however, and in the context of risk-adjusted investment options, apartments continue to perform well.

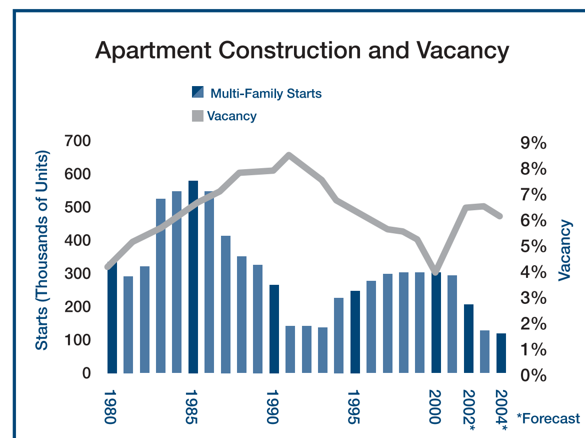


The sector's performance in the past year is an important indicator of future trends. Apartments were substantially more pressured during this downturn than previous ones. The "doubling-up" and "moving home" patterns typical of recessionary periods were compounded by a rapid rise in the homeownership rate, particularly for core renters who became entry-level buyers. U.S. homeownership reached a new high of 67.8 percent last year and has remained close to that level despite record prices, due to low mortgage rates. Notwithstanding this additional drag on renter demand, the national apartment vacancy rate remains well below its previous peak of 8.3 percent reached in 1991.

The shaky economic recovery will sustain low interest rates well into 2003, keeping the housing market strong in the short term. However, interest rates will be heading up as a new expansion cycle emerges. This will at least reduce, if not remove, the unusual push toward homeownership experienced in the last 18 months. At the same time, apartment demand will benefit from a rebound in employment and the projected growth in echo boomers. Based on the most recent job forecast for 2003, new unit deliveries should be closely aligned with demand, leaving the vacancy rate around 6.3 percent and pointing to generally flat rents nationally. Vacancy is expected to begin a correction in 2004 as the economy picks up steam, especially if construction starts fall more than expected.

Apartment Investments Wanted

Investor appetite for apartments has intensified significantly over the past year despite the overall market's weakness. The reduction of alternative investments and lack of available properties are pushing up prices in light of the strong buyer demand and attractive financing. As a result, the national median price per unit jumped 11 percent in the first half of 2002. In harder-hit markets, low cost refinancing is allowing owners to weather the storm of higher vacancies and lower rents, leading to a longer hold time. Institutional investors have modified their yield expectations in order to compete with private investors and will continue the shift toward Class B and Class C properties with renovation and/or re-development potential. Class B and Class C properties are on track to post better returns again this year, shielded, in most cases, from direct competition from new supply. On the other hand, concessions at the higher-end segment of the market are common in the majority of locales since demand for higher-rent units has suffered more dramatically.



The short- to mid-range outlook for apartment investments remains strong, although the pace of price appreciation is likely to level off as investors become more cautious. The main drivers of today's market (competitive returns, low interest rates, shortage of inventory) are likely to stay intact for the next 12 months unless an unforeseen economic shock emerges. A long-term outlook must incorporate several factors. The Fed will likely err on the conservative side and leave rates alone for some time, even after the recovery takes hold. However, as interest rates eventually rise and capital flows shift, apartments will have more competition from other real estate sectors and equities. These factors need to be balanced with the projected rent growth and income performance of today's investments. Long-term apartment investments, with today's low interest rates locked in, will produce exceptional returns as the economy recovers.

Market Summary

No market has escaped the effects of the downturn; however, the degree of impact has varied. Markets with a heavy reliance on technology, telecom and travel are suffering the most. Examples include Austin, Seattle, San Jose, Portland, Denver, Charlotte, Orlando and Tampa. More diversified economies that have suffered from a combination of weak demand and robust construction include Atlanta, Dallas and Phoenix. Recovery in these markets will lag until 2004 in most cases. Examples of healthy markets with below-average vacancies that are showing softness include Fort Lauderdale, Miami, Chicago, Sacramento, Minneapolis, Boston, Detroit and Washington, D.C. Southern California markets are among the healthiest nationally, with vacancies well below 5 percent. San Francisco and Oakland have stabilized while Houston and Las Vegas beat expectations. New York, Philadelphia, suburban Maryland and suburban Virginia have some of the lowest vacancy rates nationally.

Capital Markets Overview

Fewer deals, an increase in funds allocated to real estate and an anemic economic recovery are combining to keep the cost of borrowing low for multi-family owners. Fannie Mae and Freddie Mac are quoting spreads as low as 170 basis points over the 10-year Treasury and 80 percent LTVs for top-quality deals. Life companies and conduits are quoting 180 to 220 basis points over the relevant Treasury for both five- and 10-year deals. Lenders are favoring shorter maturities (three to five years) in markets that have recently shown softness, preferring to wait for conditions to improve before committing funds for 10 years. Because they tend to focus on historical rather than pro forma figures when underwriting deals, CMBS lenders may be less competitive in these markets. Overall, loan rates are in the 5.75 percent to 6.25 percent range, with the next move likely to be upward.

Funds for new construction projects remain available, but transaction activity has slowed. Banks are capping LTVs at 70 percent to 75 percent versus the 80 percent to 85 percent LTVs available in 2001. Spreads remain 250 to 325 basis points over six-month LIBOR, unchanged over the past two years. LIBOR floors of 3 percent are in place at most lenders, well above the current rate of 1.8 percent. The lower leverage available has reduced developer demand, contributing to falling construction pipelines in many markets, although multi-family permits remain stubbornly high.

An economic rebound in 2003 will begin to exert upward pressure on rates, although low inflation will keep rate increases moderate. Strong competition among lenders for top-quality deals will hold contract rates at current levels, at least through the early stages of an increase in Treasury yields. The overall softness in the apartment market during the early stages of the recovery will limit spread contractions to 10 to 20 basis points.

Marcus & Millichap RESEARCH SERVICES

Prepared and edited by:
Hessam Nadji
Managing Director
hnadji@marcusmillichap.com
Tel: (925) 979-9810

Christopher Oberhaus
Director, National Market Analysis Group
coberhaus@marcusmillichap.com
Tel: (602) 952-9669

Steve Witten
Senior Director
National Multi Housing Group
switten@marcusmillichap.com
Tel: (203) 495-8000

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