

Demand Momentum Eases After a Record Surge; Robust Fundamentals Sustain Sector

Rental demand momentarily settles after an outstanding stretch. The multifamily sector entered 2022 in a historic position of strength. National vacancy was 120 basis points below any quarterly recording spanning 2000-2019, stimulating a competitive market among tenants, which accelerated rent growth. The average effective monthly rent in the U.S. rose nearly 16 percent in 2021, with annual jumps eclipsing 25 percent in several major Sun Belt markets. However, in the first half of 2022 — particularly in the second quarter — demand began to normalize as roughly 80,000 fewer households were created in the U.S. relative to the same six months of 2021. The cool down was prompted by economic headwinds, as well as inflationary impacts on household budgets, including adjusting for higher rent payments. Even with a slower second half, vacancy at midyear leaves ample leeway before rates in most metros approach pre-pandemic levels.

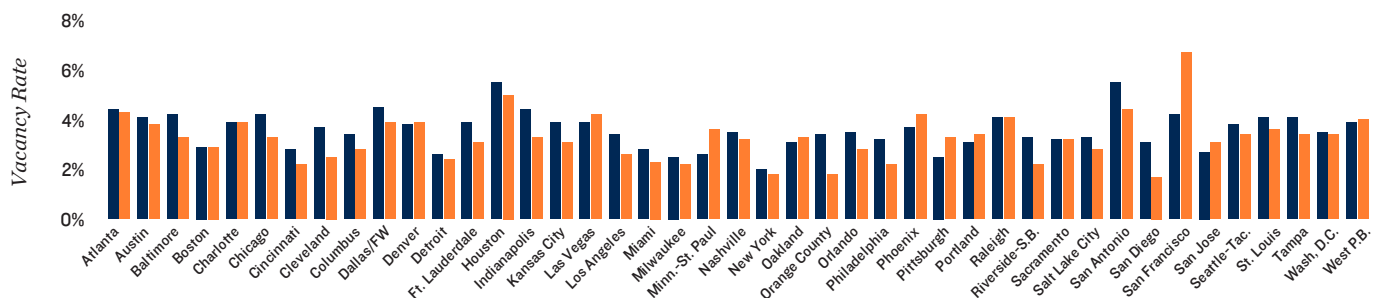
Top-performing markets in 2021 had the most notable inflections. Many of the locations that were standouts during the pandemic took a step back in the first half. After totaling more than 72,000 units of net absorption during the second half of last year, Atlanta, Dallas-Fort Worth, Houston, Las Vegas and Phoenix had a combined negative measure in the opening six months of 2022. The aggressive building pace in these markets is creating some near-term pockets of over-supply amid temporary demand slack, as some residents rebalance living costs after historic hikes. Nonetheless, migration patterns and thriving labor markets support elevated construction long term.

Sector outlook remains overwhelmingly positive. Despite the 60-basis-point rise in national apartment vacancy during the first half, approximately 20 percent fewer rentals were available at mid-year across the U.S. compared to year-end 2019. These circumstances and steep barriers to homeownership support sustained momentum in the apartment sector, with the median price of a single-family home jumping by more than 30 percent over the past two years. More recently, mortgage rates have climbed to a post-Global Financial Crisis high. This is swelling the affordability gap, or the difference between an average monthly payment on a median priced home and an average rent obligation. The margin now exceeds \$1,000 per month, about three times the magnitude of pre-pandemic norms, exemplifying the relational value of rentals. The cost-saving benefits, coupled with lifestyle elements, locational advantages and flexibility, will sustain apartment demand.

Cost-of-living preferences reflected in second quarter. Among the 140 U.S. metros with at least 25,000 units of local inventory, roughly 35 percent had positive net absorption during the second quarter. Of this grouping, almost half had an average effective rent below \$1,400 per month, compared to a U.S. average of \$1,735 per month. Smaller Southeast metros, like Huntsville, Knoxville and Augusta, are likely capturing population outflows from larger markets in the region. Comparatively affordable metros in the Midwest, such as Cincinnati, Des Moines, Madison and Omaha, also showed notable momentum.

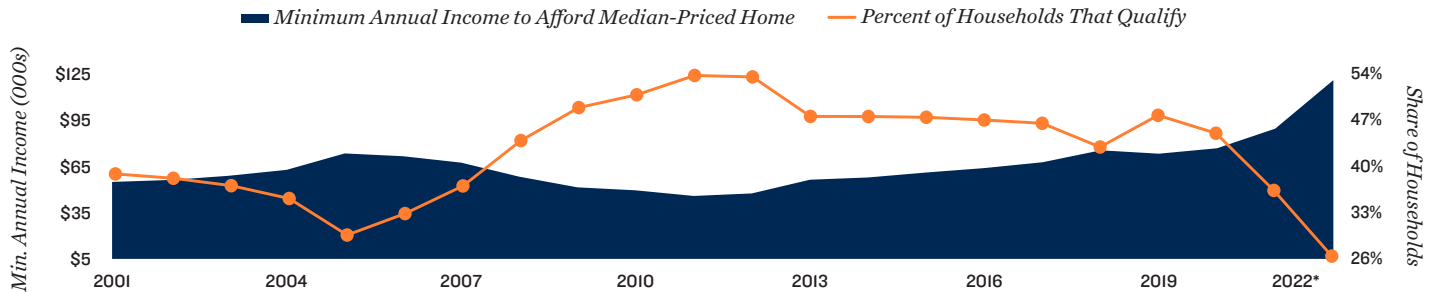
Vacancy Remains Extremely Tight in a Historic Context

■ Lowest Vacancy Recording Between 2010-2019 ■ Vacancy in 2Q 2022

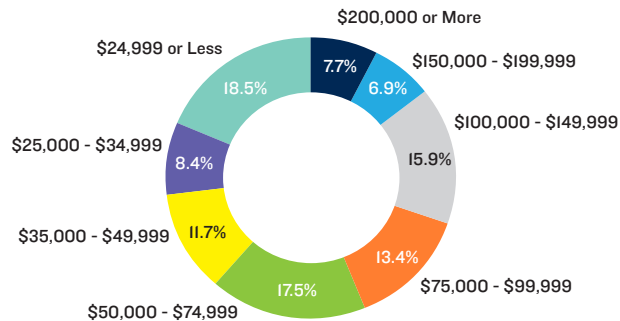


Rentals Will Accommodate Excess Demand in the Coming Years

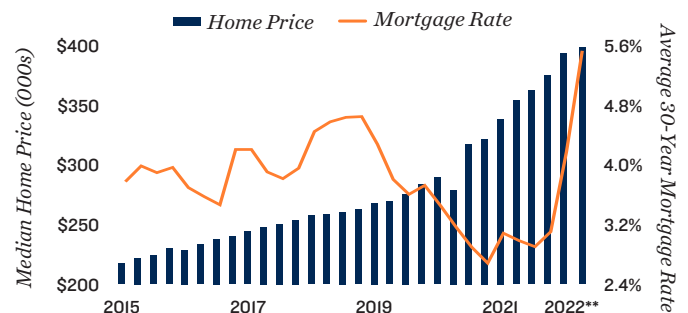
Home Ownership Potential Limited by High Prices and Mortgage Rates



2021 Estimated Households by Income Level



Rate Surge Compounds Price Escalation



* Income through mid-June; Households through April ** Through Second Quarter

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Capital Economics; Federal Reserve; Freddie Mac; Moody's Analytics; Mortgage Bankers Association; National Association of Home Builders; National Association of Realtors; Pew Research Center; RealPage, Inc.; U.S. Bureau of Labor Statistics; U.S. Census Bureau; Wells Fargo

SINGLE-FAMILY HOUSING MARKET

- Robust home buying in 2020 and 2021, when financing was favorable and many households desired larger living spaces to accommodate at-home work and education, shrunk listing inventories in most metros. High demand amid low market supply caused prices to skyrocket, with the cost of an existing single-family home rising for 24 straight months through May 2022. The streak ended with a softening in June and July, but the median price held north of \$390,000.
- The volume of home purchases began to slow in the second quarter and is directly correlated to higher borrowing costs. The average 30-year fixed-rate mortgage rapidly climbed into the mid-5 percent band during the first half, after starting the year close to 3 percent. The Federal Reserve's aggressive response to inflation, including multiple interest rate hikes, catalyzed this surge. Additional Fed action in the coming months could sustain upward pressure on the cost and criteria to obtain a home mortgage.
- A near-term price softening in the single-family sector is playing out, as more homes come to market and fewer prospective buyers pursue listings; however, current dynamics do not indicate a bursting bubble. The number of home listings nationwide in July remained nearly 35 percent shy of the same month's average between 2015-2019. Low inventory will fortify the sector from a significant price collapse.

IMPLICATIONS FOR MULTIFAMILY

- Historically elevated home costs, coupled with a period where mortgage rates are the highest they have been since the Global Financial Crisis, is creating pronounced challenges for first-time homebuyers. It is estimated that the minimum annual income needed to purchase a median-priced house is now well above \$100,000, based on the standard Freddie Mac debt ratios. This is a benchmark that about three-fourths of U.S. households fall short of.
- As the millennial cohort enters an age range typically aligned with household expansion, more of this generation will gravitate to the high-end rental market to meet their needs. A substantial share of millennials will rent longer than in previous generations, and Gen Z will likely do the same. An acquired fondness for lifestyle and cost-saving aspects of apartments is another potential outcome.
- Spillover demand from the single-family market to apartments is amplifying rental costs, while the sector was also playing catch up after a national rent decline of 0.8 percent in 2020. The average Class A and Class B effective rents in the U.S. grew by about 17.0 percent year-over-year through June. The annual Class C gain was comparatively moderate at 12.3 percent. This variance stretched the rent gap within the quality spectrum, as Class C apartments are now roughly \$400 per month less costly than Class B, compared to \$290 one year ago.

Rent Growth and Housing Market Dynamics Will Keep Investors Active

2022 Forecast

U.S. EMPLOYMENT

2.9% increase Y-O-Y

- Through seven months, the nation has added nearly 3.3 million jobs, realigning with the pre-pandemic peak in July. The pace is expected to ease during the final five months of 2022, with a gain of about 1.0 million roles.

U.S. CONSTRUCTION

370,000 units completed

- More rentals finalize and inventory expands faster than in any year this century. Although, the figure is lower than earlier estimates as supply chain headwinds and higher material/energy costs impact project timelines.

U.S. VACANCY

140 basis point increase Y-O-Y

- After halving the long-term average with a vacancy rate of 2.6 percent last year, the metric will rise in 2022. At the close of the fourth quarter, the rate is expected to settle 30 basis points below 2019 at 4.0 percent.

U.S. EFFECTIVE RENT

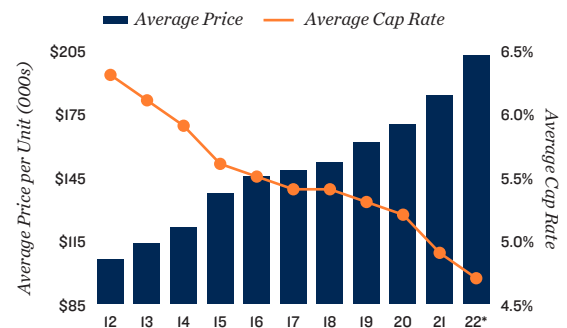
9.4% increase Y-O-Y

- Building on to last year's monumental 15.6 percent rise, the average effective rent in the U.S. ascends to \$1,788 per month in 2022. This two-year 26.5 percent lift is faster than the gains from 2014-2019.

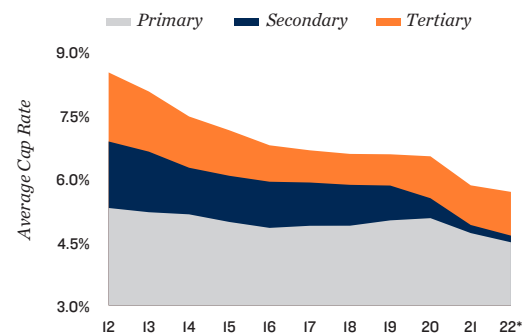
2022 INVESTMENT OUTLOOK

- **Trading velocity starting to settle after a record-setting stretch.** More apartment assets changed hands during the second half of 2021 than in any full calendar year prior to 2015. The entirety of 2021 featured the highest number of deals on record by almost 25 percent. Momentum carried into the early stages of this year, as the first quarter was the strongest January through March period in history. Activity finally started to pull back in the second quarter as interest rates started to rise, yet deal velocity remained above any equivalent three-month span prior to the onset of the pandemic.
- **Rapid price growth and cap rate compression supported by performance.** Stimulated by a competitive investment market amid record-breaking deal flow in recent quarters, the average price per unit climbed by about 15 percent during the 12-month period ended in June to \$202,400. This annual gain was faster than any year from 2011-2021. As prices rose sharply, first-year returns contracted, reaching an average of 4.7 percent during the past year. This is down 60 basis points from the pre-pandemic measure in 2019.
- **Buyers note recovering primary markets.** Many of the largest metros faced severe pandemic headwinds, suppressing transactions. A majority have since turned the corner, encouraging investment. Primary metros accounted for a roughly 4 percent higher share of all trades in the first half of 2022 compared to the same span last year, which is still well below the proportion from a decade prior. Investors have shifted substantial focus to tertiary markets.

Investment Sales Trends



Cap Rate Trends by Market Type



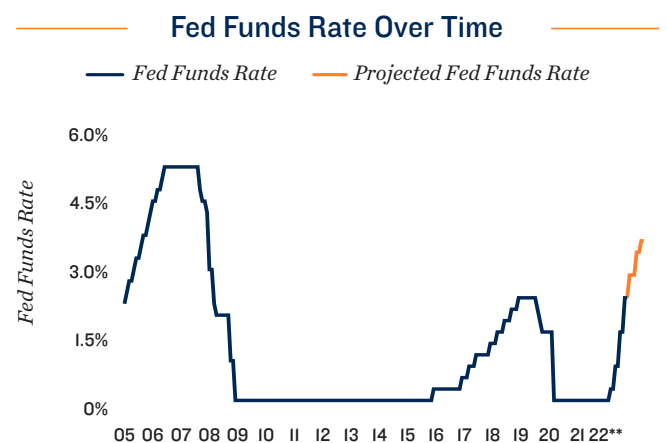
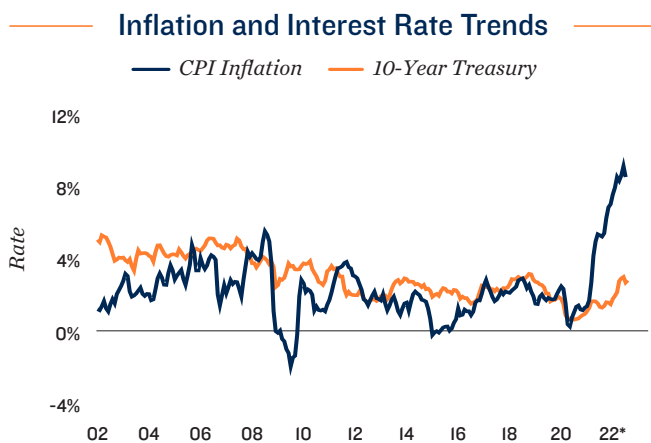
* Through 2Q

Sources: CoStar Group, Inc.; Real Capital Analytics; RealPage, Inc.

Economic Moderation and a Series of Interest Rate Hikes Influence Investment Market

Federal Reserve maintains aggressive fight against inflation, though the pace appears to be cooling. Through the first seven months of 2022, consistent month-over-month rises in headline CPI figures coaxed the Fed to lift the key policy rate by 225 basis points to a target range of 2.25 to 2.50 percent. Their combative action seems to have had an effect, as the most recent inflation measure in July showed a flat change from the previous month. At the same time, the July employment gain blew past estimates with the addition of 528,000 jobs, bringing the calendar year total to over 3 million new positions filled. This shows that the economy still has substantial muscle, despite two consecutive negative GDP releases. Nevertheless, statements from the Fed imply that it will continue with a series of planned rate hikes through year-end, with projections calling for two 50-basis-point increases and one 25-basis-point rise, to bring the target range to 3 percent to 4 percent by early 2023. Sustained job growth amid very low unemployment is providing the Federal Open Market Committee with the confidence to elevate borrowing costs, without derailing the economy. However, future risks remain apparent as supply chains continue to face headwinds and business investment has started to taper amid higher interest rates.

Strong property fundamentals and inflation-resistant qualities should help counterbalance transaction complications. Many lenders are recalibrating quoted rates and widening spreads, as monetary policy has quickly tightened. New CMBS securitization is being hindered by the rapid change in the benchmark policy rate, a challenge that is expected to persist through 2022. Balance sheet lenders, such as banks, are more insulated, but face their own set of challenges as they adjust lending criteria and objectives over time. Meanwhile, agency lenders are stepping up and providing the sector with stability and liquidity, as they have ample capacity to lend after using less than half of their annual cap through midyear. Many are providing competitive rates and terms, but are still playing it safe. It is possible that deal flow retreats in the near term amid these obstacles, which could lessen the downward pressure on cap rates as the market retreats from historic trading levels. Nonetheless, the asset classes' very strong fundamentals and ability to turn over leases on a typical basis of 12 months, which is favorable during periods of high inflation, should bolster buyer interest.



* CPI through July; 10-Year Treasury through August 15 ** Forecast — assumes three rate hikes of 50 bps, 50 bps and 25 bps
Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; Federal Reserve

Multi Housing Division

John S. Sebree

Senior Vice President | National Director, Multi Housing Division
Tel: (312) 327-5400 | john.sebree@marcusmillichap.com

Price: \$1,500

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Prepared and edited by
Benjamin Kunde

Research Analyst II, IPA Research Analyst | Research Services

For information on national multifamily trends, contact:

John Chang

Senior Vice President | Director, Research & Advisory Services

Tel: (602) 707-9700

john.chang@marcusmillichap.com

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