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From Bullish to Balanced: A Changing View of the US Apartment Market

July 2012

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Executive Summary

- Demand for apartments should continue to be strong for several years due to the growing renter base, declining homeownership rates and pent-up demand as the economy creates jobs.
- While the start of the apartment development cycle has been very well publicized and bears watching in select markets, our view is that there will be enough demand to fill new units that are in the pipeline under a normal economic scenario.
- Affordability is a risk to the sector. High occupancies have enabled landlords to raise rents aggressively, making renting expensive relative to owning a home. Also, rents are rising faster than the growth in personal income, a situation that cannot be maintained over the long haul.
- Apartments have outperformed other property types in recent years. Favorable capital markets conditions, the availability of cheap debt from government agencies and robust investor demand for stable assets with solid income yields have driven up property values.
- The relative outperformance is not likely to continue more than another year or two. For a core investment platform, our view of apartment sector allocations has shifted from a strong overweight to closer to par with the NCREIF Property Index.
- Core and value-add investors should focus on development opportunities in prime locations in which growth is high and/or supply is naturally limited due to space or zoning regulations. Prime locations are much more likely to retain demand in any economic environment.

From Bullish to Balanced

Apartments have been the best-performing segment of the commercial real estate market in wake of the Great Recession. Vacancies have dropped significantly, leading to solid increases in rents and a run-up in property values. Meanwhile, apartment property values have fully recovered from the trough levels in the recent recession, improving more than any other commercial real estate sector. And there are good reasons to be bullish on the sector's prospects going forward, since the healthy fundamentals have been driven in large part by long-term trends, particularly demographic changes that create demand for apartments and the steep decline in new supply.

While we believe that the trends underpinning the bullish outlook are all valid, there are also reasons for tempering enthusiasm. The sector has proved popular in an environment in which investors are searching for opportunities. The demand for apartments and the greater availability of financing in relation to other sectors has led to a rise in development. Although badly needed in some markets, the spate of new supply bears watching to make sure it is not overdone.

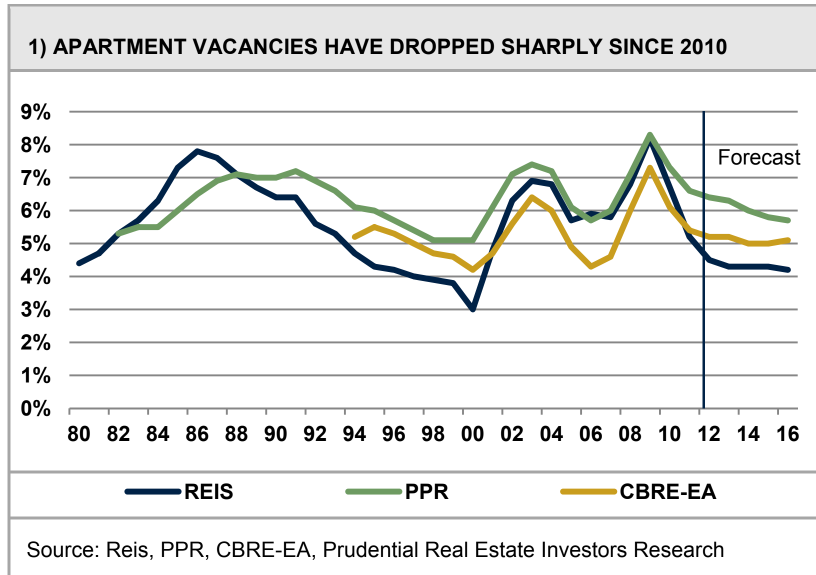
In October 2010, we published a paper entitled "*The Early Innings of an Apartment Recovery*," which contained our view that market conditions pointed toward a solid recovery. Nearly two years later, after a strong run-up in the sector, our strongly bullish view has turned more balanced. We see the market in the fifth inning: past the early part of the game, but clearly not ready to call in the closer. We remain optimistic about the sector's prospects, but at the same time see enough risks to shift to a more balanced view of the future.

Strong Market Fundamentals

Demand for apartments started to improve in 2009 and has been solid since 2010. Some 36,000 units were absorbed in 1Q12, according to Reis, the 12th consecutive quarter of positive absorption. With new supply nearly non-existent during this time, that left the national vacancy rate at 4.9% in 1Q12, down 310 bps from the peak in 1Q10 and well below the 5.7% long-term average. Other sources such as Property & Portfolio Research (PPR) and CBRE-EA show similar drops in vacancy rates (Exhibit 1).

The improvement in market fundamentals has naturally served to benefit property owners, as it has led to higher rents and a sharp increase in net operating incomes. Nationally, rents have risen over 10% since the beginning of 2010, according to Reis and PPR, which track all segments of the market. For institutional-quality assets in many major markets, the increase is even higher. Class A rents were up 7.5% year-over-year in the first quarter, according to Axiometrics.

1) APARTMENT VACANCIES HAVE DROPPED SHARPLY SINCE 2010



Source: Reis, PPR, CBRE-EA, Prudential Real Estate Investors Research

Apartments have outperformed other major sectors of the commercial real estate market since the end of the downturn. Data from the National Council of Real Estate Investment Fiduciaries (NCREIF) illustrates the gap between apartments and other property sectors. Net operating income (NOI) for NCREIF apartments rose 11% in the four quarters ending 1Q12, well above the 4.6% average for all NCREIF properties. Apartment NOI should continue to grow at a strong pace, though it will likely gradually subside from today's near-peak rates.

The tight market conditions and strong rent growth have primed the market for new construction, and a new cycle of apartment development has started. New supply of both single family and multifamily housing has been extremely limited in recent years, as credit from banks largely dried up and developers faced mounting financial difficulties. But the improving capital markets and favorable apartment dynamics have spurred renewed development activity slated for the rental market, even as single-family homebuilding remains weak.

Abundant Demand Creates Opportunities

Although the development cycle is beginning to pick up, opportunities in the apartment sector should continue to be abundant for some time because the factors that created the surge in demand will remain in place for some years to come. Among these factors are: continued population growth and strong demographic trends within key apartment renting age groups, pent-up demand stemming from the downturn and the ongoing drop in homeownership.

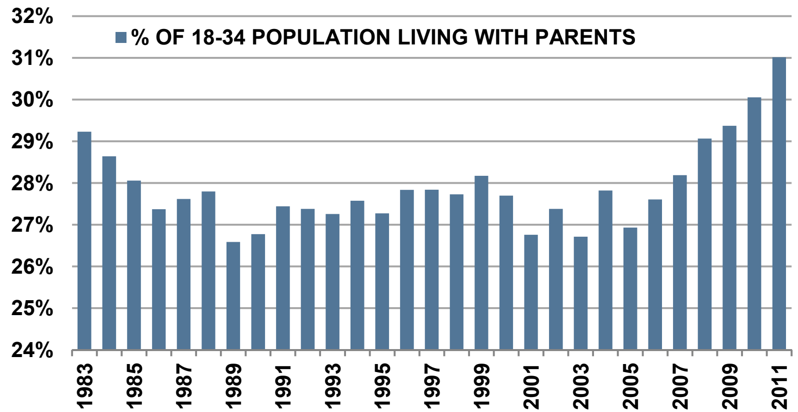
Growth in renter age group. The 20-34 age group, a prime rental age category, has grown rapidly in recent years. Although the growth in this group – known as the "Echo Boomers" because they are the children of the

Baby Boom generation – is beginning to slow, it will remain positive through the end of the decade. The US Census Bureau projects that the 20-34 age group will grow by some 2.5 million between 2012 and 2016.

Pent-up demand and job creation. The recession lingers for many young adults who live at home or double up with friends because they lack full-time jobs that pay enough to afford an apartment. Fortunately, labor market conditions are slowly improving, which should lead to stronger household formations, unleashing this pent-up demand. The unemployment rate for the 20-24-year-old age group dropped to 12.9% in May 2012, 310 bps lower than the recent peak, while the 8% unemployment rate for the 25-34 age group is closer to the overall US average. As people in these age groups find jobs, they quickly move out of their parents' houses and find their first apartment units.

Currently, some 31% of the 70 million adults ages 20-34 live at home according to the US Census Bureau (Exhibit 2). An additional 2 million renters could be created if that number were to revert to its long-term average of 28%. In all likelihood, the demand created would total less than 2 million units, since many people don't live alone, but job growth that moves young adults away from parents would certainly produce a substantial need for rental units.

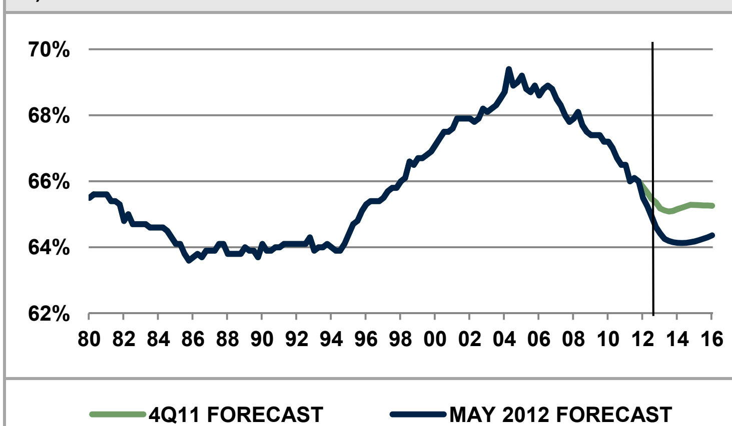
2) CONSIDERABLE PENT-UP DEMAND FOR APARTMENTS



Source: US Census Bureau, Prudential Real Estate Investors Research

Homeownership. The rental market has benefited from the dramatic decline in the homeownership rate. Each 100 bps decline in homeownership results in roughly 1.1 million new renters, although a majority of people leaving houses (a large portion due to foreclosures) will rent single-family homes rather than traditional apartment units. After peaking at 69% in 2005, the homeownership rate has fallen to 65.5%. Many analysts expect the rate to fall to 64% going forward as the lure of for-sale housing remains weak and lending markets remain constrained. Moody's Analytics recently revised down its five-year forecast of homeownership rates to 64%, from 65.3% several quarters earlier (Exhibit 3).

3) HOMEOWNERSHIP EXPECTED TO REVERT TO PRE-BOOM



Source: Moody's Analytics, Prudential Real Estate Investors Research

Whatever the precise number, the combination of declining homeownership and rising household formations (presuming the economy continues to grow) will create

demand for rental units in the years ahead. The historical annual household growth rate of 1.2% (since 1990) slowed considerably during the 2008-2010 recession, as people delayed forming a household and immigration subsided. However, a reversion to a 1.2% average annual growth rate – which is forecast by Moody's Analytics – would create 1.4 million new households annually through 2016, many of which would form renter households. Weaker economic growth would result in a lower household formation rate and hence more muted demand for apartments.

In Exhibit 4, we plot the annual renter household formations over the next five years based on a variety of scenarios. At the high end on the upper left, more than 600,000 new renter households would be created if the total household growth rate hits 1.4% and the homeownership rate drops to 62%. At the low end of the estimate on the lower right, fewer than 200,000 new renter households will be created in the event that household formations drop to 0.9% and the homeownership rate rebounds to 66%. In between those extreme scenarios are more moderate (and more likely) scenarios in which the number of renter household formations is in the 300,000 to 400,000 range.

4) POTENTIAL RANGE OF ANNUAL APARTMENT DEMAND (RENTER HOUSEHOLD FORMATIONS)

Homeownership Rate	Household Formation Annual Growth					
	1.4%	1.3%	1.2%	1.1%	1.0%	0.9%
62.0%	652,336	633,344	614,426	595,583	576,814	558,120
62.5%	601,556	582,813	564,145	545,549	527,028	508,579
63.0%	550,776	532,283	513,863	495,516	477,241	459,039
63.5%	499,996	481,753	463,582	445,483	427,455	409,498
64.0%	449,216	431,223	413,301	395,449	377,668	359,958
64.5%	398,435	380,692	363,019	345,416	327,882	310,417
65.0%	347,655	330,162	312,738	295,383	278,096	260,877
65.5%	296,875	279,632	262,457	245,349	228,309	211,337
66.0%	246,095	229,102	212,175	195,316	178,523	161,796
66.5%	195,315	178,571	161,894	145,282	128,736	112,256

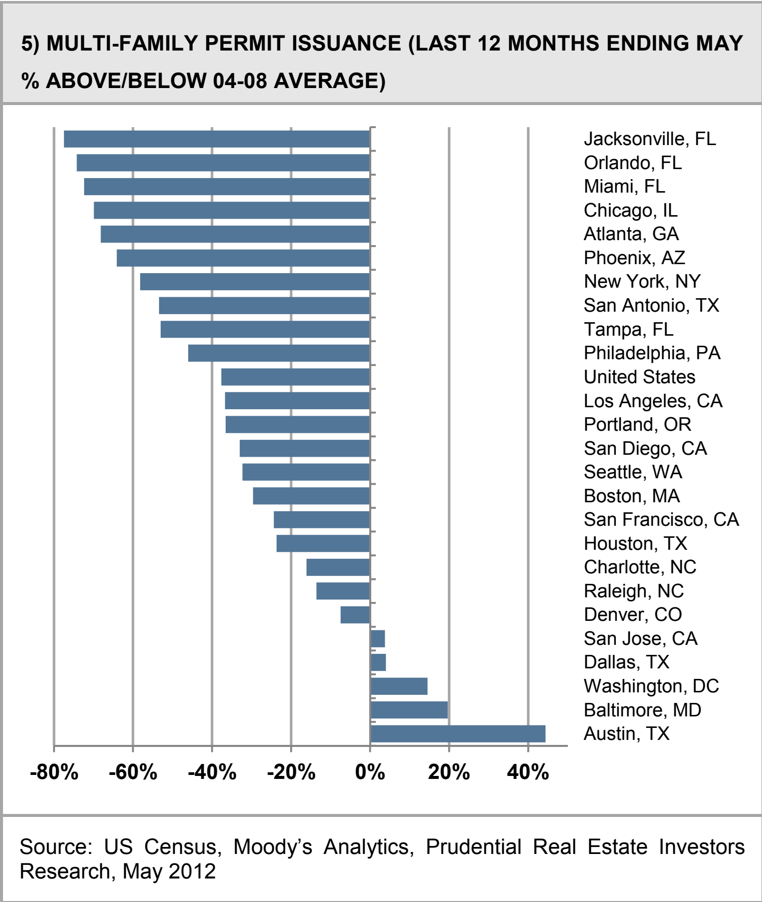
Source: US Census Bureau, Prudential Real Estate Investors Research, 2Q12

Key Risks: Additions to Supply and Affordability

Despite the positive demographic and economic trends, there are a number of risks to investing in apartments that the sector did not face two years ago. One is the danger that apartment rents are growing too fast in relation to home prices and to income. Also, multifamily units will face additional competition from the rental of single-family homes and the new apartment supply.

Development. As we saw earlier, new supply of both single- and multi-family units has been at historical lows for many years now. That fact, combined with the sore need for rental product in some markets and the loosening of the construction-loan market, has led to a noticeable increase in the number of new apartment projects receiving permits. Multifamily permit issuance averaged a 226,000-unit seasonally adjusted annual rate during the first four months of 2012, up about 55% from the same period a year ago. That sounds spectacular but remains some 40% lower than the historical norm for the multifamily market. The trend does vary by market. For example, in Austin permit issuance has surged recently, and projects not under construction already may be faced with a number of new property openings at the same time. Multifamily permit issuance remains constrained in markets such as Miami, Jacksonville, and Orlando (Exhibit 5).

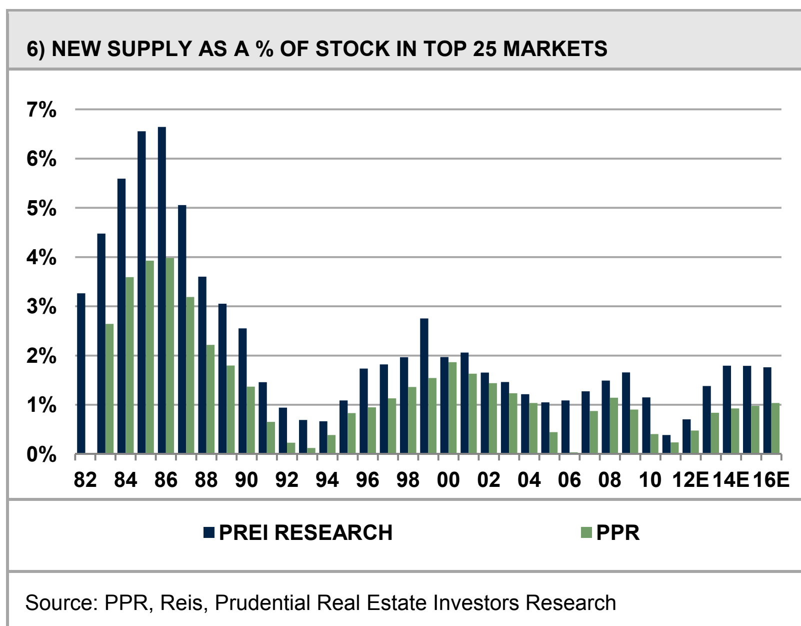
5) MULTI-FAMILY PERMIT ISSUANCE (LAST 12 MONTHS ENDING MAY % ABOVE/BELOW 04-08 AVERAGE)



Source: US Census, Moody's Analytics, Prudential Real Estate Investors Research, May 2012

It is imperative to understand market and micro-market supply trends in today's environment. Because it will take up to 24 months for this new supply to hit, pushing the early supply deliveries to late 2013/early 2014, even under the most optimistic scenario development will likely remain below trend levels in the near term. We foresee new supply in the top 25 markets to grow 0.7% this year followed by a 1.4% gain in 2013 (Exhibit 6). As such, completions will remain below the 1.5% historical average through next year. However, we estimate that new supply will expand by 1.8% per annum from 2014 through 2016, which places new supply slightly above trend level, but on par with the rate typically seen during the expansionary segment of economic cycles. Other analysts, such as PPR and Reis, also forecast below-trend supply through 2013 in the top 25 markets. Reis estimates that new supply will peak at 1.7% in 2014 before receding to 1.2% in 2015 and 0.9% in 2016. PPR forecasts a quiet new supply cycle, averaging a 1% annually from 2014 through 2016.

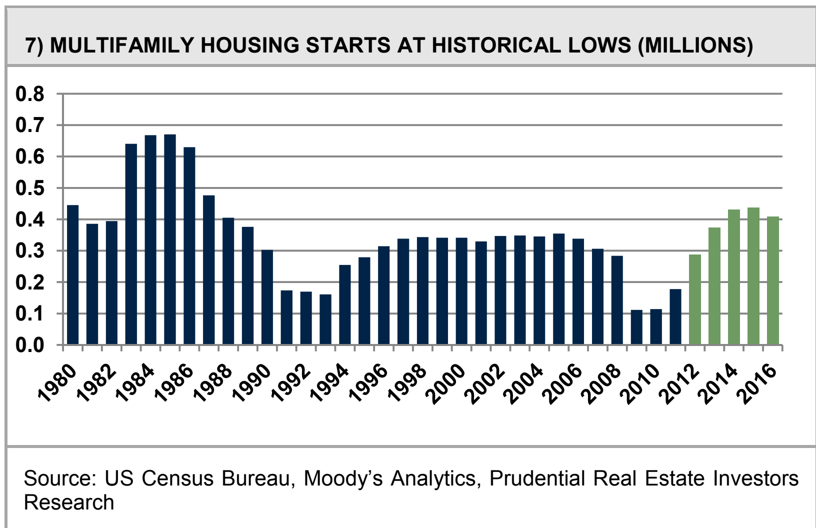
6) NEW SUPPLY AS A % OF STOCK IN TOP 25 MARKETS



Source: PPR, Reis, Prudential Real Estate Investors Research

In addition to new multifamily rental, the single family market is inured with a surplus of vacant inventory, which many investment firms are looking to purchase and operate as rental units. This may have a limited impact on rentals in suburban locations in housing-bust metros, but overall we would not expect much competition from this segment of the market for class A apartments, especially in infill markets.

7) MULTIFAMILY HOUSING STARTS AT HISTORICAL LOWS (MILLIONS)



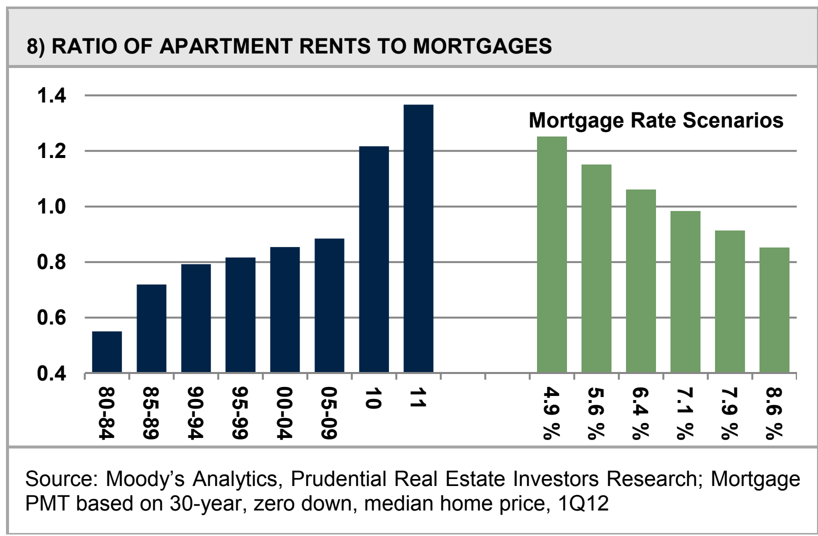
Source: US Census Bureau, Moody's Analytics, Prudential Real Estate Investors Research

Moody's Analytics projects multifamily housing starts to climb from the extreme low levels between 2009 and 2011 to roughly 400,000 per year between 2013 and 2016 (Exhibit 7) based on its view those years will see extremely robust job creation. Whether this new construction meets or overshoots demand will depend in large part on the demand side of the equation. If the economy performs well and demand grows by some 350,000 to 415,000 units annually, supply will be readily absorbed at the national level (although we have identified certain submarkets that are facing supply-side risk in our underwriting process). What's more, historical data shows a loss rate of units destroyed (and that need to be replaced) of 0.24% of existing stock, the equivalent of some 50,000 rental units annually, providing an additional incentive for new supply.

We forecast some 300,000 to 350,000 new renter household formations per year, which is fewer than Moody's. However, we also project less new supply, in part because the Moody's forecast is based on higher job growth numbers than we anticipate. As a result, our baseline forecast calls for new supply to fall roughly in line with demand from increased household formations.

Affordability. There are two risks to rental affordability: relative to single family ownership and relative to the incomes of potential renters. At the national level, rental affordability relative to homeownership has deteriorated significantly. In other words, renting is growing more expensive as the cost of owning a home has become less expensive.

8) RATIO OF APARTMENT RENTS TO MORTGAGES



Source: Moody's Analytics, Prudential Real Estate Investors Research; Mortgage PMT based on 30-year, zero down, median home price, 1Q12

Historically, renting in the US has been cheaper than owning a home. In the wake of the subprime mortgage crisis, in which millions of homes are underwater or in the process of being foreclosed and banks have sharply reduced credit availability, renting has grown more expensive relative to owning (Exhibit 8).

In 2008, renting crossed the threshold of being more expensive than owning and the imbalance has grown to unprecedented levels through the beginning of 2012. Yet, relative affordability is but one factor in the choice between rental and for-sale housing. Consumer preferences, lack of down payments and tight credit conditions also play a role.

As such, demand for homes could easily turn around if confidence in the economy and credit availability surge, and that could put a dent in the popularity of apartments. Some people who are renting are doing so involuntarily – they may have lost their homes to foreclosure or lack sufficient creditworthiness to qualify for a mortgage. Those people may be quick to buy a house if their personal situation changes or there is a change in home prices or access to credit. Even some who are renting by choice may be attracted to ownership if the imbalance continues and/or grows to any extent.

In a normally functioning market, the imbalance between renting and owning would likely be arbitraged relatively quickly – over a period of several years. But there is a strong possibility that the gap could go even higher in the near term. The for-sale housing market is still dealing with limited credit availability and utter lack of confidence that owning is a “good” choice in today’s market. Even with today’s ultra-low interest rates, home buying remains weak. Still, the growing affordability gap provides a warning that apartment owners may not be able to sustain a wide imbalance in affordability compared to homeownership, which could have implications for the timing and amount of rental increases. The correlation between home appreciation and rental prices tends to be negative in the short term, but over the long term the correlation is strongly positive. In an environment of moderate growth, rising household formations would benefit both apartments and single-family housing.

Another issue related to affordability is the level of rent in relation to income. Rent growth has outpaced income growth over the last few years. Some renters are doubling or tripling up because they cannot afford to pay rising rents on an individual basis. Rents now account for 24.3% of household income for those in the 25-34 age group and 19.9% of income for those ages 35-44, both all-time highs. Apartment landlords, looking to maximize income are pushing rents as much as possible, have not received much pushback as of yet, as evidenced by the continued decline in the vacancy rate. Many renters have no choice because of a lack of income or poor credit scores. But at some point renters will push back and rents will have to bear some relation to the level of personal income.

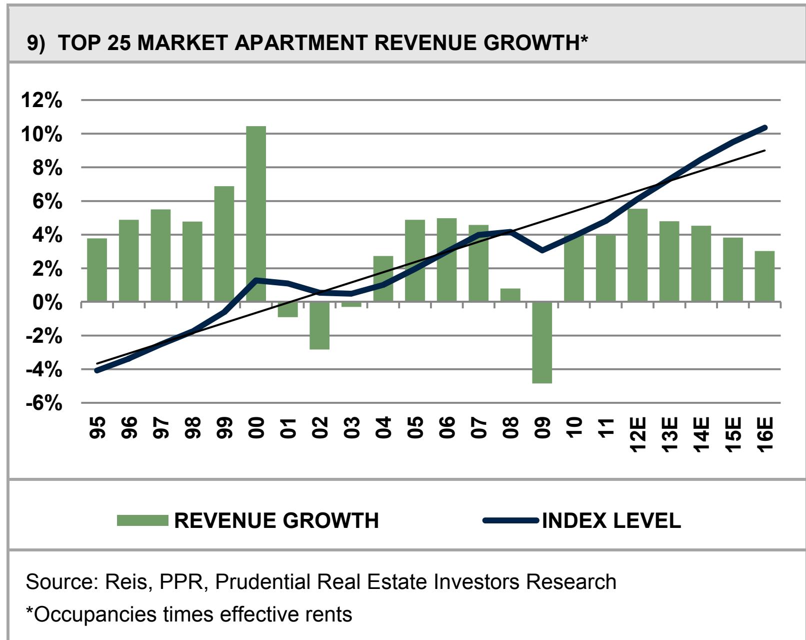
Investment Market Implications

Supply cycle. While new supply isn’t expected to reach long-term averages until late 2013, development tends to move in cycles. That is leading to concern that developers might saturate the market with new supply, but those fears may be overstated. Typically apartment development has been more sensitive to changes in demand than other property sectors because construction times tend to be faster and units are often built in phases to minimize construction risk.

Our baseline view is that there will be enough demand to fill new units that are in the pipeline. We see vacancies in the top 25 markets dropping to 4.5% at the end of 2012, down 80 bps from 5.3% at the end of 2011 and well below the 8.1% seen at the 2009 peak. Vacancies should tighten slightly to 4.3% by year-end 2013, and then edge up to 4.7% by 2016.

The biggest risk for apartments comes from any demand side correction just as new supply is delivered. If demand slips due to a downturn in the economy when new supply reverts to historical norms in a couple of years, it could create an imbalance that would produce higher apartment vacancies. By the same token, if economic growth is stronger than expected when new deliveries become healthy, some renters may be prompted to buy homes. That also would impact demand and cut into occupancy and rent growth of apartments, though both sectors may benefit in such a scenario. The optimal scenario for apartments may be a "goldilocks" economic recovery in which homeownership does not regain the popularity it had during the last decade and renter household growth continues at a solid rate.

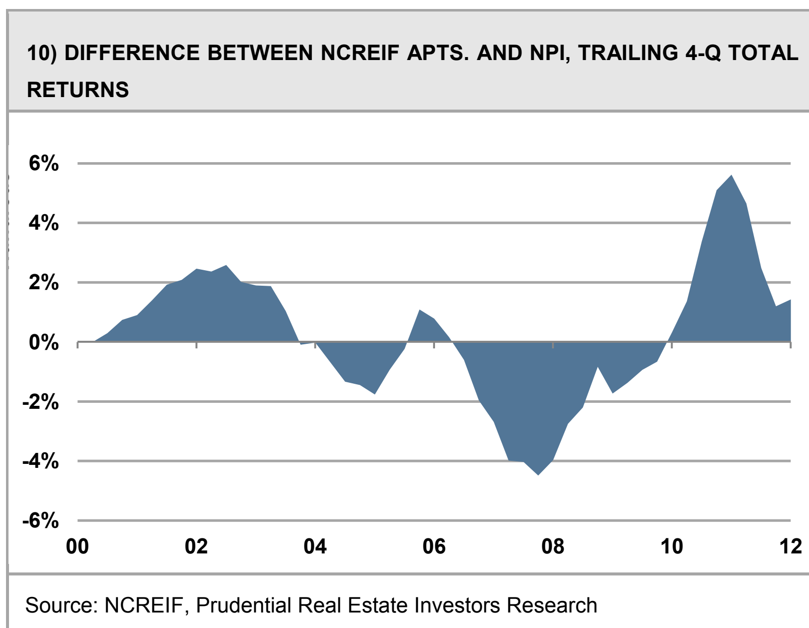
9) TOP 25 MARKET APARTMENT REVENUE GROWTH*



Source: Reis, PPR, Prudential Real Estate Investors Research
*Occupancies times effective rents

Sector performance. The outlook for revenue growth over the next five years is strong (Exhibit 9). With occupancies already tight, rental increases will be the primary catalyst for NOI growth. Our five-year revenue growth forecast calls for 4.3% average annual gains through 2016 with 2012 the strongest year and receding to 3% growth by 2016. In comparison, revenue growth averaged 6% per annum during the 1995-2000 period and 4.3% during the 2003-2007 period. Even with the consideration of inflation during those periods and a moderate inflationary environment likely in the years ahead, the current outlook for apartments looks solid.

10) DIFFERENCE BETWEEN NCREIF APTS. AND NPI, TRAILING 4-Q TOTAL RETURNS



Source: NCREIF, Prudential Real Estate Investors Research

Apartments have strongly outperformed other property sectors in recent years (Exhibit 10), due to the combination of improved fundamentals and net operating income and the sector's popularity with investors that are looking for stable returns. The average capitalization rate for an apartment property in the NCREIF universe has fallen to 5.0%, while the average for all properties was 5.6%. As relative performance between the property sectors tends to rotate depending on the economic and development cycles, it is likely that apartments will not continue to outperform for many more years, especially given the already strong cap rate compression.

For long-term investors that focus primarily on capital preservation and volatility of returns, apartments remain a favorable investment asset class. For others, now may be the time to begin shifting from our previously recommended significant over-allocation to apartments to a par allocation. That would enable them to continue to benefit from near-term upside potential and favorable long-term risk-adjusted returns while balancing potential risks that we have highlighted. Nevertheless, in today's extremely low vacancy environment and favorable demand outlook, apartment development is warranted, providing investors with value-add opportunities in select markets.

Conclusion

The argument for investing in apartments is fairly simple. Well-located properties near cities and jobs will always be in demand, and as the population grows, more units are needed to house them. Market conditions have boosted the sector's returns in recent years, and it appears that fundamentals should continue to be strong, based on demographics, declining homeownership and the amount of time it will take to get new supply in place.

We previously recommended an over-allocation to apartments, based on the outlook for improving fundamentals and return expectations. Now, however, the case for apartments has to be made with some caution. The growth in the prime rental age cohort may not produce a great deal of demand if young people can't find good jobs. The homeownership rate could rise again if renting becomes too expensive and mortgage credit becomes more available, or if preferences shift back to the ownership market if home prices begin to accelerate. Additionally, the volume of new development could rise faster than anticipated. All these concerns come in the context of an uncertain economy with exceptionally volatile financial markets that swing regularly based on news out of Europe and other parts of the world.

Consequently, with the growing risks to the outlook and the unlikely prospect that apartments will outperform other property sectors for an extended number of years, now may be the time to shift allocations so that apartments are in line with the NCREIF balance rather than over-allotted. To be sure, we're not bearish on apartments, which should continue to produce solid returns. Indeed, tight occupancies and strong rent growth have prompted welcomed development and value-added opportunities that offer investors favorable risk-adjusted returns.

How do investors take advantage of the upside in the apartment sector in a way that minimizes the potential downside? One way is to focus on development opportunities in locations in which supply is naturally limited due to space or zoning regulations. Such locations are much more likely to retain demand in any economic environment. While gateway cities are examples of such locations, prime is not limited to urban settings. There is strong demand for high-quality apartment properties in many suburban markets, where economic growth is strong and there is demand for housing for workers or other demographic groups, such as retirees. The key is to understand the supply pipeline and demand drivers in each market, and develop in areas where the need is compelling.

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