WHITE PAPER

APARTMENT AFFORDABILITY

REGIONAL REPORT

A Cushman & Wakefield Alliance Research Publication

APRIL 2015

RESPECT THE CYCLE

Real estate, despite making a strong comeback over the past couple of years continues to be on many peoples' minds. The memory of 2006 is not easily forgotten and many questions are being asked with respect to the current condition of the apartment market. Dan Lofgren from Cowboys Partners recently used the term "respect the cycle" in a roundtable with Utah Business Magazine. Looking at where we have been, where we are now, and what is next, several questions come to mind. Can pricing be sustained for investors? Are rental rates increasing too quickly? Is supply and demand in check? What is different about this multi-family market than years past?

INVESTMENTS AND DEBT

Demand for investment product in apartments remains very strong. The major limiting factor on transactions is simply the lack of product on the market. Several factors are contributing to this high level of demand that range from strong market fundamentals to availability and value of debt. As of mid-year 2014, the overall vacancy rate across the Salt Lake Valley was just 3.0%. This is the lowest vacancy recorded over the past decade and represents a steady decline of 2.7 percentage points over the past 5 years. Over this same period of time the average rental rate has increased by a healthy 3.5% per year.

The availability of debt and low interest rates for well positioned assets is another major factor pushing demand for apartments. Debt from agencies such as Fannie Mae and Freddie Mac continue to offer rates at or near historic lows, in some cases as low as 2 percent on adjustable mortgages and the mid-3 percent range on fixed rates. These low interest rates allow investors to achieve required leveraged yields while purchasing at cap rates lower than other commercial property types where interest rates are not as favorable.

Investors see healthy population growth, a strong and improving job market, solid fundamentals and historically low interest rates as reasons to invest in apartments. All these are strong reasons suggesting for now that we might just be in a stable part of the cycle. The fear of interest rates increasing has been on investor's minds for a while and although it seems likely that interest rates will go up, their impact on cap rates will be somewhat mitigated by strong demand for commercial real estate in general and in particular for apartments.

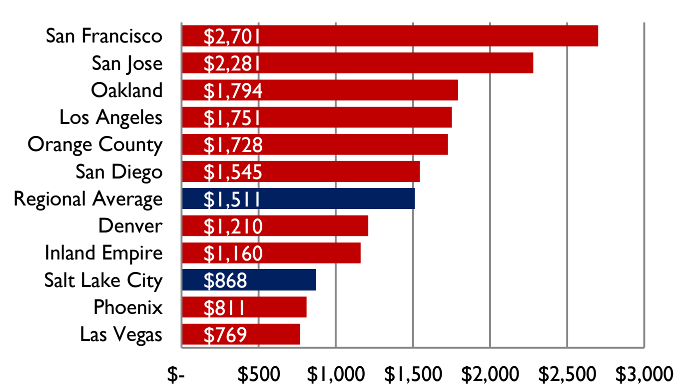
AFFORDABILITY

One of the most significant changes in the apartment market is how the renter profile has changed. Historically if you could afford and qualify for the purchase of a single family residence, home ownership was the path generally taken. Apartment dwellers, for the most part were made up of the remaining population. Led largely by the millennial generation, today the target market for renters has

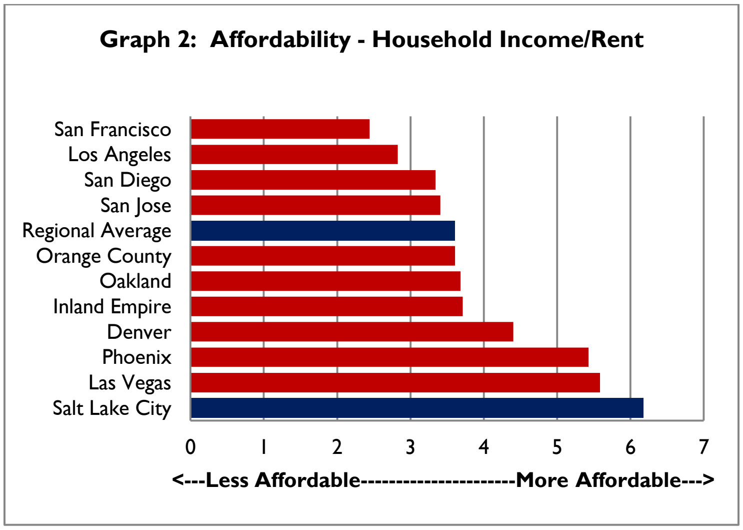
expanded to also include wealthier individuals looking at apartment life as an opportunity to be closer to urban cores without being tied down to the same place for a long period of time. With this wealthier demographic now included in the target market, new apartment buildings offer quartz counter tops, open floor plans, gourmet kitchens and modern décor. This trend toward higher-end finishes and more urban locations has pushed rates for these properties to significantly higher levels than the rest of the market. The recently completed Vue at Sugarhouse is a prime example of the higher-end offerings in the market. Their 2 bedroom/2 bathroom model that goes as high as $2,252 per month should not be compared to the average 2 bedroom/2 bathroom model in the market.

Although rental rates have increased over the past 5 years, this increase has been constrained to 3.5% per year. While ahead of inflation, this increase also includes the additions of dissimilar, high-end apartments, meaning the increase is not uniform across all apartment types. Salt Lake County offers some of the lowest rental rates in the Western United States as can be seen in the graph below.

Graph 1: Comparative Rents Year-End 2014



Rental rates are only part of the equation though as wages vary vastly from one market to another. We explore affordability from two different perspectives. Option 1 is to take the average Household Income in a market and divide by the average rental rate. The higher the number, the more affordable the market (see graph 2). Option 2 is to subtract the average rental rate from the average Household Income (see graph 3), in a sense creating a discretionary income category after rent has been paid.



These two graphs show that Salt Lake is the most affordable market when following option 1 and is still the fourth most affordable when applying option 2.

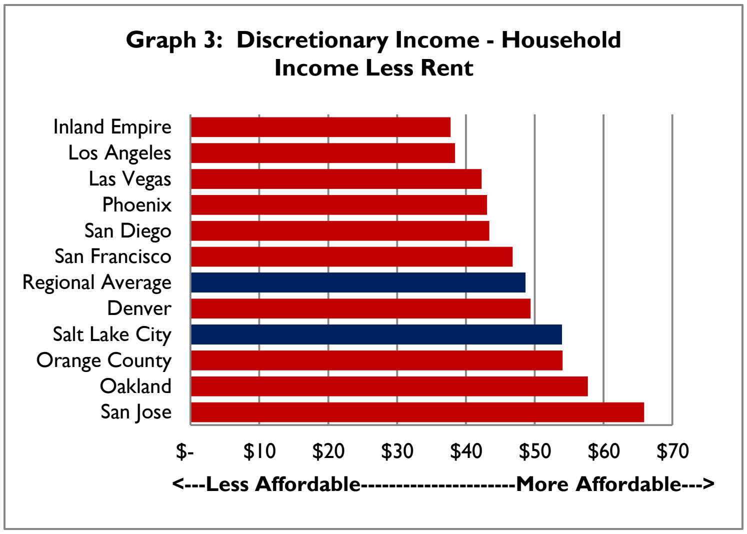
FEAR OF OVER-SUPPLY

The other major concern in the apartment world is the unprecedented level of new development currently underway. With over 4,800 apartments under construction in just Salt Lake County, many are rightfully concerned about the market's ability to absorb all these units.

Using historical absorption over an 18 month period, these units under construction would push the overall vacancy rate to around 4.8% which is right in line with the 10-year average of 4.7%. Although there are another 6,500 planned units that could start, it seems unlikely that many of these projects will be completed in the next 3 years unless there is an abnormally high level of absorption. The projects most likely to be completed are those in urban locations such as downtown and adjacent to Frontrunner or TRAX stops.

EXPECTATIONS

The real estate cycle is ever changing and can do so in a very short period of time. Despite concerns that apartments are "expensive" and that oversupply is an imminent threat, there are plenty of other



fundamentals at play that assure us of the stability of the market. Demand is high, vacancy rates are low, debt is inexpensive and the economy is expanding. All of these are strong indicators that we are in a solid place within the cycle.

The millennial generation has made its impact and will continue to do so as life decisions such as marriage, children and buying a home are pushed out and their desire to live in urban locations trumps home ownership. This is expected to be a long lasting trend. This new class will continue to push absorption to levels above the 10-year average which will allow for many of the planned units to be built. Even with this new class of renter, the level of planned units is likely too high for what the market can handle in the next 3 years. Developers, especially those in more suburban and less desirable locations will need to exercise some caution.

Cushman & Wakefield | Commerce
170 South Main, Suite 1600
Salt Lake City, UT 84101
www.comre.com/research

Contact:
Scott Lovell, Research Director
(801) 303-5451
slovell@comre.com

The enclosed information, while not guaranteed, has been secured from sources we believe to be reliable.