MARKET REPORT

Marcus & Millichap

MULTIFAMILY

Phoenix Metro Area

Q4/19

Apartment Construction Accelerating Into Next Year; Class C Sector Still Undersupplied

Developers tip the supply/demand balance. The pace of construction will begin to outpace the number of new apartment seekers beginning in early 2020. Nonetheless, fundamentals will remain favorable for owners, supporting solid rent gains. Inventory growth will approach a cyclical peak in 2019 and increase by 35 percent next year. At the same time, payroll expansion has begun to level off, partially due to a lack of available workers. Unemployment hovers in the low-4 percent range, a level first reached in early 2017 and on par with the local equilibrium rate. Most of the impact from elevated construction and slowing economic growth will be felt in the Class A sector, where properties also compete with rising housing starts. Vacancy in the top tier is expected to drift onto the upper side of 5 percent next year, encouraging operators to pull back from the steep pace of rent hikes that characterized 2019.

Significant housing shortfall in Class C sector. In the third quarter, Class C vacancy dipped below 3 percent for the first time on record and little relief is on the horizon. Due to tight conditions and developers' focus on top-tier units, rents should advance at a brisk rate again in 2020. Class B performance could be a wild card in select submarkets next year. While occupancy will favor landlords, operators will need to remain cognizant of concessions offered by new properties in lease-up. Until payroll expansion accelerates, some of the demand for new units will come from current Class B renters.

Multifamily 2019 Outlook

7,800 UNITS

will be completed

CONSTRUCTION:

Development is accelerating in the Phoenix market as more than 8,000 units are completed this year and over 10,000 apartments are slated for 2020.

100 BASIS POINT

decrease in vacancy

VACANCY:

The market will post an annual decline in vacancy to 3.5 percent in 2019. Upward pressure will intensify next year.

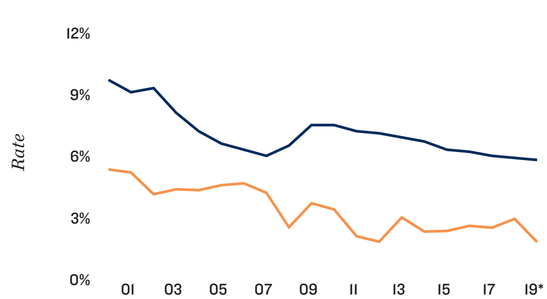
9.7% INCREASE

in effective rents

RENT:

The average effective rent will finish the year at $1,179 per month. The pace of growth should ease in 2020.

Local Apartment Yield Trends



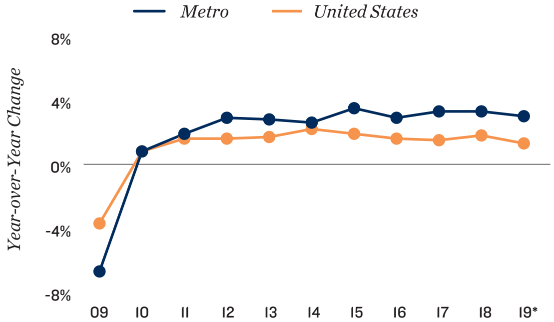
** Cap rate trailing 12-month average through 3Q; Treasury rate as of Sept. 30*

Sources: CoStar Group, Inc.; Real Capital Analytics

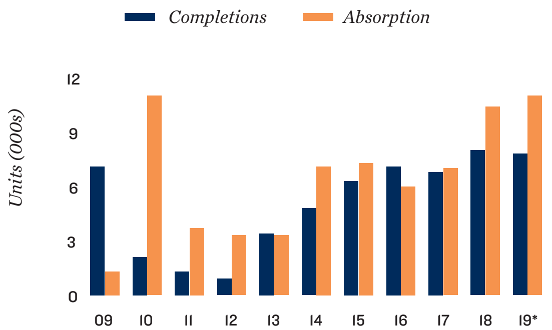
Investment Trends

- Investors awash with capital continue to scour the Phoenix market for available assets. Out-of-state buyers modestly outnumber local players, though both groups eclipse available listings. In recent quarters, investors have expanded their search parameters into more distant suburbs to find attractive assets.
- The influx of construction will do little to slow down activity in the Class A sector. In fact, the pace of deals could accelerate at developers list properties desired by institutions and high-net-worth buyers from California and the East Coast.
- Value-add opportunities can be found in the Class C sector, which is grossly undersupplied. Core locations near employment centers are on the top of investors' wish lists.
- Average cap rates dropped to a new cyclical low as listings command premium pricing. First-year returns for Class A deals can dip below 5 percent in the suburbs in some instances.

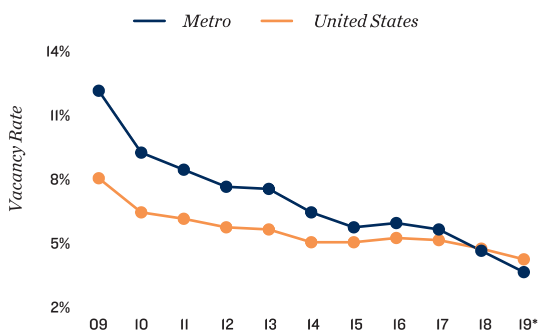
Employment Trends



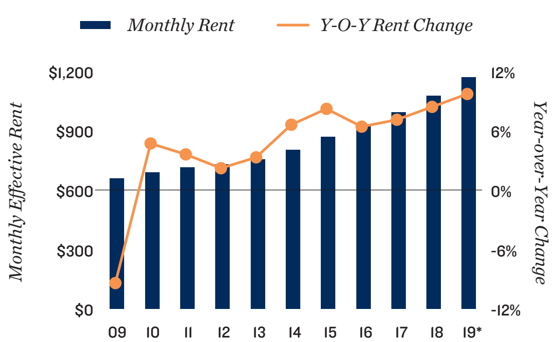
Completions and Absorption



Vacancy Rate Trends



Rent Trends



* Forecast

Source: CoStar Group, Inc.

3Q19 – 12-Month Period

EMPLOYMENT

2.3% increase in total employment Y-O-Y

- Phoenix added 48,200 jobs during the last 12 months, down from 73,600 spots in the previous yearlong period. The metro's unemployment rate of 4.3 percent has constrained the pace of hiring in the market.
- A strong housing market supported the addition of 12,200 construction positions over the past year, lifting headcounts 9.6 percent. Education and health services generated 11,100 spots.

CONSTRUCTION

7,400 units completed Y-O-Y

- Inventory increased 2 percent in the yearlong period ending in the third quarter. The pace of supply growth eased from the prior period, when 8,300 apartments were completed.
- Although completions have slowed in recent quarters, the pipeline remains robust as 17,600 units are underway. An additional 2,000 apartments are scheduled for delivery in the fourth quarter, and more than 10,000 units are anticipated in 2020.

VACANCY

60 basis point decrease in vacancy Y-O-Y

- Vacancy declined to 3.7 percent in the third quarter, representing a cyclical low. As the pace of completions rises into 2020, the rate will inch higher.
- A housing shortage in the Class C sector amplified in the last 12 months as vacancy declined 110 basis points to 2.7 percent. Class A vacancy retreated 70 basis points annually to 4.5 percent in the third quarter.

RENT

10.1% increase in the average effective rent Y-O-Y

- Effective rent reached a record high in the third quarter at $1,163 per month. Year-over-year rent gains have been in the double-digit area since the first quarter of 2019.
- The most affordable submarkets, West Phoenix and South Glendale, each recored above-average rent gains at 10.3 percent annually. Although impressive, rent growth in the more expensive areas of the metro is below average.

Demographic Highlights

3Q19 Median Household Income

Metro **$65,812**

U.S. Median **$65,205**

3Q19 Affordability Gap

Renting is **$371** Per Month Lower

*Average Effective Rent vs. Mortgage Payment**

Multifamily (5+ Units) Permits⁺

9,248 1H 2019

-2.3% Compared with 1H 2016-2018

3Q19 Median Home Price

Metro **$283,799**

U.S. Median **$272,227**

Five-Year Household Growth**

196,000 or **2.2%** Annual Growth

U.S. **1.0%** Annual Growth

Single-Family Permits⁺

23,559 1H 2019

15.8% Compared with 1H 2016-2018

*Mortgage payments based on quarterly median home price with a 30-year fixed-rate conventional mortgage, 90% LTV, taxes, insurance and PMI. **2019-2024 ⁺ Annualized Rate*

SUBMARKET TRENDS

Lowest Vacancy Rates 3Q19**

Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Average Effective Rent	Y-O-Y % Change
Southwest Mesa	3.0%	-100	$1,045	10.9%
East Phoenix	3.3%	-80	$1,103	9.4%
South Tempe	3.4%	-50	$1,265	8.1%
Chandler	3.6%	-60	$1,327	9.0%
Northeast Phoenix	3.6%	-60	$1,058	10.4%
South Scottsdale	3.8%	-90	$1,501	5.6%
North Scottsdale	3.8%	-120	$1,476	9.0%
Deer Valley	3.9%	-100	$1,263	10.6%
Northwest Phoenix	4.0%	-40	$920	9.3%
North Central Phoenix	4.2%	-30	$1,205	11.2%
Overall Metro	**3.7%**	**-60**	**$1,163**	**10.1%**

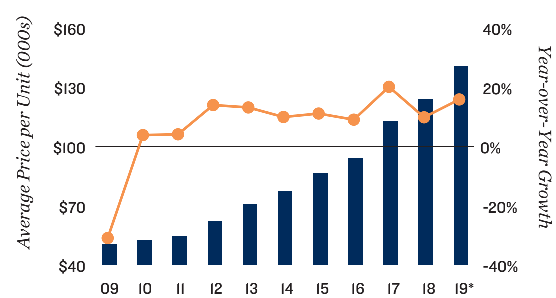
*** Includes submarkets with more than 16,000 units of inventory*

SALES TRENDS

Out-of-State Buyers' Competition for Higher Yields Than Their Home Markets Raises Values

- Sales velocity was relatively consistent year over year in the Phoenix apartment market as in increase in Class A deals offset a modest dip in Class C trades.
- The rise in top-tier sales aided but did not wholly account for an impressive 16 percent rise in the average per door price to $140,700. Average cap rates compressed to 5.7 percent, a 10-basis-point decline year over year.

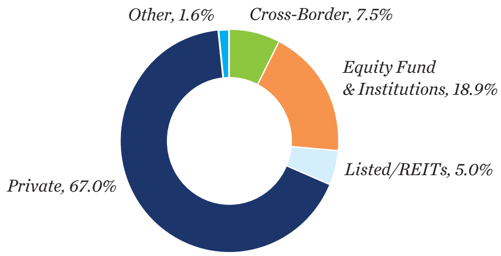
Outlook: Out-of-state buyers continue to focus on Class A and B deals, though more midtier deals are being targeted in outlying suburbs. High-net-worth local buyers primarily target value-add Class C opportunities.



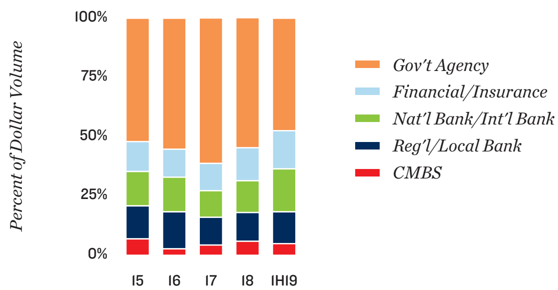
** Trailing 12 months through 3Q19*

Pricing trend sources: CoStar Group, Inc.; Real Capital Analytics

IHI9 Apartment Acquisitions
By Buyer Type



Apartment Mortgage Originations
By Lender



Includes sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

CAPITAL MARKETS

By DAVID G. SHILLINGTON, President, Marcus & Millichap Capital Corporation

- **Fed cuts rate again, while balancing assortment of factors.** The Federal Reserve cut the overnight rate by 25 basis points at the end of October, the third reduction in less than 100 days in an attempt to lengthen the economic runway. Muted inflationary pressure and continued trade negotiations have boosted the probability for an additional rate cut in December as it is anticipated by some domestic and foreign markets. However, at the end of October, the U.S. and China were in talks for finalizing the first phase of a trade deal, potentially erasing the need for another rate reduction if the preliminary agreement quickly comes to fruition. This, along with positive economic indicators like strong wage growth, sustained job creation and a rising 10-year Treasury, will continue to make future decisions difficult for Fed members as they balance the array of forces tugging at both ends of possible outcomes. Global developments including slowing European economies as well as the progression of Brexit and its potential aftermath will also help determine future Fed decisions. Though recession risks remain, the economy's solid foundation has softened it in recent months, signaling continued domestic growth in the near future.
- **Abundant liquidity balances conservative underwriting.** Debt financing for apartment assets remains strong, supported by a variety of lenders. Fannie Mae and Freddie Mac, two mainstay apartment capital sources, were recently given increased lending caps, allowing the two Government Sponsored Enterprises to purchase $100 billion in loans during a yearlong period that started at the beginning of the fourth quarter 2019. A wide range of local, regional and national banks; pension funds; insurance companies and CMBS sources will also remain active. All have responded to the falling interest rate climate by reducing mortgage rates, but lender spreads have widened as the 10-year Treasury rate remains near cycle lows. Given the downward pressure on interest rates, lender caution has risen, particularly for construction loans. Though lending is still available for these types of projects, investors may need to blend mezzanine debt with other capital sources until they prove out their concepts and substantially fill units. For stabilized existing assets in most major markets, financing remains plentiful.

National Multi Housing Group

John Sebree
First Vice President, National Director | National Multi Housing Group
Tel: (312) 327-5417 | john.sebree@marcusmillichap.com

For information on national apartment trends, contact:
John Chang
Senior Vice President, National Director | Research Services
Tel: (602) 707-9700 | john.chang@marcusmillichap.com

Phoenix Office:

Ryan Sarbinoff *Vice President/Regional Manager*
2398 E. Camelback Road, Suite 300
Phoenix, AZ 85016
(602) 687-6700 | ryan.sarbinoff@marcusmillichap.com

Price: $250