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Marcus & Millichap apartment research market update in Boston

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A stagnant housing market and strong white-collar job growth in the city core is spurring demand for rental units across the city, compressing vacancy below pre-recession levels. As single-family foreclosures continue to mount, homeownership in Boston will fall to the lowest level in over a decade to 66%. In addition, the median price contracted more than 4% in the past year, causing some potential buyers to pause when considering a transition from renting. This ill effect will help boost leasing activity in the hardest hit suburban areas such as the West/ Northwest Suburban and North Shore/Merrimack River Valley submarkets; where elevated concessions will attract renters looking to downsize to smaller residences. As such, the submarkets will outperform most of the metro as vacancy decreases an average of 140 basis points this year. Elsewhere, employment gains in the professional and business services sector will fuel demand for luxury units in highly sought-after neighborhoods near major employers and entertainment districts, including central city/Back Bay/Beacon Hill and Boston city submarkets. Owners in these areas will gain enough leverage to tighten concessions to the lowest level in a decade and lift rental rates to historical highs.

As bidding intensifies in other coastal markets, strong operations in the Boston apartment market will lure major buyers to the metro, pushing private, in-state buyers to outlying areas in search of higher yields. REITs and institutions will further expand their portfolios in Boston, targeting trophy assets in premium locations of Cambridge and Suffolk County for long-term holds. As competition intensifies, these best-in-class assets will command cap rates in the mid-5% range. Meanwhile, local investors that have been priced out of the city's core and the class A arena will migrate to densely populated suburbs in Essex and Middlesex counties. Equipped with cash, these buyers can find value-add opportunities in the sub-60 unit segment to fill units and reset rents.

2011 Annual

Apartment Forecast

Employment: Employers will replace more than 50% of the positions lost during the downturn, generating 49,000 jobs this year, an annual gain of 2%. In 2010, over 21,000 workers entered the labor force.

Construction: Building activity will fall to the lowest level in over 13 years as developers complete a mere 440 apartments in 2011, expanding inventory levels by .2%. In the prior year, more than 1,040 units came online.

Vacancy: In 2011, vacancy levels will retreat 110 basis points to the lowest level since 2002 to 4%. In the preceding year, the release of pent-up renter demand drove down vacancy 130 basis points.

Rents: By the end of the year, asking rents will reach a historical high of \$1,762 per month after spiking 2.9%, while effective rents will advance 3.3% to \$1,675 per month. In 2010, asking rents

increased 2.5%, and effective rents rose 3.1%.

Economy

* In the first half of the year, employers created more than 21,000 positions, expanding the labor force by .9%. In the same period last year, the work force gained 15,000 jobs.

* Hiring efforts have been the most profound in the leisure and hospitality sector, which expanded by 11,000 jobs in the first two quarters, growth of 5.1%. Conversely, in an attempt to balance budgets, state and local governments eliminated more than 7,000 workers in the same stretch.

* Since the recession ended, broad-based job growth has gradually been pulling the unemployment rate downward as the rate dropped 50 basis points to 7.3% through the second quarter.

* Outlook: By the end of the year, employers will replace more than 50% of the positions lost during the downturn, generating 49,000 jobs, expanding payrolls by %. In 2010, over 21,000 workers entered the labor force.

Housing and Demographics

* Single-family permitting activity rose by 28% over the last 12 months as builders pulled over 3,600 permits. Multifamily permitting, however, has remained sluggish, declining by nearly 10% over the past year.

* The median price for a single-family home contracted 4.1% in the past 12 months to \$334,500. Further, the median household income inched up 3.5% to \$78,000 per year, which is \$60 above the required amount to qualify for a single-family home.

* Using traditional residential lending standards, the monthly mortgage obligation on a median-priced home is \$385 less than the average class A asking rent.

* Outlook: As uncertainty looms over the housing market, sales activity will remain depressed, while strong job growth will support steady demand for rental units in the second half of the year.

Construction

* In the 12 months ending in the second quarter, builders completed 436 apartment units in the Boston metro, expanding stock levels by .2%, well below the 2,490 units delivered in the preceding year.

* Currently, there are over 650 apartment units under way in Boston, with completion dates stretching into the second quarter of 2012. Additionally, the planning pipeline remains full with over 10,000 proposed apartments.

* Strong demand for rental housing in the Cambridge/Watertown/Waltham submarket has attracted developers to the area. Currently, 25% of the metro's proposed units are slated for the submarket, where 60% of all households are renters .

* Outlook: Building activity will fall to the lowest level in over 13 years as developers complete just 440 apartments in 2011, expanding inventory by .2%. In the prior year, more than 1,040 units came online.

Vacancy

* In the first half of the year, vacancy sank 70 basis points to the pre-recession level of 4.4%. In the past year, vacancy dropped 180 basis points.

* Vacancy in the class A sector retreated 90 basis points in the past two quarters to a 10-year low of 5% . Strong leasing activity in the Class B/C sector pushed down vacancy 50 basis points in that time to 4% .

* One of the strongest submarkets in the past year was the South Shore/Rte. 128 South, where solid demand drove down vacancy 310 basis points to a seven-year low of 4.7%.

* Outlook: In 2011, vacancy levels will retreat 110 basis points to the lowest level since 2002 to 4%. In the preceding year, the release of pent-up renter demand drove down vacancy 130 basis points.

Rents

* Over the past six months, asking rents jumped 0.9% to \$1,728 per month, while effective rents rose .9% to \$1,636 per month. In the corresponding period last year, asking and effective rents increased 1.3% and 1.6%, respectively.

* As demand surged for top-tier units, owners raised asking rents.6% in the past six months to a two-year high of \$2,133 per month. In the class B/C arena, rental rates increased for the fifth consecutive quarter, climbing 1.2% in the first half to \$1,446 per month.

* After peaking in the first quarter of 2010, concessions have subtly been trending downward, ending the second quarter at 19 days of free rent. Leasing incentives were lowest in the Cambridge/Watertown/Waltham submarket, averaging 13 days of free rent.

* Outlook: By year-end 2011, asking rents will reach a historical high of \$1,762 per month after spiking 2.9%, while effective rents will advance 3.3% to \$1,675 per month. In 2010, asking rents increased 2.5%, and effective rents rose 3.1%.

Sales Trends

* Transaction velocity remained relatively flat over the past year, though dollar volume surged by more than twofold as local and regional banks eased lending criteria for turn-key properties allowing investors to purchase larger, Class A properties.

* The median price of an apartment surged over 30% in the past year to pre-recession levels of \$118,000 per unit as more top-tier products traded.

* As operations improved and investor demand intensified, cap rates compressed 70 basis points during the past year to the mid-7% range, with some class A assets changing hands below the 5% range.

* Outlook: Due to its proximity to the CBD, properties near major thoroughfares such as I-93 in northern Norfolk County will provide immediate returns in the mid-6% range. Institutional investors will capitalize on the cap-rate compression and unload local portfolios for less management-intensive products, attracting local syndicates looking for long-term cash flow.

Capital Markets

* Apartment mortgage rates should remain favorable through 2011, enhancing property returns and supporting values. While the 10-year Treasury yield likely will remain in the low- to mid-3% range over the next few quarters, the relatively wide spread to all-in lending rates provides some cushion against potential upticks.

* Encouraged by sustained improvements in occupancy and rents, nearly all lending sources have increased funding for apartment deals. As a result, mortgage debt has become readily available for performing assets across markets and property classes, supporting a 40% increase in multifamily origination volume over the past six months when compared to the previous period.

* The agencies continue to dominate but have lost marketshare as insurance companies, private capital sources and local/regional banks, in particular, compete more aggressively for new business. In the near term, life insurance companies will continue to favor larger, best-of-class assets in primary markets, while local and regional banks focus on lower-quality assets with consistent revenue streams and strong, proven sponsorship.

* Underwriting requirements eased over the past year as strengthening apartment fundamentals and

firming property values restored lenders' confidence in the market. Debt-service coverage requirements slipped to 1.15 to 1.25, while loan-to-values on new loans generally improved to 70 to 75%, and in some limited situations, have pushed to as high as 80%.

Submarket Overview

* After nearly a decade, the 220-unit Avalon at Cohasset apartment complex broke ground late last year. The project is slated to come online by the first quarter of 2012 in the South/Southeast Suburban submarket, expanding local inventory by 1.5%.

* As demand outweighs supply in the North Shore/Merrimack River Valley submarket, operations will outperform the rest of the metro in 2011. Further, nearly record-high concessions will help drive leasing activity, pushing down vacancy levels 150 basis points to 4.9% .

* Robust population growth in the South Shore/Rte 128 South, particularly in the prime renter cohorts segment, will boost demand for rental units over the next few years. As a result , owners will tighten concessions and elevate rents to pre-recession levels by year end.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540