CUSHMAN & WAKEFIELD

AN IN-DEPTH GUIDE TO

MULTIFAMILY LAND ACQUISITION & DEVELOPMENT

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Multifamily housing continues to be one of the most successful commercial real estate categories since the economic rebound.

Who's Got the Power?

The success of the country's multifamily market can be largely attributed to the shifting priorities and spending habits of Americans in a post-recession environment. The fiscal goals of each living generation are widely disparate, so which group has been the most instrumental in causing the uptick in demand for multifamily properties?

Research shows that demand for multi-family housing is led primarily by the Generation Z and Millennial age segments, in addition to downsizing Baby Boomers. These groups are attracted to may aspects of renting vs. buying that afford them more flexibility. Renting can be particularly good for people with a smaller portfolio of investments, because they can use the equity from the sale of their property and grow it for a more comfortable retirement.

Generation Z: Born: 1995-2012, Age in 2018: 6-23

Generation Z, defined as those born between 1995 and 2012, already comprises 21 percent of the U.S. population—66.3 million people—a small portion of whom are beginning to enter the housing market as renters. Approximately 4 in 5 (82 percent) of Generation Z renters live with someone else. Generation Z renters are twice as likely to be living with roommates, friends, and family members than all renters from all generations.

Millennials: Born: 1981 to 1996, Age in 2018: 22-37

Millennials, who at this point were expected to be well established on the property ladder and trading up from their starter homes, are instead still saving for their first down payment.

Millennials (the newest generation with spending power) came of age post-9/11, and its members are now entering their prime earning years. Many headlines proclaim this group is less inclined to home ownership than any previous generation. The popularity of sharing services like Uber, Airbnb and WeWork suggests a desire for freedom as well. This demographic started adulthood during one of the worst economic times in living memory, resulting in unprecedented amounts of debt. Understandably, these factors have discouraged them from saving money and making big purchases like cars or homes.

19 Million of current U.S. renters used to be homeowners.*
One-quarter of those renters lost their homes as a result of the foreclosure crises, which is sure to leave a lasting effect on the home ownership rate.

*Source: Urban Land Institute

Generation X, Born: 1965-1980, Age in 2018: 38-53

Gen Xers were mostly in their 30s and early 40s when the housing crisis hit — just old enough to have bought a house. By 2009, many of them found themselves either underwater on their mortgage, or in foreclosure and completely forced out of their home. Gen X was in the wrong place at the wrong time, economically speaking, and in many cases the consequences of that continue.

Baby Boomers, Born: 1946-1964, Age in 2018: 54-72

Baby Boomers and early retirees are renting while in between downsizing from one property to another. Today's older Americans want flexibility to follow their children and grandchildren.

THE ECONOMIC CRUNCH

Student debt, a tight job market, and the inability to save for a down payment have kept many potential home buyers out of the market. "Credit markets are still extremely tight, and a lot of people don't have the right credit score. With stricter lending terms than ever, some consumers aren't even potential participants in the market. Student loan debt in the U.S. stands at a hefty $1.4+ trillion. It is the second leading form of debt in the United States behind mortgage debt.

OTHER FACTORS?

Economics isn't all that drives consumers to rent. Some simply aren't interested in owning a home. "The dream of owning a home isn't as high of a priority on people's list," says Mark Wolf, CEO and founder of Irvine, Calif.–based AHV Communities, a developer that builds single-family rental communities in Texas. "Part of that is residual from the downturn, and part of that is that we're a much more experience-driven society nowadays and are more portable. People don't live in their house for 30 years anymore, and they move more for jobs, so the portability of a lease while still being able to enjoy the luxury of a home is a perfect combination."

KEY TAKEAWAYS

- One-third of all urban applications are for renters over age 60*
- Baby Boomers and early retirees are renting while in between downsizing from one property to another
- Student debt, a tight job market, and the inability to save for a down payment have kept many potential home buyers out of the market
- Millennials do share the dream of home ownership, but many have had to delay that milestone investment
- There has been a societal shift in the America Dream of home ownership with the priority lying more in short-term experiences with more flexibility

DEMAND DRIVERS

- Population growth
- Rental household growth
- Job growth
- Cost of ownership

MARKET DISCUSSION

The U.S. multifamily market remains very dynamic, reaching a **seven-year high** in 2017. Challenges in multifamily demand include rising cost of land due to rise in demand, high construction costs and wages keeping up with elevating rent increases.

VACANCY AND ABSORPTION

Multifamily demand remained very strong in 2017, as evidenced by the 241,200 units absorbed over the year-the second-highest annual total during the recovery/expansion period. The Q4 vacancy of 4.9% was relatively low, but up marginally from a year ago. New deliveries remain at peak levels, with 265,900 units completed in 2017.

RENT GROWTH AND NEW DEVELOPMENT

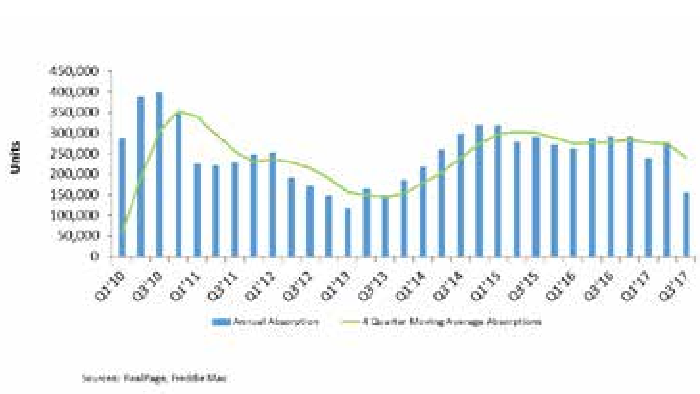
Rent growth in all metros is expected to remain above the Federal Open Market Committee's target inflationary rate of 2 percent, except for New York City and Washington, D.C. – two areas experiencing some of the highest levels of completions. Southern California (composed of San Diego, Los Angeles, Riverside, and Orange County) will also experience below-historical-average rent growth.

Yardi Matrix's monthly survey of 121 rental markets has recorded a $4 increase in the average U.S. apartment rent over the past month, up to another all-time high, of $1,217 for July. Rent growth is up 5.5% on a year-over-year basis, and occupancy rates have stabilized, at 96.0%, over the past several months, despite increased supply in many areas.

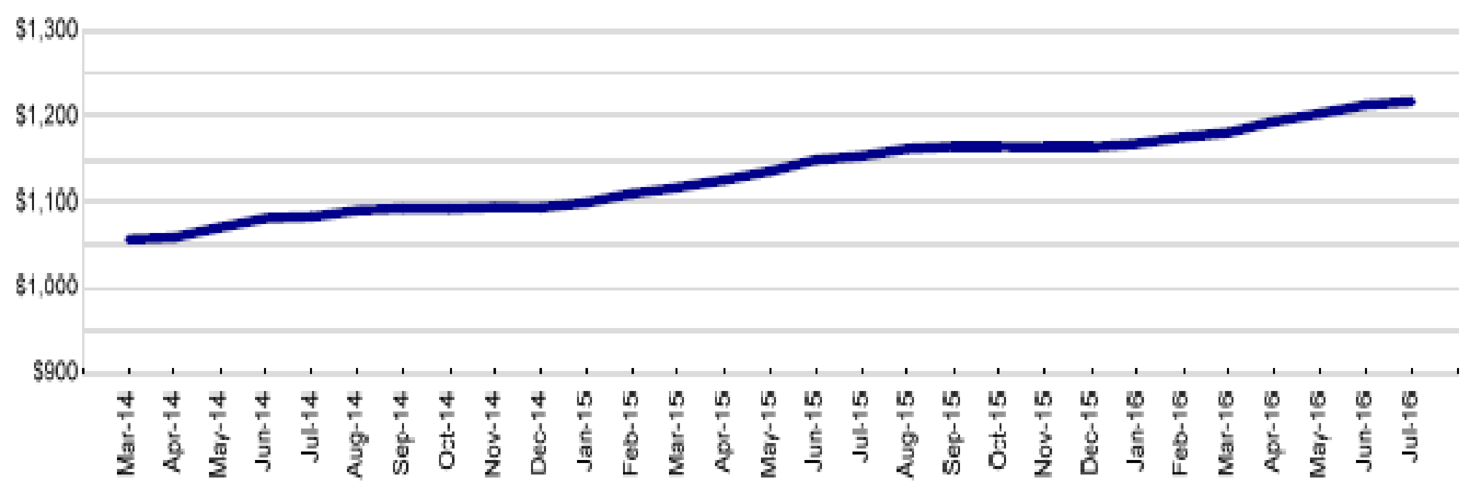
The report attributes the increased demand for rental units to the trends of "consistent job growth, rising household formations, and the ongoing dip in homeownership" in the markets surveyed.

Even though rents are high, the rate of rental growth slowed in July. Matrix Monthly attributes the slowdown to a recent trend of slower growth in the latter half of the year. The report found that some areas are seeing an increase in supply over demand or have otherwise exceeded the rate renters can afford. (Yardi Matrix expects a delivery of 300,000 new units in 2016, skewed mostly toward high-end renters.)

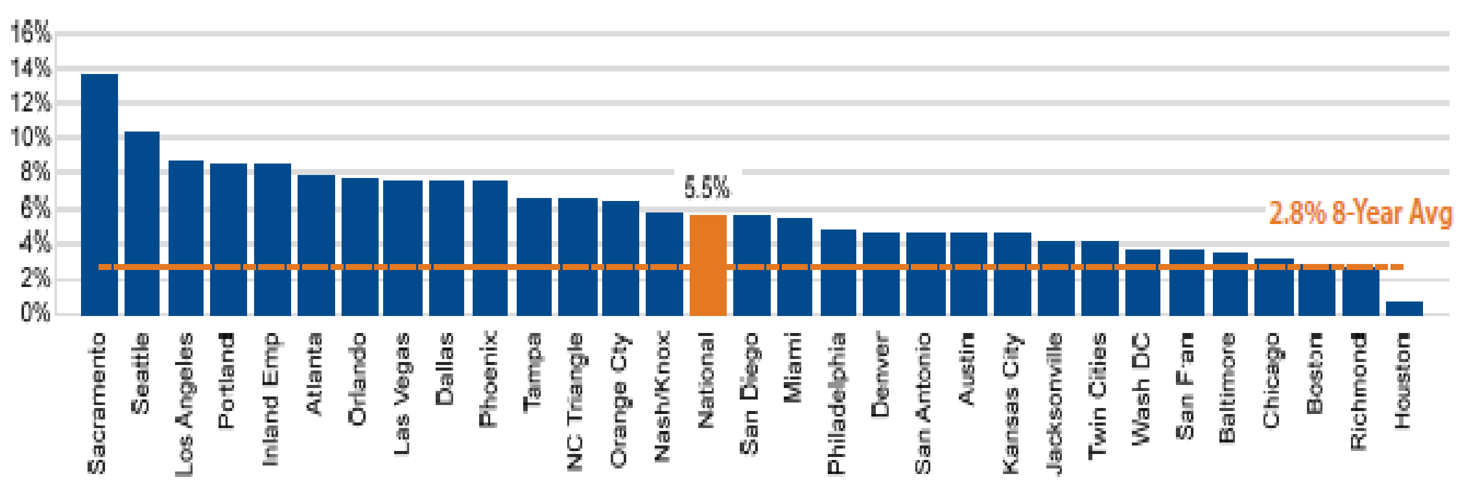
ANNUAL U.S.MULTIFAMILY ABSORPTION



NATIONAL AVERAGE RENTS



YEAR-OVER-YEAR RENT GROWTH - ALL ASSET CLASSES



National averages include 119 markets tracked by Matrix, not just the 30 metros featured in the report. All data provided by YardiMatrix.

ORIGINATION & FINANCING RESULTS

On the debt side, we expect the streak of multifamily origination volume growth will continue but the rate of growth will ease. Origination volume in 2016 came in higher than anticipated, at $269 billion, according to the Mortgage Bankers Association (MBA), up 7.6 percent over the year. One of the main reasons for the continued strength in origination volume is strong property price growth over the past several years. Property prices increased on average 12 percent annually going back to 2012, or a total of 89 percent (as of third quarter 2017).

The increasing values encourages market activity such as property sales, refinancing, and renovations, all contributing to higher volume originations.

Despite the interest rate spike at the beginning of 2017 and concerns that it might diminish multifamily investment, origination volume for the year grew by 8 to 9 percent, up to between $290 billion and $295 billion. Fannie Mae Multifamily closed 2017 with its record volume of more than $67 billion, supporting over 750,000 units of multifamily – the highest volume in the history of its Delegated Underwriting and Servicing (DUS®) program.

Concerns that origination volume in 2017 would be lower due to the interest rate increase have diminished as strong multifamily fundamentals fueled investor demand. Property prices grew at an annualized rate of 10 percent as of the third quarter.

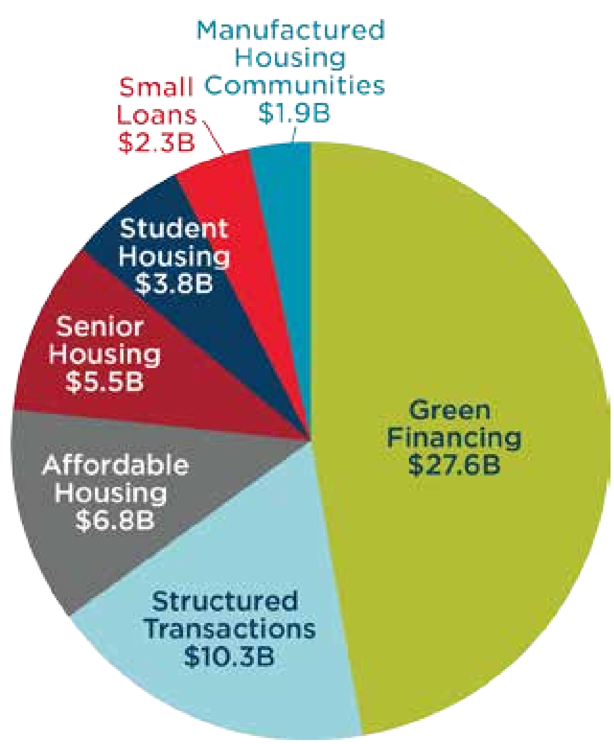
For residential mortgage professionals, **steady rent growth** and **demand for vacancies** in major rental markets, are making multifamily investments attractive to potential investors.

A Look Ahead

We expect originations to increase yet again in 2018, up to between $300 billion and $305 billion. That works out to 3 percent year-over-year growth. Interest rates are expected to slowly increase over the next year, up 30 to 40 bps through 2018. This increase will have little impact on cap rates, but they are expected to go up slightly, to around 6.1 percent by the end of 2018. In turn, property price growth will slow. Nonetheless, property prices will grow because of strong fundamentals, facilitating more market activity and increasing origination volume over the next year.

Although origination volume is expected to continue to grow in 2018, there are potential headwinds. A moderate rise in interest rates will not send the debt market into a frenzy but, if rates spike again as they did at the end of 2016 and at the beginning of 2017, originations might slow in 2018. Furthermore, as other commercial and residential industries grow, some investment appetites might shift toward them and away from multifamily.

FANNIE MAE MULTIFAMILY PRODUCTION HIGHLIGHTS BY BUSINESS CATEGORY



Multifamily investors are attacted to the high rate of return that this asset type typically affords.

INVESTING IN MULTI-FAMILY

Multifamily investment provides potential for stable cash flow and a substantial return on the initial investment. There is also the intangible value of investing in real assets that one can see, feel and touch. Multifamily investments, properly structured, have the potential to provide investors with a multitude of benefits:

- Diversification from more traditional investment vehicles
- Passive income during the holding period
- Capital gains at disposition
- A high rate of return
- Hands-off management
- Relatively recession proof
- Possible condo conversion
- The opportunity to defer taxes on capital gains
- A suitable investment for self-directed IRTA and 401 plans
- Leverage
- Investor control
- Lower volatility
- Tax advantages
- Inflation hedge

KEY INVESTMENT CONSIDERATIONS & TRENDS

- Growth is happening in some unexpected places
- More and more people are choosing to rent rather than own
- Micro-apartments are gaining in popularity
- Improved resort like amenities are appealing to a wide range of age generations
- Access to jobs, retail, and transit is critical
- Tenant control of technology is becoming more important to residents

INCOME VS COST APPROACH

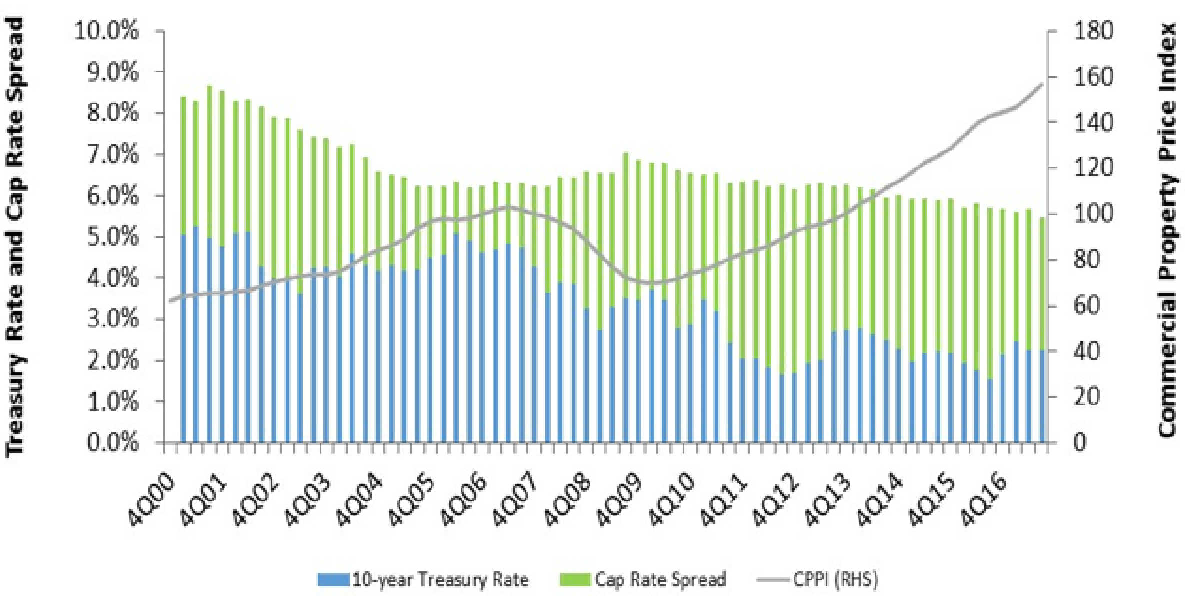
Spread value based on achievable rent, Income vs cost to build and rent the units is important to understand. A purchase price or offer must be garnered from a projection of variables. Apartments have a lower cost of capital and wider availability of debt capital. For example, government backed agencies, Fannie Mae and Freddie Mac, will lend on multifamily assets but not on other commercial real estate asset classes. In addition, when looking back at the last recession, generally speaking, multifamily is the asset class that performed the best during the depths of the financial crisis and was the asset class to lead the recovery. People still need a place to live no matter the phase of the economic cycle.

The following points must be taken into consideration before getting a clear picture on your spread value:

- **Revenues:** Rents, Parking, Laundry, Storage, Vacancy Rates
- **Expenses**: Construction, Management, Realty taxes, Water and sewer, Utilities, Garbage, R & M, Caretaker, Security, Insurance, Advertising and Leasing, Elevator, License, Landscaping, Total Operating Expense, Operating Expense, Operating Expense Ratio
- **Cap Rate**
- **Indicated Value:** Market Value / SF, Market Value / Suite, Cap Ex

Sources: Freddie Mac, Moody's/RCA CPPI, Federal Reserve Board, Moody's Analytics
Note: CPPI updated and reindexed

MULTIFAMILY PRICE INDEX, CAP RATE SPREAD AND TREASURY RATE



MULTI-FAMILY DEVELOPMENT

This step-by-step guide will ensure that decision-making strategies stay on track.

1. ECONOMIC FEASIBILITY

It is critical to determine your desired return on the property before getting started. Having a set profit in mind before developing the raw land is essential to the success of an investor because it will not only lessen the uncertainty of the market, but it will also provide a model of the costs versus profit aspect to your investment.

2. ACQUISITION

Once you understand the costs you're likely to encounter, including what you should receive in return, you can better determine the offer price. It's important for investors at this stage to have contractors submit actual bids for the project.

3. ZONING AND ENTITLEMENT

The design of the land is the foremost concern in the zoning process. This pertains to what type of property should be constructed on the parcel, including looking into local zoning codes. Zoning codes will essentially determine what types of properties, whether single-family, multifamily, condominium or commercial, can be built on the lot.

4. FINANCING

The way in which you intend to use the property will dictate the type of financing you obtain. The one aspect investors should care the most about is the "loan-to-cost" ratio (LTC). The LTC is the amount of money the lender will provide for the project, which will generally depend on the type of construction and use of the property.

5. CONSTRUCTION

In most cases, construction will consist first of horizontal development, like grading for roads, curbs and utilities, and then gradually erecting the property from the foundation up. When financing construction, contractors will be paid in increments of duties performed, including phases of the project. In many cases, construction lenders will hold back approximately 10 percent of the construction loan until the project is completed.

6. MARKETING

In this phase, research into the neighborhood, the market price, and demand for rentals will pay off. Investors should also have a marketing plan in place to attract attention to the property.

Spotlight on:

THE ENTITLEMENT PROCESS

Land entitlement is the legal process of obtaining approvals for your development plans. This process can be lengthy, complicated, and at times, expensive. But it's a vital part of the development phase because it helps determine what can and can't be done with the property. Without the appropriate entitlements, you can't legally move forward with your project.

Most development projects will go through several different aspects of the entitlement process, and some may also be required to be put through multiple public hearings for approval. You can expect the following to occur when you embark on the entitlement process:

- Commercial development will require approval from the Planning Department Review Division or the Development Review Board. Your development team will create a land use pre-application, which will comply with local codes.
- A meeting date will be scheduled where you and your team will meet with the Planning Department to review your proposed project.
- Once your site has been approved, you will then need to have your design approved and obtain your master use permits. This is where your architect will come in.
- A neighborhood hearing will likely be held. You may be asked to send out written notices or to post information on the city's website. The city will also submit notices to neighbors. An open house meeting is typically held.
- If your property contains wetlands, you will need to acquire special documentation that details whether the Wetlands Act applies to your land or not.

Understandably, many find this process cumbersome to navigate. Our Land Advisory Group members are experts in all phases of land development, in any geography. For more information on this or general land inquiries, please visit **cushwakeland.com.**

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