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SPECIAL EDITION

Deep Dive into the Twin Cities Apartment Market

2014 Recap and 2015/2016 Outlook

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Editor's note: This article is an in-depth look at Twin Cities apartment market trends in 2014 and projections for 2015/2016 (projection section begins on page 5). This analysis reflects trends in conventional, market-rate apartments of 50 or more units in the seven-county Twin Cities metropolitan area.

2014 TRENDS AND ACTIVITY IN THE TWIN CITIES APARTMENT MARKET

Broad-based employment growth, a shift in consumer preferences away from homeownership in favor of rental housing, and population growth/demographic trends have fueled apartment demand, resulting in tighter market conditions within the Twin Cities apartment market. Since the economy began to regain its footing in 2010, apartment owners have enjoyed a perfect storm scenario—surging demand and a lengthy lag time for developers to respond with new supply provided owners a window of significant opportunity. The result has been improving occupancy levels and solid rent growth.

Sustained Employment Growth

Healthy increases in employment levels have been a significant driver of improvement within the Twin Cities apartment market in recent years. Outpacing growth recorded in the previous two years, nonfarm employment in the metropolitan area increased year-on-year by 1.8% in 2014 on the net addition of approximately 32,100 jobs. While many major metropolitan areas in the nation have yet to recover all jobs lost during the economic recession, the Twin Cities recaptured virtually all of the jobs lost from 2008 to 2010 by the close of 2013.

Employment gains in 2014 were led by the manufacturing and professional/business services sectors, which increased employment by 4.8% and 4.5%, respectively, and accounted for nearly 60% of the region's employment growth. Increasing payroll figures were also experienced in 2014 within two the region's largest employment sectors, the trade/transportation/utilities and professional business services sectors. The unemployment rate in the Twin Cities metropolitan area decreased by 100 basis points in 2014, further widening the spread between the local and national unemployment rate.

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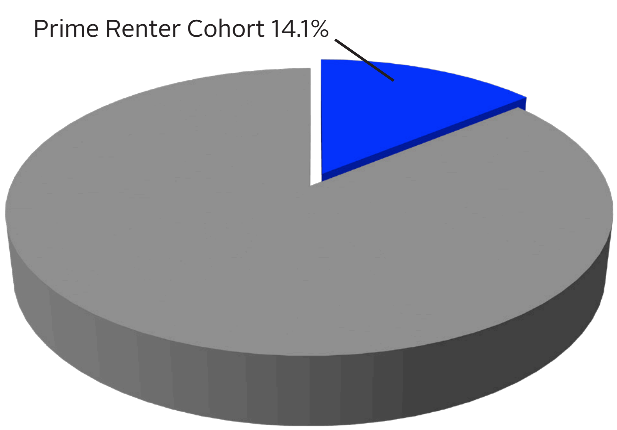
Increasing Population in Renter Profile

Favorable demographic trends, including moderate population growth, have propelled demand for additional apartment units in recent years. The population within the Twin Cities metropolitan area increased from 3,348,859 in 2010 to 3,427,858 in 2014, equating to an increase of approximately 2.4%. Population growth in the Twin Cities easily outpaced growth recorded at the statewide (1.8%) and 12-state Midwest regional (1.0%) levels.

A relatively youthful population base also serves as a catalyst for demand in the Twin Cities apartment market. Forecasts indicate the number of residents within the prime renter cohort, ages 25 to 34, will increase annually through at least 2019. Residents within the prime renter cohort comprise nearly 15.0% of the total population within the Twin Cities, compared with the percentage of residents aged 25 to 34 at the statewide (13.4%), Midwest regional (13.0%), and national (13.5%) levels.

Twin Cities Metropolitan Area Prime Renter Cohort, age 25–34 years



Source: ESRI Business Analyst

Shifts in Housing Preferences

Lifestyle preferences among young professionals and empty-nesters, including the flexibility and low-maintenance living offered by renting compared to home ownership, have elevated apartments to a desirable housing option among segments of the population that have historically favored homeownership. For young professionals, the flexibility offered by renting is attractive and the lack of a long-term housing commitment provides the ability to be agile as they move down their career paths. For many empty nesters, the low-maintenance aspect of apartment living is particularly appealing.

Other Factors Impacting Apartment Demand

Macro-level trends are also bolstering demand for apartment units within the market. High burdens of student debt, an uneven economic recovery, mortgage lending standards, and scarcity of desirable and affordable for-sale residential inventory have retained some prospective homebuyers in the renter pool. Additionally, losses suffered from the recent subprime housing crisis continue to linger and have scarred the idea of homeownership for a sizeable portion of the population.

Data indicates that major life events, including getting married and starting families, often an impetus for purchasing a home, are occurring later in life than previous generations. Lastly, the quality of new product in the marketplace continues to make renting a desirable lifestyle choice, with many recent apartment developments offering resort-style amenities and high-quality interior finishes.

Absorption and New Construction

Annual apartment absorption figures have outpaced the Twin Cities apartment market's historical average in three of the last five years. From 2010 to 2014, annual apartment absorption averaged 2,372 units, outweighing an accelerating pace of new construction activity during this period. Absorption totaled approximately 2,500 units in 2014. Most of the submarkets within the Twin Cities apartment market noted positive demand in 2014, with the strongest demand recorded within the Minneapolis submarket, followed by the Southwest Hennepin County, Washington County, and West Hennepin County submarkets.

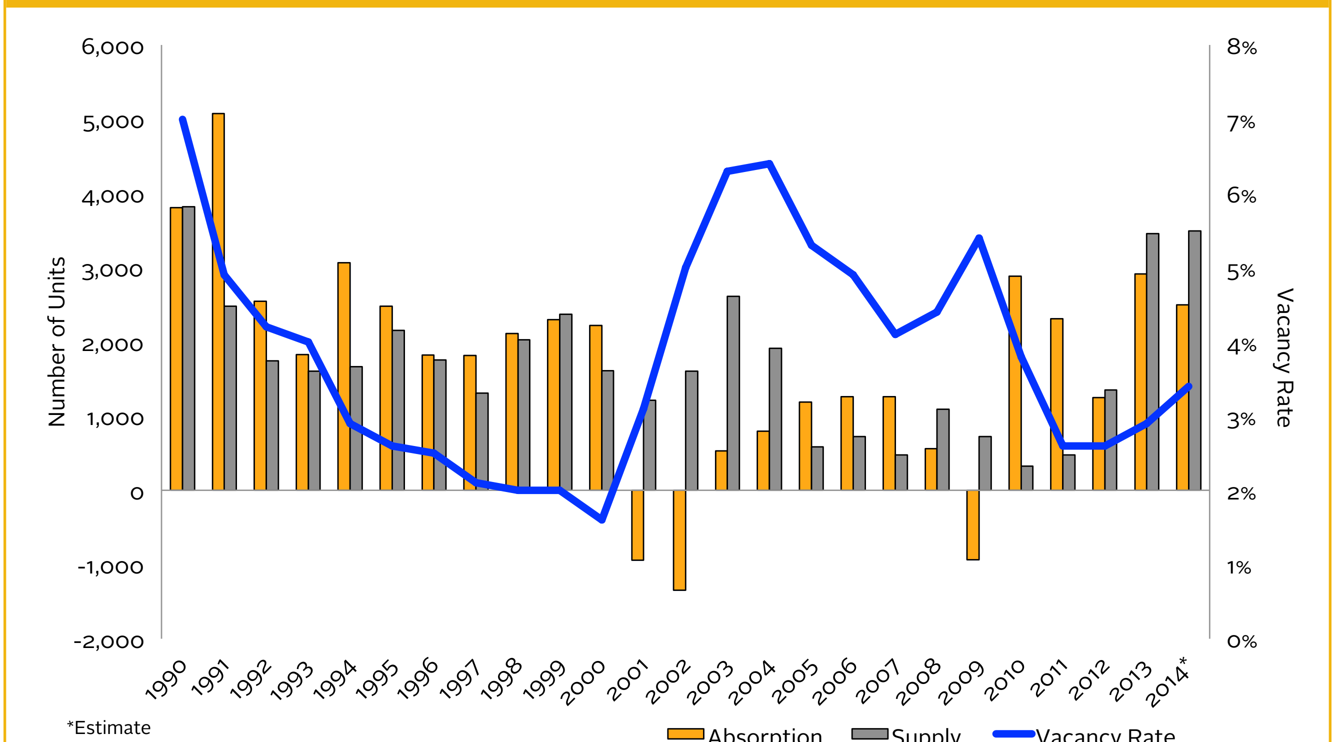
Greater availability of capital, attractive financing opportunities, and tighter market conditions have encouraged an accelerating pace of new development activity in the Twin Cities apartment market. Since bottoming out in 2010, when fewer than 500 units were delivered, the number of new apartment units reaching lease-up has increased year-on-year for four consecutive years, with new apartment construction activity appearing to have crested in 2014. New apartment deliveries averaged 1,820 units annually from 2010 to 2014 compared to a long-term historical average of roughly 1,700 units annually. During the last two years, nearly 7,000 units have come online in the Twin Cities, increasing the market's inventory by approximately 4.5% during this period.

New apartment supply in recent years has been heavily concentrated within the city of Minneapolis and specifically in the urban core, including the North Loop, Loring Park, the Central Business District downtown Minneapolis and along the Midtown Greenway in the uptown area. New apartment construction in Minneapolis accounted for nearly 55.0% of all new deliveries from 2012 to 2014. Developers also added a sizeable amount of apartment inventory within the cities of St. Paul, Bloomington, and St. Louis Park. Some 80.0% of all new apartment units added from 2012 to 2014 were delivered in these four cities. The bulk of new product delivered within the local market consists of low- and mid-rise construction, but high-rise apartment properties have accounted for approximately 10.0% of the new inventory reaching lease-up since 2010.

Vacancy Levels

Barely exceeding the market equilibrium of 5.0% even at the peak of the economic downturn, occupancy levels within the Twin Cities apartment market remain strong, and the average vacancy rate within the region stands among the lowest in the nation. The average vacancy rate in the Twin Cities apartment market was 3.4% at the close of 2014. In comparison, the average apartment vacancy rate at the national level closed the year at 4.2%, down 10 basis points from 4.3% recorded at the close of 2013.

Twin Cities Apartment Market
Absorption and New Construction



*Estimate
Source: REIS, Shenehon Company Research Services

Vacancy rates in the Twin Cities market are becoming increasingly bifurcated by asset class, and occupancy levels have suffered within some submarkets. Vacancy rates at Class 'A' apartment properties in the market increased for the third consecutive year in 2014, while vacancy rates at lower-tier properties have continued to remain strong. The vacancy rate spread between Class 'A' and lower-tier apartment properties increased to 370 basis points at the close of 2014, up from 280 basis points in 2013 and 200 basis points in 2012. In addition to softer occupancy levels among properties in the Class 'A' segment, vacancy rates within the Minneapolis submarket rose during the course of 2014, as the amount of new supply outweighed demand. Benefitting from a relative dearth of new competition in recent years, apartment vacancy rates in the Dakota County and Northeast Suburban submarkets were recorded below 2.0% at the close of 2014, remaining among of the lowest in the nation.

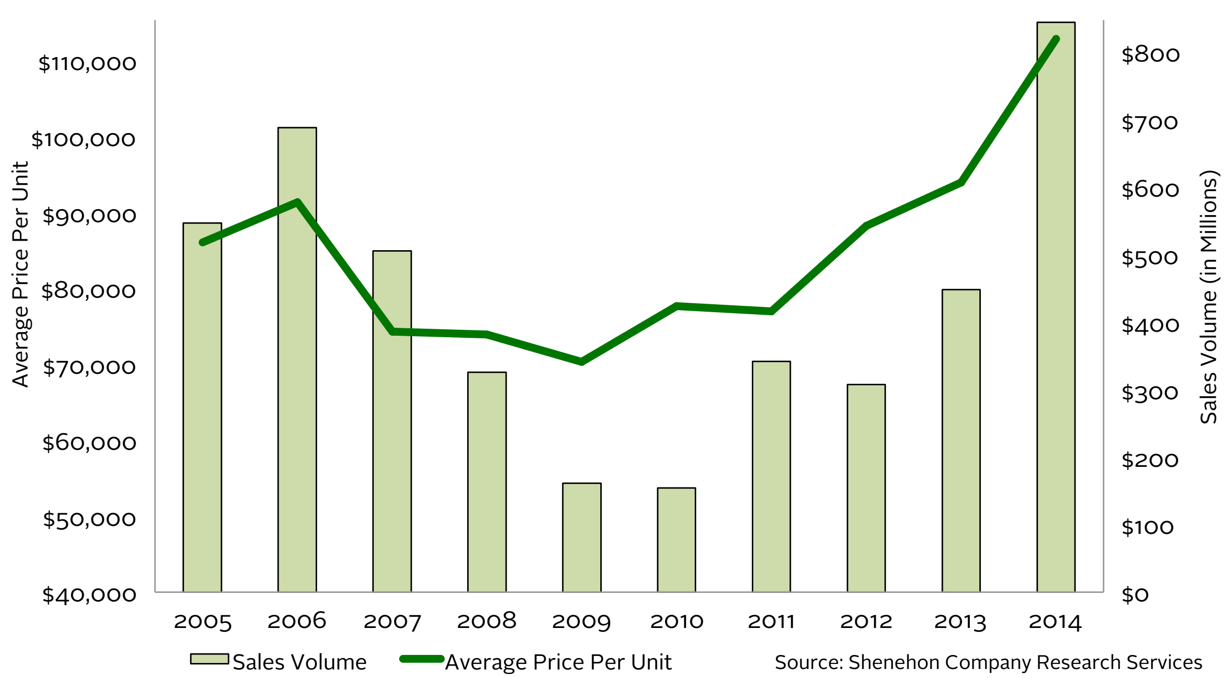
Rental Rates

Healthy demand and tight vacancy rates have allowed apartment owners and operators in the Twin Cities to raise rents at an accelerating pace. Outpacing rent growth in 2013, the average apartment asking rent in the Twin Cities increased by over 4.0% year-on-year in 2014, with the market recording rent growth for the fifth consecutive year. The pace of rent growth has also consistently increased since 2010, and since 2012 vacancy rates and rent growth have maintained an inverse relationship. Among asset classes, asking rent growth within the Class 'A' segment in the Twin Cities market continues to exceed growth at lower-tier apartment properties, but the spread in effective rent growth between asset classes is narrowing, as top-tier apartment properties in the market are introducing and expanding concession offerings.

2014 Apartment Sales

Sales volume in the Twin Cities apartment market totaled nearly $850 million in 2014, exceeding sales volume in 2012 and 2013 combined and the number of transactions tallied in 2014 rose by roughly 40.0% compared to 2013. The average price per unit in the Twin Cities apartment market surpassed $110,000 per unit in 2014, up 20% from 2013.

Twin Cities Apartment Market
50+ Unit Apartment Sales



Source: Shenehon Company Research Services

Notable sales transactions during 2014 included several large portfolio transactions; the largest of which was a seven-property suburban portfolio comprised of 1960s and 1970s vintage low-rise apartment buildings across the Northeast Suburban, Anoka County, and West Hennepin submarkets and containing 1,494 units. Attracting interest from a number of regional buyers, the seven-property suburban portfolio traded in December to a regional institutional buyer for $103.5 million, or approximately $69,277 per unit. The seller in that transaction also sold off a five-property urban portfolio containing 164 units in a separate transaction. Comprised primarily of pre-World War II vintage, brownstone-style apartment buildings, the five-property urban portfolio attracted attention from a number of local buyers, and ultimately sold for $17 million, or approximately $103,659 per unit.

Other notable sales transactions included several Class 'A' apartment properties in the region's urban core and a sizeable number of mid- to upper-tier and core-plus suburban properties. The largest single-property trade in the suburban market was the sale of the 424-unit Southview Gables property in Inver Grove Hills, which sold for $58 million, or approximately $136,792 per unit, in December of 2014. Demonstrating the significant increase in pricing that has occurred within the Twin Cities market in recent years, Southview Gables previously sold for $40.45 million or approximately $95,401 per units in July of 2010. Regional and national buyers appear to be optimistic about the long-term viability of the Twin Cities apartment market, and view the local market as a relatively safe investment environment with plenty of upside.

2015/2016 OUTLOOK FOR THE TWIN CITIES APARTMENT MARKET

Our most recent supply and demand scenario analysis of the Twin Cities apartment market considered a range of possible outcomes through 2016. We analyzed five potential scenarios for the Twin Cities market, from a highly optimistic "sunny day" scenario to a pessimistic outlook in which there is a complete reversal of apartment demand. The most realistic outlook for the Twin Cities apartment market assumes demand for additional apartment units remains through 2016, with the delivery of 3,600 units in 2015 and 1,700 units in 2016. The following is a detailed narrative of our baseline assumptions contributing to our apartment market outlook through 2016.

Continued Demand and Population Growth

Moderate yet broad-based employment growth will continue to facilitate healthy demand within the local market, while other demand drivers, including favorable demographic trends, remain in place to further support the absorption of apartment units. Employment growth, combined with an already tight labor market, will put upward pressure on income growth, spurring new household formation.

Forecasts indicate the population within the Twin Cities metropolitan area will increase by 4.2% by the close of 2019, outpacing growth at the statewide, regional, and national levels as well as most major metropolitan areas in the Midwest. Additionally, the population of residents within the prime renter cohort (age 25 to 34) will increase during this period, helping the area maintain a relatively youthful population base. Most importantly, forecasts indicate the number of renter-occupied housing units will increase by nearly 1.0% annually through 2019, exceeding the pace of both population and overall household growth.

Renting Will Remain a Common Choice

While employment and income growth will encourage some renters to explore the for-sale residential market, we do not anticipate a mass exodus of tenants leaving the renter pool in favor of homeownership during the next two years. First, we expect the shift of consumer preferences in favor of an active urban lifestyle and rental housing will remain intact through at least 2016. Second, although we project employment, income, and general economic growth through near-term, many of the existing macro-level trends, including soaring student debt loads and an uneven economic recovery, will continue to prevent some prospective homebuyers from becoming homeowners. Next, while the local for-sale residential market remains comparatively affordable, rising sale prices will continue to prevent many potential homebuyers from entering the for-sale residential market.

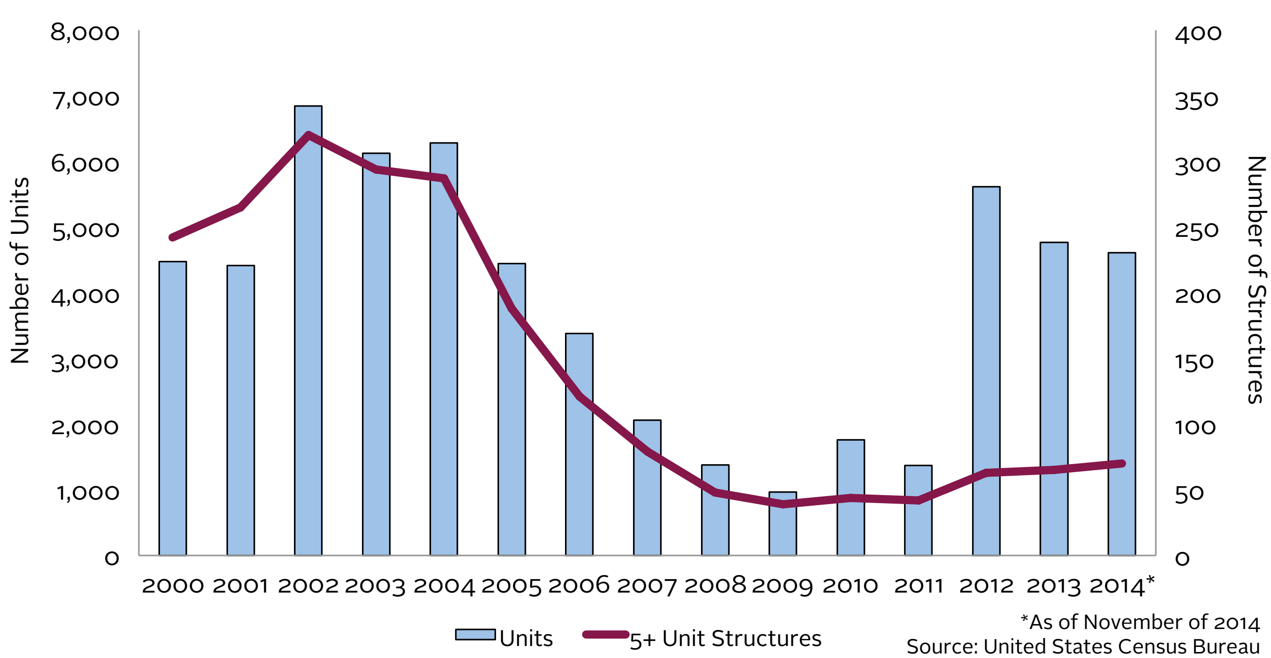
From 2013 to 2014, the median single-family home sale price in the Twin Cities increased by approximately 6.8%, rising from $192,000 in 2013 to more than $205,000 at the close of 2014. Despite compelling interest rates, many households that desire to purchase a home lack the capital necessary for a down payment. As a result, rising price levels will keep homeownership out of reach for many households.

Even if momentum in the for-sale residential market were to pick up significantly, the result could ultimately serve as a net gain for the local apartment market. In this scenario, investors who purchased single-family homes, townhouses and condos as rental units will look to sell their properties to take advantage price appreciation, forcing tenants back toward conventional apartment units. Additionally, significant improvements in the multifamily for-sale sector would invite condo conversions with some existing apartment units being transitioned into for-sale condo units, removing supply from the apartment market. Despite a slight deceleration in the pace of apartment absorption, we anticipate demand in the Twin Cities apartment market will remain healthy through at least 2016, with absorption totaling 3,500 units over the next two years.

New Construction Leveling Off

While the wave of new apartment construction activity appears to have crested in 2014, a significant number of projects are under construction (approximately 4,400 units) or in various stages of the planning or proposal phase (nearly 9,000 units). The number of development projects in the planning or proposal phase that will actually move forward is uncertain, but substantial upward pressure on construction costs and softer market conditions within some submarkets suggest that a sizeable portion of projects will eventually be scratched. Multifam-

Twin Cities Apartment Market
Multifamily Construction Permits



*As of November of 2014
Source: United States Census Bureau

ily construction permitting activity also indicates a decelerating pace of new construction at least through the near-term. Multifamily construction permits, including both for-sale and rental product, were issued for 4,608 units through the first 11 months of 2014, on par with the 4,766 units permitted in 2013, but noticeably down from 5,619 units issued permits in 2012.

Based on our research and analysis of apartment development initiatives, we estimate that 5,300 units will reach lease-up by the close of 2016, with approximately 45.0% of all new apartment units coming online over the next two years being delivered in Minneapolis.

Market Will Remain Healthy

Despite new supply outweighing demand in the near-term, our outlook indicates conditions within the Twin Cities apartment market will remain healthy through at least 2016. Competition from new supply will shift occupancy levels slightly lower, and vacancy rates within some submarkets and in the Class 'A' segment will tick upwards over the next two years, yet the market's overall vacancy rate will most likely remain below the market equilibrium of 5.0% through at least 2016. New supply will temper rent growth among Class 'A' properties and the overall pace of asking rent growth will decelerate in 2015 and 2016. Despite a decelerating pace, healthy rent growth will continue to be recorded in the near-term, as tight market conditions and minimal new competition among the lower- and mid-tier segments will drive asking rents higher. In sum, the Twin Cities apartment market remains on solid footing, and the near-term outlook for the market is favorable. VV

About the Data

The data presented within this report is reflective of conventional, market-rate apartment properties containing 50 or more units. Although the report may also reference selected condominium, co-operative, student housing, senior housing, and subsidized properties, these properties are excluded from inventory, completions, investment activity, and all other apartment statistics. For the purposes of our assessment, the Twin Cities apartment market includes Anoka, Carver, Dakota, Hennepin, Ramsey, Scott, and Washington counties.

Data Sources

Market data contained within this report comes from a variety of available primary and third party data sources:

American Community Survey; CoStar; ESRI Business Analyst; Federal Reserve; Mortgage Bankers Association; National Association of Realtors; Minneapolis Area Association of Realtors; REIS; Real Capital Analytics; Shenehon Company Research Services; The Business Journal; The Star Tribune; United States Bureau of Economic Analysis; United States Bureau of Labor Statistics; United States Census Bureau

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