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Multifamily Housing Industry
2011 Mid-Year Review and Second Half Outlook Report

September 2011

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UPDATE ON THE MULTIFAMILY INDUSTRY

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2011 MID-YEAR REVIEW AND SECOND HALF OUTLOOK REPORT

EXECUTIVE SUMMARY

The U.S. Economy

- First half 2011 U.S. GDP growth fell below expectations, inching forward at only a 0.4% annualized rate in 1Q11, and a 1.0% pace in 2Q. Soft personal consumption expenditure growth was largely responsible as households prioritized debt reduction and savings over consumption.
- When consumption and GDP growth decelerate to this degree, recessions typically follow. While the risk of recession increased over the summer, it remains a low-probability outcome. The economy is operating well below capacity; the magnitude of monetary and fiscal stimulus is generous to a fault; inventories are lean; and export demand for agricultural commodities and durable manufactured goods is strong: elements that make faster growth the default once economic headwinds subside. GDP growth near 2% is likely in the second half and moderate acceleration can be expected in 2012.
- July's surprisingly strong 154,000-job private payroll job add is likely to set the trend for the second half, with gains in the 100,000- to 150,000-job range representing the norm rather than the exception.
- Employment growth among Americans aged 20- to 29-years is a metric to monitor closely. This critical apartment renting cohort found jobs in abundance from May 2010 to May 2011, triggering the strongest apartment demand observed in a generation. But substantial winter and spring gains turned to net summer year-on-year losses, posing a potential threat to the apartment market recovery.

Metro Payroll Trends

- High tech hubs and Texas metros posted the strongest job growth in the spring, led by Dallas, Seattle, Fort Worth, Houston, San Jose and Austin. Milwaukee delivered the biggest surprise, leading the nation in year-over-year job growth with a 21,800-job, 2.7% second quarter advance. Miami also delivered stronger than expected results, posting an 11,800-job, 1.4% performance, the eighth fastest gain registered among the RED 50 markets.
- An export-driven manufacturing revival fueled stronger than expected hiring in other corners of the Heartland as well. Nashville, Pittsburgh, Columbus, Louisville and Saint Louis figured among the 20 strongest RED 50 labor markets and Cleveland, Chicago and Cincinnati followed in 21st through 23rd positions.
- With the exceptions of Seattle, San Jose, San Diego and Portland, Western Region economies continued to struggle. Sacramento, Riverside, Oakland, Las Vegas, Los Angeles and San Francisco posted negative or flat results in the second quarter while Denver posted a statistically insignificant 0.2% advance.

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- Our payroll forecasting models suggest that Southeast Region growth markets are poised to roar back from the depths in 2012. After posting an uncharacteristic 5,000-job projected loss in 2011, the model anticipates a robust 54,000-job surge for Atlanta next year. Likewise, Charlotte should create 19,400 payroll jobs next year, up from 2Q11's soft 3,100-job, 0.4% advance. A summary of our latest payroll forecasts is attached on Appendix A.

The U.S. Apartment Market: Occupancy Trends

- Reis report that tenants net leased 44,617 apartments in the top 82 metropolitan markets in 1Q11, the most units absorbed during the seasonally weak January-to-March period in the data service's 13-year quarterly data series and likely the most in the modern era. But absorption trends slowed in the seasonally stronger second quarter, falling to 41,174 units, suggesting that weakening employment growth may have inhibited household formation among the "renter cohort" of 20- to 29-year old individuals.
- Fifteen major markets recorded 40% or more quarter-to-quarter net absorption decreases from the seasonally-weaker winter quarter to the typically stronger spring leasing period, including a host of institutional investor favorites: Boston, Denver, Los Angeles, New York, San Francisco, San Jose and Seattle. Slowing employment growth and recent rent increases contributed to the trend.
- Overall metro occupancy continued to rise, however, gaining 30 basis points to a three-year high 94.1% March to June after advancing 40 bps during the first quarter.
- RED Research's unbiased econometric forecasting model predicts that absorption will decline in the second half to about 56,200 units among the RED 46 markets, down from 70,860 units in the first half. By way of comparison, Reis forecast net absorption of 67,215 units in the period for these markets.
- The RCR model occupancy forecast is commensurately lower than Reis's for year-end 2011 and 2012. Our model projects unit-weighted average occupancy among the RED 46 to be 94.3% at YE11 and 94.2% at YE12. By way of comparison, Reis forecast 94.9% and 95.1%. The year-end occupancy rate forecasts for 2011 to 2015 produced by the RCR model are displayed on Appendix B.

The U.S. Apartment Market: Rent Trends

- First half rent growth was steady in most markets as average asking and effective rents increased at 2.0% and 2.4% y-o-y rates, respectively, according to Reis. By way of comparison, the same metrics were 1.7% and 2.3% during the second half of 2010.
- San Jose registered the fastest y-o-y effective rent growth (5.2%), while San Francisco, New York, Northern Virginia and Baltimore posted gains of 4% or more. Conversely, rents in only one market continued to fall: Las Vegas.
- Reis project considerably stronger asking and effective rent growth in 2H11, the annualized equivalents of 3.8% and 5.6%, respectively. The service expects asking and effective gains to moderate to 3.1% and 3.6% in 2012.
- RED Research's model again foresees more conservative gains in the second half and 2012. Our model predicts a 2H11 annualized effective rate of rent growth of 4.4% for the RED 46, followed by a 3.0% advance in 2012. The RCG model effective rent forecasts for 2011 to 2015 are displayed on Appendix C.

Expected Investment Total Returns

- Beginning this cycle, RCR will calculate generic metro expected total return metrics employing our own occupancy, rent and terminal cap rate forecasting models.
- Forecasting equations were derived econometrically relative to U.S. GDP, employment, income, price and rate data employing Reis rent and occupancy series and newly available robust cap rate series from Fannie and Freddie.
- Terminal cap rate assumptions are calculated within the model based on metro specific equations that determine the probable spread between the generic cap rate and the 10-year Treasury yield. The 10-year yield is forecast using econometric equations taking the rates of GDP and employment growth rates and inflation into account.
- All equations can be stressed stochastically in a Monte Carlo simulation, allowing for the calculation of meaningful probability statistics for each forecasted outcome.
- The average total return for the RED 46 generated from the new model is 6.2%, 280 bps below our March 2011 estimate using the previous method. The principal factor driving the decrease is the dynamic modeling of the terminal cap rate. Rather than the naïve static "up 50 basis points" assumption used previously, our new method produces an expected increase averaging 150 bps (about 100 bps above our previous estimates), resulting in materially lower terminal proceeds upon the sale of the modeled "generic" metro properties.
- Barrier-protected gateway cities fare relatively better in the new calculations owing to the more stable and at times counter-cyclical behavior of their cap rate spreads under various economic scenarios and our more optimistic view for rent growth in these markets. New York, Boston, Miami and San Francisco now offer some of the strongest expected returns, validating the portfolio decisions made by some of the top trusts and fund managers. Texas metros perform well too, both in terms of expected total returns and risk-adjusted returns.
- Second tier tech hubs and Southern California metros are among the losers under the new regime: Denver, Portland, Los Angeles and Inland Empire estimates are among the lowest in the group. Also, most of the Heartland "high-yield" metros look weaker than before, largely due to adverse cap rate behavior. The three Ohio markets and Nashville are the exceptions to this rule. All total return estimates and return distributions can be found on Appendix D.

What if?

- The new model allows us to engage in all manner of "what if" games that analyze the effects of economic or market variances on probable metro asset performance, investment total returns and portfolio returns and risk.
- We engage in two what if exercises in the full report, testing the effects of an upward inflation shock and the effects of a second half "double dip" recession shock on two markets. We also attempt to construct several "efficient portfolios" as defined by Harry Markowitz in his seminal work "Portfolio Selection: Efficient Diversification of Investments" that achieve the highest possible expected total return given a defined level of risk to see if they are aligned along an "efficient frontier." Gratifyingly, our first efforts conformed to the good doctor's theory.
- Readers with interest in exploring similar questions are invited to contact us. We would be pleased to apply the power of the model to address your questions.

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