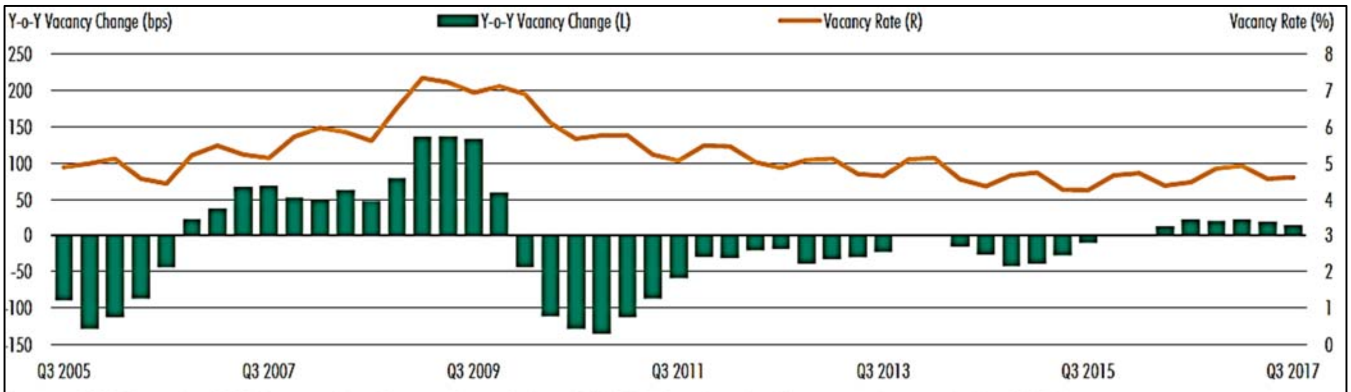
Mick Law P.C. Multifamily Market Outlook – February 19, 2018

Please find below our firm's most recent summary of the national multifamily market, based upon research from CB Richard Ellis ("CBRE"), our firm underwriters' REIS database research, and recent engagements for legal due diligence and valuation in the Reg. D multifamily investment space.

Vacancy

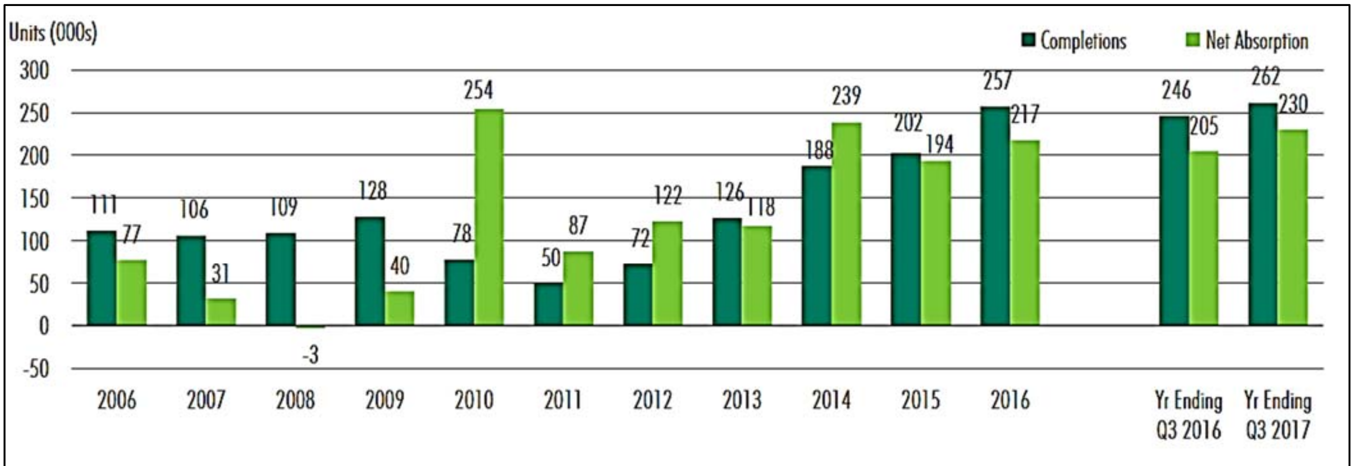
According to the third quarter, 2017 CBRE U.S. Multifamily Market Report (the latest report issued as of the date of this research document), the national vacancy rate was 4.6%, unchanged over the prior quarter, and up 0.1% over the level found at the end of the third quarter of 2017. While the increase was minimal, the third quarter of 2017 marked the sixth consecutive quarter in which vacancy rates had either reported no change, or trended up over the previous year. A summary of the United States vacancy rate since the third quarter of 2005 is outlined within the chart below:



Source: CBRE Research, CBRE Econometric Advisors, Axiometrics Inc., Q3 2017. Based on the 62 metro markets tracked by CBRE EA.

Of the 62 major metro areas tracked by CBRE, Minneapolis had the lowest vacancy rate at 2.4%, with a number of the nation's major metro areas reporting a vacancy below 5.0%. Over the past 20 years, the national average vacancy rate has been 5.3%. In 13 of the metro areas tracked by CBRE, the vacancy rate rose by more than one half of a percentage point. The oil-driven metro areas of Oklahoma City, Tulsa, and Houston reported the highest vacancy of 8.6%, 8.0%, and 7.5%, respectively.

The increase in vacancy can be attributed to strong levels of new construction. Nationally, for the year ending September 30, 2017, CBRE reported net absorption of 230,400 units. Despite this impressive level of demand, the year-over-year absorption represented just 88% of the 262,000 of new unit completions. A summary of the historical national new completions and absorption is outlined within the chart below:



Source: CBRE Research, CBRE Econometric Advisors, Q3 2017. Based on the 62 metro markets tracked by CBRE EA. Completions and net absorption are counted in the quarter in which the new property reaches occupancy stabilization.

REIS reported similar data, indicating a third-quarter 2017 vacancy rate of 4.5%, up only 0.1% over the prior quarter, but up 7.0% over the level found during the third quarter of 2016. The vacancy rate has been below 5.0% since the first quarter of 2012. Nationally, REIS anticipates a nearly stable vacancy rate, with a five-year forecast for a vacancy rate at or near 5.0%.

New deliveries have been nearly all concentrated in the Class A sector. During the 12 months ending September 2017, 196,439 new units were added to the Class A inventory, representing growth of 2.97%, while the Class B inventory grew by just 7,364 new units, representing growth of 0.05%. The past five years have seen a similar pattern. The Class A sector gained nearly one million units from 2012 to 2017, representing an average growth rate of 3.94%, while the Class B sector gained just 19,138 units for an average growth rate of less than 0.01%. CBRE reports construction starts are beginning to taper off, albeit moderately. Nationwide, in September 2017, the U.S. Census Bureau reported a seasonally-adjusted, annual construction starts rate of 286,000 units. While still a very strong level, construction starts were down from the 2016 annual level of 380,800 units. Additionally, as of the third quarter of 2017, year-to-date construction starts were 255,000 units, approximately 9.0% below the same period in 2016.

Market Rents

According to REIS, as of the third quarter of 2017, the national monthly average asking and effective rental rates were $1,365 per unit and $1,295 per unit, respectively. Both asking and effective rates were up 1.0% over the prior quarter. REIS has forecast asking rental rate growth of 4.0% in 2018 and effective rental rate growth of 0.9%. Consistent with increased supply, REIS has forecast both the average asking and average effective rental rate gains to decline (rates will increase at a decreasing rate) in the subsequent years.

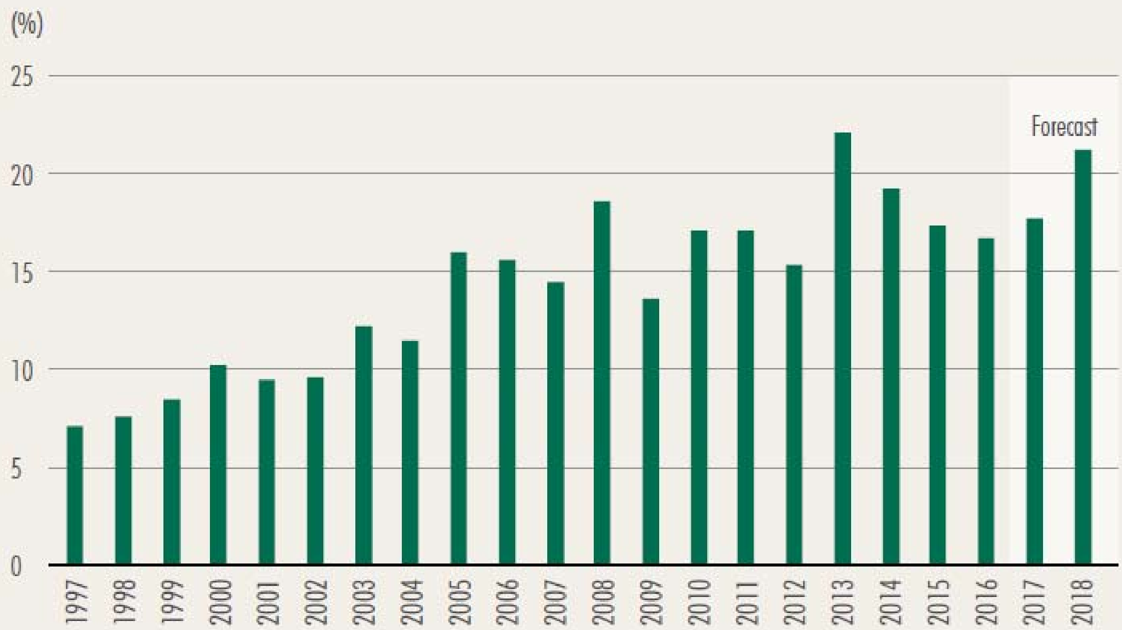
CBRE data indicates a monthly effective rental rate of $1,653 per unit, or $1.91 per square foot, as of third quarter 2017. According to CBRE, effective rents declined during the second quarter of 2017. In a number of areas of the country, the reported strong rental rate increases are due, in part, to the rent premiums associated with Class A new construction, and the large number of new additions in the Class A sector relative to Class B adds. CBRE data would seem to support this conclusion, reporting that same-location effective rents fell by 0.5% year-over-year, marking the second quarter where same-location effective rents declined.

The Year Ahead

Development will play a key role in 2018. As indicated above, new construction is already beginning to taper off. According to the CBRE 2018 Multifamily Real Estate Outlook, in 2018, new deliveries are estimated at 258,000 units, down 9.2% from the 2017 peak of 284,000 units (forecasted). Banks have drastically scaled back lending on multifamily projects over the past two years; however, other sources of financing have emerged (e.g., debt funds, HUD financing, etc.). The climate for financing is anticipated to be more conservative in 2018 and beyond. In addition, the availability and cost of labor are driving a significant rise in overall construction costs, pushing some projects past the point of economic justification.

As of December of 2017, nearly 23% of all units under construction in U.S. markets are in urban cores. Over the long run, CBRE anticipates urban core development will perform well; however, in the short term, market statistics indicate the best performance will be in suburban markets. A chart outlining the past 20 years of increasing urban core construction is found below:

FIGURE 19: TWO DECADES OF INCREASING FOCUS ON URBAN CORE CONSTRUCTION



Note: Historical values are shares of completions; 2018+ is the share of units currently under construction.
Source: CBRE Econometric Advisors, December 2017.

Higher overall living costs are pushing some residents out of larger metro areas. While not true for all demographics, migration data indicates that affordability is a serious concern for many. Emerging low-cost urban hubs like Dallas and Atlanta continue to post some of the highest net in-migration numbers in the nation. These low cost urban hubs offer supply side challenges and increasing construction costs as well. Additionally, secondary markets, which offer diverse employment sectors and labor pools (e.g. San Diego and Portland) are also experiencing strong in-migration.

Capital Markets

Pursuant to the First Half 2017 CBRE Cap Rate Survey, on a national basis, cap rates for suburban multifamily fell by seven basis points from the year-end 2016 to reach an average level of 5.66%. Multifamily properties in all classes saw a decline in cap rates during the first half of the year with Class A decreasing by seven basis points, and Class B and Class C decreasing five and nine basis points, respectively. Cap rates among suburban Class A properties averaged 5.03%, Class B cap rates averaged 5.56%, and Class C cap rates averaged 6.41%. Going forward, CBRE projected stable pricing conditions; 79% of surveyed real estate professionals expected little or no change in cap rates during the second half of 2017.

Conclusion

In conclusion, we find a number of factors which may be merging to create downward pressure on net operating income ("NOI") and valuation growth in the multifamily sector. In many markets, either rental growth rates are slowing (increasing at a decreasing rate) and vacancy rates are rising or both are forecast to do so in the immediate future. Furthermore, increasing new deliveries among Class A product in Tier 1 markets, have combined to create a situation in which future NOI growth may be challenged and valuation increases may be cooling. That said, certain data points in the multifamily sector may support continued investment. First, in the past five years, the Class B multifamily sector has gained just 19,138 units, for an average growth rate of less than 0.01%. Second, affordability and job availability are driving growth in the suburban markets and away from the core urban areas into secondary markets. These facts demonstrate the need for additional affordable housing units in the Class B and Class C asset classes which may provide opportunities to acquire, renovate, reposition, and sell.