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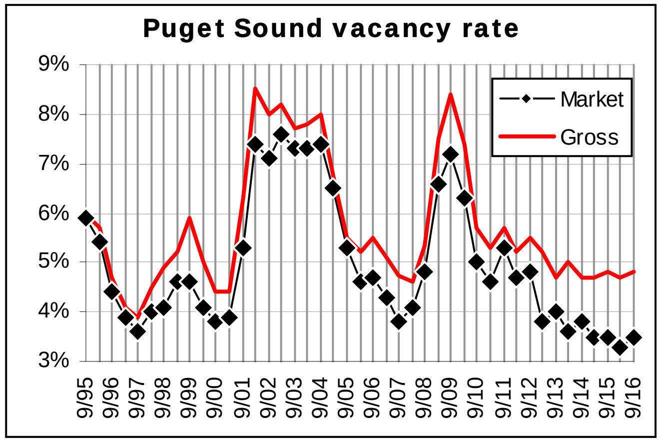
Pokemon Go?

The Game May Be Fading But We Still Need To Consider — Is This Market Pokemon "Go" Or Is It Pokemon "No"?



A few weeks ago we gave a presentation at the Washington Multi-Family Housing Association's annual *Washington Apartment Outlook* and titled it, *Is this market Pokemon Go or is it Pokemon No?* The point of the title was to ask and then answer whether our region's rental market and the investment market are a "go" or a "no" given the record amount of new apartment construction we're about to experience. Answering that question requires looking at a lot of issues, which we'll do here, plus we've added a discussion of some important affordability issues, so please be patient.

Vacancies – an overview

The market vacancy rate is 3.5% in the Puget Sound region, up slightly from 3.3% last March. The market rate excludes vacancies in new properties in lease-up. Counting those, the gross vacancy rate is 4.8% now. That's up just a little from 4.7% in the spring.

The gross vacancy rate has been hovering just below 5% for three years now. That means the region has been handling near record levels of apartment construction quite well, at least so far.

Vacancies rose in most of the major submarkets in the region over the past six months. The exceptions were Pierce and Thurston counties where market vacancies are the same as they were in the spring, at 2.8% and 2.6% respectively. Kitsap County saw vacancies fall from 2.8% in March to 2.3% currently.

The market vacancy rate in Seattle rose from 3.5% last spring to 3.7%. In fact, vacancies have been increasing slowly but steadily in Seattle since the spring of 2013 when the market vacancy rate bottomed out at 2.5%. The gross vacancy rate is 5.7%.

Rents & the "skew of the new"

Rents rose 5.8% in the region since March and are 9.3% higher than they were a year ago. Most of each year's rent growth usually takes place between spring and fall, and this past year was no exception.

But properties didn't really raise their rents that much. One thing investors need to be careful about right now is the impact that new construction has on rent trends. The *Rent premium for newer versus older* chart on page 2 show that new units rent for more, distorting rent trends. We call this the *skew of the new*. With so much new construction taking place now, this rent distortion is becoming significant. So investors need to take this into account more than ever.

Granted, the *skew of the new* won't matter as much in markets with little new construction, but you can see from the *One bedroom rent premium* chart on the next page that new construction in all of the major submarkets around the region will have an impact on rent trends. But it matters most in places like Seattle, where developers opened 26,000 units since the beginning of 2012 and plan to open another 37,500 units over the next five years. On top of that, they are working on sites that could handle another 10,000 units but are not far enough along to set construction dates.

Ignoring the *skew of the new* will lead to bad business decisions for apartment investors, frustrating budget meetings for property managers, and bad policy decisions for our community.

We're just beginning to see the distortion that new construction will create. Seattle leads the way because of all the new construction there. With vacancies increasing, the rate of rent growth slows. We have seen that trend repeat regularly over the past 40 years. Excluding new units that opened in the past year, Seattle rents rose 5.6% in the past 12 months. That's less than the increase in the region.

Do rents increase over time?

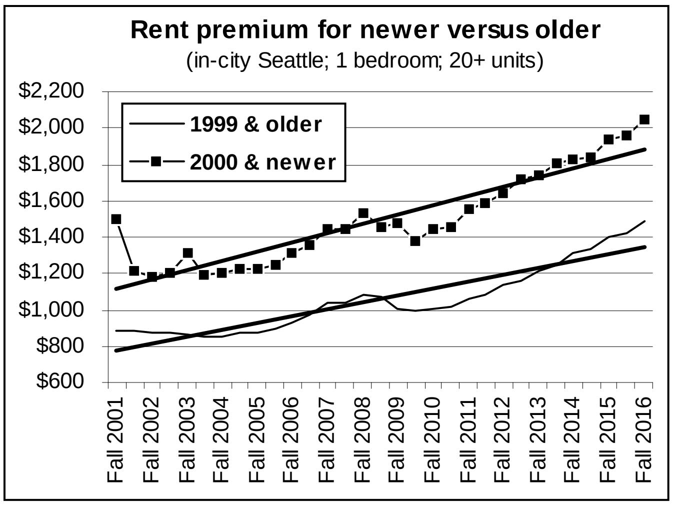
The *Inflation-Adjusted King County Rents* graph below shows how rents have risen and fallen over the past 47 years, adjusted for inflation. The "all property ages" trend shows rents today are 53% higher than they were in 1969, once you take inflation into account.

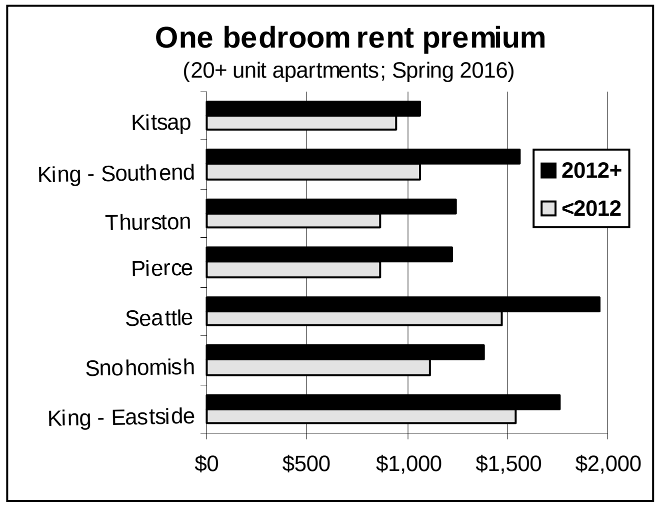
The graph also shows rents rose rapidly in the good economies of the late 1980s, late 1990s, and late 2000s. Unfortunately, rents fell almost as rapidly during economic downturns, most recently in 2009, another downturn that began in 2001, one in the early 1980s, and one in the early 1970s.

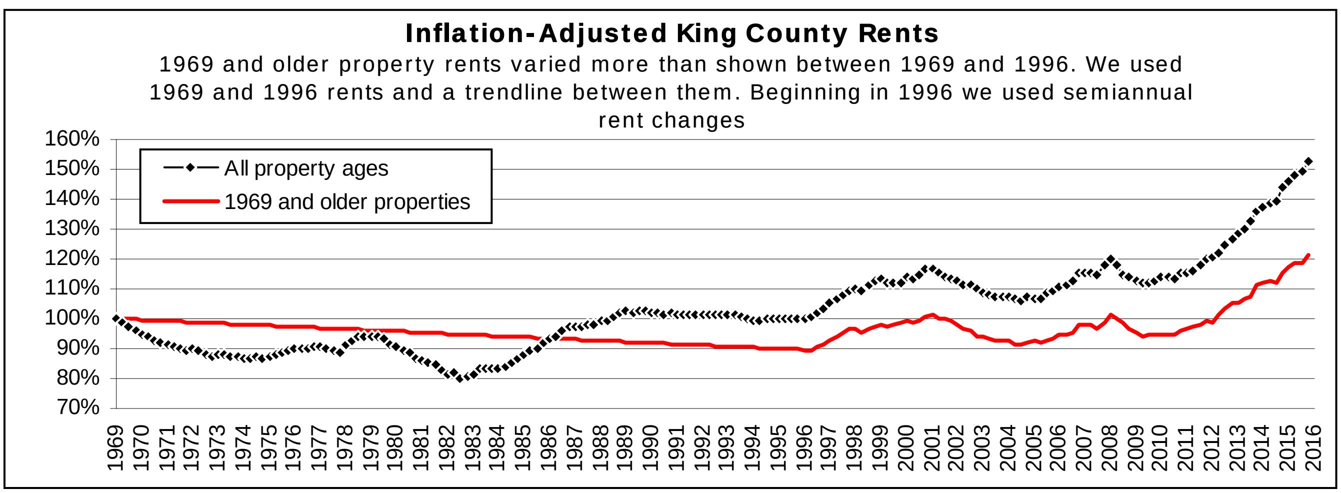
The "all property ages" category includes rents for all apartments. That means apartments built after 1969 as well as those built before 1969. That creates a misleading rent trend, because more than two-thirds of the properties in the region were built after 1969. At least some of the increase shown in the "all ages" trend is simply the result of the extra value of new amenities in newer properties.

So we also looked at the rent trend since 1969 for only those properties already operating by 1969. We were lazy on this part of the analysis. We did not calculate the rent of these properties for each of the past 40 years. We just compared the 1969 rent with the spring 1997 rent and adjusted the 1997 rent for inflation since 1969. Then we used actual rents from our surveys for 1969 and older properties after that, adjusted for inflation, so you can see the rent trend each year.

Anyway, the bottom line is that most of the time rents have just barely kept up with inflation over the past 47 years. They have been moving higher since 2013 though. Today they are about 20% higher than they were in 1969. That's a total, not an annual change. That 20% increase works out to less than four-tenths of one percent each year. And there's an argument to be made that rents increased







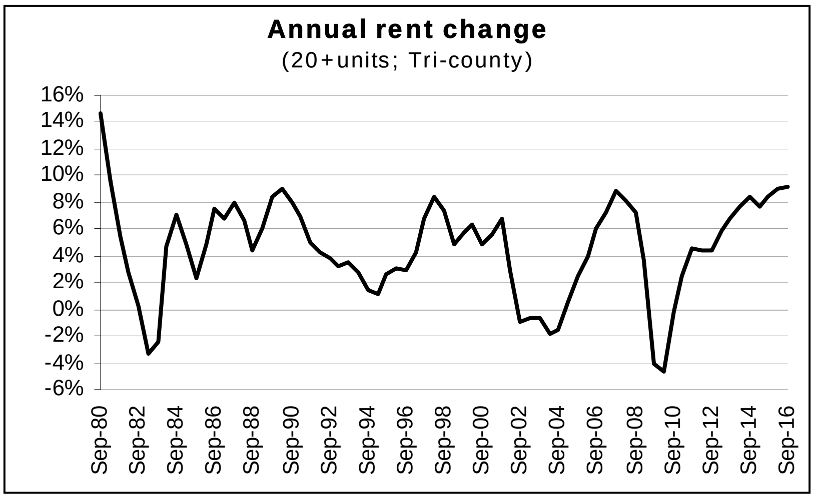
even less, but have been propped up by a lot of older properties that have undergone significant renovation and modernization.

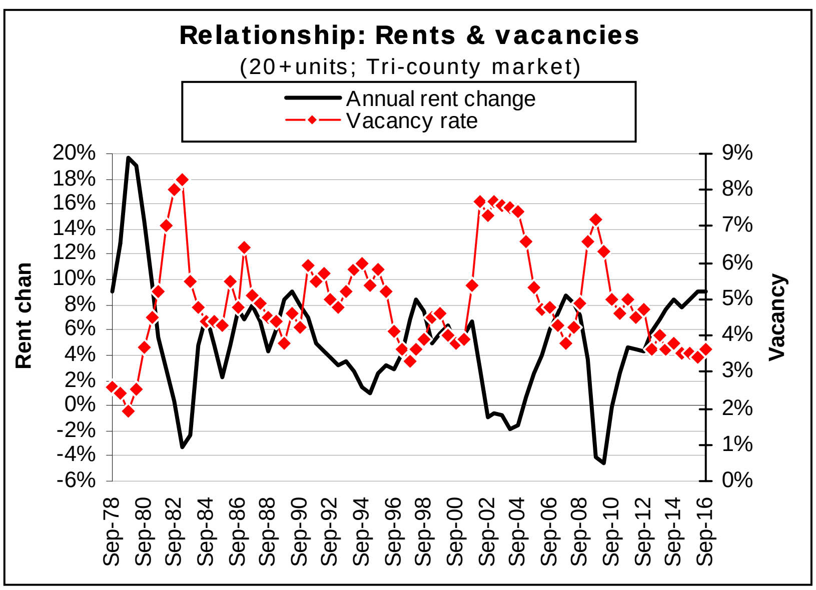
What this means is that, at least over the long term, investors should not expect rent increases to beat inflation. It also suggests that, when the time is right, upgrading older properties makes a lot of sense, especially given the sharp increases in real estate taxes and utilities.

Rents don't always go up

The topic-du-jour seems to be all about how much rents are going up right now. Rents have gone up a lot in the past few years. Right now we hear a lot of investors express surprise at how much rents are climbing. It's as though they have never experienced rent increases like this before. Maybe they haven't, if they are relatively new to our market.

Recent increases are actually not that unusual. And recent increases aren't record increases. The *Annual rent change* chart shows that rents have gone up significantly many times before. But the chart also shows that investors need to remember that they don't always go up as much as we have seen lately, and sometimes they even go down.





We have gone through five cycles in the past 45+ years.

The result is that in spite of significant rent increases in the past couple of years, rents have climbed 4.3% a year since 1981. Actually, they went up less, because this chart does not take into the distortion created by the addition of new units each year. Sorry about that, but making that adjustment would have been a little more effort than we were ready for.

The increases we've seen lately aren't unusual when the economy is strong. But they happen less often than investors think, and they barely make up for the downturns.

The rate of rent change is clearly variable. Out of 70 semiannual surveys, 28 of them found annual rent increases of 4% or less. However, 26 of them found rent increases of 6% or more.

So, if you are relatively new to investing, managing apartments, or renting, it's easy to see how you can have a distorted view of market trends. You would have seen rents climb 4.4% from the fall of 2011 to the fall of 2012, then 6.8% the next year, then just over 8% in 2014 and 2015 and 9% this year. It seems shocking, until you step back and look at the big picture.

The *Relationship: Rents & vacancies* chart shows that rents will climb faster when vacancies are low, like they have been recently. And rents will climb more slowly or even fall when vacancies are high. High or low vacancies are caused by an imbalance between supply and demand. If we have more supply than demand, either as a result of over-building or a from a recession or more commonly both, then vacancies go up, and rent growth slows or rents even fall.

Or vice-versa, we have more demand than supply. That's what we have had during the past couple of years. But developers are clearly stepping in to take care of that problem.

Economists like to talk about "equilibrium," where supply and demand match each other exactly. It's a great concept because then there are no wild up or down swings in rents and vacancies. That makes life easier for everyone.

But, having experienced this market for almost 40 years, it is clear that the market is never in equilibrium, at least not for more than a nanosecond. It merely passes through it as vacancies fall due to demand outstripping supply and then passes through it in the other direction as vacancies rise because now supply is outpacing demand.

Development

Developers opened almost 10,500 apartment units last year and we expect they will open another 10,000+ units this year in King, Pierce, and Snohomish counties. And that's just for starters. The latest update to our online *Apartment Development Report* shows they plan to open almost 14,000 units next year, followed by close to 21,000 units in 2018, and another 18,000 units in 2019. In fact, developers will open more units next year than we've seen since 1989, and if they manage to stay on schedule with everything they have planned for 2018, it will be an all-time record. Of course, our population and economy are a lot larger now, but that's still impressive.

They probably won't build all of these units, at least not as scheduled. There will be delays and some projects may get shelved. And if condominium sales are robust enough, some developers may opt to build condos instead. Even so, we're looking at a lot of new units. Plus, there's still time for developers to find sites and get projects built between 2019 and 2020.

Urban is hot again

We have a record-setting apartment building boom on our hands. We certainly haven't seen this much apartment development since the late 1980s. And it definitely feels like a record to people living in a lot of neighborhoods in Seattle.

That's because Seattle is getting a larger share of the region's development than it has seen in decades. Seattle lost share beginning in the 1960s as demand rushed to suburbia. In the last few years both consumers and the changes brought about by the adoption of the Growth Management Act back in 1990 have pushed demand back into urban areas. Over the past few years, and looking ahead a few years, Seattle is capturing 60% to 70% of the total development in the Tri-county market (King, Pierce, and Snohomish counties).

It's all relative

Comparing current and past development activity can be misleading. Yes, it looks like we will match or beat the 1980s building boom. In the seven years from 1985 to 1991 developers opened just over 80,000 apartment units. In our current seven year boom, from 2013 through 2019, we expect developers will open almost 90,000 new units.

But our region is a lot larger now. There were 2.8 million people living in the region in 1991 holding down 1.4 million jobs. Now there are 4 million people living here with just over 2 million jobs. So it looks like developers will open about 12% more units into a region with 42% more people and 48% more jobs.

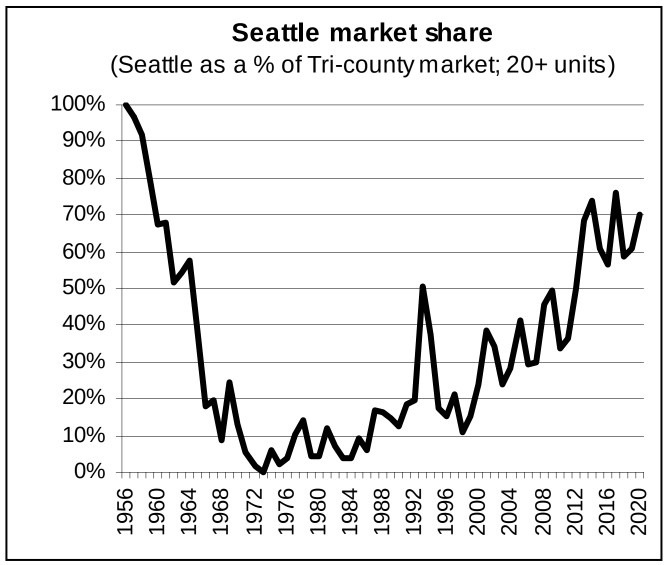
Granted, making all this development fit isn't just about jobs and population. Demographics matter. Baby boomers fueled the housing market in the 1980s. But now we have the millennials which is nearly as large a group. Plus, the boomers are becoming, what we started calling a few years ago, the "geezers."

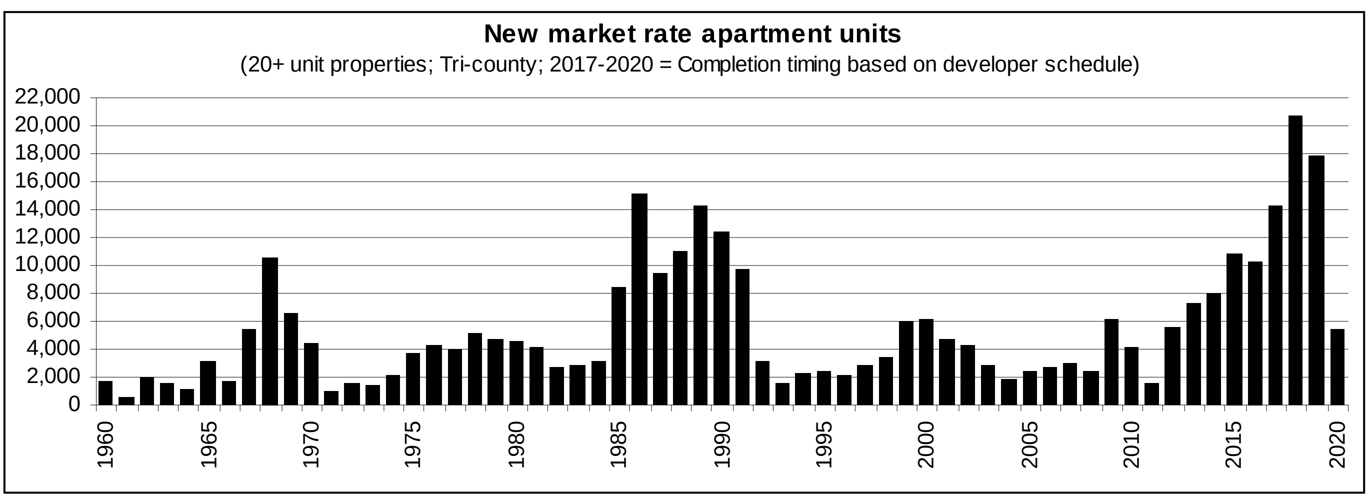
We won't go into detail here because we've talked about this trend a lot is past issues of the *Advisor*. However, in summary, as they retire from the job market in larger numbers than we've ever seen, the overall job market becomes younger. That matters to apartment investors because younger households are more renter-oriented.

Demand

Can demand keep up with all this new supply? The honest answer is who knows. Demand in King, Pierce, and Snohomish counties has averaged almost 9,000 units a year over the past three years. In the past 12 months demand totaled almost 10,500 units.

But will demand match the number of units developers





plan to open over the next few years? That's asking a lot. So investors should plan for higher vacancies and fewer rent increases. But it's always possible, especially if the economy gives us some positive surprises. We've seen it before. The *Annual absorption* chart below shows that demand averaged just over 11,000 units a year between 1986 and 1990.

Concessions

Only 9% of the properties surveyed offer concessions, averaging $873 over the lease term. That's not a lot of properties offering concessions, which makes sense in this low vacancy environment. But the amount of concessions is significant. Two years ago concessions averaged $600 and three years ago they were just $461. We expect the use and size of concessions will grow next year.

Parking & utilities

Half the properties include at least one parking space in the rent. Garage parking averages $120 a month, up 8.1% from $111 a year ago. Parking is likely to become a more valuable commodity, since new construction is putting in an average of less than one parking space per unit. This month's survey found that 83% of the properties pass through water and sewer charges to residents.

Data sources

The rent and vacancy trends are from the findings of our fall survey of 20-unit and larger apartments in the Puget Sound region, published in the *Apartment Vacancy Report*. We survey the entire market and collected reliable information for 250,068 units in 2,431 properties. That's 89.9% of the market. The development trends are from our *Apartment Development Report*. It tracks 20-unit and larger apartment developments in King, Pierce, and Snohomish counties. We update the report online at least monthly.

Rent distribution

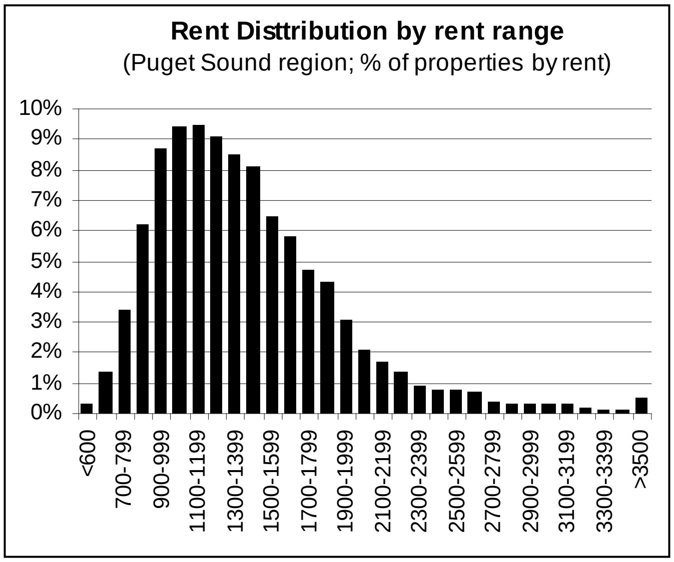
So much for the overview. Now let's dig into the numbers to learn more about trends in the market. There's a lot of talk about affordable housing. That's one thing the private market does well, up to a point. Close to half of all of the units in the Puget Sound region rent for less than $1,300 a month. Almost two-thirds of all of the units rent for less than $1,500 a month. These are regular market-rate apartments. There's no government subsidy.

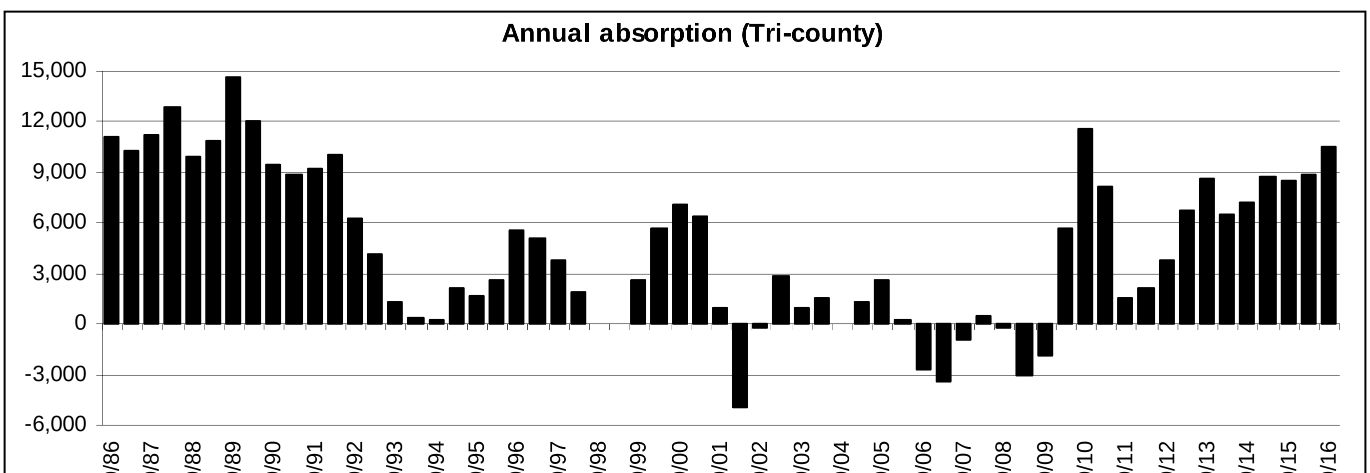
But that's just part of the story. The *Rent distribution by rent range* chart shows that only about 20% of the market rate units in the region rent for less than $1,000. And the *Average rent by property age* chart on the next page shows that traditional new market rate construction can't boost the supply of those less expensive units, except indirectly when new construction outpaces demand, putting pressure on rents in older properties.

Frugality exists

Now let's complicate things. We just said 20% of the units in the region rent for $1,000 or less. That makes all of those units affordable to households earning at least $3,000 a month. That's if affordability should be calculated based incomes being three times the rent.

We're just using that amount as an example. But not everyone pays one-third of their income on rent. Some pay more. Some pay less. That means that although some households can afford to spend more than $1,000 a month,





they choose to be frugal and rent an apartment for less than that.

Greg Willett, the Chief Economist at RealPage, also spoke at WMFHA's *Washington Apartment Outlook* and commented that his company did an extensive nationwide analysis of leases and found that the typical renter household spent 23% of income on rent.

We decided to do a small survey locally to see if things are different here. It was a very quick and small survey, but we found the median rent payment was 24% of income at the time of the initial lease. Only one-third of the households spent more than 30%.

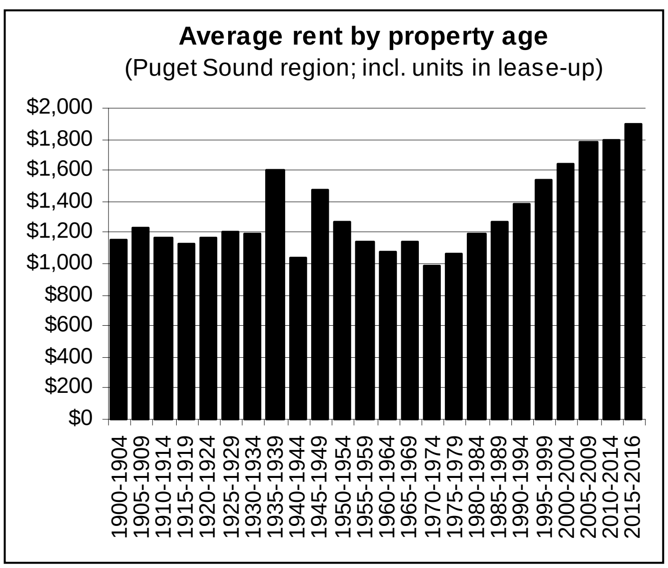
We caution that this was a small survey. A more comprehensive survey will likely change the numbers. However, it still will show that a significant number of households spend less than 30% of their income on rent. That's commendable and it should not be discouraged. But it suggests two things.

Pardon me, you're in my seat

First, those households spending less than 30% of their income on rent are consuming housing that would be barely affordable for other renters. That means that however you measure the number of units that are affordable at any particular income level, some of them are occupied by households making more than that. So, you'd think that whatever developers can do to add lower cost units would be encouraged. We'll talk more about that shortly.

It's like U2 said

Second, it means that some renters, if not quite a few, can afford to pay more rent than they are paying now. Of course that's just based on our simple one-third of income formula. Maybe they have the same problem U2 pointed out on their *Joshua Tree* album, singing, "I still haven't found what I'm looking for." That suggests there is room for them to move up into more expensive housing, if developers create the right kind of product and amenities in the right locations. Given how quickly new construction has been leasing up, and the high occupancy rate in these units, that may be happening now.



Why encourage competition?

We're guessing that if you own a property with those lower cost, more affordable rents, you're wondering about now why we would encourage more construction in your rent range to compete with you. Well, the simple answer is, you can handle it. Look at the *Vacancy & rent range: Stabilized units* chart on page 7. That's the middle one. It shows that units renting for $1,200 a month or less don't have a lot of vacancies.

A little new construction in that rent range isn't likely to impact existing properties negatively. The problem is how can developers deliver new units in that price range?

Actually, they have been doing just that with congregate housing and were ready to do more of it until Seattle balked. Ironically, as Seattle backed away from this simple affordable housing option, other cities like Tacoma, Redmond, Kirkland, and likely more to come are stepping in and embracing the concept of smaller living spaces. Their solutions are less dramatic than what Seattle developers were doing, but their problems are less dramatic as well. The point is they are jumping in while Seattle backs out.

The Stones said it best

Some people view congregate housing, and Small Efficiency Dwelling Units (SEDUs) undesirable housing options, not just for them as next door neighbors, but also for the ultimate occupants. But they have very low vacancies, so they clearly meet a need. Like the Rolling Stones said on their *Let It Bleed* album, "You can't always get what you want, but if you try sometimes, you might find, you get what you need."

Not only that, we believe these housing options not only fill a need, but are a preferred housing choice for some consumers. Choice and variety are valuable assets for any community.

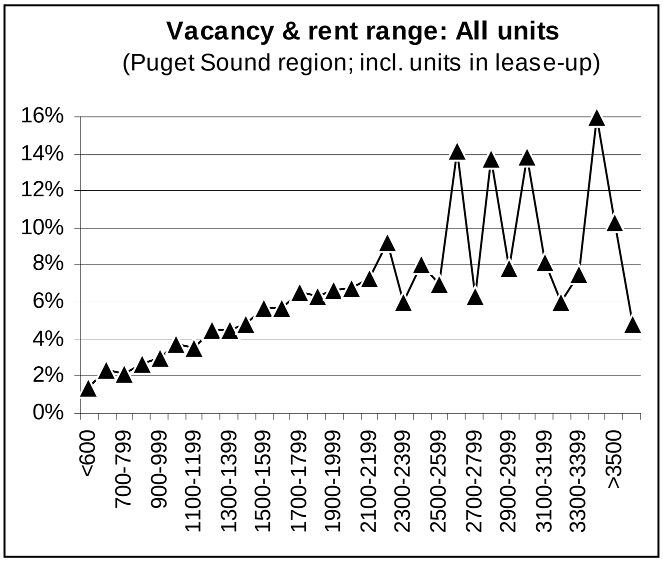
Rent by unit size

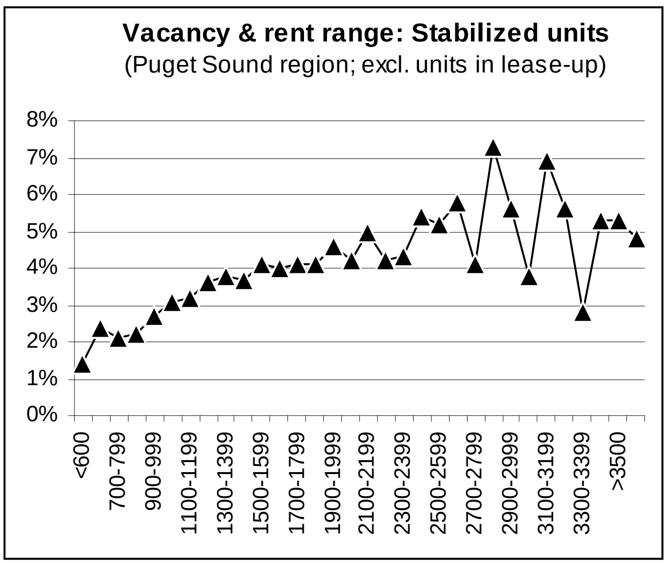
We have not included congregate housing that developers have built in Seattle in our regular rent and vacancy surveys. But we did a supplemental survey of these properties last month and their rents are included in the *Rent by unit size range chart* on the next page.

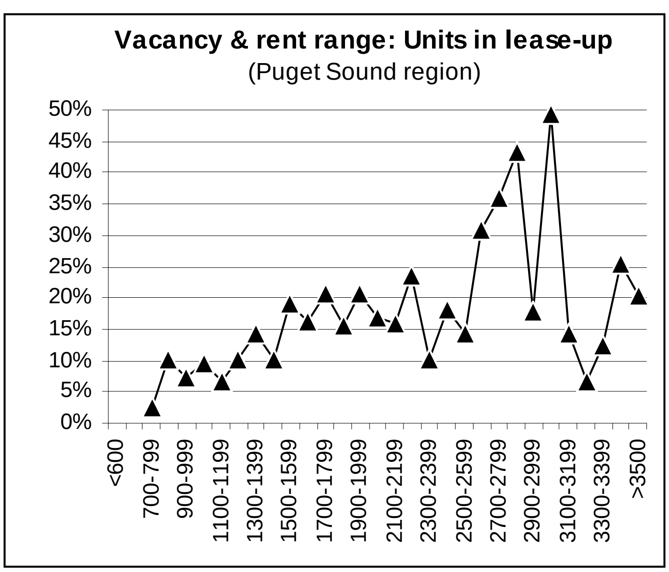
We do include Small Efficiency Dwelling Units (SEDUs) in our surveys as studio apartments. Even though there aren't many yet, more are coming. They are typically a lot smaller than traditional studios, but differ from congregate units because they include full cooking facilities. And they are more affordable than traditional studios in new construction.

So, where do these congregate housing and SEDU units show up in the chart? Way over on the left side. There are not a lot of things developers of traditional apartments can do on their own to lower construction costs enough to be able to deliver many new units for less than

$1,500 a month. The *Average rent by property age* chart we discussed on page 6 shows that's the case.







The average rent in properties built in the past year or two is approaching $2,000 a month. But, as the table below shows congregate housing, and SEDUs are renting for a lot less.

We took a closer look at the rents in new apartments developers opened last year and this year in Seattle. We excluded units subsidized through the Multi-Family Tax Exemption (MFTE) program. Only 6.4% of all of the market rate units rent for less than $1,500 a month. Only 2.5% rent for less than $1,300 and just 1.2% rent for less than $1,200 a month.

One reason there aren't more units in these price ranges is that only 15% of all of the units opened since the beginning of last year in Seattle are studios. And the average studio size is 469 square feet. Traditional apartments normally include a mix of unit types, weighted towards one- and two-bedroom units. The new properties that opened last year and this year in Seattle are no exception, with 56% of those units one-bedrooms, and 24% two bedrooms.

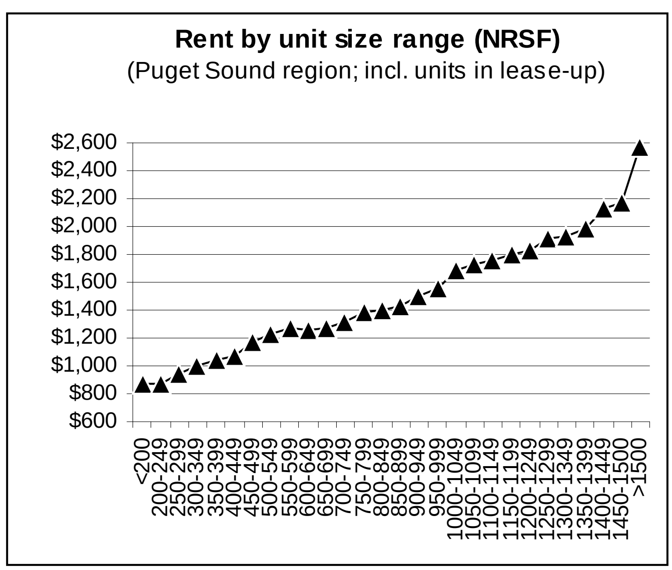
But the table below shows congregate housing, and SEDU units are a lot more affordable than traditional apartments, in part, because the units are smaller. However, new rules will force SEDUs to be bigger than they were yesterday which will result in more expensive construction and higher rents.

And while construction costs for SEDU apartments per square foot are higher than traditional multi-family construction (due to much of the square footage taken up by the costliest parts of a unit; the kitchen and bathroom),

Congregate Housing & SEDUs in Seattle
Fall 2016 rental survey

	Unit size (nrsf)	Rent
Congregate	196	$887
SEDU	286	$1,156

Note: Unit sizes and rents are medians



overall development costs are substantially less than typical multifamily construction due to the elimination of structured parking.

Big yellow taxi

Way back in 1970 Joni Mitchell sang, "They paved paradise and put up a parking lot." Some neighborhoods are feeling like that's what is happening to them now.

Parking is one of the culprits that helped derail congregate housing in multifamily zoned neighborhoods. Not long ago most apartments had more than one parking space for each apartment. The *Parking spaces per unit by year built* chart shows the trend for the region. The average number of parking spaces per unit has fallen from 1.6 spaces or more just a dozen years ago to just one space this year, and it looks like it will keep falling.

However, the *Parking: Seattle vs. the region* chart shows that although there is a trend to reduce the amount of parking per unit region-wide, it is most significant in Seattle where properties built this year offer an average of 0.7 parking spaces per unit.

With fewer parking spaces in projects, neighbors are worried that more parking may flow onto already crowded streets, assuming that the same number of people have cars. Although with ridesharing such as Uber and Lyft, and hourly rental cars like Car2Go, ReachNow, Zipcar, and Rapid ride bus lines, many people are choosing not to own a car.

So it is understandable why long-time residents in the traditional single-family neighborhoods tend to resist new construction that provides little or no on-site parking, because it changes how they have lived.

But just because it is understandable doesn't mean it should be acceptable. We need to accommodate more people that keep moving here for jobs, and these urban neighborhoods with public and private transportation and great amenities are where new, and returning residents, are going.

Real estate taxes and rent

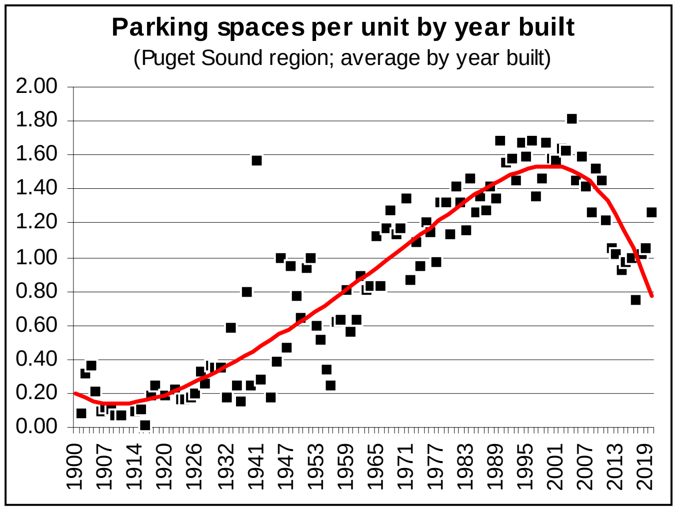
In addition to looking for ways for the private market to create some more affordable housing, it is important to look at trends that are hurting affordability in existing properties. We have been talking about how rapid increases in real estate taxes and utilities are a problem. Well, the problem not only isn't going away, it is getting worse.

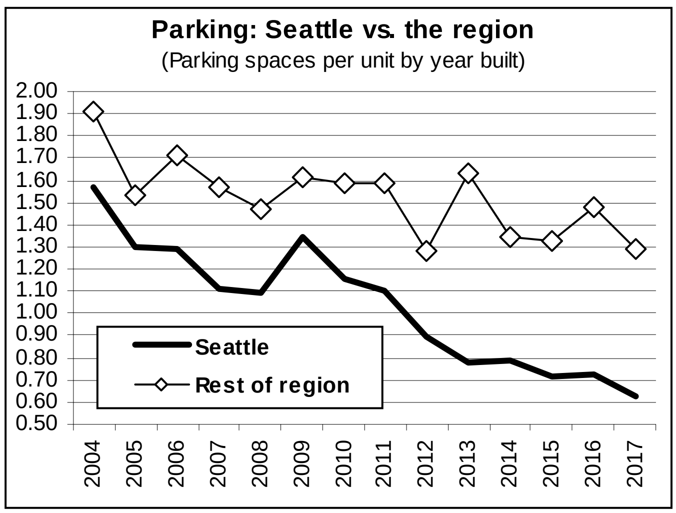
A number of investors have called us recently expressing concerns about real estate tax increases. Some have sent us spreadsheets showing their actual cost changes over the past few years. We have been expressing concern for a number of years about how much taxes increase each year.

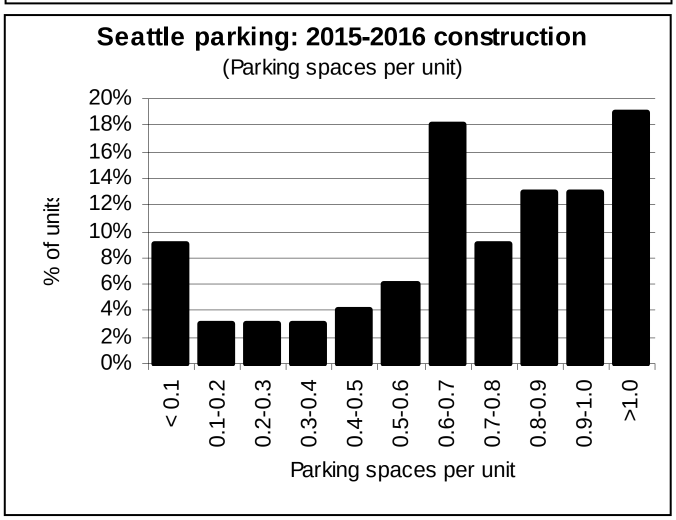
A few investors who sent us tax changes in the past year for their Seattle portfolios saw an average one-year increase in real estate taxes of 18%. The *Change in real estate taxes: 2015-2016* chart on the next page shows that more than 85% of their properties saw tax bills jump by at least 10% in just one year. Almost one-quarter of them paid increased taxes of 20% or more.

One of these investors, with a portfolio of about a dozen Seattle properties, sent us their tax payments for the past three years. Those properties saw taxes jump 26% in the past year, and 67% in the past three years. That's an 18.6% compound annual increase in taxes, in spite of a drop in the levy rate from 10.5 in 2013 to 9.5 in 2016.

Why does it matter? Real estate taxes are the biggest







expense most apartment investors have, except for mortgage payments. Our annual *Apartment Expense Report* found that real estate taxes represented 25% of total operating expenses last year. It's a large expense, making these kinds of increases unsustainable. Will these large increases continue? Hopefully not, but another investor told us this week that they just got an increase in assessed valuation for 2017 of 15% for their small portfolio of four properties in Seattle.

These are just a few examples for a small percentage of all the properties in the region. And they are all concentrated in Seattle. Investors in other cities around the region may be faring better. So we will take a much more detailed look at this tax trend in future issues of the *Advisor*.

But these are still important "case studies" because we doubt these are isolated cases. And if that's true, then we've got a problem. Here's why.

Currently, total operating and capital expenses consume almost 50% of the rents. And that doesn't include mortgage payments. The *Expenses as a percent of rent* chart below shows that if real estate taxes keep increasing 18.6% a year, total expenses would be more than rental income in just 16 years even if rents increased 5% a year. Try explaining that to your lender.

Realistically, total expenses need to hover around 50% of revenue, or even less. But to do that when taxes are going up 18.6% a year, rents would have to increase 10% a year.

And that's an optimistic scenario because we assumed other expenses would climb just 3% a year. Plus, that only works for a while. As the *Expenses as a percent of rent* chart shows, within 25 years expenses would consume 80% of revenue. So even 10% annual rent increases wouldn't solve the problem.

Clearly these recent tax increases are not sustainable. Please let someone know that. But even if we cut them in half, to 9.3% a year, rents would have to increase 5% a year every year just to keep up for the next 15 to 20 years. And that assumes all of the other expenses climb just 3% a year. And even that is just a patch job to get us through the next couple of decades. Then that scenario starts to fall apart too.

Forecast

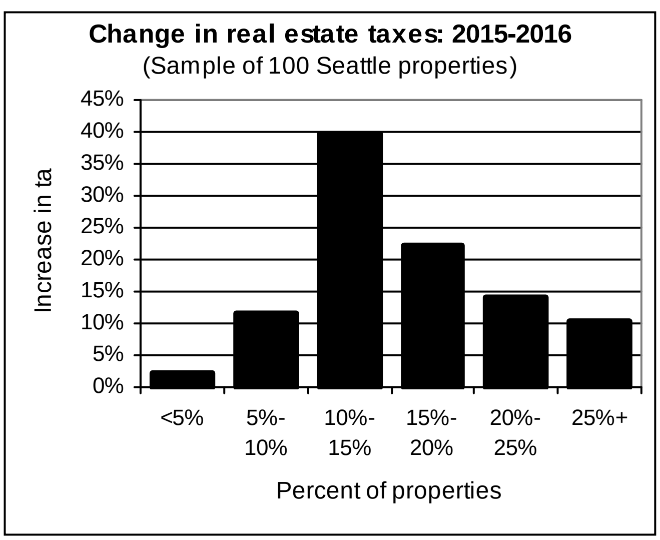
In our last forecast in the spring we expected the market vacancy rate would be 4.1% now and climb to 5.5% by this time next year. Vacancies are lower because job growth this year has been better than expected. But we're also expecting more new units to hit the market over the next few years than we counted last spring. So we will update our forecast for rents and vacancies in the October issue of *The Apartment Advisor*.

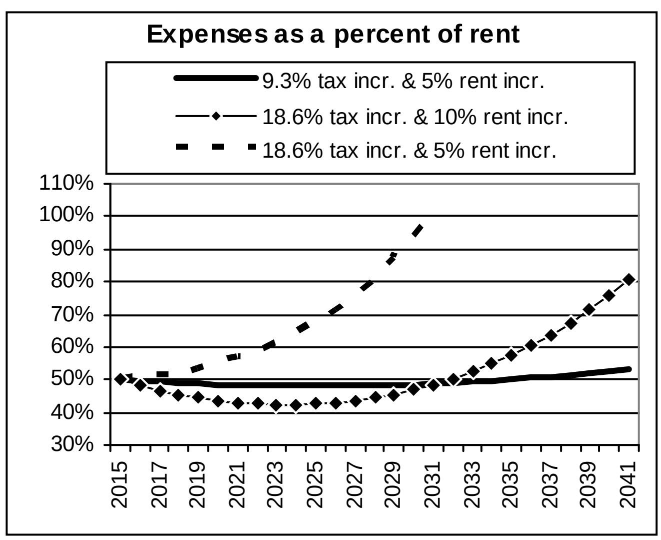
As you can see from the charts on page 3, rents are cyclical. Sometimes investors forget that. They shouldn't. Over the past fifteen years, rents have gone up, down, and flattened out, resulting in an increase of just 3.8% compounded annually, excluding the distortion caused by new construction. And when you adjust for the *skew of the new*, rents really increased 3.4% a year.

By comparison, the 2016 edition of our *Apartment Expense Report* found that real estate taxes and utilities increased 4.4% compounded annually over the same period, once you exclude distortions from the new units added. There is a very significant and unsustainable disconnect between these cost increases and apartment rents. That's particularly true since these are the two largest operating expenses investors have. And it happened even though most investors have invested significantly in energy conservation measures over the past five to ten years to rein in utility costs. And it happened even though our weekly update to *The Apartment Investment Report* shows that sales since the beginning of last year were assessed at less than 80% of the selling prices on average.

What's next?

Our forecast model is based on our research of rents, vacancies, development, investment and other trends. It also uses a lot of information from other sources, including employment, net migration, population forecasts and other data from Conway Pedersen Economics, the Department of Licensing, Office of Financial Management, and the Puget





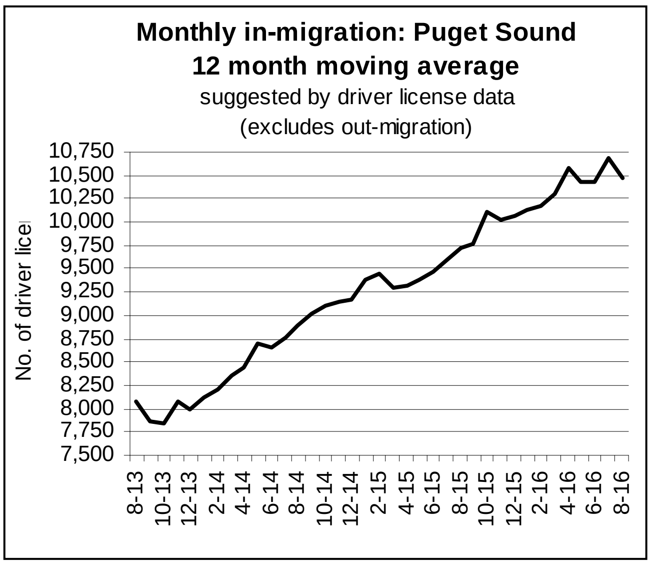
Sound Regional Council.

In-migration

We look at driver license data published by the state each month to get a sense of current in-migration trends. This information just tells us how many people moved here and turned in out-of-state driver licenses. It doesn't count the people who moved out. And, yes, some people actually leave the region once in a while. But move outs are typically no more than half of the move-ins, and recently have been a lot less. So if you cut the driver license data in half, you've got a reasonable estimate of net migration. And it is current information, updated monthly.

Almost 200,000 people in Washington turned in out of state driver licenses in the past 12 months. More than 125,000 of them are in the Puget Sound region. And the trend has been accelerating over the past few years. Three years ago an average of 8,000 people a month moved into the Puget Sound region. Now we're seeing an average of more than 10,000 people a month moving into the region.

Even if half as many moved out, that still means there are 60,000 more people in the region lining up at Starbucks every morning than there were a year ago. Now don't go putting offers on more apartment sites based on that news. Some people, hard as it is to accept, will opt for a condo or single-family house. But it is still good news. And it is good news all around the region.



Demand forecast

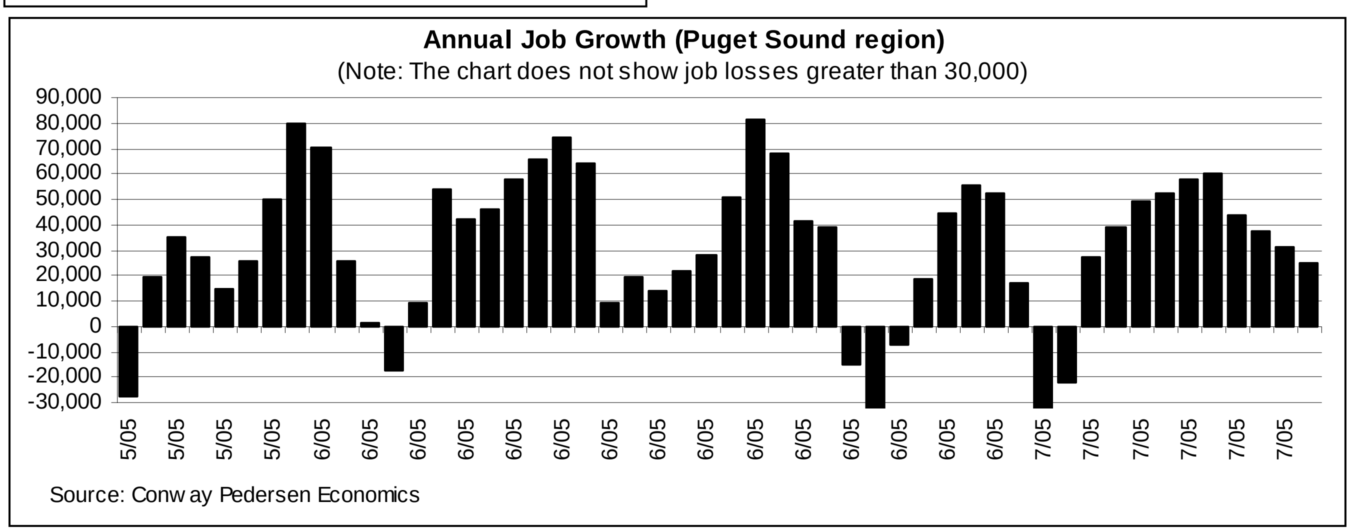
Population growth, net migration changes, income, demographic changes, consumer attitudes and preferences, and other factors all impact demand. Rent, home prices, and interest rates also impact rental housing demand. Right now a lot of factors favor apartments over other housing options. Between last October and the end of September, our region added 56,600 jobs, developers opened 11,200 units, and the apartment market absorbed 10,500 units units.

The latest *Puget Sound Economic Forecaster* by Conway Pedersen Economics, expects our region will add 142,000 jobs between the beginning of this month and the end of 2020. Our forecast anticipates demand for 45,000 units over that same period. That forecast is driven by the jobs forecast, but it is also impacted by the influx of millennials into the job market and the somewhat reluctant exit from the job market, by the geezers. It our view that when one geezer leaves the job market and a millennial fills that job, the market will experience increased demand for rental housing even though there was no net increase in jobs in this example.

Supply forecast

Between now and the end of 2020, developers plan to open 61,000 units. This number changes almost daily, usually to the upside, so we update the online *Development Report* regularly. Realistically though, some of these projects will be delayed by a few months or even longer. And some projects may not happen at all. So we made some adjustments to account for likely delays.

Once you take into account construction delays and postponed or cancelled projects, our forecast assumes 51,400 units will actually open between now and the end of 2020. Of course, developers will also find new sites and still have plenty of time to build and lease-up in 2019 and 2020. So we update this forecast regularly. We'll do it next



in December.

Occupancy in lease-up

A telling trend is monitoring the occupancy rate new construction that is currently in initial lease-up. Over the past 30 years it averaged 67.1%. Right now it is 85.7%, which is a record.

Vacancy rate forecast

As a result of our supply and demand forecasts, we expect the market vacancy rate to barely increase next year from 3.5% last month, to 3.6% by the end of next year. Then it will edge up to 5.4% by December 2018 and peak at 6.8% by the end of 2019. The gross vacancy rate will climb fairly steadily from 4.8% currently to a peak of 7.7% by the summer of 2019. By comparison, Conway Pedersen's new forecast expects vacancies to stay below 4.5% through 2018. We like their forecast better.

Rent forecast

We expect rents will climb 5.9% between now and the end of 2017, and then slow considerably in 2018. We expect rents to dip somewhat in 2019 before starting to increase slowly in 2020. By the end of 2020, rents will be about 8% higher than they are now. That's not great, especially when you consider what's happening to operating expenses, but at least it is positive.

Concessions & credit loss forecast

Credit loss should not be much of a factor over the next few years as long as our economy holds up. But it shouldn't be ignored. It will likely cost investors a little less than 1% of scheduled gross each year.

Concessions, however, will take an increasing share of scheduled rent starting in early 2018. We expect concessions to climb steadily between then and late 2019. Some of the new developments in lease-up will use concessions aggressively. Others will just adjust rents based on their pricing models. So much so that many existing properties will have to offer some concessions or lower rents as well.

Net operating income forecast

Over the past three years, net operating income (NOI) has gone up an average of 6.9% compounded annually. Last year it increased 9.8%. We expect net income to post another significant increase this year and next. But with revenue growth deteriorating after next year, coupled with continued cost increases, we unfortunately expect it to fall in 2018 and 2019 before edging higher in 2020. By the end of 2020 NOI should be about 14% higher than it is now.

Prices

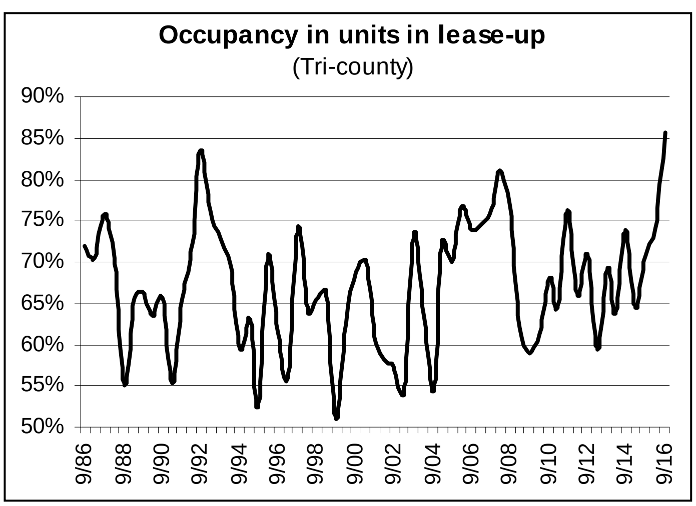
What happens to apartment prices is a little more complicated. Basically, they should move in tandem with net operating income. But they will ultimately move faster or slower than that as a result of buyer activity, mortgage rates, and investor yield expectations. If buyers remain bullish on our market, and interest rates stay low, competition could push capitalization rates a little lower.

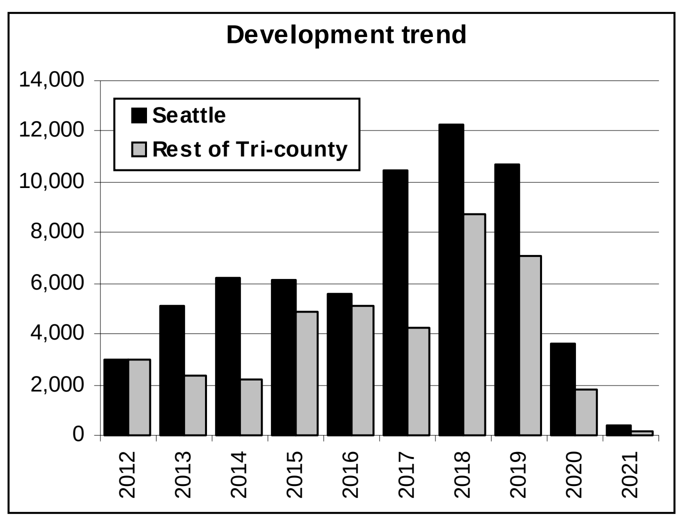
Cap rates are down a little so far this year, averaging 5% in King, Pierce, and Snohomish counties. Cap rates are still higher than mortgage rates, creating positive financial leverage for investors and giving them some wiggle room to compete for properties. But investors have been reluctant to push cap rates lower because they are concerned about higher interest rates.

We did not assume cap rates will fall further. So price increases become totally dependent on increasing net operating income. As a result, our model expects prices in 2016 will be about 10% higher than last year.

So far that doesn't seem to be the case, with prices up just 5% based on sales. But that's a bit of an apples-to-oranges comparison. Anyway, next year we're looking for prices to climb about 8%. Then over the following two years they are likely to give back those gains and end up where we are this year. Then they should start climbing again in 2020.

Sometimes prices fall. Prices fell 12.5% in 2009 and 2010. That was more dramatic than we expect for the next few years, and it was for a different reason. But if net income slips as expected, and buyers have run out of room to lower cap rates any more, the price drop in the forecast makes sense. And if mortgage rates climb, that will put upward pressure on cap rates. D+S





Forecasts

These graphs show our forecasts for apartment trends in the Puget Sound region based on the market and economic trends discussed in this issue of *The Apartment Advisor*. You can decide whether or not you agree with our observations and whether or not these forecasts are reasonable.