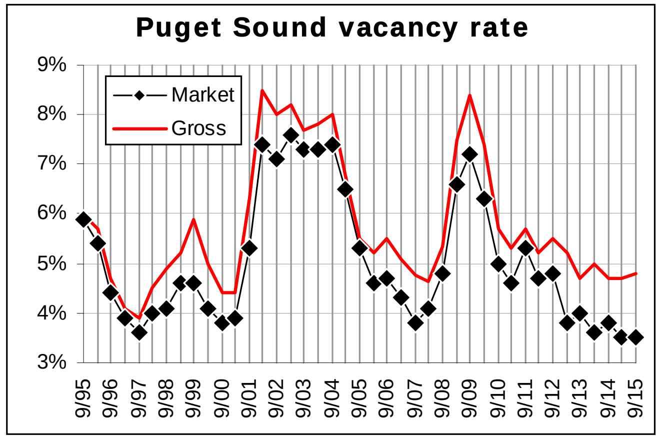
THE APARTMENT ADVISOR.™

VOL. 38 NO. 5 ★★★★★★ OCTOBER 2015 PUGET SOUND REGION WWW.DUPRESCOTT.COM $160/YEAR

Red Herring



And The Award Of The Year Goes To Miss Information Or Is It Really Disinformation? Just Sayin'

We get a lot of our real estate insights from movies, theatre, music, and dance and we have shared those ideas in past issues of the *Advisor*. Now we can add to that list of insight generators binge-watching offbeat television series.

This summer we binge-watched *The Killing*. It's based on a Danish series we can't pronounce. We were attracted to it partly because it was filmed in Seattle, some of it spectacularly. Our only complaint with the series is the director doused every scene with torrential artificial rain so we're not sure if the series created much PR value for the region.

It's a whodunit with two detectives as lead characters, Linden and Holder, trying to solve a missing person case. It's a series rather than one show because they end up chasing one false lead, or red herring, after another. And we followed right along, believing every red herring was the right way to go because each one sounded so good. It took 26 episodes for them to shake free of all of the red herrings and find the truth. Hey, when we binge watch, we binge watch.

Anyway, not long after watching the series it dawned on us that *The Killing* was really talking about things going on in our local apartment market. Lately we have seen a lot of red herrings tossed out about apartment market trends. And right now these red herrings appear to be driving a lot of decisions by investors, developers, and government. This is really troubling because we don't get 26 chances to get things right.

Right now Seattle is up in arms about rents. Signs and headlines around town this summer read, "Rent is too damn high" and "Rent is out of control" and "Rents are skyrocketing" and "there's a Rent crisis" and "Rental emergency," to cite just a few of them. It's unfortunate that hyperbole like this is so easily accepted as truth. And it is doubly unfortunate that it is being used by smart people in positions of public trust in organizations, the media, and government because these red herrings are now driving important discussions and leading housing investment and policy decision-makers on one wild goose chase after another. Granted, statements like these make for dramatic headlines. That's fun, isn't it. But it's all hyperbole, not fact, and it leads to bad decisions. Unfortunately, this kind of talk is misleading at best, and dishonest at worst. At the very least it is misinformed and lazy.

Yes, vacancies are low. Yes, rents rose significantly in the past year, even the past few years. Yes, neighborhoods are feeling the impact of new development and congestion around them because there is a lot of new development.

Even so, now seems like a really good time to take a step back, take a deep breath, cut through all the hype and misinformation, and calmly take a look at what is really happening in our region's apartment market. Because the last sentence in our mission statement printed at the bottom of the front page of every issue of the *Advisor* turns out to be only half true. We are still convinced, "the market will work best when informed, timely, reliable, and unbiased market information is available." But clearly that's not enough. Decision-makers need to put a lot more energy into understanding all of this market information. We should have known that. Doing that takes some effort. So we're going to try and help by putting current market trends in context in the next few pages.

General rent trend

Our fall rental market survey found that rents in the Puget Sound region climbed 5.6% in the past six months

DUPRE + SCOTT
apartment advisors, inc

We provide research on apartment investment and market trends in the Puget Sound region of Washington. Our goal is to enhance the quality of information available to help our clients make better decisions. We believe the long-term health of the Puget Sound region's rental housing market is important to everyone involved in this housing market. We are convinced the market will work best when informed, timely, reliable, and unbiased market information is available. Thank you for supporting our research.

Patty Dupré + Mike Scott

and a total of 8.3% in the past year. Most of each year's rent increase happens between spring and fall, and this year was no exception.

But even though it is our own report, we'll tell you that rents didn't really increase that much. At least not "increase" in the way that is being bantered about today.

Skew of the new

In the past year developers opened almost 9,500 new apartment units. New units rent for more because… well, because they are brand new. And they typically have more amenities than older properties. The *One bedroom rent premium* chart below shows that's true all around the region. Region-wide, apartments built after 2011 rent for a 54% premium compared to properties built before 2012.

We started cautioning investors to beware the "skew of the new" at least three years ago. That's because we saw that a surge of new construction was on its way and we knew it would distort rent trends.

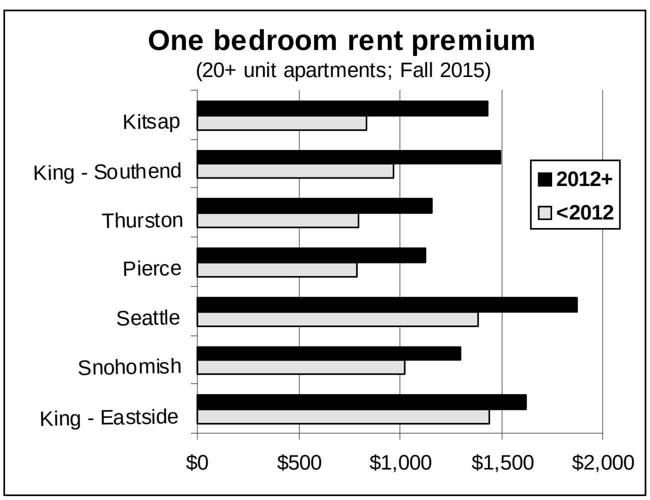
Well, the construction boom began in 2012 and developers have already opened more than 30,000 new units in the region since then. And they show no sign of letting up any time soon. So this distortion will only become greater next year.

Granted, the skew of the new won't matter in markets with little new construction. But it does matter in places like Seattle, where developers opened 18,000 units since the beginning of 2012 and are working on a lot more.

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

Same store rent change

Let's say there was only one property in a market last year and it rented for $1,000. Then a few months ago a developer opened a new property and its units rent for $1,500. Last year the average rent in that market was $1,000. Now it's $1,250, even if the older property didn't raise rents at all.



So here's the issue. Yes, the average rent in that market today is $1,250. No getting around it. That's just simple math. But does that mean that rents went up 25%? Of course not. That older property didn't even raise rents. It just means that the average rent in the market is $1,250. And that is useful information to compare the cost of renting in one market area to another. But that's the only way that number should be used.

Granted, this is too simplistic an example because it means developers doubled the housing stock in one year, from one unit to two units. That won't happen in the real world, at least it isn't likely. But it does illustrate a problem for investors and policy makers. The problem is how to figure out how much rents are really increasing.

Fortunately, there's an easy solution. All you have to do is look at how much rent changed in the same properties over the past year. That will eliminate distortion from new units that came into the market in between the two surveys. This "same store" analysis is the real measure of rent change.

When you exclude the new units that opened up after last year's fall survey, rents in the region increased 6.4%, not 8.3%. That's still a significant increase, but keep in mind that rent changes are cyclical. More about that later.

The difference between same store rent changes and overall averages is even more significant in Seattle, which has seen 60% of the new construction since the beginning of 2012. The overall average rent in Seattle increased 8.4% in the past year. But when you look at a same store analysis, rents are up 6.2%.

Because the skew of the new is becoming more of a factor, we looked at same store rent increases in the past 12 months for 66 cities in the Puget Sound region. You can see the results on the next page in the *One year "same store" rent change* chart.

Now is the time to take out your 3-D glasses because we printed the chart twice. The version on the left ranks each city from the lowest rent increase to the highest. The problem with that chart is that it's hard to find your city. So the chart on the right is organized by cities alphabetically.

Out of 66 cities, Seattle had the 32nd highest rent increase, at 6.2%. That means Seattle rents increased more than 34 cities around the region in the past year. But it also means 31 cities had higher rent increases than Seattle.

Bellevue same store rents are up 6.9%, Tumwater is up 8.3%, Redmond is up 7%, Everett is up 7.3%, Kent is up 7.7%, and Woodinville saw rents climb 11%.

So it's odd that Seattle is talking about a rent crisis, or skyrocketing rents when almost half the cities in the region

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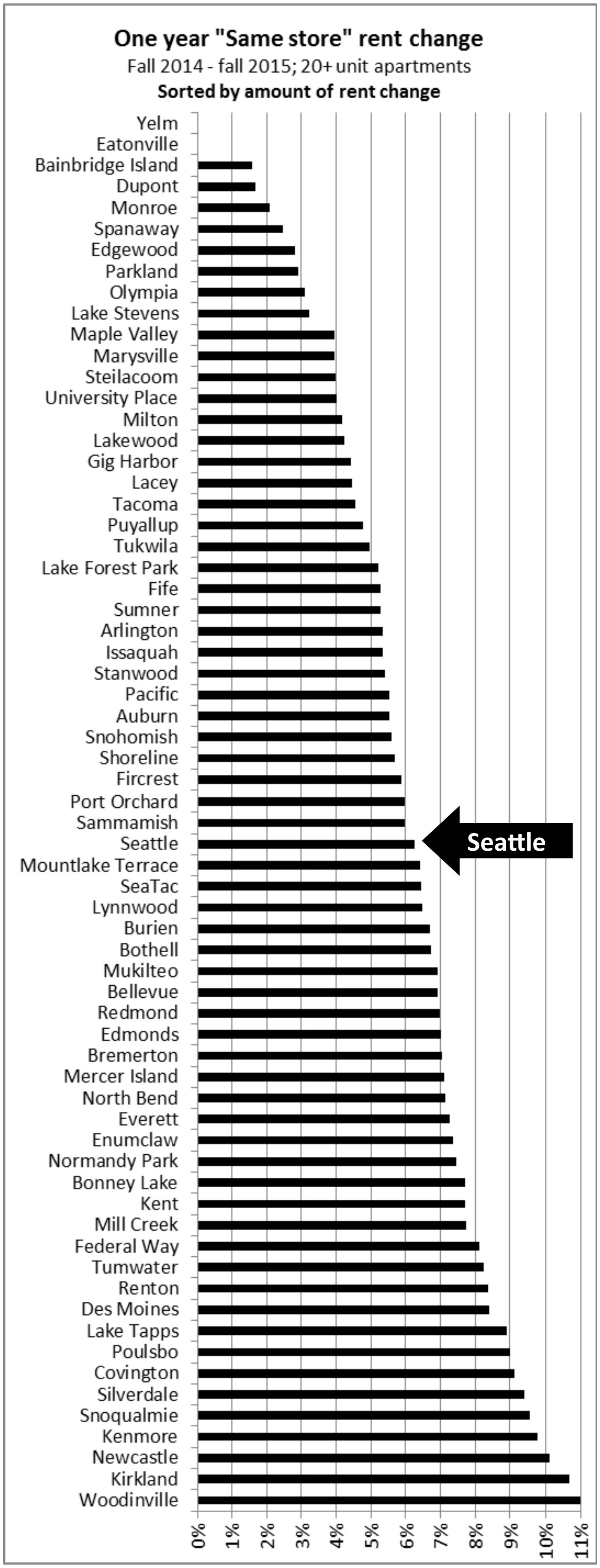
One year "Same store" rent change
Fall 2014 - fall 2015; 20+ unit apartments
Sorted by amount of rent change
Yelm
Eatonville
Bainbridge Island
Dupont
Monroe
Spanaway
Edgewood
Parkland
Olympia
Lake Stevens
Maple Valley
Marysville
Steilacoom
University Place
Milton
Lakewood
Gig Harbor
Lacey
Tacoma
Puyallup
Tukwila
Lake Forest Park
Fife
Sumner
Arlington
Issaquah
Stanwood
Pacific
Auburn
Snohomish
Shoreline
Fircrest
Port Orchard
Sammamish
Seattle
Mountlake Terrace
SeaTac
Lynnwood
Burien
Bothell
Mukilteo
Bellevue
Redmond
Edmonds
Bremerton
Mercer Island
North Bend
Everett
Enumclaw
Normandy Park
Bonney Lake
Kent
Mill Creek
Federal Way
Tumwater
Renton
Des Moines
Lake Tapps
Poulsbo
Covington
Silverdale
Snoqualmie
Kenmore
Newcastle
Kirkland
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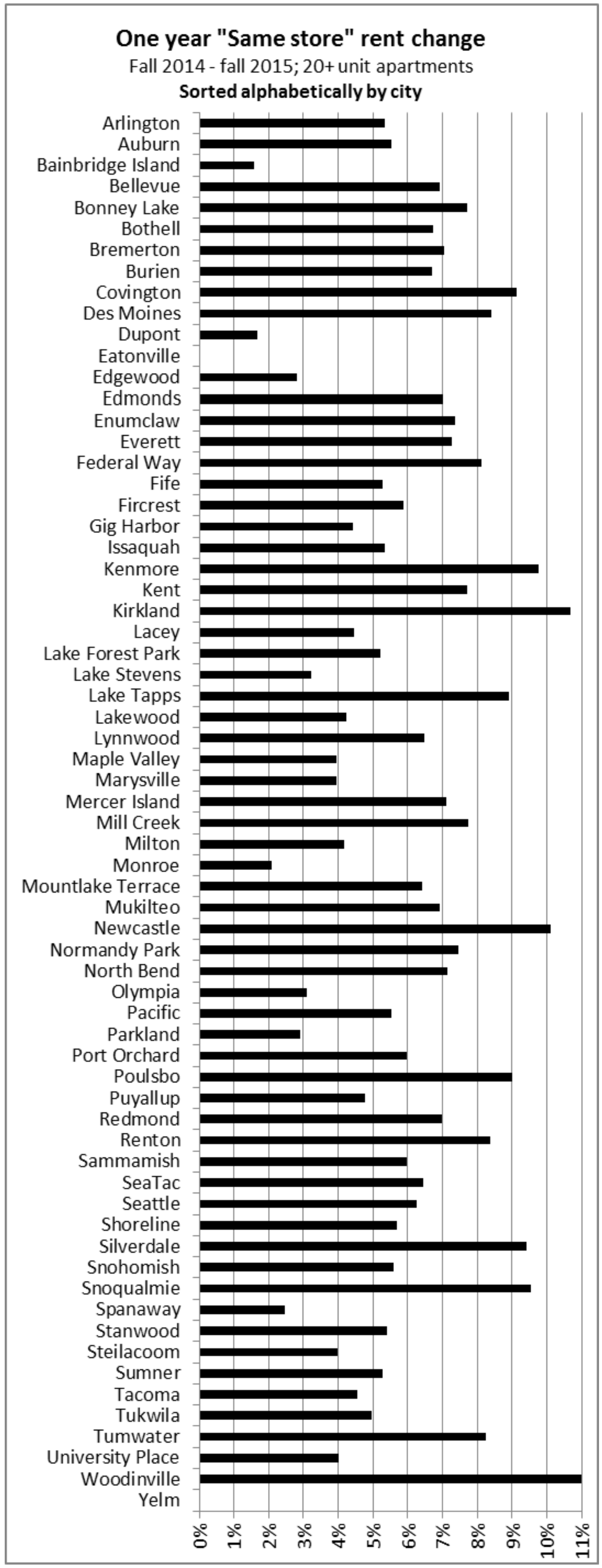
9%
10%
11%


One year "Same store" rent change
Fall 2014 - fall 2015; 20+ unit apartments
Sorted alphabetically by city
Arlington
Auburn
Bainbridge Island
Bellevue
Bonney Lake
Bothell
Bremerton
Burien
Covington
Des Moines
Dupont
Eatonville
Edgewood
Edmonds
Enumclaw
Everett
Federal Way
Fife
Fircrest
Gig Harbor
Issaquah
Kenmore
Kent
Kirkland
Lacey
Lake Forest Park
Lake Stevens
Lake Tapps
Lakewood
Lynnwood
Maple Valley
Marysville
Mercer Island
Mill Creek
Milton
Monroe
Mountlake Terrace
Mukilteo
Newcastle
Normandy Park
North Bend
Olympia
Pacific
Parkland
Port Orchard
Poulsbo
Puyallup
Redmond
Renton
Sammamish
SeaTac
Seattle
Shoreline
Silverdale
Snohomish
Snoqualmie
Spanaway
Stanwood
Steilacoom
Sumner
Tacoma
Tukwila
Tumwater
University Place
Woodinville
Yelm
0%
1%
2%
3%
4%
5%
6%
7%
8%
9%
10%
11%

saw their rents climb faster. Granted, we're still talking about some significant rent increases, but there are other factors to consider besides the skew of the new that will help put these increases in a better perspective.

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 4.2% 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. More about that later.

The rate of rent change is clearly variable. Out of 68 semiannual surveys, 28 of them found annual rent increases of 4% or less. However, 24 of them found rent increases of 6% or more.

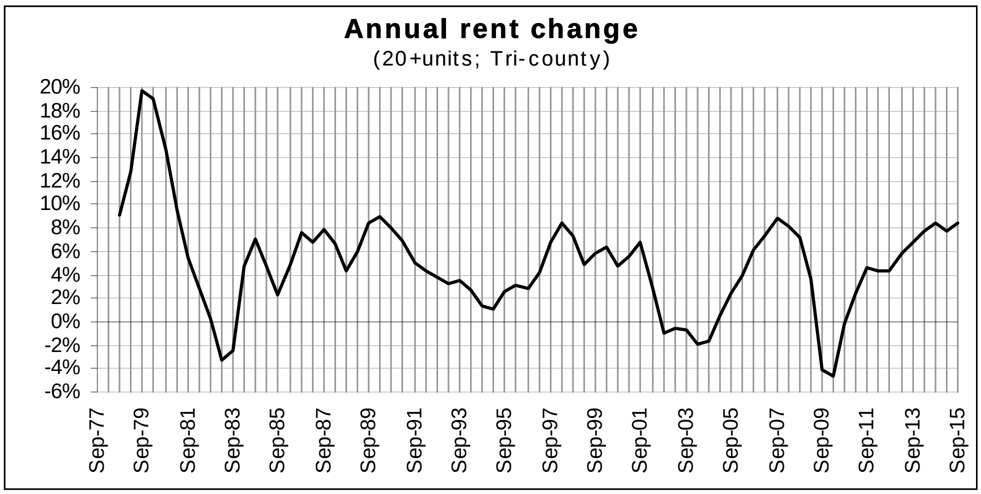
So, if you are relatively new to investing, managing apartments, or renting, it's easy to see how you can have a distorted view of market trends. You would have seen rents climb 4.4% from the fall of 2011 to the fall of 2012, then 6.8% the next year, then just over 8% in 2015 and again this year. It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

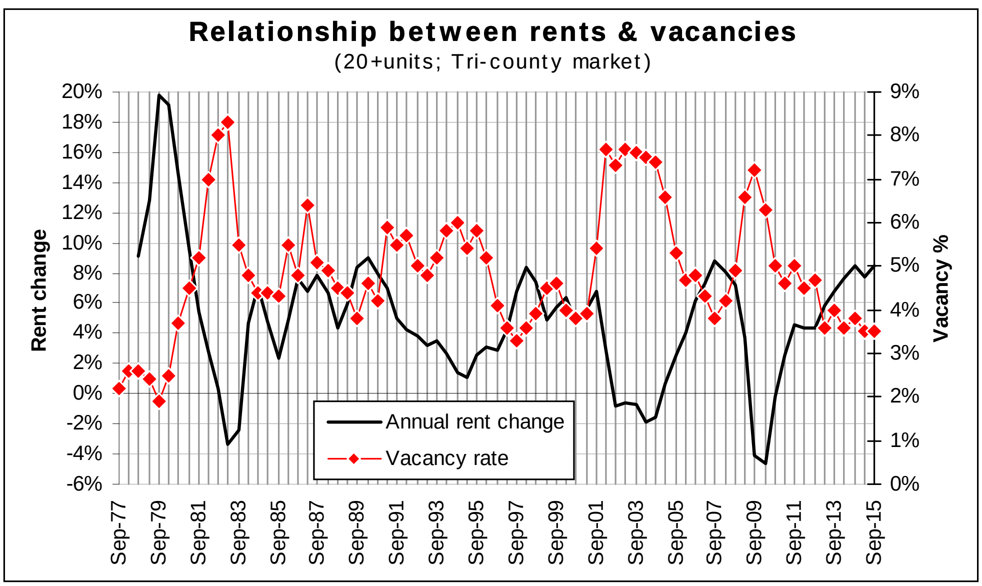
The *Relationship between rents & vacancies* chart shows that rents will climb faster when vacancies are low, like they have been recently. And rents will climb more slowly or even fall when vacancies are high. High or low vacancies are caused by an imbalance between supply and demand. If we have more supply than demand, either as a result of over-building or a 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 more than 30 years, it is clear 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.





Expenses and rents

Rents are cyclical but expenses aren't. That creates risks that are playing out in the market for investors today. Our annual *Apartment Expense Report* finds that between 2004 and 2014 collected apartment rent in the region went up 3.9% a year while total expenses rose 4.5% a year. It's never good when costs climb faster than revenue, and sooner or later it becomes unsustainable.

Why did that happen? Taxes and utilities combined went up 5.3% a year compounded annually. These two costs alone represent almost 45% of a property's total operating costs and there's no slowdown in sight, which will put pressure on rents sooner or later.

The *Taxes & utilities vs. income* chart below shows that while taxes and utility costs have doubled since 2000, rental income has increased just 40%. At some point you have to wonder how all the other bills will get paid, don't you?

Renovation

New construction isn't the only thing that distorts rent trends. Renovation does too, because it usually adds amenities and features found in newer properties. So, just like new construction, renovation also tends to skew rent trends.

We estimate that about 3,200 units were significantly renovated in the past twelve months. That's just 1.2% of the entire market. These units increased rents an average of 34% in the past year. But be careful. This is an apples-to-oranges rent comparison because these properties have more amenities or features now than they had a year ago.

It's kind of like reading all those really cool car reviews. The writer tells you the base price of the car being tested is $40,000. And the review sounds awesome. Then you read the small stats box at the end of the article and find out that the cost of the car "as driven" is really $55,000. It has more features.

Anyway, even though major renovation each year represents a relatively small group of properties, they have an impact on rent trends. So the average rent increase in the past 12 months of 8.3% dropped to 6.4% when we adjusted for the distortion of new construction. Now it drops to 5.9% when we adjust for the distortion created by renovation.

The "J. Wellington Wimpy Paradox"

We have talked about how rents sometimes go down. That's something to keep in mind when looking at recent rent increases. In some cases investors are raising rents significantly now because it is a strong rental market. But are those increases doing much more than simply making up for lost ground during the recession? Glad you asked. Let's see.

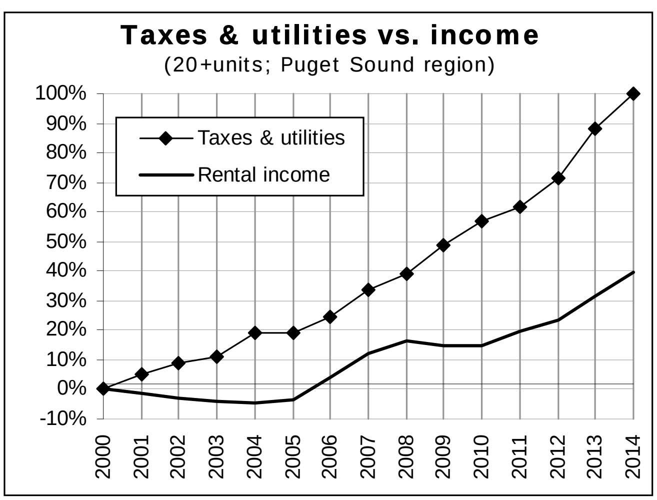
The *Actual rent vs. steady increase* chart below shows just one real world example. This isn't a cherry-picked case study. The trends at this property over the past seven years were common in our market. This example is a 100+ unit property on the Eastside that was built in 1989. It rented for an average of $1,159 a unit a month back in the fall of 2008. Then the recession hit and the manager ended up lowering rents for the next few years, bottoming out at $908 by the spring of 2011. After that, rents rose slowly until last fall. In the past 12 months rents increased 28.1%.

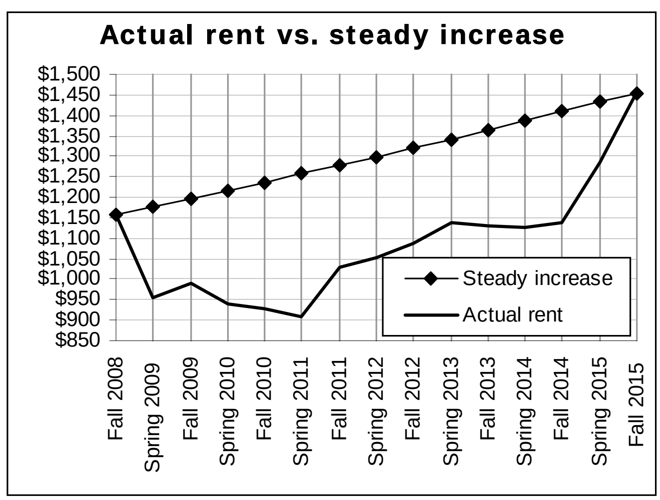
Yes, a 28% increase hurts. Especially when it happens in one year. After all, it was a $316 a month increase. That will strain anyone's budget if they weren't prepared for it.

But that's the only side of the story we hear about in the media. Once again, take a step back and look at the bigger picture. Even after the large increase in the past year, rents increased just 3.3% a year over the past seven years. Well that's just too boring for a headline, isn't it?

That's because 3.3% doesn't sound like a problem. But the problem for the renters is that the increase happened all at once. Even so, they each enjoyed $19,205 of lower rents over the past seven years compared to paying a 3.3% increases each year. That's a $19,205 windfall for each resident, even after a 28% rent increase in the past year. That $19,205 savings will cover the $316 a month rent increase for the next five years.

But here's the problem. Although the math shows that residents got a windfall that more than made up for the recent rent increase, and for a long time to come, these things never end well. That's because the *J. Wellington Wimpy Paradox* sets in. Wimpy was a character in the





Popeye comic strip. He often uttered the phrase, "I'll gladly pay you Tuesday for a hamburger today."

But, like the *Urban Dictionary* says, the phrase implies the underlying feeling that the person will unlikely actually pay for the hamburger on Tuesday or ever, for that matter. Well, in this real-world example, the $19,205 was the hamburger. And the 28% rent increase is the beginning of the payment for the burger. The $19,205 savings felt good. But the rent increase didn't.

Do rents increase over time?

The *Inflation-Adjusted King County Rents* graph shows how rents have risen and fallen over the past 40+ years, adjusted for inflation. The "all property ages" trend shows rents today are almost 45% 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 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 rents have just barely kept up with inflation over the past 40 years. Today they are about 15% higher than they were in 1969. That's a total, not an annual change. That 15% increase works out to one-third 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.

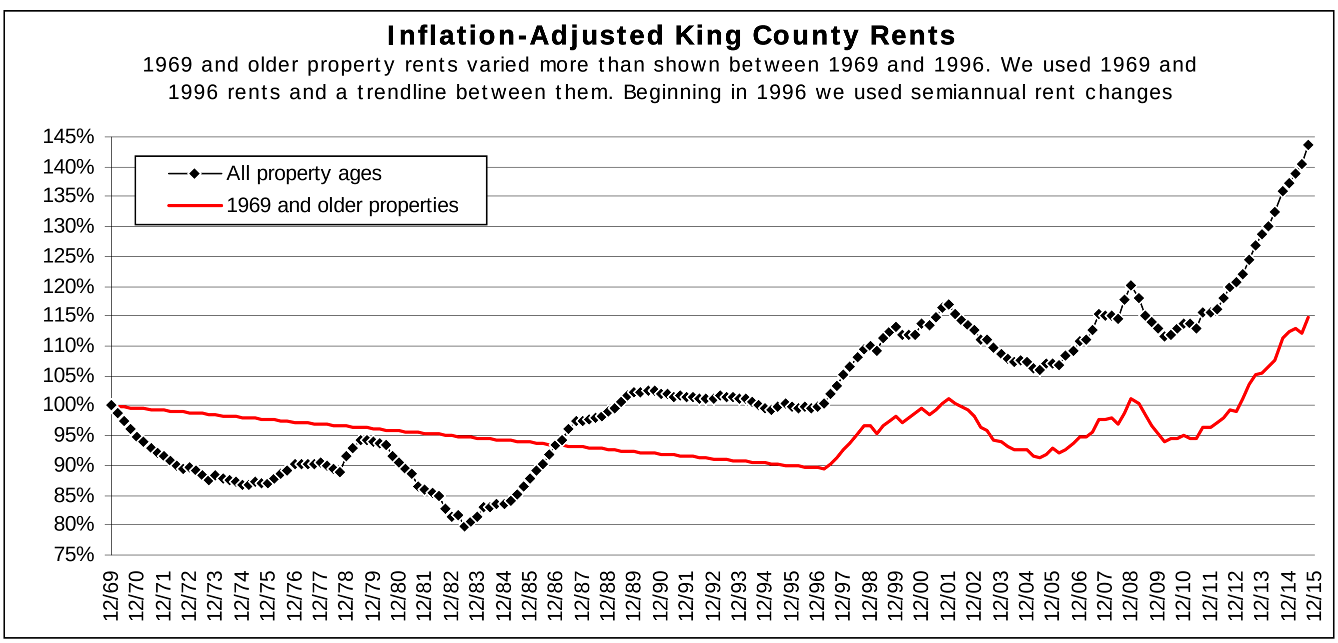
What this means is that, at least over the long term, investors should not expect rent increases to beat inflation. It also suggests that, when the time is right, upgrading older properties not only makes a lot of sense, it is essential. More about that later.

Rent distribution

There's a lot of talk about affordable housing. That's one thing the private market does well, up to a point. Just over half of all of the units in the Puget Sound region rent for less than $1,200. Two-thirds of all of the units rent for less than $1,400. 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 on the next page shows that there are few market rate units renting for less than $700. And a lot of those are studios. And the accompanying *Vacancy distribution by rent range* chart shows that these units don't have a lot of vacancies. Finally, the *Average rent by age of property* chart shows that new market rate construction can't boost the supply of those less expensive units.

So there clearly are housing market issues that we need to address as a community. The problem is we're going off on the wrong tangents, chasing all of those red herrings that have popped up in the past few years, wasting time, energy, money, and goodwill. Seriously, a little goodwill hunting right now would be a good thing.



New construction

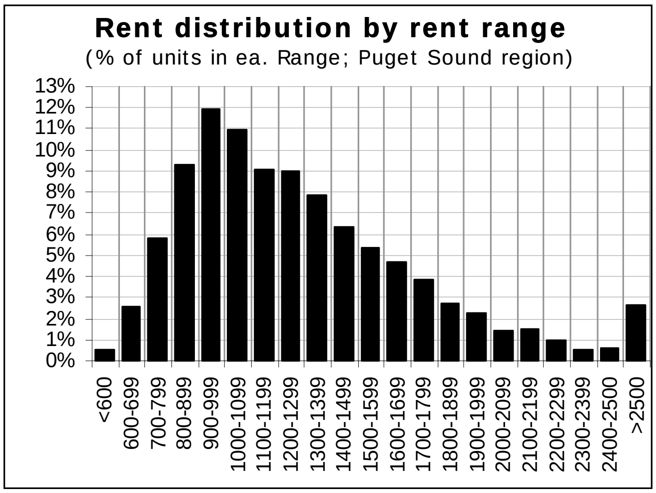
Developers opened almost 7,400 units last year in King, Pierce, and Snohomish counties. That's the highest level of production we have seen since 1991. And that's just the beginning. This year developers will open more than 11,000 units. A year ago we were expecting 14,500 units would open this year. The total dropped because some projects got pushed into 2016. Those delays have helped boost our 2016 forecast from 9,400 units we anticipated a year ago to 11,000 units currently.

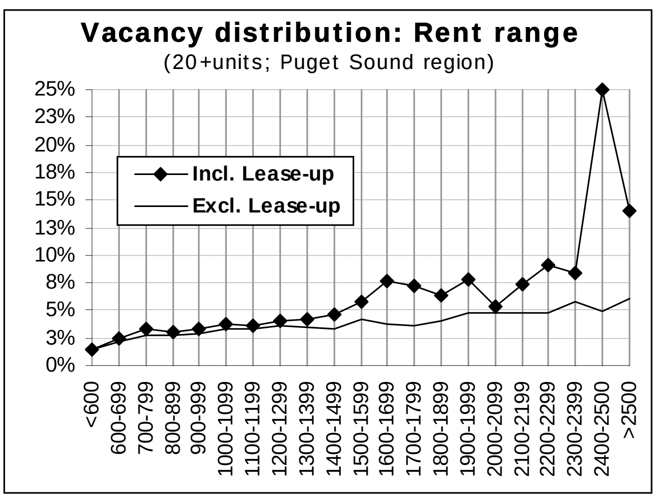
Will all of these new units actually happen? Well, there are two correct and contradictory answers to that question. The first answer is yes, because almost all of the units scheduled to open next year are already under construction.

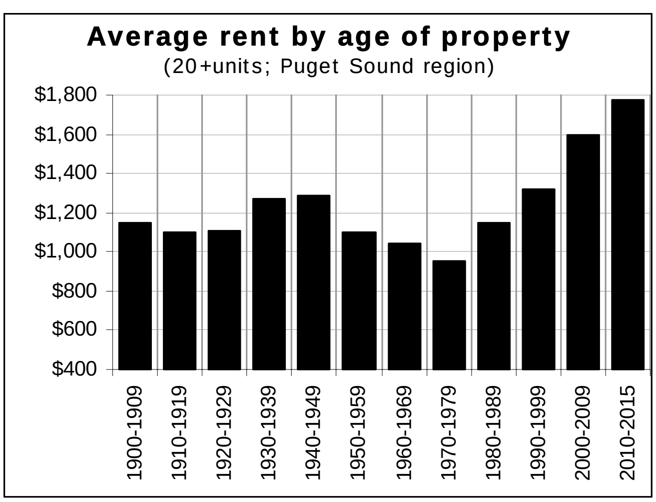
Things are different when you look beyond next year though. As the *Under construction/planned* chart below shows, a lot of the development scheduled for the next few years isn't under construction yet. Only one-third of the units scheduled to open in 2017 are under construction. And even fewer of 2019's production is underway. So the second answer is no. Construction delays will push some completion dates into future years.

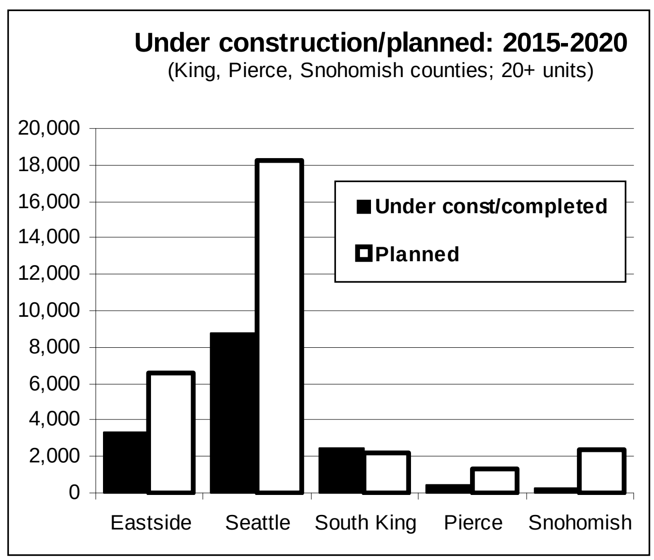
We are also tracking 124 sites that can accommodate at least 9,000 more units. These are sites developers own but haven't finalized plans for, or sites that are for sale now, or were in the past. We've seen some of this "on hold" product come to life in the past six to twelve months, and we expect to see more of that in the next six months.

The *Development forecast adjustments* table below shows how we have rearranged development activity. We cut completions between 2016 and 2019 expecting that some projects will either be delayed or shelved. Let's face it, although we are not currently tracking many projects that are planned to open in 2019, that's still a long way off. We will increase our estimates if the rental market holds up









Development forecast adjustments (units/year)

	Baseline	Adjusted	Discount
2015	11.541	11,646	0%
2016	11,085	10,810	2%
2017	15,259	11,334	25%
2018	15,093	9,310	38%
2019	2,957	1,558	47%

Baseline = Completion timing based on developer schedule well enough to keep new projects feasible.

Urban is hot again

It looks like 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 Seattle neighborhoods.

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.

It's all relative

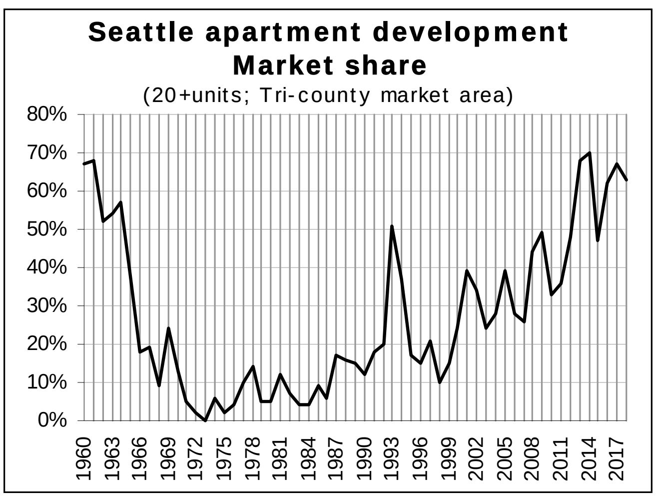
But comparing current and past development activity can be misleading. So here's another red herring to discard. Yes, it looks like we will match or beat the 1980s building boom. And development will be far greater than it was in the boom before that in the late 1960s. But our region is a lot larger now. The *Population & jobs* chart below shows there are about 2 million jobs in the Puget Sound region. In the late 1960s the region employed about 650,000 people. And population has doubled.

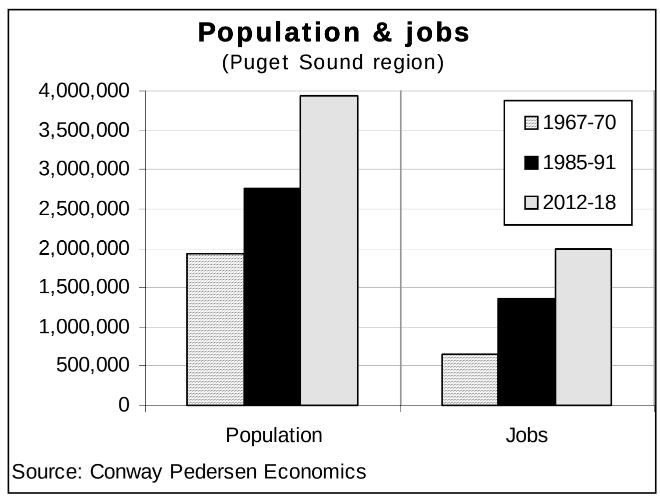
So it makes sense to look at construction activity adjusted for the economy over time. Here's an analogy. Is 50,000 new units really a lot? Well, it depends. In Sequim it would be an astoundingly high number. But in Shanghai you have to wonder if anybody would even notice.

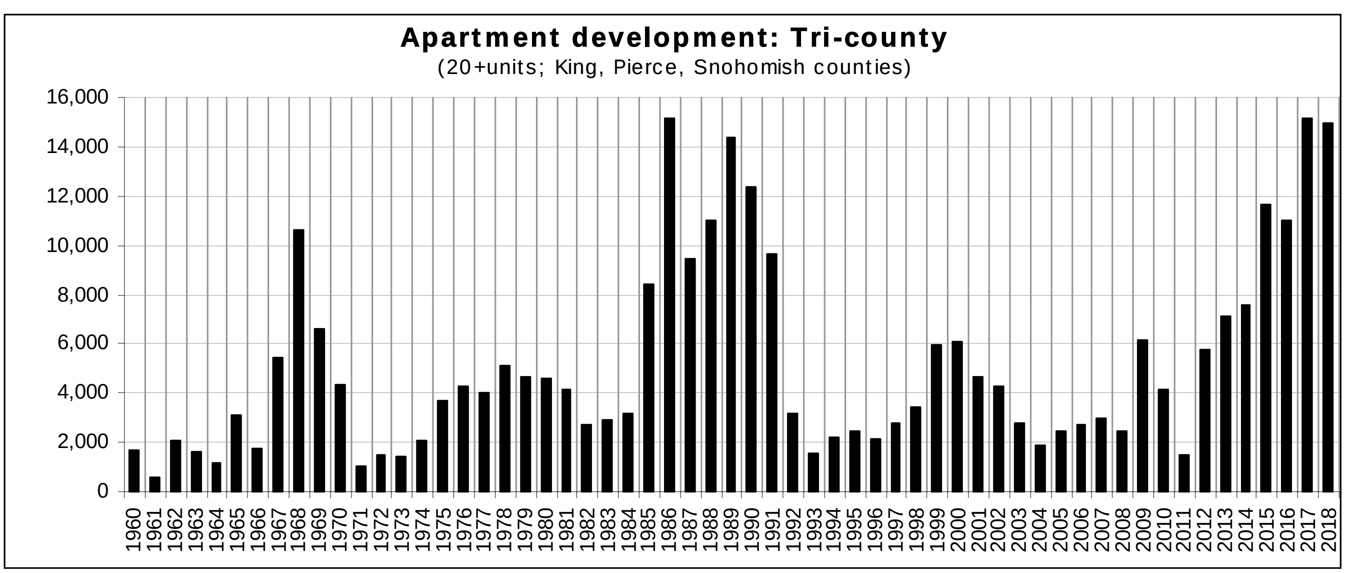
When you take changes in our economy into consideration, the *Building booms adjusted for size of the economy* chart on the next page shows that our current seven year boom from 2012-2018 will produce about as many units per job in the economy as developers created in the four year boom during the late 1960s. And we are adding a lot fewer units relative to jobs than developers built in the seven year boom in the late 1980s.

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. There

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 190,000 people in Washington turned in out of state driver licenses in the past 12 months. More than 110,000 of them are in the Puget Sound region. And the trend has been accelerating over the past few years. Two years ago an average of 8,000 people a month moved into the Puget Sound region. The *Monthly in-migration chart* below shows that it's closer to 9,400 a month now.

Even if half as many moved out, that still means there are 55,000 more people in the region lining up at Starbucks every morning than there were a year ago. That means we have added demand for 20,000 or more housing units in the past 12 months. Now don't go putting offers on more apartment sites based on that news.

Some of that demand, 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. In-migration was higher in all five counties last month compared to a year ago. But they need jobs to be able to afford housing, so let's take a look at that.

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. In the past 12 months our region added 60,100 jobs and the apartment market absorbed almost 8,400 units.

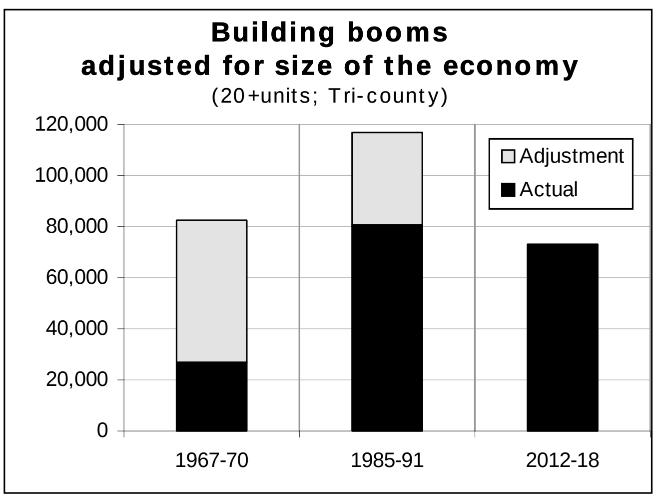
The latest *Puget Sound Economic Forecaster* by Conway Pedersen Economics, expects our region will add 132,000 jobs between the beginning of this month and the end of 2019.

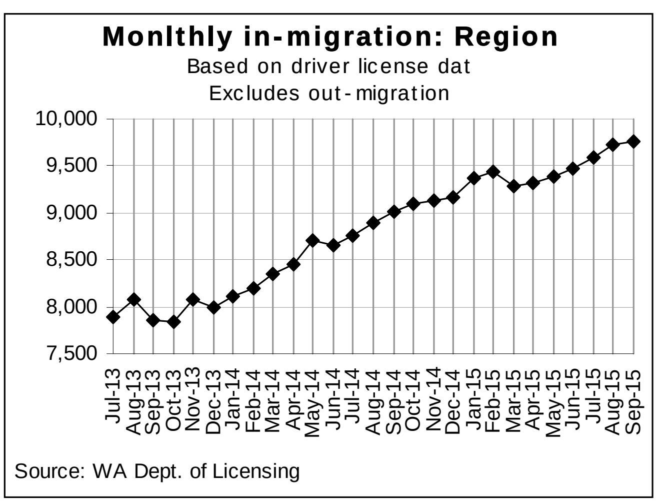
They publish a new forecast every quarter and have been increasing their total jobs forecast for 2015 through 2019 each time recently, as shown in the chart below. But their latest forecast puts all of that increase in 2015 and 2016. They have started lowering expectations for 2018 and 2019. The question is, will the market similarly lower its expectations?

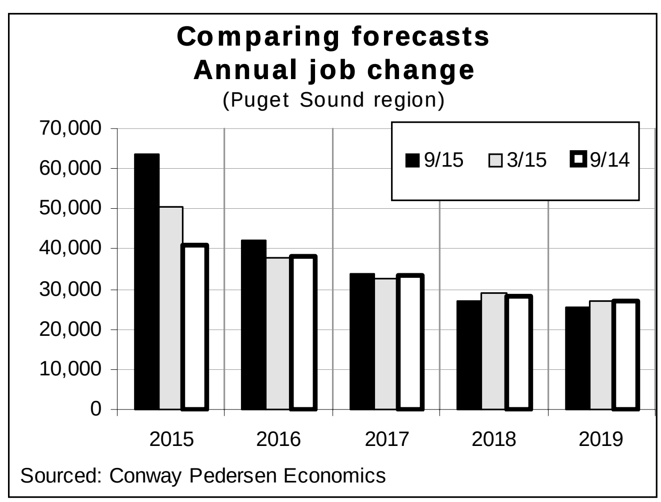
Anyway, our forecast anticipates demand for 32,900 units. That's largely due to the impact of millennials.

Supply forecast

Between now and the end of 2019, developers plan to open 49,000 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 won't 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 just over 37,000 units will actually open between now and the end of 2019.







Units in lease-up

There are currently almost 13,000 units in new projects that are in lease-up. That's a lot, but it is not unexpected when development activity is as strong as it has been lately. And that number will likely get larger next year. A large number of units in lease-up like we're seeing now is not automatically a problem, but it is something that investors should pay attention to.

Occupancy in lease-up

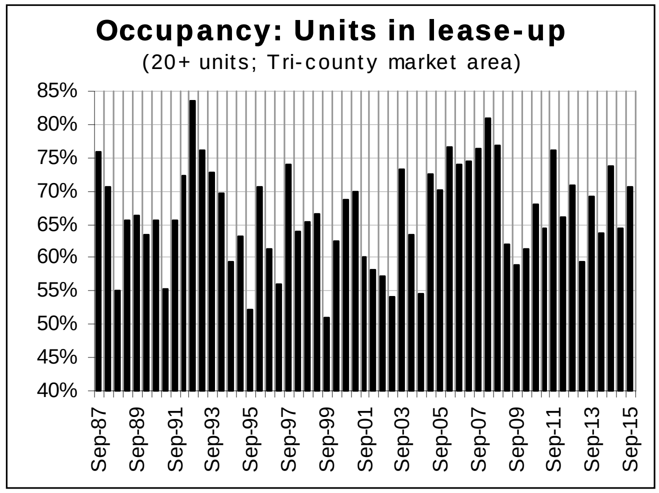
A more telling trend than tracking the number of units in lease-up is monitoring the occupancy rate in those units. Over the past 25 years it averaged 66.5%. Right now it is 70.7%, which is a very comfortable level. But it will be lower if a large number of new units start lease-up at the same time, which we expect to happen soon.

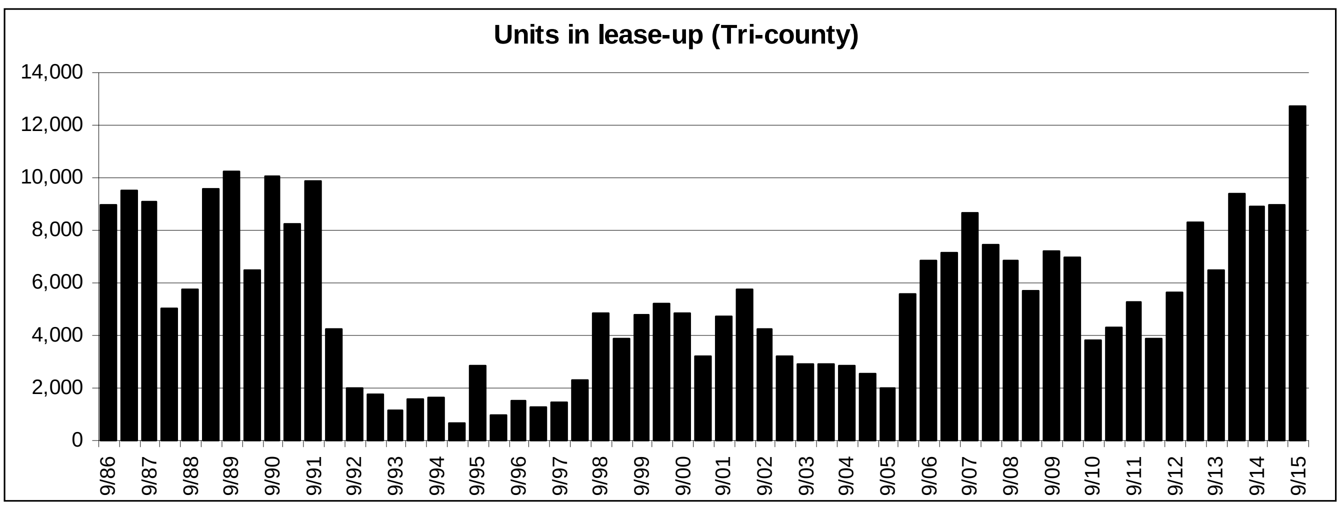
Vacancy rate forecast

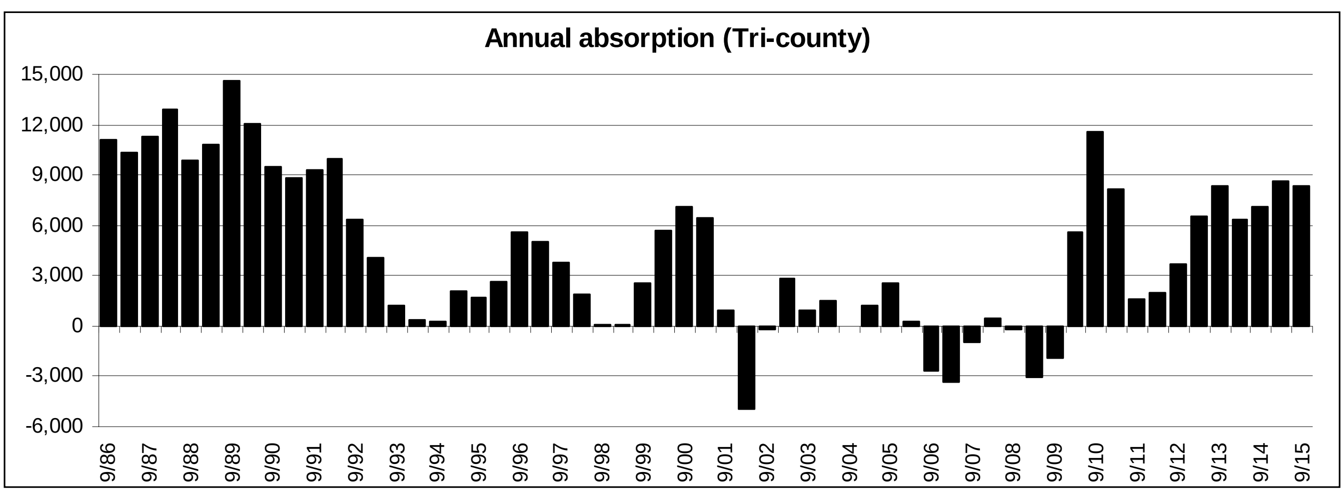
As a result of our supply and demand forecasts, we expect the market vacancy rate to increase moderately next year from 3.5% last month to 4.5% by the end of next year. Then it will edge up to 5.6% by December 2017 and peak at 6.7% by the fall of 2018. The gross vacancy rate will climb fairly steadily from 4.8% currently to a peak of 7.7% in late 2018. By comparison, Conway Pedersen's new forecast expects vacancies to stay below 5% through 2017. We like theirs better. Oh well.

Rent forecast

We expect rents will climb 4.4% between now and the end of 2016 and then slow considerably between 2017 and 2019. By the end of 2019 rents will be about 7% to 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. We expect concessions to climb steadily between now and late 2018. New developments in lease-up will use concessions aggressively. So much so that many existing properties will have to offer some concessions as well.

Net operating income forecast

Over the past three years, net operating income has gone up an average of 5.1% compounded annually. Last year it increased 3.4%. We expect net income to increase 3.5% next year. But with revenue growth deteriorating over the next couple of years, coupled with continued cost increases, we unfortunately expect it to fall a little more than 2% in 2017 and about 4% in 2018 before picking up again. The bottom line: between now and the end of 2019 net operating income should only increase about 5%.

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 5.1% 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.

As a result, we did not assume cap rates will fall further. So price increases become totally dependent on increasing net operating income. As a result, we expect prices will increase almost 7% between now and the spring of 2017. But, as a result of net operating income declines in 2017 and 2018, prices should fall back to their current level by late 2018 before accelerating again in 2019. That sounds extreme, especially given the fact that prices jumped 8.8% compounded annually over the past five years.

Sometimes prices fall. You probably don't put that in your spreadsheet analysis, but it is true. 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.

What if

There are so many things that can go wrong with our forecast. For example, some of the rental demand we expect in the forecast could vanish, either by switching to home ownership instead of renting, doubling up in the face of higher rents, or simply disappearing due to an unexpected weakening of the economy. If that happens, and developers still build everything we're forecasting, vacancy rates would increase. That would put downward pressure on rents, net operating income, and prices. But wouldn't these changes also slow development, which would soften the blow? That seems likely, but let's do a little sensitivity analysis to see what could happen.

We'll just look out to September 2018, when the gross vacancy rate peaks at 7.7%. Our forecast expects demand for 24,400 apartments between now and then. We also expect developers will open 34,900 units by then. That's why vacancies jump to 7.7%.

So what happens if only one-half of the demand shows up, either because half of the job growth in the forecast doesn't materialize or because some consumers switch to home ownership? Well, if developers just keep plugging away and build all 34,900 units that are scheduled to open, then the gross vacancy rate climbs to 11.8%.

Before you reach for the defibrillator, not only is that scenario scary, it just doesn't make sense. If vacancy rates were to move up that much surely some developers, their lenders, or their investors would get cold feet. We would expect them to delay or shut down at least some of the projects that are planned. So let's make an adjustment to the scenario.

Although we expect that developers will open 34,900 units over the next three years, only 19,300 units are under construction now. Let's assume they all get completed on schedule and none of them get shut down. That leaves 15,600 units that are planned to open by September 2018 but have not started construction yet. It is reasonable, given the demand scenario above, to expect a lot of them to disappear or at least get delayed. Let's say only half of them get built, or at least get built by September 2018. In that case, the gross vacancy rate peaks at 9.1%.

That's still not a number any sane investor wants to hear. We could cut the planned development even more, but some of it will happen if only because it gets underway before vacancies soar. It is also possible that some of the projects under construction simply stop. That actually happened in the last downturn. It would be reasonable to expect that again.

Of course, there's also a variety of positive scenarios we could play with. Our region is attracting a lot of jobs and a lot of people. Conway Pedersen Economics has been increasing their jobs forecast every quarter for the past four quarters. We've been a desirable place to live and work for a long time. But now everyone knows that, not just us locals. All the recent development and job growth is changing our community, making it more vibrant than ever before. So, while testing some negative scenarios makes sense, play with some positive ones too. D+S

Forecasts

These graphs show our forecasts for apartment market trends in the Puget Sound region based on the market, investment, and economic trends discussed in this issue of *The Apartment Advisor*. We update these forecasts in *The Apartment Advisor* each April, October, and December.