

# ApartmentResearch

M A R K E T U P D A T E

Marcus & Millichap

Cleveland Metro Area

Third Quarter 2010

## FASTEST HIRING SINCE 1980s TO JUMP-START APARTMENT MARKET

Cleveland employers ignited hiring efforts during the first half of the year, accelerating the recovery of the local apartment market. Metro employers created 18,000 jobs in that time, the most significant two-quarter gain since 1987. Further, three of the five sectors that posted a negative net change in payrolls between year-end 2009 and mid-2010 added workers during the second quarter, suggesting the start of a recovery in these industries. The manufacturing sector accounts for a significant number of the jobs generated thus far in 2010, though rapid and sustained growth will not persist in the second half. Nonetheless, apartment fundamentals will continue to strengthen metrowide. On the west side, where residential expansion stalled during the recession, operators have recorded measurable improvements in Class A operations so far this year. Revenues in submarkets within this area, including Lakewood/Brooklyn, Parma/Independence and North Olmsted, will track higher over the second half of 2010 as occupancy gains support rent increases. Additionally, the slowdown in construction activity expected over the next several quarters will limit competition among Class A owners for tenants.

As the local economy improves, buyer interest will build for nondistressed assets. Sales of operationally challenged properties persists, though investors have given greater attention to newer, stabilized assets. As a result, acquisition activity has shifted from older, more affordable areas, such as East Cleveland and Garfield Heights, to more recent builds in the Lakewood and North Olmsted submarkets. While deal flow will remain low in these areas, velocity will likely tick higher in the top tier as cap rates in the segment fail to ascend to the levels owners once anticipated. Currently, initial yields for Class A assets average near 7.5 percent, within 80 basis points of the lows recorded in recent years.

## 2010 ANNUAL APARTMENT FORECAST



**Employment:** Only modest hiring during the second half of the year will limit total employment growth in 2010 to 21,000 jobs, or a gain of 2.1 percent. Last year, 53,300 workers were let go in the metro.



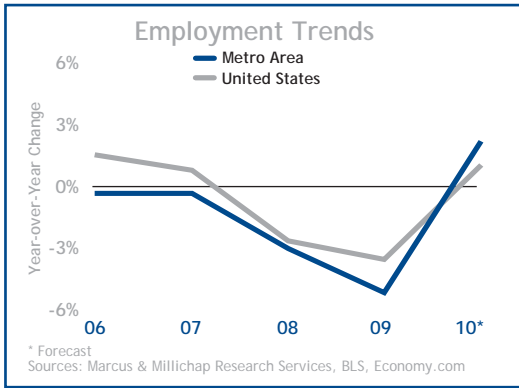
**Construction:** Supply growth will reach 236 units this year, after builders brought online 56 units in 2009. As the local population continued to dwindle over the past five years, apartment inventory only expanded by 1.7 percent.



**Vacancy:** Limited construction activity, along with an uptick in employment, will push down the marketwide vacancy rate 20 basis points to 6.6 percent in 2010. Last year, vacancy rose 70 basis points.

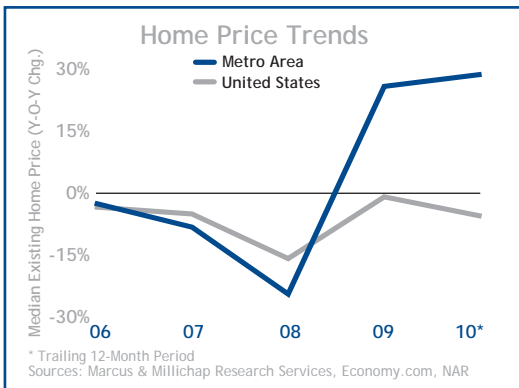


**Rents:** Asking rents will increase 1.3 percent this year to \$724 per month, while effective rents will expand 1.2 percent to \$687 per month. In 2009, asking rents fell 3.2 percent, and effective rents slid 3.7 percent.



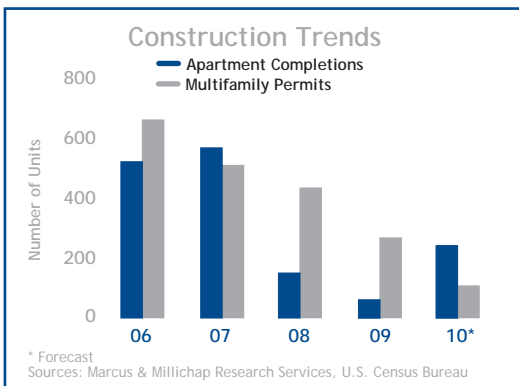
## ECONOMY

- ◆ Cleveland employers expanded payrolls rapidly during the first half, adding 18,000 jobs for growth of 1.8 percent. While this marked the largest six-month increase to employment levels in more than 20 years, the gains represent only a fraction of the 84,400 positions cut through the recession.
- ◆ Hiring has been most robust in the manufacturing and professional and business services sectors, which have added a total of 11,100 positions year to date, or a 4.6 percent payroll increase. Just five of the metro's 11 employment sectors recorded a net job loss between year-end 2009 and mid-2010, and no segment shed more than 900 jobs during that stretch.
- ◆ After peaking at 9.5 percent in the second half of 2009, the local unemployment rate declined 50 basis points during the first half of this year to 9 percent. The jobless rate averaged 5.7 percent in the three years preceding the recession.
- ◆ **Outlook:** Only modest hiring during the second half of the year will limit total employment growth in 2010 to 21,000 jobs, or a gain of 2.1 percent. Last year, 53,300 workers were let go in the metro.



## HOUSING AND DEMOGRAPHICS

- ◆ After bottoming in the third quarter of 2009 at 1,790 units, single-family permitting climbed to 2,020 units in the second quarter. Builders' cautious short- to mid-term outlook for multifamily demand resulted in a 59 percent decrease year over year to just 175 units.
- ◆ Supported by early year payroll growth, home prices have begun to rebound in Cleveland, as the median price of an existing single-family home has appreciated 6 percent year to date to \$124,290. Expiration of the first-time homebuyer tax credit, though, will slow sales going forward, putting pressure on home prices.
- ◆ The median household income of \$47,000 annually is currently 56 percent greater than the income necessary to qualify for a mortgage for a median-priced home, using traditional financing.
- ◆ **Outlook:** Though home affordability could lure some renters into homeownership, projected growth in the key renter age group of 30- to 34-year-olds will total 5.2 percent through 2015, helping support Class A renter demand.

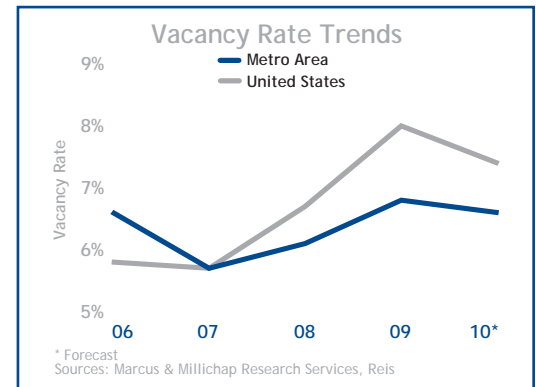


## CONSTRUCTION

- ◆ Developers added more than 290 rental units to Cleveland inventory over the past 12 months, after no new units came online in the preceding year. Since 2000, supply growth averaged just 0.4 percent annually.
- ◆ The 400 units under way in the neighboring Medina County market will boost competition for tenants in the Strongsville/Berea/Brook Park submarket.
- ◆ Only 300 apartment units are proposed for the local market, indicating minimal supply threats over the next few years.
- ◆ **Outlook:** Apartment inventory growth will reach 236 units this year, after builders brought online 56 units in 2009.

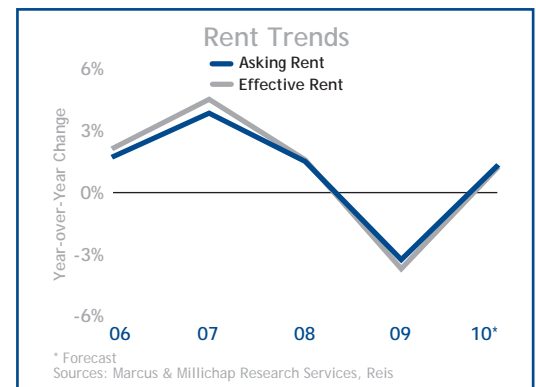
## VACANCY

- ◆ After renters doubled up in previous quarters due to economic woes, the summer rental season released pent-up demand, driving down the market-wide vacancy rate 30 basis points to 6.7 percent during the second quarter. In the first three months of the year, vacancy increased 20 basis points.
- ◆ Strengthening Class A demand underpinned an 80 basis point year-over-year improvement in the top-tier vacancy rate to 6.4 percent, identical to the vacancy rise recorded during the previous 12-month period.
- ◆ The average vacancy rate at lower-tier properties has fallen 10 basis points so far in 2010 to 6.9 percent, following a 50 basis points increase during the second half of 2009.
- ◆ **Outlook:** Limited construction activity, along with an uptick in employment, will push down the marketwide vacancy rate 20 basis points to 6.6 percent in 2010. Last year, vacancy rose 70 basis points.



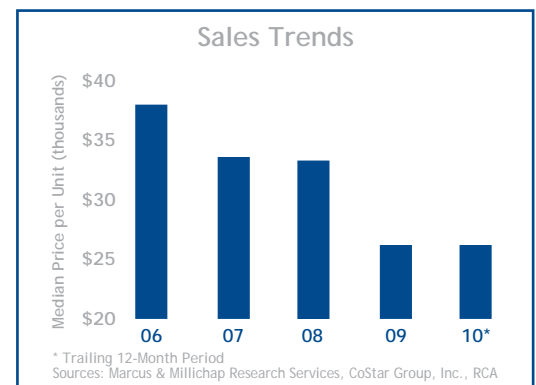
## RENTS

- ◆ Falling vacancy rates have encouraged owners to increase asking rents 1 percent to \$722 per month so far this year, while effective rents have advanced 0.9 percent to \$685 per month. In the prior six-month stretch, asking and effective rents retreated 1.4 percent and 1.5 percent, respectively.
- ◆ At Class A apartment properties, asking rents ascended 1.4 percent over the past two quarters to \$902 per month, while Class B/C asking rents appreciated 0.4 percent to \$649 per month. Persistent delinquencies, particularly among Class C operations, have kept owners from raising rents at a quicker pace.
- ◆ Concessions have been relatively stable over the past year, increasing 10 basis points to 5.1 percent of asking rents. Leasing incentives are also only 10 basis points above pre-recession levels.
- ◆ **Outlook:** Asking rents will increase 1.3 percent this year to \$724 per month, while effective rents will expand 1.2 percent to \$687 per month. In 2009, asking rents fell 3.2 percent, and effective rents slid 3.7 percent.



## SALES TRENDS\*\*

- ◆ Although regional banks remain eager to finance deals for stabilized assets, stricter underwriting criteria, coupled with greater buyer interest in distressed properties, caused deal flow to fall 56 percent during the past year. The number of sales had increased 14 percent in the prior 12 months.
- ◆ To compensate for rent and revenue declines, sellers discounted prices in the last year, forcing down the median 13 percent to \$26,135 per unit. In the previous 12-month period, the median price decreased 10 percent.
- ◆ Cap rates average in the low-8 percent range, although initial yields for 1960s-vintage product can range between 8.25 percent and 9.5 percent.
- ◆ **Outlook:** Renters continue to balk at metro-high Class A rents in the Beachwood area, driving solid occupancy and rent gains at more affordable Class B complexes within the submarket. Consequently, cap rates for these properties will likely remain unchanged around 8 percent during the second half of 2010.



\*\* Data reflect a full 12-month period, calculated on a trailing 12-month basis by quarter.

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## CAPITAL MARKETS

By WILLIAM E. HUGHES, SENIOR VICE PRESIDENT, MARCUS & MILLICHAP CAPITAL CORPORATION

- ◆ Mixed economic indicators, stock market volatility and concerns surrounding the European debt crisis continue to drive investors to safety. As a result, the yield on the 10-year U.S. Treasury has declined since peaking at 4 percent in April; as of late July, the yield had fallen to 3 percent.
- ◆ Capital markets loosened over the past year, with life insurance companies ramping up lending and CMBS showing renewed signs of life. Nonetheless, the agencies remain the dominant sources of multifamily lending. This trend will continue through 2010 as the GSEs' multifamily portfolios outperform their residential mortgage operations, reducing the likelihood of drastic government-mandated changes to their apartment lending arms.
- ◆ Multifamily loan originations increased 37 percent in the second quarter but remained below levels reported during the same period last year. Fannie Mae and Freddie Mac's origination volume followed a similar pattern, rising in the second quarter but falling short of year-earlier levels.
- ◆ Loan-to-values range from 60 percent to 75 percent for portfolio lenders and push up to around 80 percent for best-of-class, agency-financed deals. All-in rates for five-year agency loans fall into the low-4 percent range, while 10-year loans price between 4.75 percent and 5.15 percent. While life companies will compete at these levels for best-of-class deals, most portfolio lenders are 100 basis points to 225 basis points higher.

## SUBMARKET OVERVIEW

- ◆ Plans to expand the Parmatown Mall were recently approved by city officials as part of local revitalization efforts. Construction on the project and eventual retail operations at the site will create hundreds of jobs, boosting multifamily demand in the Parma/Independence submarket.
- ◆ The outlying location of the North Royalton/Brecksville submarket, along with its older supply of apartment stock, caused area owners to expand renter incentives 60 basis points in the past year to 9.5 of asking rents, far above the metro average of 5.3 percent of asking rents.
- ◆ An average vacancy rate well below the market average has allowed operators in the Strongsville/Berea/Brook Park submarket to rescind concessions and boost revenues. So far this year, average revenues have climbed 0.9 percent, after rising by the same measure during the second half of 2009.

## SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Strongsville/Berea/Brook Park	4.5%	-20	\$630	1.6%
2	Beachwood	4.9%	110	\$1,069	-2.3%
3	Lyndhurst/Richmond Heights	5.4%	-70	\$704	0.3%
4	Lakewood/Linndale/Brooklyn	6.0%	-10	\$611	-1.5%
5	Lake County	6.1%	-70	\$689	0.4%
6	North Olmsted/Fairview Park	6.9%	-210	\$660	-0.2%
7	Parma/Independence	7.2%	50	\$638	-2.4%
8	East Cleveland/Cleveland Heights	8.0%	10	\$642	0.9%
9	North Royalton/Brecksville	8.2%	-60	\$648	-2.4%
10	Downtown/Warehouse District	12.2%	350	\$997	-0.8%