Job Cuts Softening Renter Demand; Vacancy on the Rise

Following several years of nation-leading employment growth, payrolls are contracting in the Houston metro, softening demand for apartments. While oil prices have rebounded from recent lows, employers have yet to reverse course and begin hiring again, although modest payroll expansion is possible by the end of this year. The local employment outlook brightens when viewed with a long-term perspective. The planned expansion of the Texas Medical Center is expected to create thousands of new jobs over the coming years, which will result in increased renter demand over the extended term. On the supply side 12,800 units will be completed in 2009 which will drive vacancy higher in the coming quarters. The average vacancy rate in properties built in the past 10 years is 250 basis points higher than the metrowide average, and that disparity should expand as new units are delivered in the coming quarters. As vacancy rises and job losses persist, owners will be pressured to offer greater concessions to retain renters.

The expectations gap between buyers and sellers remains quite wide, a trend that is restricting investment activity. Out-of-state investors were active in the market from 2005 to 2007, and some properties that were aggressively underwritten during that time are now becoming distressed as fundamentals weaken. As a result, buyers are seeking deeply discounted assets, and the market for operationally sound properties is soft. Rather than list properties amid the uncertainty that is prevalent in the current market, many owners are choosing to attempt to ride out the downturn. Cap rates vary considerably by age and location. Newer Class A assets generally trade between 7.5 percent and 8.0 percent, while initial yields in Class B properties are typically in the mid-8 percent to low-9 percent range. Older Class C assets feature average cap rates in the 9 percent to 10 percent range, and there are wide pricing disparities for properties in distress. In the coming quarters, investors with long-term strategies will likely target complexes in the Inner Loop, where new supply is prevalent but renter demand is expected to be strongest going forward.

2009 Annual Apartment Forecast

3.1% decrease in total employment

Employment: Job losses should ease in the third quarter, and employers will likely make modest additions to payrolls late in the year. On the whole, metrowide employment is forecast to contract by 3.1 percent, or 80,000 jobs, in 2009.

12,800 units will be completed

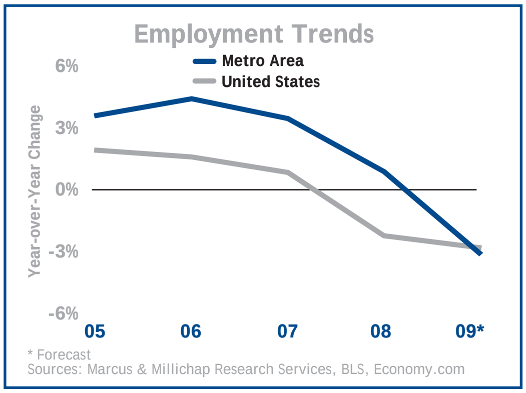
Construction: In 2009, 12,800 apartments will come online, nearly identical to last year's total. An average of 9,000 units have been completed annually over the past five years.

200 basis point increase in vacancy

Vacancy: Metrowide vacancy is expected to rise 200 basis points to 12.1 percent in 2009 as job reductions weigh on demand and robust construction outpaces household formation. Last year, vacancy pushed up 130 basis points.

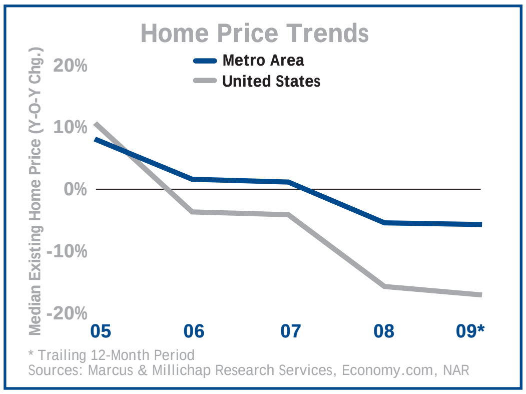
0.3% decrease in asking rents

Rents: As renter demand eases and competition from new stock intensifies, owners will trim rents modestly. Asking rents are forecast to dip 0.3 percent to $767 per month, while effective rents will contract 2.4 percent to $698 per month.



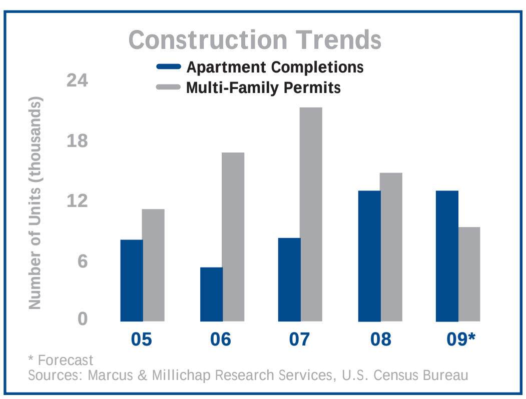
Economy

- In the past 12 months, employers in Houston have cut payrolls by 2.7 percent, eliminating 69,200 jobs. All of the layoffs occurred in the past two quarters; losses total 69,400 workers year to date.
- The manufacturing sector, which steadily added jobs through 2008, has been a considerable source of economic contraction so far this year. During the first half of 2009, 15,200 manufacturing positions were trimmed, a 6.2 percent decline.
- Following several years of robust growth, employment in Houston is clearly weakening. In June, the local unemployment rate increased 110 basis points from May to 8 percent. One year ago, unemployment was just 5 percent.
- **Outlook:** Job losses should ease in the third quarter, and employers will likely make modest additions to payrolls late in the year. On the whole, metrowide employment is forecast to contract by 3.1 percent, or 80,000 jobs, in 2009.



Housing and Demographics

- Permitting activity has slowed in response to weaker economic conditions. During the past 12 months, 19,100 single-family housing permits have been pulled, a 39 percent decline. The drop-off in multi-family permit issuance is more considerable; developers have been issued 9,500 permits in the last year, a reduction of 50 percent.
- The Houston area has been largely immune to the housing downturn. The median home price dipped just 5.7 percent year over year to an estimated $142,800 in the second quarter.
- The median household income of $54,100 annually is $14,200 more than the amount required to afford a median-priced home, using traditional financing. Affordability is increasing; one year ago, the surplus was $9,300.
- **Outlook:** While the monthly mortgage payment on a median-priced home is approximately $50 less than the average Class A asking rent, uncertainty in the job market will encourage residents to choose rental housing.



Construction

- Builders have completed 14,300 units in the past year, increasing area stock by 3.1 percent. Approximately 6,800 units were delivered in the first half of 2009, including 4,600 units in the second quarter.
- Roughly 8,600 rentals are under construction, nearly all of which are expected to be completed by year end. An additional 8,000 units are planned, although softening fundamentals could cause some projects to be delayed until conditions begin to firm.
- Projects totaling approximately 3,300 units are under construction in the Montrose/River Oaks submarket. The new units will represent a 10 percent increase to the area's apartment inventory.
- **Outlook:** In 2009, 12,800 apartments will come online, nearly identical to last year's total. An average of 9,000 units have been completed annually over the past five years.

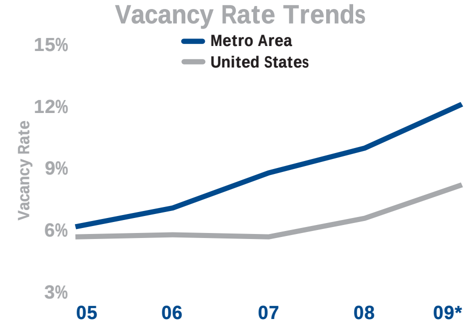
Vacancy

- During the past 12 months, metrowide vacancy has increased 180 basis points to 11.3 percent. Vacancy rose 120 basis points in the first half of 2009 amid continued additions to inventory and employment reductions.

- Class A vacancy has increased 230 basis points year over year to 11.2 percent and will push higher in the coming months as new inventory is delivered. In the lower tiers, vacancy has pushed up 140 basis points year over year to 11.4 percent.

- While vacancy has been rising throughout much of the metro, modest construction and healthy absorption have resulted in a 110 basis point decline in vacancy in the Sugar Land/Fort Bend County submarket over the past 12 months. Vacancy in the area could edge higher in the coming months, however, as 820 units are expected to come online.

- **Outlook:** Metrowide vacancy is forecast to increase 200 basis points to 12.1 percent in 2009 as job cuts weigh on demand and robust construction outpaces household formation. Last year, vacancy rose 130 basis points.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

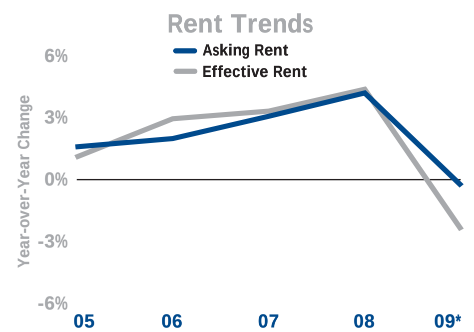
Rents

- Asking rents have increased 2 percent year over year to $771 per month, while effective rents have ticked up 1.6 percent to $713 per month. Year to date, however, rents have been essentially flat, as asking rents have advanced 0.3 percent, and effective rents have dropped 0.1 percent.

- The delivery of new, expensive space has driven up asking rents in the top tier 2.5 percent in the past year to $960 per month. In the Class B/C segment, asking rents have risen 1.4 percent in that time to $633 per month.

- The Bellaire/West University submarket has posted some of the metro's healthiest rent improvements over the last 12 months, with asking and effective rents gaining 5.2 percent and 4.2 percent, respectively.

- **Outlook:** As renter demand eases and competition from new stock intensifies, owners will trim rents modestly. Asking rents are forecast to dip 0.3 percent to $767 per month, while effective rents will contract 2.4 percent to $698 per month.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

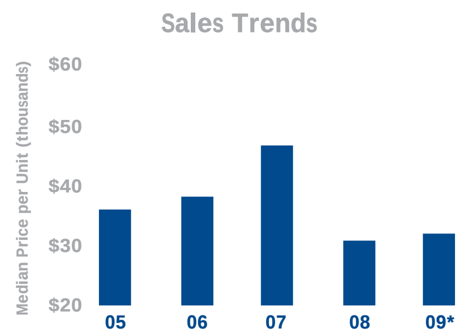
Sales Trends**

- Transaction velocity has fallen 31 percent in the past 12 months from the same period, one year ago. The decline was more significant through the first half of 2009, as investment activity was down 55 percent compared to the first six months of last year.

- While there is a wide pricing disparity between distressed and stabilized properties, the median price for all closed transactions in the past 12 months has declined 3 percent to $31,300 per unit.

- Average cap rates in deals closed so far in 2009 are in the mid-8 percent range, up 100 basis points to 150 basis points from one year ago.

- **Outlook:** Buyers are increasingly targeting distressed deals and deeply discounted pricing. As a result, most owners of stabilized assets are not expected to list properties before market-level prices reach a bottom.



* Trailing 12-Month Period
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., RCA

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

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National Multi Housing Group
Tel: (678) 808-2700
lthompson@marcusmillichap.com

Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- During the first quarter, multi-family mortgage originations were 61 percent below year-earlier levels and 79 percent lower than the late-2006 peak. Though considerable, the reduction in apartment originations remains less significant than declines among other core commercial property types, due largely to the availability of financing through Fannie Mae and Freddie Mac.

- Portfolio lenders are issuing apartment financing at all-in rates of 6.0 percent to 6.3 percent for three-year loans and up to 6.8 percent to 7.5 percent for a 10-year term. Loan-to-value requirements range from 55 percent to 75 percent.

- Agency lenders are offering five-year loans at all-in rates of 4.8 percent to 5.0 percent with 10-year mortgages available at rates averaging 5.35 percent and 5.7 percent, respectively. Maximum leverage among agency lenders ranges from 55 percent to 75 percent.

- Freddie Mac recently completed a $1 billion securitization of multi-family debt, the first issuance to hit the market since last June. The securities, dubbed "K Certificates," vary from traditional CMBS in that buyers are provided a guarantee by Freddie Mac. In addition to the potential for another similar offering, government programs designed to increase credit flows into commercial real estate could be operational by late summer/early fall.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Westchase/Woodlake	7.4%	70	$794	0.6%
2	Montrose/River Oaks	8.0%	60	$1,090	-1.4%
3	Sugar Land/Fort Bend County	8.0%	-110	$877	1.6%
4	Bellaire/West University	9.1%	350	$973	4.2%
5	Spring Branch	9.3%	70	$636	0.0%
6	Katy/Bear Creek	9.5%	-110	$771	0.9%
7	Sharpstown	9.9%	90	$564	2.9%
8	North Loop East/Sheldon	10.5%	60	$630	5.0%
9	Pasadena/Deer Park	10.5%	50	$584	0.9%
10	Clear Lake	11.0%	290	$749	1.2%
11	Energy Corridor	11.2%	170	$759	0.9%
12	Medical Center/Museum District	11.6%	250	$635	1.0%
13	Alief	12.0%	60	$585	4.5%
14	Inwood/Northwest Houston	12.1%	80	$593	1.5%
15	San Jacinto/Galena Park	12.5%	110	$565	-0.7%
16	Braeswood/Meyerland	12.7%	-40	$557	-0.4%
17	Baytown	12.8%	-70	$556	4.5%
18	Cypress/Fairbanks	13.6%	400	$792	4.5%
19	Kingwood/Lake Houston	14.5%	520	$729	-0.3%
20	North Houston	14.6%	330	$527	2.3%
21	Montgomery County	15.0%	510	$761	3.0%

Marcus & Millichap
Real Estate Investment Services

Prepared and edited by
Peter O'Neil
Senior Market Analyst
Research Services

For information on national apartment trends, contact
John Chang
National Research Manager
Tel: (602) 687-6700 ext. 6803
john.chang@marcusmillichap.com

Houston Office:
Brent Smith
Regional Manager
brent.smith@marcusmillichap.com
777 Post Oak Boulevard
Suite 900
Houston, Texas 77056

Tel: (713) 452-4200
Fax: (713) 452-4210

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