

ApartmentResearch

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

Marcus & Millichap

Orange County

Third Quarter 2009

VACANCY RISING AS DELIVERIES ACCELERATE, JOB LOSSES MOUNT

Persistent job losses and elevated completions will weigh on the Orange County apartment market in the second half of this year and likely into the early part of 2010. Countywide payrolls have contracted by nearly 7 percent since the recent peak, or by more than 100,000 jobs, suppressing apartment absorption. While renter demand is softening as employers trim staffing levels, new supply had been relatively restrained until recently. Deliveries during the first half of 2009, however, nearly matched the number of units completed in all of last year, increasing the supply/demand imbalance and pushing vacancy higher. This trend is forecast to continue in the coming quarters as large projects are delivered in the Irvine and South Anaheim submarkets. Irvine in particular could underperform this year, as the submarket's Class A vacancy rate is already among the highest in Orange County, and approximately 3,000 layoffs at major firms in the city have been announced year to date.

As fundamentals have weakened, sales velocity has cooled considerably from the peak levels of a few years ago. Recently, however, there have been signs that the expectations gap is closing and that the investment market could regain some momentum in the months ahead. Investment activity in the fourth quarter of 2008 and the first quarter of this year was limited almost exclusively to smaller properties and stabilized assets priced under \$3 million. During the second quarter, though, the deals closed consisted of a diverse product mix, as some institutional buyers came off the sidelines to obtain larger properties at attractive prices. Cap rates countywide have increased by an average of 100 basis points to 150 basis points to the mid- to high-6 percent range, with many assets trading recently with initial yields at or above 7.5 percent. The recent rise in cap rates, along with the sale of larger assets and properties with higher vacancy levels, should aid in price discovery for buyers, sellers and lenders, which could generate further investment activity in the coming quarters.

2009 ANNUAL APARTMENT FORECAST



Employment: Payroll contraction will continue in the second half of this year, albeit at a more modest pace than in recent quarters. In 2009, employers are projected to cut 51,100 jobs, a 3.5 percent decrease. Last year, nearly 57,000 jobs were lost countywide.



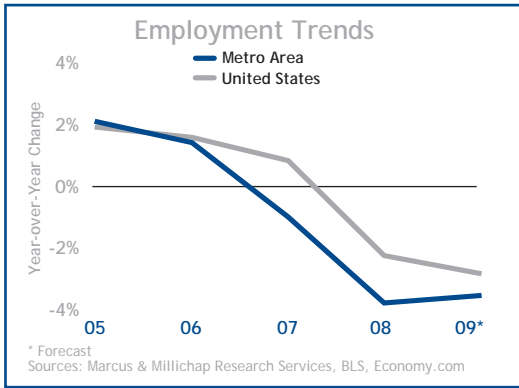
Construction: Following the delivery of fewer than 1,000 apartments in 2008, developers will bring approximately 3,800 units online this year as a number of projects consisting of 300 or more units are completed. Local inventory will expand by 1.9 percent.



Vacancy: A wave of construction will drive up vacancy 280 basis points to 7.9 percent by year end. Last year, when deliveries were more modest, vacancy rose 140 basis points.

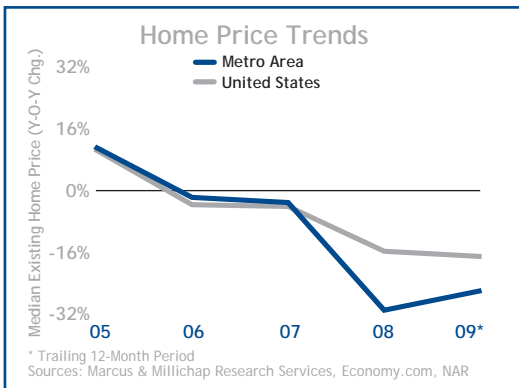


Rents: Asking rents are forecast to recede 3.3 percent to \$1,518 per month this year, while effective rents will drop 5.5 percent to \$1,431 per month. In 2008, asking rents ticked up 0.6 percent, and effective rents retreated 0.8 percent.



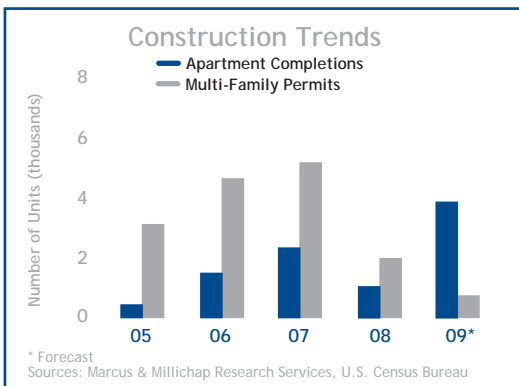
ECONOMY

- ◆ During the past 12 months, employers in Orange County have cut payrolls by 4.8 percent, or approximately 72,000 positions. Losses have been fairly consistent; in the first half of 2009, 34,900 workers were shed from payrolls.
- ◆ The professional and business services segment, the metro's largest employment sector, has contracted for the past seven quarters, declining by more than 18,000 positions. Year to date, approximately 6,000 jobs have been trimmed in this industry, with more modest losses forecast for the remainder of 2009.
- ◆ Layoffs among major banks and investment firms persist, causing employment in the financial activities sector to be reduced by 6,300 positions, or 5.5 percent, year over year.
- ◆ **Outlook:** Payroll contraction will continue in the second half of this year, albeit at a more modest pace than in recent quarters. In 2009, employers are projected to cut 51,100 jobs, a 3.5 percent decrease. Last year, nearly 57,000 jobs were lost countywide.



HOUSING AND DEMOGRAPHICS

- ◆ Approximately 1,000 single-family housing permits have been issued during the past 12 months, a 45 percent decline from one year ago. Multi-family permit issuance has declined nearly 85 percent over the last year to fewer than 700 units.
- ◆ During the second quarter, the median price of a single-family home in Orange County was estimated at \$417,700, a year-over-year decrease of 26 percent. The area's median home price has dropped more than 40 percent from the peak.
- ◆ Despite falling prices, home affordability remains a challenge. The median household income of \$70,970 per year is still 32 percent below the income needed to qualify for the monthly mortgage obligations on a median-priced home, using traditional financing.
- ◆ **Outlook:** Home prices have come down considerably, but renting remains the best option for many residents, as the monthly mortgage payment on a median-priced home is still \$550 more than the average Class A asking rent.

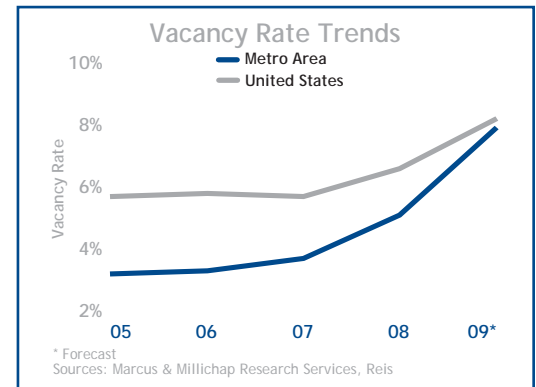


CONSTRUCTION

- ◆ Year over year, builders have delivered approximately 1,800 apartment units, increasing countywide stock by 0.9 percent. Nearly 1,300 units have come online in the past six months.
- ◆ More than 3,500 apartments are under construction, the majority of which will be completed this year. Future deliveries should cool, as there are only 2,300 units in the planning pipeline.
- ◆ The Park at Irvine Spectrum in the Irvine submarket is one of the region's largest developments. The project will consist of two 725-unit phases that will likely come online in early 2010 and late 2011.
- ◆ **Outlook:** Following the delivery of fewer than 1,000 apartments in 2008, developers will bring approximately 3,800 units online this year as a number of projects consisting of 300 or more units are completed. Local inventory will expand by 1.9 percent.

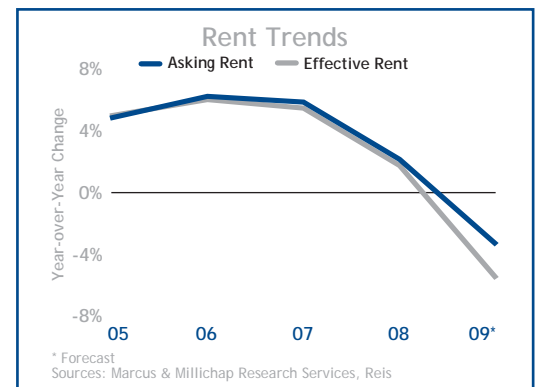
VACANCY

- ◆ The addition of new inventory, coupled with receding demand, has caused vacancy to creep up 160 basis points in the past 12 months to 6.1 percent. The rise was most significant in the first six months of 2009, when the rate spiked 100 basis points.
- ◆ After remaining fairly steady for much of 2008, vacancy in Orange County's Class A properties has increased 140 basis points year to date to 7.1 percent. Vacancy in the top tier rose 50 basis points in the second quarter.
- ◆ In the Class B/C segment, vacancy has jumped 170 basis points year over year to 5.5 percent. During the past 12 months, negative net absorption of nearly 2,300 lower-tier units has been recorded, as renters have doubled up in an effort to reduce costs.
- ◆ **Outlook:** A wave of construction will drive up vacancy 280 basis points to 7.9 percent by year end. Last year, when deliveries were more modest, vacancy rose 140 basis points.



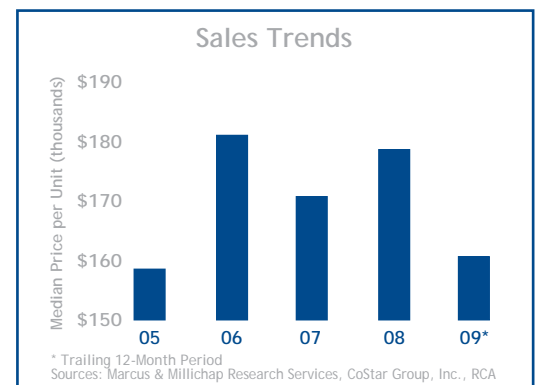
RENTS

- ◆ During the past 12 months, asking rents have retreated 1.9 percent to \$1,537 per month, while effective rents have declined 3.6 percent to \$1,465 per month. Both asking and effective rents have ticked lower in each of the past three quarters.
- ◆ Rising vacancy rates and increased competition from new space have driven down Class A asking rents 2.4 percent year over year to \$1,792 per month. Asking rents in the Class B/C segment have dropped 1.8 percent in that time to \$1,394 per month.
- ◆ As owners have increased the use of concessions to combat higher vacancy levels, average revenue has dipped 5.6 percent in the past 12 months.
- ◆ **Outlook:** Asking rents are forecast to recede 3.3 percent to \$1,518 per month this year, while effective rents will drop 5.5 percent to \$1,431 per month. In 2008, asking rents rose 0.6 percent, and effective rents retreated 0.8 percent.



SALES TRENDS**

- ◆ Year-to-date transaction velocity has dropped 47 percent compared to the same period in 2008. Sales activity in the past two quarters is down nearly 60 percent from the previous six-month stretch.
- ◆ As revenues and investor demand have declined during the past 12 months, the median price has dipped 10 percent to \$160,600 per unit. Further decreases have been recorded thus far in 2009; the median price in deals closed year to date was \$150,000 per unit.
- ◆ Cap rates are averaging in the mid- to high-6 percent range, up 100 basis points to 150 basis points from last year. Cap rates in recent deals have been near 7.5 percent.
- ◆ **Outlook:** Investment trends appear to be changing in Orange County. During the first quarter of this year, nearly all of the properties that changed hands had fewer than 20 units. In recent months, however, a few larger transactions have taken place, as REITs and institutional buyers have begun to re-enter the market. These large deals often have closed at cap rates well above current metro averages, however, and further rises are likely.



** 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

- ◆ 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 OVERVIEW

- ◆ The 890-unit Enclave was completed during the second quarter, increasing inventory in the South Santa Ana submarket by nearly 9 percent. A wave of new stock has driven up area vacancy 290 basis points in the past 12 months to 6.1 percent.
- ◆ The fallout from the weak financial sector is impacting the Irvine submarket. The Capital Group Cos., which includes American Funds, announced plans to lay off another 240 positions late in the second quarter. So far in 2009, the company has released nearly 400 employees.
- ◆ Tight conditions are drawing developers to South Anaheim. Vacancy in the submarket has declined year over year, but more than 1,700 units are under construction in the area, which will likely push vacancy higher in the coming quarters.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Buena Park	3.9%	140	\$1,286	-3.2%
2	Newport Beach	4.1%	70	\$2,007	-3.5%
3	Huntington Beach	4.3%	170	\$1,405	-2.9%
4	North Santa Ana	4.6%	180	\$1,181	-4.4%
5	Westminster/Fountain Valley	5.3%	70	\$1,299	-4.6%
6	South Anaheim	5.5%	-110	\$1,291	-4.8%
7	Laguna Beach/Dana Point	5.7%	80	\$1,666	0.8%
8	Fullerton	5.7%	240	\$1,270	-5.5%
9	Brea	5.8%	220	\$1,328	-1.0%
10	Tustin	5.8%	190	\$1,432	-5.4%