

# ApartmentResearch

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

Marcus & Millichap

Phoenix Metro Area

Third Quarter 2009

## ROBUST COMPLETIONS DRIVING VACANCY HIGHER

Renter demand for apartments in Phoenix continues to moderate due to severe job cuts that have spread to every segment of the economy. Population-serving employment sectors, including education and health services and government, held up well in the early stages of the downturn but are now contracting, a trend that is likely to persist for the next few months. In addition to receding demand brought on by strains in the job market, inventory growth will hamper market fundamentals. Accelerated completions over the next few quarters are expected to put upward pressure on vacancy, particularly in the outer suburbs, such as the Goodyear/Avondale/Tolleson submarket, and areas near the Anthem community in North Phoenix. Also, housing prices have fallen dramatically across the metro, encouraging some current renters to consider migrating to homeownership. While concerns over job security and additional home price declines have kept some would-be buyers in rental units, demand for homes could pick up if signs of an economic recovery emerge.

Weakening fundamentals have caused apartment investment velocity to slow considerably from earlier levels when the economy was advancing at a rapid clip. Recent activity, however, could be an early sign of some momentum in the marketplace. More transactions closed during the second quarter of this year, for example, than in the preceding six months. Average cap rates have increased to at least the mid-7 percent to low-8 percent range, with some properties having changed hands with initial yields approaching 9 percent. While future cash flows are uncertain in the near term, some buyers have begun to move off of the sidelines in response to attractive per-unit pricing. These investors are finding affordable apartment properties that offer upside potential due to the metro's still-attractive long-term growth prospects, despite currently lackluster fundamental performance. With buyers largely targeting distressed assets, significant demand for stabilized properties has yet to materialize and will likely require a few more months to take hold.

## 2009 ANNUAL APARTMENT FORECAST



**Employment:** In 2009, job losses are expected to total 104,000 positions across the metro, a 5.8 percent reduction. Last year, 111,200 workers were cut.



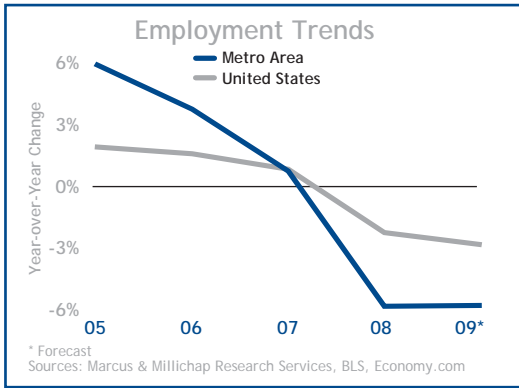
**Construction:** Deliveries are projected at 5,350 units this year, after approximately 4,400 rentals came online in 2008. During the past five years, an average of 4,000 apartments have been completed annually.



**Vacancy:** Vacancy in Phoenix is forecast to increase 230 basis points to 13.4 percent in 2009. Last year, when completions were more modest but job losses were steeper, vacancy rose 280 basis points.



**Rents:** Owners will continue to respond to weaker fundamentals by lowering rents. Asking rents are expected to drop 3.3 percent to \$751 per month this year, while effective rents will decline 5.1 percent to \$674 per month.

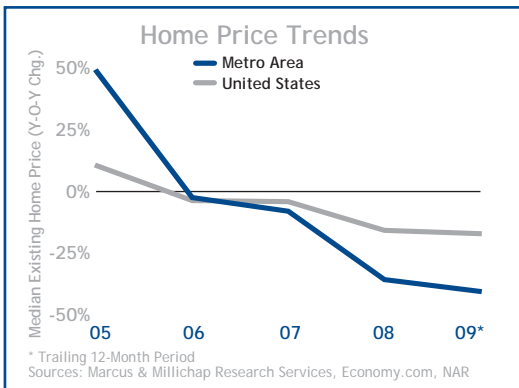


## ECONOMY

- ◆ The downturn in the housing market and corresponding contraction in construction have weighed on employment in Phoenix. During the last year, local payrolls have been reduced by 7.1 percent, or 132,600 positions. In the first two quarters of 2009, employers cut 67,600 workers in the metro.
- ◆ While every sector of the Phoenix employment market has recorded year-over-year job losses, the construction sector has been hit the hardest. Nearly 40,000 construction positions have been trimmed in the past 12 months, a decrease of more than 25 percent.
- ◆ Declining property and income tax revenues are driving employment reductions in the government sector, which once grew steadily as the metro's population expanded. This year, more than 7,000 government jobs are expected to be cut, a 3 percent drop.
- ◆ **Outlook:** In 2009, job losses are expected to total 104,000 positions across the metro, a reduction of 5.8 percent. Last year, 111,200 workers were cut.

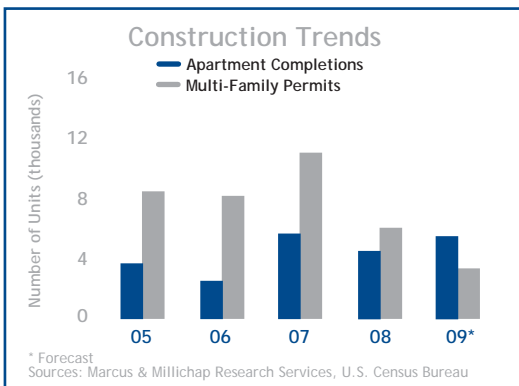
## HOUSING AND DEMOGRAPHICS

- ◆ During the past year, 8,200 single-family housing permits have been issued, down 55 percent from the corresponding period one year ago. Developers have pulled permits for 3,600 multi-family units in the last 12 months, a 60 percent drop-off from the year-earlier level.
- ◆ The Phoenix housing market has been one of the weakest in the country in recent quarters. The median price of a single-family home in the metro was \$120,900 in the second quarter, sliding 40 percent year over year. Since peaking in 2006, the median price has declined 56 percent.
- ◆ Steep price reductions in for-sale housing have increased affordability. The mortgage obligation for a median-priced home, using traditional financing, is now \$200 per month less than the average Class A asking rent. A glut of unsold new houses and a full pipeline of lender-owned single-family residences and condos will likely drag on home prices in the coming quarters.
- ◆ **Outlook:** Falling income due to a weak job market should continue to discourage home purchases in Phoenix; during the past 12 months, the median household income has declined 9.4 percent.



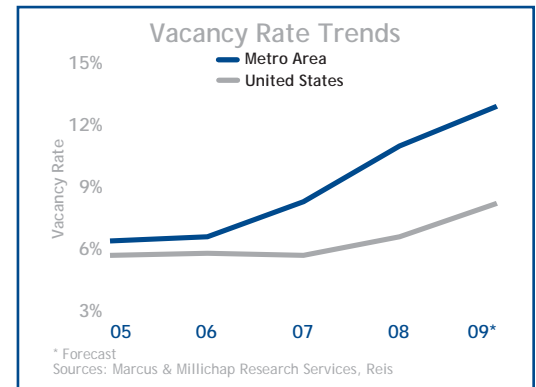
## CONSTRUCTION

- ◆ Despite easing demand and a growing shadow rental market, builders have delivered 5,000 apartment units over the last year. Deliveries have been fairly steady, with completions totaling 2,400 units so far in 2009.
- ◆ Approximately 6,100 units are under construction in the Phoenix metro, and another 14,700 rentals are planned. The delivery of projects that have already broken ground will yield a 2.4 percent increase to inventory.
- ◆ The largest development to come online in the metro in 2009 will be the 724-unit Trillium at Pinnacle Peak. While some of the units have been delivered already this year, final completion of the project is expected in the second half of 2009.
- ◆ **Outlook:** Deliveries are forecast at 5,350 units this year, after approximately 4,400 rentals came online in 2008. During the past five years, an average of 4,000 apartments have been completed annually.



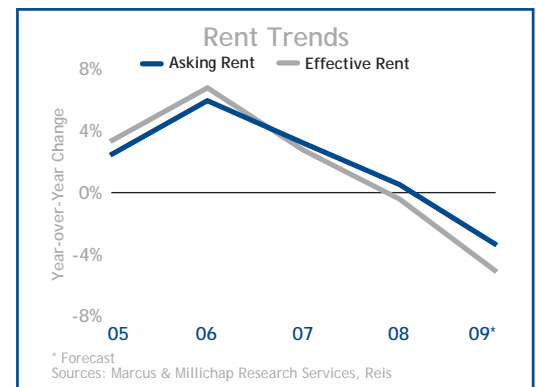
## VACANCY

- ◆ Additions to stock and ongoing job losses have driven up vacancy 180 basis points during the past 12 months to 11.3 percent. Vacancy rose only 20 basis points in the first half of 2009, but the delivery of new stock in the months ahead will result in a more significant increase in the coming quarters.
- ◆ While the absorption of new units is slow, vacancy in the metro's Class A apartments has risen steadily since the beginning of 2007. Over the last year, vacancy in the top tier has increased 190 basis points to 10.9 percent.
- ◆ Vacancy in Class B/C apartments is up 170 basis points year over year to 11.6 percent. Negative net absorption in the lower tiers has averaged 700 units per quarter since the beginning of 2008.
- ◆ **Outlook:** Vacancy in Phoenix is forecast to increase 230 basis points to 13.4 percent in 2009. Last year, when completions were more modest but job losses were steeper, vacancy rose 280 basis points.



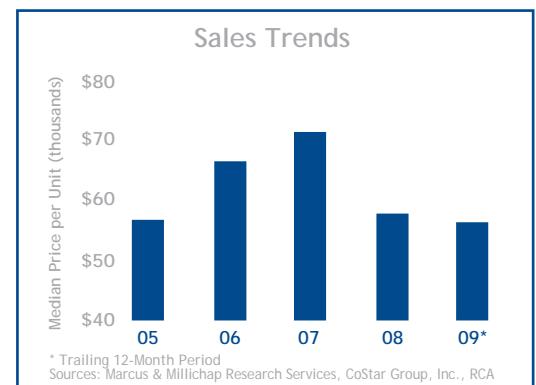
## RENTS

- ◆ During the past 12 months, asking rents have ticked down 0.8 percent to \$776 per month, while effective rents have retreated 2.6 percent to \$698 per month. Asking and effective rents have dipped 0.1 percent and 1.7 percent, respectively, thus far in 2009.
- ◆ Asking rents in the metro area's Class A assets have been flat year over year at \$924 per month. Steep job cuts within lower-wage sectors have put downward pressure on asking rents in Class B/C units, which have fallen 2.2 percent year over year to \$660 per month.
- ◆ Concessions account for 10.1 percent of asking rents, up from 8.3 percent of asking rents one year ago. As a result, revenue has contracted by 5.1 percent in the past 12 months.
- ◆ **Outlook:** Owners will continue to respond to weaker fundamentals by lowering rents. Asking rents are expected to drop 3.3 percent to \$751 per month this year, while effective rents will decline 5.1 percent to \$674 per month.



## SALES TRENDS\*\*

- ◆ Sales velocity during the past 12 months was down approximately 60 percent from the previous year. Transaction activity year to date has declined 46 percent when compared to the first half of 2008, despite a recent quarter-over-quarter rise.
- ◆ Weakening fundamentals and buyer demand for deeply discounted properties are driving down prices. The median price has dipped 16 percent year over year to \$56,300 per unit. In deals closed thus far in 2009, the median price has dropped to \$48,300 per unit.
- ◆ Cap rates are currently in the mid-7 percent to low-8 percent range, up approximately 150 basis points from last year.
- ◆ **Outlook:** Sales activity has slowed considerably from peak levels, but the market is showing some signs of positive momentum. The number of deals closed in the second quarter of 2009 exceeded the combined transaction activity of the first quarter of this year and the fourth quarter of 2008. Buyers are looking for deep discounts, however, so increased activity is not expected to buoy prices.



\*\* 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 Chandler/Gilbert submarket is one of the few areas in the Phoenix metro to have recorded a vacancy decline in the past year, improving 200 basis points to 10.6 percent. Competition from shadow rentals is elevated, however, causing operators to increase concessions to 11.6 percent of asking rents from 10.2 percent of asking rents one year ago.
- ◆ Continued demand from students and recent graduates, coupled with the delivery of expensive new space, has pushed up asking rents in the North Tempe submarket 7.3 percent year over year to \$856 per month.
- ◆ Oversupply concerns persist in the Goodyear/Avondale/Tolleson submarket, where the scheduled delivery of 870 units will increase inventory in the area by more than 10 percent. Local vacancy has increased 590 basis points year over year to 19.1 percent, the highest rate in the Phoenix metro.

## SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	South Scottsdale	7.8%	190	\$794	-4.2%
2	East Mesa	8.5%	-20	\$697	-5.2%
3	South Tempe/Ahwatukee	9.0%	50	\$787	-2.0%
4	North Glendale/Peoria	10.1%	80	\$742	-1.6%
5	West Mesa	10.2%	-50	\$592	-2.5%
6	Northeast Phoenix	10.2%	280	\$673	-3.3%
7	Chandler/Gilbert	10.6%	-200	\$766	-2.9%
8	North Tempe	10.7%	150	\$766	5.1%
9	North Scottsdale/Fountain Hills	10.8%	240	\$929	-3.0%
10	Sunnyslope	11.0%	240	\$633	-4.1%