ApartmentResearch
MARKET UPDATE
Marcus & Millichap

Riverside-San Bernardino Metro Area *Third Quarter 2009*

REO Sales Rise but Have Yet to Reach Anticipated Levels

Deep job cuts and a surplus of shadow stock in the Inland Empire will continue to erode property fundamentals during the second half of 2009. The negative effects of the recession have intensified since the beginning of the year, causing apartment vacancy rates to rise in nearly all of the metro's submarkets. The widespread reduction in occupancy levels is due in part to layoffs in key demand-supporting sectors, such as construction and manufacturing, that have driven more Class B/C residents to double up in order to ease living expenses. Moreover, aggressive rent cuts and steep concessions in Class A complexes have enabled some renters to upgrade without significantly increasing their monthly costs. Despite this, top-tier fundamentals have weakened, as operators continue to compete with an excess of investor-owned single-family houses serving as rentals. This trend has been pronounced in the High Desert region and eastern reaches of the metro. Specifically, owners in the Palm Springs/Palm Desert submarket will encounter greater occupancy challenges this year, as vacancy in the area has increased more than 600 basis points year over year to the high-14 percent range.

Thus far, REO sales in the Inland Empire have yet to reach the levels anticipated by investors late last year. In addition to conservative underwriting policies, many owners are attempting to hold and stay afloat rather than sell at a discount, which has contributed to a drop in deal flow. As falling occupancy levels and rent reductions weigh on owners' ability to generate positive cash flow, however, distressed and REO listings are expected to increase toward the end of this year and into early 2010, pulling cash-equipped buyers off of the sidelines. In the eastern portion of the metro, where vacancy rates are significantly higher, cap rates have risen rapidly to as high as the 9 percent range in some cases. Marketwide, though, first-year returns have averaged in the mid- to high-7 percent range during the past six months and will likely increase as weakened fundamentals pull down valuations.

2009 Annual Apartment Forecast

4.7% decrease in total employment

Employment: Metro employers are forecast to shed 55,400 jobs this year, a 4.7 percent decrease. In 2008, total employment contracted by 6.1 percent, or 77,500 positions.

670 units will be completed

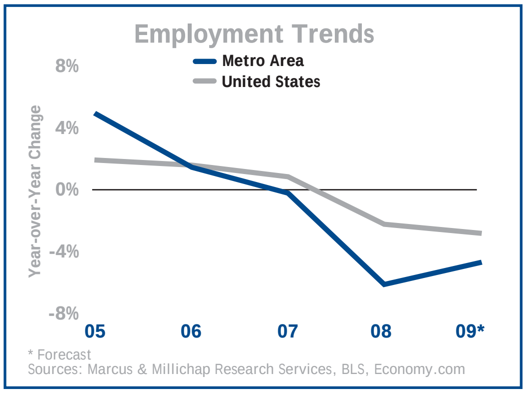
Construction: A year after builders delivered 440 apartment units, 670 units are slated to come online in 2009. Completions have averaged 2,300 units annually over the past five years.

210 basis point increase in vacancy

Vacancy: The troubled local labor market is forecast to cause vacancy to increase 210 basis points to 9.1 percent this year, following a 70 basis point rise in 2008.

3.5% decrease in asking rents

Rents: Asking rents are expected to decline 3.5 percent to $1,021 per month in 2009 while effective rents drop 4.6 percent to $971 per month. Last year, asking rents gained 0.1 percent, and effective rents fell 0.7 percent.



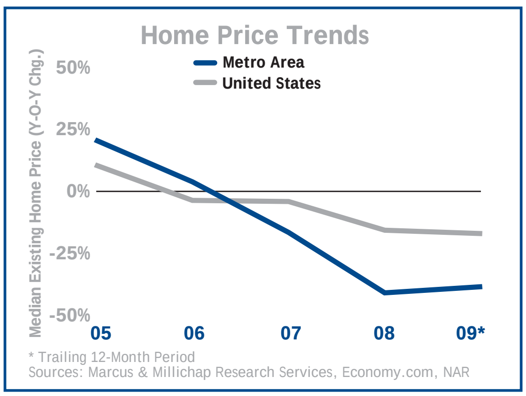
Economy

- Layoffs have deepened in the Inland Empire's job market as companies attempt to rein in operating costs. Local employers have cut 75,100 workers over the last 12 months, or 6.1 percent of the work force, after releasing 46,500 positions in the previous year. During the first two quarters of 2009, approximately 37,200 spots were eliminated.

- The construction trade continues to suffer from an elevated number of postponed projects. Roughly 21,830 workers have been laid off in the sector over the past year, or a 23.9 percent reduction, similar to cuts recorded in the prior 12 months. Since the beginning of 2009, 10,320 construction employees have been let go.

- Cautious consumer spending has driven manufacturers to scale back production. As such, employers in the manufacturing sector have thinned payrolls by 13,500 spots year over year, or 12.5 percent, including 7,600 positions during the past six months.

- **Outlook:** Metro employers are forecast to shed 55,400 jobs this year, a 4.7 percent decrease. In 2008, total employment contracted by 6.1 percent, or 77,500 positions.



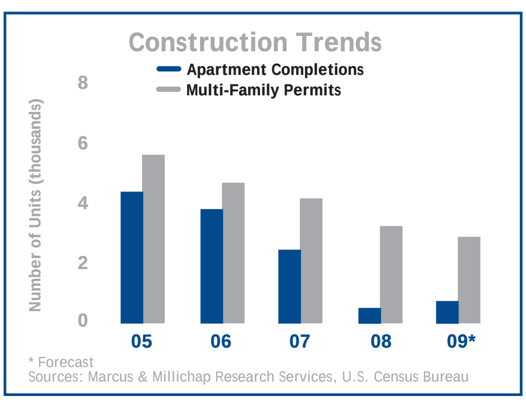
Housing and Demographics

- The struggling housing market has resulted in a steep decline in permitting activity. Single-family permit issuance has dropped 53 percent during the last year to 4,300 units. Multi-family developers have pulled permits for 2,170 units in that time, a year-over-year decrease of 47 percent.

- The median price of a single-family home in the metro was estimated at $162,000 in the second quarter, almost 39 percent less than one year earlier. The median household income of $53,100 annually is $10,700 above the amount required to qualify for a median-priced residence.

- The typical mortgage payment for a median-priced home, using traditional financing, was $250 per month less than the average Class A asking rent during the second quarter.

- **Outlook:** Despite falling values, the region's turbulent job market will likely cause a considerable portion of residents to delay home purchases, sustaining demand for rental properties.



Construction

- Apartment building activity has slowed significantly over the past year, with fewer than 100 market-rate units coming online. In the prior 12-month stretch, 2,690 units were delivered.

- Approximately 1,050 rental units are under way in the metro, with more than 60 percent scheduled to be delivered by year end. The planning pipeline consists of 5,400 units.

- Developers have completed roughly 450 condo units over the past year. At present, 2,500 for-sale units are under construction, and an additional 11,000 units are planned.

- **Outlook:** A year after builders delivered 440 apartment units, 670 units are slated to come online in 2009. Completions have averaged 2,300 units annually over the past five years.

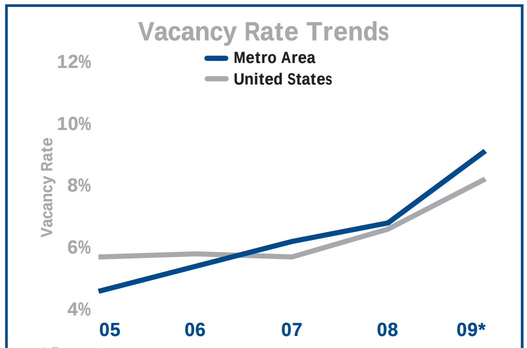
Vacancy

- Despite easing supply growth, job cuts and competition from shadow stock have weighed on absorption. Metrowide vacancy has climbed 170 basis points year over year and 100 basis points since year-end 2008 to 8 percent.

- Over the last 12 months, Class A vacancy has jumped 130 basis points to 8.7 percent, after rising 40 basis points in the prior year.

- The vacancy rate in the lower tiers has pushed up 200 basis points in the past year to 7.6 percent. The rise stems from ongoing weakness in the economy, most notably in the construction and manufacturing sectors.

- **Outlook:** Vacancy is forecast to increase 210 basis points to 9.1 percent this year, following a 70 basis point rise in 2008.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

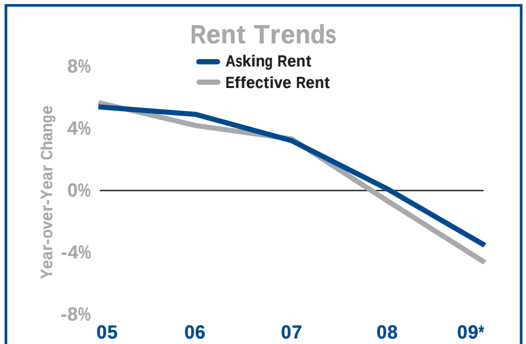
Rents

- Waning renter demand has forced owners to reduce rents and widen concessions. Asking rents have fallen 2.6 percent over the past year and 1.2 percent in the last two quarters to $1,045 per month. Effective rents, meanwhile, have retreated 4 percent year over year to $995 per month and dropped 2.3 percent since the beginning of 2009.

- Class A asking rents have decreased 3.7 percent to $1,211 per month during the last 12 months, while asking rents in the lower tiers have receded 1.8 percent to $936 per month.

- Average revenues have slipped 3.3 percent since the end of 2008 and 5.7 percent on a year-over-year basis, driven by increasing leasing incentives enacted to curtail rising vacancy rates.

- **Outlook:** Asking rents are expected to decline 3.5 percent to $1,021 per month in 2009 while effective rents drop 4.6 percent to $971 per month. Last year, asking rents gained 0.1 percent, and effective rents fell 0.7 percent.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

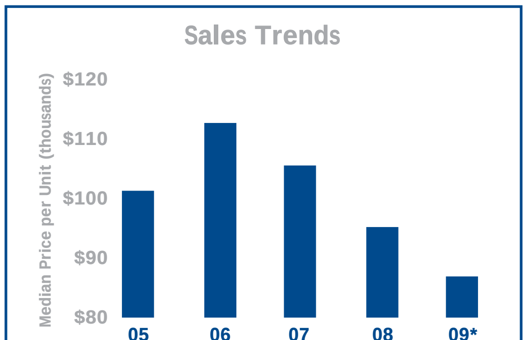
Sales Trends**

- The number of apartment assets that traded over the most recent 12-month period was down 49 percent from one year prior, the largest drop-off of all major Southern California markets. The subdued pace of sales activity stems from greater buyer caution, as well as challenges securing financing.

- The median price of an apartment property in the Inland Empire has decreased more than 16 percent year over year to $86,700 per unit. In the past six months, the median price was $75,000 per unit.

- Cap rates have averaged in the mid- to high-7 percent range, up approximately 140 basis points since the end of 2008. Several properties with deferred maintenance have changed hands with initial yields in the mid-9 percent range. As some overleveraged owners look to divest, average first-year returns will likely edge higher by year end.

- **Outlook:** More cash-equipped buyers are targeting smaller assets, which, when combined with greater hurdles securing large loans, should help to boost demand for smaller lower-tier assets priced below $5 million as 2009 progresses.



* 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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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 Loma Linda City Council has approved several projects designed to limit the area's affordable housing deficit. In recent years, the city has incurred a 300-unit deficit that is required by the state to be eliminated by 2014.

- Class A owners in the Rancho Cucamonga submarket are posting relatively healthy operations. Over the past year, vacancy has fallen by 100 basis points to the mid-5 percent range; however, the improvement was achieved by lowering asking rents by more than 5 percent in that time.

- Despite lower-tier vacancy in the Southwest Riverside County submarket decreasing 300 basis points year over year to the low-12 percent range and asking rents dropping more than 6 percent, area Class B/C occupancy levels are the metro's lowest. Moreover, nearly 300 rental units are slated for delivery in early 2010, which may offset some recent improvements.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Rancho Cucamonga	5.0%	40	$1,275	-4.9%
2	North Ontario	5.8%	20	$1,114	-1.8%
3	Riverside County/Corona	6.2%	90	$1,050	-6.7%
4	Colton/Loma Linda	6.7%	180	$1,034	-4.1%
5	Riverside/North Magnolia	6.8%	190	$935	-4.8%
6	South Ontario/Chino	6.9%	250	$1,247	-4.7%
7	Upland	6.9%	240	$1,040	-4.1%
8	Hemet	8.2%	210	$727	-4.0%
9	Southwest Riverside County	8.6%	-150	$1,070	-3.7%
10	San Bernardino	8.7%	190	$795	-3.6%

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