

ApartmentResearch

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

Marcus & Millichap

Phoenix Metro Area

Third Quarter 2010

LEVERAGE DICTATING DEAL LOCATION IN PHOENIX

The Phoenix apartment market is on the mend following years of distress due to the collapse of the housing market and local economy. Although fundamentals show improvement, apartment demand remains 2.5 percent lower than peak levels, and vacancy is double its cyclical low, indicating a long road to a full recovery. The resumption of job growth will be the primary catalyst of new demand, and eight of the 11 primary employment sectors in the metro have expanded thus far in 2010. While gains in sectors ranging from the high-paying professional and business services segment to lower-paying trade, transportation and utilities industry point toward a broad recovery in the apartment market, conditions in Class C rentals could remain weak due to the ongoing legal battle over immigration legislation. A significant number of the estimated 460,000 undocumented immigrants in Arizona live in Phoenix and rent lower-tier apartments, which will face occupancy challenges if a sizable portion of this population moves elsewhere. Less expensive properties already have struggled, as the five most affordable submarkets for renters posted an average vacancy increase of 240 basis points over the past year, compared to a metrowide decline of 20 basis points.

Like apartment operating performance, the investment climate shows signs of renewed health, which should continue through the end of the year. Outlying areas challenged by pronounced foreclosure activity in the single-family and multifamily segments have received the greatest attention. California buyers have been particularly active in these suburbs, tripling their acquisition activity in the most recent 12-month period. In these fringe areas, the combination of average cap rates in the mid-7 percent range and vacancy rates near 25 percent at some listed properties has created substantial upside potential. Local investors, meanwhile, remain active in core areas near employment centers, such as Midtown, targeting stabilized properties with cap rates under 7 percent. While financing largely remains limited to Fannie Mae, performing assets remain highly sought-after, keeping leveraged buyers within these core submarkets.

2010 ANNUAL APARTMENT FORECAST



Employment: After slashing 230,000 jobs since the beginning of the recession, Phoenix employers will expand payrolls by 35,200 positions this year, a 2.1 percent increase.



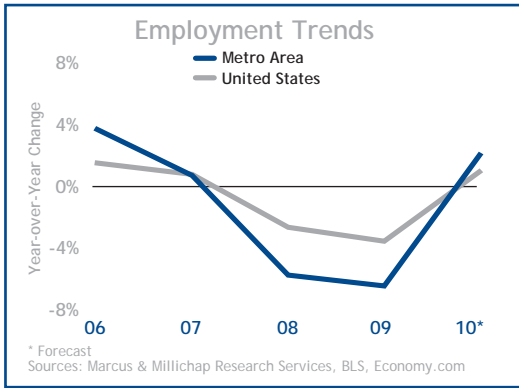
Construction: Construction on a few projects will wrap up in the second half, pushing annual deliveries to 2,900 units. Building activity will slow into 2011. Over the past five years, average annual completions totaled 4,400 units.



Vacancy: An uptick in construction will ease vacancy declines over the final two quarters of this year. Nonetheless, apartment vacancy will finish 2010 at 11.3 percent, a 100 basis point improvement from year-end 2009.

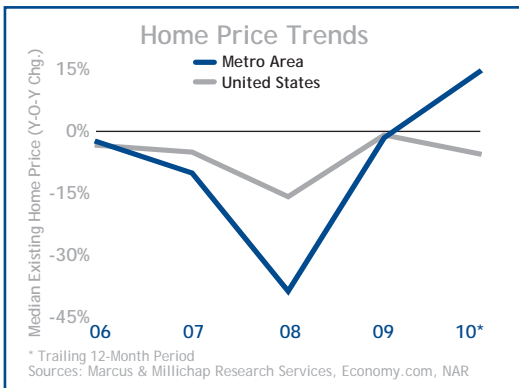


Rents: This year, asking rents will reach \$753 per month while effective rents settle at \$684 per month, annual gains of 0.7 percent and 1.2 percent, respectively. In 2009, asking rents retreated 3.7 percent, and effective rents slid 4.8 percent.



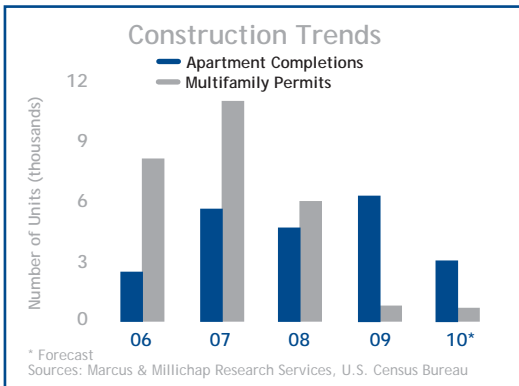
ECONOMY

- ◆ The once-robust Phoenix employment market showed signs of life in the first half of 2010, when 16,800 positions were added, a 1 percent gain. Government job losses related to census hiring likely culminated in June, bringing year-to-date cuts in the sector to 800 workers.
- ◆ Since the beginning of 2010, the leisure and hospitality segment has added 4,800 positions, erasing a similar loss in the same period last year. One of the healthiest sectors in the metro is professional and business services, which expanded by 5,000 positions in the first half.
- ◆ Developers will begin construction on the Loop 303 freeway in Surprise later in 2010, improving access to this suburban area. As a result, retail and apartment demand may get an earlier-than-anticipated boost if Westcor accelerates planned construction of its Prasada mall, currently the state's largest proposed retail project.
- ◆ **Outlook:** After slashing 230,000 jobs since the beginning of the recession, Phoenix employers will expand payrolls by 35,200 positions this year, a 2.1 percent increase.



HOUSING AND DEMOGRAPHICS

- ◆ During the past 12 months, developers pulled 9,800 single-family permits in the metro area, up 20 percent from the previous year. Multifamily permitting plummeted 87 percent in the last year to just 460 units, indicating a relief to supply-side pressure over the next 18 months.
- ◆ Home prices recovered from recent lows as short-sale activity replaced foreclosures. In the second quarter, the median home price was \$150,200, a year-over-year gain of 14.6 percent. The median household income of \$50,600 per year is currently \$14,100 above the minimum qualifying income for a median-priced home.
- ◆ Homes are far more affordable in Phoenix than a few years ago. Class A asking rents average \$63 per month above the monthly mortgage obligation on a median-priced home, using traditional financing.
- ◆ **Outlook:** While homeownership is within reach of more local residents, the federal tax credit has siphoned much of the demand from renters seeking to move into ownership, limiting further weakness in the Class A segment.

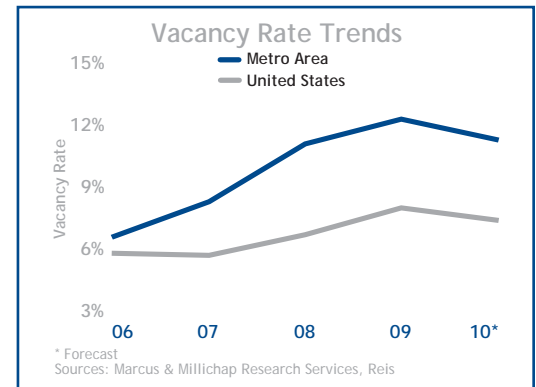


CONSTRUCTION

- ◆ Over the past year, 4,100 units were added to local apartment stock, a 1.6 percent increase. Since 2004, however, apartment inventory has expanded just 1.5 percent due to conversions.
- ◆ Nearly 1,700 units are under construction in the metro, and an additional 9,000 apartments are planned, representing 3.5 percent of stock. Only 3,100 of the planned units are in submarkets with above-average vacancy rates.
- ◆ The 724-unit Trillium at Pinnacle Peak was completed earlier this year, increasing supply levels in the North Scottsdale/Fountain Hills submarket by 4.5 percent.
- ◆ **Outlook:** Construction on a few projects will wrap up in the second half, pushing annual deliveries to 2,900 units. Next year, apartment construction will continue to slow.

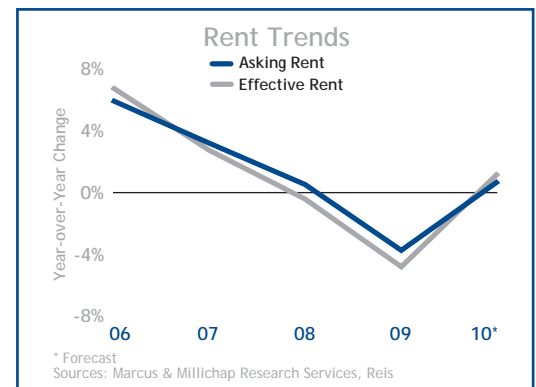
VACANCY

- ◆ Marketwide vacancy declined 60 basis points in the second quarter to reach 11.5 percent. Vacancy fell 20 basis points in the first three months of 2010, marking the first six-month improvement since mid-2006.
- ◆ Class A vacancy dropped to 9.7 percent in the second quarter, an annual decline of 160 basis points. Since the cyclical peak in the third quarter of 2009, top-tier vacancy has fallen 210 basis points.
- ◆ In the Class B/C segment, vacancy retreated 30 basis points in the second quarter to 13.1 percent. Year to date, the rate has ticked up 20 basis points. A recovery in this segment will be far choppier than in the top tier due to concerns surrounding immigration legislation.
- ◆ **Outlook:** An uptick in construction will ease vacancy declines over the final two quarters of 2010. Nonetheless, apartment vacancy will finish the year at 11.3 percent, a 100 basis point improvement from year-end 2009.



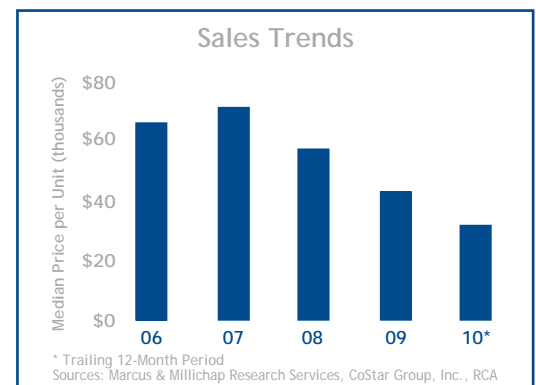
RENTS

- ◆ Asking rents finished the second quarter at \$746 per month while effective rents were \$680 per month, annual losses of 3.1 percent and 1.9 percent, respectively. Since the beginning of the year, both asking and effective rents have stabilized.
- ◆ Class A asking rents average 2.7 percent lower than one year ago at \$887 per month. Higher vacancy in the Class B/C segment pushed down asking rents 4.3 percent year over year to \$624 per month.
- ◆ After concessions peaked one year ago, some owners began to withdraw incentives in favor of cutting asking rents, resulting in a five-day decrease in average concessions to 32 days of free rent.
- ◆ **Outlook:** By year-end 2010, asking rents will reach \$753 per month while effective rents settle at \$684 per month, annual gains of 0.7 percent and 1.2 percent, respectively. Last year, asking rents retreated 3.7 percent, and effective rents slid 4.8 percent.



SALES TRENDS**

- ◆ During the most recent 12-month period, sales velocity jumped 125 percent, marking a significant turnaround in the local investment climate. Nearly 60 percent of those deals took place within the last six months, indicating a return of buyer confidence.
- ◆ Although velocity rebounded in the past year, pricing still favors buyers due to weak operating fundamentals. In that time, the median price was \$31,800 per unit, down 40 percent from the previous 12-month period.
- ◆ Cap rates for deals closed in the past 12 months averaged in the low-7 percent range, up 30 basis points year over year. The uptick was mitigated by investors' preference for newer, larger assets.
- ◆ **Outlook:** Out-of-state buyers have begun to target properties with value-add potential in suburban areas where foreclosure activity peaked. Investor-to-investor deals, meanwhile, will be focused in core locations adjacent to employment centers, such as Midtown and the 44th Street corridor.



** 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

- ◆ Affinitas Corp. plans to relocate a call center from Mesa to the Gilbert Business Center near Gilbert and Guadalupe roads. More than 100 employees will make the transition, boosting apartment demand in the submarket.
- ◆ Planners in Scottsdale approved a revitalization project for McDowell Road that could include an event center. Located in the South Scottsdale submarket, the area already boasts the tightest occupancy rate in the Valley due to its proximity to Arizona State University and entertainment options.
- ◆ The owner of the Arizona Cardinals submitted plans to rezone nearly 130 acres near the University of Phoenix Stadium from agriculture to commercial. Current plans allow for 3 million square feet of commercial space and include 250 apartment units in the Glendale South submarket.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	South Scottsdale	6.4%	-150	\$748	-4.1%
2	South Tempe/Ahwatukee	7.1%	-190	\$772	-1.8%
3	Chandler/Gilbert	8.1%	-250	\$766	0.1%
4	North Tempe	8.4%	-250	\$734	-4.1%
5	North Scottsdale/Fountain Hills	8.5%	-340	\$896	-1.3%
6	East Mesa	9.9%	140	\$678	-1.6%
7	Peoria/Sun City/Surprise	10.7%	-50	\$731	-0.4%
8	Paradise Valley	11.0%	-180	\$618	-7.2%
9	Deer Valley	11.9%	20	\$628	-1.9%
10	Northeast Phoenix	12.2%	170	\$658	-2.1%