

ApartmentResearch

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

Marcus & Millichap

San Jose Metro Area

Third Quarter 2010

SAN JOSE METRICS DISPLAY VIGOR IN EARLY PHASE OF RECOVERY

As the South Bay economy pulls out of the downturn, apartment fundamentals will strengthen this year, catalyzed by payroll expansion and a shortage of affordable housing. In 2010, metro employers will recapture roughly 20 percent of the jobs cut during the recession, with additions in the professional and business services, and information sectors accounting for a sizable share of overall gains. Resumed hiring in these high-paying segments will improve operations rapidly at top-tier complexes near major employers, especially in the Sunnyvale, Santa Clara, Mountain View/Los Altos and Campbell/Los Gatos submarkets. As such, owners of Class A properties in these areas will increasingly withdraw concessions and post substantial rent gains in the second half of 2010. Signs of recovery also continue to surface in the South Bay's overbuilt condo market, highlighted by a 28 percent year-over-year jump in sales during the first half. This trend bodes well for downtown San Jose apartments, in particular, as increased condo sales will gradually reduce the number of such units employed as rentals. Nonetheless, pockets of the metro, including the East San Jose submarket, will not improve considerably until 2011, when more meaningful, broad-based job formation releases pent-up renter demand.

Greater accessibility to capital and signs of sustainable economic improvements have helped restore sales velocity momentum. Indeed, year-to-date closings increased more than 20 percent from the corresponding span in 2009. Despite improving apartment operations, some long-time owners have begun to divest ahead of potential capital gains tax increases, while other operators are exchanging into passive, triple-net assets. These dispositions have placed seldom-traded properties on the market. As a result, cash-heavy and qualified buyers can now acquire core market assets in Mountain View and Sunnyvale. Investors seeking distressed listings, on the other hand, may find prospects in tertiary communities where smaller, entry-level buyers active during the run-up now face refinancing headwinds. Assets in less sought-after locations will sell with cap rates in the 6 percent range, while mid-tier assets in core areas will trade with a 100 basis point premium.

2010 ANNUAL APARTMENT FORECAST



Employment: Employers in the San Jose metro area will add 14,600 workers in 2010, a 1.7 percent gain. Last year, 55,900 positions were eliminated.



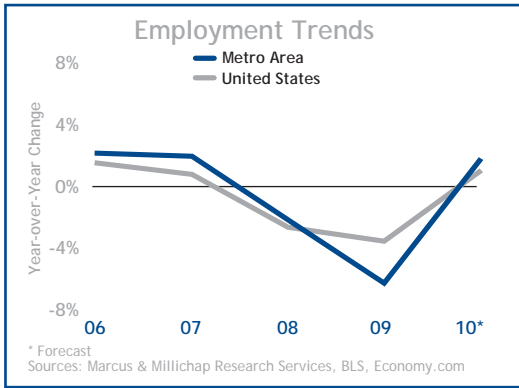
Construction: Deliveries will remain below-trend this year, as builders will complete just 290 units, roughly 60 percent less than the five-year average. In 2009, developers brought online 491 units.



Vacancy: The gradual resumption of employment growth and subdued building activity will drive down vacancy 130 basis points to 3.8 percent in 2010. Last year, the vacancy rate climbed 70 basis points.

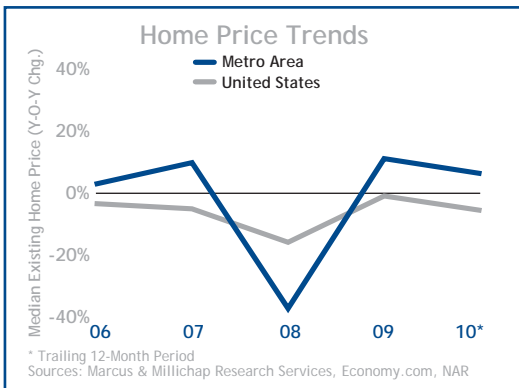


Rents: Asking rents will rise 5.2 percent this year to \$1,474 per month, and effective rents will increase 5.7 percent to \$1,379 per month. In 2009, asking and effective rents retreated 11.8 percent and 13.3 percent, respectively.



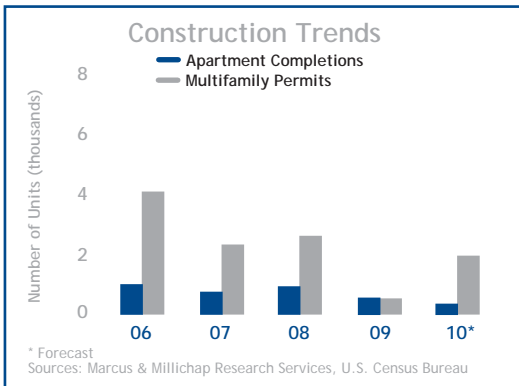
ECONOMY

- ◆ The San Jose job market has turned the corner. Local employers hired 8,800 workers during the first half of 2010, reducing year-over-year job losses to 6,000 spots, or a 0.7 percent decline. In the prior 12-month period, metro employment levels shrank by 62,500 positions.
- ◆ Nearly all office-using sectors are expanding payrolls. White-collar hiring has been led by the professional and business services sector, which has added 2,400 positions year to date, followed by the information segment, where 700 jobs have been created this year. Financial services employers, however, have shed almost 400 workers since the start of 2010.
- ◆ The unemployment rate in San Jose reached 11.3 percent during the second quarter, down from 11.9 percent six months earlier. Still, the local unemployment rate remains well above the national rate of 9.5 percent.
- ◆ **Outlook:** Employers will add 14,600 employees to local head counts this year, a 1.7 percent gain, after eliminating 55,900 positions in 2009.



HOUSING AND DEMOGRAPHICS

- ◆ Permits for 620 multifamily units were issued during the past year, down from the issuance of 1,370 units one year earlier. Permitting activity for single-family housing, meanwhile, increased 32 percent to 940 units.
- ◆ The median home price in San Jose was \$513,800 in the second quarter, up 6.4 percent from the same quarter in 2009. The current median household income of \$85,800 per year is 28 percent below the amount required to qualify for a mortgage on a median-priced metro home.
- ◆ The mortgage payment on a median-priced home in the metro is \$2,691 per month if using traditional financing, more than \$1,100 higher than the monthly average Class A asking rent.
- ◆ **Outlook:** Although home prices have fallen 39 percent from peak levels, the median-priced home remains out of reach for an estimated 60 percent of the local population, which will sustain strong renter demand in the long term.

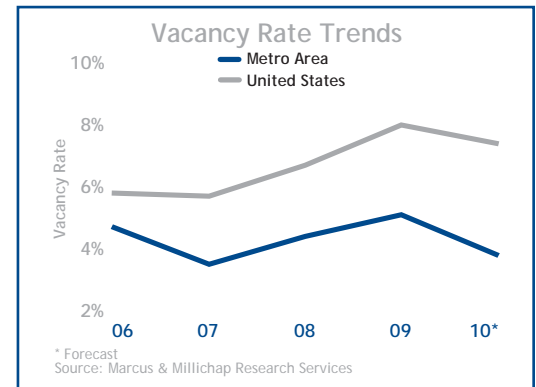


CONSTRUCTION

- ◆ Following the addition of 1,109 units one year ago, builders completed just 243 apartment units during the most recent 12-month stretch.
- ◆ As of the second quarter, approximately 390 units were under construction, and 5,300 units were planned. A metro-leading 2,600 units are planned for the Northeast San Jose submarket.
- ◆ The most recent completion in the metro was the 243-unit Elements complex in the West San Jose submarket. The project came online in the fourth quarter of 2009 and increased area inventory by nearly 2 percent.
- ◆ **Outlook:** Deliveries will remain below-trend in 2010, as builders will complete just 290 units, roughly 60 percent less than the five-year average. Last year, 491 units were brought online.

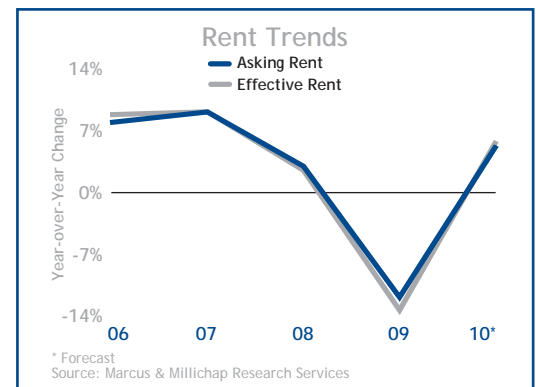
VACANCY

- ◆ Improvement in the local job market, combined with a lack of apartment construction, helped decrease the South Bay vacancy rate by 80 basis points year over year to 4.2 percent in the second quarter. So far in 2010, vacancy has fallen 90 basis points on positive net absorption of 980 units.
- ◆ Job growth in typically higher-paying office-using sectors contributed to improving the vacancy rate at Class A complexes 110 basis points over the past year to 4.5 percent.
- ◆ Lower-tier vacancy of 4 percent in the second quarter was 30 basis points below the rate recorded one year earlier and 70 basis points less than the cyclical peak reached at year-end 2009.
- ◆ **Outlook:** The gradual resumption of employment growth and subdued building activity will drive down vacancy 130 basis points to 3.8 percent in 2010. Last year, the vacancy rate climbed 70 basis points.



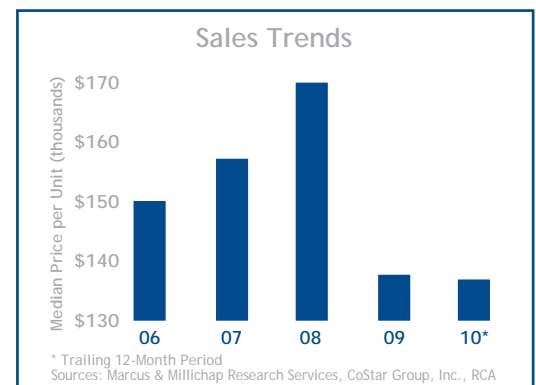
RENTS

- ◆ Owners have leveraged recent occupancy gains to raise rents. Asking rents have advanced 1.1 percent year to date to \$1,417 per month, and effective rents have risen 0.9 percent to \$1,317 month. Measured year over year, however, asking and effective rents contracted by 2.8 percent and 3.8 percent, respectively.
- ◆ Asking rents for Class A units ended the second quarter at \$1,616 per month, up 1.3 percent from six months earlier. Lower-tier asking rents increased 1.1 percent during the first half to \$1,196 per month.
- ◆ Strengthening property fundamentals have led to a 1.9 percent revenue gain this year, easing the year-over-year decline to 3 percent. In the preceding 12 months, revenues declined 10.4 percent.
- ◆ **Outlook:** Asking rents will rise 5.2 percent in 2010 to \$1,474 per month, and effective rents will increase 5.7 percent to \$1,379 per month. Last year, asking and effective rents retreated 11.8 percent and 13.3 percent, respectively.



SALES TRENDS**

- ◆ Sales velocity increased 16 percent during the past year, largely attributable to greater financing accessibility. Moreover, year-to-date closings are up roughly 24 percent compared to the same period last year.
- ◆ Despite the uptick in transaction volume, the median price of an apartment building slipped 13 percent during the most recent 12-month stretch to \$136,700 per unit, a level that is also down nearly 20 percent from the peak in 2008.
- ◆ Over the past year, cap rates averaged in the mid- to high-5 percent range, up approximately 20 basis points from one year earlier. Although initial yields should hold relatively steady through year end, first-year returns for lower-tier properties farthest from major employment centers may trend higher as some owners attempt to dispose of assets.
- ◆ **Outlook:** High-net-worth buyers seeking cash-flowing assets will focus on areas proximate to rooted demand drivers such as Stanford University, where enrollment reached 18,500 students last year. Going forward, strong student demand for housing will help firm operations at nearby complexes.



** 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

- ◆ The city of Santa Clara approved plans for a new headquarters campus for Yahoo in the Santa Clara submarket. The site will employ up to 12,000 workers, providing a significant boost to area Class A operations. The company has yet to announce a timeline for the project.
- ◆ Hewlett-Packard will shutter its Cupertino site and transfer employees to its Palo Alto headquarters, a move that bodes well for owners in the Mountain View/Los Altos submarket. The relocation will take place over the next two years and involve an estimated 3,000 to 5,000 workers.
- ◆ The recent acquisition of the last large parcel of undeveloped land in Gilroy will limit future rental supply growth upon its build out. While no plans have been approved, established parameters include no more than 750 housing units and a maximum of 580,000 square feet of commercial space.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Sunnyvale	3.1%	-90	\$1,312	-3.5%
2	Campbell/Los Gatos	3.6%	-100	\$1,184	-3.0%
3	Cupertino/Saratoga	4.2%	-60	\$1,626	0.8%
4	West San Jose	4.3%	-110	\$1,178	-4.6%
5	Santa Clara	4.4%	-100	\$1,335	-2.6%
6	Mountain View/Los Altos	4.5%	-60	\$1,481	-2.4%
7	Northeast San Jose	4.6%	-50	\$1,393	-3.5%
8	South San Jose	4.9%	-150	\$1,076	-11.7%
9	East San Jose	5.2%	120	\$1,224	-4.3%