

ApartmentResearch

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

Marcus & Millichap

Cleveland Metro Area

Fourth Quarter 2009

MINIMAL NEW SUPPLY TO KEEP VACANCY NEAR HEALTHY LEVELS

Cleveland apartment operations are expected to moderate through year end, as vacancy will stay at a relatively healthy level. Additionally, while employment conditions in most sectors remain soft, the education and health services segment is creating jobs. The metro's traditionally strong healthcare presence, which includes the large Cleveland Clinic system, will continue to provide stability to the local economy, in turn attracting other companies. Immediate Pharmaceutical Services Inc., for instance, may expand into Avon Lake with the aid of local government incentives, potentially adding 200 positions. Marketwide, employment-generated apartment demand will remain tepid at best over the next two quarters; however, limited construction activity will help to mitigate a significant rise in vacancy. Only one 240-unit project is under way in the metro, and there are no additional developments scheduled for completion over the next 18 months, which should keep both vacancy and concessions at modest levels.

Transaction velocity will remain constrained through year end, given investors' uncertainty over current property fundamentals. While sales activity has declined 30 percent during the past 12 months, deal flow over the last two quarters has dropped 55 percent compared to the same period in 2008 suggesting the investment market may be closer to reaching a bottom. Softer demand is pushing initial yields closer to historical levels, a trend that may bring more buyers into the market. Overall cap rates are averaging in the low- to mid-8 percent range, up about 100 basis points in the past year, while stabilized Class B properties are trading near 9 percent. Most of the deals that have taken place this year have been in more affluent submarkets, such as Shaker Heights and Cleveland Heights, where tenant demand remains healthy to due the area's desirability. This investment trend will likely continue until signs of an economic recovery become more apparent.

2009 ANNUAL APARTMENT FORECAST



Employment: This year, employers are expected to cut 40,000 workers from payrolls, a 3.8 percent drop and up from the loss of 32,900 jobs in 2008.



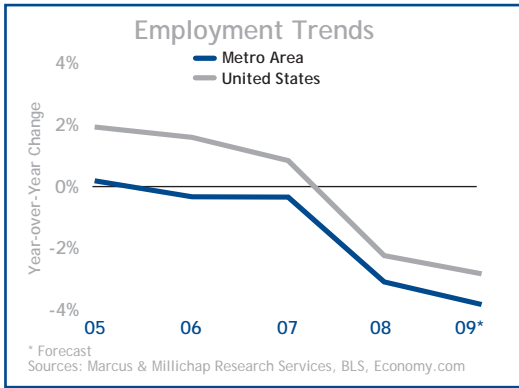
Construction: A year after builders completed 144 apartment units, just 56 units will come online in 2009, expanding inventory by less than 0.1 percent. Over the past five years, deliveries have averaged 400 units annually.



Vacancy: The vacancy rate is expected to end the year up 140 basis points at 7.4 percent, as demand will remain soft due to employment market conditions. Last year, vacancy rose 40 basis points.



Rents: Asking rents are forecast to fall 2.3 percent to \$722 per month in 2009, and effective rents are projected to decline 3 percent to \$684 per month. Last year, asking rents ticked up 1.5 percent, while effective rents increased 1.6 percent.

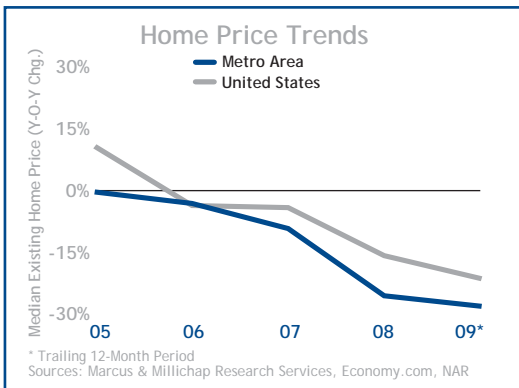


ECONOMY

- ◆ Year to date, 38,200 positions have been cut from local payrolls, including 7,000 jobs in the third quarter. During the first three quarters of 2008, employers shed 11,300 workers.
- ◆ Staff reductions in the professional and business services and manufacturing sectors have contributed most to the decline in overall employment since year-end 2008. Professional and business services payrolls have been thinned by 13,300 employees during this time, and 12,200 manufacturing jobs have been eliminated.
- ◆ As of the third quarter, unemployment in Cleveland was 9.3 percent, up 260 basis points year to date and the highest rate recorded this decade.
- ◆ **Outlook:** This year, employers are expected to cut 40,000 workers from payrolls, a 3.8 percent decrease. In 2008, roughly 32,900 jobs were lost.

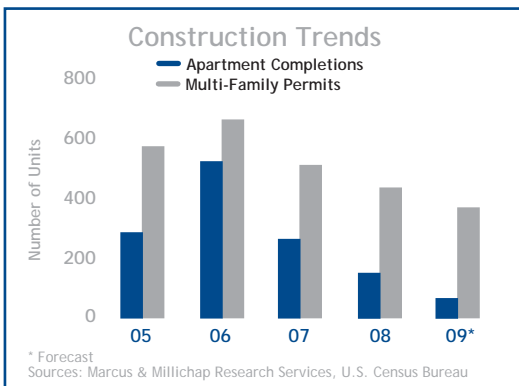
HOUSING AND DEMOGRAPHICS

- ◆ Permit issuance continues to decline in the Cleveland metro, which should minimize supply-side threats over the next few years. During the 12 months ending in the third quarter, permits for 1,700 units of single-family housing were issued, a decrease of 22 percent from the year before. Multi-family permit issuance amounted to 200 units in the most recent 12-month period, down 61 percent.
- ◆ The median price of an existing single-family home in the metro area ended the third quarter at \$75,700, 28 percent less than one year earlier. Prices are falling in response to sluggish demand and increased sales of distressed or foreclosed units.
- ◆ The current median household income of \$49,000 per year in Cleveland is nearly three times the minimum income required to afford a median-priced home.
- ◆ **Outlook:** Despite housing affordability, apartment demand will remain supported by tighter local financing standards and soft conditions in the single-family market.



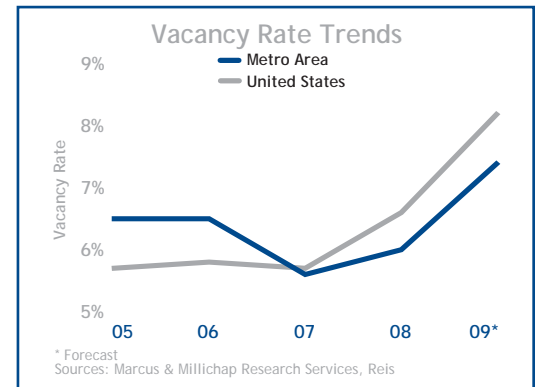
CONSTRUCTION

- ◆ In the 12 months ending in the third quarter, only 56 units were delivered in the metro. In the previous year, 400 units were added.
- ◆ There is currently one project under way in Cleveland. The 240-unit property, located at 668 Euclid Avenue in the Downtown/The Flats/Warehouse District submarket, is slated for completion in the first quarter of 2010.
- ◆ Approximately 475 condo units are under construction throughout the metro, most of which are scheduled for delivery next year. Due to weak for-sale conditions, though, some of the units will likely come online as rentals.
- ◆ **Outlook:** A year after builders completed 144 apartment units, just 56 units will come online in 2009, expanding inventory by less than 0.1 percent. Over the past five years, deliveries have averaged 400 units annually.



VACANCY

- ◆ A decline in employment-generated housing demand has underpinned a 180 basis point rise in the apartment vacancy rate since the third quarter of last year to 7.1 percent. Vacancy fell 20 basis points in the preceding 12-month period due to fewer employment cuts.
- ◆ Despite minimal supply growth, staff reductions within the professional and business services sector have reduced renter demand for Class A units, pushing up top-tier vacancy 170 basis points in the past year to 7.6 percent.
- ◆ The vacancy rate in the lower tiers has increased 200 basis points over the last 12 months to 7 percent. Upward pressure on vacancy will likely persist in the metro's Class B/C assets due to forecasts for continued weakness in construction and services industry employment.
- ◆ **Outlook:** The vacancy rate is expected to end the year up 140 basis points at 7.4 percent. Last year, vacancy rose 40 basis points.



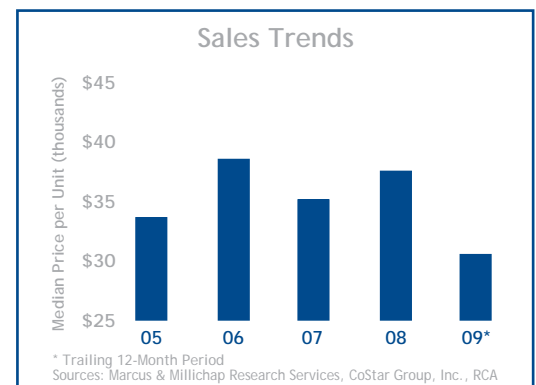
RENTS

- ◆ In the third quarter, asking rents were estimated at \$727 per month, down 0.8 percent from the previous quarter and 1.7 percent less than in the third quarter of 2008. Effective rents fell 0.9 percent in the third quarter to \$690 per month and were down 2.4 percent on a year-over-year basis.
- ◆ Class A asking rents were \$905 per month in the third quarter, a 1.2 percent decrease from one year earlier and 0.8 percent less than rents in the second quarter. In the Class B/C segment, asking rents declined 0.7 percent to \$659 per month in the third quarter and have fallen 1.9 percent over the last 12 months.
- ◆ Concessions currently account for 5.1 percent of asking rents, up from 4.5 percent of asking rents a year ago. Owners may push concessions higher through year end to combat rising vacancy rates.
- ◆ **Outlook:** Asking rents are forecast to fall 2.3 percent to \$722 per month in 2009, and effective rents are projected to drop 3 percent to \$684 per month. Last year, asking rents ticked up 1.5 percent, while effective rents increased 1.6 percent.



SALES TRENDS**

- ◆ During the most recent 12-month period, transaction velocity fell 30 percent, following a 9 percent drop in the preceding year. Velocity will remain constrained in the near term as investors continue to underwrite for greater vacancy and concessions.
- ◆ The median price recorded in deals made over the past 12 months was \$30,500 per unit, or 21 percent less than in the previous year, when the median price increased 6 percent.
- ◆ During the last 12 months, cap rates have risen about 100 basis points. Initial yields for Class A assets have averaged from 8.0 percent to 8.5 percent in that time, and lower-tier properties have traded with cap rates from 9.0 percent to 10.5 percent.
- ◆ **Outlook:** Investment activity will remain limited due to expectations for softer operations over the next six months. Investor interest will continue to center on close-in submarkets with steadier demand, like Beachwood and Shaker Heights.



** 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

- ◆ Compared to other core property sectors, apartments have fared best due to the availability of financing through government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. Recent modifications to GSE guidelines will impact lender decisions, however, as borrower requirements include more substantial apartment ownership experience.
- ◆ Loan-to-value requirements range from 55 percent to 75 percent. Portfolio lenders are issuing loans at all-in rates of 6.00 percent to 6.75 percent for a five-year term and 6.9 percent to 8.0 percent for a 10-year term. Rates among agency lenders are roughly 150 basis points to 175 basis points lower. The government recently assumed full control of Fannie Mae and Freddie Mac, which may boost confidence in the GSEs, putting downward pressure on rates, but it also creates several near-term uncertainties.
- ◆ Delinquencies will rise further as a wave of maturities approaches; however, at-risk borrowers may find lenders amenable to loan extensions/modifications. Furthermore, Freddie Mac is under way on its second securitization of multi-family debt this year, and the government's TALF program is expected to at least provide a much-needed spark to the traditional CMBS market.

SUBMARKET OVERVIEW

- ◆ OfficeMax will close its call center in the Euclid/West Lake County submarket in late October, eliminating 200 full-time employees.
- ◆ State and local officials are finalizing plans to encourage the expansion of Immediate Pharmaceutical Services Inc. in Avon Lake, which could result in the addition of 200 jobs within the Bay Village/Westlake/Rocky River submarket.
- ◆ Class A units in the Beachwood submarket remain some of the most sought-after in the metro by renters. As of the third quarter, vacancy in top-tier apartments was below 3 percent, while vacancy for Class B/C properties in the area was nearly 5 percent.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Beachwood	4.1%	-30	\$1,092	-0.2%
2	Strongsville/Berea/Brook Park	4.9%	30	\$618	-4.6%
3	Lakewood/Linndale/Brooklyn	6.6%	110	\$618	0.4%
4	Lyndhurst/Mayfield/Richmond Heights	6.8%	310	\$701	0.8%
5	Parma/Independence	6.9%	140	\$653	-0.9%
6	Euclid/West Lake County	6.9%	230	\$639	-2.1%
7	Bay Village/Westlake/Rocky River	7.3%	100	\$790	-5.0%
8	Bedford/Garfield Heights	7.7%	210	\$582	-2.6%
9	East Cleveland/Cleveland Heights	8.4%	340	\$635	-3.0%
10	North Royalton/Brecksville	9.3%	230	\$663	-1.6%