

## CREDIT ISSUES CONTINUE TO SLOW DEAL FLOW IN THE TWIN CITIES

Apartment fundamentals in the Twin Cities have posted mixed results so far this year, as occupancy levels remain flat while rents are falling; however, ongoing weakness in the labor market is forecast to deteriorate conditions into 2010. Vacancy is projected to end this year above 5 percent for the first time since 2006, which will drive further rent reductions. In fact, owners are expected to raise concessions to 26 days of free rent in 2009, the largest amount offered in five years, and leasing incentives will likely push higher as employment remains soft over the next few months. Outlying counties, particularly Anoka, Dakota and Washington, will struggle due to job cuts and competition from shadow rentals, pushing concessions in these areas to over one month of free rent by year end. Meanwhile, interior locations such as the St. Paul and Northeast submarkets are averaging less than two weeks of free rent, as demand has been propped up by cost-conscious residents moving into the areas.

Investors continue to be hindered by restricted access to credit, as well as diminished equity in their current properties. In addition, the expectations gap is being perpetuated by owners of assets in strong locations who have been unwilling to discount prices to meet the market, resulting in slow transaction velocity in recent months. Deal flow will likely move at a measured pace into 2010, as smaller buyers are having trouble meeting debt-coverage ratios and out-of-state players are cautious about the local economy. Cash-heavy buyers, however, are facing limited competition and are targeting properties in the Minneapolis and West submarkets, as occupancy levels in these areas have held up comparatively well recently. Buyers with greater risk tolerance may find opportunities in distressed assets in locations with fixed infrastructures and solid demographics, like the Gateway area in St. Paul or the Uptown portion of Minneapolis.

## 2009 ANNUAL APARTMENT FORECAST



**Employment:** Total employment in Minneapolis will continue to be weighed down by heavy losses in the manufacturing and professional and businesses services sectors. Payrolls are expected to contract by 3.6 percent, or 63,000 positions, this year. In 2008, roughly 39,900 jobs were cut.



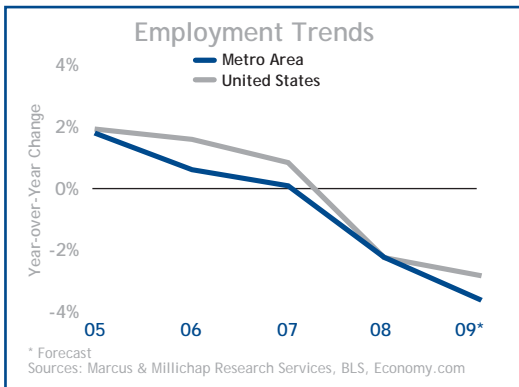
**Construction:** Approximately 650 units are projected to come online in 2009, a 0.4 percent boost to apartment stock and less than the 1,050 units completed last year.



**Vacancy:** A spike in deliveries in the second half, coupled with ongoing weakness in the employment market, is forecast to drive up vacancy 80 basis points this year to 5.2 percent, following a 20 basis point improvement in 2008.



**Rents:** Operational challenges will continue to drag down rents. Asking rents are projected to end 2009 at \$946 per month, a 1.2 percent decline, and effective rents will slip 2.9 percent to \$879 per month.

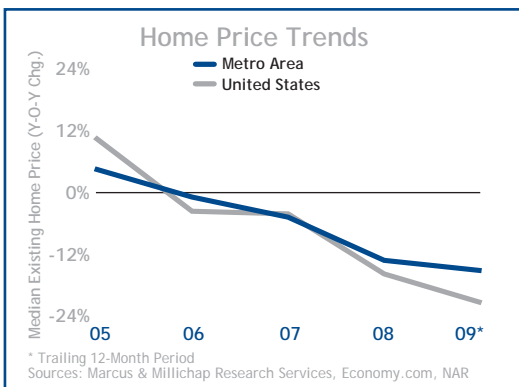


## ECONOMY

- ◆ During the past 12 months, employers in the Twin Cities have trimmed approximately 68,000 jobs, thinning payrolls by 3.8 percent.
- ◆ Manufacturing head counts have been reduced by 9 percent, or 17,600 spots, over the last year. Locally based manufacturer Donaldson Inc. recently announced layoffs of 100 additional workers, bringing the company's total cuts thus far in 2009 to 2,700 employees.
- ◆ The education and health services sector has added 4,200 positions in the past year, while government payrolls have expanded by 4,600 jobs, making these the only metro employment segments to still be posting gains.
- ◆ **Outlook:** Total employment in Minneapolis will continue to be weighed down by heavy losses in the manufacturing and professional and business-services sectors. Payrolls are expected to contract by 3.6 percent, or 63,000 positions, this year. In 2008, roughly 39,900 jobs were cut.

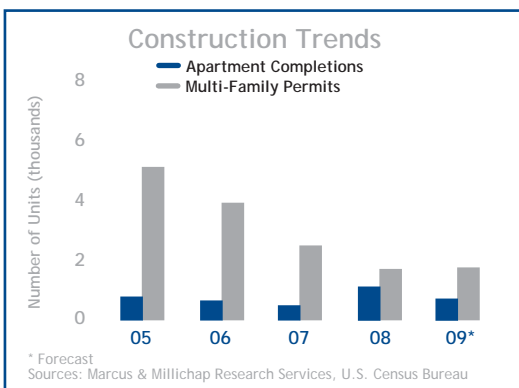
## HOUSING AND DEMOGRAPHICS

- ◆ Single-family permit issuance has slowed 31 percent in the last year to 3,290 units; however, the number of permits pulled in the third quarter increased significantly, indicating a growing confidence among area builders.
- ◆ Permits for 1,575 multi-family units have been issued during the past 12 months, a 15 percent decline from the previous year.
- ◆ The median home price fell nearly 18 percent year over year to an estimated \$169,200 in the third quarter. As prices have dropped, affordability has improved; the current median household income of \$57,700 per year is \$15,500 greater than the amount needed to finance a median-priced home, using traditional financing.
- ◆ **Outlook:** Despite rising affordability, many renters are reluctant to transition into homeownership due to the overall uncertainty regarding the duration and severity of the downturn in the local employment market.



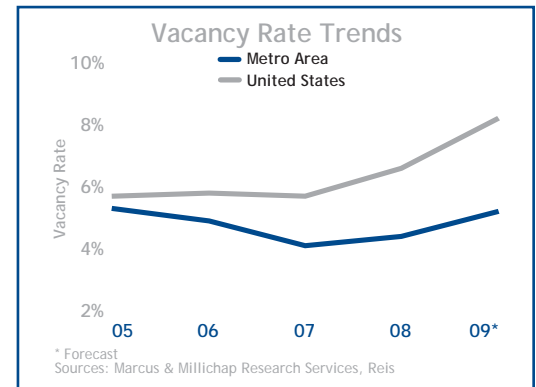
## CONSTRUCTION

- ◆ Developers have completed roughly 900 units over the last 12 months, boosting metro inventory by 0.6 percent. Nearly 60 percent of those units came online in the third quarter of this year.
- ◆ There are 705 apartments under way marketwide. Approximately 600 units are scheduled for the Minneapolis and St. Paul submarkets, as builders are attempting to capture demand from young professionals and students in these areas.
- ◆ Over the past year, the metro's planning pipeline has swelled by nearly 30 percent to roughly 4,360 units. The largest proposed developments are located in the Minneapolis submarket, including the 445-unit Bassett Creek and 358-unit Marmot complexes.
- ◆ **Outlook:** Approximately 650 units are projected to come online in 2009, a 0.4 percent boost to apartment stock and less than the 1,050 units completed last year.



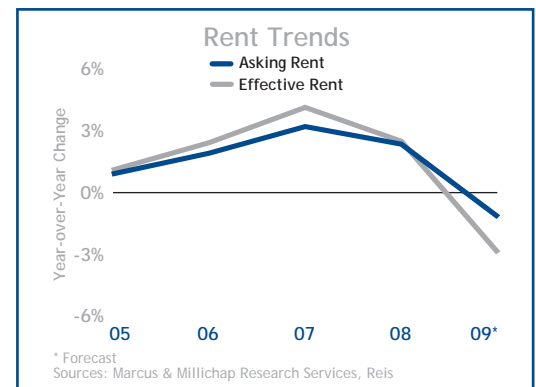
## VACANCY

- ◆ Preliminary figures place the metrowide vacancy rate at 4.9 percent in the third quarter, 100 basis points higher than one year earlier.
- ◆ During the past year, vacancy in Class A units has risen 130 basis points to 5.5 percent, due in large part to inventory additions. While construction is expected to ease, the rate will likely continue to climb in the coming months as residents seek more affordable housing options.
- ◆ Demand for Class B/C units has been bolstered by job losses that have thinned the Class A renter pool, limiting the vacancy increase in the sector to 70 basis points over the last year to 4.4 percent.
- ◆ **Outlook:** A spike in deliveries in the second half, coupled with ongoing weakness in the employment market, is forecast to drive up vacancy 80 basis points this year to 5.2 percent, following a 20 basis point improvement in 2008.



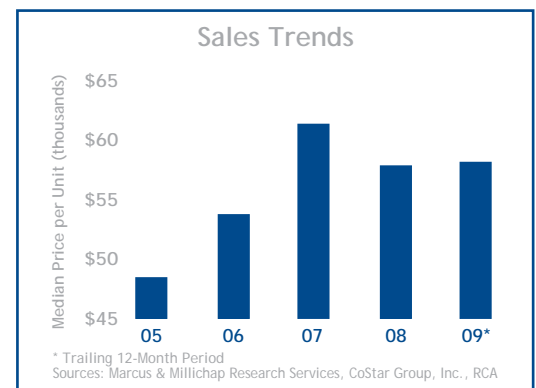
## RENTS

- ◆ Owners reduced asking rents 0.6 percent year over year to \$950 per month in the third quarter, according to early estimates. During the same period, effective rents fell 1.8 percent to \$887 per month.
- ◆ Class A asking rents ended the third quarter at \$1,128 per month, while Class B/C asking rents were \$811 per month, annual declines of 0.9 percent and 0.6 percent, respectively.
- ◆ While vacancy remains relatively tight, rising concessions are playing a role in decreasing revenue. Average revenues contracted by 2.8 percent through the 12 months ending in the third quarter, the first annual decrease in five years.
- ◆ **Outlook:** Operational challenges will continue to drag down rents. Asking rents are projected to finish 2009 at \$946 per month, a 1.2 percent decline, and effective rents will slip 2.9 percent to \$879 per month.



## SALES TRENDS\*\*

- ◆ The tight credit markets and still-wide expectations gap continue to hinder deal flow, as transaction velocity slowed 25 percent during the most recent 12-month period. In the past six months, sales activity has dropped nearly 40 percent when compared to the previous six-month stretch.
- ◆ While the median sales price has remained around \$58,100 per unit over the past year, prices have increased 12 percent in the last six months, due in large part to investors' flight-to-safety strategies.
- ◆ Top-quality assets are closing with cap rates around 8 percent, while underperforming properties or those in struggling locations have initial yields in the mid-10 percent to mid-11 percent range.
- ◆ **Outlook:** Risk-averse investors may find opportunities near the metro's many universities and colleges. The weak labor market has contributed to an upturn in enrollment, generating renter demand for apartments close to campuses, particularly Class B/C properties.



\*\* 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

- ◆ Vacancy in the Northeast submarket has increased 130 basis points year over year, one of the largest rises in the metro. As a result, owners are expected to widen concessions from the current level of one week of free rent to fill vacant units over the next few months.
- ◆ Oversupply may become a concern in the Minneapolis submarket. Although current construction activity is in line with the historical average, nearly 1,900 units are planned for the area, representing a 7 percent increase in stock, the largest total in the metro.
- ◆ City officials in Woodbury, located in the Washington County submarket, are offering loans to help residents make first-time home purchases, which could sap renter demand from top-tier apartments in the coming quarters.

## SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Northwest/ Anoka County	4.3%	90	\$756	-2.2%
2	Northeast	4.6%	130	\$803	-3.2%
3	West	4.9%	70	\$934	-3.0%
4	St. Paul	4.9%	80	\$852	-1.4%
5	Southwest	4.9%	120	\$893	-2.1%
6	Dakota County	5.0%	120	\$863	-1.0%
7	Minneapolis	5.3%	80	\$1,041	-0.9%
8	Washington County	6.5%	200	\$933	-1.2%