

OVERBUILDING, SHADOW STOCK WEIGHING ON FUNDAMENTALS

The Phoenix apartment market will continue to falter as a result of additional completions, pressure from shadow stock and ongoing job losses. The housing downturn has worsened in recent quarters, which has led to steep declines in metrowide employment due to the area's high concentration of real estate-related jobs. Year to date, employers have eliminated 79,000 positions, or 4.4 percent of the local work force. As a result, outlying areas, where builders once depended on job growth for household creation, are now registering some of the highest vacancy rates in the metro. In the Goodyear/Avondale/Tolleson submarket, for example, vacancy rates are nearing 20 percent, almost double the market average, as overbuilding in recent years has led to a supply/demand imbalance, and investors have turned low-priced, foreclosed single-family residences into income-producing properties. The South Scottsdale submarket, on the other hand, will continue to outperform the metro, as the area is close to employment hubs such as the Scottsdale Fashion Square mall and has had no additions to inventory since 2000.

Transaction velocity has picked up in recent months, increasing 44 percent in the first two quarters of the year from the second half of 2008. As the credit markets remained tight and conservative lenders required higher contributions from buyers, the majority of deals closed in the metro during the first half of 2009 were penned for under \$10 million. Activity in the months ahead will likely be centered around infill areas like central Phoenix and Tempe, where limited supply additions and employment centers will help to curb further fundamental weakening. Metrowide, cap rates are averaging in the mid-7 percent to low-8 percent range and will likely trend higher in the coming months as investors underwrite for increasing vacancy rates and lower rents.

2009 ANNUAL APARTMENT FORECAST



Employment: Local employers are projected to shed 106,000 jobs this year, a 5.9 percent decrease. In 2008, employment contracted by 111,200 positions, or 5.8 percent.



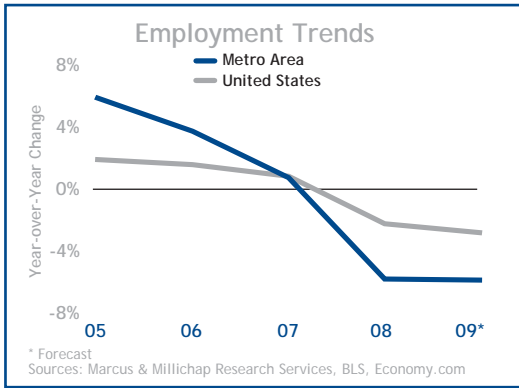
Construction: Builders are forecast to deliver 5,000 apartment units in 2009, increasing stock by 2 percent. Last year, 4,300 units came online in the metro, a 1.7 percent expansion.



Vacancy: Additional completions and competition from shadow stock will drive up vacancy this year. Apartment vacancy is expected to reach 12.3 percent, 120 basis points higher than the rate at year-end 2008.

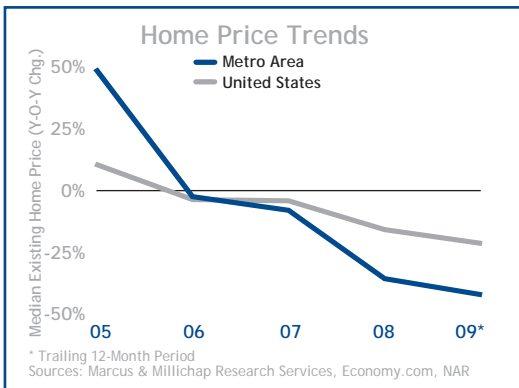


Rents: As vacancy continues to climb, asking rents are forecast to recede 1.5 percent to \$765 per month in 2009, while effective rents will fall 4.2 percent to \$680 per month. Last year, asking rents edged 0.5 percent higher, and effective rents slipped 0.4 percent.



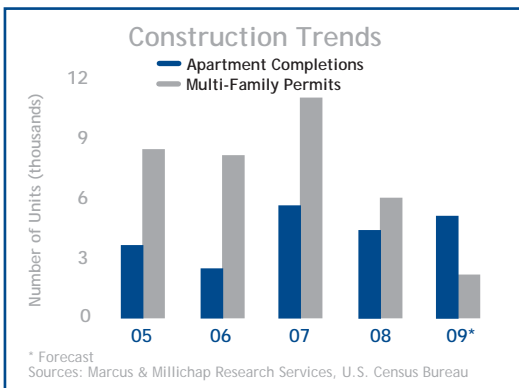
ECONOMY

- ◆ Employment levels in Phoenix contracted by an estimated 140,000 positions year over year in the third quarter, a decrease of 7.9 percent. In the preceding 12-month period, 65,000 jobs were eliminated.
- ◆ Although home sales have picked up recently, the metro's oversupply of housing continues to weigh heavily on construction employment. Year over year, nearly 40,000 construction workers have been let go in Phoenix, reducing sector head counts by 30 percent. Every major employment segment has recorded layoffs over the past year, though education and health services has contracted the least, trimming less than 1 percent from payrolls.
- ◆ In the third quarter, the unemployment rate in Phoenix was estimated at 9 percent, the highest rate in over two decades. Unemployment is forecast to reach 10 percent by year end.
- ◆ **Outlook:** Local employers are projected to shed 106,000 jobs this year, a 5.9 percent decrease. In 2008, employment contracted by 111,200 positions, or 5.8 percent.



HOUSING AND DEMOGRAPHICS

- ◆ In the past 12 months, permits for 2,000 multi-family units have been issued, down from 7,500 units one year earlier. Single-family permit issuance has declined nearly 50 percent to 7,900 units.
- ◆ As a result of increasing foreclosure sales in the metro, the median price of a single-family residence was estimated at \$106,400 in the third quarter, a year-over-year decrease of 42 percent. Sales velocity of single-family homes dropped 30 percent during that time.
- ◆ Homes remain highly affordable, as the median household income of \$48,300 per year is 74 percent greater than the income needed to meet the monthly mortgage obligations on a median-priced residence.
- ◆ **Outlook:** Despite the availability of affordable homes, continued uncertainty in housing prices and ongoing employment weakness will help to curb demand for single-family homes and keep individuals in the renter pool.

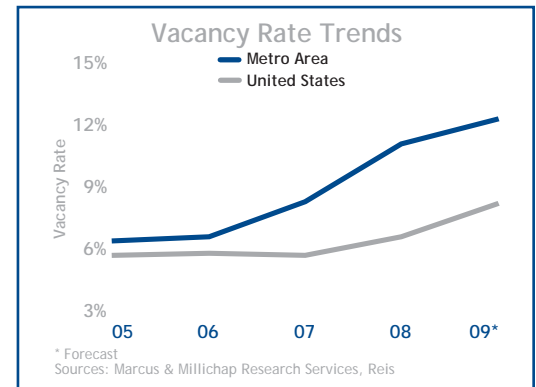


CONSTRUCTION

- ◆ Apartment inventory in Phoenix has increased 1.8 percent year over year, or by 4,500 units. In the preceding 12-month period, roughly 3,200 units were delivered.
- ◆ Approximately 9,000 rental units are in the planning stages in the metro. Most of the proposed projects are slated for the Central Phoenix South, North Glendale/Peoria and Goodyear/Avondale/Tolleson submarkets.
- ◆ The largest project under way is the 700-unit Trillium at Pinnacle Peak in the North Scottsdale/Fountain Hills submarket. Construction is scheduled to be completed in February 2010.
- ◆ **Outlook:** Builders are forecast to deliver 5,000 apartment units in 2009, increasing stock by 2 percent. Last year, 4,300 units came online in the metro, a 1.7 percent expansion.

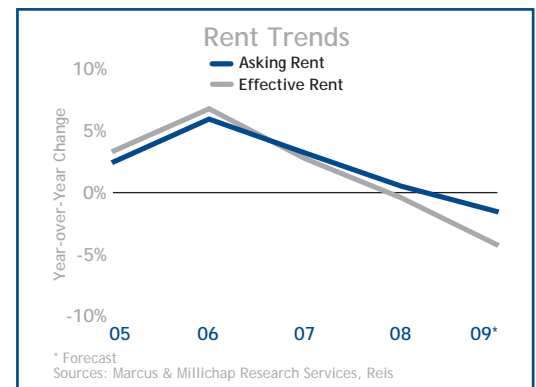
VACANCY

- ◆ Steady job losses and additional completions continue to widen the metro's supply/demand imbalance. Vacancy ended the third quarter at an estimated 11.7 percent, rising 130 basis points year over year. This is the highest apartment vacancy rate in Phoenix in more than 20 years.
- ◆ With deliveries remaining elevated over the past year and demand softening further, Class A vacancy rose 150 basis points through the third quarter to 11.5 percent.
- ◆ The vacancy rate in the lower tiers has pushed up 110 basis points in the last 12 months to 11.8 percent. The increase is primarily the result of job losses in the metro, most notably in the construction sector.
- ◆ **Outlook:** Ongoing completions and competition from shadow stock will drive up vacancy this year. Apartment vacancy is expected to reach 12.3 percent, 120 basis points higher than the rate at year-end 2008.



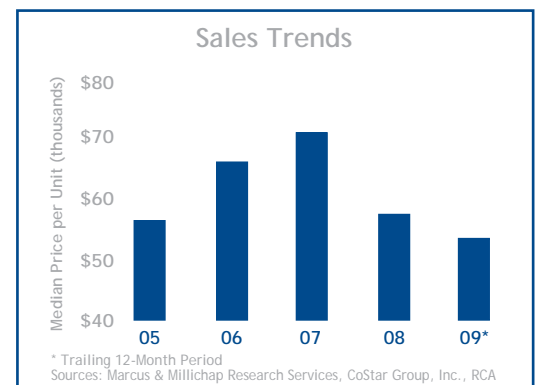
RENTS

- ◆ During the past year, asking rents have receded 1.4 percent to \$770 per month, and effective rents have decreased 4.2 percent to \$687 per month. Year to date, asking and effective rents have fallen 0.9 percent and 3.2 percent, respectively.
- ◆ Asking rents in the Class A sector slipped 0.7 percent to \$917 per month year over year in the third quarter, while a 3 percent cut to \$653 per month was posted in the lower tiers.
- ◆ Revenue has declined as a result of increasing vacancy and additional concession offerings. In the past 12 months, the average revenue has dropped 3.8 percent, following a 0.9 percent contraction in the previous year.
- ◆ **Outlook:** As vacancy continues to climb, asking rents are forecast to recede 1.5 percent to \$765 per month in 2009, while effective rents will fall 4.2 percent to \$680 per month. Last year, asking rents edged 0.5 percent higher, and effective rents slipped 0.4 percent.



SALES TRENDS**

- ◆ Transaction velocity has declined by 50 percent in the last year, as lenders remain cautious when underwriting deals, and many buyers are waiting on the sidelines for distressed properties to be listed. The number of deals closed in the second quarter of 2009, however, exceeded total transactions in the first quarter of this year and fourth quarter of 2008.
- ◆ As investors have targeted deeply discounted assets, the median price has fallen nearly 20 percent year over year to \$54,000 per unit.
- ◆ Cap rates are currently averaging in the high-6 percent to mid-7 percent range for Class A properties and the high-7 percent to high-8 percent range for lower-tier assets. During the past 12 months, cap rates have increased approximately 150 basis points.
- ◆ **Outlook:** The expectations gap is beginning to narrow, as falling prices have begun to attract buyers. Still, demand for stabilized properties will remain low over the next few months as investors continue to focus on deeply discounted, troubled assets.



** 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

- ◆ This year, the North Scottsdale/Fountain Hills submarket is expected to receive 1,300 units, expanding inventory by 8.5 percent. As such, vacancy is projected to reach 12 percent by year end, up 130 basis points annually.
- ◆ Investors may want to consider opportunities in South Chandler, as a large proportion of dual-income families resides in the area, and vacancy is still improving. Additionally, the Price Road corridor is home to high-tech employers such as Intel and continues to receive interest from renewable energy companies.
- ◆ Vacancy in the East Mesa submarket has decreased 20 basis points over the past 12 months to 8.5 percent. Concessions in the area have been elevated significantly, however, and now equal 12 percent of asking rents, compared with 9.4 percent of asking rents one year ago.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	South Scottsdale	7.8%	190	\$794	-4.2%
2	East Mesa	8.5%	-20	\$697	-5.2%
3	South Tempe/Ahwatukee	9.0%	50	\$787	-2.0%
4	North Glendale/Peoria	10.1%	80	\$742	-1.6%
5	West Mesa	10.2%	-50	\$592	-2.5%
6	Northeast Phoenix	10.2%	280	\$673	-3.3%
7	Chandler/Gilbert	10.6%	-200	\$766	-2.9%
8	North Tempe	10.7%	150	\$766	5.1%
9	North Scottsdale/Fountain Hills	10.8%	240	\$929	-3.0%
10	Sunnyslope	11.0%	240	\$633	-4.1%