ApartmentResearch
MARKET UPDATE
Marcus & Millichap

Riverside-San Bernardino Metro Area *Fourth Quarter 2009*

Buyers Shy Away from Outlying Cities, Target Infill Areas

The long-term outlook for the Inland Empire apartment market remains positive due to healthy population growth projections, though significant headwinds will persist into 2010. Renter demand will moderate further during the final months of 2009 due to widespread layoffs in most sectors. With the region's unemployment rate exceeding 14 percent in August, apartment vacancy is expected to exceed 9 percent by year end, a level unseen in more than two decades. Years of aggressive apartment building activity also will weaken operations, particularly in the University City/Moreno Valley submarket. The area has received almost 3,500 rental units over the past five years, expanding inventory by 26 percent. Farther outlying areas such as the Palm Springs/Palm Desert submarket will be challenged by investor-owned single-family homes entering the rental market. This trend helped push vacancy in this area to over 15 percent in the third quarter, pressuring owners to raise concessions to 8 percent of asking rents, the most in the metro.

Although apartment sales activity in the Inland Empire continues to decelerate, some buyers may be poised to re-enter the market as recent transactions pave the way for better price discovery. The majority of closings during the past six months have been in dense locations such as the North Ontario and San Bernardino submarkets, with deal flow in the latter accounting for roughly 60 percent of all activity in that stretch. Increased sales in this area have been supported partially by an uptick in distressed-asset and REO transactions by bargain-seeking investors based in neighboring Southern California markets. As such, average cap rates in the San Bernardino submarket have climbed into the low- to mid-8 percent range, approximately 75 basis points to 100 basis points above the marketwide average. As fundamentals across the region soften further and a greater number of troubled assets come to market at attractive cap rates, buying activity should begin to gain traction throughout the Inland Empire in 2010.

2009 Annual Apartment Forecast

5.1% decrease in total employment

Employment: Local employment is expected to shrink by 60,000 workers this year, a 5.1 percent decrease. In 2008, head counts contracted by 77,500 positions, a loss of 6.1 percent.

850 units will be completed

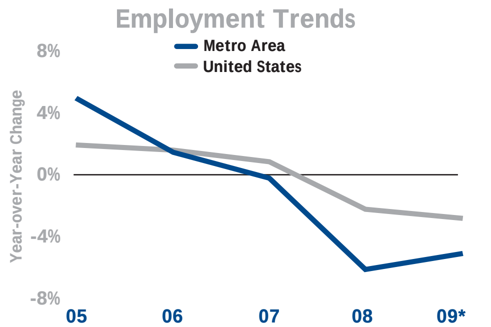
Construction: A year after builders delivered 440 apartments, 850 units will come online in 2009. During the past five years, completions have averaged 2,350 units annually.

220 basis point increase in vacancy

Vacancy: Despite still-moderate construction activity, weak renter demand will increase vacancy 220 basis points this year to 9.2 percent. In 2008, vacancy climbed 70 basis points.

2.8% decrease in asking rents

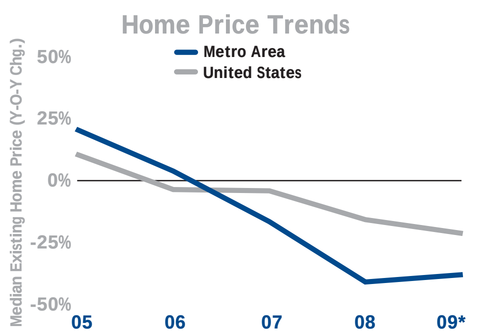
Rents: Asking rents are forecast to retreat 2.8 percent to $1,028 per month in 2009, while effective rents will slip 4.6 percent to $971 per month.



* Forecast
Sources: Marcus & Millichap Research Services, BLS, Economy.com

Economy

- Employment levels in the region contracted by an estimated 79,000 positions year over year in the third quarter, a decrease of 6.5 percent. In the preceding 12-month period, 55,900 jobs were eliminated.
- Key industries in the Inland Empire continue to record substantial losses. The trade, transportation and utilities sector has posted the largest job cuts, with nearly 25,000 workers released during the past year, an 8.5 percent payroll decrease. Stalled development activity, meanwhile, has resulted in an estimated 22,500 construction layoffs, a decline of 26.1 percent.
- The education and health care sector has begun to reduce staffing levels. Following the addition of almost 3,700 workers one year earlier, preliminary data indicates that roughly 180 spots were cut during the most recent 12-month period. Cardinal Health Inc., for instance, eliminated approximately 300 local positions in the third quarter.
- **Outlook:** Employment is expected to shrink by 60,000 workers this year, a 5.1 percent decrease. In 2008, head counts contracted by 77,500 jobs, a loss of 6.1 percent.



* Trailing 12-Month Period
Sources: Marcus & Millichap Research Services, Economy.com, NAR

Housing and Demographics

- Permit issuance for single-family residences has decelerated by 84 percent during the past year to 4,670 units. Multi-family permitting activity has declined 86 percent year over year to 1,580 units.
- The median price of a single-family home in the Inland Empire was estimated at $139,800 in the third quarter, an annual decrease of 38 percent. The median household income, meanwhile, dropped 3.9 percent to $52,200 per year, 44 percent above the minimum amount required to qualify for a median-priced metro home.
- The rapid decline in the median home price has resulted in a monthly mortgage obligation that is $400 per month lower than the average Class A asking rent, using traditional financing.
- **Outlook:** Although the potential for more residents to transition into ownership could increase due to falling values, the local job market remains in turmoil, preventing many local inhabitants from making home purchases.

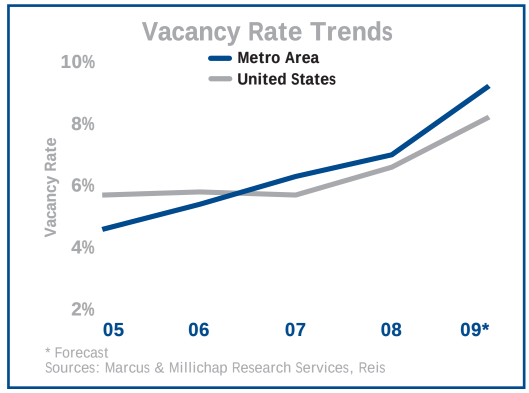
* Forecast
Sources: Marcus & Millichap Research Services, U.S. Census Bureau

Construction

- Fewer than 100 apartment units have been delivered over the past year, expanding inventory by just 0.1 percent. During the previous 12 months, 1,710 units came online.
- At present, more than 1,500 units are under way across the metro, and an additional 6,050 apartments are in the planning stages.
- The only rental project to come online so far this year is the 74-unit Magnolia Court Townhomes, located in Riverside County/Corona submarket. The development includes luxury units ranging in size from approximately 1,450 square feet to 1,550 square feet.
- **Outlook:** A year after builders delivered 440 apartments, 850 units will come online in 2009. During the past five years, additions have averaged 2,350 units annually.

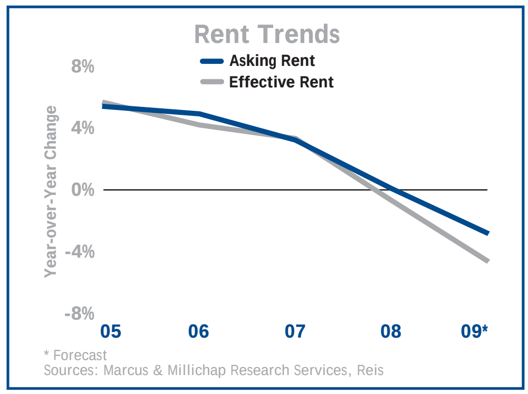
Vacancy

- Receding demand and residential oversupply issues pushed up vacancy an estimated 190 basis points to 8.4 percent during the year ending in the third quarter. In the prior 12-month stretch, vacancy rose 120 basis points.
- With a greater number of investor-owned single-family homes absorbing some apartment demand, the metro's Class A vacancy rate has increased 210 basis points year over year to 9 percent.
- The vacancy rate in the Class B/C sector has risen 170 basis points in the last year to 8 percent. The uptick stems from weakness in typically lower-paying employment sectors forcing some residents to seek roommates.
- **Outlook:** Despite still-moderate construction activity, weak renter demand will increase vacancy 220 basis points this year to 9.2 percent. In 2008, vacancy climbed 70 basis points.



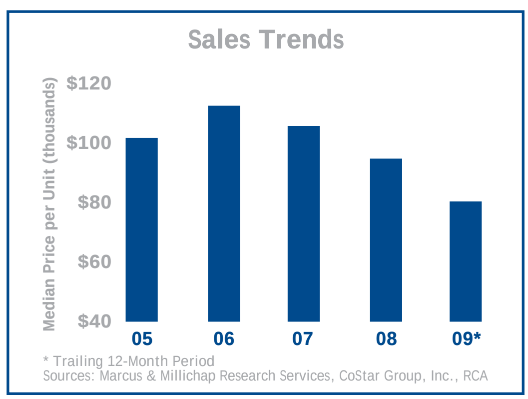
Rents

- Over the 12 months ending in the third quarter, asking rents decreased 3 percent to $1,038 per month, and effective rents retreated 4.7 percent to $983 per month. Year to date, asking and effective rents have dropped 1.9 percent and 3.4 percent, respectively.
- Class A asking rents slid 3.5 percent to $1,205 per month year over year in the third quarter, while rents in Class B/C properties declined 2.4 percent to $930 per month.
- Revenues have contracted in the Inland Empire due to rising vacancy and falling rents. During the past year, average revenues have decreased 6.7 percent, following a 0.4 percent downtick in the previous 12 months.
- **Outlook:** Asking rents are forecast to retreat 2.8 percent to $1,028 per month in 2009, while effective rents will slip 4.6 percent to $971 per month.



Sales Trends**

- Transaction velocity has declined 48 percent during the past 12 months, as buyers expect a greater number of distressed assets to be listed in the coming quarters.
- The median price of an apartment asset in the Inland Empire has decreased nearly 16 percent to $80,000 per unit year over year. Over the last six months, closings have registered a median price of $72,500 per unit.
- In the past two quarters, cap rates have averaged in the mid- to high-7 percent range, up more than 150 basis points from year-end 2008. Several transactions with deferred maintenance issues, however, have sold with first-year returns above 9 percent. Additional upward movement may occur into 2010 as elevated vacancy levels and rent reductions fuel conservative underwriting.
- **Outlook:** Buyers seeking steadier operations will continue to target properties in the North Ontario submarket, where proximity to neighboring coastal markets is expected to sustain relatively healthy demand. Currently, vacancy in the area is among the tightest in the metro, and concessions are a market-low 3.7 percent of asking rents.



*** Data reflect a full 12-month period, calculated on a trailing 12-month basis by quarter.*

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 100 basis points to 150 basis points lower. The government's creation of a conservatorship for Fannie Mae and Freddie Mac has most likely boosted confidence in the two GSEs, putting downward pressure on rates, but it also creates several near-term uncertainties, as the conservatorship is due to expire at the end of the year.

- 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

- Fourth quarter apartment additions in the Upland submarket are expected to total approximately 450 units, which will expand the area's inventory by more than 8 percent. As a result, vacancy in the submarket is forecast to exceed 8 percent by year end.

- Construction continues at the Southern California Logistics Centre, which is located at the site of the former George Air Force Base in Victorville. Upon the project's final build-out, more than 20,000 jobs and 19,000 support positions are expected to be created in the area, bolstering rental housing demand.

- The state's budget deficit and recession have impacted local redevelopment funds. Cathedral City, for instance, located in the Palm Springs/Palm Desert submarket, will lose $22 million in redevelopment money due to falling property values and requirements to lend funds to the state.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Rancho Cucamonga	5.2%	140	$1,260	-5.0%
2	North Ontario	6.1%	60	$1,101	-1.6%
3	Riverside County/Corona	6.5%	120	$1,037	-7.7%
4	Colton/Loma Linda	7.0%	190	$1,022	-5.2%
5	Riverside/North Magnolia	7.1%	210	$924	-4.8%
6	Upland	7.2%	290	$1,027	-5.0%
7	South Ontario/Chino	7.2%	340	$1,232	-4.6%
8	Hemet	8.6%	200	$718	-4.6%
9	Southwest Riverside County	9.0%	-50	$1,057	-4.4%
10	San Bernardino	9.1%	190	$785	-4.9%

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NATIONAL MULTI HOUSING GROUP

Visit www.NationalMultiHousingGroup.com or call:
Linwood C. Thompson
Senior Vice President, Managing Director
National Multi Housing Group
Tel: (678) 808-2700
lthompson@marcusmillichap.com

Marcus & Millichap
Real Estate Investment Services

Prepared and edited by
Michael L. Brown
Research Analyst
Research Services

For information on national apartment trends, contact
John Chang
National Research Manager
Tel: (602) 687-6700 ext. 6803
john.chang@marcusmillichap.com

Ontario Office:
Doug McCauley
Regional Manager
dmccauley@marcusmillichap.com
One Lakeshore Center
3281 E. Guasti Road
Suite 800
Ontario, California 91761

Tel: (909) 456-3400
Fax: (909) 456-3410

Price: $150