

BUYERS MONITOR PRICE ADJUSTMENTS AS RENTS SLIDE

Economic contraction fueled by steep employment losses will continue to deteriorate rents in the San Francisco apartment market this year, with further softening projected through the first half of 2010. Unemployment has reached its highest level in more than two decades, dragging on apartment demand and causing operators to implement sharp rent declines to maintain occupancy levels. In fact, effective rents in some areas where rates were inflated during the most recent period of economic expansion have fallen more than 10 percent since peaking several quarters ago. Work force reductions in the high-paying professional and business services and technology sectors have spiked vacancy in submarkets that command premium rents, such as Russian Hill/Embarcadero and the South of Market area. In the Civic Center/Downtown submarket, where rents are the lowest and the tenant base consists primarily of blue-collar demographics, residents have been doubling up or relocating to more affordable markets, pushing vacancy higher. As such, conditions have held the steadiest in the Richmond/Sunset and Haight-Ashbury submarkets due to their relative affordability and stable tenant bases.

San Francisco's investment climate will shift over the next several quarters as activity spurred by some large, private owners looking to realign portfolios reveals how rapidly deteriorating fundamentals have adjusted valuations. Trading has gained momentum in the last few months due to the uptick in transactions involving discounted lender-owned properties. Such activity will have a cascade effect on market valuations, setting the benchmark for future price corrections and generating interest from previously inactive investors with accumulated cash reserves. This could allow buyers to acquire properties in desirable neighborhoods such as Pacific Heights and Russian Hill, where operations should begin to firm when the economy turns around. Marketwide, cap rates are averaging in the mid-5 percent to low-6 percent range, with some assets in tertiary neighborhoods garnering initial yields near the mid-7 percent mark.

2009 ANNUAL APARTMENT FORECAST



Employment: San Francisco employers are projected to trim staffing levels by 5.3 percent in 2009, or 51,600 workers. Last year, 15,700 jobs were cut.



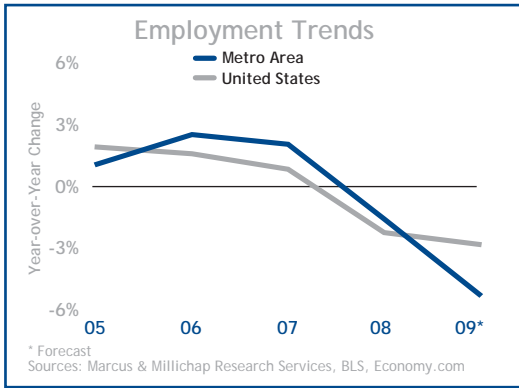
Construction: Developers are on pace to complete 450 apartment units this year, a 0.3 percent expansion and up from 2008, when 280 units were delivered. Annual stock additions have averaged roughly 540 units for the last five years.



Vacancy: Steep employment cuts will continue to weigh on occupancy levels. Vacancy is expected to end the year at 5.6 percent, a 200 basis point annual climb, following a 30 basis point improvement in 2008.



Rents: This year, economic contraction will bring down rents to levels last recorded in 2007. Asking rents are forecast to slip 8.3 percent to \$1,773 per month, and effective rents are projected to fall to \$1,649 per month, a 9.7 percent drop.

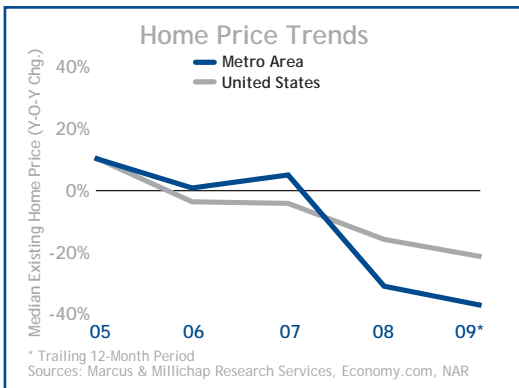


ECONOMY

- ◆ San Francisco employers have thinned head counts by 5.2 percent during the past year with the elimination of 52,100 positions through the third quarter. In the last six months, roughly 21,000 jobs have been cut.
- ◆ A considerable slowdown in consumer spending tied to the loss of high-paying jobs, in addition to waning tourism activity, has driven a year-over-year contraction in the trade, transportation and utilities segment of 8.3 percent, or 13,400 workers.
- ◆ Significant payroll reductions resulted in metro unemployment rising to 9.4 percent in August, the highest rate in more than 20 years and up 420 basis points from the same period in 2008.
- ◆ **Outlook:** San Francisco employers are projected to trim staffing levels by 5.3 percent in 2009, or 51,600 workers. Last year, 15,700 jobs were cut.

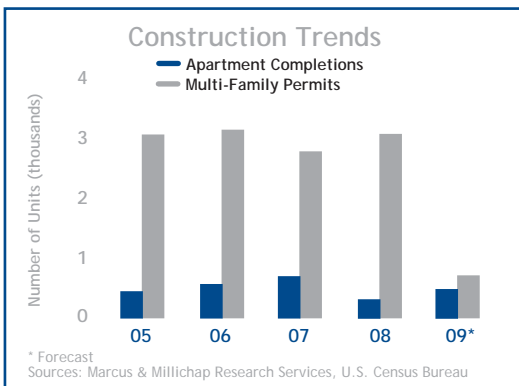
HOUSING AND DEMOGRAPHICS

- ◆ A decrease in housing demand has driven a considerable decrease in permitting activity during the past year. Roughly 350 single-family housing permits have been issued in that time, a 45 percent year-over-year drop. Multi-family permit issuance has declined nearly 70 percent to 890 units.
- ◆ The median price of a single-family home was estimated at \$439,000 in the third quarter, an annual decrease of 37 percent. The area's median home price has fallen roughly 50 percent from the peak.
- ◆ Despite softening prices, home affordability in San Francisco remains a challenge. The metro's median income has slipped 5 percent in the past year, making it \$36,700 less than the minimum amount required to qualify for a median-priced residence.
- ◆ **Outlook:** The metro's affordability gap has narrowed recently, as the average Class A asking rent is only \$220 per month more than the typical mortgage obligation, using traditional financing methods. Despite this, some of the highest home prices in the country and a deep renter pool continue to prop up apartment demand.



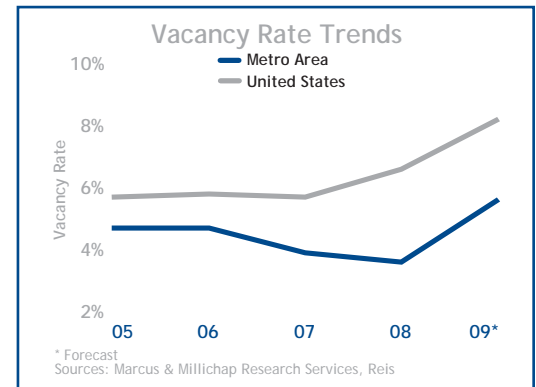
CONSTRUCTION

- ◆ Developers have completed roughly 450 units during the past year, up from the previous 12-month period, when 280 units came online.
- ◆ Approximately 770 units are under way, all scheduled for delivery by 2011. More than 4,300 units are in the planning pipeline, almost half of which are located in the Civic Center/Downtown submarket.
- ◆ Condo construction persists, as developers are finalizing several projects that broke ground before the economic downturn worsened. In 2009, builders are expected to complete 1,800 condo units.
- ◆ **Outlook:** Developers are projected to bring online 450 apartment units this year, a 0.3 percent expansion and up from 2008, when 280 units were delivered. Annual stock additions have averaged roughly 540 units for the last five years.



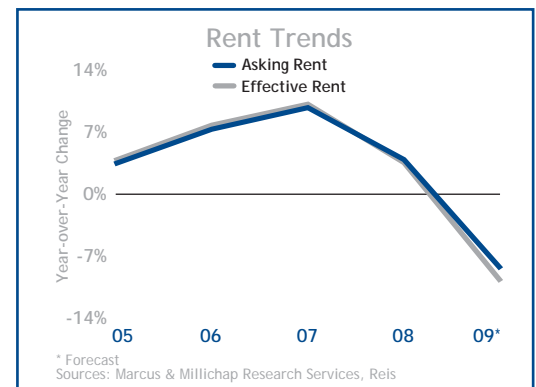
VACANCY

- ◆ Vacancy has jumped 160 basis points over the past 12 months to 5.3 percent as a result of receding renter demand. During the last six months, vacancy has risen 100 basis points.
- ◆ Employment losses in the high-paying professional and business services and financial services sectors have been a drag on demand for premium units. Class A vacancy spiked 200 basis points year over year to 6.6 percent in the third quarter.
- ◆ In the Class B/C segment, many tenants are doubling up to cut costs. As such, lower-tier vacancy reached 4.2 percent in the third quarter, a 130 basis point climb from one year earlier.
- ◆ **Outlook:** Steep employment cuts will continue to weigh on occupancy levels. Vacancy is expected to end the year at 5.6 percent, a 200 basis point annual increase, following a 30 basis point improvement in 2008.



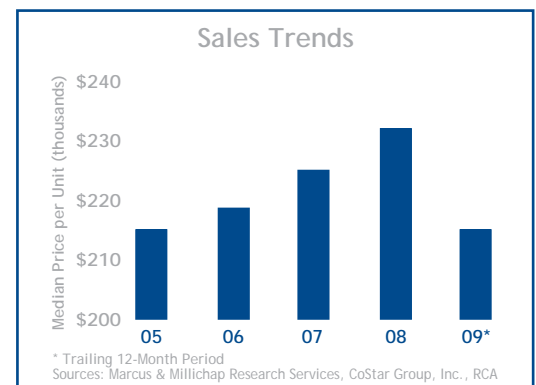
RENTS

- ◆ Weakened economic conditions continue to deteriorate rents. Over the last year, asking rents retreated 5.6 percent to \$1,820 per month, while effective rents dropped 7.1 percent to end the third quarter at \$1,699 per month.
- ◆ Class A asking rents have decreased 6.3 percent in the past 12 months to \$2,197 per month. In the lower tiers, asking rents have fallen to \$1,505 per month, a 5 percent decline.
- ◆ Steep reductions in effective rents have driven an 8.6 percent slide in average revenues during the past 12 months, compared with a 6.8 percent gain in the previous year.
- ◆ **Outlook:** This year, economic contraction will bring down rents to levels last recorded in 2007. Asking rents are forecast to slip 8.3 percent to \$1,773 per month, and effective rents are projected to fall to \$1,649 per month, a 9.7 percent drop.



SALES TRENDS**

- ◆ Rapidly declining fundamentals and uncertainty regarding the depth and length of the recession have elevated investor caution during the past year. Transaction velocity has dropped 30 percent in that time, though activity gained momentum recently, closings in the third quarter outpaced those in previous quarters.
- ◆ Over the last 12 months, declining revenues have driven a 7 percent drop in the median price to \$215,000 per unit. Increased sales involving distressed properties has placed further downward pressure on valuations, as the median price fell to \$193,300 per unit during the most recent six-month span.
- ◆ Cap rates for recently closed deals have averaged in the mid-5 percent to low-6 percent range, depending on property quality and location. Some assets in tertiary areas may require yields above 7 percent to generate bids.
- ◆ **Outlook:** As more lender-owned properties trickle into the market in the coming quarters, sales activity is expected to gain traction. Previously inactive investors with accumulated cash reserves will begin to enter the buyer pool, seeking out discounted assets with maintainable rents.



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

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CAPITAL MARKETS

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- ◆ 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

- ◆ Operators in the Richmond/Sunset submarket have widened concessions to compete with the steep rent discounts offered in more desirable close-in submarkets. As a result, average revenues in the area have dropped 12 percent over the last year.
- ◆ As elevated job cuts have prompted some lower-tier renters to double up in order to reduce monthly expenses, Class B/C vacancy in the Civic Center/Downtown submarket has spiked more than 300 basis points in the past year to the low-5 percent area.
- ◆ The largest development to come online this year was the Avalon at Mission Bay North, located in the South of Market area. Delivered in the third quarter, this project added 260 units to stock and expanded submarket inventory by 2.8 percent.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Marina/Pacific Heights	3.6%	120	\$2,059	-6.7%
2	Haight-Ashbury	4.6%	90	\$1,760	-4.4%
3	Civic Center/Downtown	5.3%	310	\$1,314	-9.7%
4	Russian Hill/Embarcadero	5.3%	330	\$2,135	-7.4%
5	Richmond/Sunset	6.1%	80	\$1,731	-11.7%
6	South of Market	8.2%	390	\$2,087	-4.9%