

LAYOFFS, DELIVERIES WEAKEN TOP TIER; CLASS B UNITS OUTSHINE

While Puget Sound employment contraction is projected to ease by the end of the year, the effects on apartment fundamentals will likely linger through the first half of 2010. Major employers and local support firms have implemented mass layoffs during the past 12 months, as the metro has slipped deeper into the recession. Steep job losses in high-paying sectors have affected top-tier operations in the Downtown/Queen Anne/Capitol Hill and Redmond submarkets, where the majority of Washington Mutual and Microsoft job cuts were concentrated. Operators in these areas have implemented the most drastic year-over-year effective rent reductions in the metro in response to reduced tenant demand and recent oversupply issues. Mid-tier conditions in submarkets adjacent to downtown, such as North Seattle/Northgate and Beacon Hill/Rainier Valley/Skyway, have held relatively steady due to more affordable rents and strong tenant bases. As firms relocate from secondary locations to discounted top-tier office space, apartment conditions in these areas will likely soften. Russell Investments, for example, announced plans to move their headquarters from downtown Tacoma to the former WaMu building in downtown Seattle, which will relocate 900 workers and drag on renter demand in the North Tacoma submarket.

Transaction velocity has slowed considerably from peak levels due to fewer quality offerings and projections for further operational weakening. Deals involving distressed assets have been limited since the start of the year; however, as owners find it increasingly difficult to meet debt obligations, REO activity will likely pick up in the beginning of 2010. Recent oversupply issues have hampered trading in the typically strong Downtown/Capitol Hill/Queen Anne submarket, as climbing vacancy levels have eroded revenues over the past 12 months. As such, buyers have been looking to stable-operating Class B assets in areas such as the North Seattle/Northgate submarket, where proximity to job centers and more affordable rents have propped up conditions. Cap rates marketwide, meanwhile, are averaging in the low-7 percent area, with some lesser assets garnering initial yields roughly 100 basis points higher.

2009 ANNUAL APARTMENT FORECAST



Employment: Puget Sound employers are forecast to shed 53,200 jobs this year, a 3.1 percent contraction. In 2008, 28,000 workers were let go.



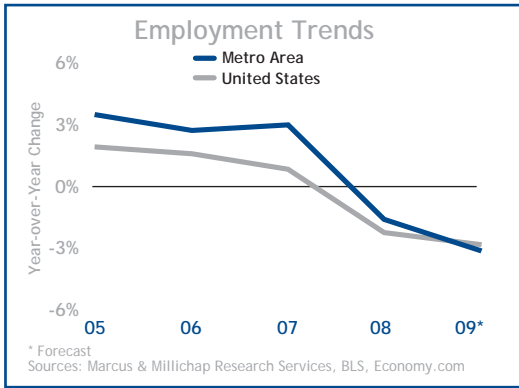
Construction: Deliveries are expected to accelerate in 2009, as 4,275 apartment units are scheduled for completion, well above the five-year average of 2,800 units and a 1.9 percent inventory expansion. Last year, 3,000 units came online.



Vacancy: Mounting deliveries will be met with receding demand, as vacancy is projected to reach a historic high of 8.2 percent this year, a 240 basis point annual spike. In 2008, vacancy increased 140 basis points.



Rents: In 2009, asking rents are forecast to retreat 3.9 percent to \$975 per month. Owners will widen concessions in response to climbing vacancy levels, as effective rents are expected to fall 6.7 percent to \$895 per month.

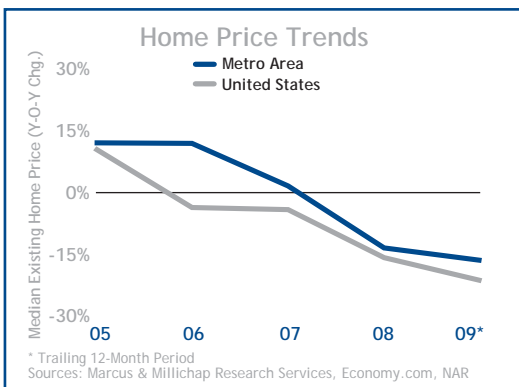


ECONOMY

- ◆ Puget Sound employers have trimmed staffing levels by 4.4 percent during the past 12 months with the elimination of 77,200 workers. Job losses have eased recently, however, as payroll reductions over the last six months have totaled roughly 20,000 workers.
- ◆ Weakness in the manufacturing and construction sectors has significantly contributed to overall payroll contraction in the past year. Losses within these segments amounted to nearly 35,000 jobs year over year in the third quarter.
- ◆ Mass layoffs within locally based corporations have weighed heavily on support firms in the professional and business services sector. In the 12 months ending in the third quarter, employers reduced head counts by 7.2 percent, or roughly 17,500 positions.
- ◆ **Outlook:** Employers are forecast to shed 53,200 jobs this year, a 3.1 percent contraction. In 2008, 28,000 workers were let go.

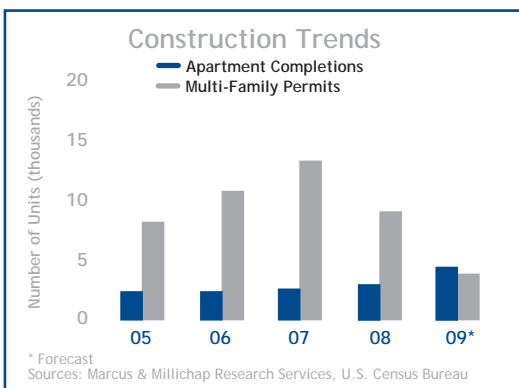
HOUSING AND DEMOGRAPHICS

- ◆ The weak local economy and housing market have generated a steep decline in permit activity. Year over year, 4,500 single-family permits have been issued, down 44 percent from the preceding 12 months. The drop in multi-family permit issuance was more pronounced, declining 65 percent to 3,700 units.
- ◆ The median price of a single-family home in the Puget Sound fell 16 percent over the last 12 months to \$288,400 in the third quarter. The median household income slipped 8 percent to \$63,200 in that time, \$7,500 less than the minimum income required to qualify for a median-priced home.
- ◆ The monthly mortgage payment on a median-priced residence, using traditional financing, is \$430 more than the average Class A asking rent.
- ◆ **Outlook:** Out-of-reach single-family home prices and continued economic uncertainty will likely minimize the number of renters making the jump to homeownership over the next several quarters.



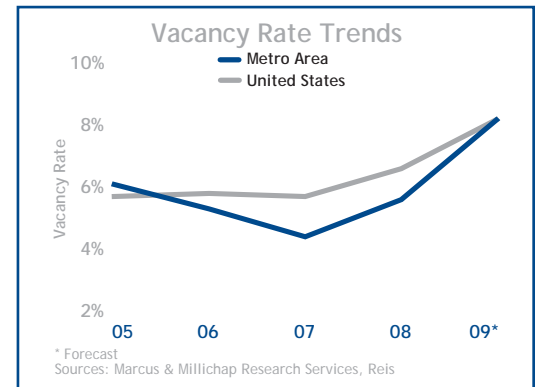
CONSTRUCTION

- ◆ Construction activity remains robust, as projects that broke ground before the recession took effect are being finalized. Developers have added nearly 4,200 units to stock during the past 12 months, expanding metrowide inventory by 1.8 percent.
- ◆ Builders continue to move forward with projects, despite economic weakness, as more than 5,500 units are under way, more than half of which are scheduled for completion in 2010. The planning pipeline contains approximately 15,600 units.
- ◆ Condo construction has accelerated, as 2,300 for-sale units are slated for delivery in 2009. A dampened housing market, however, may result in some of the units coming online as high-end rentals.
- ◆ **Outlook:** In 2009, 4,275 apartment units are due for delivery, well above the five-year average of 2,800 units and a 1.9 percent inventory expansion. Last year, 3,000 units were completed.



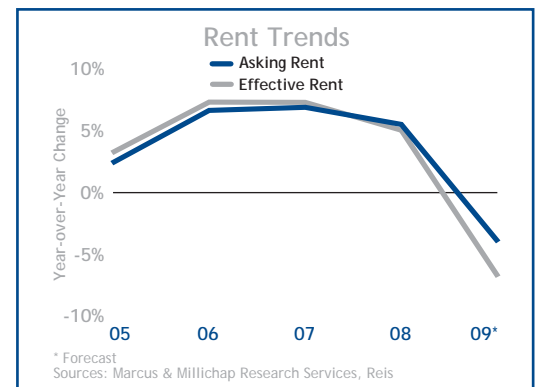
VACANCY

- ◆ Over the 12 months ending in the third quarter, a wider supply/demand imbalance pushed up vacancy in the Puget Sound region by 240 basis points to 7.5 percent.
- ◆ Elevated construction levels have placed supply-side pressure on Class A conditions, as vacancy jumped 270 basis points during the last year to 8.2 percent in the third quarter.
- ◆ Employment losses within lower-paying sectors such as manufacturing and construction have dragged on Class B/C demand. As a result, vacancy in the lower tiers has risen 200 basis points to 6.9 percent in the past 12 months.
- ◆ **Outlook:** Mounting deliveries will be met with receding demand, as vacancy is projected to reach a historic high of 8.2 percent this year, a 240 basis point annual spike. In 2008, vacancy increased 140 basis points.



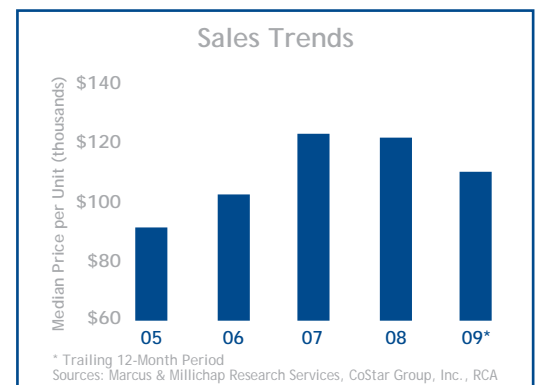
RENTS

- ◆ In the third quarter, asking rents dipped 3 percent year over year to \$984 per month. Effective rents retreated 4.8 percent in that time to \$918 per month. Rent declines have accelerated, as asking and effective rents fell 2.4 percent and 2.9 percent, respectively, during the most recent six-month span.
- ◆ Class B/C asking rents dropped 2.9 percent over the year ending in the third quarter to \$848 per month. Elevated competition has prompted top-tier operators to employ steeper rent reductions, as Class A asking rents fell 3.7 percent to \$1,158 per month during that time.
- ◆ Weakened occupancy levels have driven a 7.2 percent contraction in revenues over the past 12 months, following a 7 percent gain in the preceding year.
- ◆ **Outlook:** In 2009, asking rents are forecast to retreat 3.9 percent to \$975 per month. Owners will widen concessions in response to climbing vacancy levels, as effective rents are expected to slip 6.7 percent to \$895 per month.



SALES TRENDS**

- ◆ Sales activity has slowed by more than 50 percent during the past 12 months, as many buyers remain on the sidelines, given projections for further fundamental weakening.
- ◆ Declining revenues and a reduced bidding climate have placed downward pressure on valuations, as the median price has fallen 11 percent in the last year to \$109,600 per unit.
- ◆ Average cap rates are currently in the high-6 percent to low-7 percent range, with some recent deals involving lesser assets closing at cap rates above 8 percent. Some quality assets in primary locations such as downtown Seattle and the Eastside, however, have garnered initial yields in the high-5 percent area.
- ◆ **Outlook:** Buyers will likely seek out stabilized properties in core submarkets where rents were not overinflated during the most recent period of economic expansion. Mid-tier assets are expected to attract the most attention, as an oversupply of high-end units in these areas continues to batter Class A operations.



** 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 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.

MARKET OVERVIEW

- ◆ In Seattle, elevated supply additions have spiked Class A vacancy 320 basis points during the past 12 months to 8.7 percent. Lower-tier vacancy has jumped 210 basis points to 7 percent. Asking rents for high-end units have dropped 4.2 percent in the last year to \$1,219 per month, while Class B/C asking rents have fallen to \$882 per month, a 3.2 percent annual decline.
- ◆ Over the past year, Tacoma's Class A vacancy rate has risen 110 basis points to 6.5 percent, and asking rents have slipped 0.9 percent to \$880 per month. Vacancy in the lower tiers has increased 120 basis points year over year to 6.3 percent, while asking rents eased to \$652 per month, a 0.1 percent dip.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	University Place/Fircrest	3.9%	60	\$721	-3.9%
2	Edmonds/Lynnwood	5.6%	180	\$856	-4.4%
3	Tukwila/Sea-Tac	5.8%	180	\$753	-6.1%
4	North Tacoma	6.1%	180	\$726	-3.5%
5	Auburn/Enumclaw	6.2%	190	\$776	-2.8%
6	Lakewood	6.4%	160	\$728	-3.8%
7	McChord Air Force Base	6.4%	-10	\$572	-0.1%
8	Kent	6.5%	270	\$835	-3.0%
9	South Tacoma	6.9%	70	\$719	-1.4%
10	Renton	7.0%	110	\$884	-7.3%
11	Downtown/Capitol Hill/Queen Anne	7.4%	270	\$1,229	-7.3%
12	East Tacoma	7.5%	150	\$791	-2.1%
13	Everett/Mukilteo/Mill Creek	7.6%	150	\$861	-5.5%
14	Redmond	7.7%	360	\$1,068	-9.5%
15	Bellevue/Issaquah	7.9%	260	\$1,113	-4.9%
16	Kirkland/Juanita	8.1%	280	\$1,166	-5.1%
17	Des Moines/West Kent	8.1%	370	\$811	-4.3%
18	North Seattle/Northgate	8.6%	420	\$967	-3.1%
19	Federal Way	8.6%	220	\$806	-3.0%
20	Parkland/Spanaway/Midland	8.8%	380	\$698	1.0%
21	Bothell/Woodinville	9.2%	530	\$1,012	-4.8%
22	West Seattle/Burien	9.7%	570	\$819	-4.2%
23	Beacon Hill/Rainier Valley/Skyway	10.7%	-170	\$916	-5.3%