

## FUNDAMENTALS SLIP, DESPITE EASING ECONOMIC OUTLOOK

After peaking in mid-2009, work force reductions in Washington, D.C., are beginning to ease, potentially setting the stage for job growth in 2010. Although NOI increases will lag employment gains, easing economic stresses are expected to yield incremental improvements in key operating metrics such as rents and vacancy. Thus far, revenues have been most stable in Northern Virginia, where modest rent reductions have kept vacancy within 20 basis points of rates one year ago. Furthermore, resilient demand for close-in apartment properties has supported revenue growth in the North-east Alexandria/Glebe Road, Pentagon City/Crystal City and Old Town submarkets. In the district, concessions are rising quickly, particularly in large, newer apartments with extended lease-up periods, though vacancy remains stable in core locations like the Downtown/Logan's Circle submarket. While concessions also have increased considerably in suburban Maryland, the use of incentives has been less effective in moderating vacancy rises, especially in tertiary areas with new apartment product. Construction is beginning to subside marketwide, however, a trend that, when coupled with the possibility of economic improvement, could translate into a reduction in concessions next year.

In light of marked price declines, owners are hesitant to list their properties, while prospective buyers are awaiting further discounts. As a result, deal flow in the Washington, D.C., metro has declined sharply during the past year, and the buyer/seller pricing expectations gap remains wide. In northern Virginia, NOIs have dipped modestly, and owners are reluctant to sell properties at a discount. Although there are few assets for sale in Virginia, buyers will likely have to look to outlying areas such as Manassas and Prince William County for rising cap rates. Conversely, sizable price decreases are discouraging sellers at close-in Maryland locations, though a narrower bid-ask gap in Prince George's County is buoying velocity. Across the district, attractive pricing has maintained velocity, while failed condominium developments are garnering attention in the Uptown and Southeast areas.

### 2009 ANNUAL APARTMENT FORECAST



**Employment:** Lingering economic stresses will force 26,500 metro employees out of work in 2009, a 0.9 percent decline. Last year, 12,900 jobs were eliminated.



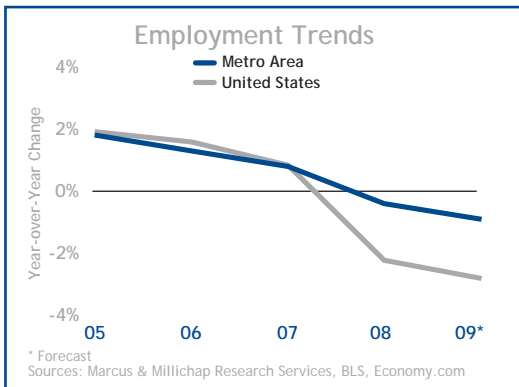
**Construction:** After 6,130 units were brought online in 2008, builders will slow the pace of development to 5,680 units this year.



**Vacancy:** Job losses and slower household creation will keep upward pressure on vacancy, with the rate rising 130 basis points to 6.8 percent in 2009. Last year, vacancy pushed 40 basis points higher.



**Rents:** This year, waning renter demand will cause asking rents to slip 0.7 percent to \$1,355 per month, while effective rents are expected to retreat 1.8 percent to \$1,282 per month. Asking rents gained 3.6 percent in 2008, and effective rents ascended 3.2 percent.

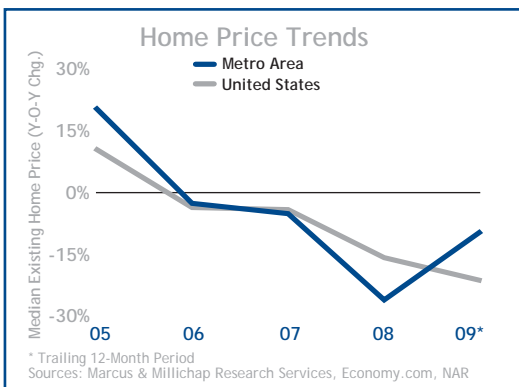


## ECONOMY

- ◆ Local businesses thinned payrolls by 46,200 positions, or 1.5 percent, in the 12-month period ending in the third quarter. In the previous year, 19,600 new hires were added.
- ◆ Some metro employment sectors are adding workers. Approximately 5,200 government jobs have been created in the last year, while businesses in the professional and business services sector have generated 1,700 positions.
- ◆ Over the past year, the unemployment rate has climbed 220 basis points to 6.1 percent. Reflecting a slower pace of layoffs, unemployment has increased just 80 basis points in the last six months.
- ◆ **Outlook:** Lingering economic stresses will force 26,500 metro employees out of work in 2009, a 0.9 percent decline. Last year, 12,900 jobs were eliminated.

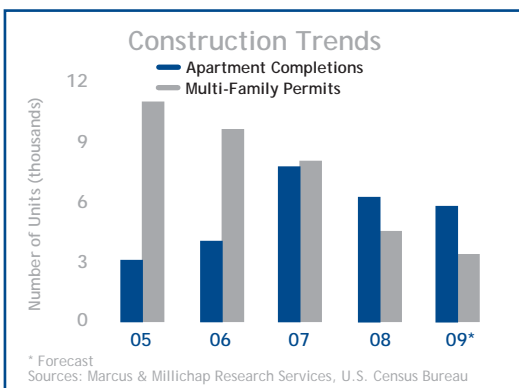
## HOUSING AND DEMOGRAPHICS

- ◆ Job losses and falling residential demand have caused developers to slow their efforts throughout the metro. The number of single-family permits issued has declined 9 percent in the last year to 8,900 units. During the same stretch, multi-family permitting activity retreated 45 percent to 3,260 units.
- ◆ As of the third quarter, the median price of an existing single-family home was \$297,790, 10 percent less than in the same quarter last year and 33 percent below the peak median price in early 2007.
- ◆ Plummeting home values have narrowed the gap between homeownership and renting. The monthly mortgage payment on the metro's median-priced home is \$1,651, slightly above the metro's average Class A asking rent of \$1,638 per month.
- ◆ **Outlook:** Declines in single-family home values will allow some renters to make the jump to homeownership. Nevertheless, the possibility of further job losses and home price depreciation will minimize the number of residents exiting the renter pool.



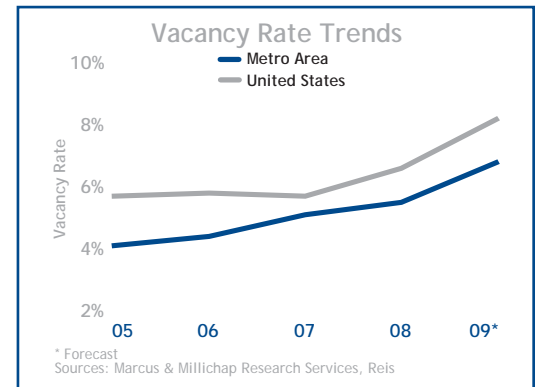
## CONSTRUCTION

- ◆ The recession is becoming apparent in the metro's construction pipeline, as just 6,420 apartment have been added to inventory in the past year, down from 8,740 units in the previous 12 months.
- ◆ As delivery dates stretch into 2011, there are currently 8,400 units under way. Additionally, 20,800 units are in planning, though a lack of construction capital will prevent some builders from breaking ground.
- ◆ Construction efforts are accelerated in northern Virginia, as the 788 units slated for completion in the Rosslyn/Ballston submarket and 724 apartments in Tysons Corner/Fairfax City are the most in any area of the metro.
- ◆ **Outlook:** After 6,130 units were brought online in 2008, builders will slow the pace of development to 5,680 units this year.



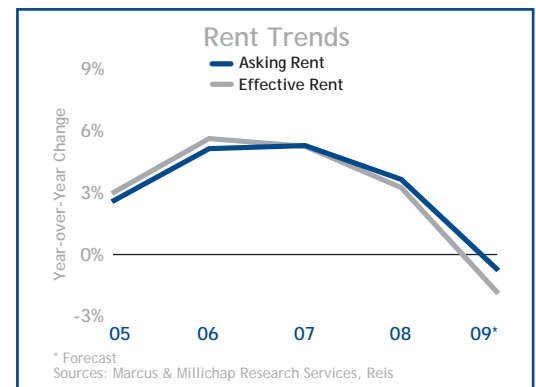
## VACANCY

- ◆ Waning renter demand drove up marketwide vacancy 130 basis points year over year to end the third quarter at an estimated 6.6 percent. Vacancy rose 80 basis points in the preceding 12 months.
- ◆ Class A vacancy has ascended 120 basis points in the past year to 7.2 percent. The rate increased by the same measure in the previous 12 months.
- ◆ Over the last year, a sharp decline in demand for the metro's lower-tier properties has underpinned a 140 basis point rise in Class B/C vacancy to 6.2 percent, compared with a 50 basis point uptick in the prior year.
- ◆ **Outlook:** Job losses and slower household creation will keep upward pressure on vacancy, with the rate rising 130 basis points to 6.8 percent in 2009. Last year, vacancy pushed 40 basis points higher.



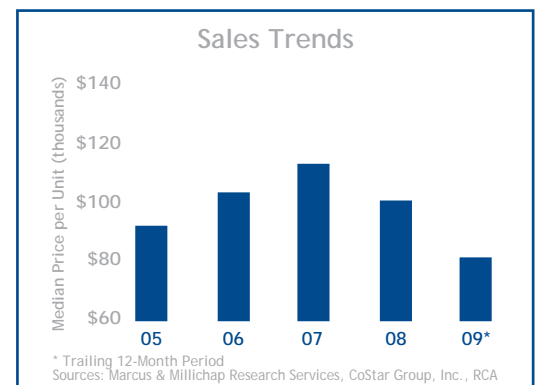
## RENTS

- ◆ In the 12-month period ending in the third quarter, asking rents inched up 0.1 percent to an estimated \$1,361 per month, though effective rents decreased 1.2 percent to \$1,290 per month. Asking and effective rents appreciated 4.7 percent and 4.6 percent, respectively, in the preceding year.
- ◆ Top-tier asking rents have declined 0.2 percent year over year to \$1,638 per month. Among Class B/C properties, however, owners have been able to raise asking rents 0.3 percent to \$1,168 per month.
- ◆ Increased vacancy and concessions are weighing on cash flows, as the average revenue has declined 2.6 percent since the third quarter of 2008. Revenues advanced 3.8 percent in the previous one-year span.
- ◆ **Outlook:** This year, asking rents are forecast to slip 0.7 percent to \$1,355 per month, while effective rents are expected to retreat 1.8 percent to \$1,282 per month. Asking rents gained 3.6 percent in 2008, and effective rents ascended 3.2 percent.



## SALES TRENDS\*\*

- ◆ Tight lending standards and waning investor demand have slowed transaction velocity 22 percent over the past year. In each of the two previous 12-month periods, however, deal flow decreased by roughly 32 percent.
- ◆ Declining revenues are causing buyers to push for discounts. As a result, the median price has plummeted 28 percent in the last year to \$81,030 per unit. Prices appreciated 5 percent during the preceding 12-month stretch.
- ◆ In 2008, cap rates for most metro assets averaged approximately 6 percent. Stricter debt markets and falling NOIs, however, have since pushed initial yields into the high-6 percent range. Cap rates for assets in tertiary locations start near 7.5 percent.
- ◆ **Outlook:** With buyers reluctant to accept elevated prices in near-in northern Virginia areas and deep discounts dissuading sellers in core cities in Maryland, activity is expected to be concentrated in the district. Conservative buyers are finding solid Class B/C opportunities in historically strong locations such as Georgetown. Meanwhile, aggressive investors are targeting failed condominium projects, which have the possibility of above-average returns.



\*\* 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.

## SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Kensington/Wheaton	3.3%	0	\$1,289	0.4%
2	Dupont Circle/Adams Morgan	3.4%	20	\$1,474	-4.9%
3	Falls Church/Annandale	4.4%	10	\$1,304	-0.1%
4	Rosslyn/Ballston	5.1%	-30	\$1,727	-0.9%
5	Northeast Alexandria/Glebe Road	5.3%	50	\$1,113	3.2%
6	Takoma Park	5.4%	230	\$1,108	0.3%
7	Seminary Road/Landmark	5.4%	0	\$1,345	-0.4%
8	Southeast Fairfax County	5.7%	40	\$1,325	-1.4%
9	Western Fairfax County	6.0%	70	\$1,317	-5.4%
10	Gaithersburg/Germantown	6.0%	170	\$1,226	-1.8%
11	Hyattsville	6.0%	280	\$1,016	2.0%
12	Northwest D.C./Georgetown	6.1%	300	\$1,542	-3.8%
13	Prince William County	6.2%	60	\$1,027	-2.8%
14	Tysons Corner/Fairfax City	6.3%	180	\$1,379	-2.6%
15	College Park/Greenbelt	6.3%	180	\$1,223	-2.8%
16	Landover	6.6%	190	\$1,044	-1.4%
17	Downtown/Logan Circle	6.9%	0	\$1,441	-0.3%
18	Anacostia/Northeast D.C.	7.0%	260	\$832	-3.1%
19	Columbia Pike/Shirlington	7.2%	70	\$1,373	1.2%
20	Pentagon City/Crystal City	7.3%	-230	\$1,839	-1.4%
21	Silver Spring	7.6%	330	\$1,356	0.4%
22	Rockville	7.8%	400	\$1,519	0.7%
23	Forest Heights/Oxon Hill	8.3%	190	\$1,014	-0.6%
24	Capitol Hill/Southwest	8.6%	450	\$1,323	4.8%
25	District Heights	9.3%	340	\$960	-1.1%
26	Bethesda/Chevy Chase	10.4%	160	\$1,778	1.7%
27	Laurel	12.7%	150	\$1,181	-0.3%