

ApartmentResearch

M A R K E T U P D A T E

Marcus & Millichap

Phoenix Metro Area

First Quarter 2010

DISTRESSED ASSETS IN OUTLYING SUBURBS DRIVING SALES

The weakening of apartment property operations in Phoenix will moderate this year as employers resume hiring and the local housing market begins to stabilize. Since bottoming in the second quarter of 2009, the median single-family home price in the metro has increased 11 percent to \$145,900, primarily due to out-of-state investors flocking to the market to purchase rental homes. Price volatility will persist for a few more quarters, however, as the metro continues to post one of the highest foreclosure rates in the nation. The 58 percent drop in apartment completions projected for 2010 should help offset some supply-side pressure from shadow-rental stock, with supply-restricted areas expected to rebound this year and outer-ring suburbs starting in 2011. Vacancy in the South Scottsdale submarket, for instance, continues to average well below the metrowide rate, as there has been no construction activity in nearly 10 years and renter demand remains high. Occupancy levels in the submarket will likely improve further later this year due to employment growth. Online review company Yelp, for example, plans to open an office in South Scottsdale during the third quarter, creating approximately 200 jobs in the area.

Investment activity has picked up in the Phoenix apartment market as a result of lower prices. As more distressed properties have traded in the last year, the median price has retreated 40 percent to \$42,000 per unit. Investor interest has centered on areas where distress is pronounced, including parts of the Northwest, West and East Valley. Nearly 60 percent of all transactions during the past 12 months have taken place in these areas, where prices remain some of the lowest in Phoenix and population growth will lead the metro over the next five years. Marketwide, cap rates continue to trend up as buyers underwrite for increasing vacancy rates and falling revenues. Initial yields will likely need to average in the high-7 percent to low-8 percent range, however, in order to generate bids in the current investment climate.

2010 ANNUAL APARTMENT FORECAST



Employment: Led by gains in the education and health services and professional and business services sectors, Phoenix employment will expand 0.7 percent in 2010, or by 11,000 positions. Last year, 115,900 jobs were eliminated in the metro.



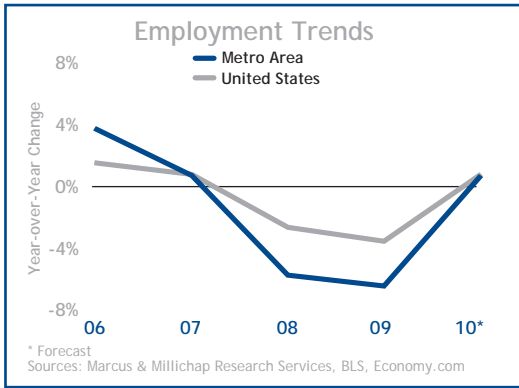
Construction: Approximately 2,400 apartment units are expected to come online this year, down 58 percent from 2009. Over the past five years, completions have averaged 4,400 units annually.



Vacancy: With additional stock entering the market and soft leasing activity forecast through the first half, vacancy is projected to rise 30 basis points in 2010 to 12.6 percent. Last year, vacancy increased 120 basis points.



Rents: Asking rents will fall 2.5 percent this year to \$729 per month as owners attempt to improve occupancy levels. With concessions forecast to increase to 10 percent of asking rents by year end, effective rents will decline 3 percent to \$656 per month.

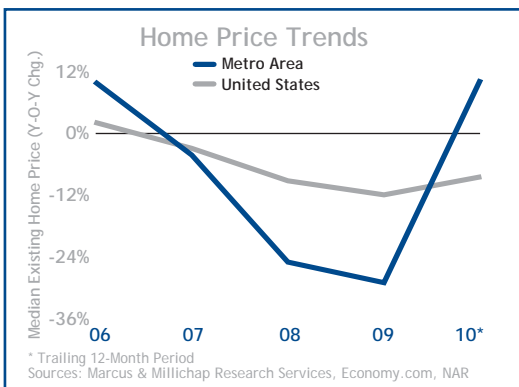


ECONOMY

- ◆ Employment in Phoenix contracted by 64,900 positions, or 3.7 percent, in the last year. In the previous 12-month period, employers eliminated 144,300 jobs in the metro.
- ◆ The education and health services sector has added more than 5,700 new hires over the past 12 months, following the creation of 7,910 positions in the preceding year. Although the government sector has outperformed the metro in previous downturns, state budget woes have led to the slashing of nearly 9,000 positions in the segment during the last year.
- ◆ The unemployment rate in Phoenix was an estimated 9.4 percent in the first quarter, the highest level in more than two decades, and should remain around 9 percent through the rest of the year.
- ◆ **Outlook:** Phoenix employment will expand 0.7 percent in 2010, or by 11,000 positions. Last year, 115,900 jobs were eliminated in the metro.

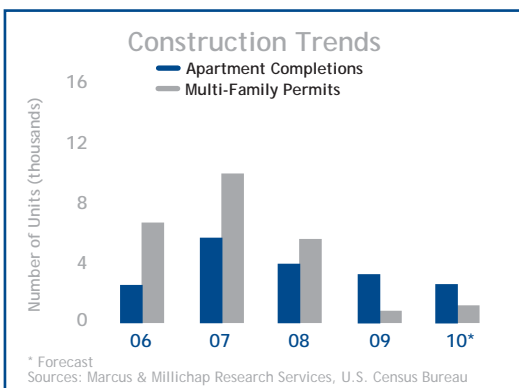
HOUSING AND DEMOGRAPHICS

- ◆ During the past 12 months, developers have pulled permits for 660 units of multifamily housing, down 86 percent from the previous year. After peaking at 59,000 permits in 2005, only 9,000 permits for single-family units have been issued in the past year, a 17 percent decline from the preceding 12-month period.
- ◆ The median price of a single-family residence in Phoenix was estimated at \$145,900 in the first quarter, up 1.5 percent from the previous quarter. Sales velocity of single-family homes increased 17 percent in that time.
- ◆ Single-family homes remain highly affordable in the metro, as foreclosures have driven down prices. The current median household income of \$48,500 per year is 45 percent more than the amount needed to meet the monthly mortgage obligations on a median-priced residence.
- ◆ **Outlook:** The population of 20- to 34-year-olds in Phoenix is projected to increase by 12 percent over the next five years, or 115,300 people, helping to sustain demand for rental properties.



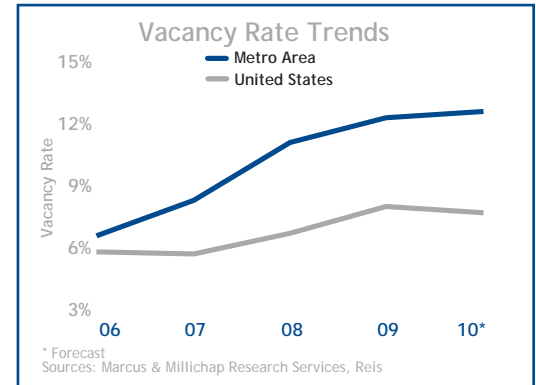
CONSTRUCTION

- ◆ Apartment inventory in Phoenix has increased 2 percent year over year, or by 4,400 units. In the previous 12-month period, 4,100 units were delivered.
- ◆ Approximately 6,900 rental units are planned in Phoenix, with nearly 3,000 units slated for the submarkets of Peoria/Sun City/Surprise and Good-year/Avondale/Tolleson. Many proposed projects may not materialize in these areas, however, as robust construction over the past five years, including 600 units currently under way, have created oversupply issues.
- ◆ The North Scottsdale/Fountain Hills submarket is expected to receive 1,030 units in 2010, a 6.4 percent stock addition and an amount equal to 43 percent of metrowide completions for the year.
- ◆ **Outlook:** Approximately 2,400 apartment units will come online this year, down 58 percent from 2009. During the last five years, completions have averaged 4,400 units annually.



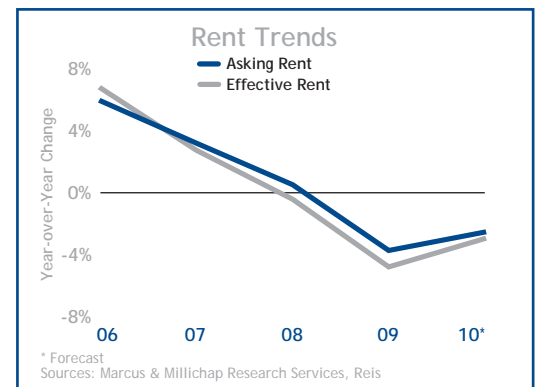
VACANCY

- ◆ In the first quarter, apartment vacancy ticked up 20 basis points to 12.5 percent as additional stock entered the market. Year over year, vacancy has increased 100 basis points.
- ◆ Over the past 12 months, inventory expansions and elevated rental rates have led to a 70 basis point rise in Class A vacancy to 11.6 percent. The vacancy rate for Class A properties has begun to stabilize in recent months, however, falling 20 basis points over the last two quarters.
- ◆ The vacancy rate in the lower tiers has increased 120 basis points during the last year to 13.2 percent, largely due to heavy job cuts in the blue-collar construction and retail trade segments. On a quarterly basis, the vacancy rate among Class B/C space rose 30 basis points in the first quarter.
- ◆ **Outlook:** Vacancy is projected to rise 30 basis points in 2010 to 12.6 percent. Last year, vacancy increased 120 basis points.



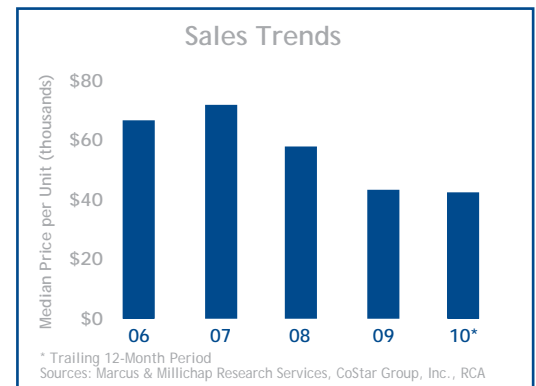
RENTS

- ◆ In the 12-month period ending in the first quarter, asking rents declined 4.9 percent to \$740 per month, while effective rents fell 5.5 percent to \$668 per month, pushing up concessions to 5 weeks of free rent.
- ◆ Class A asking rents retreated 4.7 percent year over year to \$887 per month in the first quarter, while asking rents in the lower tiers slipped 5.6 percent to \$624 per month.
- ◆ As a result of rising vacancy rates and increased concession offerings, the average revenue has dropped 6.6 percent in the past 12 months, following a 3.8 percent contraction in the previous year.
- ◆ **Outlook:** Asking rents will fall 2.5 percent this year to \$729 per month as owners attempt to improve occupancy levels. With concessions forecast to increase to 10 percent of asking rents by year end, effective rents will decline 3 percent to \$656 per month.



SALES TRENDS**

- ◆ Transaction velocity in Phoenix has increased 39 percent during the past 12 months, with most of the sales involving properties under \$10 million, as financing remains a hurdle.
- ◆ Although velocity has picked up in recent months, the growing number of REO sales taking place continues to pull prices lower. The median price has fallen 40 percent year over year to \$42,000 per unit.
- ◆ Cap rates currently average 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 12-month period ending the first quarter, cap rates increased by 100 basis points.
- ◆ **Outlook:** Prices will recede further over the next few quarters as REO and distressed assets change hands at a discount. Properties located in supply-restricted areas such as South Scottsdale and Tempe will hold their values, however, as operations in these areas are among the tightest in the metro and buyer interest remains high.



** 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

- ◆ The yield on the 10-year U.S. Treasury crept higher near the end of the first quarter, reaching almost 3.9 percent, the bond's highest yield since June 2009. Bond yields have been rising in response to record auction volume and increasing investor concern surrounding outstanding U.S. debt.
- ◆ Despite some recent upward pressure on the 10-year bond yield, the Federal Reserve's \$1.25 trillion program to purchase mortgage-backed securities has kept overall rates low. The program formally ended on March 31, which may lead to higher mortgage rates in the coming quarters.
- ◆ Multifamily loan originations ticked higher in the fourth quarter but remained below year-earlier levels. Fannie Mae and Freddie Mac, which proved to be consistent sources of multifamily financing throughout the recession, slowed originations moderately at the end of last year.
- ◆ On average, LTVs are at 65 percent to 75 percent, while DSCRs are 1.20x to 1.30x. All-in rates for 10-year loans are in the mid-6 percent range, led by agency rates, which are averaging below 6 percent. Gentle upward pressure on rates will likely persist going forward.

SUBMARKET OVERVIEW

- ◆ Suntech Power Holdings Co. plans to open a manufacturing plant in Good-year during the third quarter, creating up to 250 jobs. This should help improve future renter demand in the Goodyear/Avondale/Tolleson submarket, which currently has the highest apartment vacancy rate in the metro.
- ◆ The first phase of CityScape in downtown Phoenix is scheduled for completion later this year. The project includes 200,000 square feet of retail space and 600,000 square feet of office space, which could attract residents to apartments in the Central Phoenix South submarket.
- ◆ Concessions in the South Tempe/Ahwatukee submarket increased to 5.5 weeks of free rent in the first quarter. The rise contributed to improving vacancy by 110 basis points during that time, including a 220 basis point fall in the Class A vacancy rate to 7.6 percent.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	South Tempe/Ahwatukee	8.6%	-110	\$764	-5.6%
2	South Scottsdale	9.0%	150	\$732	-8.3%
3	North Tempe	10.3%	-100	\$727	-7.1%
4	Chandler/Gilbert	10.7%	-90	\$741	-5.2%
5	North Scottsdale/Fountain Hills	10.9%	50	\$880	-6.3%
6	Northeast Phoenix	11.4%	140	\$649	-4.8%
7	West Mesa	11.7%	100	\$551	-7.3%
8	East Mesa	12.1%	240	\$679	-4.4%
9	Peoria/Sun City/Surprise	12.4%	90	\$703	-4.9%
10	Deer Valley	12.8%	230	\$619	-4.8%