

LOW CONSTRUCTION, WEAK FOR-SALE MARKET TEMPER VACANCY RISE

Despite near-term weakness within the local employment market, minimal supply-side pressure and softer for-sale housing conditions will moderate losses in Cleveland apartment occupancy levels and rents. Ongoing changes within the auto industry will drive additional job cuts, with manufacturing employment expected to reach the lowest level this decade by year end. Helping to offset waning renter demand, however, is still-limited apartment construction. Although development activity will increase from 2008, this year's completions will represent a mere 0.3 percent uptick to inventory. Consequently, vacancy is forecast to rise through the coming quarters but remain healthy relative to the national average. Instability within the single-family housing market will also support rental housing demand in the metro. Single-family housing prices are down nearly 40 percent year over year due to distressed sales, and rising unemployment will likely sustain current for-sale housing conditions over the next 12 months.

Activity within the Cleveland investment market continues to slow as a result of buyers' expectations for softer market conditions in the near term. Velocity is down considerably since the beginning of the year, falling 47 percent from the same period in 2008. Investors are targeting properties in established close-in neighborhoods with sustainable tenant demand that has been minimally affected by current economic headwinds, such as Cleveland Heights and Shaker Heights. Despite buyers' flight to quality, cap rates continue to ascend, and investors will likely seek higher initial yields over the next 12 months to compensate for added near-term risk. Class A properties are being offered with cap rates in the high-7 percent to mid-8 percent range, up about 75 basis points during the last year, while Class B apartments with stable rent rolls are trading near 9 percent. Longer-term opportunities may exist in Beachwood, where more than 600 jobs are expected to be relocated in about three years if the proposed Eaton Corp. campus at Interstate 271 and Harvard Avenue is completed.

2009 ANNUAL APARTMENT FORECAST



Employment: Led by cuts in the manufacturing and professional and business services sectors, local employers are forecast to trim payrolls by 50,000 positions this year, a loss of 4.8 percent. Approximately 32,900 jobs were removed from the market in 2008.



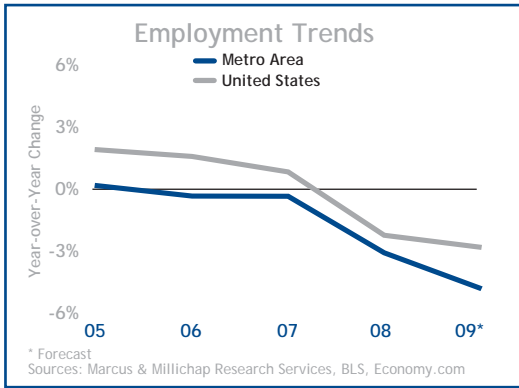
Construction: Only 250 rental units are expected to be completed in 2009, following the delivery of 144 units last year. The return of condo projects to rental stock continues to represent the greatest potential threat to local inventory levels.



Vacancy: Weaker employment and competition from shadow rentals are projected to drive up vacancy 140 basis points to 7.4 percent this year.



Rents: Asking rents are forecast to fall 2.3 percent to \$722 per month in 2009, while effective rents will drop 3 percent to \$684 per month in response to a rise in vacancy resulting from a weak employment market.

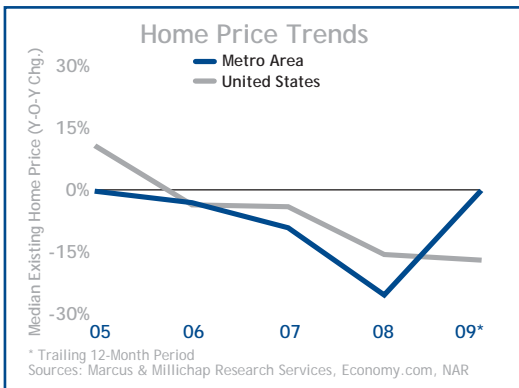


ECONOMY

- ◆ Employers are trimming jobs at a faster pace than one year ago. Through the first two quarters of 2009, employers eliminated 17,000 positions, compared with a loss of 5,300 workers in the corresponding period last year.
- ◆ In the professional and business service sector, 8,000 jobs were cut in the first half of this year, while 9,600 manufacturing workers were let go. Changes in the local banking industry and bankruptcies among automakers will weigh on these sectors throughout 2009.
- ◆ As of the second quarter, the unemployment rate in Cleveland was 9.5 percent, up 290 basis points over the last year. The unemployment rate is expected to rise through year end.
- ◆ **Outlook:** Led by cuts in the manufacturing and professional and business services sectors, local employers are forecast to trim payrolls by 50,000 positions this year, a loss of 4.8 percent. Approximately 32,900 jobs were removed from the market in 2008.

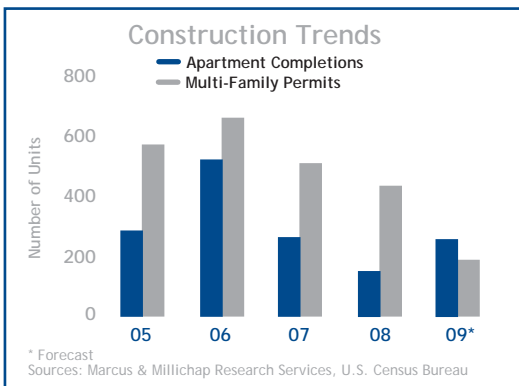
HOUSING AND DEMOGRAPHICS

- ◆ Permits for 1,725 single-family units and 188 units of multi-family housing were issued in the 12 months ending in the second quarter.
- ◆ The estimated median price of a single-family home in the second quarter was \$76,000, or 38 percent less than one year earlier. Downward pressure on prices will persist in the near term due to a high number of foreclosed homes on the market.
- ◆ The metro's median household income of \$49,400 per year is more than double the income needed to meet the monthly mortgage obligations on a median-priced residence.
- ◆ **Outlook:** While homes will remain affordable in Cleveland, weakness within the local single-family market and pending job cuts will still cause many residents to opt for rental housing.



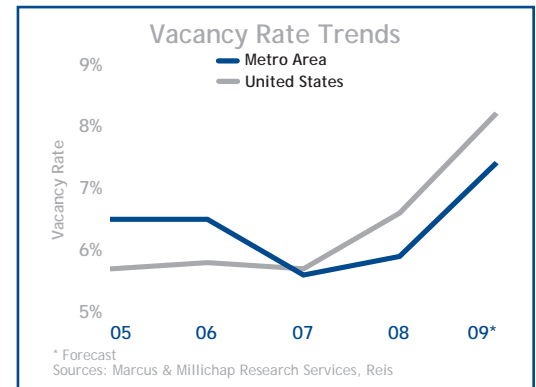
CONSTRUCTION

- ◆ Rental stock increased by just under 60 units during the 12-month period ending in the second quarter. In the previous annual span, apartment inventory rose by about 400 units, or 0.4 percent.
- ◆ Nearly 600 units are under construction in four projects, the largest of which, the 252-unit Stratford Crossings in Wadsworth, is scheduled for delivery late this year.
- ◆ Almost 280 condo units were added in the market during the first two quarters of 2009, more than half of which came online in the Downtown/The Flats/Warehouse District submarket. Currently, 250 for-sale units are under way and expected to be completed by year end.
- ◆ **Outlook:** Only 250 rental units are forecast for delivery in 2009, following the addition of 144 units last year. The return of condo projects to rental stock continues to represent the greatest potential threat to local inventory levels.



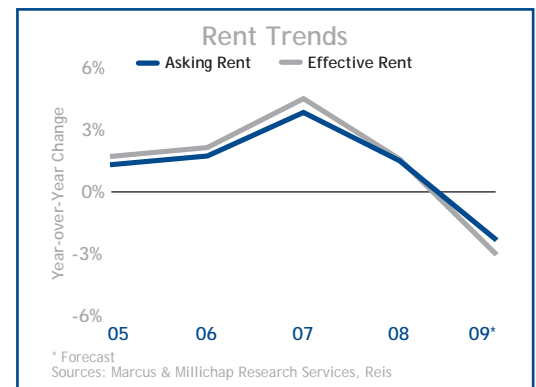
VACANCY

- ◆ The metro's vacancy rate was 6.7 percent in the second quarter, a rise of 160 basis points from the same period in 2008 and up 70 basis points since the beginning of the year. Weaker employment-generated tenant demand and competition from unsold condos entering the rental market accounted for the increase.
- ◆ The Class A segment recorded a 20 basis point uptick in vacancy in the second quarter, pushing the rate to 7.1 percent. Demand for high-end units wavered in response to job cuts within the professional and business services sector.
- ◆ The vacancy rate in the lower tiers has pushed up 170 basis points in the last year to 6.5 percent. The rise is the result of ongoing weakness in the economy, most notably in the manufacturing and construction sectors.
- ◆ **Outlook:** Weaker employment and competition from shadow rentals are projected to drive up vacancy 150 basis points to 7.4 percent this year.



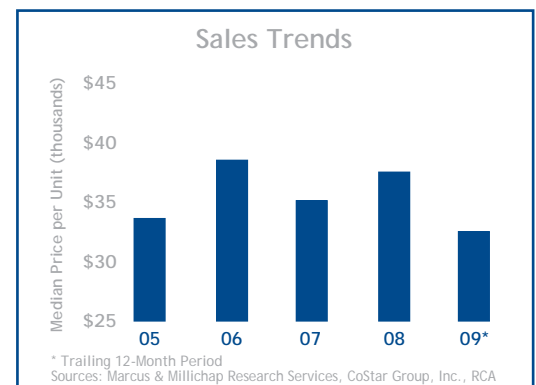
RENTS

- ◆ Asking rents were \$733 per month in the second quarter, down 0.4 percent year over year. Effective rents of \$696 per month were 0.7 percent less than in the second quarter of 2008.
- ◆ Job losses have most affected the Class B/C sector, where asking rents fell 0.5 percent over the past year to finish the second quarter at \$664 per month. Class A asking rents, meanwhile, dropped 0.3 percent to \$912 per month.
- ◆ Revenues are declining due to rising vacancy. During the last 12 months, gross revenue has decreased 2.2 percent, compared to a 4.3 percent gain in the previous year.
- ◆ **Outlook:** Asking rents are forecast to fall 2.3 percent to \$722 per month in 2009, while effective rents will drop 3 percent to \$684 per month in response to an increase in vacancy resulting from a weak employment market.



SALES TRENDS**

- ◆ Transaction velocity has declined 32 percent during the past 12 months, following a decrease of 4 percent in the preceding year. Buyers are more cautious when underwriting properties due to tighter lending criteria.
- ◆ The median price in deals made over the last year was \$32,500 per unit, 4.2 percent less than in the prior 12-month stretch. The median price in 2008 was \$37,500 per unit, the highest annual median price on record in Cleveland.
- ◆ In the past 12 months, cap rates have averaged in the high-7 percent to mid-8 percent range for Class A assets and 9 percent and above for lower-tier properties. Cap rates have increased about 75 basis points to 100 basis points year over year.
- ◆ **Outlook:** Although near-term concerns over the direction of the local and national economies, along with more conservative lending standards, will further constrain transaction velocity this year, investors will likely focus on Class A and Class B properties with stabilized rent rolls near the more affluent areas such as Westlake, Avon Lake, Beachwood, and Shaker Heights.



** 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

- ◆ During the first quarter, multi-family mortgage originations were 61 percent below year-earlier levels and 79 percent lower than the late-2006 peak. Though considerable, the reduction in apartment originations remains less significant than declines among other core commercial property types, due largely to the availability of financing through Fannie Mae and Freddie Mac.
- ◆ Portfolio lenders are issuing apartment financing at all-in rates of 6.0 percent to 6.3 percent for three-year loans and up to 6.8 percent to 7.5 percent for a 10-year term. Loan-to-value requirements range from 55 percent to 75 percent.
- ◆ Agency lenders are offering five-year loans at all-in rates of 4.8 percent to 5.0 percent with 10-year mortgages available at rates averaging 5.35 percent and 5.7 percent, respectively. Maximum leverage among agency lenders ranges from 55 percent to 75 percent.
- ◆ Freddie Mac recently completed a \$1 billion securitization of multi-family debt, the first issuance to hit the market since last June. The securities, dubbed "K Certificates," vary from traditional CMBS in that buyers are provided a guarantee by Freddie Mac. In addition to the potential for another similar offering, government programs designed to increase credit flows into commercial real estate could be operational by late summer/early fall.

SUBMARKET OVERVIEW

- ◆ Class A properties in Beachwood remain in high demand, averaging vacancy at 3.6 percent, while Class B/C assets in the area are registering vacancy of around 6 percent. Longer-term upside potential may exist by capturing occupancy and greater rents through repositioning lower-tier properties.
- ◆ Nearly 350 condos are expected to be added in the Downtown/The Flats/Warehouse District submarket this year, which may increase competition among local apartment owners if these units come online as rentals. As a result, area vacancy is forecast to trend up to nearly 10 percent by year end.
- ◆ State and local officials are finalizing plans that would encourage the expansion of Immediate Pharmaceutical Services Inc. to Avon Lake, a move that could increase the company's presence in the area by 200 employees.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Beachwood	3.8%	-60	\$1,102	0.9%
2	Strongsville/Berea/Brook Park	4.7%	-10	\$624	-3.4%
3	Lakewood/Linndale/Brooklyn	6.1%	50	\$624	2.3%
4	Lyndhurst/Mayfield/Richmond Heights	6.1%	170	\$707	1.9%
5	Euclid/West Lake County	6.2%	190	\$645	0.5%
6	Parma/Independence	6.7%	170	\$659	1.9%
7	Bay Village/Westlake/Rocky River	6.9%	40	\$797	-3.9%
8	Bedford/Garfield Heights/Bedford Heights	7.4%	180	\$587	-1.2%
9	East Cleveland/Cleveland Heights	7.9%	370	\$641	-1.1%
10	Downtown/The Flats/Warehouse District	8.7%	120	\$1,012	-4.3%