

## DISTRESSED LISTINGS DRIVING INDIANAPOLIS INVESTMENT ACTIVITY

Key metrics in the Indianapolis apartment market are expected to soften in 2009, driven by job losses, the growing shadow market and accelerating completions. Payroll cuts are on pace to be higher than last year, so many residents are seeking cheaper housing options. As a result, fundamentals in the metro's Class B/C segment will likely outperform Class A operations in the second half of the year while renters step down to a more affordable tier. Further impacting upper-tier conditions are the metro's relatively low home prices and supply-side pressure. In outlying communities, a greater number of low-priced, bank-owned homes on the market has lured some current renters into homeownership. In the downtown area, meanwhile, top-tier properties are competing with recently completed condo projects that are being employed as rentals, such as the 105-unit Maxwell development. This year's apartment deliveries will outpace annual completions over the last five years and are concentrated in the northern portion of the metro, which will likely prolong a recovery in that area.

Many owners of stabilized properties are opting to hold through the recession, limiting the pool of offerings, while tightness in the credit markets persists, reducing the size of the qualified buyer pool. These trends are expected to continue through the remainder of the year, keeping deal flow measured. Sales activity will likely be driven by the growing number of distressed listings that are drawing interest from local buyers, as well as from out-of-state investors who are attracted to discounted offerings for their long-term potential. Buyers with extended hold strategies in mind may find opportunities in the Boone/Hendricks County submarket. Demand in the area is expected to increase with robust population growth, while elevated home prices will continue to sustain the size of the renter pool, and both current and planned construction activity will be modest due to ongoing difficulty obtaining construction loans.

### 2009 ANNUAL APARTMENT FORECAST



**Employment:** After 21,300 jobs were trimmed in 2008, employers are expected to cut 25,600 positions this year, thinning payrolls by 2.8 percent. Losses were likely heaviest in the first half of the year, as cuts in the professional and business services and financial activities sectors are projected to ease in the coming months.



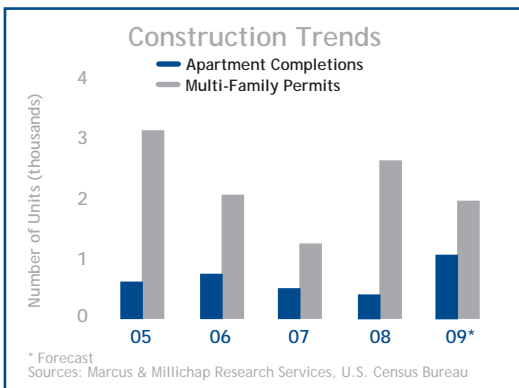
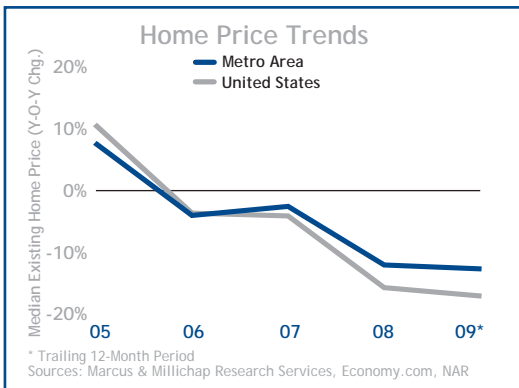
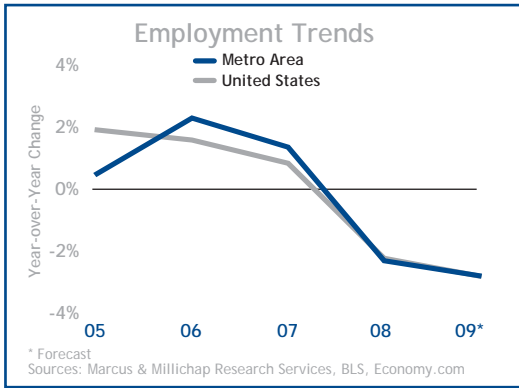
**Construction:** Deliveries are on pace to ramp up in 2009, as 1,030 units are slated to come online, a 1 percent expansion of stock and the largest annual addition in five years. Last year, only 370 units were completed.



**Vacancy:** Elevated construction activity and a weak labor market are expected to drive up metrowide vacancy 140 basis points to 9.1 percent this year, following a 60 basis point improvement in 2008.



**Rents:** The projected spike in completions will increase competition and should lead to lower rents. Asking rents are forecast to fall to \$669 per month in 2009, while effective rents will drop to \$621 per month, annual decreases of 0.9 percent and 2.5 percent, respectively.



## ECONOMY

- ◆ During the last 12 months, roughly 33,000 positions have been eliminated from local payrolls, a 3.6 percent decline. Losses have eased modestly in the past two quarters, however, as roughly 16,000 jobs were trimmed in that span.
- ◆ Heavy cuts in the manufacturing and construction segments have most impacted the local apartment market, particularly in the eastern portion of the metro. Over the last 12 months, employers in these industries have thinned head counts by 7,800 jobs and 8,300 jobs, respectively.
- ◆ After enacting a round of layoffs late last year, Firestone announced the closure of its manufacturing plant in Noblesville due to the recession and weak demand. A total of 450 positions were eliminated.
- ◆ **Outlook:** After 21,300 jobs were trimmed in 2008, employers are expected to cut 25,600 positions this year, thinning payrolls by 2.8 percent. Losses were likely heaviest in the first half of the year, as cuts in the professional and business services and financial activities sectors are projected to ease in the coming months.

## HOUSING AND DEMOGRAPHICS

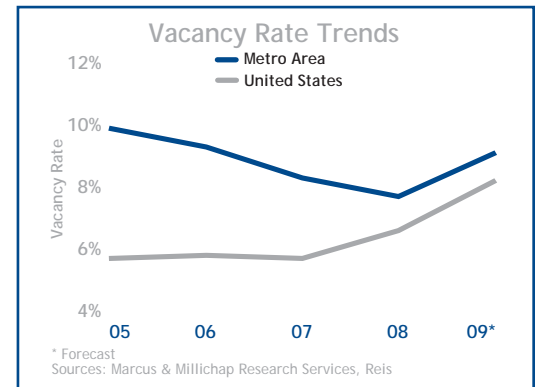
- ◆ Single-family permit issuance has declined for the last three years, including a 37 percent slowdown over the past 12 months to 3,600 annualized units. Multi-family builders, meanwhile, pulled permits for 1,920 annualized units year over year, a decrease of 13 percent.
- ◆ The median home price in Indianapolis has dropped 12.6 percent in the past year to \$99,520, while the median household income has slipped 9.7 percent to \$50,500 annually. As such, there is a \$24,000 surplus in the amount needed to meet the monthly mortgage obligations for a median-priced home.
- ◆ Despite falling rents, the typical mortgage payment for a median-priced home is \$180 per month less than the average Class A rent, using traditional financing methods.
- ◆ **Outlook:** Modest renter demand has led to fewer permit applications, a trend expected to continue into 2010. This will ultimately allow for housing supply and demand to regain balance.

## CONSTRUCTION

- ◆ Construction activity has accelerated. Approximately 850 units have been completed in the last year, well above the 80 units delivered in the previous 12-month period.
- ◆ Many projects that broke ground before the downturn are slated to come online in the coming quarters. Builders have nearly 1,100 units under way, roughly 70 percent of which are due to be completed by year end.
- ◆ Developers remain attracted to the metro's relatively diverse employment market and projections for a fairly quick economic recovery. As such, there are currently 4,570 units in the planning stages, including 2,600 units in the Hamilton County submarket.
- ◆ **Outlook:** Deliveries are on pace to ramp up in 2009, as 1,030 units are slated to come online, a 1 percent expansion of stock and the largest annual addition in five years. Last year, only 370 units were completed.

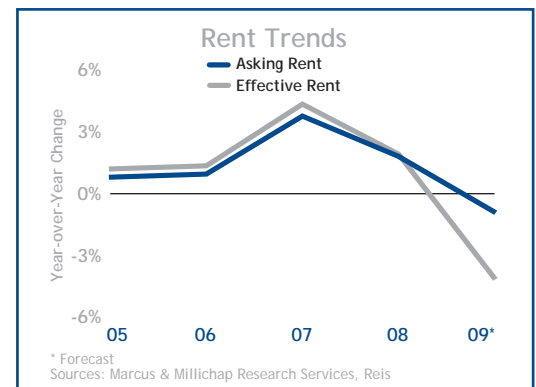
## VACANCY

- ◆ Vacancy reached 8.6 percent in the second quarter, up 110 basis points from one year earlier. Most of the increase came in the first half of 2009, when vacancy jumped 90 basis points due to supply-side pressures and mounting job losses.
- ◆ Some renters are using tax credits to transition into homeownership. As such, Class A vacancy has risen 30 basis points during the past 12 months to 6.9 percent, the highest rate in two years.
- ◆ Many lower-tier renters are opting to double up to manage costs. As a result, vacancy in the Class B/C segment has increased 90 basis points year over year to 9.1 percent and is 70 basis points steeper than at year-end 2008.
- ◆ **Outlook:** Elevated construction activity and a weak labor market are expected to drive up metrowide vacancy 140 basis points to 9.1 percent this year, following a 60 basis point improvement in 2008.



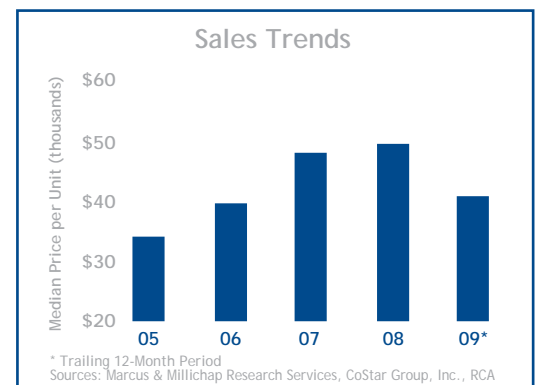
## RENTS

- ◆ On a year-over-year basis, owners have dropped asking rents 0.2 percent to \$672 per month and increased concessions, pushing effective rents 0.5 percent lower to \$633 per month. The second quarter marked the first three-month period since early 2004 in which both asking and effective rents fell.
- ◆ While Class A asking rents have decreased by 0.6 percent during the last year to \$774 per month, Class B/C asking rents ticked up 0.2 percent to \$595 per month.
- ◆ Due to declining occupancy levels, owners have posted a 1.3 percent contraction in revenues over the past 12 months, the first annual drop since 2003. In the previous year, revenues expanded by 5.8 percent.
- ◆ **Outlook:** The projected spike in completions will increase competition and should lead to lower rents. Asking rents are forecast to fall to \$669 per month in 2009, while effective rents will drop to \$621 per month, annual decreases of 0.9 percent and 2.5 percent, respectively.



## SALES TRENDS\*\*

- ◆ Sales activity slowed during the most recent 12-month period, as investors are becoming increasingly wary of weakened conditions, and owners of stabilized properties are opting to hold through the recession.
- ◆ The median price has dropped 16 percent year over year to \$40,800 per unit due to an increase in transactions involving distressed assets.
- ◆ Sellers continue to adjust pricing to attract offers and avoid prolonged marketing times, which has pushed up average cap rates approximately 125 basis points to the high-8 percent to low-9 percent range. A growing number of distressed properties, however, are trading with initial yields in the 10 percent to 12 percent range.
- ◆ **Outlook:** Current infrastructure improvements along Keystone Avenue and Meridian Street in the Hamilton County submarket will reduce commuting times and improve access to key arterial routes. As a result, population growth in the northern portion of the area is expected to increase, which will likely bolster apartment demand.



\*\* 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

- ◆ Rents in the East submarket are the lowest in Indianapolis, which has lured renters from more expensive neighboring areas. As a result, owners in the submarket have recorded a 2.1 percent gain in revenues over the last year, the largest increase in the metro.
- ◆ In the Central submarket, city officials have delayed a hearing over the proposed \$65 million redevelopment of the former Bank One operations center, which would require \$6.5 million in tax abatements, upon learning that the site is not zoned for the planned 600 apartments and retail space.
- ◆ M/I Homes recently withdrew plans for an apartment complex and a light industrial development at U.S. 40 and Mount Comfort Road in the Hancock/Shelby submarket after county officials expressed concerns over the best use of the 27.5-acre site.

## SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Central	3.0%	-180	\$802	2.3%
2	Boone/Hendricks	5.4%	-180	\$770	-1.0%
3	East	6.5%	-240	\$541	-0.6%
4	Far Northwest	7.1%	20	\$635	-1.9%
5	Castleton	7.9%	140	\$699	-1.8%
6	Southwest/Johnson	8.0%	40	\$604	0.8%
7	Near Northwest	8.7%	140	\$579	-1.0%
8	Hamilton County	9.0%	220	\$795	0.0%
9	Southeast	9.2%	-70	\$607	0.8%
10	Far Northeast	9.5%	240	\$539	-2.5%