ApartmentResearch
MARKET UPDATE
Marcus & Millichap

Minneapolis-St. Paul Metro Area *Third Quarter 2009*

Investor, Renter Interest in Southwestern Suburbs Continues

Conditions in the Minneapolis-St. Paul apartment market will continue to soften this year due to ongoing weakness in employment and competition from both affordable housing and shadow rentals. Vacancy in the lower tiers is beginning to rise at a faster rate than in Class A assets, as many renters are moving to the upper tier to capture falling rents; Class A rents are dropping in response to declining home prices and tax-credit incentives that encourage homeownership. Further impacting Class B/C conditions is the growing trend of renters doubling up in an effort to control costs. This is most evident in the Northwest/Anoka County submarket, where lower-tier vacancy has climbed 120 basis points in the last year. One positive trait of the economic downturn, however, is its impact on marketwide construction activity. This year's completions are on pace to be below 2008 deliveries and under the five-year average, which will alleviate supply-side pressure, particularly in the Minneapolis and West submarkets, where deliveries have been concentrated in recent years.

Transaction velocity is expected to continue at a modest pace through the remainder of 2009, as many local buyers are waiting for the market to reach a bottom. Some savvy investors, however, have become active in recent months and are willing to purchase top assets in long-term plays at prices slightly above the metro average and with cap rates in the mid-8 percent range. First-year returns in all deals will likely creep higher in the second half of the year, due in large part to an increasing number of distressed listings and sellers' adjusting prices to attract offers. Recent sales activity has involved Class A assets in the southwestern suburbs and the Uptown area in downtown Minneapolis, where demand remains relatively healthy. Opportunistic investors may find opportunities along the future Northstar rail line, which is expected to increase development activity and renter demand in the coming years.

2009 Annual Apartment Forecast

3.2% decrease in total employment

Employment: Despite expectations for slowing job losses in the coming months, 56,000 positions are forecast to be cut this year, contracting head counts by 3.2 percent. In 2008, approximately 39,900 jobs were eliminated.

650 units will be completed

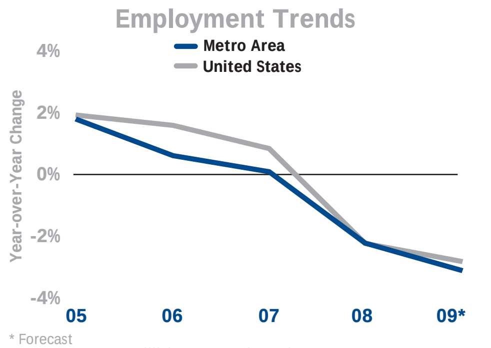
Construction: After 1,030 units were delivered last year, developers are on pace to complete nearly 650 units in 2009, approximately 5 percent below the five-year average.

90 basis point increase in vacancy

Vacancy: Following a 20 basis point rise in 2008, vacancy is forecast to increase 90 basis points to 5.2 percent this year due to the struggling labor market weakening demand.

1.5% decrease in asking rents

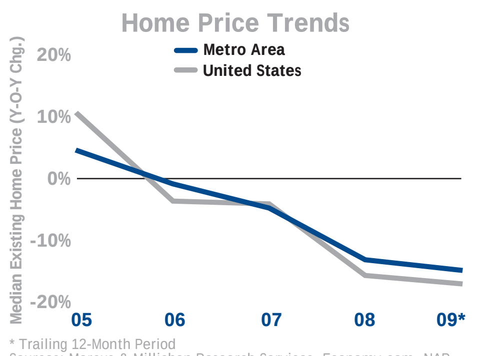
Rents: Asking rents are projected to fall 1.5 percent to $943 per month in 2009, and effective rents are expected to retreat 2.8 percent to $880 per month.



* Forecast
Sources: Marcus & Millichap Research Services, BLS, Economy.com

Economy

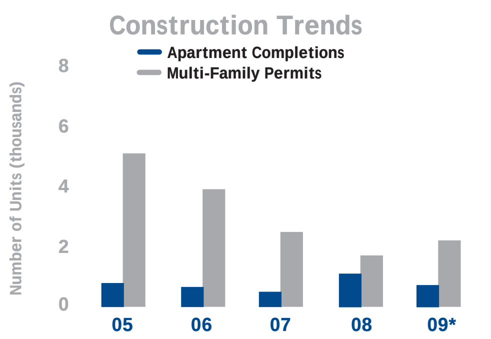
- Local employers have eliminated roughly 70,000 positions during the last 12 months, a 3.9 percent contraction. Losses appear to be easing slightly, however, as just under 34,000 jobs were trimmed in the first half of 2009.
- Cuts in the manufacturing and construction industries have been heavy in the past year, hampering apartment fundamentals. These segments were thinned by a total of approximately 30,000 spots in that time, declines of 8.3 percent and 22.5 percent, respectively.
- While the metrowide unemployment rate climbed to 7.9 percent in the second quarter, 290 basis points higher than one year earlier, the rate remained relatively in line with the first three months of 2009.
- **Outlook:** Despite expectations for slowing job losses in the coming months, 56,000 positions are forecast to be cut this year, contracting head counts by 3.2 percent. In 2008, approximately 39,900 jobs were eliminated.



* Trailing 12-Month Period
Sources: Marcus & Millichap Research Services, Economy.com, NAR

Housing and Demographics

- Single-family permit activity has dropped steadily for the past five years. Permits for 3,350 units were issued in the past 12 months, 37 percent fewer than one year ago. The pace of multi-family application requests, on the other hand, recently increased, as roughly 1,880 units have been permitted year over year, a rise of 5 percent.
- The median home price has retreated 15 percent in the past 12 months to $177,300, while the median income level has slipped 12 percent. As a result, there is a $13,000 surplus in the amount needed to qualify for a mortgage on a median-priced residence in the metro.
- Class A asking rents have been higher than mortgage payments for the last three quarters. Currently, upper-tier rents are roughly $90 per month more than a traditionally structured monthly mortgage obligation.
- **Outlook:** With a 26 percent decline in total permit issuance during the last year and projections for increasing household creation, supply and demand will continue to realign over the coming quarters.



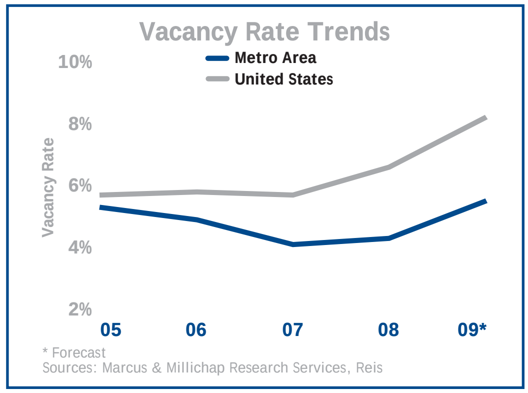
* Forecast
Sources: Marcus & Millichap Research Services, U.S. Census Bureau

Construction

- In the last 12 months, developers have added nearly 900 units to metro inventory, a 0.6 percent expansion; however, building activity is slowing, as more than 90 percent of these completions came online early in the period.
- There are 925 units under way throughout the metro, most of which are scheduled for delivery this year. Condo construction remains elevated, meanwhile, as roughly 1,560 for-sale units are being built.
- The planning pipeline has swelled by 36 percent in the past year to 4,600 apartments. Nearly half of the projects are proposed for the Minneapolis submarket, which may increase competition in the coming years.
- **Outlook:** After 1,030 units were delivered last year, developers are on pace to complete nearly 650 units in 2009, approximately 5 percent below the five-year average.

Vacancy

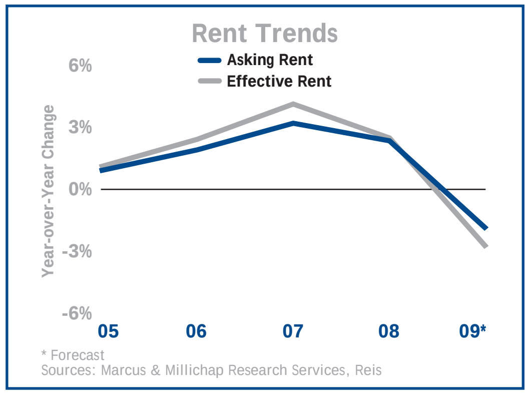
- Vacancy has increased 30 basis points in the last 12 months to 4.4 percent. The rate rose just 10 basis points in the first half of 2009, as many recently completed deliveries were met with healthy demand.
- Many residents are taking advantage of falling rents in the metro's upper-tier. As a result, vacancy in the Class A segment has increased 60 basis points during the past 12 months to 5 percent, 60 basis points lower than the first quarter of 2009.
- Class B/C vacancy has ticked up 10 basis points to 4.0 percent in the last six months, but is expected to climb in the coming months as the trend of tenants doubling-up becomes more popular.
- **Outlook:** Following a 20 basis point rise in 2008, vacancy is forecast to spike 90 basis points to 5.2 percent this year due to the struggling labor market weakening demand.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

Rents

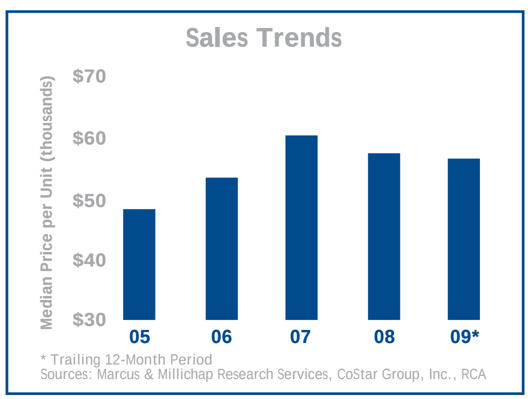
- Asking rents were $953 per month in the second quarter, 0.2 percent higher than one year ago, and effective rents have retreated 0.8 percent to $893 per month. Asking rents are down 0.4 percent from last year, however, and are expected to continue decreasing at a rapid pace through the remainder of the year.
- Class A asking rents were $1,136 per month during the second quarter, 0.4 percent higher than one year earlier, but were 0.1 percent lower than in the previous quarter. Class B/C rents were $811 per month in the most recent three-month stretch and have fallen 0.1 percent from the second quarter of last year.
- Rising vacancy has resulted in the first annual decrease in revenues in the last five years. Owners have recorded a 1.1 percent contraction in revenues over the past 12 months, following a 4.4 percent advance in the previous year.
- **Outlook:** Asking rents are projected to fall 1.5 percent to $943 per month in 2009, and effective rents are expected to retreat 2.8 percent to $880 per month.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

Sales Trends**

- Many owners are opting to hold through the recession, reducing the number of listings. This trend, coupled with elevated investor caution, resulted in a 36 percent decrease in transaction velocity during the most recent 12-month period.
- Prices have remained relatively stable in the last 24 months. The median price is currently $59,300 per unit, a modest 1 percent increase from one year ago.
- Cap rates for well-performing assets are in the mid-7 percent range, while initial yields for lower-tier or distressed properties are in the 10 percent to 11 percent range, both roughly 50 basis points higher than year-earlier levels.
- **Outlook:** Buyers may find opportunities in the northeastern portion of downtown Minneapolis, near the University of Minnesota and the Mississippi River. The area is close to employment and entertainment centers and offers stable demand driven by a growing number of students and young professionals.



* Trailing 12-Month Period
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., RCA

*** Data reflect a full 12-month period, calculated on a trailing 12-month basis by quarter.*

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Visit www.NationalMultiHousingGroup.com or call:
Linwood C. Thompson
Senior Vice President, Managing Director
National Multi Housing Group
Tel: (678) 808-2700
lthompson@marcusmillichap.com

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

- The St. Paul submarket has been the only area to post an improvement in vacancy during the last year, with the average rate falling 40 basis points. A small increase in demand has allowed area owners to raise rents modestly, generating revenue gains of 0.7 percent, the metro's only revenue growth.
- City planners have approved four developments around the University of Minnesota in the Minneapolis submarket that would add several hundred apartment units to the East and West banks. Groundbreaking on the projects has not started yet, however, due to limited construction loans.
- The state Court of Appeals recently decided not to allow city officials in Eagan, located in the Dakota County submarket, to purchase land to create a more vibrant downtown area. Developers are moving ahead, though, and have planned a 250-unit apartment complex and hotel.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Northwest/Anoka County	3.9%	10	$761	-1.3%
2	Northeast	4.2%	40	$808	-1.9%
3	West	4.4%	20	$940	-1.3%
4	St. Paul	4.4%	-40	$858	0.2%
5	Southwest	4.4%	80	$899	-1.0%
6	Dakota County	4.5%	40	$869	-1.1%
7	Minneapolis	4.8%	50	$1,048	0.1%
8	Washington County	5.9%	150	$939	-1.2%

Marcus & Millichap
Real Estate Investment Services

Prepared and edited by
Josh Gisselquist
Research Analyst
Research Services

For information on national apartment trends, contact
John Chang
National Research Manager
Tel: (602) 687-6700 ext. 6803
john.chang@marcusmillichap.com

Minneapolis Office:
Solomon Poretsky
Regional Manager
sporetsky@marcusmillichap.com
8300 Norman Center Drive
Suite 810
Bloomington, Minnesota 55437

Tel: (952) 852-9700
Fax: (952) 852-9710

Price: $150