

# ApartmentResearch

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

Marcus & Millichap

Sacramento Metro Area

Third Quarter 2009

## STATE BUDGET TURMOIL DRIVING RENTER DEMAND DECLINE

A weak housing market and California's state budget distress will weigh on apartment fundamentals in Sacramento throughout the rest of 2009. The state government, which serves as the metro's largest single employer, with more than 80,000 workers, has announced furloughs that will amount to a pay cut of approximately 10 percent for local workers, reducing incomes and putting downward pressure on rents. In addition, thousands of government job cuts have been proposed throughout the state in an effort to balance the budget, with many of the reductions likely to occur in Sacramento. These losses, along with widespread reductions throughout the private sector, will result in a continued downturn in renter demand in the coming quarters. On the supply side, multi-family development in the area has stalled, as a number of proposed high-rise rental and for-sale projects in the Downtown submarket no longer pencil out. The primary supply threat in the market is shadow rental stock, which will likely increase in the near term as foreclosed homes are sold to investors and subsequently employed as rentals.

In most cases, investors are responding to softening fundamentals by either demanding reduced prices or remaining on the sidelines in anticipation of future bargains. The gap between buyers' and sellers' expectations appears to be narrowing; velocity picked up modestly in the second quarter as the median price hit its lowest level since 2003. Average cap rates have been in the low- to mid-7 percent range during the past 12 months, though most recent deals had average initial yields closer to 8 percent. While many owners of stabilized assets are choosing to ride out the downturn rather than sell in the current economic climate, some buyer demand persists for smaller properties with low vacancy, and a few of these assets recently sold with cap rates in the low- to mid-6 percent range. Going forward, investors may find busted development deals in the Downtown and West Sacramento submarkets, where a number of apartment and condo projects that were planned during the height of the market could encounter distress in the coming quarters.

## 2009 ANNUAL APARTMENT FORECAST



**Employment:** This year, employers are forecast to contract payrolls across every sector, driving a loss of 40,000 positions, or a 4.6 percent reduction. In 2008, when a few industries expanded, metrowide cuts totaled 37,300 jobs.



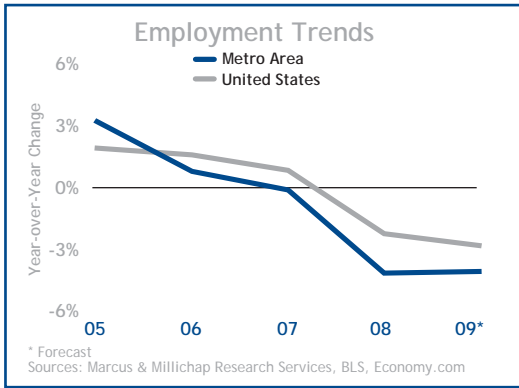
**Construction:** No new units are expected to be delivered in 2009, following the completion of fewer than 200 apartments last year.



**Vacancy:** Contraction in the local labor force will drag on renter demand. As a result, vacancy in Sacramento is on pace to spike 180 basis points to 9 percent this year.

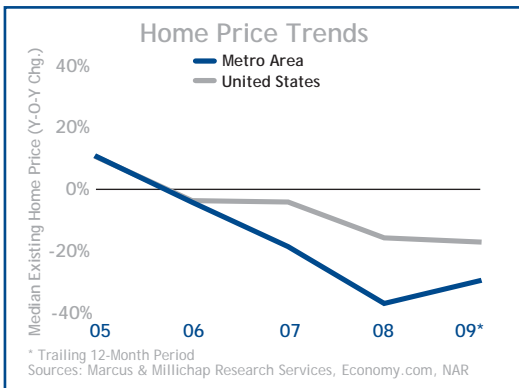


**Rents:** Asking rents are expected to drop 3.8 percent to \$929 per month in 2009, while effective rents will decline 6.6 percent to \$860 per month. By the end of the year, concessions are forecast to total 7.4 percent of asking rents.



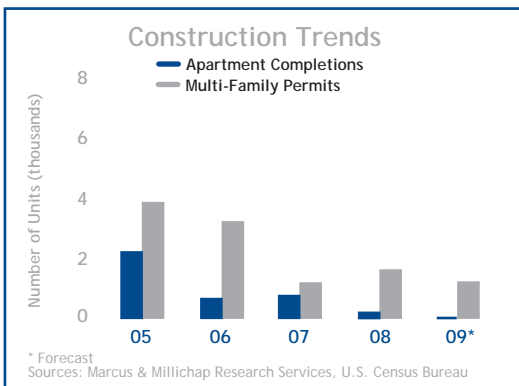
## ECONOMY

- ◆ During the last year, payrolls in Sacramento have contracted by 4.9 percent, or 43,500 positions. Losses have been fairly steady, as employers cut 22,100 jobs in the first half of 2009, including an estimated 5,300 workers in the second quarter.
- ◆ With the local economy reeling, commercial and residential construction has slowed considerably from the building boom of recent years. As a result, employment in the construction sector has declined by 12,800 jobs year over year, a 22 percent drop.
- ◆ Widespread job losses pushed the local unemployment rate up 460 basis points over the past 12 months to an estimated 11.3 percent in the second quarter. In addition, the metro's underemployment rate is likely to increase due to unpaid government furloughs.
- ◆ **Outlook:** This year, employers are forecast to contract payrolls across every sector, driving a loss of 40,000 positions, or a 4.6 percent reduction. In 2008, when a few industries expanded, metrowide cuts totaled 37,300 jobs.



## HOUSING AND DEMOGRAPHICS

- ◆ During the past year, developers have pulled 2,600 single-family housing permits, down 44 percent from the preceding 12-month period. Permits for 1,000 multi-family units have been issued, 9 percent lower than one year ago but down more than 75 percent from the peak levels recorded earlier in the decade.
- ◆ The median price of a single-family home in Sacramento was \$160,700 in the second quarter, a decrease of approximately 30 percent year over year. Since peaking at the end of 2005, the median price has fallen nearly 60 percent.
- ◆ Homeownership has become increasingly affordable due to steep price declines. The median household income, which has contracted 3.6 percent to \$56,800 annually in the past 12 months, is nearly \$15,000 more than the amount required to qualify for a median-priced home.
- ◆ **Outlook:** Homes will stay affordable in the quarters ahead, although many residents will remain in the renter pool due to concerns about buying an asset that could depreciate further in the near term due to heightened foreclosure activity and soft sales volume.

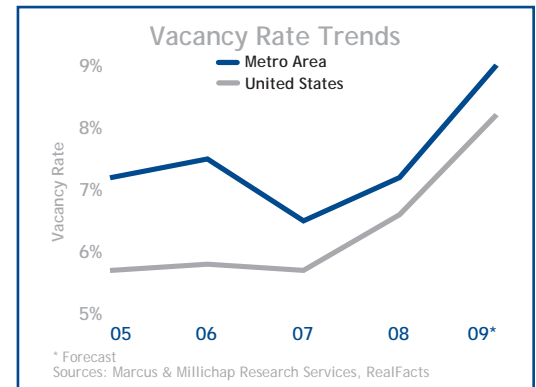


## CONSTRUCTION

- ◆ While renter demand is contracting due to job losses, apartment construction has been minimal. During the past 12 months, no new rental units have been completed, although 425 condos have been delivered.
- ◆ There are no apartment projects under construction, but the planning pipeline includes more than 4,000 units. Approximately 625 condos have broken ground, some of which could come online as rentals if the housing market remains soft.
- ◆ Developers of the proposed 225-unit East End Gateway apartment complex in the Downtown submarket missed a deadline to begin construction early in the third quarter. As a result, the future of the project is uncertain.
- ◆ **Outlook:** No new units are expected to be delivered in 2009, following the completion of fewer than 200 apartments last year.

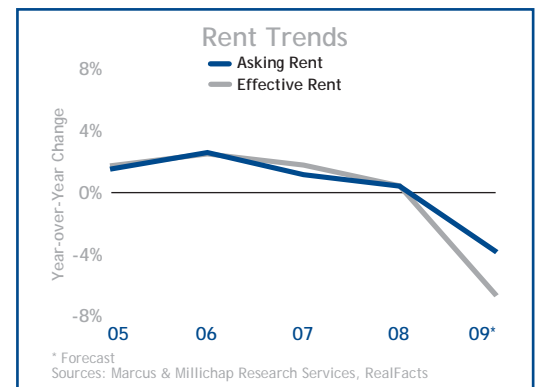
## VACANCY

- ◆ During the past 12 months, the apartment vacancy rate in Sacramento has jumped 200 basis points to 8.4 percent, despite steady inventory levels. Job losses have reduced demand for units, while a growing shadow market is competing directly with apartments.
- ◆ Vacancy has escalated in the top tier as single-family homes continue to flood the rental market. Year over year, vacancy in the metro's Class A units has spiked 250 basis points to 9.6 percent, including a 160 basis point increase year to date.
- ◆ Vacancy in Class B/C units has risen 160 basis points in the past year to 7.6 percent. Absorption in the lower tiers has been negative in each of the past six quarters as renters double up to trim costs.
- ◆ **Outlook:** Contraction in the local labor force will drag on renter demand. As a result, vacancy in Sacramento is on pace to spike 180 basis points to 9 percent this year.



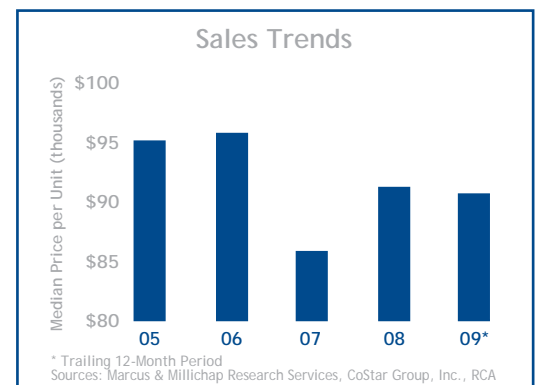
## RENTS

- ◆ In response to competition from shadow rentals and receding household incomes, asking rents have dropped 2.3 percent in the past 12 months to \$949 per month, while effective rents have dipped 3.8 percent to \$892 per month. Declines have accelerated thus far in 2009, with asking and effective rents falling 1.8 percent and 3.1 percent, respectively.
- ◆ Asking rents in Sacramento's Class A properties have retreated 2.8 percent in the last year to \$1,090 per month, while asking rents in the lower tiers have ticked down 1.6 percent to \$852 per month.
- ◆ Increased concessions and falling occupancy levels have decreased average revenues by 5.8 percent during the past 12 months.
- ◆ **Outlook:** Rents will continue to creep lower in response to economic weakness. Asking rents are expected to drop 3.8 percent this year to \$929 per month, while effective rents will decline 6.6 percent to \$860 per month. By the end of 2009, concessions are forecast to total 7.4 percent of asking rents.



## SALES TRENDS\*\*

- ◆ During the past 12 months, sales velocity has slowed by 33 percent. Year to date, however, investment activity has dropped 48 percent from the same period in 2008.
- ◆ The median price for all properties that have changed hands in the last year has decreased just 3 percent to \$91,200 per unit. More significant discounting has been evident in deals closed thus far in 2009, where the median price has fallen to \$80,000 per unit.
- ◆ Average cap rates in the past 12 months have been in the low- to mid-7 percent range, although initial yields have averaged around 8 percent in recent deals.
- ◆ **Outlook:** As prices move lower, buyers have started to make their way off of the sidelines. The median price in deals closed during the second quarter was \$74,000 per unit, down from \$83,300 per unit in the first quarter. Velocity accelerated in the second quarter, and buyers will likely continue to pursue discounted properties.



\*\* 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

- ◆ The most significant project in the planning pipeline is the 1,646-unit Capitol Towers in the Downtown submarket. The initial proposal was to raze existing apartments on the site to be replaced by four high-rise towers. Given the weak economy, no groundbreaking date has been set.
- ◆ The North Sacramento submarket is suffering from recent overbuilding. In the past five years, more than 2,000 units have come online in the area, pushing up vacancy past 10 percent in the second quarter.
- ◆ The January opening of the Red Hawk Casino added approximately 1,700 jobs and is expected to support renter demand in the Orangevale/Folsom submarket. Vacancy in the area has increased only 100 basis points year over year to 8.5 percent.

## SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Davis	3.1%	70	\$1,125	-2.8%
2	Woodland	5.9%	110	\$797	-3.3%
3	West Marconi Avenue/Del Paso	6.5%	80	\$711	-2.0%
4	South/Elk Grove	6.5%	110	\$719	-2.9%
5	North Highlands	6.8%	40	\$813	-2.5%
6	East Marconi Avenue	6.8%	80	\$773	-5.1%
7	Rancho Cordova	7.7%	180	\$841	-3.7%
8	Carmichael	7.9%	380	\$769	-2.3%
9	Citrus Heights	8.0%	270	\$819	-4.6%
10	West University	8.3%	270	\$927	-1.3%