ApartmentResearch
MARKET UPDATE
Marcus & Millichap
San Diego Metro Area *Fourth Quarter 2009*

Demand Soft, but Slow Deliveries Keeping Vacancy in Check

Although a modest pace of apartment completions in the San Diego market should keep supply and demand from moving too far out of equilibrium through the rest of this year, property fundamentals have softened. Employers have reduced payrolls in the metro for eight consecutive quarters, with additional losses expected during the next few months. Unemployment has increased approximately 400 basis points in the past year to the mid-10 percent range and will likely creep higher prior to a recovery gaining traction. As a result, vacancy, which hovered in the low single digits as recently as 2007, has crept to above 5 percent and will likely edge higher again in 2010. Operators have reduced rents in response to falling household incomes and tapering demand, but the rate of rent reductions has been more modest than in nearly every major metro area on the West Coast. Properties in the lower tiers, particularly those closer to the metro's beaches, have performed the best in recent quarters. In the Class B/C segment, the average vacancy rate for the eight submarkets with a coastal boundary is still below 4 percent and an estimated 70 basis points lower than in the metro's noncoastal submarkets.

Investment activity in San Diego has settled into a fairly steady pace in recent quarters. Buyers are pursuing distressed assets as they come to market but are also making competitive offers on well-performing properties. Stable assets typically change hands with cap rates in the low- to mid-6 percent range depending on location, while distressed or REO properties are selling with initial yields closer to 8 percent. Going forward, properties with fewer than 20 units are expected to remain popular with buyers and represent the bulk of the metro's investment activity, as these assets are much easier to finance in the current capital markets environment. Since the beginning of this year, cap rates in these properties have averaged in the high-5 percent to mid-6 percent range.

2009 Annual Apartment Forecast

4.0% decrease in total employment

Employment: Following the loss of 24,900 workers in 2008, local employers are forecast to eliminate 50,800 jobs this year, a 4 percent contraction. Metrowide employment is expected to reach levels last recorded in 2003.

650 units will be completed

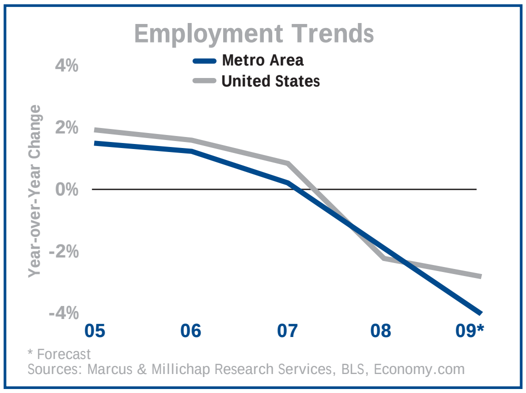
Construction: In 2009, developers will complete 650 apartment units, down from 910 units last year and well below the metro's five-year average of nearly 1,400 units annually.

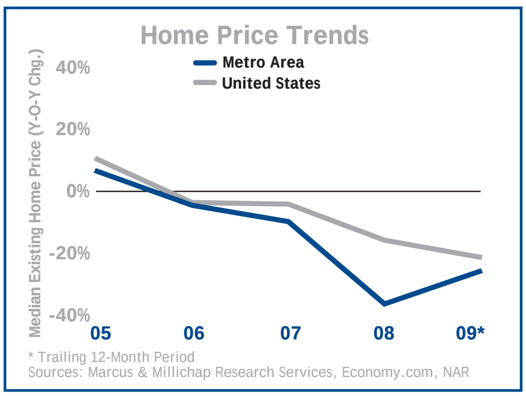
110 basis point increase in vacancy

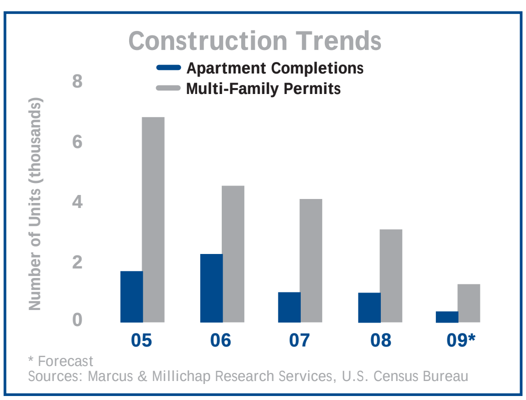
Vacancy: Metrowide vacancy is expected to increase 110 basis points to 5.2 percent this year, following a 40 basis point rise in 2008. Construction will likely accelerate in 2010, which could continue to drive the rate higher.

2.5% decrease in asking rents

Rents: This year will mark the first time in more than a decade that metrowide rents have declined. Asking rents are forecast to drop 2.5 percent to $1,310 per month, while effective rents will retreat 4.3 percent to $1,246 per month.







Economy

- During the 12-month period ending in the third quarter, employment in San Diego contracted by 58,000 jobs, or 4.5 percent. Nearly all of the losses have occurred in 2009; year to date, 48,000 positions have been eliminated, including an estimated 14,400 layoffs in the third quarter.
- The high-paying professional and business services sector, a typical driver of Class A apartment demand, has decreased by 5.7 percent in the past 12 months with the trimming of 12,900 positions. No other employment sector has recorded greater year-over-year job losses.
- Some of the metro's traditionally lower-paying industries also are recording steep cuts. Combined, the leisure and hospitality and construction segments have contracted by more than 17,000 jobs in the last year, contributing to a decline in renter demand for lower-tier apartments.
- **Outlook:** Following the loss of 24,900 workers in 2008, local employers are forecast to eliminate 50,800 jobs this year, a 4 percent reduction. Metrowide employment is expected to reach levels last recorded in 2003.

Housing and Demographics

- In the past year, single-family permit issuance has fallen 30 percent to 1,800 units. Multi-family permitting activity has declined more rapidly, dropping 71 percent to just 1,170 units.
- The median single-family home price retreated 26 percent year over year and 55 percent from the peak to an estimated $275,500 in the third quarter. The metro area's median household income has fallen 4.8 percent in the last 12 months to $58,200 per year, approximately $4,900 less than the amount required to qualify for a median-priced home.
- The average Class A asking rent is roughly $100 per month more than the mortgage payment on a median-priced residence. Two years ago, the typical mortgage payment was $2,000 per month more than the average Class A asking rent.
- **Outlook:** Household growth in San Diego is expected to total just 0.3 percent this year with the addition of only 2,800 households. Slowing growth and increasing housing affordability will cause renter demand for apartments to wane and put downward pressure on rents. In 2008, the metro expanded by more than 14,500 households.

Construction

- During the past 12 months, 700 apartments have come online in the metro, compared to the delivery of 1,000 rentals in the preceding year.
- Nearly 1,300 units are under construction in San Diego, although nearly all of the completions are scheduled for 2010 or later.
- The 254-unit Aquaterra apartment complex in the Clairemont/Linda Vista Mission submarket was the metro's largest delivery this year. The project increased the area's inventory by 1.2 percent.
- **Outlook:** In 2009, developers will complete 650 apartment units, down from 910 units last year and well below the metro's five-year average of nearly 1,400 units annually.

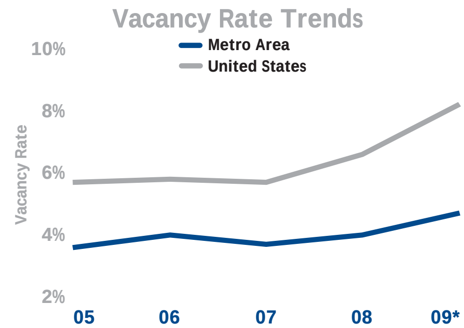
Vacancy

- Year over year, vacancy increased an estimated 150 basis points to 5.1 percent through the third quarter, as job losses have suppressed renter demand. Year to date, vacancy has ticked up 100 basis points.

- In the past 12 months, vacancy in Class A properties has risen 180 basis points to 6.3 percent, due in part to a 1.1 percent expansion of inventory. Thus far in 2009, vacancy in the top tier has increased 100 basis points, including an estimated 60 basis point uptick during the third quarter.

- Class B/C vacancy is up 130 basis points year over year at 4.3 percent, as payrolls in traditionally lower-paying sectors have contracted at an accelerated pace, driving negative net absorption of more than 1,400 units in the past year.

- **Outlook:** Metrowide vacancy is expected to increase 110 basis points to 5.2 percent this year, following a 40 basis point rise in 2008.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

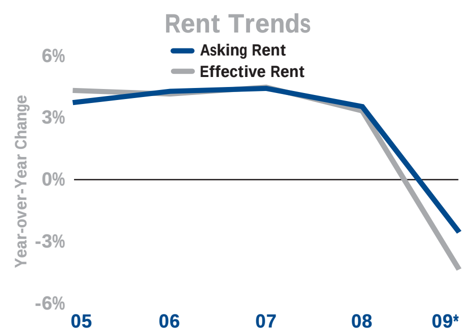
Rents

- Asking rents dipped 1.5 percent in the past year to an estimated $1,323 per month in the third quarter, while effective rents fell 3.5 percent to $1,258 per month. Nearly all of the rent declines have occurred thus far in 2009, and further decreases are expected in the coming months.

- Class A asking rents have slipped 2.3 percent year over year to $1,640 per month. Asking rents among Class B/C properties are down just 0.8 percent at $1,133 per month, as affordable housing options are limited.

- Rising vacancy and contracting rents have pushed down revenues 5 percent in the past 12 months. Concessions now total 18 days of free rent, up from 11 days of free rent one year ago.

- **Outlook:** This year will mark the first time in more than a decade that metrowide rents have declined. Asking rents are forecast to drop 2.5 percent to $1,310 per month, while effective rents will retreat 4.3 percent to $1,246 per month.



* Forecast
Sources: Marcus & Millichap Research Services, Reis

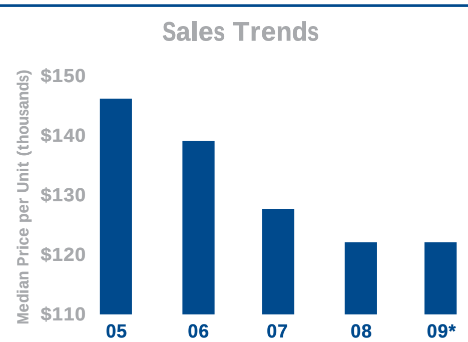
Sales Trends**

- During the past 12 months, sales velocity has declined 25 percent. Investment activity has been fairly steady for the past three quarters, however, signaling that the market has begun to stabilize.

- While rents have fallen, the median price has stayed essentially flat in the last year at $121,900 per unit.

- Cap rates for most properties that have changed hands in 2009 have been in the mid- to high-6 percent range, approximately 100 basis points higher than at the end of last year. In recent months, some REO and distressed assets have traded; average cap rates in these deals have been between 7.0 percent and 8.5 percent.

- **Outlook:** While apartment fundamentals have softened in recent quarters, NOI declines in San Diego have been far more modest than in many other major metro areas. Investors are expected to maintain steady activity levels during the next few quarters, as the expectations gap between buyers and sellers is manageable, and minimal threats from new stock limit the downside risk in acquiring properties.



* 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.*

Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- Compared to other core property sectors, apartments have fared best due to the availability of financing through government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. Recent modifications to GSE guidelines will impact lender decisions, however, as borrower requirements include more substantial apartment ownership experience.

- Loan-to-value requirements range from 55 percent to 75 percent. Portfolio lenders are issuing loans at all-in rates of 6.00 percent to 6.75 percent for a five-year term and 6.9 percent to 8.0 percent for a 10-year term. Rates among agency lenders are roughly 100 basis points to 150 basis points lower. The government's creation of a conservatorship for Fannie Mae and Freddie Mac has most likely boosted confidence in the two GSEs, putting downward pressure on rates, but it also creates several near-term uncertainties, as the conservatorship is due to expire at the end of the year.

- Delinquencies will rise further as a wave of maturities approaches; however, at-risk borrowers may find lenders amenable to loan extensions/modifications. Furthermore, Freddie Mac is under way on its second securitization of multi-family debt this year, and the government's TALF program is expected to at least provide a much-needed spark to the traditional CMBS market.

Submarket Overview

- The Grossmont Trolley Station project, located in the La Mesa/Spring Valley/Lemon Grove submarket, will add 447 market-rate apartments in two phases by the end of next year.

- Vacancy in Class B/C units in the Mission Bay/Pacific Beach submarket has declined 30 basis points in the past year to 3.1 percent, as renter demand for affordable apartments in top locations remains elevated. Operators have trimmed asking rents in the submarket's lower tiers by 3.6 percent during that time to $1,377 per month.

- Despite a 130 basis point year-over-year improvement to 7.8 percent, vacancy in downtown San Diego remains the highest in the metro, as recently constructed condos continue to compete with apartments for renters.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Mission Bay/Pacific Beach	3.2%	-10	$1,436	-5.7%
2	National City/Chula Vista	3.9%	110	$1,121	-3.3%
3	El Cajon/Santee/Lakeside	4.0%	110	$989	-1.9%
4	Balboa Park/West of I-15	4.0%	0	$1,020	-3.3%
5	Ocean Beach/Point Loma Boulevard	4.4%	240	$1,242	-3.5%
6	La Mesa/Spring Valley/Lemon Grove	4.8%	130	$1,176	-1.5%
7	La Jolla/University City	4.8%	180	$1,653	-4.7%
8	Oceanside	5.1%	190	$1,172	-2.9%
9	Escondido/San Marcos	5.3%	210	$1,063	-4.2%
10	Vista	5.5%	-30	$1,141	-3.3%

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