

ApartmentResearch

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

Marcus & Millichap

San Jose Metro Area

Fourth Quarter 2009

CONTRACTING DEMAND DRIVES AGGRESSIVE RENT DECLINES

The recession has weighed heavily on fundamentals in the San Jose apartment market, with employment losses in technology-related sectors in particular dragging on renter demand. As unemployment has soared to record levels, an increasing number of residents have opted to double up or relocate to more affordable markets to reduce expenses. Owners have responded by reducing rents aggressively; metrowide effective rents have slipped more than 11 percent in the past year. While rents are projected to soften further through the first half of 2010, declines will ease, as this downturn is expected to be shallower than the dot-com recession. Despite near-term weakness, the Mountain View/Los Altos and Sunnyvale submarkets will likely stabilize ahead of the metro, as proximity to dense employment centers should maintain steadier conditions. Renter demand in Palo Alto, for instance, will receive a boost when electric carmaker Tesla Motors Inc. relocates its corporate headquarters to the former Agilent Technologies facility, a move that will eventually bring up to 600 employees to the area.

San José's investment climate will continue to transition through the next several quarters as buyers and sellers attempt to pinpoint how valuations have shifted since the economic downturn intensified. Sales activity has been limited during the last year, as declining revenues have helped maintain a wide buyer/seller expectations gap and investors continue to hold out for distress-level pricing. Discounting has started to take shape in recent months, especially in the West San Jose and Northeast San Jose submarkets, where concessions are among the highest in the metro. While recent trading has consisted primarily of smaller-sized properties, a handful of assets with more than 100 units have changed hands, indicating that investment trends could be changing as REITs and institutions enter the market to acquire properties below replacement cost.

2009 ANNUAL APARTMENT FORECAST



Employment: Job losses are expected to total 43,600 workers in 2009, a 4.8 percent annual decline. Last year, 15,600 positions were cut.



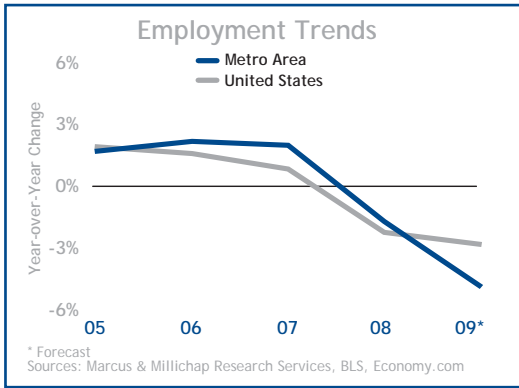
Construction: Stock additions will be minimal this year, as only 270 units are scheduled for completion, a 0.2 percent inventory expansion; 860 units came online in 2008. Deliveries have averaged more than 900 units annually over the past five years.



Vacancy: Metrowide vacancy is forecast to end 2009 at 5.8 percent, a 60 basis point rise from last year, when vacancy climbed 130 basis points.



Rents: This year, asking rents are projected to fall 9.5 percent to \$1,515 per month. Owners will respond to softened conditions by raising concessions, as effective rents are expected to drop 10.4 percent annually to \$1,421 per month.

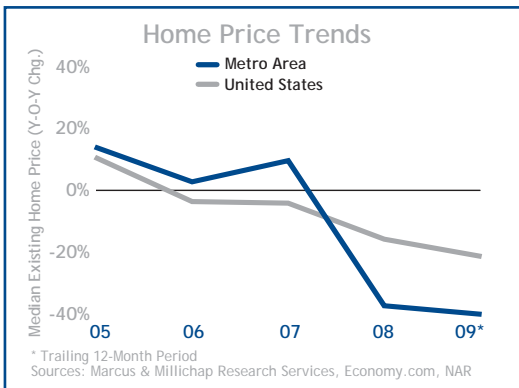


ECONOMY

- ◆ Over the last 12 months, employers in the South Bay have thinned head counts by 5.8 percent, or 53,500 positions. Job losses have eased recently, however, as roughly 18,200 workers have been released during the past six months.
- ◆ As consumer demand wanes, technology-related work force reductions in the manufacturing sector have accelerated, driving metrowide employment contraction during the last year. In the third quarter, year-over-year losses in the segment amounted to 14,300 positions, an 8.5 percent drop from the previous 12 months.
- ◆ Unemployment in San Jose has climbed to record highs. In August, the unemployment rate reached 12 percent, up significantly from 6.4 percent one year earlier.
- ◆ **Outlook:** Employment losses are expected to total 43,600 workers in 2009, a 4.8 percent annual decline. Last year, 15,600 jobs were cut.

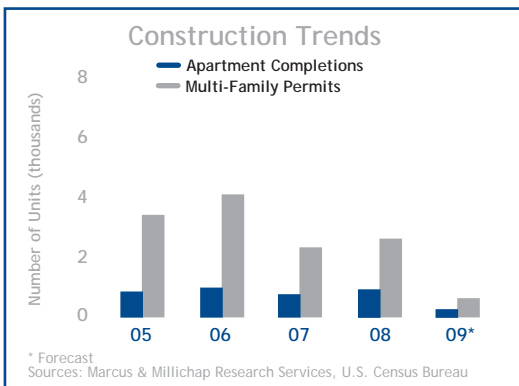
HOUSING AND DEMOGRAPHICS

- ◆ Builders have pulled 600 single-family permits in the past 12 months, approximately 50 percent lower than in the previous period. Permitting in the multi-family sector also has dropped by nearly 50 percent to 1,100 units.
- ◆ The median price of a single-family home in the metro was estimated at \$401,000 in the third quarter, almost 40 percent less than one year earlier. The median household income of \$77,400 annually is nearly \$21,000 below the minimum amount required to qualify for a median-priced residence.
- ◆ Using traditional financing, the typical mortgage payment for a median-priced home was \$460 per month less than the average Class A asking rent during the third quarter.
- ◆ **Outlook:** While the median home valuation has declined more than 50 percent since peaking several quarters ago, prices are still among the highest in the country, and home affordability remains out of reach for a large portion of renters.



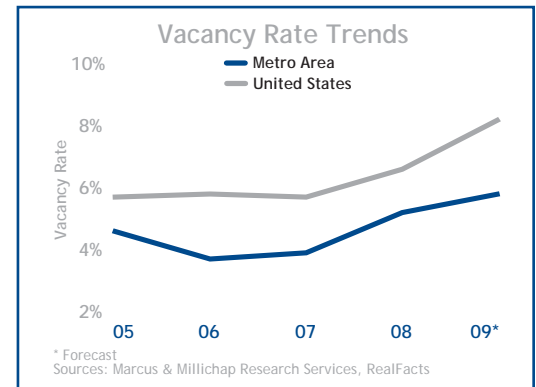
CONSTRUCTION

- ◆ During the past 12 months, developers have completed 860 units, a 0.8 percent inventory expansion. No projects have come online since the start of 2009, however.
- ◆ Roughly 760 units are under way in the metro, many of which are slated for delivery within the next two years. The planning pipeline, meanwhile, contains approximately 6,400 units.
- ◆ Development activity involving condo projects remains strong, as more than 1,300 units are currently under construction. As the metro's housing woes persist, some of these units may enter the market as rentals, posing a threat to Class A operators.
- ◆ **Outlook:** Apartment stock additions will be minimal this year, as only 270 units are scheduled for completion, a 0.2 percent inventory expansion; 860 units came online in 2008. Deliveries have averaged more than 900 units annually over the past five years.



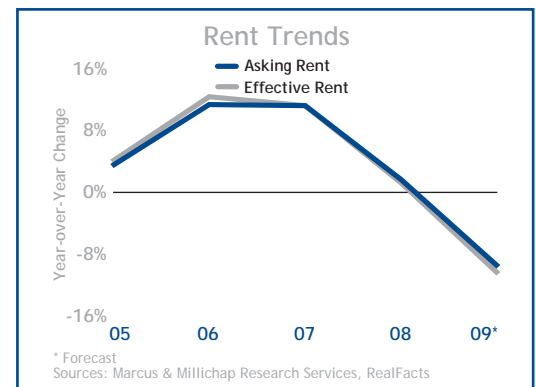
VACANCY

- ◆ Metrowide vacancy reached 5.4 percent in the third quarter, 100 basis points higher than in the same period in 2008, as a result of moderate stock additions and contracting renter demand.
- ◆ Top-tier inventory expansion and work force reductions in higher-paying sectors have placed upward pressure on Class A vacancy. High-end vacancy climbed 130 basis points year over year to 6.2 percent in the third quarter.
- ◆ In the Class B/C segment, economic contraction has forced some renters to double up or relocate to more affordable markets. As such, lower-tier vacancy has risen 90 basis points over the last 12 months to 4.6 percent.
- ◆ **Outlook:** Vacancy is forecast to end 2009 at 5.8 percent, up 60 basis points from last year, when vacancy climbed 130 basis points.



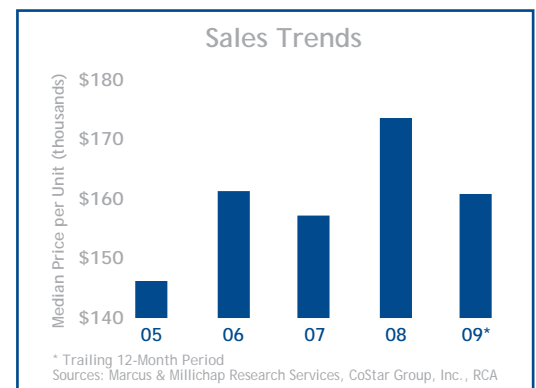
RENTS

- ◆ Owners have implemented aggressive rent reductions in an attempt to maintain occupancy levels. Asking rents retreated 9.9 percent to \$1,540 per month over the year ending in the third quarter. Effective rents slipped 11.4 percent in that time to \$1,447 per month.
- ◆ Class B/C asking rents have fallen 8.4 percent during the past 12 months to \$1,302 per month. Top-tier asking rents have contracted at a more rapid rate, sliding 11 percent to \$1,752 per month.
- ◆ Sharp effective rent declines have pushed down average revenues 12.3 percent in the last year, following a 4.2 percent gain in the previous 12 months.
- ◆ **Outlook:** This year, asking rents are projected to fall 9.5 percent to \$1,515 per month. Owners will respond to softened conditions by raising concessions, as effective rents are expected to drop 10.4 percent annually to \$1,421 per month.



SALES TRENDS**

- ◆ Sales activity has slowed by nearly 40 percent over the past year, as rapidly falling rents have eroded NOIs and created a wide disparity between buyers' and sellers' expectations. An uptick in third quarter closings, however, could indicate that the gap has begun to narrow.
- ◆ During the last 12 months, declining revenues have softened valuations. The median price has dipped 6 percent to \$160,600 per unit in that time, though over the most recent six-month period, the median price fell to \$154,000 per unit.
- ◆ Cap rates for recently closed deals have averaged in the low- to mid-6 percent range, though some lesser assets in more management-intensive locations have traded with initial yields in the mid-7 percent area.
- ◆ **Outlook:** Cash-heavy private investors will likely continue to seek out stabilized Class B properties in core locations such as Mountain View and Sunnyvale, where operations have outperformed the metro. Recent trends, however, suggest that REITs and institutions may be ready to re-enter the marketplace, as some large properties have changed hands over the last six months.



** 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

- ◆ 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

- ◆ In the Campbell/Los Gatos submarket, operators have responded to climbing vacancy by widening concessions, driving a 15.3 percent slide in revenues year over year in the third quarter, the steepest decline in the metro.
- ◆ Sharp effective rent reductions and elevated vacancy levels have dragged on valuations in the West San Jose submarket. During the most recent 12-month span, the median price fell 11 percent to \$131,800 per unit.
- ◆ Over the last year, job losses in the lower-paying construction and trade, transportation and utilities sectors have weighed heavily on lower-tier demand in the South San Jose submarket, generating a 320 basis point vacancy spike through the third quarter.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Sunnyvale	4.2%	30	\$1,436	-12.6%
2	East San Jose	4.3%	80	\$1,351	-10.2%
3	Mountain View/Los Altos	4.9%	60	\$1,602	-11.2%
4	Campbell/Los Gatos	5.0%	170	\$1,289	-13.9%
5	Cupertino/Saratoga	5.4%	100	\$1,704	-11.6%
6	Northeast San Jose	5.7%	-50	\$1,524	-10.7%
7	Santa Clara	6.0%	180	\$1,447	-10.8%
8	West San Jose	6.0%	170	\$1,305	-11.3%
9	South San Jose	6.8%	320	\$1,288	-9.6%