

ApartmentResearch

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

Marcus & Millichap

Tucson Metro Area

Fourth Quarter 2009

BUYERS TARGET DISTRESS; SALES ACTIVITY SOFT IN STABLE ASSETS

Steep job losses across multiple employment sectors are weighing on renter demand in Tucson, pushing vacancy higher. In 2009, approximately 5,500 construction jobs will be cut in the metro, bringing total losses in the sector since the onset of the recession to nearly 11,000 workers. The decline has led to a sharp drop-off in demand for Class B/C units, particularly in the South/Southwest Tucson submarket. While the construction sector has been shedding jobs for nearly three years, the professional and business services segment did not begin to contract until late in 2008. The loss of these traditionally high-paying positions has stifled demand in the metro's Class A apartments and driven up vacancy. Apartment completions will accelerate to approximately 400 units in 2009, but new supply is typically not a significant concern; prior to this year, fewer than 550 units were delivered since the end of 2003. As such, apartment fundamentals in the metro should begin to level off as the employment market stabilizes; job losses eased considerably in the third quarter, and modest growth will likely resume near the middle of next year.

The expectations gap between buyers and sellers remains quite wide in Tucson, which has limited traditional investment activity and price discovery. Buyers are primarily targeting properties that have been foreclosed, especially in the southern stretches of the metro, or assets that are in some sort of distress. Owners of stabilized properties are choosing not to list at a time when market prices are skewed by high foreclosure activity and short sales. Cap rates are in the mid-7 percent to mid-8 percent range in most cases, although a few top properties could change hands in the low-7 percent area. Investment activity will likely begin to gain momentum when the number of foreclosed, deeply discounted assets falls off and fundamentals begin to firm.

2009 ANNUAL APARTMENT FORECAST



Employment: Every sector is expected to cut jobs in 2009, leading to a 6.4 percent decline in metrowide employment as 16,800 workers are let go. Last year, both the education and health services and government sectors added thousands of jobs, which limited total losses to 12,700 positions.



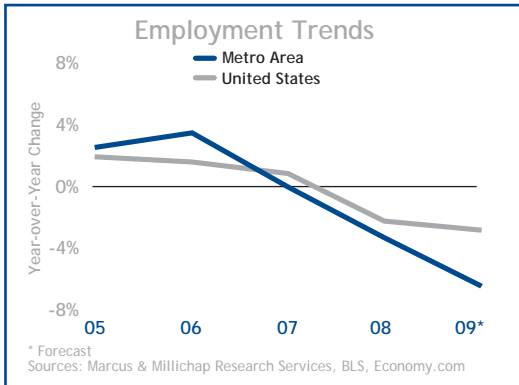
Construction: This year, approximately 400 apartments will come online, following no stock additions in 2008. Despite the increase, it will take several years of deliveries to offset the thousands of units that were removed from rental stock as condo conversions.



Vacancy: Metrowide vacancy is expected to rise 230 basis points to 13.3 percent by the end of this year. No new apartment construction is projected for 2010, and the employment market should stabilize, which could lead to fairly flat vacancy next year.

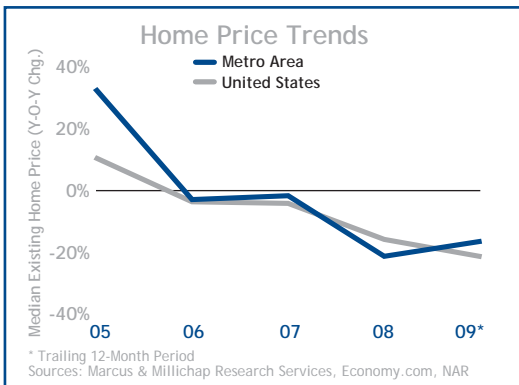


Rents: Asking rents are forecast to decline 2.3 percent this year to \$636 per month, while effective rents will fall 4.1 percent to \$591 per month. In 2008, asking and effective rents advanced 2.2 percent and 1.8 percent, respectively.



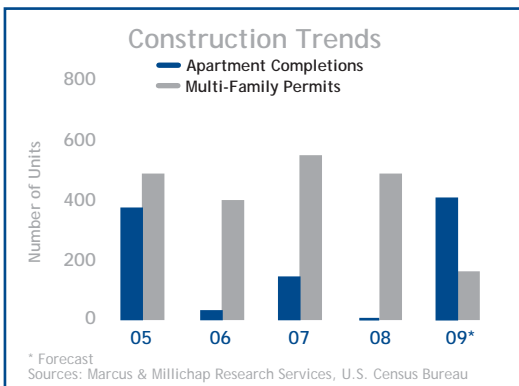
ECONOMY

- ◆ Year over year through the third quarter, local employment in Tucson contracted by an estimated 6.5 percent with the elimination of 24,800 positions. Losses eased in the third quarter, when layoffs totaled 4,100 jobs.
- ◆ The professional and business services sector, which grew rapidly during the metro's economic expansion, has decreased by more than 10 percent in the last 12 months with the elimination of 5,300 workers.
- ◆ Weakness in the housing market and slowing population growth have resulted in deep cuts in construction employment. In the past year, sector payrolls have declined by 29.4 percent, or 6,400 positions. Year to date, losses have totaled 4,000 jobs, including 1,000 layoffs in the third quarter.
- ◆ **Outlook:** Every sector is expected to cut head counts in 2009, leading to a 6.4 percent decline in metrowide employment as 16,800 workers are let go. Last year, both the education and health services and government sectors added thousands of jobs, which limited total losses to 12,700 positions.



HOUSING AND DEMOGRAPHICS

- ◆ During the past 12 months, 1,490 single-family permits have been issued, a 53 percent decline from the previous year. The drop-off in multi-family issuance was more substantial, falling 86 percent to just 110 units.
- ◆ The metro's median single-family home price decreased an estimated 16 percent in the past year to \$166,500 in the third quarter, while the median household income receded 9.7 percent to \$39,900 per year. Despite a 34 percent drop since the peak, fewer than half of all local residents can afford a median-priced home on their current incomes.
- ◆ The average Class A asking rent is roughly \$190 per month more than the mortgage payment on a median-priced home, using traditional financing. At the end of the third quarter of 2008, the monthly mortgage payment was more than \$500 higher than the average Class A asking rent.
- ◆ **Outlook:** Declining household incomes and a weak labor market have kept many renters from moving to homeownership, despite more reasonable prices and a government credit for first-time buyers. The metro area's large population of current students and recent graduates will likely support continued renter demand for apartments.

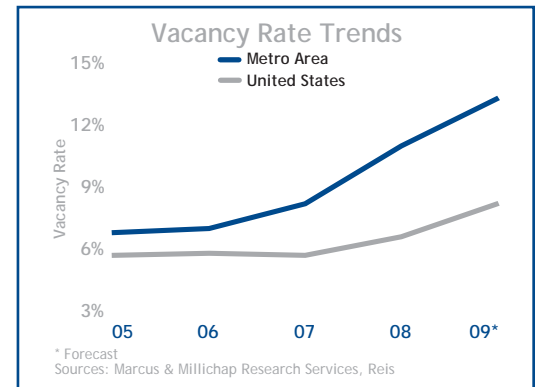


CONSTRUCTION

- ◆ In the past year, the 288-unit Summit Vista development has been the only significant delivery in the metro, increasing inventory by 0.5 percent.
- ◆ Approximately 110 units are currently under construction, with another 290 units in planning.
- ◆ While no condo units are under way, 780 condos are in the planning phases. If the housing market remains soft, these projects could be abandoned or eventually be delivered as rentals.
- ◆ **Outlook:** This year, approximately 400 apartments will come online, following no stock additions in 2008. Despite the increase, it will take several years of deliveries to offset the thousands of units that were removed from rental stock as condo conversions.

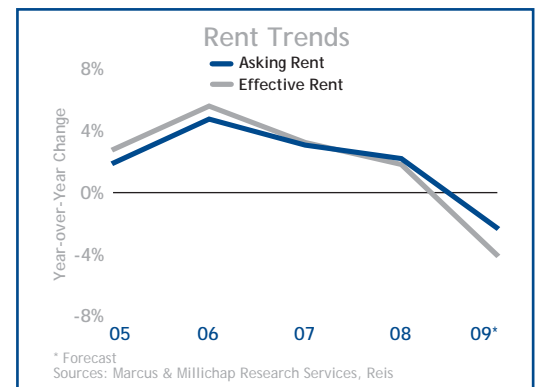
VACANCY

- ◆ In the 12-month period ending in the third quarter, vacancy increased 250 basis points to 12.9 percent. Following a 90 basis point rise in the second quarter, vacancy was estimated to have ticked up just 30 basis points in the third quarter.
- ◆ While completions have been minimal, shadow rental stock is competing with Class A apartments, and some residents are moving to Class B units to cut costs. As a result, vacancy in the top tier has increased 270 basis points year over year to 13.1 percent, including a 150 basis point rise over the past two quarters.
- ◆ Vacancy in the Class B/C segment is up 220 basis points in the last year to 12.6 percent, as steep declines in traditionally lower-wage employment sectors are reducing renter demand.
- ◆ **Outlook:** Metrowide vacancy is expected to rise 230 basis points to 13.3 percent by the end of this year. No new apartment construction is forecast for 2010, and the employment market should stabilize, which could lead to fairly flat vacancy in 2010.



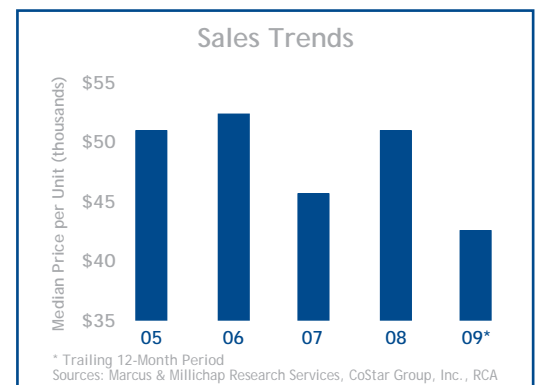
RENTS

- ◆ During the past 12 months, asking rents slipped 0.6 percent to an estimated \$645 per month in the third quarter. Effective rents contracted 2.4 percent to \$601 per month.
- ◆ Asking rents in Class A apartments have dipped 0.3 percent year over year to \$769 per month, while asking rents in the lower tiers have fallen 1.6 percent to \$561 per month. With vacancy elevated and the job market weak, asking rents in both segments are forecast to retreat further during the next few quarters.
- ◆ As vacancy has reached its highest point in more than a decade, average property revenues have declined 5.2 percent in the past year, while concessions have increased from 19 days of free rent to 25 days of free rent.
- ◆ **Outlook:** Asking rents are forecast to decline 2.3 percent this year to \$636 per month, while effective rents will fall 4.1 percent to \$591 per month.



SALES TRENDS**

- ◆ In the past year, sales velocity has dropped 55 percent. Investment activity has been steady throughout much of 2009.
- ◆ With property revenues declining, the median sales price has fallen 17 percent over the last 12 months to \$42,400 per unit.
- ◆ Based on limited sales thus far in 2009, cap rates for most properties likely average in the mid-7 percent to mid-8 percent range. For much of last year, cap rates were in the high-6 percent to low-7 percent range.
- ◆ **Outlook:** A decline in activity from out-of-area buyers will restrict sales velocity in the coming quarters, which, along with softening fundamentals, should put downward pressure on valuations. Cap rates may have to creep higher, particularly for properties that are in distress or in assets where vacancy is above the metro average.



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

Marcus & Millichap

NATIONAL MULTI HOUSING GROUP

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

Marcus & Millichap

Real Estate Investment Services

Prepared and edited by

Peter O'Neil

Senior Market 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

Tucson Office:

David Guido

Regional Manager

dguido@marcusmillichap.com

4031 E. Sunrise Drive

Suite 151

Tucson, Arizona 85718

Tel: (520) 202-2900

Fax: (520) 202-2910

Price: \$150

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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 150 basis points to 175 basis points lower. The government recently assumed full control of Fannie Mae and Freddie Mac, which may boost confidence in the GSEs, putting downward pressure on rates, but it also creates several near-term uncertainties.
- ◆ 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

- ◆ While fundamentals are weakening throughout the metro, property operations in the Central Tucson/University-North submarket are among the strongest in Tucson and should be the first to rebound. The large population of students and recent graduates in the area provides a fairly stable renter base.
- ◆ While vacancy has pushed higher, concessions in the Flowing Wells/West Tucson submarket have remained the lowest in the metro at 17 days of free rent. One year ago, area concessions were 15 days of free rent.
- ◆ Renter demand in the Pantano submarket could build over the long term, as the Davis-Monthan Air Force Base may become one of the bases for the F-35 joint strike fighter, which would create jobs in the area. Class A vacancy in the submarket is up just 40 basis points year over year at 8.4 percent.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Central Tucson/University-North	8.2%	180	\$613	-3.2%
2	Catalina	12.0%	50	\$663	-1.7%
3	Pantano	12.8%	140	\$588	-2.6%
4	North/Northwest Tucson	13.2%	360	\$689	-3.6%
5	Flowing Wells/West Tucson	13.2%	300	\$589	-0.5%
6	East Tucson	14.0%	320	\$541	-3.1%
7	South/Southwest Tucson	16.9%	270	\$525	-1.0%