

SUPPLY GLUT THREATENS CLASS A UNITS; LOWER TIERS STABLE

Despite the halt in apartment construction activity in the Sacramento metro this year, supply-side concerns persist. After rampant residential overbuilding in recent years, Class A apartment operators now are faced with an oversupply of single-family homes employed as rentals, particularly in suburban areas such as Elk Grove and Roseville. In the Downtown submarket, elevated condo development also could pose a threat to high-end apartment operators if the unsold units come online for rent. Further weighing on metrowide occupancy levels is reduced renter demand stemming from ongoing job losses, as the contracting economy and growing state budget deficit are dragging on employment in Sacramento's key government sector. While job cuts will result in moderately higher vacancy in the lower tiers, conditions will remain far steadier than in Class A properties due to more modest competitive threats from shadow rental stock.

Challenges securing capital, combined with softened operating fundamentals, will continue to weigh on sales activity this year. Experienced local investors will likely dominate the buyer pool, targeting Class B/C properties in primary locations such as the Downtown submarket. Investors with extended horizons will maintain interest in apartment assets in Roseville due to the area's healthy household growth projections for the years ahead. The submarket's supply overhang from the over-saturated single-family residential market, however, will likely steer potential buyers toward Class B/C properties, which are expected to outperform this year. Upward pressure on the metro's average cap rates, currently in the mid- to high-6 percent range, is expected to remain in place. Meanwhile, lower-grade assets in tertiary locations may require steep discounting in order to receive offers.

2009 ANNUAL APARTMENT FORECAST



Employment: For the second consecutive year, employers are forecast to cut local payrolls by 4.1 percent, or 35,000 workers. The state budget deficit will weigh heavily on Sacramento's government sector and be the primary driver behind the mass layoffs.



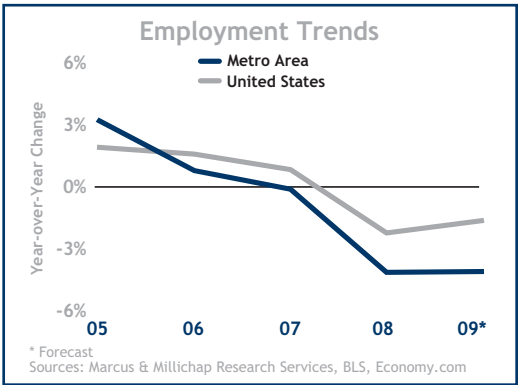
Construction: Apartment development will slow this year, as there are only 100 units slated to come online. In 2008, developers completed 170 units.



Vacancy: Despite the relative absence of new supply, ongoing job losses will weigh on demand for apartments in 2009. Vacancy is expected to rise 180 basis points to 8.7 percent, following a 70 basis point increase last year.

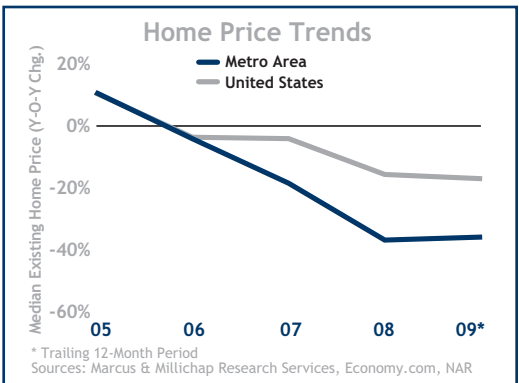


Rents: As vacancy creeps higher, downward pressure will be placed on rents. Asking rents are projected to contract by 2 percent to \$947 per month, while effective rents will end the year at \$900 per month, a 2.3 percent drop from 2008.



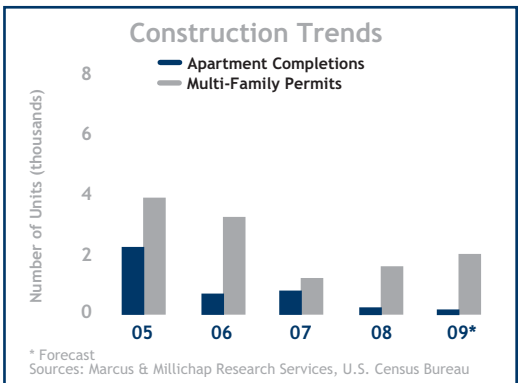
ECONOMY

- ◆ Economic weakness continues to drag on Sacramento-area employment. Through the first quarter, employers thinned payrolls by 48,800 workers, a net loss of 5.5 percent annually.
- ◆ Layoffs in the trade, transportation and utilities segment that are tied to softness in the retail industry have driven significant job cuts in the last 12 months. Employers have eliminated 13,300 positions in this sector over the past year, a 7.7 percent decline.
- ◆ Due to ongoing weakness in the economy, JCPenney closed its Carmichael call center in the first quarter, trimming roughly 260 jobs.
- ◆ **Outlook:** For the second consecutive year, employers are forecast to cut local payrolls by 4.1 percent, or 35,000 workers. The state budget deficit will weigh heavily on Sacramento's government sector and be the primary driver behind the mass layoffs.



HOUSING AND DEMOGRAPHICS

- ◆ Permit issuance was mixed through the first quarter. Single-family permits totaled 2,000 annualized units, down 33 percent from one year earlier as a result of continued turmoil in the housing market. Developers pulled permits for 1,900 multi-family units in that time, a 74 percent spike, as construction reached a low point in 2008 due to recent overbuilding.
- ◆ The median price for a single-family home in the metro was \$168,200 in the first quarter, 36 percent lower than 12 months earlier. The median household income has fallen 2 percent during the last year to \$57,700 annually, though it remains \$19,000 more than the amount needed to qualify for a median-priced single-family residence.
- ◆ Homeownership has become more affordable relative to renting. The typical mortgage payment, using traditional financing methods, is approximately \$191 per month less than the average Class A asking rent.
- ◆ **Outlook:** Although current mortgage payments favor homeownership, many residents will continue to hesitate before stepping into the buyer pool, given the possibility of further declines in the local housing market.

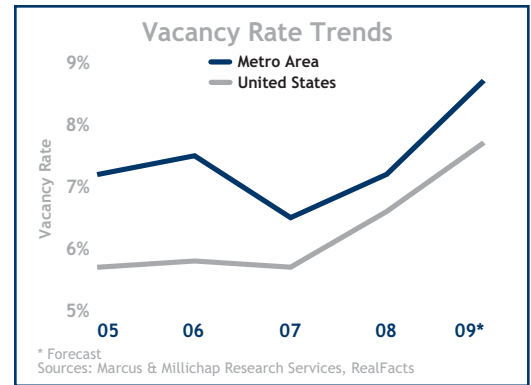


CONSTRUCTION

- ◆ Apartment construction has come to a virtual standstill, as oversupply issues remain a concern for developers. During the 12-month period ending in the first quarter, 100 units came online, following the addition of 430 units in the previous year.
- ◆ There are no units under construction and approximately 2,100 units in the various planning stages. A significant portion of the proposed projects are located in the Downtown submarket, where redevelopment efforts continue.
- ◆ Condo construction is still active, as there are 900 for-sale units scheduled for delivery in 2009. Another 1,300 units are under way and projected to be completed in the coming years, though some of these developments may come online as rentals if weakness in the housing market persists.
- ◆ **Outlook:** Apartment development will slow this year, as there are only 100 units slated to be delivered. In 2008, developers added 170 units.

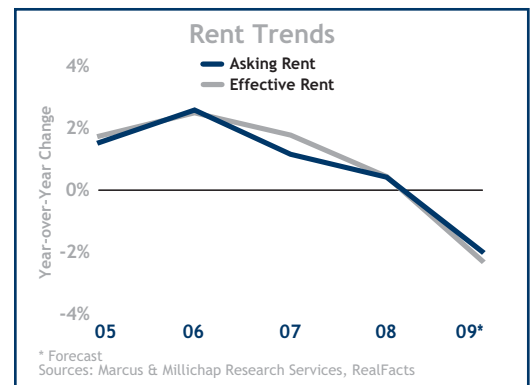
VACANCY

- ◆ Despite a lack of new construction, vacancy increased 90 basis points to 7.8 percent year over year in the first quarter due to continued job cuts. In the first quarter alone, vacancy climbed 60 basis points.
- ◆ Top-tier vacancy spiked 120 basis points to 9.1 percent over the 12-month period ending in the first quarter as a result of single-family homes and unsold condos being employed as rentals.
- ◆ In the Class B/C segment, vacancy rose 70 basis points during the past year to 6.9 percent in the first quarter. Lower-tier conditions should remain more stable than those in the Class A sector due fewer competitive threats.
- ◆ **Outlook:** Despite the relative absence of new supply, ongoing job losses will weigh on demand for apartments in 2009. Vacancy is forecast to rise 180 basis points to 8.7 percent, following a 70 basis point increase last year.



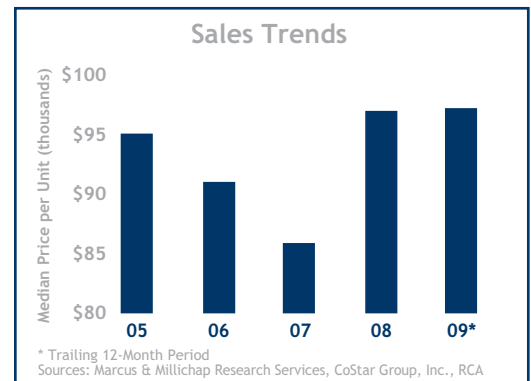
RENTS

- ◆ Over the 12-month period ending in the first quarter, asking rents dipped 0.5 percent to \$961 per month. Effective rents retreated 0.8 percent to \$915 per month in that time.
- ◆ Asking rents for top-tier units were \$1,107 per month in the first quarter, down 1 percent from one year earlier, as high-end operators are competing with more alternative housing options. In Class B/C apartments, owners have recorded a 0.3 percent year-over-year asking rent gain to \$863 per month.
- ◆ Widening concessions contributed to a 1.8 percent decline in revenues during the 12 months ending in the first quarter.
- ◆ **Outlook:** As vacancy creeps higher, downward pressure will be placed on rents. Asking rents are forecast to contract by 2 percent to \$947 per month, while effective rents will end the year at \$900 per month, a 2.3 percent drop from 2008.



SALES TRENDS**

- ◆ Uncertainty over further weakening in the market, combined with limited access to capital, resulted in transaction velocity slowing 20 percent during the most recent 12-month period.
- ◆ Despite the decline in sales activity, the median price has risen 12 percent to \$96,700 per unit in the last year. Buyers turned their focus to stabilized assets in the metro, leading to fewer value-add deals taking place and generating a higher median price.
- ◆ Cap rates have averaged in the mid-6 percent range during the past 12 months, roughly 40 basis points higher than in the previous year. As buyers and sellers realign their expectations to reflect softness in the market, initial yields will likely continue to increase in the quarters ahead.
- ◆ **Outlook:** Investment activity is forecast to remain measured this year as buyers evaluate potential deals with greater caution. The investor pool will be dominated by experienced local buyers who will likely seek out Class B/C apartments in core locations due to the heightened risk in the Class A segment.



** 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

- ◆ Despite ongoing uncertainty in the financial markets and among some of the country's largest banks, debt financing remains available for multi-family loans. Standards have tightened considerably, however, with lenders requiring LTVs of 55 percent to 75 percent marketwide. Debt-service coverage ratios are in the 1.25 to 1.30 range, higher than in recent years, but closer to historical norms.
- ◆ The apartment sector has benefited from the presence of Fannie Mae and Freddie Mac, as both agencies continue to fund deals. The yield on the 10-year Treasury has been volatile, dropping to nearly 2 percent late last year, prompting many lenders to favor all-in rates, which are averaging in the high-5 percent to mid-6 percent range for agency loans. Commercial banks and life insurance companies are issuing loans with all-in rates ranging from the mid-6 percent range to 8 percent.
- ◆ With apartment fundamentals weakening and delinquencies creeping higher, lenders are devoting greater attention to sponsorship. A borrower's asset base and potential economic stresses that may affect the underlying assets are playing a significant role in determining loan terms.

SUBMARKET OVERVIEW

- ◆ Buyers seeking stability may want to investigate opportunities in the Davis submarket, where conditions historically are some of the tightest in the metro. Minimal supply-side threats and the student population maintain a large and consistent renter pool. Buyers could have to stretch to acquire area assets, however, due to limited trading.
- ◆ Apartment operators in the Woodland submarket may benefit from the opening of the first phase of the Woodland Gateway power center, currently scheduled for this spring. Retailers including Costco, Target and Best Buy will bring hundreds of jobs to the area, generating renter demand.
- ◆ Investors with extended horizons may find upside in properties located in the Roseville submarket. Although the supply overhang stemming from residential overbuilding is serving as a near-term drag on occupancy levels, well-capitalized buyers can still discover opportunities near the recently opened Fountains at Roseville lifestyle center. This development and the revitalization of the Westfield Galleria across the street are expected to boost renter demand nearby.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Davis	2.1%	-20	\$1,142	-1.1%
2	Woodland	4.3%	10	\$813	-0.6%
3	Carmichael	5.6%	140	\$777	0.0%
4	West Marconi Avenue/Del Paso	6.2%	-90	\$706	-3.1%
5	Citrus Heights	6.5%	30	\$854	-1.4%
6	East Marconi Avenue	6.7%	10	\$786	-2.5%
7	Rancho Cordova	6.9%	30	\$859	-1.2%
8	South/Elk Grove	7.0%	50	\$746	1.1%
9	Orangevale/Folsom	7.2%	-70	\$1,085	0.7%
10	North Highlands	7.7%	90	\$833	0.6%