

TECH LAYOFFS UNDERPIN NEAR-TERM FUNDAMENTAL WEAKNESS

In San Jose, large-scale layoffs within the technology sector at companies such as Advanced Micro Devices and Intel will thin the work force by thousands, serving as a drag on apartment demand in 2009. Nevertheless, fundamental erosion will not be as deep as it was during the economic downturn earlier this decade, when roughly 200,000 jobs were eliminated. Following elevated completions last year, supply-side threats from apartment construction are limited in 2009 due to a small development pipeline, though alternative housing options have emerged in areas such as Northeast San Jose, where vacant single-family homes are being employed as rentals. In addition, upside pressure on vacancy in Class A properties will persist downtown as a result of more unsold condos coming online as rental stock. Conversely, operations should remain fairly stable in the desirable areas of Mountain View and Sunnyvale, where proximity to employment hubs will likely help the submarkets to outperform the metro this year.

Investors remain attracted to the region's low housing affordability and relative isolation from new competition, but most are pursuing assets cautiously. Sales activity will remain measured in the first half of the year, as assumptions for further price corrections will sustain a wide expectations gap and hinder metrowide trading. In areas such as East San Jose and Santa Clara, however, where valuations have declined significantly, transaction velocity has been stable. Cap rates for properties in these areas have settled in the low- to mid-6 percent range in recent months, roughly 100 basis points higher than the metrowide average. Meanwhile, assets in primary locations within the heart of Silicon Valley, such as Mountain View and Sunnyvale, where redevelopment efforts persist, should maintain buyer interest, though prospective investors may have to stretch in order to acquire stabilized assets due to steady interest.

2009 ANNUAL APARTMENT FORECAST



Employment: Corporate restructuring and the failures of smaller startup firms will continue to drag on employment this year. Employers in San Jose are forecast to trim payrolls by 3.9 percent, or 35,000 workers, in 2009; 15,600 jobs were cut last year.



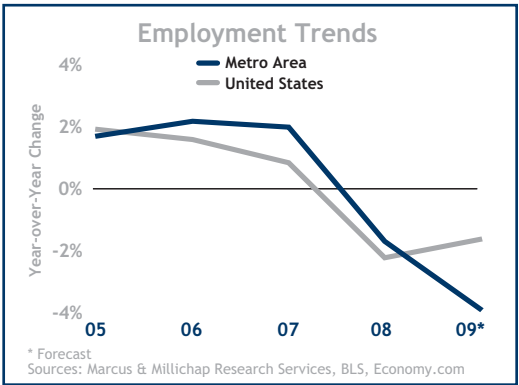
Construction: Apartment construction will come to a near standstill this year, as only 50 units are slated for completion. In 2008, 865 units were delivered.



Vacancy: Despite minimal construction activity, continued layoffs will weigh on renter demand. Vacancy is forecast to rise 90 basis points to 6.1 percent in 2009, following a 130 basis point increase last year.

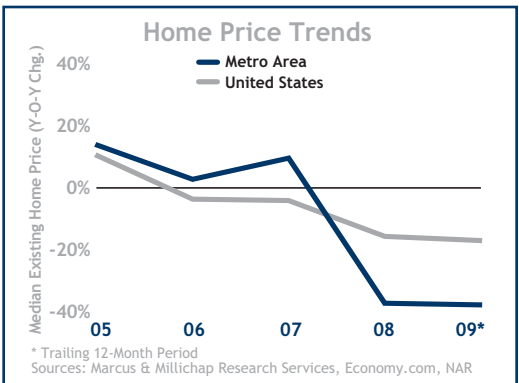


Rents: After a steep run-up in rental rates in recent years, rents are projected to contract in response to elevated vacancy and weakened economic conditions. Asking rents are expected to decrease 6.9 percent to \$1,558 per month, while effective rents will fall 8.2 percent to \$1,456 per month.



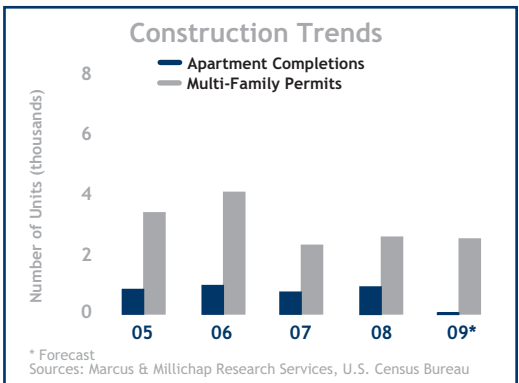
ECONOMY

- ◆ As the effects of the economic downturn began to fully impact the metro late last year, layoffs accelerated. Employers eliminated 32,600 positions over the 12-month period ending in the first quarter, a 3.5 percent decrease. In the last six months alone, 32,300 jobs have been shed.
- ◆ The professional and business services and trade, transportation and utilities sectors have recorded the most significant payroll cuts. Year over year in the first quarter, job losses in these segments totaled 21,800 workers.
- ◆ In the early stages of the downturn, employment in the technology sector held relatively steady, though continuing struggles have resulted in mounting layoffs in recent months. National Semiconductor recently announced plans to eliminate 330 workers at its Santa Clara headquarters in response to declining chip sales.
- ◆ **Outlook:** Employers in San Jose are forecast to trim payrolls by 3.9 percent, or 35,000 workers, in 2009; 15,600 jobs were cut last year.



HOUSING AND DEMOGRAPHICS

- ◆ Near-term uncertainty surrounding local economic conditions has dampened permit activity. Single-family permits totaled approximately 950 units over the 12-month period ending in the first quarter, down 38 percent from a year ago. Developers pulled permits for 2,400 multi-family units during the same period, down 7 percent.
- ◆ The median price for a single-family home in San Jose was \$493,300 in the first quarter, 38 percent lower than one year earlier. Despite the decline in prices, the median household income falls \$27,500 per year short of the minimum amount required to purchase a median-priced residence.
- ◆ Using traditional financing, the average mortgage payment for a median-priced home is approximately \$600 per month more than the average Class A asking rent.
- ◆ **Outlook:** Despite weakening in the residential market, home prices that are among the highest in the country and persistent low home affordability will sustain a deep renter pool.

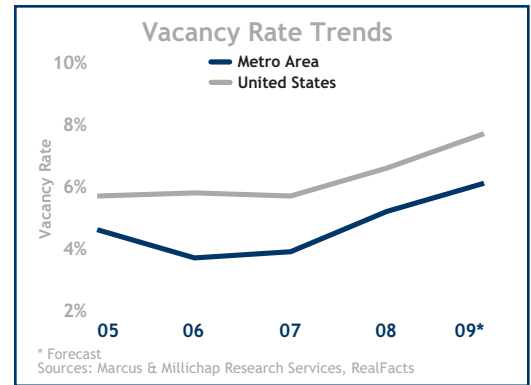


CONSTRUCTION

- ◆ Developers delivered 865 apartment units during the 12 months ending in the first quarter, a 1 percent expansion to metrowide stock. All of these units came online in the second half of 2008.
- ◆ Weakened economic conditions have slowed construction in recent months, as only 540 units are under way. The planning pipeline is full, however, with nearly 5,000 units.
- ◆ The largest complex under construction is Avalon Mountain View, located in the Mountain View/Los Altos submarket. Scheduled for completion in early 2010, this project will add approximately 250 units to inventory.
- ◆ **Outlook:** Apartment development will come to a near standstill this year, as only 50 units are slated for completion. In 2008, 865 units were delivered.

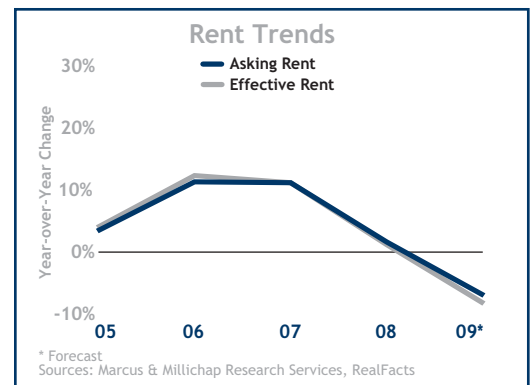
VACANCY

- ◆ Modest supply-side pressures have been met with contracting demand. Metrowide vacancy climbed 210 basis points year over year to 5.6 percent in the first quarter.
- ◆ Elevated construction, along with layoffs in the professional and business services sector, resulted in Class A vacancy reaching 6.4 percent in the first quarter, a 220 basis point spike from one year earlier.
- ◆ In the Class B/C segment, job cuts within lower-paying industries such as retail trade have driven up vacancy 190 basis points in the past 12 months to 4.6 percent.
- ◆ **Outlook:** Despite minimal construction activity, continued layoffs will weigh on renter demand. Vacancy is forecast to rise 90 basis points to 6.1 percent in 2009, following a 130 basis point increase last year.



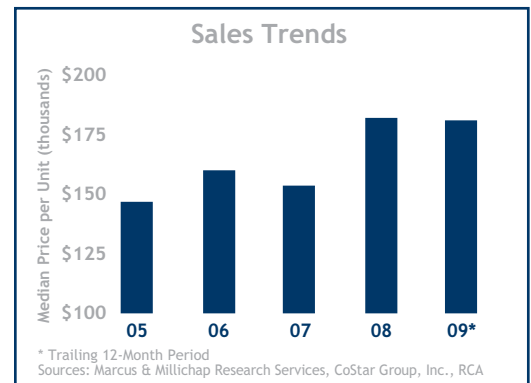
RENTS

- ◆ Climbing vacancy has placed downward pressure on rents. Asking rents retreated 2.8 percent year over year to \$1,614 per month in the first quarter, while effective rents softened 3.5 percent to \$1,527 per month.
- ◆ Class A asking rents ended the first quarter at \$1,848 per month, down 3.5 percent from one year earlier. In the lower tiers, asking rents dipped 2 percent to \$1,353 per month.
- ◆ A spike in vacancy levels in the last year has resulted in a 5.6 percent decline in average revenues.
- ◆ **Outlook:** Asking rents are expected to decrease 6.9 percent to \$1,558 per month, while effective rents will fall 8.2 percent to \$1,456 per month.



SALES TRENDS**

- ◆ While investor interest in the local apartment market persists, sales activity has slowed by more than 30 percent during the past 12 months, as a considerable expectations gap exists between buyers and sellers. Sales activity will remain measured in the first half of the year, though a narrowing bid-ask spread could generate increased trading in the second half.
- ◆ Despite the slowdown in deal flow, the median price was \$180,600 per unit in the most recent 12-month period, up 13 percent from one year earlier. The increase in valuations was a result of a greater proportion of smaller per-unit transactions taking place.
- ◆ Cap rates have averaged in the low- to mid-5 percent range during the past year, roughly 30 basis points higher than in the previous 12-month stretch. Cap rates are expected to remain on an upward path as sellers further adjust expectations to meet current market conditions.
- ◆ **Outlook:** San Jose's investment landscape will continue to transition in the quarters ahead as some owners who purchased during the run-up look to divest assets as loans come due. Cash-equipped local buyers will likely capitalize on this, seeking out attractive Class B/C deals in densely populated areas near commuter rail-line stops.



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

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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
Patricia Trinidad
Research Analyst
Research Services

For information on national
apartment trends, contact
John Chang
National Research Manager
Tel: (602) 952-9669
john.chang@marcusmillichap.com

Palo Alto Office:
Steven J. Seligman
Regional Manager
sseligman@marcusmillichap.com
2626 Hanover Street
Palo Alto, California 94304

Tel: (650) 494-8900
Fax: (650) 494-0213

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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

- ◆ Investors may want to monitor the progression of the Santa Clara Station Area Plan, located between the cities of Santa Clara and San Jose. The proposal contains a 432-acre project that will consist of a major transit hub and a mixed-use development, with nearly 4,000 housing units planned. If approved, this project could generate employment and renter demand nearby.
- ◆ Properties in the Mountain View/Los Altos submarket remain a fairly safe haven for investors, despite modest softening in fundamentals. Proximity to employment centers should sustain renter demand, while a thin development pipeline will present minimal supply-side threats, keeping occupancy levels relatively stable.
- ◆ Buyers seeking attractively priced deals may want to track opportunities in the Santa Clara submarket, where cap rates in the low- to mid-6 percent range have generated heightened sales activity in recent months, despite weakened conditions. Investors may want to look to assets in the traditionally stable Class B/C segment, as elevated construction over the past year has resulted in a spike in upper-tier vacancy.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Campbell/Los Gatos	3.6%	130	\$1,411	-1.9%
2	East San Jose	3.9%	170	\$1,439	-1.6%
3	Sunnyvale	4.5%	160	\$1,546	-1.3%
4	Mountain View/Los Altos	4.9%	150	\$1,728	-0.7%
5	Cupertino/Saratoga	5.2%	240	\$1,814	-3.3%
6	West San Jose	5.9%	300	\$1,408	-1.8%
7	Northeast San Jose	6.1%	20	\$1,616	-0.5%
8	South San Jose	7.1%	380	\$1,378	-1.8%
9	Santa Clara	7.4%	440	\$1,570	-4.0%