

SOFT ECONOMY AND EXCESS HOUSING PUSHING VACANCY HIGHER

After years of robust economic growth, the Phoenix market will continue to adjust in 2008. Residents will have more housing options this year due to a growing number of single-family homes and newly built condos being employed as rentals, particularly in outlying suburban areas. In addition, many condo conversion units will likely return as for-rent space, as sales have stalled. Fortunately, apartment builders will slow activity to a more sustainable pace, easing upward pressure on vacancy. On the demand side, volatility in the housing market will generate a decline in employment, especially in the construction sector. Apartment owners may also face new hurdles in the coming quarters, as the state has enacted some of the country's toughest employer sanction laws against hiring illegal immigrants. While it is too early to know the impact of this legislation, a weakened economy and the recent hiring restrictions may slow the metro's recovery. Over the long term, however, the market's outlook remains bright, with household growth forecast to stay steady going forward. This sustained demand will help to support local apartments in 2008, despite a troubled housing market and stricter lending criteria.

Waning conversion sales and tighter lending requirements have slowed overall deal flow in Phoenix and will likely continue to do so in the near term. As such, cap rates that are currently in the low- to mid-6 percent range are expected to push higher as buyers and sellers bridge the expectations gap. While assets are staying on the market longer than a few quarters ago, properties with strong operations in infill locations will remain in high demand. Additionally, institutional investors will continue to be active for the best assets, lured by projections for extended population growth. Buyers with built-up equity and long-term holding periods will find ample opportunities for upside potential in Phoenix once the housing market normalizes.

2008 ANNUAL APARTMENT FORECAST



Employment: Due to the metro's reliance on real estate-related fields, local employers are forecast to reduce payrolls by 5,000 workers, or 0.3 percent, this year. In 2007, 3,700 jobs were added.



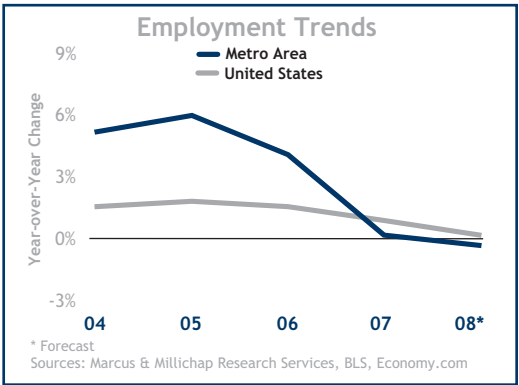
Construction: Builders are projected to deliver 3,800 units in 2008, compared with 5,500 units last year. Additionally, an increasing number of recently converted rentals and unsold condos are likely to return as rental stock by year end.



Vacancy: Slower employment growth and competition from the metro's excess of alternative housing will result in continued upward pressure on metrowide vacancy rates. In 2008, vacancy is forecast to rise 140 basis points to 9.5 percent after increasing 150 basis points last year.

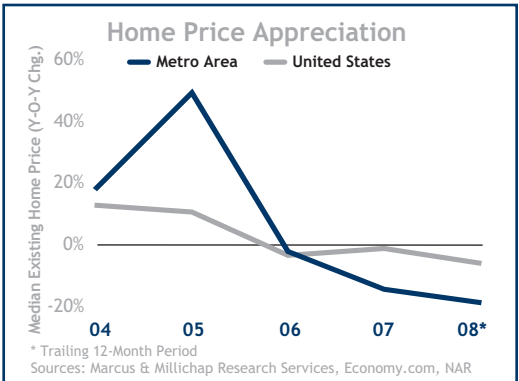


Rents: Rent growth will be more subdued this year due to softer demand, combined with strong competition from the metro's single-family housing market and unsold condos. As a result, asking rents are projected to gain 1.5 percent to \$785 per month, while effective rents will end the year at \$710 per month, a 0.5 percent drop.



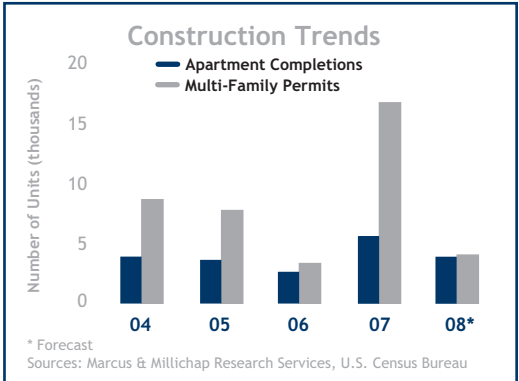
ECONOMY

- ◆ Softness in housing-related employment sectors has resulted in a decrease in total employment over the past 12 months. On a year-over-year basis, approximately 4,800 jobs have been cut, a 0.3 percent reduction. In the first quarter, however, 4,500 employees were hired, compared with a loss of 10,000 workers in the fourth quarter of last year.
- ◆ Employers in the metro’s construction sector have eliminated 18,100 positions year over year, or 10.4 percent of the segment. Phoenix’s financial services industry has also contracted by 3 percent during that time, losing 4,700 jobs.
- ◆ Despite the economic slowdown, the educational and health services and government sectors have maintained impressive growth rates, adding 7,500 and 8,900 positions, respectively, over the last 12 months.
- ◆ **Outlook:** Due to the metro’s reliance on real estate-related fields, local employers are forecast to reduce payrolls by 5,000 workers, or 0.3 percent, this year. In 2007, 3,700 jobs were added.



HOUSING AND DEMOGRAPHICS

- ◆ New home construction starts have dropped off to the metro’s lowest annualized rate since 1990. In the first quarter, permits for single-family homes totaled 13,700 annualized units, down 64 percent from one year earlier. Annualized multi-family permits stood at 3,900 units, a 73 percent decline from the previous 12-month period.
- ◆ The excess of single-family homes on the market in Phoenix has resulted in rapidly declining home values. The median price of a single-family home was \$217,000 in the first quarter, 18.8 percent lower than the median one year ago. In that time, the median household income rose to 6.7 percent above the minimum required income to qualify for the metro’s median-priced home.
- ◆ The standard mortgage payment for a median-priced home in Phoenix is approximately \$150 per month higher than the average Class A asking rent.
- ◆ **Outlook:** Phoenix has been one of the hardest-hit housing markets in the country over the past 12 months, and the market may not bottom for several more quarters. As such, apartment demand is expected to remain healthy.

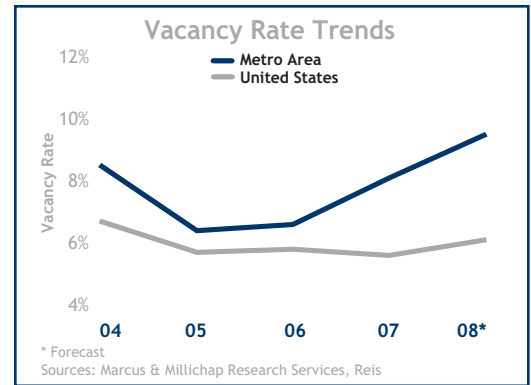


CONSTRUCTION

- ◆ Over the past 12 months, builders have completed approximately 4,900 apartment units for a 2.2 percent increase in metrowide inventory. In the first quarter, 700 rental units were delivered, down from the 1,400 units brought online during the same period one year earlier.
- ◆ Currently, there are 3,330 rental units under construction, with another 7,900 units in the various planning stages. Projects slated for delivery this year will be concentrated in the North Tempe and Chandler/Gilbert submarkets, where nearly 1,600 units are expected to come to market.
- ◆ While apartment construction is set to slow, condo developers have roughly 4,500 for-sale units scheduled for completion this year. Given the current housing market, many of the units are expected to be employed as rentals.
- ◆ **Outlook:** Builders are projected to deliver 3,800 units in 2008, compared with 5,500 units last year.

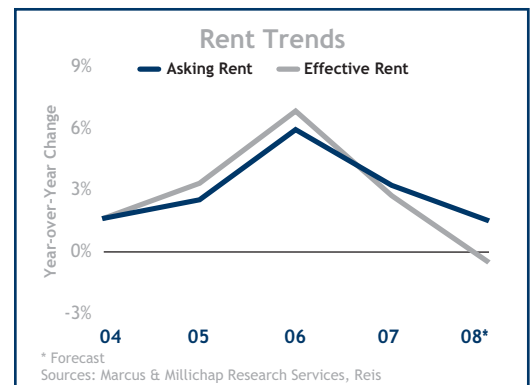
VACANCY

- ◆ Preliminary figures indicate that vacancy ended the first quarter at 8.7 percent, up 160 basis points from one year earlier. During the first three months of the year, vacancy rose 60 basis points.
- ◆ A surplus of unsold condos and single-family homes entering the rental market has increased vacancy in the top tier. The vacancy rate in the first quarter is estimated at 7.9 percent, a 60 basis point rise from one year ago.
- ◆ The metro's lower tiers have also experienced waning occupancy, as renters are finding ample opportunities to upgrade to higher-quality properties. Early data shows that the Class B/C vacancy rate ended the first quarter at 8.7 percent, up 130 basis points from one year earlier.
- ◆ **Outlook:** Slower employment growth and competition from the metro's excess of alternative housing will result in continued upward pressure on metrowide vacancy rates. In 2008, vacancy is forecast to rise 140 basis points to 9.5 percent after increasing 150 basis points last year.



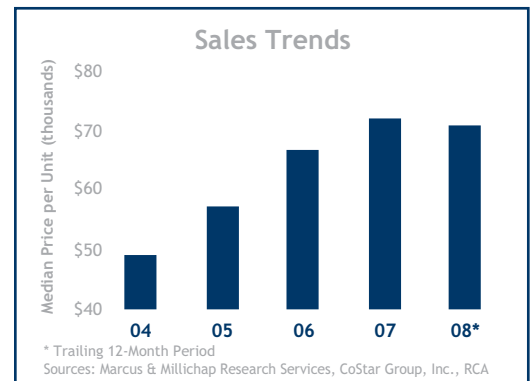
RENTS

- ◆ Asking rents were estimated at \$779 per month at the end of the first quarter, up 3 percent over the past year. Effective rents reached an estimated \$715 per month during the same period, a 2.1 percent increase.
- ◆ Asking rents in Class A properties have risen 2.5 percent over the last 12 months to \$922 per month. Rent growth in the metro's Class B/C assets was similar; asking rents in the lower tiers have advanced 2.3 percent in the past year to \$668 per month.
- ◆ Revenue growth has averaged just 0.7 percent since the first quarter of 2007 due to the metro's rising vacancy rates. Owners will increase their use of concessions this year in an effort to attract and retain renters, which will likely result in slower revenue growth in the near term.
- ◆ **Outlook:** Rent growth will be more subdued this year due to softer demand, combined with strong competition from the metro's single-family housing market and unsold condos. As a result, asking rents are projected to gain 1.5 percent to \$785 per month, while effective rents will end the year at \$710 per month, a 0.5 percent drop.



SALES TRENDS**

- ◆ Led by an end of conversion sales and tighter lending criteria, transaction velocity has fallen 20 percent over the past year.
- ◆ On a year-over-year basis, the median price has advanced 6 percent to \$70,700 per unit. While the median price for deals closed has pushed higher, the increase is largely a function of higher-quality assets changing hands rather than a true appreciation in asset values.
- ◆ Cap rates for apartment properties have averaged in the low-6 percent range over the past year, modestly higher than during the previous 12 months.
- ◆ **Outlook:** Cap rates are expected to push up over the course of the year as sellers realign expectations in light of the current lending environment. Buyers will remain cautious in outlying areas of the metro, where foreclosures and condos will continue to compete with apartments for renters.



** 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

- ◆ The Fed has become aggressive in its efforts to prevent an extended economic downturn. In addition to rate cuts, the Fed has taken measures to stabilize credit markets and restore liquidity.
- ◆ Lenders are increasingly cautious, resulting in lower loan-to-values (LTVs) and higher debt-service coverage ratios (DSCRs). On average, LTVs are at 65 percent to 70 percent, compared with 75 percent to 80 percent in mid-2007, while DSCRs are 1.2x or greater, versus 1.1x prior to the credit crunch.
- ◆ Portfolio lenders today are generally pricing multi-family loans at 235 to 265 basis points over the 10-year Treasury. Apartment investors have the advantage of using Fannie Mae and Freddie Mac, which have increased originations and are pricing loans at 220 to 250 basis points over the 10-year Treasury. Conduit lenders are largely out of the market at this point, with spreads at 400-plus basis points over the 10-year Treasury.
- ◆ The stock market remains volatile, leading investors to seek safety in U.S. Treasury securities. As a result, the yield on the 10-year Treasury has declined 170 basis points since last summer to 3.6 percent.

SUBMARKET OVERVIEW

- ◆ Properties near the three Arizona State University campuses may experience a boost to occupancy this fall. While enrollment at the university continues to expand, the Arizona Board of Regents recently approved of a living expense increase. As such, students may be encouraged to move into off-campus housing that offers additional amenities near the campuses.
- ◆ Unimodal Inc. has proposed the development of a six-mile SkyTran transportation network in downtown Mesa. If approved by city officials, the project would add a significant number of manufacturing jobs to Phoenix-Mesa Gateway Airport, as well as bolster the appeal of the downtown area.
- ◆ In South Scottsdale, property owners have improved occupancy by pushing rents lower, as effective rents have declined roughly 1 percent over the past year, while asking rents remain flat. Owners may continue to forgo rent growth; vacancy is expected to increase slightly into the high-5 percent range in 2008 as diminishing employment growth cools renter demand.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	South Scottsdale	5.2%	-10	\$810	-0.9%
2	Northeast Phoenix	6.1%	170	\$692	0.9%
3	Paradise Valley	6.5%	140	\$710	0.9%
4	North Tempe	7.2%	-60	\$737	2.2%
5	North Scottsdale	7.5%	270	\$957	0.6%
6	Deer Valley	7.6%	110	\$695	3.0%
7	East Mesa	7.7%	30	\$714	1.0%
8	South Tempe/Ahwatukee	8.4%	90	\$807	3.6%
9	West Mesa	8.4%	90	\$611	0.8%
10	Central Phoenix	8.4%	130	\$666	0.6%