ApartmentResearch

MARKET UPDATE

Marcus & Millichap

Boston Metro Area — *Third Quarter 2010*

Improving Economy Lifting Class A Renter Demand

A broad-based recovery continues to take shape in Boston, with most private employment sectors projected to expand through the second half. Though a pullback of government hiring will ease the pace of overall growth, continued gains in the professional and business services, leisure and hospitality, and education and health services sectors will support household formation and demand for both Class A and Class B/C apartments. Consequently, the average vacancy rate will fall below 6 percent this year, a level last reached prior to the recession. Vacancy is highest among top-tier properties, exceeding 7 percent, though the segment posted the largest improvement in fundamentals during the first half. In the Central City/Back Bay/Beacon Hill submarket, both occupancy levels and rents rose measurably in that time as renters continued to seek housing near major employers. Class A properties in under-supplied suburban submarkets, including the North Shore/Merrimack River Valley, also remain in high demand. This strengthening in renter demand has enabled some owners to rein in concessions, though operators of lower-quality complexes or assets in most tertiary locations still report asking rent declines and leasing incentives averaging as much as one month of free rent.

Apartment cap rates continue to rise in the metro, though a dearth of high-quality, for-sale assets and investors' growing willingness to leave the sidelines should minimize yield increases in the top tier. Currently, Class A, institutional-grade cap rates average in the low-6 percent range due to limited for-sale supply; marketwide, cap rates average nearly 8 percent. Top-tier sales velocity, however, will remain limited over the short term as owners resist selling amid depressed pricing. In the Class B/C segment, deal flow remains low, despite rising buyer confidence. Recent price declines have investors targeting smaller lower-tier properties, primarily assets containing 25 or fewer units in Boston's core, while more aggressive buyers continue to look to Quincy, where initial yields generally start at 9 percent.

2010 Annual Apartment Forecast

2.0% increase in total employment

Employment: Employers will increase Boston head counts by 48,000 positions in 2010, growth of 2 percent. Last year, economic troubles underpinned the elimination of 85,100 jobs in the metro.

1,010 units will be completed

Construction: After local apartment inventory expanded by 3,540 units in 2009, supply growth will ease to 1,010 units this year. Since 2000, construction efforts have yielded an average of 2,740 apartments annually.

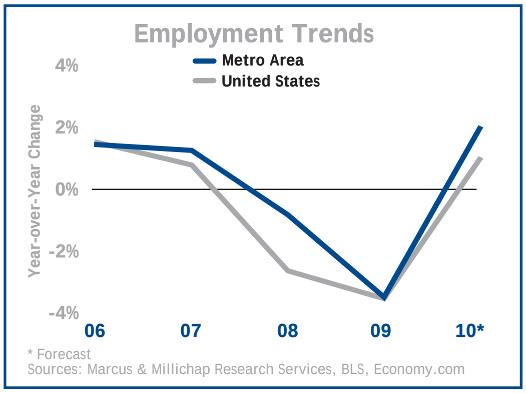
50 basis point decrease in vacancy

Vacancy: Employment-generated demand will contribute to decreasing the apartment vacancy rate by 50 basis points in 2010 to 5.9 percent, following a 40 basis point rise last year.

2.1% increase in asking rents

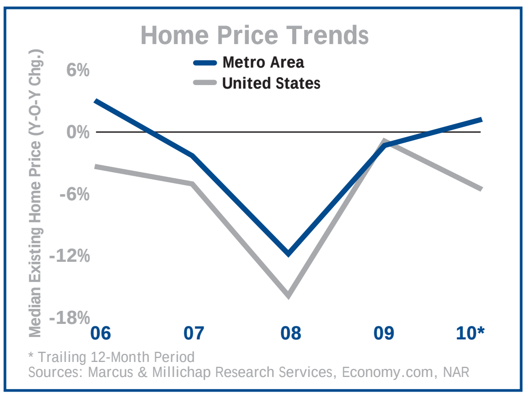
Rents: In 2010, asking rents will rise 2.1 percent to $1,705 per month, while effective rents will appreciate 2.9 percent to $1,618 per month. Asking rents slipped 4.1 percent last year, and effective rents retreated 1.5 percent.

ECONOMY



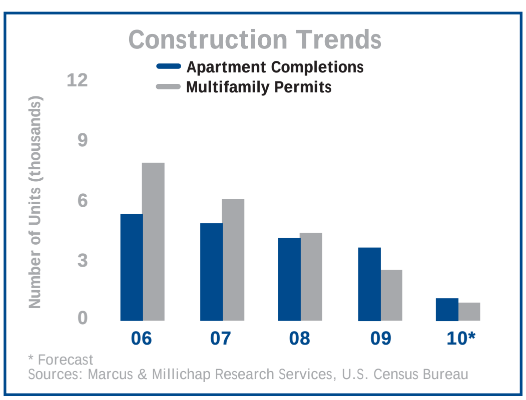
- Economic improvements supported robust job growth in Boston during the second quarter, pushing year-to-date employment gains to 26,500 positions, a 1.1 percent increase. In the second half of 2009, employers released 16,000 workers.
- Hiring efforts have been greatest in the leisure and hospitality and professional and business services sectors, which, combined, expanded by 13,000 positions, or 2.2 percent, during the first half of 2010. Construction companies, on the other hand, shed 2,800 workers, a 3.8 percent loss.
- The strengthening economy and resumption of job growth improved the local unemployment rate by 20 basis points to 8.3 percent in the first six months of this year. During the three years preceding the recession, however, the jobless rate averaged 4.4 percent.
- **Outlook:** Boston employers will expand payrolls by 48,000 positions in 2010, growth of 2 percent. Last year, economic weakness underpinned the elimination of 85,100 jobs.

HOUSING AND DEMOGRAPHICS



- The first-time homebuyer tax credit has renewed builder activity in Boston, as single-family permitting activity increased 23 percent annually to 3,565 units at the end of the second quarter. The number of multifamily permits pulled in the past year, however, fell 25 percent to 2,035 units, after plunging 50 percent in the prior 12 months.
- After remaining flat in the previous 24 months, single-family home sales jumped 13 percent in the last year. Since peaking in mid-2006, the median price of an existing single-family home plummeted 20 percent to $329,150 at the end of the second quarter.
- Home prices remain prohibitive to most Boston households, as the monthly mortgage payment for a median-priced home is currently $51 above the metro's average asking rent of $1,690 per month.
- **Outlook:** Slumping demand after the expiration of the first-time homebuyer tax credit, combined with expectations for milder economic expansion during the second half, will prevent a number of renter households from making the transition into homeownership.

CONSTRUCTION



- Mirroring multifamily permitting activity, apartment construction output has fallen to 685 units since the end of 2009, compared to the delivery of 1,385 apartments during the prior six months.,
- There are 450 units under way in Boston, with completions stretching into 2011. Additionally, 29 projects totaling 5,230 units are proposed, though few developers have announced start dates.
- Builders are most active in the North Shore/Merrimack River Valley submarket, where 510 units will come online this year and another 760 units are under consideration.
- **Outlook:** After local apartment inventory increased by 3,540 units last year, supply growth will ease to 1,010 units in 2010. Since 2000, construction efforts have yielded an average of 2,740 apartments annually.

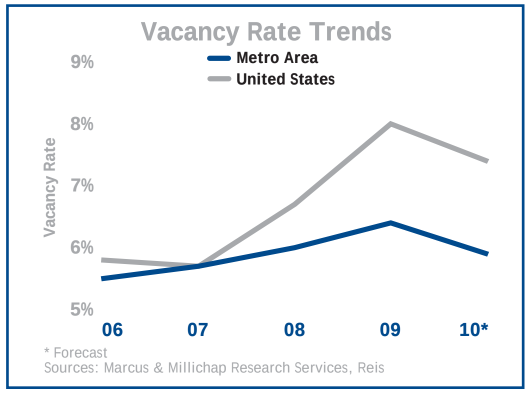
Vacancy

- Slowing supply growth and expanding payrolls supported a 20 basis point improvement in the metrowide vacancy rate to 6.2 percent in the past six months. Vacancy fell 10 basis points during the second half of last year.

- Steep rents cuts in the final six months of 2009 lured renters to top-tier units during the first half of this year, driving down the Class A vacancy rate 60 basis points in that time to 7.3 percent; the average rate dropped 30 basis points in the previous half year.

- Vacancy at lower-tier apartment properties rose 10 basis points to 5.5 percent in the past year. In the prior 12 months, vacancy spiked 80 basis points.

- **Outlook:** Employment-generated demand growth will underpin a 50 basis point decline in vacancy to 5.9 percent in 2010, following a 40 basis point rise last year.



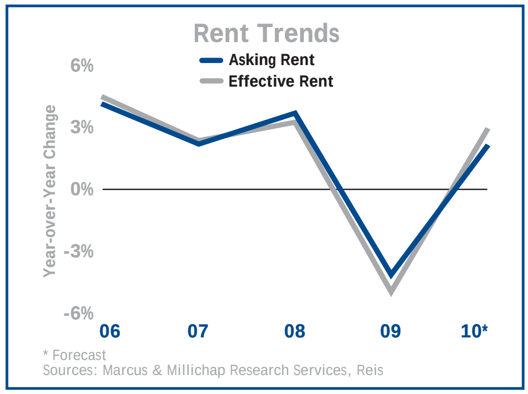
Rents

- Owners reduced asking rents by 1.7 percent year over year to $1,691 per month, while effective rents fell 1.8 percent to $1,597 per month. Asking and effective rents slid 0.3 percent and 1.3 percent, respectively, during the previous 12 months.

- Improving Class A vacancy rates have permitted owners to raise rents in this segment 1.2 percent since the start of the year to $2,085 per month. Asking rents were trimmed by 3.8 percent in the preceding six-month period.

- Lower-tier asking rent trends have been less extreme, though demand has been slower to recover. As of the second quarter, Class B/C asking rents of $1,407 per month were 0.4 percent higher than at the beginning of the year but down 1.8 percent from the second quarter of 2009.

- **Outlook:** In 2010, asking rents will rise 2.1 percent to $1,705 per month, while effective rents will appreciate 2.9 percent to $1,618 per month. Asking rents slipped 4.1 percent last year, and effective rents retreated 1.5 percent.



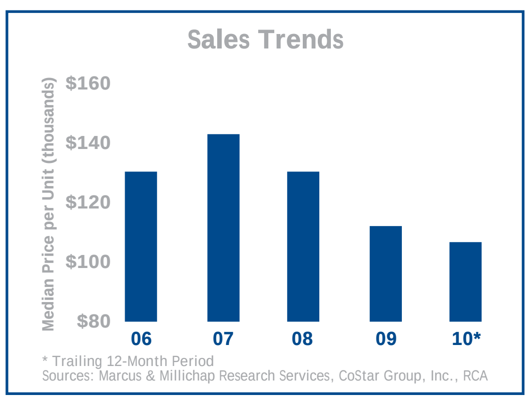
Sales Trends**

- Even as GSE lenders have remained active and regional banks have competed for operationally sound assets, tighter lending criteria and revenue uncertainty have slowed deal flow 23 percent since the second quarter of last year. The number of sales decreased 34 percent in the prior 12 months.

- Apartment values have slipped alongside rents. In the past year, the median price declined 27 percent to $106,250 per unit, following an increase of 12 percent in the preceding one-year span.

- Cap rates in deals closed this year averaged 8 percent, as buyers are more willing to acquire older assets or properties in secondary submarkets.

- **Outlook:** Supply additions and tenant shuffling have hindered Class B/C operations in the North Shore/Merrimack River Valley submarket. As a result, already elevated cap rates continue to rise, attracting aggressive investors with sufficient capital and management experience to add value to struggling properties.



*** 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

- Mixed economic indicators, stock market volatility and concerns surrounding the European debt crisis continue to drive investors to safety. As a result, the yield on the 10-year U.S. Treasury has declined since peaking at 4 percent in April; as of late July, the yield had fallen to 3 percent.

- Capital markets loosened over the past year, with life insurance companies ramping up lending and CMBS showing renewed signs of life. Nonetheless, the agencies remain the dominant sources of multifamily lending. This trend will continue through 2010 as the GSEs' multifamily portfolios outperform their residential mortgage operations, reducing the likelihood of drastic government-mandated changes to their apartment lending arms.

- Multifamily loan originations increased 37 percent in the second quarter but remained below levels reported during the same period last year. Fannie Mae and Freddie Mac's origination volume followed a similar pattern, rising in the second quarter but falling short of year-earlier levels.

- Loan-to-values range from 60 percent to 75 percent for portfolio lenders and push up to around 80 percent for best-of-class, agency-financed deals. All-in rates for five-year agency loans fall into the low-4 percent range, while 10-year loans price between 4.75 percent and 5.15 percent. While life companies will compete at these levels for best-of-class deals, most portfolio lenders are 100 basis points to 225 basis points higher.

Submarket Overview

- The planning pipeline remains full in the Boston City submarket. Five projects comprised of 960 units are planned, though no major developments are under way. Over the past five years, local supply grew by an average of 0.9 percent annually.

- Despite rising 110 basis points in the last year, concessions in Cambridge/Watertown/Waltham area remain the lowest in the metro, ending the second quarter at 4.7 percent of asking rents, compared to the metrowide average of 6 percent of asking rents. Strong renter demand persists in the submarket due to its high concentration of both students and employers.

- Steadying demand over the past six months maintained revenues in the Central City/Back Bay/Beacon Hill submarket, as vacancy improvements during that time offset modest rent reductions.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Brookline/Brighton/Newton	4.1%	50	$1,745	-1.4%
2	Central City/Back Bay/Beacon Hill	5.0%	0	$2,481	0.9%
3	Cambridge/Watertown/Waltham	5.3%	-40	$2,032	-4.2%
4	Boston City	6.1%	-50	$1,398	0.8%
5	Mystic River North/Route 128	6.3%	-50	$1,377	-1.4%
6	South/Southeast Suburban	6.7%	-130	$1,121	-2.6%
7	West/Northwest Suburban	6.8%	20	$1,335	-2.8%
8	North Shore/Merrimack River Valley	7.4%	20	$1,303	-1.1%
9	South Shore/Route 128 South	7.8%	-120	$1,366	-4.2%