

ApartmentResearch

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

Marcus & Millichap

Riverside-San Bernardino Metro Area

Third Quarter 2010

BUYERS CAPITALIZING ON UNIQUE INVESTMENT OPPORTUNITIES

Apartment fundamentals in the Inland Empire improved during the first half of 2010 and will remain encouraging through year end, driven by modest job gains and below-trend completions. The recovery, however, will proceed differently in each of the two counties in the region. Resumed hiring and strengthening renter demand will most benefit densely populated submarkets along the western edge of the metro, including South Ontario/Chino and Rancho Cucamonga, by generating positive net absorption over the remainder of 2010. As a result, operators in close-in cities will start to trim concessions as rents tick higher. Communities far from major employment centers will continue to struggle with high vacancy rates, sustaining generous incentives. Meaningful new demand derived from job formation will be slow to materialize in these areas. Still, as renters seek to reduce living expenses by moving into steeply discounted complexes, apartment vacancy rates to the east and in the High Desert region should start to flatten later this year.

Severe market disruption during the downturn has weighed on owners' ability to operate profitably, presenting distress opportunities for large and small bargain-seekers. Sales velocity has intensified already, with most investors focusing on financially challenged properties. Smaller, opportunistic buyers continue to explore outlying areas, where rent rolls have been slow to stabilize and owners cannot meet debt obligations. Smaller complexes purchased by less sophisticated investors during the boom years comprise the bulk of REO sales, but an increased number of larger properties are trickling through the pipeline. Over the last 12 months, assets containing more than 100 units accounted for 11 percent of sales, compared with less than 4 percent one year ago. With the median price for larger buildings falling 20 percent during the past year, more major cash investors will emerge in search of attractive deals.

2010 ANNUAL APARTMENT FORECAST



Employment: After more than 160,000 positions were cut locally over the past three years, employers will increase payrolls by 0.4 percent in 2010, or 4,300 workers.



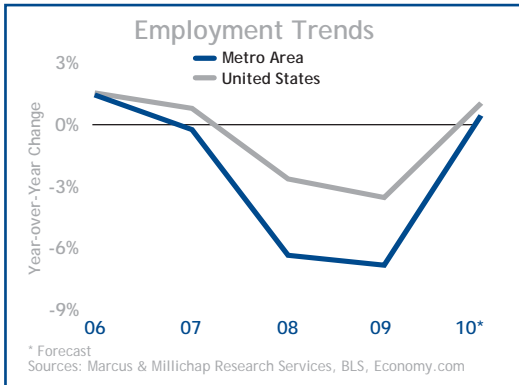
Construction: Apartment completions will slow to 1,000 units this year, down from 1,340 units in 2009 and 60 percent less than the five-year average. The new units will expand rental stock by 0.8 percent.



Vacancy: The resumption of hiring will begin to release pent-up demand this year, resulting in the metro's first annual vacancy improvement since 2004. By year end, vacancy will decrease 50 basis points to 7.5 percent, following a 100 basis point jump in 2009.



Rents: Asking rents will grow by 0.8 percent in 2010 to \$1,014 per month, while effective rents will advance 0.7 percent to \$955 per month. Last year, asking rents dropped 4.9 percent, and effective rents retreated 6.9 percent.

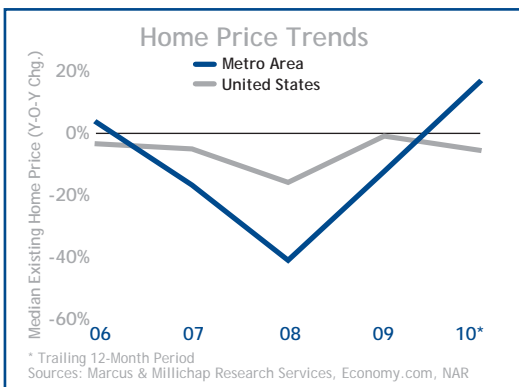


ECONOMY

- ◆ Employment levels have begun to steady, following severe job cuts through the downturn. During the first half of 2010, metrowide payrolls remained flat, after employers slashed 29,700 workers in the prior six months.
- ◆ The leisure and hospitality and professional and business services sectors created 1,500 jobs and 1,400 jobs, respectively, year to date. The government segment grew by 1,000 workers, driven by the addition of census positions; however, many of these jobs will be cut in the coming months.
- ◆ The metro's unemployment rate peaked at 15 percent in March and then improved 60 basis points to 14.4 percent in June. Year over year, the rate is up 150 basis points.
- ◆ **Outlook:** After more than 160,000 positions were cut over the past three years, employers will increase payrolls by 0.4 percent in 2010, or 4,300 jobs.

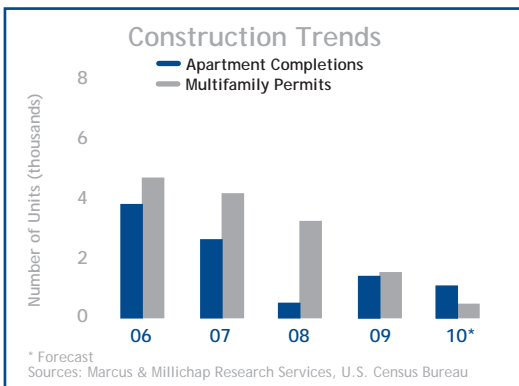
HOUSING AND DEMOGRAPHICS

- ◆ After reaching a historical low in 2009, single-family permit issuance totaled 5,900 units in the past 12 months, up 31 percent from the prior year. Multifamily builders pulled 1,390 units in the last year, a 24 percent drop.
- ◆ Since bottoming in the second quarter of 2009, the median price of a single-family home in the Inland Empire has increased 16.8 percent to \$190,300. Despite recent home price growth, the metro's median household income of \$57,500 per year is \$11,300 more than the minimum income required to qualify for a mortgage on the median-priced home.
- ◆ The average Class A asking rent is roughly \$120 per month higher than the typical mortgage payment using traditional financing, a gap that continues to place downward pressure on rents.
- ◆ **Outlook:** As job creation becomes more vigorous, likely in 2011, a greater number of renters will transition into homeownership. In the near term, however, continued employment market uncertainty and the expiration of the first-time homebuyer tax credit will sustain a considerable renter pool.



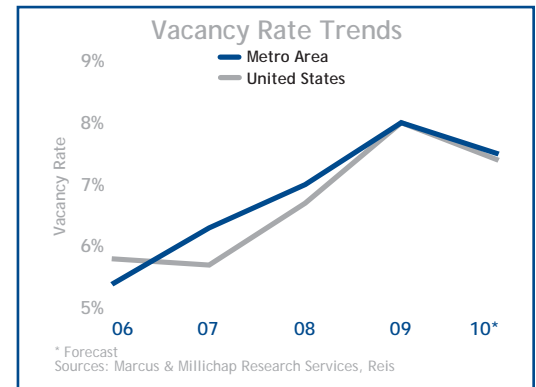
CONSTRUCTION

- ◆ During the 12 months ending in the second quarter, builders completed 1,687 apartments, expanding inventory by 1.3 percent. One year earlier, approximately 200 units were delivered.
- ◆ In the second quarter, roughly 620 rental units were under way, and 4,740 units were planned, though no groundbreaking dates have been announced.
- ◆ More than 1,600 condo units are under construction, and almost 9,200 for-sale units are proposed in the metro. Given the nearly 60 percent decline in metrowide condo prices since early 2007, many of these projects will be shelved or deployed as rentals.
- ◆ **Outlook:** Apartment completions will slow to 1,000 units this year, down from 1,340 units in 2009 and 60 percent less than the five-year average. The new units will expand rental stock by 0.8 percent.



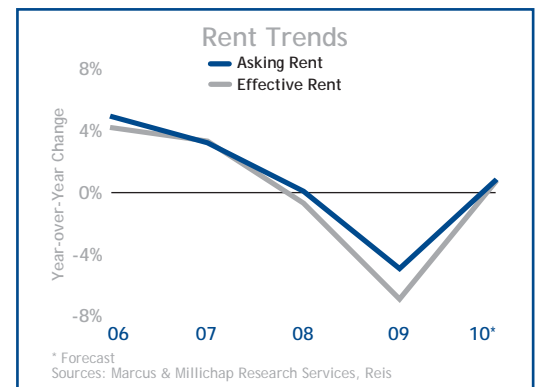
VACANCY

- ◆ Housing and job market uncertainties have supported demand for apartments, driving down vacancy. The metro's vacancy rate finished the second quarter at 7.8 percent, down 30 basis points from one year earlier. In the prior 12 months, vacancy spiked 180 basis points.
- ◆ Operators of newer Class A communities continue to offer generous concessions to fill vacant space and compete with single-family homes employed as rentals. As a result, top-tier vacancy improved 90 basis points in the last year, including a 30 basis points year-to-date decrease to 7.8 percent.
- ◆ More residents upgrading from the lower tiers into rent-reduced Class A units caused the Class B/C vacancy rate to rise 10 basis points year over year to 7.8 percent. In the first half of 2010, vacancy edged down 10 basis points.
- ◆ **Outlook:** The resumption of hiring will begin to release pent-up demand this year, resulting in the metro's first annual vacancy improvement since 2004. By year end, vacancy will decrease 50 basis points to 7.5 percent, following a 100 basis point jump in 2009.



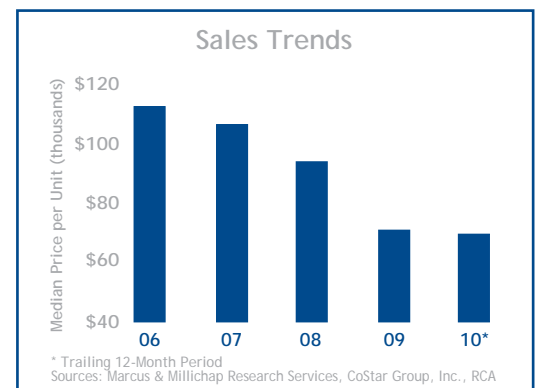
RENTS

- ◆ Despite a modest vacancy reduction, asking rents contracted 0.6 percent in the last 12 months to \$1,004 per month in the second quarter. Effective rents of \$947 per month are 1.6 percent less at this time in 2009.
- ◆ The sharpest year-over-year rent drops occurred in the lower tiers, where asking rents fell 1.2 percent to \$892 per month. In Class A properties, asking rents slipped just 0.2 percent in that time to \$1,165 per month.
- ◆ Owners raised concessions to 21 days of free rent in the second quarter, up from 17 days of free rent one year earlier. Since the start of 2010, however, incentives have held relatively flat, and owners may begin to withdraw incentives later this year as the job market recovers.
- ◆ **Outlook:** Asking rents will grow by 0.8 percent in 2010 to \$1,014 per month, while effective rents will advance 0.7 percent to \$955 per month. Last year, asking rents dropped 4.9 percent, and effective rents retreated 6.9 percent.



SALES TRENDS**

- ◆ The number of closings during the most recent 12-month stretch nearly doubled the number of deals recorded in the prior year, when sales decreased 52 percent.
- ◆ The median price of an apartment property in the Riverside-San Bernardino metro fell 19 percent year over year to \$69,400 per unit.
- ◆ In the last 12 months, cap rates averaged in the low- to mid-7 percent range, up roughly 30 basis points from a year ago. Initial yields for high-vacancy properties, however, averaged above 8 percent.
- ◆ **Outlook:** While traditional investment sales are intensifying, more buyers are purchasing bank notes at considerable discounts, a trend that will strengthen as lending institutions become more willing to sell.



** 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

- ◆ Class A vacancy in the Palm Springs/Palm Desert submarkets peaked at 24 percent in the fourth quarter of 2008 and has since fallen to 14.5 percent, driven by concessions that currently average more than 30 days of free rent. With Class A vacancy remaining higher than the historical average of 7 percent, owners will continue to utilize above-trend incentives into 2011.
- ◆ The delivery of 248 apartment units to the Perris submarket in the third quarter will delay a recovery in occupancy rates and weigh on owners' ability to trim concessions. As the area's inventory expands by 9 percent this year, leasing incentives will total almost 40 days of free rent.
- ◆ During the past year, the vacancy reduction in the University City/Moreno Valley submarket, which contains the metro's largest rental inventory, were driven by a rebound in Class A demand. Top-tier vacancy in the area improved 200 basis points year over year to 9.3 percent, despite the delivery of 216 units in that time.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Riverside County/Corona	5.3%	-100	\$1,031	1.6%
2	Riverside/North Magnolia	5.6%	-120	\$905	0.1%
3	South Ontario	5.8%	-140	\$1,184	-1.8%
4	Rancho Cucamonga	5.9%	90	\$1,228	-0.4%
5	North Ontario	6.2%	20	\$1,025	-4.8%
6	Colton/Loma Linda	6.6%	-10	\$989	-1.1%
7	University City/Moreno Valley	7.7%	-130	\$913	-1.7%
8	Upland	7.8%	90	\$967	-3.9%
9	San Bernardino	8.5%	-40	\$736	-4.3%
10	Fontana/Rialto	9.7%	90	\$898	-2.4%