

VELOCITY ACCELERATING AS INVESTORS ALTER ACQUISITION PLANS

Apartment fundamentals and the local economy will begin to stabilize in Sacramento this year, though the impact of the housing bust, severe job losses during the recession and uncertainty surrounding the state budget will linger in the coming quarters. Government hiring in the first half of 2010 contributed to slight metrowide employment gains, but the elimination of temporary census workers and likely cuts of state employees will lead to public-sector contraction in the final two quarters of this year. Private industries, meanwhile, particularly the professional and business services and trade, transportation and utilities sectors, will expand only modestly during this time, keeping the unemployment rate elevated and limiting growth in renter demand. While completions will accelerate from the minimal levels of the past two years, only a couple of new projects will come online, and inventory growth will lag household gains significantly. Supply concerns remain, however, particularly as investors acquire foreclosed single-family homes to be used as rentals.

Two investment strategies will continue to be the primary sources of demand for apartments in Sacramento through the second half, with buyers targeting either discounted, distressed properties or top-tier assets. Institutional investors were active in the first half as large Class A complexes entered the market, and a competitive bidding environment pushed down cap rates for these properties to approximately 6 percent. On the opposite end of the quality spectrum, the influence of distressed assets in the market continues to drive prices lower; the median price per unit in deals closed in 2010 is 45 percent below the market's peak a few years ago. Considerable distinctions exist within the distressed market. With banks offering modifications and extensions when feasible, many of the REO assets coming to market feature significant challenges for owners to overcome, and these assets often trade at less than \$50,000 per unit. Cap rates for the few stabilized Class B assets being listed start in the low-7 percent range.

2010 ANNUAL APARTMENT FORECAST



Employment: The private sector will increase hiring in the second half, contributing to overall payroll expansion of 0.3 percent this year, or the addition of 2,200 jobs. In 2009, local employment levels contracted by more than 50,000 workers.



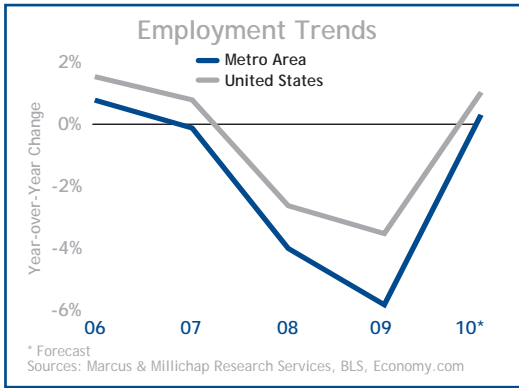
Construction: Builders will complete 430 units this year, increasing local inventory by 0.4 percent. Fewer than 250 units came online in 2008 and 2009 combined.



Vacancy: Modest employment growth and continued softness in the housing market will support a 10 basis point decline in metrowide vacancy this year to 7.2 percent. In 2009, vacancy rose 150 basis points.

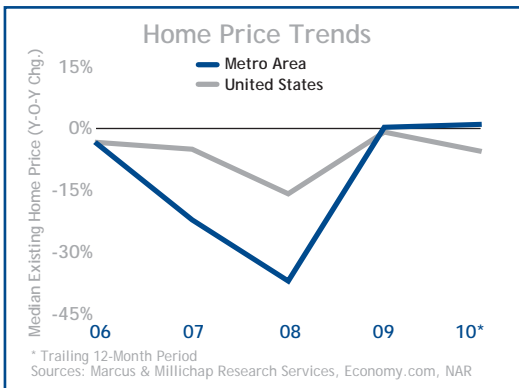


Rents: Asking rents will decline 1 percent in 2010 to \$884 per month while effective rents dip 1.2 percent to \$817 per month. Contraction was far more severe in 2009, when asking rents fell 4.9 percent, and effective rents plummeted 7.6 percent.



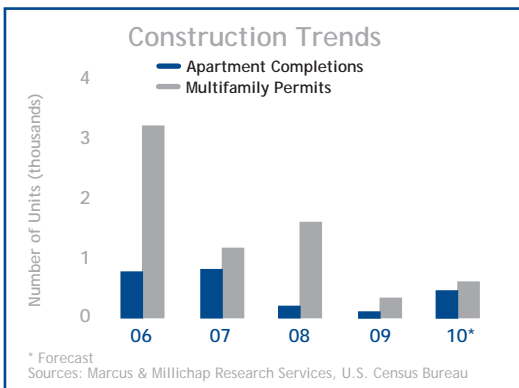
ECONOMY

- ◆ Employment in Sacramento expanded by 300 workers in the first half, despite the loss of 1,900 jobs during the second quarter. While year-to-date payroll additions were minimal, conditions were far less volatile than in the first half of last year, when employers slashed 29,600 jobs.
- ◆ The government sector, by far the largest in the metro, added 6,300 jobs in the first half. These gains will not be sustained, however, as some of the growth was attributable to the hiring of census workers, and the state budget remains a concern. Consequently, in the second half of the year, 3,500 government jobs will be slashed.
- ◆ Continued weakness in the local housing market, coupled with cooling commercial development, caused construction employment to contract by 3,200 workers in the first half. The sector will shed another 600 jobs in the second half of 2010.
- ◆ **Outlook:** The private sector will increase hiring in the second half, contributing to overall payroll expansion of 0.3 percent this year, or the addition of 2,200 jobs. In 2009, employment fell by more than 50,000 workers.



HOUSING AND DEMOGRAPHICS

- ◆ Single-family and multifamily permit issuance each declined 20 percent in the past year to 725 units and 2,530 units, respectively. Persistent softness in the housing market will limit permitting for the next several quarters.
- ◆ Home sales in Sacramento accelerated in the second quarter as buyers responded to state and federal tax incentives. The median existing single-family home price during the quarter was \$177,400, nearly identical to one year earlier.
- ◆ For-sale housing remains affordable when compared to market rents, which will likely restrict apartment rent gains even as the economy stabilizes. Class A asking rents are approximately \$100 per month more than the mortgage payment on a median-priced single-family home in the metro.
- ◆ **Outlook:** While the local employment market remains weak, the Sacramento area's low cost of living continues to attract new residents. During the past 12 months, household growth hit 11,500, a 1.4 percent expansion, and another 6,500 households will be added in the second half of this year.

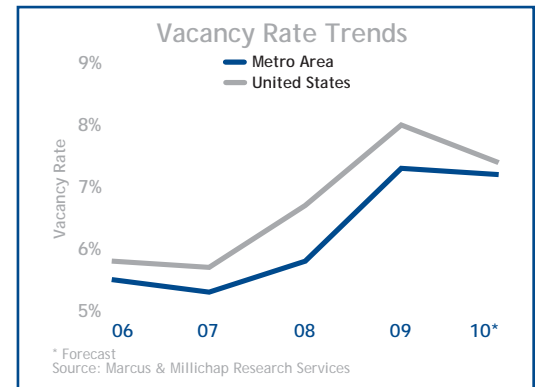


CONSTRUCTION

- ◆ During the 12-month period ending in the second quarter, only one project totaling 160 units came online in Sacramento. The Wolf Ranch complex in the South/Elk Grove submarket was delivered in the first quarter. In the preceding year, only 81 units were completed.
- ◆ The 270-unit Alexan Midtown in the Downtown submarket will be the only notable completion in the second half. No other projects are under way.
- ◆ Despite minimal construction activity over the past several quarters, there are approximately 15 planned projects in the metro, totaling 3,800 units. Developers will remain reluctant to break ground until the local economy begins to firm.
- ◆ **Outlook:** Builders will complete 430 units this year, adding 0.4 percent to local inventory. Fewer than 250 units came online in 2008 and 2009 combined.

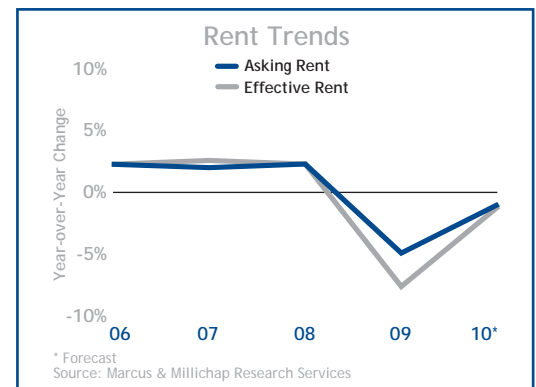
VACANCY

- ◆ Vacancy improved 20 basis points in the first half to 7.1 percent. The recent steadying contrasts conditions from 2009, when vacancy spiked 140 basis points in the first half.
- ◆ A lack of significant inventory growth supported a 100 basis point year-over-year decline in the Class A vacancy rate to 6.3 percent. The top-tier rate fell 50 basis points in the first half and will likely creep lower in the coming quarters.
- ◆ Vacancy in the lower tiers continues to rise as renters double up or leave the area. Class B/C vacancy rose 30 basis points to 8 percent in the first six months of the year and is up 90 basis points from one year ago.
- ◆ **Outlook:** Modest employment growth and continued softness in the housing market will support a 10 basis point decline in metrowide vacancy this year to 7.2 percent. In 2009, vacancy rose 150 basis points.



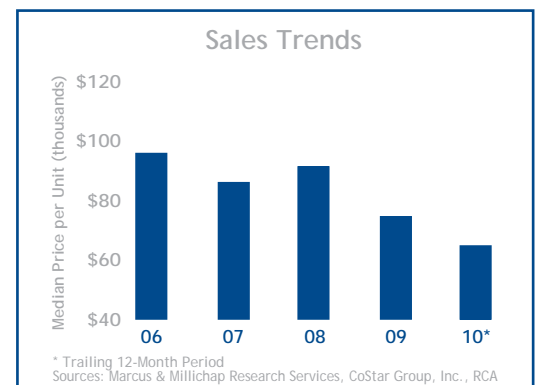
RENTS

- ◆ Rent pressures eased as vacancy stabilized. Asking rents dipped 0.2 percent in the first half to \$891 per month while effective rents ticked up 0.1 percent to \$828 per month. Asking rents are 2.1 percent lower than one year ago, while effective rents have dropped 3 percent.
- ◆ Asking rents in the top tier fell 1.9 percent year over year to \$1,056 per month, while Class B/C asking rents declined 2.3 percent to \$805 per month. The trends diverged in the first half, however, with Class A asking rents ticking up 1 percent and asking rents in the lower tiers contracting 1.3 percent.
- ◆ While vacancies stabilized over the past year, operators continued to offer concessions to attract renters. Average concessions reached 26 days of free rent in the second quarter, up from 22 days of free rent one year earlier. Leasing incentives will inch higher in the second half, but the pace will be far more subdued than in recent quarters.
- ◆ **Outlook:** Asking rents will decline 1 percent in 2010 to \$884 per month while effective rents dip 1.2 percent to \$817 per month. Contraction was far more severe in 2009, when asking rents fell 4.9 percent, and effective rents plummeted 7.6 percent.



SALES TRENDS**

- ◆ Sales velocity rose 13 percent in the past 12 months but was more than 60 percent lower than during peak levels from 2002 to 2004. Investment activity year to date is well ahead of the pace set in the corresponding period in 2009.
- ◆ Despite a greater number of properties changing hands, prices continue to retreat. The median price in deals closed during the past year was \$64,600 per unit, down 29 percent from a year earlier. Downward pressure on prices persisted in the first half, when the median price reached \$59,500 per unit.
- ◆ The average cap rate in transactions made during the last 12 months was in the high-7 percent to low-8 percent range, 150 basis points higher than in the preceding annual period.
- ◆ **Outlook:** As more distressed properties enter the market, activity levels will likely accelerate, and downward pressures on market prices will continue. A stronger private sector will be necessary to buoy metrowide prices.



** 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

- ◆ Vacancy in the Roseville submarket's large Class A inventory continues to inch lower, despite competition from shadow rentals. Top-tier vacancy in the area was 7 percent as of the second quarter, 80 basis points lower than at the end of 2009.
- ◆ Inventory growth will be most significant in the Downtown submarket in the coming years. Planned projects in the area total nearly 2,900 units, approximately 75 percent of the metro total.
- ◆ The absorption of Class A units continues to drive vacancy improvement in the Fair Oaks submarket. Vacancy in the top tier dropped 120 basis points in the first half to 6.8 percent; the rate is 590 basis points below the peak recorded in early 2009.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Davis	3.2%	30	\$1,063	-1.7%
2	Citrus Heights	5.8%	-180	\$750	-3.7%
3	Rancho Cordova	6.0%	-120	\$751	-6.0%
4	West Marconi Avenue/Del Paso	6.4%	-160	\$655	-3.2%
5	North Sacramento	6.8%	-50	\$899	-1.9%
6	Roseville	6.9%	-50	\$967	-2.9%
7	Carmichael	7.1%	-50	\$728	-2.4%
8	North Highlands	7.1%	150	\$762	-3.4%
9	South/Elk Grove	7.4%	80	\$688	-0.6%
10	Fair Oaks	7.6%	-70	\$839	-0.7%