Apartment Research

MARKET REPORT

Marcus & Millichap

Phoenix Metro Area *Third Quarter 2012*

Major Developments Spur Economic Growth in the Valley

As the recovery gains steam, stalled economic development projects are being revived as businesses expand in Phoenix, sparking demand for rental housing. In the East Valley, demand growth is accelerating as construction progresses on the new Intel plant and data centers spring up along the Price Road Corridor, which is providing jobs for nearby residents. Additionally, the expanding pool of talent at Arizona State University's Polytechnic campus and the rapidly expanding Gateway-Mesa Airport are also major catalysts for growth. To make the area more accessible, the city recently broke ground on state Route 24, which will connect Loop 202 to the Gateway Airport by late 2013. The overall growth has also enticed developers to begin building the infrastructure at the master-planned community, Eastmark, at the old GM Proving Grounds. The project will combine residential, hotel, and retail over 3,200 acres. The new developments will support solid job gains in the region, while generating demand for apartments. Indeed, many of the newly employed will remain hesitant about buying a home in the near term, and opt for the convenience of renting. Communities near employment centers or freeways will draw the most interest, a trend that is unfolding across the Valley.

Investment activity will remain steady in the coming months as owners capitalize on the low-interest-rate environment and sell cash-flowing properties. Operators who bought troubled Class A assets well below replacement cost in the last couple of years will list recently stabilized properties at a cap rate near 5 percent to reap a significant profit. Demand will remain intense for these well-occupied, infill assets, as yield-driven buyers re-enter the market to acquire complexes providing long-term stability. Investors looking to bolster their purchasing power and enhance cash-on-cash returns to double-digit territory will secure interest-only loans from Fannie and Freddie that offer favorable LTVs around 80 percent. Meanwhile, buyers with an established presence in the Valley will diversify their holdings and target mid-tier properties with a value-add component. After injecting up to $4,000 into each unit for upgrades, investors may capture upside of roughly $75 to $150 per month.

2012 Annual Apartment Forecast

2.3% increase in total employment

Employment: In 2012, bolstered by solid gains in the professional and business services as well as the education and health services sectors, payrolls will grow by 40,200 jobs, or 2.3 percent. Last year, total employment expanded by 28,600 workers.

1,260 units will be completed

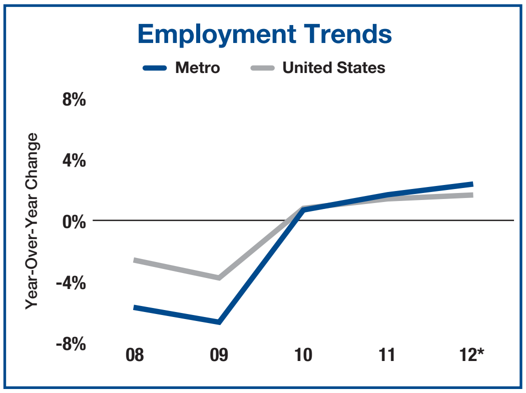
Construction: After 450 apartments came online in 2011, less-stringent requirements for construction loans have helped revive projects put on hold during the recession. As a result, completions will accelerate to 1,260 units this year, increasing stock by 0.5 percent.

110 basis point decrease in vacancy

Vacancy: An improving employment picture and strict financing requirements for single-family homes will support demand for rental units for the remainder of the year. For 2012, vacancy will record a 110-basis point decrease to 6.2 percent after falling 240 basis points in the prior year.

2.9% increase in asking rents

Rents: By year end, asking rents will rise 2.9 percent to $787 per month, while effective rents will jump 3.4 percent to $720 per month, both of which are record highs. Last year, asking and effective rents increased 2 percent and 2.2 percent, respectively.



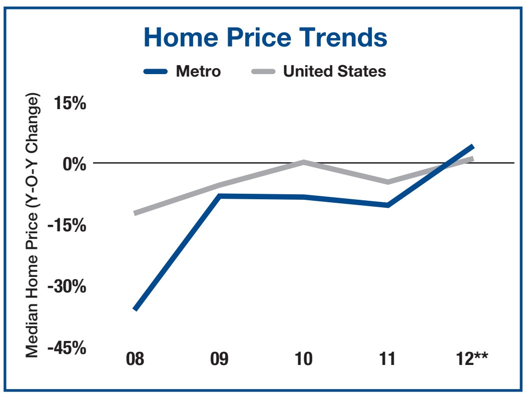
Economy

- In the last year, Phoenix has ranked in the top-five nationwide in job growth as employers expanded payrolls 2.4 percent, or by 40,500 positions. Approximately 35 percent of the positions cut during the recession have been recouped since the recovery began three years ago.

- Broad-based employment growth is in full swing in Phoenix, with the education and health services sector recording the largest year-over-year increase, totaling 13,000 jobs. Also, while most local governments across the nation are shedding positions, the public sector in the metro gained 6,000 workers in the last year.

- The 330,000-square foot Tanger Factory Outlet Center is under way near Westgate City Center in Glendale. The mall will feature 85 brand-name outlet stores, and will employ 900 workers once the doors open in the fourth quarter.

- **Outlook:** Hiring will modestly cool in the second half as employers await the outcome of the election. For 2012, payrolls will grow by 40,200, or 2.3 percent.



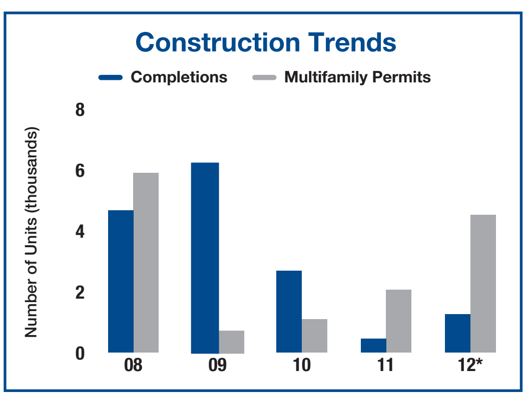
Housing and Demographics

- As the housing market shows signs of stabilization, construction activity is picking up. Builders obtained 10,000 single-family permits in the last year, growth of 40 percent. Further, intense demand for rentals prompted multifamily developers to pull permits for 4,500 units, a significant increase from a year ago, when builders obtained just 315 units.

- The Phoenix housing market is one of the few metros that has seen values increase for three consecutive quarters. After falling 60 percent during the downturn, the median price currently sits at $116,000, marking a 4 percent increase from last year. In that time, median household incomes rose 3 percent to $52,500 per year.

- The low-interest-rate environment and accelerating rents have kept the spread between Class A asking rents and the monthly debt service on a typical mortgage of a median-priced home around $275 per month in favor of owning.

- **Outlook:** As speculative investors target bank-owned houses, the single-family foreclosure pipeline will continue to dwindle in the second half of the year. As a result, prices should continue to trend upward. However, most residents will be outbid by cash-heavy buyers in the near term, forcing them to remain in rentals.



Construction

- So far this year, builders have delivered 685 apartment units in the metro, including the second phase of the 180-unit Trillium Deer Valley. Overall, the market has gained 1,025 units in the last year, expanding inventory 0.3 percent.

- Nearly 4,000 units are under construction in the Valley, with the Chandler/Gilbert submarket expected to receive over 700 apartments by next year, expanding the area's supply by 3.9 percent. Additionally, 15,000 units are planned.

- Developer Mark Taylor is in the process of constructing multiple apartment communities throughout Phoenix, including the 384-unit San Capella in south Tempe. The complex is located at the former site of Fiddlesticks, and will increase stock in the South Tempe/Ahwatukee submarket by 2.6 percent.

- **Outlook:** This year, 1,260 units will be finished, increasing stock by 0.5 percent. Last year, 450 units came online.

* Forecast
** Through 2Q

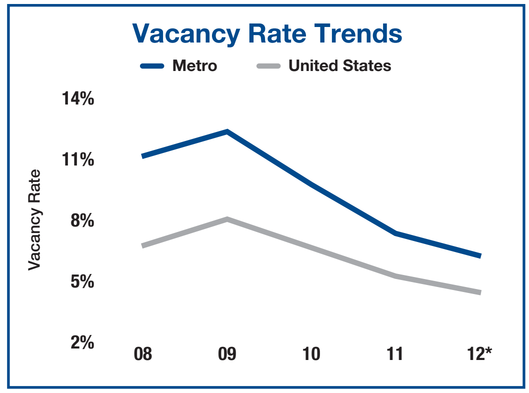
Vacancy

- The lack of financing for single-family homes supported demand for apartments in the last year as tenants leased 6,000 units in that period, reducing vacancy 190 basis points to 6.4 percent. Vacancy sits at its lowest level in six years, and is 600 basis points below the peak recorded during the height of the recession.

- Driven by solid demand in the Chandler/Gilbert and North Scottsdale/Fountain Hills submarkets, the overall Class A vacancy rate improved 130 basis points in the last year to 5.3 percent.

- As momentum modestly cooled in the top-tier sector, demand for Class B/C units remained firm due to strong low- and mid-level job growth, especially in the construction, and trade, transportation and utilities segments. As a result, vacancy in the sector tumbled 230 basis points year over year to 7.5 percent.

- **Outlook:** Tight financing for single-family homes will support demand for rental units this year. As such, vacancy will fall 110 basis points in 2012 to 6.2 percent.



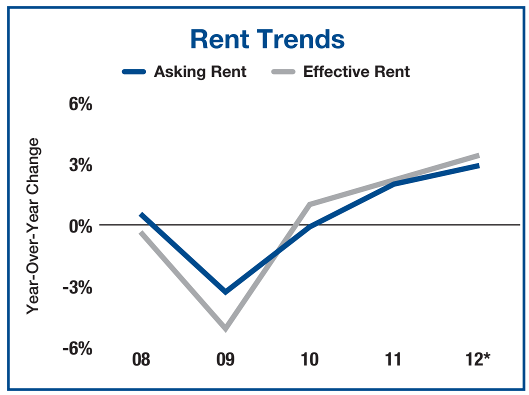
Rents

- Landlords took advantage of fierce demand and raised asking rents 0.9 in the first two quarters of this year to $772 per month, which mirrors the increase in the second half of 2011. Meanwhile, effective rents rose at a faster pace in the last year, growing 2.5 percent to $706 per month, including an increase of 1.4 percent in the first six months of 2012.

- Class A asking rents reached an all-time high of $921 per month in the second quarter, which is a 1.5 percent increase from a year earlier. At the same time, Class B/C asking rents climbed 2.2 percent to $642 per month, though lower-tier rents still remain 4.6 percent below peak levels.

- Operators of Class A properties in the North Tempe submarket capitalized on supply constraints and record-low vacancy rates in the past year, raising asking rents at Class A properties 5.4 percent to $1,020 per month.

- **Outlook:** In 2012, asking rents will rise 2.9 percent to $787 per month, while effective rents will jump 3.4 percent to $720 per month.



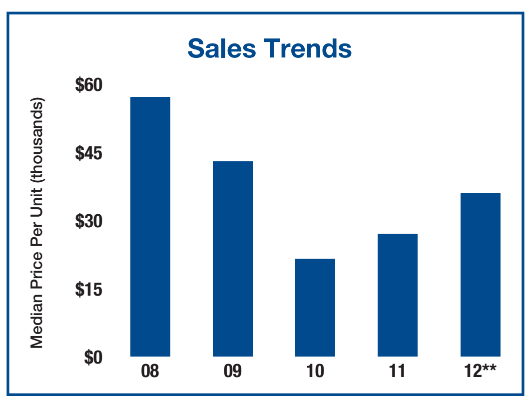
Sales Trends**

- In the most recent 12-month stretch, sales velocity spiked 13 percent as institutional investors snapped up larger, Class A product in densely populated neighborhoods. As a result, dollar volume surged by 30 percent.

- Intense demand, coupled with a rise of high-end properties changing hands, applied upward pressure to the median price, which increased 35 percent in the last year to $36,000 per unit.

- As interest rates remain near record lows and deal flow surged, initial yields tightened 50 basis points in the last four quarters to the low-7 percent range. The best-in-class products sold at cap rates in the low- to mid-5 percent range.

- **Outlook:** The sale of REOs will begin to cool in the second half of the year as a significant portion of the distressed inventory has restabilized. Bank-owned properties that do reach the market will trade around $30,000 per unit and offer value-add buyers significant upside once the units are backfilled.



* Forecast
** Trailing 12-Month Period
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., Real Capital Analytics

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The Federal Reserve recently pledged to sell $267 billion in short-term securities to buy long-term Treasurys in order to maintain low borrowing costs for consumers and businesses to continue to support an economic recovery. The purchases will occur in the second half of 2012 and extend a program known as "Operation Twist." The target to keep short-term interest rates low is now late-2014.
- Pipelines of under way and planned apartment projects are expanding in many metro areas and several major lenders appear willing to underwrite construction on select projects. The primary considerations for lenders include the quality of sponsorship and strong market fundamentals, including low vacancy and rising rents.
- The potential for elevated development may encourage the GSEs to underwrite acquisitions more conservatively in markets with large pipelines. In many metros, however, the agencies will underwrite deals at up to 80 percent LTV and rates 200 to 250 basis points above the 10-year U.S. Treasury. Life companies, meanwhile, are also active in the Class A arena, offering rates that are competitive with the GSEs.
- Commercial banks generally offer shorter-term financing for acquisitions from $1 million to $5 million at interest rates starting in the low-3 percent range for three-year terms and up to 4.5 percent for seven-year loans. In the growing CMBS market, looming issuance of several billion dollars in the next few months will affirm spreads for AAA bonds and establish investor appetites for B-rated tranches.

Submarket Overview

- Infusionsoft will relocate its headquarters from Gilbert to the Allred Park Place in the Price Corridor by year end. The company's staff is increasing by 15 percent a quarter, and will grow by 700 high-paying tech jobs over the next four years, which will spark demand for Class A apartments near the site.
- The Blue Sky apartment community is expected to break ground across from Fashion Square Mall by year end. The 749-unit luxury complex has been set back multiple times due to zoning and height restrictions. Once complete, the property will raise Class A inventory in the South Scottsdale submarket by 17 percent.
- As supply for Class A properties within the core remains scarce, keeping yields compressed, private investors turned to Class A/B assets in the suburbs to capture higher returns. In Mesa, for example, closings rose by 20 percent in the last year, while the influx of capital helped tighten cap rates to the low-7 percent range.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	South Scottsdale	3.6%	-110	$770	4.0%
2	North Scottsdale/Fountain Hills	4.7%	-130	$928	2.5%
3	Chandler/Gilbert	4.8%	-80	$798	1.4%
4	North Tempe	5.0%	-150	$786	3.8%
5	Goodyear/Avondale/Tolleson	6.3%	-180	$829	1.1%
6	Sunnyslope	6.7%	-250	$616	2.2%
7	West Mesa	7.3%	-330	$590	3.7%
8	Central Phoenix South	7.5%	-250	$679	3.3%
9	Maryvale	9.5%	-370	$532	1.9%
10	Central Phoenix North	9.9%	-280	$593	2.8%

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