JANUARY 2009
VOL 7 ISSUE 1

APARTMENT TALK BY BOB KAPLAN

2008 IN REVIEW

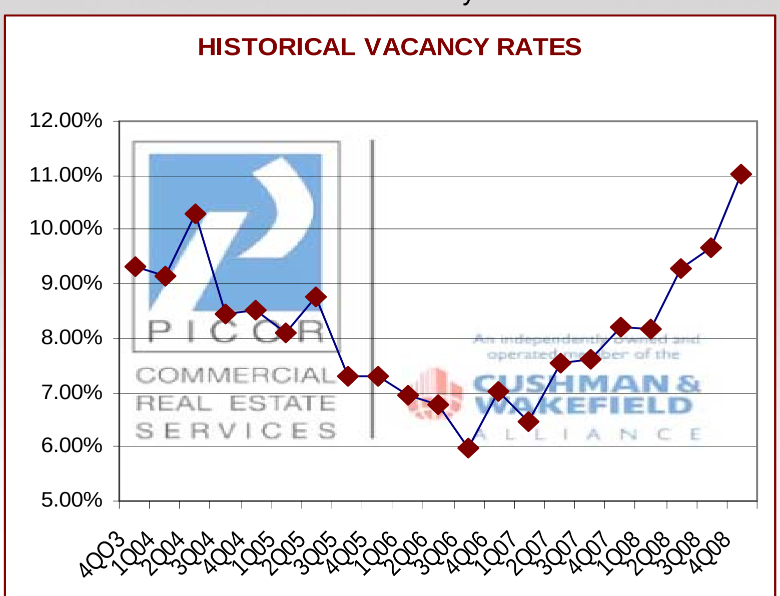
2008 will be a year that many in the apartment industry, including investors, brokers and management companies, will want to forget. It seems that every time we thought the markets had found a bottom, fundamentals deteriorated again. Occupancies dropped throughout the year, financing was increasingly more difficult, valuations and investor interest continued to drop and transaction volume also continued to drop. People are very happy to see an end to 2008.

APARTMENT FUNDAMENTALS

Vacancy Rate ⇩   Lease rates ⇩   Absorption ⇩

Vacancies have increased again; up another 1.37% to 11.02% citywide. As discussed in our last market report, the disparity of vacancies between submarkets continues to be quite wide. Generally A and B properties in better locations are faring much better than C properties in lower income neighborhoods. The vacancy rates in the South and Southeast submarkets are in the high teens while the rates in the Catalina foothills remain at fairly healthy levels; in the 7% to 9% range.

In this past quarter, the continuation of negative absorption of units and a net decrease in the average rental rate has compounded the poor occupancy numbers. Tucson experienced a 1,489 unit decline in occupied units year over year with a 603 unit decline in the 4th quarter of the year. The high vacancies have forced owners to offer concessions and lower their rental rates. This resulted in a 4th quarter rental rate decline of $5 from the 3rd quarter to an average rate of $635 per unit and $0.87 PSF. The rental rates remained flat for the year.



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SALES:

Price Per Unit ↓ Price PSF ↓ CAP Rates ↑

Pima County's 2008 transaction volume trends mirrored the national trends . Sales volume in 2008 has fallen off 80% from 2006 levels and 74% from 2007 levels as measured in Dollars. As measured in # of units, the drop has been 79% from 2006 levels and 69% from 2007 levels. One of the interesting trends this year is that Tucson based buyers (or other owners who have been in the Tucson market for many years) aggressively jumped back into the market in 2008 after being less aggressive buyers in the previous years. Buyers making major acquisitions this year include: Holualoa Companies, HSL properties and Dart Realty; all long time players in the Southern Arizona multi-family business. Prices have fallen on a price per unit, price per square foot basis and also on a CAP rate basis.

TUCSON APARTMENT SALES (40 Units & More)

	2006	2007	2008
# of Units	10,913	7,451	2,328
Total Sales $	$615,150,240	$497,163,500	$131,240,000
Avg Price/Unit	$56,369	$66,724	$56,375
Avg Price PSF	$86.32	$87.92	$79.79
Avg Year Built	1981	1983	1980

How much have apartment values dropped in Tucson?

This is a question I am often asked in the current environment and a difficult one to answer as there are many variables in the formula. The factors include:

1. Net Operating Income (NOI): many apartment properties are making less money than 2 or 3 years ago due to higher vacancies and concessions.
2. Cost of Debt
3. Internal Rates of Return and Cash on Cash returns required by Buyers
4. Cap rate buyers are willing to pay

The cost of debt heavily impacts # 3 and # 4 above as returns and CAP rates buyers are willing to pay are a function of the cash flow from the property after debt service . The conservative underwriting and lending of today's' environment alone has reduced values by approximately 20% to 25% for high leverage buyers which have been the dominant buyer in the past 5 years.

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The following assumptions are used to illustrate the impact of a changed debt environment on valuation.

Assumptions:

Mid 80s apartment property of B grade in B location
Net Operating Income of $250,000

December 2006 Assumption:		December 2008 Assumptions:	
Debt Loan to value:	80%	Debt Loan to value:	65%
Debt Interest Rate:	5.25%	Debt Interest Rate:	6.25%
5 year interest only – 30 year amortization		30 year amortization	
Debt Coverage Ratio	1.1%	Debt Coverage Ratio	1.25%
Debt available:	$4,330,000	Debt available:	$2,720,000
Equity (20%):	$1,082,500	Equity (35%):	$1,464,615
Implied Value:	$5,412,500	Implied Value:	$4,184,615

The reduction in debt available is 37% based upon this simple underwriting example, falling from $4,330,000 in the 2006 assumption to $2,720,000 in the 2008 assumption causing the implied value to drop 23%.

This simplified exercise shows that the implied value on an income stream of $250,000 on a B property has dropped 23% and over $1.2 Million for the leveraged buyer based upon the amount he can borrow at a bank. When we add in other variables such as more strict underwriting assumptions by banks and investors as well as higher Cash on Cash and IRR's required by investors, it is easy to see why values have dropped in the range of 30% to 35% for B properties. The amount of decline in value is greater for C properties and a bit less for newer A properties, however the drop is drastic across the board, and applies to all types of investment real estate, not just apartments.

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Looking ahead to 2009

While all the news seems to be bad there are a number of positives for the multifamily industry in Southern Arizona. Among the positives are:

1. Tucson and Arizona is ahead of the curve in this downturn in relation to many other markets. Arizona, California, Nevada and Florida economies and multifamily markets started feeling the recession and drop in multifamily fundamentals before other markets and should pull out of the downturn sooner.
2. Housing starts in Pima County have fallen off drastically and will continue to be at very low levels for the next few years. 2008 housing starts ended up around 3200 units and projections for new housing starts for 2009 and 2010 are around the 3000 unit range (down from over 12,000 units in 2005). These are levels not seen since 1992. This will allow the excess capacity of single family homes to be absorbed as the credit markets start to stabilize and consumer confidence returns.
3. Multifamily starts in Tucson in 2009 and 2010 will be extremely low due to lack of financing and pessimism on behalf of developers. Although over 700 units will come on the market between late 08 and late 09, this number will drop drastically in 2009 and 2010. Speakers at last week's National Multifamily Housing Conference predicted that the 2009 and 2010 new multifamily housing starts would drop nationally to 30,000 to 40,000 units. While this may be an extreme prediction it is indicative of the pessimism in the marketplace among developers and industry players.
4. The demographics continue to be strong for the multifamily industry particularly for Arizona in the coming years. The percent of the population in the 20 to 34 year old population (the group most prone to rent apartments) will continue to grow in the coming years and particularly in Arizona with its young population.

Most people feel that the first half of 2009 will remain slow and that some time in the second half of the year we will see a rebound in transaction volume. There are clearly large amounts of money on the sidelines waiting to invest when people have a sense of some market stabilization and that the bottom is near. While the environment is very challenging, as it is in most areas of commercial real estate, there is a sense of optimism that the worst will soon be behind for the multifamily industry here in Tucson.

ECONOMIC INDICATORS

National	2007	2008	2009F
GDP Growth	2.0%	1.2%	-1.5%
CPI Growth	2.9%	4.2%	0.9%
Regional			
Unemployment	3.7%	4.7%	4.1%
Employment Growth	0.9%	-1.7%	-0.8%

Source: Arizona Department of Commerce, Moody's|Economy.com

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