OCTOBER 2008
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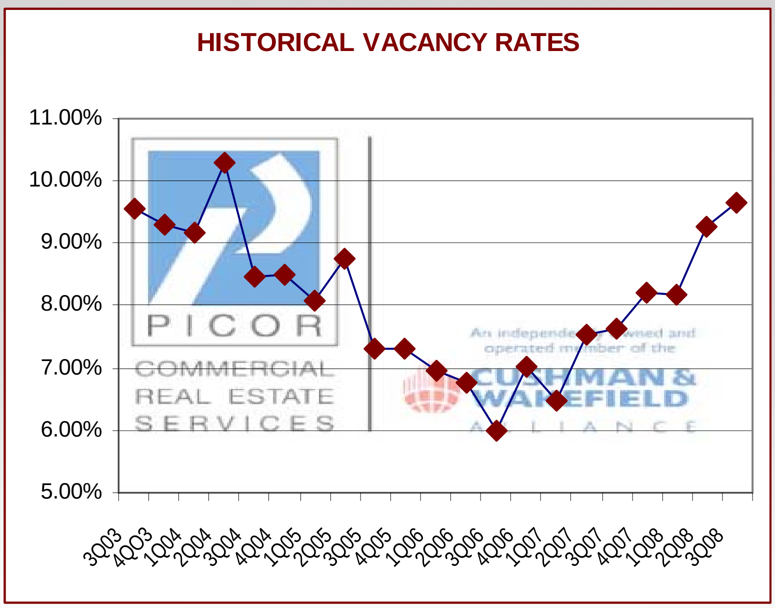
APARTMENT TALK BY BOB KAPLAN

CLIMBING OUT OF THE HOLE

In our February 2008 newsletter, I talked about the market hitting a bump in the road. Well it turns out the bump is a pothole and it does not look like we are out of it yet . The economic winds have continued to blow us into choppy waters and we are still looking for smoother sailing. This has resulted in a continuation of declining fundamentals in operations and a decline in the investment market to levels many of us never expected to see.

Vacancy has risen to 9.65%(which are levels not seen since 2002) from just 8% one year ago, this decline is similar to what we say after the September 2001 terrorist attacks. Net absorption of apartment units has dropped about 1350 units over the past 12 months and rental rates in that time have increased a mere 1.43%. Many properties that may have been at 92 to 95% economic occupancy a year ago are now operating in the range of 83 to 85% economic due to increases in vacancies, concessions and credit losses. Vacancies will almost certainly increase in the next few quarters given the current economic downturn.

Market fundamentals vary quite a bit by submarkets. The South and Southeast submarkets have been hit the hardest with vacancies in these markets both over 14%, while vacancies in the University area, Catalina Foothills and Northeast Tucson are all below 7%. The wide variance is due to a number of factors including the loss of many low wage construction and service jobs and the employer sanctions laws which have affected the southside much more than the higher income areas. Other factors include the strong demand for housing near the U of A due to the tight supply of on campus housing and the growing student population which is now over 38,000 students. Additionally middle income and upper income residents are waiting to purchase homes; which has kept occupancy at these apartment properties higher than in lower income areas.



The investment market is currently very quiet. As you can see from the below chart, sales volume has collapsed from the levels of 2006 and 2007. The drop in sales activity is due to differing price expectations between buyers and sellers as well as the lack of motivated buyers.

Data provided by Real Data / Apartment Insights.

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CLIMBING OUT OF THE HOLE (continued)

CAP rates have risen 110 to 135 basis points over levels of a year ago for A and B properties and even more for C properties. The increased CAP rates are due to the higher cost of debt and higher expectations of returns from equity investors raising CAP rates required to underwrite a purchase and thus lowering prices. The combination of increasing CAP rates and declining operating fundamentals have created a perfect storm pushing down values quite a bit since the peak in 2006. Many properties sold during 2005, 2006 and 2007 are worth less than they were; creating refinancing problems and some default on mortgage terms. Currently more than 48% of all CMBS (Commercial Mortgage Backed Securities) loan delinquencies are coming from transactions issued in 2005, 2006 and 2007.

A number of things will need to change before we see improvements. We will need to see better consumer confidence and job growth in order to see an improvement in occupancy and rental rate growth. Most economists are now predicting that job growth will not return until perhaps the 2nd half of 2009. The investment market will begin to improve when the credit markets regain stability and when investors begin feeling more confident that a bottom is in sight. There are indicators (such as LIBOR, and short term treasury rates beginning to retreat back to more normal levels) that this will occur in the first quarter of 2009.

While the picture looks pretty bleak now, Tucson remains a great place to invest in Multifamily for the long-term investor. Most cities throughout the country are seeing increased vacancies and a drop in fundamentals like Tucson. However Tucson's long-term trends of in-migration, population and job growth, little new apartment construction, and a growing young population of potential renters remain in place. When the economy regains its footings, Arizona will again be a leader in job growth and in-migration. Our population is one of the youngest of any state thus the demand for apartment housing will be strong. The University of Arizona will continue to grow reaching over 41,000 students by 2013. All of these factors will reward the patient investor who picks up properties in the current downturn.

TUCSON APARTMENT SALES (40 Units & More)

	3rd Qtr 2006	3rd Qtr 2007	3rd Qtr 2008
# of Units	7,545	6,170	1,619
Total Sales $	$434,469,175	$439,115,509	$94,240,000
Avg Price/Unit	$57,784	$71,169	$58,209
Avg Price PSF	$80.09	$90.01	$79.81
Avg Year Built	1980	1982	1980

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