

# Phoenix, Arizona



Multifamily Housing Update

January 2010

## EXECUTIVE SUMMARY

**A** brutal combination punch of real estate collapse, consumer spending draught and plummeting leisure and business travel knocked the Valley of the Sun economy to the canvas in the first half of 2009, a period in which employers trimmed 114,000 jobs from payrolls. After taking an eight count, the metro struggled to regain its footing in 2H09. Data suggest that the metro labor market troughed in 3Q09 and probably began the long rally back to title contention in the fourth quarter.

Payroll job losses proceeded at a 147,900-job, -8.0% year-over-year rate in 3Q09, down from a 138,200-job, -7.3% pace in the 2Q. Trend deterioration was largely attributable to faster school district cuts and attrition at consumer service shops. Seasonally-adjusted data were consistent, recording a total of 25,100 job losses in the third quarter, up from a 27,500-job setback posted in 2Q09.

Trends were clearly stronger in the fall. Year-over-year losses slowed to a 111,100-job, -6.0% rate, boosted by firmer conditions in retail trade, construction and health care, as well as a significant increase in the use of contract labor. YoY losses in December declined to a 92,100-job pace, the first print of 100,000 or fewer job losses posted since October 2008. Moreover, payroll aggregates expressed on a seasonally-adjusted basis actually turned positive in the period after October and November gains propelled 4Q payrolls up by 8,000 jobs.

Although a seasonally-adjusted job loss in December was a disappointment, the Phoenix market is recovering a bit faster than the **RED Research** econometric payroll model forecast in October. At that time, we didn't expect positive payroll comparisons to emerge before 1Q11, but it seems likely that beleaguered Val-

ley workers can look forward to earlier gains, perhaps by summer 2010. Losses this year will average about -25,000 jobs, up from our previous forecast of -33,600. In 2011, the Valley should enjoy a 33,300-job gain.

After posting relatively healthy apartment demand in 2Q09, Phoenix owners experienced weaker conditions in 3Q, losing a net of 145 leased tenants. Accounting for total delivery of 658 new units, average occupancy slipped 30 basis points sequentially to 88.1% (Reis), a 20-year series low. Demand for class-A suburban space was constructive, as occupancy rates rose in Chandler, North Scottsdale and South Tempe. On the other hand, retail traffic in Glendale- and Mesa-area submarkets was soft, contributing to 60 to 290 bps occupancy rate declines.

Average asking rents plummeted in 3Q, falling \$9 (-1.2%) to \$767 as owners resorted to deeper discounting to fend off competition from shadow supply and maintain occupancy in a weak retail environment. Class-B/C properties suffered the largest losses as class rents declined \$10 (-1.5%), underperforming a smaller \$9 (-1.0%) reduction at class-A complexes. Reis aver that average concession levels declined materially, however, dropping \$7 per month sequentially from 10.1% of gross rent revenue in 2Q to 9.3% of GRR, holding effective rent attrition to a net of only \$2 (-0.3%).

Preliminary Reis data suggest 4Q09 market trends were weaker than expected. Average occupancy plunged 40 bps to 87.7%, while mean face rents dropped -1.4% to \$751, the lowest average recorded in 3 years. By way of comparison, M/PF report respective YE09 occupancy and YoY effective rent metrics at 87.1% and -7.3%, attributing the performance to weakness in Westside submarkets, especially Glendale and Peoria.

## SNAP SHOT

	Y-o-y change	Projected YE09 Metric
Vacancy (11.9% - 3Q09)	↑ 1.5%	↑ 0.4%
Effective Rents (\$696 - 3Q09)	↓ 2.9%	↓ 4.0%
Median Cap Rate (6.6% - 3Q09)	↑ 0.8%	↓ 0.5%
Employment (1,699.6m - 3Q09)	↓ 148m	↓ 133m

## KEY POINTS

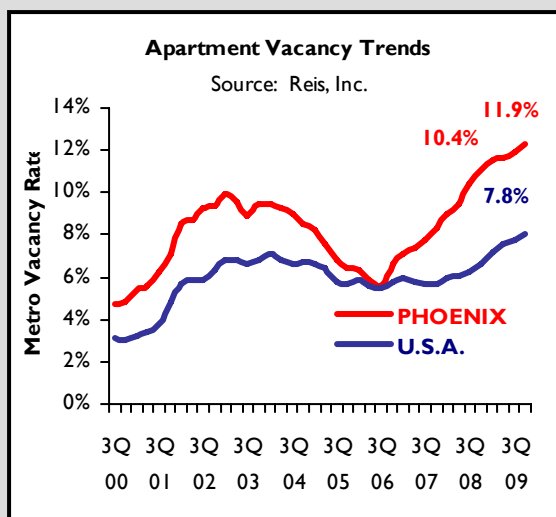
- After posting dreadful 3Q09 payroll figures, trends improved materially in the fall. Year-over-year job decelerated from 3Q09's 147,900-job pace to a slower 111,100-job rate during 4Q09. Seasonally-adjusted data indicate metro work rolls actually increased 8,000 jobs in the October-December period.
- A net of 145 tenants vacated units in 3Q09. Accounting for delivery of 658 units, metro occupancy fell 30 basis points sequentially to 88.1%(Reis), second lowest among the **R50**.
- Average asking rents plunged \$9 (-1.2%) quarter-to-quarter to \$767. Reis believe concession levels also subsided, limiting effective rent losses to \$2 (-0.3%) to \$696.
- Preliminary 4Q09 data reflect further market performance deterioration. Reis report average occupancy and face rent slipped to 87.7% and \$751, respectively, while M/PF and Marcus & Millichap report that effective rents probably fell about -2.5% sequentially.
- Property sales gained momentum in 4Q09 as buyers stepped up acquisitions of distressed properties. Eighteen transactions were consummated for total proceeds of \$261mm, up from 10 trades for \$141mm in 3Q09.

### VACANCY TRENDS

- After chalking down the first quarter of positive absorption in 18 months in 2Q09, owners struggled to retain and attract tenants again in 3Q when renters vacated a net of -145 units. Accounting for delivery of 658 units, occupancy fell to 88.1%, a 20-year Reis series low.
- Demand was constructive in Central and Eastern Valley submarkets, notably Scottsdale and Northeast Phoenix. By contrast, occupancy trends were discouraging in Mesa and West Valley neighborhoods, especially in Glendale, Peoria and Sunnyslope area submarkets.
- Supply pressures will continue to exert downward pressure on metro occupancy. Reis expect more than 4,000 units to be added to the market inventory from October 2009 through December 2010.

**RANK:** 49<sup>th</sup> out of 50

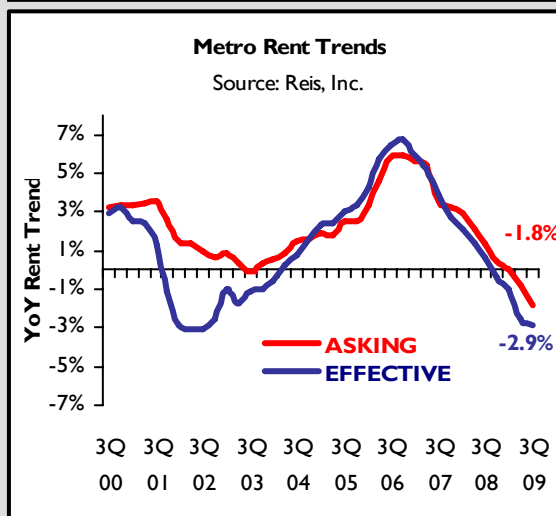
Reis report that average metro occupancy declined to 87.7% in 4Q09. M/PF concur.



### RENT TRENDS

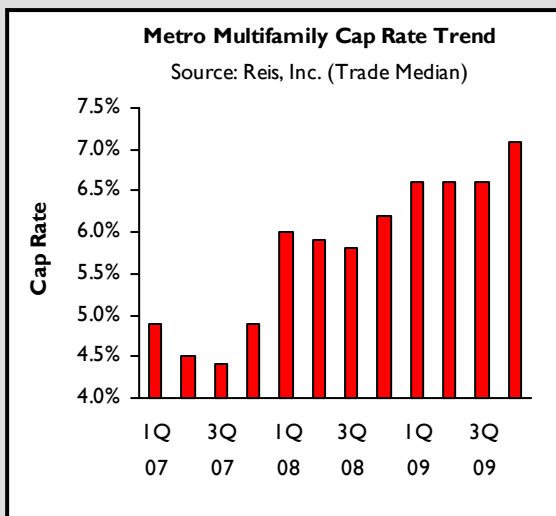
- Reis reported mixed rent trends in the third quarter. On one hand, the data suggest that owners discounted face rents significantly to maintain occupancy: average asking rent fell \$9 (-1.2%) from June to September. On the other, the service reported an average \$7 decrease in average rent concessions (from 10.1% of gross rent revenue to 9.3%), producing a small \$2 (-0.3%) decline of average effective rent.
- Effective rent metrics for Tempe and Mesa submarkets were generally higher, rising 0.1% to 1.3% quarter-to-quarter. Trends were considerably weaker in higher cost areas: sequential rents fell in Scottsdale, Glendale, Peoria and Sunnyslope submarkets.
- Rent momentum, such as it was, probably faltered in 4Q09. Reis report a -1.4% sequential decline in asking rent. Marcus & Millichap and M/PF indicate that effective rents fell by an even greater percentage.

**RANK:** 36<sup>th</sup> out of 50



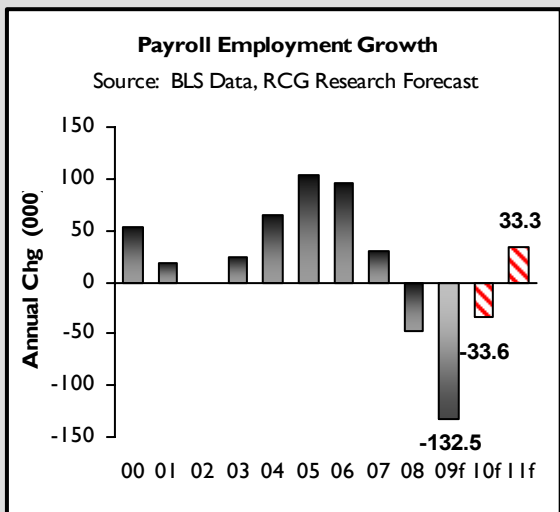
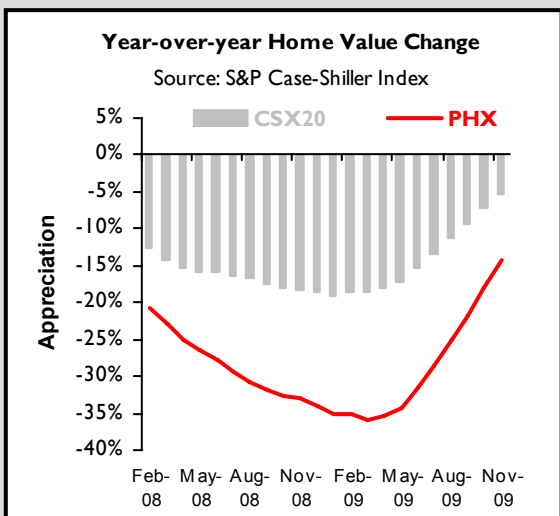
### PROPERTY MARKET & CAP RATE TRENDS

- Distressed property trade fueled material increases in sales velocity and total proceeds in 4Q09. A total of 17 major transactions (excluding bulk condo sales) were consummated in the period for total proceeds of \$261mm. This compared to 11 closings for \$143mm in 3Q09, and 16 sales for \$196mm during the first six months of the year.
- Trade continued to accelerate in early 2010. Real Capital Analytics identify seven multifamily trades (including bulk condos) closed by January 22. Total proceeds were about \$40mm. Again, assets consisted principally of distressed properties. Prices equated to -35% to -55% discounts from prior sales completed from 2003 to 2006.
- **RCR** estimate that cap rates for institutional quality Phoenix properties increased about 80 basis points over the past year to roughly 6.7%. Using this level, we estimate that a generic metro investment will generate expected total returns of 5.8%, 10 bps above the **R50** mean.



### NOTABLE TRANSACTIONS

Property Name (Submarket)	Property Class	Date of Transaction	Total Price (in millions)	Price per unit	Estimated Cap Rate
Morgan Park (Sunnyslope)	B	23-Dec-2009	\$18.5	\$43,224	7.7%
Painted Trail (Chandler / Gilbert)	A	25-Nov-2009	\$15.6	\$80,000	5.5%
Paragon @ Kierland (No Scott)	A	13-Nov-2009	\$34.2	\$123,913	6.4%
San Brisas (Chandler / Gilbert)	A	13-Nov-2009	\$19.0	\$91,346	8.0%



## DEMOGRAPHICS & HOUSING MARKET

- Value trends in the Phoenix residential real estate market remained among the weakest in the country in 2H09. The median price of a metro home sold in 3Q09 was \$142,700, representing year-on-year depreciation of -22.9%. This statistic compares to -11.2% and -16.4% declines for the U.S. and West Region, respectively.
- S&P Case-Shiller report that Phoenix home values increased for the sixth consecutive month in November. While the November index was -14.2% below the comparable 2008 level it represented a 7.2% rise from the April cycle low and was 1.1% higher sequentially.
- Home sales in November rose 62% above depressed 2008 levels. Liquidation of foreclosed homes remained the principal motivating factor. More than 50% of homes sold in November were foreclosed upon during the preceding twelve-month period.

## EMPLOYMENT TRENDS

### Third Quarter 2009

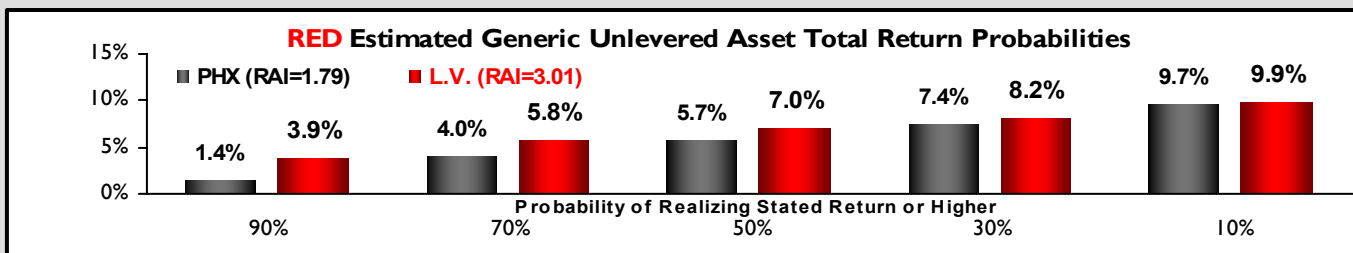
- Year-over-year payroll trends deteriorated in the third quarter. Losses accelerated from 2Q's 138,200-job, -7.2% pace to a 147,900-job, -8.0% rate, representing the fastest rate of attrition among the nation's top 75 metropolitan areas and the second largest number of payroll job losses recorded among the group after Los Angeles.
- Construction industry job losses decelerated but remained the largest contributor to Phoenix's distress. Sector headcounts declined at a 37,600-job, -26.1% annual pace, up from a 40,900-job YoY rate in 2Q. Business service sector trends were nearly as weak, as establishments trimmed 36,900 (-12.0%) workers from payrolls year-on-year.

### Fourth Quarter 2009

- Conditions appeared to improve materially in the fourth quarter. Average year-over-year employment losses decelerated to a 111,100 (-6.0%) job rate, the slowest rate of attrition posted since 4Q08. The December comparison reflected a 92,100-job loss, the smallest 12-month payroll decrease registered since October 2008.
- Net gains were largely attributable to reduced losses in the retail trade and business service sectors. The business services rebound was fueled primarily by increased use of contract labor.
- On a seasonally-adjusted basis, Phoenix payrolls increased in 4Q, rising by a net of 8,000 jobs. This was the first quarter of positive job growth recorded since 3Q07.

### Forecast

- In October, the RCR econometric payroll model forecasted a -127,600 job YoY payroll loss for 4Q09, 16,500 jobs below the actual print, suggesting that the Phoenix economy may be mending faster than we anticipated. Therefore, our existing 2010 loss forecast of 33,600 jobs may be too pessimistic. Rather, a loss projection in the neighborhood of -25,000 jobs may be more appropriate. For 2011, we continue to foresee gains in the 33,300-job area.

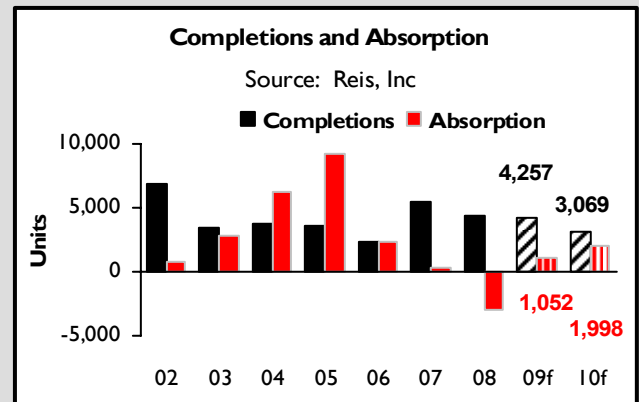


## SUBMARKET TRENDS

Submarket	Effective Rent			Physical Vacancy		
	3Q08	3Q09	Change	3Q08	3Q09	Change
North Tempe	\$741	\$774	4.5%	9.7%	10.9%	120 bps
South Tempe	\$812	\$792	-2.5%	7.3%	8.5%	120 bps
West Mesa	\$608	\$593	-2.5%	10.1%	10.9%	80 bps
South Mesa / Ahwatukee	\$648	\$621	-4.2%	10.5%	13.3%	280 bps
Chandler / Gilbert	\$803	\$768	-4.4%	12.0%	10.1%	-190 bps
South Scottsdale	\$811	\$770	-5.1%	5.3%	8.8%	350 bps
North Scottsdale	\$939	\$924	-1.5%	10.5%	10.5%	Unchd
Paradise Valley	\$703	\$654	-6.9%	9.6%	13.5%	390 bps
Deer Valley	\$677	\$646	-4.6%	8.0%	12.2%	420 bps
Central Phoenix North	\$620	\$586	-5.4%	12.0%	13.3%	130 bps
Northeast Phoenix	\$704	\$670	-4.9%	7.2%	10.5%	330 bps
Central Phoenix South	\$676	\$647	-4.2%	9.8%	14.9%	510 bps
East Mesa	\$732	\$706	-3.5%	8.5%	11.4%	290 bps
Goodyear / Avondale	\$829	\$845	1.9%	11.7%	18.6%	690 bps
Maryvale	\$589	\$547	-7.1%	10.8%	13.0%	220 bps
Glendale South	\$602	\$599	-0.5%	12.2%	14.3%	210 bps
Sunnyslope	\$648	\$621	-4.3%	9.6%	12.1%	250 bps
North Glendale / Peoria	\$749	\$733	-2.2%	10.9%	10.7%	-20 bps
<b>Metro</b>	<b>\$717</b>	<b>\$696</b>	<b>-2.9%</b>	<b>10.4%</b>	<b>11.9%</b>	<b>150 bps</b>

## SUPPLY TRENDS

- Irrespective of the fact that Phoenix vacancy rates have climbed steadily for the last three years, developers continue to bring new product to the market. In all, Reis identify nine projects in the under construction pipeline. The deals contain an aggregate of 3,500 units. All but one underway project is tipped to receive a final certificate of occupancy by year end.
- The Scottsdale and Northeast Phoenix submarkets will receive the largest number of new units this year, about 1,353. The largest of these is a 724-unit luxury garden property located in the Happy Valley District in Far North Phoenix. The project is partially complete and renting at rates ranging from \$645 to \$1,421 per month. Rents equate to \$0.95 to \$1.15 per square foot. In late January, the developer offered lease concession of up to three months free rent with a 12-month lease.
- A 500-unit project located in Downtown Phoenix is projected to be ready for occupancy sometime in the fourth quarter 2010, according to Reis. Data obtained from the property web site indicate that the developer still plans to market the units as condominiums, although lease options seem likely as well.



- After leasing for about 12 months, a 408-unit project in the South Tempe/Ahwatukee submarket was 80% occupied in September at rents averaging \$853. A 332-unit loft building sited Downtown was nearly 30% occupied after leasing for about six months. Rents averaged \$1,127.

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