

Tucson, Arizona

Multifamily Housing Update

November 2007

EXECUTIVE SUMMARY

Economic conditions grew moderately weaker in 3Q07. Year-over-year employment growth fell to 9,800 (2.6%), the lowest level recorded since 4Q05 and down 3,600 from the previous quarter. The unemployment rate decreased 80 basis points year-over-year to 3.3% in September.

The slowdown in job creation is largely attributable to weakness in the housing market. Single family residential permit issuance dropped sharply in 2H06 and remained below trend this year. Consequently, construction sector payrolls fell 1,100 jobs in 3Q07, after posting average monthly gains of 2,400 in 2006. Financial sector job losses totaled 500 in 3Q07, owing to reduced demand for residential mortgages.

RED forecast payroll job growth of 10,600 (2.8%) in 2007, with a confidence interval of 10,000 (2.6%) to 11,100 (2.9%) jobs. In 2008, **RED** anticipate employment growth to range from 3,000 (0.8%) to 8,000 (2.0%), with a point estimate of 5,000 (1.3%). By way of comparison, Economy.com project payroll growth of 9,360 (2.4%) in 2007 and 6,590 (1.7%) in 2008.

The rate of population growth rose to 2.3% in 2006, owing to stronger domestic and international migration trends. The size of the 20- to 29-year old “renter” cohort expanded 14.6% since 2000, according to commercial demographer Tactician Corp., and is projected to grow at a 1.0% annual rate through 2012, boding well for apartment demand.

Positive demographic trends failed to translate into occupancy gains. Average occupancy fell 10 bps sequentially to 94.3%. The drop was attributable to negative net absorption. On a year-over-year basis, the occupancy rate increased 20 bps largely due to

limited supply. Demand was relatively weak. Only 222 net leases were signed in the twelve-month period ended in September.

Effective rents increased \$24 (4.2%) y-o-y in 3Q07 to \$600. Asking rents grew at a moderately faster 4.3% rate to \$633. The value of the average concession package rose from 5.1% of asking rent in 3Q06 to 5.2%.

Reis expect stronger tenant demand to absorb 182 units in 4Q07, giving rise to a 40 bps increase in occupancy rate to 94.7%. The service forecasts y-o-y effective rent growth to decelerate to 3.4% in 4Q07 and 3.6% in 4Q08.

The North / Northwest Tucson submarket boasted the highest 3Q07 average occupancy rate (95.5%) among metro submarkets. Submarket effective rents increased 3.1% y-o-y. Asking rents advanced at a faster 3.7% rate, reflecting an increase of average concessions from 4.7% of asking rent in 3Q06 to 5.2%. Reis forecast effective rent growth to accelerate to 3.3% in 2008 and 3.7% in 2009.

According to Loopnet, transaction volume fell 23% sequentially to \$74.7 million in 3Q07. The average price per unit increased 20% from \$68,726 in 2Q07 to \$82,558 in 3Q07. The most expensive trade involved a 304-unit Class A asset in the Pantano submarket. The property sold for \$34.7 million or \$113,980 per unit. Reis estimate a going-in yield of 3.7%.

Tucson exhibits compelling fundamentals and the Reis forecasts are constructive. Moreover, we expect payroll growth to remain at a supportive level through 2008. Market liquidity, on the other hand, is low. We recommend that buyers bid “*opportunistically*” for metro assets, keeping in mind that the peak of the rent growth cycle has past and 3.5% annual growth is probable.

SNAP SHOT

	Y-o-y change	Projected 2008
Vacancy (5.7% - 3Q07)	↓ 20bps	↓ 70bps
Effective Rents (\$600 - 3Q07)	↑ 4.2%	↑ 3.6%
Cap Rate (6.4% - 3Q07)	↑ 40bps	↔ unch
Employment (386.2k - 3Q07)	↑ 8.1k	↑ 5k

KEY POINTS

- The metro vacancy rate rose 10 basis points sequentially to 5.7% in 3Q07. The rate decreased 20 basis points year-over-year.
- Asking and effective rents increased 4.3% and 4.2% year-over-year, respectively. This marked the first time asking rent growth outpaced effective rent gains since 4Q04.
- According to DataQuick, home sale velocity fell 31.6% year-over-year in 3Q07 as 3,979 homes traded. The median sale price was \$218,226, down 3.0% from the same period last year.
- According to Loopnet, sales volume totaled \$74.7 million in 3Q07, down from \$96.7 million in the previous quarter. The average per unit price rose 20% to \$82,558, largely due to one large transaction.
- **RED** assign an “**Opportunistic**” ranking to metro assets. Acquirers need to adjust rent growth assumptions lower following a period of above average growth.
- **RED** estimate job growth will total 10,600 (2.8%) in 2007, before falling to 5,000 (1.3%) next year.



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