

EXECUTIVE SUMMARY

National Economic Trends

- Real GDP growth slowed to 3.3% in 2006, largely attributable to a weaker housing market, slower wage growth and rising tax burdens and interest rates. The preliminary estimate of 1Q07 GDP growth is 0.6%, the slowest quarter recorded in more than four years.
- The outlook for domestic economic conditions is relatively positive. National City Bank economist Dr. Richard DeKaser (*USA Today Economist of the Year, 2007*) forecasts GDP growth of 2.2% in 2007 and 3.1% in 2008.
- Although inflation remains a primary concern for Fed policy makers, recent data suggest that inflationary pressures are subsiding. Therefore, the next move of the Fed Funds rate is more likely to be a decrease. Nevertheless, a change in Fed policy is not imminent.

California Economic Trends

- The rate of California employment growth averaged 1.9% in 2006, outpacing the national average by 0.1%. Unemployment averaged 4.9% last year, down 50 basis points from 2005.
- Payroll growth moderated to an annual average rate of 1.8% during the first four months of 2007. On a seasonally adjusted basis, California produced 37,600 jobs, comparing favorably to the 31,300 jobs added in the same period of 2006.
- The unemployment rate increased 30 bps sequentially to 5.1% in April, up 30 bps sequentially and 10 bps year-over-year.
- The California housing market weakened in 1Q07. The inventory of unsold homes rose to 8.7 months in March, up from 4.7 months in the comparable period of last year. According to the OFHEO home price index, appreciation slowed to 1.2% in 1Q07, 310 basis points below the national average.
- **RED** Research forecast payroll growth of 1.7% in 2007 and 1.6% in 2008. By way of comparison, Dr. DeKaser projected national job growth of 1.4% per annum in 2007, and 1.2% growth in 2008 in his June 2007 *Economic and Interest Rate Forecast*.
- **RED** Research anticipate slower state output growth in 2007, falling from 6.2% in 2006 to 4.7%.

Total Return Analysis

- Estimates of un-levered returns for generic metro apartment assets indicate that Sacramento offers the highest rate of expected total return (8.1%) among the eight major California markets, owing to the metro's above average going-in yield. The Inland Empire ranks second, with an expected rate of total return of 8.0%. Other markets, such as Los Angeles and San Francisco, exhibit relatively unattractive return profiles. This is largely attributable to low going-in yields typical of these metros and the relatively modest expectations for metro rent growth published by Reis.
- Low acquisition cap rates typical of California assets limit potential 10-year holding period returns. To assess the degree to which this is true we performed a cap rate sensitivity analysis to determine the amount of decompression necessary for the eight markets to achieve a 10% rate of return. San Diego, Orange County, Riverside and Sacramento need only 40 basis points, while Los Angeles would require 100 basis points.

Investment Rankings

- On the basis of our total return analysis and assessment of market fundamentals, **RED** assign an investment ranking of "Accumulate" to Oakland, Orange County, Riverside - San Bernardino and Sacramento assets. This indicates that in our view property prices support an active buying program.
- **RED** assign a rating of "Opportunistic" to Los Angeles, San Diego, San Francisco and San Jose investments, indicating that although fundamentals remain strong, property prices are too high to achieve a rate of return commensurate with other acquisition opportunities.