

Suburban Virginia

Multifamily Housing Update

March 2008



EXECUTIVE SUMMARY

Northern Virginia's proximity to Washington continued to support metro economic fundamentals in 4Q07. Although the pace of hiring slowed considerably, strong flows of homeland security and defense spending and federal wage and salary income kept employment and income growth rates above the national average.

Metro payrolls increased 15,500 (1.2%) jobs last year, down about 50% from 2006. The harvest was the smallest since 2002, when Northern Virginia suffered the only annual net job loss of the past 18 years.

Slower hiring was observed in a broad spectrum of industry sectors, ranging from skilled services to government. The housing slump caused job losses in the construction industry as sector payrolls shrunk 7,500 from 2006 levels. Tighter budgets caused government hiring to slip from 6,500 to 4,400, the lowest level since 2001. Reduced corporate IT spending was a drag on business service and information sector expansion, with job creation in the former dropping 22% to 10,800, while information headcounts declined by 1,200.

RED CAPITAL Research expect sluggish job trends to persist in 2008, but are cautiously optimistic for 2009. **RCR** project employment growth ranging from 7,000 to 14,000 jobs this year, with point estimate of 10,000 (0.8%). A recovery will emerge in 3Q08, leading to stronger 2009 employment trends, when NoVA will produce 16,000 to 25,000 jobs, with a probable outcome of 20,000 (1.5%).

In spite of healthy tenant demand, conditions in the metro apartment market weakened in 2007. In addition to the largest vintage of new product (4,961 units) delivered since 2002, failed condo converters returned at least 2,218 units to the rental

inventory. While tenants absorbed 5,413 units last year, an 18-year series record, the deluge of supply sent occupancy down 90 basis points year-over-year to 94.4%, the lowest rate recorded since 1991, when cuts in Cold War defense spending dealt a devastating blow to the metro economy. Much of the damage was done in 4Q07, when an all-time high 3,471 new units were completed, sending occupancy plummeting 100 bps, the worst performance posted by a **RED 50** metro market.

Regardless, landlords were not deterred from implementing significant rent hikes. Tenants absorbed an average \$19 (1.4%) effective rent increase to \$1,331 in 4Q07, the largest sequential advance in 15 months. Over-the-year, average effective rent increased \$57 (4.5%), a moderate deceleration from 2006's \$64 (5.0%) advance, but good enough to earn 24th place among the **RED 50**. Submarkets absorbing the lion's share of new supply (Old Town, Pentagon City) recorded smaller real gains as property owners were compelled to price competitively while new high-end properties lease up.

Although supply pressures will moderate, Reis do not expect metro occupancy or rent trends to improve in the near term. The service projects vacancy rates to rise 20 bps by YE2009, and effective rent growth to slow to 3.1% in 2008 through decade's end.

The downbeat Reis forecast coupled with ultra-low cap rates applicable to NoVA assets produce less than compelling 5.7% expected 5-year holding period total returns (**RED 50** average 6.3%). Considering the metro's volatile NOI trends, **RCR** recommend that investors **Hold** existing assets and **Underweight** NoVA acquisitions until sellers moderate unrealistic cap rate expectations.

SNAP SHOT

| | Y-o-y change | Projected 2008 |
|-------------------------------------|--------------|----------------|
| Vacancy (5.6% - 4Q07) | ↑ 90 bps | ↑ 10 bps |
| Effective Rents (\$1,331 - 4Q07) | ↑ 4.5% | ↑ 3.1% |
| Cap Rate (5.5% - 4Q07) | ↓ 50 bps | ↑ |
| Employment (1,316.6m - 4Q07) | ↑ 22.4m | ↑ 16m |

KEY POINTS

- Northern Virginia economic growth decelerated in late 2007, as the housing slump put downward pressure on construction activity and governments and skilled service firms hired at a slower pace.
- Payrolls increased at a 11,800-job, 0.9% pace in 4Q07, down from 18,800 (1.5%) in the first half and 31,300 (2.5%) in 2006.
- **RED** expect the economy to exhibit further below-trend growth. The **RCR** payroll model produces job creation of 10,000 (0.8%) in 2008, and 20,000 (1.5%) in 2009.
- Heavy supply of high-end high-rise product in Pentagon City and Old Town put downward pressure on occupancy rates. The metro average fell 90 bps on the year to a 16-year low 94.4%, and 100 bps sequentially in the supply-rich 4Q07 environment.
- Owners managed to exert pricing power nonetheless. Effective rents increased 4.5% for the year and 1.4% sequentially in 4Q07. Reis expect rents to rise \$46 (3.1%) in 2008 and \$50 (3.4%) in 2009.
- **RCR** endorse NoVA fundamentals, but cap rates are too low. **Hold** and **Underweight**.