

METRO OPERATIONS OUTPERFORM SOUTHERN CALIFORNIA MARKETS

The pace of San Diego's post-recession apartment sector recovery continued to strengthen in the first half of 2011, as supply growth nearly stalled and employers boosted staff counts, trends that are supporting Southern California's lowest vacancy. Last year's apartment rebound was led by the absorption of Class A units, but filtered strongly to the lower tier early in 2011 as job gains, dominated by typically lower-paying industries, such as leisure and hospitality, bolstered demand. Renewed blue-collar job creation, combined with more renters between the ages of 20 to 34 leasing affordable units, drove down lower-tier vacancy in half of the metro's submarkets to below 3 percent in the second quarter. With business activity across the metro recovering, though, Class A occupied stock climbed in line with expanding professional and business services payrolls, particularly in dense office districts. Demand growth for downtown San Diego's high-end rentals, for instance, accelerated at a substantial clip, setting the market's sharpest year-over-year vacancy improvement. As the metro's job market broadens further and the supply pipeline stays thin in the second half, household formation will outpace stock additions, facilitating operational improvements in each submarket through 2011.

With marketwide operations firmly rooted in a sustainable recovery, cash-rich investors and institutions are back in the local investment arena and driving up sales velocity for institutional-grade product. The bidding environment for larger deals has intensified, and over the past year, sales velocity for assets priced above \$10 million doubled, driving up per-unit prices substantially. As such, average cap rates for properties at the upper end of the tier spectrum retreated approximately 100 basis points to below the 5 percent range. Deals priced between \$1 million to \$5 million, however, continued to dominate closings during this time, as private-equity buyers eagerly pursued near-in properties while interest rates remained favorable. Year-one cap rates for average trades, for the most part, are in the low-to mid-6 percent range, while smaller, lower-tier properties traded closer to the low-7 percent range.

2011 ANNUAL APARTMENT FORECAST



Employment: Marketwide job creation will total 28,000 positions this year, increasing local employment by 2.3 percent. During 2011, local employers expanded staff levels by 10,200 positions.



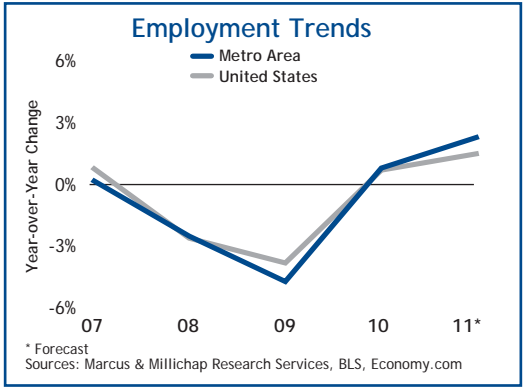
Construction: A year after the reversion of large condo developments and the delivery 637 apartment units, only 460 units will come online in 2011, roughly 65 percent below the metro's five-year annual average.



Vacancy: Vacancy will finish the year at 3.2 percent, down 110 basis points from 2010, when vacancy retreated 60 basis points.

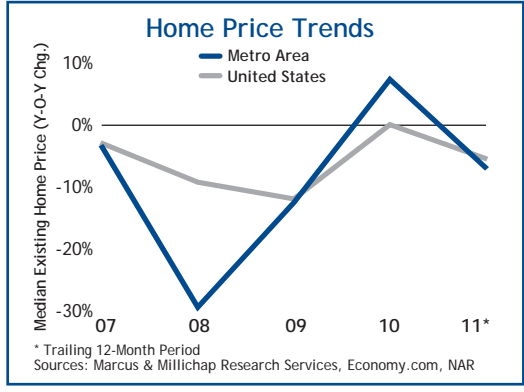


Rents: Asking rents will climb 3.9 percent in 2011 to \$1,371 per month, and effective rents will advance 4.6 percent to \$1,326 per month. Last year, asking rents gained 1 percent, while effective rents improved 1.5 percent.



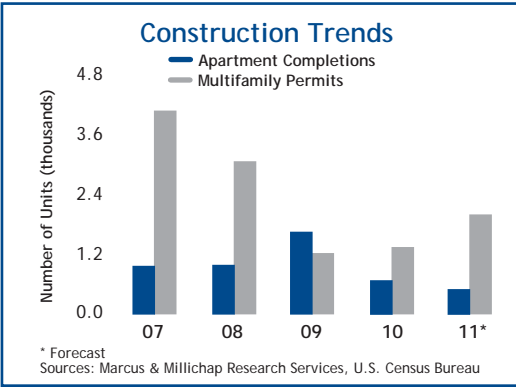
ECONOMY

- ◆ San Diego metro employers expanded payrolls by 12,300 workers through the first half of this year, a 1 percent gain, outpacing the creation of 7,400 jobs during the same time last year. Measured year over year, metrowide staff levels grew by 15,000 positions.
- ◆ A national job recovery has enabled households within a reasonable drive’s distance of the metro to move forward with vacation plans, boosting local visitor volume in recent quarters. As such, the local leisure and hospitality sector grew by 3,700 positions in the first half, an increase of 2.4 percent.
- ◆ Unlike previous recessions, when government payrolls aided in stabilizing the economy, the metro’s public sector remains the most significant drag on local job growth. During the first half of the year, government staff counts shrunk by roughly 2,000 positions.
- ◆ **Outlook:** Marketwide job creation will total 28,000 positions this year, increasing local employment by 2.3 percent. During 2011, local employers expanded staff levels by 10,200 positions.



HOUSING AND DEMOGRAPHICS

- ◆ Over the past year, home builders pulled permits for 2,060 single-family residences, down nearly 12 percent from year-ago levels. Multifamily permitting activity, meanwhile, swelled 39 percent during that time to 1,340 units obtained in the preceding 12-month period.
- ◆ During the second quarter, the median home price for a metro home was \$361,400, 6.9 percent lower than 12 months earlier. The median household income ticked up 1.9 percent year over year on renewed job growth to \$63,300 annually.
- ◆ Rentals remain a more affordable alternative for a sizable share of the population. As it stands, average Class A asking rents are \$260 per month more than the monthly mortgage payment, using traditional lending criteria.
- ◆ **Outlook:** Despite declining home prices, the threat of renters migrating to ownership remains limited, as more than 65 percent of metro households earn less than the \$84,300 annual income required to qualify for a median priced home.

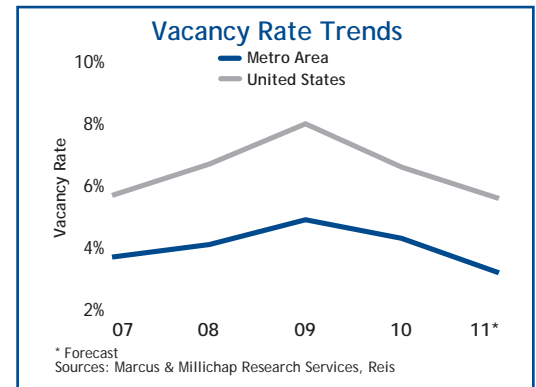


CONSTRUCTION

- ◆ No apartment units were brought online to the San Diego metro during the first half of 2011, easing local supply concerns. During the preceding 12-month period, builders completed 1,873 rental units.
- ◆ In the second quarter, approximately 830 apartment units were under construction, a mere 0.5 percent increase to existing stock. The market’s planning pipeline, meanwhile, totals 3,800 unit.
- ◆ Condo developers have nearly 1,250 units under way, with an additional 4,600 units under consideration, 40 percent of which are planned for the downtown San Diego submarket.
- ◆ **Outlook:** A year after the reversion of large condo developments and the delivery 637 apartment units, only 460 units will come online in 2011, roughly 65 percent below the metro’s five-year annual average.

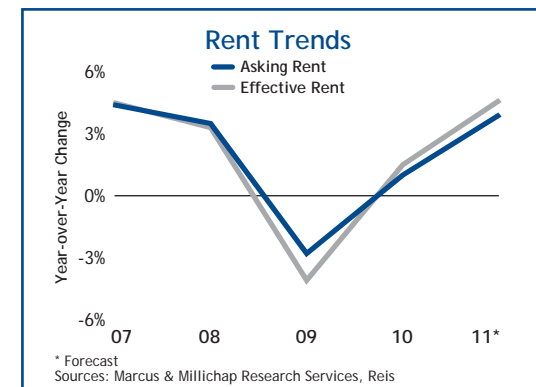
VACANCY

- ◆ Renter demand continues to strengthen in line with employers' renewed staffing efforts. Through the first half, marketwide vacancy receded 60 basis points to 3.7 percent, which is down 120 basis points from year-ago levels.
- ◆ Top-tier vacancy averaged 4.7 percent in the second quarter, 170 basis points below the rate recorded during the same period in 2010. In the preceding year, Class A vacancy rose 60 basis points.
- ◆ In the Class B/C segment, vacancy decreased 100 basis points year over year to 3.1 percent, besting the sector's 10 basis point improvement registered 12 months earlier.
- ◆ **Outlook:** Vacancy will finish the year at 3.2 percent, down 110 basis points from 2010, when vacancy retreated 60 basis points.



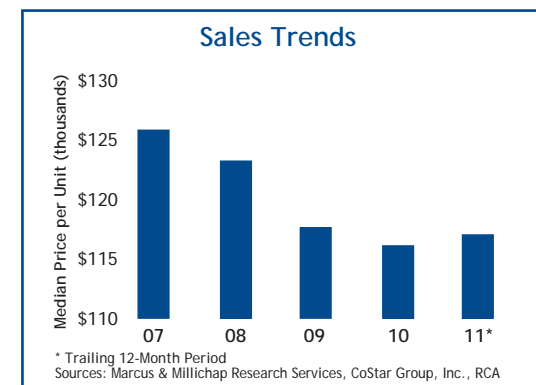
RENTS

- ◆ Asking rents reached \$1,328 per month in the second quarter, a year over year increase of 1.5 percent, while effective rents rose 2.1 percent to \$1,282 per month. In the first half, asking and effective rents advanced 0.7 percent and 1.1 percent, respectively.
- ◆ Top-tier asking rents grew 1.2 percent over the past year to \$1,642 per month, while an extremely tight Class B/C market resulted in a 1.4 percent rent hike to \$1,134 per month.
- ◆ Leasing incentives averaged 12 days of free rent in the second quarter, down from 15 days of free rent one year earlier. As operating conditions improved, revenues rose 3.4 percent over the past year, outpacing the 1.2 percent gain recorded during the prior 12-month period.
- ◆ **Outlook:** Asking rents will climb 3.9 percent in 2011 to \$1,371 per month, and effective rents will advance 4.6 percent to \$1,326 per month. Last year, asking rents gained 1 percent, while effective rents improved 1.5 percent.



SALES TRENDS**

- ◆ The re-emergence of sponsored capital groups and REITs contributed to a near 40 percent acceleration in sales velocity over the most recent trailing 12-month period, a sharp turnaround from the 26 percent decrease registered in the previous year.
- ◆ Strengthened rent rolls and growing buyer competition helped stabilize property valuations across the market. The median price over the past year was \$117,000 per unit, up 2 percent from one year earlier.
- ◆ As REITs intensified competition for best-in-class assets, direct cap rates for top-tier product compressed to the low to mid-5-percent range. Average yields for lower-tier properties metrowide, meanwhile, range between the mid-6-percent to the low-7 percent.
- ◆ **Outlook:** San Diego's limited pipeline of distressed assets and lack of new supply continues to narrow buyers' and sellers' pricing expectations. As such, investors looking to purchase properties may be required to stretch for deals, especially as more buyers enter the market ahead of eventual interest hikes.



** Data reflect a full 12-month period, calculated on a trailing 12-month basis by quarter.

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CAPITAL MARKETS

By WILLIAM E. HUGHES, SENIOR VICE PRESIDENT, MARCUS & MILLICHAP CAPITAL CORPORATION

- ◆ Apartment mortgage rates should remain favorable through 2011, enhancing property returns and supporting values. While the 10-year Treasury yield likely will remain in the low- to mid-3 percent range over the next few quarters, the relatively wide spread to all-in lending rates provides some cushion against potential upticks.
- ◆ Encouraged by sustained improvements in occupancy and rents, nearly all lending sources have increased funding for apartment deals. As a result, mortgage debt has become readily available for performing assets across markets and property classes, supporting a 40 percent increase in multi-family origination volume over the past six months when compared to the previous period.
- ◆ The agencies continue to dominate but have lost marketshare as insurance companies, private capital sources and local/regional banks, in particular, compete more aggressively for new business. In the near term, life insurance companies will continue to favor larger, best-of-class assets in primary markets, while local and regional banks focus on lower-quality assets with consistent revenue streams and strong, proven sponsorship.
- ◆ Underwriting requirements eased over the past year as strengthening apartment fundamentals and firming property values restored lenders' confidence in the market. Debt-service coverage requirements slipped to 1.15 to 1.25, while loan-to-values on new loans generally improved to 70 to 75 percent, and in some limited situations, have pushed to as high as 80 percent.

SUBMARKET OVERVIEW

- ◆ Class A vacancy in downtown San Diego fell 340 basis points over the past year and 510 basis points since peaking late in 2008 to 7 percent, driven by re-employed professionals relocating closer to work. Additional improvements are likely to materialize in 2011 as office-using sectors expand.
- ◆ The 368-unit Cresta Bella, located in the Mira Mesa/Rancho Bernardo submarket, is the largest market-rate development scheduled to come online this year, marking the area's first addition to inventory since the first quarter of 2008.
- ◆ Among the planned projects, more than 2,000 units are located in the Clairemont/Linda Vista Mission submarket, or nearly 10 percent of existing units. Approximately 500 apartments are planned in the Summit at Mission Bay, which does not yet have a scheduled date to start construction.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Mission Bay/Pacific Beach	2.2%	-230	\$1,484	0.5%
2	El Cajon/Santee/Lakeside	2.3%	-100	\$1,007	2.0%
3	Balboa Park/West of I-15	2.5%	-80	\$1,011	1.3%
4	National City/Chula Vista	3.0%	-90	\$1,151	2.1%
5	Ocean Beach/Point Loma Blvd.	3.2%	-90	\$1,263	2.7%
6	Oceanside	3.4%	-150	\$1,180	1.7%
7	North Beaches	3.5%	-150	\$1,500	1.5%
8	Vista	3.5%	-120	\$1,159	2.8%
9	Escondido/San Marcos	3.9%	-60	\$1,083	3.2%
10	La Mesa/Spring Valley/Lemon Grove	4.1%	-100	\$1,227	3.2%