

# Tucson, Arizona



Multifamily Housing Update

November 2007

## EXECUTIVE SUMMARY

**E**conomic 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

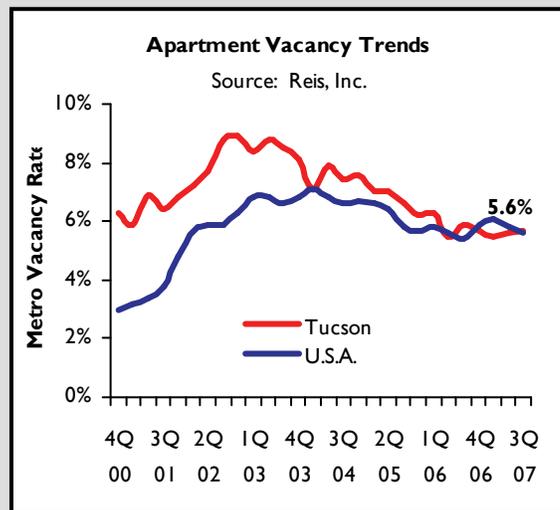
	Y-o-y change	Projected 2008
Vacancy (5.7% - 3Q07)	↓ 20bps	↓ 70bps
Effective Rents (\$600 - 3Q07)	↑ 4.2%	↑ 3.6%
Cap Rate (6.4% - 3Q07)	↑ 40bps	↔ unch
Employment (386.2k - 3Q07)	↑ 8.1k	↑ 5k

## 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.

## VACANCY TRENDS

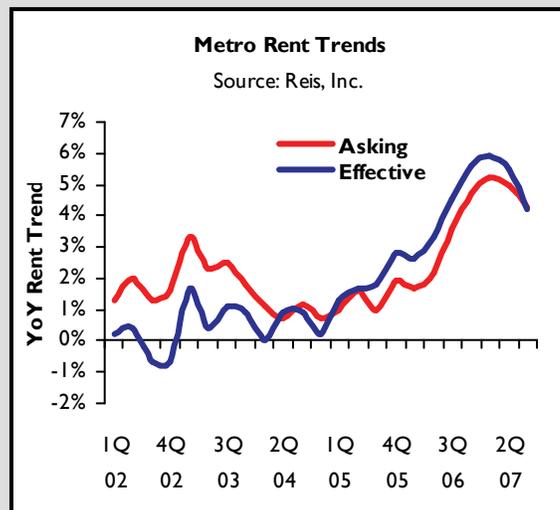
- The metro vacancy rate increased 10 basis points to 5.7% in 3Q07. The increase was attributable to negative net absorption of 37 units. No completions or condo conversions were recorded.
- Vacancy fell 20 basis points year-over-year, owing largely to robust demand in the first quarter. Positive net absorption totaled 222 units in the twelve-months ended in September and 140 units in 1Q07.
- Reis forecast vacancy to decline 40 basis points in 4Q07 to 5.3%. The projection implies net absorption of 182 units. In 2008, the service expects a 30 bps of improvement due to limited supply (55 unit completions) and steady demand (242 units absorbed). Completions are anticipated to increase to an average of 696 units annually from 2009 to 2011, raising the potential for static or declining occupancy.



## RENT TRENDS

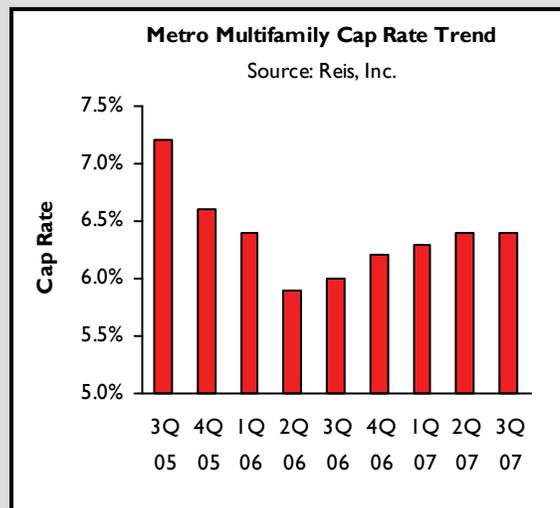
- Effective rents increased 0.5% sequentially and 4.2% year-over-year to \$600 in 3Q07. Asking rents grew at a moderately faster 0.6% sequential pace. The average asking rent was \$633 in 3Q07, up 4.3% from the comparable period last year.
- The value of the average concession package was 5.3% of asking rent. This is below the 5.7% RED 50 average and approximately equal to 0.6 months free-rent on a twelve month lease.
- Reis forecast year-over-year effective rent growth to decelerate to 3.4% in 4Q07 before rising to 3.6% in 2008.

**COMMENT:** Reis expect effective rent growth in Tucson to average 3.6% annually from 2007 to 2011.



## PROPERTY MARKET & CAP RATE TREND

- According to Reis, four apartment complexes traded in 3Q07, totaling \$83 million in sales proceeds. This compares to 11 trades and \$127 million in volume in the same period of 2006. The median cap rate was 5.4% in 3Q07, down from 6.6% in 3Q06.
- Loopnet identified three apartment sales involving properties priced at or above \$5 million in 3Q07. Sales volume totaled \$74.7 million and the average per unit price was \$82,558.
- The most expensive trade involved a 304-unit Class A asset located in the Pantano submarket. The buyer paid \$34,650,000 or \$113,980 per unit. Reis estimate a 3.7% initial yield.

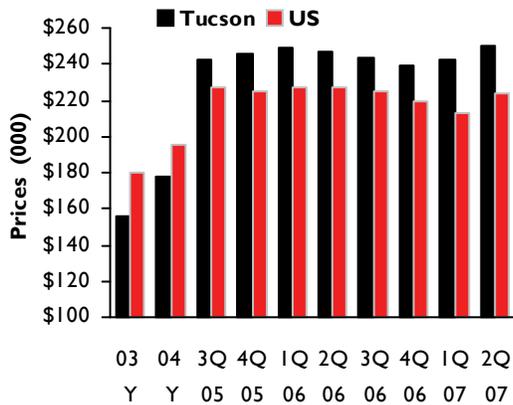


## NOTABLE TRANSACTIONS

Property Name	Property Class	Date of Transaction	Total Price (in millions)	Price per unit	Estimated Cap Rate
Wilmot Vista Apartments	BC	October 2007	\$8.7	\$43,909	5.7%
Arcadia Garden Apartments	A	October 2007	\$13.0	\$64,815	6.0%
7700 Place	BC	August 2007	\$15.6	\$51,786	6.1%
The Retreats at Speedway	A	July 2007	\$34.7	\$113,980	3.7%

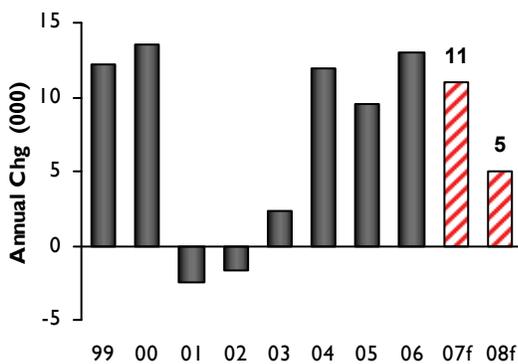
### Metro Median Single Family Home Prices

Source: National Association of Realtors



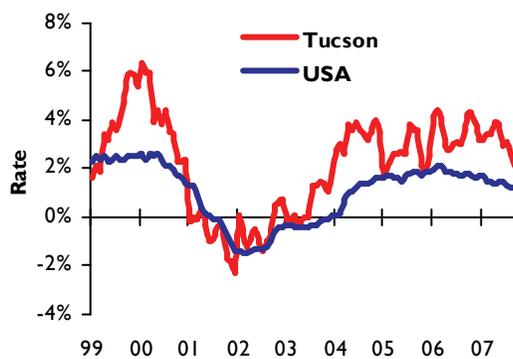
### Payroll Employment Growth

Source: BLS Data & RCG Research Forecast



### Year-over-year Payroll Growth Rate

Source: BLS



## DEMOGRAPHICS & HOUSING MARKET

- Metro population increased 2.3% in 2007, up from the 2.1% growth rate recorded in 2005. The advance was attributable to increased net domestic and international migration.
- According to the National Association of Realtors, the median price of a single-family home in Tucson rose 1.1% year-over-year in 2Q07 to \$250,100. The source estimated a 10.2% decline in the median condo price from \$171,200 to \$153,800.
- The median price increased 0.5% y-o-y to \$244,800 in 3Q07 (NAR).
- DataQuick report a median sale price of \$218,226 for all homes in 3Q07. This represents a 3.0% decrease, year-over-year. Sales velocity fell 31.6%, according to the source.

## EMPLOYMENT TRENDS

### Past 12 Months

- Payroll employment in Tucson rose 8,100 (2.1%) year-over-year in September, the weakest month since November 2005.

### Third Quarter 2007

- The pace of job growth slowed to 9,800 (2.6%) year-over-year in 3Q07. The metro posted gains of 12,600 (3.3%) and 13,400 (3.5%) in 1Q07 and 2Q07, respectively.
- The slowdown is largely attributable to weakness in the housing market. Year-over-year hiring among construction contractors slowed through 1H07 and a net of 1,100 job losses were recorded in 3Q07. This compares to 2,300 hires in the same period last year.
- Reduced mortgage origination volume contributed to payroll attrition among financial activities firms. Third quarter finance employment fell 500 year-over-year, the sectors first losses since 1Q05.
- Information sector establishments lost 1,000 employees year-over-year in 3Q07. Sector attrition averaged 200 in 2006.
- Lower paying sectors such as retail trade and leisure and hospitality services experienced an up-tick in employment. Combined, the sectors accounted for 2,300 net new jobs in 2006 and 4,500 year-over-year in 3Q07.

### Forecast

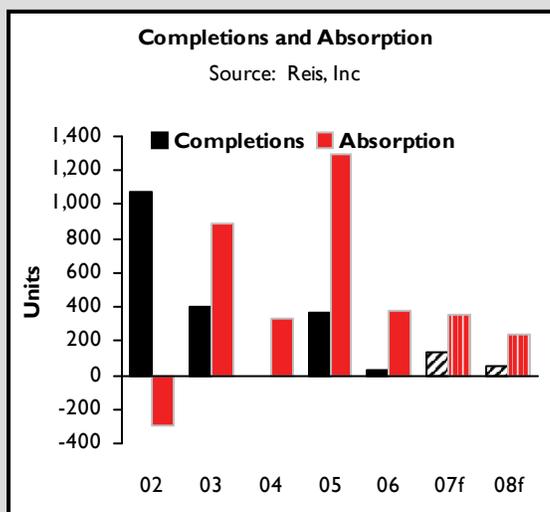
- **RED** forecast job growth to range from 10,000 (2.6%) to 11,100 (2.9%) in 2007. Our econometric model generates a point estimate of 10,600 (2.8%) jobs.
- In 2008, **RED** expect payroll growth to decelerate to approximately 5,000 (1.3%), with a confidence interval of 3,000 (0.8%) to 8,000 (2.0%).

## SUBMARKET TRENDS

Submarket	Effective Rent			Physical Vacancy		
	3Q06	3Q07	Change	3Q06	3Q07	Change
South / Southwest Tucson	\$498	\$514	3.2%	5.5%	6.6%	110 bps
Flowing Wells / West Tucson	\$551	\$584	6.0%	6.2%	7.0%	80 bps
Central / University	\$594	\$613	3.3%	6.4%	4.9%	-150 bps
East Tucson	\$509	\$535	5.1%	6.3%	4.8%	-150 bps
Pantano	\$560	\$587	4.8%	6.0%	5.5%	-50 bps
Catalina	\$682	\$675	-1.1%	7.4%	10.0%	260 bps
North / Northwest Tucson	\$675	\$696	3.1%	4.6%	4.5%	-10 bps
<b>Metro</b>	<b>\$576</b>	<b>\$600</b>	<b>4.2%</b>	<b>5.9%</b>	<b>5.7%</b>	<b>-20 bps</b>

## SUPPLY TRENDS

- No units were completed in Tucson in 3Q07 and Reis expect the same in 4Q07. The service expects light supply of only 55 units next year.
- Starting in 2009, Reis forecast average annual completions of 696 units through 2011. On the other hand, the service counts only 119 apartment units in the planned / proposed stage. In addition, only 125 multifamily permits were issued in the 12-month period ended in September, a 72% decrease year-over-year.
- Three project were recently completed in the North / Northwest submarket. One of which was an apartment community offering 138 units (one, two and three bedrooms). Another property, containing 65 units, offers assisted living and Alzheimer's care services. The third development is a 218-unit condo project (asking price of \$200,000 but offering \$10,000 savings).



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November 2006

## EXECUTIVE SUMMARY

**E**mployment growth accelerated in 3Q06, averaging year-over-year growth of 18,400 or 5.1%. By comparison, growth in 1H06 averaged 15,000 or 4.1% and growth in 2005 totaled 5,700 or 1.6%. **RED** forecast payroll growth to reach 17,000 or 4.6% in 2006.

Recent vigor is attributable to faster growth in the retail sales and professional and business service sectors. Retail employment increased 7.3% in 3Q06, accounting for 16.0% of total payroll growth. Growth in 1H06 was less spectacular, averaging 3.7% year-over-year. Professional and business service payrolls increased 7.1% y-o-y in 3Q06, 50 basis points above the 1H06 growth rate of 6.6%.

Metro unemployment (seasonally adjusted) fell 80 bps year-over-year and 40 bps from 1H06 to 3.9%. The unemployment rate in the city of Tucson was moderately higher at 4.5%.

**RED** forecast payroll growth between 9,000 and 15,000 in 2007 with a point estimate of 12,000 (3.1%). The relatively wide forecast range is attributable to historic payroll growth volatility and recent cyclical behavior.

Occupancy increased 70 bps y-o-y to 94.1%. The occupancy improvement resulted from the loss of 4.5% of apartment inventory to condo conversion. On a sequential quarter basis, occupancy trended downward 40 bps from 94.5%, due to negative net absorption of 211 units and no condo conversions.

Future occupancy gains hinge on demand growth rather than condo conversions. The Arizona Department of Economic Security forecast population growth acceleration of 40 bps (to 2.4%) through 2007, which will boost demand. In addition, home price ap-

preciation and sales velocity slowed in 3Q06, indicating that many new residents chose to rent rather than buy.

Reis forecast vacancy to increase 20 bps in 4Q06 to 6.1%. In 2007, Reis project a more active leasing period to allow vacancy to fall 70 bps to 5.4% by YE07.

Effective rents increased 4.5% between 3Q05 and 3Q06 to \$576. Asking rents increased 3.6% over the period. Concessions declined for seven consecutive quarters to an average of 5.1% of asking rent in 3Q06.

Reis anticipate the trend of healthy rent growth to continue through 2007. The service forecast effective rent growth of 4.7% in 4Q06 and 4.5% in 4Q07. Constrained supply growth and healthy absorption contribute to this forecast.

Property trading activity was dominated by condo converters over the past couple of years, putting downward pressure on cap rates. The reduction in conversion activity and improving NOI lead to the first increase in going-in yields for the metro in years. Reis estimate cap rates averaged 6.0% in 3Q06. Trade data suggest 3Q06 yields for investor grade units are slightly lower at 5.9% but are up 70 bps from 5.2% in 2Q06. **RED** anticipate cap rates will continue to increase through 2007 as prices moderate in the absence of converter bids and NOI gains accelerate. Given the market fundamentals and recent cap rate decompression **RED** assign a rating of “*Accumulate*” to Tucson. Development is also a good option in Tucson as population growth will remain strong and conversion activity reduced inventories by 4.5% over the past four quarters.

## SNAP SHOT

	Y-o-y change	Projected 2007
Vacancy (5.9% - 3Q06)	↓ 70bps	↓ 50bps
Effective Rents (\$576 - 3Q06)	↑ 4.5%	↑ 4.5%
Cap Rate (6.0% - 3Q06)	↓ 120bps	↑ up
Employment (380.8k - 3Q06)	↑ 18.4k	↑ 12.0k

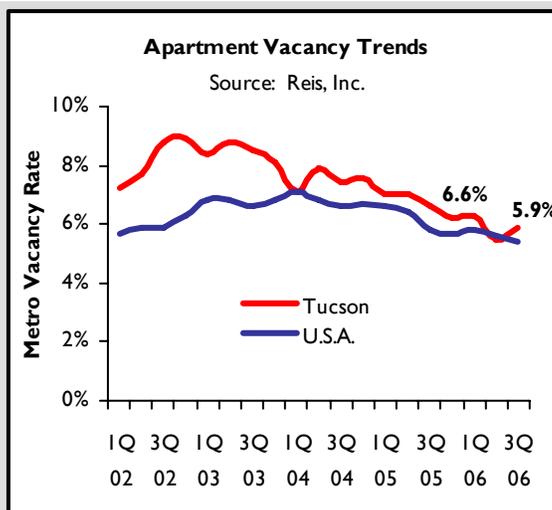
## KEY POINTS

- Vacancy fell 70 basis points year-over-year to 5.9%. On a sequential quarter basis, however, vacancy increased 40 basis points due to negative net absorption of 211 units.
- Effective rent growth soared to 4.5%, more than twice the rate of growth achieved in 3Q05 (1.8%). Asking rents increased 3.6% year-over-year, an increase of \$21.
- The Reis cap rate index increased 10 basis points between 2Q06 and 3Q06 to 6.0%. Nevertheless, year-over-year cap rates were down 120 basis points from 7.2%.
- **RED** forecast payroll growth of 16,000 in 2006. In 2007, **RED** anticipate job creation to total 12,000, with a downside scenario of 9,000 new jobs.

## VACANCY TRENDS

- Vacancy fell 70 basis points between 3Q05 and 3Q06 from 6.6% to 5.9%. The improvement is primarily attributable to the conversion of 2,662 apartment units (equal to 4.5% of 3Q05 inventory) to condo.
- On a sequential quarter basis, vacancy increased 40 basis points, resulting from negative net absorption of 211 units and no condo conversion activity.
- Reis project weak absorption and modest unit deliveries to increase vacancy 20 basis points by year end. In 2007, Reis project improving demand and limited new supply to push vacancy down 70 basis points to 5.4%.

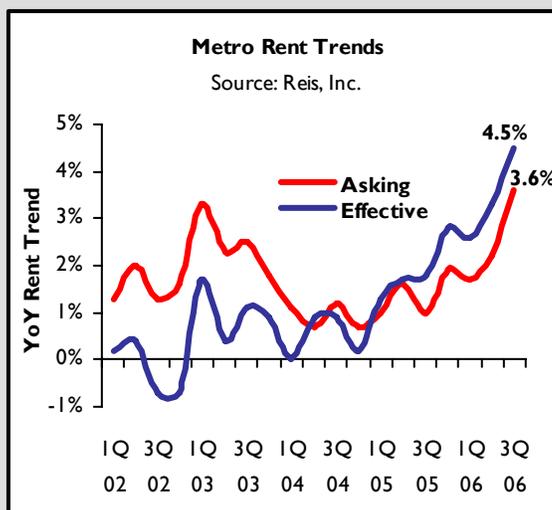
**2007 VACANCY RATE OUTLOOK:** Decreasing



## RENT TRENDS

- Effective rents increased \$25 or 4.5% year-over-year to \$576. Asking rents grew at a moderately slower rate of 3.6% (\$21) over the past twelve months.
- Increases in effective rents outpaced asking rent growth for the seventh consecutive quarter, decreasing the average concession package to 5.1% of asking rent, the equivalent of \$31.
- Reis anticipate effective rent growth of 4.7% in 4Q06 and 4.5% in 4Q07. Taking into account projected vacancy declines, Reis anticipate average revenues per unit to increase 4.8% between 4Q06 and 4Q07 from \$550 to \$576.

**2007 RENT GROWTH RATE OUTLOOK:** Stable

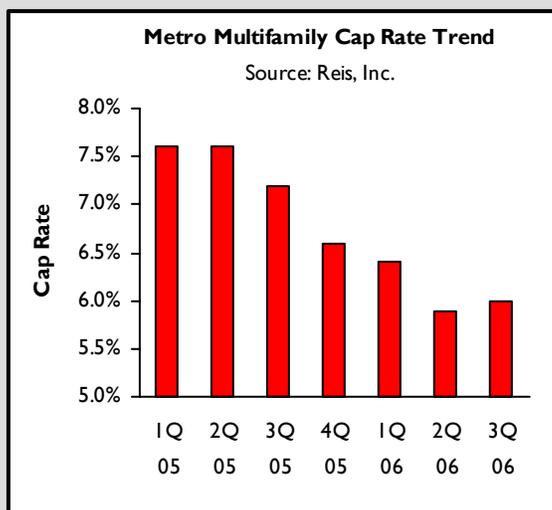


## PROPERTY MARKET & CAP RATE TREND

- The metro average cap rate increased 10 basis points between 2Q06 and 3Q06 from 5.9% to 6.0%, the first increase since 3Q04. On a year-over-year basis cap rates fell 120 basis points.
- Transaction data indicate that investor grade properties traded at an average cap rate of 5.9% in 3Q06, up from 5.2% in 2Q06. Prices per unit decreased between 2Q06 and 3Q06 averaging \$66,252 and \$53,720, respectively.
- The North / Northwest Tucson submarket garnered the most investor interest over the past twelve months as eleven properties traded hands.

**2007 CAP RATE OUTLOOK:** Increasing

The reduction in condo conversion activity caused slower trading velocity, decreased prices and increased going-in yields.

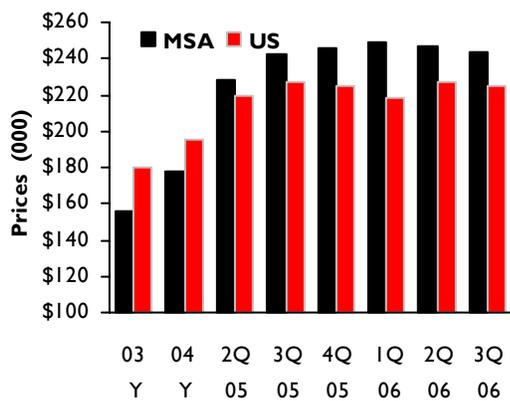


## NOTABLE TRANSACTIONS

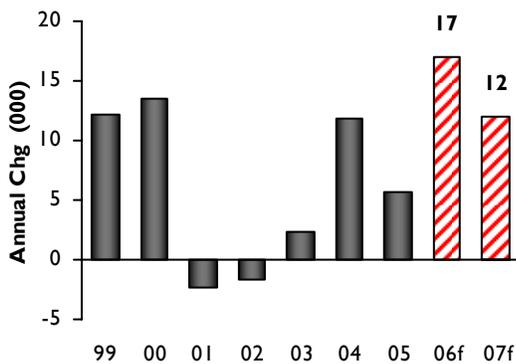
Property Name	Property Class	Date of Transaction	Total Price (in millions)	Price per unit	Estimated Cap Rate
Meridian East Apartments	A	October 2006	\$15.8	\$50,479	6.8%
Arcadia Park Apartments	A	October 2006	\$16.8	\$58,160	5.2%
Property Portfolio	N/A	September 2006	\$57.4	\$39,911	6.7%
Copper Star Apartments	A	September 2006	\$5.8	\$66,860	4.7%

**Metro Median Single Family Home Prices**

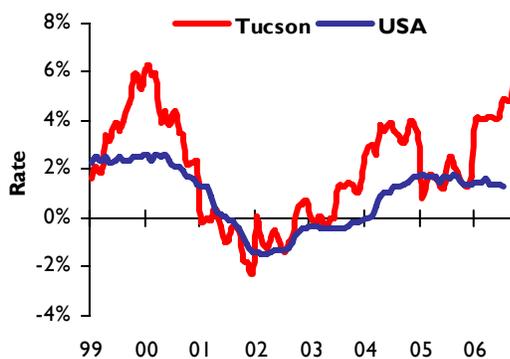
Source: National Association of Realtors

**Payroll Employment Growth**

Source: BLS Data &amp; RCG Research Forecast

**Year-over-year Payroll Growth Rate**

Source: BLS

**DEMOGRAPHICS & HOUSING MARKET**

- Metro population increased 2.0% between 2004 and 2005, adding 18,246 to the population base. The Arizona Department of Economic Security forecast metro population to increase 2.4% annually through 2007.
- The rate of homeownership increased 560 basis points since 2000 to 66.1%. The national homeownership rate is 68.9%
- The median price of a single family MSA home increased 0.6% year-over-year to \$243,700 in 3Q06. The median condo price decreased 0.6% over the period.

**2007 DEMOGRAPHIC OUTLOOK: Increasing**

The Arizona Department of Economic Security forecast an increasing rate of population growth through 2007.

**EMPLOYMENT TRENDS****Past 12 Months**

- Payroll growth fell to 5,700 jobs (1.6%) in 2005, down from 11,900 or 3.4% in 2004.
- Over the past twelve months, payroll growth averaged 13,500 or 3.7%.

**Year-to-Date**

- In 3Q06 payrolls averaged 380,800, an increase of 18,400 (5.1%) year-over-year. In 1H06, growth averaged 15,000 (4.1%).
- Retail sales employment growth accelerated adding 2,900 jobs (7.3%) in 3Q06 (accounting for 16.0% of total payroll growth) compared to the average growth 1,500 jobs (3.7%) in 1H06 (accounting for 9.9% of total payroll growth).
- Professional and business service employment followed a similar trend, increasing 7.1% in 3Q06 and 6.6% in 1H06. In 2005, growth in the sector averaged 5.5%.

**Forecast**

- **RED** forecast payroll growth between 16,000 (4.4%) and 18,000 (4.9%) in 2006.
- In 2007, **RED** anticipate payroll growth between 9,000 (2.4%) and 15,000 (3.9%).
- The forecast range for 2007 is wide relative to the size of the regional economy due to recent employment growth volatility.

**2007 EMPLOYMENT GROWTH RATE OUTLOOK: Increasing**

## SUBMARKET TRENDS

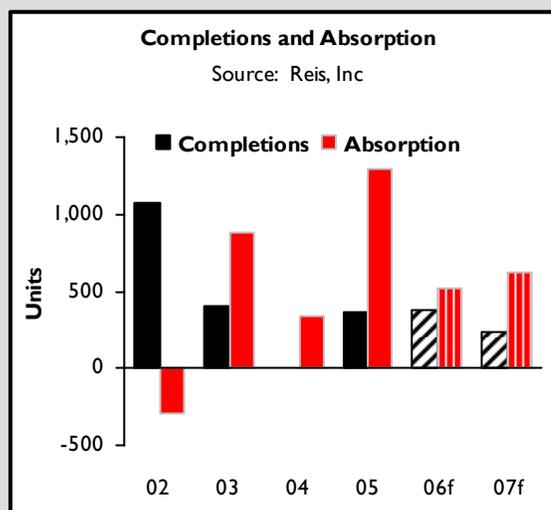
Submarket	Effective Rent			Physical Vacancy		
	3Q05	3Q06	Change	3Q05	3Q06	Change
South / Southwest Tucson	\$473	\$498	5.3%	5.8%	5.5%	-30 bps
Flowing Wells / West	\$519	\$551	6.2%	7.6%	6.2%	-140 bps
Central / University	\$565	\$594	5.1%	7.5%	6.4%	-110 bps
East Tucson	\$493	\$509	3.2%	6.7%	6.3%	-40 bps
Pantano	\$537	\$560	4.3%	6.0%	6.0%	unch
Catalina	\$644	\$682	5.9%	8.6%	7.4%	-120 bps
North / Northwest Tucson	\$640	\$675	5.5%	5.8%	4.6%	-120 bps
<b>Metro</b>	<b>\$551</b>	<b>\$576</b>	<b>4.5%</b>	<b>6.6%</b>	<b>5.9%</b>	<b>-70 bps</b>

## SUPPLY TRENDS

- Fewer units were delivered between 2003 and 2005 (768) than were completed in 2002 (1,070).
- Year-to-date only 25 units were delivered in the metro. The units are contained in a community called Academy Lofts, located in the Central Tucson / University North submarket.
- There are 591 units currently under construction, 356 of which will reach the lease-up phase in 4Q06. The remaining 235 are slated for delivery in 2006.
- Over the next five quarter 400 units will be added to inventory in the North / Northwest submarket.

### 2007 SUPPLY TREND OUTLOOK: Small Decrease

Reis project continued slow supply growth in the metro as inventories will increase by 1.0% over the next five quarters.



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