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Job growth to push rents higher this year - Tight capital markets driving multifamily values

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In southwestern Connecticut, improving economic conditions have yielded only modest changes in apartment fundamentals. Both the Fairfield and New Haven MSAs posted job growth during the first quarter, an event that has not occurred in both areas since the fourth quarter of 2007. Additionally, vacancy rates in each metro remained steady in the quarter, and rents increased modestly. While the apartment market recovery will gain momentum in the second half of the year, consecutive quarters of job creation will be required to spur household formation and buoy housing demand. Further, stabilized vacancy during the first quarter can be attributed partly to a lack of major apartment deliveries since mid-2009. While builders will ramp up completions through the rest of the year, increasing competition for renters, deliveries will be concentrated in the Fairfield West submarket, placing only mild pressure on operations in non-neighboring submarkets. Although investment activity remains at depressed levels in the Fairfield and New Haven Counties, local buyers continue to make acquisitions, capitalizing on decreased competition due to a smaller pool of investors. The median price has increased in both counties over the past year, though the gains are likely attributable to tight lending; constrained debt markets have caused buyers to focus on smaller properties, which generally trade at higher per-unit prices. In transactions made in Fairfield County during the last year, the average deal size was nine units, compared with 38 units in the preceding 12 months, while the median price surged 36%. In the two major on-market transactions involving assets with eight or more units conducted during that time, the median price was \$96,070 per unit, 7% below the previous year's median. Similarly, in New Haven County, the average sold property size has plummeted 73% year over year to 40 units. The median price, meanwhile, has climbed due to smaller property sizes, more upper-tier asset sales and milder rent declines.

Although the recovery has been slow to start in the Hartford metro area, economic headwinds have begun to diminish, and payroll growth should resume by year end. In the first quarter, local employers shed more than 3,000 jobs, weighed down by the manufacturing and professional and business services industries, which have eliminated a total of 7,100 positions in the past year. Nevertheless, gains have been recorded in the leisure and hospitality and education and health services sectors, while trade, transportation and utility employers will likely begin hiring again in the second quarter. The education and health services and trade, transportation and utilities industries comprise more than one-third of all jobs in the metro, and growth in these segments will eventually fuel expansion in other sectors. The steadying economy has already affected apartment operations, as vacancy was a relatively tight 5.7% in the first quarter and should inch down further as the year progresses. Additionally, asking and effective rents, both of which fell 0.4% last year, will increase by more than 1% in 2010. Renter demand will remain strongest in the North/West Hartford submarket, where healthy demand for top-tier units and a metro-leading median household income

of \$106,560 annually will continue to suppress vacancy rises and accelerate rent growth. Economic uncertainty and tight capital markets have limited multifamily investment activity in the Hartford market, but resilient pricing levels also have constrained deal flow. Sales prices have held steady over the past two years, as owners have been reluctant to offer discounts in light of modest rent declines. Nevertheless, prices are expected to dip in the coming quarters due to previous revenue decreases and soft investor demand. Cap rate rises should be modest among Class A assets, however, where operating fundamentals have begun to improve quickly since the start of 2010.

Employment: Southwestern Connecticut employers will add 8,200 positions in 2010, a gain of 1.1%. Economic headwinds drove local businesses to trim 45,600 jobs last year. Hartford employers will add 3,400 jobs to head counts in 2010, growth of 0.5%. Last year, 4,600 positions were eliminated.

Construction: Southwestern Connecticut - As construction activity picks up over the remainder of the year, a total of 810 rental units will come online. Approximately 360 units were added to local apartment inventory in 2009. Hartford Region - Deliveries made during the second and third quarters will lift annual apartment completions to 225 units this year. In 2009, developers completed 70 units.

Vacancy: New Haven/Fairfield - Supply growth will increase vacancy by 20 basis points to 4.8% in 2010, after the average rate rose 60 basis points last year. Resumed hiring will bolster renter demand in the Hartford metro. In 2010, vacancy will decline 60 basis points to 5.6%, after surging 100 basis points last year.

Rents: Asking rents will tick up 0.8% to \$1,533 per month this year, and effective rents in southwestern Connecticut will gain 0.5% to \$1,448 per month. In 2009, asking and effective rents plummeted 4.5% and 6.2%, respectively. In Hartford County asking rents will advance 1% this year to \$973 per month, while effective rents will gain 1.1% to \$931 per month. Asking and effective rents slipped 0.4% and 0.2%, respectively, in 2009.

VACANCY AND RENTS

Economic contraction and subsequent shifts in renter demand have underpinned erratic vacancy trends. In the six months ending in the first quarter, vacancy increased 20 basis points to 4.6%, following a 90 basis point decline in the prior two quarters.

Asking rents have retreated 2.7% in the past year to \$1,527 per month, while effective rents have fallen 3.5% to \$1,447 per month. In the previous 12-month period, asking rents ticked 0.1% higher, though effective rents regressed 1.6%.

In both counties, weak demand has pushed down average revenues 2.8% in the last 12 months, after revenues decreased by 2.3% in the preceding year.

Outlook: In 2010, supply growth will drive up vacancy 20 basis points to 4.8%, after the rate rose 60 basis points last year. Asking rents will tick up 0.8% to \$1,533 per month, and effective rents will gain 0.5% to \$1,448 per month.

SALES TRENDS

Tight capital markets and declining revenues continue to slow investment activity. Since the first quarter of 2009, deal flow has retreated 45%, following a 37% decrease during the previous year.

An increased number of small assets trading has caused the median price to rise 6% to \$92,860 per unit over the last year. In the prior 12 months, the median price appreciated 12%.

In the past year, cap rates have increased an average of 60 basis points to the high-7% to low-8% range. Initial yields for top-quality assets start at approximately 6.5%.

Outlook: Deliveries will be concentrated in the West Fairfield County submarket this year, which will increase competition for renters and weigh on property performance in the area. Operational

challenges will, in turn, drag on revenue gains and loan underwriting, creating opportunities to acquire assets at a discount through the near term.

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