

# ApartmentResearch

M A R K E T U P D A T E

Marcus & Millichap

San Diego Metro Area

Third Quarter 2010

## BUYER DEMAND STRENGTHENING AS OPERATIONS GAIN TRACTION

San Diego apartment fundamentals will improve modestly this year, serving as a springboard to more robust revenue growth in 2011. While local operating conditions softened during the recession, vacancy never crept higher than 5 percent due to restrained construction and expensive home prices. With the local economy in the early stages of a recovery and vacancies still tight, operators no longer face significant pressure to trim rents. As a result, rents will rise modestly in the second half, followed by a period of gains more in line with the long-term average of between 3 percent and 5 percent beginning in 2011. The few areas under the greatest pressure during the recession already show improvement; vacancy in submarkets where rates were the highest, including Downtown San Diego, Mira Mesa/Rancho Bernardo and the North Beaches, inched lower in the past 12 months, with further drops anticipated through year end. The National City/Chula Vista submarket is one of the only areas where vacancy will rise in 2010, as renter demand has softened in the past year, and the delivery of more than 600 units this year will result in a short-term supply glut.

While many owners who retained assets through the downturn will be slow to list, investors will respond to improving apartment fundamentals by modestly increasing acquisition activity. This trend began to take shape in the first half of this year, as sales velocity outpaced the levels set in both the first and second halves of 2009 and should continue to inch up, barring any significant change in interest rates or financing availability. Cap rates range from 5.5 percent for best-of-class assets in top submarkets, to above 7 percent for lesser properties. While distressed assets are filtering through the market, there will not be a significant number of bank-owned properties changing hands. Instead, the investment market will become increasingly driven by sales of performing properties as NOIs tick higher and the buyer/seller expectations gap narrows. Areas such as Uptown San Diego, University Park and Balboa Park will likely record an increase in listings and closings as investor momentum builds.

## 2010 ANNUAL APARTMENT FORECAST



**Employment:** Local payrolls will expand by 1.8 percent this year with the addition of 22,000 workers. The unemployment rate will remain elevated, however, as more than 100,000 jobs were slashed during the recession.



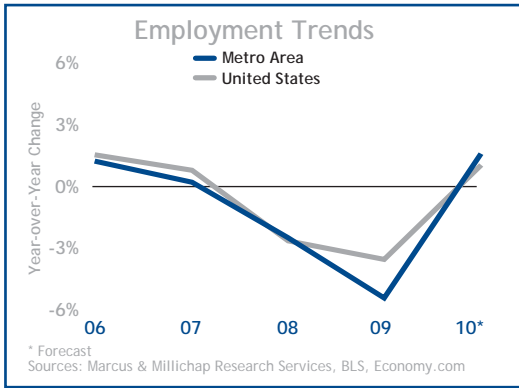
**Construction:** Deliveries will accelerate to 1,300 units in 2010, after 884 apartments came online last year. New rentals will increase apartment inventory by 0.7 percent.



**Vacancy:** The metrowide vacancy rate will end the year at 4.8 percent, 10 basis points lower than at the close of 2009. Accelerating completions in the second half will offset strengthening renter demand.

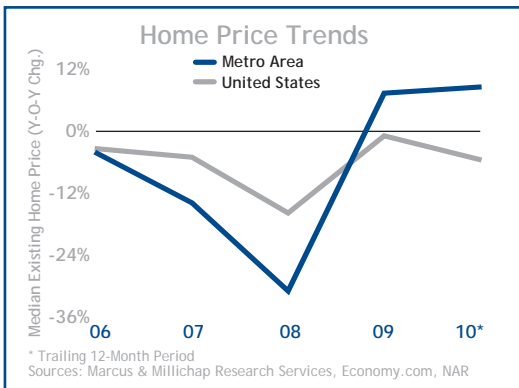


**Rents:** Asking rents will tick up 2.1 percent to \$1,334 per month this year, while effective rents will advance 2.5 percent to \$1,280 per month. These gains will not completely offset losses incurred in 2009, when asking and effective rents slipped 2.8 percent and 4.1 percent, respectively.



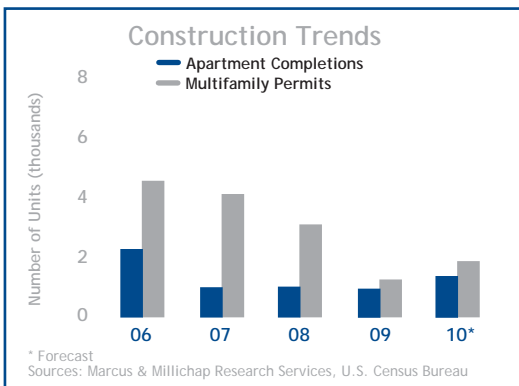
## ECONOMY

- ◆ Employers expanded payrolls during the first six months of this year, adding 15,000 workers. Recent gains were exceeded by losses in the second half of 2009, however; in the past year, payrolls contracted 0.5 percent with the elimination of 5,800 positions.
- ◆ Employment growth has been strongest in the professional and business services sector, which expanded by 4,200 positions in the first half. Another 2,000 positions are forecast for addition by year end, contributing to annual growth of 3.2 percent.
- ◆ Early in the third quarter, software company Solera Holdings announced plans to relocate its San Diego headquarters to the Dallas/Fort Worth area. The move will not likely have a significant short-term impact on local employment, however, as many of the company's 165 workers are expected to remain in San Diego.
- ◆ **Outlook:** Local payrolls will expand by 1.8 percent this year with the addition of 22,000 workers. The unemployment rate will remain elevated, however, as more than 100,000 jobs were slashed during the recession.



## HOUSING AND DEMOGRAPHICS

- ◆ Developers pulled permits for 2,250 single-family units during the past year, up 17 percent from the low levels one year earlier. Permits for only 1,270 units of multifamily housing were issued in the last 12 months, a 25 percent drop from the preceding year.
- ◆ The monthly mortgage payment for a median-priced single-family home in San Diego is approximately \$275 higher than the average Class A asking rent and remained relatively steady for the past 12 months.
- ◆ Population growth in the key renter age cohort, those aged 20 to 34, will reach approximately 2 percent during the next 12 months, providing a boost to renter demand. In the past year, the segment grew 1.1 percent.
- ◆ **Outlook:** While the monthly mortgage payment for single-family homes remains higher than metrowide rents, the mortgage payment on a median-priced condo is approximately \$500 per month less than the average Class A rent. This could encourage some renters of high-end apartments to transition into for-sale housing if interest rates remain low.

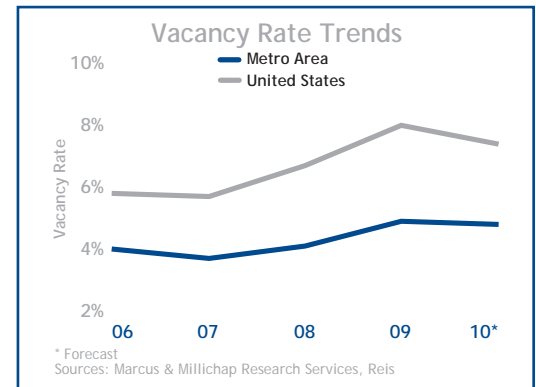


## CONSTRUCTION

- ◆ Approximately 1,200 apartments were delivered in the past year, more than half of which came online in the first half of 2010. Completions in the year-earlier period totaled 890 units.
- ◆ Projects consisting of 1,020 units are under way, although some rentals will not debut until 2011.
- ◆ While only a few complexes have broken ground, the development pipeline consists of more than 4,500 rental units, some of which will likely begin construction as the economy improves and vacancy tightens.
- ◆ **Outlook:** Deliveries will accelerate to 1,300 units in 2010, after 884 apartments came online last year. New rentals will increase apartment inventory by 0.7 percent.

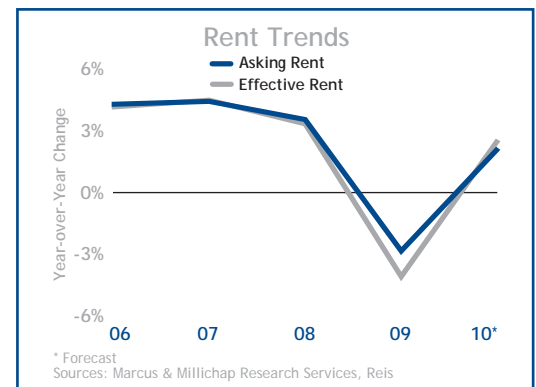
## VACANCY

- ◆ Vacancy was flat the first half at 4.9 percent. After renter demand waned early in the recession, net absorption was positive in each of the past four quarters, although completions have been in line with increasing demand, keeping the vacancy rate relatively steady.
- ◆ Class A vacancy remained unchanged year to date at 5.8 percent and is also flat from one year ago. While the vacancy rate among top properties has yet to improve, demand persists; net absorption was positive in each of the past five quarters as renters moved into newly built units.
- ◆ The vacancy rate in the metro's Class B/C properties declined 10 basis points year over year and 20 basis points thus far in 2010 to 4.1 percent.
- ◆ **Outlook:** The metrowide vacancy rate will end the year at 4.8 percent, 10 basis points lower than at the close of 2009. Accelerating completions in the second half will offset strengthening renter demand.



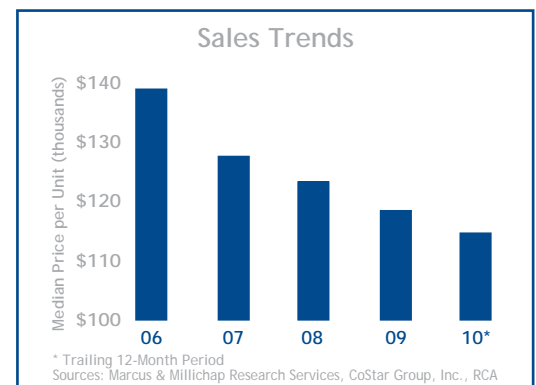
## RENTS

- ◆ Asking rents gained 0.2 percent in the first half reaching \$1,309 per month, while effective rents rose 0.6 percent to \$1,256 per month. Asking and effective rents are up 1.2 percent and 1.3 percent, respectively, year over year. During the first half of 2009, asking rents fell 3.8 percent, and effective rents plummeted 4.8 percent.
- ◆ New-space premiums buoyed Class A asking rents, which advanced 1.1 percent during the last year to \$1,666 per month. During the same period, asking rents in the lower tiers dipped 0.5 percent to \$1,131 per month.
- ◆ Modest rent gains drove up average revenues 1.4 percent during the past 12 months. Similar NOI growth is likely for the remainder of this year, and more robust increases will be recorded beginning in 2011.
- ◆ **Outlook:** Asking rents will tick up 2.1 percent to \$1,334 per month this year, while effective rents will advance 2.5 percent to \$1,280 per month. These gains will not completely offset losses incurred in 2009, when asking and effective rents slipped 2.8 percent and 4.1 percent, respectively.



## SALES TRENDS\*\*

- ◆ During the past 12 months, sales velocity retreated 5 percent. Activity is gaining momentum, however, as the number of deals closed in the first half of 2010 was 9 percent higher than in the same period last year.
- ◆ The median price dipped 5 percent year over year to \$114,600 per unit as modest rent declines weighed on prices. The median price has fallen approximately 17 percent from the peak achieved in 2006.
- ◆ Cap rates for traditional investment transactions average in the low-6 percent range, similar to last year's levels. Initial yields in REO deals or properties with significant deferred maintenance are more volatile, with some bank-owned assets changing hands above 8 percent. These transactions make up only a small share of all property sales.
- ◆ **Outlook:** Improving investor sentiment has led to increased sales velocity. As more buyers return to the market and rents begin to inch higher, prices will stabilize and the buyer/seller expectations gap will narrow.



\*\* 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

- ◆ Mixed economic indicators, stock market volatility and concerns surrounding the European debt crisis continue to drive investors to safety. As a result, the yield on the 10-year U.S. Treasury has declined since peaking at 4 percent in April; as of late July, the yield had fallen to 3 percent.
- ◆ Capital markets loosened over the past year, with life insurance companies ramping up lending and CMBS showing renewed signs of life. Nonetheless, the agencies remain the dominant sources of multifamily lending. This trend will continue through 2010 as the GSEs' multifamily portfolios outperform their residential mortgage operations, reducing the likelihood of drastic government-mandated changes to their apartment lending arms.
- ◆ Multifamily loan originations increased 37 percent in the second quarter but remained below levels reported during the same period last year. Fannie Mae and Freddie Mac's origination volume followed a similar pattern, rising in the second quarter but falling short of year-earlier levels.
- ◆ Loan-to-values range from 60 percent to 75 percent for portfolio lenders and push up to around 80 percent for best-of-class, agency-financed deals. All-in rates for five-year agency loans fall into the low-4 percent range, while 10-year loans price between 4.75 percent and 5.15 percent. While life companies will compete at these levels for best-of-class deals, most portfolio lenders are 100 basis points to 225 basis points higher.

## SUBMARKET OVERVIEW

- ◆ The competitive impact of condos employed as rentals is easing in the Downtown San Diego submarket. Class A vacancy in the area declined 200 basis points in the past year to 6.9 percent, including a 110 basis point drop in the first half of 2010.
- ◆ Renter demand for Class B/C apartments in the Escondido/San Marcos submarket will likely accelerate in the second half, with as many as 10 retailers opening locations. The area's Class B/C vacancy rate ended the second quarter at 4.9 percent, unchanged from one year earlier.
- ◆ The first half delivery of the 237-unit Alterra at Grossmont Trolley project was the largest addition to inventory in the La Mesa/Spring Valley/Lemon Grove submarket in more than a decade. The increase to stock drove up the Class A vacancy rate in the submarket to 8.8 percent in the second quarter.

## SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	Balboa Park/West of I-15	3.3%	-30	\$1,000	-0.5%
2	El Cajon/Santee/Lakeside	3.3%	-50	\$988	1.3%
3	National City/Chula Vista	4.0%	30	\$1,129	2.1%
4	Ocean Beach/Point Loma Boulevard	4.2%	0	\$1,232	0.7%
5	Escondido/San Marcos	4.5%	-80	\$1,052	0.4%
6	Mission Bay/Pacific Beach	4.5%	170	\$1,478	4.4%
7	Vista	4.7%	-40	\$1,129	0.4%
8	La Jolla/University City	5.0%	50	\$1,646	1.0%
9	North Beaches	5.0%	-40	\$1,479	0.2%
10	Oceanside	5.0%	30	\$1,163	0.7%