

ApartmentResearch

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

Marcus & Millichap

San Francisco Metro Area

Third Quarter 2010

INVESTORS' QUALITY PREFERENCE DRIVING ACQUISITIONS

Renter demand for San Francisco apartments, particularly those in the city's better areas, gained momentum ahead of employment growth, setting the stage for a strong rebound in fundamentals as the local economy firms. Four consecutive quarters of positive net absorption steadied metrowide vacancy, although the rate remains only slightly lower than its decade high. After mixed monthly employment performance in the first half of 2010, local employers will increase head counts modestly over the remainder of the year before making more robust additions in 2011. Even mild payroll growth, coupled with decelerating apartment completions, will cause vacancy to tighten. As demand picks up and vacancy improves in the second half, operators will postpone raising rents until clear signs of an economic recovery emerge. Operations will improve most rapidly in the city, while vacancy rates could rise slightly in suburban areas of Marin and San Mateo counties. Falling office rents may prove to be a driver of renter demand in the short term; as firms relocate to the city, employees could choose to move closer to work, particularly with apartment rents in many areas down nearly 10 percent from peak levels.

Investors will return to the San Francisco apartment market as fundamentals stabilize and low financing rates attract buyers who are finding few attractive alternative investment options. Sales activity, while still far below the levels recorded a few years ago, accelerated in the first half of 2010 and will continue to gain momentum as buyers compete for low-vacancy properties in the city's most desirable neighborhoods. Velocity has yet to increase in Marin and San Mateo counties, but prices have stabilized as the economic outlook brightened. With investor sentiment improving, cap rates could inch lower in the second half; initial yields for apartments in the best areas of the city can trade between the low-4 percent to mid-5 percent range. Properties in lesser locations trade with initial yields between 6 percent and 7 percent. Dispositions of distressed assets will likely add complexity to the market.

2010 ANNUAL APARTMENT FORECAST



Employment: Payroll expansion will resume in the second half of 2010, and metro head counts will increase by 0.5 percent, or 5,000 jobs. Additions will only partially offset losses incurred during the recession, however, including the elimination of nearly 60,000 positions in 2009.



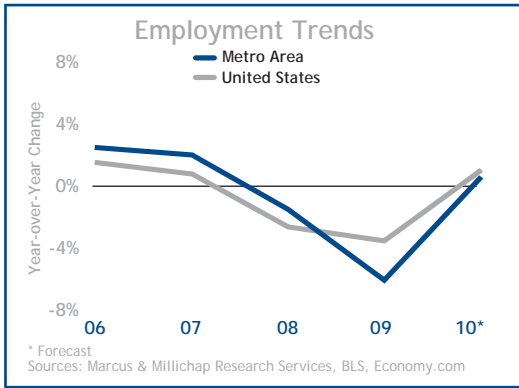
Construction: Builders will nearly double completions from last year as 900 units come online, increasing stock by 0.7 percent. The 440-unit Trinity Place complex will be the largest project to debut this year.



Vacancy: Metrowide vacancy will fall 10 basis points this year to 4.7 percent, after rising 110 basis points in 2009. More desirable areas in the city will likely fare best, while outlying neighborhoods will record modest rate increases.

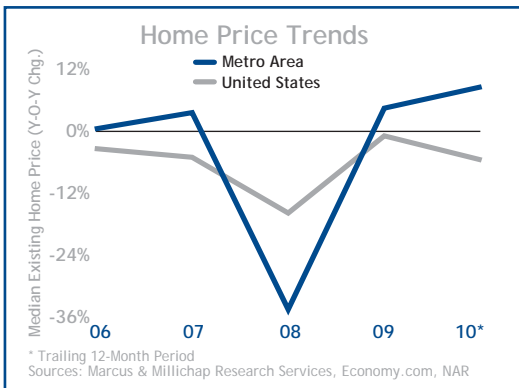


Rents: Asking rents will dip 1 percent to \$1,740 per month in 2010, while effective rents will decline 1.2 percent to \$1,626 per month.



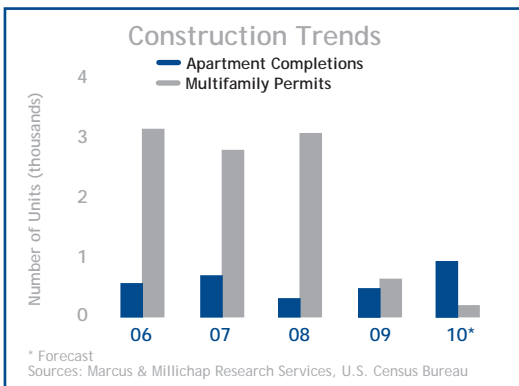
ECONOMY

- ◆ During the past 12 months, payrolls contracted by 2.4 percent, as 22,700 jobs were lost. Year to date, the employment market has been mixed, as net additions were recorded in three of the first six months of 2010.
- ◆ Year over year, each of the metro area's major employment sectors contracted. A few segments expanded in the first half of 2010, however, led by manufacturing and government, which added a total of 800 positions.
- ◆ The metro's largest employment sector, professional and business services, contracted by more than 6 percent in 2009, as 12,500 jobs were slashed. Signs of stabilization emerged in the first half of 2010, when just 200 positions were eliminated. In the second half, 1,400 professional jobs are forecast to be added.
- ◆ **Outlook:** Metro employment will increase 0.5 percent annually with the creation of 5,000 jobs. Additions will only partially offset losses during the recession, however; in 2009 alone, nearly 60,000 positions were slashed.



HOUSING AND DEMOGRAPHICS

- ◆ Space constraints and obstacles to new construction limited single-family permit issuance to just 427 units in the past 12 months, up 1 percent from one year earlier. At the height of the housing market, single-family permit issuance peaked at approximately 1,600 units annually.
- ◆ A 60 percent year-over-year decline in multifamily permit issuance to 520 units will slow future construction of apartment properties. Developers will wait until the local economy firms before accelerating permitting activities.
- ◆ Modest strengthening of the median home price in San Francisco has widened the gap between renting and owning. Through the second quarter, the mortgage payment on a median-priced metro home was \$900 per month more than the average Class A asking rent; one year earlier, the gap was \$784 per month.
- ◆ **Outlook:** A weak job market has hampered household formation and weighed on renter demand for apartments; 2010 will mark San Francisco's second consecutive year of less than 1 percent household growth, as only 6,600 new households will be formed. Gains of 1.3 percent to 1.4 percent were typical prior to the recession.

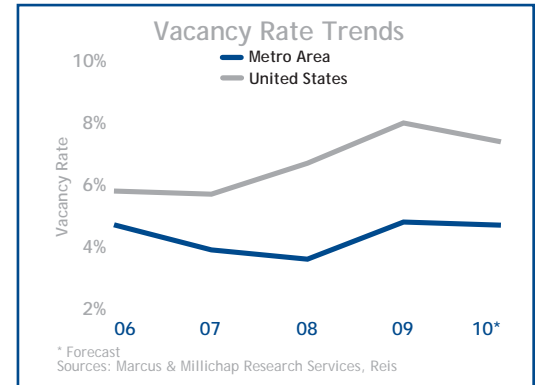


CONSTRUCTION

- ◆ During the past year, 973 market-rate apartments were completed in the MSA, of which 810 units were located within the city of San Francisco. In the preceding annual period, only 371 rentals debuted; all of these projects were located in the city.
- ◆ The 154-unit Presidio Landmark was completed early in the third quarter, featuring asking rents in the \$4 per square foot range. No other projects are scheduled to come online through the remainder of this year.
- ◆ Projects totaling more than 5,600 units are planned, including 4,650 rentals in the city. Completion of new units will likely not occur until 2012, however, as only a few developments have break-ground dates in 2010.
- ◆ **Outlook:** Builders will nearly double completions from last year as 900 units come online, increasing stock by 0.7 percent.

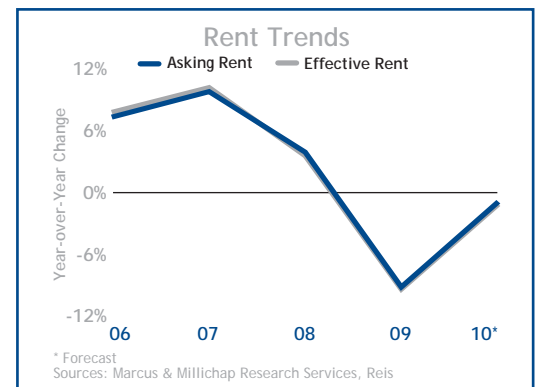
VACANCY

- ◆ Metrowide vacancy rose 20 basis points to 5 percent in the first half and was unchanged over the past 12 months. Slowing completions and resumed job growth in the second half of the year will cause vacancy to tick lower.
- ◆ While vacancy in the city of San Francisco is 20 basis points higher than one year ago at 5.6 percent, the rate should improve in the second half. In San Mateo County, the vacancy rate was just 4.6 percent at the end of the second quarter, down 20 basis points from one year earlier.
- ◆ In northern Marin County, vacancy averaged just 3.5 percent in the second quarter, 40 basis points higher than in the second quarter of last year. The county's vacancy rate will likely creep higher in the second half due to lingering soft economic conditions.
- ◆ **Outlook:** Metrowide vacancy will fall 10 basis points this year to 4.7 percent, after rising 110 basis points in 2009. More desirable areas in the city will likely fare best, while outlying neighborhoods will record modest rate increases.



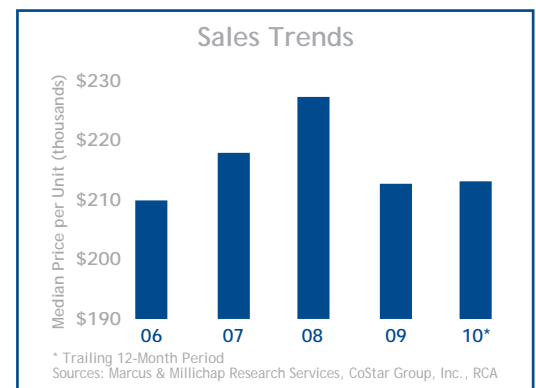
RENTS

- ◆ Average asking rents in the three-county region inched up 0.4 percent in the first half of this year, reaching \$1,764 per month. Despite the uptick, asking rents remain 3.8 percent lower than one year ago. The stabilizing trend is a stark contrast from the severe declines registered in 2009; during the first half of last year, asking rents retreated 5.2 percent.
- ◆ Effective rents rose 1 percent in the first half of 2010 to \$1,673 per month, an improvement from the 6.1 percent drop during the same period in 2009. Effective rents retreated 2.5 percent year over year.
- ◆ Average property revenues are down 2.8 percent from a year ago as a result of rent declines during the second half of 2009.
- ◆ **Outlook:** Asking rents will dip 1 percent to \$1,740 per month this year, while effective rents will recede 1.2 percent to \$1,626 per month.



SALES TRENDS**

- ◆ Sales velocity declined 10 percent during the past 12 months but slowly gained momentum in the first half of 2010, rising 3 percent from the corresponding period in 2009.
- ◆ Year over year, the median price dropped 7 percent to \$212,900 per unit, as contracting revenues and economic uncertainty weighed on prices. In deals closed in the first half of this year, the median price rose to \$214,300 per unit.
- ◆ The parameters of value continued to emerge in the second quarter in San Francisco, with an increasing number of sales, including a few distressed assets. While valuations are down from the peak, prices are far from cheap, particularly for properties in the city's best locations.
- ◆ **Outlook:** Investor sentiment for apartment properties in San Francisco should improve through the remainder of 2010 as stabilizing fundamentals, particularly in the city's better areas, fuel buyer demand.



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

Marcus & Millichap

NATIONAL MULTI HOUSING GROUP

Visit www.NationalMultiHousingGroup.com or call:

Linwood C. Thompson

Senior Vice President, Managing Director

National Multi Housing Group

Tel: (678) 808-2700

lthompson@marcusmillichap.com

Marcus & Millichap

Real Estate Investment Services

Prepared and edited by

Peter O'Neil

Senior Market Analyst

Research Services

For information on national
apartment trends, contact

John Chang

Vice President, Research Services

Tel: (602) 687-6700 ext. 6803

john.chang@marcusmillichap.com

San Francisco Office:

Jeff Mishkin

Regional Manager

jmishkin@marcusmillichap.com

750 Battery Street

Fifth Floor

San Francisco, California 94111

Tel: (415) 963-3000

Fax: (415) 963-3010

Price: \$150

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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

- ◆ More companies relocating to capture increasingly affordable office rents will likely support renter demand for apartments. Recently, for instance, Forbes announced plans to move from Burlingame to the North Financial District, which could spark demand for apartments near its new office.
- ◆ Job losses and the delivery of new stock have pushed up Class A vacancy in the South of Market area by approximately 500 basis points since year-end 2008 to 9.5 percent. Vacancy in the submarket's Class B/C inventory ended the second quarter at a still-tight 4.2 percent.
- ◆ Renter demand in less desirable areas of the city will be slow to rebound in 2010. Class B/C vacancy in the Civic Center/Downtown submarket, for example, averages 4.8 percent, 110 basis points higher than at the end of 2009 and up more than 200 basis points from the area's pre-recession average.

SUBMARKET VACANCY RANKING

Rank	Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Effective Rents	Y-O-Y % Change
1	North Marin	3.0%	-20	\$1,341	-1.1%
2	Marina/Pacific Heights	3.2%	-20	\$2,025	-2.8%
3	South San Mateo	3.3%	-100	\$1,409	-4.0%
4	Central San Mateo	3.6%	-70	\$1,571	-5.3%
5	South Marin	3.7%	70	\$1,631	0.1%
6	Haight-Ashbury	4.5%	20	\$1,743	-2.1%
7	Russian Hill/Embarcadero	4.5%	-50	\$2,182	1.0%
8	Civic Center/Downtown	5.4%	40	\$1,356	2.0%
9	Sunset/Richmond	6.5%	80	\$1,678	-4.2%
10	North San Mateo	6.6%	100	\$1,482	-6.9%