

# San Francisco

Multifamily Housing Update

March 2011

## EXECUTIVE SUMMARY

**R**ecent San Francisco labor market trends read like a *Tale of Two Cities*. On one hand, the City's bio-tech and high-tech industries and the real estate markets that serve them enjoyed salad days. On the other, the more prosaic side of the economy — construction, tourism, retail, health care and government—remained mired in a slump of nearly three years duration.

Overall, payrolls declined at a 14,300-job, -1.5% annual pace during 4Q10, up moderately from 3Q's 17,900-job, -1.9% year-over-year rate of attrition. Sequential progress was largely attributable to hiring in the professional business and technical services sector, mostly at network design and engineering shops, and expansion by electronics and bio-tech / pharmaceutical manufacturing firms.

But there was scant evidence that economic recovery had expanded beyond these specialized niches. Tourism flow was steady, but weak hotel revPAR trends and a 1,900-job y-o-y decline in retail trade and hospitality headcounts suggest that visitors were unusually careful with their money. Real estate development was sluggish, and construction headcounts fell to the lowest level in fifteen years in December (30,400). Even the normally recession-proof health care, education and government sectors suffered attrition, falling at a combined 2,900-job pace.

The **RCR** econometric payroll forecasting model suggests that the pace of job creation will accelerate in 2011. Notwithstanding a soft 12,500-job payroll decline over the 12 months ended in December, the model foresees a net gain of 10,400 jobs in 2011, followed by addition of 23,500 in 2012, which would be, were it to come to pass, the most bountiful crop harvested since 2000.

Apartment demand suggests that job creation rates perhaps were stronger than government statistics indicate. Tenants absorbed 567 units during 4Q, representing the strongest demand recorded in any fourth quarter since 1999 and the halcyon days of the dot.com boom. No new supply was added to the inventory, allowing occupancy to increase 50 basis points sequentially to 95.7%, a 2-year high.

Ten of the metro's 11 submarkets reported stable or higher occupancy in the quarter. SoMa posted the largest sequential advance: 120bps to 95.1%. Average occupancy was at least 95% in every submarket except West San Francisco and North San Mateo Co.

Tightening markets bestowed owners with renewed pricing power that had been largely absent since the summer 2008. Average asking rents rose \$20 (1.1%) sequentially to \$1,858, retracing all the ground lost since March 2009. Concessions also receded, allowing metro effective rent to increase \$23 (1.3%) to \$1,775.

Three submarkets recorded 2.0% sequential gains or greater: Central and South San Mateo Co. and the Haight. Neighborhoods popular with financial and digital industry workers (SoMa, Downtown) also registered strong gains, rising 1.6% and 1.7%, respectively. West SF, Russian Hill and the Marina continued to lag the average.

Reis models are not bullish regarding NOI growth prospects, forecasting no better than moderate occupancy and rent gains through 2015. The service expects rents to climb 3.4% this year but only at a 2.9% compound rate from YE11 to YE15. With cap rates plunging into the mid-4% area, total returns are unlikely to top the charts. Presently, we estimate that a 5-year hold will generate a 5.9% un-levered rate of total return, ranking only 49th among the **RED 50** markets.

## SNAP SHOT

	Y-o-y change	Projected 2011
Vacancy (4.3% - 4Q10)	↓ 0.5%	↓ 0.4%
Effective Rents (\$1,775 - 4Q10)	↑ 1.3%	↑ 3.4%
Cap Rate (4.3% - 4Q10)	↓ 1.7%	↔ Neutral
Employment (917.7m - 4Q10)	↓ 14.3m	↑ 10.1m

## KEY POINTS

- While the digital side of the City economy is enjoying a season comparable to the baseball **Giants**, the broader labor market more closely resembles the 2010 NFL **49'ers**. Payrolls declined on a year-over-year basis for the 26th consecutive month in December, and trends aren't likely to return to parity before opening day on McCovey Cove.
- Apartment demand belied the dour job statistics, however, as a net of 567 tenants stepped up to bat and inked leases in 4Q10. Occupancy advanced 50 basis points sequentially to 95.7% as a result, the highest metric recorded in two years.
- Rent trends also gained momentum. Asking rents rose 1.1% sequentially and 2.5% year-over-year. Concession costs receded as well, allowing effective rents to rise 1.3% q-o-q and 3.4% y-o-y, the strongest results recorded in nearly two years.
- A diversified REIT acquired a class-A tower located near the Embarcadero and Rincon Park in December for an estimated \$185 million or approximately \$537,000 per unit. **RED Research** estimate a low- to mid-3% cap rate, based on Reis rent and occupancy figures as of December 31.



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