

San Jose, California

Multifamily Housing Update

March 2011

EXECUTIVE SUMMARY

Silicon Valley has recovered its mojo and restored its image as the cutting edge leader in consumer product development. Although Cupertino's Apple can claim much of the credit — AAPL now stands as the most valuable technology company on the planet — it is the Valley's software industry that garners more attention lately. How else to explain that Britons under the age of 25 now consider *Facebook* founder Mark Zuckerberg a bigger influence on the modern age than Isaac Newton or Martin Luther King?

Social networks and search engines may be passing fancies of our day but they had a very tangible impact on the San Jose labor market, contributing to the first positive year-over-year payroll comparisons in 2 years in 4Q10. The metro posted a 6,300-job 0.7% year-on-year gain, representing the strongest quarterly expansion recorded in two and one-half years.

Faster hiring among high tech manufacturers and information service providers was largely responsible. The former expanded at a 6,400-job, 6.1% pace in 4Q while the smaller internet related sub-sector brought on employees at a 6.5% y-o-y rate.

The influx of stock option wealth and hefty bonus distributions began to trickle down into the wider Santa Clara economy. Residential construction activity showed signs of life and hiring at retail stores was marginally stronger during the holiday season.

The **RCR** econometric payroll forecasting model interprets the recent payroll job up-swing as a precursor of the development of much faster job creation over the next several months. The model projects a 26,800-job net advance in 2011, representing an 11-year high 3.2% increase. Conditions will be even stronger in 2012, when average monthly gains of nearly

30,000 (3.4%) jobs are forecast.

By contrast, Reis surveys did not detect a flood of tenants entering into new apartment leases. The service reports that metro properties absorbed only 95 net units in 4Q, down from 646 during the prior quarter. Still, average occupancy improved 10 basis points sequentially to 96.2% as no new professionally-managed supply was completed October to December.

Only two of San Jose's nine submarkets experienced a sequential occupancy rate decline, namely Northeast (20bps) and South San Jose (30bps). East San Jose (50bps) and Campbell (40bps) posted the largest gains.

Sequential rent growth was moderately weaker in line with typical seasonal patterns. Tenants paid an average of \$15 (1.0%) more in face rent in the period but benefited from stable lease concession levels (4.7% of gross revenue). Therefore, effective rents also advanced \$15 (1.1%) to an average of \$1,459, comparing unfavorably to respective \$25 and \$19 sequential increases recorded in 2Q and 3Q.

Effective rent growth in Santa Clara (0.0%) and South San Jose (0.6%) submarkets lagged the market average. Areas with greater tech worker concentration posted larger gains, especially Mountain View (2.0%), Sunnyvale (1.4%), and the urban infill Central San Jose submarket (1.5%).

Reis forecast that the weaker NOI gains in 4Q10 are merely a brief intermission before a large up-move commences. The service forecasts an 8.1% pop in rents in 2011, followed by a 6.1% hike in 2012, while occupancy is tipped to rise 30 bps in each year reaching 96.8% by YE12. NOI growth in the 8% to 10% per year range should result, establishing the groundwork for unlevered investment returns approaching 8.5% or higher.

SNAP SHOT

	Y-o-y change	Projected 2011
Vacancy (3.8% - 4Q10)	↓ 1.3%	↓ 0.3%
Effective Rents (\$1,459 - 4Q10)	↑ 4.1%	↑ 8.1%
Cap Rate (6.0% - 4Q10)	↑ 0.5%	↓ 1.25%
Employment (852.4m - 4Q10)	↑ 6.3m	↑ 26.8m

KEY POINTS

- Santa Clara County establishments hired workers at a 6,300-job, 0.7% pace in 4Q10, the first positive metric posted in more than two years. Expansion in the high tech and internet sectors was primarily responsible.
- Population growth was sluggish and apartment demand commensurately slow. Only 95 units were absorbed in 4Q10, down from an aggregate of 1,599 during the previous nine months, and occupancy gained only 10 basis points sequentially to 96.2%.
- Rent growth also was moderately slower. Average effective rent rose 1.1% quarter-to-quarter, down from 1.3% and 1.8% during 3Q10 and 2Q10, respectively.
- Investors had little inventory for sale to choose from and sales velocity was slow. Real Capital report only 14 trades valued at \$2.5mm or more closed in 2010 for proceeds of \$428mm. No notable transactions were reported from October to February 2011.
- Reis project exceptional rent growth in 2011 and 2012. As a result, expected total returns are sharply higher than one year ago, rising from 5.9% at YE09 to 8.5% presently, a compelling yield for a barrier protected area.



To register for free access to RED's full research reports, please click here.