Year in Review

Apartment Management

December 2005

Information for the rental housing industry in San Mateo, Santa Clara & Santa Cruz Counties

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Silicon Valley Recovering from Downturn

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After struggling through what local owners say has been the worst rental market in 30 or more years, Silicon Valley seems to have hit the recovery stage of the commercial real estate economic cycle, where demand growth continues, new construction begins and rents rise.

Though the U.S. Bureau of Economic Analysis has been saying for some time that the country is experiencing such a recovery, Silicon Valley only recently began seeing promise on the local front. In a 2005 Bay Area Economic and Apartment Market Outlook, Lawrence Souza, who is a real estate/financial economist for the Johnson/Souza Group, Inc., noted that though Bay Area job losses since 2000 have exceeded 350,000 (many of which were in the tech sector), job growth in the market is on a strong upward trend.

Bay Area vacancy rates also have stabilized from all-time lows of up to 20 percent in 2004 to approximately 7 percent today. Turnaround time to rent a multifamily unit has decreased from an average 6 to 8 weeks—occurring last summer at possibly the worst point of the cycle—to just 2 to 4 weeks today.

Though new housing permits are on the rise, the shortfall of housing units in California is projected through 2008, and though mortgage rates are also still down and only expected to increase incrementally as the Fed carefully manages the growth of the economy, the average Bay Area single-family home price sustains an affordability gap in the market that plays well for apartments. As of late 2004, the median home price in the Bay Area was just above $660,000 (ranking at 14 percent on the housing affordability index) as compared to the U.S. median home price of $188,500 (a housing affordability index of 55 percent.) Yet even with this positive industry news, hitting bottom was an unforgettable experience for owners who had been operating in Silicon Valley for any significant period of time.

Such was the case for Denny LeVett who has been investing in Silicon Valley-area properties since 1961. LeVett now owns between 300 and 400 units in Palo Alto and Carmel, as well as some hospitality properties. He sits on the board for several Palo Alto banks and on the Economic Development Committee for Downtown Carmel.

"From when I purchased my first building in 1961 up until 2002, I had never had a vacancy; even when the market in certain areas of Santa Clara County was overbuilt and a local newspaper was saying that there was a 28 percent vacancy factor," says LeVett. "Then the market turned in 2001 and everybody, including me, went into shock. People were in denial. They couldn't believe what they were seeing in terms of rents and vacancies because they'd never had to face it before. It was the worst I've ever seen here, no question."

At his low point, LeVett had 45 available units throughout his properties. "I threw the book away and rented them at whatever people would pay," he says. "I'd rather have someone in an apartment paying *something* rather than no one paying anything. That lost income is money lost forever."

In contrast, today's indicators have created "conservative optimism" with owners sensing a growing ability to rent out apartment properties again.

LeVett has a number of properties in the upscale downtown Palo Alto area at which he plans to increase rents at an anticipated 10 to 15 percent as the units become available. Rents at these units range from $1,000 to $1,800 per month for a one-bedroom unit to $1,800 to $2,700 per month for a two-bedroom unit. Though LeVett's returns are down significantly from the peak of the market, when they were renting for $2,000 to $3,000 per unit, his rents have not decreased in the last six months. Currently, only one in all of his 300 units is vacant.

Jim Rose, managing partner of Rose Properties, tells a similar

story of improving conditions. His company invests in commercial properties in and around the San Francisco Bay area and owns five multifamily buildings here consisting of 300 units.

"Our current vacancy rate is under 3 percent, down from 17 percent late last year," says Rose, "but we've also gotten really aggressive in marketing and advertising in that time and have provided more training and move-in bonuses to our leasing staff."

Rose reports it takes his properties an average 15 to 20 days to rent. He has offered concessions such as half a month free rent with a six-month lease and a full month free rent with a 12-month lease. He also runs move-in specials, when necessary. "We closely monitor our properties, and if we build up inventory on one building, we get more aggressive in marketing those units. In one instance, our combination of a move-in special and an aggressive sales and marketing campaign led to seven units being rented in one weekend."

Owners across the market are experiencing this positive activity and are looking foward to marginal rent increases. While the ability to raise rents may come slower for the C-class properties that seemed to enjoy strong demand and solid returns even during the low times, there is a growing opportunity to raise rents in more affluent areas—the luxury and well-located A/B properties that took the hardest hit with downturn of white collar jobs.

Submarket trends like these indicate again that we've already hit bottom and are now moving toward a recovery stage. Investors and local economists such as Souza expect we'll be in full swing again in 2008. Souza, in particular, believes that we are already well in the midst of the next business cycle peak (2004–2005) and that the next technology employment cycle peak is just ahead of us (2006–2008). His research shows that the unemployment rate in the San Francisco Bay Area has decreased from 6 percent in late 2003 to 4.6 percent in 2004 and that it will drop even further, to 4.4 percent in 2005 and to 4.1 percent by 2006.

In anticipation of these events—and even though GRMs are at an all-time high and CAP rates are at an all-time low—out-of-area investors ranging from Southern California to New York are looking to buy Silicon Valley multifamily holdings. My ringing phone supports this statement and economic data says they will pay well.

Despite a roughly 30 percent drop in rents since the local multifamily market decline started in 2001, Silicon Valley property values did not decline commensurate with a decrease in income. In some cases, in fact, they continued to rise.

"Investors believe that this market will come back, and that keeps demand high. The investors we deal with, purchasing properties in the $2 to $6 million range, believe they will get a better return than at present or they would not be buying," says Thomas Scott, CPM, board member with the Tri-County Apartment Association and president of Cambridge Management Company, which manages about 3,000 units consisting of 100 properties in the area.

Yet there are very few properties on the market for these potential buyers to move on. As of the time of this writing, there are just 87 properties (greater than four units) on the market and more than 115 properties currently in contract!

"The market is constricted beyond anything I've seen here in 30 years," adds Scott. "You used to be able to call up a broker and buy a quality property with numbers that made sense and offered a positive cash flow, but there are few of those available today."

That has not, however, seemed to diminish demand or a positive outlook among industry participants.

While Rose has recently purchased apartments in Santa Cruz "because coastal properties have been taking off recently," he prefers to buy in Silicon Valley when he can find a good location with upside potential. Rose says he looks for location, building construction, size of units and tenant profile. "I just don't think you'll ever lose with a property here," he says. "Vacancies and rents seem to have firmed up, and we think things will get progressively better."

LeVett concurs. "I've never seen anything like the collapse we went through in the early 2000s, but we are seeing things come back." He recently purchased a six-unit property in Palo Alto, is negotiating a 10-unit property in Carmel, and has offers out on other properties as well. "I'm an incurable optimist. I have a good feeling about our future." ◆

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The views and opinions of this author do not necessarily state or reflect those of the CAA Tri-County.