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Publication Date

2002-03-01

Peer reviewed



Institute of
Business and
Economic Research

University of
California at
Berkeley

FISHER CENTER FOR REAL ESTATE AND URBAN ECONOMICS

WORKING PAPER SERIES

WORKING PAPER NO. 02-281

**THE SAN FRANCISCO BAY AREA APARTMENT MARKET:
A RENTERS MARKET**

By

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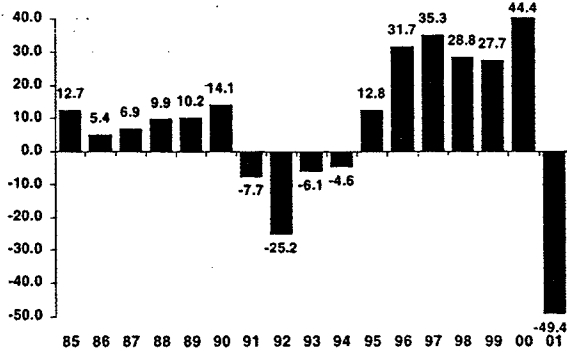
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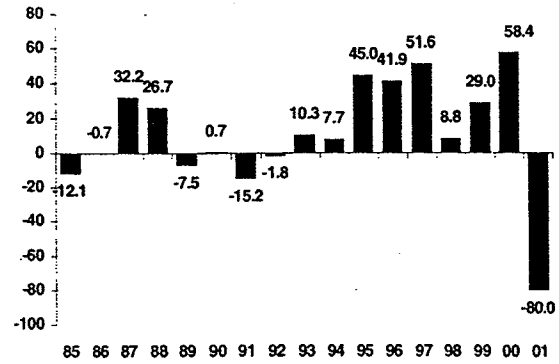
**Working Paper 02-281
March 2002**

**San Francisco MSA Employment
Absolute Job Growth, in thousands**



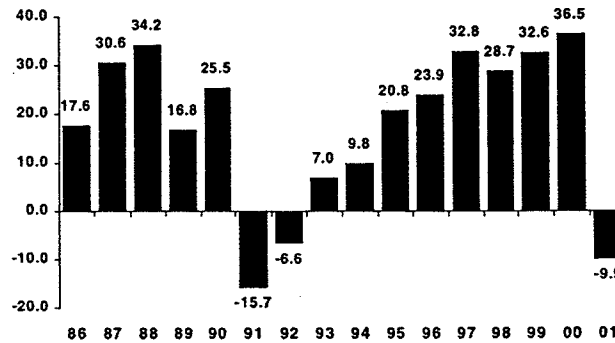
Source: Bureau of Labor Statistics

**San Jose MSA Employment
Absolute Job Growth, in thousands**



Source: Bureau of Labor Statistics

**Oakland MSA Employment
Absolute Job Growth, in Thousands**



Source: Bureau of Labor Statistics

Job Market

The euphoria of the technology revolution resulted in the creation of hundreds of new Bay Area technology companies and the expansion of traditional industries. Employment in the Bay Area expanded by 590,700 jobs from 1995 to 2000. San Jose experienced the most dynamic growth, adding more than 230,000 jobs from 1995 to 2000. The San Francisco area added more than 180,000 jobs during this time period, and the Oakland area added 175,000 jobs.

However, the economy reversed course in 2001 as the technology bubble burst, the Nasdaq plunged downward and thousands of employees lost their jobs. In the past year, the Bay Area lost more than 140,000 jobs.

Leasing demand

At the peak of the market in 2000, demand for apartment units was frenzied. Vacancy reached 1 to 2 percent in the Bay Area in 2000, and rents increased more than 30 percent from 1999 to 2000. Affordable units became increasingly more difficult to find, and some renters choose to move outside of the Bay Area where less expensive apartments could be found.

However, demand has weakened considerably over the last year. Especially slow were the months of November and December 2001. Some of the sluggish leasing could be attributed to seasonal patterns — tenants are loath to move during the holidays. However, landlords' initial reluctance to lower rents was also a factor. Tenants are now taking their time to select apartments since the number of choices has expanded dramatically. Apartment listing services report that listings tripled from the end of 2000 to the end of 2001 and remain at that level.

Landlords continue to lower and negotiate rents, which are already down as much as 20 percent in parts of the Bay Area, with tenants. For example, in San Francisco the average rent at the end of 2000 was \$2,169. It's now \$1,805, a drop of 17 percent. The properties experiencing the greatest decreases in rent are Class A apartment buildings in the areas that benefited the most from the technology boom, San Francisco and Silicon Valley. For example, in San Francisco's South Beach area, which saw a flurry of luxury apartment construction in the last three years, asking rents dropped 55 percent from the end of 2000 to 2001, according to MetroRent. Other areas of San Francisco associated with high-end apartments also saw large declines in rent. For example the scenic Marina and upper Nob Hill districts of San Francisco each saw a 32 percent drop in rents from 2000 to 2001. In the San Jose area, leasing agents are lowering rents by as much as \$250 to \$300 a month. Among South Bay cities, Palo Alto has experienced some of the sharpest drops in rent — more than 20 percent in 2001. The city was an epicenter of both technology and venture capital jobs. Mountain View and Sunnyvale, where many Internet firms were located, have also seen significant softening of rents.

The weakness in the local apartment market can also be seen in changes in vacancy in the Bay Area portfolios of real estate investment trusts. REITs reported vacancy of 8.6 percent in San Jose at the end of 2001, up from 2 percent at the end of 2000. In San Francisco, REIT vacancy stood of 6.2 percent at the end of 2001, compared to 2.2 percent at the end of 2000.

Although the large number of vacancies will take time to fill, there are some positive signs for the market. San Francisco leasing has started to pick up in 2002 as former residents who were priced out of the city during the boom begin to consider moving back. Some of these former San Franciscans will move from the East Bay, impacting vacancies there.

Listing agencies also report that use of their services by people outside the Bay Area has declined significantly. Whereas in 2000, finding a Bay Area job was easy and finding an apartment was difficult, finding employment is now a challenge and finding a multifamily unit is relatively simple.

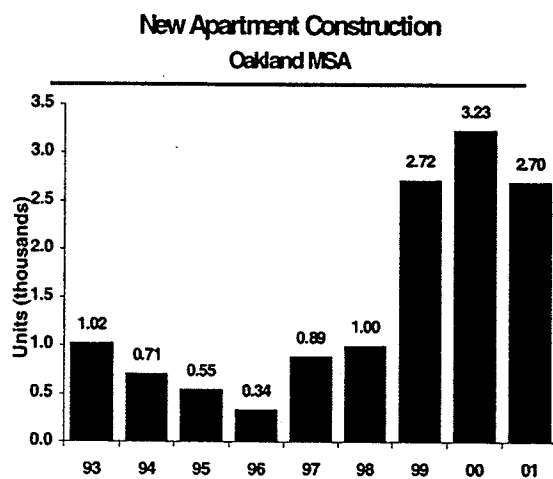
Two sectors have been severely impacted by the recession: live/work lofts and corporate housing. Live/work units have been hard hit as the segment of the population most attracted to such dwellings – young technology executives – has experienced a large number of job losses. Also, some of these units were built in former industrial areas far from the city’s core. These areas had a large number of Internet offices in 1999 and 2000, but now quite a number are empty. For example, in San Francisco’s South of Market more than one quarter of offices are vacant. Since office vacancies have dramatically increased in these areas, they are also less desirable areas for housing. In addition, many of these units, although built as housing, were actually used exclusively as offices by fledgling Internet companies. Now that many of these start-ups have ceased operations, some of these properties have significant vacancies.

Like live/work lofts, corporate housing was a flourishing sector during the technology boom. Large corporations leased blocks of furnished apartments for employees who were in the Bay Area for temporary assignments, or for recent recruits while they searched for housing of their own. With the economy now in recession, corporate travel has been severely curtailed. Some landlords have converted corporate housing units to standard rentals, but this is costly as all furniture and kitchenware must be stored.

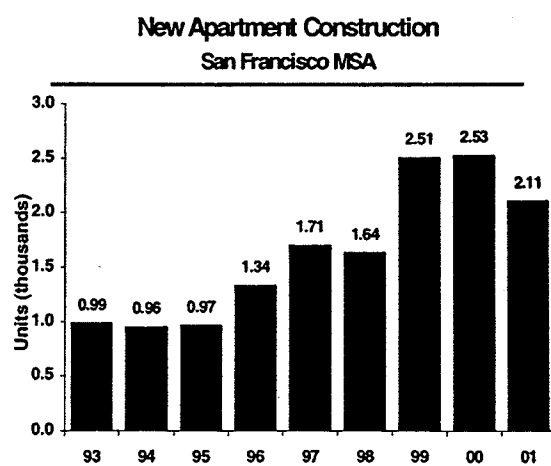
Landlord response

Landlords are responding to slow demand by lowering rent and increasing concessions. Some landlords are even offering rent decreases for tenants who signed leases in the last 15 months at the height of the market.

Signs reading “Ask us about our move-in specials” and “A month’s free rent,” which had not been seen in the

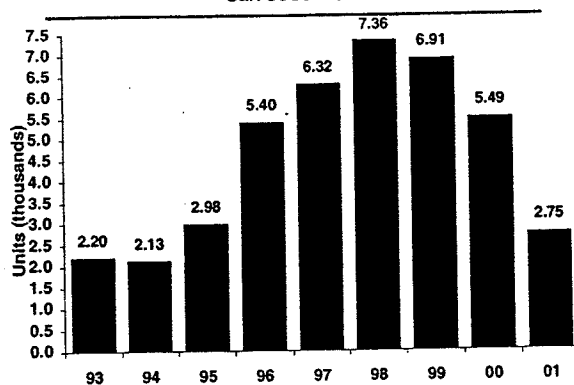


Source : Marcus & Milichap



Source : Marcus & Milichap

New Apartment Construction San Jose MSA



Source: Marcus & Millichap

Bay Area in more than three years, are increasingly displayed. In rent-controlled San Francisco, offering free rent is a desirable alternative to lowering the overall rent. However, outright rent reductions are more widespread. In the Silicon Valley, landlords have been willing to reduce rent by as much as 20 to 25 percent for tenants who signed leases during the boom. With such reductions, tenants can save several thousands of dollars per year.

In addition to lowering rent, many landlords are undertaking relatively inexpensive measures to spruce up their units, such as adding a fresh coat of paint or landscaping to their properties. Apartment building owners are also adding amenities such as in-unit washer/dryers, microwave ovens or dishwashers. Some landlords are also allowing pets, whereas in 2000 they were banned from many complexes. One apartment complex in San Jose offered free televisions to tenants as an incentive to sign a lease. Flexible leases, such as month-to-month terms, are also being offered in the Silicon Valley. In addition, many other landlords have increased their marketing budget to advertise vacancies. Landlords are also aggressively perusing renewals. They are approaching tenants several months ahead of their lease expirations and offering to negotiate terms for extending their leases.

Development

To house the wave of new employees migrating to the Bay Area, apartment developers built thousands of new units over the past three years. From 1999 to 2001, there were more than 30,000 apartment units completed in the San Francisco, Oakland and San Jose areas. That's on top of the 26,000 that were built in the three previous years. Many developers who launched complexes in the last two years anticipated high rents but will now be forced to meet the market. A few planned projects, especially large luxury high-rises, have been put on hold until the economy recovers. Still the Bay Area is not at risk for overbuilding. Limited land and stringent development controls have kept supply in check.

Sales

Apartment investors flocked to the San Francisco Bay Area in 1999 and 2000 when 518 and 482 properties respectively traded hands, according to Marcus & Millichap. However, rising vacancies and declining rent caused sales transactions to drop 30 percent from 2000 to 2001. Many owners opted to refinance rather than sell. In San Francisco, Marcus & Millichap data show that 128 properties worth \$250.2 million traded hands in 2001, down from 187 transactions worth \$288.4 million in 2000 and 233 transactions worth \$687.8 million in 1999. In Alameda County, 111 properties sold in 2001 for \$233.1 million, down from 151 transactions for \$337.3 million in 2000 and 155 transactions worth \$283.2 million in 1999. In Santa Clara County, 144 transactions worth \$460 million took place in 2000 and 130 sales worth \$425 million occurred in 1999 versus 100 transactions worth \$237 million in 2001.

San Jose has experienced some loss in apartment value, particularly in complexes with more than 50 units. However, per unit prices remained steady in Oakland and went up slightly in San Francisco in 2001. That suggests the Bay Area is viewed as a favorable long term market. Due to rent control in San Francisco, some buyers also see more potential upside in San Francisco properties than in Silicon Valley. According to apartment sales experts, many of the 2001 buyers were local investors, in contrast to 2000 when many buyers were institutional investors or real estate investment trusts. That apartment prices remain strong could also be an indicator that investors are allocating money out of the riskier office and hotel sectors to multifamily. Lenders are still willing to finance the purchase of well-located properties. Still, some small investors who paid for luxury units at the height of the market with the goal of renting them are struggling. Sales will likely remain slow in 2002 as owners hold their properties and wait for a better market.

Conclusion

The large number of jobs lost in the Bay Area propelled apartment rents down and vacancies up in 2001. Renters who were laid off or had their income reduced are having a great effect on the market. Renters still actively leasing are employing a wide range of strategies to save costs, from moving back home or taking on roommates, to moving to less expensive apartments or renegotiating their rent. Landlords, who are eager to fill their units, are offering a number of concessions, from amenities such as added appliances to free rent. Especially hard hit by the recession are live/work lofts and corporate housing, two product types that were wildly popular during the technology boom. The rise in vacancy and decline in rent has caused both construction and sales of multifamily dwellings to slow. However, the Bay Area is one of the most desirable urban areas in the county and the long term prospects for the apartment market are favorable. Limited land and development restrictions mean the area is not at risk for being overbuilt. A bottoming out of rents and slow sales will characterize the market through much of this year until hiring starts to pick up. Rent appreciation and decreases in vacancy will likely occur in 2003 as the Bay Area recovers.

Acknowledgments

We would like to thank the following people and companies for giving us their insights into the apartment market: John McWeeney of MetroRent; Ron Stern of Bay Rentals; Mark Bonn and Hap Albers of Grubb & Ellis; Jeff Michkin, Alan Pontius, Adam Bandel and Rehmat Kharal of Marcus & Millichap. We are also grateful to Marcus & Millichap for providing data for this report.

