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S.D. apartment market slips, but still one of nation's strongest

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SAN DIEGO — While San Diego County saw its apartment ranking slip from second last year to sixth place in 2011 in a real estate brokerage report, it's still among the strongest in the United States.

According to a **Marcus & Millichap** report, the local apartment market in 2011 will regain much of the strength it lost during the recession.

"As business activity and biotech employment accelerates, the addition of higher-paying jobs will fuel an uptick in Class A absorption, especially near the downtown area," the report stated.

The report said one of the primary catalysts for apartment demand is the estimated \$1 billion currently being spent on military construction in the county.

"The 500,000-square-foot hospital at Camp Pendleton, for instance, will create up to 1,000 construction jobs during build out, underpinning demand for Class B/C complexes near the site," the report continued.

"As a result, lower-tier vacancy in the Oceanside submarket will fall into the low 3 percent range this year, enabling area owners to raise rents considerably," M&M added.

The countywide rents, which have remained remarkably stable despite the recession, are projected by M&M to increase by 4.1 percent this year to the end of 2011 at \$1,327 per month.

This is a high enough figure to force many to double up.

With an estimated 4,000 more Marines and 7,000 more sailors expected to come into the region in the next few years, the report said there will be further pressure to create more rental housing from Naval Base San Diego to Camp Pendleton.

In addition, investors are expected to scramble to purchase apartments near the bases — if they are available.

The report also said that as construction continues at military bases, existing apartment owners of non-distressed properties will find themselves in the catbird's seat.

"Long-term growth at these (military) sites, along with minimal new apartment development will benefit nearby operations, with local owners likely to achieve outsized rent gains during the coming years," M&M wrote.

The demand may be strong but with a sluggish economy, only 500 apartments are projected to come online countywide in 2011, the lowest total since 1997.

The county had 1,280 apartments come online in 2010.

With a vacancy rate that M&M projects will decline by 70 basis points to finish the year at 3.6 percent, and a limited number of projects in the pipeline, the apartment market is expected to be tight.

Other factors exist that could impact the inventory, not the least of which are former condominiums being converted (or converted back) to apartments.

One conversion to apartments involved the 679-unit Vantage Pointe development at Ninth and B streets that sold to Sam Zell's **Equity Residential** (NYSE: EQR) for \$200 million last fall.

Well-located apartment projects have continued to be in high demand by investors, but with owners holding out for higher prices, few have been offered for sale.

"Investor demand will outstrip supply of marketed properties this year, but velocity will gain momentum as private buyers widen their range of acceptable assets to expand their portfolios," the report continued.

Conversely M&M wrote that improved operations will encourage non-distressed owners to reposition

portfolios.

That may mean many of the so-called "mid-tier" assets in these portfolios may be sold in order to purchase Class C apartments with a high upside potential.

"As more investors target lower-quality complexes in communities considered less desirable in 2010, such as those in the in eastern San Diego County, yields for vintage Class C assets in these areas will steady in the mid-7 percent range," the report said.

M&M added that "the demand for top-tier properties that come to market will remain intense and cap rates for best-in-class assets near Balboa Park will further compress in the low- to mid-6 percent range."

The top apartment sale thus far this year, according to **CoStar** (Nasdaq: CSGP), was the \$78.1 million acquisition of 450-unit Waterstone Carlsbad apartment complex that was purchased by **AvalonBay Communities Inc.** (NYSE: AVB) on Jan. 6.

That property had been sold for \$15.5 million in March 1996, \$50.7 million in May 2002, and \$77.8 million in February 2006.

As for San Diego's No. 6 ranking, the county's apartment market was ranked behind New York City, Washington, D.C., Boston, San Jose and Philadelphia, which were deemed to have a somewhat higher investment potential.

Los Angeles was only in 11th place in terms of market strength, but it's still expected to have an apartment vacancy rate of just 4.4 percent this year.

The vacancy rate in San Francisco is projected to be 3.9 percent at the end of this year. It is ranked just behind San Diego at seventh place, despite having a much more geographically constrained market.

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