California Real Estate in a Slow Recovery

The California economy is showing signs of improvement. Employment has begun to grow again, unemployment is dropping, and some real estate markets are picking up. The recovery, however, is slow and uneven. Some employment sectors are stabilizing or growing, while other sectors continue to contract. Geographically, employment is expanding in some regions of the state, while other regions are still losing jobs. Furthermore, as a result of the recession, the growth and movement of population has shifted, with increased migration out of state found for many different age groups. These shifts in employment and in population composition and location influence the types of opportunities occurring in both residential and non-residential real estate.

A Slow Start To Recovery

A turnaround in employment growth appears to have occurred last fall, when employment reached a low of 11,940,300 in December 1993, as shown in Figure 1. From December through May of this year, the state steadily added jobs each month, with employment reaching 11,970,700 in May 1994, adjusting for seasonality. Taking a historic look at the recession in California, the period of job loss lasted 41 months, from July 1990 to December 1993, and over 600,000 jobs were lost, from peak to trough, on a seasonally adjusted basis.

The recovery is occurring unevenly among sectors of the economy and among geographic areas. Sectors associated with defense production continue to shrink in size. Other high technology sectors remain well below levels of a year ago, although their job losses are much smaller than in defense sectors. A few nondurable manufacturing sectors (textiles, food products) have begun growing again, showing employment levels either slightly above, or close to, 1993 levels. Growth patterns also vary for nonmanufacturing sectors. Some services sectors, such as business services, social and other services, amusement and recreation, and motion pictures have had steady growth in employment since 1993, while engineering and management services continue to lose jobs.

Geographically, the strongest employment growth is occurring in the Central Valley and on the periphery of the coastal metropolitan areas. Metropolitan areas with employment levels higher than a year ago include Bakersfield, Fresno, Modesto, Sacramento, and Stockton in the Central Valley, as well as the Riverside-San Bernardino area east of Los Angeles and the Santa Rosa-Petaluma area in the northern San Francisco Bay Area (see Figure 2). The recovery of these areas is an indication that economic expansion in California has not ended permanently. Even before the recession,

(Continued on page 2)
Recovery...

(Continued from page 1)

growth in these regions was generated by expansion from the more congested coastal areas and by companies seeking lower-cost locations within the state.

Many coastal metropolitan areas continue to have employment levels below those of 1993, but are beginning to see job increases on a month-to-month basis. In the San Francisco Bay Area, signs of recovery occurred in the second quarter in all metropolitan areas, despite continuing job losses related to base closures. In Southern California, only Los Angeles County showed employment losses in the second quarter, whereas San Diego, Orange, Santa Barbara and Ventura Counties all grew.

The recovery in California's economy will foster a changing distribution of activity within the state. Defense-related high-tech sectors will continue to shrink in importance while other manufacturing sectors will stabilize or grow slowly. Nonmanufacturing sectors will dominate growth in the recovery period. The state's largest metropolitan areas will cease to lose jobs, while much of the new growth will concentrate in smaller, less dense locations.

A Shifting Population Base

The state's long economic recession has left its imprint on California's population base. Natural increase (the difference between births and deaths) and foreign immigration showed few changes during the recession, as shown in Figure 3. Patterns of domestic migration, however, have reversed. In the late 1980s, California attracted annually about 200,000 more interstate migrants than it lost to other parts of the United States. In contrast, in 1993, the state netted a loss of over a quarter of a million people to other parts of the country.

As shown in Figure 4, changing migration patterns have brought about a significant shift in the movement of people by age categories. The state once had a net outflow of people only in their retirement years (65 and older), while employed workers of all ages were drawn to the state. Skilled workers who had lost their jobs often stayed in the state to seek new employment opportunities. In contrast, the past year saw a strong outflow of people over 30 years old, implying that a significant share of the workforce that has been displaced during the recession has chosen to leave the state rather than to seek new employment or open a business in the state. Major destinations of migrants from California are neighboring and Pacific Coast states such as Nevada, Arizona, Oregon, and Washington. This direction of population movement is not new in itself. However, the numbers of people moving to these states has increased.

Despite a larger outflow of people to other states, California's population grew by over 430,000 in 1993. This growth has not been matched by an equivalent level of household formation. In the late 1980s, California added households as quickly as it added population. In contrast, in 1993, the rate of household growth was about half the rate of population growth (see Figure 5). The San Fran...
San Francisco Bay Area and Los Angeles County had particularly high differentials between population growth and household growth in the 1990s. For the period 1991-1993, the population of the San Francisco Bay Area grew by 292,235, a 4.8% increase, but the number of households went up by only 52,862, or 2.3%. In the case of Los Angeles County, the rate of household formation has slowed dramatically. A 3% increase in population was accompanied by household growth of less than 1%. Some of the differential between population growth and household growth can be attributed to pent-up demand—households delaying formation in difficult economic times. Another portion of the differential reflects the type of growth that has occurred, with existing households adding children and relatives.

The Real Estate Recovery Begins

Recovery of the real estate market reflects the unevenness of economic recovery in the state. The residential market shows clear signs of recovery, yet the improvements have not spread to all segments of the market or to all geographic areas. Nonresidential markets as a whole have not yet expanded, although a few areas, in selected segments of the market, are doing well. Recent shifts in residential and nonresidential building permit activity are summarized in Figures 6 and 7 and are discussed in detail in the following sections.

Single Family Housing Dominates Residential Recovery

The single family home market shows clear signs of recovery, and multi-family activity has also shown signs of improvement. The first six months of 1994 have seen an increase in single family residential permits of 12% (a 16% increase in value) over the same period last year. The activity was unevenly distributed with Orange County registering the largest percentage increase—a doubling of single family permit values—followed by Santa Rosa-Petaluma, Oxnard-Ventura, San Diego, and San Francisco. Permits remained down in several Central Valley counties, Vallejo, and Los Angeles. Significantly, each of the three major areas of the state—Southern California, San Francisco Bay Area and the Central Valley—experienced an increase in single family construction activity.

Multi-family permits showed the first signs of recovery in April. By the end of June, permit values for the first half of the year were up 20% from the first half of 1993. Southern California permit values are up 37% despite a drop in Los Angeles. Central Valley multi-family permit values are up 35%. In the San Francisco Bay Area, multi-family permits are up slightly in terms of units, but the value of permits is down 12%.

Altogether, permits for new housing units total 50,966 in the first half of 1994, an increase of 15.4% over the same period in 1993. Among the state's 25 metro areas, 14 show growth in the first half of 1994.
Home sales activity, tracked by the California Association of Realtors (CAR), gives further evidence that California's housing market is in recovery. The first four months of 1994 saw solid gains in home sales over 1993. The momentum of December 1993, a month that registered a huge jump in the annualized sale rate to 542,000, continued through April 1994. The January through April period sustained sales at an annual rate of 508,100, the best start of any home buying year since 1989, and an increase of 26% over the previous year. This remarkable performance was carried out in the face of rising mortgage rates sparked by the earlier rate increases by the Federal Reserve. Possibly, the paradoxical expectational effect may be at work here, with people buying now to avoid expected future increases in interest rates. Rising mortgage rates though, may still have a negative effect: sales began dropping in May, and by July were at an annualized level of 453,400.

The CAR affordability index for regions within California shows a decline in recent months, reflecting increasing interest rates. In terms of affordability, Los Angeles, San Diego and Orange County are now either at the same level as in 1993 or worse off. For the state as a whole, 39% of households can afford to buy the median priced home (down from a high of 44% in February.) For the U.S. the affordability index stood significantly higher at 56%.

The increase in sales activity has not yet been accompanied by rising prices statewide. Most of the recovery in home sales has occurred at the lower end of the market. According to CAR data, homes under $160,000 accounted for 38% of the sales in May 94 as compared to 35.7% in May 93. This shift to the lower segment of the market has come about mostly at the expense of the middle price range, since the upmarket homes also show a small increase in sales over the previous year. With sales concentrated in lower priced homes, the median price of a single family detached home in California was $183,310 in May, 2.3% below the level of May 1993.

Real Estate Research Council indices based on tracking comparable homes over time also show continuing declines in home prices. Home price indices dropped in April for all of the Southern California counties tracked. Regionwide, April home prices in southern California were 6% below the April 1993 level. San Bernardino had the sharpest drop at 8.9%, followed by Los Angeles and Riverside counties at 7%. San Diego and Santa Barbara counties had the smallest rates of decline, at less than 3%. Home price declines were more modest in Northern California, with an average drop of 2.5% since April 1993, and the rate of decline has slowed in the last six months. Monterey, San Mateo and Santa Clara counties all showed small price increases over the past year. In Sacramento County, where home prices peaked as late as April 1992, the RERC price index has dropped by 9.3% in the past year.
The long recession has led to an increase in foreclosure activity, despite lower interest rates. California maintained foreclosure rates well below the national average in the first two years of the recession. However, long term unemployment and the drop in home value (and thus in owner equity) have now led to increased foreclosure activity. The percent of loans in foreclosure went up from 1.23% in fourth quarter 1993 to 1.26% in the first quarter of 1994, and percent of loans with installments past due went up from 3.69% to 3.75%.

**The Office Glut Continues**

Office building permit activity shows no signs of recovery. After accounting for inflation, office permit value for 1993 in California was 84.5% below the peak level reached in 1985. In the first six months of 1994, office permit value reached only 75% of the value for office permits in the first six months of 1993. The drop in permits continues most sharply in the Southern California area, where the value of office permits for the first six months of 1994 was only half of the sixth month level in 1993. The San Francisco Bay Area has come closest of the major California regions to stabilizing, with permits up 22% from the first six months of 1993.

The lack of building activity is reflected in the stability of leased or for-rent office stock figures. California added close to 300 million square feet of space, or almost 30 million square feet each year between 1980 and 1990. Since 1990, about 26 million square feet have been added to office stock, or less than 9 million yearly, with some coming from the addition of formerly single tenant or owner-occupied buildings to the for-rent stock, rather than from new construction. There was no net increase in office stock in 1993, and changes to stock so far this year come largely from the removal of buildings from Stock following the Northridge quake in Southern California, and the addition of smaller buildings to the inventory tracked in Santa Clara County.

Office vacancy rates statewide are higher than 1990 levels, but most metropolitan markets have shown at least small drops in vacancies in the first quarter of 1994, as shown in Table 1. However, the net absorption of office space is occurring at a far slower rate than in the 1980s. Statewide, absorption rates have dropped from over 25 million square feet annually in the 1980s, to only 7.1 million square feet annually in the 1990s, and to only 4.0 million square feet absorbed, net, in 1993. With shrinking absorption rates, the amount of space still vacant remains overwhelming in many parts of the state. Even at absorption rates of the 1980s, the Los Angeles market has more than a four-year supply of vacant space, and the San Francisco market over a ten-year supply of space. The drop in vacancy rates in the first quarter of 1994 sug-

(Continued on page 6)

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++ Annual net absorption numbers are for 1985-90, not 1980-90.

Recovery...

(Continued from page 5)

gest that absorption levels are improving this year. Nevertheless, office construction opportunities in California are likely to remain very limited and area-specific for some time.

Industrial Building Turns Around

In contrast to the office sector, industrial building activity shows definite signs of a revival. Statewide, industrial building permit values for the first six months of 1994 are up by 52% compared to the same six months in 1993. Many different parts of the state are participating in this increased activity, including all of the Southern California counties. While the percentage increase in industrial building activity is high, this in part reflects how sharply industrial permits had fallen. Industrial permit value for 1993 for California was 80.5% below its 1984 peak (adjusting for inflation).

Vacancy rates in most California markets are above the national average of 7.9%, as reported by CB Commercial for March 1994. Vacancies are highest in Orange County, the Riverside-San Bernadino area, Los Angeles County, and Santa Clara County (see Table 2). Nevertheless, most of these areas are showing improvements over vacancies at the end of 1993. In a few markets, vacancy levels for the first quarter of 1994 are below the levels experienced in 1990. The San Diego market, for example, has a relatively low vacancy rate (8.9%), and the ratio of vacant space to the amount absorbed the previous year is only 2/1, compared to 6.6/1 for the state as a whole.

Fluctuations in Retail Building Permit Activity

Retail building permit values have begun to edge toward recovery, but the progress has not been steady. While retail building permits for first quarter 1994 in California were stronger than the first quarter of 1993, this progress was not maintained in the second quarter. The value of retail permits for the first six months of 1994 ended 3% below the same period in 1993 (prior to any adjustments for inflation). Only the San Francisco Bay Area maintained a stronger pace of retail permitting through the second quarter of this year.

As housing construction strengthens, opportunities for retail building permits may also expand. Data on retail trade activity for the end of 1993 indicate that retail sales had begun to stabilize throughout the state, providing a base for the recovery of retail building activity.

The Longer Term Prospects

The state is emerging from a severe recession with a restructured economy and a more restrained real estate market. In contrast to the speculative periods of

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**TABLE 2**

Trends in Industrial Stock and Vacancies, 1990 – 1994, California Metropolitan Areas

<table>
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<td>Fresno *</td>
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* Total stock and space vacant is for 4th quarter 1993, not 1st quarter 1994.


(Continued on page 10)
CREUE sponsors two forecast conferences each year with the California Building Industry Foundation. The following article summarizes presentations at the spring conference held May 12, 1994 and includes information available as of that date. The fall conference will be held on September 28, 1994.

**Economic & Real Estate Outlook**

Dwight Jaffee, Co-chairman, Center for Real Estate and Urban Economics, forecast a 3% growth rate in U.S. GDP and 3% inflation. Due to the Fed's action to head off inflation, interest rates rose quickly during early 1994, with long rates rising higher and becoming more volatile than short rates, an unusual pattern. As high interest rates slow down economic activity and damp inflationary expectations, rates will stabilize or fall, but it is hard to predict when.

Jaffee noted that California's economic performance in the 1990s has been similar to its performance in the 1970s, when there were also large defense cutbacks. In the 1970s, it took about 10 years for the state to catch up to the U.S., and the outlook is similar today, because defense-industry capital and labor skills take substantial time to modify for non-defense production. But there are differences between the two eras. In 1970, the median price of housing (at a hard-to-imagine $24,000) was the same in California and the U.S.; now it is much higher in the state. The migration of the 1970s included domestic and foreign migrants; now net domestic migration is negative, while foreign immigration remains strong. In the 1970s, the state's public infrastructure was much newer, stronger, and better matched to the needs of increased production than it is now.

Like Jaffee, Sunne McPeak, Chair, Bay Area Economic Forum, pointed to the need to improve public infrastructure to achieve development, and also cited the need for affordable housing. McPeak stated that we must target both the industries based on new technologies and retention of the existing industrial base, rather than take an either-or stance.

Unlike previous recoveries, this time real estate has held the economy back, rather than propelling it forward. Real estate represents about 2/3 of national wealth: $50,000 per capita. Over the past several years, total land values have fallen from $6 trillion to $5 trillion, with non-residential taking the biggest hit, according to Jaffee.

Sanford Goodkin, Principal and CEO, Goodkin & Associates, insisted that real estate must concentrate on the consumer, and take account of factors such as the potential increased demand for congregate care as the population ages, retrofitting of buildings, and the reduced need for storage space due to increased computerization and telecommuting.

**Retail**

According to John Riordan, Executive Vice President, International Council of Shopping Centers, the essence of retail real estate is "location that produces sales." In the U.S., there are about 40,000 shopping centers, of which only 800-2,000 can be termed regional centers.

John Gilchrist, President and CEO, the Hahn Company, noted that the key factors for regional malls are population, household income and the extent of retail competition in the area. The ability to draw customers comes from the number, size, and quality of the anchor and mall stores, but the revenues for the owner come from the shops in between the anchors.

What's wrong and right about the regional mall business includes factors associated with department stores and other tenants, financing and capital access, the consumer, and developers.

Leveraged buyouts and a loss of consumer focus have hurt department stores. J.C. Penny and Sears are gaining momentum, while Mays, Nordstrom, and Dil-lards are viable long-term players.

For malls, less tenants are available, and more of them think the rents and extra charges are too high. Nevertheless, business is starting to grow, with average sales per square foot at $275 for Hahn Co. properties, and occupancy levels moving up: the 45 Hahn properties are 90% occupied, with another 4% under lease. Average rents are $23 per square foot, with $12 per square foot going to maintenance, utilities, taxes, and other operating expenses. Total sales were up 4.3% year over year by May 1994, and up 1.5% on a comparable store basis. Financing is still hard to come by because of the view that there is too much product, and REITs are the funding source for new capital. Prime regional centers have cap rates of 7-7.5%.

Malcolm Riley, Partner and Co-President of Riley/Pearlman/Mitchell Company, noted that there is 18+ square feet of retail store space per capita in the U.S., compared with 12-13 in Canada and 2-3 in Europe. Building has declined drastically since the 1970s, when 1,500-2,000 new centers were built each year in North America, compared to 400-500 in 1993. Many centers throughout the country should not have been built. However, new centers are still being built because some of the old vacant space is no longer attractive to today's retailers. Consumers have changed, with less time for shopping, more concern about security, and greater desire for no-nonsense value. There are architectural solutions to the time crunch through tenant grouping and more vertical transportation.

Technology is also changing retailing. Home shopping, really an extension of catalog, is not a big threat because people

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like the social interaction of shopping. The casualties include department stores, local merchants, and poor merchants. Riley believes that department stores failed because of inefficiency, rather than the high debt burden.

Successful operating centers have 4-7% vacancy rates. Winners include stores in a variety of categories, such as warehouse clubs, and focused efficient, value, and service oriented specialty stores. Substantial consolidation is going on, and eventually, only 2-3 national chains will exist in each category.

Real estate locations for these new tenants are free-standing, small (200,000 - 400,000 square feet) clusters of big boxes, or power centers (500,000 sf and up, 50 acres, 50-25 stores). The latter have the same demographics as B+ malls, but in general enclosed malls do not work for these stores because they are inefficient and time consuming. Total market will support about 800 power centers, based on the same demographics as a regional mall, which will make them overbuilt in 2-3 years. Many shopping centers of today will be like downtowns were 25 years ago.

Robert Rodde, Partner, Rodde McNellis, discussing smaller neighborhood and community centers with up to 200,000 sf, stated that developers need to think like retailers. Convenience is very important, and the demand for retail space is relatively price inelastic.

California has 5,200 centers, 90% of which have 200,000 sf or less. These smaller centers account for 25-35% of total retail sales. Despite higher incomes, per square foot sales in California have fallen below those in the U.S., but consumer confidence has moved up, which is correlated with sales.

Three smaller center formats are currently expanding: Warehouse Clubs take a little business from each retailer with supermarkets most affected. Category Killers target one category and go after inefficient stores. Combination stores have absorbed sales of drug stores, florists, health and beauty stores. Opportunities exist for infill, recycling/renovation, and limited fringe area expansion, but un-anchored strips will not be a winner.

Riordan, discussing the transfer and adaptation of the modern shopping center, a North American invention, to other parts of the globe, noted that there has been some cross-border intercontinental and even global merchandising, but relatively little such development. Developers interested in entering a new country generally need a local joint venture partner to overcome numerous complex obstacles, much more so than retailers.

**Residential**

Roger Menard, President - U.S. Operations, Kaufmann and Broad, stated that the demand for housing is much improved, and that value is the key word. Higher interest rates won't begin to hurt development unless they broach the 10% psychological barrier. Home sales were up 31% year over year in March. In 1994, 82,000 housing starts are projected for California. California's affordability index was 43% in the first quarter of 1994, compared to 17% in 1989; however, the state still lags behind the U.S. The state's strengths are its educated labor force, high tech manufacturing, and international linkages. Its challenges are the reduction in aerospace and other defense jobs, corporate downsizing, tarnished image, and high crime rates. While Northern California has been doing better economically than Southern California, a recent Price Waterhouse study sees the biggest growth in some Southern California counties. N. California is higher cost, more regulated, with design restrictions, and high environmental sensitivity. Labor costs are also higher in N. California. All in all, N. California building costs are 20-25% higher than S. California, with development fees adding $20,000-30,000 to the cost.

Larry Kelley, President Stanford Ranch, discussed the milder housing recession experienced by the Sacramento Metropolitan Area than the coastal counties. Employment in Sacramento held up better because of its reliance on state government jobs, which have increased by 9,000 even as federal government jobs have dropped. The California Department of Finance projects a 47,000 increase in population per year for Sacramento, resulting in a population of 2 million for the metro area by the year 2000.

Prior to 1980, Sacramento had the lowest home prices of major areas in the state because of more available land and smaller homes, in line with the modest incomes of the area's government and agricultural employment base. In the 1980s, the size and quality of housing constructed was pushed up by the demand from higher income employees of firms such as NEC, Intel, and HP which moved into the area. In the 1990s, the boom collapsed, with single family unit construction falling from 16,000 per year in 1989 to 8,000 per year in 1993. Prices fell, but have stabilized. Now, with restrictions leading to a lot shortage and driving construction out to outlying areas, housing prices and rents will likely rise.

Donald Terner, President of BRIDGE Housing Corporation discussed the prospects for low income housing. At BRIDGE'S latest development, 3,000 people were in a lottery for 118 units, demonstrating the high demand. These people, teachers, policeman, and others who are priced out of local markets, include 1/4 to 1/3 of the state's population. High density is the key to producing affordable housing, which, contrary to popular opinion, can be very attractive and can be created as part of mixed income developments.

Impediments to producing large volumes of low income housing are NIMBY/BANANA (Build Absolutely Nothing Anywhere Near Anything)/NIMTO
(Not in My Term in Office), environmental regulations (which are useful but can be abused), other regulations (seismic, ADA, etc.), costs (which actually can be higher in slumps, as builders try to make up all losses on each project), opposition from a belief that quality will be poor and bring down values, and unavailability of capital. The latter will be helped by the recent $300 million program put together by CalPERS, CalSTRS, and World Savings. Long term debt is very hard to come by. There is no program capability in HUD, with the only government program being the low income tax credits provided by the 1986 Tax Act.

Real Estate Finance

Barry Greenfield, Portfolio Manager, Fidelity Management Research, sees total REIT capitalization reaching $200-300 billion during the next decade, as does Alan Stein, Executive Director -Investment Banking, Montgomery Securities. This forecast is based on the fast growth already seen in REITs, growing from $5 billion at the beginning of 1992 to $40 billion currently, and the observation that about 10-15% of equity real estate is securitized in many other countries. According to Greenfield, REIT-quality real estate represents about $2 trillion of the total of $3.5-3.6 trillion in non-residential real estate.

The securities industry is filling the financing gap left by commercial banks and insurance companies. The demand for REITs came first through mutual funds, attracting investors with 7-8% yields versus the 2-3% yield of money market funds. While generally bullish on REITs, Greenfield noted that most real estate cycles end with overbuilding, but he thinks this one will end with REITs overinvesting.

Stein believes the REIT boom will be long-lasting. The equity REITs of the 1990s are a much better investment vehicle than the failed mortgage REITs of the 1970s. The new REITs have been issued by many of the nation's most respected developers and include good properties, with purchases based on cash flow in place rather than projected. The vast majority of REITs are self-managed, self-administered, actively managed to increase shareholder value (rather than being a passive portfolio), include the positive incentive of significant insider ownership, feature conservative capital structures (with debt-to-capital ratios around 30-40%), are larger in average size (1993 average size almost $185 million), and are highly focused in terms of property type and/or location.

Increasing numbers of institutions, especially pension funds and mutual funds (both growth and income oriented) will see REITs as viable, ongoing investment vehicles with upside potential similar to growth stocks and downside protection from regular cash dividends. Advantages for pension funds over privately held real estate include liquidity, a real estate pricing mechanism, diversification by property type and/or geographic region, and a lower need for internal staffing. Stein believes there will be increasing consolidation of the real estate industry, now highly fragmented, which will increase market liquidity and attract larger investors. Vertically integrated organizations occupying a niche will be most attractive. The future dominant real estate companies will be full service, offering asset management, property management, acquisitions, redevelopment, and new development. Apartment, manufactured housing, and hotels offer the greatest current opportunities, with industrial and commercial REITs offerings coming forth later in the year.

Barbara Cambon, President, Institutional Property Consultants, noted that pension funds have taken a long time to invest in real estate. After 25 years, they have reached only $125 billion. The vehicles have changed from commingled real estate funds and other vehicles to REITs. One justification for real estate investing had been the lower volatility that real estate was assumed to show compared to stocks and bonds, but this perception has clearly changed. Investors are looking for increased control, shift from an assumed growth component to a return on current income component, returns that must stand up to international returns on other types of investment, broader approaches to investing with exit strategies, and liquidity. While pension funds don't need liquidity, they are demanding it. The creation of a secondary market helps create the desired liquidity. The clearinghouse for real estate investments that will provide a secondary market should be "on the way" by the fourth quarter of 1994.

Cambon projects that there will be $6-8 billion in new acquisition action this year by pension funds, in contrast to the $10-13 billion levels of 1988-1990. Price declines on real estate in investment portfolios were 6% in 1993, projected to be 2-3% in 1994, and will stabilize in 1995. Pension fund investment in office have gone from 50% 10 years ago to 25% today. Residential has increased from a negligible amount to 16%. Acquisitions this year will be mainly in apartments and retail. Cambon believed that 20-25% of total pension fund real estate assets will be in REITs in 2-3 years.

Stephen Trafton, Chairman and CEO, Glendale Federal Bank, indicated that the real estate lending climate in California had improved. Total real estate lending in the state climbed to $274 billion in 1993, after dropping to a low of $103 billion in 1991. Lending volumes varied across the state, with San Francisco and San Diego showing increases while Los Angeles slipped. In 1993, 80% of residential loan originations were for refinancing, but the purchase market started to come back in the fourth quarter. In 1994 home purchases will come to the fore, while refinancing activity will drop. There will also be a shift from the popularity of fixed interest rate mortgages toward ARMs. While the dominance of fixed rate contracts made 1993 "the year

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Conference...
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of the mortgage banker." the revitalization of the adjustable rate market will cause a shift in business to thrift institutions. Consequently, mortgage banking will experience consolidations.

Impact of Earthquakes on Real Estate

Mary Comerio, Professor and Vice-Chair, Department of Architecture, UC Berkeley, said the good news from the Northridge quake was that the most recent building codes had worked—only 1.5% of the housing stock in Los Angeles was damaged. However, 15 steel frame buildings were damaged when welds failed, and heretofore, steel frames were considered relatively safe. In general, building codes are meant to protect against loss of life more than property damage, but the big economic loss will result in more code changes.

The Northridge and Loma Prieta quakes were different in their effects. Loma Prieta caused about $7-10 billion in damage, mainly to the Bay Area's infrastructure. Residential buildings were affected more than commercial. The area lost 12,000 housing units, and an additional 31,000 were damaged. Single family units were relatively easy to replace, but the multi-family was not.

The Northridge quake affected a much wider range of structures than the Loma Prieta quake. It caused $15-30 billion in damage, including 50% of LA's schools. Of the 20,000 units vacated and 30,000 damaged, 90% were in apartments, many low income.

Property owners should be aware that most government dollars go to repairing infrastructure; FEMA mostly ignores private building owners. In addition, for single family owners, normal price appreciation compensates for 50% of the earthquake loss af

Recovery...
(Continued from page 6)

the 1980s, real estate activity today in California reflects a more cautious attitude, with much more attention to basic trends in demand and supply. The challenge that now faces builders, investors, lenders and regulators is to understand how the components of supply and demand have changed in California's recovering economy. Much of the economic restructuring the state is undergoing is happening nationwide, and the responses of firms and families cross statewide boundaries. However, California remains unique, due to the state's size, cost structure, and demographic mix. Demand may be affected by the types of job and population growth, location of growth, and the changing nature of work. Any increases in supply will need to be responsive to these changes in demand.

Cynthia A. Kroll
Ashok Bardhan
With the assistance of Jessica Congdon

The Center for Real Estate and Urban Economics, founded in 1950, promotes research in real estate finance and construction, land use, and urban and regional development. It serves as a practical forum for academics, government officials, and business leaders and sponsors creative and thoughtful academic research and executive education programs with the goal of promoting understanding and encouraging innovation in the field of real estate. There were no contractors or subcontractors used in the preparation of this publication.

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