

Where Are Real Estate Prices Going in San Diego? **by Hendricks & Partners**

2004 REVIEW

Bolstered by a heightened level of home construction, San Diego's economy displayed an impressive performance in 2004 by adding 18,500 jobs, the equivalent of a 1.5% increase in total non-farm employment. Nearly half of this job growth came from the region's booming housing industry, which accumulated over 9,000 new jobs over the year ended December. Also posting healthy gains were the financial sectors and professional/business services, due in part to their real estate geared operations such as brokerage and lending. The median home price skyrocketed another 23.8% by December compared to the same time last year, resulting in only 11% of the area's inhabitants being able to afford ownership-down from the 15% observed a year prior. Illustrating strong demand for affordable housing, over 3,500 apartment units were converted into condominiums in 2004, up from the 2,300 units converted the year prior.

While the apartment market remains solid, competition created by a surge in new attached product has pulled a large amount of potential tenants into entry-level home ownership.

- Apartment absorption finished at negative 1,384 units in 2004, down from the 1,302 units absorbed in 2003.
- A total of 1,340 apartment units were delivered in 2004. The new inventory was offset by nearly three times that amount of product being converted into condominiums
- Permit activity remained strong as 5,595 multifamily units were approved in 2004, compared to the 6,457 units posted in 2003.
- The average vacancy rate remained intact at 4.8% by year-end, similar to the 4.6% observed the year prior.
- Rents increased an average of just 3.1% over the 12 months ended December, as apartment owners were cautious not to lose tenants to home ownership.

FORECAST 2005

Concern over whether or not San Diego's housing industry will collapse is perhaps currently the most prominent issue considered by investors and homeowners throughout the region. While no substantial downfall is anticipated in 2005, the industry is expected to lose some steam from the exorbitant price appreciation and sales activity observed in 2004. The median price increase of a single-family home will taper off to around 6.0%, compared to the 23% posted last year and 22% in 2003. Meanwhile, condominiums values should appreciate at a slightly faster pace than their detached counterpart, diminishing their marketability as an affordable housing alternative. Subsequently, this will allow demand for apartments to rebound to roughly 700 units absorbed by the end of 2005 and continue increasing into the following year. Moreover, rent growth should be able to break out of the suppressed growth slump observed over the past two years and ramp up to the 4.0% range by year-end.

Multi family permit activity is expected to reach 6,500 units by year-end – primarily for condos – compared to the 8,000 single-family permits anticipated for approval. The downtown area will continue to garner the majority of multifamily interest within San Diego, including an abundant amount of condo conversions as available land in this region remains increasingly difficult to secure. The number of condo conversions planned for the coming year throughout the metro currently total over 3,000 units. This will once again substantially outpace the level of new additions to apartment inventory in 2005, which is currently estimated to be roughly 1,750 units. These conditions will help to create downward pressure on apartment vacancies, which should drop to roughly 4.5% by the end of the 2005 and continue on this trend into the following year.

SALES PRICE / UNIT

HISTORICAL REVIEW

The composition of San Diego's economic base can be traced back to World War 1, when the area was established as a strategic naval base location. Since then, numerous military installations and manufacturing companies catering to the defense industry have migrated to the region, forming a symbiotic dependency on military expenditures that has been responsible for the region's economic performance. To illustrate, during the substantial military build-up from 1984 to 1990, San Diego averaged 5.3% employment growth and 3.2% population growth per year. Consequently, the military downsizing that followed during the beginning of the next decade left the region's economy crippled and its population growth virtually stagnant. During this time, San Diego began to garner international attention as an attractive tourist destination given its desirable year-round climate. The leisure/hospitality industry has since grown to become a substantial employment source for the area, expanding at an average of 2.8% annually since 1994.

During the 1980's, San Diego began to observe a trend toward rapid appreciation in home values, with affordability decreasing 33% from 1985 to 1989. Much of the region's home price increases over recent history can be attributed to demand outpacing supply, due largely to the diminishing availability of developable land. To illustrate the housing deficit observed in the market, in 1988 the metro was gaining a little over two residents per housing unit constructed. By 1994, that ratio increased to more than six persons per unit and has been unrelenting since.

EMPLOYMENT FORECAST

In 2005, San Diego's economy will build upon growth enjoyed in 2004 and add another 20,000 -25,000 jobs, equating to roughly 2.0% increase in total non-farm employment. One of the more significant leaders in the year will be the region's biotechnology industry, which stands to benefit from the newly passed Proposition 71 and the mandated \$3 billion in government subsidies dedicated to stem-cell research. While the forth-coming funding may be slow to arrive, the industry should show signs of benefiting by the fourth quarter of 2005.

Rounding out the economic picture, tourism is expected to continue its resurgence as a major economic contributor to the region amid a nation-wide increase in travel. Moreover, the continued boost in defense spending will help manufacturing post long-awaited gains as well. While the construction industry currently accounts for nearly half of the new jobs created, a mild deflation of this industry and its ancillary sectors is anticipated over the next several years. However, the aforementioned growth created by the remainder of the region's economic base will help to sustain unemployment levels near the 4.0% range over the long term.

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