

apartment management

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CAA Tri-County
October 2009
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back to school

—Brian Henry & Jamie D'Alessandro

“While sales volume is at a historical low, further investigation does illuminate a bright spot in the Santa Cruz apartment market—namely, the high demand for student housing.”

Overnight, on September 16, 2008, the commercial real-estate market changed drastically when the once venerable 158-year-old Lehman Brothers collapsed, rocking financial markets around the world. Although there were many indications of the coming downturn, the collapse of Lehman sent ripples through all market types and signaled the beginning of a new era in the commercial and apartment real-estate sectors. As a stark example, in Santa Clara and Santa Cruz counties, apartment transactions of buildings five units and larger came to a grinding halt.

The completion of these transactions decreased by over 80% during the period from September 16, 2008, through the second quarter of 2009, compared to the number of transactions in the same time period one year earlier. Santa Cruz County historically has had many long-term owners and very low transaction volume relative to other Bay Area counties. Since the market downturn, their transactions have come to a standstill. We brokered the last significant transaction in Santa Cruz, handling the sale of the 100-unit Chestnut Street Apartments in August 2008, from the

original developer to a publicly traded real-estate investment trust.

While sales volume is at a historical low, further investigation of the above transaction does illuminate a bright spot in the Santa Cruz apartment market—namely, the high demand for student housing. The buyers of the Chestnut Street Apartments had a successful operating history and saw an opportunity to take advantage of the demand for student housing. Upon close of escrow in August 2008, the tenant mix in the Chestnut Street Apartments was made up of 6% students and 94% nonstudents. Today, the current percentage is 90% students and 10% nonstudents.

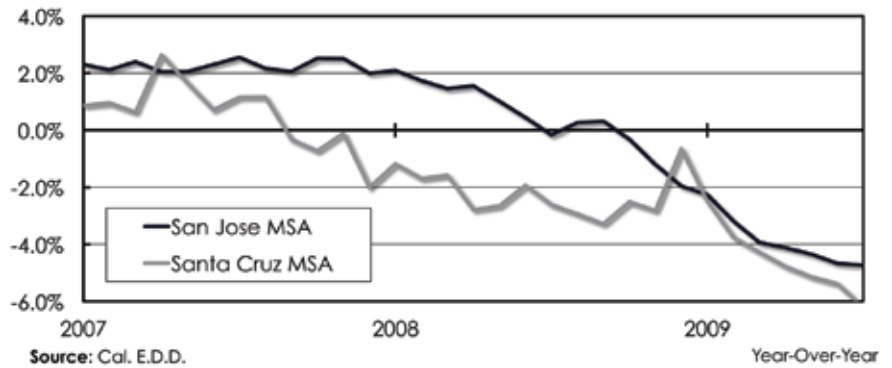
While demand for student housing in Santa Cruz has remained robust, demand for market-rate apartments has dropped considerably with the contracting economy causing severe downward pressure on rents throughout Santa Cruz, the Bay Area and the country. Tenants have turned into bargain hunters and are looking for less expensive rents. There has not been the mass tenant exodus we saw in the technology crash in early 2000, but to reduce expenses former tenants are moving back in with parents, downsizing or doubling up with other tenants. Many savvy tenants have simply relocated locally to more affordable and nicer apartments given the concessions being offered by many apartment building owners in a veritable game of housing musical chairs.

Santa Cruz County apartments have bucked the trend and have weathered the storm quite well relative to some of the historically strongest submarkets of San Mateo and Santa Clara counties. Second quarter 2009 average asking rents for Santa Cruz County only dropped 3.1% from one year ago compared with an 8.2% drop for Santa Clara County and a 6.6% drop for San Mateo County.

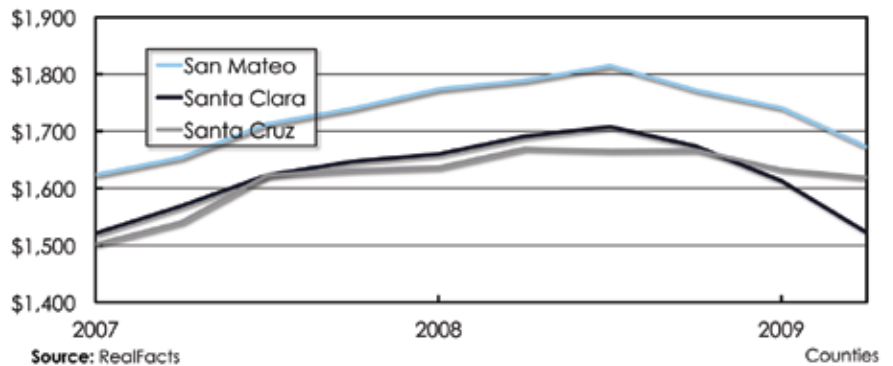
Rents have held up in large part due to the growing UC Santa Cruz student population, demand for less expensive off-campus housing, and an inadequate supply of on- and off-campus housing in Santa Cruz's supply-constrained market.



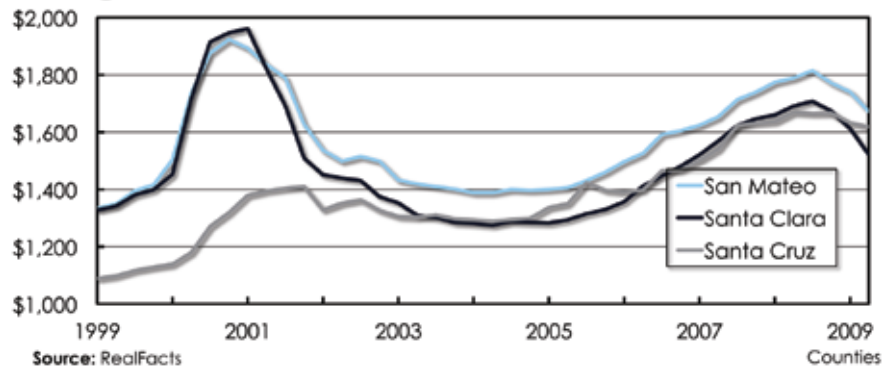
Payroll Gains/Losses



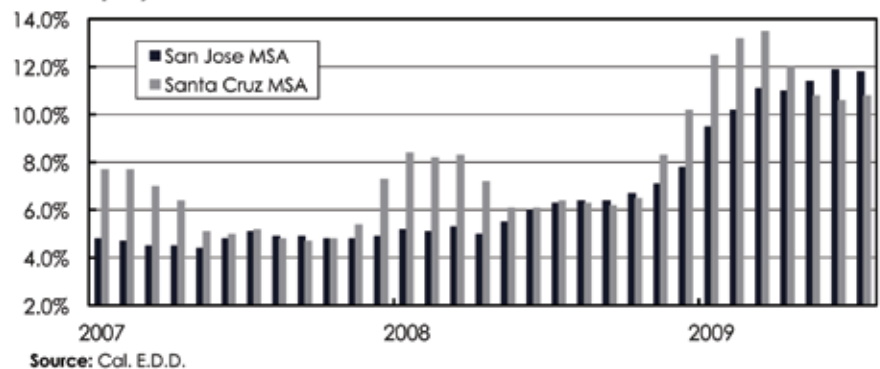
Asking Rents



Asking Rents



Unemployment Rate



Notwithstanding the above, there is risk to the local market as it relates to the state-wide budget shortfall and the impact it is having on the University of California system. The state government has cut \$115 million from the UC system's funding for the upcoming academic year. The University of California has responded by raising tuition by 9% systemwide, which is close to \$1,000 per year per student. At UC Santa Cruz specifically, the cuts amount to \$13 million, and the university administration has prescribed 10% cuts across the board and is also raising the rent for students living in the university's family and student housing apartments. Nonetheless, the need for student housing remains and is even posted on the UC Santa Cruz website:

Demand for on-campus housing at UC Santa Cruz continues to increase. This stems both from campus enrollment growth and the impact of the housing market crisis of the last two years on the local demand for rental living space... students with a second-year housing guarantee, as well as older students, are generally looking for housing that offers more independent lifestyles than can be offered in residence halls. The supply of on-campus student apartments is insufficient to meet student demand for this housing type. In addition to constructing new housing, one strategy to allow the campus to meet demand has been the conversion of double rooms to triples and of lounges and other common areas to bedrooms. This short-term strategy has allowed the campus to accommodate additional students to meet increased demand for campus housing. However, even with these adjustments and additions, the campus will need to continue to add new bed spaces to ensure an adequate supply of on-campus housing as enrollment grows.

Off-campus apartments often have lower rents than on-campus housing. Also, the effective city bus system simplifies transportation to and from campus for these tenants. Nearly all students move off campus after their sophomore year, and many typically stay in the same apartment for the duration of their college years.

Throughout the Bay Area, the apartment sector in general has seen a decline in sales and deep softening in rents corresponding to a decline in overall value ranging from 15% to 30%. The Santa Cruz apartment market has been somewhat insulated to these major declines in rents as evidenced in the graphs (page 39). Without many recent sales comparables in Santa Cruz, there is difficulty in predicting where local apartment values are today. Cap rates in other Silicon Valley locations have adjusted up by 150 to 200 basis points. Even with this assumed cap rate adjustment, Santa Cruz County apartments should hold their values more favorably than the majority of other Bay Area locations because of the robust local demand for rentals resulting in lower rent declines.

Over the past six months, we have provided detailed valuation analyses and assessments of apartment building operations for dozens of apartment owners in the area. Regardless of an owner's intent to sell, this is an excellent time to establish the value of your property in today's market and to ensure that you are maximizing the performance of your asset in this challenging environment. In many cases, we have often been able to point out strategies for owners to significantly improve operations and their overall cash flow on the property by identifying opportunities for additional revenues, cost efficiencies, expense reductions, unique rental marketing ideas, as well as other suggestions.

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