



# Q3 2011 Quarterly Real Estate Commentary

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## Summary

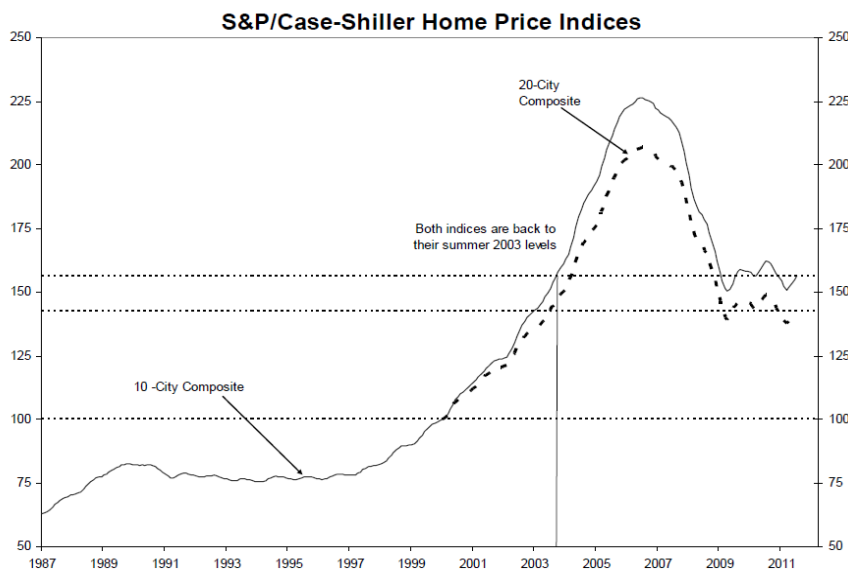
During the third quarter of 2011 the national housing market continued its decline with average sales price and volume down from levels one year ago. It's uncertain if record low mortgage rates and the Federal Reserve's commitment to maintaining these low rates will provide enough support to pull the housing market out of its doldrums. Many argue that an improvement in housing fundamentals will not occur until sustained and substantive economic growth returns and unemployment declines.

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Taking its cue from the economy, commercial real estate ("CRE") markets have begun to show a marked slowdown in the pace of their recovery. Although ample capital is still available to deploy for investments, new capital raising dropped 35% from the second quarter to \$23.18 billion, according to CoStar. Global financial volatility, stagnant job growth, federal government gridlock, and an economic recovery that Federal Reserve Chairman Ben Bernanke recently told Congress is "close to faltering" has taken a toll on confidence levels and the appetite for risky investments.

## Residential Real Estate - National

Well, it hasn't quite been a lost decade for the national housing market, but average home prices across the United State are back to the levels where they were in the Summer of 2003. Since the peak in June/July 2006, the 10-City Composite and 20-City Composite have declined 31.0% and 30.9%, respectively (see graph to the left). Average national home prices seem to have found a bottom, and may very well bounce along the bottom for the next several years. A recent survey of residential related professionals (realtors, brokers, title, etc.) by Deloitte & Touche found the average participant didn't expect housing prices to increase until 2013.

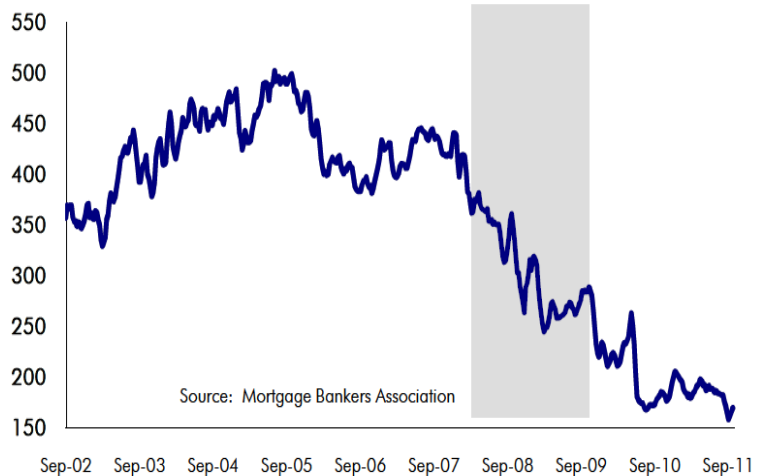


Source: S&P Indices and Fiserv

Mortgage applications increased for the fifth straight week ending the third quarter, but the purchase index remains near historic lows. As European debt problems threatened to infect the finance and

banking sectors, long-term yields fell to historic lows. Despite all of this, home sales remain problematic. Fewer buyers, many of them all-cash investors, and more application rejections due to more strident conditions and low appraisals are keeping the purchase index at levels experienced in mid-2010 (see graph to the right). The refinance index has been posting strong gains and refinance applications outnumbered purchase applications 4-to-1. Recent gains in the purchase index signal some improvement in housing demand, but remain sluggish.

Weekly Mortgage Application Survey: Market Purchase Index  
4-wk MA, Index 1990 = 100



The mass liquidation of foreclosure properties has not come to pass as expected, but U.S. homes are entering the foreclosure process faster - they're also taking even longer to get sold or repossessed by lenders. The number of U.S. homes that received a first-time default notice during the third quarter increased 14% compared to the second quarter, according to RealtyTrac. That increase signals banks are moving more quickly now against borrowers who have fallen behind on their mortgage payments than they have since industry-wide foreclosure processing problems emerged last fall. Those problems resulted in a sharp drop in foreclosure activity this year. In all, 195,878 properties received a default notice in the third quarter. Despite the sharp increase from the second quarter, the total was still down 27% versus the third quarter last year, RealtyTrac said. Lenders took back 196,530 homes during the quarter, down 4 percent from the second quarter and down 32 percent from the same quarter last year. Banks remain on track to repossess some 800,000 homes this year, down from more than 1 million last year.

An outcome stemming from the increase in default notices is that residential short selling is rising rapidly in some of the nation's largest metropolitan area. U.S. banks are finally approving more short sales to preemptively remove troubled mortgage loans off their balance sheets, thus avoiding the cost and complications involved with selling bank-owned properties. This shift means bigger discounts and faster short sales transactions in some markets, which many experts agree will help clear inventory and fuel an eventual market recovery.

## **Residential Real Estate – Local**

The median price of \$523,827 paid for a Bay Area home was significantly below the year-ago level for all counties except for Marin, which showed a slight 1.6% increase (see graph on the next page). This is the 11th consecutive month the median price paid for a home remains below the amount paid a year ago. Average home sales for the Bay Area rose 7.72% from July and are also up 11.7% from August 2010. August is typically one of the stronger sales months because many families want to move before school starts.

County	Median Price of Existing Single-Family Homes					Sales	
	11-Aug	11-Jul	10-Aug	MTM% Chg	YTY% Chg	MTM% Chg	YTY% Chg
Alameda	\$468,900	\$462,890	\$515,620	1.30%	-9.10%	-1.00%	22.50%
Contra-Costa	\$607,310	\$618,420	\$670,450	-1.80%	-9.40%	7.00%	21.20%
Marin	\$806,550	\$761,030	\$794,120	6.00%	1.60%	2.30%	26.80%
Napa	\$354,760	\$334,780	\$394,230	6.00%	-10.00%	24.50%	5.40%
San Francisco	\$632,270	\$648,330	\$675,780	-2.50%	-6.40%	-10.00%	-3.80%
San Mateo	\$742,000	\$729,900	\$780,000	1.70%	-4.90%	1.60%	3.60%
Santa Clara	\$595,000	\$607,000	\$625,000	-2.00%	-4.80%	10.70%	9.90%
Santa Cruz	\$490,000	\$470,000	\$514,000	4.30%	-4.70%	32.50%	6.40%
Solano	\$197,880	\$190,560	\$207,090	3.80%	-4.40%	-3.70%	7.90%
Sonoma	\$339,200	\$333,490	\$378,830	1.70%	-10.50%	13.30%	16.80%

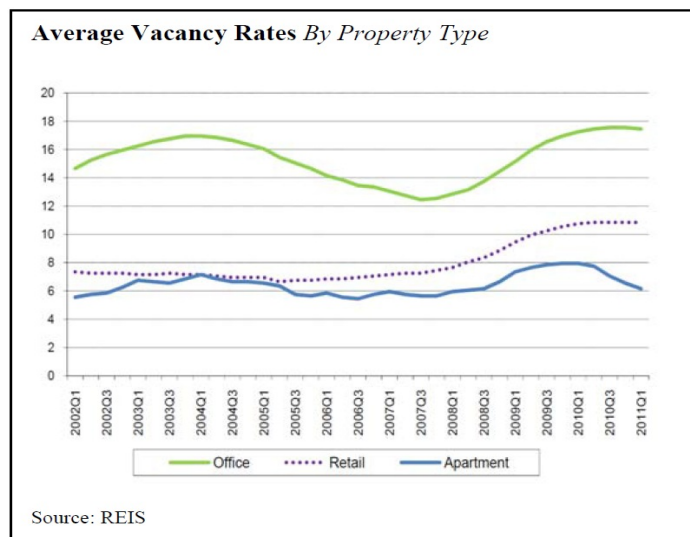
According to DataQuick, Bay Area homes that have been foreclosed on in the past year accounted for 26.4% of the resale market in August, with 18.6% of the resale market consisting of short sales. August statistics reveal that foreclosure activity remains high by historical standards, but below peak levels, while mortgage default notices increased from July.

The Bay Area submarkets of Palo Alto, Los Altos, and Menlo Park, along with San Francisco and parts of Marin County, continue to defy all other residential real estate markets locally and nationwide. These microcosms continue to receive multiple offers and sales over listing price. The \$1 to \$2 million market is strong, while the \$2 to \$4 million range is nothing to laugh at. However, sales activity has slowed somewhat relative to the second quarter. The financial market’s volatility has made buyers question whether to buy now or wait for sellers to reduce pricing.

The risk is that buyers missed this slowdown in the market and the sales frenzy continues. Facebook, Google, LinkedIn, and other significant local companies are in the midst of the largest hiring expansion in their history. These newly hired employees are relocating and want to be near where they work. With little inventory available, and even less land to build, plus historically low interest rates, it is definitely a seller’s market in several lucky Bay Area locales.

## Commercial Real Estate – National

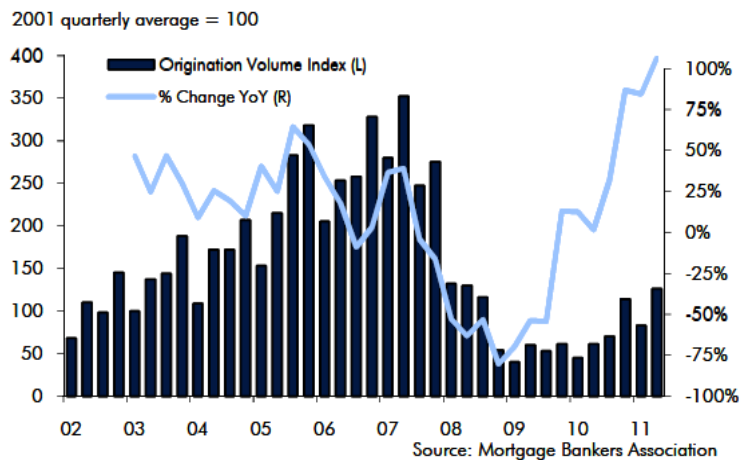
Commercial real estate fundamentals hit a plateau in the third quarter of 2011, except for multi-family/apartment property types. Apartment vacancy rates continued to decrease during the third quarter, down to approximately 6% (see graph to the right), which has put upward pressure on rents. Some markets have reported an increase of 10% or more in year-over-year rents. The housing market continues to suffer with foreclosures still near all-time highs, in addition to a bleak jobs picture and high unemployment, and the result is many previous or would be home owners have found themselves unable to afford or qualify for home ownership.



Consequently, this segment of the population is turning to apartment dwellings to house their families. This increase in demand coupled with all-time low interest rates has been a boon for apartment property owners.

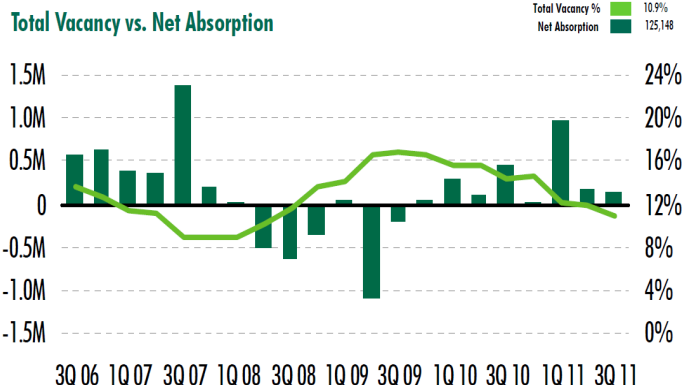
Average vacancy rates remained flat for office and retail properties in the second quarter. Office vacancy rates stayed level at 17.5% in Q2 2011, while retail vacancy rates ticked slightly up to 11% from 10.9% in the first quarter. Like the economy, CRE fundamentals seem to have stagnated during the end of the second quarter.

The CRE debt market has done a 180 degree turnaround from the first half of last year with optimism for the second half of the year showing the same trepidation as the overall CRE market. While overall loan originations have demonstrated significant gains over the past year, origination volume is still 20% below its 10-year average. Commercial and multi-family loan originations showed 107% year-over-year gains, comprised of a CMBS volume increase of 683%, 150% for commercial bank portfolios, and 87% for life insurers (see graph to the right).



Most insurance companies are becoming more selective as they reach their lending goals for the year. Domestic banks have moderately increased their CRE lending and maintained their market share, but many are still plagued with legacy lending issues. Strong demand for senior bonds helped stabilize the CMBS market earlier this year, but demand for the more risky tranches of CMBS deals has waned. After a promising first half of the year, the CMBS market finds itself back in uncertain territory with the more than \$4 billion of new deals currently in the marketplace getting mixed investor interest.

### Commercial Real Estate – Local



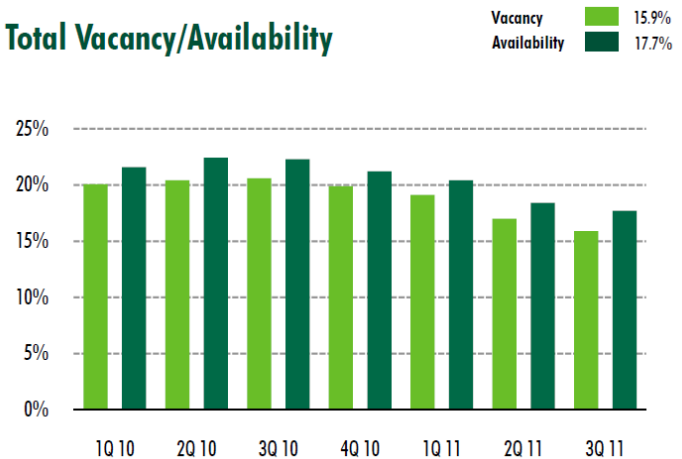
The San Francisco Peninsula office market continued its trend in the third quarter of 2011 of steady consistent growth seen over the last two years. The Peninsula market posted absorption of ±125,000 SF, according to CB Richard Ellis, marking the eighth consecutive quarter of occupancy gains (see graph to the left). Asking rates increased 7% in the third quarter and 17% year to date. Asking rates should continue to trend upward in the fourth quarter with very little new supply hitting the market.

The trend of dwindling available options in the Southern Peninsula at the beginning of the year has moved north and now this same trend is driving vacancy down in the Central Peninsula corridor. All of the recent large transactions in the Central Peninsula could bode well for the Northern Peninsula submarkets like South San Francisco and Brisbane. While much of the activity on the Peninsula this year has come from larger tenants, space under 10,000 SF are still abundant. With many of the large users having recently taken available space, it will be smaller tenant demand that will determine how well the market does during the next several quarters.

After experiencing a relatively high amount of positive absorption in the second quarter of 2011, activity in the San Francisco Peninsula industrial market remained flat in the third quarter. While net absorption was slightly positive, the overall vacancy rate did not change, holding steady at 7.8%. Average asking rates continued to stabilize with the overall rate increasing to \$1.18 NNN, while available sublease space remained just above 1 MSF. While there was not a further reduction in vacancy as anticipated, the market still remains in healthy vacancy territory (under 10%).

Signs of a recovery were evident in the Silicon Valley R&D market as performance met and exceeded expectations. The third quarter of this year showed positive numbers not seen since the end of 1999 and beginning of 2000. Silicon Valley R&D vacancy rates have continued a steady decline for the fourth consecutive quarter, down 450 basis points since the third quarter of 2010 and 110 basis points quarter-over-quarter to 15.9% (see graph to the right).

**Total Vacancy/Availability**



The consistency of positive fundamentals, solid occupancy gains and decreasing vacancy rates indicate characteristics of a strong recovery. Moving forward, the market will likely experience reduced demand as many companies have already signed on noteworthy new spaces over the past three quarters. Additionally, third quarter investor sales have accounted for a sizable amount of transactions, strengthening market confidence as the end of 2011 approaches. The outlook for the fourth quarter is positive, but will not likely post the dramatic occupancy gains as previous quarters have seen this year.

Some notable Bay Area CRE deals during the third quarter were:

- Sony Computer Entertainment of America agreed to lease the 450,505 SF former Seibel/Oracle campus in San Mateo.
- Perfect World Entertainment leased 99,535 SF of class A office space at 101 Redwood Shores Parkway in Redwood City.
- State Comp Insurance completed its \$44 million (\$125 psf) sale of 1275 Market Street, San Francisco, to DivcoWest and TMG Partners.



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## **Conclusion**

Like the US economy, the commercial real estate market is starting to show a slowdown in its recovery; however most investors think CRE fundamentals will keep it from facing the headwinds encountered by its cousin, the residential real estate market. Both markets appear to have hit a plateau and will bounce along until economic fundamentals improve.

It's not just the US economy that will effect CRE markets. US real estate markets, like most other US markets in general, are inter-wound with the global economy. A default by Greece has an indirect impact on US real estate markets. Many European banks make loans to US real estate investors, and purchase CMBS and the residential mortgage securities that now dominate home financing. These same European banks also own debt issued by Greece. If one borrower refuses to pay then ultimately there is less money available for other borrowers, and in the end we all pay. I personally don't think that will happen, but it's a fact we all should remember.

Sincerely,

Carlos Valdivia  
Real Estate Investment Advisor