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California Real Estate Recovery Begins as Economy Expands

California is in the midst of a strong economic expansion. Real estate sectors, which until recently were lagging in recovery, are showing new signs of strength. Directions of growth, however, differ from historical experience, suggesting that the structural changes that have affected the state's economy have also created new conditions in California's real estate markets.

Strengths and Weaknesses of California's "New" Economy

By the end of 1995, California had replaced all of the jobs lost in the 1991-1993 recession. Since then, the state's employment growth has exceeded the national growth rate, as shown in Figure 1. Growing at 2.8% in 1996, California has added over 350,000 jobs in the past year. The new growth is well diversified both among employment sectors and among regions of the state. Even areas that lost substantial proportions of their job base (e.g. Los Angeles, San Francisco, Orange County) are adding employment, often coming close to the statewide rate of growth.

All of the state's major industry categories expanded in 1996, with the strongest growth showing not only in expanding services and reviving construction activity, but also in many different manufacturing sectors, as shown in Figures 2 and 3. The most rapidly growing employment sectors illustrate the breadth of the state's expansion. In the

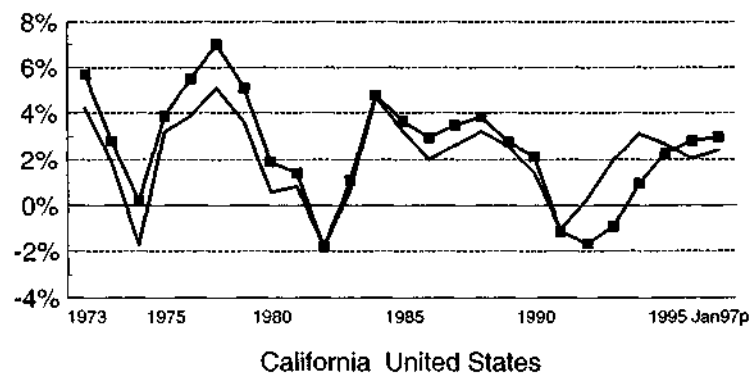
services sector, which accounted for more than half of all jobs added, expanding activities ranged from business services (adding 86,000 jobs in 1996, an annual growth rate 9.7%) to entertainment and tourism related activities such as hotels, amusement and recreation, and motion pictures, which added 26,000 jobs. While both construction and manufacturing employment are still below pre-recession levels, construction employment grew by 25,000 in 1996, and manufacturing added 59,000 jobs, with expanding sectors including electronics, industrial machinery (including computers), food processing and apparel, as shown in Figure 4. Overall, job growth in strong sectors far exceeds the continuing losses in some defense related

sectors (missiles and space products and civilian employment at military bases) and some finance sectors (depository institutions) and insurance.

The geographic distribution of growth within the state is well balanced, with growth rates ranging between 1% and 6% for most metropolitan areas. The San Jose MSA, where jobs grew at an annual rate of almost 6%, enjoyed the strongest growth of any metropolitan area in California over the past year, followed by the Santa Rosa area, with a growth rate of 4.6% (Figure 5). Monterey County (the Salinas MSA) and San Francisco both had employment increases of close to 4%. The Oakland and Vallejo-Napa-

(Continued on page 2)

Figure 1
Employment Change, California and U.S.
Annual Rate of Change, 1973-1997(Jan,prelim)
Percent Change



Source: California Employment Development Dept. and Bureau of Labor Statistics, FCREUE ests.

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Fairfield areas still showed impacts of base closure related job losses, but nevertheless had growth rates close to 2%.

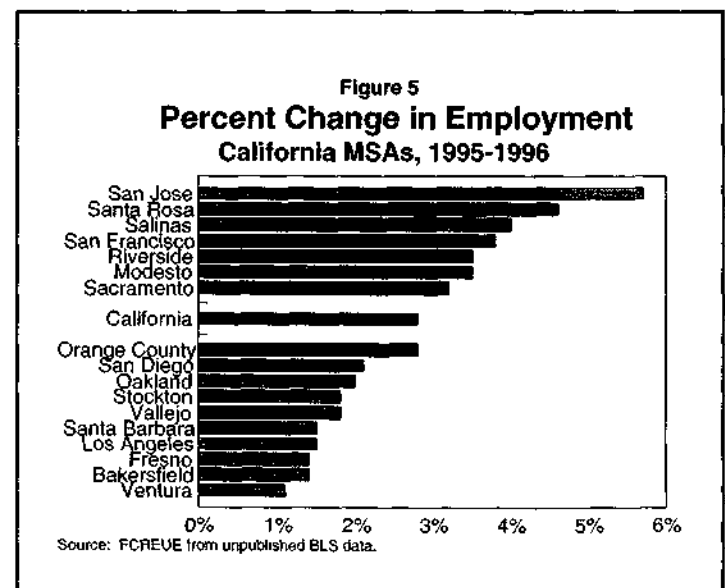
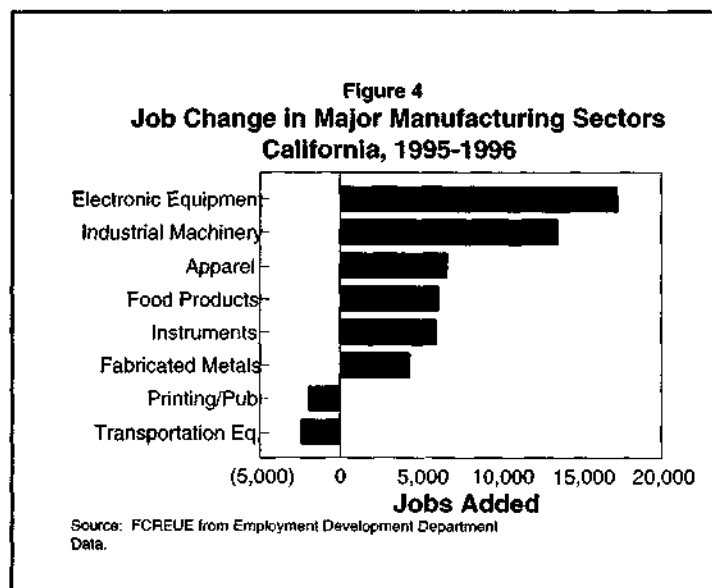
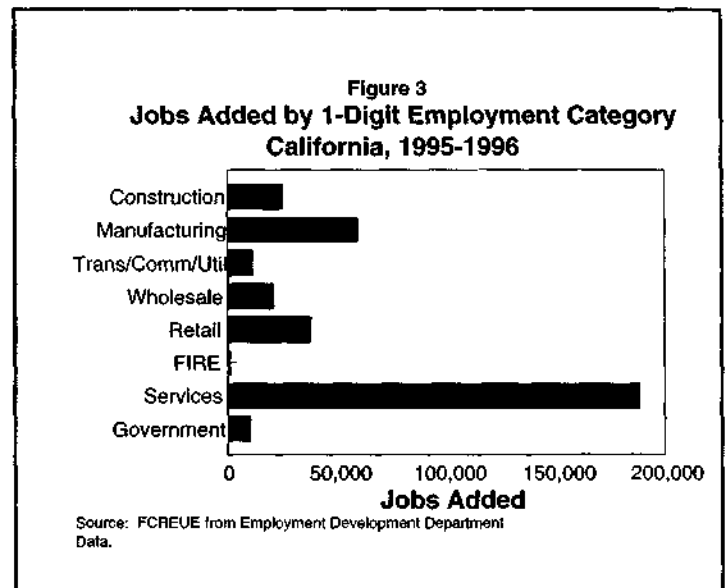
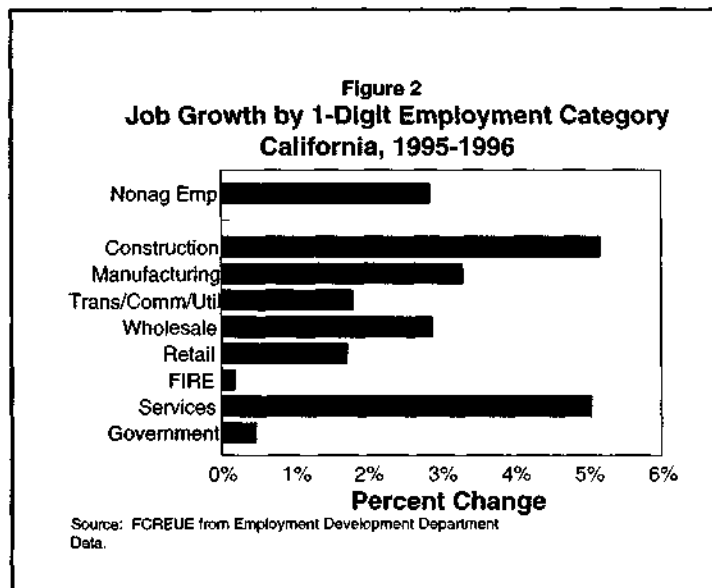
Southern California showed a more uneven pattern of growth. The Riverside/San Bernardino metropolitan area was among the fastest growing in the state, adding jobs at a rate of 3.5%, and Orange County expanded at the statewide average of 2.8%. San Diego County grew somewhat more slowly, at 2.1%, but like Riverside/San Bernardino

and Orange County, has an employment level significantly above its pre-recession peak. In contrast, Los Angeles, Santa Barbara, and the Bakersfield MSA are experiencing slower recovery, with job growth in the range of 1% to 1.5% and employment levels still below the 1990 peak. Despite slower growth, the Los Angeles area added 55,000 jobs to its large job base in 1996, more than any other county in the state.

Some of the more troubling impacts of the recession on the state's income and unemployment are also showing signs of improvement. The state's income advantage relative to the rest of the US was

heavily eroded during the early 1990s. California's per capita income, which was 10% above the US level in 1990 showed only a 3% advantage by 1994. By 1995, the differential showed signs of widening again, with a 4% advantage over the rest of the US. The unemployment gap has also narrowed, as shown in Figure 6. While unemployment is still above the US rate, the gap has narrowed from more than 2 percentage points to a difference of 1.6 percentage points in 1996 and only 1.2 percentage points in the first two months of 1997.

Perhaps the slowest recovery will come in losses in wealth. Per capita in-



come from wealth (e.g. rents, dividends) was 5.6% above the US in 1990, but below the US level by 1994. Losses in wealth were particularly strong in the real estate sector, but these losses finally began to moderate in 1996, as described below.

Depressed Real Estate Values Show Signs of Rising

Many owners suffered a recession-induced loss in real estate values that has not yet been restored by growth. The Real Estate Research Council index (which is built around the appraised value of specific homes, not median sales price) indicates that housing prices in southern California bottomed out at almost 20% below their 1990 levels in April 1996 and had not yet shown a significant increase by fall of 1996. Housing prices in northern California reached a low in April 1996 about 9% below October 1990 prices, but had risen a half of a percentage point by fall 1996, as shown in Figure 7. Most San Francisco Bay Area markets had shown a definite turnaround by the end of 1996, with the largest increase found in Santa Clara County, where prices rose by 5% in the second half of the year, and where more than half of the loss in value experienced in the recession has now been recovered. Central Valley communities

more poorly, with prices still dropping as of October 1996 in the Sacramento and Fresno markets.

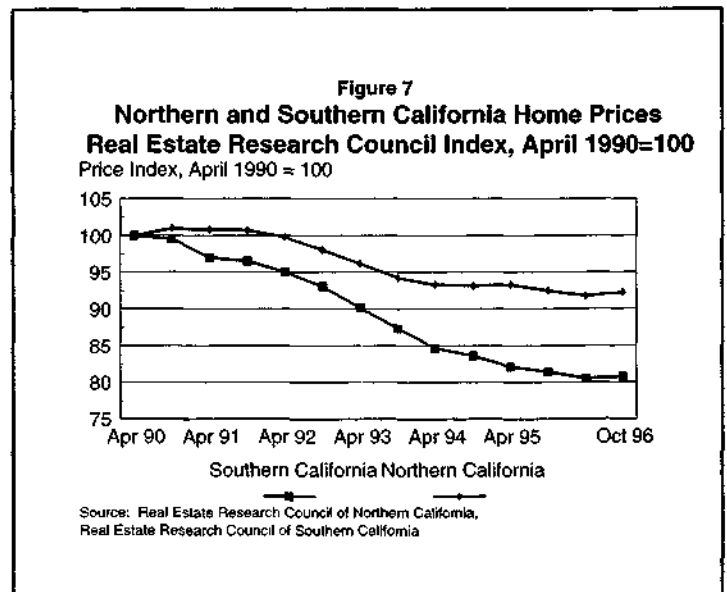
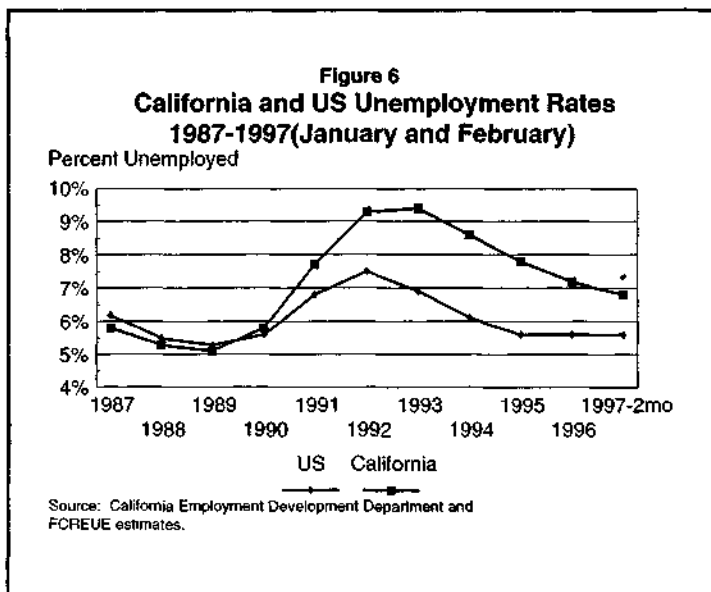
Median prices as reported by the California Association of Realtors still showed a very slight decline (-0.3%) in 1996 for the state as a whole. However, a number of market areas showed significant increases, as shown in Figure 8. Santa Clara County led with a median price increase of 7.3%, contributing to an overall rise in the San Francisco Bay Area of 4.7%. Southern California showed a slower turnaround. In Los Angeles County, where the overall job level has not fully recovered, the median price was still dropping in 1996. San Diego and Orange counties, which are experiencing stronger job growth, began to see median home price increases, although in the modest 2% range. Despite relatively strong job markets, the Central Valley as a whole and the Sacramento area in particular had declining median home prices in 1996.

Nonresidential California real estate and apartments experienced even larger declines in value during the recession than single family housing. The National Real Estate Index shows that prices have begun to recover, but for most products prices remain well below 1990 levels. The price per square foot of California office space dropped by 36% between

1990 and 1994, and has risen by only 4% since then. The value of retail square footage dropped by 25% through 1994 followed by a 7% increase through first quarter 1996. Warehouse space, which dropped by 39% in California, has risen more strongly than office or retail, recovering by 16% since 1994. Apartment markets are in the strongest position relative to 1990, with a loss of 27% though 1993 followed by price increases of 32% through 1996.

As in single family housing, the strongest recovery in investment, commercial and industrial space centers in the San Francisco Bay Area. Rents are above their pre-recession (1990) levels in San Francisco and Santa Clara counties for retail, apartment, office and warehouse facilities, and in East Bay and Sacramento office and apartment markets, according to the National Real Estate Index. Rent levels are significantly weaker in most southern California markets, but even in these markets, recovery is clearly underway, with apartments again showing the greatest degree of recovery. Rising rent levels are beginning to be reflected in dropping capitalization rates in both Bay Area and southern California apartment markets, but cap rates remain high in many areas for most other types of product.

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Delayed Return of Residential Building and Home Sales

The losses in wealth contributed to a very weak recovery in housing construction. Increases in building activity and home sales have historically been leading indicators of the end of a recession. This was not the case for California in the 1990s. Building activity remained depressed through 1995, despite the signs of economic recovery that began in 1994. Only 85,263 residential building permits were filed in California in 1995, compared to 84,656 at the trough of the recession in 1993, to 97,047 in 1994, and to 237,747 in 1989 (Figure 9).

Typically, building activity doubles in the first year of recovery following a recession. Yet even in 1996, five years after the employment losses began, the rate of growth was still modest, with single family permits rising 9% from 1995 levels, and multifamily permits rising 15%. Overall, building is stronger in the northern part of the state. In the San Francisco Bay Area, single family permits rose 21% and multifamily permits rose 88% in 1996. The northern Central Valley also is seeing an

in residential building permits, particularly in the Sacramento and Modesto areas. Residential building activity grew more slowly in southern California, where single family permits rose by 13% and multifamily permits by only 2%. Building activity was flat in the Los Angeles area, up in the Orange County and Riverside/San Bernardino areas, and very slow in the Bakersfield and Fresno areas.

The caution demonstrated by homebuilders in California was a natural response to falling prices, low rates of household formation, and weak home sales activity. Household formation (the rate of growth of households) has been below 1% annually since 1992 and is less than one-third the rate of the late 1980s. Sales of existing homes brought brief signs of recovery in early 1994, but these quickly dissipated, as sales dropped below the levels seen in 1993. Data on household formation is not yet available for 1996, but home sales strengthened, up 19% over the previous year, to 505,220 sales.

The coming year is likely to see continuing improvements to the housing market. With moderate interest rates and lower housing prices, housing affordability is much better than in the 1988-1990 period, as shown in Figure 10. Restored confidence in the economy and faster population growth may lead to in-

creased household formation, keeping home sales at the 500,000 level or above in 1997. Price increases are likely to follow, with the strongest increases occurring in areas with the fastest employment growth.

New Signs of Life in Nonresidential Building

Nonresidential building activity has also recovered slowly in California. The value of nonresidential permits grew by only 3% annually in 1994 and 1995 (by 2% after accounting for inflation). Growth was stronger in 1996, with permit value expanding by 17% (15% after adjusting for inflation). Improvements in nonresidential sectors are evident throughout the state.

Of the three major nonresidential sectors, industrial building activity has rebounded most strongly, increasing in value (after adjusting for inflation) by 29% in 1994, by 12% in 1995, and by 52% in 1996 (Figure 11). Office activity began recovering a year later than industrial. Between 1989 and 1994, office building permit values dropped by 85%. Permit values rose by 27% in 1995 and by 22% in 1996, but remain at less than one-fourth of 1989 value.

Periods of fairly high percentage growth in both industrial and office sec-

Figure 8
Annual Change in Median Home Price, 1995-96
Major California Markets

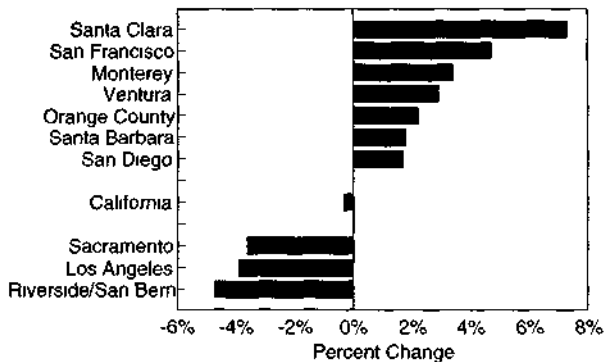
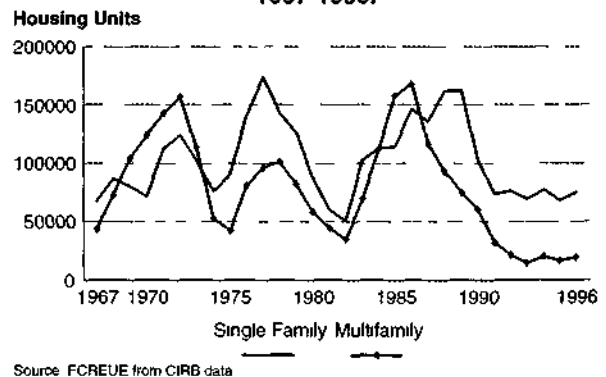


Figure 9
California Residential Permits
1967-1996P



tors should be seen in the context of the very low levels of activity reached in 1993 or 1994. In contrast, retail building activity, which declined far less during the recession (down in value by 42% between 1989 and 1994), grew very slowly in 1994 and 1995 (3% and 1%, in real terms), and grew by 11% in 1996.

Industrial building activity has been strong in all but a few markets. Industrial permit value grew by over 70% throughout southern California, and by close to 50% in the San Francisco Bay Area and the major Central Valley markets. Office building activity was slowest in the Central Valley, increasing by only 2% in 1996, while permits expanded at close to 20% in southern California and the San Francisco Bay Area. Retail permit recovery was strongest in the Central Valley and San Francisco Bay Area markets, growing at about 16%, but also expanding by 7% in the southern California metropolitan areas.

The continued low levels of office and retail building is a reflection less of the uncertainty as to the strength of the current expansion and more of the restructuring that has taken place in the economic sectors that underlie the demand for commercial space. The retail sector has been affected by the weakening role of traditional department store anchors, the ex-

pansion of new product types such as power centers, and the redefinition of the role of entertainment activities within regional malls. Office demand has reflected both the changing growth patterns of traditional office users (with declining employment in finance and insurance, for example) and the changing structure of doing business. Office activities are now firmly entrenched in suburban markets, as is reflected in the redistribution of vacancies and absorption, described below.

Office Vacancies and Absorption Improve Significantly in 1995 and 1996

While building activity is weakest in the office market, there has been significant improvement in vacancy and absorption figures throughout the state, according to our annual survey of commercial brokers in California's major office markets. (See Table 1.) Net absorption in the state's 12 largest markets, at over 9 million square feet statewide in 1995 and close to 11 million in 1996, is well below levels of the 1980s, when the state absorbed more than 25 million square feet of space annually, but far exceeds the less than 2 million square feet constructed in 1995 and the 4 million square foot addition to inventory in 1996. With

absorption exceeding construction for most of the 1990s, vacancies have dropped throughout the state. In several northern California markets, vacancies are close to or below the rates that existed prior to the major building boom of the 1980s. We estimate the region wide vacancy rate for the San Francisco Bay Area at 7% in December 1996, with the lowest rates in San Mateo (1.8%, as reported by SAMCEDA), the 680 corridor (6.0%, according to CB Commercial), and Silicon Valley (5.2%, based on Grubb & Ellis statistics). The highest vacancy rates in the region are in the East Bay Shore (primarily Alameda County), where vacancies dropped from 18.4% in 1994 to 16.7% in 1995 and 13.9% in December 1996, as tracked by Cushman and Wakefield. San Francisco, which for years had the tightest office market in the region, shows a moderate vacancy level of 7.6%, according to Cushman and Wakefield data (down from 10.3% in 1995 and 11.1% in 1996).

Vacancy rates have dropped steadily since 1994 in the three largest southern California markets (Los Angeles, Orange and San Diego) but the 1996 vacancy rate for the southern California area was still fairly high, at 16.6%. The high vacancy rates represent the overhang of

(Continued on page 6)

Figure 10
California Housing Affordability Index
Selected Markets and Time Periods

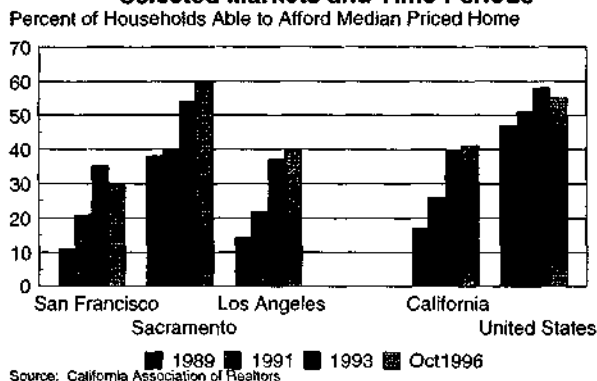
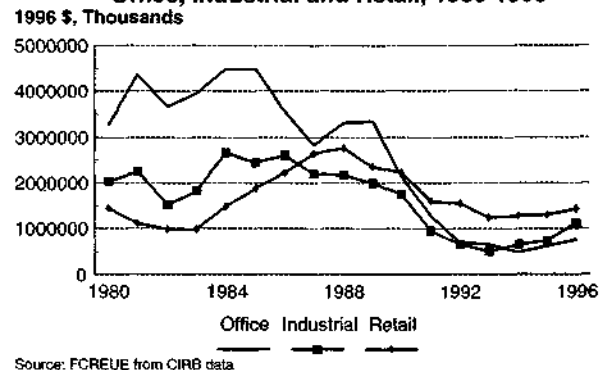


Figure 11
California Building Permit Values
Office, Industrial and Retail, 1980-1996



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(Continued from page 5).

overbuilding from the 1980s, rather than weak demand. Net absorption doubled for the six county area in 1996 to almost 5 million square feet, while new construction occurred only in the San Diego market, where (because one building was destroyed) the net increase in square footage was below a half million square feet. CB Commercial shows San Diego with the lowest vacancy rate in the region for 1996, at 12.9%. Ventura County (tracked by Grubb and Ellis) had 13.6% of space vacant, down from 16.4% in 1994. Vacancy has been dropping slowly in the Los Angeles market, reaching 17.6% in December 1996, after net absorption for the year of 1.8 million square feet. The Riverside-San Bernardino area had the highest vacancy rate, according to Grubb and Ellis figures, at 23%, but strong employment growth in the MS A may lead to further absorption of this space in the next year.

Vacancy rates are also down in the Sacramento area, where vacancy has dropped from 13% in 1994 to about 10% in 1995 and 1996. Moderate construction and absorption has kept the market in balance in the past year.

A Positive Outlook for California

All signs indicate that California has climbed out of the abyss it had allegedly fallen into and is experiencing significant, relatively robust growth. The repositioning and restructuring of the California economy has been a necessary precursor to the state's newly emerging economic base. Since real estate is a derived demand based upon economic activity, California's expanding economy should lead ultimately to renewed prosperity in the real estate market. Will renewed prosperity bring with it the extreme booms and busts of the 1980s and early 1990s? Although there are new

signs of booms in a few California markets, some moderating influences may make it harder for markets to boom as broadly, as quickly, and as widely as in the 1980s.

Housing construction activity is likely to continue to be moderated by several factors. A stronger housing market is not likely to bring the rate of profits gained in the late 1980s for homebuilders, especially in southern California where prices remain weak. Builders who once specialized in California have begun building in new markets and have found them welcoming. Thus, residential building activity in California is likely to recover to levels below the peaks of the 1980s.

While demand for nonresidential real estate is clearly growing and the excess supply of the 80s is finally being absorbed, new construction is proceeding cautiously. The financial market for non-residential construction has changed radically since the early 1980s, making it much more difficult to build speculative buildings. At the same time, tenants are experimenting with alternative work arrangements that may lead to slower growth in demand for space, relative to the size of the workforce. Changing patterns of work are also affecting where employers locate, making detailed market information critical in understanding the future of different non-residential real estate products in California.

These moderating factors are most effective in terms of building activity. In contrast, the fuel for real estate price booms has begun to appear in a few markets. In Silicon Valley, for example, with very low vacancy rates in both residential and nonresidential space, home prices and rental rates may rise rapidly. In fact, the slow rate of building activity is likely to contribute to escalating prices. However, to date the boom has not spread far beyond Silicon Valley. Many Bay Area markets continue to see stabilized prices without rapid increases, and slower job growth and higher vacan-

cies in many southern California markets should lead to more modest increases in prices and rents in those markets.

In conclusion, the California economy is growing strongly and real estate is in recovery, yet the strength and pace of recovery varies among markets within the state. All markets face a changing mix of industries, occupational structure within industries, and financial structures that will lead to a different type of real estate market than was experienced a decade ago.

Robert H. Edelstein
Cynthia A. Kroll

*The California economy is discussed in further depth in *Assessing the California Economy, Working Paper 96-250*, from the Fisher Center for Real Estate and Urban Economics, October 1996. The discussion of office markets in this article draws heavily on data received in our annual office update survey from CB Commercial (Sacramento, San Diego, 680 Corridor and Stockton), Cushman and Wakefield (Alameda Bay Shore, San Francisco), Grubb and Ellis (Los Angeles, Marin, Riverside/San Bernardino, Santa Clara and Ventura counties), Newport Economics Group (Orange County), and the San Mateo County Economic Development Association (San Mateo).*

The Fisher Center for Real Estate and Urban Economics, founded in 1950, promotes research in real estate finance, construction, land use, and urban and regional development. It serves as a platform 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 contractors used in the preparation of this publication.

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Table 1
California's 12 Largest Office Markets, Through 1996

Area	Stock 12/96	Net Increase in Stock 1996	Net Absorbed 1996	Vacancy 1996	Vacancy 12/95	Vacancy 12/94	Average Absorbed		Average Net Increase in Stock	
							80-89	90-95	80-89	90-95
Southern California	277.9	0.4	4.8	16.6%	18.3%	18.2%	16.7	3.4	21.2	3.2
Los Angeles	156.1	0.0	1.8	17.6%	18.7%	19.1%	7.5	1.2	9.4	2.4
Orange	63.2	0.0	1.4	15.5%	17.6%	18.5%	5.6	1.0	6.9	0.6
San Diego	39.8	0.4	1.5	12.9%	16.7%	17.9%	1.9	0.8	2.7	0.2
Riverside/San Bernardino	12.2	0.0	0.0	23.2%	23.8%	19.8%	1.3	0.2	1.7	0.0
Ventura	6.6	0.0	0.1	13.6%	13.9%	16.4%	0.4	0.2	0.5	0.1
San Francisco Bay Area	175.9	3.6	5.6	7.0%	9.8%	11.2%	6.7	3.0	8.6	1.3
Alameda	21.1	0.0	0.4	13.9%	16.7%	18.4%	0.7	0.1	0.6	0.1
Central Contra Costa ⁽¹⁾	33.6	0.4	0.6	6.0%	7.7%	9.2%	2.5	0.7	3.1	0.2
Marin	5.8	0.0	0.3	8.4%	11.6%	16.5%	0.4	0.1	0.3	0.1
San Francisco ⁽¹⁾⁽²⁾	59.2	1.0	2.5	7.6%	10.3%	11.1%	0.6	0.8	1.4	0.3
San Mateo ⁽²⁾	19.1	0.0	0.8	1.8%	6.2%	6.7%	0.7	0.7	1.0	0.3
Santa Clara	37.1	2.2	1.1	5.2%	8.6%	14.9%	1.7	0.6	2.2	0.4
Central Valley										
Sacramento ⁽¹⁾	33.9	0.3	0.5	9.8%	10.3%	13.0%	2.1	0.8	2.7	0.8
California	487.7	4.3	10.9	12.6%	14.6%	15.2%	25.5	7.2	32.5	5.3

Note: Where there has been no addition or subtraction of existing buildings to or from the stock, FCREUE calculates net absorption as the change in occupancy levels over the year. Some of the numbers in the table therefore differ from numbers reported by the brokerage firms, perhaps by as much as 50%.

⁽¹⁾ With the exception of San Diego, much of the inventory change in these markets came from changing use patterns rather than new construction.

⁽²⁾ Net absorption 95-96 estimated as the difference in occupancy, 95-96.

Source: FCREUE calculations from data provided by commercial brokers, as follows: CB Commercial-Contra Costa, San Diego, San Joaquin; Cushman and Wakefield-San Francisco, Alameda; Grubb & Ellis-Los Angeles, Riverside/San Bernardino, Ventura, Santa Clara, Marin; Newport Economics Group-Orange County; SAMCEDA: San Mateo County.