



Northern California

Industry Intelligence Report

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The Economy

By | **Christopher Thornberg**, Economist
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LIMITS TO CALIFORNIA'S ECONOMIC GROWTH

For most of the post-recession era, the California economy has been among the fastest growing of the 50 states, both in terms of job gains and growth in economic activity. Credit for this growth trajectory has largely been attributed to high tech, which has experienced phenomenal growth since the recession. But it was also made possible by enormous slack in the labor market as the state recovered from the highest rates of unemployment seen in at least 40 years. For more than 60 months, from early 2012 through mid-2016, California added jobs at roughly twice the rate as the United States. Job gains were impressive, at times exceeding 3% year-over-year, and the state gradually chipped away at its double-digit unemployment rate, which fell from 12.2% in 2010 to 5.4% in 2016.

Yet, by the third quarter of 2016, that slack had been squeezed out: Instead of handily outpacing U.S. job gains, California's growth rate slipped to just above 1.5% putting it roughly on par with the nation. But by early 2017, slack in the labor force was wrung out as California saw its unemployment rate hit a 16-year low, effectively at full employment. Job gains continued in most industries, to be sure, but the pace of growth was much slower than in recent years. Entering the final quarter of 2017, some observers have worried that the slowdown in the labor market is a precursor to a stalling statewide economy.

NOT SO FAST!

Yes, California's pace of job growth has slowed considerably, but not because the expansion is stalling out. In fact, the state continued to add jobs through the first several months of this year, but at a slower rate. Wage and salary jobs rose by 1.5% year-over-year in October, adding 256,800 jobs year-to-year. In the private sector, the Health Care industry made the largest contribution, followed by Construction, and Accommodation and Food Services (by far the largest sector within Leisure and Hospitality). Professional Scientific, and Technical Services, the source of so much job growth in recent years, was essentially flat, as was Retail Trade. The Government sector saw a significant gain mostly due to hiring by local governments. Otherwise, job losses occurred only in Mining and Logging and in Non-Durable Goods. In all, growth across the state has driven the unemployment rate below 5% in recent months, to the lowest rate since 2000.

Despite the slowdown in job growth, California's gross state product continues to advance at a modest pace, increasing by 2.6% from the second quarter of 2016 to the second quarter of this year. However, taxable sales growth slowed in the first quarter of 2017, but increased by 4.2% year-to-year in the second quarter of 2017.

With the state at full employment, job growth and general economic gains will largely be constrained by the availability of workers. This is good for workers who might achieve pay increases in the coming months and quarters, but it poses a challenge for firms that want to grow but cannot because they are unable to hire the necessary workers. Data at the national level indicates that job openings in general have reached historic highs. This holds true for most industries, from professional and business services to manufacturing to food and beverage establishments. There are shortages of skilled workers in well-paying occupations, of unskilled workers in food services and similar industries, and even of skilled and semi-skilled occupations in manufacturing and construction.

What is holding back growth and can be anything done about it? There is an easy answer to the first question but the second is a different story.

BUILD IT... THEY'RE ALREADY HERE

For decades, California augmented its home-grown labor force with workers from elsewhere, drawing from both other states and other countries. Through much of the post-World War II era, the state was a magnet for workers from around the country and the world. There were opportunities for aerospace engineers, fruit pickers, and everything in between. In the 1970s and 1980s, California's labor force grew by an average of 3.1% per year, during which time net migration matched or exceeded California's internal population gains. But net migration turned negative with the 1990s recession, and in turn, growth in the labor force has slowed to just 0.9% annually since 1991. Significantly, in the last decade and a half, consistent state-to-state migration out of California has been offset only by international migration into the state.

It is no coincidence that slower labor force growth has occurred as the cost of living has soared in California. As recently as the mid-1970s, the median price of a California home was just a few thousand dollars higher than the national median. But since 1990, the California median has consistently exceeded the U.S. median by more than 50%, with the state median at least double the U.S. median in 10 of the last 27 years. Meanwhile, rents have reached such heights that rent burdens in many communities across the state are among the nation's highest.

Countless headlines in recent years have described California as facing a housing shortage and an affordability crisis as construction has lagged demand. This is not a new theme, just the latest chapter in California's housing story. One need only look back to the early 2000s to find the same storylines:

- the state's need for housing far outstrips the current pace of building
- the state needs more affordable and workforce housing
- even middle and upper middle income households face affordability challenges

Without attempting to sound trite, it all boils down to supply and demand. On the demand side, the much-anticipated arrival of Millennials on the housing scene, coupled with recent job and income growth and low interest rates, are all driving demand for housing, both owner-occupied and rental. On the supply side, existing home sales have fallen below expectations, given the strength of the economy, while new single-family and multi-family construction has been relatively weak since the recession.

Demand-side solutions to the problem include easier underwriting standards (though not as slack as in the 2000s), reduced down payments, and special finance programs for would-be buyers, along with rent subsidies for qualified households. But in the absence of increased supply, these programs result in more would-be buyers/renters competing for scarce

Jobs by Major Industry

California

Industry	Oct-16	Oct-17	YTY	YTY %
Total Nonfarm	16,603.5	16,860.3	256,800	1.5
NR/Mining	23.3	22.7	-600	-2.6
Construction	784.1	828.5	44,400	5.7
Manufacturing	1,301.8	1,297.1	-4,700	-0.4
Durable Goods	816.3	820.4	4,100	0.5
Non-Durable Goods	485.5	476.7	-8,800	-1.8
Wholesale Trade	726.6	740.1	13,500	1.9
Retail Trade	1,690.6	1,694.0	3,400	0.2
Transport,Warehouse,Util.	588.3	600.4	12,100	2.1
Information	528.7	534.3	5,600	1.1
Finance and Insurance	548.5	551.3	2,800	0.5
Real Estate	283.1	284.9	1,800	0.6
Prof Sci and Tech	1,229.1	1,232.9	3,800	0.3
Management	226.3	230.8	4,465	2.0
Admin Support	1,085.7	1,088.7	3,000	0.3
Educational Services	356.4	372.2	15,800	4.4
Health Care	2,205.2	2,265.8	60,600	2.7
Leisure and Hospitality	1,918.2	1,955.7	37,500	2.0
Accommodation and Food	1,613.2	1,645.1	31,900	2.0
Other Services	563.3	581.3	18,000	3.2
Government	2,543.5	2,578.9	35,400	1.4

Source: EDD; Analysis by Beacon Economics

housing. No, the situation must ultimately be addressed by increasing supply, a tall order indeed. But until California does so, in earnest, growth of the statewide economy will be constrained.

That is not to say that California won't grow. It will. The state and its regions should experience continued growth in economic activity and jobs well into 2018. Most of the job gains will occur in Health Care, Leisure and Hospitality, and Construction. But California will fall short of its potential until it crafts long-term supply-oriented solutions to the chronic problem of high housing costs and low housing affordability.

The Industry:

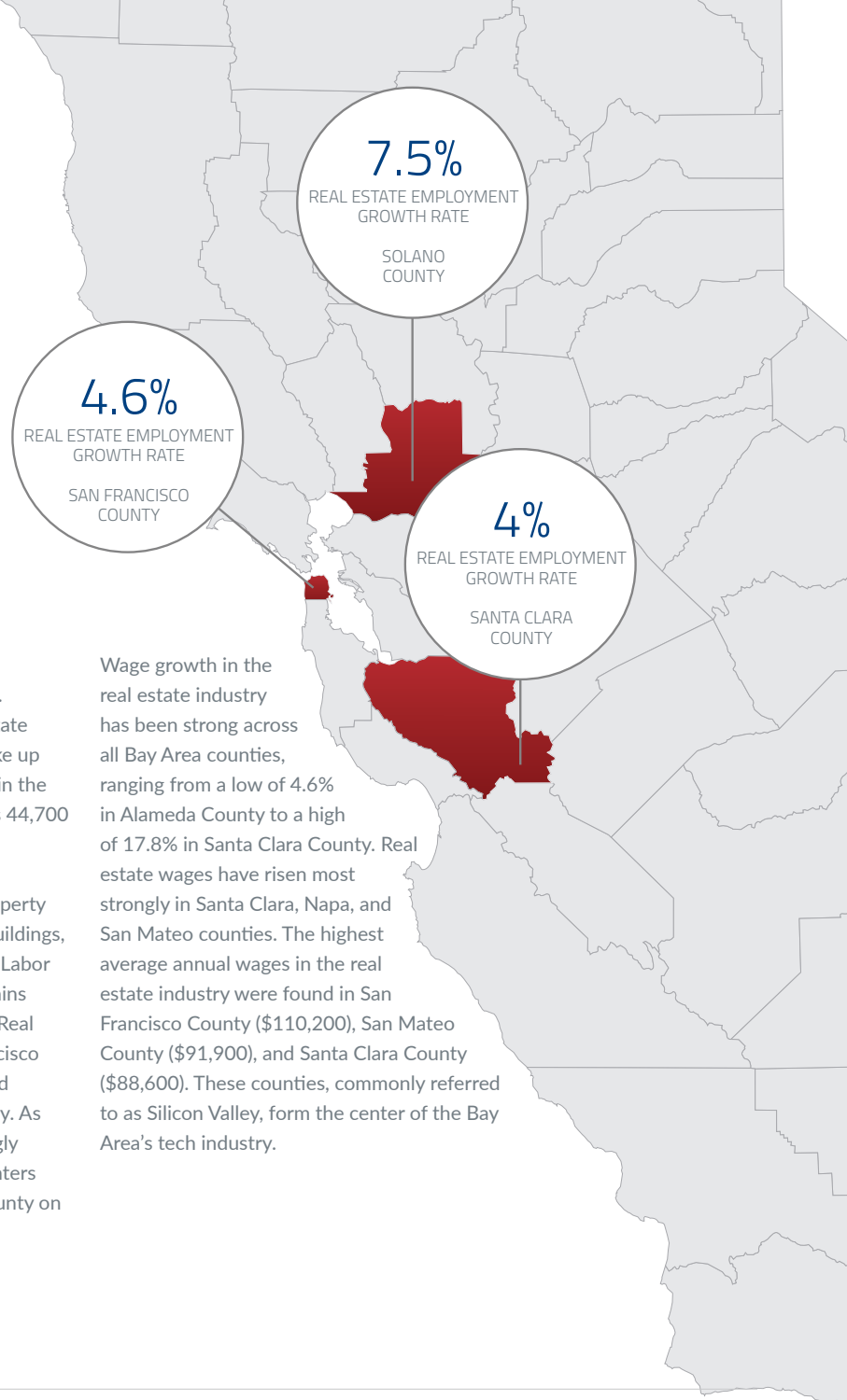
Employment & Wages

By **Christopher Thornberg**, Economist
Chris Chau, Research Associate
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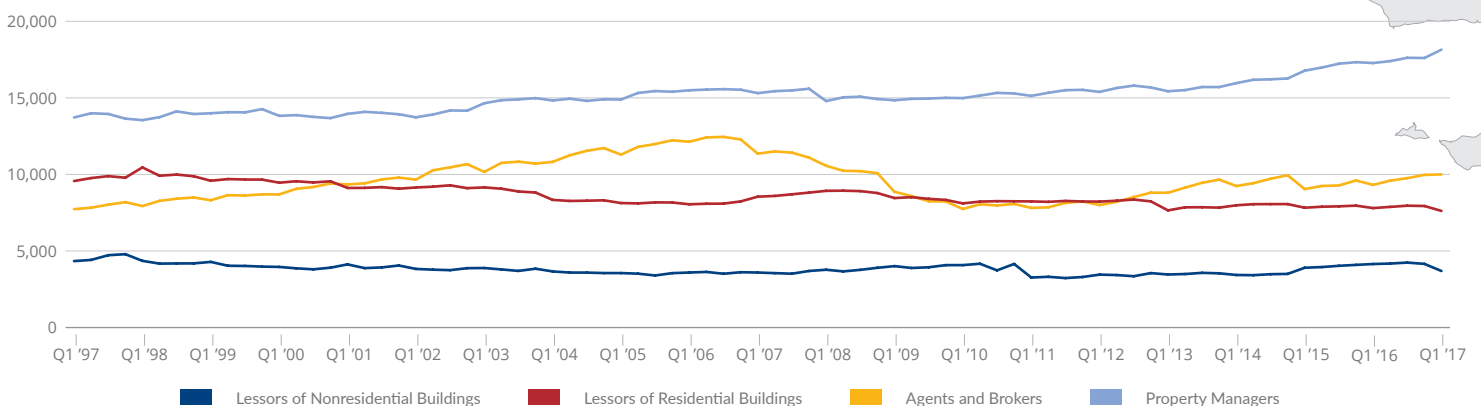
California's recent economic strength has been driven in part by the economic output of the Bay Area, the wealthiest region of the state. Its booming housing market has led to strong growth in the real estate industry's employment and wages. Across all nine counties that make up the Bay Area, employment in the real estate industry grew by 2.9% in the first quarter of 2017 from the year before. In total, the Bay Area has 44,700 workers employed in the real estate industry.

The largest employers in the real estate industry are Real Estate Property Managers, Real Estate Agents and Brokers, Lessors of Residential Buildings, and Lessors of Nonresidential Buildings, according to the Bureau of Labor Statistics. Increases in real estate employment mirror broader job gains across all industries in the Bay Area, driven by a strong tech sector. Real estate employment growth has been particularly strong in San Francisco (4.6%), Santa Clara (4%), and Solano (7.5%) counties. Santa Clara and San Francisco Counties are both centers of the region's tech industry. As housing prices have increased in the Bay Area, people are increasingly moving farther from the Bay Area's population and employment centers and toward cheaper options, such as Solano County, a suburban county on the eastern fringe of the Bay Area.

Wage growth in the real estate industry has been strong across all Bay Area counties, ranging from a low of 4.6% in Alameda County to a high of 17.8% in Santa Clara County. Real estate wages have risen most strongly in Santa Clara, Napa, and San Mateo counties. The highest average annual wages in the real estate industry were found in San Francisco County (\$110,200), San Mateo County (\$91,900), and Santa Clara County (\$88,600). These counties, commonly referred to as Silicon Valley, form the center of the Bay Area's tech industry.



Bay Area Real Estate Employment
 Largest Sub Industries



Source: QCEW; Analysis by Beacon Economics

The Legislative Housing Package

By | **Chris Chau**, Research Associate
Beacon Economics

The California Legislature passed a landmark series of 15 bills in 2017 designed to increase the supply of affordable housing. Measures include financing new affordable housing developments, streamlining local regulations, and committing local governments to building an equitable share of their region's new housing needs. Ambitious in scope, the housing package represents the first significant legislative action related to housing since the elimination of the redevelopment agencies in 2011. But after years of inaction on the crisis, these steps are only the beginning in reversing the state's affordable housing shortage. Highlights from the package:

Senate Bill 2, authored by Sen. Toni Atkins, creates a \$75 fee on select real estate transactions. The projected \$200 million to \$300 million in revenues from this fee will go toward affordable housing development and services for homeless people.

Senate Bill 3, authored by Sen. Jim Beall, places a \$4-billion bond proposal on the ballot for the 2018 state election. This bill would fund affordable housing programs in California that were previously supported by the state's redevelopment agencies, which were cut in 2011. Additionally, this bill includes \$1 billion to extend the CalVet Home Loan Program.

Senate Bill 35, authored by Sen. Scott Wiener, requires local governments that have not met goals for housing development to follow a streamlined local review process that would fast-track development in areas lacking sufficient affordable housing and serve as an incentive for cities and counties to commit to state housing development goals.

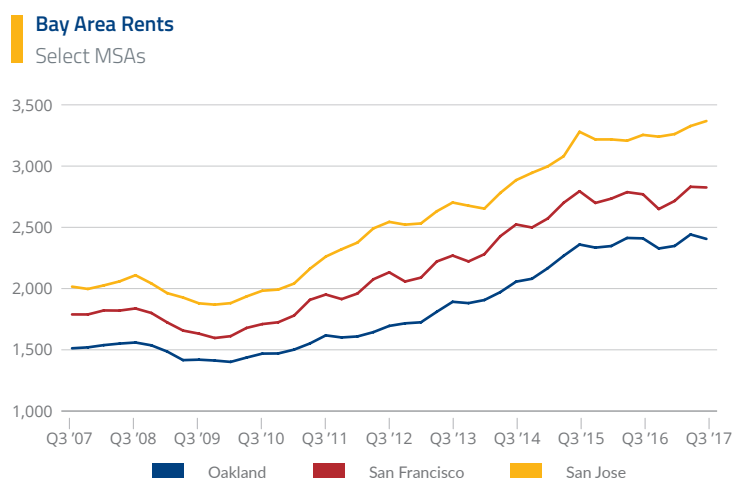
Assembly Bill 1515, authored by Assemblyman Tom Daly, forces courts to give less deference to local governments in legal challenges to blocked housing developments. This legislation pushes back on obstacles to new housing proposals driven by so-called not-in-my-back-yard (NIMBY) motives.

Senate Bill 678, authored by Assemblyman Raul Bocanegra, D-San Fernando, and its companion bill, Senate Bill 167, authored by Sen. Nancy Skinner, also combat NIMBY movements that have used downsizing to challenge new development. It increases the burden of proof for local governments to reject or downsize developments that include affordable housing units.

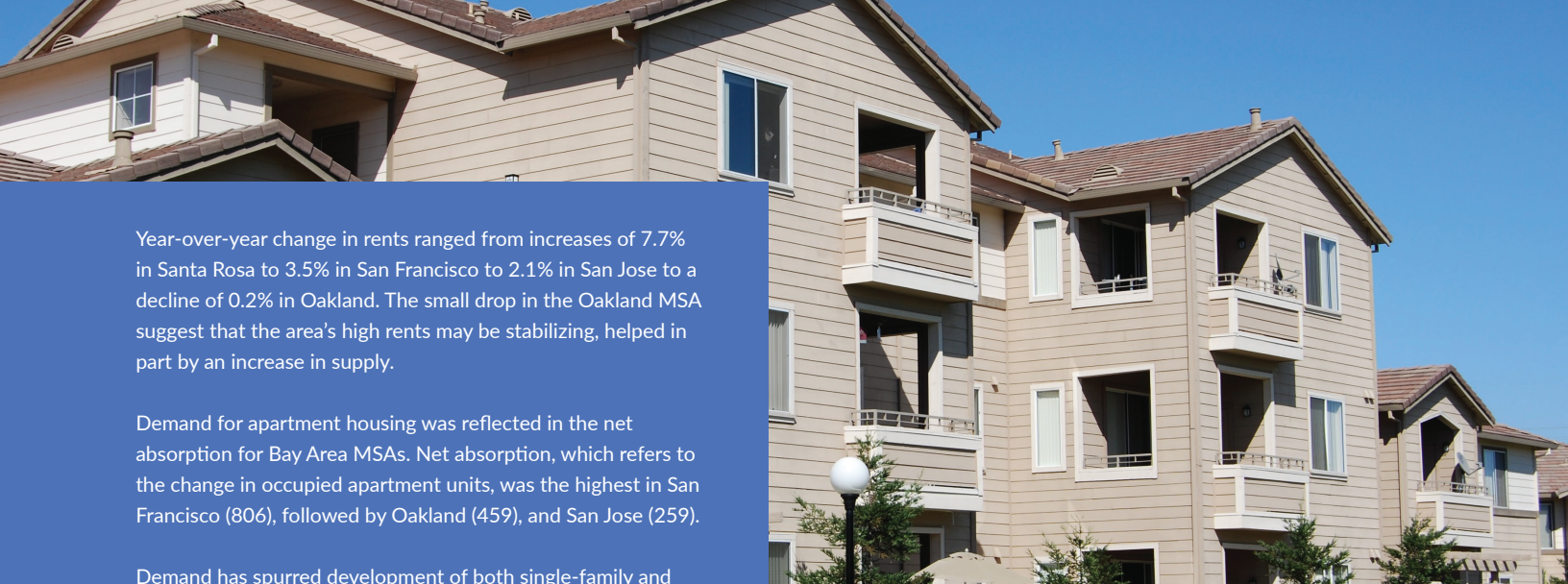
Apartment Trends

By | **Adam J. Fowler**, Research Manager
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Renting has become expensive throughout the state but especially in Northern California. Effective apartment rents in the Bay Area are among the highest in the state and in the country. In the third quarter of 2017, rents in the Bay Area's three main MSAs (Oakland, San Francisco, and San Jose) were all more than \$2,400 a month. The San Francisco MSA had the highest average rent in the Bay Area (\$3,381), followed by San Jose (\$2,835) and Oakland (\$2,412). At the lower end, average rent was \$2,096 in the Santa Rosa MSA.



Source: Axiometrics; Analysis by Beacon Economics



Year-over-year change in rents ranged from increases of 7.7% in Santa Rosa to 3.5% in San Francisco to 2.1% in San Jose to a decline of 0.2% in Oakland. The small drop in the Oakland MSA suggest that the area's high rents may be stabilizing, helped in part by an increase in supply.

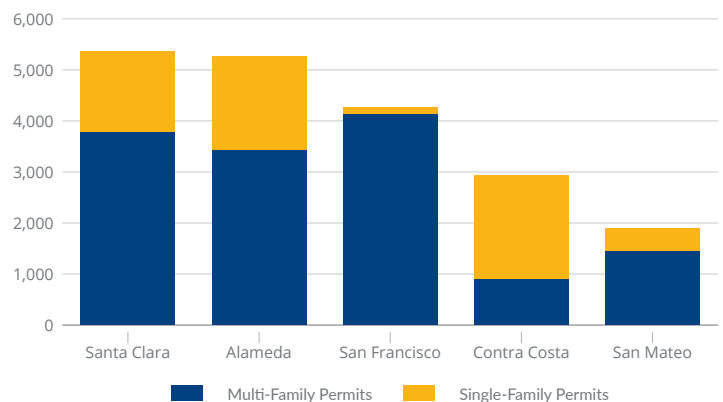
Demand for apartment housing was reflected in the net absorption for Bay Area MSAs. Net absorption, which refers to the change in occupied apartment units, was the highest in San Francisco (806), followed by Oakland (459), and San Jose (259).

Demand has spurred development of both single-family and multi-family units. In 2016, 13,130 multi-family units and 7,170 single-family units were permitted for construction, increases of 8.5% and 7.2% in multi-family and single-family permits, respectively, from the year before. Most of the multi-family construction has been concentrated in a few areas of the Bay Area.

Of the Bay Area's 13,130 multi-family building permits issued in 2016, 80% were for three counties: San Francisco (4,113), Santa Clara (3,859), and Alameda (3,442), which contain the most urban and developed neighborhoods of the Bay Area. In addition to new construction, renovations and additions to existing housing have increased. Permit values for residential alterations have increased by 6.5% across the Bay Area, with 44% of the Bay Area's total permit values for residential alterations in San Francisco and San Mateo Counties. Given that those counties have 21 % of the Bay Area population, that number is significant.

Residential Permits 2016

Northern California



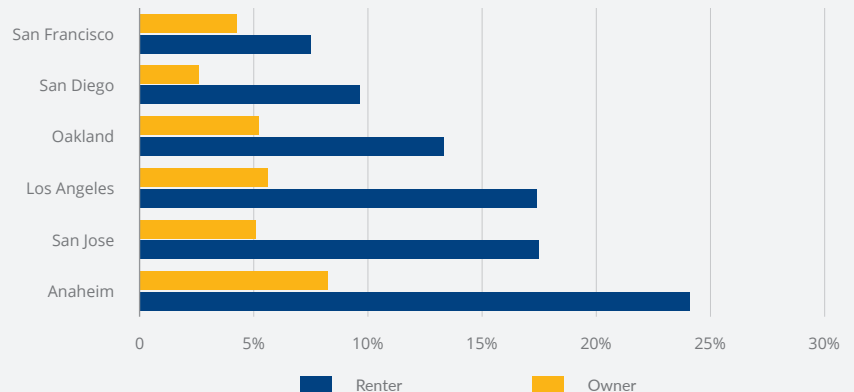
Source: CIRB (Construction Industry Research Board); Analysis by Beacon Economics

Northern California Renters

By **Adam J. Fowler**, Research Manager
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Average renter households in Bay Area counties were mostly smaller than the statewide average of 2.9 persons. At the smaller end were Marin (2.3) and San Francisco Counties (2.1).

Percent of Units Having More Than 1.0 Occupants per Room



Source: American Community Survey, 1-year estimates; Analysis by Beacon Economics



Average rent
was more than
29%
of median renter
household income
in every county except San Francisco

The smaller households for these counties could reflect the wealthier and younger renter populations. At the larger end were Solano and Napa counties, which had average household sizes of three persons, slightly above the statewide average.

Median renter household incomes varied considerably across the Bay Area. More rural counties like Napa, Solano, and Sonoma had median incomes between \$52,000 and \$56,000 while counties in Silicon Valley (San Francisco, San Mateo, Santa Clara) had median incomes between \$81,500 (Santa Clara) and \$85,000 (San Francisco). Middle income counties in the Bay Area were Alameda (\$62,600) and Contra Costa (\$63,500).

For the most part, the burden is high across the Bay Area as measured by the average rent as a percentage of median renter income. In every county except San Francisco, the average rent was more than 29% of median renter household income. San Francisco was an outlier in the Bay Area as average rent was 24.6% of the median household income in the county. Renters can find comfort in the fact that the burden has been trending down in recent years because of rising incomes. This has been especially the case in San Francisco, which saw its median gross rent as a percentage of household income decline from 29.1% in 2012 to 24.6% in 2016.

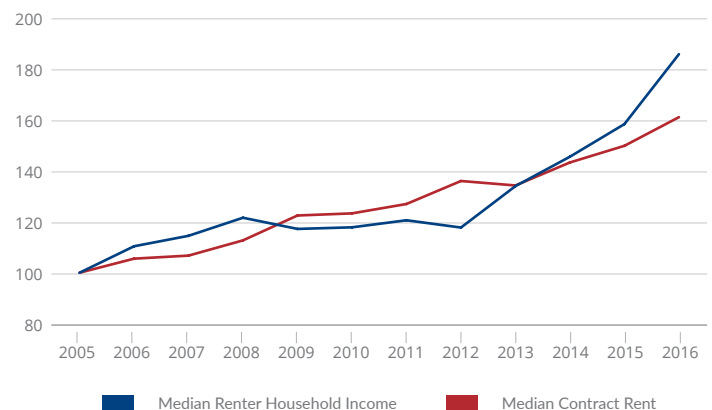
The year a renter moved into a unit reveals wide ranging differences in mobility among Bay Area Counties. For instance, San Francisco had the smallest percentage of renters who moved after 2010 (61%) and Contra Costa County had the highest (80%). A high percentage of recent movers is characteristic of areas with recent multi-family development that previously did not have large apartment stocks. San Francisco County's low share of recent movers reflects the large presence of long-term renters.

The age of the rental stock in the Bay Area varies significantly across counties. In Napa, Contra Costa, and Solano, 15% of the rental housing stock was built after 2000. Counties with the lowest shares of rental stock built after 2000 were San Francisco (9%), San Mateo (8%), and Marin (6%). In general, fast-growing and more recently urbanized areas have higher shares of new housing stock. For comparison, in Texas' Harris County, an area known for unrestrained residential development, 24.6% of the housing stock was built after 2000.

Vacancy rates among Bay Area MSAs were led by San Jose (4.1%), Oakland (4.0%), San Francisco (4.0%), and Santa Rosa (3.9%). Overall low vacancy rates reflect the high demand for housing that has caused rents to soar in the Bay Area.

Indexed Renter Income and Rents

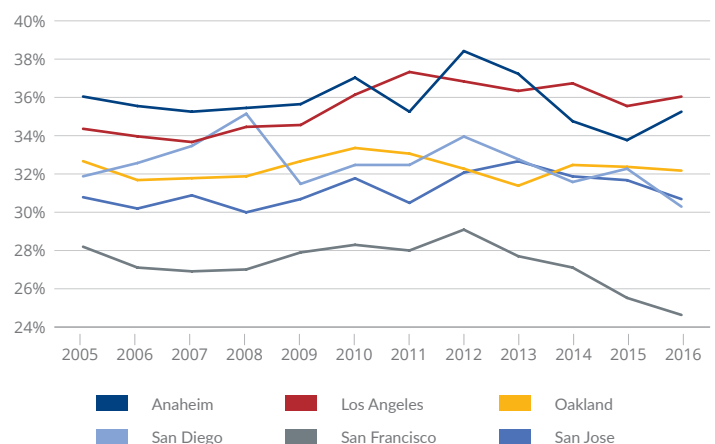
San Francisco County, 2005 to 2016



Source: American Community Survey, 1-year estimates; Analysis by Beacon Economics

Rent Burden

Select California Cities



Source: American Community Survey, 1-year estimates; Analysis by Beacon Economics

Region in Focus: San Francisco

By **Adam J. Fowler**, Research Manager
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San Francisco has emerged in recent years as the center of the Bay Area's real estate and rental activity. In 2016, it had the most multi-unit building permits among Bay Area counties even though its population is smaller than many of its neighboring counties. The city is home to 222,700 renter households and has the highest proportion of renters in the Bay Area.

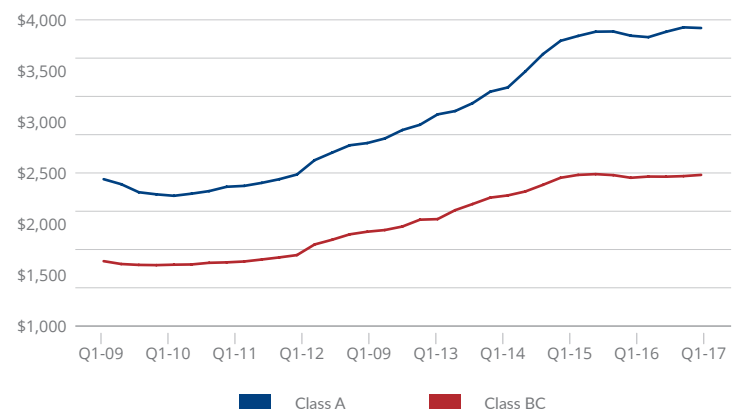
Rents in the San Francisco market are among the highest in the state and nation. As of the third quarter of 2017, San Francisco's average effective rent was \$3,381, making it the most expensive rental market in the Bay Area.

In the San Francisco market, rents varied considerably from neighborhood to neighborhood. The cheapest were found south of the city limits in North San Mateo (\$2,826), South San Mateo (\$3,111), and Central San Mateo (\$3,114). Neighborhoods in San Francisco commanded the highest rents, led by Haight Ashbury/Western Addition (\$4,128), South of Market (\$3,889), West San Francisco (\$3,558), and Russian Hill/Embarcadero (\$3,412).

After years of rapid increases, rents have recently stabilized in the San Francisco market. For the third quarter of 2017, they grew by 3.5% from the year before. After years of double-digit rent growth, the rate has been below 10% since the third quarter of 2015. Between the third quarter of 2015 and the third quarter of 2017, San Francisco rents rose from \$3,291 to \$3,381. During a similar two-year period between the third quarter of 2013 and the third quarter of 2015, the average rent increased by more than \$500.

Rents by Apartment Class

San Francisco County



Source: REIS; Analysis by Beacon Economics

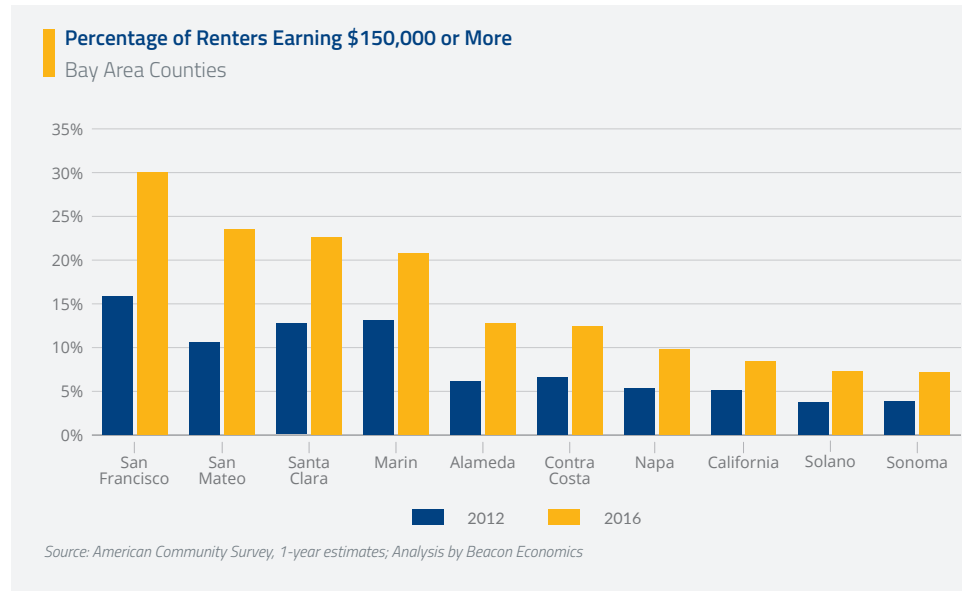


Slower rent growth has been aided by additions to stock from new multi-family developments through a steady stream of multi-unit permits. In the second quarter of 2017, 1,445 multi-unit building permits were issued, after 4,113 multi-unit permits were issued in 2016 and 3,542 were issued in 2015.

San Francisco's rent appreciation has been led by the high-end section of the market. Over the past 4 years, Rents for Class A Apartments in San Francisco have increased by 31%. In comparison rents for lower-end Class BC Apartments have increased by 21% during the same period. As of the third quarter of 2017, the average cost of rent was \$3,648 for Class A apartments and \$2,347 for Class BC apartments.

Because of new units, vacancy rates in San Francisco have increased from a low of 2.8% in the third quarter of 2011 to 4.0% as of the third quarter of 2017. Continued demand has kept with new development, as evidenced by quarterly net absorption that has been above 650 units since the first quarter of 2016. During this time, vacancy rates have remained between 4.0% and 4.5%.

Increases in housing supply have primarily occurred in the higher-end, Class A apartment market, as shown in the higher vacancy rates for Class A apartments versus in Class BC apartments. The recent boom in new construction was associated with vacancy rates for Class A apartments peaking at 7.2% in Q2 2016 while vacancy rates in Class BC



apartments were still only 2.7%. Since then, the gap in vacancy rates between Class A and BC apartments have shrunk and as of Q3 2017 vacancy rates are 5.1% for Class A apartments and 3.9% in Class BC apartments.

San Francisco's real estate activity has been driven by a strong economy. The city's unemployment rate has been consistently decreasing and reached 4.5% in 2016. More significantly, average household incomes have skyrocketed in recent years. Between 2012 and 2016, city renters' incomes rose 58.4% from \$53,700 to \$85,100. Most of that growth has been driven by the top earners. Between 2012 and 2016, the share of renter households in San Francisco making more than \$150,000 has almost doubled from 16% to 30%. The influx of tech wealth to the city can be attributed to this change. Changing demographics can also be found in its age distribution. The share of the city's population between 25 and 29 years old has risen from 6.5% in 2008 to 11.9% in 2016. Low homeownership rates among this growing cohort have placed further demand on the city's rental market.