

## Shadow Market Pressures Linger for I.E. Apartments

*Job losses, foreclosures signal slow residential recovery throughout region*

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When a renter can get a three-bedroom, two-bath home on Craigslist for \$1,375 per month in Lake Elsinore, there is little reason to bother with renting an apartment, moving to an outlying submarket where there is little work or buying a condominium in the Inland Empire.

As the latter half of 2008 so clearly spelled out, the shadow market in the region is not going away any time soon. The jobs and housing situation has forced itself on the rental market pressuring tenants with far more housing options and economic issues than what existed just a few years ago.

"Clearly, with the amount of foreclosures for both condos and single-family, it has created a shadow market in the eastern part, away from the job centers, and its impact is much greater out there," said Alex Garcia, senior vice president of investments in **Marcus & Millichap Real Estate Investment Service's** Ontario office. "I'm talking about Moreno Valley, the Coachella Valley, the High Desert, where there was a high concentration of entry-level homes, true sub-prime candidates that have picked up in droves and entered the rental pool."

According to Novato-based **RealFacts Inc.**, rents in the Inland Empire fell 2.4 percent in fourth-quarter 2008 from the previous quarter to an average of \$1,129. In Marcus & Millichap's 2009 annual report, asking rents are forecasted to fall in the Inland Empire 1.3 percent to \$1,055 per month this year.

But the rent averages do not tell the full story of the disparity between what is occurring in the secondary and tertiary apartment markets of the eastern Inland Empire and what is occurring in the prime locations on the west end.

In the western part of the two-county region are cities such as Rancho Cucamonga and Chino Hills, where average rents are \$1,314 and \$1,562, respectively, according to RealFacts. Meanwhile, cities such as Indio and Victorville are commanding average rents of \$805 and \$817, respectively.

"The west end is much more secure and insulated from the foreclosure market and the job-loss impact," Garcia said. "Last year was a real tough year. The closer you are to job centers, the better off you're going to be and the west end will continue to outperform."

This year is expected to be all about the shadow market's grasp on apartments even as the gap between buyers and sellers may finally be shrinking.

"There may be more deals in 2009 than in 2008 simply by virtue of the adjustment with sellers and buyers," Garcia said. "They're going to come to grips with the fact that liquidity in the market isn't what it used to be."

**Sperry Van Ness** Senior Advisor Cameron Hall said location has become increasingly important to investors.

"C locations are tough to sell, to put it bluntly," Hall said. "It is all about actual income. That is more important today than ever. If the location is excellent, buyers are still willing to pay a little more. If the location is poor, you're not seeing a transaction, or it sells at a lower price."

According to Garcia, capitalization rates are now in the 6 percent to 7 percent range, but inch up closer to the 7 percent area moving east.

"Hemet has always been considered a B or better location, but Hemet is not close to jobs," Hall said. "It is about a 30-minute commute to Riverside where the jobs are, so C locations are getting hurt in low-income areas and areas where there are not enough jobs."

As a result, Hall said there is little impact on C-location rents because they were already low to begin with. Instead, he's seeing the rents flattening out on A-location properties."

### **The Condo Story**

Even in a relatively good location where there are jobs, condominiums are a tough sell. The city of Riverside's \$1.8 billion ongoing Riverside Renaissance investment in public works projects includes high-density development such as developer Alan Mruvka's m solÃ© live/work lofts in downtown.

Developed on an infill site running along Market Street, m solÃ© was supposed to help infuse the area with residents. The goal was to create nightlife, something sorely lacking in the 9-to-5 daily lifespan of the downtown core, which is dominated by legal and government workers.

Today, a two-bedroom, two-bathroom condominium at m solÃ© can be rented for \$2,500 monthly. The average monthly rent in Riverside was \$1,148 in the fourth quarter, according to RealFacts. The average rent in the region for a two-bedroom, two-bath apartment in the fourth quarter was \$1,206, according to RealFacts.

"Condo conversions in the Inland Empire have always been very, very difficult mainly because condo pricing has been so low," said Paul Daneshrad, chief executive officer of **StarPoint Properties LLC**. "There was a wave of condo conversions in '07, early '08, but that's going. We don't see that as a viable [investment] strategy moving forward."

Condominium development will not completely stop in the region despite general sentiment that the condominium market is ailing and far from a recovery.

In early January the Palm Springs Planning Commission approved a four-story retail and condominium project, proposed by **Wessman Holdings LLC**, that includes ground floor retail and 19 residential units above.

"There's some softness in the Coachella Valley, and vacancies have crept up there," Garcia said. "They're having a tough time selling condos in Palm Springs because there are foreclosed condos available. I've seen quite a few in auction."

At the same Palm Springs Planning Commission meeting where Wessman's mixed-use project was approved, **Enterprise California's** 81-unit condominium project, Privado, received a one-year time extension for its project.

"We don't see the condo market recovering until the single-family market recovers," Daneshrad said. "The single-family market won't recover until 2010, and the condo market would then follow."

But some are holding on to their recovery predictions, waiting to see how many more foreclosures will be released into the market.

"I've been told by Realtors that lenders have been holding back," Garcia said. "In some cases, banks have foreclosed on properties and haven't been putting them on the market. It's almost like a plan by the banks to not dump too much on the market and cause further deterioration."

### **Jobs and Downsizing**

In general, predictions for the secondary and tertiary markets are not as positive. While Daneshrad said he expects the start of a recovery in late 2009 to early 2010 for primary locations, secondary and tertiary locations are not expected to start recovering until the latter part of 2010.

"We're seeing a large amount of delinquencies and bad debt because of tenants' inability to pay, which is mainly the result of job losses and the poor economy," Daneshrad said. "We had a lot of construction jobs and employment in that area that have been lost and we're seeing a dramatic impact from that."

According to economist John Husing's quarterly economic report released in January, 71.3 percent of the region's job losses are attributed to the downturn in the building industry. Once work on the remaining residential, office and industrial projects is complete, jobs tied to those projects will not be replaced with other construction projects until market confidence is restored enough to propel new development, the report said. Job losses are another factor that, coupled with housing, has finally led to some deterioration on the multifamily side, beginning with the Class A properties. It was only a year ago that industry watchers were labeling multifamily as a relatively safe and sound investment as the outlooks for other property types fell.

"There's a substantial amount of pressure on Class A rents," Daneshrad said. "That's mainly because Class A rent, especially on the new product being built, had some aggressive rental structures. The main reason for that is downsizing: As people can't afford the Class A properties, they start moving down to the Bs, and the Bs start moving to the Cs."

For Michael Stewart, co-founder and chief executive officer of **Pacific Property Assets**, the rental situation is manageable because Pacific does not operate Class A or B properties.

In the Inland Empire, Pacific Property, with headquarters in Irvine, owns mainly Class C properties in the Riverside submarket's downtown area. Stewart said Pacific Property made a few offers on some properties in south Riverside, but has not yet received any positive responses.

"We're pretty comfortable with the [Class] C," Stewart said. "We like to have very clean, well-run C properties and have the ability to get people moving up in the D scenario, and in a bad time like now, we have the ability to get the people that want to save a few bucks to move down."

According to RealFacts, the Inland Empire is dominated by Class C with 232 properties totaling 49,959 units, which accounts for more than half of the total units in the region. The situation has presented options for investors like Mitchell Bradford, president of Irvine-based **Sycamore Urban Properties**, a recent start-up focused on acquiring distressed assets.

Sycamore recently invested in a property in San Bernardino County and is pursuing 10 other properties or loans in the Inland Empire.

"These properties would have been for-sale properties but because of the precipitous value throughout the world and particularly in the Inland Empire area, we identified the property as meeting a profile that we could buy and then lease out," Bradford said of the recent investment. "Then in the future, when the market recovers, sell. As always, it was an investment price that we thought was attractive."

## **Planning Ahead**

Bradford, along with many others, said that the market recovery will start in primary locations, including the Ontario Airport area, because that is where the jobs are.

"Any property owners and financial institutions that have assets that they're holding from 2008 thinking the market's going to be better in 2009 should focus on their business plan," Bradford said. "It's sort of self-serving, but that's the truth."

Stewart from Pacific Property expects little change this year.

"I think it's going to be a status quo sort of year," Stewart said. "At the end of the year, we're sitting pretty much right where we are. If you're looking for progress, you're not going to see it."

A total of 480 units were delivered to the market last year, according to Marcus & Millichap, and construction is again expected to remain at a minimum this year with 260 apartments forecasted for delivery in 2009.

While some projects have been put on hold, others, including many affordable-housing projects, are moving forward.

In November, the city of Lake Elsinore signed an agreement with San Francisco-based affordable-housing developer **BRIDGE Housing Corp.** to develop the 800-unit Pottery Court project.

In Rancho Cucamonga, **Workforce Homebuilders LLC**, in partnership with **National Community Renaissance** and **Hope through Housing**, is working on the Villaggio at Route 66 project. Construction crews are currently working on the grading for the 166-unit project.

Charles Addington, principal at **KTGY Group Inc.**, the architect for the Villaggio project, said developers are coming to designers looking for ways to bring value to their projects.

"With the higher-density products, the podium-structured parking and wrapped products are just not penciling out," Addington said. "The rents are just too expensive, so we're partnering with developers to get three- or four-story wood construction without the structured parking."

Addington said KTG Y also worked on the recently approved University Hills specific plan and master plan in San Bernardino, which will include a mix of single-family and multifamily units along with commercial and retail.

"We're working with several developers in Riverside, Corona and the Lake Elsinore area on multifamily projects, including market-rate, affordable family and senior affordable housing," Addington said.

Although KTG Y remains busy with projects, Addington said he is noticing in the projects the firm is doing that development is coming back to prime areas. It is a trend that many speculate will be the short-term mantra of developers and investors until the economy picks back up.

"Most development now is coming back toward the city centers and the more-developed areas along transportation centers," Addington said. "In outlying areas, development has slowed. People want the ease of transportation and transit-oriented development in infill areas close to activity centers like downtown Riverside, San Bernardino and Corona."