The Complete Guide to Apartment Investing in San Diego County

Written by
James L. Scott
Scott & Quinn Real Estate

October 2003
Version 9.4

Some Notes From the Author

The purpose of this paper is to provide some historical and current perspective on the apartment market in San Diego, give information on how to find, evaluate, purchase and operate an apartment building, and offer some opinions about the market in 2004 and beyond.

The first part of this paper will address the past and future of the market. Owners, investors, banks and brokers have recently experienced several market cycles over the past four decades. Neighborhoods, investor expectations, capital markets, investing guidelines and underwriting standards change from cycle to cycle.[1] The past is not always a good guide to the future.

The second part of this paper is a guide to evaluating, purchasing, financing and managing an apartment building. This section will also review all of the major apartment sub-markets in the County.

[1] One example of a difference between the recovery years of 1985 and 2001 is that loan underwriting guidelines are far stricter today. Loan margins are higher and banks are requiring higher down payments. Another major change is the market in converting older apartments to condominiums.

In the third and final section of the paper, there will be an analysis of the long-term trends that will affect the apartment market beyond 2003.

When I wrote the first edition of this paper in 1988, the apartment market was very different just as it was when I syndicated my first apartment building in 1974. Over time my investments in units have proven to be very stable and profitable ventures. To be sure, everyone in the apartment world should not forget the lessons of the past recessions. The danger is to allow the past to inappropriately influence current decision making. The unique set of social, political and economic circumstances that created cycles are always changing and will not be duplicated in the future. Who would have predicted the boom in conversions? The current cycle will both defy and mimic history. Many buyers are may miss opportunities as their investment criteria are often rooted in past behaviors.

Apartment investing is very much like the classic confrontation between the hitter and pitcher in baseball. Good hitters understand that they cannot directly influence the speed, type and location of the pitches they will see at any given time. They learn to adapt and take good swings at the best pitches they will see in a particular sequence from a particular pitcher in a particular game situation. The most successful investors in apartments will be those who realize the era of easy home runs is over. A good conversion project can still lead to the homerun, but many prefer the long rewarded strategy of holding units long term.

Please call me if you have any comments on this paper. My number is 619-920-9511.

The opinions, research and conclusions expressed in this paper are solely those of James L. Scott. The author has made every effort to insure the accuracy of the data presented herein. You should seek competent advice from other sources when considering making an investment in apartments.

Part I
The San Diego Apartment Market
1960-2003

The Six Apartment Cycles Since 1960

There have been six distinct cycles in the San Diego County apartment market since 1960. Even accounting for the past recession, apartments have been relatively low-risk and profitable investment vehicles over the long term. Like any financial commodity, their value can vary dramatically over short periods.

The 1960's

Before 1973, apartments traded in a relatively stable marketplace. Interest rates were generally at seven percent fixed rate and apartments sold for six to eight times gross annual rents depending on the age and location of the building. Two to three thousand new units were built annually. Apartments were purchased for moderate appreciation gains, tax benefits, mortgage reduction and cash flow. Buyers who purchased with a ten to fifteen percent down payment could expect positive cash flow. The price per unit during the 1960's ranged from $5,000 to $10,000.

There were two moderate downturns during the decade. In 1962 San Diego had a severe local recession resulting from substantial reductions in government spending.[2] The local economy was influenced by massive cuts in Defense spending not unlike the reductions made after 1990. In the latter part of the decade, there was a mild national recession accompanied by moderate inflation. Because of the financially conservative nature of apartment investing, the impact of the recession on the apartment market was not as strong as later recessions, particularly the recession of 1990-96.

Apartments and Inflation

The oil crisis of 1973 and fiscal impact of the Vietnam War caused fundamental changes in the American economy. These two events resulted in a nine-year period of high inflation rates, eventually affecting the local apartment market. Because the Vietnam War was financed by borrowing money instead of raising taxes, inflation and higher interest rates became a problem by 1970. The Nixon Administration attempted several methods of arresting inflation, including experimenting with price and wage controls. By 1973 the inflation rate increased even more as the price of oil quadrupled. Fixed rate mortgages climbed to more than ten percent.

[2]The similarities between 1961 and 1990 are very clear. Both times reductions of government spending in the region created severe recessions in real estate. Following the former recession, the region did diversify slightly, but not enough to buffer the 1990 cutbacks.

This caused a mild recession in San Diego real estate during 1974-1975. This recession was driven largely by interest rates.

High interest and inflation rates eventually changed the criteria that investors used to purchase apartments. As you can see from the chart at right prices of apartments rose in tandem with the rate of inflation during the late 1970's. It is also interesting to note the relationship between low inflation rates and apartment prices. This relationship has not always been consistent.[3]

North Park is used in the chart above because of the high volume of sales. In the past, inflation and prices ran in tandem. Now we are in a period of rising prices and low inflation.

[3] During inflationary cycles people tend to buy hard goods and hold less cash. If you compare the cycles of the prices of collectible cars and the rates of inflation, there is a remarkable similarity. This illustrates that apartments a excellent inflation hedges. That also explains the near disregard for cash flow on the part of buyers in high inflation periods.

Buyers realized that the use of leverage combined with inflation-driven appreciation rates made cash flow considerations insignificant. Apartments were purchased primarily for appreciation benefits instead of cash flow. This was a major change in investor behavior that would have serious negative effects decades later. By the end of the 1973-75 recession the average price of a North Park unit increased to $13,800. The 1973-1975 down cycle is worth comparing to the 1990-1996 recession. When the earlier recession ended in 1975, the local apartment construction industry was moribund. Interest rates were moving back to pre-1970 levels. The rate of in-migration to San Diego County was increasing. Local investors began to seek inflation hedges, such as commodities, antiques and real estate. Vacancy rates dropped from more than eleven percent in 1972 to less than four percent by 1975. The following factors were in place in early 1976: a) stable interest rates and generous underwriting standards from lenders, b) increasing in-migration to San Diego County, c) a recovery from the national recession with resultant job growth in San Diego, d) an inflation driven market psychology, and e) low vacancy rates.

1976-1979 Bull Market

From 1976 to 1980 the price of a typical North Park apartment rose from $15,000 to nearly $40,000 per unit. Sale gross rent multipliers, once seven to eight times annual rents in average neighborhoods, increased to as high as ten. Along with prices, fixed rate mortgage rates increased from nine to eleven per cent. Higher prices and rates did not dampen demand. This period was the golden age of apartment investment in San Diego.

Builders responded to low vacancy rates and investor demand for apartments by building nearly as many units during 1976-79 as they did during the period of 1970-73 even though land was more difficult and expensive to obtain. As happened in 1970-73, investors were quick to ignore traditional investing rules because appreciation and leverage made operating losses less important.

The 1980-1984 Recession

The inflationary price cycle in apartments ended in 1980. In October 1979, the Federal Reserve Board adopted a new policy to reduce inflation, then running at twelve percent per year. Monetarism is a strategy to lower inflation that relies on controlling the size of the money supply. Interest rates rose immediately reflecting the lower supply of money available to consumers and banks. The Federal Reserve Board allowed the prime rate to rise to more than twenty percent. The result was a deep and long recession. Fixed rate mortgage rates topped eighteen percent. The Federal Reserve Board's policy of monetarism did reduce inflation and deflated the price of most commodities, including San Diego apartments. From 1980 to 1984, the price of apartments declined twenty percent.[4] This occurred for several reasons.

One reason the resale market slowed was because of high interest rates and lack of apartment financing. Without cheap and available funds, the demand for units decreased. Without easy credit, effecting 1031 tax-deferred exchanges was nearly impossible. Many owners had purchased apartments in the late 1970's with small down payments and short term secondary mortgages or wraps.[5] Many sellers could not, at any interest rate,

[4]The 20 percent drop is not adjusted for the effects of inflation. The real loss of value is actually more because of the decrease in the purchasing power of the dollar. Homes in this same period in San Diego County increased three percent over five years.

[5]This refers to seller financing schemes where sellers were able to pass on the lower interest rates of their old mortgages to buyers. This was not sanctioned by the lenders. Often sellers profited from these notes by marking up the rate of interest charged to the buyers.

obtain enough money from a refinance to pay off their balloon payments. Apartment buyers had difficulty getting loans for more than 55 percent of appraised value and rates hovered near 20 percent. Investors often bypassed lenders and purchased buildings by resorting to all-inclusive Trust Deeds and other creative financing schemes. The lack of credit depressed demand and therefore prices.

Gross Rent Multipliers (GRM) came down to compensate for the lack of investor demand and also reflected the fact that rents were rising rapidly. From 1982 to 1984 astute buyers were able to obtain bargains in the apartment market, often purchasing at Gross Rent Multipliers below seven times annual rents. These purchases were in actuality much better than purchases made during the past recession. Since rents were increasing ten percent per year, the A real GRM was far less than those made in periods when rents were stagnant.

The Recession Ends, 1985

After 1984 the demand for apartments began to increase. High interest rates and the recession had reduced the production of new apartments and the size of the building industry in the early part of the decade. In-migration into the county increased, reflecting regional job growth.[6] Economic recovery increased wages leading to more tenant purchasing power and higher rents. Vacancy rates in the County dropped to a low of 2.8 percent. Credit became cheap and readily available for apartment lending, spawning a spate of exchanging. As the returns from money market funds plummeted, investments in real estate increased. Buyers came back to the market, attracted by low gross rent multipliers of 8.3 to 8.5, coupled with the prospect of future rent increases.

One important factor driving the market was the tax advantages given to apartments and other real estate by the 1981 tax bill, known as ERTA.[7] This law was intended to encourage investing in capital goods and manufacturing to foster job growth. Although well meaning, the law created a false prosperity in the apartment market. Encouraged by generous tax benefits, investors purchased marginal real estate deals. Syndicators often offered three and four-to-one tax benefits. That allowed investors to deduct three or four dollars from their annual income for each dollar invested in a project. During the 1984-1986 period, tax benefits usually provided one-third to three-quarters of the net return from apartment limited partnerships. In many instances, the tax benefits accounted for one hundred percent of the return. Organizers of limited partnerships were willing to bid up prices for larger real estate projects because the projects could often succeed solely on tax benefits.[8]

The largesse of the 1981 bill led to substantial abuses from taxpayers. Because the paper losses generated by Limited Partnerships could directly offset earned income from all sources, wealthy investors were reaping benefits from investments that did little to better the national wealth. The result was the tax bill of 1986, which sharply curtailed the benefits derived from real estate and real estate limited partnerships that came from the

---

[6]After 1982, Southern California received more than its fair share of the 1982-1989 defense spending binge.

[7] The key component of the Economic Recovery Tax Act of 1981 was a radical depreciation schedule. Owners were allowed to depreciate over eight percent of the value of the structure in the first year. This is in sharp contrast to the old system which allowed a maximum of about three percent for the first year.

[8]Organizers of these limited partnerships were also compensated at the beginning of the investment. The reigning mentality at the time was to just get an investment that would generate maximum tax benefits and not to worry about the real economics of the transaction.

1981 tax law. Under the 1981 bill, limited partners in real estate limited partnerships were able to use tax losses as an offset to regular earned income. The 1986 tax bill phased out that key tax benefit. Depreciation schedules[9] were also dramatically altered, reducing tax benefits to limited partners even more. Syndicators left the market as buyers as the pool of potential limited partners gravitated to other financial investments, because real estate had lost so many of its tax advantages. Many foreclosures of the 1990-1994 period can be partially attributed to the loss of tax benefits for apartment ownership. Without tax benefits that could be applied to ordinary income, the post-1986 economics of limited partnerships made those vehicles unattractive.[10] Since there were no new limited partnerships being formed to buy out the existing limited partnerships, many of these projects went begging on the marketplace. Since many of these investments were built of real and paper cash flow losses, several of these projects started to collapse in the latter part of the decade. The amount of additional tax revenue generated by the 1986 bill is minuscule compared to the massive losses suffered by lending institutions and the Federal Government over the past six years because of the tidal wave of apartment and commercial foreclosures.

The Market Peak of 1989-1990

By 1987 several events occurred which helped change the direction of the market. As noted above, the 1986 tax reform bill sharply reduced the generous tax benefits for all owners of real estate and investors in limited partnerships. The building boom of 1984-86 caused a vacancy problem by mid-1987, forcing many landlords to reduce rents, usually disguised as free microwaves and other move-in incentives. Vacancy problems were worsened by the healthy residential real estate market, as many tenants purchased entry level homes and condominiums. Gross rent multipliers increased fifteen to twenty percent during the late eighties. Rising GRMs are a sign of a seller's market, and when they approach ten, as happened during 1990, it is generally a signal the market is about to make a major correction.

The First Stage of the Recession

The transition period from a seller's to a buyer's market happened in 1989 and 1990. Building of new units dropped dramatically for reasons I will discuss later. Vacancies continued to be a problem since expected rent increases never appeared. In spite of the vacancy problems, sale multipliers were bid up to near record highs as investor demand remained strong. Because the building of apartments had essentially ceased and the population continued to increase, many investors believed the early part of the nineties would be a replay of the early part of the previous decade. The expectation that rents would move up sharply kept sale Gross Rent Multipliers at high levels well into 1990.

Another factor that pushed the apartment market toward recession was the looming crisis of the area's Savings and Loans. Under pressure from Federal regulators, lenders began to change their underwriting guidelines for apartments. The disappearance of liberal lending practices eventually affected the demand for units. This fundamental restructuring of apartment lending will be addressed in another section.

The Great Apartment Fire Sale, 1991-1995

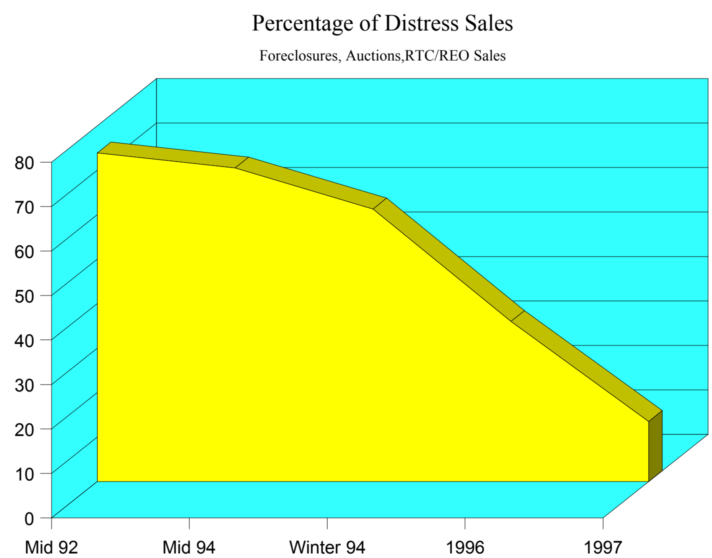
---

[9] The accelerated deprecation system was scrapped as well which affected owners of non-limited partnership investments in real estate.

[10] It could also be argued that the 1981 bill distorted investment real estate markets and that the 1986 tax bill was necessary to restore economic reality to the markets.

The end of the Cold War, reductions in defense and federal spending in Southern California, corporate downsizing and the growth of the global economy tipped the local apartment market into a serious recession. Lenders became reluctant to make apartment loans. Banks that remained in the apartment market adopted lending policies that discouraged sales, which further depressed resales. Vacancy rates climbed and rents began to drop as the regional recession began to impact the tenant class. Tenants began doubling up in apartments and moving back in with parents. Many left the region in search of employment in other states.

Bank sales were decreasing in relation to the total number of apartment sales as the recovery progressed. The 1997 total is deceptive because bank sales nearly disappeared toward the end of that year.



By mid-1992, the market became completely lender-driven. It was a catastrophe for owners, taxpayers and lending institutions. Rather than encouraging owners to hold and manage property, banking regulations and congressional pressure dictated a strategy that resulted in the total collapse of the commercial pricing structure. The practice of bundling nonperforming loans from failed lending institutions and selling them at an auction at twenty cents on the dollar further depressed prices. Had the Resolution Trust Corporation and the banking regulators somehow conspired to devalue commercial property values in this country, to destroy stockholder equity in many thrift and lending institutions and to wipe out the savings of many individuals, their strategy could not have been better. The concept behind the fire sale was to quickly recognize losses and reorganize the thrift industry in order to restore public confidence in the system. The policies forced lenders to foreclose on troubled apartment projects and sell them at desperation prices.[11] *By following this fire-sale strategy, lenders and the RTC created future losses for themselves and the taxpayers*. Foreclosures and short sales determined the market price for apartments. Sale prices averaged sixty to seventy percent of the existing debt. The REO/RTC market represented seventy-five percent of the units transferred and affected the

[11]Loans made outside California and on commercial projects proved to be the undoing of local thrifts. These institutions often carried non-performing loans on their books in order to keep the regulators at bay. Once they were forced to foreclose on under-performing and non-performing notes, the era of the foreclosure began in earnest.

remaining non-bank sales. There are several effects that resulted from the wave of foreclosures.[12] The major result from the foreclosure sales of larger projects is that those sales set the market for all buildings. The few sales of smaller buildings that did occur during this period do show a decline in sale gross rent multipliers. This decline is only twenty to forty percent of the decrease in sale GRMs registered by the sales of larger buildings or sales of all buildings in less desirable areas of the County. The net result was that the disaster in large buildings affected the market for smaller buildings.

Further analysis of the non-foreclosure/REO sales shows that the remaining sales were still below the market prices of 1986-1989. For example, there was one 1993 sale at below the 1983 purchase price and another below the 1985 purchase price. In some neighborhoods, such as those in the 92105 zip code, the prices were twenty percent *below*
1984 prices.

The Transition Market of 1996-1998 The transition from recession to recovery was complete by 1998. There were many factors which caused this, several of which will be discussed below. Later I will examine future scenarios based on the events of this transition period and the current bull market. This recovery cycle was uniquely different from that of earlier recovery periods. First, the interest rate of most apartment loans was 6.7 to 7.5 percent during this period, substantially lower than the period of 1985-1987, the last transition market. The 11th District Cost of Funds Index, the most prevalent index used for adjustable rate mortgages, was in the range of 4.8 to 4.9%. Not since the index started nearly twenty years ago has it exhibited such stability. The only real change, in effect an increase in the index, has been that 2.25 percent margin loans have all but disappeared, replaced by 2.6 to 3.0 percent margin loans.[13]
Second, although there was a widespread belief among buyers that the market had bottomed out, there remained a legitimate concern during 1997 and 1998 that the market would bump along the trough of the cycle for an extended period. This was a valid concern in certain areas of the county even though investors had noted the near absence of foreclosures and increasing rents in upscale areas.[14]

---

[12]See The London Advisory Groups pamphlet "The Impact of the Resolution Trust Corporation of the San Diego Real Estate Market" dated September 1, 1993. To quote, "The effect of their (the RTC) activities has been like that of a stealth bomber: they have quietly attacked and destroyed the market".

[13]For those not familiar with adjustable loans, the Cost of Funds Index (COFI) is added to the Amargin@ rate to arrive at the loan rate. If interest rates decline, the 11th District Index will not decline as fast. In order to stay competitive, lenders will drop the margins to keep the loan costs in line with the market. The opposite occurs when the COFI moves upward; lenders raise the margin to keep the loan profitable as the base index moves very slowly. Lenders prefer more volatile indices like treasury bills. The COFI is consumer-friendly.

[14]Property managers and owners were also reporting firming of rents in areas serving lower and lower-middle income areas as early as 1998.The shift was not as dramatic as that in the better areas.

Third, sellers and owners believed high vacancy rates were recession driven. This is different from the vacancy problems of 1987-1990, which were related more to oversupply than to tenant purchasing power. Sellers had less motivation to sell at reduced prices if there was a perception of continued job and wage growth over the near term. Very few people in the apartment business thought vacancies would still be a problem in 1997. Construction has been at historic low levels for six years and the population in the County has increased two to three percent per annum. Apartment construction was almost entirely for upscale units so building would have little effect on the majority of the rentals in the county. To put it another way, owners were convinced that the worst was over, but were not willing to market their properties or to do a tax-deferred exchange.

As illustrated below, building booms in apartments have followed periods of low vacancy rates. The three peaks that represent the three periods of major apartment construction each precede the corresponding nadir in the vacancy rate. What was different about this cycle was that the persistently high vacancy rates were not being driven by overbuilding. In the past three cycles when permits dropped, they were followed by drops in vacancy rates. Although vacancy rates fell below three percent in the Fall of 1997 and have dropped lower since, building remains below historic averages. Building new apartments to serve the lower half of the tenant market was not economically feasible. It was that simple. The really smart purchases were those made in 1997 and 1998 of B and C properties. Those properties are not going to be replaced as rents will not support the cost of replacing these properties.

Is history a good guide to the current and future apartment market? Eventually population growth, new jobs and higher wages combined with low building rates did force down vacancy rates to a level that permitted modest rent increases by 1998, even in North Park. Thirty to forty thousand new residents per year could not continue to squeeze into the current housing stock. To put it another way, many people were living in situations that they wished to change. Once they became economically enabled, they began to change their living arrangements and sought quarters with fewer people living in them or would live alone.[15] The restructuring of the

[15]The effect of the any increase in the n
Assuming that 35 cents of every dollar
gross county rental income.

state and local economies and the recessions were the major contributors to the high vacancy rates this decade.[16]

A recent study showed that tenants nationwide are paying a larger percentage of their income for rent than a decade ago. The same study also pointed out that San Diego was relatively more expensive for tenants than the average major metropolitan area. Even considering the fact that tenants pay over thirty percent of their income for rents, job growth predicted for the region for 2002 and 2003 will improve the purchasing power of the tenant class and apartment resale prices.

The Bull Returns-1998-2002

As the bull market in stocks accelerated after 1998, the market apartment reacted in mirror-like fashion. When stocks took a pratfall in the Spring of 2000, apartment values continued to rise. Driving this market was a booming job market in San Diego County, realized stock market gains and the cost of replacement apartments.

2003 and the Year of the Converter

Rents are the usually holy grail of resale value. Rents, in some markets, had declined precipetiously during the earlier decade. 1999 saw the beginning of a process of bringing the rents more in line with the cost of replacing apartments. As of this writing, rents have begun to level off but not before registering substantial increases over the past 48 months. Rents are currently stable featuring little or no appreciation at the upper end of the rents and solid gains at the lower end. Future increases over the short term should be just above the rate of inflation. Rents currently do not seem that important to buyers.

Toward the end of this recovery cycle a new factor appeared which sharply distorted the apartment market place.
As the San Diego real estate economy matured, it more and more resembled the older metropolitan areas of the Midwest and East. In those markets, entry-level home ownership would feature converted apartments instead of the traditional single family home. As the price of entry level homes went past $400,000, less expensive alternatives were needed to allow young families to obtain home ownership. The converters, aided by easy regulation, low financing expenses and increasing demand, went on a buying binge and drove up the price of apartments. Resale price and not rents determined value.

As with any important change, these phenomena brought good and bad. Inexpensive home ownership was created and will continue to be created by the segment of the market. Our governing bodies and the development sector cannot decide on how to create affordable home ownership. Governments court the converter as they provide cheap home ownership and a trove of fees. The only downside is for tenants. The existing stock of units will be diminished potentially exacerbating the already tight market for rentals.

---

[16]Moderate job growth is in evidence in 2003 in spite of the statewide recession. A persistent problem is that the new jobs on average pay far less than the jobs that were lost in the early part of the decade. The current County unemployment rate is less than the state and national numbers.

There is another shoe. The converters have distorted the market place for apartments. Prices for buildings are usually set by the relationship between rents and price. This has always been so. The converter does not care about the old rules as his profit and success will be based on another set of factors. The converter bids up the prices for apartment buildings regardless of the rent structure. Ordinary investors must meet the competition of the converters, and as such are gambling on rents and rates moving in their direction. There is no room for error. They are willing to invest and not see any real return on their investment for some period of time--hoping to make a profit solely with appreciation. If they lose that gamble there may be another wave of foreclosures or at least some bargains floating around.

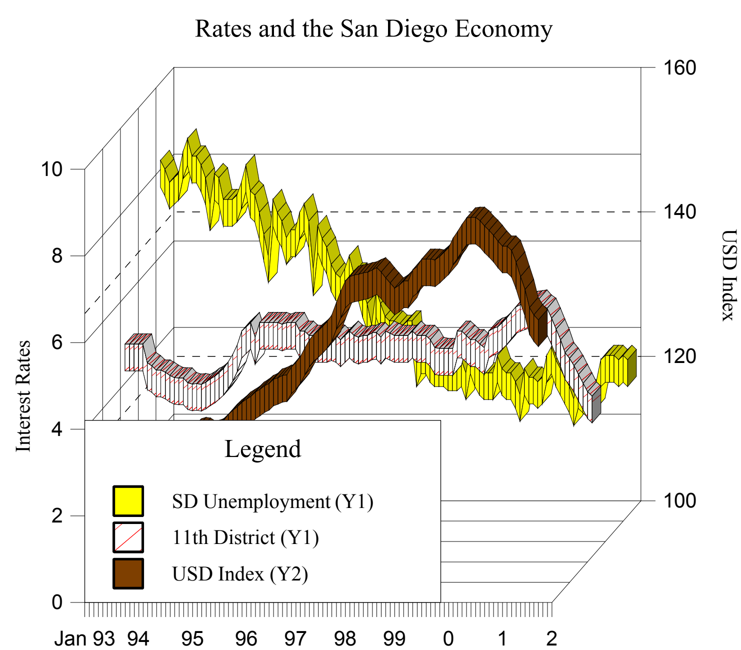
There are two factors that tend to drive what economists call "bubbles" in prices. The first is when real economic fundamentals, to earnings growth for example, make the investment rise in value. The second is when the expectation of price increases causes prices to go up. The latter represents a high level of risk for any investor who is thinking of entering the market place. The question any prospective apartment purchaser should ask is which of the two factors is driving the market in 2004.

The Apartment Market for 2004 and Beyond

The San Diego County Economy

The most important factors that will affect apartment prices going forward will be the local job market and rents, interest rates, and the expectations of future price appreciation based on non-economic factors. The last point refers to inflation psychology and the growing condominium conversion market.

The San Diego economy has performed exceptionally well over the past five years given the substantial restructuring that took place during the early part of the decade. The reduction of Federaldefense spending after 1990 and the demise of most San Diego-based corporations were crippling blows to the economy. The county real estate market was one of the main casualties of the recession as aggregate wages paid to the tenant class either stagnated or declined during the recession.



Unemployment is at relatively low levels and most of the tenant class is currently able to afford higher rents. The increased jobs and population created in 1998-2003 should continue in 2004, albeit at a much more moderate pace. Home prices have improved and sales are at near record levels, particularly for lower priced entry-level homes. The need for gateway homeownership will continue to push up prices of buildings suitable for conversion.

The out-migration of the past decade of area residents has been reversed. People are coming to San Diego as the economy continues to create new jobs. Apartment owners are experiencing a period of low vacancy rates and increasing rents. Tenants will benefit from more service sector jobs, the tight labor market and the multiple increases in the California minimum wage.This is not to minimize any adverse effects which will surely flow from the recent terrorist events. The County job market will be affected which will affect the ability of tenants to pay future rent increases. The risk of rent deflation must also be considered in the event more terrorist activity freezes the economy. This is not out of the realm of possibility.

Interest Rates

The 11th District Cost of Funds Index, which is the base index for the vast majority of all apartment loans, has been gradually decreasing since early 1996 and is currently around two percent. This index is at record lows but can move even lower. The earlier low of 3.6 percent occurred in June 1994. The 11th District COF index tends to lag seven or eight months behind major changes in the capital markets and prime rate.[17] Margins for new loans, once 2.25 to 2.5 percent over the base index, are now 2.6 to 2.8 percent. As of this writing, the consensus view is that the Federal Reserve Board will maintain lower rates and provide liquidity in response to the national jobless recovery and the economic drain following the terrorist attacks.[18] In addition, 2004 is an election year and rates should stay down at least into early 2005.

---

[17]As long as the Fed continues to keep the Fed Funds Rate at current levels, it is possible to COFI will drop below two percent.

[18]The Federal Reserve Board can only set the Federal Funds Rate, the rate at which banks loan money to each other. By adjusting the rate, banks generally follow suit and adjust their prime rate and rates paid to certain depositors. This in turn raises the cost of money which eventually is translated into higher mortgage rates as the

Cost of Funds Index increases. The general volatility of the capital markets, while often dramatic, rarely is translated into changes in the 11th District Index. It takes a sustained change in rates to move the Index one way or another. Apartment loans based on six month and one year treasury bills will adjust instantly. That is why lenders prefer those shorter term indexes.

The 11th District Cost of Funds Index is determined primarily by rates paid to depositors. Certain structural factors in how the Index is calculated make the Index more debtor friendly than in the past. The interest rate paid to depositors is related to how much liquidity the Federal Reserve Board wants to have in the monetary system and the amount of aggregate loan demand in the country. The rates paid to savers determine 84% of the index. Liquidity, which then drives short-term rates (and therefore rates paid to depositors) is determined by the Federal Funds Rate and the Discount Rate, both of which are set by the Federal Reserve Board.[19]

Fixed rate financing for apartments continues to be a less attractive option. Most terms are from three to ten years and the rates are from seven to nine percent. Some convert to adjustable rate loans after a certain period of time. Most buyers will opt for the traditional variable rate financing based on-one year Treasury Bills, LIBOR or the 11th District Cost of Funds Index.

New Construction

New permits and apartment construction projects are sharply up over the past decade. This should not be cause for alarm. First, the actual numbers of new units are running at about 40% of the rate during the overbuilding of the mid and late 1980s. Second, the number permitted is far below what will be needed to service the population increases. In addition, most of the permits are for Class A apartments that garner rents of $1.30 to $1.50 per square foot. The majority of the remainder is for specialized housing, such as for nonprofit agencies or subsidized housing. The number of permits for affordable market rate units over the past three years is minuscule. I define affordable as units that would compete with the existing stock of B and C apartments.

Real Estate Investment Trusts

Real Estate Investment Trusts (REITs) have returned as popular investment vehicles for individual and institutional investors. These institutions purchase only large class A properties. Most of the new construction in apartments over the next few years will be REIT driven. They are building market rate projects primarily north of Interstate Eight. They are projecting rents of $1.30 to $1.75 per square foot, substantially over the North Park standard of $1.05 to $1.20. These investments will be fully amenitized high quality buildings and will attract an upscale clientele. They will have little impact on the bulk of existing units. Older A class buildings with fewer amenities will suffer the most rental competition from new projects.

Planning and Growth

Management of growth is being regulated by lenders, economics government planners. The older general assumption that density is not desirable is being debated and I suspect several high density mid-to-low income projects will be built over the next few years. The issue of affordable housing and density cannot be separated.

---

[19] A study released several years ago by First Boston accurately predicted the drop in the Index in 1993 and 1994. Part of the reason is that the Index was changed by the Federal Reserve Board and is now different than in the 1980's. The net effect is that if today=s formula were used in 1985, for example, the rate would in 1985 would have been about 75 basis points lower that it actually was. This makes the Index even more attractive for borrowers in the future. This change partially explains why lenders favor LIBOR and other Indexes, which are more favorable to banks.

Density can be increased, which would have a major impact on the current rental structure. Politics and density are an ugly mix. I doubt the County or City has the political will to provide substantial relief for the renting class. There will be a few projects built along this mode, but not enough to impact the rental market.

Land use decisions are very important when considering the future price of units. The City of San Diego reduced the supply of buildable apartment land from 1975 to the present by downzoning most existing apartment sites. Local volunteer planning groups, generally not in favor of development, gained political power with the Planning Commission and City Council. Ordinances were adopted that restricted apartment development by such means as prohibiting the destruction of older single family homes, increasing off-street parking requirements, and establishing construction standards that decreased density. The net effect has been to increase the land portion cost of a new apartment unit at a rate higher than increases in rents and inflation.

Because of the general lack of political consensus on how to limit growth, most cities have passed from a system of political regulation to a system of informal regulation based on permit fees and economics. The rate of future apartment construction in the city and county will be limited more by land costs, permit fees, rents, and lender requirements than by land use regulations. If it becomes economic to build apartments in the future, the cities and County would have to allow another building boom to occur similar to the one of 1985-1987. But it that were to happen, I think the local governments would erect other types of barriers to new apartment construction.

Subsidized Housing and Section Eight Rental Subsidies

Once considered the province of older urban areas, government regulated or subsidized housing is increasing as a factor in the local apartment market. Many owners owe their survival in the past decade to Section 8 tenants. Now that the rental market is robust, the San Diego Housing Commission, which administers the rental subsidy program, is actively courting owners and is quick to agree to annual rental increases. The future effect should grow as incomes of the lower one-quarter of the population fall in relation to rent. Investors looking to low rent segments of the market should pay special attention to changes in both State and Federal law about housing subsidies. Section Eight has a great many enemies on Capital Hill. Given the current rental market, owners could probably survive a sharp reduction in Section Eight funds. In purchasing, however, I would avoid buying any property that traditionally is reliant on subsidized tenants. The political future of the program is solid for now but there could be some changes made over the next two years.

Non-profit agencies are also increasing their influence on the local market place as they move into the role of developers, benefitted by multiple funding sources including tax credits. Some opportunities may exist in the older urban areas for individual investors who may wish to explore private/public partnerships. One example of this concept would be the acquisition of Sober Living Environment complexes in which residents expect to pay above market rents for the assurance that the surrounding units are occupied by like-minded individuals.

Price Appreciation

Prices appreciation over the next two years is problematic. Rents may gradually increase and lower interest rates will maintain into lower operating costs but gross rent multipliers are at record levels. It would appear there is little room for price growth. There are only two sources: higher GRMs and higher rents. Since the GRMs are already at absurd levels, it would appear the only engine for future growth in rent increases. That will be driven by job and wage growth. Population growth is not a consistent indicator of future values.

Tenants demonstrated that fact to owners during the past decade when they doubled up or moved back in with Mom.

Tax Benefits and Apartments

There are minimal tax advantages today for apartment investors compared to the early 1980's. The tax reform bill of 1986 phased out the tax benefits for limited partnerships and changed the depreciation schedule for apartments. There are still some advantages for owners earning under $150,000 per year or for those with several rental properties. There are also certain kinds of low income housing which are tax advantaged under the current code. The conservative depreciation schedule now in effect will not likely be altered over the next decade as all governments struggle for new revenue sources. Potential investments should be analyzed in economic terms without considering tax incentives. This represents a major change in the way an investor evaluates a building.

The apartment sales boom of the early-to-mid 1980's was fueled largely by the tax benefits of the 1981 tax bill and federal spending in Southern California. When the advantages of the 1981 law were reduced by 1986 bill, real estate values were negatively affected. Tax benefits available from the current Administration=s budget offer little to the investment community. There appears to be no political will in 2002 to encourage real estate investments through tax policies. The trend of less government involvement in the private economy appears to be a permanent change for the next twenty or thirty years. Economists and others are generally in agreement that it is constant rule changes, not the rules themselves, that tend to create distortions in a market. The current tax laws governing apartments should remain in effect for many years.[20]

Land and Development Costs

As noted above, the political obstacles to development help maintain the rental structure. There is little question that the amount of developable land, for any use, is decreasing annually, either through construction or governmental taking. Adding to this, the actual cost of raw land is also a major factor in restricting new apartment construction. The twin expenses of development fees and land cost make B and C grade apartments extremely attractive investments going forward.

Conclusion

The apartment market for 2004 will be less volatile than 2002-2003. Occupancy rates and rental increases will remain positive for owners as long as the local economy thrives and produces job growth. I see little downside risk in the market for the next two years. Occupancy rates and the rate of rental increases will mirror 2003. Interest rates may continue to drift downwards at least for the next 18 months.
To be sure there is risk. Investors should not lose sight of the hidden value in apartments--their long-term stability and profitability. There are few investments around that can match the long-term performance of San Diego units. Trying to focus on the short-term situation may be appropriate in some cases, but taking the long view will guarantee a successful investment.

---

[20] Other than the reduction of capital gains taxes, there are no other future tax benefits that will likely be bestowed upon real estate. In fact, some flat tax proposals would eliminate real estate benefits.

Part II

How to Find, Evaluate, Purchase and Manage an Apartment Building in San Diego County

Determining Your Investment Goals

Determining your investment goal is the first step in successful apartment investing. There are two questions to ask. First, what are the cash flow requirements of the investor? Second, how much risk can the investor tolerate?

Apartments can be classified as income, growth and income, and growth investments, just the way common stocks are grouped. Growth stocks usually carry more risk than income stocks; the opposite is true with apartments. Growth apartments are class A buildings in better neighborhoods that sell for low capitalization rates.[21] Income apartments are usually class B, C and D buildings in average to below average neighborhood. These investments carry more risk and present more management problems. Growth apartments have the potential for greater price and income appreciation over the long term. Income apartments earn higher rates of cash flow immediately but may yield a lower total return over the life of the investment.

Is it necessary to use a Broker?

Brokers are involved in over ninety percent of the apartment transactions. There are many ways to utilize brokers or avoid them.

Selling a building by yourself is a far easier matter than purchasing one. All good apartment brokers regularly read the classified advertisement. If you advertise in section 4300 every Sunday in the *Union Tribune* for four or five weeks nearly every apartment broker will know of your product. You will need to pay a three, or possibly less, percent commission to the broker who brings you an offer. It is not difficult to represent yourself in negotiations and you may want to pay some small additional fee to the buyer's broker to expedite your paper work. You may also want to consider a fee based transactional attorney to represent you.

There are some risks to selling the property without proper representation. This is particularly true if the transaction is complicated or there are real or potential problems with your building. You are probably better off in the long run by listing the building with an agent at some reduced commission. As the market shifts toward a seller's market, the broker's value in marketing the building diminishes. Agents will discount their fee

[21]The term cap rate refers to a method of measuring the relationship between the selling price of the building and the net operating income (NOI)of the building. NOI is the cash left over after all the income and expenses have been accounted for but before any debt service. It is the same as the percentage return on the investment if you purchased the building for cash. Cap rates in sellers' market are around seven and over twelve in buyers' markets. Using cap rates is a more sophisticated method of evaluating cash flow than using gross rent multipliers. The GRM does not account for differences in expense and vacancy profiles in different buildings. You get the cap rate by dividing Net Operating Income(NOI) by the sales price.

accordingly.[22]

If you are going to use a broker, interview three or four agents. My best advice is to hire someone who is knowledgeable, experienced and has a good reputation. Do not be too concerned with the company the agent works for. What you really have is a business and personal relationship between the broker and client. Big firms have no real advantage in the marketplace. Agents in this business are highly competitive and view other agents in their firm as competitors. Most of the market in small properties is controlled by small or one-person brokerage concerns. The market in larger properties is thoroughly dominated by brand-name firms. The best advice is to hire the individual, not the firm.

Buying a property is a far more difficult process than selling. As the market changes to a seller's market, buyers who avoid having a good broker represent them are very unlikely to capture a good investment. There are three main ways to buy an apartment.

First, you can represent yourself. You will still have to deal mainly with the brokerage community. You may read the ads, write letters to owners or phone them. All of these tasks will consume a great deal of time. Many owners of buildings enjoy the regular contact with potential buyers and brokers and use it for a strange form of entertainment.

A second variant is to call several agents and have them look for property. Many successful investors use this technique. When a new property comes on the market, those buyers may get several phone calls from various agents. There is a another more serious downside risk to this method. Because you have no loyalty to any particular agent and they to you, you may not get the best advice. Certain buyers of this type can actually become well known in the brokerage community. This may not always be positive.

Third, you may choose to work exclusively with one agent. If there is mutual trust and loyalty, you are assured of getting the best service and more importantly, the best advice. You are paying, through the commission structure, for more than just the routine tasks of finding properties and handling the paperwork. The most valuable thing an agent can offer is his or her experience and judgement. By having an exclusive relationship with one agent, you maximize the value of having an agent and obtain the most value for your commission dollar.

The decision about using an agent will vary upon your experience level and time commitments. It is a very important part of the process and should not be taken lightly. Properly evaluate prospective agents and insist on referrals.

Finding the Right Building

This part of the investment process is the most difficult to accomplish. Not all buildings are appropriate for all investment goals. The traditional problem involves a mix of neighborhood, leverage and cash flow. These three elements must be properly matched with your financial abilities and investment goals. Your broker or a good financial consultant will greatly assist you in this area.

---

[22]The standard commission of six percent is usually split evenly between the buyer's agent and the sellers' agent. This should always be negotiated with apartment sales. There is no reason to pay full retail for an undifferentiated service that you can get at a discount.

Evaluating a Proposed Purchase

Once you have found a building to buy you must carefully evaluate the building from four major aspects; the sub-market and neighborhood, the physical condition of the building, the income and expenses, and the future upside potential of the building. Evaluating the market is the job of a broker. The broker should be able to supply you with detailed records of sales in the immediate area. When evaluating the records, you need to adequately understand the terms and conditions of the sale. You must pay careful attention to the condition of the building at time of the actual sale as well as the marketplace at the time of sale. A reliable service like COMPS, Inc. can supply most of the detail you will need. If your broker cannot supply this, get another agent. The best method is to augment the above by calling the principals in the transaction.

An accurate assessment of the physical characteristics of the building(s) is vital to evaluating the investment. Hire licensed experts to examine any part of the structures that may be questionable. Your broker=s experience is very important here. For example, an experienced broker will know when to ask for an environmental assessment. You should know if the water supply pipes are in or under the slab. You should be very careful about purchasing a building with plastic water supply pipes. You should be familiar with any permitting and building code issues. Always hire an expert to evaluate the building and the surrounding land.

Pay attention to current zoning. These are but a few issues that are very important and relate to how the building will perform over the long term.

In your offer be sure and ask for three years' records of expenses and income. Pay careful attention to any recurring repairs. If you think the books are not accurate, ask for copies of the appropriate pages of the seller=s tax returns. Most sellers will not like this, but it is a good way to verify the accuracy of the books. Be sure and review rental agreements and pay close attention to any concessions made to tenants. If a landlord is giving tenants a certain bonus
upon signing a lease, his stated gross rent schedule will have to be adjusted to reflect the true rental rate.

Most buildings have some potential for adding value. Some buildings and neighborhoods have more than others. This area involves knowing rents and rent trends in a given neighborhood. You also need to have intimate knowledge of the zoning politics of the area and any social and economic trends. If a building is renting at rent levels below the neighborhood market, it may be that there is some reason for this that is not readily apparent.
Visit the building unaccompanied at various hours. You will learn valuable information about the tenants and the general ability of the resident manager. My favorite litmus test is the laundry room. That room speaks volumes about the management of the building and the character of the tenants.

Making the Offer

I recommend using the standard nine-page California Association of Realtors offer form. Many agents may wish to use their own form or a form from a company that manufactures forms in this state. In my opinion, the California Association of Realtors form offers the best protection from potential problems for both buyer and seller.

Always insist on a California Association of Realtors Transfer Disclosure Statement. Most apartment brokers and many sellers will be reluctant to employ this document, which is required for all transfers of real estate in

California for one to four units. They will argue correctly that the document is not required and is not common practice. They are right but that is not the point of having the agents and seller fill out this document. The purpose of this document is to disclosure latent and patent defects in the building or the surrounding area. Since the seller, and the agents, are in effect making a warranty, the buyer can save time in evaluating the building and prevent potential fraud, intentional or otherwise, on the part of the sellers or agents . Of course, it is possible for the seller or agents to withhold material information. In the event the seller or agents do this, the Transfer Disclosure Statement will make it difficult for them to defend their position. In my view, this is good practice and is worth insisting on. For a five or more unit building, they are not obligated by law to provide it.

You should have the seller provide, at seller's expense, a termite report. In the 1970's and 1980's most of the apartment stock in San Diego was less than twenty-five years old. Most buildings have never been cleared of infestation and it is far more common today to obtain a clearance, so ask for one.

Ask for estoppel certificates from the tenants. You can make your own form or use a standard form. I have my own form which seeks the following information from the tenants: a) rental history, b) concessions made to tenant on move-in, and c) a list of all of the things wrong with the apartment. I also ask if they are planning to move, and if so, why. If you follow this one step you will learn the most valuable information about the building.

Finally, make a realistic offer. The key factors that will drive value are rents and condominium conversion potential.

Financing the Purchase

Financing your purchase can be difficult. The ranks of institutions willing to lend on apartments were dramatically thinned over the past decade. The details of this debacle were noted above. Now you have two basic choices. First, going to one of the major lenders still lending on apartments. Currently there are three to four players in this league. Second, you can utilize the services of a loan broker. This course will probably cost more money but will save you time. The broker should be able to access investors other than institutional lenders. Your choices will be limited.

The lender will also require from you a larger downpayment than that was required in the past. Seller secondary financing will also be more scrutinized, along with the physical condition of the building. In this market, most prime lenders are willing to loan only on class A and B buildings. There are lenders for C and D buildings but money is more expensive and difficult to obtain.

All of the above could change very quickly as the market improves. Apartment lending could become in favor with banks at any time. New lending competitors will move into the marketplace. The new competitors will not compete on price as much as terms. The net effect will be the ability to purchase buildings with lower downpayments. Be prepared to have thirty to thirty-five percent of the purchase price as a downpayment. Lenders will usually represent that they will loan sixty-five to seventy percent of the purchase price. In most cases, the amount to be loaned will be scaled back at some point in the loan process. There are no guarantees so you should have some seller financing in place or more money in the bank.

Keep in mind that the rules of apartment lending can change at anytime. Will the old underwriting guidelines reappear? Leverage is not well thought of with lending institutions and with more stringent federal oversight now in place, leveraged purchases are probably going to be out of favor for many years.

Exchanging and Capital Gains

This path has been a classic path to prosperity in apartment investing in the past. It has also been a real trap for many investors. The time deadlines imposed by the rules of exchanging forced many people to overpay for buildings. Sellers were aware of the time restrictions placed on exchangors and negotiated accordingly. Many foolish purchases made in 1988 to 1990 were the direct result of trying to protect gains from the taxes.

Beware of brokers who advertise themselves as exchange specialists. Escrow and title companies do 99% of the work involved. All that is involved is a simple purchase and sale. There are no tricks in this particular part of the business.

Secrets of Good Property Management

After your purchase, the second most important decision concerns property management. You need to make a decision about both on and off-site management. If the building is over 16 units, it is a requirement to have a resident manager. Off-site management is generally paid four to five percent of the gross rents for their professional services. The on-site manager is paid on a formula that is very complicated.

Use a payroll services and abide by the employment laws of the state. I realize they can be onerous and expensive. I also know that many owners in San Diego do not properly insure their managers. The potential liability to the owner is enormous. I once had a worker=s compensation claim for a manager who was stabbed pursuant to a lover's quarrel. Even though we argued the stabbing did not occur in the normal course of his duties, the claim was upheld. Without proper insurance coverage, I would still be making payments today to that manager. Do not underinsure the property. Carry two to three million in general liability insurance. Most lenders will accept $500,000 in general liability insurance but I think that amount is too low. An assault or rape on the premises can easily bring a judgement in excess of that amount. The amount of extra premium for the higher limits is more than justified in the legal climate of California.

Hiring a top quality manager with professional designations is difficult for smaller buildings. If you do not retain the services of an off-site manager, you will need to perform this task. The best managers want to manage large buildings that will pay them a full time wage. If you have a thirty to sixty unit building you cannot afford to pay a full time wage. You need someone who can subsist on a part time wage yet be on the premises during the work day. Retired married couples can generally fit this bill. You can get lists of managers from the San Diego Apartment Owners Association and you can also advertise in the Help Wanted section of the newspaper.

Managing Your Own Units

The experience of the Scott & Quinn property management division is that professional management can add ten to fifteen percent to the operating costs of a typical building.[23] Good property management is time intensive so it behooves any investor to properly evaluate the hidden costs of doing your own management. I have found that over time, the drudgery of management can cloud an owner's judgement. People sometimes make a decision to sell because they are tired of property management. If you have the necessary time readily available and you enjoy the nature of the work, it makes monetary sense to do it yourself. Like any do-it-yourself project, however, there are expenses, some of which are not readily apparent.

Sub-markets in San Diego County

The South County

The south county encompasses the area south of National City to the border. Apartments in these areas cater primarily to Hispanic, Navy and blue collar families. Gross Rent Multipliers are similar to North Park and now average 8.2 to 8.5 depending on the exact area.[24]. Most units are usually larger than average and there is lower density than in North Park. During the late 1980's there was significant building in the San Ysidro area. As Otay Mesa develops South Bay apartments may be subject to competition from newer projects in the border area. Imperial Beach is a good investment if you purchase near the ocean or in the southern portion of the city next to the Navy base. Imperial Beach is the least expensive beach area in Southern California and can command some high prices in areas adjacent to the beach. During 2001, the older less desirable areas of Imperial Beach suddenly achieved cachet with investors. Chula Vista is the most established small city in the region Chula Vista has a progressive outlook and is actively improving city and public facilities. The area will benefit from cross border commerce, NAFTA and the development of the Marina District. When Mexico=s economic crisis subsides, this area will be a prime apartment market. The apartment market here has been historically stable and the past recession was no exception. The number of bank sales in relation to non-bank sales was one of the lowest in the county. The presence of retirees, Navy personnel, enlightened City government and a stable homeowner base allowed this area to survive the apartment recession.

The East County

The East County would include the area from La Mesa eastward to Ramona. El Cajon is a major apartment area where much of the County's apartment stock is located. Multipliers tend to be five to ten percent lower than North Park. Most projects are 20 to 40 units in size with pools and air conditioning. During the last building boom, El Cajon, Lakeside and Santee were severely overbuilt. The market caters primarily to blue collar families. El Cajon has proved to be a stable investment area in the and as of late has been a stellar performer. Since rents have increased rapidly in more desirable areas, many renters are rediscovering El Cajon. During slow markets it can be difficult to market properties there. Nicer La Mesa apartments are an excellent investment, but most tend to be institutional-sized or high priced. The inner city of La Mesa is a good place to

---

[23]An older eight-unit building would cost about forty to forty-five percent(including vacancy) of the gross scheduled rents to operate. An active owner who is somewhat handy with tools can operate the same building for twenty-five to thirty percent.

[24]The source of the GRM figures is COMPS, Inc and the Multiple Listing Service.

rehab older apartments. Spring Valley is widely perceived as a difficult place to manage units and is demographically unstable. It has more potential for overbuilding as most of the community is in the County.

The North County Inland

The north county inland covers Mira Mesa to the Escondido/Vista/San Marcos area. Most of the newer product is two bedroom, two bath units of 1000 square feet. Multipliers in the nicer areas are higher than North Park. There are quality projects in Escondido, but mostly over 50 units. The three cities referred to above were also overbuilt and experienced 18 percent vacancy rates in the late eighties. Those areas cater to blue collar families, migrant workers, and military families. There is some risk with the latter group, as the vacancy rate hit 18 percent during the Gulf War. Escondido is becoming more restrictive on growth issues and has relatively high permit fees. There have been substantial buildings sold through foreclosure in Escondido, Vista and San Marcos during this recession. South of those three cities is Rancho Bernardo, Rancho Penasquitos and Poway. These are investment grade areas highly favored by institutional buyers. Most projects are over 30 units. Poway has some smaller units in the 18 to 30 unit range. Any investment in these three cities will be a sure winner. Poway, for example, has the highest per capita income in the county and is rapidly expanding its industrial parks.

North County Coastal

North county coastal encompasses Del Mar to Oceanside. Oceanside has a market very similar to North Park. Oceanside's market is heavily influenced by Camp Pendleton. Many investors shy away from Oceanside due to its reputation as a high crime area. Sales of Oceanside apartments have been primarily bank sales. The city does have an ambitious redevelopment plan and units close to the pier are a good bet over the next ten years. Carlsbad to Del Mar is an excellent apartment area. Tenants tend to be more upscale than any other area of the county. Vacancy rates can be less than two percent in some communities. Tenants' wages are higher and as a result rents can be expected to increase at a greater rate. Typical of high demand areas, multipliers are substantially higher. There are many pride of ownership properties, mostly 30 units and up. With the addition of the Coaster, tenant demand in this area should increase.

High-Urban

High-urban is a small area surrounding downtown San Diego primarily in the 92103 and 92101 zip code. There are few projects in the 20 to 40 unit range. Most apartments tend to be smaller and older than average. The area caters to an upscale professional clientele. Multipliers tend to be 20 to 25 percent higher than North Park. Hillcrest, University Heights and Mission Hills are premium investment areas and have many rehab opportunities. Hillcrest is rapidly changing and is the center of San Diego's medical and arts community. New residential/loft construction downtown will further benefit this area. Vacancy rates in this area are very low and rents are being increased.

One key point: All of these urban areas represent the epicenter of condominium conversions. This will have a major impact on the pricing structure.

Medium-Urban

Medium-urban encompasses better North Park and the fringes of downtown and Hillcrest. This area has the greatest density of apartments in San Diego. Most apartments are seven to sixteen units in size. The streets have a mix of single family homes and apartments. It should be noted that managers and owners are reporting that they are now able to raise rents and get a better quality tenant in North Park. Nearly all apartment investors think the traditional line of Interstate 805 that divides the metro market in units is now obsolete and that City Heights will redevelop and improve values in North Park. It is clear than the improving economy has greatly benefited the apartment market in North Park. The area has regained popularity with investors and developers. In the renovation of the North Park Theatre and business districts occurs and is successful, this market will have the great appreciation over the next five years.

Low-Urban

Low-urban would be southeast San Diego, City Heights, Golden Hill, parts of Normal Heights and parts of the college area. Multipliers were as low as the mid-threes during 1993 and 1994. The apartment mix is the same as North Park. Most investors demand the lower multipliers because of the perceived and actual management and appreciation problems in these areas, which have been heavily affected recently by social and crime problems. This area will benefit going forward because parts of it have been designated as a community renewal zone by HUD. One of the benefits, aside from generous loans and redevelopment opportunities, is that capital gains from units purchased and held for five years can be sold without any capital gains. The new baseball stadium has driven a boom in 92102 apartments and homes. City Heights has already seen major investment in the business areas. They now have a Starbucks. That should tell you something.

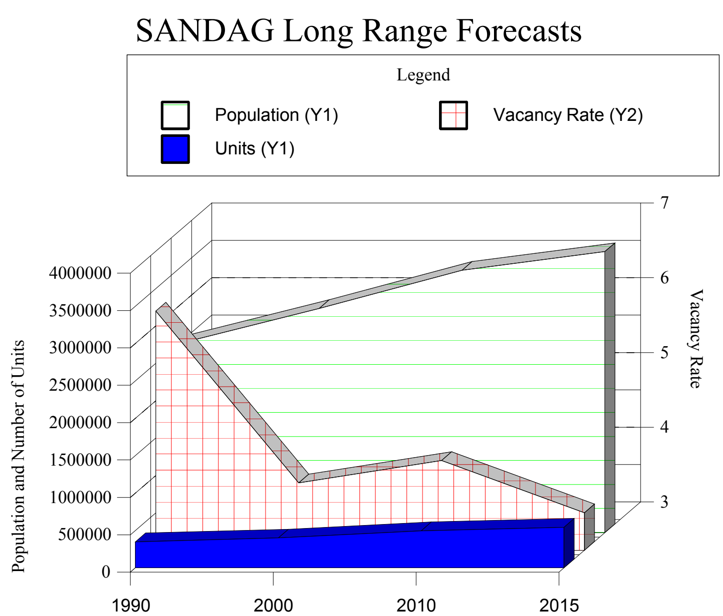
Part III
Conclusion

For Apartment Owners

Current owners of apartments should hold their investments unless they have other needs for the cash. As the purchasing power of tenants improves, rents should continue to increase at a rate substantially higher than inflation.

Interest rates should drift lower so owners will continue to enjoy low mortgage payments in the short run. The end of the recession will stabilize turnover so operating costs will continue to decline over the next two to three years except for water and sewer expenses.

The most important point for owners to keep in mind is that it is not profitable to build medium to low rent apartments.



Long Term Trends

SANDAG recently reported that San Diego will need 696,000 new housing units by the year 2015. Current construction rates will handle about one-quarter of the total needed. Older apartment stock will be torn down and replaced with fewer units because of downzoning. Many existing apartment units will be converted to condominiums over the next fifteen years to meet the demand for entry level home ownership. Many condominium projects, now used as apartment buildings, will be reconverted and sold as condominiums. The share of the condominium market held by conversions has increased from 10 percent to 24 percent over the past year. This will have a profound effect on rents.

Over the medium term, there seems little doubt that the existing apartment stock will be diminished from conversions and demolition and that replacement units will be relatively expensive and less plentiful than in the past. There also seems little doubt that the population will continue to increase. In the long term, owners of existing, well located units in San Diego County should profit.

The "Safety Valve"

In the past, new apartment construction has acted as a safety valve to relieve excess upward pressure on rents.[25] Because the factors discussed above, there will be no significant building boom in this decade and therefore no safety valve for tenants. Tenants have three of their own safety valves: rent control, leaving the area or doubling up. Rent control failed in the late seventies, garnering only twenty-five percent of the vote. Tenants doubled up or moved back home during the past recession. That strategy drove rents down on average about twenty percent during the recession of the 90s'. Tenants will need to either pass some form of rent control, not likely in this conservative community, or hope that the development community will build more units.

A Final Note

Much has been said and written recently concerning the attack on America and what that will mean to this market. Certainly if the nation and region spin into a serious recession rents and value will be negatively impacted. There is no other conclusion to draw. There is little question of short term damage to the San Diego economy. I am not sure as of the date of this report exactly how rents will fare. The apartment market is hostage to job growth and retention. I believe any adverse affects from September

[25]SANDAG's latest population forecasts for the
4.3 percent per year. With little construction o
toward the end of the decade.

11th will eventually pass.

Remember this final point. All real estate apartment investments in San Diego eventually make money. This writer mistimed the last downturn and had to endure holding units during a difficult seven year run. Now things are great and I have made lots of money. It is just a matter of when and fast you make it.

About Scott & Quinn: Scott & Quinn is a full service real estate company that was founded in 1982. Scott & Quinn offers a complete line of real estate services including a property management division. The company is located at 1111 Fort Stockton Drive in Mission Hills. The phone number is 619-296-9511. The company web site is www.sqre.com and you can email at jimscott@sqre.com

About the author: Jim Scott has a solid educational and professional background. Born in 1943, Jim has resided in San Diego most of his life. He graduated from San Diego State College in 1966 with a degree in Marketing. Following graduation, Jim served in the Marine Corps-rising to the rank of Captain. His military experiences included a tour in Vietnam in 1967-68. Leaving the service in 1970, Jim earned a Masters degree from San Diego State University in American History. He then taught history and business at community colleges and later worked as a San Diego County Probation Officer. In 1973 he began investing in San Diego real estate. He became a broker in 1982, founding Scott Pacific Investments. In 1987 he teamed with Jeff Quinn to form Scott & Quinn. Jim is experienced in all phases of commercial and residential real estate. A 43 year resident of San Diego, Jim is married to Greer Knopf, an Administrative Law Judge. They have two children.

Economics at the University of San Diego, the San Diego Economic Research Bureau, the California Department of Labor Statistics, the San Diego Apartment Owners Association, the San Diego Union-Tribune, The Valuation Network, Inc., COMPS, Inc., Damar Inc., Market Profiles of San Diego, First Boston Fixed Income Research Report of August 25, 1992 and the San Diego Board of Realtors. The graphs, the conclusions drawn and the analysis presented herein are solely the responsibility and property of Scott & Quinn.