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Cover story

San Francisco rental construction soars

A \$5 billion wave of apartment construction is now starting to wash over San Francisco. What will it change? Just about everything.



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A historic \$5 billion explosion of rental housing is about to dramatically reshape San Francisco's skyline, neighborhoods and politics.

Ending last decade's flirtation with high-end condo towers, the city is rattling and humming with the biggest burst of apartment construction witnessed since Joe Alioto was mayor in the late 1960s and early 1970s. Nearly 8,000 new apartments, mostly in mid-rise and high-rise buildings, will come on line between now and 2015 — 3,498 in 2015 alone. It's more new rental housing than was built in the last 15 years combined, according to real estate research firm Polaris Pacific.

"I have never seen so much construction going on in my life," said Angelo Sangiacomo of Trinity Properties, who has been building housing in San Francisco for 50 years.

Driven largely by the growth in San Francisco's tech-fueled economy, the apartment boom will permanently change the pockets of the city where it is concentrated, including Mid-Market, Mission Bay, Potrero Hill, the Dogpatch, Rincon Hill and parts of SoMa. It's expected to bring in thousands of new renters, mostly educated technology workers who can afford to pay up to \$3,500 a month in rent for an 800-square-foot apartment. Such a large influx of affluent professionals in a short time could sharply alter voting patterns in districts long dominated by progressives, and tip the balance on hot-button local issues such as rent control and condo conversions.

The historic level of rental housing production is being celebrated by advocates of urban density and transit-oriented development. Gabriel Metcalf, executive director of the San Francisco Planning and Urban Research Association, calls the trend "unambiguously one of the best things that has happened in San Francisco in a long time." Metcalf said the amount of housing, if sustained, has the potential to make San Francisco more affordable for everyone.

"It's happening in all the right places, next to transit and jobs," said Metcalf. "We don't know what will happen if we build enough housing because we have never done it. We know what happens if we don't build enough housing because we are living it."

Leasing up quickly

So far the three apartment complexes that are finished are leasing up rapidly: the Emerald Fund's 326-unit Rincon Green at 333 Harrison St., CityView's 196-unit Potrero Launch at 2235 Third St. and AvalonBay's 173-unit Avalon Ocean Avenue at 1200 Ocean Ave. All three have averaged monthly rents above \$4 a square foot. AvalonBay's project leased up fully in six months.

Rincon Green shows just how robust demand is. With studios renting for \$2,186, one bedrooms for \$2,846, and two-bedroom units for \$3,590, Rincon Green started leasing in August. By April 1 it was 90 percent leased.

Using the usual yardstick that a renter shouldn't pay more than 2.5 percent of annual gross income in monthly rent, tenants will need to be making \$80,000 a year and up.

"You are looking at some good salaries," said Emerald Fund Leasing Manager Carl Wagner, who described the average renter as "young, female, and upwardly mobile."

It's the same story at Potrero Launch, said Tony Cardoza of CityView. Its 196 units are 85 percent leased at an average of \$4.60 to \$4.70 per square foot per month — more than 20 percent higher than they expected.

At both Potrero Launch and Rincon Green, more than 30 percent of residents work south of San Francisco. "The most surprising thing has been the number of candidates who work down on the Peninsula," said Cardoza. "It speaks to the quality of life in San Francisco."

A fourth complex will open in September: Avant Housing's 194-unit Vara. Leasing started this month. The project features an on-location co-working space free to residents, as well as a woodworking studio, communal chef's kitchen and bike repair shop, according to Avant principal Eric Tao, who said the renter pool has been surprisingly diverse. "The first \$6,100-a-month penthouse was reserved by a family with three children relocating from London," he said.

Political calculations

Skeptics say the two dozen construction cranes that now hover from Mission Bay to Upper Market are a sign of too much capital chasing too narrow a market. Rather than creating a broad range of housing that is affordable to an eclectic mix of people, the projects under construction are aimed almost entirely at young, wealthy technology workers who have embraced San Francisco as a vibrant and hip alternative to the traffic-choked suburban sprawl of Silicon Valley.

Ted Gullicksen of the San Francisco Tenants Union said, "We are so overbuilt on the high-end luxury end of housing, we just don't need any more."

"It's the one area where we are exceeding goals," he said. "We are falling way short for low- and medium-income housing. These buildings are all going up in places that could be sites for affordable housing."

While the new housing is overwhelmingly rental, it's unlikely that the new crop of renters will identify with the progressive rent-controlled voters who have dominated politics in neighborhoods like the Haight and the Mission, said longtime local political analyst David Latterman of the University of San Francisco. The upscale renters could tilt San Francisco's Board of Supervisors toward more moderate, business-friendly views.

"There is a reason why the left has worked so hard to keep new housing construction out of the east side because they know that market-rate housing changes the demographics," said Latterman. "You bring folks in of higher income and they are going to vote on economic interests, on schools, on things that make it easier for families to stay in San Francisco. They are going to be anything but progressive."

Latterman said the changes would be gradual. "It takes a long time for people to move in, learn about the neighborhood issues and get politically active," Latterman said. But in the long run, "every new renter who comes in to District 6 or District 10 reduces the chances of (a progressive) getting elected."

However, Corey Cook, an associate professor of politics at University of San Francisco, said the huge amount of upscale housing could create a backlash similar to the powerful anti-development wave that emerged from the dot-com boom.

"In politics, perception is what counts," said Cook. "If the perception is that the economy is doing well, but only for a select few, and that there is a lot of housing being built, but only for a select few, it has the potential to raise concerns about rising housing prices and gentrification and the out-migration of low-income populations."

From bust to bonanza

The current apartment boom is rooted in the dark days following the 2008 crash. Real estate investors reeling from losses on condos, office buildings and retail space identified urban apartment buildings as a safe haven for capital.

Developers including Urban Housing Group, Emerald Fund, Crescent Heights, Gerding Edlen and MacFarlane Partners scooped up San Francisco sites. Real estate investment trusts such as AvalonBay, flush with cash and already active in San Francisco apartment development, doubled down. Other REITs, such as BRE Properties, Equity Residential, UDR and Essex Property Trust piled in. Those five REITs have 17 projects under construction in the Bay Area, representing 5,084 units, or 34 percent of all housing under construction in the region, according to an International Strategy & Investment Group report.

Developers who bought up cheap development sites in 2009 or 2010 found themselves in an enviable position: They picked off land at the bottom of the cycle and bid out their jobs when the construction trades, facing 30 percent unemployment, were desperate for work.

And none did better than AvalonBay at Ocean Avenue. The REIT got a steal, paying just over \$5.1 million for the site, or about \$29,000 a unit. Meg Spriggs, vice president of development for AvalonBay, said, "After a seven-year process, we were lucky to hit the market when we did."

"It really is a lesson in diligence and the strength of a good underlying land deal," she said. "Our yield exceeded all expectations — we will likely never see a yield like this in San Francisco again."

Since then, land values have jumped to \$120,000 per buildable unit. And with construction costs up 5 to 8 percent year-over-year, developers are now paying \$600,000 a unit to build high-end apartment towers.

Will supply exceed demand?

That combination of rapidly rising land and building costs, plus the impending flood of new units, could spell trouble for some builders.

MPP research says the broader SoMa area has 3,290 units under construction, with 1,876 units set for completion in 2013. It forecasts demand at 1,163 new apartments, a level that will "fall well short of concurrent new supply."

San Francisco historically has been able to absorb 1,500 new units a year safely. Economists expect that this year the city will match the peak employment number reached in 2007, and jobs will continue to grow 3 percent a year through 2017. That will create about 17,000 new households in a city that is 63 percent renters. Veteran apartment developer Dan Deibel, who formerly headed Urban Housing Group, expects that there will be enough demand to absorb 7,500 to 8,000 new rental units.

"It's going to be a little oversupplied, but not grossly oversupplied," he said. "I am more optimistic than pessimistic about where we are in the cycle and the prospect of absorbing what's in the pipeline."

If developers are stuck with half-vacant buildings, or are forced to lower rents to draw tenants, some could find themselves in violation of the terms of their loans. "It's very easy in a period like this not to pay close attention to the terms because you don't think that anything can go wrong — but this is exactly the time to be paying attention," Deibel said.

But the impending raft of new buildings has not dampened the optimism of developers like John Hyjer, Equity Residential's vice president of investments for Northern California. The company has four projects totaling 800 units in progress in San Francisco.

"Who could ask for better timing, with job creation that is occurring and all the social networking companies planting a flag in the city?" he said.



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