

DEMOGRAPHIC DEMAND FOR HOUSING IN CALIFORNIA: IMPLICATIONS FOR APARTMENT MARKETS AND PROPERTY OWNERS

Introduction

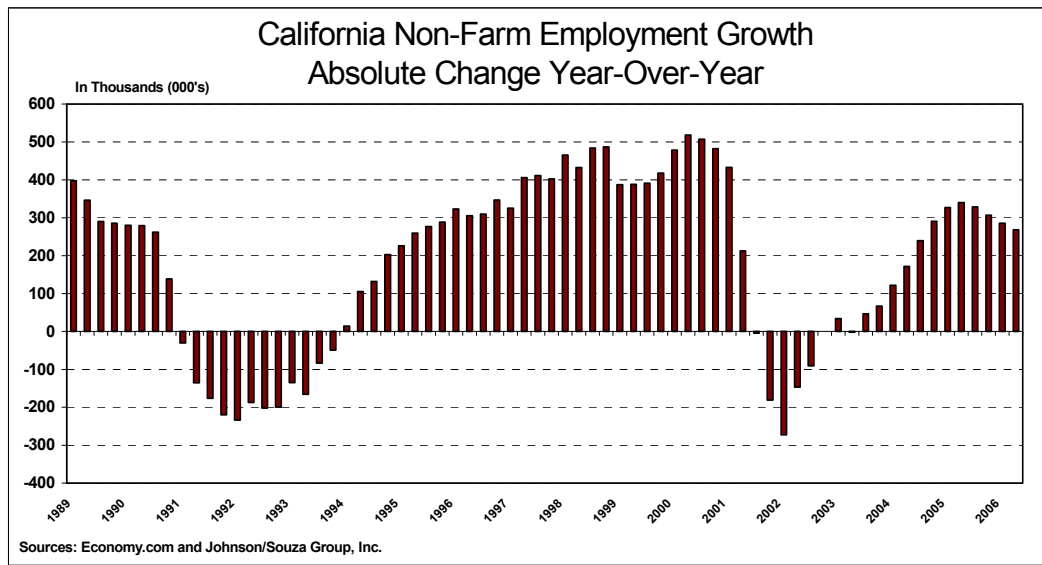
California is the fifth largest economy in the world with over \$1.3 trillion in Gross State Product (GSP), and is projected to continue to be a leader in absolute employment and population growth over the next 10 years. Due to its location along the Pacific Coast, the Sierra Nevada mountain range, and expansive interior valley, California obtains natural and man-made competitive advantages that draw people from all over the country, and all over the world. *Continued job growth and in-migration to the state provides solid underlying demand fundamentals for apartment ownership.* These comparative advantages, along with current and future demographic changes, will have major impacts on demand for apartments, and how, we as managers, manage our properties.

Employment Growth

The key driver of apartment demand is employment growth. Firms in California employ over 14.6 million people, 11% of the total U.S. employment base. California's employment base is concentrated in five main industries: government (17% of the total non-farm employment base), wholesale and retail trade (15%), professional and business services (15%), manufacturing (11%), and education and health services (11%). Currently, industries growing the fastest are: construction (2.0% YOY as of December 2003), education and health services (1.8% YOY), and leisure and hospitality (1.6% YOY); and those industries continuing to exhibit negative employment growth rates are: manufacturing (-2.1% YOY), government (-2.0% YOY), and information and professional- business services (-0.9%).

Employment in California is projected to grow by 1.7% per year through 2009, above 1.3% per year forecast for the United States. California is projected to add a total of 1.4 million jobs during this same time period, or 233,800 jobs per year. Future job growth is projected to be driven by professional and business services (3.1% per year through 2009), leisure and hospitality (3.0%), education and health services (2.3%), and information (2.1%) sectors. California is projected to account for 13% of total U.S. employment growth through 2009. Employment growth will be driven by high-value added exports to Asia, Canada, South America and Europe; and services, construction, manufacturing, and trade sectors to meet the needs of a growing population base.

Employment growth drives migration and immigration to California, which in turn contributes to population growth, demographic make-up, household formations and ultimately the gap between supply and demand for housing. This gap eventually affects home prices and rental rates, affordability and access.



Population Growth

Population growth of an area or region drives demand for housing services; this in turn determines owner and renter occupancy rates, home prices and rents. One in 10 Americans reside in California, the nation's most populous state and one of the three fastest growing. California is projected to add 10 million new residents by 2040, four million new homes will be needed to meet the demand. There are over 35 million people living in California, 12% of the total U.S. population: 46% white, 35% Hispanic, 12% Asian Pacific Islander, 6% Black, and 1.4% Other. Due to high immigration rates, the overall population will become more diverse, particularly Hispanic. Half of the state's population lives in the four most populace counties: Los Angeles (10 million people), Orange County (3 million people), San Diego (3 million people) and San Bernardino (1.9 million people).

From 2000 to 2003, the top ten cities with the largest population changes were: Los Angeles (170,000 people), San Diego (52,000 people), San Jose (30,100 people), Sacramento (26,400 people), Chula Vista (26,100 people), Irvine (21,800 people), Fresno (20,800 people), Bakersfield (19,900 people), Long Beach (19,500 people), and Rancho Cucamonga (19,000 people).

The California population base is projected to grow by 1.3% per year through 2009, above 1.0% per year for the United States. California is projected to add a total of 2.8 million people during this time period, or 470,800 people per year, the majority of growth in Los Angeles and Riverside counties. Population growth toward inland locations will continue to be driven by migration flows out of California's high cost coastal markets.

Demand for housing is driven by employment and population growth rates, but certain types of housing are determined by demographic composition (age cohorts) and socio-demographic make-up (household types) of the population base.

Demographic Cohorts

Renter-age cohort demographic trends in California are changing dramatically. For multifamily developers, owners and managers, the most significant demographic trends over the next 10 years will be:

- 1) the aging of the baby boomers; and,
- 2) the emergence of the echo boomers (children of the baby boomers).

As the population of 25 to 44 year-olds decline, the population of 19 to 24 year-olds is projected to rise. Over the next ten-years, the echo boomers will rival baby boomers in size, buying power, and political clout. In the United States, Echo boomers (8-to-25 years old) are over 73 million strong, compared to 47 million for Generation X (26-to-37 years old). Echo boomers are the biggest demographic bulge since the 79 million baby boomers (38-to-56 years old).

CALIFORNIA GENERATIONS				
(Population Dates of Birth and Age Cohorts)				
Generations	Born Between	Age Cohorts	2002 Size of Cohort	Percent of West
Generation Z	1995 - 2002	0-to-7 years-old	4,173,162	54.4%
Echo Boomers/Gen Y	1977 - 1994	8-to-25 years-old	9,440,123	54.0%
Generation X	1965 - 1976	26-to-37 years-old	6,092,778	56.6%
Baby Boomers	1946 - 1964	38-to-56 years-old	9,346,542	52.8%
- Young Baby Boomers	1955 - 1964	38-to-47 years-old	5,623,621	54.4%
- Older Baby Boomers	1946 - 1954	48-to-56 years-old	3,722,921	50.5%
Swing Generation	1933 - 1945	57-to-69 years-old	3,213,718	49.2%
WWII Generation	Prior to 1932	70+ years-old	2,652,153	51.7%

Sources: Tom Exter, TGE Demographics, Honeoye Falls, New York, 1998; Economy.com; U.S. Department of Commerce, Census Bureau; Susan Mitchell, American Generations, New Strategist Publications, Inc., Ithaca NY, 2000; and Johnson/Souza Group, Inc.

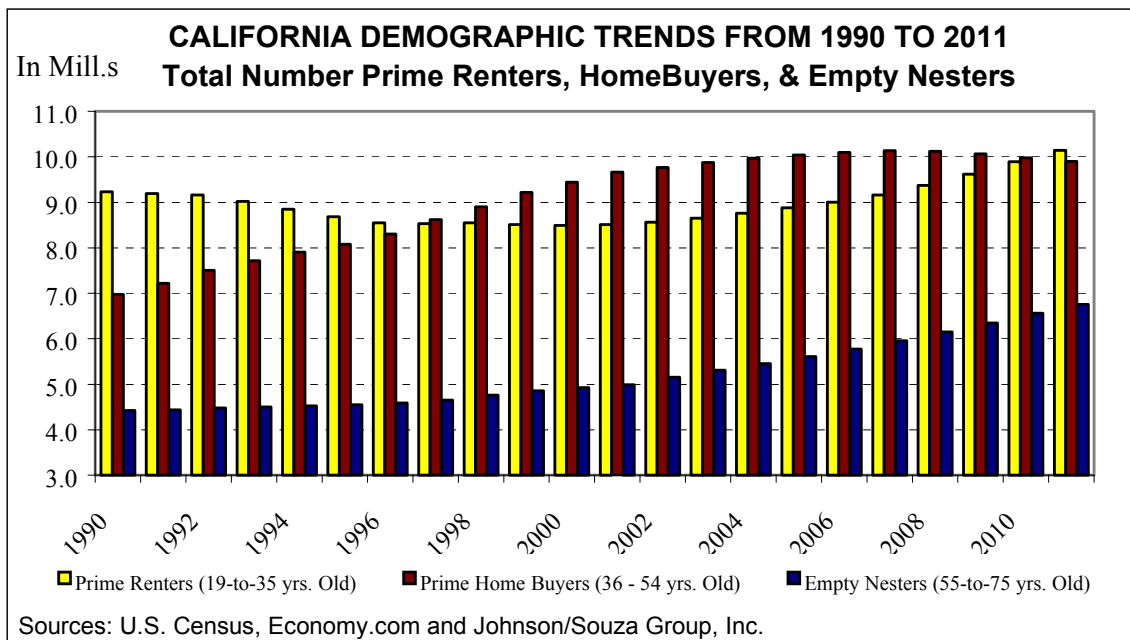
In California, the Echo Boomers (ages 8-to-25 years old) are larger than the Baby Boomers at 9.4 million people. As the echo boomers enter the workforce and housing market, they will put upward pressure on unemployment rates, owner and renter occupancy rates, home prices and rental rates; and will test the limits of state and local governments to provide and promote health and human services, education and housing services, transportation infrastructure, and jobs that meet their needs.

If these needs are not met, this highly mobile workforce will look outside the state for educational and occupational opportunities, losing one of California's most valued assets (human capital).

Apartment amenities that would appeal to echo boomers include:

- Bike, skateboard, rollerblading trails
- High-speed Internet access with video and audio capabilities
- Access to latest computer games via the Internet
- Extreme sport television entertainment channels
- Surround-sound speaker systems
- Multi-use surface courts—basketball, volleyball, rollerblade hockey, tennis, etc.

The number of prime renters (19-to-35 years old) bottomed at 8.5 million in 1999, and are projected to reach over 10.0 million by 2011; prime home-buyers (36-to-54 years old) are projected to grow from 9.0 million to 10.0 million, for this same time period; and empty nesters (55-to-75 years old) are projected to grow from 5.0 million to 7.0 million, for this same time period. Rapid growth in prime renters and empty nesters will put demand on developers and owners to deliver amenities that meet their needs.



Aging baby boomers will have a significant impact on future demand for apartments as they move into their peak income-earning and home-buying years. A good number of baby boomers will decide to remain – or become – renters-by-choice or “lifestyle renters.” *Baby boomers will be looking for more convenience. Many will sell their homes, invest in liquid financial assets, and rent in locations close to family, jobs, entertainment and academic institutions.* Sixty-five percent of all Californian’s live within 29 minutes of their work, the average is 25 minutes.

Household Formations

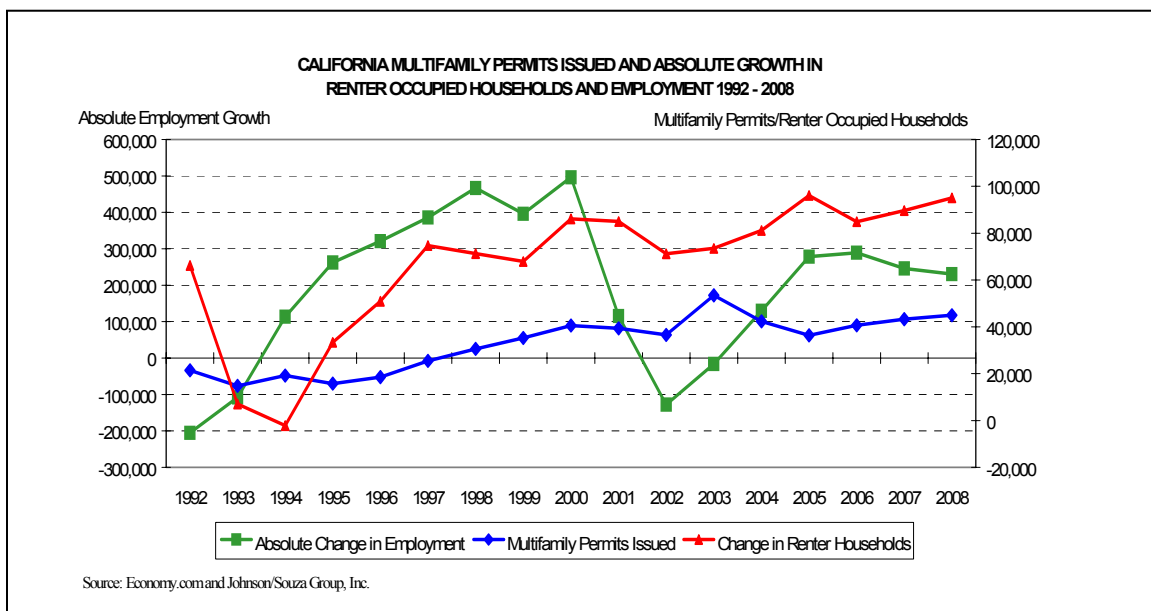
The rate of household formations and sociodemographic trends will significantly impact demand for certain types of housing (renter vs. owner occupied). Households in California total 12.1 million, and are projected to grow by 1.7% per year through 2009, above 1.2% per year for the United States. California is projected to add 209,000 households during this time period, or 35,000 households per year. Roughly, 43.1% of all occupied housing units are expected to be renter.

A significant portion of new household formations will be driven by:

- Foreign immigration
- Emergence of the echo boomers
- Aging of the baby boomers
- High divorce and marital postponement rates
- Fewer households with children
- Longer life expectancy
- Alternative households and lifestyles

Sociodemographic trends should have a major impact on apartment demand and desired amenities over the next 10 years. Married couples without children and individuals living alone are projected to grow rapidly. *Married couples without children under 18, individuals living alone, and women living alone will be looking for more safety, social, travel, entertainment and recreational amenities.*

Population and household growth is projected to be driven by internal growth (births minus deaths), interstate migration, immigration, changing socio-demographics (household types), and the emergence of the echo boomers.

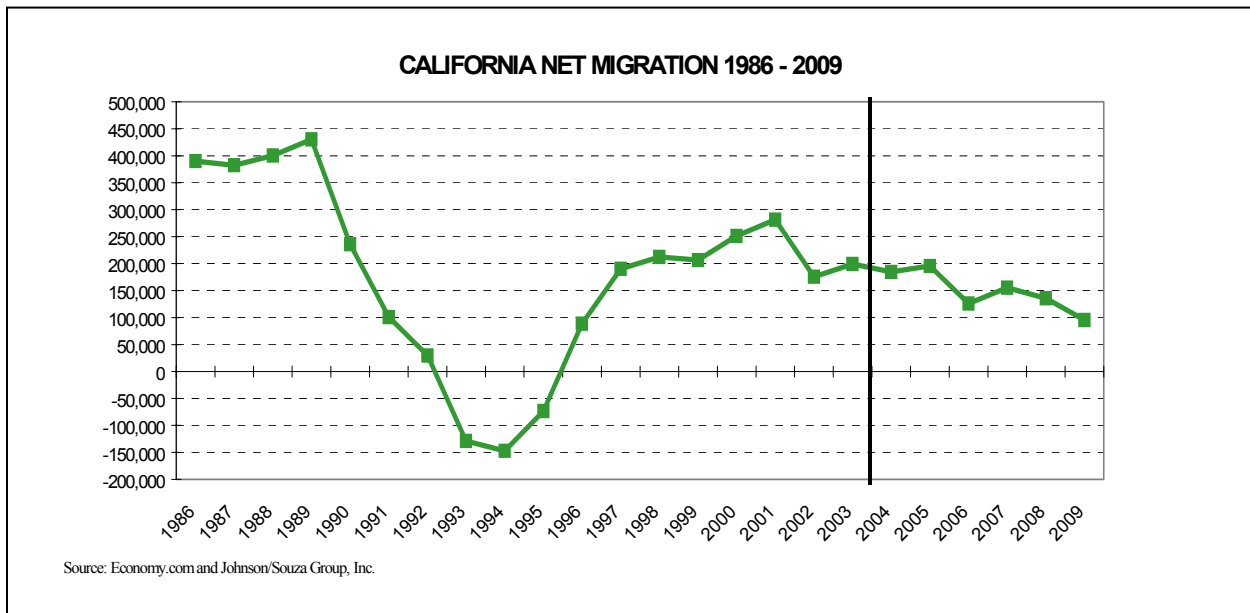


Migration

Particularly for California, major contributors to population growth and household formations are migration and immigration into the state. Metro areas will be impacted differently depending on their location, access and existing relationships with communities in other boarding states, metro areas and countries. Migration activity into and out of California will continue to be driven by job growth, quality-of-life issues and housing affordability relative to inland locations and bordering state metros.

In 2002-2003, California net migration totaled over 200,000 people. California counties experiencing the highest net migration were: Los Angeles (64,800 people), Riverside (61,000 people), San Bernardino (33,700 people), San Diego (20,200 people), and Sacramento (19,000); and counties experiencing negative net migration were: Santa Clara (-11,300 people), Alameda (-4,300 people), San Mateo (-4,000 people), and San Francisco (-3,000 people).

Annual net migration for the state is projected to average 150,000 people per year through 2009. Although net migration will continue to remain positive, it has been declining since 2001. It is projected that net migration will fall from its peak of 300,000 people in 2001 to 100,000 people by 2009. Lower net migration rates are due to high business, housing and education costs.



Gross positive migration flows into California totaled 338,600 people in 2002, the majority coming from Texas (31,000 people), Washington (25,100 people), Arizona (25,100 people), and Nevada (22,000 people); and the majority of migrants leaving California went to Texas (44,000 people), Nevada (43,000 people), Arizona (40,000 people) and Washington (30,000 people).

Migration Flows - California - 2002

Into CA	Number of Migrants	Median Income	From CA	Number of Migrants	Median Income
Texas	31,419	23,033	Texas	44,091	24,772
Washington	25,095	22,635	Nevada	43,257	24,326
Arizona	25,091	21,525	Arizona	40,247	24,946
Nevada	21,286	20,643	Washington	30082	25,884
New York	19463	27,301	Oregon	26131	23,837
Florida	17432	21,601	Florida	23565	26,802
Illinois	17080	25,904	Colorado	20293	26,633
Colorado	15459	23,237	New York	16026	27,776
Oregon	15158	18,902	Virginia	15555	32,140
Virginia	13596	28,397	Illinois	13861	26,758
Total Immigration	338,623	21,185	Total Outmigration	466,719	23,942
			Net Migration	-128,096	-2,757

Note: Net Migration - Number of Migrants is the net flow of migrants. Income is the difference between the weighted average of the median income of immigrants and that of outmigrants.
Source: Economy.com calculation from 2002 IRS data.

Population growth for inland California locations and bordering state metro areas will continue to be driven by migration flows out of California’s coastal markets. California migration outflows will be more than offset through natural population increases and foreign immigration.

Immigration

As the gateway to the golden state, people from all over the world want to come to California to find jobs, gain their education, raise their children, and obtain their freedom. Immigration boosts the nation’s and California’s population growth. More than 5 million people entered the United States from 1991 to 1995, and over 5 million people entered the country from 1998 to 2003. A new record for immigration was set in the 1990s. Of the 800,000 immigrants admitted to the United States per year, one third plan to live in the West. Most end up in California. California was the intended state of residence of one-quarter (25.5%) of all legal immigrants in 1997. California and Florida were the only leading states to show increases in legal immigration between 1996 and 1997.

Immigration to the United States	
1901-1910	1991-2000f
8,795,000	9,106,000
Source: U.S. Department of Justice, Immigration and Naturalization Service, <u>1997 Statistical Yearbook</u> , October 1999, pg. 23; and Johnson/Souza Group, Inc.	

Percent of Immigrants Planning to Live in the West	
Country	Percent
Mexico	59.0%
Philippines	60.0%
China	50.0%
Vietnam	47.0%

Source: Janet Heslop, *The American Market Place*, 3rd Edition, New Strategist, New York, 1997.

From 1984 to 2002, California received over 3.7 million legal immigrants, 197,400 people per year. Counties receiving the majority of these immigrants were (annual average per year): Los Angeles (74,500 people), Orange (17,930 people), Santa Clara (15,634 people), San Diego (13,130 people), San Francisco (10,500 people), Alameda (9,915 people), San Mateo (5,710 people), Sacramento (5,135 people), San Bernardino (4,815 people), Riverside (4,000 people), Contra Costa (3,860 people), Fresno (3,800 people), and Ventura (3,180 people).

In 2002, California was the home to the largest number of U.S. immigrants (291,000 or 27%), as many as New York, Florida and Texas combined. Forty-nine percent were born in Latin America, 40% were born in Asia, 66% were married, 56% were female, and the median age was 30 years old. The majority of immigrants were admitted to join family members, 72% of immigrants were family-sponsored, 15% based on employment preference, 5% refugees or asylees, and 8% as other.

Housing Gap

Employment and population growth, household formations, socio-demographics, migration and immigration are primary drivers of demand for housing in California. Due to employment and demographic trends over the next decade, demand for housing will exceed supply, driving up home prices and pushing people further out to inland areas and bordering states. Lack of supply, steep fees and environmental regulations in California have produced extraordinarily high housing costs and some of the lowest home-ownership rates in the nation.

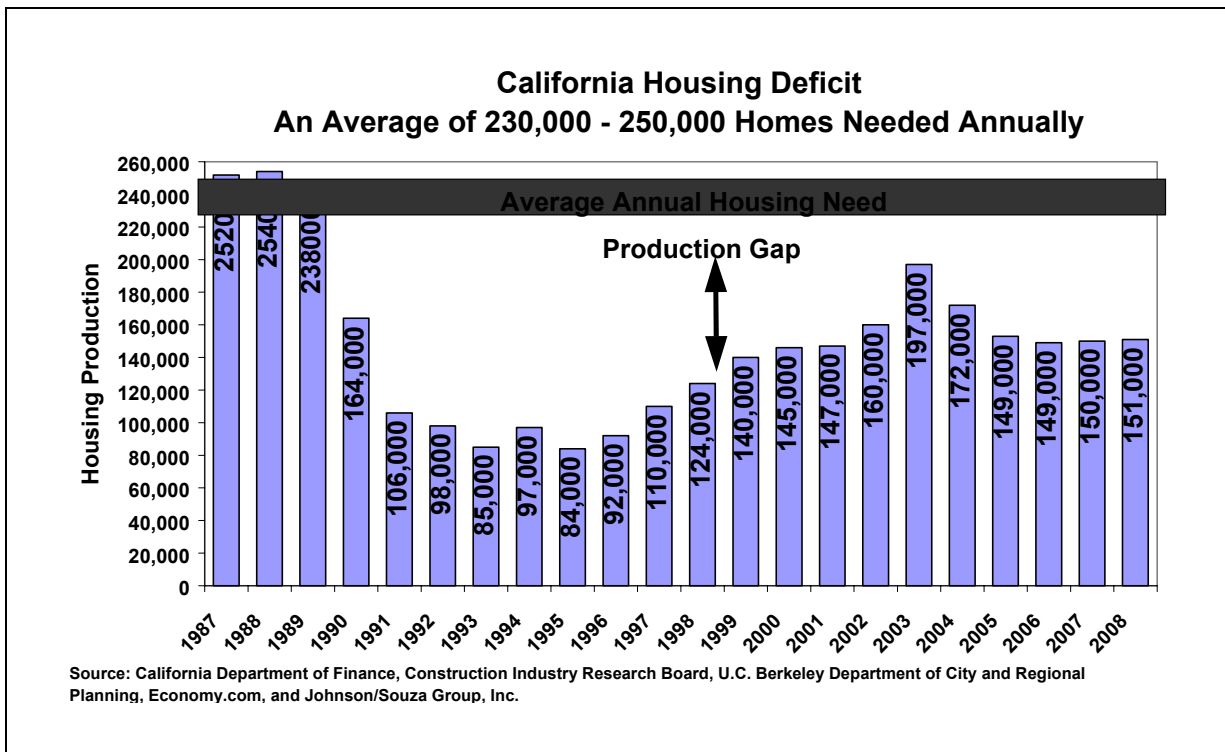
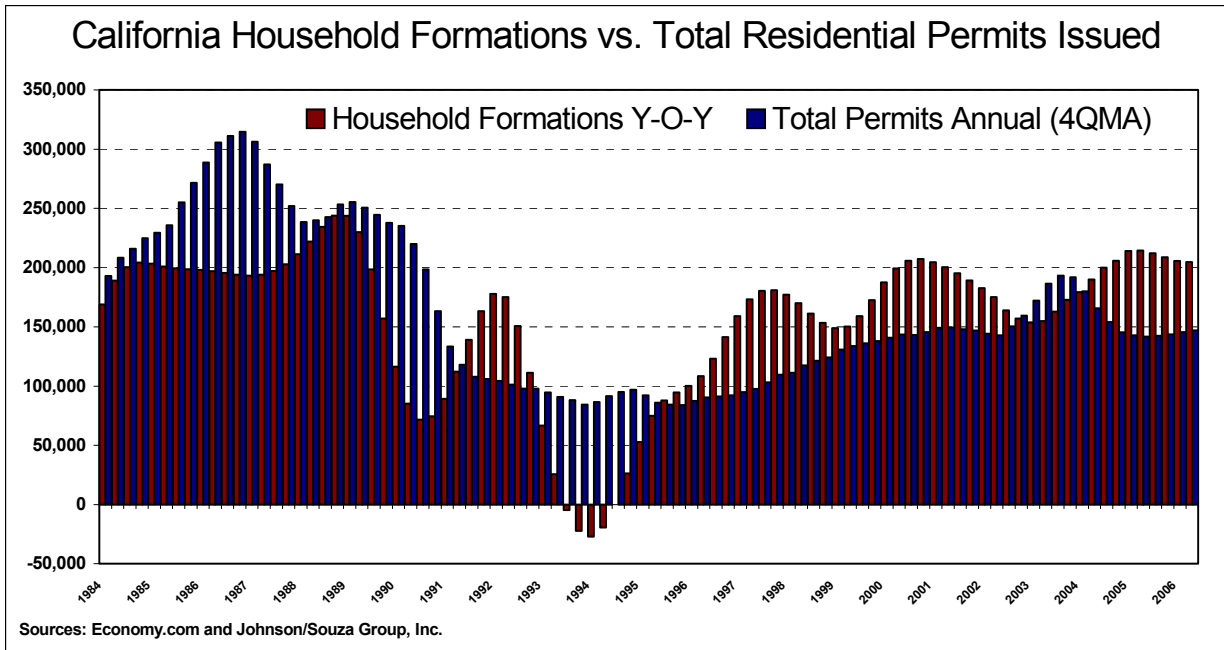
As the gap between supply and demand continues, and the price of housing becomes more and more unaffordable, California residents will look to inland locations and bordering states for employment prospects, a relatively good quality of life and lower-cost housing. California will need to build 225,000-to-250,000 new homes each year to meet demand over the next decade.

The most likely scenario is for California to issue from 150,000-to-160,000 permits per year after taking into consideration:

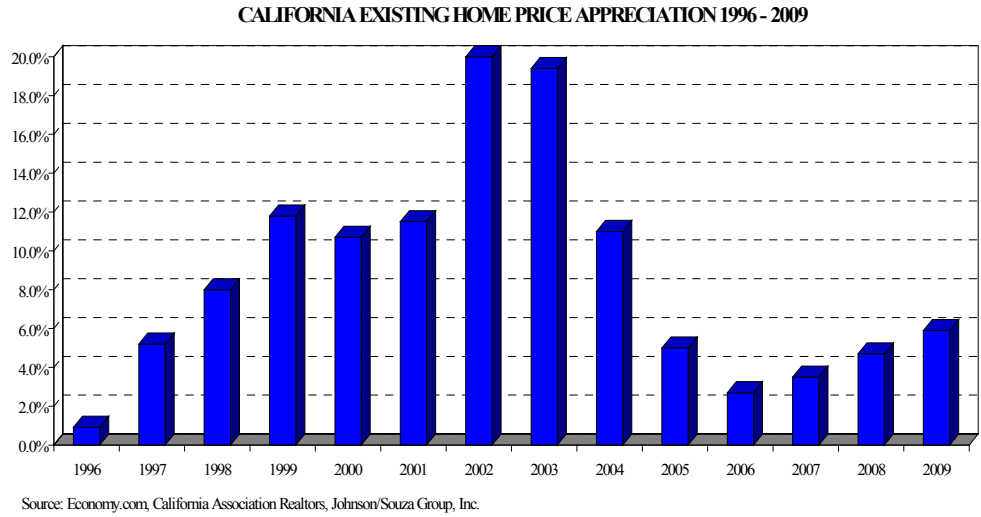
- L-T Capital constraints
- Entitlement constraints
- Land constraints
- Environmental regulation

- No-growth ordinances

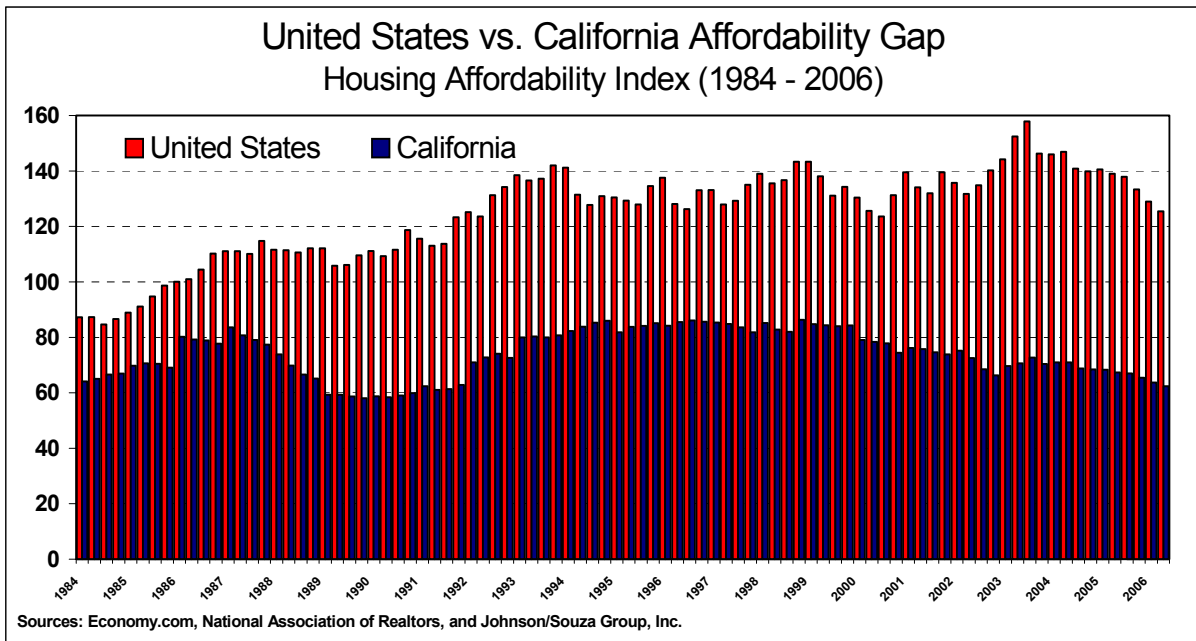
From 1986 to 2003, assuming housing demand from 225,000-to-250,000 units per year, California's accumulated a gap between supply and demand ranging from 1.0 million-to-1.4 million housing units, or an average of 60,000-to-85,000 units per year. From 2004 through 2009, the anticipated-accumulated gap between housing production and housing demand is projected to total 209,000-to-333,000 units, or an average of 12,300-to-19,600 units per year.



This accumulated gap between supply and demand has caused home prices in California to appreciate at an average annual rate of 11% per year since 1996, and over 18% per year in 2002-2003; driving home prices up to \$404,520 as of December 2003.



Rapid home price appreciation, has driven affordability rates to there lowest level since the late-1980s, where a household with the median income, has only 60% of the income necessary to purchase the median-priced home. California’s affordability gap is 2x less then the United States, the average U.S. household has roughly 40% more income than needed to afford the median-priced home.



Conclusions

Employment growth, population growth, household formations, sociodemographic trends, migration and immigration all contribute to housing demand, and since California is supplied constrained by nature and politics, severe housing shortages have emerged, causing home prices to spike upward, affordability to fall rapidly, and pushing people further out to inland areas and bordering states. These factors drive population and households into more affordable housing arrangements, particularly rental housing.

Since 1995, net absorption for California totaled 88,000 Class A units, or 9,800 units per year. Net absorption in excess of new construction over the years has kept vacancy rates below structural levels. Vacancy rates in California have averaged 4.4% per year since 1996, well below those of bordering states and below the structural vacancy rate of 5.0%. This has allowed rental growth rates rise well above inflation rates over the long run.

Since 1995, California has added 91,400 units to its Class A apartment base, or 10,150 units per year. At an average of 10,150 units per year, on top of a Class A base of 660,000 units, California is adding 1.5% of new construction to its based per year, well below the 2% annual rate necessary to offset conversions and obsolescence.

California's apartment production cannot even keep up with internal replacement needed to maintain its existing stock of Class A apartments. This along with external demands from population growth, household formations, migration and immigration will continue to keep vacancy rates below structural levels and rental rates well above the inflation rate for the foreseeable future.