

### PAYROLL JOB SUMMARY

|                    |              |
|--------------------|--------------|
| Total Payrolls     | 1,061.5m     |
| Annual Change      | 46.4m (4.6%) |
| RCR FY15 Forecast  | 43.5m (4.5%) |
| RCR 2016 Forecast  | 38.5m (3.7%) |
| RCR 2017 Forecast  | 34.9m (3.2%) |
| RCR 2018 Forecast  | 28.4m (2.5%) |
| RCR 2019 Forecast  | 18.0m (1.6%) |
| Unemployment (NSA) | 3.1% (Sept.) |

### 3Q15 PAYROLL TRENDS AND FORECAST

Payroll job growth continued to surprise on the high side as City establishments added payroll employees at a blistering 46,400-job, 4.6% year-on-year rate during 3Q15, up from 2Q's 43,900-job, 4.4% performance. The business services sector remained the mainstay, expanding at a 23,700-job, 9.6% clip, fueled by nearly insatiable demand for engineers, architects, programmers and computer system designers. Likewise, the Bay Area building boom resumed after a brief lull, producing new jobs at a 2,200-job, 5.9% annual rate, fastest in 12 months.

Rising wage costs and rents did not deter the restaurant, and tourism and convention sectors. Accommodations

and food service headcounts advanced at a 5,200-job, 4.6% y-o-y rate, the fastest pace this year.

As noted previously, San Francisco's history of booms and busts and abrupt changes of pace make reliable forecasting a challenge. Under the circumstances, simple models seem to be the most effective. In this case, RED Research settled on a payroll forecasting model using the rate of change of U.S. job growth, the 3rd lag of the 10-year yield and current metro income growth as independent variables. The resulting 95.9% adjusted-R<sup>2</sup> (SE=0.7%) model projects 3% or faster growth through 2017, followed by gradual convergence with the U.S. average by 2020.

### OCCUPANCY RATE SUMMARY

|                       |                  |
|-----------------------|------------------|
| Occupancy Rate (Reis) | 96.1%            |
| RED 50 Rank           | 20 <sup>th</sup> |
| Annual Chg. (Reis)    | -0.4%            |
| RCR YE15 Forecast     | 96.4%            |
| RCR YE16 Forecast     | 95.6%            |
| RCR YE17 Forecast     | 96.0%            |
| RCR YE18 Forecast     | 96.3%            |
| RCR YE19 Forecast     | 96.5%            |

### 3Q15 ABSORPTION AND OCCUPANCY RATE TRENDS

Renters expressed weaker demand for apartment space than would be anticipated given the robust level of job creation, perhaps reflecting the impact of soaring rents on affordability. Tenants inked a net of only 224 leases on vacant units, lowest in a year, in spite of delivery 617 new units to market. Occupancy declined -30 basis points sequentially as a result to a four-year low 96.1%.

Axiometrics's smaller survey of professionally managed properties arrived at a similar result. This service recorded a 96.4% occupancy rate for stabilized, same-store properties, down -20 bps year-over-year. Class-B asset occupancy increased 40 bps sequentially to grab the lead among

classes from previous leader, class-A (96.5%). Class-C occupancy advanced 30 bps to 95.5%. Civic Center/Downtown recorded the highest average occupancy (97.4%), while only North San Mateo and the Haight failed to reach 96%. Demand for space in two new high-end properties in Hayes Valley was robust but absorption was relatively slow among other new assets in lease-up.

RCR finds that S.F. absorption is influenced by inventory, job, rent and home price growth and interest rate levels. The resulting 91.6% ARS model is optimistic, but supply will outpace demand in the near term. Occupancy should recover to the mid-96% area by 2017 as supply wanes.

### EFFECTIVE RENT SUMMARY

|                         |                 |
|-------------------------|-----------------|
| Mean Rent (Reis)        | \$2,452         |
| Annual Change           | 10.1%           |
| RED 50 Rent Change Rank | 1 <sup>st</sup> |
| RCR YE15 Forecast       | 9.4%            |
| RCR YE16 Forecast       | 4.8%            |
| RCR YE17 Forecast       | 5.4%            |
| RCR YE18 Forecast       | 4.6%            |
| RCR YE19 Forecast       | 3.2%            |

### 3Q15 EFFECTIVE RENT TRENDS

Reis revised San Francisco rent trends in each of the past three quarters, raising the average period annual growth rate from 7.5% to 8.6%. This set the stage for a powerful \$71 (3.1%) sequential quarter 3Q15 surge, representing the third consecutive quarter of 3% or faster quarterly gains. Expressed on a year-on-year basis, average rent increased 10.1%, the fastest advance recorded in seven years.

Axiometrics surveys of 113 same-store stabilized larger properties arrived at a similar result, finding a 12.2% y-o-y rent increase, up from 9.8% during the prior quarter. The class-C segment notched the largest percentage gains (14.5%) for the second consecutive quarter, followed by

classes-B (11.8%) and -A (10.3%). San Mateo submarkets chalked down the fast advances (North: 15.2%/Central: 12.7%), while only Civic Center failed to reach double digits.

RCR concludes that a simple model best captures the City's roller coaster rent trends. A model employing two lags of the dependent variable; the first lag of Baa bond yields; and current payroll growth captures 95.4% of trend changes, but suffers for a high (1.6%) standard error. The model projects slower rent growth in 2016, consistent with our expectation for moderating job creation. Rents regain momentum in 2017-18, fueled by rising mortgage interest rates, but decelerate gradually through years four and five.

### TRADE & RETURN SUMMARY

|                         |                  |
|-------------------------|------------------|
| \$5mm+ / 60-unit+ Sales | 5                |
| Approximate Proceeds    | \$797mm          |
| Average Cap Rate (FNM)  | 4.5%             |
| Average Price / Unit    | \$770,926        |
| Expected Total Return   | 6.9%             |
| RED 46 ETR Rank         | 25 <sup>th</sup> |
| Risk-adjusted Index     | 3.89             |
| RED 46 RAI Rank         | 33 <sup>rd</sup> |

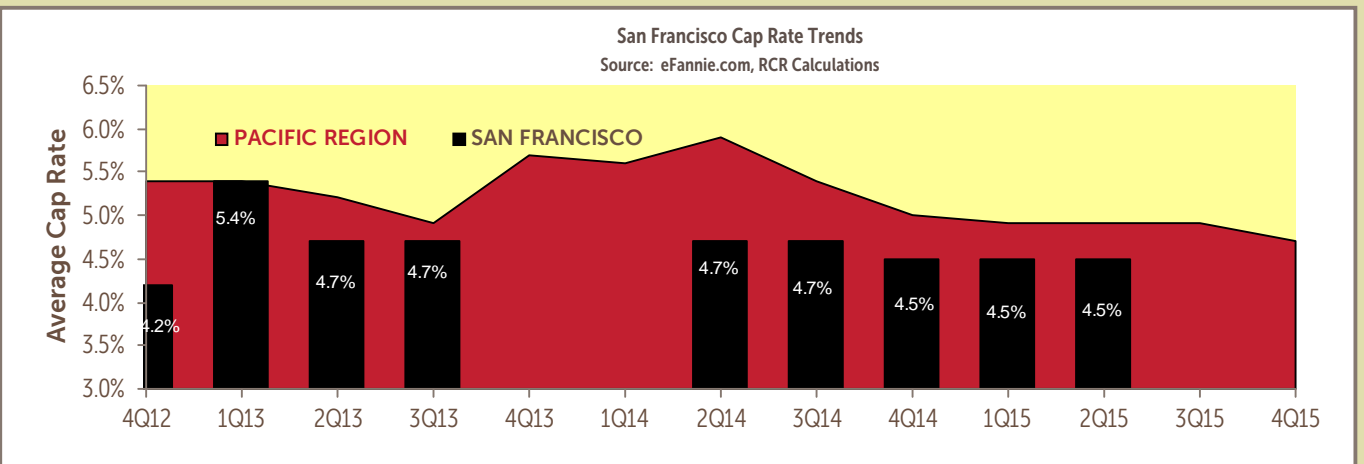
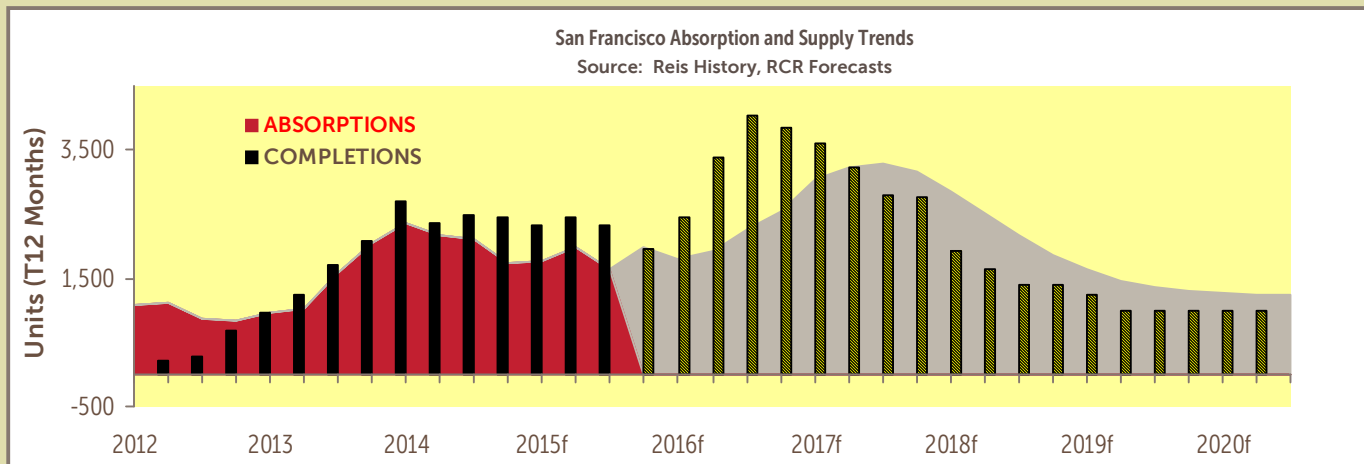
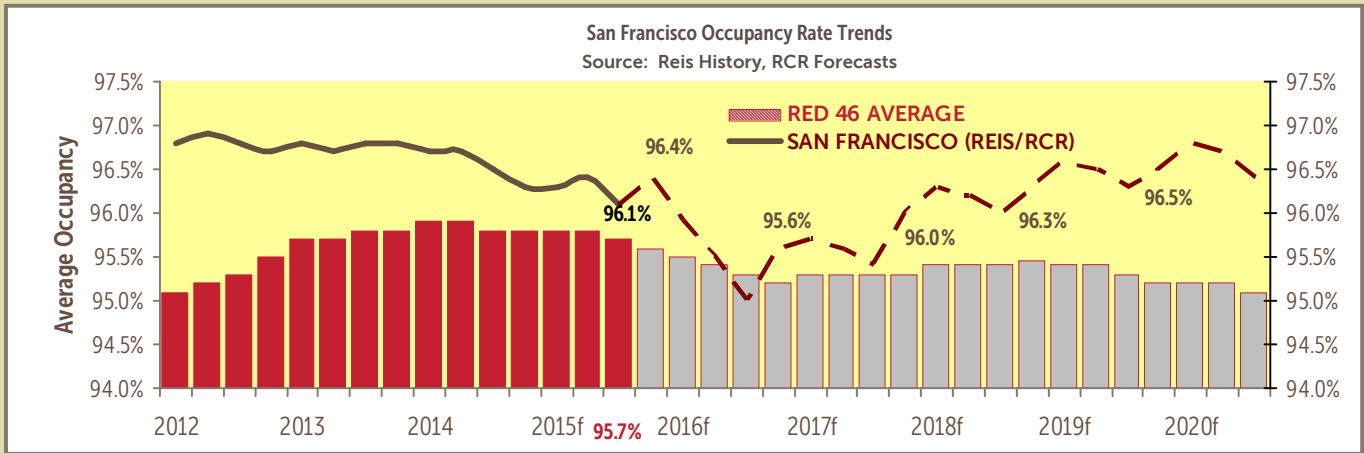
### 3Q15 PROPERTY MARKETS AND TOTAL RETURNS

Transaction velocity was slow in the second half of 2015 as owners retained core San Francisco holdings in anticipation of further rapid value appreciation. Only ten property transactions were recorded July through November. Of these, three were affordable housing, one was a rental manufactured housing community and one related to the corporate acquisition of a publicly-traded REIT.

Only two traded assets were investment quality assets. The first related to a luxury Rincon Hill high rise initially developed as a condominium. Buyer acquired the high vacancy asset for \$1.4 million per unit at a pro forma yield we estimate to be approximately 4.1%. The second was a

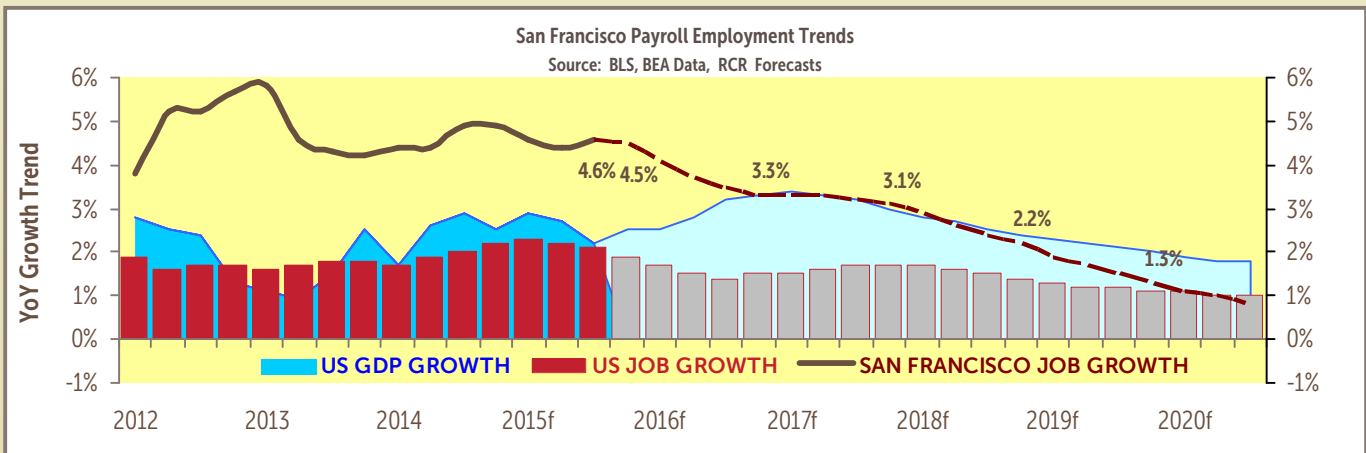
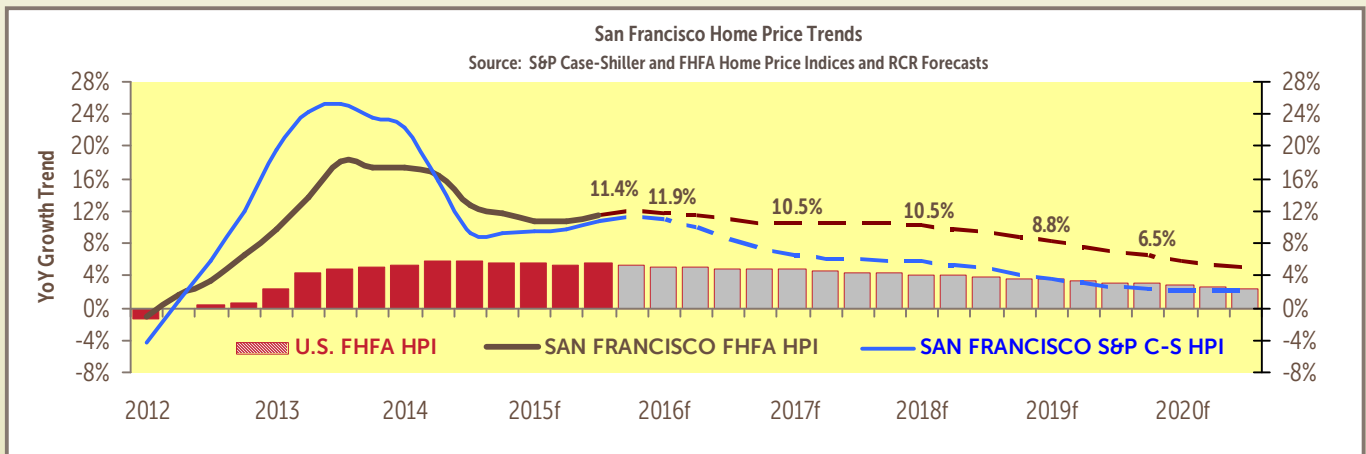
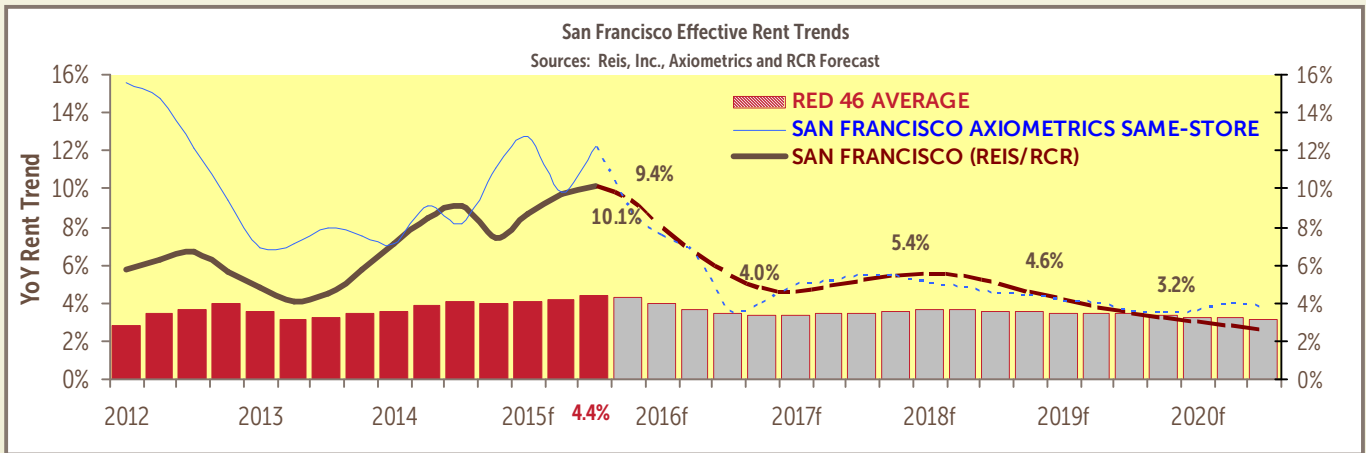
class-B Burlingame mid-rise which exchanged hands at approximately \$477,000 per unit, producing a going-in yield of about 3.9%. The affordable transactions generate initial yields in the 5% area, based on HUD rent guidelines.

In light of the strong bid for City properties at very low cap rates, RCR elected to trim 20 basis points from the purchase cap rate proxy to 4.2%. Using this level, a terminal cap rate of 4.9% and model derived occupancy and rent point estimates, we calculate that an investor would expect to achieve a 6.9% annual total return over a five-year hold, ranking 25<sup>th</sup> among the RED 46. High rent model standard error hinders S.F. risk-adjusted returns, which rank #33.



## NOTABLE TRANSACTIONS

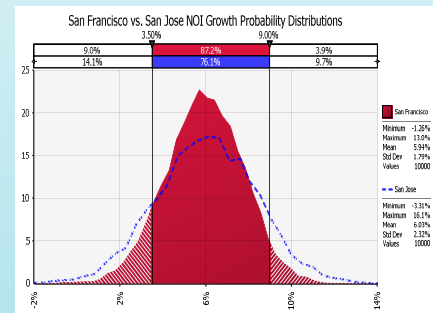
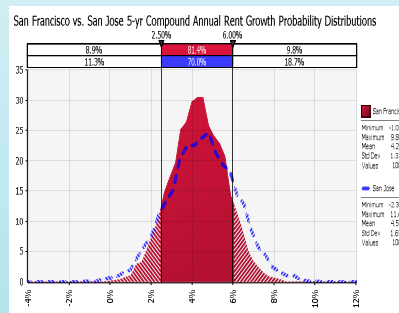
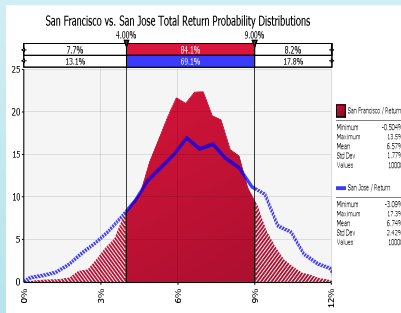
| Property Name (Submarket)                 | Property Class/ Type (Constr.) | Approx. Date of Transaction | Total Price / (in millions) | Price / per unit | Estimated Cap Rate |
|---|--------------------------------|-----------------------------|-----------------------------|------------------|--------------------|
| Three21 @ Belmont (Central San Mateo)     | C / GLR (1964)                 | 1-Jul-2015                  | \$23.7                      | \$363,846        | 4.8%               |
| One Rincon Tower (SoMa / Rincon Hill)     | A+ / HR (2015)                 | 2-Jul-2015                  | \$410.0                     | \$1,371,237      | 1.2% / 4.1% p.f.   |
| Burlingame Towers (Central San Mateo)     | B / RC MR (62/08)              | 2-Oct-2015                  | \$40.6                      | \$477,353        | 4.0%               |
| Ocean View Apts. (No. San Mateo/Pacifica) | Sr. AH / LR (1972)             | 18-Oct-2015                 | \$19.4                      | \$194,480        | 4.8%               |



The information contained in this report was prepared for general information purposes only and is not intended as legal, tax, accounting or financial advice, or recommendations to buy or sell currencies or securities or to engage in any specific transactions. Information has been gathered from third party sources and has not been independently verified or accepted by RED Capital Group. RED makes no representations or warranties as to the accuracy or completeness of the information, assumptions, analyses or conclusions presented in the report. RED cannot be held responsible for any errors or misrepresentations contained in the report or in the information gathered from third party sources. Under no circumstances should any information contained herein be used or considered as an offer or a solicitation of an offer to participate in any particular transaction or strategy. Any reliance upon this information is solely and exclusively at your own risk. Please consult your own counsel, accountant or other advisor regarding your specific situation. Any views expressed herein are subject to change without notice due to market conditions and other factors.

## SUBMARKET TRENDS (REIS)

| Submarket                   | Effective Rent |                |              | Physical Vacancy |             |               |
|-----------------------------|----------------|----------------|--------------|------------------|-------------|---------------|
|                             | 3Q14           | 3Q15           | Change       | 3Q14             | 3Q15        | Change        |
| Central San Mateo           | \$2,200        | \$2,501        | 13.7%        | 2.4%             | 2.4%        | 0 bps         |
| Civic Center / Downtown     | \$1,880        | \$2,032        | 8.1%         | 4.2%             | 4.8%        | 60 bps        |
| Haight Ashbury/Hayes Valley | \$2,375        | \$2,669        | 12.4%        | 3.7%             | 5.5%        | 180 bps       |
| Marina / Pacific Heights    | \$2,683        | \$2,839        | 5.8%         | 1.6%             | 1.3%        | -30 bps       |
| North Marin County          | \$1,751        | \$1,935        | 10.5%        | 1.3%             | 1.1%        | -20 bps       |
| North San Mateo County      | \$2,048        | \$2,165        | 5.7%         | 3.0%             | 3.8%        | 80 bps        |
| Russian Hill / Embarcadero  | \$3,019        | \$3,204        | 6.2%         | 1.9%             | 2.0%        | 10 bps        |
| South Marin County          | \$1,990        | \$2,204        | 10.8%        | 1.4%             | 4.1%        | 270 bps       |
| South San Mateo County      | \$1,969        | \$2,087        | 6.0%         | 2.7%             | 2.2%        | -50 bps       |
| South of Market / So. Beach | \$2,609        | \$2,891        | 10.8%        | 5.5%             | 8.2%        | 270 bps       |
| West San Francisco          | \$2,089        | \$2,424        | 16.1%        | 3.6%             | 3.2%        | -40 bps       |
| <b>Metro</b>                | <b>\$2,227</b> | <b>\$2,452</b> | <b>10.1%</b> | <b>3.5%</b>      | <b>3.9%</b> | <b>40 bps</b> |



FOR MORE INFORMATION ABOUT RED'S RESEARCH CAPABILITIES CONTACT:



**Daniel J. Hogan**  
 Director of Research  
 djhogan@redcapitalgroup.com  
 +1.614.857.1416 office  
 +1.800.837.5100 toll free

