WEST BAY HOME PRICES: SHOCK AND AWE. OR...
AVERAGE HOME PRICE IN PALO ALTO HITS $3.0M IN 2018. REALLY?

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EXECUTIVE SUMMARY

The West San Francisco Bay Area (West Bay) is loosely described by an area anchored by Los Gatos in the south, extending along the western flank of the Santa Clara Valley, and up the San Francisco Peninsula to Burlingame. This area includes many communities and neighborhoods with the most sought after and expensive housing in the Bay Area, if not the US. In Palo Alto, one of the most popular of these communities, the price of the average home in 1968 was 55% greater than the average price of a California home. By 2012, the difference had grown to 529%!

This suggests at least three questions:

1. Why is the West Bay (as represented by Palo Alto) out of sync with California and, for that matter, most of the US?
2. Why is West Bay housing so expensive?
3. Will this trend continue?

OUT OF SYNC

A fundamental distinction of the West Bay housing market is the lack of supply and high demand. The area was largely built-out in the 1960’s and 1970’s, and there are limited opportunities to add to the housing stock. What is particularly unique, however, is the large number of wealthy people seeking this housing.

THE HIGH COST OF HOUSING

It is the norm for buyers to purchase homes based on their wages augmented by a loan. In contrast, the West Bay market has come to be dominated by households that purchase out of their net worth. For this reason, prices are not limited by typical income parameters but are driven by the depth of financial resources. For those who participate in the equity created by Silicon Valley companies through stock options and the like, the resources have proven to be considerable. This is what pushes prices to levels that shock buyers and awe sellers.

WILL THIS CONTINUE?

The appreciation of home values in the West Bay has long exceeded state and national levels. Appreciation in Palo Alto, the city for which the most reliable historic data is available, was 8.8% per year from 1953 to 2012 and 9.4% from 1968 to 2012. Appreciation in California and the US over this latter period was 6.0% and 5.0% respectively. Despite numerous economic cycles, the West Bay has been a consistent high performer. To look to the future, look to the recent past. The median house price reached $1M in Palo Alto in 2004. Nine years later, in 2013, it was just over $2M. At the historic 8.8% per annum rate, it will reach $3M in 2018.
Even if the rate slackens to 6.0%, the $3M price will occur in 2020. At these rates, the $5M threshold will be achieved six to eight years later respectively.

This seems unfathomable. Could it occur? That depends entirely on the vibrant, resilient, and wealth-sharing economy of the Silicon Valley. For many decades, prices have seemed to stretch reality, and they are likely to continue to do so as the Valley creates wealth. As prices compound upward, there will be fewer and fewer people with the magnitude of wealth needed, and demand will decrease in the prime areas and spill over to nearby areas. At that point, appreciation will move below historic levels. While the logic is clear, it is not clear when demand will thin sufficiently to cause the rate of appreciation to flatten. From the perspective of the chronic condition of multiple bidders for every property, that day seems far off.

CONCLUSION

The home prices in the West Bay are not the result of a bubble, but the result of market fundamentals. The underlying foundation is the economy of the Silicon Valley which continues to adapt and lead in many fields of technology. This economy is the envy of the world and continues to attract creative minds, entrepreneurs, and investors. While success breeds urban, environmental, and social issues, overall the fundamentals for a robust economy and the housing market it supports are in place.

INTRODUCTION

In 1968, the median cost of a home in the US was $20,100, in California $23,200 and in Palo Alto $35,900. In 2012, the median prices in these areas were $177,200, $319,300, and $2,009,800 respectively.1 (Refer to Exhibit 1.) In 1968, the spread in prices between California and Palo Alto2 was 55%, and by 2012, it had leapt to 529%.

If one is to invest in the West San Francisco Bay Area (West Bay)3 housing market where homes are among the most expensive in the nation, it is best to understand why it is fundamentally different from most other housing markets in the US. Exhibit 1 suggests three questions, the answers to which may help to better illuminate the West Bay market.

1. Why is there a divergence between the median prices in California and Palo Alto, and why has it widened?
2. Will the gap continue to grow?
3. Will prices continue to increase at their historic pace?
EXHIBIT 1: HOME PRICES (US, CALIFORNIA & PALO ALTO)

Sources: California and US, California Association of Realtors, Annual Historic Data, Summary, 2013; Palo Alto, Palo Alto Boards of Realtors and SILVAR
WHY IS THERE A DIVERGENCE IN PRICES, AND WHY HAS IT WIDENED?

Taken in the aggregate, the US and California markets are fundamentally different from the West Bay markets. In general, in the US and California, increases in demand trigger additions to supply. On average, across the entire market, this tends to keep supply and demand in relative balance and moderates prices.

In the West Bay, the dynamics are much different. The area was largely built-out in the 1960’s and 1970’s, so supply is limited. In addition, many of the high-demand areas are the most supply constrained.

Two key drivers of demand are household formation and ability to purchase. The standard measure of the latter is the Housing Affordability Index (HAI), which is the percentage of households that can afford to purchase a median priced single-family home. In Q3 2013, the index stood at 56 in the US and 32 in California. In Palo Alto, the reference city for the West Bay housing market, the HAI is under 10, while the homeownership rate is 57%, which is on par with the state rate. This anomaly is explained by the fact that many West Bay homebuyers purchase out of their net worth rather than their wages; therefore, the HAI, like other standard reasoning, does not apply. The entrepreneurial and equity participation culture of large sectors of the Silicon Valley economy result in creation of personal wealth through stock options, initial public offerings, company acquisitions, and the like. The accumulation of personal wealth and what are sometimes referred to as “liquidity events” increase personal buying power considerably.

The combination of high capacity to purchase, the desirability of a few communities, and the constrained supply explains the divergence between West Bay home prices and those in the region, state and nation. The gap has widened over time as more people have shared in corporate wealth. Certain areas have become established as the “go-to” residential communities, and housing scarcity there has become even more acute.

WILL THE GAP CONTINUE TO WIDEN?

Exhibit 1 demonstrates that the gap has widened for over three decades. If the trend were to reverse, it would require a change in conditions in the US/California (US/CA), or in the West Bay, or both. Structural changes in the supply and demand in the US/CA markets is highly unlikely; however, it is not without precedent.

The easy availability of mortgage money in the early to mid-2000’s caused a spike in demand and prices within parts of CA (excluding the West Bay) and other states. (Refer to the “lump” on the CA curve in Exhibit 1.) This artificial stimulus resulted in disaster, and many markets are still seeking the “old normal.” Aside from such tinkering, overall market stability should
be the norm. In fact, one lesson from this event is that when appreciation wanders off its traditional path, caution is required.

The foundation of the West Bay housing market is the economy of Silicon Valley with its ability to grow, adapt, and make people wealthy. However, this economy is not without its problems. Surveys of business leaders annually cite the same issues that negatively effect companies in the Valley: shortcomings in transportation, cost of doing business, and ironically, the cost of housing. These have and will continue to dampen growth in the Silicon Valley, but they are not likely to cause the capitol of technology to wither. Further, the essential element of the culture, sharing of profits, is likely immutable.

The economy of Silicon Valley has changed as rapidly as technology itself. In the 1960’s, the dominant technology businesses were aerospace and defense related. This gave way to non-defense manufacturing and later to software development, clean tech, social media, and biotech. The ability to adapt to, if not lead in, new arenas is perhaps the most encouraging evidence that the underpinnings of the West Bay housing market are resilient and that the market will continue to separate itself from the US/CA and other regional markets.

In all likelihood, the gap in prices between the West Bay and the national and state markets will continue to open-up. The question, which follows, is whether historic growth trends will continue.

**WILL PRICES INCREASE AT THEIR HISTORIC PACE?**

Between 1968 and 2012, the price of the median home increased annually by 5.0% in the U.S., 6.0% in CA, and 9.4% in Palo Alto. (Refer to Exhibit 2.) There has been significant year-to-year variation brought on by recessions, high costs of debt, easy accessibility to debt, and so forth.

In Palo Alto, the annual rate of increase in the succeeding 10 year increments since 1954 have been 7.7%, 6.1%, 13.8%, 8.3%, 11.1%, and in the final nine year increment (2004 to 2012) 6.4%. The rate of increase has been relatively steady when the various cycles of residential development and economic conditions are taken into account. For example, extensive residential construction occurred the first 10-year period (1954-1964), and the city was not built-out until the following period during which there was a significant recession. The rate of increase has been relatively high over the period except most recently. The compound rate of appreciation over the entire period (1954 to 2012) was 8.8%.

The recent drop-off could be a result of a slowing trend, or a shortened time window (9 rather than 10 years) and the effects of the recent economic meltdown. If the latter and prices appreciate in 2014 as they did in 2013 (17.3%), the appreciation over this ten year period will be about 7.5%, closer to the historic pattern.
If prices increase at the 8.8% rate experienced between 1954 and 2012, the average home in Palo Alto will cost $3M in 2018. This stretches belief. (Even if prices increase...
at a 6% annual rate, the $3M threshold would be realized in 2020.) To consider this possibility, two facets of the homebuyer bear investigation: (1) the willingness to pay premium prices, and (2) the capacity to pay those prices.

**Willingness to Purchase**

For any commodity, there will be a price at which there will be resistance, and a consumer will seek alternatives. For West Bay housing, this could occur because of (1) a lack of perceived value, (2) acceptable alternatives, (3) price shock, or (4) investment fear.

**Lack of Perceived Value**

Within the West Bay and markets beyond, there is a diversity of prices and living environments. The most expensive housing on a cost per square foot basis is in Palo Alto. Buyers who do not see the value of the Palo Alto premium may, and have, opted for other communities where the housing dollar will purchase more. This spillover, or substitution, effect moderates price differentials in the region.

**Acceptable Alternatives**

Over time, spillover causes gentrification which lessens the difference in quality among the communities within the area. For example, 20 years ago Mountain View was known as the location of many 1960’s and 1970’s apartments and the Moffett Field Naval AirStation, and it had a small, failed downtown. Today it has a downtown that rivals the best, improved public schools, and new residential in-fill development. The Navy is gone and Moffett Field is home to major technology parks and is slated for a new Google campus. Home values have increased rapidly, but are less than those in neighboring Palo Alto. This dynamic, in turn, facilitates more spillover.

**Price Shock**

There is a point at which the price of a commodity appears to be out of alignment with its value to such a degree that there is an extreme negative visceral reaction. This is the “You have got to be kidding me!” phenomenon that pushes consumers to seek alternatives.

Over time, the Palo Alto market has crossed many “shock” thresholds, yet enough buyers accept the new high prices to perpetuate the now well-established rate of appreciation. One such threshold was experienced some years ago in Palo Alto when the Mid-Century Modern homes built by Joseph Eichler reached the $1M mark. In the 1950’s and 1960’s, these homes sold new for tens of thousands of dollars. Some 40 years, later after most had become tired and out of favor, even jaded real estate agents thought that something was not right in the world when Eichlers sold for over $1M. (As of this writing, an upgraded Eichler sells in the low $2M’s.)

While someone from outside the area may be repelled by the prices, those living in the area
seem to rapidly grow accustomed. It is observed that the price shock only occurs once, at initial purchase; after that, every new high is a right to be enjoyed.

**Investment Fear**

People attracted to the West Bay are often savvy investors. The high prices raise the concern of sustainability. Out-of-area buyers conclude that the disconnect with prices elsewhere is the sign of a bubble begging for correction, not a long-term trend. This, too, spawns the spillover effect.

**Conclusion**

There are always those unwilling to pay the high prices and who will substitute with other locales or rent rather than buy. Even though the ranks of prospective buyers are whittled down by such individual decisions, there has been chronic over-demand as evidenced by multiple offers on most West Bay homes for sale. For example, in Palo Alto for 97 out of the past 120 months (a period that includes the meltdown), the monthly cumulative sale price has exceeded the cumulative monthly list price.8 It appears that the willingness of many to buy at premium prices is a market norm and could continue for many years.

**CAPACITY TO PURCHASE**

The ability of households to purchase expensive homes is a result of the spawning of new companies and ideas and the value they generate. Will the Silicon Valley remain the preeminent center of technology, and will its businesses continue to enrich its investors and employees? For the foreseeable future, the answer to these questions is “Yes.”

As described earlier, Silicon Valley has the infrastructure and momentum to maintain its position as the center of technological activity. There are more technology jobs in Silicon Valley than in any other area in the US. In addition, it has the components needed to perpetuate the industry: world-class universities, venture capital, legal support, and so forth. Further, the widespread sharing of company equity has caused there to be more per capita millionaires and billionaires in Silicon Valley than in any other place in the world.

International demand for Silicon Valley housing has been increasing for several years. The South Asian and East Asian population of Palo Alto has increased from 17% in 2000 to 27% in 2010.10 There are also many international absentee homeowners. Nonetheless, the high demand for West Bay housing long precedes the influx of international real estate investors. This element of demand is not trivial, and its absence would reduce pressure on prices but would not affect overall trends.
CONCLUSION

Based upon these conclusions, it is expected that the historic rate of appreciation will continue until demand abates, which likely will not occur until there are not enough people with sufficient resources to purchase the available housing. For home prices to continue to increase exponentially at the historic rate of appreciation, the increase in the number of people with sufficient financial resources will need to keep pace. It is possible that a limit could be reached.

Consider that it took nine years (2004 to 2013) for the median home price in Palo Alto to increase from $1M to $2M. At the historic rate, it will take 5 years (2018) to reach $3M, another 3 years (2021) to reach $4M, and 3 more years (2024) to reach $5M. At some point on this curve, the pool of buyers may become shallower, demand will slacken, and the rate of appreciation will diminish.

If and when this occurs, it will not be an abrupt change, but a slow reduction that may be hard to read in the noise of recessions and other market influencing events. Be cognizant, too, that even at lower rates of appreciation, the price thresholds described above will be reached, though it will take longer to achieve.

SUMMARY

If it is assumed that the economy of the Bay Area, including the technology sectors, continues to grow and more wealth is created, and more people share in that wealth, then the demand for housing and the price of that housing will increase.

Expect the spillover effect to continue. When people cannot or will not purchase in the most expensive neighborhoods, they will opt for less expensive places and the competition for those homes will increase accordingly. This has been occurring for decades and has increased appreciation throughout the region.

Most of the Silicon Valley was developed in the two decades following World War II. The growth and maturing of the Silicon Valley economy has triggered a wave of redevelopment and gentrification. Homes in the toniest neighborhoods of Atherton to the more modest in San Carlos are being torn down and replaced with newer and finer abodes. Earlier tech buildings are likewise being replaced to accommodate current needs. The example of the gentrification of Mountain View cited earlier is occurring in several locations.

This is the likely scenario for growth and redevelopment of the region. Home prices will continue to escalate, and significant investment and redevelopment will extend further into the West Bay and Silicon Valley.

This is the structure of the housing market. Recent price increases are not the result of a bub-
ble. The market will be impacted by national and global economic conditions and international upheaval, but baring a major dislocation in the Silicon Valley economy, these trends in the housing market will continue.

FOOTNOTES

1 Sources: California and U.S., California Association of Realtors; Palo Alto, The Palo Alto Board of Realtors and Silicon Valley Association of Realtors (SILVAR).

2 The cost of housing in Palo Alto is used to represent the West Bay market because Palo Alto is geographically central to the area of interest, it is one of the most desired places of residence as reflected by unitary cost, and because of the availability of historic data for the city.

3 The West Bay market is defined as those neighborhoods and communities that contain the most expensive and sought after housing in Silicon Valley. Geographically, it is loosely described by an area anchored by Los Gatos in the south and extending along the western flanks of the Santa Clara Valley up the San Francisco Peninsula to Burlingame in the north. The housing markets in this area are not homogeneous and exhibit the characteristics described in this paper to varying degrees.

4 Source: California Association of Realtors, Traditional Housing Affordability Index, Nov. 7, 2013.

5 Source: US Census, 2010

6 Based upon information from the following sources: Silicon Valley Board of Realtors (SILVAR) and the Palo Alto Board of Realtors. (1954 is the earliest year for which data is available).

7 Silicon Valley Board of Realtors (SILVAR)

8 Ibid


10 Source: US Census, 2000 and 2010
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