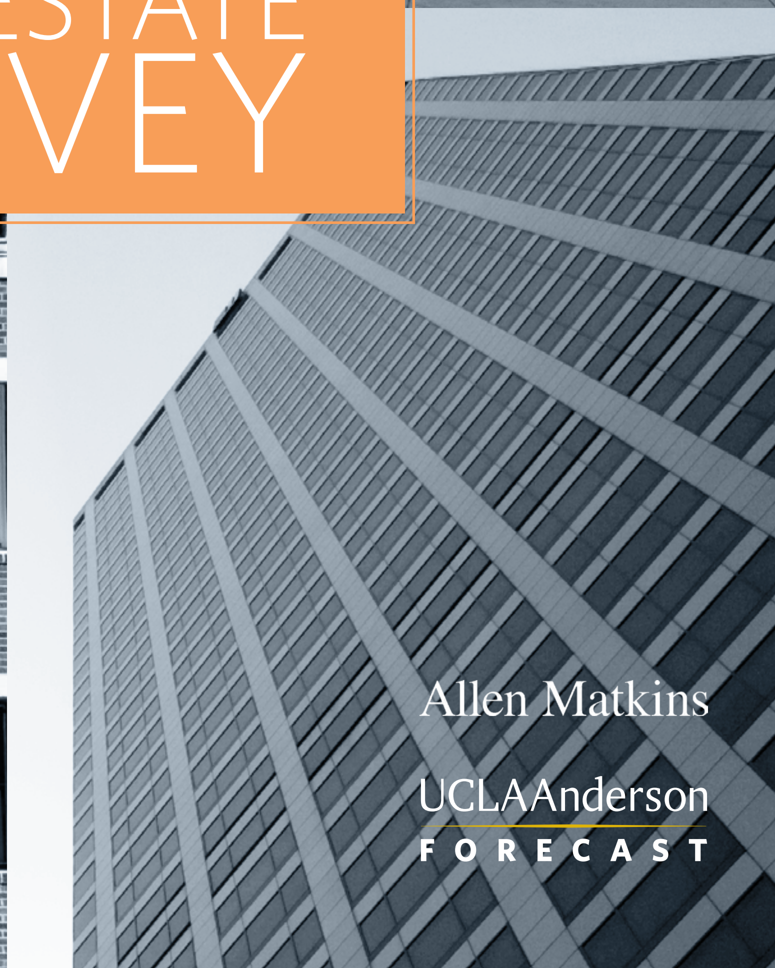
Winter/Spring 2018
Issue No. 22

ALLEN MATKINS | UCLA ANDERSON FORECAST

COMMERCIAL REAL ESTATE SURVEY



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Allen Matkins FORECAST
A Increase faster than the rate of inflation
B Increase slower than or at the rate of inflation
C. Stay the same
D. Decrease
E. N/A
9. If you invest in office space in Los Angeles
vacancy rate in Los Angeles will
A Increase
B Decrease
C. Stay the same
D. N/A

Welcome to the latest edition of the Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey and Index.

Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for insights into their markets. The Survey and the resulting Index provide a measure of the commercial real estate supply-side participants' view of current and future conditions. Since participants make investment actions based upon these views, it provides a leading indicator of changing supply conditions.

Through an analysis of the Index and the incorporation of the Index into other economic forecasting models, the Survey is designed to provide more accurate information on future office, industrial, retail and multi-family space in major California geographical markets. This twenty-second survey covers the major Southern California and Bay Area markets for office, industrial, retail and multi-family space.

The Allen Matkins and UCLA Anderson Forecast partnership:

At Allen Matkins, a top-ranked California-based law firm servicing the real estate industry according to *Chambers USA*, we have been fortunate to work with and assist leading institutions, developers and lenders in the real estate industry. We have prospered, along with our clients, in this vital sector of the California economy. We sponsor this Survey to provide value to the industry. We have partnered with UCLA Anderson Forecast, the leading independent economic forecast of both the U.S. and California economies for over 65 years, and have tapped the knowledge of the leading developers and financiers of real estate development in California to provide what we believe is the best, clear-sighted forecast of the California commercial real estate industry.

We hope you will find this Survey and Index to be helpful.

John M. Tipton

John M. Tipton
Partner, Real Estate Department
Allen Matkins

CALIFORNIA COMMERCIAL REAL ESTATE SURVEY:

THE TAX BUMP AND RETAIL SLUMP

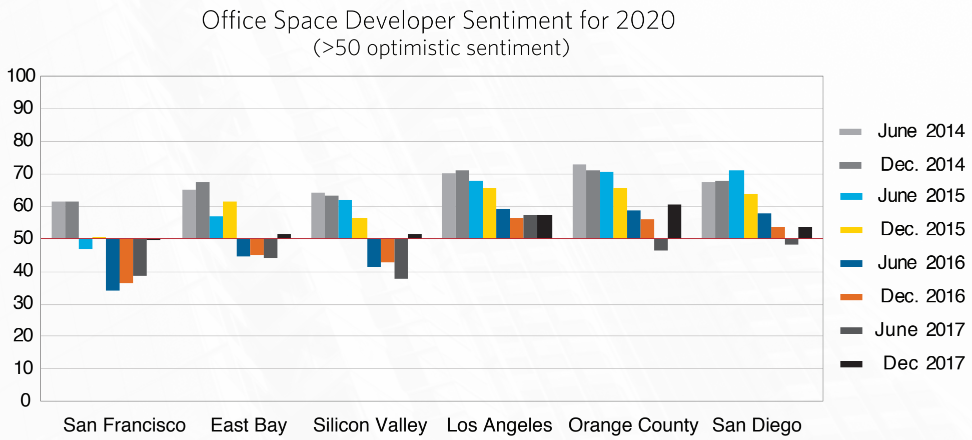
The end of the year brought a flurry of activity in Washington including the federal tax overhaul. Overall, the new tax structure does not look favorable for home buyers in California as it imposes lower limits on home mortgage interest and the deductibility of property tax. However, for commercial real estate the opposite appears to be true. The new tax structure contains provisions for "pass through" income and it allows a deduction limit based on the value of structures owned by the corporation. This increases the rate of return on commercial real estate and makes CRE investment more attractive. Moreover, as the tax overhaul makes home ownership relatively less attractive it shifts some demand towards multi-family rental housing.

The year ended with solid economic news as evidenced by two quarters of 3% GDP growth and continued job growth. Going forward the outlook for the economy in 2018 is good.[1] Investors who were previously concerned about no new tax bill and the continuation of sluggish economic growth are now, with the prospect of higher rates of return, considering getting back in the game and our survey reflects that. The only fly in the ointment is in brick-and-mortar retail. Though the 2017 holiday season was relatively good for in-store purchases, there is a general recognition that too much retail space is available. Indeed restructuring is expected to continue through 2018.[2] The Survey results for the seven largest markets in California reflect these changes.

The Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey compiles the views of commercial real estate developers with respect to markets three years hence. The three-year time horizon was chosen to approximate the average time a new commercial project requires for completion (though projects with significant environmental issues often take much longer). The panelists' views on vacancy and rental rates are key ingredients to their own business plans for new projects, and as such, the Survey provides insights into new, not yet on the radar, building projects and is a leading indicator of future commercial construction. For example, if a developer were optimistic about economic conditions in the industrial market of Silicon Valley in 2020, then initial work for a new project with an expected ready for occupancy date of 2020--a business plan, preliminary architecture, and a search for financial backing-- would have to begin no later than 2017. Although optimism does not always translate into new construction projects, this sentiment is a prerequisite for it.

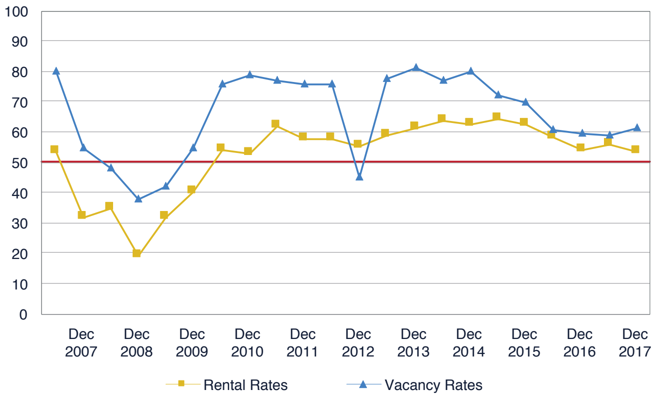
OFFICE SPACE MARKETS:

In the Bay Area, office developer sentiment has been trending down for the last two years, but in December the index turned up to a watershed, a value of 50, between better and worse markets in 2020.

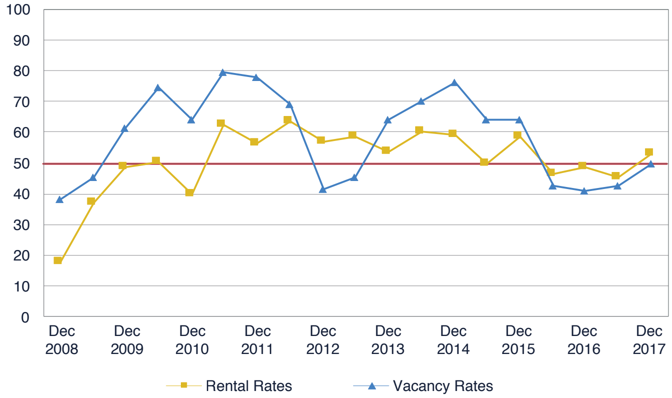


1. UCLA Anderson Forecast, December 2017.
2. "Are Malls Over" in The New Yorker by Amy Merrick provides a good discussion of the restructuring taking place in America's malls today. https://www.newyorker.com/business/currency/are-malls-over

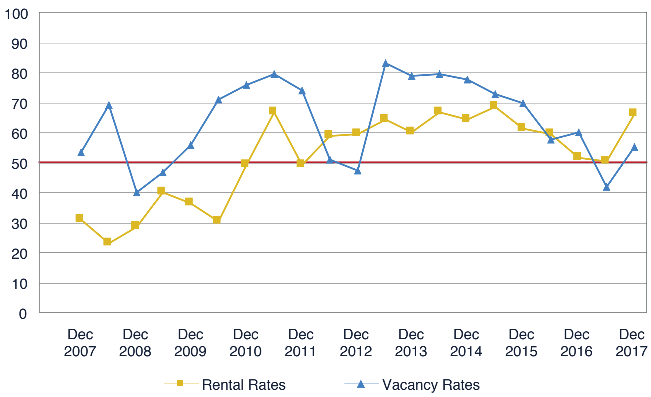
Los Angeles Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



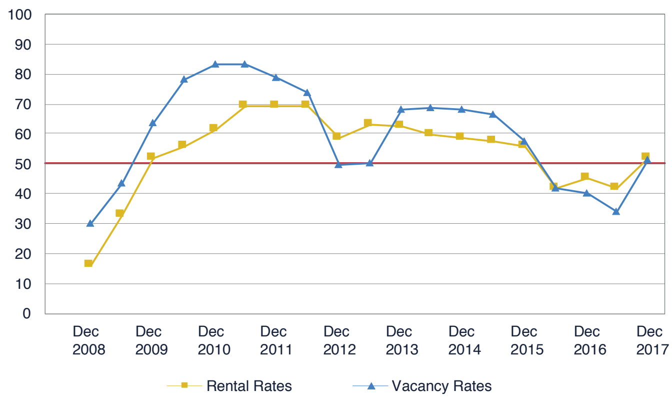
East Bay Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



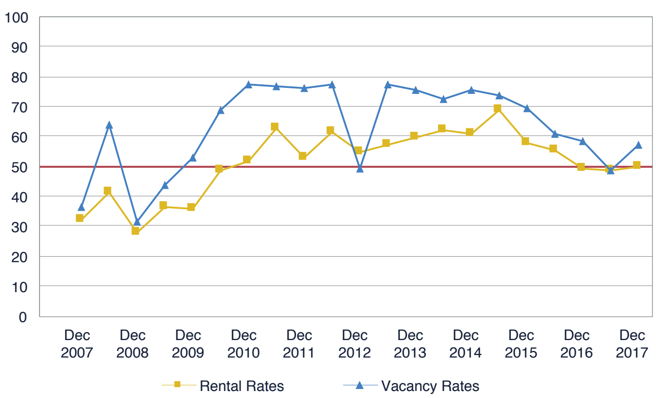
Orane County Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



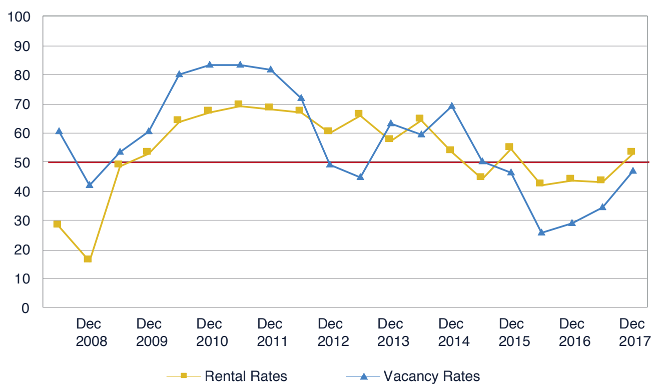
Silicon Valley Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



San Diego Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



San Francisco Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



The index first went below 50 for San Francisco two years ago and below 50 for Silicon Valley and the East Bay in June 2016. Today, all three markets are back in the neighborhood of 50. Our panelists are only negative about vacancy rates in San Francisco. Not much has changed in the overall Bay Area economy since the June survey. Economic growth is still occurring, but the very rapid growth earlier in the expansion that abated a year ago continues. Importantly there is a distinct slowdown in the growth of professional and business services, a key driver of demand for office space. Thus one would not anticipate this turnaround in expectations based on past data and those facts point to the tax overhaul.

However, this change in sentiment has not yet induced a change in behavior on the part of the panelists. Just under two-thirds of the panelists were on the sidelines during the last 12 months and a similar percentage state they will be on the sidelines during the next 12 months. Moreover, they have changed their view of the cost of land and the non-labor cost of building from declining relative to today to increasing relative to today. The Bay Area panel is therefore sending a signal that while they think office markets will be similar to today's markets three years hence, that there is not yet enough improvement to jump in and cause significantly different build rates.

Although the indexes for San Diego and Orange County only dropped below 50 in the previous survey, the sentiment jumped dramatically over the past six months. The panel reported that they now view 2020 as decidedly better in both rental rates and vacancy rates than today. This shift in sentiment occurred with no change in subleasing, a slowing in the growth of employment, and a forecast of falling commercial land prices. A larger percentage of the panel, more than two-thirds and the highest since 2014, said they would be on the sidelines in the coming 12 months.

How does one reconcile the seemingly contradictory behavior in these five markets? The answer lies in the recently passed tax overhaul. The new tax code is more favorable for commercial real estate owners and developers and the prospect of higher profits leads to optimism. Nevertheless, the panelists don't think the difference is enough to change the fundamentals in these markets. So we are left with a tax bump and data indicating an increase in building associated with a forecast of no-change to a decrease in building. Nevertheless, the change in sentiment, if it holds, ought to lead to more construction in the future.

Los Angeles continues to buck the trend. There was no fall off in sentiment and there is no tax bump either. The difference between L.A. and the other California cities is Hollywood and Silicon Beach. The entertainment and tech industries continue to grow in the Los Angeles region in response to robust demand for gaming, streamed content, and television programming, and due to critical mass being achieved in Silicon Beach. The L.A. panel did not view the office products in the pipeline as sufficient to meet all of the expected demand two years ago and they are of the same mind today. The obvious conclusion is that rates of return are high enough in L.A. and increasing them with more generous taxation has not changed investment decisions.

COMMERCIAL MARKETS DEVELOPER SENTIMENT

>50 INDICATES POSITIVE OUTLOOK

Arrow denotes change from last survey

Office | Multi-Family | Industrial | Retail

Los Angeles

▼	57.22	Office
▲	59.80	Multi-Family
▲	59.70	Industrial
▼	33.27	Retail

Inland Empire

▲	55.38	Industrial

Orange County

▲	60.84	Office
▼	56.20	Multi-Family
▲	59.16	Industrial
▼	36.19	Retail

San Diego

▲	53.57	Office
▲	54.62	Multi-Family
▼	55.68	Industrial
■	39.58	Retail

East Bay

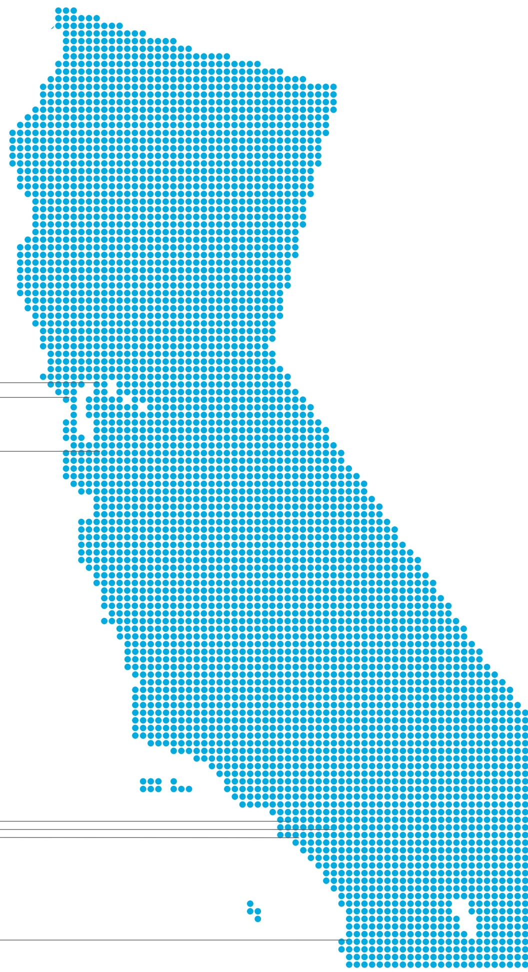
▲	51.58	Office
▼	51.96	Multi-Family
▲	59.00	Industrial
▼	40.83	Retail

San Francisco

▲	49.85	Office
▲	51.18	Multi-Family
▲	65.00	Industrial
▼	40.56	Retail

Silicon Valley

▲	51.67	Office
▲	52.94	Multi-Family
▲	61.48	Industrial
▼	38.10	Retail



* Index weights have been updated

"This exuberance that our office market panel is showing, seems to be reflective of the fact that the tax overhaul has increased rates of return to investment in office space."

- Jerry Nickelsburg
Director and Senior Economist
UCLA Anderson Forecast

"The smarter players in the office market are all going to Oakland."

- Tony Natsis
Partner
Allen Matkins

"Retailers who master omni channel – the ability to look at the product online or in the store, touch it at the store, order it online, return it at the store – are the ones who have the best outlook going forward. "

- Ivan Gold
Of Counsel
Allen Matkins

"Perhaps driven by an increase in economic activity in the last half of 2017, and presumably by the tax cut, we see a little bit of a new wind to real estate activity, in 2018."

- John Tipton
Partner
Allen Matkins


"There's really an insatiable demand for these big, huge e-commerce and fulfillment centers to be built in the Inland Empire."
- Steve Belletti
Senior Executive Vice President
Colliers International

INDUSTRIAL SPACE MARKETS

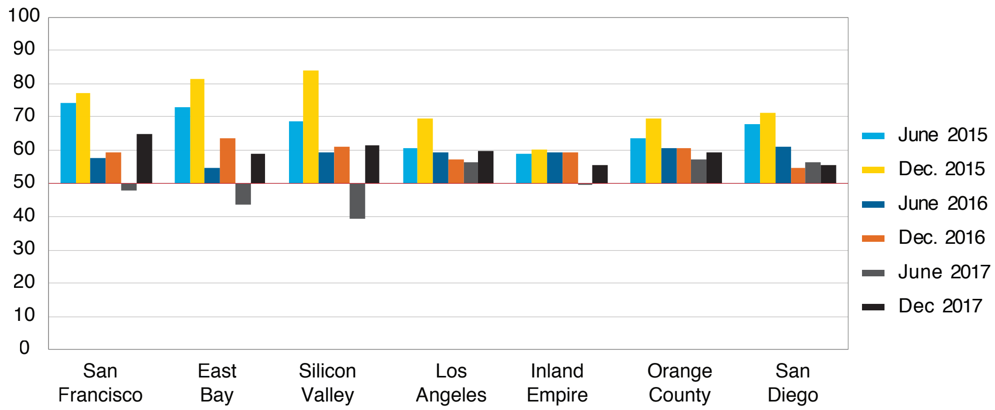
Six months ago Bay Area industrial sentiment tanked. In each of the three markets, San Francisco, Silicon Valley, and the East Bay sentiment was the most pessimistic it has been since we began the survey in 2009. But negative sentiment in the index does not necessarily correspond to a negative view of the market. With vacancy rates below 2% in 2017 it was is difficult to see how the market could be better in 2020. Thus, the panel last June saw the Bay Area industrial market as being at its zenith.

Except it wasn't. In June, occupancy rates were expected to fall sharply over the next three years, but events in the meantime, including expected higher consumer spending due to the tax overhaul, has led the panelists to now conclude the opposite; that not enough industrial space exists and therefore occupancy rates will hold or even rise and rental rates will increase in step with the lack of available space.

In Southern California there was only a modest fall off in sentiment six months ago and a modest increase in December. In the latest survey, there is an increase in plans to start new projects relative to a year ago, likely caused by imports from Asia that have grown at double-digit rates and a sense that the economy is still growing.

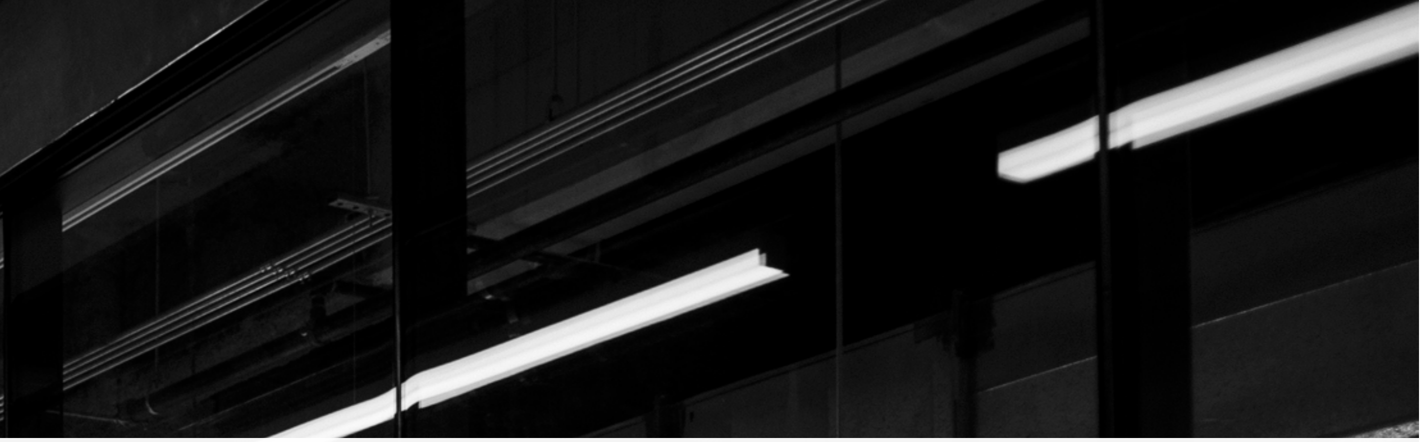
In addition to import logistics, e-commerce will continue to drive a hot market for warehouse space, and though it is not quite as searing hot as before, there still exists robust demand in Southern California. With high occupancy rates and the improvement in market conditions our panelists forecast for the next three years is for higher rental rates and a market that is still somewhat away from an adequate supply of space.

Industrial Space Developer Sentiment for 2020
(>50 optimistic sentiment)



"We may be in brick-and-mortar, but we're not in the business of selling product anymore. We are selling an experience."

- Rhonda Caldewey-Diaz
Managing Director
Cushman & Wakefield

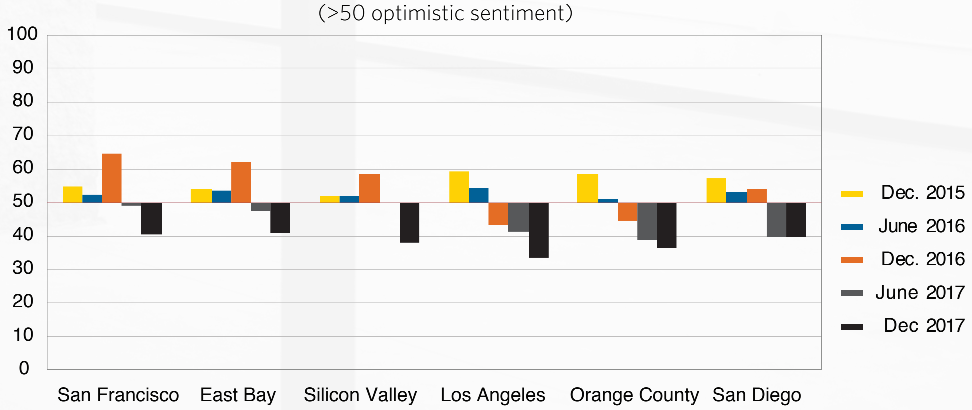


RETAIL SPACE MARKET

And then there is retail. If the tax overhaul was supposed to make investment rates of return higher it did not do near enough for this sector. Indeed, the survey panels in each of the six markets are more pessimistic now than they were before the tax bill passed. Though there have been reports of a good holiday buying season for brick-and-mortar retail establishments this year, the trend to online retail is sufficiently strong that California store closings, including retailers Sears, Kmart, WalMart, Kitson, and Macy's, even in this expanding economy continue apace.

In the Bay Area none of our panel of retail developers started a new retail project last year and only a little over 10% stated they are planning on starting one this year. In Southern California 53% of the panel began new retail projects last year and that has dropped to one-third for the coming 12 months. Clearly there are opportunities but in general retail is overbuilt.

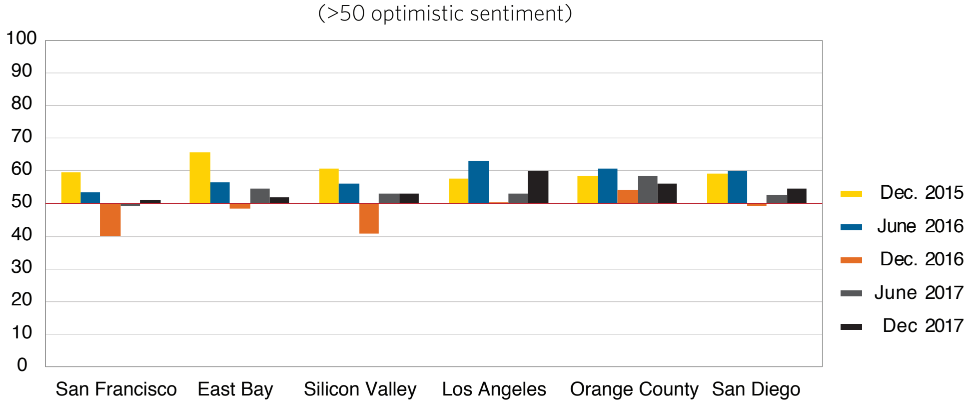
Retail Space Developer Sentiment for 2020
(>50 optimistic sentiment)



"For apartment developers in Los Angeles, the market is very strong. Our vacancy rates are at 3.8% and we're poised to stay under 5% for the next five years."

- Laurie Lustig-Bower
Executive Vice President
CBRE

Multi-Family Space Developer Sentiment for 2020
(>50 optimistic sentiment)



MULTI-FAMILY HOUSING

The multi-family market has been tight since early in this economic expansion. Job growth, the precursor to household formation, has remained robust and the new tax plan makes rental housing relatively more attractive. Nevertheless, there was no significant change in multi-family developer expectations for 2020 since last June. In the Bay Area, the expectation of the panel is for the market to remain unchanged from today three years hence and for Southern California it is for improving markets, but not by more than was expected earlier in the year.

But unlike retail, this is a market that is performing well for investors. Permits for new units rose by 12.8% from the previous year. Developers' activity reflects these sentiments. In the Bay Area about two-thirds of all developers have plans to start at least one new project this year with half planning more than one. This is up significantly from plans one year ago.

In Southern California two-thirds of the panelists are also planning new projects with 45% expecting to begin multiple multi-family developments. This represents an improvement of 18 percentage points from a year ago. According to FannieMae[3], the very low vacancy rates in Los Angeles should remain for the balance of the decade. Our panelists strongly agree for Los Angeles, and they forecast unchanged vacancy rates for Orange County, and a slight increase in San Diego.

The difference in the two parts of the State can be inferred from the panel's views on land prices. In each of the three Bay Area markets, the average increase in the cost of land in the responses corresponded to price increases matching the rate of inflation. This is consistent with the very expensive Bay Area market having reached an equilibrium and is reflective of the sharp slowing of growth in Bay Area employment. Though there is little difference between the three markets in the Bay Area, there should be a slight tightening of the East Bay multi-family market.

By contrast, in Southern California the panel's view is that land prices are going to increase faster than the rate of inflation. This is driven by the improved job growth in the Southland and indicative of a faster rate of household formation. For the three markets, San Diego, Orange County and Los Angeles, there is very little difference in the sentiment indexes.

However, the differences in sentiment throughout the State are not reflective of any pull back in this sector, only a continuation of a shortage of housing creating excess demand for new rental units. What about the favorable treatment of real estate development in the new tax code? When the rate of return is sufficient to hit capacity in development and construction, a higher rate of return cannot induce more. Thus, at least in the difficult building environment in California, there is no tax bump in multi-family home construction.

THE TAX BUMP IN PERSPECTIVE

The ostensible purpose of the tax overhaul is to ease the tax cost to businesses and free up cash for investment. This is advertised as a way to increase economic growth. The proposition for a full employment economy is controversial, but it is an empirical question as to whether or not these outcomes will obtain that result. As our retail and multi-family housing panels demonstrate, other fundamentals may be more important than corporate tax rate reductions and new income pass-through provisions. However, the office and industrial markets are interpreting the change in the tax code as inducing more office using employment and more consumption on the part of households. Thus just as economists are not in agreement on the potential outcome of the tax overhaul, our panelists are also of different minds as to how the new tax structure will affect their business. The June 2018 survey might give us more insight, but for now we can expect moderate but uneven growth in commercial real estate development.

3. https://www.fanniemae.com/content/fact_sheet/multifamily-metro-outlook-quarterly-losangeles.pdf

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