

Summer/Fall 2018
Issue No. 23



ALLEN MATKINS | UCLA ANDERSON FORECAST

COMMERCIAL REAL ESTATE SURVEY

Allen Matkins

UCLAAnderson
FORECAST

Allen Markins **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, do you forecast that between 2014 and 2015, the vacancy rate in Los Angeles will:

- A Increase
- B Decrease
- C Stay the same
- D N/A

10. If you invest in office space in San Diego, do you forecast that between 2014 and 2015, the vacancy rate in San Diego will:

- A Increase
- B Decrease
- C Stay the same
- D N/A

11. If you invest in office space in Orange County, do you forecast that between 2014 and 2015, the vacancy rate in Orange County will:

- A Increase
- B Decrease
- C Stay the same
- D N/A

12. In the last 12 months, interest rates have increased. Do you forecast that between 2014 and 2015, the vacancy rate in Los Angeles will:

- A Increase
- B Decrease
- C Stay the same
- D N/A

13. In the last 12 months, interest rates have increased. Do you forecast that between 2014 and 2015, the vacancy rate in San Diego will:

- A Increase
- B Decrease
- C Stay the same
- D N/A

14. In the last 12 months, interest rates have increased. Do you forecast that between 2014 and 2015, the vacancy rate in Orange County 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.

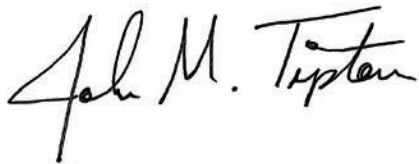
Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for insights into their markets. The Survey and the resulting Index provide a measure of the commercial real estate supply-side participants' views 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 24th 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.

A handwritten signature in black ink that reads "John M. Tipton". The signature is written in a cursive, flowing style.

John M. Tipton
Partner, Real Estate Department
Allen Matkins

CALIFORNIA COMMERCIAL REAL ESTATE SURVEY:

GROWTH, STAGNATION, AND DECLINE



Tax cuts and incentives, tariffs, higher interest rates, higher cap rates, and slowing employment growth ought to affect the sentiment of developers as they look to new commercial real estate projects, particularly ones scheduled to open three years hence. In the latest (June 2018) Allen Matkins/UCLA Anderson Forecast Commercial Real Estate Survey, we find none of these events have moved the needle from the November 2017 Survey. The view that office markets have topped out, but are not tumbling, that retail is in fact tumbling, and that multi-family housing and industrial space will remain hot is not much different from that which we have observed over the past two years.

A recent study of the indexes created from Survey responses demonstrated two aspects of the data.¹ First, the prediction that optimism or pessimism as recorded by the Survey indexes would correspond to higher or lower levels of development of new properties three years into the future, proved to be empirically accurate. Second, trends in the Survey data, to the limited extent the data can tell us at this point, indicate early warnings of directional shifts in the commercial real estate building cycle.

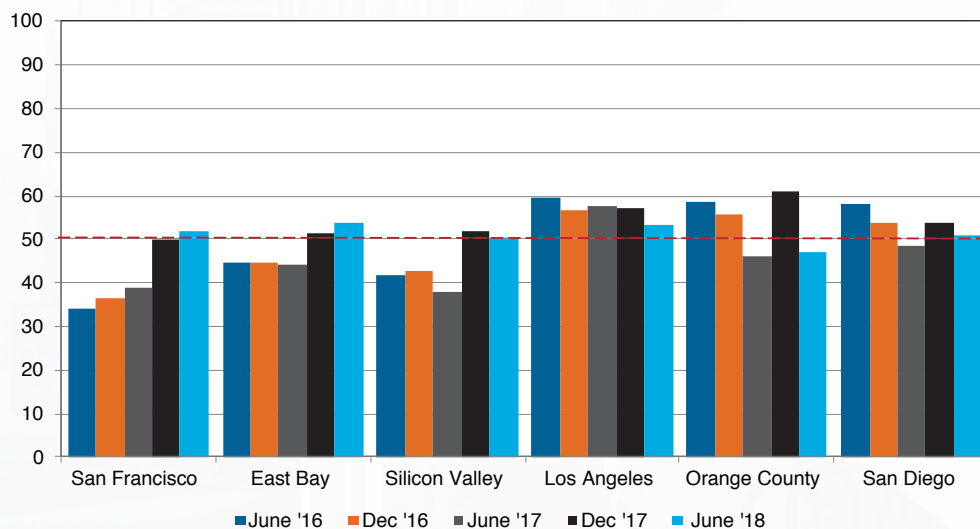
Applying the methodology from that study to the most recent Survey, we conclude that as the responses by the panelists look much like those of the past two years, the indexes are not predicting a change in direction of commercial real estate development between today and 2021.

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 for future commercial construction. For example, if a developer were optimistic about economic conditions in the industrial market of Silicon Valley in 2021, then initial work for a new project with an expected ready-for-occupancy date of 2021—a business plan, preliminary architecture, and a search for financial backing—would have to begin no later than 2018. Although optimism does not always translate into new construction projects, this sentiment is a prerequisite for it.

OFFICE SPACE MARKETS

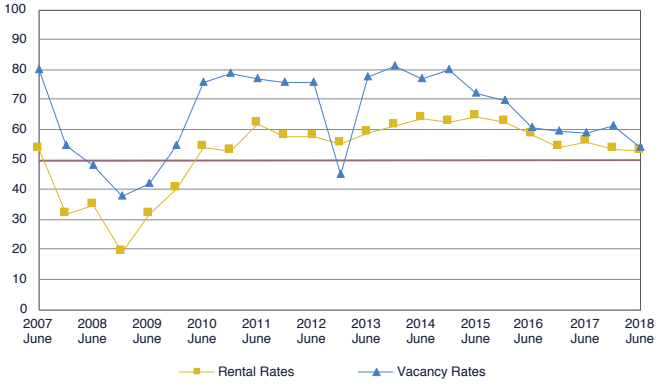
In our previous analysis of office markets, we have deduced from the Survey that the peak of the market has been reached. The latest Survey confirms this prediction. One of the highlights of the aforementioned analysis of the predictive capability of the Survey indexes was that both the level

Office Space Developer Sentiment Index
(>50 optimistic sentiment)

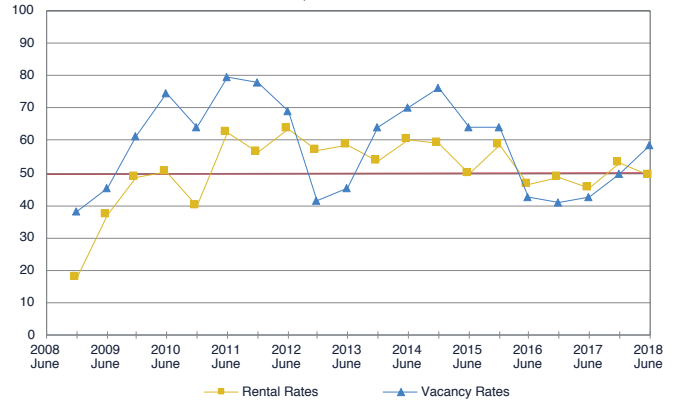


1. Jerry Nickelsburg, "Predicting Commercial Real Estate Supply: An Analysis of The Allen Matkins/UCLA Anderson Forecast CRE Indexes" 2018.

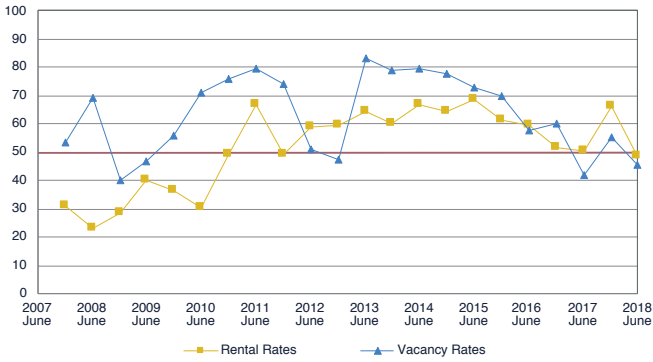
Los Angeles Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



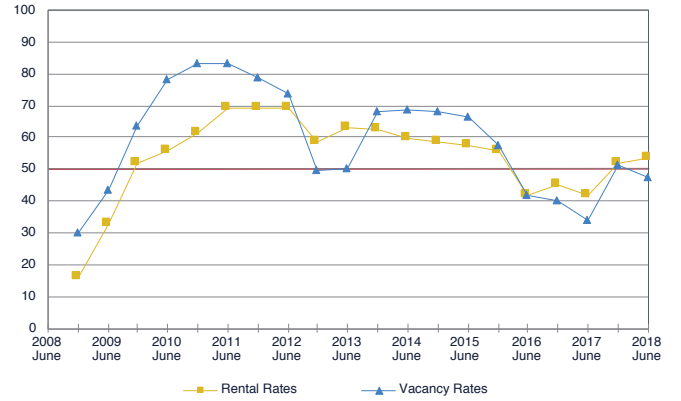
East Bay Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



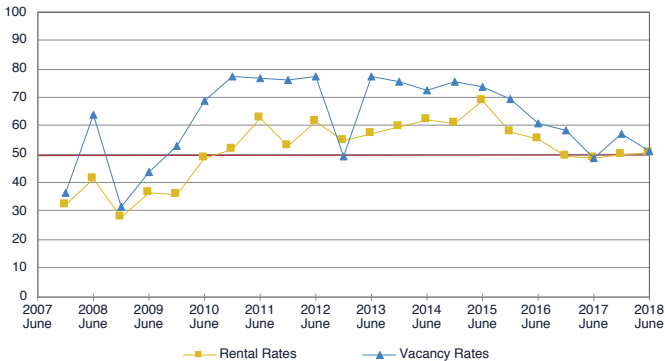
Orange County Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



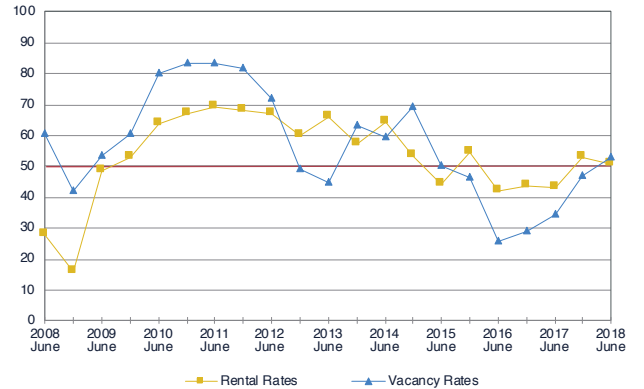
Silicon Valley Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



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)




of sentiment (positive, neutral, negative) and the trend in the index are important. Both confirm the inference from the current office market Surveys.

In the Bay Area, the Survey index of the three markets returned to neutral sentiment. That is, there is the expectation that rental rates adjusted for inflation and occupancy rates will remain unchanged over the next three years. This view, combined with expected higher building and financing costs, ought to result in a slight reduction in building by the time 2021 rolls around. For 2019, the panelists have no plans for either a decrease nor increase in building activity; also consistent with the Survey findings. Nevertheless, the expected slight decrease in building by 2021 is from an extraordinarily

high level, a level that has been driven by the robust increase of hiring in the region.²

In the three Southern California markets surveyed, the message is also clear. For the last two years the Survey participants have been signaling that markets today (measured by occupancy and rental rates) are as good as they are going to get for some time. Indeed, with rising cap rates one can expect marginal business plans to not make it past the first round of approvals. Two-thirds of the panelists sat out this past year, and the same percentage are planning on being on the sidelines in the coming year. Even though there are a spate of cranes reaching for the sky around Southern California, the office market appears to have achieved its apex for this cycle.

2. <https://www.mercurynews.com/2018/04/25/silicon-valley-growth-spurs-huge-office-rd-building-boom-google-apple-adobe-facebook/>



“We’ve hit an apex in office development. People are continuing to develop what they previously bought, but there doesn’t seem to be a ton of new development acquisition deals on the horizon.”

- Crystal Lofing
Partner
Allen Matkins

COMMERCIAL MARKETS DEVELOPER SENTIMENT

>50 INDICATES POSITIVE OUTLOOK

Arrow denotes change from last survey



Office



Multi-Family

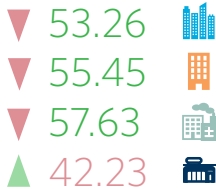


Industrial

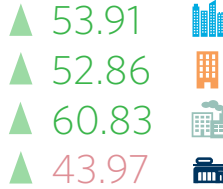


Retail

Los Angeles



East Bay



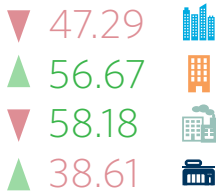
Inland Empire



Sacramento/SJV



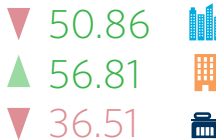
Orange County



San Francisco



San Diego



Silicon Valley



* Index weights have been updated

“The fact that our Survey predicts well changes in development three years out in all markets we survey in California, simply reflects the fact that we are getting real insight as to those business plans – the first step of any new development.”

- Jerry Nickelsburg
Director and Senior Economist
UCLA Anderson Forecast

“The shortage of manpower, along with the cost of labor and the cost of construction, are causing pressures on the real estate industry that we’ve not seen in years.”

- Gary McKitterick
Partner
Allen Matkins

“Interest rates are going up, construction costs continue to go up, construction labor continues to be limited, and so it’s becoming more and more expensive to get development from the ground to the finish line.”

- Sandy Jacobson
Partner
Allen Matkins

“We’ve hit an apex with office development. Now, apex means the top, the zenith. It doesn’t mean that the world is ending.”

- John Tipton
Partner
Allen Matkins



"In some coastal constrained markets, we are starting to see stacked industrial buildings that we haven't seen until this cycle, which is quite fascinating."

- Matt Fogt
Partner
Allen Matkins

INDUSTRIAL SPACE MARKETS

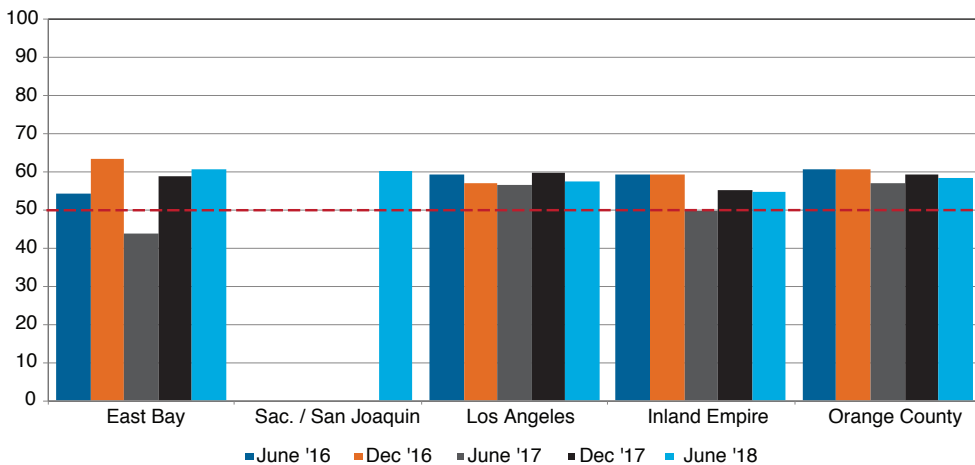
Industrial markets continue to be where the action is in non-residential commercial real estate development. Since California began transforming from a factory economy to an information economy, the space has shifted to being dominated by warehouses. We are pleased to announce the addition of an increasingly important warehouse and distribution region in the State—San Joaquin and Sacramento Counties—to the Survey. With rail service from the Ports of Oakland and Stockton and three cargo intensive airports, these two counties are among the fastest-growing in the State.

In the East Bay, the jitters of late 2017 have abated and the trend over the last year is positive. In addition to robust demand for online consumption requiring distribution centers to serve the seven million Bay Area residents, the ports, serving a wider geographical area, have had a good year. For the first four months of 2018, container traffic and its equivalent have increased by 4% over the same period in 2016, and air cargo at Oakland International Airport and the two Sacramento airports, Sacramento International and Mather, have increased

by a two-year total of 17.5%. With low vacancy rates and increasing freight movement, it is not a surprise that our panelists are optimistic about the next three years, both in the East Bay and San Joaquin and Sacramento Counties. Based on our trend analysis of the panelist responses, it is expected that industrial space development will increase in the four-county region by 2021.

The same phenomena are present in Southern California warehouse demand. Concern in early 2017 that there were sufficient warehouses being built in the Inland Empire has completely abated, and through all three Southern California regions, 2021 is judged to be as good in terms of rental and occupancy rates as today, and likely better. Since vacancy rates are extraordinarily low, rising cap and interest rates do not change our expectation for increased building in Los Angeles, Orange County, and the Inland Empire. Increasing imports and increasing online shopping are the fundamentals driving this demand. The risk to the forecast is the potential for disruptive trade wars affecting goods movement at the ports.

Industrial Space Developer Sentiment Index
(>50 optimistic sentiment)





“Experiential retail is up, but experiential retail takes a lot of effort. You have to have the right kind of mix and it’s a challenge, and so repurposing existing retail to fit the new model can be difficult.”

- Pete Roth
Partner
Allen Matkins

RETAIL SPACE MARKET

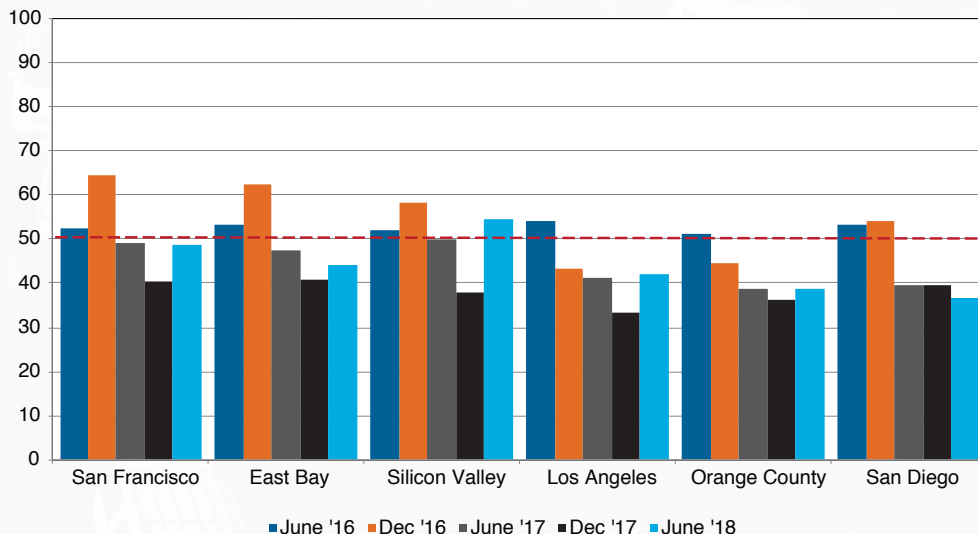
Retail continues to be the weakest space in commercial real estate. In the current Survey, developer sentiment is the same or lower in five of the six markets studied as compared to one year ago. The only exception is Silicon Valley. The difference in sentiment there may be related to sampling error, or perhaps to the continued run-up in disposable income and concomitant consumption in the fastest-growing region of the State. Over the last 12 months, payroll employment in the Silicon Valley grew at an astounding +3.5%, a rate that is more than double that of the U.S. rate. Even with the increased usage of e-commerce by Silicon Valley residents, this is good news for brick-and-mortar retail.

Silicon Valley notwithstanding, in-store retail shows all the signs of continuing its decline over the next three

years, with or without a recession. Though sentiment is up slightly from six months ago, that statistic is likely a function of seasonality in the data. Our panelists report that today, two-thirds of their space is occupied by tenuous leases, and that they are not increasing the number of projects they will be developing over the next year.

To be sure, there are opportunities in retail. These are found in the conversion of space to experiential retail, and to the building out of brick-and-mortar retail for new housing developments. Nevertheless, the trends and levels of the index portend a shrinkage of building and a softening of the market through 2021 for those with existing space and those contemplating new projects.

Retail Space Developer Sentiment Index
(>50 optimistic sentiment)

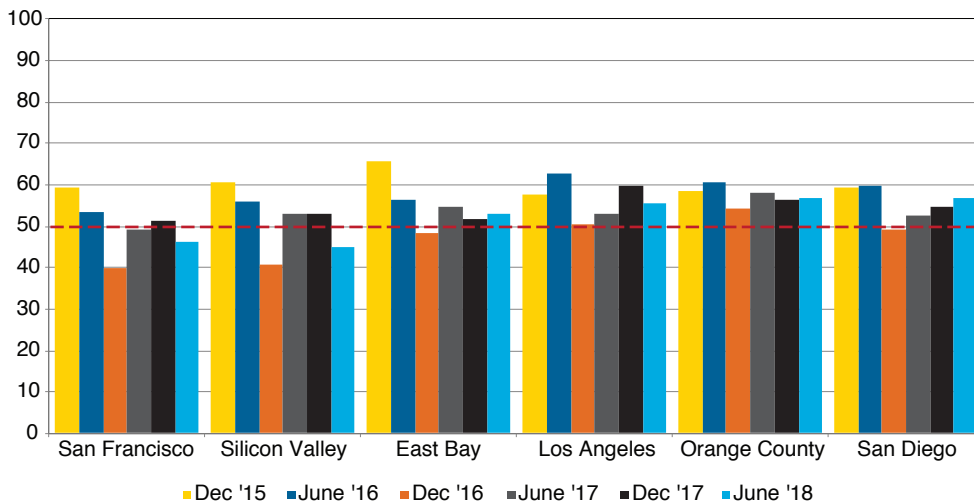


“Multi-family is so hot right now because there’s huge demand for housing coupled with the new tax plan which incentivizes multi-family use over single-family ownership.”

- Steve Etheredge
Partner
Allen Matkins



Multi-Family Space Developer Sentiment Index
(>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. Once again, there were no big swings in multi-family developer expectations for the next three years. In the Bay Area, the expectation of the panel continues to be that the market will be slightly softer three years hence and for Southern California it is for improving markets relative to today.

Unlike retail, multi-family is a market that is performing well for investors. Permits for new units in the first four months of 2018 rose by 18% from the same period the previous year. Developer activity reflects these sentiments. In the Bay Area, about 80% of all developers have plans to start at least one new project this year with half planning more than one. This is up from 63% the previous year.

How does one reconcile this with the pessimism in San Francisco and Silicon Valley (sentiment averaging less than 50)? Part of the answer is that the market has been sufficiently hot that even though there is the expectation of it cooling, demand conditions still warrant new construction for occupancy in 2021. Moreover, investors looking at long-term demand are projecting that softening at the high end of the market is a temporary phenomenon.

In Southern California, three-fourths of the panelists are also planning new projects with 45% expecting to begin more than one multi-family development. This represents an 11% point improvement over the past year. The panel's expectations are that rental rates will continue to rise faster than inflation and that occupancy rates will remain high. This is consistent with the UCLA Anderson Forecast projections through 2020 and with a separate analysis by FannieMae economists.

THE SURVEY IN PERSPECTIVE

Six months ago, Congress approved a tax overhaul and a stimulus package both designed to spur the economy to faster growth. A key part of these policies was an inducement to invest, including investment in commercial real estate. The Allen Matkins/UCLA Anderson Forecast California CRE Survey should pick up changed propensities to invest as evidenced by either a change in the direction of a trend in the indexes or a change in the rate of increase in the indexes, if it exists. What we have found in the Survey is that neither has occurred.

Clearly, underlying fundamentals in the eight California markets surveyed are dominating investment decisions and these create something of a "headwind" with respect to the Federal fiscal stimulus. Consequently, the Survey prediction is the not very exciting "more of the same," at least in the near-term. Since multi-family and industrial markets have been doing quite well, this is good news. For office markets, it is not bad news, as the level of development is neither growing nor declining. And for retail space markets, it is the expected continued realignment of brick-and-mortar capital to meet 21st Century needs.

3. The California Report, UCLA Anderson Forecast, June 2018.

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

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