



ALLEN MATKINS | UCLA ANDERSON FORECAST

COMMERCIAL REAL ESTATE SURVEY

Allen Matkins

UCLAAnderson
FORECAST

Winter/Spring 2019
Issue No. 24

Office Space | Multi-Family | Industrial | Retail

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

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

13. If you invest in office space in San Francisco, do you forecast that between 2014 and 2015, the vacancy rate in San Francisco 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-fourth 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

ECONOMIC
HEADWINDS

UNCHANGED
EXPECTATIONS



The Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey for 2018-2021

Trade wars, interest rate hikes, higher cap rates, falling equity values, and slowing employment growth all ought to affect the sentiment of developers as they consider new commercial real estate projects, particularly ones scheduled to open three years hence. In the latest (November/December 2018) Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey we again find none of these events have moved the needle from the November/December 2017 Survey. It seems clear that our panelists long ago discounted the uncertainty in the market, increasing cap rates, and slower economic growth, and although the last 12 months have been turbulent, they have not changed the panels' views on California commercial real estate markets over the next three years.

Their perspective for CRE markets in California is simply that industrial space—warehouses in particular—will remain the hot market in spite of the fluctuations of the economy and the threat of trade wars. Similarly, the shortage of housing in California, even with a softening of the resale market, is such that multi-family housing remains strong. By contrast, the panels' views of office and retail markets, while having specific niche opportunities, is that they have topped out for this cycle.

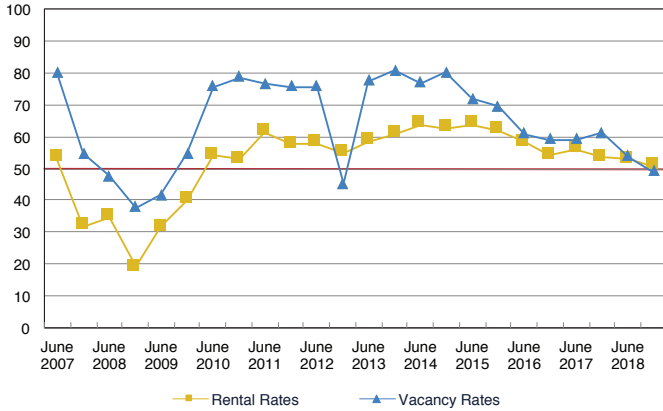
An important aspect of the survey is its ability to predict turning points in CRE markets. In a recent study of the indexes created from survey responses, this was demonstrated through two characteristics of the data.¹ First, the prediction that optimism or pessimism as recorded by the survey indexes corresponded to higher or lower levels of development of

new properties three years into the future. 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. In the current survey, those trends have continued to provide more confidence in the predictions of a decline in retail, the end of the boom cycle in office space, and the continued shortage of warehouse and distribution centers.

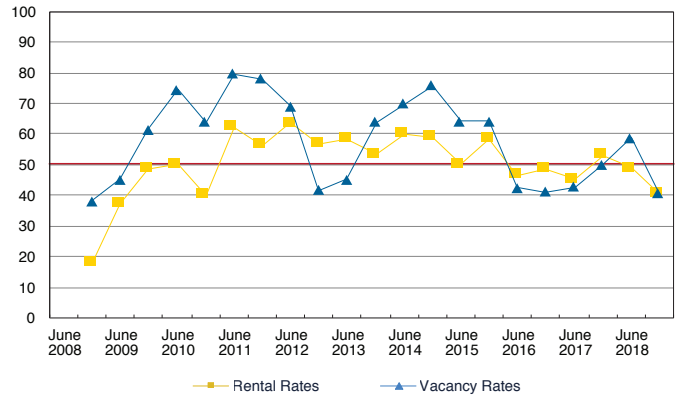
The Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey compiles the views of commercial real estate developers with respect to California markets three years hence. The three-year time horizon was chosen to approximate the average time a new commercial project requires for completion (though projects with significant environmental issues often take much longer). The panelists' views on vacancy and rental rates are indicative of their own business plans for new projects, and so 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 Sacramento 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 early 2019. Although optimism does not always translate into new construction projects, this sentiment is a prerequisite for it.

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

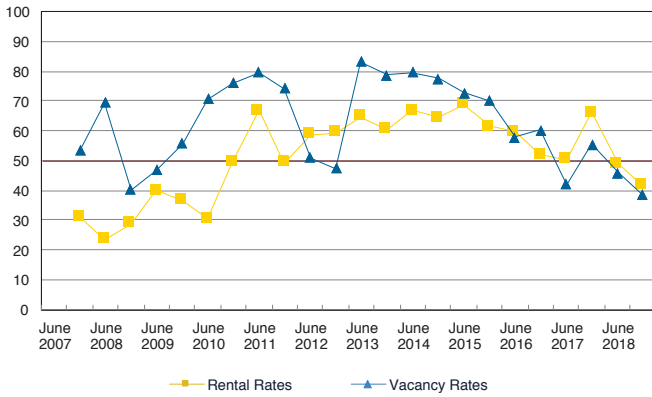
Los Angeles Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



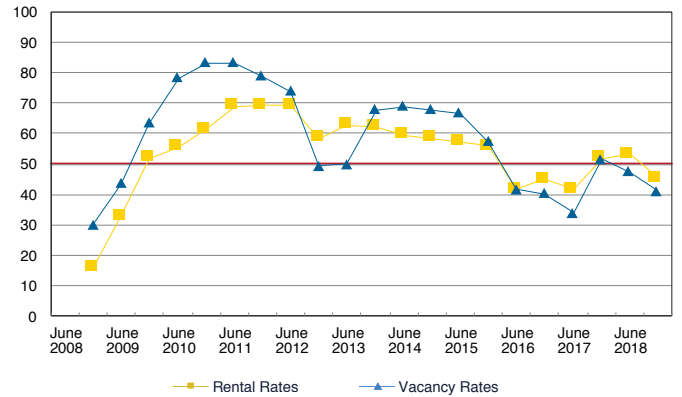
East Bay Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



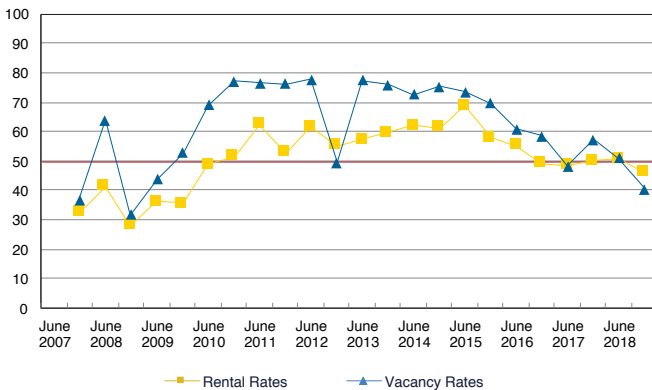
Orange County Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



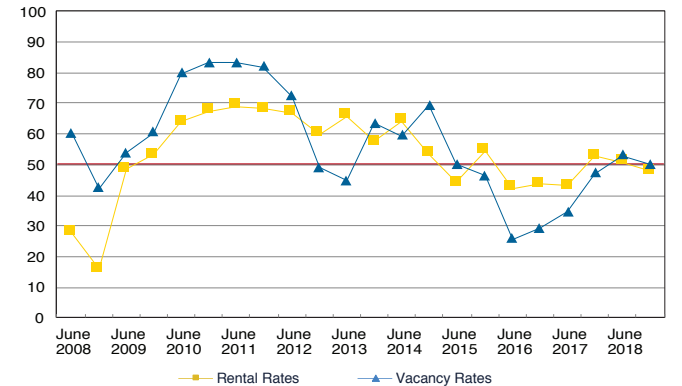
Silicon Valley Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



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)



OFFICE SPACE MARKETS

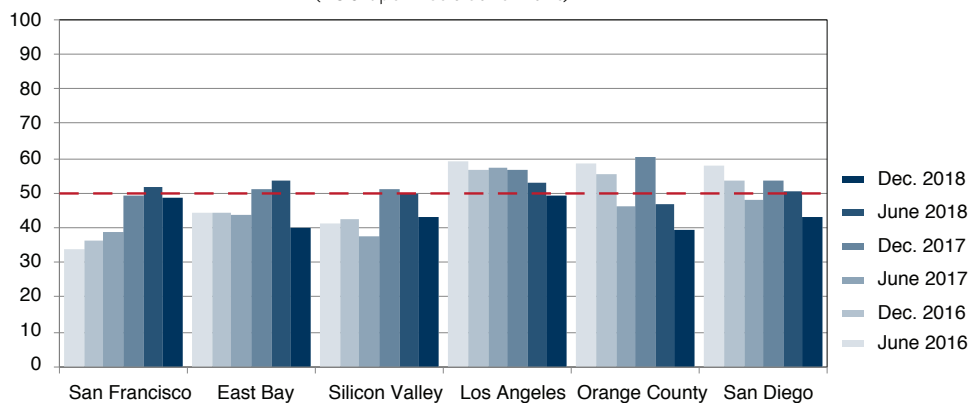
Over the last year and a half, sentiment in four of the six office markets we survey has weakened. In the current survey, sentiment in the remaining two has dropped significantly. One of the highlights of the aforementioned analysis of the predictive capability of the survey indexes was that both the level of sentiment (positive, neutral, negative) and the trend in the index are important. The survey now tells us that for California, office markets have peaked, and will over the next two years begin the more moderate part of the cycle.²

In the Bay Area, Silicon Valley is the only market exhibiting a clear trend. Though sentiment fell in both San Francisco and the East Bay, there is not enough data as yet to tell if this is statistically significant. The supporting data we collect—activity over the past 12 months, planned activity in the next 12 months, and weakness in leases—is mixed. Overall, Bay

Area developers are not indicating an immediate cut-back in their development activity. In the East Bay, leases remain relatively firm while they are slightly weaker in San Francisco. And in Silicon Valley, the data indicates that the market has now topped out as the negative trend in sentiment continues and slow-walking and sublease activity picks up.

In the three Southern California markets surveyed, the panelists indicate increased weakness between now and 2021. Although actual and planned building is currently higher, in San Diego, Los Angeles, and Orange County developers see rental rates being eroded by inflation and vacancy rates increasing from today. Thus, even though office markets are relatively strong today, the responses by the panelists over the last two years has now signaled a slowdown in the office space markets.

Office Space Developer Sentiment Index
(>50 optimistic sentiment)



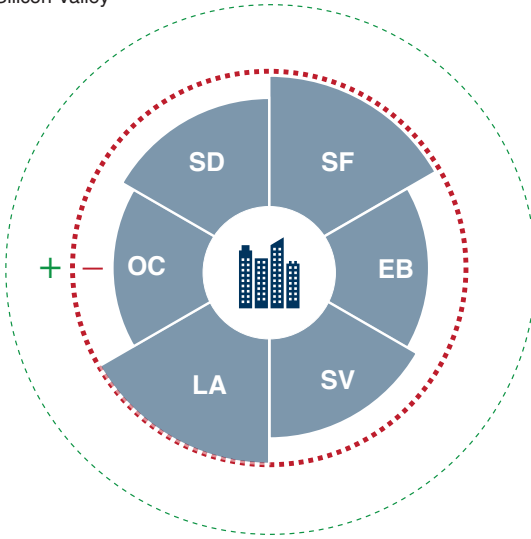
2. That office markets are not currently experiencing a downturn but are exhibiting signs of the end of the expansion was reported independently in: <https://www.businessinsider.com/silicon-valley-companies-arent-using-as-much-office-space-as-used-to-2017-10> for the Bay Area and <http://www.savills-studley.com/research/market-reports/2017/q2/3q18-los-angeles-office-market-report.pdf> for Los Angeles.

COMMERCIAL MARKETS DEVELOPER SENTIMENT

>50 INDICATES POSITIVE OUTLOOK
 Arrow denotes change from last survey

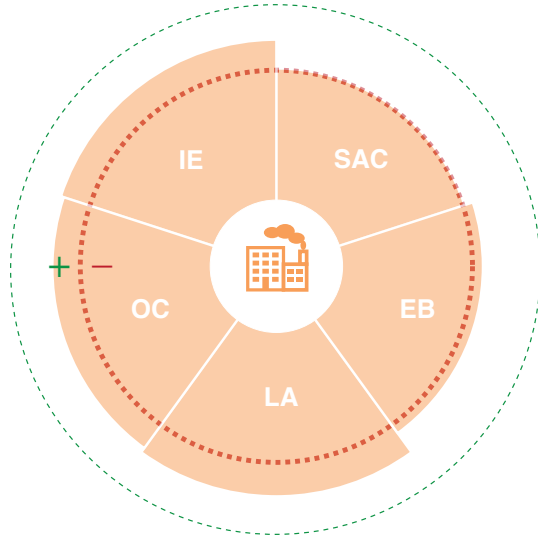
- 49.79 ▼ Los Angeles
- 39.86 ▼ Orange County
- 43.24 ▼ San Diego
- 48.89 ▼ San Francisco
- 40.57 ▼ East Bay
- 43.33 ▼ Silicon Valley

OFFICE

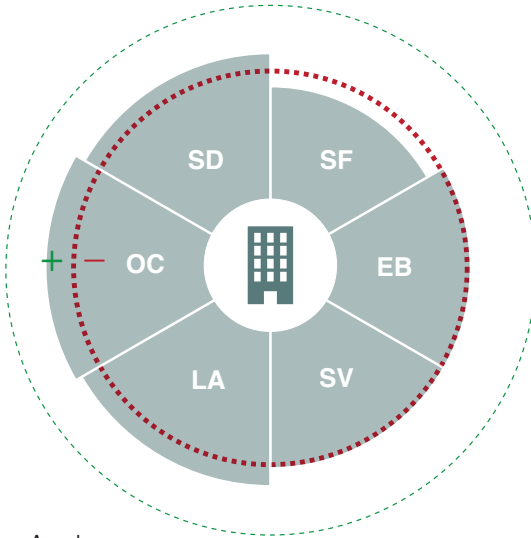


- 58.67 ▲ Los Angeles
- 57.12 ▼ Orange County
- 57.78 ▲ Inland Empire
- 50.45 ▼ Sac./San Joaquin
- 52.67 ▼ East Bay

INDUSTRIAL

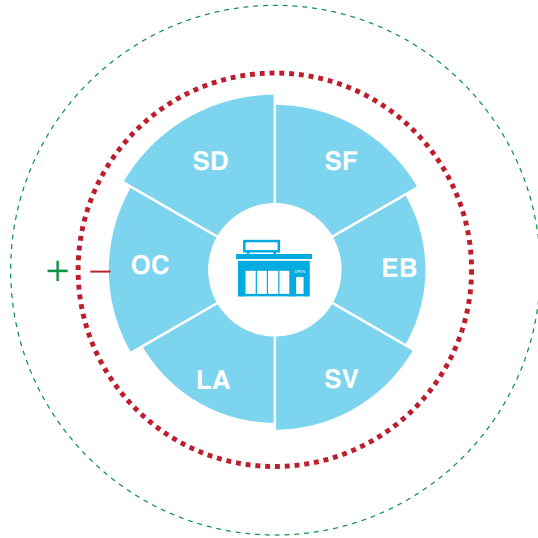


MULTI-FAMILY



- 55.48 ▲ Los Angeles
- 57.18 ▲ Orange County
- 54.56 ▲ San Diego
- 46.15 ▼ San Francisco
- 52.00 ▼ East Bay
- 50.92 ▲ Silicon Valley

RETAIL



- 39.21 ▼ Los Angeles
- 42.50 ▲ Orange County
- 44.81 ▲ San Diego
- 42.22 ▼ San Francisco
- 38.57 ▼ East Bay
- 40.95 ▼ Silicon Valley

“The co-working companies are competing head on with the landlords, although on a short-term basis, for these major tech players.”

- Tony Natsis
Partner
Allen Matkins

“Industrial is the belle of the ball. It doesn't show any signs of slowing down and will continue to be solid through 2019 and probably a few years longer.”

- Kevin Shannon
Co-Head of U.S. Capital Markets
Newmark Knight Frank

“In retail in California, we see continued reassessment by owners of retail projects as to whether or not they should repurpose the site for a new higher and better use.”

- Pete Roth
Partner
Allen Matkins

“We need to find a way to solve the problem, which is build more housing so that it's not too expensive to live here, so that corporations aren't leaving.”

- Kitty Wallace
Executive Vice President
Colliers International



“In Los Angeles in general, we’re not seeing what other people are seeing right now in the retail market. LA is a healthy market”

- Carine Mamann
Senior Director
Cushman & Wakefield



RETAIL SPACE MARKETS

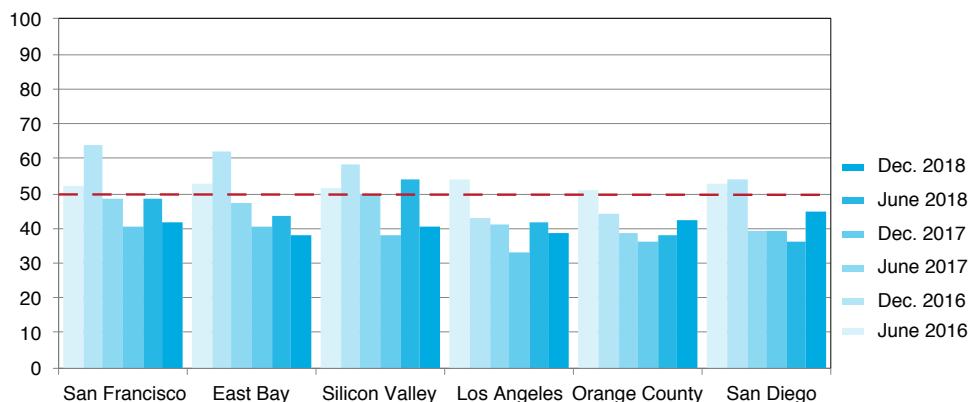
The current survey extends the recent stretch of pessimism about future retail markets to two years. This has occurred in spite of good job growth, rising incomes, and more than three percent GDP growth. In the last 12 months, new projects were started by only 18 percent of our developer panel in the Bay Area and 38 percent in Southern California. Vacancy rates are expected to continue to deteriorate through 2021. While this is indicative of too much capital in brick-and-mortar retail in the aggregate, a bit over 30 percent of the panelists have found projects that will pencil out and are planning new developments in 2019. New retail for housing, office, and hospitality projects provide niche opportunities in this space.

The recent holiday season has been good for some retailers and less so for others; particularly old-line mall anchors.³

Overall retail sales in the U.S. have increased at a 5.3 percent annual rate for the past year, but net store closings and traditional shopping mall stress remain prevalent characteristics in this space, as they have for some time. This is, of course, because of the shift away from brick-and-mortar to online shopping, resulting in too much aggregate space in retail markets.

Between the last two surveys, internet sales have grown at a 10.7 percent rate, twice that of total retail sales.⁴ As such, a net 2,900 store closings nationwide occurred in 2018.⁵ From the survey results, this is a phenomenon likely to continue in California for at least the next three years. A case in point is the recently announced conversion of the West Side Pavilion Mall in Los Angeles from retail to an office campus for Google.

Retail Developer Sentiment Index
(>50 optimistic sentiment)



3. For a national summary see: <https://www.wsj.com/articles/retail-report-card-for-2018-from-walmart-to-tiffanys-11546084800>

4. <https://www.census.gov/retail/marts/www/timeseries.html>

5. <https://coresight.com/news/weekly-store-openings-and-closures-tracker-2018-50-hm-home-to-open-second-store-in-london/>

INDUSTRIAL SPACE MARKETS

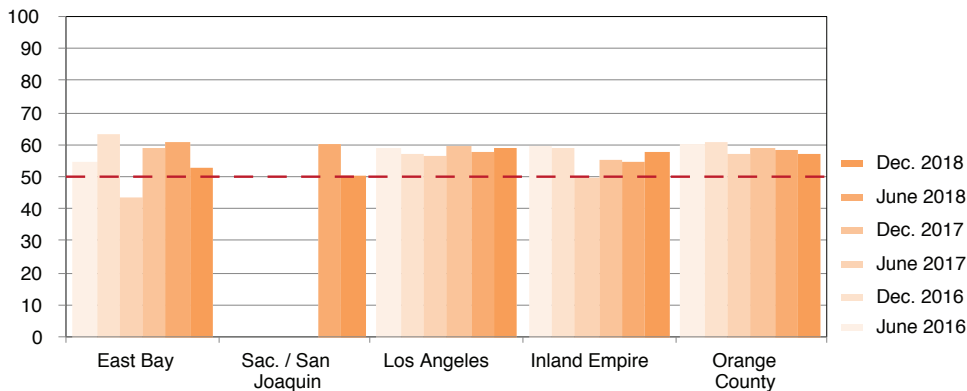
Of the three major non-residential real estate markets, only industrial space is still trending upward. This is of course a mirror image of the decline in retail and it is bolstered by a continued increase in imports. Since industrial space is now dominated by warehousing and distribution centers, it is more sensitive to the continued growth in consumption. While the UCLA Anderson Forecast outlook for the economy is for GDP growth slowing to one percent nationally in 2019, real personal income growth in California is expected to hold up and support the current expansion in industrial space.

In the East Bay, sentiment with regard to rental rates and vacancy rates has been optimistic for the past 18 months. In addition to robust demand for online consumption requiring distribution centers to serve seven million Bay Area residents, the ports, serving a wider geographical area, have experienced increased traffic in the second half of 2018. Since our last survey, seaport traffic in the region has increased at an annual rate of approximately nine percent, and air cargo at Oakland International Airport and the two Sacramento airports, Sacramento International and Mather, increased at an annual rate of 3.4 percent through November. With low vacancy rates and increasing freight movement, it is not a surprise that our pan-

elists are optimistic about the next three years in the East Bay, and San Joaquin and Sacramento counties. As evidence of this, 80 percent of the panelists started a new industrial space project in the four-county region last year and 80 percent will begin at least one this year, with three-quarters of them planning for more than one new project.

The same optimism is present in all three of the Southern California markets surveyed. Over the last three years the panelists have viewed these markets as playing catch-up with demand, and the expectation is that this will continue through 2021. Continued growth at the ports and strong consumer demand nationwide is adding to demand, particularly in the Inland Empire. Over this time there has been an increase in new projects started by our panelists. During the last 12 months, a larger proportion of them began new projects than they originally anticipated in last year's survey. It is estimated that 15 million square feet of new industrial space is under construction in the Inland Empire, and that absorption will take it off the market rapidly.⁶ Absent interruption in imports due to national trade policy, the industrial space market in Southern California ought to remain strong.

Industrial Space Developer Sentiment Index
(>50 optimistic sentiment)



6. See for example analysis by Voit: http://voitco.com/docs/default-source/market-reports/2018-3q-inland-empire-industrial.pdf?sfvrsn=d3aa31a2_6



“The industrial market is undersupplied today with the lowest vacancies we’ve ever seen in California history.”

- Darla Longo
Vice Chairman, Managing Director
CBRE



“We’re seeing a mixed bag in California with respect to commercial real estate. Industrial markets continue to do well. Office markets seemed to have topped out. Retail is still hurting. The housing markets remain tight in California, so multi-family will continue to do well over the next three years.”

- Jerry Nickelsburg
Director
UCLA Anderson Forecast



MULTI-FAMILY HOUSING MARKETS

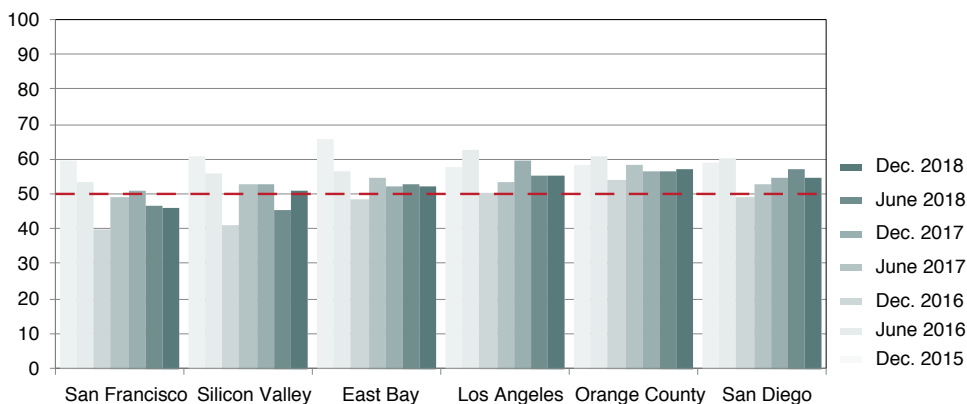
The multi-family market sentiment is decidedly mixed. In the Bay Area, occupancy rates are expected to creep down over the next three years and rental rates are expected to outpace inflation, though not by much, in the same time frame. Overall, three quarters of our panelists plan on starting new projects in 2019 and over half expect to start multiple projects. However, the expected slowing of job growth coupled with new building signals the end of increasingly tight Bay Area housing markets, but not an end to the relatively high cost of housing.

In Southern California, three-fourths of the panelists are once again planning new projects, with about half expecting to begin more than one multi-family development. The panel's expectations are that rental rates will continue to rise faster than inflation and that occupancy rates will remain high. The implication is that even though job growth in Southern California is expected to slow, the building process will not keep up with the growth in demand. This is consistent with the UCLA Anderson Forecast⁷ projections through 2020 and with a separate analysis by Fannie Mae⁸ economists.

THE SURVEY IN PERSPECTIVE

The Allen Matkins/UCLA Anderson Forecast CRE Survey and indexes provide a window into the evolution of California's CRE markets. The latest survey shows no significant impact of the headwinds to the economy from policy in Washington with respect to changes in the tax laws, trade policy, Fed policy, and gridlock. The underlying fundamentals, strength in housing and warehousing, weakness in retail, and a slowing of office using employment, as they reflect on future demand for CRE, have been unchanged through 2018. As divided government and trade negotiations with China take us into 2019, it is not expected that these trends will change significantly, though unexpected economic news may exacerbate or moderate them.

Multi-Family Housing Developer Sentiment Index
(>50 optimistic sentiment)



7. *The California Report, UCLA Anderson Forecast, December 2018.*

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

ALLEN MATKINS | UCLA ANDERSON FORECAST

COMMERCIAL REAL ESTATE SURVEY

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