

ALLEN MATKINS | UCLA ANDERSON FORECAST

COMMERCIAL REAL ESTATE SURVEY



Allen Matkins

UCLA Anderson
Forecast

Winter 2020
Issue No. 26

Office | Multi-Family | Industrial | Retail

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**, do you forecast that between 2010 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 2010 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 **Owens Valley**, do you forecast that between 2010 and 2015, the vacancy rate in **Owens Valley** will:

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

12. If you invest in office space in **Orange County**, do you forecast that between 2010 and 2015, the

vacancy rate in **Orange County** will:

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

13. If you invest in office space in **Long Beach**, do you forecast that between 2010 and 2015, the

vacancy rate in **Long Beach** will:

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

14. If you invest in office space in **Los Angeles**, do you forecast that between 2010 and 2015, the

vacancy rate in **Los Angeles** will:

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

15. If you invest in office space in **San Diego**, do you forecast that between 2010 and 2015, the

vacancy rate in **San Diego** will:

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

16. If you invest in office space in **Owens Valley**, do you forecast that between 2010 and 2015, the

vacancy rate in **Owens Valley** will:

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

17. If you invest in office space in **Long Beach**, do you forecast that between 2010 and 2015, the

vacancy rate in **Long Beach** will:

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

18. If you invest in office space in **Los Angeles**, do you forecast that between 2010 and 2015, the

vacancy rate in **Los Angeles** will:

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

19. If you invest in office space in **San Diego**, do you forecast that between 2010 and 2015, the

vacancy rate in **San Diego** will:

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

20. If you invest in office space in **Owens Valley**, do you forecast that between 2010 and 2015, the

vacancy rate in **Owens Valley** will:

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

21. If you invest in office space in **Long Beach**, do you forecast that between 2010 and 2015, the

vacancy rate in **Long Beach** will:

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

22. If you invest in office space in **Los Angeles**, do you forecast that between 2010 and 2015, the

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, now in its 26th issue, is designed to provide more accurate information on future office, industrial, retail, and multi-family space in major California geographical markets.

The Allen Matkins and UCLA Anderson Forecast partnership

At Allen Matkins, a California-based top-ranked law firm 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 fluid and cursive, with a large, stylized "J" at the beginning.

John M. Tipton
Partner, Real Estate Department
Allen Matkins

RIDING A RECORD-LONG EXPANSION



The Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey for 2019-2022

Although economic forecasts, including that of the UCLA Anderson Forecast, have GDP growth slower in 2020 than in 2019, the expected continuation of growth in the California economy bodes well for most commercial real estate (CRE) types. The current Allen Matkins/UCLA Anderson Forecast California CRE Survey, conducted at the end of 2019, asked questions that look forward to 2022. The answers from the Survey confirm the more optimistic outlook observed in the mid-year survey. The Survey is designed to gauge the viewpoints of real estate developers. The sentiment as expressed in the current Survey is the backdrop for new CRE projects due to come online in 2022 and beyond. That timeframe jumps over what the UCLA Anderson Forecast predicts will be a somewhat weaker economy with an elevated risk of recession in 2020, and strongly suggests that for the most part, developers are already looking at getting in on the ground floor of the next CRE expansionary cycle. In this Winter 2020 Allen Matkins/UCLA Anderson Forecast California CRE Survey report, we examine these trends for four market sectors: office, industrial, retail, and multi-family.

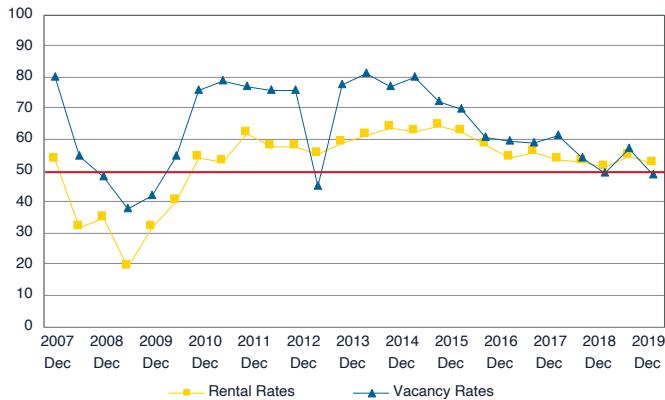
A recent study of the indexes discussed here, which were created from survey responses, demonstrated two aspects of the data.¹ First, the prediction that optimism or pessimism as recorded by the survey indexes would correspond to higher

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 CRE building cycle.

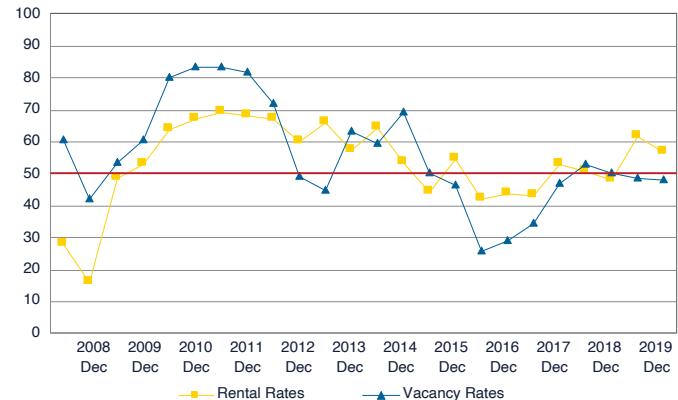
The Allen Matkins/UCLA Anderson Forecast California CRE Survey compiles the views of commercial real estate developers with respect to markets three years hence. The three-year time horizon was chosen to approximate the average time a new commercial project requires for completion (though projects with 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 Silicon Valley's industrial market in 2022, then initial work for a new project with an expected ready-for-occupancy date of 2022 — a business plan, preliminary architecture, and a search for financial backing — would have to begin no later than the latter part of 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.

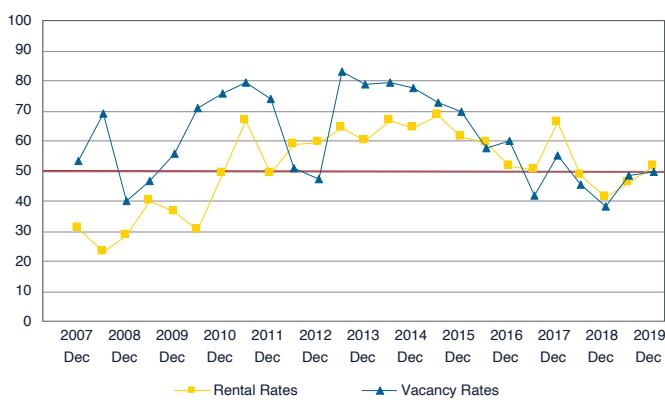
Los Angeles Office Market
Indexes of Survey: 3-year forecast
(>50 optimistic sentiment)



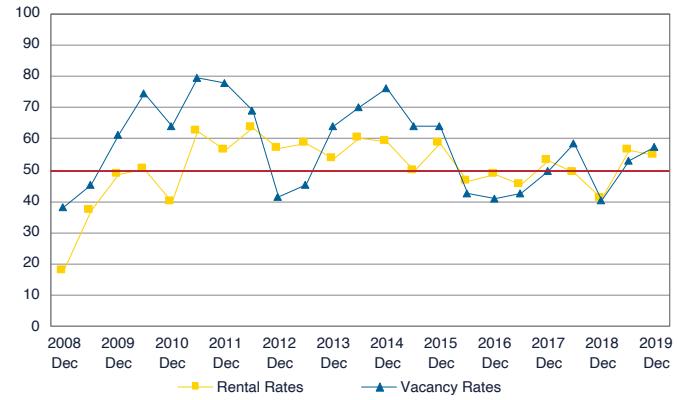
San Francisco Office Market
Indexes of Survey: 3-year forecast
(>50 optimistic sentiment)



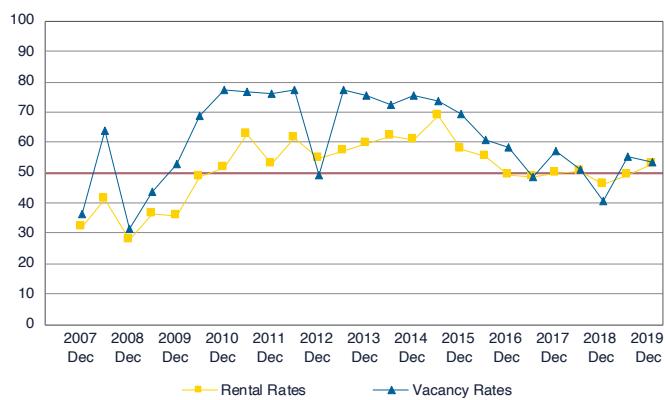
Orange County Office Market
Indexes of Survey: 3-year forecast
(>50 optimistic sentiment)



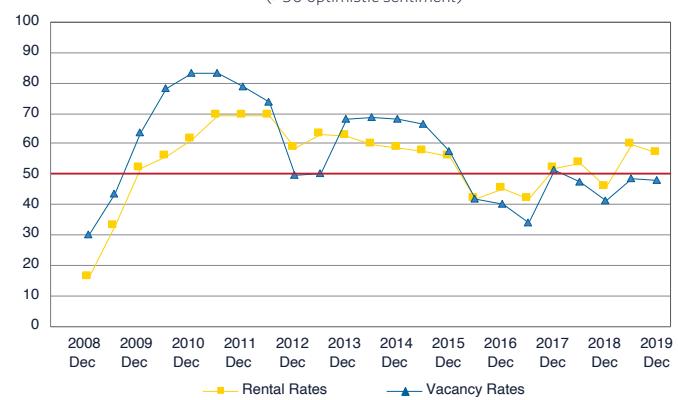
East Bay Office Market
Indexes of Survey: 3-year forecast
(>50 optimistic sentiment)



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



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



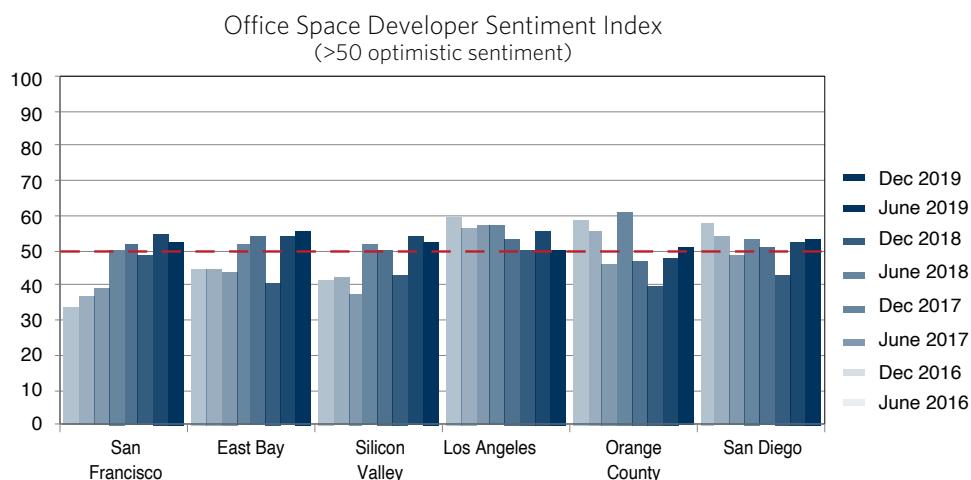
OFFICE SPACE MARKETS

In our recent analyses of office markets, we deduced from the Surveys that the peak of the market had been reached. For each of the markets surveyed over the last two years, with the exception of Los Angeles, the sentiment index fluctuated about the 50 level; the value dividing between a majority of the panelists being pessimistic and a majority of them being optimistic. The basis for this prediction was a forecast of tech-intensive/office-using employment growth to slow dramatically in 2019 and 2020. The Survey prediction was, once again, accurate. However, the lower growth rates did not foretell a downturn in development, but rather a pause in the growth of development.

In the latest Survey, there is the beginning of a return to confidence, though it is not yet a trend. All six markets surveyed have sentiment index values above 50, an indication that the panelists for each market predict that 2022 will be better than

2019. For the East Bay, Orange County, and San Diego, the panelists were bullish on both rental rates increasing faster than inflation and vacancy rates at or below those currently experienced. In the balance of the markets of San Francisco, Silicon Valley, and Los Angeles, the optimism is confined to rental rates. For these last three markets, the panelists' view is that some moderate erosion of occupancy will occur.

Their views are consistent with the perspective of most economists that the California economy will return to faster growth in 2022. That is, a two percent national economy in 2021 and 2022 will generate office-using jobs, particularly in tech-heavy California. Since building has been at a moderate pace with 60 percent of our Bay Area panelists and 45 percent of our Southern California panelists on the sidelines recently, there is only a small overhang of space requiring absorption over the coming three years.



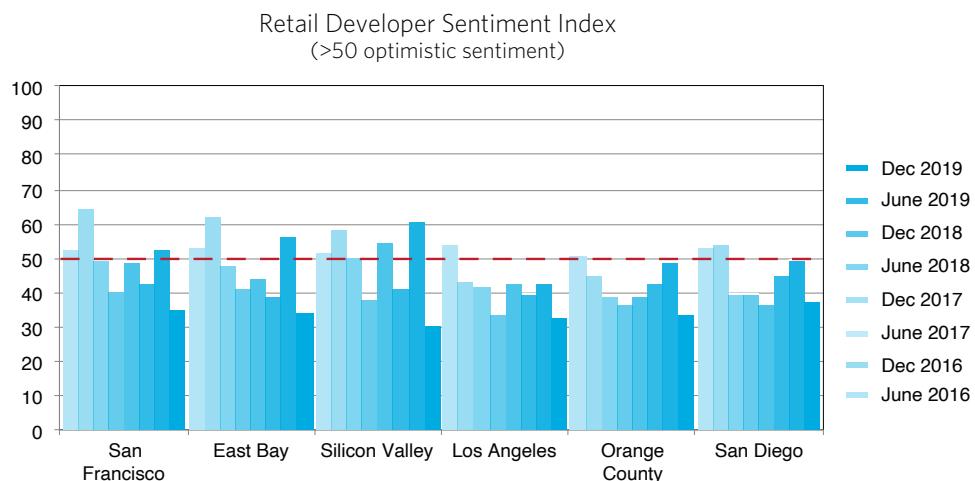
RETAIL SPACE MARKETS

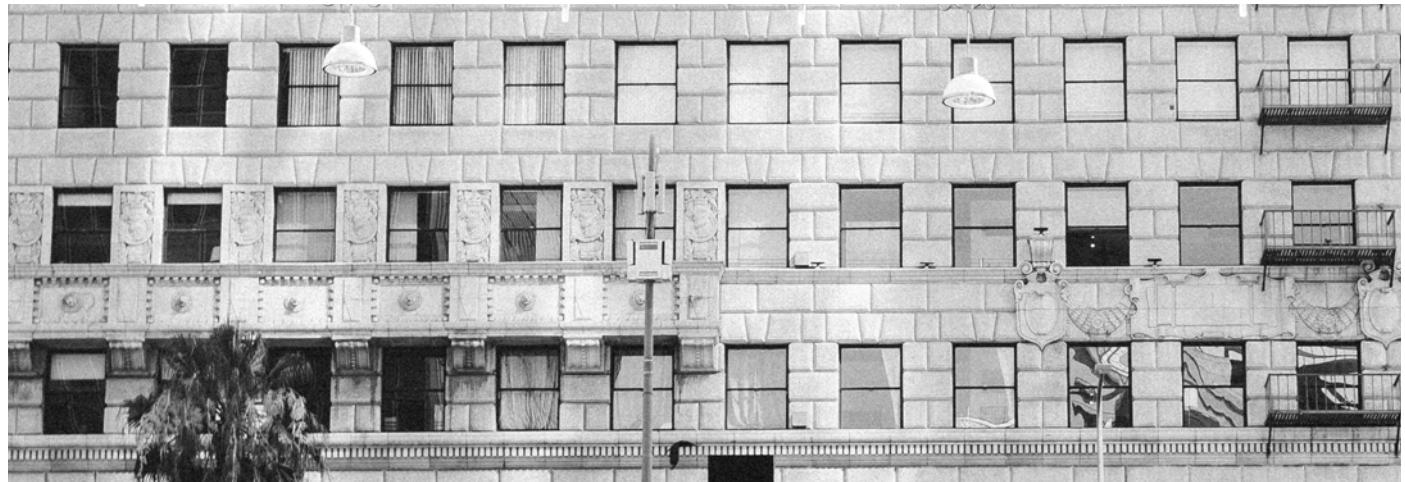
The previous Survey of retail markets throughout California showed some glimmer of optimism. Though one observation does not make a trend, one possibility was that the dearth of new retail construction over the past few years had left developers a bit more optimistic with regard to returns in this space. While it appears that our thoughts were correct as our panelists ended up with more new projects than they originally forecast, the uptick in sentiment was fleeting at best. The long-run trend in sentiment throughout the retail space has resumed its downward spiral, hitting the lowest values since we began surveying retail markets four years ago.

The pessimism with regard to retail space over the next three years has likely been fueled by the stronger-than-expected shift to online shopping and the weaker-than-expected start to the 2019 holiday shopping season, which was when this

Survey was taken. These factors have led investors to increase threshold rates for new project internal rates of return in their business plans for all markets surveyed in the State. Moreover, the weakness in the demand for the revitalization of existing retail space leads our panelists to predict that in each market, existing retail space will depreciate in value.

Overall, this is not good news for retail property markets, however, it does not mean the absence of solid targeted opportunities. Indeed, 55 percent of our Bay Area panelists began new retail development or re-development projects in the last year and 45 percent expect at least one new project this year. For the Southern California panelists, the numbers were similar, 53 percent and 40 percent respectively. Overall, the level of new retail property construction is expected to fall from today's levels through 2022.





"We have underperforming retail assets that are depressed and no longer serving their intended use for their developer or owner. And so what we're seeing is the conversion of these spaces into a better use."

- Ari Shaeps,
Partner,
Allen Matkins



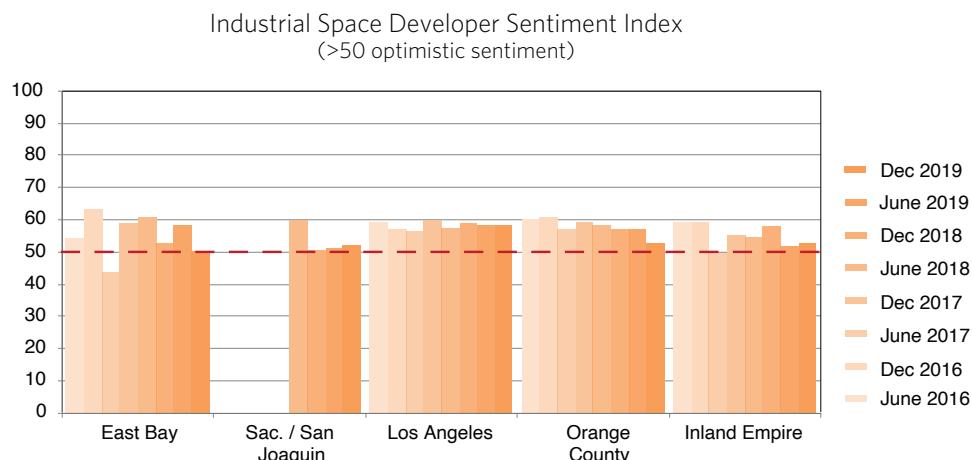


INDUSTRIAL SPACE MARKETS

Industrial markets continue to be where the action is in non-residential CRE development. As California began transforming from a factory economy to an information economy, this space has shifted to being dominated by warehouses. In spite of the impact of the trade dispute with China and the falling goods transport through the three largest California seaports and the two major international airports, the survey panelists do not foretell a pull-back in industrial space between now and 2022.

The developers' responses for the Inland Empire, East Bay, San Joaquin County, and Sacramento, were that markets will remain about the same as today: neither optimism about an improvement in, nor pessimism about a deterioration of the economics. This means the red-hot markets in Northern California and the Inland Empire will continue to be red-hot. Thus, there is really no change there.

However, Los Angeles, which is closer to the largest seaport complex in the Western Hemisphere and home to the second-largest population center in the country, is projected to remain on an ever-improving trajectory. This sentiment is based on a shortage of space close to the ports and a sense that the current downturn in goods movement is temporary. A more rapid expansion of space requires warehouse densification; multi-story edifices with productivity enhanced by robotics, and new technologies to manage the high-rise warehouses. These technologies are now in the process of development, and when implemented, will drive Los Angeles industrial property values. However, the timing of, and the introduction of the requisite new technology is very much up in the air and is not expected in the next few years.



MULTI-FAMILY HOUSING MARKETS

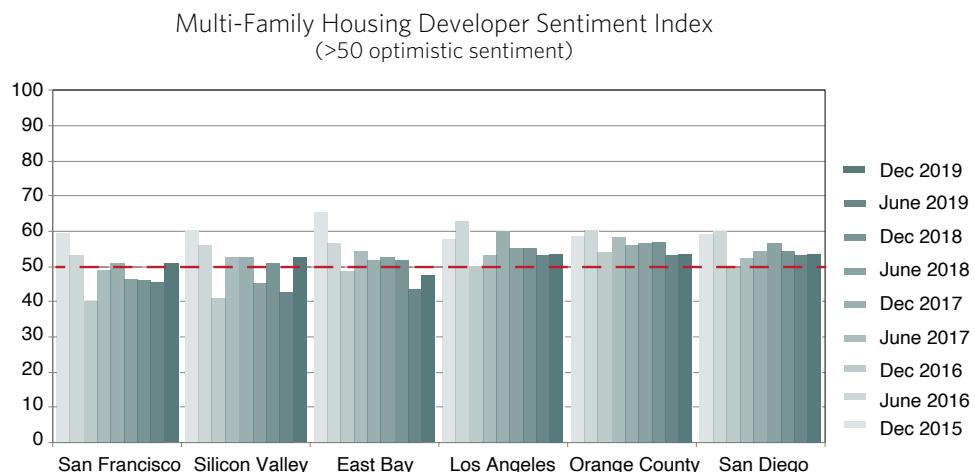
In 2018, permits for new multi-family housing projects declined sharply in the Bay Area and San Diego, and increased marginally in Los Angeles and Orange County. While the cause of this decline in new building is not known with accuracy, we surmise that the principal contributing factor was uncertainty in the overall housing market, characterized by falling home sales and little home price appreciation. Nevertheless, there remains significant demand as evidenced by rent increases in 2019, which is reflected in our panelists' view of multi-family housing going forward.

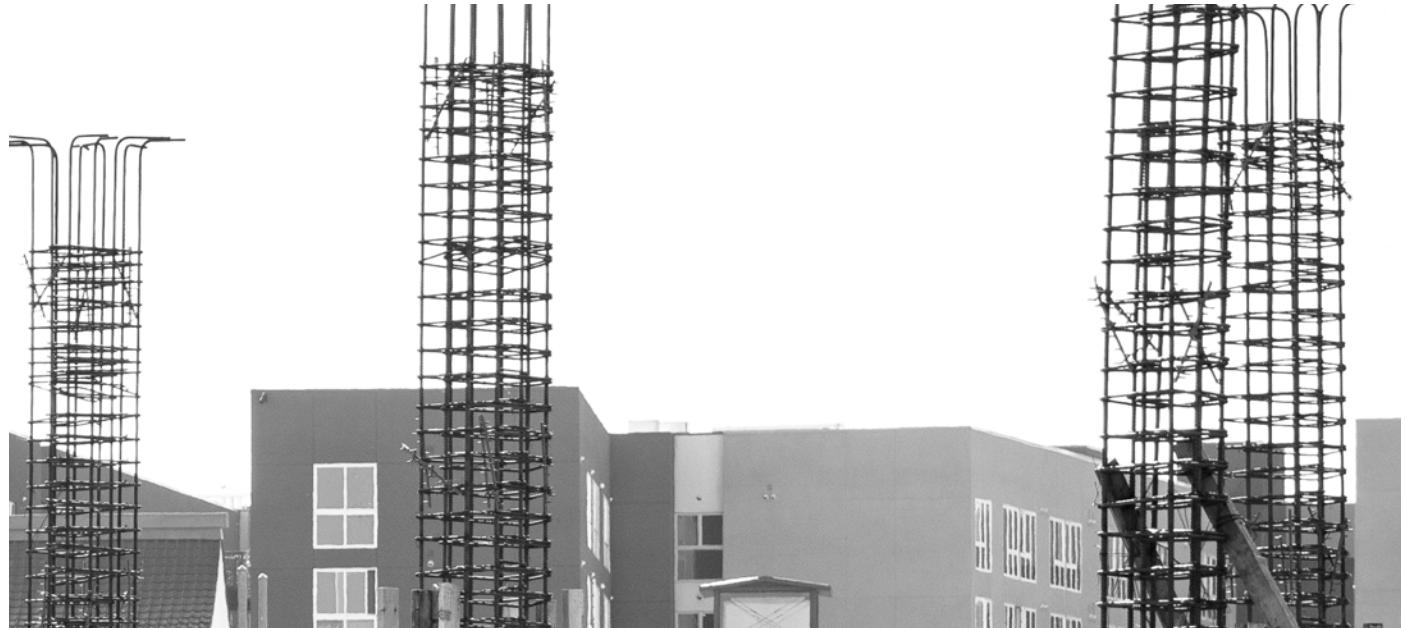
Once again, there were no big swings in multi-family developer expectations in any of the markets surveyed. The Southern California markets look to continue their building boom, while the Bay Area markets, now that rent control has more certainty to it with AB 1482, ought to see an increase in the amount of new multi-family construction.

In Los Angeles, Orange County, and San Diego, developers are close to being uniformly optimistic, as they have been since 2015. This has manifested itself in 60 percent of developers

beginning one or more new projects in the past year, and a similar percentage looking at beginning new projects in the coming 12 months. Moreover, interest rates have lowered and lending conditions are not changing in any significant way. The fly in the ointment is a lack of construction workers to build the homes. California's construction workforce has reached levels close to that experienced during the housing boom of 2004-2006.

For all three Bay Area markets - San Francisco, Silicon Valley, and the East Bay - developers think that 2022 will be marginally better than 2019. In the previous six months, Bay Area developers had pulled back on new development. This has turned around and now 60 percent of the developer panelists are planning to start at least one new project in the next 12 months. The extent to which the State rent control law eliminated uncertainty in the Bay Area is not known, but it clearly helped. As with Southern California, lower interest rates and current lending conditions are boosting returns to new construction.





"AB 1482 has given developers more clarity. They know what they can charge and they know what their returns will be. And that's allowed people to feel a lot more comfortable."

- Heather Riley,
Partner,
Allen Matkins



“The cash on cash returns shown in office investment continues to be an attractive place to put your money.”

- John Tipton,
Partner,
Allen Matkins

“Office is in great shape as evidenced by current deals, future deals, ground up development deals, the price per pound that people are buying assets for. I haven't seen any flattening or slowdown of that at all.”

- Tony Natsis,
Partner,
Allen Matkins

“The industrial market is insanely hot because of the changing economics of our time. With all the negative pressures on retail space right now, there is a lot of market demand for warehouse space in particular.”

- Rick Miltimore,
Partner,
Allen Matkins

“The office markets have been strong because there's been a lack of inventory going back to 2010 when development entirely stopped.”

- Elizabeth Wilgenburg,
Partner,
Allen Matkins

THE SURVEY IN PERSPECTIVE

"Even though most forecasters are looking at 2020 as a pause in the growth in this expansion, commercial real estate developers in California are seeing a growing market and improving market conditions."

- Jerry Nickelsburg,
Director & Senior Economist,
UCLA Anderson Forecast

The fiscal stimulus stemming from a tax overhaul and spending bill in Washington, D.C., at the beginning of 2018 has now run its course. The Allen Watkins/UCLA Anderson Forecast California CRE Survey did not pick up any potential impact on CRE development in California, and subsequent development activity has confirmed that prediction. That is not to say there was no significant activity. Office market development continued apace while industrial and multi-family development increased. With the slowing of economic growth in late 2019 and into 2020, we are expecting some abatement of this growth. However, the forecast for more solid economic growth in 2021 and 2022, the time when many property developments begun today will receive their certificates of occupancy, has kept our panelists optimistic about the status of the industrial and multi-family projects, and relatively neutral with respect to office markets going forward. In the coming years, the downward trend pertaining to retail space sentiment should manifest itself in the conversion of more marginal properties to other commercial and enterprise uses.



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Orange County
Inland Empire
San Diego
Sacramento
San Joaquin County
San Francisco
East Bay
Silicon Valley

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