BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

MARKET REPORT *Los Angeles Metro Area* 2H/20

Hard Hit by Health Crisis, Los Angeles County Enters Transitional Period for Commercial Real Estate; Attractiveness of Suburban Investment Grows

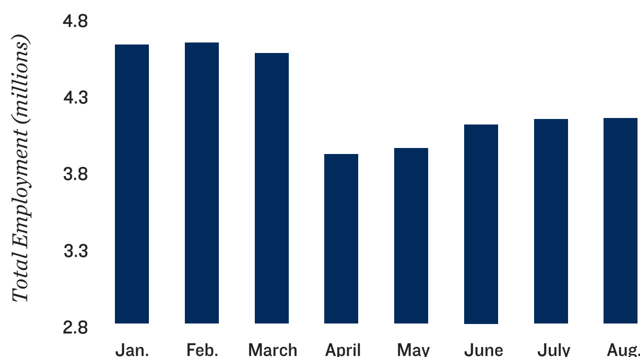
Span of strong commercial performance interrupted by wave of job losses. Shelter-in-place orders and nonessential business closures that extended through the second quarter had a profound impact on Los Angeles County's economy and commercial real estate sectors. During the three-month window, nearly 470,000 jobs were lost in the metro, raising the local unemployment rate to a national high of 19.4 percent in June. The leisure and hospitality, and retail trade sectors were hardest hit during this span, accounting for nearly half of the slashed positions. The number of traditional office jobs in the county also plummeted by nearly 120,000 in the second quarter. Together, the combination of prolonged stay-at-home mandates and widespread layoffs disrupted demand across property types, reversing recent vacancy and rent trends while also creating uncertainty surrounding the metro's sizable construction pipeline.

Development pipeline gauges demand across all sectors. The initial months of the health crisis coincided with an influx of new apartments as quarterly delivery volume reached a 20-year high. In other real estate segments, supply additions were historically below average on a quarterly basis, with retail and office deliveries sparse and industrial completions totaling less than 1 million square feet. This lull in development, however, is temporary and potentially the result of nonessential construction shutdowns recorded at the onset of the pandemic. Entering the second half of 2020, construction was underway on approximately 15 million square feet of retail, industrial or office space, with at least 19,000 rentals being built.

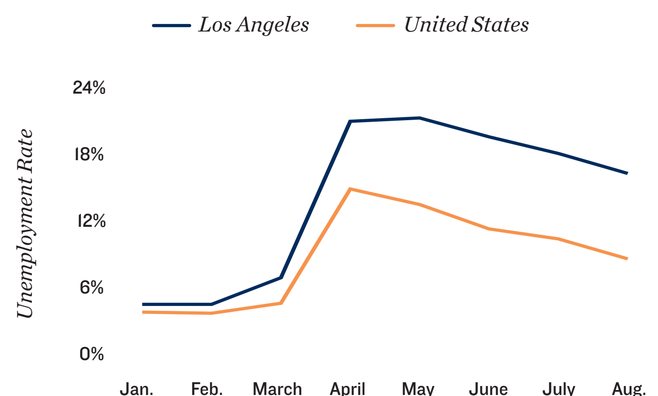
Quarterly vacancy fluctuations blur some sectors' outlooks. Vacancy rose across all Los Angeles' primary real estate segments on a quarterly basis. The retail sector recorded the least fluctuation; however, the impacts of indoor dining bans, store closures and shifting consumer behavior were yet to be fully realized during the second quarter. The metro's industrial market remains the nation's tightest among major markets, buoyed by dual ports and a sizable population. In contrast, the apartment and office sectors are in a state of transition. An influx of new rentals and temporary office closures combined with widespread job losses translated to vacancies in both segments rising above the U.S. average. As apartment deliveries continue and office tenants reevaluate their long-term space needs, demand will be further tested in both sectors.

Suburban investment supports deal flow. Economic volatility and the inability to physically tour properties motivated some investors to take a wait-and-see approach during the second quarter. As a result, sales activity across the metro's primary commercial real estate sectors slowed, with multifamily assets accounting for roughly half the transactions closed. Warehouse and medical office-related trades also supported deal flow, driven by investor demand for suburban properties. While more investors gain clarity on property performance and pricing in the second half, proposed statewide changes to commercial property assessments and apartment owners' abilities to raise rents may cause investors to pause until the outcomes of Propositions 15 and 21 are determined in November.

2020 Employment Trends

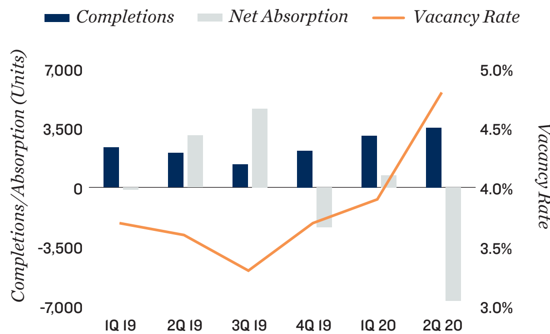


2020 Unemployment Rate Trends

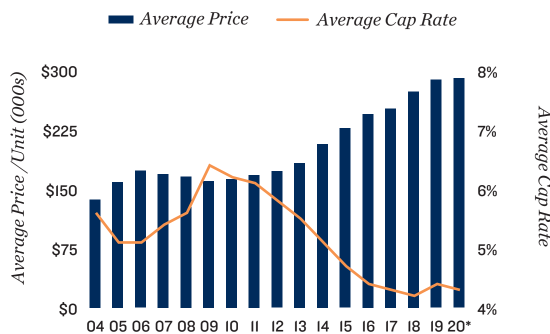


Source: BLS

Apartment Completions and Absorption



Apartment Price and Cap Rate Trends



** Through second quarter*

Sources: Real Page Inc.; CoStar Group, Inc.; Real Capital Analytics

APARTMENT

Wave of Apartment Deliveries Occurs Amid Health Crisis; Buyers Target Smaller Complexes Outside Metro Core

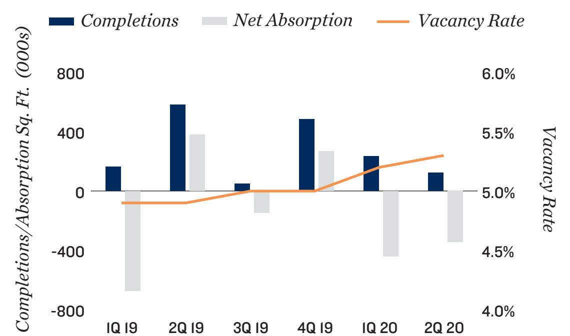
- For a second consecutive quarter, delivery volume in Los Angeles County exceeded 3,000 units. More than half of the 3,250 apartments completed from April to June were in Greater Downtown Los Angeles, led by the 679-unit Thea at Metropolis.
- An influx of new units and a wave of job losses lifted the number of available rentals in the county by 10,200 during the second quarter, increasing metro vacancy 90 basis points to 4.8 percent in June. Economic volatility notably impacted demand for luxury units, elevating Class A vacancy by 200 basis points on a quarterly basis.
- The recent reduction in leasing velocity lowered the average effective rent in both the Class A and B segments, with the Class C sector registering a nominal gain compared with the first quarter. These adjustments dropped the metro's average monthly rate 2.8 percent on a quarterly basis to $2,264 per month.
- During the past 12 months ending in June, average pricing in the county rose 3.4 percent to $290,000 per unit, while the average cap rate was unchanged at 4.3 percent. Transaction velocity during the second quarter was supported by closings in South Bay/Long Beach and Tri-Cities/San Fernando Valley. In both regions, acquisitions provided investors with high-3 to low-5 percent first-year returns.
- Smaller Class C complexes continue to trade despite economic uncertainty. Buyers seeking below-average pricing have been recently active in southeast Los Angeles.

RETAIL

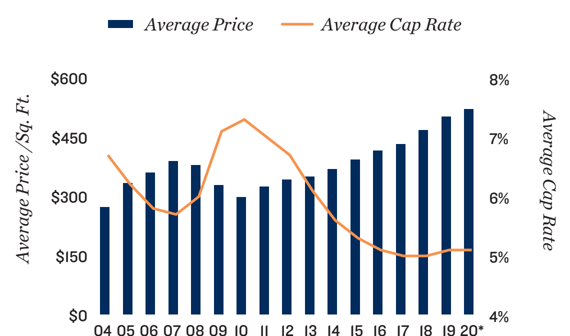
Sizable Shift in Vacancy and Asking Rent Delayed; Northern Submarkets, Redevelopment Garner Investor Attention

- Developers finalized 123,000 square feet of retail space during the second quarter, trailing the prior five-year quarterly average of 363,000 square feet. Over the past 12 months ending in June, less than 900,000 square feet of space was completed.
- Single- and multi-tenant vacancy both rose marginally during the second quarter, lifting overall vacancy in the metro 10 basis points to a six-year high of 5.3 percent.
- A lack of supply additions and a nominal shift in vacancy translated to a 0.2 percent uptick in average asking rent during the second quarter. At $32.14 per square foot, the average marketed rate in June was up 2.3 percent over the past year.
- Average retail pricing in Los Angeles County rose 7.4 percent on a trailing 12-month basis, reaching $519 per square foot in June. During the same yearlong span, the average cap rate increased 10 basis points to 5.1 percent. From April to June, most property sales fell in the $1 million to $5 million price tranche as buyers largely avoided midsize and larger shopping center acquisitions.
- Tri-Cities/San Fernando Valley and the city of Los Angeles were the primary submarkets for recent deal flow, with activity in the latter locale driven by tax-deferred 1031 exchanges. In both regions, investor demand for smaller mixed-use properties and restaurants appears strongest, with some of these assets purchased for their redevelopment potential.

Retail Completions and Absorption

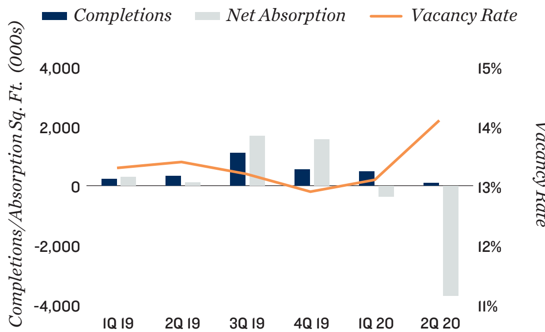


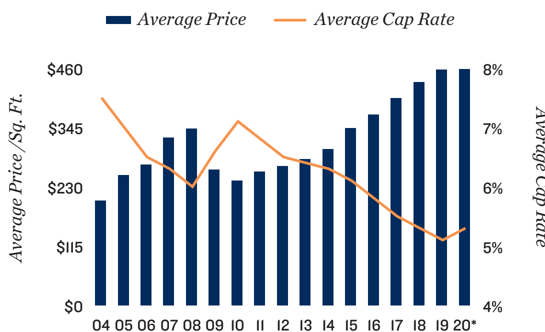
Retail Price and Cap Rate Trends



** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics





* Through second quarter

Sources: CoStar Group, Inc.; Real Capital Analytics

OFFICE

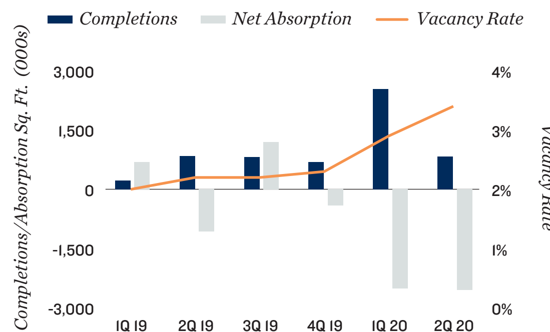
Tenants Reevaluate Future Office Needs, Lifting Vacancy; Medical Office Sales Account for Larger Slice of Deal Flow

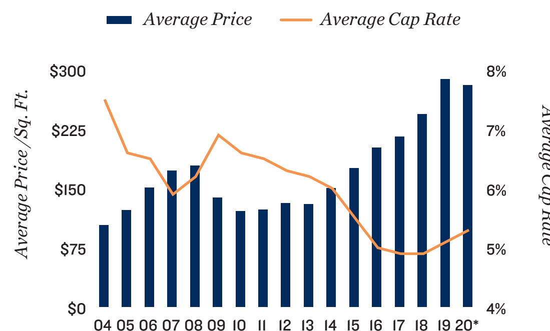
- After completing 2.1 million square feet of office space during the previous nine months, developers finalized less than 100,000 square feet in the second quarter.
- The metro's vacant stock rose by 3.8 million square feet in the second quarter, lifting vacancy 100 basis points to a three-year high of 14.1 percent. In both Westside Cities and Greater Downtown Los Angeles, the volume of available space increased by more than 1 million square feet during the three-month window.
- Despite a sharp quarterly increase in vacancy, the county's average asking rent adjusted minimally, inching up to $40.14 per square foot in June. A 1.0 percent uptick in the Class B/C marketed rate drove the slight improvement in overall asking rent.
- Average asset values in the office sector rose 3 percent to $458 per square foot over the past year ending in June. During the same 12-month span, the average cap rate climbed 10 basis points to 5.3 percent. Since 2018, the metro's average return has hovered in the low-5 percent range.
- Transactions involving low-rise medical office properties drove sales velocity from April to June, with deals most frequently closed in the San Gabriel Valley and Tri-Cities/San Fernando Valley region.

INDUSTRIAL

Los Angeles Remains Nation's Tightest Industrial Market; Close-In Suburbs Attract Buyers

- Following the finalization of nearly 2.6 million square feet of space in the first quarter of 2020, developers completed an additional 826,000 square feet from April to June. Deliveries were centered in the Santa Clarita and San Gabriel valleys.
- The county's vacant stock increased by nearly 8.4 million square feet from January to June, lifting vacancy 110 basis points to 3.4 percent.
- The average asking rent fell 2.7 percent during the second quarter, reaching $12.48 per square foot in June. In contrast to most submarkets, the average marketed rate in Santa Clarita Valley rose 2.5 percent, driven by recent supply additions.
- The average pricing in the metro rose 5.3 percent to $280 per square foot over the past 12 months ending in June, with most second quarter transactions closing below this asset value threshold. The average cap rate climbed 30 basis points to 5.3 percent during the past year.
- Buyer demand for closer-in suburban properties near major freeways supported overall sales activity during the second quarter. Deal flow was strongest in the San Fernando and San Gabriel valleys, where trades involving sub-20,000-square-foot warehouses translated to a compilation of $1 million to $5 million transactions.





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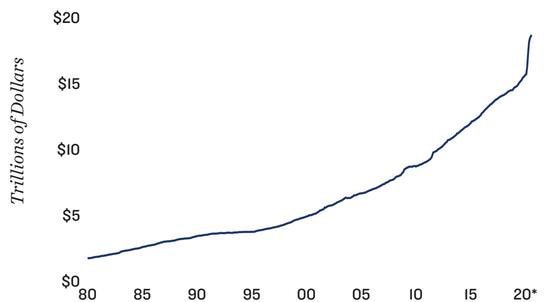
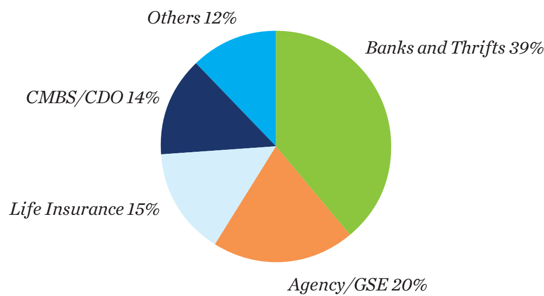
Sources: CoStar Group, Inc.; Real Capital Analytics

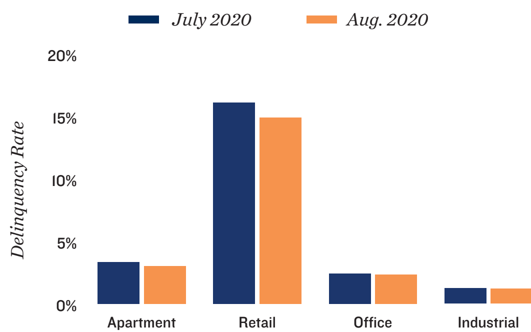
Fed Sharply Increases Money Supply During Health Crisis



Total Outstanding Mortgage Debt**



30+ Day CMBS Delinquency Rate



** Through August*

*** As of second quarter*

Sources: Federal Reserve; Mortgage Bankers Association; Trepp

CAPITAL MARKETS

By TONY SOLOMON, Senior Vice President, Marcus & Millichap Capital Corporation

- **The capital markets are thawing relative to the height of the crisis.** Most lenders have adapted to dispersed working, and more information on the economic damage of the pandemic is affording buyers, sellers, and lenders risk and price clarity for large swaths of the commercial real estate sector. Both property performance and location can impact financing as some areas of the country outperform and the pace of recovery remains in doubt for others. Capital is readily available for assets that perform on or near par with pre-crisis levels, especially industrial assets, which buyers and lenders see as a safe part of their portfolios. Single-tenant retail with national credit tenants are also heavily favored by lenders, followed by grocery-anchored multi-tenant properties. Apartment rent rolls are more heavily examined, though financing remains available from the agencies and banks. Loans are more readily accessible for suburban office, while core buildings are more difficult to leverage. Some lenders continue to operate in the hospitality space, but obtaining financing is challenging.
- **Loan-to-value ratios were already declining prior to the pandemic and average 60 percent.** Freddie Mac is offering rates in the high-2 percent to high-3 percent range for seven-year terms. Debt service coverage is approximately 1.35 times. Life insurance companies will finance below 3 percent for apartments in some cases, and peak at 4 percent for retail. CMBS loans are available, though strict criteria makes deals more difficult to find. Rates bottom in the low-3 percent range for apartment and industrial and rise to 4 percent for office.

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; Mortgage Bankers Association; Real Capital Analytics; RealPage, Inc.; Trepp

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