BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

MARKET REPORT *Riverside-San Bernardino Metro Area*

2H/20

Apartment and Industrial Sectors' Strength a Bright Spot During Volatile Second Quarter; Suburbanization Expectations Prompt Investment Activity

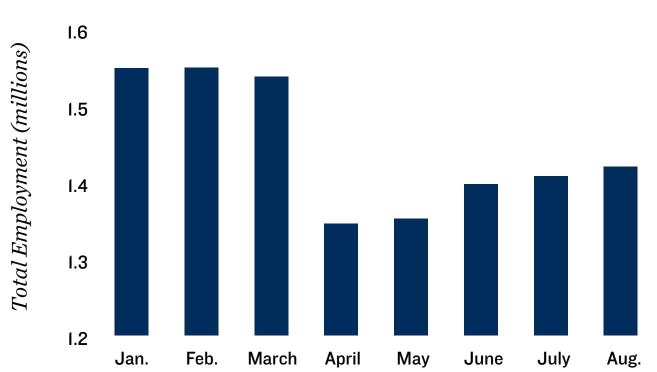
Potential household and business shift to lower-density areas could aid region's recovery. Following a stretch of population gains and commercial expansion, Riverside-San Bernardino's economic growth hit a roadblock during the second quarter. Nonessential business closures and a reduction in consumer spending translated to widespread job cuts across the leisure and hospitality; and trade, transportation, and utilities sectors, industries that accounted for nearly 40 percent of the region's pre-pandemic worker count. Still, the 141,000 total positions shed from April to June, and the coinciding 9.1 percent decline in employment base, ranked lowest among Southern California metros. This performance and the projected acceleration of household and business relocations to suburbs and areas of lower population density have the potential to hasten local economic resurgence and bolster demand for commercial real estate moving forward.

Dual sectors record positive absorption. Fueled by demand for lower-cost housing and the rapid growth of e-commerce, the apartment and industrial sectors noted declines in vacancy during the past three months ended in June. Both Class A and C apartment availability compressed, lowering the Inland Empire's overall rate 30 basis points below the prior five-year average. With less than 1,000 units slated for delivery before mid-2021, tight conditions are positioned to continue. Similarly, industrial vacancy sits near a record low, driven by the absorption of newly delivered space. However, unlike the rental sector, the industrial pipeline remains robust as 20 million-plus square feet is underway.

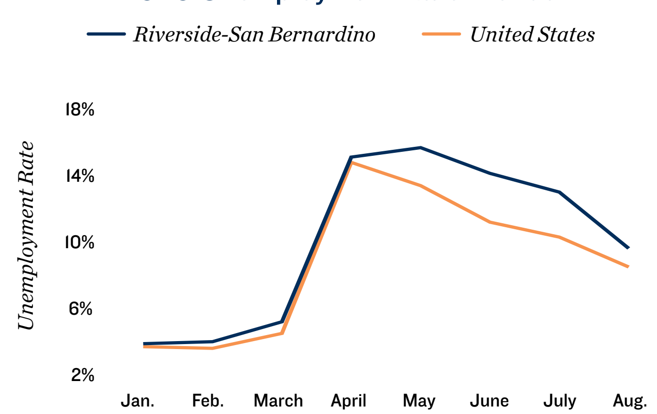
Lack of urban office inventory a potential boon. Home to a wealth of one- and two-story office properties in lower-density areas, Riverside-San Bernardino is positioned to benefit if demand for suburban space intensifies among organizations in the coming quarters. Office vacancy increased during the past three months ending in June, yet the region's rate remained down on a year-over-year basis and a minimal number of projects were under construction. The office sector's ability to maintain historically low vacancy moving forward has the potential to assist nearby dining establishments and shopping centers at a time when retail vacancy is higher than any other major U.S. metro.

Accelerated trends improve upside potential of certain assets. Amid a slowdown in overall deal flow during the second quarter, lower-tier rentals and well-located nonresidential properties built within the past 20 years continued to trade. Tight Class C apartment vacancy suggests room for future rent growth exists within the asset class, motivating buyers to acquire smaller complexes in the region's larger cities and outlying submarkets. Across other major commercial sectors, drugstore-anchored retail centers, warehouses and medical office buildings, assets with long-term demand drivers in place, were favored property types. While more investors gain clarity on property performance and market pricing in the second half, proposed statewide changes to commercial property assessments and apartment owners' abilities to increase 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



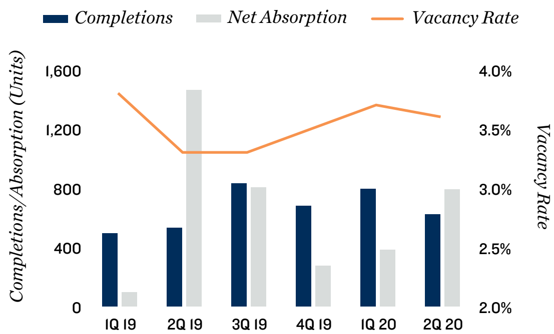
Source: BLS

APARTMENT

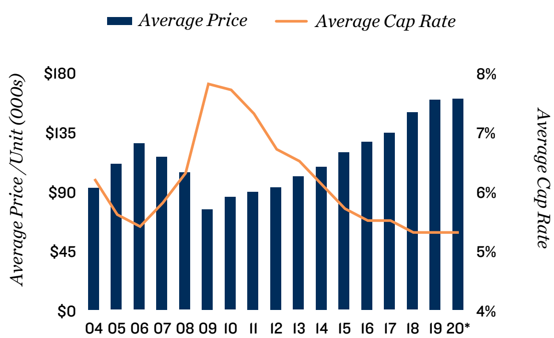
Class C Apartment Demand Reduces Overall Vacancy; Regionally High Yields Draw Buyers to Outlying Submarkets

- Developers finalized 620 units from April to June, exceeding the prior five-year quarterly average of 400 rentals. The 126-unit Alexan Kendry in Montclair highlighted the list of recent completions.
- On the net absorption of nearly 800 apartments, vacancy compressed 10 basis points to 3.6 percent during the second quarter, more than 100 basis points below the U.S. average. Strong demand for lower-cost rentals dropped Class C vacancy 70 basis points to 2.1 percent during the three-month window.
- The effective rent adjusted nominally across all classes of apartments in the second quarter, translating to a 0.3 percent dip in the region's average rate. At $1,588 per month in June, the Inland Empire's average effective rent is $400 to nearly $700 per month less than other Southern California metros.
- Average pricing rose 3.6 percent to nearly $160,000 per unit over the past year ending in June. Amid this increase, the average cap rate was unchanged in Riverside-San Bernardino at 5.3 percent.
- Opportunities to acquire Class C complexes at mid-5 to low-6 percent cap rates supported deal flow in outer portions of San Bernardino and Riverside counties, where vacancy trails the regional rate. In these locations, lower price points and rents below the U.S. average equate to upside potential for investors.

Apartment Completions and Absorption



Apartment Price and Cap Rate Trends



** Through second quarter*

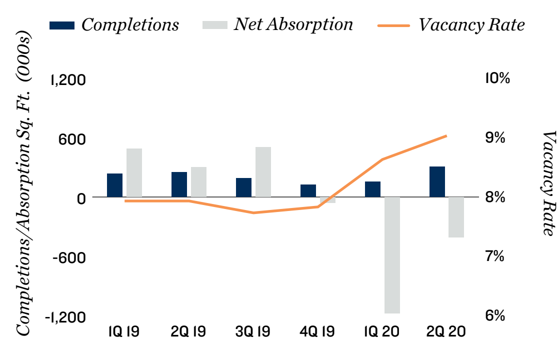
Sources: Real Page Inc.; CoStar Group, Inc.; Real Capital Analytics

RETAIL

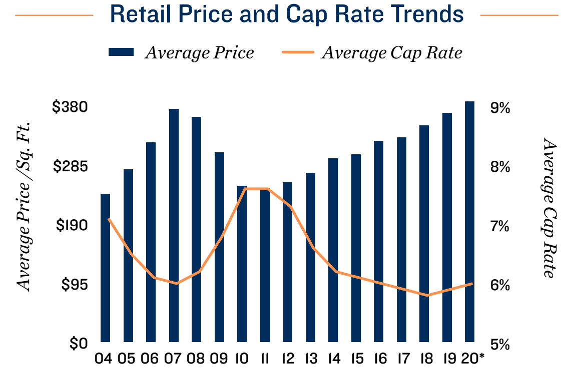
Vacancy Rate Climbs to Four-Year High Prior to Uptick in Retail Deliveries

- Supply additions during the second quarter totaled approximately 300,000 square feet of space, contributing to the 770,000 square feet finalized over the past 12 months ending in June. Entering the second half of 2020, construction was underway on at least 1.2 million square feet of space.
- The volume of vacant single and multi-tenant space both expanded by more than 300,000 square feet on a quarter-over-quarter basis, pushing the overall retail vacancy rate to 9.0 percent in June.
- The average asking rent fell 6.6 percent to $18.54 per square foot during the past three months ending in June, driven by an 8.9 percent decline in single-tenant marketed rent. In contrast, the multi-tenant sector registered a nominal gain of 0.7 percent, lifting the property type's average asking rate to $19.24 per square foot.
- Retail pricing elevated 8.0 percent to an average of $386 per square foot on a year-over-year basis ending in the second quarter. During the same 12-month span, the region's average cap rate rose 10 basis points to 6.0 percent.
- South Riverside County and San Bernardino notched the most sales in the second quarter, driven by $1 million to $3 million closings. Overall, drugstore-anchored assets with triple net leases in place accounted for most deals above $5 million.

Retail Completions and Absorption



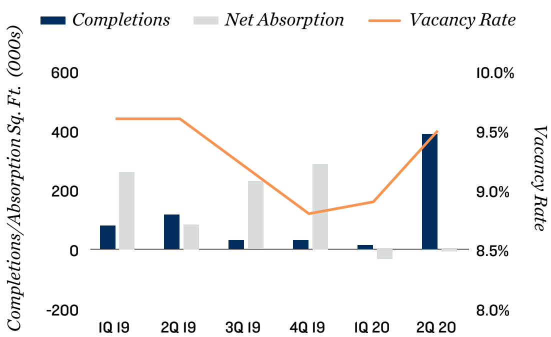
Retail Price and Cap Rate Trends



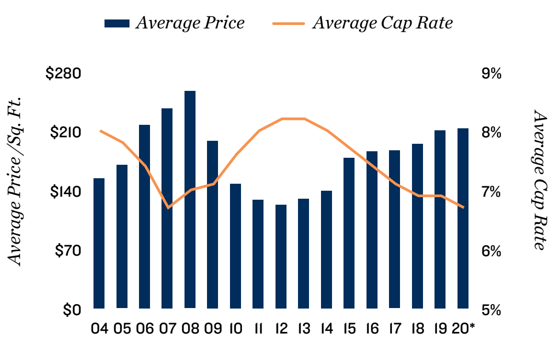
** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

Office Completions and Absorption



Office Price and Cap Rate Trends



** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

OFFICE

Preservation of Low Vacancy Benefits Marketed Rents and Asset Values, Bolsters Investor Confidence

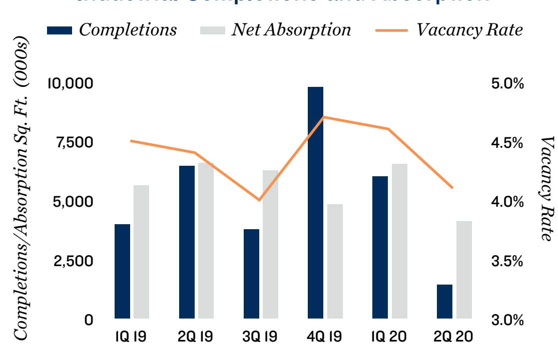
- Driven by two medical office projects in Beaumont and Moreno Valley, the Inland Empire's office inventory grew by 388,000 square feet from April to June, surpassing the volume of space finalized during the prior seven quarters.
- Despite recording a quarterly increase of 60 basis points, the region's vacancy rate dipped 10 basis points on a year-over-year basis, falling to 9.5 percent in June.
- Both Class A and B/C marketed rents rose by more than 2 percent on a quarter-over-quarter basis, lifting Riverside-San Bernardino's average asking rate 2.7 percent to $23.75 per square foot.
- Pricing for office properties rose 5.2 percent over the past 12 months ending in June. At $213 per square foot, the region's average asset value trails the previous high, which was recorded during 2008, by 17 percent. During the recent yearlong span, the average cap rate dipped 20 basis points to 6.7 percent.
- Riverside and San Bernardino counties recorded comparable deal flow during the second quarter, highlighted by sub-20,000-square-foot property trades that changed hands for $1 million to $5 million. Throughout the region, medical and traditional office assets traded at low-5 percent minimums from April to June.

INDUSTRIAL

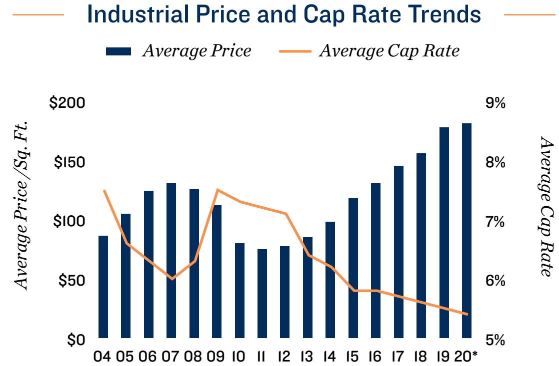
Health Crisis Highlights Strength of the Industrial Sector; Absorption Outpaces Supply Additions

- The region's industrial stock expanded by 21 million square feet over the past 12 months ending in June. However, just 1.4 million square feet was finalized during the second quarter, suggesting the shutdown of nonessential construction activity at the onset of the pandemic delayed projects in the final stages of development.
- From April to June, 4.1 million square feet of industrial space was absorbed in Riverside-San Bernardino, supporting a 50-basis-point drop in quarterly vacancy. At 4.1 percent, the region's vacancy rate is 140 basis points below the national average.
- The average asking rent in Inland Empire East and West, the submarkets with the largest industrial inventories, rose by 1.4 percent and 1.6 percent, respectively, on a quarterly basis. Yet, the region's average marketed rate dipped 0.2 percent during the same span to $9.01 per square foot.
- Industrial pricing over the past year ended in June rose 8.7 percent to $181 per square foot in Riverside-San Bernardino. During the same 12-month period the average cap rate lowered 20 basis points to 5.4 percent.
- The volume of warehouses that sold above the metro's average price point during the second quarter indicates investors remain confident in the long-term performance of properties near freeway intersections and Ontario International Airport.

Industrial Completions and Absorption



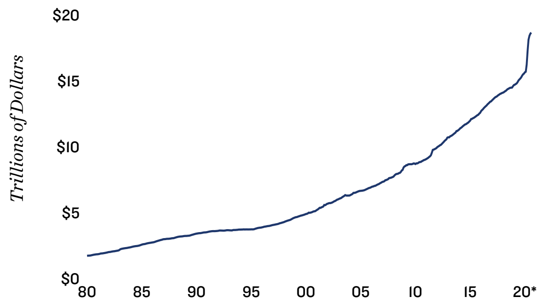
Industrial Price and Cap Rate Trends



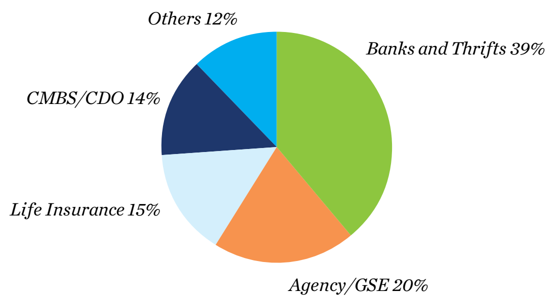
** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

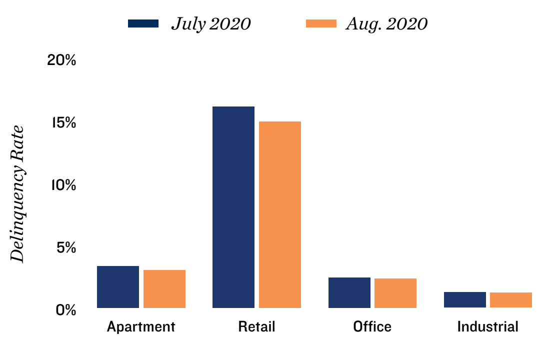
Fed Sharply Increases Money Supply During Health Crisis



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

Price: $250