BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

MARKET REPORT *Los Angeles Metro Area*

4Q/20

Hard Hit by Health Crisis, Los Angeles County Navigates Transitional Period for Commercial Real Estate; Metro's Standing as Regional Logistics Hub Preserves Industrial Deal Flow

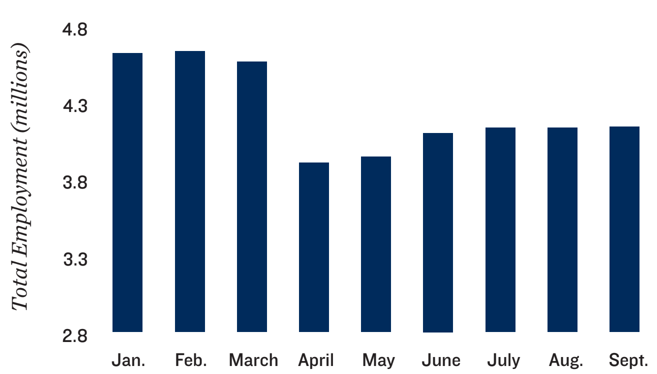
Span of strong commercial performance interrupted by wave of job losses and prolonged COVID-19 restrictions. Shelter-in-place orders and nonessential business closures that extended through the second quarter had a profound impact on Los Angeles County's economy. During March and April, nearly 727,000 jobs were shed, raising the local unemployment rate to a national high. While the county replenished 193,000 positions during the subsequent two months, the metro added just 40,000 jobs during the third quarter, with businesses' ability to bolster staffs hindered by capacity restrictions and subdued tourism. Stagnant employment growth during August and September and stringent reopening guidelines point to a longer economic recovery for the metro that will potentially disrupt demand across property types.

Pipeline remains robust. The initial months of the health crisis coincided with a wave of new apartments as delivery volume reached a 20-year high during the second quarter. In the subsequent three months, supply additions surpassed the 2019 quarterly average and another 17,000 units were underway. In other real estate segments, supply additions were below average from April to June, with retail and office deliveries sparse. The lull in development, however, was temporary and likely the result of nonessential construction shutdowns at the onset of the pandemic. During the third quarter, retail and office supply additions returned to more historical norms, with approximately 2.5 million square feet of retail and 4.3 million square feet of office space underway as of October.

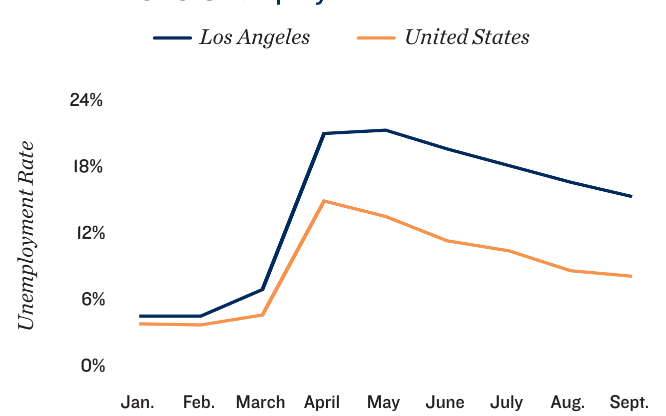
Availability fluctuations blur some sectors' outlooks. Vacancy rose across all of Los Angeles' major commercial segments from April to September. The retail sector recorded the least adjustment; however, the impacts of COVID-19 restrictions and store closures have yet to be fully realized. Amid a 50-basis-point vacancy increase, the metro's industrial market remains one of the tightest in the nation. In contrast, the apartment and office sectors are in a state of transition. An influx of new rentals and the county's inability to recapture many office jobs lost during the onset of the pandemic has pushed vacancies in both segments above the U.S. average. As apartment deliveries continue, office tenants reevaluate their long-term space needs, and eviction moratoriums are likely lifted in early 2021, demand will be further tested.

Accelerated trends maintain buyer demand for warehouses. Economic and pricing volatility motivated many investors to take a wait-and-see approach during the spring and summer months, dampening sales activity across most major commercial real estate segments. The industrial sector, however, has not been significantly impacted. Instead, buyers have consistently acquired smaller warehouses fit for last-mile distribution in Los Angeles County's industrial hubs in response to consumers' increasing reliance on e-commerce and the metro's regionally tight vacancy. With more investors gaining clarity on property performance and pricing, and voters rejecting Propositions 15 and 21, a return to more historical levels of sales activity is likely for other commercial sectors moving forward.

2020 Employment Trends

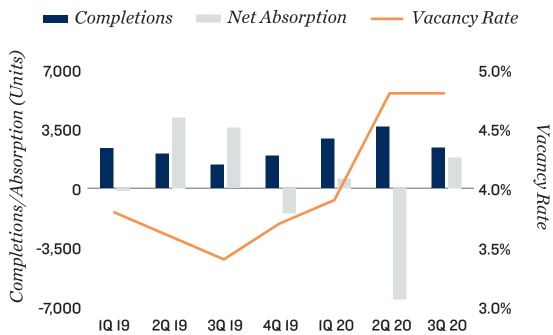


2020 Unemployment Rate Trends

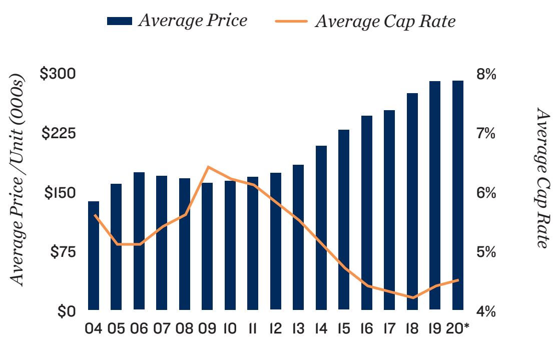


Source: BLS

Apartment Completions and Absorption



Apartment Price and Cap Rate Trends



* Through third quarter

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

APARTMENT

Influx of Supply Additions Persist Amid Health Crisis; Renter Demand for Low-Cost Units Fuels Class C Investment

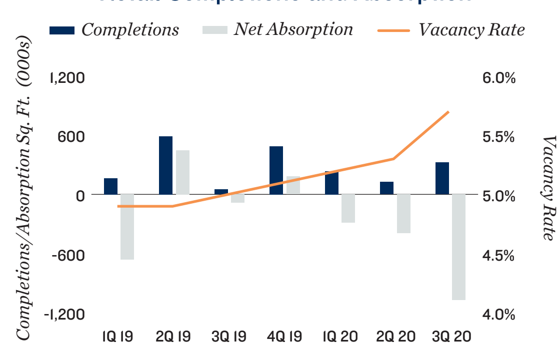
- Nearly 2,400 units were delivered in Los Angeles County during the third quarter, contributing to the 10,800 rentals finalized over the past 12 months. Greater Downtown Los Angeles and the San Fernando Valley each added more than 800 apartments from July to September.
- After recording vacancy increases across all apartment tiers during the second quarter, the metro registered net absorption of more than 1,800 units during the summer period, holding vacancy at 4.8 percent.
- An improvement in leasing velocity did not translate to positive rent growth. Instead, effective rent declined moderately in each rental segment, dropping the metro's average rate 1.7 percent on a quarterly basis to $2,229 per month.
- During the past 12 months ending in September, average pricing in the county rose 2 percent to roughly $289,00 per unit, while the average cap rate increased 20 basis points to 4.5 percent.
- Sales activity during the pandemic has been carried by sub-30-unit Class C trades in lower-priced submarkets and locales adjacent to Downtown Los Angeles. The lack of larger-scale Class A and B transactions during the third quarter suggests most institutional investors remained hesitant to resume acquisitions.

RETAIL

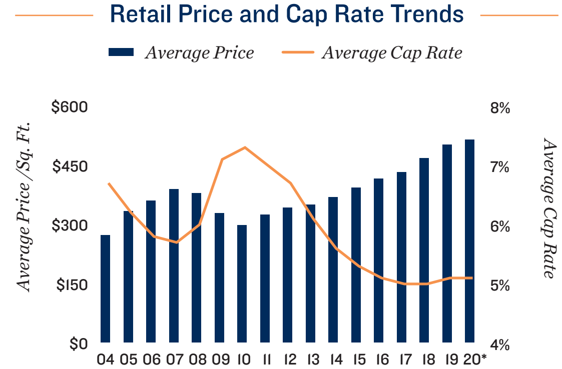
Retail Vacancy Reaches Seven-Year High; Repositionable Assets Garner Buyer Attention

- Developers finalized more than 320,000 square feet of retail space from July to September, exceeding the prior four-quarter average of nearly 225,000 square feet. During the first nine months of this year, retail deliveries were concentrated in the San Fernando Valley.
- Multi-tenant vacancy rose moderately during the third quarter, reaching 5.8 percent, while single-tenant availability increased 50 basis points. Overall, the county's vacant stock grew by 1.4 million square feet from July to September, lifting availability 40 basis points to a seven-year high of 5.7 percent.
- For a second consecutive quarter, the metro's average asking rent rose nominally. At $32.34 per square foot in September, the average marketed rate was up 1.7 percent over the past year.
- Average single-tenant pricing climbed 5 percent to $526 per square foot over the yearlong period ended in September while the mean cap rate was 5.3 percent. A 4 percent uptick raised multi-tenant pricing to an average of $505 per square foot during the same period as the mean first-year return fell to 5.0 percent.
- Since July, retail sales activity has improved, driven by multi-property transactions and trades involving vacant properties and assets positioned for redevelopment.

Retail Completions and Absorption



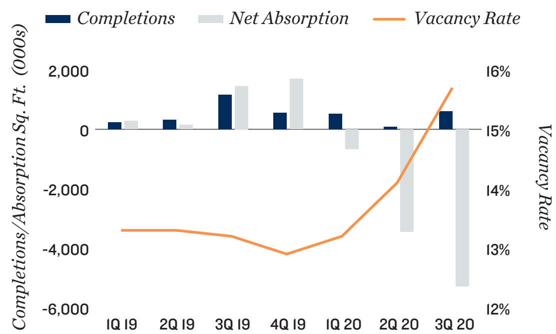
Retail Price and Cap Rate Trends



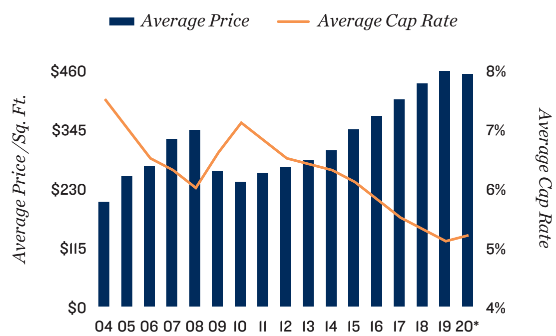
* Through third quarter

Sources: CoStar Group, Inc.; Real Capital Analytics

Office Completions and Absorption



Office Price and Cap Rate Trends



** Through third quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

OFFICE

Tenants Reevaluate Future Office Needs, Elevating Vacancy; Investors Focus on Medical Office and Tech-Heavy Locales

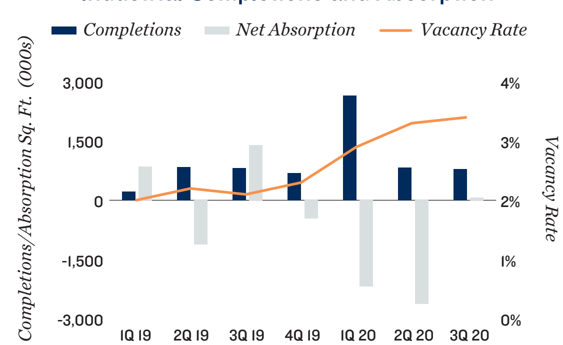
- After completing more than 1.1 million square feet of office space during the previous nine months, developers finalized 600,000 square feet in the third quarter. Roughly one-third of the space finalized over the past 12 months was in the San Fernando Valley.
- The metro's vacant stock rose by 5.9 million square feet from July to September, pushing vacancy up 160 basis points to a nine-year high of 15.7 percent. Availability in the central business district climbed 140 basis points to 18.2 percent during the three-month window and suburban vacancy lifted 150 basis points to 14.6 percent.
- Amid a sharp quarterly increase in vacancy, the county's average asking rent dropped 1.6 percent to $37.32 per square foot in September. The decline in marketed rates was most pronounced in the CBD, where the average rent fell 2.2 percent. The suburbs recorded a decrease of 1.3 percent.
- Average pricing was unchanged over the past 12 months holding at $451 per square foot in September. Similarly the average cap rate remained at 5.2 percent. Since 2018, the metro's average first-year return has hovered in the low-5 percent range.
- Transactions involving medical office buildings drove sales velocity during the initial months of the health crisis. Since, traditional office assets have traded more frequently, with deals concentrated in Mid-Wilshire and Westside Cities.

INDUSTRIAL

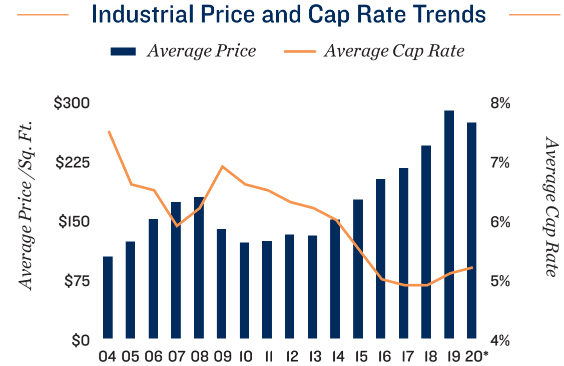
Los Angeles Remains West Coast's Tightest Industrial Market; Suburban Hubs Attract Buyers

- Following the finalization of more than 2.6 million square feet of space in the first quarter, developers completed an additional 1.6 million square feet from April to September. Deliveries were centered in the Santa Clarita Valley.
- Spanning the second and third quarters the county's vacant stock increased by 4.2 million square feet of space, lifting vacancy 50 basis points to 3.4 percent in September. During the same period, the average marketed rent fell 1.5 percent to $12.64 per square foot.
- Home to the metro's largest inventory of industrial space, South Bay recorded a 110-basis-point rise in availability during the six-month span, placing vacancy at 3.3 percent. Amid the uptick in for-lease space, the submarket's average asking rent decreased 3.0 percent to $13.79 per square foot.
- The average price per square foot over the past year ended in September declined 2 percent to $273. Trades of several lower-quality deals and a spattering of high-end properties, the metro's average trailing-12-month cap rate rose 20 basis points to 5.2 percent.
- Buyer demand for closer-in suburban assets near freeways continues to support overall sales activity. During the pandemic, deal flow has been consistent in South Bay and the San Fernando and San Gabriel Valleys, where sub-50,000-square-foot warehouses have accounted for the bulk of transactions.

Industrial Completions and Absorption



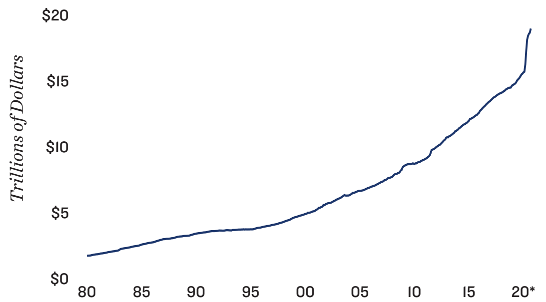
Industrial Price and Cap Rate Trends



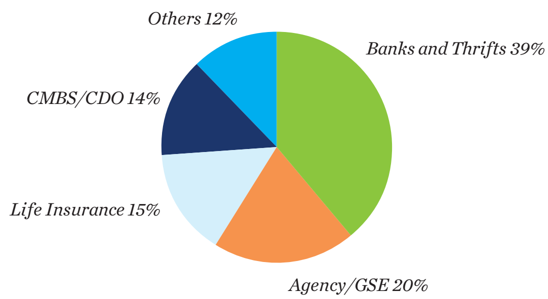
** Through third quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

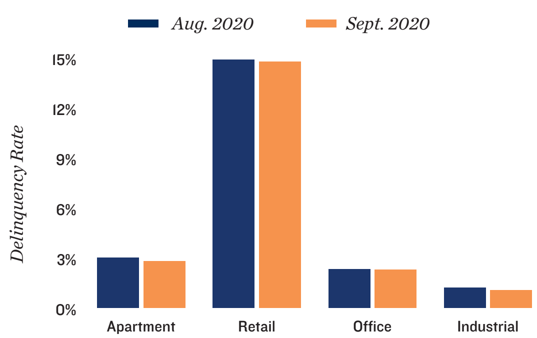
Fed Sharply Increases Money Supply During Health Crisis



Total Outstanding Mortgage Debt**



30+ Day CMBS Delinquency Rate



* Through September

** 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.** Most lenders have adapted to the health crisis, and more information on the economic damage of the pandemic is affording buyers, sellers, and lenders price clarity for large swaths of commercial real estate. 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 available for assets that perform at 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 collections are heavily examined, though financing remains available from the agencies. Loans are more readily accessible for suburban office, while core buildings require lower LTVs.
- **Record-low interest rates to encourage investment activity.** Freddie Mac and Fannie Mae are originating loans in the high-2 to low-3 percent range for gateway and secondary markets, while interest rates in smaller markets can reach the mid-3 percent band for well-capitalized buyers. Life insurance companies are offering rates in the 3 to 4 percent range with LTVs of 60 to 70 percent, though some premier properties have been able to achieve rates in the mid- to high-2 percent band. Most banks, credit unions and CMBS lenders are offering debt in the 3.25 to 4.25 percent range, and debt funds start slightly higher in the 3.5 to 4 percent territory. Stricter criteria for CMBS loans have limited options for many borrowers though. The Federal Reserve's commitment to keep the overnight rate near zero through 2023 should support historical low interest rates over the coming quarters, providing investors with compelling risk-adjusted returns in contrast with other asset classes.

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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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