Forecast 2021

Southern California

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While the world was dominated by the effects of the Covid-19 pandemic in 2020, the Southern California economy was not exempt from the havoc. Volatility and uncertainty were primary influencers for dealmakers for the majority of 2020 and will continue to weigh on decisions in 2021 and beyond. Some level of disruption in every aspect of the economy will likely be the defining feature of 2021. If anything is certain for the commercial real estate industry, it's that more time will be spent evaluating potential scenarios as experts struggle to anticipate reactions to new developments in the story of the pandemic.

The sheer size of the Southern California region means we could see elements of every type of impact possible within commercial real estate. With a population of more than 22 million, between Los Angeles, San Diego, Inland Empire, and Orange County; many challenges at the national level will be echoed at the regional level. Along the same lines, many

industry decisions trail blazed by California may reverberate through the national level. Uncertainty surrounding health and safety, supply chain issues, and lockdown measures, are more immediate concerns, but they will remain at the forefront well into 2021. Meanwhile, the longer-term disruptions involving global trade trends, business closures, relocations, city infrastructure, technology acceleration, cyber security, remote working and childcare, will be reshaped permanently and require years of adaptation.

While Southern California is well positioned to adapt, there will continue to be uncharacteristic market indicator figures to digest during this process. In a region that has been defined by tight vacancy rates and rents clocking in at record highs year-over-year for most property sectors, --managing expectations will become increasingly paramount. Long-term upward pressure on vacancy is expected to persist well into 2021, as flexible workspace and remote working influence decisions regarding lease renewals, asset investments, and new development. The volume of sublease space on the market is expected to continue to climb, as companies reevaluate their footprint. Rental rates have not been as negatively impacted in the region, and in-fact remain flat near record highs in many submarkets, however vacancy and construction deliveries will likely apply downward pressure on rents indefinitely. Meanwhile, unemployment claims have climbed to unprecedented levels in Southern California, and the state of California will continue to bear the weight of some of the highest unemployment rates in the nation due to its heavy exposure to retail, entertainment and tourism industries.

The region's high cost of living is encouraging further out-migration to other states, slowing population growth to levels encountered in other primary metropolitan markets. People may be moving out of state, or considering it more seriously, but the population is well beyond critical mass, and is not expected to be detrimentally impacted by outmigration. Ultimately, there are enough fundamental desirable qualities in the region to attract people who are prepared to take on the growing cost of living. Some businesses may leave for tax relief and cost benefits, but there will remain an abundance of businesses who can afford to be here, and in-fact can thrive only in a region of this magnitude and location. Southern California is a primary metropolitan area that can't be dismantled from its core market drivers. While jobs may be lost in the region, the established economic infrastructure, and potential for employment is rivaled only by other comparable markets. Post-pandemic, the opportunities for new jobs in this region will be more abundant than secondary and tertiary markets, particularly for workers in high tech industries, the retail sector and the gig-economy. As the region inevitably rebounds, this is where opportunities will be.

Office trends that existed in the region prior to the pandemic are in many cases being accelerated by the newly evolving demands in the market. High profile office landlords had already been spending more on trending amenities to retain top tenants and encourage economically resilient companies to touch down, and this is precisely the direction of thought that will be needed going forward as landlords aim to help tenants feel comfortable returning to offices mid-pandemic. However, the rise in sublease availabilities will shadow vacancy stats for some time to come. As some tenants begin to recognize the prudent cost savings that may be possible by continuing some degree of remote working over the long run, other tenants will opt to downsize out of immediate necessity for financial viability. Short term renewals will trend heavily as companies weigh these factors of space use through an updated lens of efficiency and effectiveness.

Trends watch

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Life science companies are on the bleeding edge of mid-pandemic growth, and Southern California is a standout market in this arena. San Diego is home to the third largest life science market in the nation, and leasing activity and venture capital funding have increased during the pandemic. Demand for R&D office space has contributed to the highest rents in the county and will continue to be a source of resilience for the economy, in a trend that existed well prior to the pandemic and will prove to grow in new directions long after. Los Angeles is also experiencing a surge in building conversions to accommodate the demand for life science space, while establishing itself as another national hub in the biotech sector.

Construction will continue to be strong for select sectors, specifically: industrial distribution centers, last-mile warehousing, cold storage, life science facilities, and affordable housing. Renovations of existing structures have already been picking up speed with these property types. Where previously there had been restricted maneuverability for expanding development, there is now a necessity to redevelop low performing spaces. There are emerging trends in property conversions of spaces sitting idle within retail centers. Medical office space requirements have also bolstered development, while nudging investors toward high-quality medical office buildings. While construction is progressing at a slower pace, projects that were underway before the pandemic will wrap up in 2021. New projects will face delays in the development stage due to permitting issues, materials costs, global trade disruptions, and intermittent labor shortages.

Trends watch

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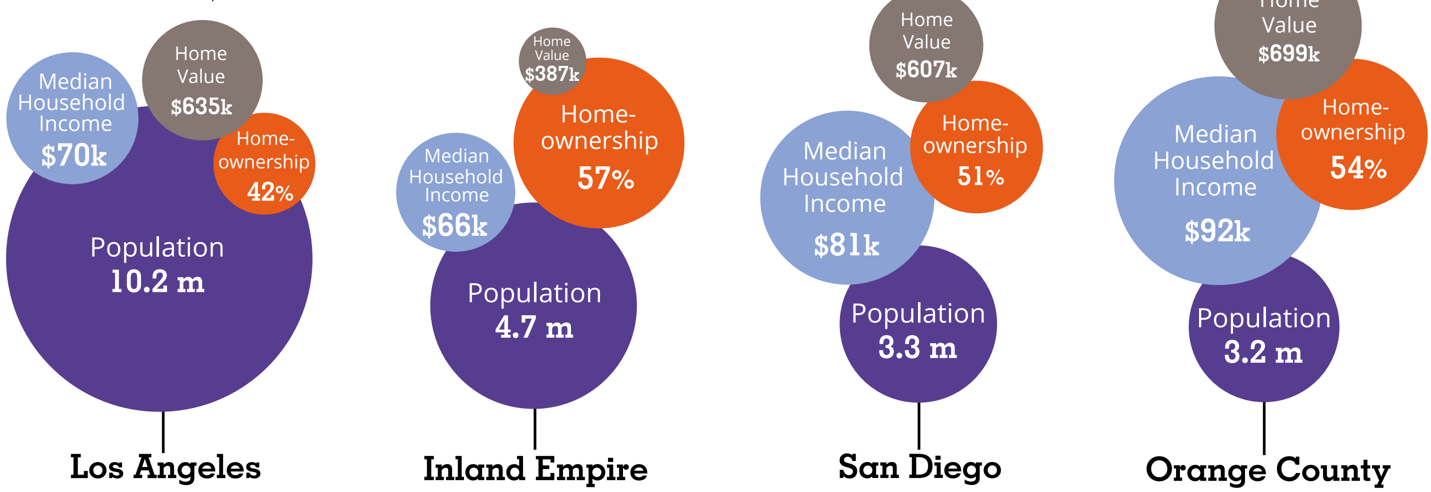
Southern California Demographic Data

Source: U.S. Census Bureau, Esri forecasts for 2020



Retail space, which has been decimated on many fronts, had already been trending toward alternative uses, and many shopping centers may ultimately become chameleons as existing space meets cyclical needs. Retail centers had already begun to embrace new strategies to capture foot traffic and captivate potential customers for longer stretches of time. Therefore, less traditional tenants like grocers, fitness centers, medical offices and service-oriented vendors had infiltrated many malls and shopping centers, aiming to transcend them to lifestyle focused gather hubs. These concepts will reemerge post-pandemic. Yet, in the meantime, conversions to last-mile warehouse space, storage and logistics centers may define the latest retail adaptation.

Industrial is one of the brightest spots in commercial real estate mid-pandemic, as e-commerce continues to drive the recovery. The Inland Empire is at the heart of warehousing and distribution requirements for the entire Southern California region, and is recognized as a vital logistics hub for the nation. Construction should persist at a steady pace, aiming to meet ongoing needs ranging from those of major retail fulfillment centers to last-mile distributors. Additionally, foreign investment from Europe and Asia will continue to be drawn to the premium industrial assets in this market. Meanwhile, last-mile warehousing needs are driving construction and renovations in Los Angeles, San Diego, and even Orange County, where older industrial had been converted to multifamily and office in years prior.

Multifamily properties across the region are on solid footing for a mid-pandemic rebound. Residential rental activity that slowed during the majority of 2020, kept rent pricing relatively flat throughout the region. With some migration from denser central business locations to the suburbs, support for pricing increases has been bolstered in the suburbs, while downward pressure has plagued downtown areas. As workers who have the ability to work remotely are flexing their options for now, demand in downtown areas will return in time with the pandemic's end. Meanwhile, tenants who are struggling to meet their rent obligations, while somewhat shielded by eviction moratoriums, will continue to loom as source of potential distress for smaller owners. However, for the overall sector,

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rent deferrals have yet to weigh significantly on property values in the region. Transaction opportunities in the aftermath of the pandemic are not expected to resemble the discounted transactions of the financial crisis of 2007-2009. Opportunities will be recognized in relation to the positive long-term recovery expectations of the Southern California market. Heated competition for single-family homes has been unassuaged from its fever pitch despite economic uncertainty, and this trend will continue to drive demand in the rental market. Homeownership rates in Los Angeles and San Diego counties are 42% and 51% respectively, and as a semblance of stability returns, institutionally managed properties will forge ahead with new rental rate highs, setting the pace for the market. Meanwhile the rental market in Inland Empire will continue to be strengthened by renters seeking affordable alternatives to the coastal markets.

The labor force will experience the most profound effects of all. While many are expecting human ingenuity and perseverance to bring forth an acceleration of technological innovations, there remains a certain level of excitement for the possibilities that will be born out of our darkest times. And, as the economy finds its way back afloat, there will be winners, head-and-shoulders above the rest. The acceleration of adopting new technology will bring about advancements that weren't expected for many more years. Technology may replace workers in some cases, or make it possible for workers to work remotely, and this is a factor that has contributed to the "K-shaped recovery." Where some jobs will be lost permanently, new jobs will arise in the service industry which may not pay as well. More gig economy opportunities have emerged, and the newfound convenience that it brings to those employing those services is not expected to disappear post-pandemic. Ultimately, a trend that has been gradually developing over the long term – that of a growing class divide – is becoming a starker reality and will require relief in the form of government stimulus or subsidies formulated in concert with domestic investment in the creation of new job opportunities.

The human toll of the pandemic, both in life and livelihood, will long serve as a reminder of what to prepare against as we build out new infrastructure. Affordable housing, warehouse distribution centers, medical facilities, and adaptable business spaces will be at the forefront of commercial real estate needs for years to come.

The role of **Advisors** has become just as necessary as it has challenging. The region is grappling with a reduction in sales and leasing activity overall, as expectations between buyers and sellers are misaligned, and concessions in lease transactions have become a matter of survivability for businesses. Deals have become immensely more complex; valuations are more time-consuming and debatable, while financing is also more challenging across the board. And, it is out of these slower more methodical transaction processes, that an increased need for thoughtful consultative services has emerged and will be a continued requirement into the future.

Get more market information

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