

# BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

## MARKET REPORT *Orange County Metro Area*

4Q/20

### Subdued Tourism Lengthens Metro's Road to Recovery; Future Supply Pressure Minimal in Most Submarkets

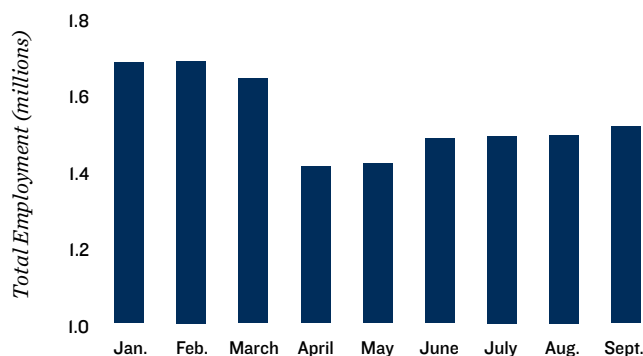
**Concentration of high-paying jobs buoys economy.** Heavily dependent on tourism and its sizable office-using sector, Orange County was significantly impacted by nonessential business closures at the onset of the health crisis. From March to April, nearly 275,000 positions were shed, including more than 100,000 leisure and hospitality jobs and 50,000 professionals in traditional office fields. Since, the two employment bases have been on different paths. From May to September, the office-using segment recaptured nearly half the positions lost during the pandemic's initial months. In contrast, the number of leisure and hospitality employees was unchanged from the second to third quarter, as the continued closures of Disneyland and Knott's Berry Farm translated to internal layoffs and handcuffed nearby businesses' ability to bolster staffs. With both parks unlikely to return to full operation until next summer, the sector is unlikely to record a near-term uptick in hiring as tourism will remain muted.

**Development subdued during health crisis.** Supply additions were historically sparse across most major commercial real estate sectors from April to September. The apartment industry registered less than 1,000 new units during the six-month period, after adding an average of 940 rentals during the prior 12 quarters. Retail and office completions were also minimal during the second and third quarters, totaling 20,000 square feet and 70,000 square feet, respectively. Still, the latter two sectors recorded notable increases in availability, while the slowdown in luxury rental deliveries enabled Class A absorption to outpace new supply.

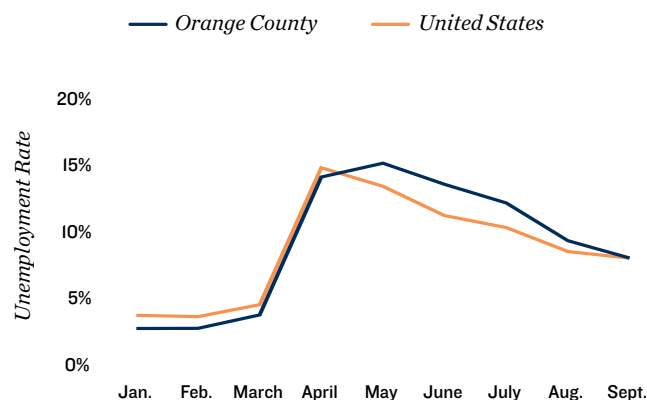
**Future supply additions concentrated in Airport Area.** Upcoming completions will be largely situated in Irvine and Costa Mesa, testing local demand for new space. Most of the market's active apartment and office pipelines — 1,900 units and nearly 1.4 million square feet of space — are in this area. Additionally, the metro's largest retail addition underway, a food hall element of The Press redevelopment project, is in Costa Mesa. Industrial construction is also ongoing in the submarket, with nearly 300,000 square feet slated for fourth quarter delivery. Elsewhere, most Orange County submarkets will not be impacted by new development in the next 12 months.

**Investors gravitate to smaller assets.** A mix of local and Los Angeles-based investors are targeting assets in built-out areas that lack active construction pipelines. Class C apartments in lower-cost submarkets and beach cities have traded most frequently during the health crisis as room for future rent growth and consistent demand for coastal living has sustained buyers' confidence in these assets' long-term performance. Tight industrial vacancy has investors acquiring warehouses near major interstates, while retail and office deal flow is being supported by smaller strip center and low-rise building trades. Entering the final months of 2020, more investors have gained clarity on property performance and pricing. Greater confidence in future market conditions and voters' recent rejection of Propositions 15 and 21 have the potential to further bolster investors' pursuit of the aforementioned property types moving forward.

#### 2020 Employment Trends



#### 2020 Unemployment Rate Trends

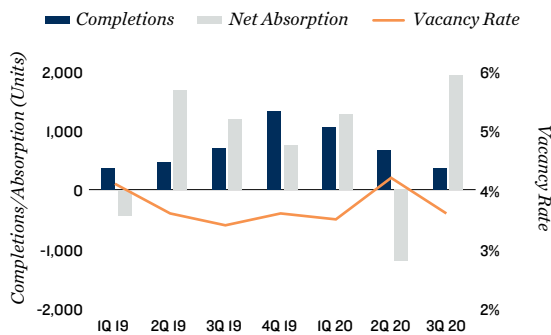


## APARTMENT

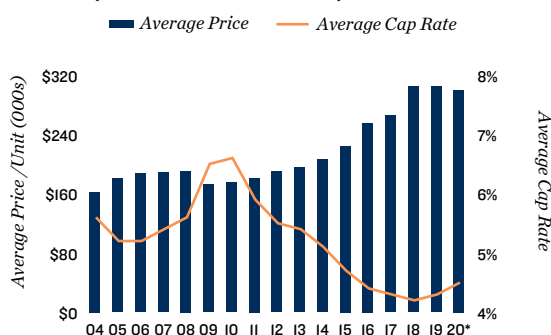
### Pent-Up Demand Reduces Availability Across All Rental Tiers; Buyers Target Low-Cost Units in Larger Cities

- Developers finalized 360 units from July to September after completing more than 3,000 units during the prior three quarters. Los Olivos III, an 845-unit property in Irvine, accounts for one-third of the metro's active construction pipeline.
- Apartment availability decreased 60 basis points to 3.6 percent in the third quarter, nearly offsetting the 70-basis-point uptick registered during the prior three months. From July to September, vacancy compression was recorded across all rental tiers, led by the Class A sector, which noted a decline of 80 basis points.
- The metro's average effective rate rose nominally on a quarterly basis to \$2,111 per month, as Class A rent was unchanged at \$2,346 per month and the Class B sector notched an uptick of 0.8 percent.
- With an average sales price of roughly \$300,000 per unit over the past year ending in September, Orange County remains the highest-cost metro for apartment investment in Southern California. During the same 12-month span, the market's average cap rate rose 30 basis points to 4.5 percent.
- Most transactions registered during the second and third quarters involved sub-40-unit Class B and C complexes in Anaheim, Santa Ana and beach cities. Minimum returns for these pre-1980s-built assets hovered in the low-3 percent band.

#### Apartment Completions and Absorption



#### Apartment Price and Cap Rate Trends



\* Through third quarter

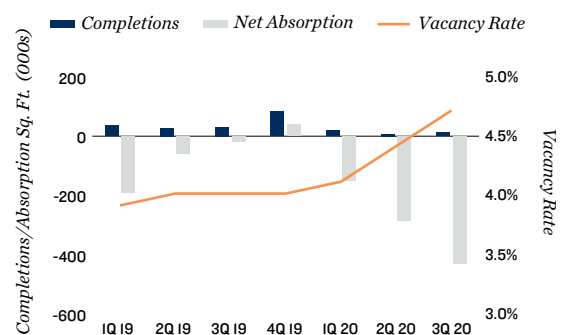
Sources: Real Page Inc.; CoStar Group, Inc.; Real Capital Analytics

## RETAIL

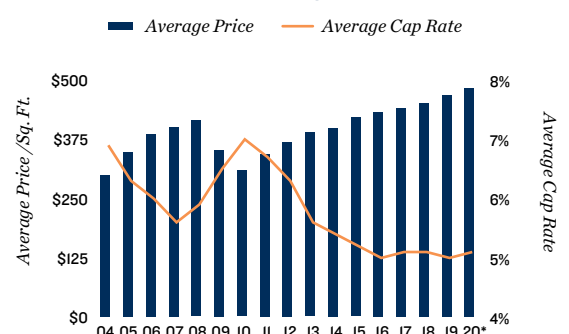
### Rising Vacancy Warrants Sparse Construction; Investors Cautious as Span of Subdued Tourism Positioned to Extend

- Builders completed 39,000 square feet of space during the first nine months of 2020, extending a streak of subdued development that began in late 2018. Entering the fourth quarter construction was underway on nearly 135,000 square feet.
- For a second consecutive quarter a 30-basis-point increase in retail availability was recorded as the volume of vacant single-tenant and multi-tenant space grew by 245,000 square feet and 200,000 square feet, respectively, from July to September. At 4.7 percent, Orange County's overall vacancy rate is 70 basis points above its prior five-year average.
- Single- and multi-tenant asking rents declined by more than 3 percent in the third quarter, slashing the overall marketed rate 3.2 percent to \$28.36 per square foot.
- The average single-tenant sales price rose 7 percent to \$511 per square foot over the past year ended in September, lowering the average cap rate 20 basis points to 4.9 percent. Multi-tenant pricing increased 1 percent to an average of \$451 per square foot as the mean first-year return reached a seven-year high of 5.2 percent.
- Smaller strip and neighborhood centers along major thoroughfares supported sales activity during the spring and summer months; however, several super-regional malls slated for redevelopment have also traded during the health crisis.

#### Retail Completions and Absorption



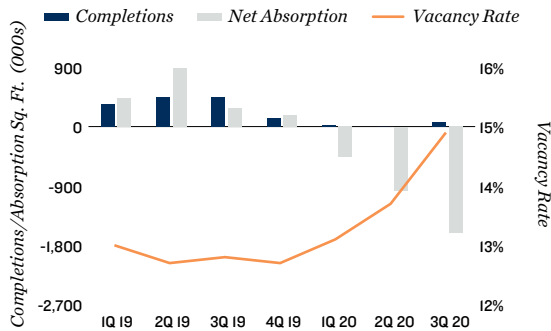
#### Retail Price and Cap Rate Trends



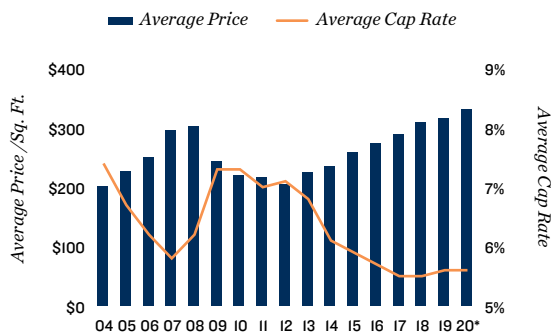
\* Through third quarter

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

## Large Corporate Tenant Base Heightens Airport Area's Exposure to Shifting Office Landscape

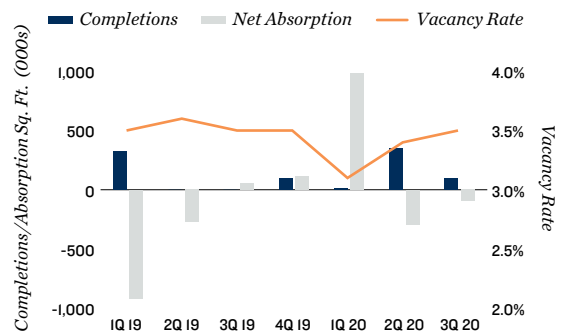
- Roughly 100,000 square feet was delivered during the first nine months of 2020, a decline from the more than 1.2 million square feet completed during the same period last year. Entering September, construction was underway on nearly 1.4 million square feet of space, all of which is in Irvine, Tustin and Costa Mesa.
- Driven by a 190-basis-point uptick in Class A availability, the metro's vacancy climbed 120 basis points during the third quarter to 14.9 percent, the highest rate since 2014. Home to half of Orange County's Class A inventory, the Airport Area recorded a 150-basis-point spike in overall vacancy from July to September.
- An increase in higher-quality space available for lease did not elevate asking rent. Instead, the metro's average marketed rate fell 2.3 percent during the third quarter. At \$29.52 per square foot in September, the metro's asking rate is down 1.0 percent on a year-over-year basis.
- Orange County's average sale price climbed 5 percent to \$331 per square foot over the past year ended in September, while the average cap rate held at 5.6 percent.
- Since the second quarter, Class B property transactions in the central and southern portions of the county have carried deal flow. Most of these buildings are 1980s- to post-2000-built assets with less than five tenants. Additionally, two larger Class A properties in Irvine Spectrum sold during September buoying overall sales volume.

# INDUSTRIAL

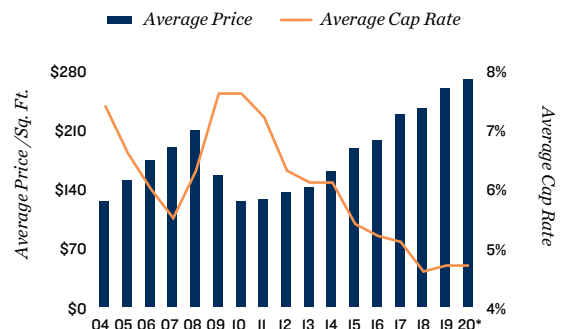
## Metro Ranks Among Nation's Tightest Industrial Markets; Buyers Bullish on Demand for Smaller Warehouses

- Completions in the third quarter increased the metro's industrial inventory by less than 100,000 square feet. An expansion of Edwards Lifesciences' headquarters in Irvine accounts for 60 percent of Orange County's active construction pipeline.
- After rising 30 basis points during the second quarter, vacancy rose 10 basis points from July to September, reaching 3.5 percent. Accounting for roughly 45 percent of the metro's industrial stock, the North County submarket recorded compression of 40 basis points in the third quarter, reducing availability to 2.3 percent.
- Orange County's marketed rate dipped slightly to \$12.21 per square foot during the third quarter, as asking rent adjusted by less than 2 percent across all submarkets. Nevertheless, the metro's average rent is up 3.7 percent on a year-over-year basis.
- The average sale price lifted 7 percent to \$269 per square foot over the past year ended in September. During the same span, the metro's mean cap rate of 4.7 percent ranked lowest among Southern California markets.
- One-off transactions involving pre-1990s-built warehouses in larger cities and locales near the Los Angeles County line have supported deal flow throughout the health crisis. Comprising less than 50,000 square feet, these Class B and C assets have closed in the \$2 million to \$10 million range.

## Industrial Completions and Absorption



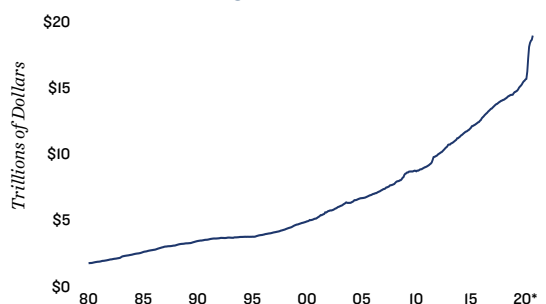
## Industrial Price and Cap Rate Trends



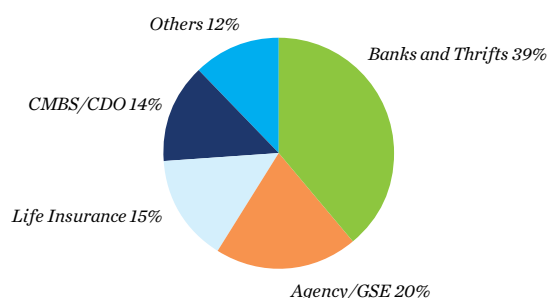
\* Through third quarter

Sources: CoStar Group, Inc.; Real Capital Analytics

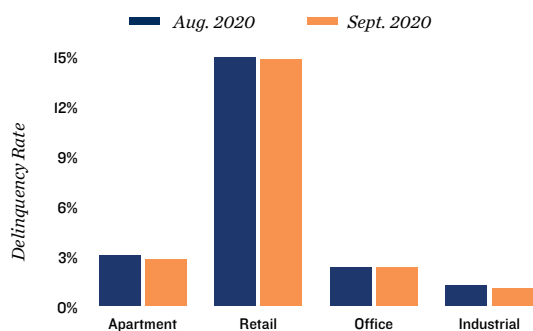
### Fed Sharply Increases Money Supply During Health Crisis



### Total Outstanding Mortgage Debt\*\*



### 30+ Day CMBS Delinquency Rate



\* Through September

\*\* As of second quarter

Sources: Federal Reserve; Mortgage Bankers Association; Trepp

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## CAPITAL MARKETS

By **TONY SOLOMON**, Senior Vice President,  
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- **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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