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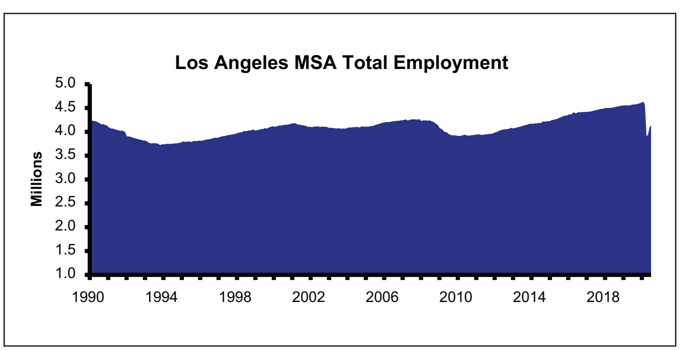
Office Market Close-up: Los Angeles MSA

Overview and Economy. The COVID-19 shutdown created an economic shock that brought the U.S. economy into a severe recession. The Los Angeles MSA economy was similarly at exceptional strength prior to the shutdown. Then overnight, restaurants, commercial buildings, public transportation, schools, retail establishments, hotels, etc. were shuttered.

The Los Angeles MSA is the second largest in the U.S. and home to nearly thirteen million residents. Its top employment sectors are education and health services (18%); trade, transportation, and utilities (18%); professional and business services (16%); government (13%); and leisure and hospitality (10%) The MSA's top private employers include: Kaiser Permanente (37,400 employees), Northrop Grumman Corp. (16,600 employees), Target Corp. (15,000 employees), Cedars-Sinai Medical Center (14,900 employees), and Ralphs/Food 4 Less (Kroger Co.) (14,900 employees).

The MSA office market has a total inventory of 204 million square feet in eight submarkets. The Downtown CBD submarket accounts for 27.7 million square feet in seven submarkets, while the Los Angeles Downtown Non-CBD submarket accounts for 10.7 million square feet. The balance and vast majority of office space in the LA MSA is in the outer submarkets (Mid-Wilshire, LA West, LA North, LA, South, Tri-Cities, and San Gabriel Valley) In the second quarter of 2020, Cushman and Wakefield reported troubling MSA vacancy rates of 20.5% for the Downtown CBD and 23.8% in the Downtown Non-CBD, while the outer submarkets averaged 12.5%, resulting in an overall metro area vacancy rate of 14.9%. The average metro area real asking rent was $42.24 per square foot in the second quarter of 2020, while the downtown CBD and non-CBD markets averaged $44.52 and $43.80, respectively. In comparison, the U.S. office market saw an average vacancy rate and asking rent of 13.7% and $34.03 per square foot, respectively.



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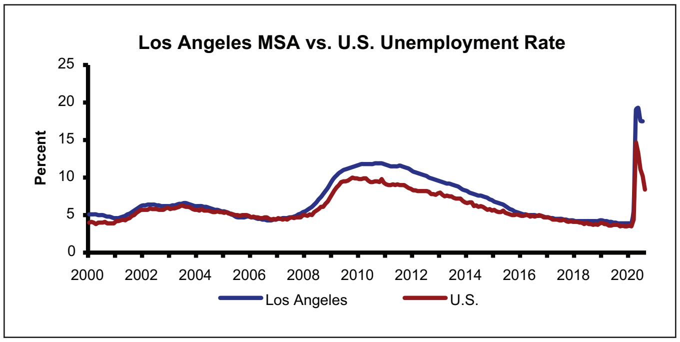
In previous issues, we have discussed a covariance analysis that was first published in the *Spring 2007 Wharton Real Estate Review* and is updated regularly in this publication. This analysis examines how various economic indicators behave in individual metropolitan areas based on national economic changes. Specifically, for each MSA, we estimate a statistical equation, which summarizes how a 100-basis point change in national employment affects local employment. The equation consists of a constant ("alpha") for each market and a "beta," which is a multiplier applied to the national percent change in employment. The alpha indicates MSA growth that is independent of national growth. If there is no national job growth, then the alpha is the expected annual change in MSA employment. The beta for the U.S. as a whole is defined as one. An MSA with a beta of one registers (on average) an increase of 100 bps in employment growth (plus its alpha) when national employment rises by 100 bps. A beta that is less than one indicates that the MSA does not boom (or bust) to as great an extent as the national economy, while a beta of greater than one indicates that such an MSA experiences swings of greater magnitude (around its trend) than percentage changes at the national level.

With an employment beta of 1.09, Los Angeles' employment base is 9% more volatile than national employment growth. The MSA's alpha of -0.68 indicates that when U.S. employment growth is zero, the MSA experiences job growth of -0.68% per year. The MSA's break-even point for U.S. job growth is 0.63, meaning that as long as U.S. job growth is 0.63% or greater, the MSA's job growth is positive. The MSA's R-squared statistic of 0.63 indicates that the forecasting model for Los Angeles explains future job growth with a solid 63% "fit."

Our model projected that Los Angeles's employment would decline by 8.2% during the recession, given the 6.3% national job loss. In actuality, during the Financial Crisis, the Los Angeles MSA lost 356,000 jobs (8.4%) from its August 2008 peak. During the recovery, U.S. employment grew by 17.6% from the bottom through February 2020, while the employment in the MSA increased by 18.4% from the bottom, well above our prediction of 11.5%. From the shutdown low in April, through August 2020, the nation's job base increased by 7.1%, implying an expected MSA rise of 7.6%. In actuality, the MSA gained 235,000 jobs

(6%) from its shutdown low, through July and 502,000 jobs since the recessionary low.

The MSA unemployment rate bottomed at 3.2% in February 2020 after peaking at 11.8% in August 2010, 190 bps higher than the national rate at that time. It officially increased to 19.3% in May due to the shutdown but moderated to 17.5% as of July 2020 (latest available). The U.S. unemployment rate was 3.5% in in February 2020 after hitting 10% in 2009. It officially stood at 10.2% in July and 8.4% in August after spiking to 14.7% in April. As discussed in detail in the fall 2020 issue of The Linneman Letter, actual unemployment rates are much higher than the reported rates.



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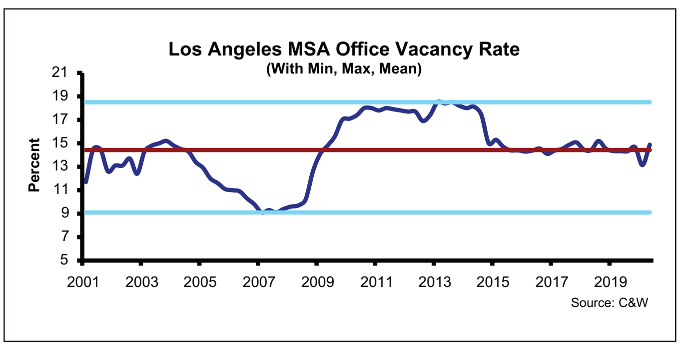

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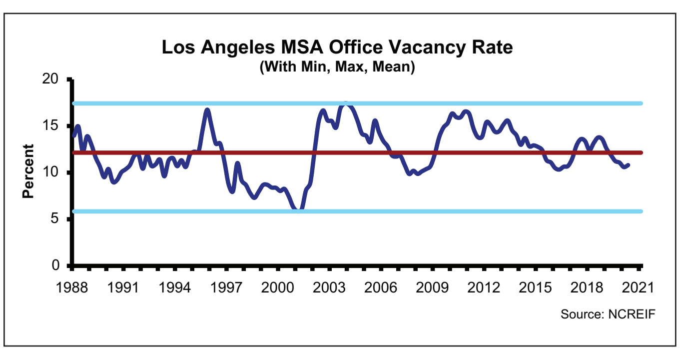

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Absorption and Vacancy. The MSA office market has a total inventory of 204 million square feet, the largest submarkets of which are Los Angeles West (54 million square feet), Los Angeles South (31.2 million square feet), and Los Angeles North (31 million square feet). During the second quarter of 2020, the non-CBD market saw -1.1 million feet of net office absorption, while the CBD saw -165,000 feet of net office absorption.

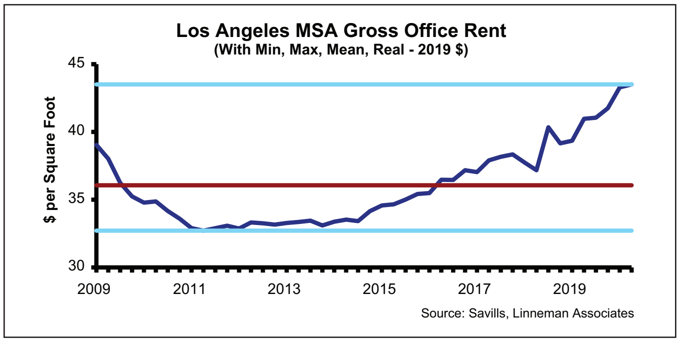
The MSA's broker-reported vacancy rate of at 14.9% in the second quarter of 2020 was 50 bps above the long-term average (since 2001) of 14.4% but still below the historical peak of 18.5%. Supply is substantially outpacing demand. The local vacancy rate was trending upwards, with an increase of 60 bps over the last year through the second quarter of 2020. In comparison, the second-quarter 2020 U.S. vacancy rate was 13.7%, up 50 bps over both the previous quarter and year. Expect office vacancy rates to rise over the next several quarters due to the lingering effects of the COVID-19 economic shutdown.

The NCREIF-reported office vacancy rate (institutional quality properties) for the MSA was 10.8% in the second quarter. This compares to the historical low of 5.8%, the long-term average (since 1988) of 12.1%, and the historical high of 17.4%. Both the broker and NCREIF data indicate that office vacancy rates in the Los Angeles MSA are above their respective long-term averages, with the broker data reflecting a significantly higher premium above norm. For the MSA and all U.S. office markets, very challenging times are ahead.

Rental Rates. Cushman and Wakefield reported average office asking rents of $44.53 per square foot in the CBD, $41.68 per square foot in the non-CBD, and $40.66 per square foot in the outer submarkets in the second quarter of 2020, reflecting nominal increases of 1-4% year-over-year. The real average U.S. office asking rent was $34.03 per square foot in the second quarter, reflecting a 4.4% increase year over year.

The real average office rent in the MSA, as reported by Savills was $43.51 per square foot in the second quarter of 2020, down 6.2% over the last year and effectively flat over the quarter. The latest rent is 33% above the historical (since 2014) low, 20.7% higher than the long-term average, and now at an all-time high.

NCREIF real (2019 dollars) average base office rent for the MSA stood at $34.33 per square foot in the



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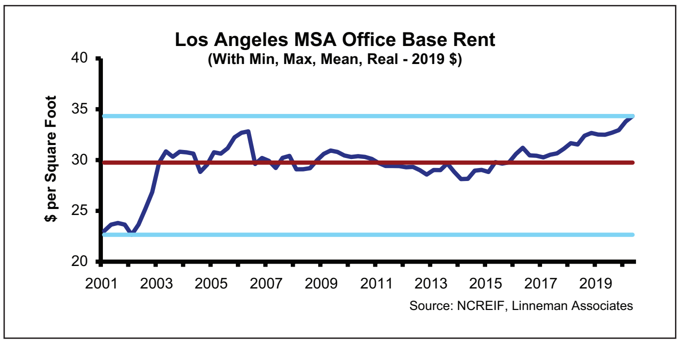

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second quarter of 2020. The NCREIF series dates from 2001 and shows the current real rent 15.4% above the long-term average of $29.75 per square foot.

Major second-quarter leases in the MSA included: Los Angeles Department of Water & Power (132,000 square feet) at 233 South Beaudry Avenue in the Los Angeles Downtown Non-CBD/Central City West submarket; the U.S. Army Corps of Engineers (115,000 square feet) at 915 Wilshire Boulevard in the Los Angeles Downtown CBD/Financial District submarket; and a confidential tenant (84,616 square feet) at 12105 West Waterfront Drive in the Los Angeles West/Playa Vista.

Development/Construction Pipeline. The MSA has had a consistent over-supply of new office space, resulting in rising vacancy rates. There were 5.7 million square feet (2.8% of inventory) of office space under construction in the MSA in the second quarter of 2020. This is comparable to the U.S. office market construction pipeline of 2.5% of inventory (134.5 million square feet under construction on 5.4 billion square feet of inventory). Excess development was underway in the MSA prior to the shutdown, and we expect substantial negative net absorption and rising vacancy as 2020 continues, the exact amount of which will depend on the length and severity of the Butterfly Recovery.

Submarkets

- ***Downtown CBD.*** With 27.7 million square feet of inventory, the submarket had a second-quarter 2020 vacancy rate of 20.5%, real rent of $44.52 per square foot, and no space under construction in the second quarter of 2020. The submarket saw net absorption of -175,040 square feet during the quarter.
- ***Downtown Non-CBD.*** With 10.7 million square feet of inventory, the submarket had a vacancy rate of 23.8%, real rent of $43.8 per square foot, and 305,000 square feet under construction in the second quarter of 2020. The submarket saw net absorption of about 127,000 square feet during the quarter.
- ***Mid-Wilshire.*** With 12.5 million square feet of inventory, the submarket had a vacancy rate of 22.3%, real rent of $35.88 per square foot, and about 464,000 square feet under construction in the second quarter of 2020. The submarket saw net absorption of about -404,000 square feet during the quarter.
- ***Los Angeles West.*** With 54 million square feet of inventory, the submarket had a vacancy rate of 10.9%, real rent of $58.92 per square foot, and 3.1 million square feet under construction in the second quarter of 2020. The submarket saw net absorption of about -298,000 square feet during the quarter.
- ***Los Angeles North.*** With 31 million square feet of inventory, the submarket had a vacancy rate of 11.5%, real rent of $31.2 per square foot, and 284,000 square feet under construction in the second quarter of 2020. The submarket saw net absorption of about 246,000 square feet during the quarter.
- ***Los Angeles South.*** With 31.2 million square feet of inventory, the submarket had a vacancy rate of 19.4%, real rent of $37.44 per square foot, and 903,000 square feet under construction in the second quarter of 2020. The submarket saw net absorption of about -40,000 square feet in the quarter.
- ***Tri-Cities.*** With 24.4 million square feet of inventory, the submarket had a vacancy rate of 10.3%, real rent of $40.56 per square foot, and 593,000 square feet under construction in the second quarter of 2020. The submarket saw net absorption of about 373,000 square feet in the quarter.
- ***San Gabriel Valley.*** With 12.6 million square feet of inventory, the submarket had a vacancy rate of 10.5%,

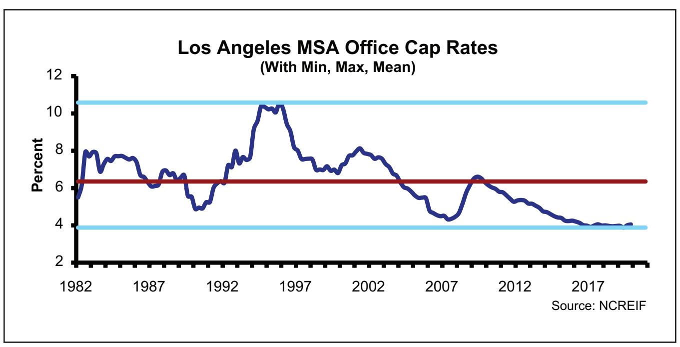
real rent of $28.56 per square foot, and 62,000 square feet under construction in the second quarter of 2020. The submarket saw net absorption of about 178,000 square feet in the quarter.

Investment and Sales. In the second quarter of 2020, the average NCREIF cap rate in the Los Angeles office market was 4%, 660 bps and 240 bps below the historical high of 10.6% and the long-term average of 6.4% (since 1982), respectively. Meanwhile, according to Real Capital Analytics (RCA), the average MSA cap rate in the second quarter of 2020 was significantly higher, at 7.3%. This compares to the long-term RCA high, low, and average of 8.8%, 5.6%, and 6.9%, respectively. The U.S. office cap rate, as reported by NCREIF, was 6.5% in the second quarter of 2020. Large bid-ask spreads continue to bring sales down in the second quarter of 2020.

In the second quarter of 2020, the real (2019 dollars) four-quarter moving average price of office space in the Los Angeles MSA was $354 per square foot, compared to $263 for the nation, according to Real Capital Analytics. Current pricing is 24.6% and 71.8% above the long-term average and low, respectively, but 5.4% below the historical high. Expect pricing declines during the fourth quarter of 2020 and a subsequent increase as people go back to the office in greater numbers. By comparison, current real U.S. office sale pricing is 17.2% above the long-term average of $250 per square foot and 66.5% above the historical low of $176 per square foot. Real U.S. office values peaked at $311 per square foot in 2007.

Real rolling four-quarter sales volume in the MSA was $7.3 billion through the second quarter of 2020, down 56.4% from the previous year and 37.5% below the long-term average of $10.3 billion. The current level is 26.2% below the previous quarter and 297% lower than the long-term high of $29 billion seen in the third quarter of 2007. Little sales activity will occur during the remainder of the year.

Major sellers of office properties over the past two years in the Los Angeles MSA included: Hines ($767.7 million in dispositions, twenty-one properties); Blackstone ($754.4 million, nineteen properties); CBS Broadcasting Inc. ($750 million, one property); Pensioenfonds ABP ($630 million, one property); Tishman Speyer ($630 million, one property); and CPP Investment Board ($630 million, one property).



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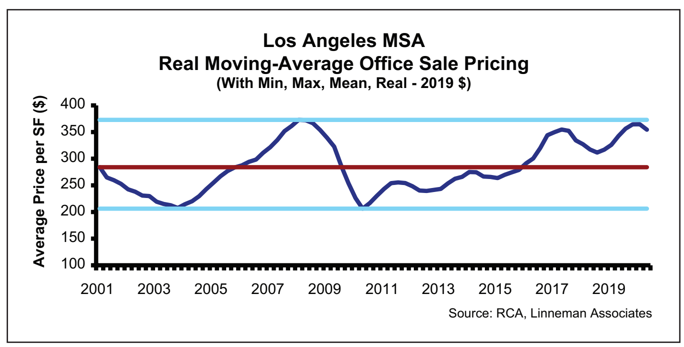

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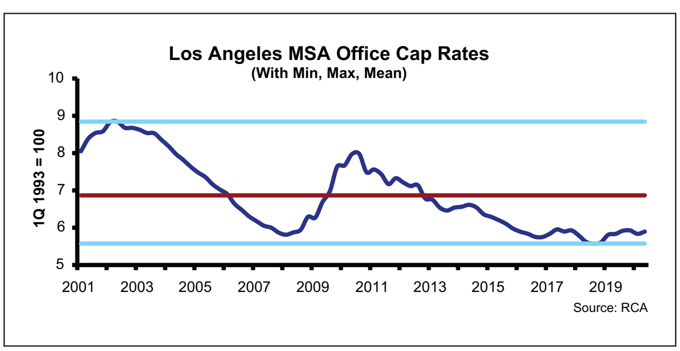

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Major buyers of office properties over the last two years in Los Angeles included: Hackman Capital ($750 million in acquisitions, one property); Square Mile Capital ($750 million, one property); Onni Group ($732.6 million, three properties); and Blackstone ($578.7 million, eight properties).

The largest sales transactions in the second quarter included the acquisition of 101 South Marengo Avenue/Pasadena Center for $72 million ($200 per square foot) in the Tri-Cities/Pasadena submarket, the acquisition of 3465 & 3475 East Foothill/Pasadena Corporate Park for $78 million ($312 per square foot) in the Tri-Cities/Pasadena East submarket, and the acquisition of 2355 & 2377 Crenshaw Boulevard/Park Del Amo for $39 million ($191 per square foot) in LA South/Central Torrance submarket.

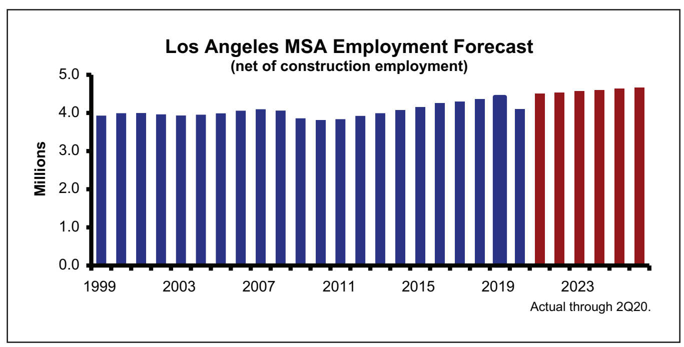
Opportunities and Challenges. The prevalence of open-floorplan and co-working office space in the MSA will require a shift back toward traditional cubicles due to COVID-19. The laid back open-floorplan approach is intended to encourage connectivity and group involvement but is actually shown to reduce productivity. In addition, such floor plans are not conducive to social distancing requirements.

Though the MSA has been hit by several disasters, the local economy is again moving upwards. In August 2020, California governor reported that state of California was battling over 350 wildfires which burned down more than 1,000 acres of land. The governor also declared a state of emergency in response to the rapidly spreading fires. Rain throughout March and April helped to contain the wildfires at that time, but as of September, many are still blazing out of control throughout the West Coast.

The MSA is increasingly attracting tech companies. Over the last five years, Netflix, Facebook, Apple, Amazon, and Google collectively leased 3.4 million square feet in the MSA, according to Curbed LA. Netflix leased a 13-story high-rise through 2031, occupying about 328,000 square feet. In 2018, the Commercial Observer reported that Facebook has been renting more space in Playa Vista and was set to lease about 260,000 square feet. Apple also moved to Culver City along with Amazon, occupying 128,000 square feet and 530,000 square feet of office space, respectively. A historical landmark has been redesigned into an LA-office for Google. The 450,000-square foot Spruce Goose Hangar is about 750 feet long and is set to take occupancy next year.

A number of infrastructure projects are underway in the MSA. One is the county's $250 million soundwall construction project to reduce freeway noise levels. Another ongoing project is the $33 million replacement of the U.S. 101/Lost Hills Road intersection with a new intersection and overcrossing called Lost Hills Overpass and Interchange. In addition, a new transportation line will connect LAX with Crenshaw, passing through Los Angeles, Inglewood, and El Segundo. This project will relieve congested roadways while creating more job opportunities in the MSA.

Outlook. The truth is that no one knows what near-term job growth will be, but we use our best estimates of job recovery for the MSA. Our employment forecasts are net of construction jobs due to the volatility and short-term nature of that sector. We forecast that the Los Angeles MSA will add about 305,000 jobs in 2021 and 32,000 jobs per year in 2022-2024. Our projections indicate that a total of 432,000 jobs will be added to the MSA over the next 5 years through 2025. We expect that the current vacancy rate of 14.9% will increase to 16.9% by year-end 2020 and then begin a three-year recovery as jobs are regained.



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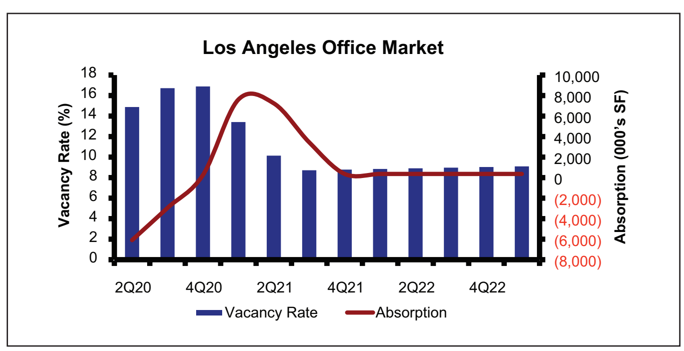

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