BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

MARKET REPORT *East Bay/Oakland Metro Area*

2H/20

Dual Paths Forward Emerge for East Bay Economic Recovery; Underlying Property Performance Could Be Impacted by Ballot Initiatives

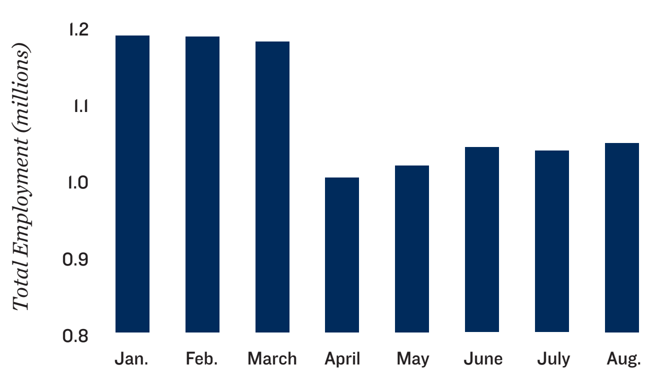
East Bay outlook most uncertain among Bay Area metros. Although a diverse employment base is generally a hedge during a recession, the metro's smaller percentage of office-using jobs relative to the other two Bay Area markets puts the metro in a disadvantageous position for a recovery. Unemployment is 150 basis points above San Francisco and only 24 percent of the jobs lost during the health crisis have been recovered. Nonetheless, the market has been slower to reopen than many others and a bump in payrolls in service industries could emerge as conditions warrant. Through August, 40,900 leisure and hospitality jobs, and 15,900 trade, transportation and utilities positions have yet to return. An additional 17,300 jobs in the education and health services sector should return as hospitals and doctors' offices reopen to more elective procedures and private schools resume in-person classes.

Recovery centers on tech giants. If the Bay Area's large tech companies move to a hub-and-spoke office model or increase the number of days that workers can be remote, the East Bay could see a brisk recovery. Home sales in Contra Costa County, for example, have been robust as local families seek larger accommodations to manage work from home and online schooling. The influx of high-earning households to more suburban areas will eventually translate to the necessity for more food and entertainment options. Spreading the wealth around the Bay Area should lead to a more balanced tax base. Furthermore, a reduction in commute times could help level apartment rents.

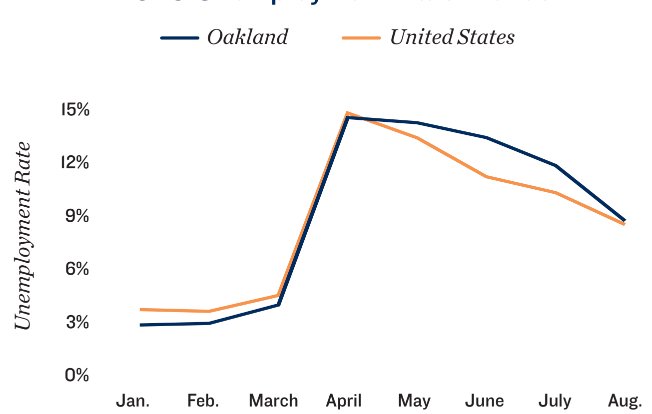
Headwinds form if business as usual returns. Google and Apple have significant office commitments in Silicon Valley and neither have committed to a long-term dispersed work-from-home strategy. These anchors could discourage workers from moving into the East Bay while also attracting support firms to newly vacant office space in San Jose rather than Oakland. The second phase of BART Silicon Valley is not expected until 2035, limiting transportation options for commuters. Another challenge awaiting commercial real estate in the East Bay is the office supply overhang in San Francisco. During a traditional recovery, a glut of vacant space across the Bay would be filled ahead of the East Bay. However, some San Francisco firms may consider relocating to their own space, which would benefit the metro in the short term.

Tax initiatives have potential to reshape East Bay investment climate. If passed, Proposition 21 would grant local municipalities the ability to implement new rent control laws. The city of Oakland, which already has rent control, might increase the number of properties that fall under local ordinances. By doing so, the ability of an owner to increase rent to the market rate will give way to rent control through vacancy. Cities in the East Bay that fall under existing Assembly Bill 1482 will still allow rents to reset to the market rate during a vacancy, creating an uneven apartment market. Proposition 15, meanwhile, would eliminate commercial properties from current tax protections. Under the proposed legislation, taxes will be set to the assessed value rather than the acquisition price.

2020 Employment Trends

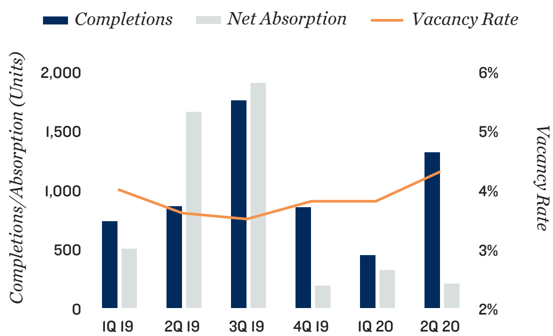


2020 Unemployment Rate Trends

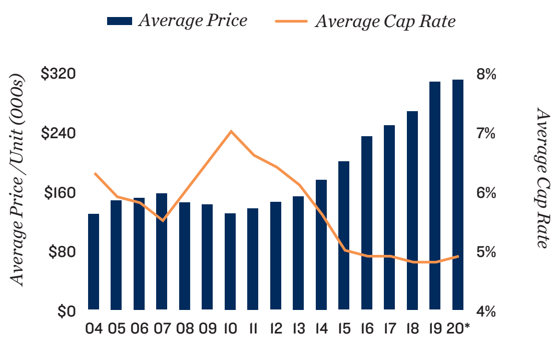


Source: BLS

Apartment Completions and Absorption



Apartment Price and Cap Rate Trends



*Through second quarter

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

APARTMENT

Oakland Apartment Fundamentals Relatively Healthy as Fewer Residents Have Remote Work Available

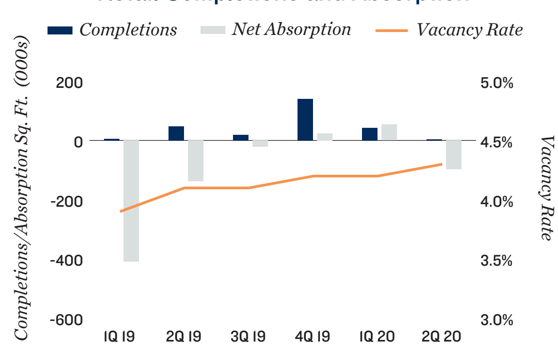
- Builders added 4,400 units in Oakland over the past 12 months, expanding stock 2.0 percent. Approximately 13,500 apartments are underway and scheduled for delivery over the next few years, representing 6.4 percent of inventory.
- Apartment vacancy in the East Bay has fared better than the other Bay Area markets since the health crisis. Vacancy climbed 50 basis points in the second quarter to 4.3 percent. Year over year, the rate is up 70 basis points.
- At midyear average effective rent was $2,351 per month, down 1.4 percent from mid-2019. All of the decline came in the second quarter when average rents dipped 1.8 percent, led by a 3.3 percent decrease in the Class A sector.
- Investors paid an average of $309,900 per unit in the 12-month period ending in June, up 8 percent from one year ago. The average cap rate rose 10 basis points to 4.9 percent.
- Smaller assets will carry the investment market through the shutdown before institutions resume acquisitions after price discovery and any discounting. The health crisis and a pending initiative on rent control may also persuade some longtime owners to liquidate.

RETAIL

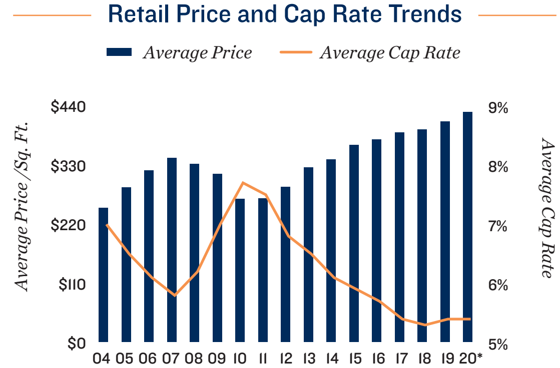
Oakland Retail to Underperform Bay Area in Near Term Due to Weaker Underlying Employment Base

- Development came to a near standstill during the second quarter, limiting first-half deliveries to just 45,000 square feet. Only 240,000 square feet is under construction and pre-leasing remains high.
- Retail vacancy inched up 10 basis points to a still-low 4.3 percent in the second quarter. The rate has been rising since the second half of 2018, largely due to big-box closures that occurred across the metro.
- Pressure on asking rents emerged in the second quarter, and additional weakness is anticipated through year end. The average asking rent ticked down 0.6 percent to $29.63 per square foot in the second quarter.
- Demand for single-tenant properties remained healthy despite the shutdown as 1031-exchange deals that started prior to the health crisis were pursued. The average price per square foot was $454 during the yearlong period ending in the second quarter while the average cap rate was 5.6 percent.
- Investors pulled back in the multi-tenant sector as lending slowed and risk tolerance plunged. The average price was up 4 percent year over year amid an increase in the quality of assets while the average cap rate was in the low-5 percent range.

Retail Completions and Absorption



Retail Price and Cap Rate Trends



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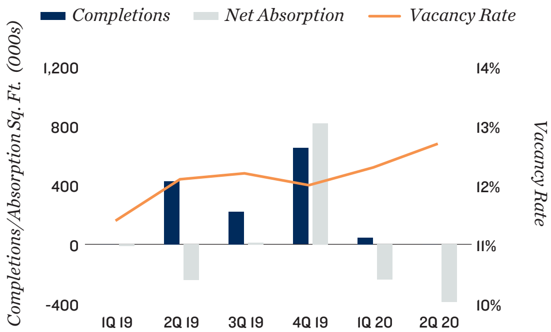
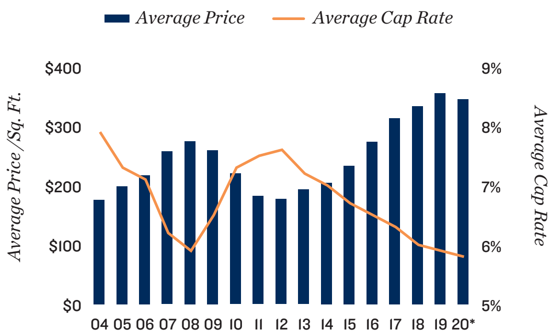
Sources: CoStar Group, Inc.; Real Capital Analytics

Office Completions and Absorption



Office Price and Cap Rate Trends



** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

OFFICE

Resilience in Office Sector Hinges on Other Bay Area Metros; Investors Await More Clarity

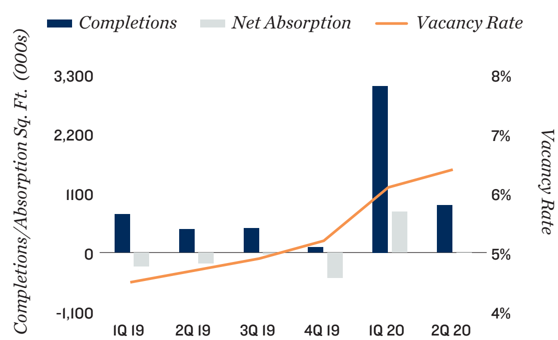
- Less than 50,000 square feet of office space was completed in the first half of the year as the East Bay's lockdown orders limited some construction activity. In the previous six-month period, nearly 900,000 square feet was added to inventory.
- Low development activity limited the increase in vacancy related to the health crisis to just 40 basis points in the second quarter. Vacancy stood at 12.7 percent at midyear, the highest level since early 2015.
- Operators decreased asking rents 0.3 percent in this year's second period to $40.59 per square foot as most office-using employers delayed making long-term plans regarding space needs. In the last half of 2020, more local employers will begin looking beyond this year and adjust lease terms.
- Prior to the health crisis, local office space was favored due to spillover demand. In the 12-month period ending in the second quarter, the sale price was relatively stable at $345 per square foot and the average cap rate was in the high-5 percent range.
- Investor sentiment on office assets in the East Bay is relatively soft as owners await more clarity from local employers. Some owner-users could emerge in the coming months along with an appetite for small assets.

INDUSTRIAL

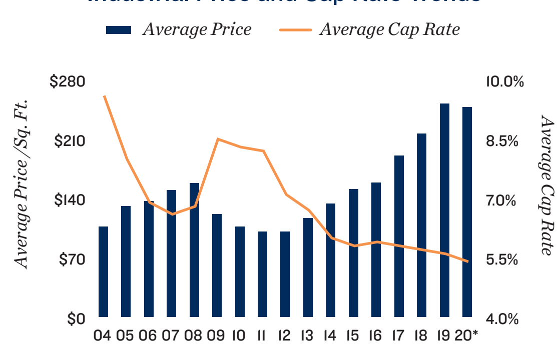
Industrial Thriving Through Downturn, Keeping Investors Active in the Sector

- More than 4.5 million square feet of space was completed in the last 12 months, including 3.1 million square feet in the first quarter. Another 2.3 million square feet is under construction, approximately 50 percent pre-leased.
- Largely due to the surge in deliveries in the first quarter, vacancy jumped 170 basis points to 6.4 percent annually. The rate only climbed 30 basis points in the second quarter, which was also due to supply additions.
- Healthy demand and the addition of high-valued new speculative space supported a 2.4 percent rise in asking rents for available space to $14.52 per square foot. Annually, rents ticked up 1.3 percent.
- Buyers continued to target industrial space during the downturn. In the 12-month period ending in the second quarter, the average price climbed 6 percent to $248 per square foot. The average cap rate ticked down 20 basis points year over year to 5.4 percent.
- Assets near new suburbs will attract investors seeking last-mile distribution centers as an increase in online sales lifts demand for industrial space. Owner-users may also step forward to acquire assets.

Industrial Completions and Absorption



Industrial Price and Cap Rate Trends



** Through second quarter*

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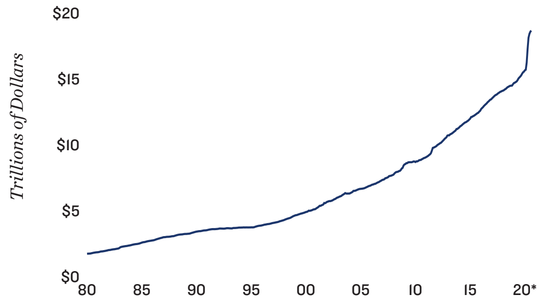
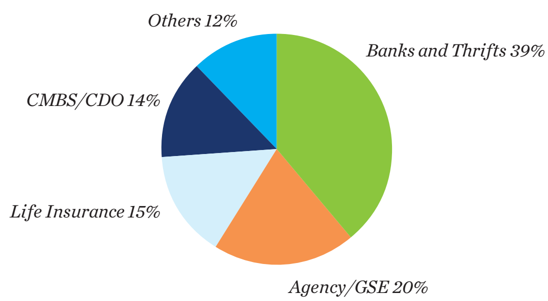
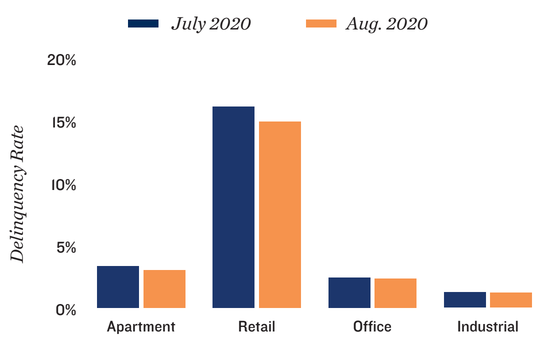
Fed Sharply Increases Money Supply During Health Crisis



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