LA COUNTY APARTMENT SECTOR IS FEELING THE PRESSURE FROM BUYERS, RENTERS

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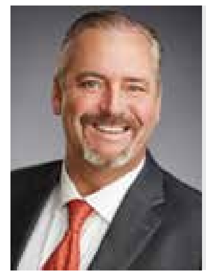
Los Angeles County is facing a significant lack of housing product — an issue that can't be resolved any time soon. With the fight to limit new development, it is a very uphill and challenging battle that is unfortunate for the economy, business and, most of all, residents. An influx of about 160,000 new residents moved to the county from 2010 through 2015, but we have only seen upwards of 25,000 new housing units built during that same time frame. The demand drivers are extremely significant for new housing, but supply constraints like zoning and regulations are preventing an adequate supply. Additionally, with an unemployment rate currently at a historical low of about 4 percent, projections for housing demand over the next decade all point to a severe shortage in this growing region. Despite all the news about companies moving out of state to enjoy less expensive business costs as well as more affordable housing for their employees, this region, along with California as a whole, continues to see a population increase.

Even with all this being said, the multifamily sector has and will continue to be the darling of the commercial real estate industry as it's fueled by a lack of supply and significant demand. However, rents can only go as high as the market can bear. Investors are already begrudgingly paying very low cap rates with sub-3 percent cap rates being commonplace in many core areas.

Deal flow this year for apartment properties with five or more units appears to be on par with 2016 for the same period, according to CoStar. By that comparison, the average price per unit is up just 2.83 percent, while average gross rent multipliers are up 3.6 percent.

The market is tightening, and as brokers on the street, we feel it. Buyers are pushing back at the aggressive pricing of 2015 and 2016, while at the same time we see the dichotomy of a burgeoning inventory constraint. With LA County's lack of new inventory coming online to meet the needs of the general rental population, rents will continue to remain high. Whether they will push higher, time will tell.

FUELED BY TECH AND NEW MEDIA COMPANIES, L.A. OFFICE SECTOR SEES MORE DEMAND



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The Los Angeles office sector remains healthy with new tenants coming into the market and a number of existing companies expanding. Most of the service industry has completed its right-sizing, and that will reflect positively for absorption rates moving forward. With that said, the preliminary unemployment rate in March was 4.3 percent, a 10-year low, which is great news for the county and the confidence of both owners and occupiers moving forward.

The first part of the year has been a little slower than some expected in terms of absorption. NGKF's first quarter report shows that it was positive for the 15th consecutive quarter, but down 31.8 percent from 12 months prior. The main reason for this slowdown was statistical and reflected in two large occupiers of space. Both E! Entertainment and Sony Pictures Studios gave back large blocks of space. This was no surprise to the market as these moves had been planned for the past couple of years and were part of their long-term real estate strategies. E! Entertainment, a division of NBCUniversal, completed its move from 385,000 square feet in Miracle Mile to Comcast-owned Universal City Studios lot. Likewise, Sony Pictures Studios vacated nearly 339,000 square feet of leased space at One Culver in Culver City to move into a smaller, newly constructed building on their lot at Sony Pictures Studios.

Tech and new media industries continue to fuel tenant growth, particularly in the lower Westside, Culver City and Westside submarkets. These areas have experienced substantial rent growth over the past 18 months with owners of new developments or newly renovated projects seeking to further capitalize on that trend with even higher rents moving forward.

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OWNERS OF OFFICE PROPERTIES SHOULD MATCH LENDERS WITH PRODUCT TYPE

A majority of the population will always need to work, and chances are many will need an office space in which to work. While this property type requires significant capital to re-tenant vacant spaces, as long as the cash flow and re-tenanting costs are underwritten correctly, all major lender segments have an appetite to lend on office properties. Office properties are also less susceptible to the internet eating into its tenant demand, unlike the retail property segment. In fact, many technology/internet companies like Google, Microsoft, Apple, Salesforce and LinkedIn have absorbed the most office space over the past five to 10 years due to their rapid growth.

While these groups have been driving the creative office movement that everybody is so excited to talk about these days, many office users still prefer a traditional office space. Tenants like the idea of having four walls and a door to allow for privacy when needed throughout the day. Whether it's a high-rise office tower in the central business district (CBD), a low-rise office building in a suburban location, or a value-add creative office conversion near the beach, the location, loan to value, loan per square foot, tenant mix, occupancy history, historical and current cash flow and sponsorship are all going to be driving factors behind the type of lender that will lend on that particular property and the loan terms they will provide.

As an example, a downtown high-rise office building on either coast will likely have a very high value per square foot. Life company lenders based in the Midwest will have a tough time swallowing an $800 per square foot value and a 5 percent cap rate, even if it is a core asset in a great location. While some New York- or West Coast-based life companies might get comfortable with those numbers (depending on LTV), most of the time, a CMBS lender will be a better fit. This is particularly true if the borrower is looking for 70 percent loan to value or more on a non-recourse basis. While CMBS rates are currently higher than life company rates, CMBS lenders can offer interest-only payments for the life of the loan, which helps owners increase their cash flow and, ultimately, their investment returns. CMBS spreads are currently 175 to 265 over the 10-year swap rate depending on loan size, leverage and quality of the transaction.

If you're an owner of a suburban office property with an upcoming loan maturity, CMBS is not your only option for a long-term, fixed, non-recourse loan. Many of the non-recourse life insurance company lenders like office product and have earmarked a portion of their annual allocations for office properties. It will be important to show good occupancy and operating history for the property in order for a life company lender to be interested in lending on a suburban office property. Many lenders will look back to how the property performed in 2008, 2009 and 2010 to anticipate how it will fare during the next recession. Life company lenders also prefer rent rolls with staggered lease expirations to avoid periods with multiple vacancies that will significantly disrupt cashflow. Having a sponsor with a good balance sheet and significant liquidity also helps lenders get comfortable. This lets them know that the sponsor will have the means available should a major lease expire, resulting in significant dollars needing to be spent to re-tenant the space. With all non-recourse loan requests, each deal is unique and needs to be diligently underwritten and analyzed before knowing which lender will offer the best loan terms for that particular property.

The value-add creative office conversion continues to be an active segment in the office property sector. While San Francisco has been at the forefront of this movement, there has been significant momentum in Southern California for a few years now. Many value-add operators will buy a property with a high-leverage, non-recourse bridge loan, and then put significant capital expenditures, tenant improvement and leasing commission dollars into the property to attract new tenants at higher rents. They are able to create significant value on the back-end sale with minimal equity contribution at the start. There are several non-recourse debt fund bridge lenders actively lending in the office sector today. Some will go as high as 85 percent loan to cost but will be north of 600 over LIBOR for the higher leverage. Others will provide more moderate leverage, of 65 percent to 70 percent loan to cost, but will be between 450 to 600 over LIBOR for the lower risk profile. This lender segment has gotten more crowded over the past 12 months as lenders continue to chase yield.

There are a variety of capital sources available for office properties in the Western region. Life companies, CMBS lenders and debt fund bridge lenders each fill a need for non-recourse financing in the office segment. They each have their pros and cons. It is important to understand them to ensure you are getting the best loan possible for your specific property and business plan.

— Joe Giordani, Vice President, Producer, NorthMarq Capital