www.REBusinessOnline.com
December 2020 · Volume 18, Issue 4

WESTERN REAL ESTATE BUSINESS®
Connecting Real Estate in the West


*Image credit: Humphreys & Partners Architects*

Though multifamily development stalled in the spring, it had resumed by summer. One of the projects in the pipeline is Adams & Grand, a $125 million mixed-use project located in an Opportunity Zone near the University of Southern California (USC) in Los Angeles.

# OFFICE TRENDS RAISE PROPERTY TAX CONCERNS

During the pandemic, taxpayers need to track and document all issues affecting net operating income to help with the property tax valuation process.

By Kirk Garza

With property taxes comprising a significant portion of the real estate operating budget at most companies, both tenants and landlords need to understand how trends sparked by COVID-19 can impact their property tax valuations.

The pandemic has spurred governments to impose unprecedented restrictions on office capacity and fueled widespread uncertainty among companies that own or lease office space. Organizations are asking if, when and how they will use their offices in the months ahead and are scrutinizing expenses to reduce costs.

Many businesses are reevaluating their space requirements after adopting work from home initiatives, while greater familiarity with Zoom and other applications that support remote training and online collaboration have firms reconsidering their ongoing need for conference or meeting space. It is essential for real estate decision-makers to monitor the effects of such trends on taxable property values.

## Office Demand Evolves

In the early 1990s, it was common for companies to occupy 350 square feet of office

*see PROPERTY TAX, page 37*

# OPTIMISM, NEW HABITS ABOUND IN 2021

Commercial real estate experts throughout the West see light at the end of the tunnel as we head into 2021.

By Nellie Day

News that a coronavirus vaccine should be available to the general public by mid-2021 has given many in the commercial real estate industry new hope that we'll begin to return to business as usual…whatever business as usual looks like post-pandemic. As operations and commerce begin to get back to normal, there will likely be some changes in store for each of the four main product types.

Whether these changes are welcomed or not isn't necessarily relevant (though one would imagine anything that allows businesses to operate at full capacity would be a welcome addition), but what is relevant is whether these businesses and industries can weather the storm, make adjustments and make it to the finish line in one piece.

"2020 posed several challenges faster than any of us in the real estate industry have ever faced before," says Jordan Schnitzer, president of Harsch Investment Properties in Portland, Ore. "As the COVID vaccines get distributed throughout the country, I believe there will be a desire to get back to experience life as it was pre-COVID."

## Multifamily Demand Continues, Though Landlords Lack Assistance

The multifamily market has been an interesting one during the pandemic. On the one hand, many people have hunkered down in their current dwelling, which also served as an office and entertainment hub in 2020. On the other hand, the residential real estate market is extremely strong, particularly out West, as some search for more space and take advantage of low interest rates.

Then you have the eviction moratoriums.

"Multifamily has been a challenge in every municipality in the country," Schnitzer notes. "When people don't have income, it's pretty difficult to pay rent. Every politician wants to pass legislation to stop evictions without having solutions for landlords and their mortgage payments."

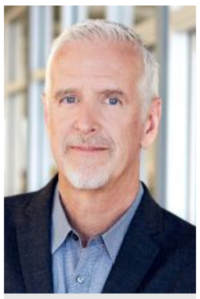
*see OUTLOOK, page 36*

## *INSIDE THIS ISSUE*

OUTLOOK from page 1

As landlords struggle with non-paying tenants, cities and residents are grappling with the lack of affordable housing. Freddie Mac estimates that more than 3.3 million new multifamily units are needed nationwide to address this shortage. California alone needs to bolster its existing inventory with 3.5 million new units by 2025 to accommodate pent-up demand and a growing population, according to McKinsey & Company.

Factors like these have led R.C. Alley, a partner at AO Architects in Orange, Calif., to believe next year will bring increased development activity and demand to the multifamily sector.



Alley

"Based on the demand we're currently seeing, we expect 2021 will be a good year for the multifamily sector, although still somewhat trailing as it recovers from the COVID-19 economic slowdown," he says. "Demand picked up in the summer and we had a busy fourth quarter, closing the year strong with a solid pipeline for 2021."

Alley is optimistic that this uptick in demand will extend throughout the multifamily sector, with the affordable niche getting a little help from President-Elect Biden.

"Joe Biden released a plan during his campaign to address our nation's current housing crisis, signaling his intention to expand affordable housing by establishing a $100 billion affordable housing fund and providing incentives to construct or rehabilitate low-cost housing in areas that need it the most," he notes.

Demand will also likely increase for sanitation and social distancing features and protocols as residents can't simply unlearn what they've been taught during the pandemic, regardless of whether there's a vaccine or not.

Schnitzer

"There will be mid-term changes that will last from one to three years," Schnitzer asserts. "For example, people will continue to be cautious in elevators and enclosed spaces. People will continue to wear masks throughout 2021, even if they've had the vaccine shots. People will wash their hands more — those are the long-lasting impacts of a post-COVID world."

For multifamily developers, this likely means a prolonged focus on adding sanitizing stations to amenities, incorporating dedicated work areas in the units and dividing common spaces into a series of smaller, more private gathering spaces. Though these changes will result in more time, effort and money for developers and landlords, Alley doesn't believe these additions are overwhelming. Rather, they involve a little modification here and there.

"Multifamily communities across the nation had to adapt and find quick, easy-to-implement solutions — and they've done that," he says. "For projects that are currently on the boards, we are not seeing sweeping changes in terms of design, but rather a few tweaks and improvements to make these projects more pandemic proof."

John Drachman, co-founder of Waterford Property Company in Newport Beach, Calif., agrees that slight modifications are necessary, though the core consumer remains the same.

Drachman

"We believe holistically that all of the trends that were going on pre-COVID-19 have only been exacerbated through the pandemic," he says. "We think tenants will continue to focus on highly amenitized apartments that provide a high-quality living experience. Where you live has never been more important. This will continue to be true post-COVID."

## Office Users Will Return, But When? And How Many?

For many, it seems like a foregone conclusion that workers will return to the office once they get the all-clear (if they haven't already).

Cordoves

"The widespread availability of a viable and safe COVID-19 vaccine in 2021 is likely to facilitate office users' return to the workplace," says Giovanni (Gio) Cordoves, Western regional president of KBS in Newport Beach. "The pace of this return depends largely on the public's acceptance of the vaccine, leading to better control of the virus, which will enable people to feel safe and comfortable going back to the office."

In addition to a vaccine, Cordoves notes this return will likely be facilitated by a number of factors, including statewide and local restrictions. In areas with looser restrictions, like Dallas, 40.3 percent of office workers were already back in the office by Nov. 18.

Not all companies have been as spurred to action as those in Texas, however, as Amy Bradac, founder and CEO of Bradac Co. in San Francisco, can tell you.

Uber's new Mission Bay campus project in San Francisco emphasizes flexibility and people-centric design, two elements that will likely be key for future office projects post-pandemic.

"Companies have deferred many corporate real estate decisions during the past nine months and that creates a pent-up demand," she says. "It will take time for many businesses to start to grow again, but I think the cycle will start to turn up again mid-2021."

Martin Pupil, executive managing director at Stream in Irvine, Calif., has seen a similar hesitancy throughout the West.

Pupil

"Office is currently in a holding pattern and will continue to be until people return to work," he says. "We foresee this being the case for office through mid-2021, with an anticipated recovery sometime in 2022."

Predictably, those who are returning to the office are greeted with new and updated features. For KBS properties, these include increased daylight, better HVAC systems to combat the circulation of pathogens and the elimination of finishes that led to off-gassing of hazardous materials.

Cordoves also believes we're likely to see more built-out outdoor spaces, such as decks, patios, and rooftop bars and restaurants where tenants can feel safer about congregating. Many offices may also feature anti-bacterial surfaces and touchless systems in common areas like elevators and restrooms. Social distancing could also mean more square footage per employee.

Bradac sees these efforts as steps in the right direction, though she thinks an overall change in the way we view work is necessary if the ultimate goal is employee health.

"I think — and hope — that flexibility and a 'people first' culture will be two of the many permanent changes we see as a result of COVID-19," she says.

Bradac

"Allowing people flexibility is key to a work-life balance, but even more important is creating and maintaining a culture where people are supported when they need to rest or take time off due to illness or duties outside of work. I hope that depriving oneself of sleep, proper diet, exercise, and time to rest and spend with friends and family will no longer be a badge of honor."

Despite all these efforts and estimated recovery periods, Pupil isn't convinced the office sector will return full force, regardless of when that return occurs. The reason? The work from home movement.

"Remote working was already present pre-pandemic," he says. "Approximately 10 percent of the workforce was remote back then. We anticipate this number going to 30 percent. This elongated work from home experiment has been embraced by many. I also believe that business travel will not return to pre-pandemic levels as we have realized many of our visits can be replaced by teleconferencing."

## SoCal Industrial Has A Banner Year As Supply Shrinks

The pandemic has spelled bad news for many businesses and people. Industrial is not among that list. Instead, this sector has soared to new heights, with no signs of slowing down.

"This has been one of the most successful years that I have experienced in my more than 40 years in service to the industry," says Rick John, executive vice president of DAUM Commercial Real Estate Services in Ontario, Calif. "The industrial sector has continued to perform exceptionally well throughout the pandemic. Business has essentially been full speed ahead since summer, following the first couple months of uncertainty when industry players took a step back to review and assess the market thought process."

One needs to only look as far as the Inland Empire — the most robust industrial market in the country — to see how this product type has fared in 2020. This region is on track to complete (as of press time) more than 100 transactions on buildings with more than 100,000 square feet in 2020. This would surpass the 92 transactions it recorded in 2019, which was a record year.


John

"In 2021, we expect this trajectory will continue to accelerate," John continues. "A lack of inventory will be our only obstacle to sustaining this growth down the line."

The Inland Empire saw 8.2 million square feet of new industrial space delivered in the third quarter of 2020, according to JLL's latest market report. The problem was that 39.1 percent of that product was already pre-leased. The region's active development pipeline is just 15.5 million square feet, the lowest it's been since 2015.


Hewett

"In the Inland Empire, we are anticipating a continuation of the velocity we are seeing from tenants in the industrial and distribution sector for at least the first portion of 2021, and realistically the foreseeable future, until there is a timeline for normal life to resume," says Mac Hewett, managing director at JLL in Ontario. "The biggest concern we have is running out of available buildings. At the same time that COVID-19 caused a massive spike in tenant demand, it disrupted the development cycle and put everything on pause for several months over the second and third quarters of this year. We will likely see this shortage hit in mid-2021, and will have a shortage until the developments can catch up. This is causing a massive spike in pricing as the imbalance between supply and demand continues to widen."

True to form, industrial rents in the Inland Empire climbed 1.6 percent between the second and third quarters of 2020 as vacancy sat at 4.7 percent, per JLL's report.

Fortunately, firms like Real Estate Development Associates (REDA) are working to address this shortage. The Newport Beach-based diversified investment company plans to break ground on more than 4 million square feet of industrial real estate in the Inland Empire in 2021. One of those projects will be for Uline, a private supplier of shipping and business supplies. The company has experienced rapid growth since the pandemic as consumers turned to ecommerce to fulfill their shopping needs.


REDA plans to break ground on more than 4 million square feet of industrial real estate in the Inland Empire in 2021, alleviating some of the pent-up demand. One of those projects will be for ecommerce company Uline, which has experienced rapid growth since the pandemic.


Krotts

"One thing the pandemic has done is reinforced how easy it is to get everyday necessities online and shipped directly to your home," says Jason Krotts, a principal at REDA. "I think 2021 will be an exceptional year for industrial real estate."

A Biden administration may make it an even better year, some experts assert.

"Under Joe Biden, the industrial sector is likely to continue to thrive," John contends. "It could be positively impacted due in part to the fact that Biden has proposed that he will mend relations with China. In the Inland Empire, we saw an influx of foreign distribution groups start to come back in a significant way just prior to November, including Chinese importers, so this will likely continue to increase as restrictions are eased. This will lead to more and more competition in the industrial sector and push up rents, which is ultimately great for Inland Empire business."

It may also be great news for business at the ports.

"Southern California industrial demand is primarily driven by imports into the ports of L.A. and Long Beach," Hewett adds. "Imports are driven by U.S. trade with Asia. The immediate reaction to a Joe Biden presidency, as it relates to foreign relations, seems to be positive as most commentators are predicting a less turbulent relationship. At the surface, this appears to be positive for Southern California as trade becomes more stable in the Pacific region."

## Retail Waits To Reopen, Recover

Right now, retail is a tale of two markets: the essential and the nonessential. Or the "haves" and "have nots." This is particularly true in California where current stay-at-home orders limit retail capacity to 25 percent, while dining — whether indoors or outdoors — is not allowed in most regions.

This has forced many retailers and restaurants to embrace ecommerce, omnichannel and third-party delivery apps.


Mark Sigal

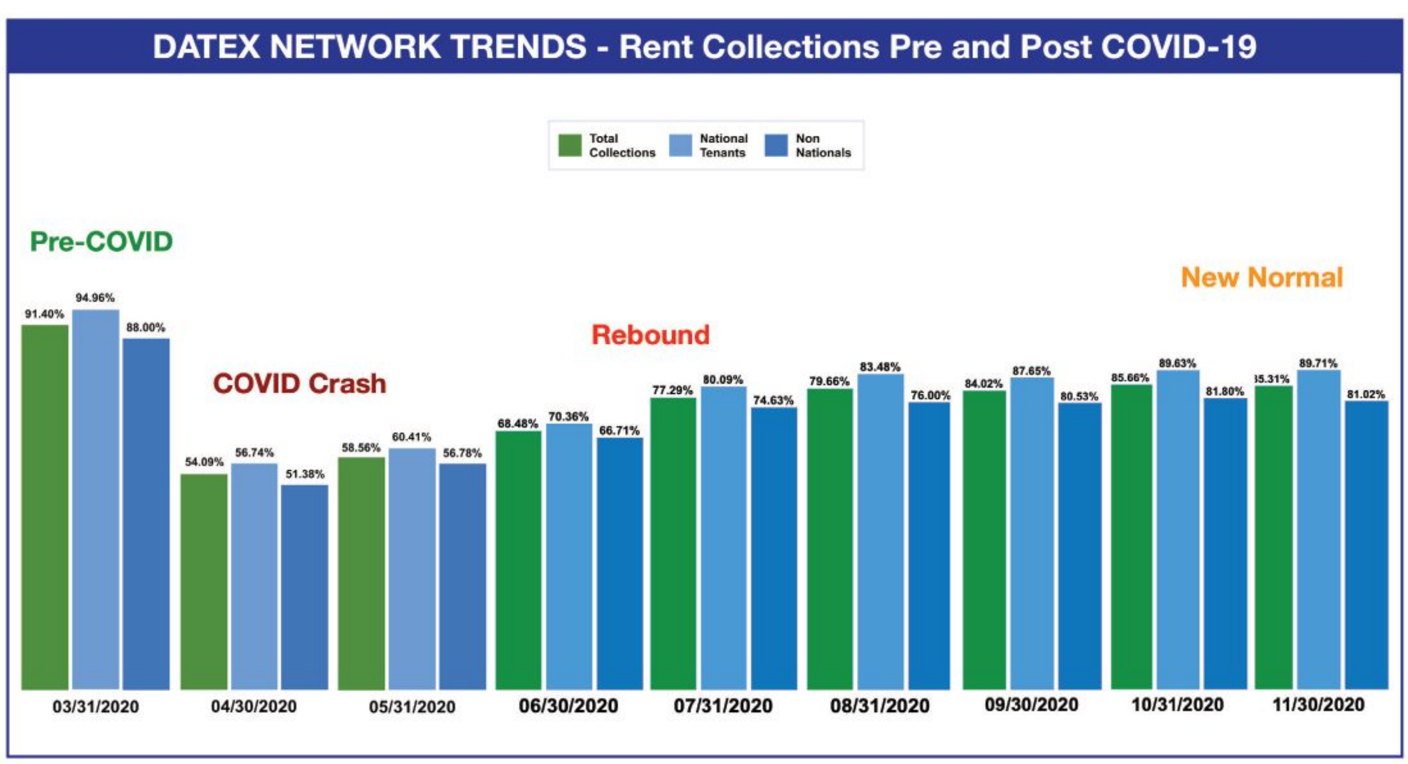
"COVID-19 has been an accelerant of the trends — good and bad — that were already underway," explains Mark Sigal, CEO of Datex Property Solutions in Woodland Hills, Calif. "As that pertains to retail, this is a segment that is in a permanent state of disruption and reinvention. On the positive front, necessity is the mother of invention, especially in retail — a technology-laggard industry — and more retailers are innovating and experimenting because they must. One clear area of accelerant is supporting omnichannel for ordering, pickup and/or delivery."

The Nielsen Global New Shopper Normal Study notes 66 percent of the general population now takes an omnichannel approach to shopping, while 72 percent of "constrained" (those with income challenges since the pandemic) shoppers embrace this approach. The October 2020 study further noted that only 9 percent of global consumers were regularly shopping online before the pandemic hit.

This leaves retailers who haven't embraced the ecommerce and omnichannel models in a precarious spot, especially as restrictions linger.

"The retailers that over the years have been slow to adjust to omnichannel retailing have not survived," says Vicky Hammond, a principal at Coreland Companies in Tustin, Calif. "Both national and local alike, these stores were behind from the start — caught by surprise and unable catch up in the midst of rolling lockdowns. Sadly, this included a number of small businesses without market share or extra cash flow to have made so many significant changes in such little time."

continued next page



# OFFICE TRENDS RAISE PROPERTY TAX CONCERNS

PROPERTY TAX from page 1

space per person. This requirement changed as some businesses sought to maximize density and encourage collaboration.

In a COVID-19 world where social distancing precludes density, many companies are limiting the number of employees returning to the workplace. Some companies have adopted permanent work from home policies. If this trend continues, office tenants may renegotiate leases to occupy smaller spaces, or decline to renew.

Taxpayers working with assessors need to understand renewal probability, which measures the likelihood of a tenant renewing its lease during the holding period. Before the pandemic, renewal probability in a given market may have been 80 to 90 percent, while a post-COVID renewal probability could well be 50 percent or less.

Because assessors typically value property annually, they seldom consider renewal probabilities. Given the uncertainty of a pandemic, however, property owners need to discuss renewal plans with any tenants that have leases expiring within the next 12 months, and then share that information with assessors.

If there are a significant number of tenants at risk of vacating — and this is a trend that is being observed in the market — the assessor may need to adjust the capitalization rate used in the income approach to value the property.

## Adjust Assumptions

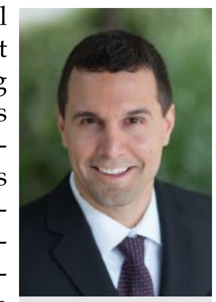
Owners of office buildings operating at stabilized occupancy levels for their markets must work with assessors to evaluate and analyze their vacancy risks. Buildings that lack stable occupancy rates as of valuation dates will face additional challenges as the pandemic continues.

When working with assessors, owners must properly forecast an appropriate absorption period for their vacant office spaces, in addition to projecting appropriate costs to build out spaces for occupancy. With the volume of office space offered for sublease increasing at a record pace across the nation, and often at below-market rental rates, taxpayers and assessors must consider an additional layer of competition that could create downward pressure on rental rates for direct office space. An office building that may have reached stable occupancy in 12 months in a healthy real estate market could now require 24 to 36 months to stabilize.

COVID-19 has also ushered in new health and safety measures that office owners and operators may be required to address when building out office space. Touchless entry systems, improved HVAC and filtration, and antimicrobial construction materials are just a few build-out responses companies are evaluating to bring workers back into the office safely.

If these additional costs become standard, they must be considered in a lease-up analysis. Furthermore, these calculations must include any additional time needed to complete build-outs at a time when construction crews across the nation are operating under their own COVID policies.

Office protocols will likely continue to evolve into 2021. That makes it important to save all documentation that may have a bearing on the property's net operating income. This includes rent relief agreements, renewal information, relocation requests, lease terminations, build-out costs and other records to help ensure the assessor can properly consider all factors affecting the valuation for the upcoming tax year.



Garza

For the next few years, office space will remain at risk for declining values at least until a vaccine can be developed and properly administered across the nation. In this challenging period, it will be critical to ensure that assessors appropriately weigh all relevant documentation when selecting metrics in property tax valuation models.

Kirk Garza, Director, and Valarie Bradley and Caleb Snow, Summer Interns, Popp Hutcheson

---

*Outlook continued from page 37*

Those that are hanging on, waiting for restrictions to lift and life to resume, may not have to wait much longer, though each day that passes can feel like a lifetime for a struggling retailer.

"By late quarter-one 2021, the vaccine program should be hitting scale," Sigal says." That, coupled with the 18 million Americans who have recovered from COVID-19, starts to get us in the herd immunity zone. This should increase in the second quarter, and consumers' hunger for a summer, fall and holiday season should drive growth over the course of 2021."

Grossfeld

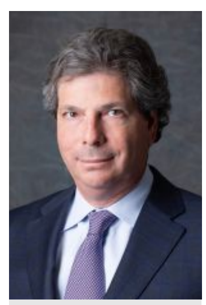
Scott Grossfeld, partner at Cox, Castle & Nicholson in Los Angeles, envisions retail's recovery starting in mid-2021 or later.

"The pandemic caused many retail bankruptcies and vacancies, which will cause the retail recovery to last longer due to the need to fill many vacant spaces," he says.

On the bright side, these elongated closures and restrictions have likely created a significant demand for on-site experiences — something brick-and-mortar retailers hope to capitalize on when they're able to resume normal operations.

"We see pent-up demand for anything that satisfies lifestyle," Sigal notes. "Be that going to the gym, shopping with friends or going out for dinner. Humans are social creatures, and we have been deprived of those experiences in 2020, something the holiday season has exacerbated. In response, we expect to see an overcorrection in 2021."

When consumers do return, they're likely to be met with heightened protocols on airflow, sanitization and mask wearing. Sigal notes many retailers are also increasing innovation efforts around experiential retail, including more showroom-centric operators with an emphasis on exceptional customer experience. He says movie theaters may also be a question mark moving forward, as Warner Brothers announced it will release its entire slate of 2021 movies simultaneously on HBO Max and in theaters.



Sandy Sigal

Sandy Sigal (brother of Mark Sigal), president and CEO of NewMark Merrill Companies in Woodland Hills, believes another question mark will be what happens at the end of 2021. The answer to this, he asserts, may determine retail's future direction.

"With the vaccine and stimulus, the re-opening of indoor dining, gyms, etcetera, seems very doable by April, even with limitations," he says. "We would expect a pretty good uptick in traffic and activity.  I would project a very strong summer as gathering activities resume, again with limitations. I think the third quarter could be very strong as well, but the fourth quarter will be the test. That's the time when stimulus wears off, depending on state and local tax policy, assuming the virus is in our rearview mirror."

NewMark Merrill's Anaheim Town Square in Anaheim, Calif., has relied on outdoor seating and gathering areas since restrictions began and restaurants were unable to serve indoor diners.

Hammond

Though no one can predict the future, current sales can give some indication of what may lie ahead, especially if restrictions loosen. Hammond notes that shopping center rent collections within Coreland's portfolio were below 75 percent in May, but have increased to 90 percent by December. Sandy Sigal states that restaurants that introduced delivery mechanisms during the pandemic were able to recover between 60 percent and 75 percent of their sales.

Industry aside, the second stimulus bill, multiple vaccines and a desire to return to the outside world has built up demand for more services, experiences and "normality" across the U.S. Just where any one industry may fall on that demand spectrum remains to be seen, though it's a safe bet that the future will look brighter for many Americans and business owners in the 12 months ahead. ■