

## **Although Tenant Demand Eases in Los Angeles and San Gabriel Valley Long-Term Fundamentals Remain Strong**

The extended outlook for the Los Angeles County and San Gabriel Valley retail market remains bright, though moderating economic conditions and the local housing downturn will ease tenant demand in the near term. The metro's retail supply is expanding, with builders targeting the redevelopment of older shopping centers and malls due to growing land constraints. Santa Monica Place, for instance, is currently undergoing a major transformation and will be reopened in the fall of 2009 as a pedestrian-friendly open-air mall. In the Greater Downtown area, the highly anticipated L.A. Live project is expected to revive the downtown retail market by bolstering the area's appeal and spurring convention traffic.

In dense office districts proximate to the urban core, rising land costs are driving mixed-use developments that contain ground-level retail beneath residential and/or office space into the higher end suburban regions of Los Angeles County. For instance, the newly constructed Avalon mixed use development in Encino, offering high-end apartment living over boutique retail is scheduled to open in the summer of 2008. Overall, new construction will expand metrowide stock by 1.1 percent this year. Demand growth, meanwhile, will cool as local employers continue to trim payrolls and a turbulent housing market diminishes equity spending. As a result, vacancy is forecast to trend up and leasing incentives may increase, especially among older, unanchored strip centers in outlying areas where home sales have been hit particularly hard.

By the numbers, job losses are expected to increase from last year, when approximately 5,000 positions were cut. In 2008, employers in Los Angeles are forecast to eliminate 8,000 workers for a 0.2 percent reduction. Builders in the county are slated to deliver 3.7 million square feet of new retail space this year, up from 3.4 million square feet in 2007. New supply will expand metrowide inventory by 1.1 percent. Following a 20 basis point rise last year, easing tenant demand and strengthened construction activity are expected to push up vacancy 80 basis points to 8.1 percent in 2008, which is still moderate compared to 8.5 percent for industrial sites and 11.5% for office space nationally. Rent growth is forecast to slow as owners seek to retain tenants. Asking rents are expected to gain 2.8 percent to \$2.55 per square foot per month in 2008, while effective rents increase 2.1 percent to \$2.31 per square foot per month.

The Los Angeles retail investment market will remain healthy this year, though a thin for-sale inventory and tighter lending standards may reduce deal flow. As such, a renewed lender focus on tenant creditworthiness will lure equity-rich local buyers to assets leased to national tenants. Also, as economic uncertainty continues to drive buyer interest for primary markets, REITs will stay active, targeting supply-constrained areas. Currently, average cap rates for single-tenant assets are in the mid-5 percent range, while initial yields for multi-tenant assets are in the low-6 percent range. Given the recent credit stresses, however, cap rates are forecast to rise modestly as sellers attempt to bridge the divide with buyers, though major price corrections are not expected.

### **New Construction Pushes Upward Pressure on Vacancies in San Gabriel Valley**

San Gabriel Valley's retail market is expected to further soften this year, as the local housing downturn weighs on retail sales growth and new construction surpasses tenant demand. Moreover, rising energy costs and a reduction in area payrolls have also contributed to a drop in spending during the past year, resulting in some retailers to scale back operations in the submarket. As a result, San Gabriel Valley's vacancy rate has pushed up 160 basis points on a year-over-year basis through the first quarter to 8.6 percent. Specifically, unanchored specialty centers are expected to lag the market. Rent growth, meanwhile, has begun to tail off, advancing 3.8 percent to \$2.24 per square foot per month in that time, down compared with one year earlier when asking rents increased 6.8 percent. In terms of new supply, retail developers brought 290,000 square feet of retail space online in the San Gabriel Valley in 2007, approximately 40 percent below the submarket's five-year annual average. This year, despite modest pre-leasing commitments, completions will pick up with the anticipated delivery of 460,000 square feet, the bulk of which will be delivered in East San Gabriel Valley.

Retail development is increasing in San Gabriel Valley. Builders are expected to deliver approximately 460,000 square feet this year, up from the 290,000 square feet in 2007. An influx of new supply, coupled with reduced consumer spending will push vacancy levels higher in 2008. After a 10 basis point rise in 2007, vacancy is projected to climb 240 basis points to 11 percent this year which is in line with the national projections regarding vacancy adjustments pursuant to the most recent report issued in the ICSC briefs, post the May convention in Las Vegas wherein they state it is projected that Vacancies will settle at or near 11.1% for the year. Rents will continue to move higher, albeit at a more measured pace than last year. For the year, asking rents are forecast to gain 2.8 percent to \$2.29 per square foot per month, while effective rents will increase 2.3 percent to \$2.09 per square foot per month.

The San Gabriel Valley investment market is expected to slow in the quarters ahead as buyers display a more cautious approach when acquiring local assets. During the most recent 12-month period, overall deal flow in the San Gabriel Valley has tapered off, largely attributable to a widened pricing gap and tighter lending requirements relegating many leveraged buyers to the sidelines. Despite the slowdown in sales velocity, asset valuations for both single- and multi-tenant assets have advanced due to strong rent growth in earlier quarters. Looking ahead, however, as rent growth continues to slow and owners endure waning occupancy, price growth will likely begin to level off. Cap rates, meanwhile, for single- and multi-tenant assets in the San Gabriel Valley area currently trade in the mid-5 percent range.

Although some portions of the retail market have recently shown some signs of softening, Los Angeles County remains one of the tightest markets in the nation. According to Marcus & Millichap's newest National Retail Index, which was released at RECon in Las Vegas in mid May, Los Angeles ranks within the top 10 out of 43 major metropolitan areas across the United States, based on forecast employment growth, vacancy, construction, household formation, retail sales, rental growth and housing formation.

Over the long term, Los Angeles fundamentals are expected to remain strong because the metropolitan area will always be a supply constrained market.

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