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Calif. Industrial Markets To Top Out Around 2016

By **Natalie Rodriguez**

Law360, New York (July 15, 2013, 8:28 PM ET) -- Between industrial developers recently flooding the California markets with new projects and other West Coast markets with easier land-use approvals winning over certain investors, some real estate attorneys and experts see the California industrial market topping out by 2016.

Currently, many Californian industrial markets are boasting enviable vacancy rates within the 4 percent to 5 percent range, according to several commercial real estate market reports. But with a full pipeline of projects expected to reset the supply-demand balance and other West Coast markets offering easier development signoffs and better fundamentals for investors, California is expected to see shrinking growth by 2016, according to experts and a recent developer survey by Allen Matkins Leck Gamble Mallory & Natsis LLP and the University of California, Los Angeles.

“One place where there seems to be a clear indication of slowing development is in the industrial markets. Demand growth is just not the same to justify continuing the recent pace of new development,” John M. Tipton, an operating partner at Allen Matkins' Century City office, told Law360. Tipton noted, however, that developers surveyed still expected to see improvements through 2016.

Mirroring the national industrial segment, many of California's markets got off to a strong start this year, with the Los Angeles and Peninsula/San Mateo County markets seeing their vacancy rates in the 4.7 percent to 4.8 percent area, and Silicon Valley showing signs that its markets are poised to tighten drastically from their first-quarter averages of 10.84 percent for manufacturing and 13.44 percent for warehouses, according to recent Kidder Matthew market reports.

“Absorption is clearly outpacing supply,” Tom Bak, senior managing director of Trammell Crow Co.'s Southern California-Newport Beach business unit, told Law360. Trammell Crow has about 3 million square feet of projects under construction in the Los Angeles basin and recently inked a major 667,909-square-foot lease in Riverside.

Meanwhile, port traffic, an important indicator for the area industry, is up 1.3 percent from last year, with containerized imports — which buoy the warehouse segment — up 5.3 percent, Shaw Lupton, a senior real estate economist for the CoStar Group, said in a Monday market report.

Racing to take advantage of market opportunities, investors have been happy to funnel cash into the area. A recent Jones Lang LaSalle report said that “Los Angeles and the Inland Empire continue to be the top destination for industrial investment dollars and the first quarter was no exception, with $427 million flowing into Los Angeles and $569 million going to the more distribution-heavy Inland Empire."

Plus, in another nod to the market's favorable headwinds, a recent California-heavy industrial portfolio also recently traded from Dexus Property Group to Heitman LLC for $561 million.

But already, the deals pace has begun to slow, with the Peninsula and San Mateo County area seeing 13 fewer deals in the first quarter than at the end of 2012, Silicon Valley demand not being able to keep up with supply and San Francisco growth flattening out in the beginning of the year, according to Kidder Matthews.

Developers already have been racing to take advantage market opportunities, and many feel like the pipeline can't take much more new product, according to experts.

“Generally speaking, I've heard from clients that they think this might be the closing of the window as far as the best returns go. There's a scramble right now to beat each other to bring projects to market before 2016,” Scott Buser, a partner in Mayer Brown LLP's real estate practice, told Law360.

Developers predict occupancy rates in 2016 will be lower than today and that rental rates will firm up, partly because consumer demand is lagging as the U.S. remains frugal and export demand sees slow growth, according to the Alllen Matkins-UCLA survey. California's ports serve as a key artery point for trade between the U.S., Asia and Mexico.

And with capitalization rates compressing, investors also are turning to Seattle, Portland and other West Coast markets, which often offer better returns.

“Equity-side investors have felt like, especially in the Bay Area, prices ran up too much, too quickly,” Buser said, noting that he believes the California real estate markets peaked at the end of last year.

Further squeezing the markets are certain land-use issues, with recent rezoning pushes tied to the multifamily and office markets making it harder to find appropriately entitled land for new industrial developments, according to Bak. And while Portland offers developers a similar time-line and approval process as California, Seattle is a marginally easier place to get shovels in the ground because there's not an extra environmental review layer, according to Buser.

But some experts say not to count California out entirely from being able to keep up in the growth race. Inland Empire, in particular, has room to rise as the industry shifts away from the 500,000-square-feet-plus users that led the industrial recovery, to smaller manufacturing and warehouse users, according to Bak.

“The under-100,000-square-foot market is just starting to gain that confidence,” he said, noting that the segment is nowhere near its prerecession levels.

And others contend that the slowing development pace is indicative of a healthy market that won't be popping in a bubble.

“What we're seeing now is the building of new space is catching up with the increase of demand in 2016, a stabilization of the market,” Jerry Nickelsburg, an adjunct full professor of the UCLA Anderson Forecast unit, told Law360.

--Editing by Elizabeth Bowen and Richard McVay.

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