CRAIG COAN, JEREMY CRAMER, KIRK MALMROSE AND MAL SERURE SHARE INSIGHTS ON THE REAL ESTATE INDUSTRY

The **Real Estate Outlook Roundtable** is produced by the LA Times Studios team in conjunction with Cathay Bank; Greenberg Glusker LLP; IDB Bank; and McDermott Will & Emery LLP.

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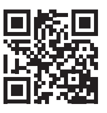

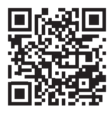

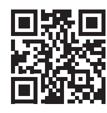

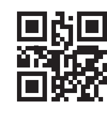

The commercial real estate sector has seen multiple shifts and pivots over the last few years, requiring the implementation of new protocols, digitization of many operations, adjustments to workplace operational practices and navigating through the hybrid work environment. This has, in turn, created shifts of focus.

As we move toward the end of 2024, questions still linger. What changes and trends are here to stay for the long term? What legal and financial issues need to be addressed? What new roles is technology playing? What will the real estate industry look like a year from now?

LA Times Studios turned to four uniquely knowledgeable experts for their thoughts and insights about what's next for L.A.'s resilient real estate sector.

Q: HOW WOULD YOU DESCRIBE THE OVERALL OUTLOOK FOR SOUTHERN CALIFORNIA CRE AS WE HEAD TOWARD THE END OF 2024?

A: Malmrose

This year is shaping up to have been one of transition. In late 2023, the industry was looking for a rebound with anticipated rate reductions, but the Fed's "higher for longer" stance has muted growth for 2024. The market is getting a reprieve as the Fed recently cut rates by 50 basis points. Cash is king. Investors with access to capital will begin seeing buying opportunities as relatively high interest rates currently in the 5.5% to 6% range have squeezed investors who levered up their properties three to five years ago with rates in the upper 3% range. These investors are facing a "cash-in" refinance scenario. Without cash, they are looking at either a sale of the property or hanging on with a high leverage/high interest rate loan with possibly an interest-only period.

Q: HOW WOULD YOU DESCRIBE TODAY'S INDUSTRIAL MARKET IN SOUTHERN CALIFORNIA?

A: Serure

The industrial sector has always been important to Southern California, because of its proximity to major local ports and its role as a hub for distributing fresh produce and other agricultural products grown in the state. Despite some softening in the industrial market in 2024, the prominence of e-commerce and increased demand for electrical power should drive a stronger industrial market in the medium term. Behind the convenience of same and next day delivery to which we've all become accustomed is a massive infrastructure of warehouses and distribution centers. Companies are increasingly looking to shorten the supply chain and build more facilities to avoid the supply disruptions of the COVID-19 era and decrease delivery distances. Industrial EV charging facilities – particularly for commercial vehicles – should also see a lot of demand as electric commercial fleets arrive on the road en masse over the next few years.

Q: WHAT ARE THE KEY OPPORTUNITIES AND RISKS FOR DEVELOPERS TO BE AWARE OF IN 2025?

A: Cramer

We anticipate Q4 2024 and Q1 2025 to present a unique window of opportunity for developers operating across certain submarkets and asset classes. Enthusiasm for Los Angeles CRE development in 2024 has been conspicuously anemic with a noticeable lull in active new building permits. Given the lack of new construction ground breaks, developers who are prepared to initiate projects in the short term can benefit from a high-supply/low-demand environment, gaining access to better subcontractors and a reduction in costs on the early trades. These conditions become increasingly advantageous in a softening interest rate environment heading into the New Year. Weighing these factors and accounting for industry challenges, population density and changing use patterns in the L.A. market, we believe the highest areas of opportunity are across multi-family, industrial and retail asset classes with the office space continuing to present the greatest risk exposures.

A: Coan

Interest rates and new regulations are risks for developers. For example, sales of real estate properties in Los Angles are being negatively impacted by high interest rates and the ULA tax. In California, regulations and laws don't always lead to the intended outcomes. Ballot propositions can be long and hard for the average voter to understand. Since legislators aren't typically real estate professionals, decisions are often made without proper facts or context. Unfortunately, the "one size fits none" approach often results from these new initiatives and laws.

A: Malmrose

Investment opportunities will be location and asset-specific. Well-located multifamily properties over the long term provide great prospects for cash flow and price appreciation. In all asset classes, excellent customer service and addressing needs will go a long way toward tenant retention and avoiding expensive turnover costs. Select retail demand has been strong, especially in neighborhood centers. E-commerce continues to draw spending away from soft goods retailers, so large-scale retail landlords will need to reinvent themselves and improve the shopping experience to be successful. There has been some softening in the industrial markets, but this is just a pause. In the long term, we will continue to see technology and logistics drive the supply chain at all levels, which will support industrial demand. The changing work environment poses huge risks for the large block office sector.

Q: WHAT DO YOU CONSIDER TO BE THE MOST MEANINGFUL POSITIVE TREND IN COMMERCIAL REAL ESTATE LATELY?

A: Coan

The strength of retail. For several years, there was a lot of talk about the death of retail and brick-and-mortar stores. It's true that retail was overbuilt, and many underperforming malls with large anchor stores had to adjust. However, we're seeing neighborhood and community shopping centers getting stronger. In Los Angeles, retail vacancy rates are about 5.5% lower than the national average. Some fast-casual restaurants are leaving California due to high operating costs, but private equity firms and publicly traded companies are pushing for continued growth to maintain stock prices and valuations. While people say office space is overbuilt and may never fully recover due to generational shifts, I believe office building owners are focusing on amenities to make return to the office more appealing, similar to what has happened with retail.

A: Cramer

Recent activity out of the Fed has spurred some industry players out of stasis. With the recent decision to lower the target rate by 50bps, at this time, we are seeing heightened activity in loan and financing queries. If this trend continues as anticipated, we believe it will likely most positively impact refinance and sale activity. Separately, but equally interesting, we are closely watching trending new construction activity, specifically as it relates to multi-family, as lease rates and absorption within the rental market have held up well amid 2024 economic volatility. These markets remain a testament to the diverse job base and related economy in Los Angeles.

Q: ANY NEGATIVE TRENDS YOU HOPE WILL GO AWAY?

A: Coan

I'd like to see successful companies stay in California. The state's strong economy attracts top talent. While we need to create affordable housing for younger generations and those priced out of the market, overregulation and excessive taxation could drive companies out. It's a delicate balance, but companies must prioritize their shareholders. I've heard from many operators that doing business in California is becoming too difficult. If that sentiment becomes widespread, it could create a bigger problem.

A: Malmrose

While some see remote and hybrid work as a negative trend, it has positives and negatives – and is here to stay. Work/life balance may have improved but collaboration and creativity may have suffered. I go into the office every day and benefit from "water cooler" discussions with my peers and impromptu "hallway meetings" with others. It is important for young people entering the workforce to develop relationships and mentorships to help them navigate their careers. The pendulum swung far during the pandemic for work-from-home. In many industries, we won't go back to the five-day workweek, but I hope we can strengthen the personal interaction and synergistic collaboration that brings out the best in us all.

Q: HOW ARE CURRENT INTEREST RATES AFFECTING PROPERTY DEMAND AND PRICING IN VARIOUS SEGMENTS?

A: Serure

The Fed's recent rate cut and expected cuts for 2025 will hopefully spur demand in the commercial real estate market. Even if the Fed continues to lower rates, there is still a lot of distress and lagging values, and we are likely going to be in a high-rate environment for the foreseeable future. Still, a lot of capital has been raised over the past few years and investors are

eager to deploy it. An important effect of even a small decrease in rates may be that market sentiment seems to be getting more positive and optimistic, and dealflow is picking up, though it is still very far off from the volume of 2021 and 2022. It feels like there are a lot more term sheets and conversations around doing deals and more willingness to transact, which can be contagious.

A: Coan

In ground-up development, interest rates are not as big of an issue. Debt is often still cheaper than equity, so if a developer has tenants lined up, can get entitlements quickly (which is a big if) and build at a reasonable cost, short-term debt can be profitable. On the valuation side, cap rates are higher due to rising interest rates, and sellers are hesitant to sell at lower prices unless they have no choice or have loans maturing that they can't refinance profitably.

A: Cramer

There has been an understanding that the high-interest rate environment has largely prevented the market from transacting and that there are some significant CRE loan maturities with refinance risk due to cash-in requirements that are on the horizon. We've seen some sales in the marketplace that demonstrate this weakness, but they appear to be situational and often due to an overly aggressive business plan, owner configurations or high-cost in-place financing. The recent Fed decision to lower rates and the expectation that we're pacing for a Goldilocks rate environment in 2025 appear to be calming nerves. However, some asset classes, such as downtown office buildings, will continue to struggle due to fundamentals in their product segment.

Q: WITH PURCHASE AND SALE TRANSACTIONS DOWN LAST YEAR, WHAT ARE THE BIGGEST HURDLES PREVENTING BUYERS AND SELLERS FROM CONSUMMATING DEALS?

A: Malmrose

The bid/ask spread between buyers and sellers has widened over the past 18 months. Tighter credit markets, higher interest rates and divergent expectations between buyers and sellers have slowed sales transactions. Additionally, in conversations with developers and investors, I hear a common refrain that Measure ULA – which imposes a new transfer tax of 4.0% on property sales in the city of Los Angeles that exceed $5 million and 5.5% on those exceeding $10 million – is dampening activity. There is a true housing shortage in the Los Angeles metro area. With rising material, labor and land costs, an additional 4.0% or 5.5% tax on the sale of a newly constructed building can be the difference between adding housing to the community and not.

Q: WHAT IMPACT IS THE CURRENT INFLATION RATE HAVING ON CONSTRUCTION COSTS AND REAL ESTATE DEVELOPMENT?

A: Cramer

We've seen that inflation has had an impact on material costs and, to my knowledge, there is no indication of these expenses coming down in the short term. However, like we discussed earlier, the current environment is highly advantageous to developers who are willing to come off the sidelines. Going back to the lull of developer activity in the L.A. market, competition is a tried-and-true great equalizer. In a high-supply/low-demand environment, we are increasingly hearing of subcontractors and suppliers who are willing to work on thinner margins, or even at a profit-neutral position, in order to maintain healthy long-term business relationships that can prove profitable under better market conditions. There has also been a trend of market rate developers moving into the affordable unit development space, spurred by the ED1 initiative allowing developers to find additional value by reducing parking and increasing unit density within a project, not to mention the fast-track approval process for these affordable projects.

Q: HAVE UNDERWRITING REQUIREMENTS BECOME MORE STRINGENT?

A: Malmrose

With the collapse of four regional banks in 2023 and the recent FDIC takeover and sale of Republic First Bank in Philadelphia, regulators are closely scrutinizing banks' CRE portfolios. This has a rippling effect of tighter underwriting and enhanced due diligence by financial institutions. Where a bank may have underwritten a loan at a 1.15x debt coverage ratio for a multifamily property, it may now underwrite to a 1.25x coverage. This limits loan proceeds. Add to that a higher interest rate than what was previously used and proceeds may be further limited. The Fed's tightening to slow inflation is making an impact on CRE markets and driving more equity into deals.

Q: HOW IS PROPTECH CHANGING THE WAY WE BUY, SELL AND MANAGE REAL ESTATE?

A: Serure

Real estate companies are focusing on technology more than ever. They are using artificial intelligence to automate property management functions, optimize operations, process data, manage leases and screen tenants. Visiting a commercial property will always be a crucial part of the due diligence process. Still, virtual and augmented reality is allowing buyers to perform more due diligence at their desks and to decrease the frequency of travel. Also, some real estate developers are using VR to view 3D renderings of construction projects and tenant build-outs in place of 2D drawings. While the opportunities in PropTech seem endless, the pivot to more and better technology will require the real estate industry to make long-term investments of money and time building out infrastructure and hiring and training personnel who will be responsible for managing these functions.

Q: HOW ARE INSTITUTIONAL INVESTORS ADJUSTING THEIR REAL ESTATE PORTFOLIOS IN RESPONSE TO CURRENT MARKET CONDITIONS?

A: Coan

Investors need to deploy capital, and they're targeting sectors where the risk-reward ratio makes sense. Multifamily developers and investors are increasingly shifting to self-storage properties. Industrial real estate remains strong and requires less hands-on management than retail, multifamily or office properties.

Q: WHAT ALTERNATIVE FINANCING MODELS ARE GAINING TRACTION IN THE REAL ESTATE SECTOR?

A: Cramer

Although we at IDB are very actively lending and growing today, many regional banks remain bloated with low-interest rate CRE loans and have paused meaningful financing activity. Banks in a balance sheet predicament won't be able to begin lending again until rates come down in a material way and can cycle through their portfolio to free up room for new business. With fewer traditional lenders in the space, alternative lenders such as Private, CMBS, Agency, and Life Cos have seen an opportunity to fill gaps and seem to be our most frequent competition. While these options may be convenient, I caution borrowers to pursue financing through these entities. With term financing, I have less reservations for clients, but I always caution clients on going with a non-bank lender for construction financing. A financing relationship is a marriage, and I think banks have more incentive to work with clients through tough times. Additionally, given construction is disbursed over a period of years, I ask clients to dive deeper into a non-bank lender's sources of funds.

A: Coan

We're seeing a lot of short-term, high-interest construction and bridge financing from non-traditional lenders like hedge funds. With interest rates as high as they are, non-traditional lenders are stepping into the real estate market, often through debt funds that provide more flexibility to borrowers. These loans usually come with hefty fees, both origination and exit, but with higher loan-to-value (LTV) ratios, there's value in having more flexible financing options.

A: Serure

Preferred equity as a substitute for subordinate debt has become more prevalent over the last few years. The preferred equity provider contributes equity to the property owner or a parent entity and typically gets debt-like terms, which are set out in an operating agreement. These terms may include a fixed monthly preferred return, a mandatory redemption date and priority repayment from cashflow after payment of debt service, taxes, insurance and other operating expenses. With less traditional mortgage financing available, especially from banks, many borrowers have turned to preferred equity to supplement their existing loans. It's become a lot more institutionalized with private equity funds and other real estate companies issuing preferred equity and mortgage lenders cooperating to recognize rights of the preferred equity holder to take over control of the borrower upon a default.

Q: THE LEASING MARKET HAS CLEARLY CHANGED OVER THE LAST FEW YEARS, PARTICULARLY IN THE OFFICE SECTOR. HOW HAVE CLIENTS ADJUSTED TO THE NEW LEASING LANDSCAPE?

A: Malmrose

Office leasing is going to be a challenge for the foreseeable future. Tenants have the upper hand in negotiations right now, and Class A buildings in prime locations will win out. High levels of service, attention to detail and upgraded amenities will help keep tenants in place; not having those things will motivate tenants to find better alternatives.

The office markets are a slow-moving trainwreck that will take years to sort out. Some have called this "The Great Reset" for office buildings. There are well-publicized sales in DTLA where buildings have traded for 50% or less than the current owners' purchase price. These sales may be 20%-25% of replacement cost and could provide redevelopment opportunities for new owners, but a study by Gensler estimates possibly only 25% of office buildings are suitable for conversion to apartments. Gregory Peck said, "Tough times don't last. Tough people do." I would add to that statement that it helps to have a cash reserve.

Q: WHAT DO CRE TENANTS NEED TO BE THINKING ABOUT AS THEY SEEK NEW SPACES IN 2025?

A: Coan

Understanding your leverage with landlords. The market can vary significantly from street to street, and landlords have different tax bases.

From a valuation perspective, landlords prefer long-term, fixed-income leases for better loan terms, while tenants are more focused on short-term EBITDA. Knowing where you can provide value to the landlord and get benefits in return is crucial. With the upcoming election and inflation easing, there may be some market hesitancy until after November. Lawyers can assist with negotiating favorable market terms, but brokers typically have a better pulse on the market.

Q: WHAT IS NEXT FOR THE CRE INDUSTRY?

A: Serure

Artificial intelligence will continue to impact the real estate industry. Besides affecting the way we work, we can expect AI to also drive real estate development towards data centers and alternative energy production. AI requires a tremendous amount of electricity and data center capacity, and its growth will increase demand for properties that can create these resources. Additionally, companies will likely move to transition their commercial trucks to electric vehicles for efficiency but also to meet California state requirements. While the majority of trucks on the road now are still filling up at gas stations, in the coming years, we can expect to see a shift to electric fleets. This should result in a corresponding spike in demand for development of commercial charging facilities, which will require more power and different technology than consumer chargers to fuel larger vehicles and longer distances for shipping.

A: Cramer

Real estate is the next industry poised for disruption through the rising prominence of PropTech and AI. While it's still early days, we know that the CRE industry is full of data points that can be leveraged for accelerated growth and opportunity. Using tech intermediaries, the industry can expect to access and analyze valuable, but siloed, data points to provide more efficiency and help make owners, vendors and lenders make better decisions. I think as this technology matures, it will have a significant impact on the industry.

This supplement was produced by LA Times Studios. It did not involve the editorial or reporting staffs of the Los Angeles Times. Contact us with comments or questions at **b2bpublishing@latimes.com**.