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SoCal's Industrial Real Estate: Will Cooling Activity Levels Affect the Outlook for the Future?

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Southern California has been one of the hottest industrial markets in the nation, and the past few years have been no exception. SoCal's commercial real estate market has been hit especially hard, with the shockwaves forcing some investors, owners, and developers to course correct in order to survive. However, for those nimble enough to pivot, the industrial sector has been a beacon of hope.

For several years now, industrial has been a strong counterpoint to the blighted climate for retail and office real estate. Demand for industrial space climbed to a historic high during the pandemic, when online retail surged and the e-commerce companies selling goods needed large industrial warehousing spaces to operate their businesses. Industrial warehouses were built as quickly as possible to meet demand. But no trend in real estate lasts forever, and the industrial sector is finally meeting headwinds, with data indicating a return to more normal (pre-pandemic) levels of activity.

According to Voit Real Estate Services' market reports, Q2 2023 Los Angeles industrial sale and lease transactions were down 45.31% compared to Q2 2022 (13,526,436 in 2022 vs. 7,397,521 in 2023). There was also a similar decrease (27.49%) in the Inland Empire (14,339,481 vs. 10,397,826).

When discussing overall outlook, several factors driving this slowdown are worth addressing. First, rising development costs (land, materials, and labor) have made it increasingly difficult to develop new industrial space. These higher capital costs, coupled with ongoing recession concerns, have many developers taking a "wait-and-see" approach. At the same time, the Federal Reserve's interest rate increases have negatively impacted the ability to purchase and/or develop industrial properties.

Second, California has one of the nation's highest tax rates, and our tax environment is not friendly, relative to certain other states. For example, the Measure ULA transfer tax in the City of Los Angeles that began on April 1 of this year helped trigger a steep drop in sales activity as measured by square footage and transaction count. For years, companies have been leaving California and going to other states with more friendly corporate tax environments. In 2020, CBRE, one of the largest commercial real estate services companies in the US, moved its headquarters from Los Angeles to Dallas. Paint manufacturer and retailer Kelly-Moore Paint Co. Inc. also announced that it will move its headquarters from California to Texas in 2024. These are just two examples of what has been a significant corporate exodus from California.

The massive rise in industrial activity over the past years has also generated a large anti-industrial sentiment, making it difficult for the sector to sustain its explosive growth. Some cities in the Inland Empire, including Colton and Norco, have already imposed a moratorium on, or limited the size of new industrial warehouse construction. Residents are unhappy about the heavy truck traffic transporting goods to and from the warehouses, as well as air and noise pollution.

Lastly, in what might be considered a positive change by many in the non-industrial sectors, consumers are finally returning to retail stores in the post-pandemic world. This means that demand for industrial space is decreasing while there is an uptick in the supply of new industrial properties coming to market, in part due to the aforementioned frenzy of developing new industrial properties during the pandemic.

All of the above present challenges that the industrial real estate market will continue to

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grapple with, and they have certainly cooled the fires of industrial real estate activity. However, the long-term outlook for the industrial sector in Southern California remains strong. While we are seeing more shoppers return to in-person, pre-pandemic habits, it seems unlikely that we as a society will completely forgo online shopping – a prime driver of the industrial craze.

Another key factor that points to long-term success is Southern California's land-constrained markets. For example, infill markets like the cities of Commerce and Industry are built out. Thus, we are likely to see more redevelopment in those areas, where dilapidated buildings will be upgraded through renovations. This dynamic is resulting in strong industrial leasing activity in infill Southern California markets. According to Voit's Second Quarter 2023 Market Report for the Greater Los Angeles Industrial area, Southern California's vacancy rate remained low at 3.4%. This is a strong sign when compared to the national overall vacancy rate of 4.1%, as reported by Cushman & Wakefield in its Q2 2023 industrial market report.

Then, there are Southern California's ports, which boast high activity relative to other ports across the country. As measured by container volume, the Ports of Los Angeles and Long Beach remain two of the largest ports in the United States. They offer the most direct route from the Asia-Pacific region, ensuring that Southern California will remain a hotbed for the global exchange of goods.

After the past three years of record activity, the downturn in the industrial sector may seem like a cause for concern. The acute challenges noted above have certainly lowered the temperature of the market and must be reckoned with by those hoping to succeed in the days ahead. Nevertheless, Southern California's unique makeup and resiliency are enough to hold promise for the future of the industrial sector.

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