KIRK MALMROSE, ED SACHSE AND KEVIN A. SHER SHARE INSIGHTS ON THE REAL ESTATE INDUSTRY

The **Real Estate Outlook** panel is produced by the L.A. Times B2B Publishing team in conjunction with Cathay Bank; Kennedy-Wilson Properties, Ltd.; and Greenberg Glusker LLP.

Kirk Malmrose
Executive Vice President, Director of Commercial Real Estate and Construction Lending
Cathay Bank
Kirk.Malmrose@CathayBank.com
cathaybank.com

Ed Sachse
President
Kennedy-Wilson Properties, Ltd.
esachse@kennedywilson.com
kennedywilsonservices.com

Kevin A. Sher
Real Estate Partner
Greenberg Glusker LLP
ksher@ggfirm.com
GreenbergGlusker.com

Thanks to the various unexpected events that have impacted virtually every kind of business over the last three years, commercial real estate companies have implemented new protocols, digitized many operations, adjusted workplace operational practices, and navigated through reopening, which has created shifts of focus…all while considering the financial health of tenants and end users.

As we move into the fourth quarter of 2023, 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?

Los Angeles Times B2B Publishing turned to three uniquely knowledgeable experts for their thoughts and insights about what's next for L.A.'s resilient real estate sector.

Q: WHAT ARE THE KEY OPPORTUNITIES AND RISKS FOR DEVELOPERS IN 2023?

A: Malmrose

There will be opportunities for well-capitalized investors in 2023 and 2024. Renovation and higher-leveraged term loans made at advantageous rates three to five years ago could face "refinance risk" with higher interest rates and tightened credit markets. Lesser capitalized investors may be pressed into selling assets rather than investing additional equity into a property to refinance and keep the asset – which will apply downward pressure on asset values to benefit investors with strong cash reserves. Current high interest rates and market dynamics are impacting asset classes differently. On one side of the spectrum, multifamily seems to be holding up fairly well with continued expected rate growth and stable occupancy. Conversely, the office market appears to be a slow-moving trainwreck with well-documented increasing vacancies, declining market rents, and significant value declines. Investing in an office at this time isn't for the faint of heart, but value investors may step in to stabilize the market.

Q: WHAT HAS BEEN THE MOST NOTABLE CHANGE IN REAL ESTATE IN THE LAST DECADE, AND HOW HAS IT IMPACTED YOUR WORK?

A: Sher

The rapid growth of e-commerce companies has reshaped the commercial real estate landscape, decimating traditional brick-and-mortar retail, while creating an industrial real estate development boom that has completely transformed areas like the Inland Empire. Even during the pandemic when other real estate sectors were at a standstill, the activity of the industrial real estate market, with my e-commerce clients seeking to expand and fill in gaps in their distribution networks, has kept me and my colleagues at Greenberg Glusker consistently busy. And now, with brick-and-mortar transforming to complete that last-mile stretch of bringing e-commerce goods to consumers, there are budding opportunities for cross-pollination of industrial with retail.

A: Sachse

Rising interest rates are notable for sure. Since 2013, we've enjoyed some of the lowest interest and inflation rates in history, with mortgages sub-3%, shorter-term money below 2%, and an abundance of available capital in the market. Supply chains damaged during COVID, combined with all that low-cost capital, resulted in sharp inflation over the last 18 months. The Fed's program to increase rates has slowed down real estate markets considerably and, in some cases, brought it to a screeching halt. As transaction volume declines, we already see stress on brokerage and finance companies as well as other real estate service companies. Despite this, our clients need us more than ever to think creatively about additional income streams and rental structures that strengthen tenants and reduce turnover.

A: Malmrose

Technology has significantly impacted real estate markets over the last several years. Access to quality data, including rental and sales comps, mapping, and historical records, is at our fingertips, helping investors and lenders make more informed decisions. These tools help market players assess target properties' economic, physical, and locational attributes quickly. However, all the technology in the world is no substitute for a "boots on the ground" site visit to understand the nuances of a property that may not be reflected in the data. You also can't undervalue the importance of building a network of "human capital," i.e., personal relationships.

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

A: Sachse

Our retail leasing agents see strength in food and beverage, health and wellness, entertainment, and approachable luxury. Consumers are literally 'hungry' for new restaurants, bars, and creative retailers that offer a unique experience. The demand is there, and consumers will

> ***Just as the "dot com" era changed the clothes employees wear to offices to a more casual standard, the pandemic has accelerated changes in how companies use space.***
>
> – Kirk Malmrose

flock to quality products and services now more than ever. It's important to recognize, though, that cities, landlords and tenants had to get creative during the pandemic to ensure the survival of brick-and-mortar businesses. Otherwise, this would be a different story. On the part of landlords, a willingness to work creatively with tenants to structure rents and extend construction periods made a huge difference. And for municipalities, the pandemic provided a case study for some pro-business efforts that I'd like to see sustained, such as reduced parking requirements for certain uses, support for al fresco dining, and more streamlined permitting processes.

Q: DO ANY TRADITIONAL PROPERTY STRATEGIES REQUIRE A RETHINK BECAUSE OF THE CURRENT MARKET?

A: Malmrose

We're currently undergoing a seismic shift in how office space will be used in the future. Just as the "dot com" era changed the clothes employees wear to offices to a more casual standard, the pandemic has accelerated changes in how companies use space. There's evidence some companies may have overshot in giving back space to landlords, who are now releasing back some of it. In my opinion, "hybrid" and "work from home" arrangements are here to stay. I expect larger office space users to continue reducing their footprint over the next five+ years. Office owners must develop strategies to attract and retain tenants in that increasingly competitive market segment. Medical and smaller professional tenants seem to be a bright spot.

Q: WHAT OTHER PARTS OF SOUTHERN CALIFORNIA ARE MOST COMPELLING IN TERMS OF COMMERCIAL REAL ESTATE RIGHT NOW?

A: Sachse

Inglewood is entering the next chapter of its really exciting evolution. For years we've anticipated the impact that redevelopment of the Hollywood Park Racetrack would have on the market, and now it's here. If we look at the line-up of world-class entertainment venues there – SoFi Stadium, YouTube Theater, Kia Forum, and the Intuit Dome (the new home of the Clippers) – this could be the largest entertainment district outside of Times Square. With these venues as anchors, there is so much future growth and demand to tap into. The initial phase of retail shops at Hollywood Park is already coming to life – Cinépolis just opened to great fanfare – and hundreds of multifamily units are now for lease at the project. It's thrilling that millions of annual visitors will be coming to Inglewood to experience sports, music, shopping, dining, and of course the Olympics in 2028.

Q: ANY NEGATIVE TRENDS YOU HOPE WILL GO AWAY?

A: Sher

The growing difficulty in finding available and affordable property insurance coverage for commercial real estate in California. Clients with older industrial and multifamily buildings are scouring insurance markets with many traditional insurers declining to quote and others quoting coverage that is 30-40% higher than comparable coverage in the last few years. From an insurance standpoint,

> ***Some companies are still operating remotely to a large degree, but if managers want people back in the office, a thoughtful return-to-work strategy is essential.***
>
> – Ed Sachse

California has the dual problem of high construction costs for rebuilding, which have become even higher due to inflation, and costly natural disasters like wildfires that have become increasingly more common with climate change. Some large insurance companies have announced they are no longer writing new casualty policies in California for commercial properties. Clients accustomed to having several different casualty insurance options to choose from are now frequently finding themselves with just one or, in some cases, with none.

Q: HAS YOUR FORECAST FOR VALUES IN DOWNTOWN LOS ANGELES MAINTAINED THROUGHOUT THE LAST YEAR?

A: Sachse

Today, the value in DTLA is on the ground floor. We all recognize the difficulty with high-vacancy office products in central business districts and acknowledge the effect that's having on building values, and it's still to be seen how that plays out. However, DTLA is an established destination with cultural vibrancy and regular events that draw people from across L.A. County. That fact, along with the City's updated DTLA 2040 Community Plan – which calls for 70,000 new housing units and 55,000 new jobs – leads me to believe that DTLA will continue to be an attractive market for restaurants, bars, entertainment and retailers. Our retail leasing team in DTLA is seeing a lot of activity, especially as the market has corrected from historically high rental rates of several years ago.

Q: WHAT NEW TRENDS ARE YOU SEEING IN RESIDENTIAL REAL ESTATE?

A: Sher

A key stumbling block for the affordable housing crisis in California has always been the sheer volume of our residential stock that is zoned solely for single-family residences. However, driving through single-family neighborhoods in California today, you see a lot of new construction of Accessory Dwelling Units, and you are constantly hearing your neighbors express an interest in adding ADUs. Recent laws passed by the California legislature earlier this year facilitate approvals for ADUs, duplexes and lot splits in single-family zones. Where once a single house stood, you may now be able to split your lot into two separate, individually salable and separately taxable, legal parcels and then construct a separate home with an ADU or duplex on each. Four dwellings are certainly better than one from an income-generating standpoint.

Q: ARE THERE ANY REAL ESTATE SECTORS THAT RUN THE RISK OF BECOMING OBSOLETE IN THE CURRENT CLIMATE?

A: Malmrose

Advancing technologies have had a profound influence on how we're using real estate. Early in my career, restaurants were a minor part of a retail center's occupancy. The emergence of e-commerce and changing shopping preferences has supported a greater use for more food, service, and experiential tenants as a percentage of the property. I recently visited the Amazon Style store in Glendale, where you can walk through a beautiful showroom, scan the items you like, and go to a dressing room where everything you selected is waiting for you to try on. This concept reduces costly showroom space, uses state-of-the-art inventory controls, and creates a more efficient business model. It is also fun. Landlords need to be ahead of the curve in spotting long-term trends and repositioning their properties to meet demands. In real-time, we're seeing certain office and mall properties becoming obsolete.

Q: WHAT DO CRE TENANTS NEED TO BE THINKING ABOUT AS THEY SEEK NEW SPACES IN 2023?

A: Sachse

For office, right now it's a tenant's market and those seeking space should try to lock in long-term rents while being thoughtful about how much space they really need. Some companies are still operating remotely to a large degree, but if managers want people back in the office, a thoughtful return-to-work strategy is essential. For example, does everyone need a permanent desk, or is hoteling an option? Implementing their strategy in the right way may provide occupiers an opportunity to cut costs, downsize, or reconfigure a current space to better support core operations. For retail tenants, doing upfront due diligence on a prospective space is crucial. Supply chain issues are still affecting opening timelines and knowing whether a build-out requires extensive demising, increased power, or specialized equipment from the get-go will save time and money in the long run.

A: Sher

If companies are looking for workspace in 2023 and want to incentivize their workers to return to the office, then they need to find locations that offer a more dynamic environment, with amenities like nearby shops, restaurants and gyms. There are great opportunities for subleasing in the office market since many office tenants are paying pre-pandemic rent for substantially underutilized space. Most of my office leasing work in 2023 has been subleasing work, while I have other clients opting for coworking spaces instead for greater flexibility and shared amenities. And while the financial terms of a sublease may be attractive, I caution my clients that being a subtenant with no contractual rights against your master landlord can put you in a precarious situation.

Q: WHAT ARE SOME CRE LENDING TRENDS YOU ARE OBSERVING?

A: Malmrose

The bank failures early this year sent a shudder through the financial markets. Virtually every financial institution is evaluating the quality and durability of their portfolios. Loans with maturities through the end of 2024 will come off very low interest rates in the 3.50% to 3.75% range. How well will these loans fare when we see interest rates in the 6.00% to 7.00% range? These higher interest rates sometimes force owners to come to the "refinance table" with cash-in. Underwriting standards are tightening, with lenders seeking higher debt coverage ratios assuming higher interest rates. We've seen increased activity from developers seeking construction financing as their existing lenders have exited the market.

> ***A new green vehicle fleet is not sustainable without investment in the supporting infrastructure, and I believe the commercial real estate industry will be at the forefront of meeting these needs.***
>
> – Kevin A. Sher

A: Sher

Financing for commercial real property has become increasingly difficult for my non-institutional commercial real estate clients. They previously opted for relationship-based regional banks, but the recent failure of some regional lenders has left a gap in the market. If you are fortunate enough to find a lender to finance your commercial property, the loan underwriting process has become much more arduous. Clients are often paying extensive reserves for interest payments, future capital expenditures, repairs, re-leasing and other contingencies. Many of my clients are trying to wait out this high-interest-rate lending market. They are paying for short-term extensions on existing loans, if available, or taking the risk of obtaining costly short-term bridge loans, with the hope that interest rates will have materially dropped before those loans mature.

Q: HOW CAN SOPHISTICATED OWNERS OF CRE MINIMIZE RISK AND OPERATE MORE COST-EFFECTIVELY?

A: Sachse

Sophisticated owners recognize that their core competencies are managing their assets effectively and investing wisely. That's what they're good at and want to stay focused on. Keeping services like property management, leasing, lease administration and construction management in-house burdens owners with personnel costs, introduces potential liability, and takes them into the operational weeds where most don't want or need to be. The property services industry is highly competitive and companies in that space must perform at the top of their game to operate at the highest level of efficiency and provide accurate and timely information to their clients. By outsourcing these essential functions, owners receive the benefit of a consultant relationship where a true expert is accountable for providing excellent service while freeing up owners to do what they do best.

Q: WHAT IMPACT DOES THE CURRENT TAXATION LANDSCAPE HAVE ON THOSE INVESTING IN REAL ESTATE IN 2023?

A: Sher

California is synonymous with high taxes, but the saving grace for real estate investors has been lower real property taxes. Since Proposition 13 passed in 1978, property tax increases have been capped at no more than 2% per year, barring a change in ownership or material improvement. Ballot attempts to remove commercial real property from Prop 13 protections have been defeated so far. But cities have successfully passed so-called "mansion taxes," a misnomer since they affect more commercial real estate than high-end homes. The ULA in Los Angeles adds a 4% tax on real estate sale transactions over $5 million and a 5.5% tax if over $10 million. At a time when investing in commercial real estate in California is already more costly with inflation and high-interest rates, this extra tax burden is an additional disincentive for investors.

Q: WHAT IS NEXT FOR THE CRE INDUSTRY?

A: Malmrose

This is an exciting time for the real estate industry. Understanding technological advances and changing attitudes, styles, and tastes are crucial to offering a compelling product to tenants. Expect to see more amenities, including rooftop lounges, high-quality common/social areas, building security, reliable high-speed internet, access to vehicle charging, and proximity to entertainment and shopping venues to drive demand in the future.

A: Sher

With California's requirement that by 2035 all new cars and trucks sold in the state must be electric, developers will need to rapidly build the electric charging network and infrastructure to support these EVs. No longer will having a few public car chargers in a mall parking lot be sufficient. Even now there are too few available chargers for each EV on the road, and many of them are often poorly maintained. The additional burden on the electric grid from many new electric chargers will also require significant investment in modernizing our power supply. A new green vehicle fleet is not sustainable without investment in the supporting infrastructure, and I believe the commercial real estate industry will be at the forefront of meeting these needs.

Los Angeles Times B2B PUBLISHING

This supplement was produced by LA Times B2B Publishing. It did not involve the editorial or reporting staffs of the Los Angeles Times. Contact us with comments or questions at **b2bpublishing@latimes.com**.