COMMERCIAL REAL ESTATE STRATEGIES

The **Commercial Real Estate Strategies** panel is produced by the L.A. Times B2B Publishing team in conjunction with Alliant Insurance Services, Inc.; Buchalter LLP; and Nixon Peabody LLP.

Michael Heid
Executive Vice President & Managing Director
Alliant Insurance Services, Inc.
mheid@alliant.com
alliant.com

Bryan LeRoy
Partner, Real Estate and Land Use
Nixon Peabody LLP
bleroy@nixonpeabody.com
nixonpeabody.com

Scott M. Salomon
Senior Counsel
Buchalter LLP
ssalomon@buchalter.com
buchalter.com

Alliant NIXON PEABODY Buchalter

Over the course of the last two years, in the wake of the COVID-19 pandemic, CRE companies needed to digitize many operations, workplace protocols changed, physical facilities were in many cases closed due to extensive lockdowns, and preparing for reopening created a whole shift of focus in itself … while ensuring the health and safety of employees as well as occupiers and considering the financial health of tenants and end-users.

As we move toward the middle of 2022 and as things return to a new form of normal, many questions still linger. What changes and trends are here to stay for the long term?

What legal, financial and insurance-related issues need to be addressed? What new roles is technology playing? What will the CRE industry look like a year from now? We turned to three uniquely knowledgeable experts for their thoughts and insights about what's next for the resilient commercial real estate sector in L.A. and Southern California.

Q: HOW HAS THE COMMERCIAL REAL ESTATE INDUSTRY CHANGED DUE TO THE COVID-19 PANDEMIC?

A: Salomon

Borrowers, investors, and lenders had to get used to a different way of doing business during the pandemic. This included conducting site visits virtually, navigating construction and eviction moratoria, and even mundane closing logistics, like coordinating the execution of documents while working remotely. Additionally, lenders and investors have become a little more hesitant to finance deals in the industries hit the hardest by the pandemic, such as hotels and office space, while appetite for housing remained steady as employees working from home prioritize space over commute.

A: LeRoy

We're at a critical moment in the industry. Some of the uncertainty that characterized the early months of the pandemic is fading, and long-term trends are starting to take shape. The backlog of permits and projects that accumulated when the world shut down is now easing. The good news is Los Angeles has maintained its appeal to residents and investors throughout this tumultuous period. The region still draws robust private investment, but the focus has shifted to different asset classes—less office space and more multifamily projects, industrial uses, and unconventional assets. The doomsday scenarios that some observers forecast did not happen. There are still some short-term questions now that federal assistance for small businesses has ended, rental protections are expiring, and interest rates are rising, but overall, investors and developers are finding opportunities. In their view, the time of waiting and watching is over.

Q: HOW WOULD YOU DESCRIBE VALUES IN SOUTHERN CALIFORNIA AS WE HEAD DEEPER INTO 2022?

A: Heid

In the commercial insurance industry, there is a significant focus on asset valuations across all real estate sectors. This is being driven by inflationary pressures associated with the increased cost of construction including labor, materials, supply chain issues, etc. As a result, underwriters are scrutinizing replacement cost valuations, rental income and asset detail benchmarking to ensure that real estate portfolios are properly underwritten. We are seeing a similar pattern of increased underwriting from the lending community to verify that insurance programs are lender-compliant with loan covenant terms.

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

A: LeRoy

Transit-oriented development. Largely because of state and local incentive programs and progressive zoning, multifamily developers

> ***"With the significant material costs increases, labor shortage and supply chain delays, there is a potential risk within the industry under pressure to deliver projects on time and budget."***
>
> — Michael Heid

are creating housing and new mixed-use developments in areas served by public transportation. This approach aligns density with infrastructure, creating welcoming urban environments and a sustainable ecosystem of jobs, housing, and transportation. As we've seen downtown, housing can fuel significant growth in other asset classes as other developers step in to build places to work, eat, shop, and socialize. And because most high-density developments have an affordable housing component, these projects benefit residents across income classes. I am also excited about the growth of the life sciences community in Los Angeles. There is great synergy here between universities, hospital complexes, and the biopharmaceutical industry that makes the region a hub for talent and innovation, and we are seeing tremendous growth in research, testing, and manufacturing facilities.

Q: ANY NEGATIVE TRENDS YOU HOPE WILL GO AWAY?

A: Salomon

Throughout the pandemic, there have been several construction delays and cost overruns arising from issues with the supply chain. Earlier in the pandemic, we saw shortages in raw materials (especially lumber) affecting the early stages of construction, and now we are seeing delays in the delivery of appliances needed for delivery of furnished units. If the supply chain returns to its pre-pandemic efficiency, we should see a return to some semblance of normalcy when it comes to construction costs and construction schedules.

A: Heid

One negative is the trend of increased exposures to wildfires and the way these exposures are viewed by insurance companies. This is a real issue that is disrupting parts of the insurance industry, especially on the personal lines/homeowner end whereby large insurance companies are making wholesale changes to their entire book of exposures. We are now seeing commercial assets being singled out and red-flagged during the renewal underwriting process as high wildfire risks. Carriers are now more prone to being unable to obtain reinsurance support on wildfire risks, so they are subsequently looking to limit their exposures including enacting a coverage sublimit to cap coverage amounts, increasing deductibles, significantly increasing rates, requiring proactive loss control measures or even non-renewing the portfolio.

Q: WHAT ARE YOUR PREDICTIONS FOR WHAT THE OFFICE OF THE FUTURE WILL BE LIKE?

A: LeRoy

It's no secret that many people love to work from home and don't plan on returning to the office. So even as more workers return to urban centers, we can anticipate some lasting changes to the market for office space. Many tenants will try to downsize when they can, but fortunately for landlords, most office leases are long-term, so the effects will be gradual. This shift will allow tenants and landlords to reimagine space planning and the office environment and find new ways to promote collaboration and spontaneous creativity. Tenants will emphasize "placemaking" to create an on-site work experience that is inviting and materially different than the at-home experience. This means flexible and adaptive spaces and Class A amenities that draw people in. I also predict an increase in office hoteling with shared spaces that can be used by different people on different days.

Q: WHAT ARE THE KEY OPPORTUNITIES AND RISKS FOR DEVELOPERS IN 2022?

A: Heid

We continue to see a tremendous push to develop single-family, multi-family housing projects and, in some cases, inclusive of mixed-use commercial property on the ground floor. The healthcare space has seen an increase in new projects along with the repurposing of facilities for

> ***"Largely because of state and local incentive programs and progressive zoning, multifamily developers are creating housing and new mixed-use developments in areas served by public transportation."***
>
> — Bryan LeRoy

the biotech industry as well. We also expect to see an increase in public infrastructure projects commencing in Q3 and Q4 of this year. With the significant material costs increases, labor shortage and supply chain delays, there is a potential risk within the industry under pressure to deliver projects on time and budget. The risk areas for concern are work-related injuries as well as quality control of work product.

A: LeRoy

There's a lot of optimism in the market, despite inflation and rising interest rates. Los Angeles continues to be highly desirable, thanks to our diverse, educated population, deep pool of talent, and in-demand asset classes. As the international market becomes less predictable, capital is moving to Los Angeles because of its population, location, and relatively stable markets. Industrial, warehousing, and distribution will continue to present opportunities this year. The supply chain issues we experienced over the last couple of years underscore the vulnerabilities of a system dependent on foreign production and displaced inventories. More manufacturers are investing in domestic production and local storage in response to this uncertainty. Multifamily developments will continue to thrive, given the ever-present housing shortage in California. There is also a new focus on unconventional assets, such as content creation, tech, and life sciences, as well as medical offices and outpatient services.

Q: HOW HAVE RECENT FEDERAL AND LOCAL GOVERNMENT ACTIONS IMPACTED THE MARKETPLACE?

A: Salomon

The Federal Reserve increasing interest rates (and fears of future rate hikes) has prompted many borrowers to seek early refinancing of their loans set to mature in the next year or two. Additionally, local decisions regarding eviction moratoria have continued to impact landlords.

A: LeRoy

State and local governments have made great efforts to streamline the entitlement process and environmental review for multifamily housing projects, recognizing the tremendous need for more housing throughout California. Recent studies estimate that California will be short about 3.5 million housing units by 2025. Even before the recent state mandates, Los Angeles has encouraged the creation of housing across income levels. The city's progressive density bonus law and its Transit-Oriented Communities Program allow density increases and other site adjustments for developers who set aside a percentage of their projects for moderate- and low-income families. Updated city regulations create more bright-line rules and greater certainty for investors and developers. And the city is starting to recognize that the availability of mass transit, autonomous vehicles, and ridesharing services are a way to free up acres of valuable space now devoted to archaic parking requirements.

Q: AS AN EXPERT IN COMMERCIAL REAL ESTATE, HOW DO YOU VIEW OPPORTUNITY ZONES TODAY?

A: Heid

Opportunity Zones can certainly yield an impact on strategically spurring investment within the community. That said, there are often associated development risks that potentially impact the pro forma underwriting, including flooding concerns (high hazard flood zone), liability (higher neighborhood crime index scores), or even environmental issues (land conversion of legacy risks such as an old manufacturing site). These are all factors to consider during the due diligence of an Opportunity Zone deal.

A: Salomon

Opportunity Zones remain an important tool to defer and mitigate capital gains taxes, particularly for investors who plan on holding their investment for 10 or more years. However, investors should note that deferment on original gain ends and gain must be recognized on December 31, 2026, so there is a declining deferral benefit the longer investors wait to make their qualified Opportunity Zone investments.

Q: WHAT PARTS OF SOUTHERN CALIFORNIA DO YOU SEE AS "HOT SPOTS" FOR COMMERCIAL DEVELOPMENT IN THE COMING MONTHS AND YEARS?

A: LeRoy

I am really excited about what's going on in Inglewood. The new Rams stadium is just the beginning for that area. Thanks to the city's vision and rapid planning, there are also thousands of new housing units, mixed-use retail developments, destination restaurants, tech facilities, and more. And all of this will be served by the new Crenshaw Connector light rail that will link Inglewood and LAX to Metro's Expo Line. I also envision a renewed focus across the city on underutilized, environmentally challenged properties. Demand is rising for large industrial parcels to be used for distribution and warehousing, but prime targets are becoming more scarce, and industrial centers are forced farther out from the urban core. As that happens, investors will rethink properties that may not have been as appealing previously. Urban locations for micro-distribution centers will also become more important for e-commerce fulfillment.

Q: WHAT EFFECT DO INTEREST RATES HAVE ON TODAY'S MARKET?

A: Salomon

With interest rates currently on the rise, construction lenders are requiring larger interest reserves, which is increasing overall construction costs. Borrowers of stabilized projects are seeking early refinancing of their loans set to mature in the next year or two to lock in the current interest rate. A rise in interest rates also historically results in lower bond prices, which may negatively affect some projects financed from the sale of bonds.

Q: ARE DISTRIBUTIONS FACILITIES AND WAREHOUSES STILL ATTRACTIVE OR ARE THEY GETTING OVERPRICED?

A: LeRoy

Still attractive. Even with all the new facilities set to come online in the next year, demand will continue to outpace supply. Los Angeles is a gateway region with the nation's largest port complex, and these types of developments will always be an essential part of the supply chain. Rising interest rates will make deals more challenging, but there will continue to be upward pressure on rents and industrial property values. Manufacturers and retailers are looking to keep more inventory

> ***"Lenders and investors have become a little more hesitant to finance deals in the industries hit the hardest by the pandemic, such as hotels and office space, while appetite for housing remained steady as employees working from home prioritize space over commute."***
>
> — Scott M. Salomon

on hand to blunt the impact of future supply chain delays. And e-commerce vendors are exploring ways to pair their large warehouse and distribution centers with smaller fulfillment centers inside the urban center. Some businesses are even buying old brick-and-mortar retail locations and converting them into shipping hubs. But that arrangement presents some infrastructure challenges, and cities are beginning to push back.

Q: WHAT TRENDS DO YOU FORESEE COMING TO OUR LOCAL INDUSTRY BY THE END OF THIS YEAR?

A: Heid

Based on the current environment of inflationary pressures, we expect continued focus on insurance underwriting of real estate portfolios. This will impact various aspects of insurance programs including modeling of portfolio risks for catastrophic exposures (i.e., earthquakes), adequacy of coverage limits, lender compliance and acquisition pro forma due diligence. These are hot topics that we are consulting with our current and prospective clients, and we foresee continuing for 2022 and beyond.

LA 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**.