MARKET FORECAST

RETAIL

Orange County Metro Area

IPA INSTITUTIONAL PROPERTY ADVISORS

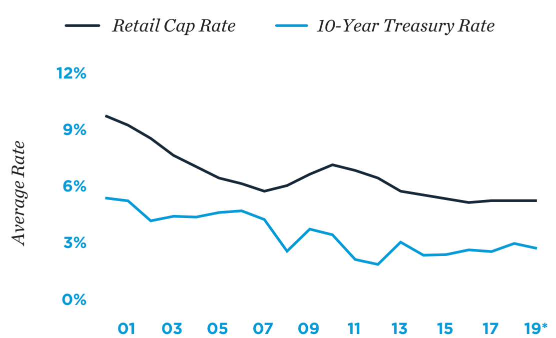
Q2/19

Robust Retailer Leasing Keeps Vacancy Low; Escalating Price Appreciation Could Slow Deal Flow

High-net-worth residents mixed with iconic tourism maintain this retail market. Orange County is one of the more affluent metros on the West Coast, and its beaches, luxury shopping, and diverse economy attract high-income residents. Household formation will remain positive with nearly 9,000 new residences projected for this year. The metro is also a tourism hub due in large part to the presence of Disneyland and the luxury shopping venues along the coast. With a high-income demand pool and a strong tourism industry, the area's stable retail sales are attractive to a variety of retailers looking to capitalize on the market's consumer spending. Yet with limited available space and new supply, leasing options are sparse. The year's construction will provide some relief with a slight increase of inventory. The largest project is the 220,000-square-foot Tustin Legacy, which will provide grocery, restaurant, service retail, and boutique fitness studio options.

Newly penned retail leases outpace expiring contracts 10 to 1 amid elevated construction. Activity among tenants is up as more than 1 million square feet of retail space in Orange County has been leased with move-in dates before the end of the year. Grocery retailers will absorb the largest amount of space, with nine new stores opening totaling 346,000 square feet. Another major addition is the opening of a Home Depot in Huntington Beach, which attracts additional retailer interest nearby. The amount of space leased this year far outweighs the space with leases expiring, reflecting the continuing compression of the vacancy rate.

Local Retail Yield Trends



** Cap rates trailing 12 months through 1Q19; 10-year Treasury up to March 29*

Sources: CoStar Group, Inc.; Real Capital Analytics

Retail 2019 Outlook

375,000 SQ. FT.
will be completed

CONSTRUCTION:

Construction will provide 375,000 square feet of new retail space in 2019. Up from last year's delivery total of 222,000 square feet.

10 BASIS POINT
decrease in vacancy

VACANCY:

Vacancy will fall 10 basis points to 3.6 percent in 2019. Last year vacancy fell 60 basis points.

5.1% INCREASE
in asking rents

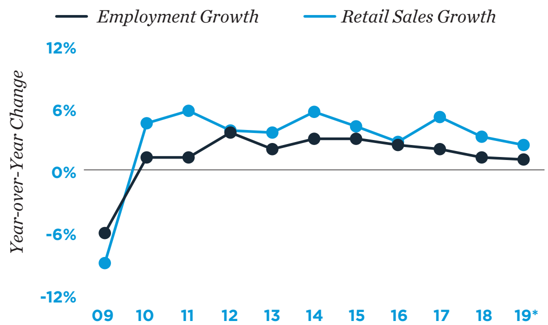
RENTS:

The average asking rent climbs to $27.85 per square foot in 2019. Rent growth averaged 1.5 percent per year since 2015.

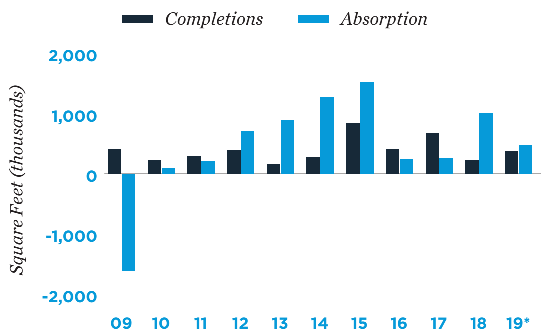
Investment Trends

- Transaction velocity for the metro decreased by roughly 5 percent over the past four quarters. This drop-off stems from slowing of buyer activity in Garden Grove, Santa Ana, Anaheim, and Costa Mesa, which all had one-third fewer trades than the previous period.
- A few areas countered this trend, such as Newport Beach, Orange, Westminster and Tustin, where trades picked up by more than 40 percent year over year.
- Multi-tenant prices escalate with first quarter trades. Cap rates for these assets remain in the low-5 percent area, though they appear to be moving up. Strip and neighborhood centers provide first-year returns that range from mid-4 to high-5 percent.
- Over the past two years, first-year yields for auto repair, casual restaurants and fast-food trades are in the mid- to high- 4 percent range, slightly below the single-tenant average.

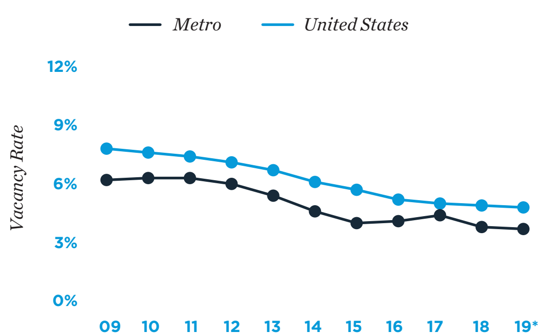
Employment vs. Retail Sales Trends



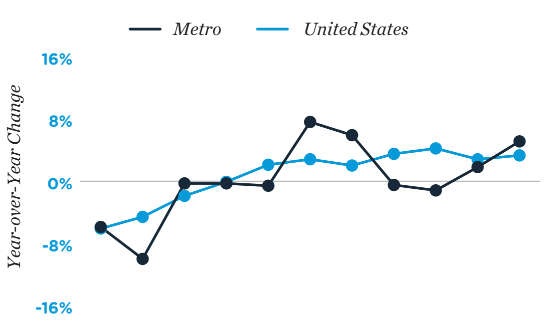
Retail Completions



Vacancy Rate Trends



Asking Rent Trends



*Forecast

Sources: CoStar Group, Inc.; Real Capital Analytics

1Q19 – 12-Month Trend

EMPLOYMENT

0.6% increase in total employment Y-O-Y

- The unemployment rate in Orange County stands at 3.0 percent, one of the metro's lowest marks since the late 1990s, making it difficult for employers to hire due to limited candidates.
- Since last March, approximately 10,300 jobs have been created, a dramatic drop from the 41,000 created over the same annual period the year before. The largest growth occurred in the business and professional services sector.

CONSTRUCTION

269,000 square feet completed Y-O-Y

- Deliveries from the past 12 months have added 269,000 square feet of retail space, a modest improvement from the prior period when 263,000 square feet were completed.
- Multi-tenant construction is significantly higher, 80 percent, than the previous period's additions, which totaled 92,000 square feet. Single-tenant construction over the same period of time decreased approximately 80 percent from the prior period.

VACANCY

40 basis point decrease in vacancy Y-O-Y

- The average vacancy rate compressed to 3.8 percent over the last year ending in March. Retail vacancy has fallen 240 basis points from the first quarter rate of 6.2 percent in 2010.
- Surrounding the John Wayne Airport, the retail market is tight, with the first quarter vacancy rate falling 50 basis points year over year to 2.2 percent.

RENTS:

6.7% increase in the average asking rent Y-O-Y

- Orange County's average retail rent rose to $27.65 per square foot over the past four quarters ending in March. In the previous period average rents declined 3.4 percent to $25.91 per square foot.
- Retail space around the airport has the highest average asking rent among Orange County submarkets at $35.36 per square foot. The area with the lowest average rent at $21.46 per square foot is the North County submarket.

Demographic Highlights

2019 Job Growth*

Metro **1.0%**

U.S. Average **1.3%**

Five-Year Population Growth**

38,700 or **0.2%** Annual Growth

U.S. **0.6%** Annual Growth

Five-Year Household Growth**

46,100 or **0.9%** Annual Growth

U.S. **1.0%** Annual Growth

1Q19 Median Household Income

Metro **$91,182**

U.S. Median **$64,259**

1Q19 Retail Sales per Month

$5,280 Per Household

U.S. **$3,971**

$1,768 Per Person

U.S. **$1,544**

Retail Sales Forecast**

Metro **10.9%**

U.S. **16.9%**

** Forecast ** 2018-2023*

SUBMARKET TRENDS

Lowest Vacancy Rates 1Q19

Submarket	Vacancy Rate	Y-O-Y Basis Point Change	Average Asking Rent	Y-O-Y % Change
Airport Area	2.2%	-50	$35.36	3.5%
Central County	3.3%	-50	$23.36	-1.5%
South County	4.1%	-50	$33.15	11.0%
North County	4.5%	-130	$21.46	3.5%
West County	4.7%	110	$28.21	21.1%
Overall Metro	**3.8%**	**-40**	**$27.65**	**6.7%**

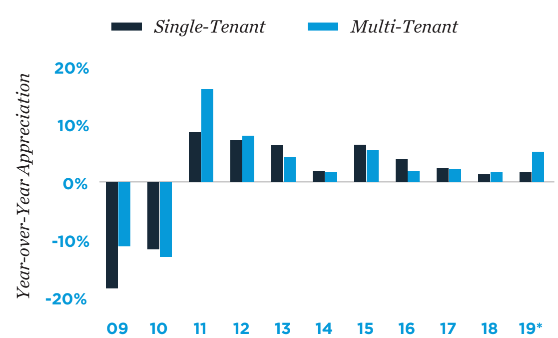
SALES TRENDS

Buyer Activity Slows as Prices Continue to Climb; Retail Yields Fall as Competitive Bidding Grows

- **Multi-Tenant:** Deal flow slowed by 11 percent over the past four quarters as the average price per square foot rose 5 percent. The average cap rate increased 20 basis points to 5.2 percent.
- **Single-Tenant:** Since March of last year, the average cap rate on single-tenant retail assets has fallen 20 basis points to 5.0 percent. Trading activity has decreased over this period by 14 percent.

Outlook: Retail transactions are likely to continue slowing in Orange County as price appreciation has pushed many buyers out of the market. Some investors though are exchanging into retail assets chasing first-year returns that are above other investment options.

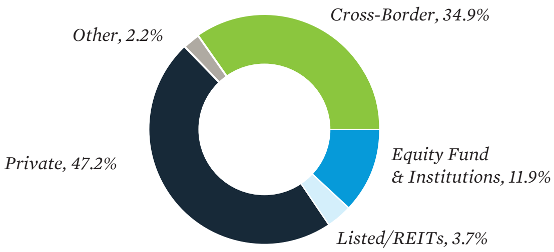
Price Per Square Foot Trends



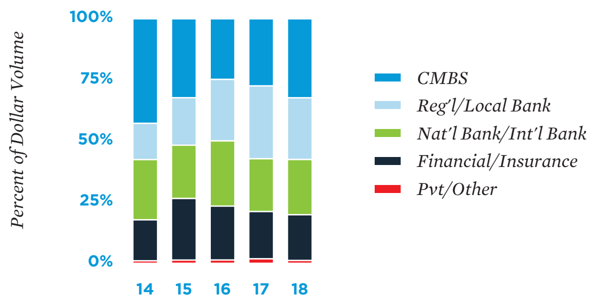
** Trailing 12 months through 1Q19 over previous time period*

Pricing trend sources: CoStar Group, Inc.; Real Capital Analytics

1Q19* Retail Acquisitions By Buyer Type



Retail Mortgage Originations By Lender



** Trailing 12 months through 1Q19*
Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

CAPITAL MARKETS

By DAVID G. SHILLINGTON, President, Marcus & Millichap Capital Corporation

- **International pressures weigh on domestic outlook; Fed remains patient.** Amid ongoing trade disputes between the U.S. and China and slowing growth throughout the European economy, the global economic outlook has become more cautious. Market volatility, combined with muted sentiment, has sponsored a flight to the safety of Treasurys, pushing the 10-year yield below 2.6 percent. While domestic growth has moderated recently, the waning impact of the tax cut stimulus will likely trim forward estimates further. As a result, the Fed decided to cease reducing its balance sheet reduction through quantitative tightening by September and removed the potential for rate increases through the remainder of the year. The bond market has begun to price in a much more dovish Fed, with flattening interest rates reflecting more caution. Fed officials will likely focus on the intersection of a global growth slowdown and continued labor market strength to refine their plans moving forward, keeping interest rates stable for the foreseeable future.
- **Malls, legacy big-box players cloud otherwise optimistic retail landscape; underwriting remains conservative.** Uncertainty surrounding legacy retailers and the ongoing shift of consumer purchasing preferences to online sources have begun to weigh on retail sentiment, with lenders proving more cautious and conservative than in prior years of the cycle. Active lenders include local, regional and national banks, and insurance companies, with a primary lender focus on net-leased assets and premier mixed-use structures being highly desirable. Meanwhile, outlying malls and non-credit tenants will undergo much more scrutiny. This has created a two-tier market structure, with loan-to-value (LTV) ratios in the 55 to 75 percent range depending on borrower, asset and location factors. Mezzanine and bridge loan structures have been more frequently used in this environment, with owners undertaking capital improvements at higher leverage ratios on the short-term debt before seeking long-term financing options once their operations have been proved.

National Retail Group

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; Moody's Analytics; Real Capital Analytics; TWR/Dodge Pipeline; U.S. Census Bureau