Marcus & Millichap

Retail Research
Market Report
Oakland Metro Area

Third Quarter 2016

Occupancy and Rents Rise as Economy Builds Steam

Relative affordability of space bolsters retail. Property operations in the East Bay retail market continue to post strong improvements as intense demand absorbs elevated levels of construction. The exorbitant cost of real estate in the rest of the Bay Area acts as a steady tailwind for the local economy. Businesses and residents alike flock to Oakland, providing ample job opportunities and bolstering the metro's demographic profile. As a result, developers have moved to capitalize on growing demand with construction on pace for a post-recession high. Builders have shown a preference for supermarket chains that offer healthy and responsibly sourced products, which usually plays well in young, up-and-coming markets. The uptick in construction will not reverse the fall in vacancy because much of the space scheduled to come online is highly pre-leased, driving the vacancy rate down to the lowest point of the current expansion. The scarcity of tenable space will encourage another year of healthy rent growth. Despite the hike, the average rent has yet to attain levels seen before the Great Recession. Lease rates trending below pre-downturn levels coupled with widening spreads between rents in Oakland compared with San Francisco and San Jose may indicate plenty of runway left for future rent growth.

Buyers balk at outsize valuations as buyer-seller expectations widen. Demand for Oakland retail properties is strong as a positive economic outlook and healthy operations draw buyers to the market. Additionally, interest rates on acquisition financing remain near historic lows, although banks are beginning to scrutinize underwriting more closely. However, lenders' attitudes have yet to significantly impact deal flow, particularly in the single-tenant sector. Transaction velocity is largely exchange driven with many owners looking to take advantage of high pricing to move up into larger assets. In both the single- and multi-tenant segments, buyers are beginning to push back against pricing as cap rates have compressed and continue to tighten to near minimum targeted returns. The average first-year return for an Oakland retail asset fell to the high-5 percent range this year with Class A single-tenant properties trading 100 basis points lower.

2016 Retail Forecast

2.5% increase in total employment

Employment:

Local establishments will create 27,600 jobs in 2016, expanding the workforce 2.5 percent. Last year, employers created 30,000 positions, led by gains in the trade, transportation and utilities sector.

973,000 sq. ft. will be completed

Construction:

Following the completion of more than 450,000 square feet in 2015, developers will bring 973,000 square feet online this year, the highest annual total in eight years.

20 basis point decrease in vacancy

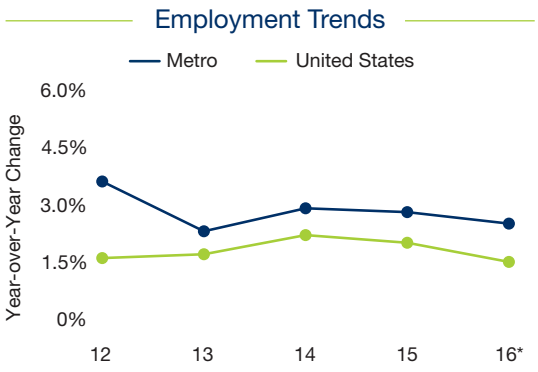
Vacancy:

Intense demand for Oakland retail space will drive down the vacancy rate to the lowest level on record. The metrowide vacancy rate will slide 20 basis points to 3.5 percent in 2016 after nearly 880,000 square feet of net absorption yielded a 50-basis-point contraction last year.

4.0% increase in asking rents

Rents:

Steady rent growth will continue in 2016 as vacancy tightens to a record low. The average asking rent will climb to $25.08 per square foot this year, an increase of 4.0 percent. In 2015, the metro recorded a rent hike of 5.6 percent year over year.



Economy

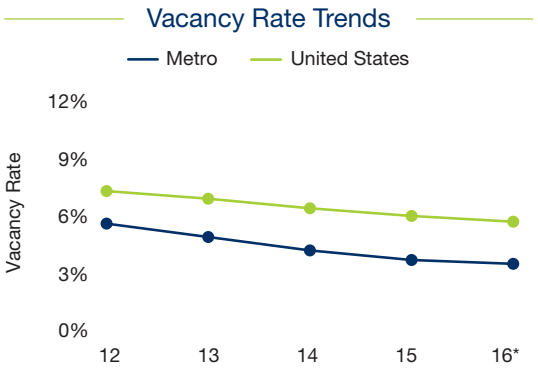
- Employers hired 10,800 workers in the first half of 2016, bringing the four-quarter job gain to 25,000 or a 2.3 percent increase. In the prior annual period, local payrolls grew 2.8 percent.
- The construction sector recorded the greatest relative gain, climbing 7.3 percent year over year through the addition of nearly 4,500 workers. Meanwhile, education and health services establishments hired approximately 6,000 new workers.
- Sitting at 4.2 percent in June, the Oakland unemployment rate was down 60 basis points over the last 12 months, reaching the lowest point since 2001. During the same span a year earlier, the unemployment rate fell 110 basis points.

Outlook: Employers in Oakland will add 27,600 positions to payrolls in 2016, representing an expansion of 2.5 percent. Last year, the metro registered an employment gain of 30,000 jobs.

Construction

- In the 12 months ending in June, developers completed more than 331,000 square feet of retail space. During the corresponding time frame a year earlier, builders delivered roughly 387,000 square feet.
- Developers targeted the Highway 4 submarket, where more than 106,000 square feet was delivered in the past year. The 680 Corridor South submarket also garnered attention, with nearly 105,000 square feet completed.
- The construction pipeline is filled with more than 962,000 square feet of space underway with completion dates scheduled through 2017. A $250 million renovation and expansion of a super-regional mall in Walnut Creek is the most significant project under construction. Approximately 300,000 square feet of space will be added to Broadway Plaza, which will measure 1.1 million square feet once completed.

Outlook: Following the completion of more than 450,000 square feet in 2015, developers will bring 973,000 square feet to the market in 2016. This year's deliveries are heavily backloaded, with more than 80 percent of the completions slated to come online in the second half of 2016.



Vacancy

- The vacancy rate slid 30 basis points in the last 12 months to 3.9 percent at midyear. Oakland registered a vacancy contraction of 40 basis points during the prior year, behind more than 730,000 square feet of net absorption.
- Nearly every submarket recorded a vacancy rate in the mid-3 percent range at midyear, with the Highway 4 area representing the lone outlier at 6.7 percent. The vacancy rate in the Oakland submarket climbed 40 basis points in the past year to 3.0 percent but remains the lowest in the metro.
- The multi-tenant sector recorded a decline in the vacancy rate of 20 basis points in the last four quarters to 4.5 percent at the end of the second quarter.

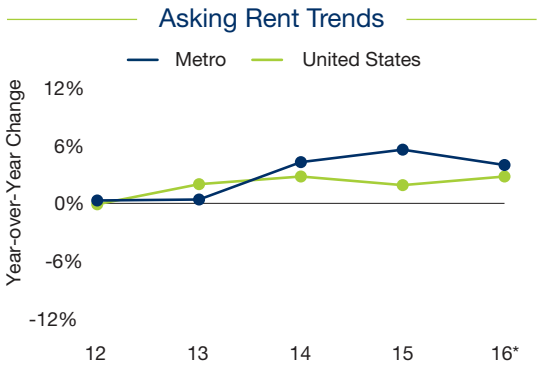
Outlook: Following a 50-basis-point improvement in 2015, the metrowide vacancy rate will dip another 20 basis points to 3.5 percent this year.

* Forecast
Source: CoStar Group, Inc.

Rents

- As the vacancy rate slides to a post-recession low, rent growth will maintain its steady climb. The average asking rent rose 5.0 percent in the last four quarters, landing at $24.79 in the second quarter. A rent increase of 4.0 percent was recorded in the prior 12-month period.
- The 80 Corridor area is the most expensive submarket in the East Bay; the average rent rose 9.1 percent from one year ago to $28.31 per square foot in the second quarter. The Highway 4 submarket offers the most affordable space with tenants paying an average $20.56 per square foot, despite a 14.3 percent increase annually.
- Rent growth is occurring across both major property subtypes. Single-tenant properties posted an increase of 5.1 percent to $25.34 per square foot in the last 12 months. Meanwhile, the multi-tenant sector registered a 4.6 percent rent increase to settle at $22.43 per square foot in June.

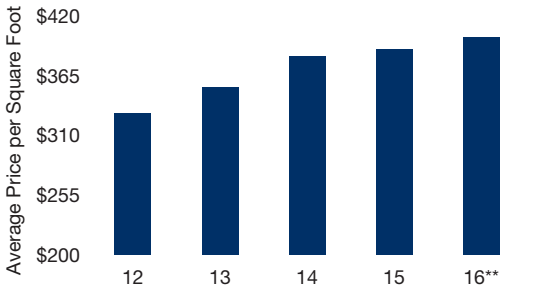
Outlook: The average asking rent will jump 4.0 percent this year to $25.08 per square foot. A gain of 5.6 percent was registered in 2015.



Single-Tenant Sales Trends**

- Transaction velocity surged 16 percent in the most recent annual period as improving operations sustained elevated demand for single-tenant assets. The gain can be largely attributed to an acceleration of trades in the city of Oakland.
- Prices have reached historic levels with intense buyer demand driving a 3.8 percent gain in the past year to nearly $400 per square foot. The average price per square foot climbed 1.7 percent in 2015.
- As prices rise in the metro, cap rates continue to fall. The average first-year return compressed 25 basis points in the last year to the mid-5 percent range. A national fast-food tenant operating on a long-term lease can fetch a yield in the mid- to upper-4 percent area.

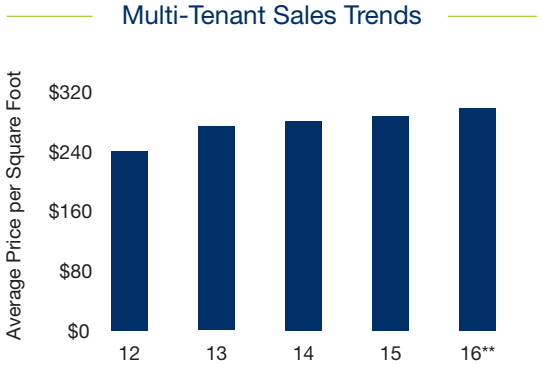
Outlook: Tri-Valley investors, particularly those with debt, have begun to temper their aggressiveness as valuations rise into the highest level seen on record. As a result, property owners have started giving some ground on pricing for larger, more expensive assets.



Multi-Tenant Sales Trends**

- Deal flow for multi-tenant properties posted a slight slowdown in the past year, although trading remains elevated by historical standards. Properties in the Concord area, however, were highly sought.
- Similar to the single-tenant sector, the average price of multi-tenant assets continues to rise. In the last 12 months ending in June, the average price rose 4.8 percent to nearly $300 per square foot.
- The average metrowide cap rate slipped further this year, tightening to the low-6 percent range in the second quarter. Yields remain above the pre-recession low set in 2007, which may indicate room for further compression.

Outlook: Retail strip centers that offer a mixed-use component or a unique restaurant concept will remain attractive as a possible defense against additional growth of e-commerce.



* Forecast
** Trailing 12-month period through 2Q
Source: CoStar Group, Inc.

National Retail Group

Visit www.NationalRetailGroup.com

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President | Marcus & Millichap Capital Corporation

- Global capital markets have remained stable over the past few weeks, even as Brexit and the continued devaluation of the Chinese yuan have induced bouts of volatility into stock and bond markets. Meanwhile, U.S. economic data has proved resilient, with increases in retail sales and steady hiring supporting a measured pace of growth. Additionally, higher bond prices have lowered prospective yields, boosting the appeal of commercial real estate.
- As the current economic cycle has continued, retail vacancy descended to 5.8 percent by the end of the second quarter. A focus on net-leased construction for pre-leased tenants and mixed-use developments has limited development activity in relation to prior cycles, supporting robust increases in average asking rents. Builders will deliver 46 million square feet of retail space this year, with more than two-thirds of new supply slated as single-tenant structures. This environment will sponsor a fourth straight year of average asking rent growth, with advancement projected to exceed inflation over the same period.
- Capital markets remain highly competitive, with a broad assortment of fixed-rate products available through commercial banks, life-insurance companies and CMBS lenders. Loans are generally offered at terms up to 10 years at maximum leverage of 65 to 75 percent. For 10-year terms, rates will typically reside in the high-3 to mid-4 percent range, depending on leverage and underwriting criteria. Floating bridge loans and financing for repositionings are typically underwritten with LTVs above 80 percent, while pricing at 300 basis points above Libor for recourse deals and extending to 470 basis points above Libor for non-recourse transactions.

Local Highlights

- As high-paying tech and healthcare positions continue to crop up in the East Bay, retailers will be well positioned to benefit from demographic improvements. In 2016, the median household income will reach more than $85,300 per year, nearly 50 percent higher than the national level. Higher incomes will facilitate a 4.4 percent increase in retail sales, bolstering underlying demand for Oakland retailers.
- The Orchards at Walnut Creek is a Safeway-anchored mixed-use town center under construction in the Shadelands Business Center. The retail portion is expected to open later this year and will encompass 200,000 square feet of space. Additionally, the project has plans to eventually include a park, outdoor theater and a 3.8-acre senior living complex; however, the completion dates for these components are slated for 2018 or 2019.
- The Oakland multifamily market is booming behind the growing job market that is also fueling the performance of the retail property sector. Apartment development is expected to reach unprecedented levels with nearly 2,600 units on pace for completion in 2016. Centers positioned near large pockets of renters and high-density housing projects will perform well moving forward.