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Getting Real About Real Estate

Five Sacramento-area commercial real estate brokers weigh in on the strengths and weaknesses of the region's market

by **JORDAN VENEMA**

Since former Sacramento Mayor Kevin Johnson announced a 10,000-unit downtown housing initiative in 2015, it seems like all eyes have been on the state of Sacramento's residential real estate market. With the steady increase of the home prices and rental rates between 2011 and 2018, Sacramento's housing crisis was the talk of the town. But in 2018, the regional commercial real estate market quietly put up its strongest numbers in the last decade. By all projections, that market should continue on a similar trajectory through 2019, although signs suggest there may be serious hurdles in the future. To find out the strengths and weaknesses of the CRE market in the Sacramento region, *Comstock's* spoke with five local brokers to discuss what's happening in the market now and what to expect in 2019 and beyond.

WHAT TRENDS CURRENTLY DEFINE THE SACRAMENTO MARKET?

According to the Pew Research Center, since 2016, millennials have made up the largest portion of the U.S. workforce. They will continue to define the market with their preference for non-traditional, green work spaces and a live-play-work lifestyle in urban centers.



Alexis Garrett, vice president at JLL, a property consultancy company, says that has resulted in a suburban-to-urban shift among her CRE tenants.

"Most of my clients are making this decision for the purpose of providing their employees with a more amenity-rich work environment," she says. "They see the benefits to being closer to [Downtown Commons], Golden 1 Center and the surrounding new amenities particularly to retain and recruit top talent and the new

generation of our workforce — that puts a high value on quality of life and urban living."



But the shift isn't just in workforce, but also work spaces. **Nahz Anvary**, senior vice president at commercial real estate firm Kidder Mathews, says, "I'm continuing to see companies fit more people into less office space through various design changes in office layouts and just simply allocating less space per employee. And coworking spaces like Urban Hive or Hacker Lab, where individuals and small companies choose to work rather than have their own office space, continue to have much draw and appeal."



Scott Bennett, senior vice president at Colliers International, agrees. He sees the potential to expand almost 600,000 additional square feet of coworking space across the market.

Garrett also predicts coworking spaces will continue to grow. "Today, coworking and flexible space consists of less than 1 percent of our total office inventory, but over the next decade, I anticipate this percentage share to increase tenfold," she says.

Another trend, Anvary says, is greener buildings. "As it relates to office properties, one trend over the past decade has been toward more sustainability in office environments and building materials, including LED lighting, efficient HVAC systems, better insulation and water conservation. Also, there is a focus on landscape improvements through investments in drought-tolerant landscaping and more efficient irrigation systems," though it may be motivated by saving on operating costs

vs. environmental consciousness. “PG&E has recently filed for bankruptcy and has also sought permission from the California Public Utilities Commission to increase utility rates by double digits.”



Though a younger workforce with urban preferences likely will shape the market in the near future,

Danny Kapic, regional manager at Marcus & Millichap, points out that Sacramento remains a government town, where government jobs account for approximately a quarter of the workforce.

“Sacramento is unique in that it is home to the State Capitol, with a majority of the largest State of California agencies and departments headquartered there,” Kapic says, though he cites the region’s proximity to the Bay Area and relatively low median home price as factors adding to “a slow but healthy diversification taking place.”

WILL LOW RENTS AND INCREASING VACANCY SPELL TROUBLE FOR SACRAMENTO’S MARKET?

Put simply, “While rates continue to climb, we are still well below the market rates needed to outweigh the exceedingly high cost of construction,” Garrett says.



“Our rents have not recovered prior to 2007 and 2008, and because of that, most of Sacramento’s buildings’ rent does not justify building new buildings,” adds

Chris Lemmon, executive vice president of Newmark Knight Frank. “You’ve got to be pretty confident to build in Sacramento right now, and really no one is doing it unless they have build-to-suit,” adding that the region’s top three housing markets — downtown, Roseville and Folsom — have no large commercial spaces available on the market.

“There’s nothing more than 40,000 square feet available in any of those three markets, and you can’t attract a huge user

to come to town without a new building. On the open market we can get a \$2.25 rent, but if you build a building, it’s going to be closer to \$2.85-\$3.15 per square feet.”

In other words, demand could soon outpace supply.

“We have an inventory problem that is going to be happening in the next year or two. We’re going to get sub 11, 10 percent for all Sacramento office vacancy, and that’s really low,” explains Lemmon.

According to Anvary, that means available office space isn’t exactly cream of the crop. “Sacramento region’s overall ‘stock’ of office space is getting quite dated and could quickly become functionally obsolete,” she says. “From 1998 to 2007, there were nearly 27 million square feet of office buildings added to the region, but in the decade since 2008, there have been just a little over 3 million square feet of office added.”

And with rising construction costs already straining speculative building in the region, Kapic says that reconstruction in areas impacted by California wildfires are pulling construction away from the region, potentially exacerbating costs.

Despite problems with vacancy, Garrett says U-Haul metrics ranked Sacramento as the No. 1 destination in the country for one-way trips in 2018. “[With] a relatively low cost of living, Sacramento continues to be an attractive place to live as well as to invest,” Kapic says.

WHAT WILL THE MARKET LOOK LIKE GOING FORWARD?

“In reality,” says Lemmon, “I think we’re poised to have another good year — 2018 is the best year we’ve had in a decade for Sacramento as a whole, and we forecast rents to go up related to the fact that no new inventory has been built.”

Though there has been no new speculative construction in Sacramento, four of the five interviewees point out the one exception that proves it can be done.

“With exception to [Heller Pacific’s] Ice Blocks project on R Street, which

last year added approximately 100,000 square feet of office space in Midtown, there has been no new office construction in the last 10 years," says Garrett. "While the market may not be ready for a new high-rise office project, I am seeing tremendous demand for low- to mid-rise office space that offers a creative or unique feel with more collaborative work areas and hotel-like amenities."

As for being a government town, Garrett points out growth there too.

"The State of California continues to expand and currently is developing 1.2 million square feet of new office space for its use," she says, adding that health care providers will add hundreds of thousands of square feet by the end of this year.

Anvary is excited about Aggie Square as another successful model in the region.

"Aggie Square is bringing together UC Davis and its partners to create educational and economic opportunities in the greater Sacramento region, and the campus will feature state-of-the-art research facilities, modern office and mixed-use space, world-class amenities and a dynamic, thriving community," she says.

Another area in Sacramento proving strong growth is downtown, says Lemmon.

"The numbers are quite compelling. According to our data, 682,259 [rentable square feet] of tenants have moved onto the grid since 2008, and of that total number, 481,326 RSF of those tenants moved to the grid since Golden 1. Essentially," he continues, "70 percent of the tenants moving downtown in the past 10 years has been directly related to the arena or the activity happening around it."

Bennett says, "The expansion of the Railyards and Bridge District are poised to extend the boundaries of downtown north and west." Plus, "Bay Area migration already is trending."

"Penumbra is opening a 160,000 square feet Roseville location in May (an expansion from Alameda), SUM Bible College from Oakland is locating to El Dorado Hills, ActiveRADAR relocated its headquarters to Sacramento from Pleasanton and expanded into 20,000 square

feet in Gold River, and the California Public Utilities Commission (headquartered in San Francisco) is looking for an additional 42,000 square feet [downtown], but where can they go?"

Cities like San Francisco don't have the physical space to expand, and that could be good for the CRE market for Sacramento.

"With Facebook, Google, Salesforce and Apple gobbling up all the space in the

Bay Area," Bennett says, "companies will continue to look east to Sacramento for future expansion." ■

Jordan Venema is a California-based writer who enjoys gin and teaching himself dead languages. He received a master's of liberal arts from St. John's College, but swears he's learned more from his precocious son, Cassian, than he ever did from a book.

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