The Drivers Behind California's CRE Sectors

Sixteen percent of forecast respondents cite the AI boom and digital infrastructure as the primary driver of industrial development

By Philippa Maister

A new forecast of the three-year outlook for CRE in California paints a generally optimistic portrait of the state of the industry. Industrial and retail appear to be in relatively good shape, and prospects for multifamily are brighter in the southern portion of the state. But there's a fly in the ointment. Unsurprisingly, it's the office sector.

The forecast indicates that one in five office owners and operators in California is ready to throw in the towel and move to convert existing office buildings to other uses like multifamily, industrial or retail within the next three years. In Northern California, no new office developments are reportedly planned, and in Southern California the number of respondents planning them has shrunk from 29% in 1Q23 to 17% this year.

"The findings underscore the industry's growing lack of conviction in this sector," reported the winter issue of the biannual CRE Forecast Survey conducted by the law firm Allen Matkins and UCLA Anderson. It cited the usual causes: high interest rates, declining valuations and ongoing remote work. Recovery is not expected until late 2026.

Meanwhile, landlords are finding that office leasing has become more complex, with 85% or more reporting increased subleases or "slow-walking" of the process. "We are seeing an increase in turnkey buildouts where landlords assume construction costs and risks that, traditionally, tenants taking a material amount of space would have been responsible for," said Crystal Lofing, a partner at Allen Matkins. "Landlords that are more flexible and more willing to take on complex projects are best positioned to boost occupancies."

California's retail sector is bubbling along, however; 80% of respondents expect demand for retail space to grow faster than supply. Limited retail development in the past 10 years, along with a new interest in expanding stores' physical footprint, has triggered competition for space and helped rents, the forecast reported.

More than half of survey respondents intend to initiate at least one retail project in 2024. Almost as many aim to target locations in residential areas, especially for grocery and convenience stores that can serve remote and hybrid workers. Foot traffic that can attract tenants will be an important factor.

The Allen Matkins/UCLA Anderson survey predicts a mixed picture of the industrial environment for the next three years. Some 74% of Southern California and 56% of Northern California respondents plan new industrial developments in 2024, even though they expect supply to grow faster than demand. Half attribute their interest to the growth of e-commerce. But the growing demand for data space for AI is also spurring interest.

"Sixteen percent of Forecast respondents cite the AI boom and digital infrastructure as the primary driver of industrial development, ahead of cold storage and electric vehicle facilities," the report stated. Facilities that meet the unique needs of digital infrastructure tenants will be especially in demand.

The outlook for California's multifamily sector depends on where in the state development is planned. In Northern California, two-thirds of respondents have no intention to build apartments in the next 12 months. In Southern California, over half – 55% — do plan on doing so. Many of those who are taking the plunge are incorporating design features to attract remote workers, like in-home offices and co-working and community spaces, along with sustainability.

"Although multifamily supply projections are very submarket specific, the overall demand for housing throughout California remains strong. As such, we expect to see construction levels begin to rebound in the next 12-18 months as supply and demand find equilibrium and as capital markets and interest rates ease," said Allen Matkins Senior Counsel Jennifer Jeffers.